

Perceived versus Calibrated Income Risks in Heterogeneous-agent Consumption Models

Tao Wang

October 21, 2023

[\[Most Recent Draft\]](#)

Abstract

Models of microeconomic consumption (including those used in HA-macro models) typically calibrate the size of income risk to match panel data on household income dynamics. But, for several reasons, what is measured as risk from such data may not correspond to the risk perceived by the agent. This paper instead uses data from the New York Fed's *Survey of Consumer Expectations* to directly calibrate perceived income risks. One of several examples of the implications of heterogeneity in perceived income risks is increased wealth inequality stemming from differential precautionary saving motivations. I also explore the implications of the fact that the perceived risk is lower than the calibrated level.

Keywords: Income risks, Incomplete market, Perceptions, Precautionary saving

JEL Codes: D14, E21, E71, G51

Bank of Canada, taowangeconomics@gmail.edu. GitHub page: <http://github.com/iworld1991/PIR>. This paper was originally circulated with the title *Perceived Income Risks*. I thank Chris Carroll, Jonathan Wright, Robert Moffitt, Yujung Hwang, Francesco Bianchi, Andrew Caplin, Edmund Crawley, Mateo Velasquez-Giraldo, Johannes Stroebel, Corina Boar, Yueran Ma, Xincheng Qiu, Eric Huang, Jeppe Druedahl, Thomas H Jørgensen, Johannes Wohlfart, Adrian Monninger, Greg Duffee, Stelios Fourakis, Xing Guo, Zheng Liu, the participants of the PhD conference at Yale SOM, the reading group at UPenn, the 4th Behavioral Macro Workshop, ESA Bologna, SNDE, Midwest Macro (2022), Asian Meeting of Econometric Society (2023), EEA-ES Meeting (2023) for the useful comments. Also, I am thankful for William Du's contribution to the development of computational methods in this paper.

1. Introduction

Income risks matter for both individual behavior and macroeconomic outcomes. Given identical expected income and homogeneous risk preferences, different degrees of risks lead to different saving/consumption and portfolio choices. This is well understood in models in which either the prudence in the utility function (Kimball (1990), Carroll and Kimball (2001)), or occasionally binding constraint induces precautionary savings. It is widely accepted on the basis of empirical research indicating that idiosyncratic income risks are at most partially insured (Blundell, Pistaferri, and Preston (2008)), and such market incompleteness leads to ex-post wealth inequality¹ and different degrees of marginal propensity to consume (MPC) (Krueger, Mitman, and Perri (2016); Carroll et al. (2017)). This also changes the mechanisms by which macroeconomic policies can affect economic outcomes.² Furthermore, aggregate movements in the degree of idiosyncratic income risks can drive time-varying precautionary saving motives—another source of business cycle fluctuations.³

The size and the heterogeneity of the income risks are one of the central inputs in this class of incomplete-market macroeconomic models. One common practice in this literature is that economists typically approximate/estimate risks under a specified income process, relying upon the cross-sectional dispersion in income realizations, and then treat the estimates as the true model parameters known by the agents who make decisions in the model.⁴

But this estimation practice has limitations. The method used by economists to calibrate the size and persistence of income risks as perceived by the agents is subject to problems such as those caused by unobserved heterogeneity or model mis-specification. The intuition behind this is simple: certain information, either the intrinsic heterogeneity of each individual or advance information about future income or risks that enters an agent's information set from time to time, is not directly observable by economists. If risks calibrated by economists based on flawed estimations differ from those perceived by agents, the model's implications will fail to match behavior even if the model is right (except for the miscalibration).

¹Aiyagari (1994); Huggett (1996); Carroll and Samwick (1997); Krusell and Smith (1998).

²Krueger, Mitman, and Perri (2016), Kaplan, Moll, and Violante (2018), Auclert (2019).

³Challe and Ragot (2016); McKay (2017); Heathcote and Perri (2018); Kaplan and Violante (2018); Den Haan, Rendahl, and Riegler (2018); Bayer et al. (2019); Acharya and Dogra (2020); Ravn and Sterk (2021); Harmenberg and Öberg (2021).

⁴Some recent examples include Krueger, Mitman, and Perri (2016), Bayer et al. (2019), Kaplan, Moll, and Violante (2018).

This paper addresses this issue by utilizing the recently available density forecasts of labor income surveyed by the New York Fed's *Survey of Consumer Expectation* (SCE). Compared to the previous work that has studied partial insurance with expectational surveys,⁵ this paper's most important innovation is its use of the SCE's density survey which contains directly perceived risks. In the density survey, respondents are asked to provide histogram-type forecasts of their wage growth over the next 12 months, and they also report perceived job-finding and separation probabilities and answers to a set of expectation questions about the macroeconomy. When the individual density forecast is available, a parametric density distribution can be fit to obtain the individual-specific subjective distribution. Then, the second moment, the implied variance of the subjective distribution, allows me to directly characterize the perceived risk profile without relying on external estimates from cross-sectional microdata. This provides a direct measure of the perception of risk that presumably guides individual decisions.

With the individual-specific reported perceived risk (PR) in hand, I first confirm that the differences in mean risk across groups (age; gender; education; etc) measured by the conventional method correspond to differences in the mean self-reported perceptions (e.g., low-income young females are measured as, and perceive themselves as, facing higher risk than middle-aged middle-income males). But within every such group, there is also a great deal of heterogeneity in PR that is not captured by the conventional approach. The R^2 of a regression of PR on the conventional explanatory variables is only about 0.1, indicating that 90 percent of the heterogeneity in perceived risk is not captured by the traditional method.

In addition, the paper also finds that the perceived income risk, on average, is lower than the indirectly calibrated size of risks even within groups. Specifically, the perceived annual real wage risk is around 3%-4% in terms of standard deviations, while the estimation following the conventional approach (consistent with the finding of [Low, Meghir, and Pistaferri \(2010\)](#)) is at least 10%. I confirm that this finding is robust to alternative specifications of the wage process and different frequencies of income shocks. This finding is corroborated by a closely related contemporaneous study [Caplin et al. \(2023\)](#) which also shows that survey-reported earning risks are lower than their indirectly estimated counterparts using Danish administrative records.

This evidence motivates me to utilize survey-implied risks as truly perceived by agents to calibrate income risks in a standard incomplete market, overlapping generation, and general equilibrium model to quantify these effects. The baseline model

⁵For instance, [Pistaferri \(2001\)](#), [Kaufmann and Pistaferri \(2009\)](#).

blends [Huggett \(1996\)](#), the income structure of [Carroll and Samwick \(1997\)](#), and persistent unemployment spells and unemployment benefits, as in [Krueger, Mitman, and Perri \(2016\)](#) and [Carroll et al. \(2017\)](#). Contrasting with conventional practice, I show that calibrating risks using surveyed PRs helps reduce two well-documented discrepancies between standard model prediction and data regarding liquid wealth holdings of U.S. households: a higher concentration of households with little liquid wealth, and a higher degree of wealth inequality in the data than in the model.

The mechanisms behind these two results are straightforward. First, allowing for heterogeneity in perceived income risks introduces a straightforward force that increases wealth inequality, as different risks induce different precautionary saving motives and heterogeneous buffer-stock savings. Second, a lower size of the perceived risk than in the baseline model implies less precautionary saving motive, hence a lower level of wealth accumulation by all agents in the economy.

The benchmark model maintains the full-information-rational-expectation (FIRE) assumption in that the perceived risks from the survey are used to calibrate the true model parameters, but in the extended model, I deviate from this assumption.⁶ In particular, the extension allows the perceived risks (subjective risks) to be different from the underlying income process (objective risks). This extension achieves two purposes within a single model. First, it serves as a robustness check with an alternative model assumption deviating from FIRE. Although our benchmark assumes that agents' lower perceived risks than indirectly calibrated are due to the existence of unobserved heterogeneity, it is also possible that agents simply under-perceive the true degree of risks they face. Second, the subjective model is an experimental model that breaks down the model implications into two channels: one via ex-ante saving behavior resulting from risk perceptions, or the "choice" channel, and the other via ex-post realized income inequality, the "outcome" channel.

The key finding from this extension is that letting consumption/saving decisions be driven by survey-reported risks alone, even if the objective risks remain the same as the conventional calibration, is sufficient to yield a closer match of the model with the empirically measured wealth inequality and the fraction of low-liquid-holding consumers.

⁶There is mounting evidence in macroeconomics that people form expectations in ways deviating from FIRE. See, for example, [Mankiw, Reis, and Wolfers \(2003\)](#), [Reis \(2006\)](#), [Coibion and Gorodnichenko \(2012\)](#), [Wang \(2022\)](#). However, most of such evidence is based on macroeconomic expectations, such as that of inflation.

1.1. Related literature

The closest to this paper in terms of the research question and findings is one contemporaneous study by [Caplin et al. \(2023\)](#). One key difference in research methodology between the two is how we compare subjective risks with their conventional counterparts. [Caplin et al. \(2023\)](#) first stimulates unconditional distributions of earnings based on surveyed belief and compares it with the cross-sectional Danish administrative records. In contrast, this paper estimates the conditional risks using a panel data structure following the common practice in income risks/HA-macro literature and compares it with conditional perceptions reported in the survey. Despite such differences in methodology and dataset, both studies find the perceived earning risks to be lower than those indirectly inferred from their conventional counterparts, which is primarily attributed to unobserved heterogeneity. Furthermore, the two studies explore the macroeconomic implications of subjective risks in two different contexts: this study works with a standard life-cycle incomplete market macro model a la [Huggett \(1993\)](#); [Carroll and Samwick \(1997\)](#); [Krueger, Mitman, and Perri \(2016\)](#); [Carroll et al. \(2017\)](#), with a primary focus on liquid wealth accumulation, while theirs works with a search and matching model.

Besides, this paper is related to and contributes to several themes in the literature. First, it closely builds on the literature estimating both cross-sectional and time trends of labor income risks and the degree of consumption insurance. Early work by [MaCurdy \(1982\)](#), [Abowd and Card \(1989\)](#), [Gottschalk et al. \(1994\)](#) and [Carroll and Samwick \(1997\)](#) initiated what is now the common practice in the literature of estimating income risks by decomposing it into components of varying persistence on the basis of panel data. Subsequent work has explored time-varying and macro trends of idiosyncratic income risks. For instance, [Meghir and Pistaferri \(2004\)](#) allowed for time-varying risks or conditional heteroscedasticity in the traditional permanent-transitory model. [Blundell, Pistaferri, and Preston \(2008\)](#) used the same specification of income process to estimate partial insurance in conjunction with consumption data. More recently, [Bloom et al. \(2018\)](#) found that idiosyncratic income risks have declined in recent decades.⁷ Moreover, recent evidence that relied upon detailed administrative records and larger data samples highlighted the asymmetry and cyclical behaviors of idiosyncratic earning/income risks ([Storesletten, Telmer, and Yaron 2004](#); [Guvenen, Ozkan, and Song 2014](#); [Arellano, Blundell, and Bonhomme 2017](#); [Guvenen et al. 2019](#); [Bayer et al. 2019](#); [Guvenen et al. 2021](#)).

⁷Synthesizing various data sources, [Moffitt \(2020\)](#) found no such obvious trend for the same period.

Additionally, a separate literature has focused on job-separation and unemployment risks (Stephens Jr 2004; Low, Meghir, and Pistaferri 2010; Davis and Von Wachter 2011; Jäger et al. 2022). Table A.2 in the Appendix summarizes the income process and estimated risks in selected papers from this literature. Compared to this work, the novelty of this paper lies in its focus on the directly reported perceptions of income risks and how they are correlated with the realized income risks estimated from the panel data.⁸

Second, my paper is most closely related to the well-documented issue of “insurance or information” in the income risk/partial insurance literature (Pistaferri (2001), Kaufmann and Pistaferri (2009), Meghir and Pistaferri (2011), Kaplan and Violante (2010), Stoltenberg and Uhlenborff (2022)). In any empirical tests of consumption insurance or consumption response to income shocks, there is always a concern that what is interpreted as the shock has actually already entered the agents’ information set. If so, this may lead to the finding of “excess smoothness” of supposedly unanticipated shocks (Flavin (1988)). My paper shares the spirit with these studies in that we all use surveyed expectations to tackle the identification problem.⁹ That is, I directly use the expectation data and explicitly control for the truly conditional expectations of the agents. This helps economists avoid making assumptions about what is exactly in the agents’ information set. What differentiates my work from that of others is that I directly use survey-reported income risks, which are available from density forecasts, rather than the estimated risks using the difference between expectations and realizations. An advantage of my approach is that I can directly study individual-specific risks instead of that at the group level.

Third, the paper speaks to an old but recently revived trend in the literature of studying consumption/saving behaviors in models that incorporate imperfect expectations and perceptions. For instance, Pischke (1995) explored the implications of the incomplete information about aggregate/individual income innovations by modeling agents’ learning about the permanent income component as a signal extraction problem. Wang (2004) studied how such forecasting uncertainty affects consumption via precautionary saving motives. Guvenen (2007) emphasizes the role of heterogeneity in life-cycle income profiles and models’ agents learning about the trend component through sequential income realizations. To reconcile low MPCs in microdata and the high MPC in the macro level, Carroll et al. (2018) introduces the information rigidity of house-

⁸Koşar and Van der Klaauw (2022) is a recent exception, that documents the cross-sectional/life-cycle/business heterogeneity in perceived earning risks using SCE data.

⁹See a recent New York Fed [blog](#) for a similar exercise.

holds with learning about macro news while they are fully updated about micro news. [Rozsypal and Schlafmann \(2023\)](#) found that households' expectation about income exhibits an over-persistent bias. More recently, [Broer et al. \(2021\)](#) have incorporated information choice in a standard consumption/saving model to explore its implication for wealth inequality. My paper has a similar flavor to all these studies in that it too, emphasizes the role of perceptions. But my work differs from those previous studies in two regards. First, it focuses on the second moment, namely income risks. Second, although most of this existing work explicitly specifies a mechanism of expectation formation that deviates from the full-information-rational-expectation benchmark, this paper advocates for disciplining the model assumptions regarding belief heterogeneity by directly using survey data.¹⁰

This paper is also indirectly related to the research that advocates for eliciting probabilistic questions to measure subjective uncertainty in economic surveys ([Manski \(2004\)](#), [Delavande, Giné, and McKenzie \(2011\)](#), [Manski \(2018\)](#)). Although the initial suspicion about people's ability to understand, use, and answer probabilistic questions was understandable, [Bertrand and Mullainathan \(2001\)](#) and others have shown respondents have the consistent ability and willingness to assign a probability (or "percent chance") to future events. [Armantier et al. \(2017\)](#) thoroughly discuss designing, experimenting, and implementing consumer expectation surveys to ensure the quality of responses. Broadly speaking, the advocates have argued, first, that analysts must go beyond the "revealed preference" approach and, second, the availability of survey data provides economists with direct information about agents' expectations and helps them avoid imposing arbitrary assumptions. ([Manski \(2004\)](#)) This insight holds for not only point forecast but also for risk/uncertainty, because for any economic decision made by a risk-averse agent, both the expectation but also the perceived risks matter a great deal.

Finally, this paper is related empirically to the literature that studies expectation formation using subjective surveys. In recent decades, a long list of theories of "expectations formation" alternative to FIRE has been developed, each of which examines how agents deviate from full-information rationality benchmarks, such as sticky expectations, noisy signal extraction, least-square learning, etc. Also, empirical work has been devoted to testing these theories comparably ([Coibion and Gorodnichenko \(2012\)](#), [Fuhrer \(2018\)](#)). Yet it is fair to say that thus far, relatively little work has been done on individual variables such as labor income, which might well be more relevant

¹⁰See [Bhandari, Borovička, and Ho \(2019\)](#) for another example of directly using survey data to discipline subjective beliefs in standard macro models.

to individual economic decisions. This paper shows that understanding the patterns of beliefs about individual variables, and, in particular, mean and higher moments, is fruitful for macroeconomic modeling.

2. Theoretical framework

2.1. Wage process and perceived risks

To be consistent with the survey-elicited question in SCE, I primarily focus on the wage risk. Conditional on being employed at the same job and same position, and the same hours of work, the log idiosyncratic earning, or the wage rate, of an individual i at time t , $w_{i,t}$ consists of a predictable component, $z_{i,t}$ and a stochastic component, $e_{i,t}$. (Equation 1)

$$(1) \quad w_{i,t} = z_{i,t} + e_{i,t}$$

There is an extensive discussion in the literature about the exact time-series nature of the stochastic component e . For instance, it may consist of a permanent and a transitory component.¹¹ Or some of the literature replaces the permanent component with a stationary/persistent component in the form of an AR process.¹² The transitory component could be moderately serially correlated following a moving-average (MA) process.¹³ I first proceed with the generic structure, as in Equation 1 without differentiating these various specifications. I defer that discussion to Section 4.2.

Hence, wage growth from t to $t + 1$ consists of the predictable change in $z_{i,t+1}$, and the change in the stochastic component $e_{i,t}$.

$$(2) \quad \Delta w_{i,t+1} = \Delta z_{i,t+1} + \Delta e_{i,t}$$

Under the assumption of the full-information rational expectation (FIRE), all shocks realized until t are observed by the agent at time t . Therefore, the expected volatility under FIRE (with a superscript *), or what this paper hereafter refers to as perceived

¹¹Abowd and Card (1989), Gottschalk et al. (1994), Carroll and Samwick (1997), Blundell, Pistaferri, and Preston (2008), and Kaplan and Violante (2010).

¹²Storesletten, Telmer, and Yaron (2004), Guvenen (2007), Guvenen (2009).

¹³Meghir and Pistaferri (2004).

risks (PR), is the conditional variance of income growth from t to $t + 1$.

$$(3) \quad \text{Var}_{i,t}^*(\Delta w_{i,t+1}) = \text{Var}_{i,t}^*(\Delta e_{i,t+1})$$

The predictable changes do not enter PR. Hence, the PR is the *conditional* variance of the change in the stochastic component, $\text{Var}_{i,t}^*(\Delta e_{i,t+1})$. Notice that it crucially depends on the time-series nature of $e_{i,t}$.

The size of the true PR is not directly observed by economists. To estimate it, researchers usually start from obtaining an approximation of the stochastic component $e_{i,t}$, denoted as $\hat{e}_{i,t}$, by subtracting observed wage growth in panel data, $\Delta w_{i,t}$, by the approximated predictable change, $\Delta \hat{z}_{i,t}$, that is $\Delta \hat{e}_{i,t} = \Delta w_{i,t} - \Delta \hat{z}_{i,t}$. To mimic $z_{i,t}$ from the agent's point of view, $\hat{z}_{i,t}$ commonly includes factors such as age polynomials, gender, education, occupation, etc. Hence, $\hat{e}_{i,t}$ are, essentially, the regression residuals of the first-step wage regression controlling for a limited number of observable variables measured in the panel data. Then, the cross-sectional variance of $\Delta \hat{e}_{i,t}$ is the input for estimating income risks. It is usually referred to as the “income volatility” in the literature.¹⁴

Note that the common practice usually estimates income risks at the group level, denoted as c , (such as age, education, and cohort, etc), although in theory, the risk as perceived by a FIRE agent could be totally individual-specific. That is so because at individual level, there are no realizations of risks, but a particular draw of income shock. (Equation 4) The within-group cross-sectional variation of a sufficiently large group size is needed for such an estimation.

$$(4) \quad \text{Var}_c(\Delta \hat{e}_{i,c,t}) = \text{Var}_c(\Delta w_{i,c,t} - \Delta \hat{z}_{i,c,t})$$

Unlike the PR of the agent, the term above is an *unconditional* variance at the group level. The distinction between the *conditional* PR by the agent and the *unconditional* volatility approximated by the economists is crucial. Two important issues affect the comparability of the two objects.

