

ESSAYS IN MACROECONOMICS AND HETEROGENEITY

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A DISSERTATION

in

Economics

Presented to the Faculties of the University of Pennsylvania

in

Partial Fulfillment of the Requirements for the

Degree of Doctor of Philosophy

2023

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Jincheng Huang

To my parents and grandparents.

ACKNOWLEDGEMENT

I am greatly indebted to my advisor, José-Víctor Ríos-Rull, for his generous mentorship and continuous support. Throughout my PhD journey, I have always been inspired by Víctor's encouragement to think outside the box, apply logic of economic thinking, and explore new perspectives on economic phenomena. I would also like to express my gratitude to my committee members, Dirk Krueger and Joachim Hubmer. Their second-year courses on household/firm heterogeneity and inequality have provided a solid foundation for my research approach, and their feedback during my lunch talks and meetings has been immensely helpful in refining my ideas. I am also grateful to Benjamin Keys at the Wharton School for funding me as his research assistant in my third year of PhD study.

I would also like to thank my trusted co-author and friend Xincheng Qiu, whose intelligence, perseverance and dedication to research has been instrumental in my academic life. Our joint work, which has now become my job market paper and the first chapter of my dissertation, has made significant progress since its inception, thanks to our countless and fruitful discussions. I have also benefited a lot from discussions with my peers, Sean McCrary, German Sanchez, Agustin Diaz Casanueva, Yoshiki Ando and Min Kim.

I owe a lot to Kelly Quinn, Gina Conway, Sandra Venne and Emily Romanello, the staff members of our department, for their assistance with everything in the PhD program, ranging from first-year entrance to the job market. Their helps have made life in the department much easier.

I should also thank my parents, whose unconditional support has enabled me to pursue my dream. I am tremendously thankful for the invaluable support of my partner, Cuimin Ba, who has been a constant source of strength and motivation during the challenging times. Last but not least, I thank my cat Melody for bringing so much joy and happiness into my life.

ABSTRACT

ESSAYS IN MACROECONOMICS AND HETEROGENEITY

Eric Huang

José-Víctor Ríos-Rull

This thesis centers around two closely related themes: the macroeconomic consequences of inequality, and the consumption-savings behavior of households at the lower end of the wealth distribution.

The first chapter studies how wealth affects the extent to which the “right” workers are matched with the “right” jobs in the labor market. Empirical analyses based on NLSY79 and O*NET shows that wealth-poor workers are more mismatched with their jobs. A model featuring worker and firm heterogeneity, search frictions, and incomplete markets is then developed to study the macroeconomic implications of this phenomenon. Workers and firms jointly face a trade-off between the speed and payoff of forming a match. A lack of wealth induces workers to trade off wages for faster job-finding due to precautionary motives, which in turn offers a wider range of firms the incentive to match. This phenomenon is referred to as “precautionary mismatch”. The calibrated model shows three main results. First, there are substantial earnings and productivity disparities between wealth-rich and wealth-poor workers of the same productivity type, especially for high-skilled workers. Second, total output would be 3% higher in the US if all employed workers were allocated to the right jobs. Finally, a counterfactual experiment through the lens of the model suggests that wealth transfers from incumbent workers to young labor market entrants reduce earnings and productivity dispersion within worker productivity types, improve sorting, and enhance labor productivity. Overall, most of the productivity increase can be attributed to reduced under-matches of high productivity type workers.

The second chapter highlights the link between the utilization of high-cost consumer credits by wealth-poor households and the risks associated with household expenditures. Using the PSID and the SCF, I document that households with very limited liquid wealth and available credit while

facing unexpected expenses are more likely to resort to high-cost credit options, such as payday loans. Furthermore, these unexpected expenses probably stem from specific spending categories, such as medical costs as well as vehicle and home repairs. For households at their borrowing constraints, occurrence of expenditure shocks tends to reduce consumption growth and savings rate, which impedes wealth accumulation. I discuss the role of expenditure shocks in models of consumption-savings and why they are crucial for understanding the demand for high-cost credits.

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CHAPTER 1

Precautionary Mismatch

This chapter is co-authored with Xincheng Qiu. I contribute to most of the empirical analysis, model computation, calibration and quantitative analysis, and part of the model construction and theoretical results.

1.1 Introduction

An important question in the study of labor markets is the determinants of sorting between workers and firms. A classical insight of Becker's theory of assortative matching is that under perfect labor market competition, workers of different levels of talent optimally match with firms of different productivity, resulting in an efficient allocation of talents. However, we live in a world where market frictions are pervasive and workers do not always find their ideal jobs. The inefficiency in labor allocation, which manifests itself as mismatches, can be exacerbated if other forms of market imperfections are present, such as incomplete financial markets.

There is growing empirical evidence that means of consumption insurance play an important role in workers' search decisions (e.g. Rendon (2006), Card et al. (2007), Chetty (2008), Lentz (2009), Herkenhoff et al. (2022), among many others). So far, research based on this finding has mostly been focused on how consumption insurance impacts workers' labor market outcomes. In this paper, we take a big step forward and study its implications on labor market allocations, determined by bilateral matching decisions of heterogeneous workers and heterogeneous firms. More precisely, we aim to study how wealth holdings, through the ability to self-insure, affect the extent to which the "right" workers are assigned to the "right" jobs, and consequently the allocative efficiency of the labor market. Answering this question calls for a framework with very rich heterogeneity.

To this end, we propose a framework with three key elements. First, there is ex-ante heterogeneity in productivity among workers and firms, so that sorting can be studied. Second, the labor market is frictional and meetings are random, so that it takes time for workers and jobs to find "good"

matches.¹ Third, workers are risk-averse and the financial market is incomplete, so that workers need to accumulate precautionary savings in order to self-insure against unemployment risk. Our framework organically nests three classes of canonical models in the macro and labor literature: an assignment model by Becker (1973), a Diamond-Mortensen-Pissarides search and matching model, and an incomplete markets model in the spirit of Bewley (1977), İmrohoroğlu (1989), Huggett (1993), and Aiyagari (1994).

The mechanism of our framework can be summarized by a tension between the efficiency of labor market assignment and workers' incentive to self-insure. Absent frictions, workers would efficiently sort into the "right" firms as in Becker's assignment model. However, due to search frictions, a trade-off exists between the speed of forming a match and the payoff from the match, resulting in an equilibrium where workers and jobs agree on a range of acceptable matches (i.e. mismatches) that deviate from the most efficient ones. In order to smooth consumption, wealth-poor workers are willing to find a job quickly at the cost of potentially lower payoff, thereby increasing the range of jobs that they accept. On the firm side, wages offered to wealth-poor workers (who are otherwise equally productive) are lower due to their lower bargaining positions, and the matches are thus profitable even if the firms are mismatched with the workers, thereby increasing the range of workers that are accepted by the firms. As a result, wealth-poor workers tend to deviate more from the efficient assignments. We refer to this phenomenon as "precautionary mismatch," as it reflects mismatches that occur due to workers' precautionary motives.

The mechanism at work in the model generates three key predictions. First, as a direct implication of the precautionary mismatch motive, the matching sets (worker-firm meetings that would result in successful matches) shrink with workers' wealth holdings. Second, wealth-poor workers have higher job finding rates since they are less picky about their job choices. Third, wealthier workers (of any productivity type) receive higher wages not only due to higher bargaining positions, but also due to smaller mismatch with firms.² Using the NLSY79 and O*NET data, we find empirical evidence

¹In reality, productivity types are hard to precisely observe ex-ante. Both sides face randomness in the types of counterparts they meet in the labor market, and that's why multiple interviews are needed before successful matches are formed. We believe that random search is a suitable framework to characterize this randomness.

²The second (i.e. mismatch) channel is novel and enables the model to generate more frictional wage dispersion,

supporting all three predictions.

In the calibration exercise, we match the model-implied relationships between wealth holdings and job finding rates as well as wages with their empirical counterparts from NLSY79. Then, using the calibrated model, we estimate the effect of wealth holdings on labor market allocations. We find that precautionary mismatch leads to pronounced earnings and productivity inequality between wealth-poor and wealth-rich workers of the same productivity type. In particular, among the highest-skilled group, the earnings gap and the productivity gap between workers in the 1st and the 99th wealth percentiles are 31.5% and 40.8% respectively. This suggests that there could be substantial gain in output if mismatched workers could be efficiently reallocated. Indeed, we estimate that total output from the labor market would be 3% higher if all workers were allocated to the “right” jobs.

Finally, we conduct a policy experiment through the lens of the model by implementing a permanent wealth transfer from incumbent workers, who tend to be wealthy, and distributed equally to young labor market entrants, who tend to be wealth-poor. We consider a quite generous payout worth of 0.5 year of average earnings in the baseline economy to each entering worker, but as the entry rate of new workers is low (1/45 of the population per year), the amount of taxes per capita needed to balance the budget is trivial. We find that over the long run, both within-type earnings and productivity inequality would shrink by over 20% with the policy, and aggregate labor productivity would increase by a modest 0.15%. Most of the productivity increase can be attributed to improved allocation of high-skilled workers: in the baseline economy, high-skilled young workers tend to be underemployed due to precautionary mismatch, and starting with a higher level of wealth enables them to be more thorough with job search and thus find higher productivity jobs.

This paper makes three major contributions. Our first contribution is theoretical: we provide a joint theory of wealth, wages and labor productivity. Specifically, we offer a novel perspective on the productivity effect of precautionary savings (or the lack thereof) through the lens of labor market (mis)allocation, which in turn shapes the wealth distribution as labor market outcomes feed which in turn leads to large savings rate heterogeneity and a wealth distribution that has a much thicker tail than earnings distribution, which is what we see in the data.

back into wealth accumulation. By incorporating two-sided labor market heterogeneity, our model provides a clear notion of the “right” workers for the “right” jobs and the cost of misallocation, which is absent in models without this feature. In the cross-section, our model also generates substantial wage dispersion due to workers’ heterogeneous job search strategies and bargaining positions at different wealth levels. In doing so we also contribute to the rapidly growing research agenda on the macroeconomic implications of micro-level heterogeneity and the rich interactions between distributions and the macroeconomy.

Our second contribution is empirical: we document the relationship between mismatch and worker wealth holdings. Following Lise and Postel-Vinay (2020) as well as Guvenen et al. (2020), we construct a measure of mismatch and find that it is negatively associated with wealth, even after controlling for a variety of confounding factors. In a companion paper (currently in progress), we aim to identify sorting based on unobserved heterogeneity using matched employer-employee data and revisit this relationship.

Our third contribution is methodological: we develop an efficient algorithm to compute a model with rich heterogeneity, in which the equilibrium depends on an infinite-dimensional object (i.e., distributions), both in and out of the steady state. We extend the state-of-the-art continuous time method developed by Achdou et al. (2022) designed for incomplete markets models to a setting with two-sided heterogeneity, frictional sorting and endogenous wages. Under the continuous-time formulation, the computation is recast as Mean Field Games so that the equilibrium conditions boil down to systems of partial differential equations. We derive a wage function that can be expressed by readily-computed equilibrium objects so that a guess-and-update procedure is avoided.³ We elaborate on the relation to the existing literature in the following subsection.

Related Literature

Theoretically, our paper contributes to equilibrium theories of labor search under incomplete markets. Early foundational works including Lentz and Tranæs (2005), Rendon (2006) and Chetty

³Krusell, Mukoyama and Şahin (2010) points out that computation of an equilibrium where assets enter Nash bargaining problem is difficult in discrete time.

(2008) study risk-averse workers’ optimal savings and search decisions under unemployment risks.⁴ Krusell, Mukoyama and Şahin (2010) builds a general equilibrium model integrating incomplete-markets into a Diamond-Mortensen-Pissarides framework, which is used to evaluate a tax-financed unemployment insurance scheme. Krusell, Luo and Ríos-Rull (2019) instead develops a directed search equilibrium model with richer risks and uses it to study employment flows over the business cycle.⁵ Caratelli (2022) studies job-to-job flows and wage growth across the wealth distribution following recessions. Other recent updates including Eeckhout and Sepahsalari (2018), Griffy (2021), Chaumont and Shi (2022) and Baley et al. (2022) introduce heterogeneous productivity on either the worker side or the firm side. Compared with those previous studies, we introduce two-sided productivity type heterogeneity, which allows us to study the effect of wealth on sorting and thus the allocative efficiency of labor. A contemporaneous paper by Herkenhoff et al. (2022) also studies an economy with risk-averse workers and two-sided heterogeneity. Our paper is complementary to theirs in that the two papers study different ways of self-insurance and differ fundamentally in the mechanisms that generate sorting.⁶ On the other hand, we also contribute to the literature on frictional sorting, including Shimer and Smith (2000), Gautier and Teulings (2006), Eeckhout and Kircher (2011) and Hagedorn, Law and Manovskii (2017), by allowing for self-insurance to affect sorting in an incomplete-markets setting. In a nutshell, our theory nests three strands of canonical models in the macroeconomics and labor literature: an assignment model as in Becker (1973), a Diamond-Mortensen-Pissarides search and matching model, and an incomplete-markets model as in Bewley (1977), İmrohoroğlu (1989), Huggett (1993) and Aiyagari (1994).

⁴Lise (2013) introduces on-the-job search and finds an important asymmetry of saving behavior between the incremental wage increases generated by on-the-job search and the drop in income associated with job loss. Luo and Mongey (2019) introduce amenities in the model so that assets holdings also affect non-wage utility of accepted jobs.

⁵See Ravn and Sterk (2021) for an analysis of the HANK&SAM model that combines incomplete asset markets, nominal rigidities and search and matching frictions.

