Abstract

“Job Loss, Consumption and Social Insurance”

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It is well known that job loss is associated with both pre- and post-job loss declines in hourly wages and earnings. Using recent data form the Panel Study of Income Dynamics, I show that consumption dynamics mirror these wage dynamics. To account for the consumption dynamics in the data, I introduce a correlation between individual hourly wages and lob loss into a life- cycle model with self insurance (through savings), social insurance and endogenous unemployment durations. I find that this model is able to relicate the joint dynamics of wages, job loss and consumption that we observe in the data. I then show that accounting for the correlation between wages and job loss has important implications for the optimal design of social insurance. The consumption smoothing benefits of unemployment insurance are larger and the cost of insurance lower, than suggested when this correlation is absent. Thus, while a model that assumes away these correlations yields optimal UI replacement rates close to zero, a model that incorporates the correlations predicts optimal rates of 0.54 slightly higher than the current US level/ Finally, there is a lot of substitutability between UI and consumption floor programs such as food stamps. Due to the permanent nature of the layoff shock, an increase in food stamps with lower UI is welfare improving.