First, it is very likely that what is controlled for in the first-step income regression, namely $\hat{z}_{i,c,t}$, does not perfectly coincide with what is *predictable* from the point of view

¹⁴For instance, [Gottschalk et al. \(1994\)](#), [Moffitt and Gottschalk \(2002\)](#), [Sabelhaus and Song \(2010\)](#), [Dynan, Elmendorf, and Sichel \(2012\)](#), [Bloom et al. \(2018\)](#).

of an FIRE¹⁵ agent at time t . That is so primarily because econometricians with the panel data of earnings cannot control for other “unobserved heterogeneity” not measured in the data. This is equivalent to the “superior information” problem,¹⁶ which refers to the possibility that agents have advance information regarding their wage growth, and this information is not available to econometricians. For instance, a worker might be concerned that a recent dispute with her boss may negatively affect her wage next year, but econometricians have no way of knowing this.

Second, the comparison is sensitive to the time-series nature of $e_{i,c,t}$. Again, this occurs because economists’ estimated volatility is unconditional, while the perception is conditional on the information until time t . To illustrate this point, imagine a very persistent component in the income shock. Under the aforementioned process, the estimated income volatility also includes the variance of the realized shock until t , which has already entered the information set of the agent. Therefore, even if the econometricians perfectly recover the $e_{i,t}$ in the first-step regression, the presence of a persistent component in income changes would result in differences between PR and estimated income volatility. Therefore, to approximate the true PR from the point of view of agents, economists need to recover a conditional variance using information from the unconditional variance, typically by assuming a particular time-series structure of the stochastic component e and using cross-sectional moments restrictions to estimate its size. I return to this discussion in Section 4.2.

To summarize, for two reasons, survey-elicited PR has an invaluable use and is preferable to the conventional income risk estimation based on cross-sectional realizations, which is also used to parameterize macro models. First, survey-reported PR is, by construction, conditional on the information set of each agent i , which is likely to include intrinsic heterogeneity specific to the individual or the advance information useful to forecasting that individual’s own wage growth.¹⁷ Economists who try to approximate the PR cannot do as well as the agents who answer the questions, because the latter’s information is not necessarily available to economists. Second, survey-implied PR provides direct identification of the degree of heterogeneity of income risks across individuals in the economy. This prevents modelers from making possibly imperfect assumptions when they estimate group-specific income risks, by grouping individuals

¹⁵In later sections of the paper, I relax the FIRE assumption, which it makes it possible that PR reported in the survey is also subject to incomplete information and behavioral bias of the agents.

¹⁶Pistaferri (2001); Kaufmann and Pistaferri (2009).

¹⁷For the same reason, the literature on partial insurance uses expectational surveys to resolve the superior information problem. See Pistaferri (2001), Kaufmann and Pistaferri (2009) and others for examples.

on the basis of very limited dimensions of observable factors, such as education and age.

It is worth pointing out that despite these advantages, survey-implied PRs may reflect the risk perceptions of agents subject to certain behavioral biases, such as overconfidence, in contrast to those assumed by FIRE. I explore below the robustness of the model results of the paper with respect to these alternative assumptions. The key takeaway is that even if the survey-implied PRs don't align with the true objective size of income risks, they prove to be a better input for predicting individual decisions than the calibrated income risks as done in the conventional approach.

3. Data, variables and density estimation

3.1. Data on perceived risks

The data used for this paper were obtained from the core module of the Survey of Consumer Expectation(SCE) conducted by the New York Fed, a monthly online survey for a rotating panel of around 1,300 household heads during the period June 2013 to July 2021, or 97 months.

I primarily rely upon the density forecast of individual earnings by each respondent in the survey to estimate perceived income risks. The main question used is framed as follows: “Suppose that 12 months from now, you are working in the exact same [“main” if Q11>1] job at the same place you currently work and working the exact same number of hours. In your view, what would you say is the percentage chance that 12 months from now, your earnings on this job, before tax and deductions, will increase by x%?”.¹⁸ Then, I fit the bin-based density forecast in each survey response with a parametric distribution.¹⁹ The variance of the estimated distribution naturally represents an individual-specific perceived risk. To obtain the wage risk in real terms, I further add the individual-specific inflation uncertainty estimated by the same procedure and use the same individual's density forecasts of inflation in SCE. This procedure is predicated on the assumption that agents regard individual wage growth and aggregate inflation as independent random variables. This assumption is by no means perfect. For the

¹⁸In the online survey, the respondent can move on to the next question only if the probabilities filled in all bins add up to one. This ensures the basic probabilistic consistency of the answers, which is crucial for any further analysis.

¹⁹This follows the approach employed by [Engelberg, Manski, and Williams \(2009\)](#) and researchers in the New York Fed ([Armantier et al. \(2017\)](#)). Appendix A.1 documents in detail the estimation methodology and its robustness.

robustness of the results, I use both adjusted PR in real terms and nominal PR for the empirical results below.

Crucially, because the survey question regards the expected earning growth conditional on the same job position, same hours, and the same location, it can be clearly interpreted as the wage. It becomes immediately clear that wage risk only constitutes a part of income risk, and this has two important implications.

First, focusing on the wage risks avoids the problem of misconstruing earning changes due to voluntary labor supply decisions as risks. Empirical work estimating income risks is often based on data from total earnings or even household income, in which voluntary labor supply decisions inevitably confound the true degree of uninsured idiosyncratic risks. This survey-based measure used here is not subject to this problem. Second, the wage risk also excludes important sources of income fluctuations, such as unemployment and job switching. As demonstrated by research (e.g., [Low, Meghir, and Pistaferri \(2010\)](#)), major job transitions often are the dominant source of income risks individual workers face. I separately examine unemployment risk expectations, surveyed as perceived job-separation and finding probabilities in SCE, in Section 4.4.²⁰

3.2. Wage data

I examine longitudinal data on individual labor earnings from the 2014-2017 and 2018-2020 panels of the Survey of Income and Program Participation (SIPP).²¹ Each panel of SIPP, which surveys thousands of workers, is designed to be a nationally representative sample of the U.S. population. The interviews, conducted once a year, collect data on individuals' monthly earnings, hours of work, and other labor market outcomes.²² On average, each individual is surveyed for 33 months over multiple waves of the survey.

For the purpose of this paper, using SIPP to estimate wage risk has obvious advantages over other commonly used datasets, the most notable of which is the Panel Study of Income Dynamics (PSID). SIPP contains information that allows me to work with

²⁰Closely related to this, [Caplin et al. \(2023\)](#) elicits subjective job transition probabilities and unconditional earning distributions for each scenario of job transitions. They are enabled to combine these into a holistic income distribution. Unlike them, I separately explore wage distribution conditional on staying in the same job and job transition probabilities.

²¹Other recent work that estimates income risks using SIPP includes [Bayer et al. \(2019\)](#), who, in contrast to this paper, use quarterly total household income rather than the monthly job-specific earning of individuals.

²²This causes the “seam” issue documented by [Moore \(2008\)](#), which states that reported changes in answers (e.g. wage growth) within survey waves are systematically smaller than cross-wave changes. For the baseline estimation, I exclude the cross-wave earning growth, which produces a lower-bound estimate of wage risks. See Appendix A.3 for more inspection of this issue.

wage changes conditional on staying at the same job with the same employer, thanks to its detailed records of job transitions and a unique employer identifier. In contrast, PSID only provides biennial records of labor earnings for years since 1997. For the overlapping periods between SIPP and SCE, it is possible to make a direct comparison between realized wage risks at the annual frequency and the ex-ante perceptions of the wage risks. This is particularly crucial if wage risks are time-varying and dependent on macroeconomic conditions.

For an apples-to-apples comparison, I obtain the hourly wage of workers employed by the same employer by dividing the total monthly earnings from the *primary job* by the average hours of work for the same job for only those who stay with the same employer for at least 2 years. To identify job stayers, I follow the same approach by [Low, Meghir, and Pistaferri \(2010\)](#) and I impose five criteria. I only include (1) the working-age population between 25-65; (2) private-sector jobs, excluding workers from government or other public sectors; (3) the same job as the last year; (4) monthly wage rates that are no greater than 10 times or smaller than 0.1 times of the average wage; (5) those who don't have days away from work during the reference month without the pay. This leaves me with a monthly panel of 350-1000 individual earners for the sample period 2013m3-2019m12. Appendix [A.3](#) discusses in greater details the data selection procedure and reports summary statistics.

4. Basic facts about perceived income risks

4.1. Observable and unobservable heterogeneity in PRs

In both income risk estimation and parameterization of the incomplete market macro models, it is common practice to assume, first, that idiosyncratic risks differ as a function of certain observable factors such as education, gender, and age, and second, there is no additional within-group heterogeneity in the degree of the risk.²³ This section reports my finding that although the observed heterogeneity in PR across individuals does reflect between-group differences—along dimensions economists have commonly assumed, a dominant fraction of the differences in PR can be attributed to other unobservable heterogeneity. Furthermore, even in those observable dimensions, the group

²³For instance, [Meghir and Pistaferri \(2004\)](#) found that more educated workers face higher income risks than the less educated ones. [Sabelhaus and Song \(2010\)](#) and [Bloom et al. \(2018\)](#) documented that income risks decrease with age, and vary with the current income level in a non-monotonic U-shape. In their models, [Cagetti \(2003\)](#), [Blundell, Pistaferri, and Preston \(2008\)](#), and [Carroll et al. \(2017\)](#) allowed for heterogeneous risks across different demographic variables.

heterogeneity seen in PR does not coincide with that seen in estimated risks.

Figure 1 plots the group average of PRs (both in real and nominal terms), approximated wage volatility, $Var(\Delta\hat{e})$, as defined in Equation 4, and the estimated conditional risk, $Var_t(\Delta\hat{e})$, (see the next section for the exact procedure of generating it), by age, gender and education. Regarding the education-risk profile, both wage volatility and approximated risks are higher for more educated workers. This is consistent with the finding of Meghir and Pistaferri (2004), who examine total labor income instead of wage. In contrast, risk perceptions exhibit the opposite pattern with respect to education level: less-educated workers report higher PRs than more-educated workers. Regarding the life-cycle pattern of risks, neither wage volatility nor estimated risks show a monotone pattern over the life cycle.²⁴ In contrast, perceived risks almost monotonically decline over the life cycle for both males and females. These findings are confirmed in Table 1, which reports the group average of PR, wage volatility and estimated risks.

Another salient fact is that PR is always *smaller* than estimated risks. In particular, both wage volatility and the estimated risk of different groups fall in the range of 5-15% per year (in standard deviation terms), which aligns with the estimates in a large literature and that used in models, as summarized in Table A.2.²⁶ But the average perceived risks reported in the survey are only about 3-4%, and at least 50% smaller. For instance, a male high school graduate on average perceives his annual wage risk to be 4 percentage points in terms of standard deviation, while the wage risk implied by wage panel data for the same group is above 9-10 percentage points.

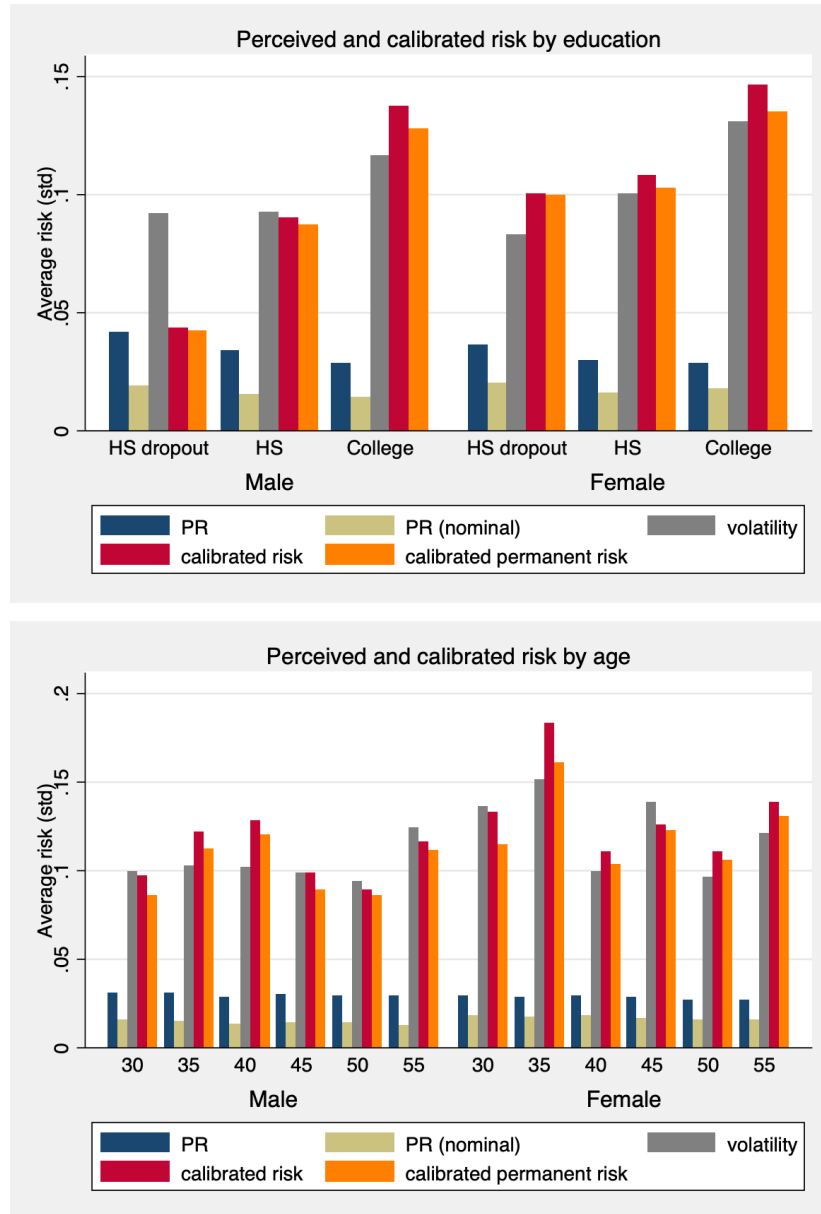
Such a size difference is also evident in the Figure 2, which plots the distribution of PRs against the distribution of individual-level annual wage volatility in SIPP that can be explained by observable demographic variables such as age, gender and education. The individual volatility is computed as the standard deviation of annual/12-month log growth rates of unexplained wage residuals. The figure shows that PRs are concentrated at a much lower range of values around (2-4%), while in contrast, the average predicted size of wage volatility falls in the range of 10-20% or even higher.

Another finding in addition to the size difference is that PRs are more heterogeneous

²⁴The homogenous age pattern of wage risks is not necessarily contradictory with the well documented declining pattern estimated using data on household income or total earning²⁵. It is likely that the decline of income risks over the life cycle has to do with non-wage risks or better insurance via work arrangements over the life cycle.

²⁶The most comparable estimates in the literature are by Low, Meghir, and Pistaferri (2010), as it explicitly estimates the wage risk of job stayers separately from job switching and unemployment spells. The authors report annual permanent and transitory risk of 10%, respectively. This implies a total risk of approximately 35%-40%.

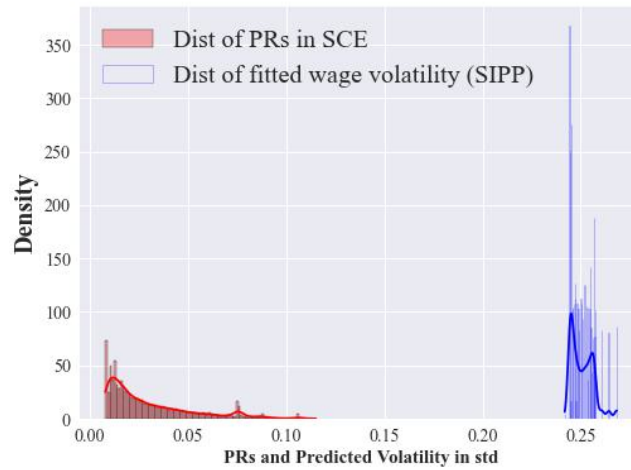
FIGURE 1. Perceived Risks, Wage Volatility and Calibrated Wage Risks by Observable Factors



Note: Real and nominal perceived risk (from SCE), average estimated wage volatility (from SIPP), estimated/calibrated wage risk, and permanent risk (from SIPP) of each education-gender (upper panel) or age-gender (bottom panel) group. The volatility is approximated by the within-group cross-sectional standard deviation of log changes in unexplained wage residuals, as defined in Equation 4. The calibrated risk is based on the process specified in Equation 5.

than that of the wage volatility that can be explained by observable factors. This can be confirmed by observing in Figure 2 that the dispersion of PRs is significantly larger than that of the explainable dispersion of individual volatility. Consistent with this, the R^2 of a regression of PR on all observable factors in SCE, without individual fixed effects, is at most 10%, while including fixed effects increases R^2 to 70%.²⁷ This finding has two implications. First, the role of within-group heterogeneity suggests that the conventional practice of estimating and modeling income risks as only differing by demographic dimensions has limitations. Second, heterogeneity in PR can be directly put into use to model heterogeneous income risks without identifying the source of heterogeneity. Therefore, in Section 5, my model calibration adopts such an approach.

FIGURE 2. Dispersion in Perceived Wage Risks



Note: Distributions of PRs regarding real wage growth in SCF and individual wage volatility explained by age, age polynomials, gender, education, and time fixed effects.

4.2. Decomposed risks of different persistency

As previewed in Section 2, a crucial aspect of income risk estimation is the time-series nature of the shocks. A realized permanent/persistent shock contains information

²⁷Appendix A.2.1 plots the distribution of unexplained residuals of PRs, expected wage growth and higher-order perceived risks such as skewness after controlling for observable individual characteristics, including age, age polynomial, gender, education, type of work, and time fixed effects. All of them show sizable within-group heterogeneity.

about future wage growth, while an entirely transitory shock does not. Therefore, in the two scenarios, agents perceive different degrees of risk. This is crucial to making an apples-to-apples comparison between survey-reported PRs and the calibrated risks using conventional methods.