⁶In Herkenhoff et al. (2022), wages are assumed to be a piece-rate of match-specific production, and each worker direct their search to firms of a certain productivity type. A logical prediction from their framework is that better consumption insurance induces all workers, regardless of their productivity, to search for higher productivity firms, generating ambiguous effects of sorting. In our framework, there is positive assortative matching due to competition among workers and firms – a classical insight from Becker (1973). Higher wealth holdings induce workers to find jobs closer to their own levels of productivity, as these are the “right” jobs from their own perspective. For low productivity workers, wages from high productivity firms can be lower than those offered by low productivity firms as the high productivity firms need to be compensated for the option value of waiting for better workers. We provide suggestive evidence of this prediction in Section 1.5.4.

Computationally, we develop a continuous-time technique based on Achdou et al. (2022), which applies the “Mean Field Games” theory in mathematics to cast rather complex optimization problems and equilibrium conditions in incomplete-markets models into systems of partial differential equations and a closed-form solution for wages that makes the model orders of magnitude more computationally tractable. In our model, the equilibrium depends on an infinite-dimensional distribution of worker and firms, and wages are a three-dimensional function of worker state variables. Computation of this model would be extremely costly in discrete time due to the curse of dimensionality. The continuous-time method not only enables us to compute the steady state efficiently, but also makes it possible to compute the model out of the steady state so that transitional dynamics can be studied.

Empirically, our paper is related to a large literature documenting relations between asset holdings and job search behavior (see, for example, Card et al. (2007), Rendon (2006), Lentz (2009), Chetty (2008), Herkenhoff et al. (2022), among many others). These papers show overwhelmingly that increasing the ability to smooth consumption, either through unemployment insurance, wealth or access to credit, leads to longer unemployment duration and higher accepted wages. These findings provide us with an important guidance to think about the implications of the observed search behavior in the context of labor market sorting. A natural prediction from a longer unemployment duration is that the match quality of unemployed workers with new jobs also increases. To our knowledge, we are the first paper to document the effect of worker asset holdings on mismatch following an unemployment spell. Our approach to measure worker-firm mismatch follows recent papers including Lise and Postel-Vinay (2020) and Guvenen et al. (2020), which also use observable worker and job characteristics from NLSY79 and O*NET to estimate skills mismatch and effects on wages.

The rest of the chapter is organized as follows. In Section 1.2, we describe the model and the algorithm to solve it. In Section 1.3, we discuss several key theoretical results regarding the connections between wealth, job search behavior and labor market outcomes. In Section 1.4, we describe the data sets we use for empirical analysis and the methods to estimate worker and firm types, and

present empirical evidence on the relationship between liquid wealth, skill mismatch and wages. In Section 1.5 we present model calibrations and quantitative exercises. Section 1.6 concludes.

1.2 Model

1.2.1 Environment

Time is continuous and there is no aggregate uncertainty. Without loss of generality, we assume that there is a unit measure of workers and jobs/firms in the steady state. Because of the nature of vacancy in our model, we use jobs and firms interchangeably in this paper.

Demography. We set up the demographic structure as in a perpetual youth model (Blanchard, 1985). Workers exit the economy stochastically at rate δ . Exiting workers are replaced by newborns that enters the economy in unemployment with zero asset. Workers draw their skill/productivity type $x \in \mathbb{X}$ from a probability density function $d_w(x)$, and x stays fixed throughout the lifetime.

Preference. Workers maximize expected present value according to a common discount rate ρ , and jobs maximize the present value of expected profits discounted at rate r , equal to the risk-free interest rate of the economy. Workers are risk averse with flow utility $u(c)$ and firms are risk neutral. The utility function $u(\cdot)$ exhibits common properties $u' > 0, u'' < 0$.

Production. Production happens when a worker successfully matches with a job. Upon entering the economy, jobs draw their productivity types $y \in \mathbb{Y}$ from a density function $d_j(y)$, and y stays fixed over time. The production function of a matched pair is denoted $f(x, y) : \mathbb{X} \times \mathbb{Y} \rightarrow \mathbb{R}_+$. We impose technical assumptions on f to guarantee existence of an equilibrium with assortative matching. Unemployed workers produce $b(x)$ (e.g., leisure, unemployment benefits, and home production). Assume $b(x) = b_0 \cdot f(x, \underline{y})$ where $b_0 \in [0, 1]$ where \underline{y} is the minimum of \mathbb{Y} .

Search and Matching. The labor market is frictional. Search and matching is random via a *meeting* function $M(u, v)$ that is constant returns to scale (CRS), where u denotes unemployment and v vacancies. We denote by $\theta = v/u$ the labor market tightness. Due to CRS, the meeting rate for an unemployed worker can be written as $p(\theta) := M(u, v)/u = M(1, \theta)$. Similarly, the meeting

rate for a vacancy can be written as $q(\theta) := M(u, v)/v = M(\theta^{-1}, 1)$. Note that $q(\theta) = p(\theta)/\theta$. The difference between *meetings* and successful *matches* is worth noting. Once a worker and a job meet, they can decide whether to start production or not. Some meetings may not end up with a successful match if the agents prefer to continue searching. Jobs are destroyed exogenously with a Poisson rate σ . In addition, at rate $\tilde{\sigma}$ workers receive the opportunity to quit voluntarily if they find it optimal. We abstract from on-the-job search. Wage is determined by Nash bargaining with worker bargaining power denoted η .

Incomplete Market. There is not a complete set of Arrow securities. Instead, there is only one asset that agents can save at a risk-free rate r to smooth consumption against fluctuations in labor income. Workers face an exogenous borrowing constraint \underline{a} . There is an annuity market such that the insurance company collects the wealth when people die, and pays people alive an annuity income flow δa which is proportional to their own wealth holdings. As a result, the effective return obtained by households is $r + \delta$.

1.2.2 Characterization

Distribution

Before characterizing the value functions, it proves useful to define several relevant measures. The population distributions over worker types and job types are given by $d_w(x)$ and $d_j(y)$, respectively. For the convenience of notations, we refer to matches as m , employed workers e , unemployed workers u , producing jobs p , and vacant jobs v , all using the first letter the words. For example, the density function of producing matches is denoted $d_m(a, x, y) : \mathbb{R} \times \mathbb{X} \times \mathbb{Y} \rightarrow \mathbb{R}_+$. We could define other densities in a similar fashion, with density of employed workers $d_e(a, x) = \int d_m(a, x, y) dy$, density of unemployed workers $d_u(a, x)$, density of producing jobs $d_p(y) = \iint d_m(a, x, y) dadx$, and density of vacant jobs $d_v(y) = d_j(y) - d_p(y)$. Notice that the aggregate unemployment and vacancy are given by $u = \iint d_u(a, x) dadx$ and $v = \int d_v(y) dy$, respectively. These add-up properties are summarized in Table 1.1.

Table 1.1: Distribution Add-up Properties

| Description | Add-up Property |
|--------------------|---|
| Workers | $d_w(x) = \int d_u(a, x) da + \iint d_m(a, x, y) dy da$ |
| Total unemployment | $u = \iint d_u(a, x) dx da$ |
| Jobs | $d_j(y) = d_v(y) + \iint d_m(a, x, y) dx da$ |
| Total vacancies | $v = \int d_v(y) dy$ |

Notes: This table summarizes the aggregation properties relating densities $d_u(a, x)$, $d_v(y)$, u , v and the match density $d_m(a, x, y)$.

Hamilton-Jacobi-Bellman Equations

The optimal consumption, savings, matching and separation decisions faced by workers and firms can be characterized by a set of Hamilton-Jacobi-Bellman (henceforth HJB) Equations. The HJB equations form the first set of partial differential equations for the equilibrium.

Worker Values Employed workers make decisions on consumption-savings and whether to separate from the current job.⁷ Let $U(a, x)$ denote the value of an unemployed worker of type x with wealth a , and $W(a, x, y)$ the value of an employed worker of type x with asset a working at a firm of type y . The HJB equation for the value of being employed is ⁸:

$$\begin{aligned}
 (\rho + \delta)W(a, x, y) &= \max_c u(c) + \sigma [U(a, x) - W(a, x, y)] + \tilde{\sigma} [U(a, x) - W(a, x, y)]^+ & (1.1) \\
 &+ \dot{a}W_a(a, x, y) \\
 \text{s.t. } \dot{a} &= (r + \delta)a + \omega(a, x, y) - c \\
 a &\geq \underline{a}
 \end{aligned}$$

where $[\bullet]^+ := \max\{\bullet, 0\}$. An employed worker receives flow interest and annuity $(r + \delta)a$ and wage $\omega(a, x, y)$ which is determined by Nash bargaining. At Poisson rate σ , the match is destroyed for

⁷As we will discuss later, a worker will choose to separate if she accumulates enough assets and the job is close to the edge of the matching set, in which case the worker is better-off quitting and wait for a better match. Moreover, Nash bargaining ensures that workers' quitting decisions align with firms' separation decisions.

⁸In Appendix A.1.1 we provide derivations of value functions.

exogenous reasons and becomes unemployed and at rate $\tilde{\sigma}$, she gets the opportunity to quit the job. Workers' values are also affected by changes in wealth holdings. The optimal consumption-saving decision is characterized by the first order condition

$$\mathbf{u}'(c^e) = W_a(a, x, y). \quad (1.2)$$

Unemployment workers make consumption-savings and job acceptance decisions. The HJB equation for the value of being unemployed is:

$$\begin{aligned} (\rho + \delta)U(a, x) &= \max_c \mathbf{u}(c) + p(\theta) \int \frac{d_v(y)}{v} [W(a, x, y) - U(a, x)]^+ dy + \dot{a}U_a(a, x) \quad (1.3) \\ \text{s.t. } \dot{a} &= (r + \delta)a + b(x) - c \\ a &\geq \underline{a} \end{aligned}$$

An unemployed worker makes home production $b(x)$ and receives flow interest and annuity $(r + \delta)a$. The unemployed worker meets a vacant job at rate $p(\theta)$, which is randomly sampled from the distribution of all vacancies, and upon meeting she decides whether to match with the job by comparing the value of working $W(a, x, y)$ against the value of not working $U(a, x)$. The first order condition for the consumption-saving decision is given by

$$\mathbf{u}'(c^u) = U_a(a, x). \quad (1.4)$$

Discussion: Matching and Separation Notice from the HJB equations that the matching set of unemployed workers is the complement of the separation set of employed workers. A key result we will show in Section 1.3 is that workers' matching sets shrink as they become wealthier. When a worker is employed, she accumulates wealth and may at some point prefer to quit if the job no longer stays in the matching set (i.e. the worker has a higher option value to quit for a better job than staying at the current one). The opportunity to quit comes at a Poisson rate $\tilde{\sigma}$ so that the worker cannot quit immediately. This is an implicit assumption in all discrete time models (decisions can

only be made in each period) and it also makes computation more tractable.

Firm Values Let $V(y)$ denote the value of a vacant job of type y , and $J(a, x, y)$ the value of a producing job of type y , with an employee of type x who has asset a . The HJB equation for the producing job is

$$rJ(a, x, y) = f(x, y) - \omega(a, x, y) + (\sigma + \delta)[V(y) - J(a, x, y)] + \tilde{\sigma}[V(y) - J(a, x, y)]^+ + \dot{a}^e J_a(a, x, y), \quad (1.5)$$

where $\dot{a}^e := (r + \delta)a + \omega(a, x, y) - c^e(a, x, y)$ is the optimal saving policy of the employee. The firm retains the remaining output net of wage paid to the worker. The match can be separated due either to an exogenous separation shock or an endogenous optimal separation decision, in which case the job becomes vacant.⁹ Note that changes in workers' wealth holdings affect firms' values as well and firms take workers' saving decisions as given.

The value of a vacant job is

$$rV(y) = q(\theta) \iint \frac{d_u(a, x)}{u} [J(a, x, y) - V(y)]^+ da dx. \quad (1.6)$$

The vacancy meets an unemployed worker at rate $q(\theta)$ that is randomly drawn from the distribution of all unemployed workers.

The mass of jobs is determined by an *ex-ante* free-entry condition. We assume that entrepreneurs need to pay a sunk investment cost of κ to set up the position. Afterwards, the skill requirement type y is realized according to a cumulative density function $G(\cdot)$.

$$\kappa = \int V(y) dG(y). \quad (1.7)$$

In equilibrium, the value of firms adjust so that the expected value of entry is zero.

⁹Qiu (2022) documents empirical prevalence of the form of separations that vacate existing positions.

Wage Determination

Following Krusell, Mukoyama and Şahin (2010), we assume that wages are determined by Nash bargaining. Firms do not commit to a wage schedule and thus bargaining happens continuously when workers are employed. Workers are risk averse, which means that their outside options depend on their wealth holdings and therefore wages should be indexed by a . We denote wages as $\omega(a, x, y)$. As there is curvature in workers' utility we need to generalize the standard Nash bargaining solution, which is derived under the assumption of linear utility on both sides. Appendix A.1.2 proves that the Nash solution can be characterized by

$$\eta \frac{J(a, x, y) - V(y)}{1 - J_a(a, x, y)} = (1 - \eta) \frac{W(a, x, y) - U(a, x)}{W_a(a, x, y)}, \quad (1.8)$$

where $\eta \in (0, 1)$ represents the bargaining power of the worker. In addition, we can derive an expression for wages (Appendix A.1.2, Equation A.1) which can be easily computed once we obtain the value and policy functions of workers and firms.

