Abstract

Consumption theory says that households should be able to smooth transitory income shocks. Unemployment episodes in the US are transitory. Nevertheless, consumption declines substantially upon job loss and remains low for several years afterward. While liquidity constraints, home production, and nonseparability are all consistent with consumption decline upon job loss, they cannot explain the persistent weakness in consumption years after re-employment. I show that these consumption dynamics can be explained by the fact that job loss is associated with both pre- and post-job loss declines in hourly wages and earnings. Specifically, I show that a life-cycle model that allows individual wages to be correlated with job loss replicates the joint dynamics of wages, job loss, and consumption that we observe in the data. I then show that accounting for the correlation between job loss and wages has important implications for the optimal design of unemployment insurance (UI). 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.