To proceed, I adopt a commonly used income/wage process in a large body of literature.²⁸ I specify that the stochastic component $e_{i,t}$ consists of a permanent component p that follows a random walk and a transitory component θ that is i.i.d. The shocks to both components are log-normally distributed, with mean zero and potentially time-varying variances σ_ψ^2 and σ_θ^2 .²⁹

$$(5) \quad \begin{aligned} e_{i,t} &= p_{i,t} + \theta_{i,t} \\ p_{i,t} &= p_{i,t-1} + \psi_{i,t} \end{aligned}$$

Under this specific wage process, the PRs of an FIRE agent are equal to the summation of the variance of the two components $Var_{i,t}^*(\Delta w_{i,t+1}) = \sigma_{\psi,t}^2 + \sigma_{\theta,t}^2$. But, in contrast, the income volatility estimated from panel data provided that the change in predictable component δz is perfectly controlled for as in Equation 4, is a sample analog of $Var(\Delta e_{i,t}) = \sigma_{\psi,t}^2 + \sigma_{\theta,t-1}^2 + \sigma_{\theta,t}^2$. It differs from the PR by $\sigma_{\theta,t-1}^2$, exactly due to its unconditional nature.

Therefore, a more comparable counterpart of PR that is from panel data estimation is the sum of *estimates of* permanent and transitory risks, $\hat{\sigma}_\psi^2 + \hat{\sigma}_\theta^2$. Denote it as $Var_t(\Delta \hat{e}_{i,t})$. To do so, I follow the same GMM estimation procedure in the literature³⁰ to identify the time-averaged variances of the permanent and transitory component of the monthly wage growth using SIPP's wage data for the same period. Then I convert these monthly risk parameters into annual frequency so that they are comparable to perceived risks about annual wage growth.³¹

Table 1 reports the group-specific estimates of total, permanent, and transitory wage

²⁸MaCurdy (1982), Abowd and Card (1989), Gottschalk et al. (1994), Carroll and Samwick (1997), Blundell, Pistaferri, and Preston (2008), etc. Crawley, Holm, and Tretvoll (2022) presents a more parsimonious process to resolve the possible model misspecification caused by “time-aggregation” problem.

²⁹This also corresponds to the model specification as in Equation 11.

³⁰See Appendix A.4.1 for details. The estimation procedure follows Abowd and Card (1989), Carroll and Samwick (1997), Meghir and Pistaferri (2004), and Blundell, Pistaferri, and Preston (2008), which have minor differences depending on the model specification.

³¹For permanent risks, the annual earning risk is the summation of monthly permanent risks over the next 12 months. The transitory risks of annual earnings, in contrast, is the sample average of monthly risks over the next 12 months. Appendix A.4.3 provides alternative estimates for quarterly and yearly frequency.

TABLE 1. Perceived Risk, Volatility and Calibrated Risks by Group

	PR(mean)	PR(median)	Volatility	Calibrated Risk	Permanent	Transitory
gender						
male (50%)	0.03	0.022	0.105	0.115	0.109	0.0238
female (49%)	0.028	0.022	0.118	0.131	0.122	0.0322
education group						
HS dropout (0%)	0.036	0.022	0.088	0.071	0.07	0.0063
HS graduate (42%)	0.03	0.022	0.096	0.098	0.094	0.0176
College/above (56%)	0.028	0.021	0.124	0.142	0.132	0.0357
5-year age						
20 (2%)	0.037	0.031	0.094	0.069	0.068	0.0061
25 (12%)	0.032	0.027	0.111	0.157	0.156	0.0083
30 (12%)	0.03	0.023	0.116	0.112	0.098	0.0372
35 (13%)	0.029	0.021	0.125	0.149	0.134	0.0524
40 (13%)	0.028	0.02	0.1	0.119	0.111	0.0287
45 (14%)	0.028	0.02	0.119	0.113	0.106	0.0224
50 (15%)	0.027	0.019	0.095	0.1	0.096	0.0203
55 (15%)	0.027	0.018	0.122	0.128	0.121	0.0283
Full sample (100%)	0.029	0.021	0.112	0.123	0.115	0.0279

The table reports the mean and median PRs, estimated annual wage volatility, and estimated risks, and the risks of permanent and transitory components of different groups. All are expressed in standard deviation units.

risks based on wage panel data in comparison with the average and median perceived risks of the same group. The main finding from this comparison is that within each group, the perceived risks are systematically lower than that indirectly estimated income risks, even if the latter is at least one step closer to the perceived risk compared to the unconditional wage volatility. In addition, Figure A.3 in the Appendix compares the two, allowing for time-variation of the risks. The size difference and disconnect between perceived risks and indirectly estimated risk remains.

The most likely explanation for this disconnect in both size and time-varying patterns between the two series is either unobservable heterogeneity or superior information, a point I will formally elaborate in the next section. For the common panel-data-based estimation to correctly identify idiosyncratic wage risks relevant to heterogeneous individuals, two requirements need to be satisfied. First, economists need to perfectly exclude the predictable changes in wage growth from the point of the agent, by both correctly approximating $z_{i,t}$ in the first-step regression, and by correctly recovering the persistent/permanent components contained in $e_{i,t}$. Second, they also need to correctly assume the dimensions by which risks differ across workers. Given the stringency of

these requirements, directly reported PRs may provide a better alternative to calibrating income risks that are truly relevant from the point of view of heterogeneous individuals.

4.3. Accounting for the evidence

This section proposes my preferred explanation for the size differences between individual PRs reported in the survey and those estimated using panel data, which is the role of unobserved heterogeneity or advanced information. In the model section 6, I explore alternative hypotheses, such as misperception of risks by agents because of behavioral biases.

For clarity, I follow the same wage process specified in Equation 5 but assume away time-variation of risk parameters. Furthermore, all agents have individual-specific permanent $\sigma_{i,\psi}^2$ and transitory risks $\sigma_{i,\theta}^2$. This is to assume that there is generally heterogeneity in perceived risks across individuals.

To capture unobserved heterogeneity (or advance information) explicitly, I allow for the change in unexplained wage residual $\Delta \hat{e}_{i,t}$ based on only a small set of observables to be different from that which is truly unpredictable from the individual i 's point of view, $\Delta e_{i,t}$, by exactly $\xi_{i,t}$. (Equation 6) To be entirely consistent with the time series nature of $e_{i,t}$ in the wage process, I also assume that $\xi_{i,t}$ consists of a corresponding permanent component $\xi_{i,t}^\psi$ and a change in transitory component $\Delta \xi_{i,t}^\theta$.³²

A good example of $\xi_{i,t}^\psi$, namely the individual-specific expected innovation to the growth rate in permanent wage, is the wage rise expected by a fresh Ph.D. graduate who will start a professor job next year. An example of the expected transitory changes yet unlikely unobservable by researchers is the future income cut to a professor expecting to be on sabbatical leave for one semester.

$$\begin{aligned}
 \Delta \hat{e}_{i,t} &= \Delta e_{i,t} + \xi_{i,t} \\
 (6) \quad &= \psi_{i,t} + \Delta \theta_{i,t} + \xi_{i,t} \\
 &= \psi_{i,t} + \Delta \theta_{i,t} + \xi_{i,t}^\psi + \Delta \xi_{i,t}^\theta
 \end{aligned}$$

When economists estimate wage risks using panel data, they typically identify the *average* permanent and transitory risks at the population or group level. It is easy to show that, except for a special case absent of such unobserved heterogeneity captured

³²This is similar to the specification of unobserved heterogeneity in *income* as in [Primiceri and Van Rens \(2009\)](#), which only allows for a permanent component of the unobserved heterogeneity.

by $\sigma_{\xi,\psi}^2 = \sigma_{\xi,\theta}^2 = 0$, the common general-methods-of-moment (GMM) estimation used in the literature can only recover an upward-biased PR from these estimates, with the difference being exactly the variance due to the unobserved heterogeneity.³³

$$(7) \quad \widehat{PR} = \hat{\sigma}_{\psi}^2 + \hat{\sigma}_{\theta}^2 = \int PR_i di + \sigma_{\xi}^2 = \int \sigma_{i,\psi}^2 di + \int \sigma_{i,\theta}^2 di + \underbrace{\sigma_{\xi,\psi}^2 + \sigma_{\xi,\theta}^2}_{\text{unobserved heterogeneity}}$$

Therefore, the size of the unobserved heterogeneity $\sigma_{\xi}^2 \equiv \sigma_{\xi,\psi}^2 + \sigma_{\xi,\theta}^2$ can be directly identified by taking the difference between average PR in SCE and what is the average estimated risk ($\hat{\sigma}_{\psi}^2 + \hat{\sigma}_{\theta}^2$) using panel data (the difference between the two vertical lines in Figure 3).

Furthermore, with an auxiliary assumption that the two unobserved terms of all individuals have the same ratio κ , we can further decompose the estimated heterogeneity into $\sigma_{\xi,\psi}^2$, and $\sigma_{\xi,\theta}^2$, which represents the size of unobserved heterogeneity in permanent and transitory wage changes, respectively.

In addition, to directly identify the heterogeneity in PRs, I assume individual PRs follow a log-normal distribution with mean μ_{PR} and standard deviation σ_{PR} .

$$(8) \quad \log(PR_i) \sim N(\mu_{PR}, \sigma_{PR}^2)$$

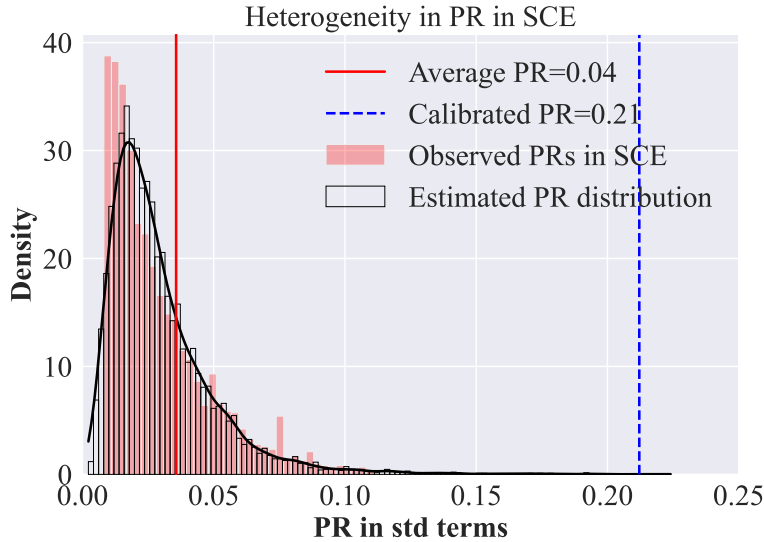
The two parameters can be straightforwardly estimated by fitting a truncated log-normal distribution to the cross-sectional distribution of the time-average PRs in SCE, as shown in Figure 3.

With the benchmark wage risk estimates of $\sigma_{\psi} = 0.15$ and $\sigma_{\theta} = 0.15$ (used to calibrate the baseline model in Section 5), hence a conventionally calibrated $\widehat{PR} = 0.41$, and $\kappa = 1$, the procedure produces the estimated unobserved heterogeneity: $\sigma_{\xi,\psi} = 0.13$ and $\sigma_{\xi,\theta} = 0.13$, and a fitted truncated-log-normal distribution of PRs, as plotted in Figure 3. In Section 5, I use these estimates to calibrate the heterogeneous perceived wage risks in the model. Using the wage risk estimates by [Low, Meghir, and Pistaferri](#)

³³The common GMM procedure produces an estimated transitory risk with a size of $\hat{\sigma}_{\epsilon}^2 = -\text{cov}(\Delta \hat{e}_{i,t}, \Delta \hat{e}_{i,t+1}) = -\text{cov}(\Delta e_{i,t} + \xi_{i,t}, \Delta e_{i,t+1} + \xi_{i,t+1}) = -\int \text{cov}(\Delta e_{i,t} + \xi_{i,t}, \Delta e_{i,t+1} + \xi_{i,t+1}) = \int \sigma_{i,\theta}^2 + \sigma_{\xi,\theta}^2$, and an estimated permanent risk of $\hat{\sigma}_{\psi}^2 = \text{var}(\Delta \hat{e}_{i,t}) - 2\hat{\sigma}_{\theta}^2 = \text{var}(\Delta e_{i,t}) + (\sigma_{\xi,\psi}^2 + 2\sigma_{\xi,\theta}^2) - 2\hat{\sigma}_{\theta}^2 = \int \text{var}(\Delta e_{i,t}) + (\sigma_{\xi,\psi}^2 + 2\sigma_{\xi,\theta}^2) - 2\hat{\sigma}_{\theta}^2 = \int (\sigma_{i,\psi}^2 + 2\sigma_{i,\theta}^2) + (\sigma_{\xi,\psi}^2 + 2\sigma_{\xi,\theta}^2) - 2\hat{\sigma}_{\theta}^2 = \int (\sigma_{i,\psi}^2 + 2\sigma_{i,\theta}^2) + \sigma_{\xi,\psi}^2 + 2\sigma_{\xi,\theta}^2 - 2(\int \sigma_{i,\theta}^2 + \sigma_{\xi,\theta}^2) = \int \sigma_{i,\psi}^2 + \sigma_{\xi,\psi}^2$.

(2010), $\sigma_\psi = 0.10$ and $\sigma_\psi = 0.09$ yield a smaller estimate of the unobserved heterogeneity $\sigma_{\xi,\psi} = 0.08$, $\sigma_{\xi,\theta} = 0.07$. In both cases, the estimates imply that a dominant fraction of observed wage inequality and volatility is attributed to observed heterogeneity, instead of risks, as the conventional calibration of the model.

FIGURE 3. Estimated Heterogeneity in PRs



Note: The observed distribution of perceived income risks from SCE and the fitted truncated log-normal distribution estimation.

4.4. Unemployment risk perceptions

My analysis has so far focused only on wage risks conditional on staying in the same job. But it only constitutes a part of the income risks, given that major labor market transitions, such as job loss and switching, usually result in more significant changes in labor income.³⁴ In addition, unemployment risks are usually another central input of the incomplete-market macroeconomic models.³⁵ In these models, as in the approach to wage risks, the common practice is to model the process of labor market transitions on the basis of on externally estimated stochastic processes.³⁶ This section shows

³⁴Low, Meghir, and Pistaferri (2010), Davis and Von Wachter (2011).

³⁵For examples, see Krueger, Mitman, and Perri (2016) and Bayer et al. (2019), etc.

³⁶The exceptions are models that endogenize job search & match mechanisms, such as Ravn and Sterk (2017), Ravn and Sterk (2021), McKay (2017) in which job-separation rates typically remains exogenous

that, although, on average, the survey-reported expectations of job separation/finding probabilities track realized aggregate dynamics computed through panel data in a standard approach in search & match labor literature, as in [Fujita and Ramey \(2009\)](#), it masks a huge amount of heterogeneity, which is not assumed in standard models.

To achieve a fair comparison between perceptions and realizations measured for different horizons, I cast both probabilities into a continuous-time rate for a Poisson point process.³⁷ Figure 4 plots the converted realizations of job-separation/finding rates, respectively, against the corresponding average, and the 25/75 percentile of the expectations across all survey respondents at each point in time. A number of straightforward findings emerge. First, although the two series are constructed independently of one another, on average, perceptions track the aggregate realizations relatively well. The most notable deviation between the belief and realization occurred during March 2020, which saw an unprecedented increase in one-month job separations³⁸ and a dramatic decrease in job findings. Second, however, as shown by the wide 25/75 inter-range-percentile around mean expectations, individual respondents vastly disagree on their individual separation and finding probabilities. Because the question in the survey concerns the individual-specific transitions, it is reasonable to assume that this reflects either the unobserved heterogeneity or information available to their individual status, which economists cannot directly observe.

4.5. Perceived income risk and consumption spending

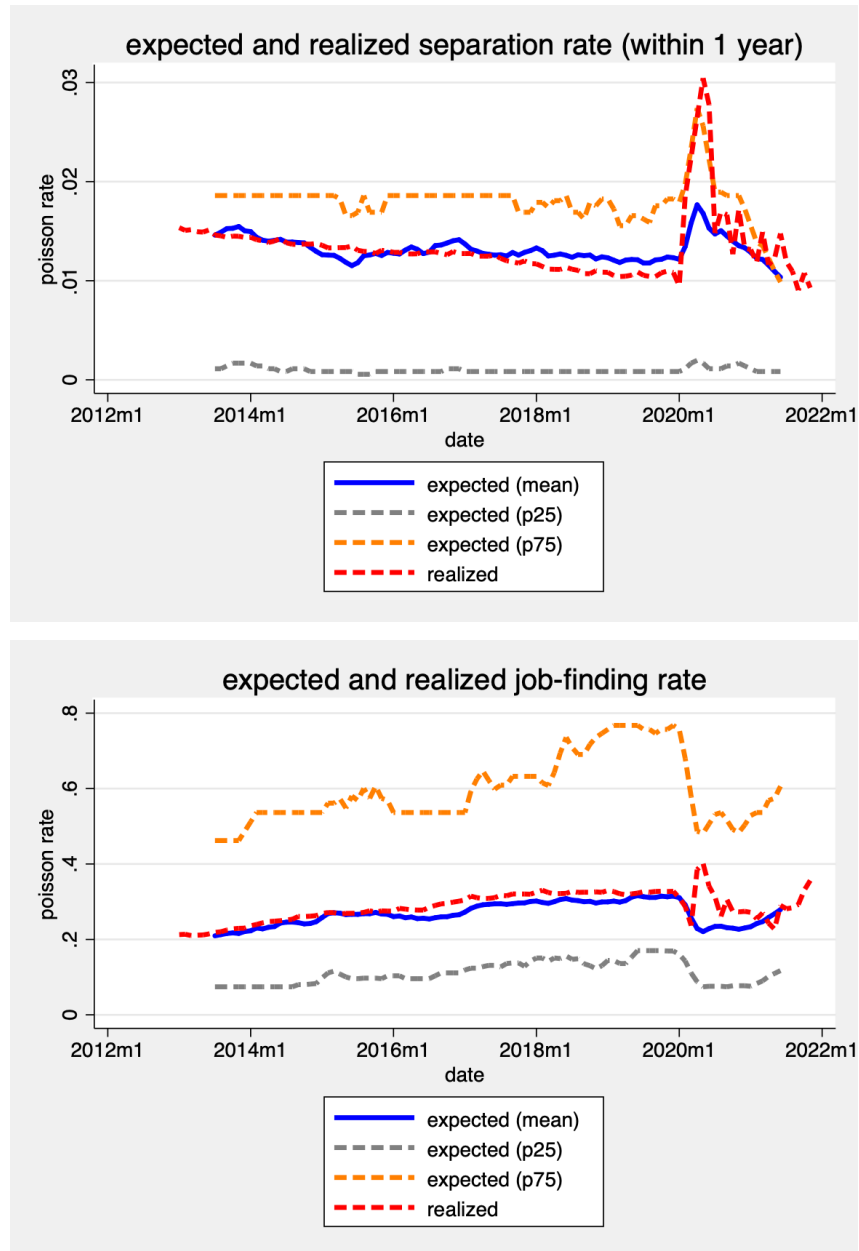
Due to precautionary saving motives, higher perceived risks induce households to lower current consumption, thus increasing expected consumption growth. Despite such a clear directional prediction in theory, identifying the exact size of such an effect (i.e., perceived risks on ex-ante consumption/saving decisions that are separate from the ex-post income impacts) has been challenging when conventional data sources are used as it does not directly elicit ex-ante plans and perceptions at the individual level. This section shows that the coexistence of individual-specific perceived risks and the

and externally calibrated.