To gain intuitions, it is useful to contrast our result with common Nash solutions in the case of linear utility. In an environment with linear utility, the match surplus is defined by the sum of worker's surplus and the job's surplus:

$$S(a, x, y) := W(a, x, y) - U(a, x) + J(a, x, y) - V(y).$$

Then Nash bargaining works in a way that the worker and the job are splitting the match surplus according to η . However, it does not make sense to directly add up the worker surplus and the firm surplus if they are not measured in the same units, as is in the case when we have curvature in the utility function. In particular, once we introduce curvature in the flow utility function, worker values are measured in present discounted util, while firm values are measured in present discounted numeraire. It turns out that W_a and $1 - J_a$ are the right adjustment terms so that we could add

up the adjusted worker value and firm value. That is, consider the adjusted surplus

$$\hat{S}(a, x, y) := \frac{1}{W_a(a, x, y)} [W(a, x, y) - U(a, x)] + \frac{1}{1 - J_a(a, x, y)} [J(a, x, y) - V(y)]. \quad (1.9)$$

The worker and the firm are splitting the adjusted surplus according to the bargaining power η .

It is obvious that W_a properly measures the marginal value of a dollar to the worker. Now we illustrate the intuition why $1 - J_a$ is the right adjustment term for the firm. Think of the scenario of a marginal dollar transfer between the worker and the firm. If the worker transfers one additional dollar to the firm, there is a direct 1 dollar increase in firm's value and an indirect impact to the firm through asset decumulation of the worker, i.e., $-J_a$. Thus the total marginal value of additional dollar to the firm is properly captured by $1 - J_a$.

From equations (1.8) and (1.9) it is easy to see that worker-job matching and separation decisions are privately efficient, in the sense that workers' surplus from the match is positive whenever firms' surplus (and total surplus) is positive, and vice versa. Note that the separation decision is just the flip side of the acceptance decision: a match would end if the worker and job post separation would not have agreed to form the match.

In the formal proof in Appendix A.1.2, we write down the full Nash problem by defining values of deviating wages with tilde notations, e.g., $\tilde{W}(w, a, x, y)$. We show that

$$\frac{-\tilde{J}_w(w, a, x, y)}{\tilde{W}_w(w, a, x, y)} = \frac{1 - J_a(a, x, y)}{W_a(a, x, y)},$$

which implies that the adjusted surplus could alternatively be written as

$$\hat{S}(a, x, y) := \frac{1}{\tilde{W}_w} [W(a, x, y) - U(a, x)] + \frac{1}{(-\tilde{J}_w)} [J(a, x, y) - V(y)].$$

This provides further intuition to the bargaining solution – the worker's surplus is adjusted by \tilde{W}_w to the dollar value, and the firm's surplus is adjusted by $(-\tilde{J}_w)$ to the dollar value. Workers and

firms split the adjusted surplus.

Notice that as the curvature of the utility function goes to 0, i.e., as the utility function goes to linear, then $W_a = 1$ and $J_a = 0$. In this case, our adjusted surplus collapses to the standard definition of surplus.

To get a sense of how wages vary by worker and job characteristics, rewrite the wage equation A.1 in Appendix A.1.2 as the following:

$$\omega(a, x, y) = \zeta(a, x, y) + \eta \frac{(\rho - r) J(a, x, y) - \rho V(y)}{1 - J_a(a, x, y)} + (1 - \eta) \frac{(\rho + \delta) U(a, x)}{W_a(a, x, y)} \quad (1.10)$$

where

$$\zeta(a, x, y) = \eta \frac{f(x, y) + ((r + \delta) a - \tilde{c}^e) J_a(a, x, y)}{1 - J_a(a, x, y)} - (1 - \eta) \frac{u(\tilde{c}^e) + ((r + \delta) a - \tilde{c}^e) W_a(a, x, y)}{W_a(a, x, y)}.$$

Two intuitions can be drawn from equation 1.10. First, from the second term on the right-hand side we can see that holding everything else constant, a higher option value of waiting on the firm side, namely a high $V(y)$ relative to $J(a, x, y)$, leads to lower wages as workers need to compensate the firms for the option value. Second, from the third term on the right-hand side we can see that a higher outside option on the worker side, i.e. $U(a, x)$, leads to higher wages. Those intuitions will help us understand the results regarding wages in Sections 1.3 and 1.5 below.

Discussion on the assumption of Nash Bargaining

Our assumption of wages being determined through Nash bargaining follows the large literature in the DMP tradition, including Krusell, Mukoyama and Şahin (2010) and Shimer and Smith (2000) which serve as benchmarks to our model. Setting wages through Nash bargaining allows us to compare the model with the earlier literature and study the additional value of modelling frictional sorting with incomplete markets. It is also a key tool to generate assortative matching in the equilibrium: a low productivity worker would not choose to work at a high productivity firm as the latter needs to be compensated for the option value of finding a worker with much higher

productivity, and for the same reason, a low productivity firm would choose not to hire a high productivity worker.

One may worry that the Nash bargaining process requires workers' wealth to be observable to employers, and wonder to what extent the results would be changed if we were to model the information structure as incomplete and asymmetric. The perfect information assumption is immaterial to our findings for the following two reasons.

First, the bargaining literature has in fact provided a microfoundation for Nash bargaining in the presence of heterogeneity and incomplete information. The idea is that agents can use strategic delays between offers and counteroffers to signal their types.¹⁰ Consider a worker with high wealth. She would decline the initial offer and defer counteroffers to signal her better outside option. The result holds when we take the limit of the time interval between offers to be infinitesimal. Therefore, even if we were to explicitly model asymmetric information about workers' wealth, wages would still depend on wealth as is reflected by Nash bargaining.

Second, we do not mean to take the Nash bargaining assumption literally. Instead, we use Nash bargaining as the standard device to capture the idea that outside options matter for wage determination. Recent works by Caldwell and Harmon (2019) and Caldwell and Danieli (2020) document empirical evidence that individual-level variations in outside options indeed affect wages. We therefore adopt the Nash bargaining wage protocol and reduce unnecessary complications.

Kolmogorov Forward Equations

We consider a stationary equilibrium so that the distribution does not change over time. The steady state conditions for the distribution of workers could be characterized by two sets of Kolmogorov Forward (henceforth KF) equations. Let $\Phi(a, x, y)$ denote the matching decision of workers/firms which equals 1 if the match is formed and 0 otherwise, and $1 - \Phi(a, x, y)$ is thus workers'/firms' separation decision. The first set of KF equations characterize the inflow and outflow for employed

¹⁰See, for example, Admati and Perry (1987); Gul and Sonnenschein (1988) and Cramton (1992)

workers $d_m(a, x, y)$, i.e.,

$$0 = -\frac{\partial}{\partial a} [\dot{a}^e(a, x, y) d_m(a, x, y)] - \{\sigma + \delta + \tilde{\sigma} [1 - \Phi(a, x, y)]\} d_m(a, x, y) + d_u(a, x) p(\theta) \frac{d_v(y)}{v} \Phi(a, x, y) \quad \forall a, x, y. \quad (1.11)$$

The first two terms on the right hand side of equation (1.11) represent outflow from the employed state (a, x, y) due to asset accumulation, exit from the economy and (both exogenous and endogenous) separation respectively. The last term in equation (1.11) represents inflow due to job acceptance.

The second set of KF equations characterize the inflow and outflow for unemployed workers $d_u(a, x)$, i.e.,

$$0 = -\frac{\partial}{\partial a} [\dot{a}^u(a, x) d_u(a, x)] - \int p(\theta) \frac{d_v(y)}{v} \Phi(a, x, y) d_u(a, x) dy - \delta d_u(a, x) + \sigma \int d_m(a, x, y) dy + \tilde{\sigma} \int [1 - \Phi(a, x, y)] d_m(a, x, y) dy + \delta d_x \cdot \mathbb{1}\{a = 0\} \quad \forall a, x. \quad (1.12)$$

The first three terms on the right hand side of equation (1.12) represent outflow from the unemployed state (a, x) due to asset accumulation, job finding and exit from the economy respectively. The next three terms represent inflow due to exogenous job separation, endogenous job separation and newborns. An assumption we make here is that agents are born with 0 asset (and are thus borrowing constrained) and enter the economy being unemployed. We make this assumption to capture the fact that young workers have relatively lower capacity to insure themselves against unemployment risk, relative to older workers.

Finally, there are some add-up conditions for the density functions:

$$1 = \int_{\underline{a}}^{\infty} d_m(a, x, y) da dx dy + \int_{\underline{a}}^{\infty} d_u(a, x) da dx \quad (1.13)$$

as well as

$$d_w(x) = \int_{\underline{a}}^{\infty} d_m(a, x, y) da dy + \int_{\underline{a}}^{\infty} d_u(a, x) da \quad (1.14)$$

$$d_j(y) = \int_{\underline{a}}^{\infty} d_m(a, x, y) da dx + d_v(y) \quad (1.15)$$

namely, the sum of employed/producing workers'/firms' density and unemployed/vacant workers'/firms' density for any productivity type must equal the marginal density of workers'/firms' productivity type.

1.2.3 Equilibrium

For the sake of tractability and in order to focus on sorting between workers and firms, we consider an open asset market so that the economy takes the interest rate as given.¹¹ Workers save in a foreign asset and firms' dividends are distributed to foreign investors. Without loss of generality we assume measure 1 of workers and firms in the steady state so that $\theta = 1$ (since for every θ there is a unique value for the efficiency of the matching technology that matches steady state job finding rate). We also assume that the marginal distributions of workers and firms over productivity types are pre-determined.

Formal Equilibrium Definition

Given interest rate r and marginal densities of worker and firm types d_x, d_y , a stationary equilibrium consists of a set of value functions $\{W(a, x, y), U(a, x), J(a, x, y), V(y)\}$ for employed workers, unemployed workers, producing jobs, and vacant jobs, respectively; a set of policy functions including consumption policy $\{c^e(a, x, y), c^u(a, x)\}$ and matching acceptance decision conditional on meeting $\Phi(a, x, y)$; a wage policy $\omega(a, x, y)$; and an invariant distribution of employed workers $d_m(a, x, y)$ and unemployed workers $d_u(a, x)$, and market tightness θ such that:

1. The value functions and policy functions solve worker and firm's optimization problem (1.1,

¹¹In the calibration exercise, we treat workers' savings as liquid assets, which is just a small fraction of total wealth. Therefore the assumption of a fixed interest rate is not completely divorced from reality.

- 1.3, 1.5, 1.6);
2. Wage setting and matching acceptance decision satisfy Nash bargaining (1.8);
 3. The stationary distributions satisfy the Kolmogorov Forward equations and add-up conditions (1.11–1.15);
 4. Market tightness adjusts so that free entry condition in equation (1.7) gives zero economic profits to firms prior to entry.

Model Outputs

We are able to provide a joint characterization of employment, wages, and wealth distributions through equilibrium objects from the model.

First, it characterizes standard labor market variables of interest. The aggregate job losing rate in the economy is

$$\pi_{eu} = \sigma + \tilde{\sigma} \frac{\iiint [1 - \Phi(a, x, y)] d_m(a, x, y) da dx dy}{\iiint d_m(a, x, y) da dx dy}.$$

where the first term on the right hand side σ is the exogenous separation rate, and the second term on the right hand side represents the rate of voluntary quits.

The job finding rate (not job meeting) in the economy is

$$\pi_{ue} = p(\theta) \int \frac{d_v(y)}{v} \Phi(a, x, y) dy.$$

The steady state unemployment rate is given by

$$u = \frac{\pi_{eu}}{\pi_{eu} + \pi_{ue}},$$

which is known as the Beveridge curve and can be derived by equating the inflow and outflow of unemployment in the steady state.

The model also allows for a joint characterization of wage and wealth distributions. Specifically,

the joint distribution of wealth and wage (among employed workers) is characterized by

$$h(a, w) = \frac{1}{e} \iint d_m(a, x, y) \mathbb{1}\{\omega(a, x, y) = w\} dx dy.$$

where e is the measure of employed workers defined below.

Additionally, the model allows us to study the determinants of aggregate output and productivity.

The total output and measure of employed is

$$\begin{aligned} y &= \iiint f(x, y) d_m(a, x, y) da dx dy, \\ e &= \iiint d_m(a, x, y) da dx dy \end{aligned}$$

and average output per employed (i.e. productivity) is $\bar{y} = y/e$. From these expressions we can see that aggregate labor productivity depends on the density $d_m(a, x, y)$, which describes the pattern of sorting between workers and jobs. We use the above statistics to compare labor productivity in different economies. In Section 1.3, we show that workers' wealth holdings affect the allocation of workers through their search decisions, thereby influencing the allocative efficiency of the labor market.

1.2.4 Algorithm

The algorithm we develop to solve for the equilibrium is in some sense an extension of Achdou et al. (2022) with two-sided heterogeneity and endogenous wages for employed workers in the entire state space. Consider grids $\{a_1, a_2, \dots, a_{N_a}\}$ for asset, $\{x_1, x_2, \dots, x_{N_x}\}$ for worker productivity types, $\{y_1, y_2, \dots, y_{N_y}\}$ for firm productivity types. Suppose they are equally spaced (probably assets are log-spaced) and $\Delta_a, \Delta_x, \Delta_y$ are the steps.

Since we only consider a stationary equilibrium, we normalize d_x, d_y to be uniform on $[0, 1]$.

1. Guess $d_v(y_k)$ and $d_m(a, x, y)$ (the other density functions are pinned down by the add-up property).

We can start by guessing, for example, that $v = 1 - e = 0.1$, $d_v(y_k)/v = 1/N_y$ for all $k = 1, \dots, N_y$ and $d_m(a, x, y)/e = 1/(N_a N_x N_y)$.

2. Guess bargaining solution for each pair $w(a_i, x_j, y_k)$.

We can start from $w(a, x, y) = \eta f(x, y)$, a fraction of the flow output.

3. Solve worker's HJB equations using the finite difference method as in Achdou et al. (2022) (see Appendix A.2 for details).
4. Calculate the stationary distribution of workers.

