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Unemployment, consumption smoothing, and precautionary saving in urban China

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The permanent income hypothesis and life-cycle models allowing for precautionary saving suggest that households may be able to smooth their consumption by saving during normal periods or when facing high income uncertainties and dissaving when adverse economic shocks occur. These hypotheses are tested using a unique data set collected from China. Our findings indicate that Chinese urban households are capable of smoothing most consumption and have a strong motive for precautionary saving. However, we find strong evidence of an inability to smooth educational expenditure suggesting educational subsidies may be necessary to prevent further increases in income inequality in the next generation. *Journal of Comparative Economics* **31** (3) (2003) 465–485. Research School of Pacific and Asian Studies, Australian National University, ACT 0200, Australia. © 2003 Association for Comparative Economic Studies. Published by Elsevier Inc. All rights reserved.

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1. Introduction

Economic shocks occur frequently, especially in the developing world, due to normal business cycles, financial shocks, and economic restructuring. Facing such shocks, many individuals and households experience difficult periods of unexpected reduction in income, and perhaps even poverty. One mechanism used by governments in the developed world to offset the effect of adverse shocks is an income support scheme.¹ Putting aside the possible negative effects of redistribution measures on economic efficiency and any

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¹ The various unemployment insurance schemes implemented in some developed countries have the benefit of pooling risks; however, these UI schemes often involve substantial income redistribution.

possible crowding out effect on private precautionary savings (Engen and Gruber, 2001), many developing countries have limited resources to provide such support. Thus, finding the most effective way to help the individuals and households that are affected adversely by economic shocks is an important policy issue.

The theoretical background for government-financed direct income support schemes assumes that individual households are limited in their ability to help themselves and that individuals are unable to save for their own uncertain future (Bauer and Paish, 1952).² However, according to the permanent income hypothesis, individual households should be able to smooth their consumption by saving in normal times and dissaving during periods of adverse economic shocks. Many empirical studies find evidence to support the permanent income hypothesis in several developing economies (Bhalla, 1979, 1980; Wolpin, 1982; Paxson, 1992). Furthermore, life cycle models allowing for precautionary saving indicate that, if uncertainty over future income increases, current consumption falls and saving increases, especially in the developing world where liquidity constraints are significant (Carroll and Sanwick, 1994; Deaton, 1997). If these theories are correct, governments from developing countries may be better off spending scarce resources in more effective ways, such as providing training to unemployed workers, incentives for self-employment, and direct income support only to the disabled, the elderly and the most severe cases of long-term unemployment. Therefore, whether individual households have precautionary saving motives and whether they are able to smooth consumption during difficult periods affect significantly the design of effective and efficient government income support policies.

This study focuses on the situation in urban China. In the last 20 years the Chinese economy experienced a significant transformation from a planned to a market-oriented economy. During the last decade or so, dramatic reforms in the state sector, the social welfare system, and the labor market have brought more uncertainty to households. Urban unemployment has become one of the most important social and economic problems in China since the mid-1990s. Over the period from 1995 to 1999, around 15 million state sector workers have been made redundant (Fan, 2000). In addition, the lack of formal credit markets indicates that urban households face significant liquidity constraints. The question naturally arises as to whether Chinese urban households are capable of smoothing their consumption in the face of a greater incidence of adverse shocks. In addition, the role of precautionary saving during this period of significant changes and dramatic increases in future uncertainty is an important topic.

Many authors have investigated the saving and consumption behavior of Chinese households (Qian, 1988; Jefferson, 1990; Qin, 1991; Ma, 1993; Wang and Chern, 1992; Wang, 1995; Jalan and Ravallion, 1999, 2001; Kraay, 2000; Aaberge and Zhu, 2001). Most of these studies focus on explaining household saving behavior rather than the ability of households to smooth consumption with respect to unexpected shocks. In addition, the majority of the studies utilize aggregate data. Although Jalan and Ravallion (1999, 2001) and Kraay (2000) investigate the effect of income shocks on

² Another justification for a government-provided income support scheme for unemployed people is to allow them to conduct an appropriate job search while facing liquidity constraints (Topel, 1983; Meyer, 1990).

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