³⁷Assuming the reported probability of separation from the current job in the next 12 months be $P_{i,t}(ue_{t+12}|e_t)$, then the corresponding monthly Poisson rate of job-separation is $-\log(1 - P_{i,t}(ue_{t+12}|e_t))/12$. This follows from the fact that for a continuous-time Poisson point process with an event rate of θ , the arrival probability over a period of Δt units of time is equal to $1 - \exp(-\theta\Delta t)$. With the realized month-to-month flow rate estimated from CPS $P(ue_{t+1}|e_t)$, the corresponding realized Poisson rate is $-\log(1 - P(ue_{t+1}|e_t))$.

³⁸The observation of March 2020 was dropped in the graph, otherwise, it overshadows all other observations in the sample.

FIGURE 4. Expected and Realized Job-separation/finding Rate



Note: realized job separation/finding rates are computed from CPS following the method of [Fujita and Ramey \(2009\)](#). Both realizations and perceived probabilities are expressed as Poisson point rates in continuous time, with one month as the unit of time. 3-month moving average of each series is plotted.

consumption plan of the same individual in SCE provides a rare opportunity to resolve

this problem.³⁹ This contrasts with the best practice to date, which is to impute ex-ante unemployment risks to a particular individual on the basis of only a number of observable factors from realizations ([Harmenberg and Öberg 2021](#)).

I run on the same individual's expected wage growth and perceived income risks a regression of expected consumption growth, specified below, under a range of specifications.

$$E_{i,t}(\Delta c_{i,t+1}) = u_0 + u_1 E_{i,t}(\Delta w_{i,t}) + u_2 \text{Var}_{i,t}(\Delta w_{i,t+1}) + \xi_{i,t}$$

In the past, the literature took it for granted that such a reduced-form regression has a clear correspondence to the commonly used approximated Euler Equation to the second-order (for instance, [Parker and Preston \(2005\)](#)), where the expected consumption growth is equal to the sum of intertemporal substitution and the precautionary saving motive. But a linearly approximated Euler equation is reasonable only under a set of unrealistic and stringent assumptions, such as the absence of external borrowing constraint, the absence of the buffer-stock-saving behavior as elaborated in [Carroll and Samwick \(1997\)](#), and mild-sized income fluctuations, a point forcefully made by [Carroll \(2001\)](#). Therefore, in the regression results below, I primarily focus on testing the significance and the qualitative effects of precautionary saving motives, without providing a structural interpretation of the size of the estimated coefficient.

Across all specifications, as reported in Table 2, in addition to the significantly positive coefficient of expected wage growth, which is consistent with the buffer-stock-saving behavior, perceived risk is positively correlated with the expected spending growth, as the precautionary saving motive predicts. Specifically, after controlling for individual fixed effect (e.g., the discount rate), and time fixed effect (e.g., interest rate), each unit increase in perceived variance leads to around a 1.7 percentage point increase in expected spending growth. Additionally, for the same individual, the perceived unemployment probability, measured by perceived job separation probability, in the next 4 months also has a significantly positive correlation with expected consumption

³⁹[Guiso, Jappelli, and Terlizzese \(1992\)](#) was an early example of directly testing precautionary saving motives using reported subjective income risks of Italian households. Other recent works that examine the impacts of expectations on readiness to spend include [Bachmann, Berg, and Sims \(2015\)](#) and [Coibion et al. \(2020\)](#). Recently, in closely related studies, [Fuster, Kaplan, and Zafar \(2020\)](#) and [Bunn et al. \(2018\)](#) have relied on survey answers to measure stated marginal propensity to consume. The most related to this paper, [Christelis et al. \(2020\)](#) also finds that expected consumption growths are positively correlated with perceived income risks at the individual level based on Dutch households.

growth.⁴⁰

TABLE 2. Perceived income risks and the household spending plan

	(1)	(2)	(3)	(4)	(5)
expected wage growth	0.324*** (0.0825)	0.306*** (0.0828)	0.254*** (0.0334)	0.243*** (0.0334)	
perceived wage risk	6.127*** (1.163)	6.185*** (1.165)	2.096*** (0.439)	1.711*** (0.442)	
perceived UE risk next 4m					0.353*** (0.0553)
R-squared	0.000939	0.00318	0.953	0.953	0.633
Sample Size	56046	56046	56046	56046	6269
Time FE	No	Yes	No	Yes	Yes
Individual FE	No	No	Yes	Yes	Yes

Regression results of expected spending growth on perceived income risks. Standard errors are clustered by household. *** $p < 0.001$, ** $p < 0.01$ and * $p < 0.05$.

5. Perceived risks and wealth inequality

Section 4.5 provides assuring evidence that individual consumption/saving decisions are indeed correlated with *their own* income expectations and perceived risks, regardless of the correctness of such perceptions. In this section, I show that recalibrating income risks based on reported perceptions in a standard incomplete-market macro model also generates more empirically plausible predictions regarding inequality in liquid wealth, compared to the indirect calibrations, and the difference is quantitatively important.

5.1. An overlapping-generation model

I reproduce a standard incomplete market/life-cycle/general-equilibrium model without aggregate risks. The model structure resembles that of [Huggett \(1996\)](#), and it embeds a

⁴⁰One common econometric concern with running regressions of this kind is the measurement error in the regressor, i.e. the perceived risks. In a typical OLS regression in which the regressor has i.i.d. measurement errors, the coefficient estimate for the imperfectly measured regressor has a bias toward zero. For this reason, if I find that expected spending growth is indeed positively correlated with perceived risks, taking into account the bias, it implies that the correlation between the two is greater.

more realistic income risk profile and economic environment a la [Carroll and Samwick \(1997\)](#), [Krueger, Mitman, and Perri \(2016\)](#) and [Carroll et al. \(2017\)](#).

In each period, a continuum of agents is born. Each agent i lives for L and works for T ($T \leq L$) periods since entering the labor market, during which he/she earns stochastic labor income y_τ at the work-age of τ . After retiring at the age of T , the agent lives for other $L - T$ periods of life and receives social security benefits. Without aggregate risks, there is no need to treat calendar time t and the working age τ as two separate state variables, hence I suppress time script t from now on. All shocks are idiosyncratic.

5.1.1. Consumer's problem

The consumer chooses the whole future consumption path to maximize expected life-long utility under a discount factor β and constant survival probability $(1 - D)$.

$$(9) \quad \max \quad \mathbb{E} \left[\sum_{\tau=0}^{\tau=L-1} (1 - D)^\tau \beta^\tau u(c_{i,\tau}) + \beta^{L-1} u(a_{i,L-1}) \right]$$

where $c_{i,\tau}$ represents consumption at the work-age of τ . The felicity function $u(c)$ takes a standard CRRA form with a relative risk aversion coefficient of ρ : $u(c) = \frac{c^{1-\rho}}{1-\rho}$. The second term is the homothetic bequest motive from the last period of life, derived from the post-consumption asset $a_{i,L-1}$.

Denote total cash in hand at the beginning of the period τ as $m_{i,\tau}$, the end-of-period saving in period τ after consumption as $a_{i,\tau}$, and the bank balance in period τ as $b_{i,\tau}$. Labor income y_τ is taxed at an income rate of λ and social tax rate λ_{SS} . Also, assume R is the gross real interest factor. The consumer starts with some positive bank balance in the first period of life, b_1 , which may partly come from a lump-sum accidental bequest from the deceased population each period. The household makes consumption and saving decisions subject to the following intertemporal budget constraints.

$$(10) \quad \begin{aligned} a_{i,\tau} &= m_{i,\tau} - c_{i,\tau} \\ b_{i,\tau+1} &= a_{i,\tau} R \\ m_{i,\tau+1} &= b_{i,\tau+1} + (1 - \lambda)(1 - \lambda_{SS}) y_{i,\tau+1} \\ a_{i,\tau} &\geq 0 \end{aligned}$$

The last line of the equation above is the no-borrowing constraint.

5.1.2. Income process

Each agent receives stochastic labor income during her working age from $\tau = 0$ to $\tau = T$ and receives a social security benefit after retirement. The income processes in both sub-periods can be defined in a generic manner as described below. By allowing the possibility of persistent unemployment spells, the process is assumed to follow a slight variant of the standard permanent/transitory income process used in the literature⁴¹. Specifically, $y_{i,\tau}$ is a multiplication of the idiosyncratic wage rate⁴² $n_{i,\tau}$ and the economy-wide wage rate W . The former consists of one permanent component $p_{i,\tau}$ and one potentially persistent or transitory $\xi_{i,\tau}$. The aggregate wage is to be determined by the forces of general equilibrium.

$$(11) \quad \begin{aligned} y_{i,\tau} &= n_{i,\tau} W \\ n_{i,\tau} &= p_{i,\tau} \xi_{i,\tau} \end{aligned}$$

During the work, the permanent wage component is subject to a mean-one white-noise shock ψ in each period and grows according to a deterministic life-cycle profile governed by $\{G_\tau\}_{\tau=1\dots L}$, which, according to existing estimates, usually follows a hump-shape (e.g. [Gourinchas and Parker \(2002\)](#)).

$$(12) \quad \begin{aligned} p_{i,\tau} &= G_\tau p_{i,\tau-1} \psi_{i,\tau} \\ \log(\psi_{i,\tau}) &\sim N\left(-\frac{\sigma_\psi^2}{2}, \sigma_\psi^2\right) \quad \forall \tau \leq T \end{aligned}$$

The persistent/transitory shock $\xi_{i,\tau}$ takes different values depending on the transitory or persistent state of unemployment, which follows a Markov process.⁴³

⁴¹[Carroll et al. \(2017\)](#), [Kaplan and Violante \(2018\)](#), etc.

⁴²This is equivalent to the usual interpretation of it in the literature as idiosyncratic productivity under the implicit assumption of a perfectly inelastic labor supply.

⁴³This formulation follows [Krueger, Mitman, and Perri \(2016\)](#).

$$(13) \quad \xi_{i,\tau} = \begin{cases} \theta_{i,\tau} & \text{if } v_{i,\tau} = e \text{ \& } \tau \leq T \\ \zeta & \text{if } v_{i,\tau} = u \text{ \& } \tau \leq T \\ \mathbb{S} & \text{if } \tau > T \end{cases}$$

$$\log(\theta_{i,\tau}) \sim N(-\frac{\sigma_\theta^2}{2}, \sigma_\theta^2)$$

where ζ is the replacement ratio of the unemployment insurance and $\theta_{i,\tau}$ is the i.i.d. mean-one white noise shock to the transitory component of the income conditional on staying employed. Notice that this process also embodies the income process after retirement after $\tau = T$. The agent receives social security with a replacement ratio \mathbb{S} , proportional to her permanent income and aggregate wage rate. That is, the effective pension benefit received is $\mathbb{S} p_{i,\tau} W$. I assume that the permanent income component after retirement follows a deterministic path without additional stochastic shocks.

During the work age of any individual i , the transition matrix between unemployment ($v_{i,\tau} = u$) and employment ($v_{i,\tau} = e$) is the following.

$$(14) \quad \pi(v_{\tau+1}|v_\tau) = \begin{bmatrix} \mathbb{U} & 1 - \mathbb{U} \\ 1 - E & E \end{bmatrix}$$

In general, this assumption implies to some degree that unemployment risks persist, but it conveniently nests the special case in which the unemployment risk is purely transitory when $\mathbb{U} = 1 - E$, meaning the probability of unemployment is not dependent on the current status.

Unemployment risks are idiosyncratic. Hence, by the law of large numbers, the fraction of the population that is unemployed and employed at each age, denoted by $\Pi_\tau^\mathbb{U}$ and Π_τ^E , respectively, are essentially deterministic and are not dependent on age.

Notice that in the benchmark model laid out here, I assume that all parameters of income risks σ_ψ , σ_θ , \mathbb{U} , and E are age-invariant (equivalent to time-independent in this setting). Doing this allows me to avoid restricting the heterogeneity in income risks only by the dimension of age.

5.1.3. Value function and consumption policy

The following value function characterizes the consumer's problem.

(15)

$$V_\tau(v_{i,\tau}, m_{i,\tau}, p_{i,\tau}) = \max_{\{c_{i,\tau}, a_{i,\tau}\}} u(c_{i,\tau}) + u(a_{i,\tau}), \forall \tau = L - 1$$

$$V_\tau(v_{i,\tau}, m_{i,\tau}, p_{i,\tau}) = \max_{\{c_{i,\tau}, a_{i,\tau}\}} u(c_{i,\tau}) + (1 - D)\beta \mathbb{E}_\tau \left[V_{\tau+1}(v_{i,\tau+1}, m_{i,\tau+1}, p_{i,\tau+1}) \right], \forall \tau \leq L - 2$$

where the three state variables for the agents are current employment status $v_{i,\tau}$, total cash in hand $m_{i,\tau}$ and permanent income $p_{i,\tau}$. $v_{i,\tau}$ drops from the state variables in the special case of a purely transitory unemployment shock ($\bar{v} = 1 - E$).⁴⁴

The solution to the stated problem above is a set of age-specific optimal consumption policies, $c_\tau^*(u_{i,\tau}, m_{i,\tau}, p_{i,\tau})$, and the saving policies, $a_\tau^*(u_{i,\tau}, m_{i,\tau}, p_{i,\tau})$. Both are functions of all state variables.

5.1.4. Technology

The economy has a standard CRS technology that turns the capital and supplied efficient units of labor into aggregate output.

(16)

$$Y = ZK^\alpha N^{1-\alpha}$$

The capital depreciates at a rate of δ each period. The factors of input markets are fully competitive.

5.1.5. Demographics

For the sake of simplicity, I assume there is no population growth. With a deterministic life-cycle profile of survival probabilities, there exists a stable age distribution $\{\mu_\tau\}_{\tau=1,2,\dots,L}$ such that $\mu_{\tau+1} = (1 - D)\mu_\tau$ and $\sum_{\tau=1}^L \mu_\tau = 1$. The former condition reflects the probability of survivals at each age and the latter is a normalization that guarantees the fraction of all age groups sum up to 1.⁴⁵

⁴⁴Another trick used in the literature to reduce the number of state variables is to normalize the value function by permanent income level p_τ , so that it drops from the state variable. I also use the endogenous grid method (EGM) developed by [Carroll \(2006\)](#).

⁴⁵In a more general setting with a constant population growth rate n and age-specific survival probability $1 - D_\tau$, the condition becomes $\mu_{\tau+1} = \frac{(1-D_{\tau+1})}{1+n} \mu_\tau \quad \forall \tau = 1, 2, \dots, L$, as discussed in [Ríos-Rull \(1996\)](#) and [Huggett \(1996\)](#).

5.1.6. Government

The government runs a balanced budget in each period. Therefore, outlays from unemployment insurance are financed by the income tax that is levied on both labor income and unemployment benefits. Given a replacement ratio ζ and the proportion of employed population $1 - \Pi^U$, the corresponding tax rate λ can be easily pinned down on the basis of the equation below.⁴⁶

$$(17) \quad \lambda [1 - \Pi^U + \zeta \Pi^U] = \zeta \Pi^U$$

The Social Security tax rate λ_{SS} is also determined in the model by the pension replacement ratio \mathbb{S} , the permanent income ratio, the relative population size of the retired and the working age, and the aggregate employment rate.

$$(18) \quad \lambda_{SS} \sum_{\tau=1}^T \mu_{\tau} G_{\tau} (1 - \Pi^U) = \mathbb{S} \sum_{\tau=T+1}^L \mu_{\tau} G_{\tau}$$

5.1.7. Stationary equilibrium

Denote $x = \{m, p, v\} \in X$ as the idiosyncratic state of individuals. At any point in time, agents in the economy differ in age τ and their idiosyncratic state x . The former is given by $\{\mu_{\tau}\}_{\tau=1,2,\dots,L}$. For the latter, $\psi_{\tau}(B)$ is used to represent the fraction of agents at age τ whose individual states lie in B as a proportion of all age τ agents. The distribution of age $\tau = 1$ agents depends on the initial condition of labor income outcomes and the size of accidental bequests, if any. For any other age $\tau = 2 \dots L$, the distribution $\psi_{\tau}(B)$ evolves as the following.

$$(19) \quad \psi_{\tau}(B) = \int_{x \in X} P(x, \tau - 1, B) d\psi_{\tau-1} \quad \text{for all } B \in B(X)$$

where $P(x, \tau - 1, B)$ is the probability that an agent will transit to B in the next period, conditional on the individual state x at age $\tau - 1$. The transition function depends on the optimal consumption policy $c^*(x, \tau)$ at age τ and the exogenous transition probabilities

⁴⁶This convenient result crucially depends on the assumption that the unemployment insurance benefit is paid proportionally to permanent income.

of income shocks.⁴⁷

In the absence of the aggregate risk, I focus on the stationary equilibrium of the economy (StE), which consists of consumption and saving policies $c(x, \tau)$, $a(x, \tau)$, as well as constant production factor prices, including the real interest rate R and the wage W , the initial wealth of newborn b_1 , unemployment benefit ζ , tax rate λ , and the time-invariant distribution $(\psi_1, \psi_2, \dots, \psi_L)$ such that

1. Consumption and saving policies are optimal given the real interest rate R , wage W , and the tax rate λ .

$$c(x, \tau) = c^*(x, \tau)$$

$$a(x, \tau) = a^*(x, \tau)$$

2. Distributions $(\psi_1, \psi_2, \dots, \psi_L)$ are consistent with optimizing behaviors of household, as described in Equation 19.
3. The factor markets are clearing.

$$(20) \quad \begin{aligned} \sum_{\tau} \mu_{\tau} \int_X a(x, \tau) d\psi_{\tau} &= K \\ \sum_{\tau=0}^{T-1} \mu_{\tau} \Pi_{\tau}^E &= N \end{aligned}$$

4. Firm optimization under competitive factor markets.

$$W = Z(1 - \alpha)(K/N)^{\alpha}$$

$$R = 1 + Z\alpha(K/N)^{\alpha-1} - \delta$$

5. The initial bank balance of newborns is equal to accidental bequests.

$$b_1 = \sum_{\tau} \mu_{\tau} D \int_{x \in X} a(x, \tau) R d\psi_{\tau}$$

6. The government budget is balanced as described in Equation 17 and 18.

The economy may potentially arrive at different stationary equilibrium, depending

⁴⁷In the model computation, the P functions correspond to age-specific transition matrices over a finite number of discretized grid points of multiple state variables. The age-specific distributions $\psi_{\tau}(B)$ are generated by forward iteration of multiplying the distribution of age $\tau - 1$ by the transition matrix of age τ .

on the specific assumptions about the size and heterogeneous income risks, which in this model, include σ_ψ , σ_θ , E , and \mathcal{U} .