Discretize the Kolmogorov forward (KF) equation using the upwind scheme. We can then write the system of KF equations compactly in matrix form:

$$\mathbf{A}(\mathbf{W}^n)' \mathbf{d} = 0$$

where \mathbf{d} is a stacked vector of employed workers' density and unemployed workers' density. The scale of \mathbf{d} is pinned down by the fact that d sums up to 1. The density of vacant jobs can be pinned down by the add-up property.

5. Solve firms' HJB equations also using the finite difference method (see Appendix A.2 for details).
6. Given the value functions of workers and firms calculated from steps 3 and 5, update the wage schedule according to the expression given by equation (A.1) in Appendix A.1.2.
7. Update the density functions based on the KF equations. In practice we need to add a dampening factor to slow down the update in order to facilitate convergence.
8. Check whether density and wages have converged. If not, go back to step 1.

In short, we need to solve for the steady state equilibrium iteratively. In each iteration, we need to in turn solve for three systems of partial differential equations, two of which (workers' and firms'

HJB) are non-linear and should thus be solved iteratively and one (workers' KF equation) is linear and can thus be solved in one iteration. Each system involves $N_a \times N_x \times N_y$ equations.

1.3 Theoretical Results

1.3.1 Two Limiting Economies

Our model provides a unified framework of incomplete market and frictional sorting. It is a generalization that nests Krusell, Mukoyama and Şahin (2010) and Shimer and Smith (2000).

If worker's preference is risk neutral, i.e., if the flow utility function \mathbf{u} is linear in consumption c , then our model becomes the frictional sorting model as in Shimer and Smith (2000). Alternatively, if workers are completely insured (for example by assuming that their assets and incomes are pooled in a family), then the problem of maximizing lifetime value is identical to the problem of maximizing lifetime income. In either case, asset level will not affect optimal decision and become irrelevant to decision making.

If \mathbb{X} and \mathbb{Y} are singletons, then we have homogeneous workers (in terms of the productivity types; workers are still heterogeneous with respect to wealth) and firms. There is no sorting so to speak. The model becomes a standard Bewley (1977); Huggett (1993); Aiyagari (1994) type incomplete market model with Diamond-Mortensen-Pissarides search frictions. This has been explored by Krusell, Mukoyama and Şahin (2010).

1.3.2 Wealth, Job Search and Wages

In this section we discuss several key implications from the model about the interactions between wealth, job search strategies and wages. These results will help us understand the mechanisms through which wealth affects labor market allocation and output, and how the model generates an endogenous joint distribution of wealth and wages.

Proposition 1. *Precautionary Mismatch.* *The matching set $\mathbb{M}(a) := \{(x, y) : \Phi(a, x, y) = 1\}$ is wider for lower-asset holders. Fix worker type x and job type y . If a is the marginal wealth level such*

that the adjusted match surplus is exactly zero, then wealthier workers reject the match while poor workers accept the match. Formally, fix arbitrary x and y , if $\hat{S}(a, x, y) = 0$, then $\hat{S}(a', x, y) < 0$ for any $a' > a$, and $\hat{S}(a'', x, y) > 0$ for any $a'' < a$.

Proof: See Appendix A.1.4.

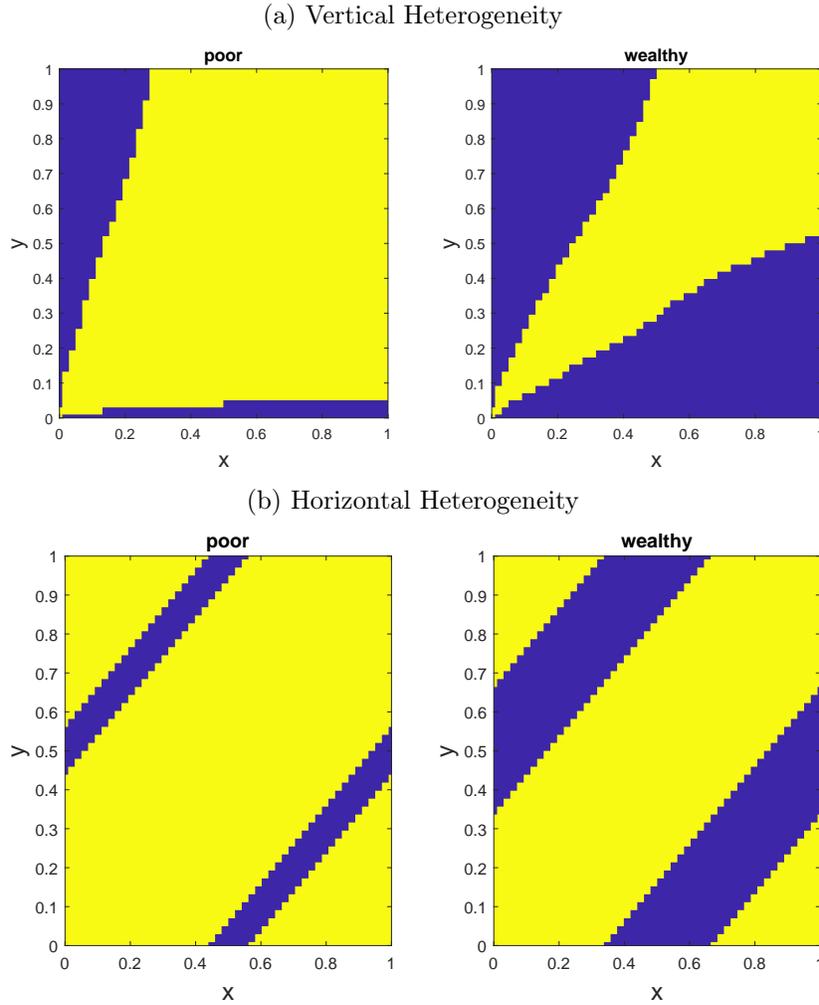
It is worth noting that this result does not rely on the properties of production function or sorting patterns. As long as workers have precautionary motives for self-insurance, matching sets will always be larger for lower-asset workers. In Figure 1.1, we demonstrate two cases of matching sets, depicted by the yellow areas. Panel 1.1a shows matching sets in a case where the production function is supermodular so that workers and firms differ vertically (in their productivity levels), while Panel 1.1b corresponds to a case where the production function is circular so that workers and firms differ horizontally (in their productivity types but not levels). We provide illustrations of the two production functions in Appendix A.4.1. In Panel 1.1a, the allocation features positive assortative matching (PAM) so that matches between workers (shown on the horizontal axis) and firms (shown on the vertical axis) happen along the 45-degree line. In Panel 1.1b, workers and firms are located on a unit-circle, and matches happen where worker and firm types are close to each other on the circle. In both cases however, there is a range of acceptable matches around the perfect matches due to search friction. The left figures of each panel show the matching sets for workers with the lowest wealth in our model, and the right figures correspond to workers with assets worth of 5 times yearly earnings. Indeed, low-wealth workers have wider matching sets regardless of the property of the matching functions.

Proposition 2. *Wealth and Job Finding Rate.* *Job finding rate $\pi_{ue}(a, x)$ is decreasing with respect to wealth a .*

Proof: See Appendix A.1.5.

Proposition 2 is a direct corollary of Proposition 1: as wealth-poor workers have wider matching sets (given productivity type), they are more likely to find successful matches, and therefore have higher job finding rates. This theoretical result has been supported empirically by many earlier

Figure 1.1: Matching Sets for Workers and Firms



Notes: This graph shows the matching sets between workers and firms of different productivity types. Panel 1.1a shows the case where agents are heterogeneous vertically and Panel 1.1b shows the case where agents are heterogeneous horizontally.

papers in the literature, such as Card et al. (2007), Chetty (2008), Lise (2013) and many others. In Section 1.5 we conduct a similar empirical analysis using the NLSY79 data.

The effect of wealth on job finding rate informs us about the extent to which workers are willing to accept mismatch due to precautionary motives. At an aggregate level, it characterizes the relationship between the allocative efficiency of labor and wealth holdings. In the calibration exercise, we replicate this moment from the model so that the aggregate implications of redistributive policies can be studied.

Proposition 3. *Wealth and Wages.* *Average wages conditional on finding a job, defined as $\bar{w}(a, x) = \int_{B(a, x)} w(a, x, y) \frac{d_v(y)}{y} dy$ where $B(a, x) := \{y : \Phi(a, x, y) = 1\}$, is increasing in wealth.*

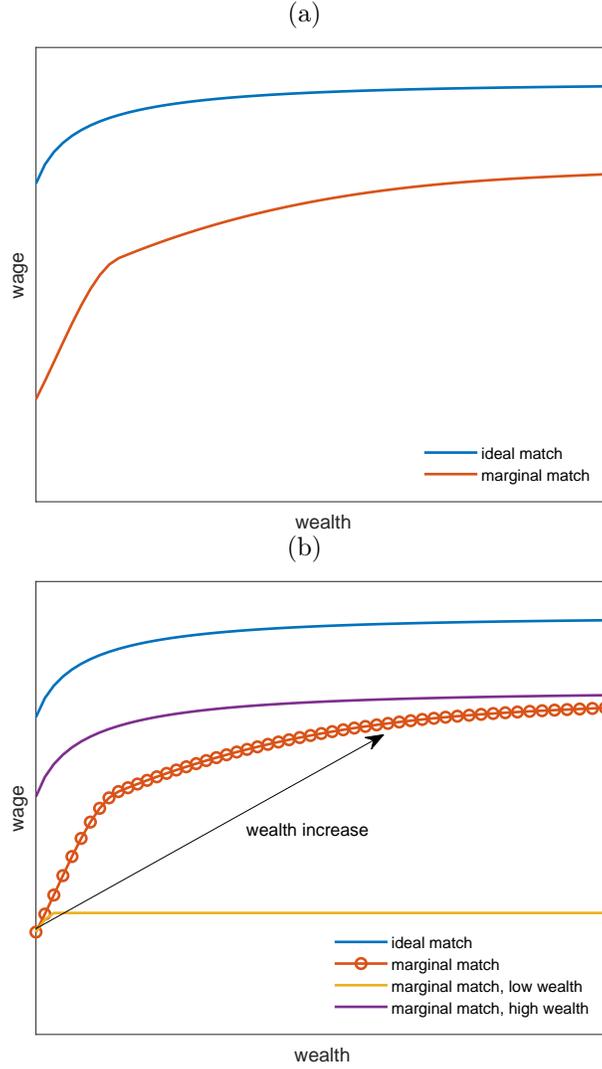
We provide some intuitions rather than a formal proof for this result, and for conciseness we focus on the case with horizontal heterogeneity. Note, however, that the result is also true under different sorting patterns. In Figure 1.2, we plot the wage functions under a perfect match (where $x = y$) in blue lines and a marginal match in red lines, which occurs at the edge of matching sets. For a marginal match, the worker and the firm are indifferent between accepting and staying unemployed/vacant.

The top panel of Figure 1.2 shows that wages for both the perfect match and the marginal match increases with wealth. For the perfect match, wage increases with wealth for the same reason as in Krusell, Mukoyama and Şahin (2010): the outside option, namely the value of being unemployed, increases quickly with wealth as precautionary motive dissipates, so that wealthier workers bargain for higher wages. For the marginal match, wage increases for two reasons, as shown in the bottom panel of Figure 1.2. First, for any given match (purple or yellow line), wage increases with wealth due to Nash bargaining. Second, as workers become wealthier, their matching set shrinks and the marginal match gets closer to the perfect match. Therefore as wealth increases, wages not only increase along but also across different wage curves (from the yellow curve to the purple curve). Since average wages lie in between the wage functions of the perfect match and the marginal match, we can conclude that average wages must also increase with wealth.

The mismatch channel, which is novel in the literature, allows for a stronger effect of wealth on wages compared with models without this channel. Earlier papers such as Rendon (2006) have documented that workers' reservation wages indeed increase with wealth holdings. In the calibration exercise, we match the model-implied relationship between wealth and wages with the empirical counterpart in order to discipline the extent to which precautionary motives affect workers' labor market outcomes.

Proposition 4. *Optimal Consumption Growth.* *The Euler equations, which specify the optimal*

Figure 1.2: Wealth and Wages



Notes: This graph shows wages as a function of wealth at the ideal match (blue curve), the marginal match at the corresponding wealth level (orange curve), the marginal match at the lowest wealth level (yellow curve), and the marginal match at the highest wealth level (purple curve).

consumption growth paths for employed and unemployed workers, can be written as follows:

$$\begin{aligned} \frac{\dot{c}^e}{c^e} &= \frac{1}{\gamma} \left\{ r - \rho + \omega_a + \sigma \left[\frac{u'(c^u)}{u'(c^e)} - 1 \right] \right\} \\ \frac{\dot{c}^u}{c^u} &= \frac{1}{\gamma} \left\{ r - \rho - p(\theta) \int_{B(a,x)} \frac{d_v(y)}{v} \left[1 - \frac{u'(c^e)}{u'(c^u)} \right] dy \right\} \end{aligned}$$

where arguments of $\omega(a, x, y)$, $c^u(a, x, y)$, $c^e(a, x, y)$ are suppressed for brevity. $B(a, x) := \{y :$

$\Phi(a, x, y) = 1$ is the acceptance set of worker (a, x) .

Proof: See Appendix A.1.6.

The equations show us the reasons behind workers' saving decisions. First, there is a standard saving motive due to the difference in interest rate r and the rate of time preference ρ . For employed workers, there are additional saving motives due to the effect of wealth on wages w_a , and the possibility of job loss. The term in square bracket corresponds to precautionary savings motive, which is particularly strong when wealth is low or current wages are high. For unemployed workers, there is a dis-saving motive due to the possibility of finding a job. Notably, the dis-saving motive depends on the worker's acceptance set $B(a, x)$. Everything else equal, a larger acceptance set induces unemployed workers to dis-save more. This term would be absent in models without endogenous job-finding strategies and two-sided heterogeneity.

