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Welfare Costs of Idiosyncratic and Aggregate Consumption Shocks

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The benefits of eliminating idiosyncratic shocks to consumption unrelated to the business cycle are 47.3% of the utility of a member of a household. By contrast, the benefits of eliminating idiosyncratic shocks to consumption related to the business cycle are 3.4% of utility and the benefits of eliminating aggregate shocks are 7.7% of utility.

Researchers have long investigated the effects of business cycles on households, with findings ranging from little effect on social welfare (or welfare costs) to more significant effects, including with variation across households. However, according to this new paper, focusing on shocks related to business cycle fluctuations masks a key point: all idiosyncratic shocks matter, and those unrelated to business cycles matter a great deal. These idiosyncratic shocks can come in the form of, for example, the death of a prime wage earner or a sudden job layoff unrelated to a recession, such as the recent pandemic.

To the point, Constantinides estimates that the benefits of eliminating idiosyncratic shocks to consumption unrelated to the business cycle are 47.3% of the utility of a member of a household. This may be more concretely characterized by saying that the welfare gain is equivalent to that associated with an increase in

Figure 1 • Median Household Resilience by Income Quintile

the path of a consumer’s level consumption by 47.3%, state by state, date by date. By contrast, the benefits of eliminating idiosyncratic shocks to consumption related to the business cycle are 3.4% of utility and the benefits of eliminating aggregate shocks are 7.7% of utility.

Broadly described, Constantinides derives these estimates by:

• distinguishing between idiosyncratic shocks related to the business cycle and shocks unrelated to the business cycle,

• recognizing that idiosyncratic shocks are highly negatively skewed,

• calibrating welfare benefits via a model using household-level consumption data from the Consumer Expenditure Survey,

• explicitly targeting moments of household consumption,

• assuming that households are responsive to long-run risks,

• and incorporating relevant information from the market.

These new estimates on the effect of idiosyncratic shocks are substantially higher than earlier estimates and should give policymakers pause. Constantinides argues that policymakers should focus on how they can insure households against idiosyncratic shocks unrelated to the business cycle. This is not to say that policies which address aggregate consumption, that is, enacting monetary and fiscal policy in reaction to a recession, do not matter; of course, they do, and this work finds that such policies likely matter more than previously understood. What this work finds, though, is that the welfare benefits of eliminating idiosyncratic shocks unrelated to the business cycle are much higher—the Coronavirus Aid, Relief, and Economic Security (CARES) Act being a case in point.

By way of example, see the accompanying figure for estimates of the impact on household financial viability following passage of the CARES Act, which was signed into law in March 2020 to address the economic shock of the COVID-19 pandemic. This figure reveals the many US households, especially at lower income levels, that would have lost financial viability relatively quickly without the relief provide by the CARES Act.