5.2. Calibration

The central inputs of the model in this paper—the size and the heterogeneity in perceived income risks—are estimated from the survey, using the auxiliary model laid out in Section 4.3. Here, I discuss other model parameters in great detail.

Life-cycle. The model is set at a yearly frequency. The working age spans 25 years old to 65 years old ($T = 40$) and the agent dies with certainty at the age of 85 ($L = 60$). The constant death probability before the terminal age is set as $D = 0.625\%$.

Regarding the deterministic permanent income profile over the life-cycle, G_τ , I draw on an age polynomial regression of the wage growth from SIPP for workers aged 25-65 while controlling for other observable demographic variables such as education, gender, occupation, and time fixed effects, etc. This yields estimation results very similar to those obtained by [Gourinchas and Parker \(2002\)](#), [Cagetti \(2003\)](#) and [Kaplan and Violante \(2014\)](#). The estimated wage profile is plotted in Appendix A.5. For the retirement phase, I assume a one-time drop of 20% in permanent wage at age 66, i.e. $G_{41} = 0.8$, and then the permanent wage stays flat till death. This produces an average expected growth rate of permanent income over the entire life cycle exactly equal to one. This serves as a normalization. Note that although alternative assumptions, such as a smoother decline of income after retirement, do change the wealth distribution across generations among the retired, they do not change consumption/saving decisions because such a profile is entirely deterministic.

Initial conditions. Assumptions about the cross-sectional distribution of the initial permanent productivity and liquid asset holdings matter for the subsequent wealth inequality. I set the standard deviation of the log-normally-distributed initial permanent wage $p_{i,\tau}$ to be 0.6 in order to match the heterogeneity in “usual income” (an approximation of the permanent income) at age 25 from the SCF. Initial liquid assets holdings at $\tau = 0$ are assumed to have a cross-sectional standard deviation of 0.50.

Income risks. Given the critical importance of the income risks assumption in my model, in addition to my estimates from SIPP (as reported in Table 1), I thoroughly survey the risk estimates used in the existing incomplete market macro literature, as summarized in Table A.2 in the Appendix. For comparison, I convert all risks into the annual frequency (because some of the estimates are for a different frequency). Whenever group-specific risks are assumed (depending on education and age), I summarize

them as a range. Also, for models that assume a persistent instead of a permanent component, I treat the assumed size of the persistent risks as a lower bound for the permanent risk.⁴⁸ For models with income risks dependent on aggregate business cycles, a la [Krusell and Smith \(1998\)](#), I compute the steady-state size of idiosyncratic risks using the transition probabilities of the aggregate economy employed in the paper.

Regardless of the disagreement in these estimates, the income risks used in these models are constantly larger than those reported in the survey. This is true for presumably the most comparable one to the surveyed PR among them, the wage risk estimate by [Low, Meghir, and Pistaferri \(2010\)](#). I use the median values of each parameter in the literature as the benchmark income risks profile, which is a combination of $\sigma_{\psi} = 0.15$, $\sigma_{\theta} = 0.15$. And following the calibration of [Krueger, Mitman, and Perri \(2016\)](#), the yearly probability of staying on unemployment is $\bar{U} = 0.18$ and that of staying employed $E = 0.96$.

Technology. The annual depreciation rate is set to be $\delta = 2.5\%$. The capital share takes a standard value of $\alpha = 0.36$, for the U.S. economy. Without aggregate shocks, Z is simply a normalizer. Therefore, I set its value such that the aggregate wage rate W is equal to one under a capital/output ratio $K/Y = 3$ at the steady-state level of employment in the model.

Government policies. As in [Krueger, Mitman, and Perri \(2016\)](#), unemployment insurance replacement ratio is set to be $\mu = 0.15$. The pension income relative to the permanent income is assumed to be $\mathbb{S} = 60\%$. This, plus the 20% drop in permanent income, gives an effective deterministic wage drop of 48% from the working-age to retirement, which corresponds to an empirical replacement ratio estimated for the U.S. economy. The corresponding tax rates that finance the unemployment insurance and social security is determined by the equilibrium within the model.

Preference. The coefficient of relative risk aversion $\rho = 2.0$, which is common in this literature. Following the common practice in the literature, the discount factor β is internally calibrated to generate a mean wealth/income ratio approximately comparable to the average net liquid wealth to permanent income ratio of 0.69 in SCF.⁴⁹

Table 3 summarizes the parameters used in the calibration of the baseline model.

⁴⁸One can think of the permanent income shock as a limiting case of AR(1) shock, with the persistence parameter infinitely close to 1. The effective income risks increase with the persistence of the shock.

⁴⁹[Kaplan and Violante \(2022\)](#) discusses in details how the internally calibrated discount factors in one-asset models differ depending on targeting liquid wealth or total net worth. Their calibration of β is 0.945 for a targeted liquid-asset-to-income ratio of 0.6, and 0.98 for a targeted net-worth-to-income ratio of 4.6. This is the same as the average value estimated in the models with heterogeneous time preferences, as in [Carroll et al. \(2017\)](#) and [Krueger, Mitman, and Perri \(2016\)](#).

This is nearly identical to what would be considered as a standard calibration of an incomplete market liquid-assets calibration. (Kaplan and Violante (2022))

TABLE 3. Model Parameters

block	parameter name	values	source
risk	σ_ψ	0.15	Median estimate from the literature
risk	σ_θ	0.15	Median estimate from the literature
risk	$U2U$	0.18	Median estimate from the literature
risk	$E2E$	0.96	Median estimate from the literature
initial condition	$\sigma_\psi^{\text{init}}$	0.629	Estimated for age 25 in the 2016 SCF
initial condition	bequest ratio	0	assumption
life cycle	T	40	standard assumption
life cycle	L	60	standard assumption
life cycle	$1 - D$	0.994	standard assumption
preference	ρ	2	standard assumption
preference	β	0.96	calibrated to match liquid-wealth-to-income ratio
policy	\mathbb{S}	0.65	U.S. average
policy	λ	N/A	endogenously determined
policy	λ_{SS}	N/A	endogenously determined
policy	μ	0.15	U.S. average
production	W	1	target values in steady state
production	K2Y ratio	3	target values in steady state
production	α	0.33	standard assumption
production	δ	0.025	standard assumption

Parameters used in the baseline model. All parameters, whenever relevant, are at the annual frequency.

6. Model results

6.1. Baseline model

I first examine the patterns of wealth accumulation and wealth inequality generated from a benchmark calibration, as reported above. In particular, under a set of standard parameterization on permanent and transitory risks at the annual frequency to be $\sigma_\psi = 0.15$ and $\sigma_\theta = 0.15$, and the unemployment risks to be $U2U = 0.18$ and $E2E = 0.96$, the baseline of Figure 5 reproduces the well-known result⁵⁰ that a carefully calibrated

⁵⁰See Guvenen (2011), De Nardi (2015), and Kaplan and Violante (2018) for a thorough survey on this topic.

standard one-asset incomplete market model without additional heterogeneity, such as that in time discount rates, predicts less wealth inequality (a Gini coefficient of 0.63 in partial and 0.64 in general equilibrium) than that in the liquid wealth inequality in the data. For instance, the distribution of net liquid wealth based on the definition of [Kaplan, Violante, and Weidner \(2014\)](#) and [Carroll et al. \(2017\)](#)⁵¹ has a Gini coefficient of 0.88 in the 2016 SCF.⁵²

The second major discrepancy between the model and data is that the former significantly underpredicts the share of agents who are close to borrowing constraints. In particular, the baseline model predicts a share of hands-to-month households (H2M) (defined as agents whose ratios of wealth to annual permanent income are below 1/24) less than 1%, which is significantly lower than 0.31, the share computed based on net liquid wealth in SCF. It is known that the strong precautionary saving motives in this model incentivize agents to build buffer-stocks and stay away from their borrowing constraints.

The baseline model proves to be a more successful starting point in terms of matching the life-cycle patterns of wealth accumulation. The baseline in the bottom panel of [Figure 5](#) plots the hump-shaped average wealth over the life cycle implied by the model against the average life-cycle profile of net liquid wealth (for PE) and net worth (for GE) computed from SCF. I use total net worth to benchmark the results from GE primarily because this is more consistent with the model assumption that savings are used as productive capital of the economy. The model-implied wealth accumulation over the life cycle roughly resembles the observed pattern from the data. In particular, allowing the voluntary bequest in the last period of life helps me match the saving behaviors better after retirement.

6.2. Model results with survey-implied risks

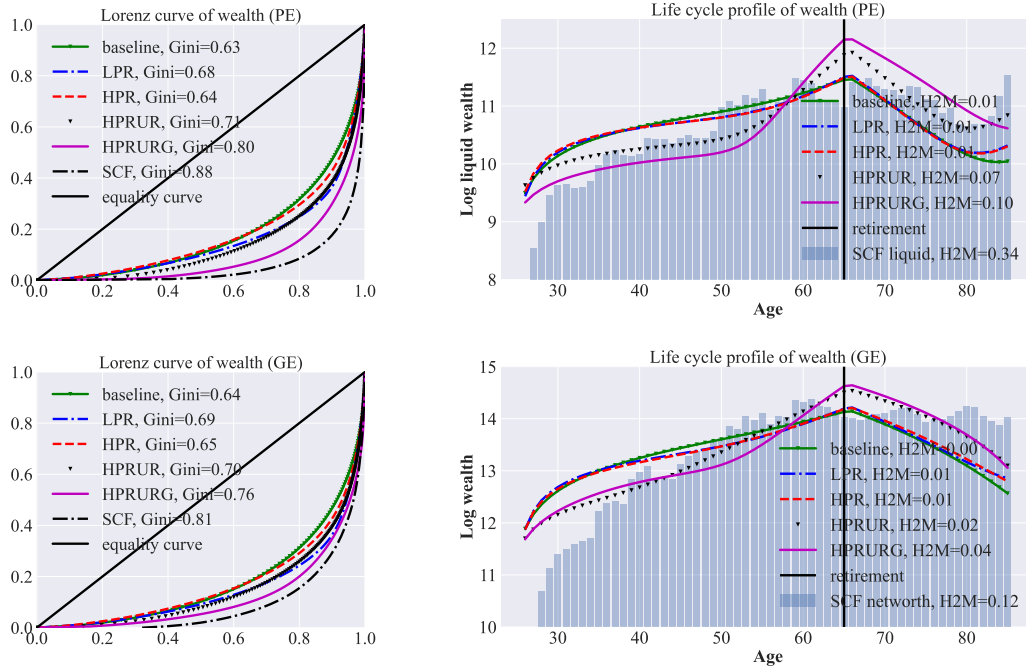
In this section, I sequentially add the following four features of income risks, estimated from the survey-reported PRs, and show that it generates a higher wealth Gini and a fraction of H2M, compared to in the baseline model, which is closer to that observed in the data. First is an average lower wage risk (*LPR*). The second is heterogeneous

⁵¹According to this definition, liquid asset includes checking, saving, money market funds, government bonds, directly held mutual funds, stocks and corporate bonds, and liquid debt is the sum of all credit card balances that accrue interest, after the most recent payment.

⁵²I exclude the households in SCF with negative net liquid wealth and the top 5% in terms of total net worth. The former is meant to be consistent with the no-borrowing constraint assumption. The latter is also a common practice in the literature (for instance, [Kaplan and Violante \(2022\)](#)) because the one-asset model has been found to poorly explain the consumption/saving behaviors of the super rich.

perceived wage risks in addition to the average lower size (*HPR*). The third is heterogeneous unemployment risks (*HPRUR*) as revealed in perceived U2U and E2E probabilities. Fourth, in addition to heterogeneous risks, I allow for heterogeneous growth rates of wage (*HPRURG*).

FIGURE 5. Wealth Inequality in Partial and General Equilibrium: A Model Comparison



Note: the upper panel shows, under various model assumptions, the Lorenz curve of households' wealth (left) and the model-generated life-cycle profile of log average wealth compared to the average net liquid wealth by age in the 2016 vintage of Survey of Consumer Finance (SCF) (right) in partial equilibrium. The bottom panel shows the same figures in the general equilibrium, with the total net worth in SCF as the measure of household wealth.

6.2.1. Lower wage risks (LPR)

For LPR calibration, I keep everything the same as in the baseline calibration above, except that I make the permanent and transitory risks smaller on the basis of an average perceived risk of 0.04, i.e. $\sigma_\psi = 0.03$ and $\sigma_\theta = 0.03$. In the meantime, I calibrate the ex-ante unobserved heterogeneity anticipated by the agents using the estimates of $\sigma_{\xi,\psi}^2$ and $\sigma_{\xi,\theta}^2$ produced in Section 4.3.

This additional step of reconfiguration of the relative importance of risks and heterogeneity is crucial to ensure comparability with the baseline model. Other things equal, a smaller size of income risks would have mechanically lowered realized income inequality in the model. In order for the model to still generate realistic income inequality as seen in the labor income data, the differences between the previous and new calibrated risks have to be “attributed” to unobserved heterogeneity.

The LPR in Figure 5 shows two implications of a smaller size of risks and a larger role of anticipated heterogeneity. First, a lower PR induce a milder precautionary saving motive and reduces buffer-stock savings of all working agents, as indicated by a lower level of wealth to income ratio than in the baseline model. This also results in a slightly larger fraction of H2M agents (1% in both PE and GE) compared nearly zero in the baseline model.

Second, allowing for a larger role in heterogeneity instead of risks unambiguously leads to *more* wealth inequality than in the baseline model (A Gini coefficient of 0.68 in PE and 0.65 in GE), as shown in Figure 5.

6.2.2. Heterogeneous wage risks (HPR)

As shown in Section 4.1, a large degree of heterogeneity in PRs is attributable to individual fixed effects, which might reflect the true ex-ante heterogeneity in wage risks that different individuals face beyond common observable factors. Hence, I directly calibrate the heterogeneity in wage risks using the estimated distribution of PRs in Section 4.3.

I use three equally probable values [0.01, 0.02, 0.04] for σ_ψ and σ_θ , which are discretized from the estimated log-normal distribution of PRs to calibrate such heterogeneity. On the top of LPR, allowing heterogeneity in PRs unambiguously contributes to more wealth inequality because it induces different precautionary saving motives and buffer stock savings. But this is counteracted by a lower average risk, which objectively induces less income and wealth inequality, as discussed in LPR. As a result of the two competing forces, the wealth Gini coefficient increases by only one percentage point to 0.64 in HPR, and from 0.64 to 0.65 in GE.

Recalibrations in both LPR and HPR scenarios do take the baseline model closer to matching the data, but it is worth noting that the improvements in model performance are not sufficiently large. This is particularly so when it comes to matching the size of H2M agents. It suggests that only incorporating heterogeneity in wage risks can be complemented by recalibrating another important source of heterogeneity, namely the

unemployment risks.

6.2.3. Heterogeneous unemployment risks (HPRUR)

Just like the calibration of wage risks, a common calibration strategy of incomplete market models with unemployment spells typically parameterizes the model with one homogenous pair of $U2U$ (\bar{U} in the model) and $E2E$ (\bar{E} in the model) probabilities (e.g., Krueger, Mitman, and Perri (2016)). But this assumption may mask the unobserved heterogeneity among agents and their true perceived unemployment risks given the information they have about their own idiosyncratic circumstances (Mueller and Spinnewijn (2021)).

To capture the heterogeneity in unemployment risks, I adopt the same approach that in Section 4.3 I apply to perceived wage risks to fit a truncated log normal distribution to the survey-reported perceived $U2U$ and $E2E$ probabilities (See Figure A.11). The estimated distribution is further discretized into three equally probable grid points $[0, 0.02, 0.24]$ of $U2U$ and $[0.96, 0.99, 1.0]$ of $E2E$.

The resulting model, which has both heterogeneous wage risks and unemployment risks (*HPRUR*) generates a significantly higher degree of wealth inequality (an increase of 8 percentage points in Gini coefficient to 0.71 in PE and 6 percentage points increase in GE). In addition, the fraction of H2M households also substantially increase to 7% in PE and 2% in GE.

Particularly noteworthy is the fact that calibrating unemployment risks produces a better fit of the life-cycle profile of wealth to data than the baseline model and LPR.

6.2.4. Heterogeneous growth rates (HPRURG)

Although the main theme of this paper is the heterogeneity in income risks, the density forecasts also provide individual-specific expected wage growths that exhibit substantial heterogeneity: a standard deviation across respondents of 0.03, or 3 percentage points in annual growth rates (See Figure A.11).

Here, I further extend the *HPRUR* model to incorporate this heterogeneity. In particular, I allow the heterogeneity in the 1-year-ahead wage growth expectations to be translated into three equally probable distinctive deterministic wage profiles, which are plotted in Figure A.10. The mean profile corresponds to the baseline model calibration of $\{G_\tau\}_{\tau=1...L}$. Because the direct survey inputs needed to capture heterogeneity in the deterministic wage growth path—expected wage growths over the life-cycle—are not

available, the calibration above essentially makes the assumption that the heterogeneity in wage growth from one year to another completely reflects perceived differences in the permanent component of the wage growth.

As shown in Table 4, the implied wealth Gini from allowing for heterogeneous growth rates (*HPRURG*) in addition to heterogeneous income risks increases from 0.71 to 0.80 in PE and from 0.70 to 0.76 in GE. Moreover, the H2M ratios further see a sizable increase to 10% in PE and 4% in GE.

TABLE 4. Summary of Model Results and Data

Model/Data	Gini	Top 0.05	Top 0.1	Top 0.5	Mean wealth/income ratio	H2M share
SCF (liquid)	0.88	0.72	0.82	0.99	0.67	0.34
baseline (PE)	0.63	0.40	0.53	0.89	1.17	0.01
HPR (PE)	0.64	0.43	0.57	0.89	0.84	0.01
HPRUR (PE)	0.71	0.48	0.62	0.93	0.51	0.07
HPRURG (PE)	0.80	0.56	0.70	0.97	0.63	0.10
SCF (net worth)	0.81	0.57	0.71	0.98	6.72	0.12
baseline (GE)	0.64	0.40	0.53	0.90	1.65	0.00
HPR (GE)	0.65	0.43	0.57	0.89	1.23	0.01
HPRUR (GE)	0.70	0.47	0.61	0.92	1.12	0.02
HPRURG (GE)	0.76	0.52	0.65	0.95	0.99	0.04

Note: model-implied Gini coefficients, the wealth shares owned by the top 5, 10 and 50 percent of the agents, mean wealth-to-income ratio, and shares of hand-to-mouth agents (H2M), in the stationary distribution of partial and general equilibrium. H2M is defined as those whose liquid wealth is no more than two weeks of (1/24 of annual) income. The same statistics in the data are computed for both net liquid wealth, and total net worth using 2016 SCF.