These propositions show the reasons why our model generates an endogenous joint distribution of wealth and wages. Wealth affect wages by increasing workers' outside options and allowing job-searching workers to wait for better matches, while wages affect wealth by affecting the flow of income and saving rates. The joint distribution would be absent or degenerate in most existing models.

1.4 Data

Our empirical analysis is based on a selected worker panel from the 1979 National Longitudinal Survey of Youth (NLSY79), a nationally representative survey conducted on individuals 14-22 years old when first interviewed in 1979. We merge the NLSY79 work history and asset information with data from the Occupational Information Network (O*NET), an occupation-level data set with scores on the skill contents of 974 occupations, so that we have a matched worker-job data set with joint worker and job characteristics. Conceptually, we construct a measure of worker skills to approximate workers' productivity x , and a measure of job skill requirements to approximate

firms' productivity y .¹² In the sections below we provide a description of the data sources, how the measures of worker skills and job skill requirements are constructed, as well as some sample statistics.

1.4.1 Data Sources and Skill Measures

NLSY79

We use the work history data from NLSY79 to construct a monthly panel, and focus on a cross-sectional sample of workers with no experience of serving in the military. We further exclude individuals who are already considered to be in the labor market at the beginning of the survey, where we consider an individual to be in the labor market if they work more than 30 hours per week or 1200 hours per year, or if they have finished their last schooling spell and started working. To minimize the effect of work experience gained during education on our estimation, we also exclude those who have more than 2 years of work experience before the end of his/her schooling spell.

Worker skill measures (x) are constructed using individual characteristics extracted from the test scores of the Armed Services Vocational Aptitude Battery (ASVAB), a special survey conducted by the US Departments of Defense and Military Services in 1980 that evaluates individuals in 10 categories. As the test was conducted before the majority of the respondents entered the labor market, we believe that our skill measure is mostly free from the endogeneity issue wherein jobs affect worker skills.

Worker skill bundles are constructed using a similar procedure to the one in Lise and Postel-Vinay (2020) (see Appendix A.3.1 for details): we run principal component analysis (PCA) on the 10 individual-level ASVAB test scores and keep the first two principal components. We then construct worker skills along 2 dimensions, namely cognitive and manual skills by recombining the principal components so that they satisfy the following exclusion restrictions: (1) the ASVAB mathematics

¹²Note that in the model, we interpret the productivity of workers and firms are unobservable (to economists) as earlier research suggests that unobserved heterogeneity accounts for the majority of wage variations and thus productivity differences. A model-consistent way of estimating worker and firm heterogeneity would be to estimate their unobserved types in a non-parametric way using matched employer-employee data with information on wealth. We develop a method to estimate it in a companion paper.

knowledge score only loads on cognitive skill, and (2) the ASVAB automotive and shop information score only loads on manual skill. We then take the percentile ranks of the two principal components, so that the worker skill measures are distributed on a unit-length interval $[0, 1]$.

In addition to work history and test scores, we also obtain annual history on assets from NLSY79. Unfortunately, NLSY79 did not start extensively collecting assets information until 1985, when over half of the respondents had entered the labor market. Therefore our sample is heavily biased towards late-entrants when examining the relationship between liquid wealth and skill mismatch. We construct a measure of liquid wealth of individuals based on the sum of financial assets such as cash, deposit, mutual fund and money market accounts and other assets more than \$500, net of debts that are not asset-backed. Since asset information is not updated in each round of survey for most respondents, we linearly interpolate the amount of assets for each individual to maximize the amount of information we can use in our empirical analysis.

O*NET

The O*NET data contains ratings of importance and level on hundreds of specific aspects, called “descriptors”, of each occupation. The descriptors can be summarized by 9 broad categories: skills, knowledge, abilities, work activities, work context, education levels required, job interests, work styles and work values. Following Lise and Postel-Vinay (2020), we keep the level ratings related to descriptors from the first 6 categories, which add up to over 200 descriptors for each occupation.

Similar to the procedure for worker skills construction, we reduce the descriptors to 2 dimensions using PCA and keep the first 2 components. Then, we recover cognitive and manual skill requirements by recombining the principal components in such a way that (1) the mathematics rating only loads on cognitive skill requirements, and (2) the mechanical knowledge rating only loads on manual skill requirements. We take the percentile ranks of the two principal components so that job skill requirements lie on a unit-length interval $[0, 1]$. Therefore, each job can be characterized by a bundle of skill requirements (y), in which a higher number in each dimension represents higher requirements of the corresponding skill.

For this paper, however, we only focus on sorting based on cognitive skills. While our structural model can easily account for multidimensional skill types in theory, solving and estimating such a model turns out to be computationally heavy.

1.4.2 Descriptive Statistics

Skill Measures and Sorting

Our selected sample includes 3,285 individuals with substantial heterogeneity in levels of education, ranging from no degree to PhD. Presumably, our measure of worker skills and job skill requirements should reflect their relative rankings and productivity in the sample respectively. An obvious way to examine this presumption is to see how the two measures vary by levels of education. Table 1.2 shows average worker cognitive skills and job cognitive skill requirements by highest degrees at the time of initial labor market entry. Both measures are normalized to a unit-length range $[0, 1]$, where a higher number represents higher cognitive skill/skill requirement.

Table 1.2: Worker Skills and Job Skill Requirements by Education Level

| | High School | Some College | 2-yr College | 4-yr College | Masters | PhD |
|-----------------------|-------------|--------------|--------------|--------------|---------|-------|
| Worker Skill (x) | 0.388 | 0.456 | 0.543 | 0.684 | 0.714 | 0.770 |
| Job Skill Req (y) | 0.272 | 0.304 | 0.336 | 0.425 | 0.474 | 0.504 |
| Observations | 1053 | 233 | 402 | 500 | 323 | 99 |

Notes: This table shows the average x and y measures for workers with different levels of education. Both x and y are normalized to $[0, 1]$. Source: NLSY79.

Comparison of the skill measures at the lowest and highest education levels (No Degree and PhD) shows that education seems to account for a substantial amount of worker skill heterogeneity, and a modest amount of job skill heterogeneity. It is perhaps not surprising to find that both worker skills (first row) and job skill requirements (second row) increase monotonically with level of education. Therefore at least with respect to skill differences across education groups, our skill measures are able to capture the relative ranking of workers and jobs, as well as positive sorting. However, some questions yet to be answered are whether we can identify sorting beyond sorting on education using

the cognitive skill measures, and whether sorting is still positive after controlling for education groups. To answer this question, we show the correlation between job skill requirements and worker skills in Table 1.3, with and without controlling for worker education levels.

Table 1.3: Skill Sorting Over Occupations

| | Job Skill Req (y) | Job Skill Req (y) |
|----------------------|-----------------------|-----------------------|
| Worker Skill (x) | 0.691*** | 0.513*** |
| | (0.020) | (0.027) |
| Education Level | No | Yes |
| Obs | 35,616 | 35,616 |

Standard errors in parentheses, * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Notes: This table shows the coefficients of x from regressions where the dependent variable is y . Standard errors are clustered on occupation level. The sample consists of the first observations of each employment spell in respondents' work history.

We take one observation from each worker-employer match in the data and regress job cognitive skill requirements on worker cognitive skills. The second column of Table 1.3 shows that the correlation between worker skills and job skill requirements are 0.69, which is both statistically and economically significant. To isolate sorting on skills from sorting on education, we perform an additional regression controlling for dummies for years of education. After controlling for education, the remaining correlation is still large and highly significant at 0.51, suggesting a substantial amount of sorting on individual skills exists beyond sorting on education.

Initial Liquid Wealth and Worker Characteristics

There are 1,114 individuals with valid information about liquid financial wealth at the time when they entered labor market. We define net liquid wealth as the value of financial assets such as cash, deposit, mutual fund and money market accounts net of debts that are not asset-backed. This measure is supposed to reflect assets that workers can access in a relatively short period of time. Table 1.4 shows the characteristics of workers upon labor market entry, where the workers are divided into quintiles according to their liquid wealth during the first month of work.

Table 1.4: Worker Characteristics by Initial Wealth Quintile

| | Quintile 1 | Quintile 2 | Quintile 3 | Quintile 4 | Quintile 5 |
|------------------------------|------------|------------|------------|------------|------------|
| Net Financial Assets (1000s) | -7.971 | 0.346 | 1.764 | 5.356 | 31.83 |
| Weekly Income | 233.8 | 195.2 | 193.3 | 255.8 | 301.4 |
| Years of Educ | 15.91 | 14.54 | 15.38 | 15.88 | 16.25 |
| Age | 27.48 | 27.09 | 26.98 | 27.68 | 29.13 |
| Male | 0.416 | 0.405 | 0.368 | 0.446 | 0.350 |
| PRTs Annual Income | 19874.5 | 18343.5 | 23147.3 | 25479.3 | 25623.4 |
| Observations | 202 | 200 | 204 | 202 | 203 |

Notes: This table shows the characteristics of workers sorted by the amount of liquid wealth they possess in the first month of employment. Liquid assets, weekly income and parents' annual income are in 1982 dollars. Source: NLSY79.

There are substantial heterogeneity in the level of liquid wealth upon labor market entry, ranging from \$-7,971 in the lowest quintile to \$31,830 in the highest quintile (in 1982 dollars), a difference of almost \$40,000. Workers who enter the labor market with higher liquid wealth tend to have higher income, more education, higher age and higher parental income. The only exception is the lowest quintile, where weekly income, years of education, age and parental income are all higher than those in the quintile above. A likely explanation is that the lowest liquid wealth quintile could consist of individuals who borrow substantial amount of debt for their higher education, thereby lowering their initial wealth. Note that the age of labor market entry is highly upward biased (most workers enter labor market in early 20s) because NLSY79 didn't start collecting wealth information until 1985, when half of the sample were above 25. This means that later when we analyze the effect of initial wealth, our sample is biased towards late entrants.

In Section 1.3.2 we discussed several implications about wealth, job search and wages generated by the model. Now we use the merged NLSY79 and O*NET data to examine whether these implications are supported by empirical evidence.

1.4.3 Precautionary Mismatch

First, let us provide a formal definition of mismatch used for our empirical analysis.

Definition 1.4.1. Mismatch measures

Let x_i denote the skill level of individual i , and y_j denote the skill requirement of job j , then we define the **mismatch** between individual i and job j as

$$m_{i,j} \equiv y_j - x_i \tag{1.16}$$

$m_{i,j} > 0$ means that worker i is under-qualified (or over-employed) for job j , and vice versa. We define the **magnitude of mismatch** between individual i and job j as

$$mm_{i,j} = |m_{i,j}| \tag{1.17}$$

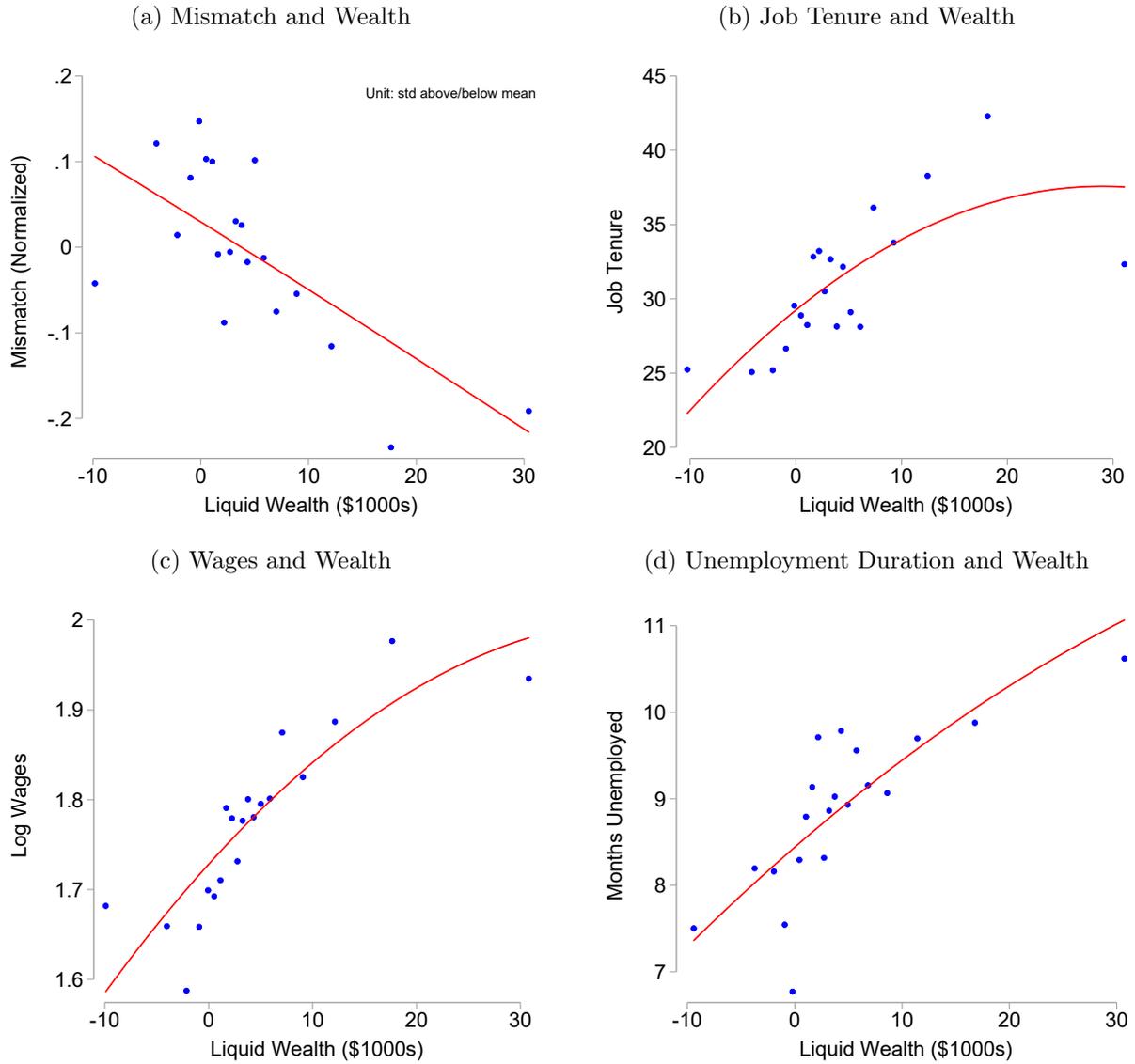
We normalize mismatch $m_{i,j}$ so that its average is 0. By doing so we implicitly assume that in aggregate, there is as much over-qualification (i.e. $m_{i,j} < 0$) as under-qualification ($m_{i,j} > 0$) in the labor market. We also re-scale the levels so that the mismatch measure has a unit standard deviation.

