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Unemployment insurance and precautionary saving ☆

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Abstract

Models of precautionary saving imply that households will hold more assets when faced with greater income uncertainty. However, previous empirical studies of income uncertainty have produced somewhat mixed support for the precautionary saving hypothesis. In this paper, we note that differences in the state-contingent income stream available to workers through the unemployment insurance (UI) program provides an excellent source of variation for testing the presence of a precautionary savings motive. Simulations of a stochastic life cycle model suggest that a UI system similar to the type currently in place in the U.S. can lead to a significant reduction in the assets accumulated by a median worker. Moreover, there is considerable variation in the UI benefit schedules for workers living in different states in the U.S., which provides an exogenous source of variation for empirically testing the precautionary saving hypothesis. We carry out this test using data on expected UI benefit replacement rates and financial assets held by households in the Survey of Income and Program

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Participation. Our empirical results are consistent with the predictions of the model and suggest that reducing the UI benefit replacement rate by 50 percent would increase gross financial asset holdings by 14 percent, or $241, for the average worker. We also find empirical evidence that this "crowd out" effect of UI on household saving is stronger for those facing higher unemployment risk and weaker for older workers, both of which are implications from our precautionary saving model. © 2001 Elsevier Science B.V. All rights reserved.

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The concept that some household saving may be undertaken as a precaution for a "rainy day" has long been recognized in the savings literature. Recent simulation studies suggest that precautionary saving is a significant, and perhaps the most important, determinant of individual wealth accumulation. Moreover, in the 1995 Survey of Consumer Finances more households report precautionary saving as their most important motive for saving than any other reason.[1] Empirical studies of precautionary saving, however, have produced somewhat mixed conclusions. This empirical ambiguity may stem, at least in part, from the difficulty in identifying and measuring exogenous indicators of the income uncertainty facing an individual.

A key element of the uncertainty in future income for working households, and thus a potential determinant of precautionary saving, is the risk of lost wages stemming from unemployment. This uncertainty is mitigated in the U.S. by the presence of unemployment insurance (UI), which on average replaces 45 percent of a covered worker's lost earnings for up to 26 weeks after a qualifying loss of a job. A testable prediction of a precautionary saving model is that this type of income insurance should reduce households' asset accumulation. Furthermore, the extent of the income insurance available to unemployed workers varies exogenously with the benefit schedule of the UI system in their state of residence. This paper therefore uses differences in workers' expected UI benefits to provide a source of variation for testing the presence of a precautionary savings motive.

We begin by developing a model of household savings decisions which allows us to present testable implications to help guide the subsequent empirical work. In particular, we address two questions. First, given the low risk of unemployment faced by many households and the limited time of eligibility for unemployment insurance, should we expect UI to have a

[1] Kennickell et al. (1997). Similar responses were reported in the 1983, 1986, 1989, and 1992 Surveys of Consumer Finances.

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