6.2.5. The role of preference heterogeneity

One of the common additional features added to the baseline model in the existing literature to match the empirical wealth inequality is heterogeneity in preferences, especially in time discount rates. (Krusell and Smith (1998), Krueger, Mitman, and Perri (2016), Carroll et al. (2017).) Such a modeling assumption has been recently supported by some empirical evidence and laboratory experiments.⁵³ Despite such indirect evidence, however, the exact degree of time preference heterogeneity in the model cannot be directly observed and estimated. Thus, the literature commonly adopts “revealed preference” approach to indirectly calibrate the model-implied heterogeneity in preferences to match the data.

⁵³For instance, Epper et al. (2020) directly elicited time preferences of individuals via experiments and show that they have real effects on wealth accumulation.

Compared to the preference heterogeneity, survey-implied heterogeneity in perceptions has the advantage of being directly observable and useful in the model. This paper shows that heterogeneity of income risks and growth rates is another observable factor that should be first accounted for before attributing the unexplained wealth inequality to solely preference heterogeneity. Another advantage (not explored in this paper), is that disciplining the model with observed heterogeneity, such as in income risks perceived by agents, makes the model more transparent and allows welfare analysis to be carried out with greater clarity than in the unobserved preference heterogeneity approach.

It would have been a straightforward exercise for this paper to quantitatively compare the estimated preference heterogeneity from the baseline model and the preferred model that additionally accounts for the observable heterogeneity in income risks. As shown in Table 4, an incremental recalibration of the baseline model gradually reduces the model residuals in comparison with the data. So it shall be no surprises that the indirectly estimated preference heterogeneity will be less.

6.3. Subjective perceived risks

So far, all the model experiments have maintained the assumption of full-information-rational-expectation. I allow for heterogeneity in these risk parameters across agents, but I treat the survey-implied risks of as the true model risk parameters that determine the dispersion of income shocks—a calibration alternative to the conventional assumptions.

But it is critical to consider how robust the results are if we adopt a different assumption that agents' perceived risks as reported in the survey only shape their consumption/saving decisions (as calibrated *HPRUR*), but are somehow different from the true underlying risk parameters, which objectively govern the distribution of income shocks (as calibrated in the baseline model).

More accurately speaking, in the subjective model, the following transition probabilities of the distribution of agents over state spaces, $\tilde{P}()$, corresponding to the $P()$ in the objective model in Equation 19, is now both a function of individual consumption/saving policies based on subjective risks and the objective income risks that determine the realization of income shocks and distribution of income.

$$(21) \quad \tilde{\psi}_{\tau-1}(\tilde{B}) = \int_{\tilde{x} \in \tilde{X}} \tilde{P}(\tilde{x}, \tau - 1, \tilde{B}) d\tilde{\psi}_{\tau-1} \quad \text{for all } \tilde{B} \in \tilde{B}(X)$$

Such a model exercise is actually not just a robustness check, but also an experiment model that breaks down the model effects of heterogeneous and lower income risks on wealth inequality into two channels. The first channel can be called the “choice” channel because it is via ex-ante consumption/saving decisions of the agents based on certain perceived income risks. The second channel can be called the “outcome” channel because it is a function of the ex-post realized dispersion of income shocks.

The key finding of this exercise is that the additional wealth inequality from heterogeneous income risks is driven by the ex-ante choice channel, which is counteracted by the outcome channel, while the higher H2M share is a consequence of both the ex-ante and the ex-post mechanisms.

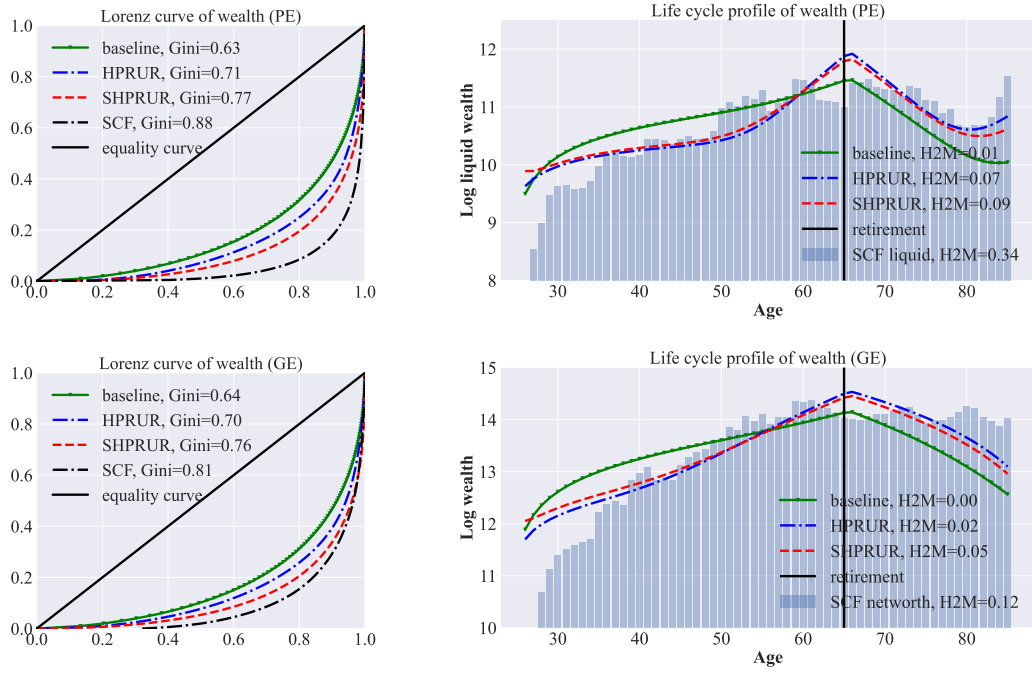
Figure 6 compares the subjective model *SHPRUR* with both the baseline and the *HPRUR* model as calibrated above. The subjective model shifts the Lorenz curve further outward (a Gini of 0.77 in PE and 0.76 in GE) than the baseline model, and the shift is greater than in the objective model. Such a shift only comes from changes in ex-ante saving behaviors when a heterogeneous and lower income risk profile is added to the baseline model. This suggests that even if we don’t recalibrate the objective income risks in the baseline model, but, instead, allow the survey-implied risks to serve as a better input when predicting consumption/saving choices, it reduces the difference in wealth inequality unexplained between the model and data. At the same time, the fraction of H2M consumers implied by the subjective model (9% in PE) is also bigger than the objective model, in both PE and GE models.

To summarize, the subjective model results reinforce the key argument of this paper: it shows that even if the perceived income risks reported in the survey are not perfectly “correct” compared to what objectively governs the size of stochastic income shocks, to the extent that household saving decisions are made based on such perceptions, they generate model predictions about wealth accumulation behaviors which are better aligned with the data.

7. Conclusion

A large class of incomplete-market macroeconomic models that features uninsured idiosyncratic income risks and resulting wealth inequality does not incorporate one observable dimension of heterogeneity in income risks. Utilizing the New York Fed’s *Survey of Consumer Expectations* which elicits density forecasts of wage growth, I explore the model implications of two major empirical findings. The survey-reported perceived

FIGURE 6. Wealth Inequality in Partial and General Equilibrium: Objective v.s. Subjective



Note: the upper panel shows, under objective (*HPRUR*) and subjective assumptions (*SHPRUR*), the Lorenz curve of households wealth (left) and the model-generated life-cycle profile of log average wealth compared to the average net liquid wealth by age in the 2016 vintage of Survey of Consumer Finance (SCF) (right) in the partial equilibrium. The bottom panel shows the same figures in the general equilibrium, with the total net worth of SCF as the measure of household wealth.

risks are more heterogeneous than that is assumed by common calibration of these models, and prove to be another observable factor useful for matching the model-predicted wealth inequality with empirical patterns. Furthermore, perceived risks are lower than the conventional estimates/ calibration, which helps explain why these models usually predict higher buffer stock savings than in the actual data.

This paper demonstrates the rich research potential of incorporating into heterogeneous-agent models survey data that reflects realistic heterogeneity in expectations/perceptions. In a world that offers increasingly rich survey data that directly measures expectations, economists no longer are obligated to calibrate important model parameters such as income risks indirectly from the panel data and adopting the stringent assumption of rational expectations. The use of survey-implied heterogeneity establishes a direct link between expectations and behaviors, and helps economists match empirical patterns

within the macroeconomy better.

References

- Abowd, John M, and David Card. 1989. "On the covariance structure of earnings and hours changes." *Econometrica: Journal of the Econometric Society*: 411–445.
- Acharya, Sushant, and Keshav Dogra. 2020. "Understanding HANK: Insights from a PRANK." *Econometrica* 88 (3): 1113–1158.
- Aiyagari, S Rao. 1994. "Uninsured idiosyncratic risk and aggregate saving." *The Quarterly Journal of Economics* 109 (3): 659–684.
- Arellano, Manuel, Richard Blundell, and Stéphane Bonhomme. 2017. "Earnings and consumption dynamics: a nonlinear panel data framework." *Econometrica* 85 (3): 693–734.
- Armantier, Olivier, Giorgio Topa, Wilbert Van der Klaauw, and Basit Zafar. 2017. "An overview of the Survey of Consumer Expectations." *Economic Policy Review* (23-2): 51–72.
- Auclert, Adrien. 2019. "Monetary policy and the redistribution channel." *American Economic Review* 109 (6): 2333–67.
- Bachmann, Rüdiger, Tim O Berg, and Eric R Sims. 2015. "Inflation expectations and readiness to spend: Cross-sectional evidence." *American Economic Journal: Economic Policy* 7 (1): 1–35.
- Bayer, Christian, Ralph Lütticke, Lien Pham-Dao, and Volker Tjaden. 2019. "Precautionary savings, illiquid assets, and the aggregate consequences of shocks to household income risk." *Econometrica* 87 (1): 255–290.
- Bertrand, Marianne, and Sendhil Mullainathan. 2001. "Do people mean what they say? Implications for subjective survey data." *American Economic Review* 91 (2): 67–72.
- Bhandari, Anmol, Jaroslav Borovička, and Paul Ho. 2019. "Survey data and subjective beliefs in business cycle models." *Available at SSRN* 2763942.
- Bloom, Nicholas, Fatih Guvenen, Luigi Pistaferri, John Sabelhaus, Sergio Salgado, and Jae Song. 2018. "The Great Micro Moderation." Working paper.
- Blundell, Richard, Luigi Pistaferri, and Ian Preston. 2008. "Consumption Inequality and Partial Insurance." *American Economic Review* 98 (5): 1887–1921.
- Broer, Tobias, Alexandre Kohlhas, Kurt Mitman, and Kathrin Schlafmann. 2021. "Information and wealth heterogeneity in the macroeconomy."
- Bunn, Philip, Jeanne Le Roux, Kate Reinold, and Paolo Surico. 2018. "The consumption response to positive and negative income shocks." *Journal of Monetary Economics* 96: 1–15.
- Cagetti, Marco. 2003. "Wealth accumulation over the life cycle and precautionary savings." *Journal of Business & Economic Statistics* 21 (3): 339–353.
- Callegaro, Mario. 2008. "Seam effects in longitudinal surveys." *Journal of Official Statistics* 24 (3): 387.
- Caplin, Andrew, Victoria Gregory, Eungik Lee, Søren Leth-Petersen, and Johan Sæverud. 2023. "Subjective Earnings Risk." Technical report, National Bureau of Economic Research.
- Carroll, Christopher D. 2006. "The method of endogenous gridpoints for solving dynamic stochastic optimization problems." *Economics letters* 91 (3): 312–320.
- Carroll, Christopher D, Edmund Crawley, Jiri Slacalek, Kiichi Tokuoka, and Matthew N White.

2018. "Sticky expectations and consumption dynamics." Technical report, National Bureau of Economic Research.
- Carroll, Christopher D, and Miles S Kimball. 2001. "Liquidity constraints and precautionary saving." Technical report, National Bureau of Economic Research.
- Carroll, Christopher D, and Andrew A Samwick. 1997. "The nature of precautionary wealth." *Journal of monetary Economics* 40 (1): 41–71.
- Carroll, Christopher Dixon. 2001. "Death to the log-linearized consumption Euler equation!(And very poor health to the second-order approximation)." *The BE Journal of Macroeconomics* 1 (1).
- Carroll, Christopher, Jiri Slacalek, Kiichi Tokunaka, and Matthew N White. 2017. "The distribution of wealth and the marginal propensity to consume." *Quantitative Economics* 8 (3): 977–1020.
- Challe, Edouard, and Xavier Ragot. 2016. "Precautionary saving over the business cycle." *The Economic Journal* 126 (590): 135–164.
- Christelis, Dimitris, Dimitris Georgarakos, Tullio Jappelli, and Maarten van Rooij. 2020. "Consumption uncertainty and precautionary saving." *Review of Economics and Statistics* 102 (1): 148–161.
- Coibion, Olivier, Dimitris Georgarakos, Yuriy Gorodnichenko, and Michael Weber. 2020. "Forward guidance and household expectations." Technical report, National Bureau of Economic Research.
- Coibion, Olivier, and Yuriy Gorodnichenko. 2012. "What can survey forecasts tell us about information rigidities?" *Journal of Political Economy* 120 (1): 116–159.
- Crawley, Edmund, Martin Holm, and Hakon Tretvoll. 2022. "A Parsimonious Model of Idiosyncratic Income."
- Davis, Steven J, and Till M Von Wachter. 2011. "Recessions and the cost of job loss." Technical report, National Bureau of Economic Research.
- De Nardi, Mariacristina. 2015. "Quantitative models of wealth inequality: A survey."
- Delavande, Adeline, Xavier Giné, and David McKenzie. 2011. "Measuring subjective expectations in developing countries: A critical review and new evidence." *Journal of development economics* 94 (2): 151–163.
- Den Haan, Wouter J, Pontus Rendahl, and Markus Riegler. 2018. "Unemployment (fears) and deflationary spirals." *Journal of the European Economic Association* 16 (5): 1281–1349.
- Druehl, Jeppe, Thomas Jørgensen, and Michael Graber. 2021. "High Frequency Income Dynamics." Available at SSRN 3816424.
- Dynan, Karen, Douglas Elmendorf, and Daniel Sichel. 2012. "The evolution of household income volatility." *The BE Journal of Economic Analysis & Policy* 12 (2).
- Engelberg, Joseph, Charles F Manski, and Jared Williams. 2009. "Comparing the point predictions and subjective probability distributions of professional forecasters." *Journal of Business & Economic Statistics* 27 (1): 30–41.
- Epper, Thomas, Ernst Fehr, Helga Fehr-Duda, Claus Thustrup Kreiner, David Dreyer Lassen, Søren Leth-Petersen, and Gregers Nytoft Rasmussen. 2020. "Time discounting and wealth inequality." *American Economic Review* 110 (4): 1177–1205.
- Flavin, Marjorie A. 1988. "The Excess Smoothness of Consumption: Identification and Interpretation." Working Paper 2807, National Bureau of Economic Research.

- Fuhrer, Jeffrey C. 2018. "Intrinsic expectations persistence: evidence from professional and household survey expectations."
- Fujita, Shigeru, and Garey Ramey. 2009. "The cyclicalities of separation and job finding rates." *International Economic Review* 50 (2): 415–430.
- Fuster, Andreas, Greg Kaplan, and Basit Zafar. 2020. "What Would You Do with \$500? Spending Responses to Gains, Losses, News, and Loans." *The Review of Economic Studies*. rdaa076.
- Gottschalk, Peter, Robert Moffitt, Lawrence F Katz, and William T Dickens. 1994. "The growth of earnings instability in the US labor market." *Brookings Papers on Economic Activity* 1994 (2): 217–272.
- Gourinchas, Pierre-Olivier, and Jonathan A Parker. 2002. "Consumption over the life cycle." *Econometrica* 70 (1): 47–89.
- Guiso, Luigi, Tullio Jappelli, and Daniele Terlizzese. 1992. "Earnings uncertainty and precautionary saving." *Journal of Monetary Economics* 30 (2): 307–337.
- Guvenen, Fatih. 2007. "Learning your earning: Are labor income shocks really very persistent?" *American Economic Review* 97 (3): 687–712.
- Guvenen, Fatih. 2009. "An empirical investigation of labor income processes." *Review of Economic Dynamics*: 22.
- Guvenen, Fatih. 2011. "Macroeconomics with heterogeneity: A practical guide."
- Guvenen, Fatih, Fatih Karahan, Serdar Ozkan, and Jae Song. 2019. "What Do Data on Millions of US Workers Reveal about Life-Cycle Earnings Dynamics?" Technical report, Federal Reserve Bank of New York.
- Guvenen, Fatih, Fatih Karahan, Serdar Ozkan, and Jae Song. 2021. "What do data on millions of US workers reveal about lifecycle earnings dynamics?" *Econometrica* 89 (5): 2303–2339.
- Guvenen, Fatih, Serdar Ozkan, and Jae Song. 2014. "The nature of countercyclical income risk." *Journal of Political Economy* 122 (3): 621–660.
- Harmenberg, Karl, and Erik Öberg. 2021. "Consumption dynamics under time-varying unemployment risk." *Journal of Monetary Economics* 118: 350–365.
- Heathcote, Jonathan, and Fabrizio Perri. 2018. "Wealth and volatility." *The Review of Economic Studies* 85 (4): 2173–2213.
- Huggett, Mark. 1993. "The risk-free rate in heterogeneous-agent incomplete-insurance economies." *Journal of economic Dynamics and Control* 17 (5-6): 953–969.
- Huggett, Mark. 1996. "Wealth distribution in life-cycle economies." *Journal of Monetary Economics* 38 (3): 469–494.
- Jäger, Simon, Christopher Roth, Nina Roussille, and Benjamin Schoefer. 2022. "Worker beliefs about outside options." Technical report, National Bureau of Economic Research.
- Kaplan, Greg, Benjamin Moll, and Giovanni L Violante. 2018. "Monetary policy according to HANK." *American Economic Review* 108 (3): 697–743.
- Kaplan, Greg, and Giovanni L Violante. 2010. "How much consumption insurance beyond self-insurance?" *American Economic Journal: Macroeconomics* 2 (4): 53–87.
- Kaplan, Greg, and Giovanni L Violante. 2014. "A model of the consumption response to fiscal stimulus payments." *Econometrica* 82 (4): 1199–1239.
- Kaplan, Greg, and Giovanni L Violante. 2018. "Microeconomic heterogeneity and macroeco-