Wealth and Mismatch

We now document the relationship between workers' liquid wealth holdings and skill mismatch, which was discussed in Proposition 1. Figure 1.3a shows a binned scatter plot for those who have gone through an unemployment-to-employment (U2E) transition in the past month, where the vertical axis shows the standardized mismatch measure, and the horizontal axis shows workers' liquid wealth holdings in 1982 dollars. We include a set of aggregate and individual-level controls, including a quadratic function of age, work experience, occupation experience, race, gender, level of education, ASVAB scores, national unemployment rate, and the geographic region of the workers.

The fitted line represents the result from the OLS regression, which estimates that a \$1,000 increase

Figure 1.3: Labor Market Impacts of (Liquid) Wealth



Notes: This figure shows binned scatter plots of labor market outcomes against workers' liquid wealth, along with fitted quadratic curves. Controls include age, age squared, work experience, work experience squared, occupation experience, race, gender, education, ASVAB scores, national unemployment rate, region. The wage specification also controls for previous wages but the pattern is barely changed with or without this control. Source: NLSY79.

in liquid wealth is associated with a 0.006-standard-deviation drop in the magnitude of mismatch, and the coefficient is significant at the 0.01 level. This finding is consistent with the theoretical results from Proposition 1, which says that for wealthier workers, the set of acceptable jobs are smaller, leading to lower levels of mismatch.

1.4.4 Wealth and Job Finding Rate

Next, we examine empirically whether the relationship between wealth and job finding rate, discussed in Proposition 2 of Section 1.3.2, also holds in the data. Figure 1.3d shows a binned scatter plot of the lengths of unemployment spells against workers' liquid wealth holdings, with the same set of controls as before. We only include observations at the beginning of each spell to avoid over-weighting long unemployment spells.

The OLS regression estimates that a \$1,000 increase in workers' liquid wealth holdings is associated with a 0.07-month, i.e. a 2-day, increase in duration of unemployment, with the coefficient significant at the 0.01 level. This finding is consistent with Proposition 2, which says that wealthier workers take longer to find a job.

1.4.5 Wealth and Wages

Here we revisit Proposition 3 of Section 1.3.2 and check whether the model-implied relationship between wealth and wages holds in the data. Figure 1.3c shows a binned scatter plot of logged wages upon employment against workers' liquid wealth holdings, where the controls include wages from the previous job as well as the ones in the previous regressions.

The OLS regression estimates that a \$1,000 increase in liquid wealth is associated with a 1% increase in wages upon re-employment, with the coefficient being significant at the 0.01 level. We will use this estimate to discipline the quantitative effect of wealth holdings on labor market outcomes in the calibration exercise.

1.4.6 Wealth and Job Tenure

Another prediction of the model, which is a direct implication of the precautionary mismatch motive, is that wealthier workers (conditional on their productivity type) tend to stay longer on their jobs upon employed, as they are better matched with their jobs and thus are less likely to have the incentive to quit voluntarily as their wealth grows. Figure 1.3b shows a binned scatter plot of job tenure (in months) for each employment spell against workers' wealth holdings upon employment, controlling for the same set of variables as in the regressions above. Note that we only keep one observation for each employment spell, and the levels of wealth holdings are taken from the first month of employment so that reverse causality (wherein staying longer on a job leads to higher wealth accumulation) can be avoided.

Indeed, higher wealth holdings are associated with longer job tenures. Our OLS estimates indicate that a \$1,000 increase in wealth holdings is associated with a 0.3- to 0.4-month increase in job tenure.

In Appendix A.3.2, we report the coefficients of the OLS regressions above. We also examine separately the effect of wealth holdings on the extent of over- and under-match ($x < y$ and $x > y$) upon re-employment. Importantly, we document that higher wealth holdings have a much more significant effect on reducing under-match than over-match, which is consistent with our quantitative results in Section 1.5.5 below.

1.5 Quantitative Exercises

Having shown that our model's key predictions are qualitatively consistent with data, we now need to estimate the model parameters in order to deliver quantitative results. It is particularly important to characterize the production function since it is the key object that determines the overall sorting pattern, the amount of wage dispersion and mismatch in equilibrium. Our strategy is to make some parametric assumptions about the production function, and discipline the parameters using moments of wage distribution since there is a tight link between them.

1.5.1 Parameterization

We adopt standard functional form assumptions to facilitate numerical analysis. We assume the flow utility function exhibits constant relative risk aversion (CRRA):

$$\mathbf{u}(c) = \frac{c^{1-\gamma}}{1-\gamma}, \quad \gamma > 0.$$

The meeting function is assumed to take the Cobb-Douglas form:

$$M(u, v) = \chi u^\alpha v^{1-\alpha}.$$

Without loss of generality, worker and job types are normalized to be uniformly distributed. To see its generality, suppose the $\tilde{F}(\tilde{x})$ and $\tilde{G}(\tilde{y})$ are the cumulative density functions of the distribution of worker and job types, respectively, with a production function $\tilde{f}(\tilde{x}, \tilde{y})$. We could redefine a type according to its rank, i.e., $x := \tilde{F}^{-1}(\tilde{x})$ and $y := \tilde{G}^{-1}(\tilde{y})$, and rewrite the production function accordingly $f(x, y) := \tilde{f}(\tilde{F}^{-1}(x), \tilde{G}^{-1}(y))$. The distribution of the rank-based type is thus uniform, as the CDF of any random variable is uniformly distributed between 0 and 1.¹³ We specify a production function that induces positive assortative matching (PAM):

$$f(x, y) = f_0 + f_1 (x^\xi + y^\xi)^{\nu/\xi}, \quad 0 < \xi < 1 \tag{1.18}$$

ξ controls the degree of complementarity between worker skills x and job skill requirements y . A less positive ξ leads to stronger complementarity. Empirical evidence in Hagedorn et al. (2017) supports PAM as a description of data. It is also intuitively correct to allow different workers and firms to have different levels of skills/skill requirements. ν controls the curvature of the production function across different skill levels. A larger ν extends the right tail of the production function and thus increases wage inequality between high- and low-skilled workers.

¹³To see this, denote the transformed cumulative distribution functions as F and G such that $x \sim F$ and $y \sim G$. Consider an arbitrary $t \in [0, 1]$. We have

$$F(t) = \mathbb{P}(x \leq t) = \mathbb{P}(\tilde{F}(\tilde{x}) \leq t) = \mathbb{P}(\tilde{x} \leq s, \text{ for some } s \in \tilde{F}^{-1}(t)) = t.$$

Therefore $x \sim \mathcal{U}[0, 1]$. Similarly, $y \sim \mathcal{U}[0, 1]$.

We allow home production b to be a function of worker type x in our model. In the quantitative exercise, we assume that $b(x)$ is a fraction of each worker type's lowest market output, i.e. $b(x) = b_0 f(x, 0)$ such that $b_0 \in [0, 1]$. This assumption makes sure that there are no job or worker types that are never matched in equilibrium.

1.5.2 Calibration

We set the borrowing constraint at $\underline{a} = 0$ meaning that workers cannot have negative net worth. For computation, we use grids with 200 asset grid points, 20 worker types and 20 job types. We assume that in the stationary equilibrium, the vacancy posting cost is such that there is the same number of jobs as workers.

Our model is calibrated to match aggregate U.S. data on a quarterly frequency. Table 1.5 summarizes the parameter values. Some parameters are set as standard values in the literature or calibrated externally, while others are calibrated internally in the model.

External Calibration

We set the quarterly interest rate r so that the annual rate is 2%, and set the parameter of risk aversion γ to 2. We follow Shimer (2005) and Krusell et al. (2010) and set both the matching function elasticity α and workers' bargaining power η to be 0.72. Note however that the Hosios condition does not guarantee efficiency in our model due to market incompleteness. The rate at which workers exit the economy δ is calibrated so that workers are expected to participate in the labor force for 45 years (age 20-65). The exogenous job separation rate is set so that the implied total (exogenous plus endogenous) job separation rate is 0.034, as in Shimer (2005). Finally, we assume the rate at which opportunities to quit voluntarily arrive is once per month on average. This assumption is made implicitly in discrete time models with monthly frequency. We have experimented with various levels of $\tilde{\sigma}$ ranging from 3 (which implies a monthly arrival frequency) to 12 (which implies a weekly arrival frequency) and have found that the model outputs of interest are quite insensitive to this parameter.

Internal Calibration

We calibrate the PAM production function specified by equation 1.18 to match moments of wage dispersion in the data. We normalize the intercept f_0 to 1 without loss of generality. Since ξ affects the strength of sorting, we set its value to match the degree of frictional wage dispersion as measured by Hornstein et al. (2011). The frictional wage dispersion is a measure of wage variations that cannot be explained by worker characteristics and thus captures the size of matching sets. To calculate it in the model, we first draw a random sample of wages from the steady state distribution of employed workers, and run the following regression

$$\log(\omega_i) = \beta_0 + D_{x(i)} + \epsilon_i.$$

The left-hand side are logged wages for workers indexed by i , and the right-hand side includes an intercept, a worker productivity type fixed-effect, and a residual. Following Hornstein et al. (2011), we measure frictional wage dispersion using the mean-min ratio, expressed as

$$\exp\left(\bar{\epsilon}_i - \min_i(\epsilon_i)\right).$$

Next, the curvature parameter ν determines the curvature of the production function and is calibrated to match the Lorenz Curve of U.S. wage distribution, provided by Lise (2013). Then, we calibrate the scale parameter f_1 jointly with the home production parameter b_0 so that 1) on average home production replaces 40 percent of labor market income, following Shimer (2005) and Krusell et al. (2010), and 2) the 90th percentile of wages is 10 times the 10th percentile of wages, as calculated from the Survey of Consumer Finances (SCF) 1989-2009.

We think that the most relevant form of wealth in our model should be liquid wealth (liquid assets including checking, saving and money market accounts net of liquid debts including credit card and personal loans), since illiquid wealth such as housing, pension and businesses cannot be easily withdrawn or costlessly liquidated and would thus have no direct effect on consumption smoothing and households' precautionary motive. Therefore, we choose the discount rate ρ to match the liquid

wealth to earnings ratio calculated from the SCF.

Table 1.5: Summary of Parameters

| Parameter | Value | Source |
|-----------------------------|----------------------|--|
| <i>External Calibration</i> | | |
| interest rate | $r = 0.005$ | annual interest rate 2% |
| relative risk aversion | $\gamma = 2$ | common parameterization |
| bargaining power | $\eta = 0.72$ | Shimer (2005) |
| matching elasticity | $\alpha = 0.72$ | Hosios condition |
| dissipation rate | $\delta = 0.0056$ | 45-year expected working life |
| separation rate | $\sigma = 0.0944$ | monthly job losing rate 0.034 |
| quitting opportunity | $\tilde{\sigma} = 3$ | monthly adjustment |
| <i>Internal Calibration</i> | | |
| discount rate | $\rho = 0.012$ | liquid wealth/annual earnings ratio 0.56 |
| production function | $f_0 = 1$ | normalization |
| home production | $b_0 = 0.75$ | avg $b(x)/w(x, y) = 40\%$ |
| production function | $f_1 = 1.78$ | wage 90-10 ratio = 10 |
| production function | $\xi = 0.8$ | Hornstein et al. (2011) M - m ratio |
| production function | $\nu = 3$ | U.S. wage Lorenz Curve Lise (2013) |
| matching efficiency | $\chi = 4.7$ | monthly job finding rate 0.45 |

Notes: This table summarizes the externally calibrated parameters and their sources, as well as the internally calibrated parameters and their targeted moments. The model is set to quarterly frequency.