- conomic shocks.” *Journal of Economic Perspectives* 32 (3): 167–94.
- Kaplan, Greg, and Giovanni L Violante. 2022. “The Marginal Propensity to Consume in Heterogeneous Agent Models.” Technical report, National Bureau of Economic Research.
- Kaplan, Greg, Giovanni L Violante, and Justin Weidner. 2014. “The Wealthy Hand-to-Mouth.” *Brookings Papers on Economic Activity*: 77–138.
- Kaufmann, Katja, and Luigi Pistaferri. 2009. “Disentangling insurance and information in intertemporal consumption choices.” *American Economic Review* 99 (2): 387–92.
- Kimball, Miles S. 1990. “Precautionary Saving in the Small and in the Large.” *Econometrica* 58 (1): 53–73.
- Koşar, Gizem, and Wilbert Van der Klaauw. 2022. “Workers’ Perceptions of Earnings Growth and Employment Risk.” *Unpublished paper*.
- Krueger, Dirk, Kurt Mitman, and Fabrizio Perri. 2016. “Macroeconomics and household heterogeneity.” In *Handbook of Macroeconomics*, vol. 2, 843–921: Elsevier.
- Krusell, Per, and Anthony A Smith, Jr. 1998. “Income and wealth heterogeneity in the macroeconomy.” *Journal of political Economy* 106 (5): 867–896.
- Low, Hamish, Costas Meghir, and Luigi Pistaferri. 2010. “Wage risk and employment risk over the life cycle.” *American Economic Review* 100 (4): 1432–67.
- MaCurdy, Thomas E. 1982. “The use of time series processes to model the error structure of earnings in a longitudinal data analysis.” *Journal of econometrics* 18 (1): 83–114.
- Mankiw, N Gregory, Ricardo Reis, and Justin Wolfers. 2003. “Disagreement about inflation expectations.” *NBER macroeconomics annual* 18: 209–248.
- Manski, Charles F. 2004. “Measuring expectations.” *Econometrica* 72 (5): 1329–1376.
- Manski, Charles F. 2018. “Survey measurement of probabilistic macroeconomic expectations: progress and promise.” *NBER Macroeconomics Annual* 32 (1): 411–471.
- McKay, Alisdair. 2017. “Time-varying idiosyncratic risk and aggregate consumption dynamics.” *Journal of Monetary Economics* 88: 1–14.
- Meghir, Costas, and Luigi Pistaferri. 2004. “Income variance dynamics and heterogeneity.” *Econometrica* 72 (1): 1–32.
- Meghir, Costas, and Luigi Pistaferri. 2011. “Earnings, consumption and life cycle choices.” In *Handbook of labor economics*, vol. 4, 773–854: Elsevier.
- Moffitt, Robert A. 2020. “Reconciling trends in us male earnings volatility: Results from a four data set project.” Technical report, National Bureau of Economic Research.
- Moffitt, Robert A, and Peter Gottschalk. 2002. “Trends in the transitory variance of earnings in the United States.” *The Economic Journal* 112 (478): C68–C73.
- Moore, Jeffrey C. 2008. “Seam bias in the 2004 SIPP panel: Much improved, but much bias still remains.” *US Census Bureau Statistical Research Division Survey Methodology Research Report Series* 3: 2008.
- Mueller, Andreas, and Johannes Spinnewijn. 2021. “Expectations data, labor market and job search.” *Handbook Chapter (Draft)*.
- Nekarda, Christopher J. 2008. “Weekly Time Series of the US Labor Market.” *Unpublished paper*, University of California, San Diego.
- Parker, Jonathan A, and Bruce Preston. 2005. “Precautionary saving and consumption fluctua-

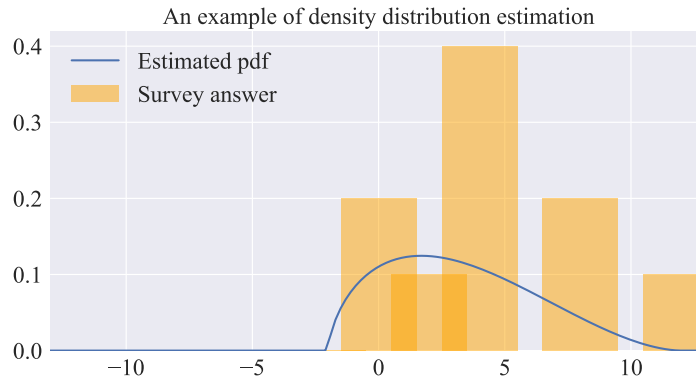
- tions.” *American Economic Review* 95 (4): 1119–1143.
- Pischke, Jörn-Steffen. 1995. “Individual income, incomplete information, and aggregate consumption.” *Econometrica: Journal of the Econometric Society*: 805–840.
- Pistaferri, Luigi. 2001. “Superior information, income shocks, and the permanent income hypothesis.” *Review of Economics and Statistics* 83 (3): 465–476.
- Primiceri, Giorgio E, and Thijs Van Rens. 2009. “Heterogeneous life-cycle profiles, income risk and consumption inequality.” *Journal of monetary Economics* 56 (1): 20–39.
- Ravn, Morten O, and Vincent Sterk. 2017. “Job uncertainty and deep recessions.” *Journal of Monetary Economics* 90: 125–141.
- Ravn, Morten O, and Vincent Sterk. 2021. “Macroeconomic fluctuations with HANK & SAM: An analytical approach.” *Journal of the European Economic Association* 19 (2): 1162–1202.
- Reis, Ricardo. 2006. “Inattentive consumers.” *Journal of monetary Economics* 53 (8): 1761–1800.
- Ríos-Rull, José-Víctor. 1996. “Life-cycle economies and aggregate fluctuations.” *The Review of Economic Studies* 63 (3): 465–489.
- Rips, Lance J, Frederick G Conrad, and Scott S Fricker. 2003. “Straightening the seam effect in panel surveys.” *Public Opinion Quarterly* 67 (4): 522–554.
- Rozsypal, Filip, and Kathrin Schlafmann. 2023. “Overpersistence Bias in Individual Income Expectations and its Aggregate Implications.” *American Economic Journal: Macroeconomics*.
- Ryscavage, Paul. 1993. “The Seam Effect in SIPP’s Labor Force Data: Did the Recession Make it Worse?” Technical report, SIPP working paper.
- Sabelhaus, John, and Jae Song. 2010. “The great moderation in micro labor earnings.” *Journal of Monetary Economics* 57 (4): 391–403.
- Stephens Jr, Melvin. 2004. “Job loss expectations, realizations, and household consumption behavior.” *Review of Economics and statistics* 86 (1): 253–269.
- Stoltenberg, Christian A, and Arne Uhlenborff. 2022. “consumption choices and earnings expectations: empirical evidence and structural estimation.”
- Storesletten, Kjetil, Chris I Telmer, and Amir Yaron. 2004. “Cyclical dynamics in idiosyncratic labor market risk.” *Journal of political Economy* 112 (3): 695–717.
- Wang, Neng. 2004. “Precautionary saving and partially observed income.” *Journal of Monetary Economics* 51 (8): 1645–1681.
- Wang, Tao. 2022. “How Do Agents Form Inflation Expectations? Evidence from the Forecast Uncertainty.” *Unpublished paper, Johns Hopkins University*.

Appendix A. Online Appendix

A.1. Density estimation of survey answers

With the histogram answers for each individual in hand, I follow [Engelberg, Manski, and Williams \(2009\)](#) to fit each of them with a parametric distribution accordingly for three following cases. (See Figure A.1 for an example.) In the first case, when there are three or more intervals filled with positive probabilities, it was fitted with a generalized beta distribution. In particular, if there is no open-ended bin on the left or right, then a two-parameter beta distribution is sufficient. If there is an open-ended bin with positive probability on either left or right, since the lower bound or upper bound of the support needs to be determined, a four-parameter beta distribution is estimated. In the second case, in which there are exactly two adjacent intervals with positive probabilities, it is fitted with an isosceles triangular distribution. In the third case, if there is only one positive-probability of interval only, i.e. equal to one, it is fitted with a uniform distribution.

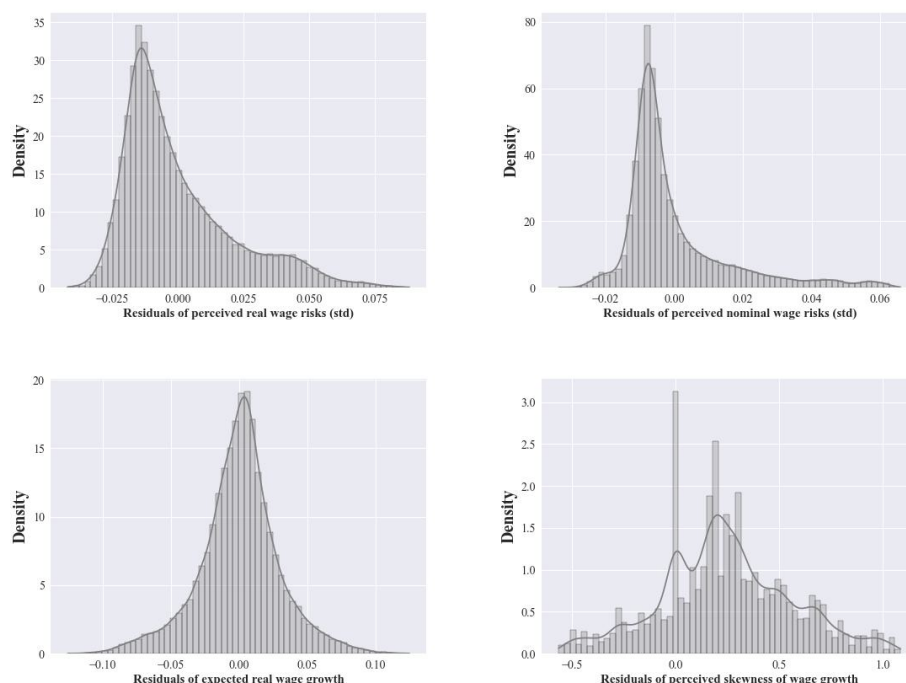
FIGURE A.1. An illustration of the density estimation of the survey answer



Note: This is one example of the bin-based forecast of wage growth in SCE and how it is fit by a parametric distribution. The horizontal axis is the values of expected wage growth and the vertical axis is the probability assigned by the respondent.

For all the moment's estimates, there are inevitably extreme values. This could be due to the idiosyncratic answers provided by the original respondent, or some non-convergence of the numerical estimation program. Therefore, for each moment of the

FIGURE A.2. Dispersion in Expected Wage Growth and Perceived Skewness



Note: The distributions of residuals of nominal PR (in standard deviation terms), expected nominal and real wage growth rates, and perceived skewness of 1-year-ahead wage growth in SCE unexplained by observable demographic variables.

analysis, I exclude top and bottom 1% observations, leading to a sample size of around 53,180.

A.2. Other facts about PR

A.2.1. Heterogeneity of expectations in other moments

Figure A.2 shows the within-group heterogeneity of real PRs, nominal PRs, expected real wage growth rates, and perceived skewness controlling for observable demographic variables in SCE.

A.2.2. Time-varying patterns of PRs

Figure A.3 plots the time-varying 1-year-ahead perceived risks and corresponding realizations of the risks of the total, permanent and transitory wage components, based on the estimates of SIPP data. Under correct model specification and FIRE of the agents, one may expect the PRs and estimated risk to be, if not equal, at least comove with each other. But the results suggest a negligible correlation between the two series. It is also obvious that the magnitudes of the PRs are significantly lower than the estimated risk using SIPP, reinforcing the finding in Section 4.1. For instance, the latter, which is based on the full sample, should be 10% in standard deviation a year, while the average earning risk perception in *SCE* is only 2%.

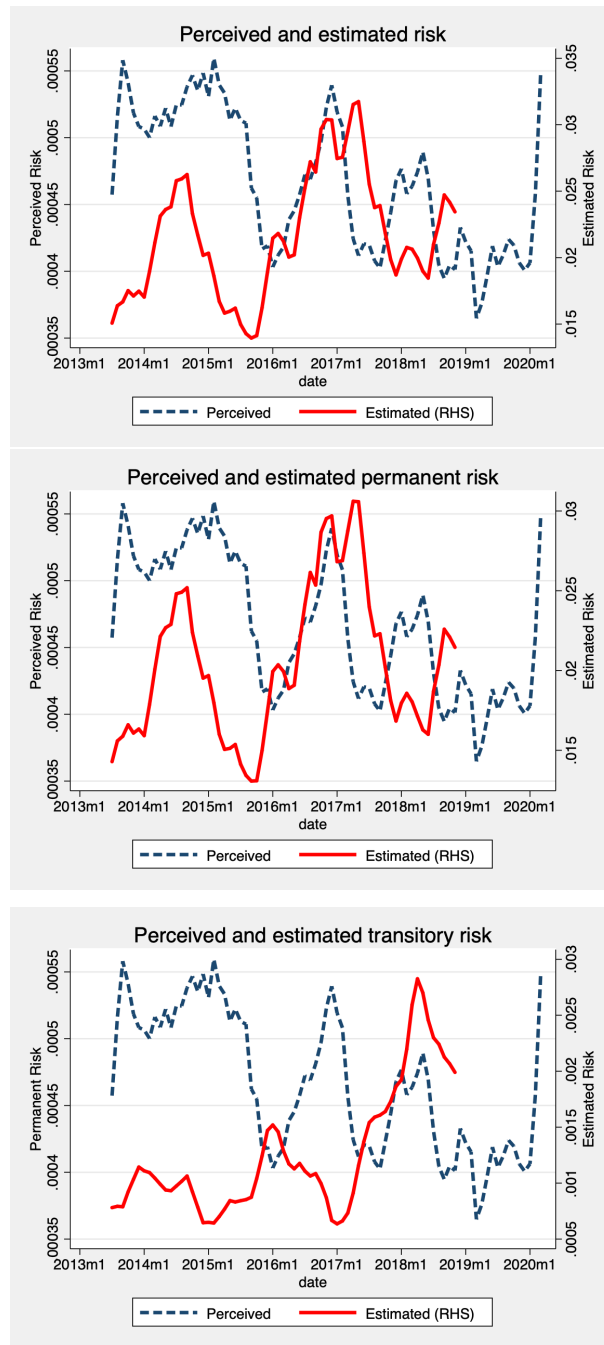
A.3. Wage risk estimation using SIPP data

A.3.1. Sample selection

To estimate the wage risks, or risks to the earning conditional on working for the same hours and staying in the same job, I restrict the universe of the SIPP sample according to this definition for the worker's primary job (JB1). The specific filtering criteria is listed as below, and it is approximately identical to that in [Low, Meghir, and Pistaferri \(2010\)](#) for computing the wage rate of the same job using 1993 panel of SIPP.

- Time: January 2013-December 2020
- Age: 20 - 60
- Work-arrangement: employed by someone else (excluding self-employment and other work-arrangement): `EJB1_JBORSE == 1`.
- Employer: staying with the same employer for a tenure longer than 4 months: the same `EJB1_JOBID` for 4 or more consecutive months.
- Wage: total monthly earning from the primary job divided by the average number of hours worked in the same job, $\text{wage} = \text{TJB1_MSUM} / \text{TJB1_MWKHS}$.
- Outliers: drop observations with wage rate lower than 0.1 or greater than 2.5 times of the individual's average wage.
- No days off from work without pay: `EJB1_AWOP1 = 2`.
- Continued job spell since December of the last year: `RJB1_CFLG = 1`.

FIGURE A.3. Perceived versus Estimated Risks over Time



Note: Median 1-year-ahead perceived wage risks (in variance terms) in the whole SCE sample against the estimated total, permanent, and transitory risks over the *same* period. Both series concern real wage growth. The realized risks are first estimated monthly from SIPP and then aggregated into annual frequency.

- Drop imputed values: EINTTYPE==1 or 2.
- Drop government/agriculture jobs: drop if TJB1_IND>=9400.

Based on the selected sample, Table A.1 reports the size and approximated group-specific wage volatility as defined in Equation 4.

TABLE A.1. Summary statistics of SIPP sample

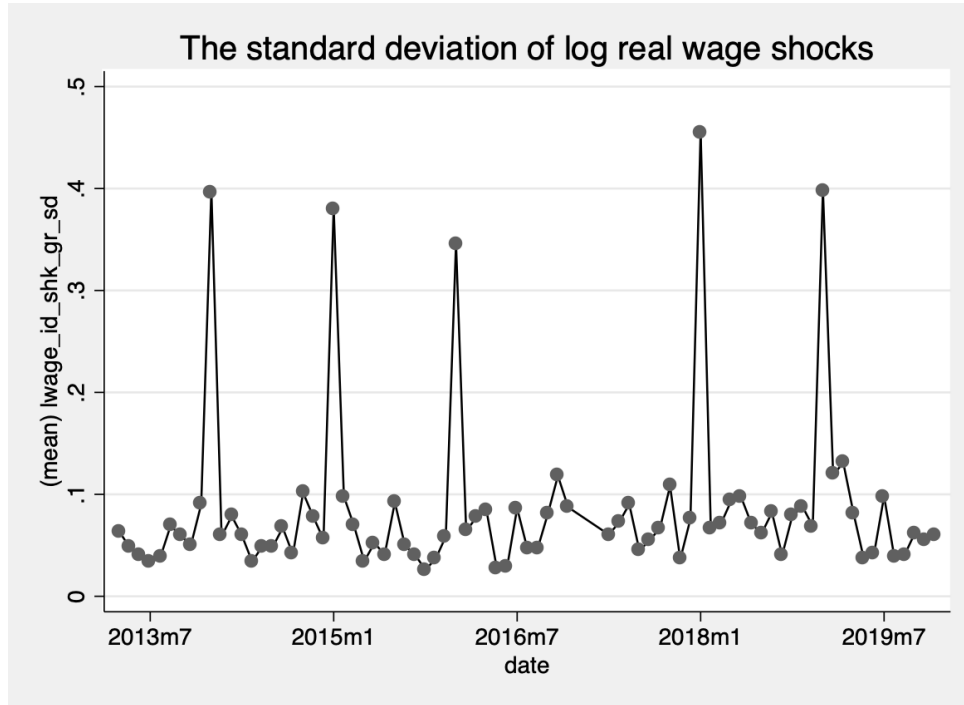
	Obs	Volatility
Year		
2013 (17%)	9,815	0.06
2014 (20%)	12,672	0.11
2015 (15%)	9,543	0.1
2016 (9%)	6,128	0.11
2017 (13%)	7,533	0.07
2018 (15%)	9,378	0.13
2019 (8%)	5,507	0.12
Education		
HS dropout (22%)	13,846	0.09
HS graduate (46%)	28,385	0.1
College/above (30%)	18,345	0.12
Gender		
male (55%)	33,842	0.1
female (44%)	26,734	0.11
Full sample (100%)	60,576	0.1

A.3.2. SEAM Effect

One special feature of SIPP is that it collects monthly information by surveying each correspondent every four months before the 2013 wave and once a year afterward (since 2014 wave). This leads to the well-documented issue of SEAM effect (Ryscavage 1993; Rips, Conrad, and Fricker 2003; Nekarda 2008; Callegaro 2008), which states that reported changes in survey answers are relatively small for adjacent months within a survey wave but much more abrupt between months across surveys. Such a difference could be either due to underreporting of changes within a reference period (due to reasons such as the recall bias) or overreporting of changes across reference periods.

This effect is clearly seen from the time series plot of monthly wage volatility in Figure A.4, where there is always a spike in the size of volatility between December to January in the sample period.⁵⁴

FIGURE A.4. Estimated monthly wage volatility



Note: The monthly wage volatility as defined in Equation 4 for the entire selected sample, estimated from SIPP.