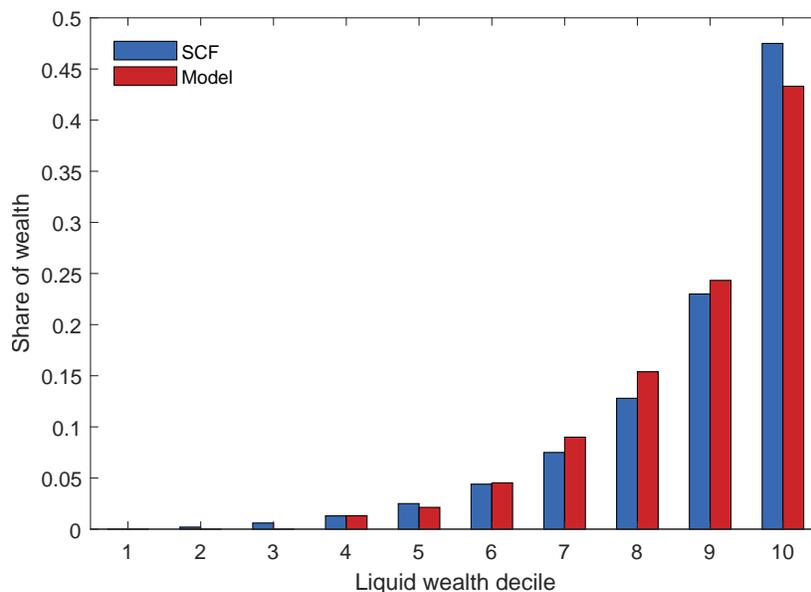
1.5.3 Model vs. Data

Liquid Wealth Distribution

Our model endogenously generates a distribution of liquid wealth as a result of workers' precautionary savings motive and their idiosyncratic shock realization. One way to lend some credibility to the mechanisms in our model is to compare the model-generated distribution of liquid wealth against the data. A close fit with the data increases our confidence in the amount of precautionary motive generated by the model as well as the effects of redistributive policies that we will discuss later.

In SCF we define liquid wealth as the sum of all liquid assets (checking and saving account, money market account) net of all liquid debts (non-mortgage debts). We focus on households with non-negative liquid wealth and whose household heads are aged between 20 to 65 years old. We also exclude households at the top 10% of the liquid wealth distribution.

Figure 1.4: Liquid Wealth Distribution Model vs. Data



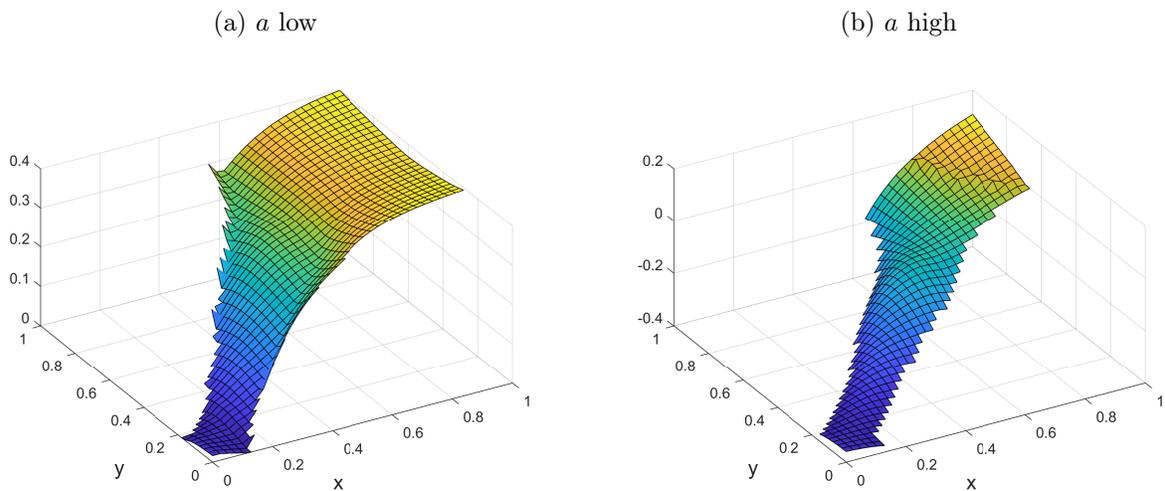
Notes: The figure shows the shares of liquid wealth owned by households in each wealth decile. The blue bars are the shares calculated using SCF 1989-2019. The red bars are the shares calculated from the equilibrium wealth distribution generated by the model.

Figure 1.4 shows the shares of liquid wealth accounted for by each quintile in the model (red) versus

in the SCF data (blue). The model provides a good fit of the empirical liquid wealth distribution for the majority of the population.

The reason why the model generates substantial wealth dispersion lies in the heterogeneity in precautionary savings motive which is caused by workers' idiosyncratic match realization, as indicated through the Euler equations in Proposition 4. Figure 1.5 provides a graphical illustration of the saving rates, defined as $\dot{a}(a, x, y) / [w(a, x, y) + ra]$, for different (x, y) matches and wealth levels. The left panel represents the case where wealth level is at the borrowing constraint, and the right panel represents the case where wealth is high. Note that matches are only realized within matching sets, and therefore saving rate at (x, y) combinations outside the sets are not shown. It shows that (1) fixing wealth, higher x workers tend to have higher savings flow, and (2) for low-wealth workers, saving rates at more mismatched jobs are higher as they have the incentive to save and quit the current job in search of better matches, while for high-wealth workers, saving rates are higher at perfectly-matched firms as these firms are at the top of the job ladder, providing strong precautionary saving motive.

Figure 1.5: Saving Rate Heterogeneity



Notes: The figure shows the saving rates of workers of different levels of productivity x employed at firms of different types y . The left panel shows the saving rates with respect to x and y when wealth is low (close to 0). The right panel shows the case when wealth is high.

Model Elasticities

Another key feature of the data which lends credibility to our model is the rates at which job finding rates and wages upon re-employment vary with liquid wealth levels. These are important moments that reflect the strength of workers' precautionary motive, and how it affects their search decisions. We use monthly labor market history from NLSY79 to construct empirical moments. For job finding rates, we perform the following logit regression estimate

$$Pr(U2E_{i,m} = 1) = F(\alpha_1 + \beta_1 a_{i,m} + \mathbf{X}'_{i,m} \beta_{1,\mathbf{x}})$$

where F is the logit function, i denotes individuals, m denotes month, and \mathbf{X} includes a variety of controls including a quadratic function of age, and quadratic function of work experience, race, gender, education, AFQT score, and national unemployment rate. The observations are taken during workers' unemployment spells.

For wages at re-employment, we perform the following OLS regression

$$\log w_{i,m} = \alpha_2 + \beta_2 a_{i,m} + \mathbf{X}'_{i,m} \beta_{2,\mathbf{x}} + \epsilon_{2,i,m} \quad \text{if } U2E_{i,m} = 1$$

where observations are taken at the months when workers experience a $U2E$ transition.

We perform corresponding regressions in the model where the controls are dummies for workers' productivity types. Table 1.6 shows the regressions coefficients based on the model-simulated sample and NLSY79 respectively. The close alignment shows the the model is able to replicate the effect of precautionary motive on job finding rates and re-employment wages as seen in the data.

1.5.4 Mismatch and Wages

Apart from the theoretical results stated in Section 1.3, another key qualitative prediction from the sorting mechanism is that wages are not always monotonically increasing in firm productivity. Consider a medium-skilled worker in the case of vertical heterogeneity shown in Figure 1.1, who are matched with firms in the middle rung of the productivity distribution but not those at the

Table 1.6: Elasticities of Job-Finding Rate and Wages w.r.t Wealth

| | Model | NLSY79 | Obs. |
|-----------------------|--------|----------------------|--------|
| U2E: β_1 | -0.193 | -0.115*** (0.021) | 56,786 |
| $\log(w)$: β_2 | 0.090 | 0.096*** (0.006) | 5,508 |

Standard errors in parentheses, * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Notes: The table shows the coefficients of regressions of job finding (U2E) rates and logged wages on inverse-hyperbolic-sine-transformed wealth, controlling for worker characteristics. The second column shows the coefficients from the model, while the third column shows the coefficients from NLSY79.

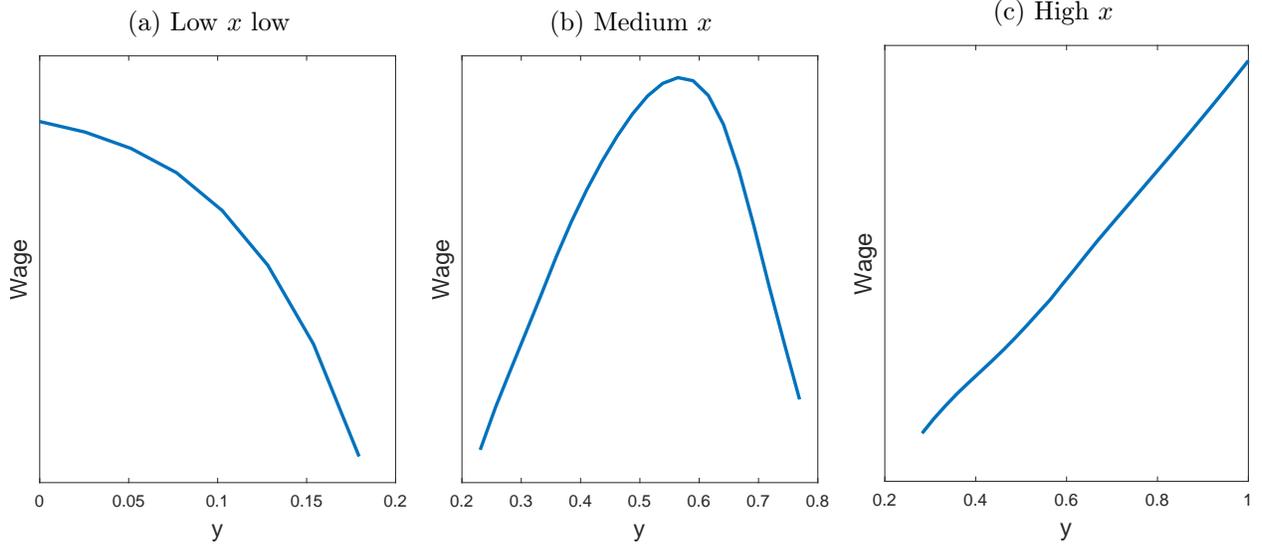
top. Because of Nash bargaining, we know that the decision not to match with the top firms is privately efficient, which means that the wages offered by these firms are low relative to the worker's reservation wage. A logical prediction from this observation is that for workers whose matching sets have an upper bound in the interior of \mathcal{Y} , wages tend to be lower as y increases towards the upper bound of the matching sets. Is it true in the model?

We show the wage function in Figure 1.6. From left to right, the subfigures show wages as a function of firm productivity y for workers of low, medium, and high productivity types, where wealth is fixed at a certain level. Wages are only plotted for firms within the matching sets of each worker type. Obviously, the supports of plotted wages increase with x in Figure 1.6.

We can see from Figure 1.6 that wages tend to peak at firms that are perfect matches for each worker type. For firms that are more mismatched with the workers, wages are indeed lower as these firms need to be compensated for the option value of waiting for better workers. So now the question is, can we find such evidence in the data?

While direct evidence is out of the scope of this paper as we need matched employer-employee data to construct model-consistent measures of worker and firm productivity (which are unobserved), we can nonetheless provide some suggestive evidence based on the NLSY79 and O*NET data, from which we have constructed measures of workers' (observable) skills and the skill requirements of

Figure 1.6: Wages $w(a, x, y)$, a fixed



Notes: This figure shows how model-generated equilibrium wages at an arbitrary wealth level vary with firm productivity y and worker productivity x .

jobs. To look at the evidence, we first run a hedonic wage regression using NLSY79, which is specified below

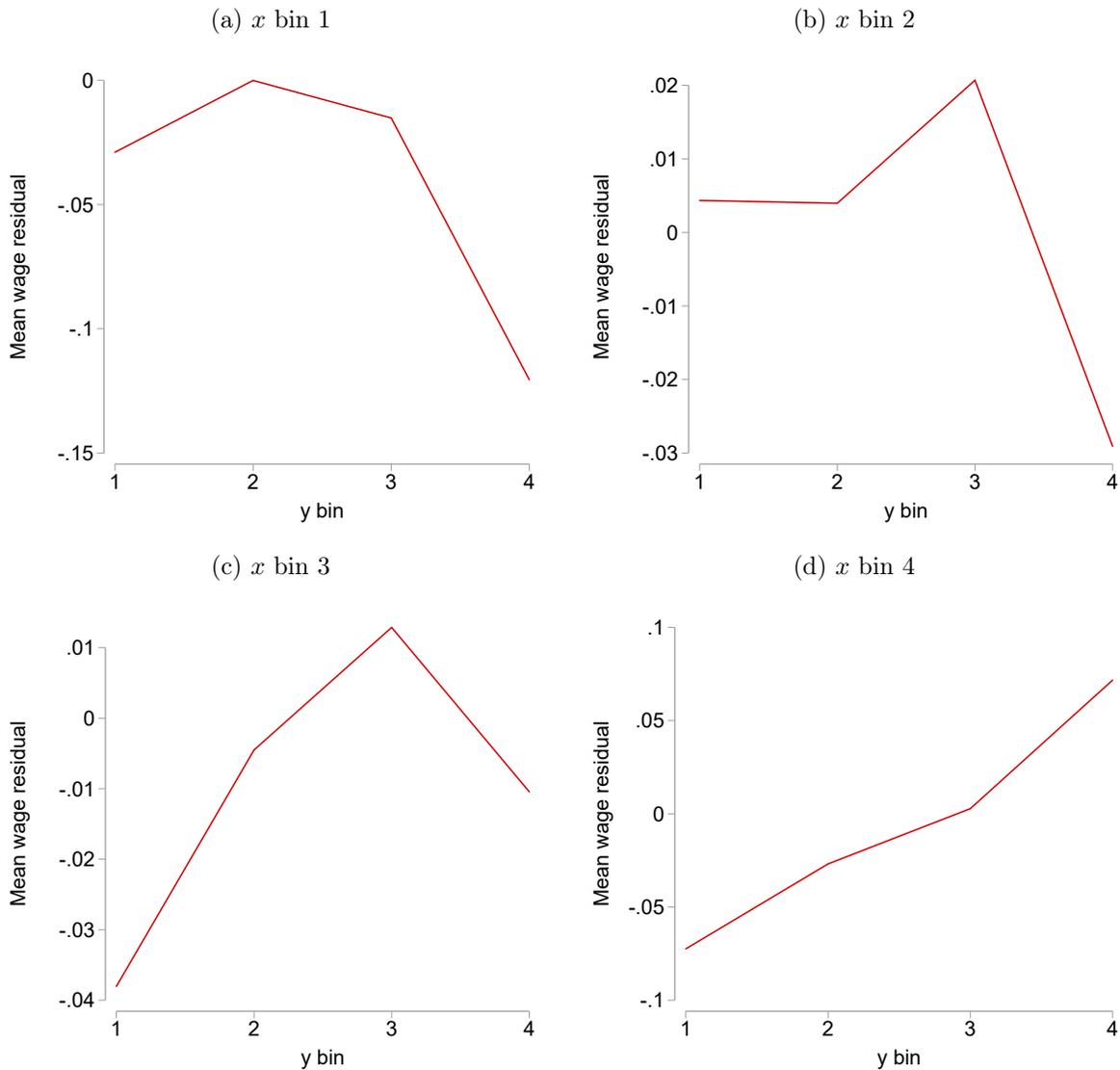
$$w_{ijt} = \alpha + \gamma_j + \mathbf{X}'_{it}\beta + \epsilon_{ijt}$$

where i denotes individual, j denotes occupation of the job, and t denotes time. w_{ijt} denotes logged wages, which is regression occupation fixed effect γ_j as well as a set of worker characteristics \mathbf{X}_{it} including a quadratic function of age, a quadratic function of work experience, race, gender and education dummies.