Because of this issue, for monthly risk estimation, I exclude the December-January observations, leading to non-identification of the risks of each January. By doing so, I basically assume that within-wave respondents do not underreport true changes to the wages, while the cross-wave answers overreport these changes. But the opposite assumption might be true, in that respondents underreport changes within the reference year when they retroactively answer survey questions, and the changes across reference periods are correctly reported.

One way to incorporate the cross-wage changes instead of dropping them by brutal force is to estimate risks at a lower frequency, i.e. quarterly and yearly, and construct

⁵⁴Note that the only exception is January 2017, for which no monthly growth rate is not available due to reshuffling of the SIPP sample.

the quarterly/yearly period such that it covers the cross-wave cutoff month December. Figure A.7 and A.8 in section A.4.3 plot the time-varying risks estimated for quarterly and annual frequency, respectively.

A.4. Wage risk estimation under alternative assumptions

A.4.1. Baseline estimation

Permanent and transitory risks are identified via the following moment restrictions.

$$\begin{aligned}
 (A1) \quad & \text{var}(\Delta e_{i,t}) = \text{var}(\psi_t + \theta_t - \theta_{t-1}) = \sigma_{\psi,t}^2 + \sigma_{\theta,t}^2 + \sigma_{\theta,t-1}^2 \\
 & \text{cov}(\Delta e_{i,t}, \Delta e_{i,t+1}) = \text{cov}(\psi_t + \theta_t - \theta_{t-1}, \psi_{t+1} + \theta_{t+1} - \theta_{i,t}) = -\sigma_{\theta,t}^2 \\
 & \text{cov}(\Delta e_{i,t-1}, \Delta e_{i,t}) = \text{cov}(\psi_{t-1} + \theta_t - \theta_{t-1}, \psi_t + \theta_{i,t} - \theta_{i,t-1}) = -\sigma_{\theta,t-1}^2
 \end{aligned}$$

With four years of wage of individual i from $t-2$ to t , hence three years of first difference Δw , the above three equations can exactly identify the permanent risk specific to time t , $\sigma_{\psi,t}$ and the time-specific transitory risk $\sigma_{\theta,t}$ and $\sigma_{\theta,t-1}$.

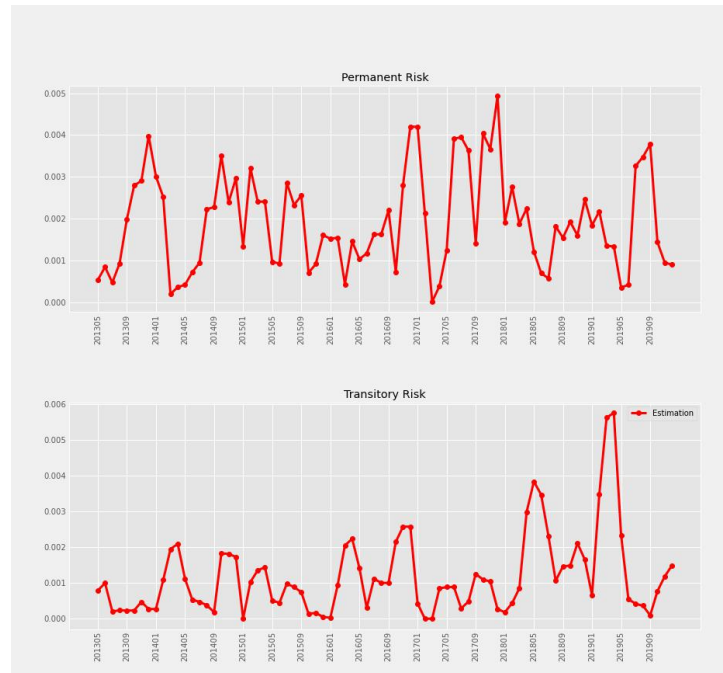
Three years of wage data is sufficient under a slightly looser restriction that the transitory risks stay constant over each 3-year horizon, between $t-1$ and $t+1$, call it $\bar{\sigma}_{\theta,t}$. In particular, we have the following identification. With wage growth in year 2014, 2015, 2016, and 2018, 2019, I can identify the year-specific permanent risks for 2014, 2015, 2016, 2018, and 2019, and the average transitory risks for 2014-2016 and 2017-2019, as shown in Figure A.7.

$$\begin{aligned}
 (A2) \quad & \text{var}(\Delta w_{i,t}) = \text{var}(\psi_t + \theta_t - \theta_{t-1}) = \sigma_{\psi,t}^2 + 2\bar{\sigma}_{\theta,t}^2 \\
 & \text{cov}(\Delta w_{i,t}, \Delta w_{i,t+1}) = \text{cov}(\Delta w_{i,t-1}, \Delta w_{i,t}) = -\bar{\sigma}_{\theta,t}^2
 \end{aligned}$$

A.4.2. Evidence for the infrequent arrival of the wage shocks

The baseline income process specified as in Equation 2 has been commonly adopted for annual or at most quarterly income/wage data in the literature. But some recent work such as Druedahl, Jørgensen, and Graber (2021) shows that income dynamics at a higher frequency, i.e. monthly, require a modification to such a process to be more consistent with the data. In particular, the authors allow for infrequent arrivals of both transitory and permanent shocks. The assumption of infrequent shocks is primarily

FIGURE A.5. Monthly permanent and transitory income risks



Note: The 3-month moving average of the estimated monthly permanent and transitory risks (variance) using the SIPP panel data on wages between 2013m1-2019m12.

motivated by the observed pattern (as confirmed in Figure A.6 using nominal wage growth in SIPP) that a sizable mass of individual monthly wage growth is concentrated around zero.

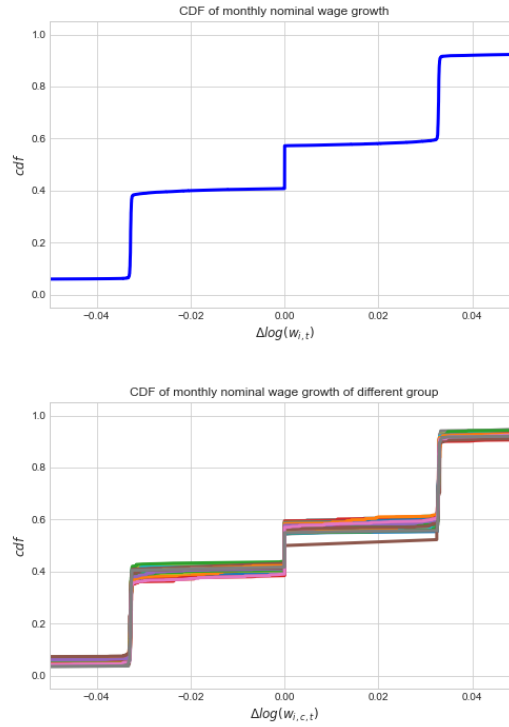
A.4.3. Estimated risks at a lower frequency

Most of the income risk estimation in the literature is done at a lower frequency, such as yearly and quarterly. Figure A.7 plots the estimated time-varying permanent and transitory risks using the annual growth of the average wage of each year in the sample.⁵⁵ Due to the reshuffling of the entire SIPP sample in 2017, no annual wage growth rate can be calculated in 2017, hence, the permanent risks of 2017 and the transitory risks of its adjacent years are unable to be identified.

For the years with identified risks, the estimated risks at annual frequency seem to be much larger than that commonly seen in the literature, as summarized in Table A.2.

⁵⁵A similar size of estimates is obtained when YOY growth of monthly wage is used.

FIGURE A.6. CDF of monthly wage growth



Note: The cumulative distribution function of the monthly wage growth from SIPP for the whole sample (left) and by the gender-education-age-specific group (right).

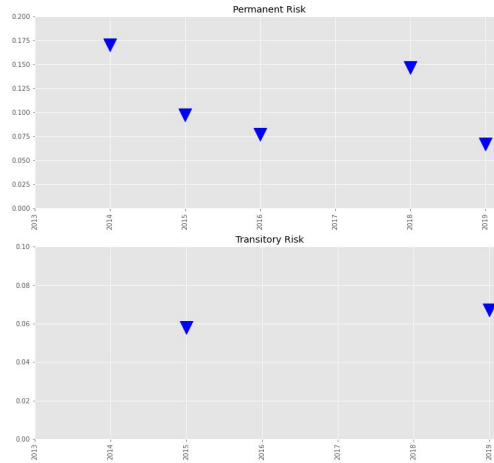
In particular, the size of the permanent shock ranges from 27% to 41%, in contrast to the standard estimation of 10-15%. And the transitory risks are estimated to be around 25%, which also exceeds the standard estimates of 10% to 20%.

A similar issue can be seen from quarterly estimates using quarterly growth of average wage rates. (See Figure A.8) Reminiscent of the seasonal spike in the monthly volatility in January, there is a similar spike in the first quarter of every year in the sample.

A.5. Homogenous and heterogeneous life-cycle wage profiles

Figure A.9 plots the deterministic wage profile used to calibrate the baseline model, which is estimated from SIPP for job-stayers. Figure A.10 plots the heterogeneous wage profiles used in the model experiment of *HPRURG*, which is calibrated based on the

FIGURE A.7. Yearly permanent and transitory wage risks



Note: The estimated yearly permanent and transitory risks (variance) using the SIPP panel data on wages between 2013m1-2019m12.

heterogeneous wage growth rates reported in SCE.

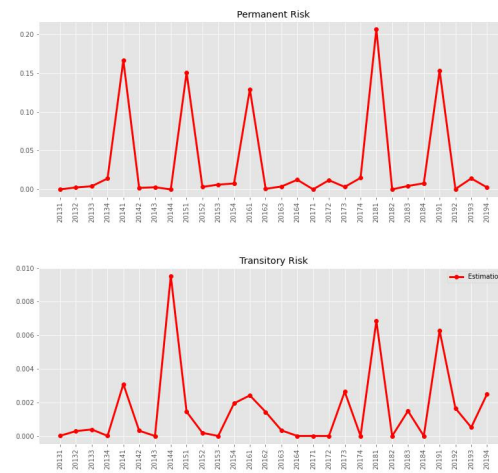
A.6. Calibration heterogeneous income risks/growth rates using the survey

In addition to fitting a truncated log-normal distribution to the heterogeneous PRs, I also calibrated the heterogeneity in perceived job finding probability, job separation probability and expected wage growth rates in the same manner. (See Figure A.11 for the illustration)

A.7. Income risks in the existing literature

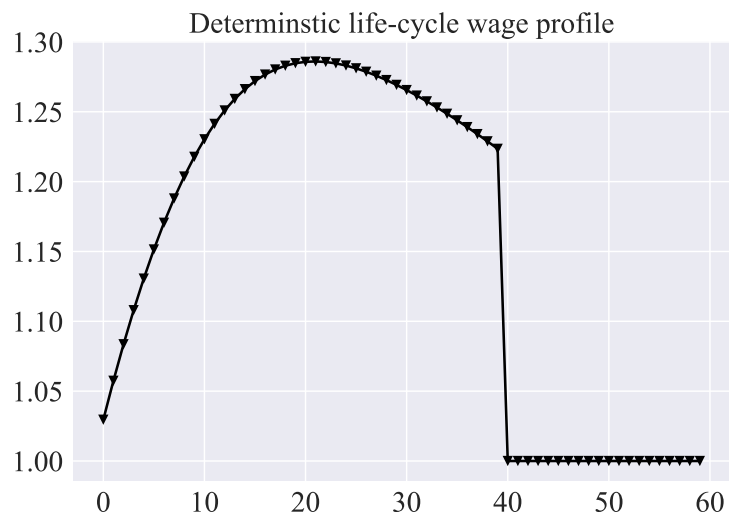
Table A.2 summarizes the most common estimates of income risks seen in the literature.

FIGURE A.8. Quarterly permanent and transitory wage risks



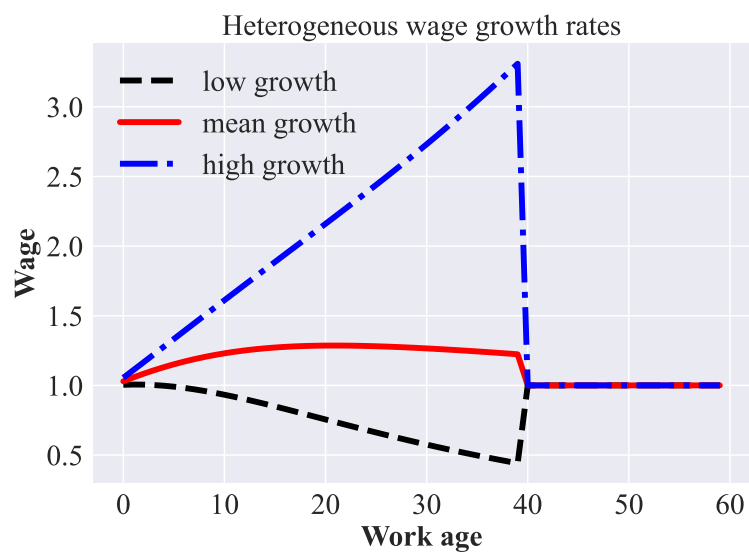
Note: The estimated quarterly permanent and transitory risks (variance) using the SIPP panel data on wages between 2013m1-2019m12.

FIGURE A.9. Estimated deterministic wage profile over the life-cycle



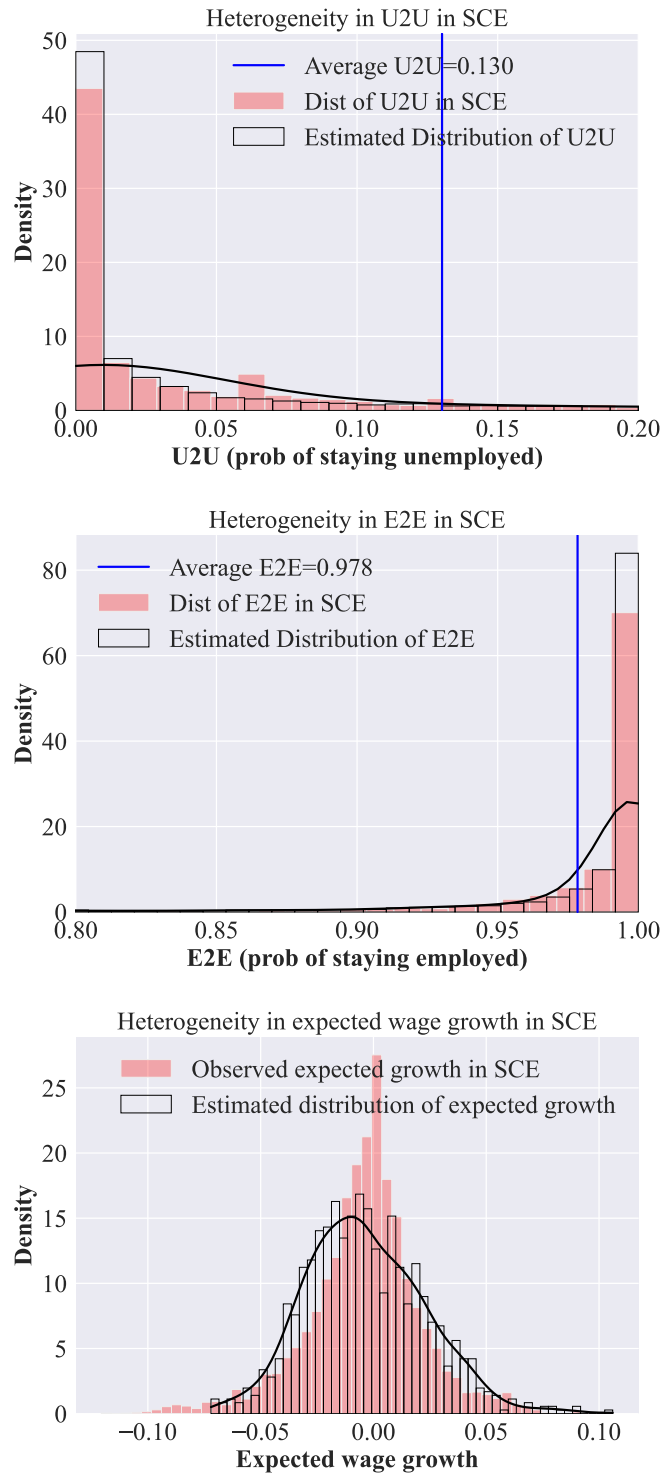
Note: The estimated average age profile of real earnings using SIPP between 2013m3-2019m12. It is based on a regression of fourth-order age polynomials controlling for time, education, occupations, gender, etc.

FIGURE A.10. Heterogeneous wage profiles over the life-cycle



Note: The heterogeneous deterministic wage profiles implied by the heterogeneous wage growth rates. This is used to calibrate the *HPRURG* model.

FIGURE A.11. Calibration of heterogeneous UE risks and wage growth rates from the SCE



This figure illustrates the calibration of unemployment risks, and wage growths using SCE.

TABLE A.2. The size and nature of idiosyncratic income risks in the literature

	σ_ψ	σ_θ	$\bar{\psi}$	E	Earning Process	Unemployment	Source
Huggett (1996)	[0.21, +]	N/A	N/A	N/A	AR(1)	No	Page 480
Krusell and Smith (1998)	N/A	N/A	[0.04, 0.1]	[0.9, 0.96]	N/A	Persistent	Page 876
Cagetti (2003)	[0.264, 0.348]	N/A	N/A	N/A	Random +MA innovations	No	Page 344
Gourinchas and Parker (2002)	[0.108, 0.166]	[0.18, 0.256]	0.003	0.997	Permanent +transitory	Transitory	Table 1
Meghir and Pistaferri (2004)	0.173	[0.09, 0.21]	N/A	N/A	Permanent +MA	No	Table 3
Storesletten, Telmer, and Yaron (2004)	[0.094; +]	0.255	N/A	N/A	Persistent + transitory	No	Table 2
Blundell, Pistaferri, and Preston (2008)	[0.1, +]	[0.169, +]	N/A	N/A	Permanent + MA	No	Table 6
Low, Meghir, and Pistaferri (2010)	[0.095, 0.106]	0.08	0.028	N/A	Permanent+transitory with job mobility	Persistent	Table 1
Kaplan and Violante (2014)	0.11	N/A	N/A	N/A	Persistent	No	Page 1220
Krueger, Mitman, and Perri (2016)	[0.196, +]	0.23	[0.046, 0.095]	[0.894, 0.95]	Persistent +transitory	Persistent	Page 26
Carroll et al. (2017)	0.10	0.10	0.07	0.93	Permanent+transitory	Transitory	Table 2
Bayer et al. (2019)	0.148	0.693	N/A	N/A	Persistent time+MA	No	Table 1
My Estimates based on SIPP	0.10	0.016	N/A	N/A	Permanent +transitory	No	Table A.1

The conservative (lower bound) estimates/parameterization on idiosyncratic income risks at the annual frequency seen in the literature.