Now let \tilde{w}_{ijt} denote the residuals from the first-stage hedonic wage regression. We then look at how \tilde{w}_{ijt} vary by job skill requirement for workers of different productivity types. In particular, we divide workers and jobs into 4 bins on each side, according to equal-sized cutoffs on their skill measures. We then label the bins from 1 to 4, with 1 meaning the lowest skill/skill requirement and 4 the highest.¹⁴ Figure 1.7 plots the means of the wage residual \tilde{w}_{ijt} by worker and job bin.

¹⁴Worker and job skill measures are normalized to $[0, 1]$. Workers/jobs with skill measures in $[0, 0.25)$ are assigned to bin 1, those with skill measures in $[0.25, 0.5)$ are assigned to bin 2, etc.

Figure 1.7: Mean Wage Residuals \tilde{w} by x and y



Notes: The figure shows how (residual) wages vary with worker productivity and job skill requirement. Each panel shows average (residual) wages for workers in a given productivity group employed at jobs of different skill requirement levels.

Figure 1.7 shows that for workers with low productivity, (residual) wages from high productivity jobs tend to be lower than those from jobs at the lower rung of the productivity distribution, while the opposite is true for workers with high productivity. This pattern aligns qualitatively with the model's predictions illustrated in Figure 1.6.

In addition to validating the model’s prediction about sorting and wages, this result highlights the importance of understanding sorting through Becker’s assignment model, as it reveals that the “right” jobs for each worker are not necessarily the jobs on the top rung, but those that are closer to their own levels of productivity. This result helps us predict whether sorting would be strengthened or weakened when we conduct policies affecting the wealth distribution.

1.5.5 Aggregate Implications of Precautionary Mismatch

Now we are ready to answer the question: how large are the effects of wealth holdings on the allocation of workers to firms, and consequently the overall productivity of the labor market? We tackle this question in two different ways.

Wealth Holdings, Worker Allocation and Labor Market Outcomes

We have shown in Proposition 1 that poor workers at any productivity level tend to be more mismatched with their jobs. What does it imply about the equilibrium allocations of (wealth) poor and rich workers? The answer is theoretically ambiguous as a lack of wealth can cause mismatch to increase in both directions (i.e. over- and under-matched).

Figure 1.8a shows the average matched firm type for workers in the top and bottom 1% of wealth distribution within each worker productivity type. The red solid line represents the outcomes of workers in the 99th percentile of the within-type wealth distribution, while the blue dashed line represents those in the 1st within-type wealth distribution. Overall, wealth-poor workers tend to be more under-matched than wealthy workers with the same levels of talents, except for the lowest-productivity workers for whom mismatch can only take the form of over-match.¹⁵ The gap between the wealthy and the wealth-poor arises as a result of precautionary mismatch, and seems to be particularly salient for high-skilled workers.

How do the differences allocations between the wealthy and the wealth-poor translate into earnings

¹⁵Although precautionary mismatch can lead to more over-employment as suggested by Figure 1.1, the difference is small in practice, as the reduction in wages due to wealth-poor workers’ lower bargaining position is quantitatively small. In other words, the additional incentive for firms to accept mismatched workers due to lower wage payments is weak. As a result, workers are more likely to be under-matched under the precautionary mismatch motive.

and productivity? To answer this question, we compare average earnings and output of workers in the top and bottom percentiles of their within-type wealth distributions. Figures 1.8b and 1.8c show average (annualized) earnings and output of wealthy and wealth-poor workers at different productivity levels. Indeed, there exists substantial earnings and productivity gap due to wealth holdings, especially for skilled workers. For the highest-skilled workers (i.e. $x = 1$), the within-group earnings gap is 31.5% and the productivity gap is even larger at 40.8%. This can be understood through the fact that for high-skilled workers, under-match not only tends to be more pronounced (as shown in Figure 1.8a), but is also more costly due to the curvature and supermodularity of the production function.

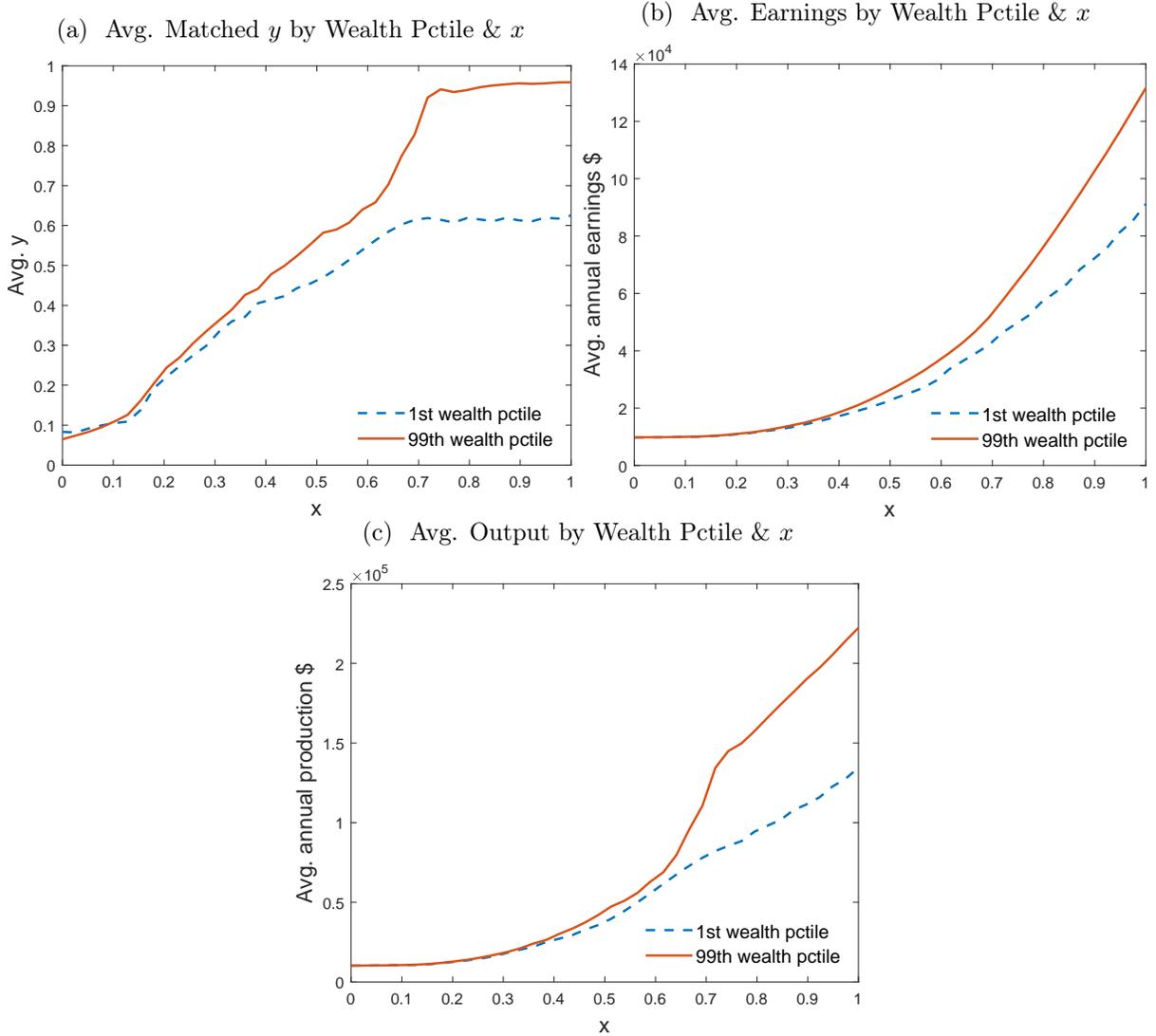
This comparison highlights a link between wealth and wage inequality: lower wealth induces workers to be under-matched, which in turn leads to lower earnings and productivity. On an aggregate level, it also suggests that there can be substantial productivity improvement if we can allocate the mismatched workers to the right jobs. In the following exercise, we estimate the productivity gain if all employed workers are assigned to the “right” jobs.

Precautionary Mismatch vs. Perfect Sorting

In this exercise, we estimate the extent to which currently employed workers are misallocated across jobs. That is, given the set of workers that are employed and firms that are producing in equilibrium, we want to find the missing output if all employed workers could hypothetically be assigned to the “right” jobs. It is an accounting exercise as in practice, there are no ways to achieve the efficient allocation, but it is nonetheless helpful to provide an upper bound on the effect of policies affecting consumption insurance.

To formalize the idea, let us introduce some notations here. Denote E the total measure of employed workers and $s(x, y) := d_m(x, y) / E$ the density of matches (x, y) , so that $\int s(x, y) dx dy = 1$. The aggregate labor productivity is thus $y = \int f(x, y) s(x, y) dx dy$. Define employed worker density $s_e(x) = \int s(x, y) dy$ and producing job density $s_p(y) = \int s(x, y) dx$, so that $\int s_e(x) dx = \int s_p(y) dy = 1$.

Figure 1.8: Effect of Wealth Holdings on Allocations, Earnings and Productivity



Notes: The figure shows, among workers of each productivity type x , expected labor market outcomes for workers in the top and bottom 1 percent of wealth distribution. From Panel 1.8a to Panel 1.8c, the labor market outcomes are average firm types, average (annualized) earnings and output respectively.

Definition 1.5.1. We define the perfect sorting allocation rule as the following:

$$\begin{aligned} \mathbb{M}(s_e(x), s_p(y)) &= \max_m \int f(x, y) m(x, y) dx dy \\ \text{s.t.} \quad &\int m(x, y) dy = s_e(x) \quad \text{and} \quad \int m(x, y) dx = s_p(y) \end{aligned}$$

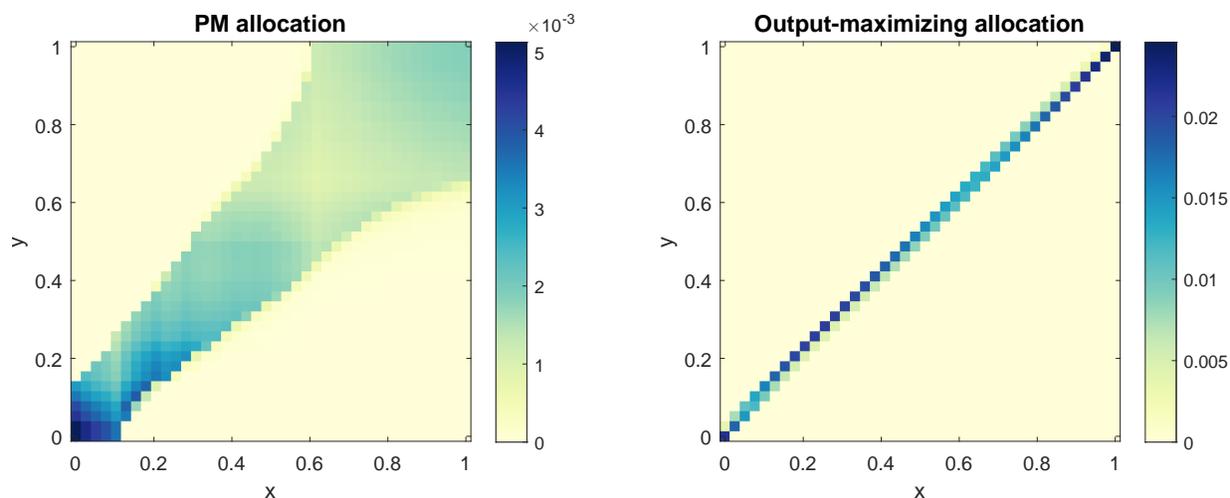
which is in essence a linear programming problem that can be easily solved numerically.

Then the output loss due to labor misallocation can be expressed as the difference between the total outputs under the two allocation rules:

$$\int f(x, y) [\mathbb{M}(s_e(x), s_p(y)) - s(x, y)] dx dy$$

Figure 1.9 shows a comparison between the equilibrium labor allocation (left panel) and the output-maximizing allocation (right panel), where the x-axis represents worker skill levels and the y-axis represents job skill requirement levels. Lighter color reflects higher density.

Figure 1.9: Equilibrium Labor Allocation vs. Output-maximizing Allocation

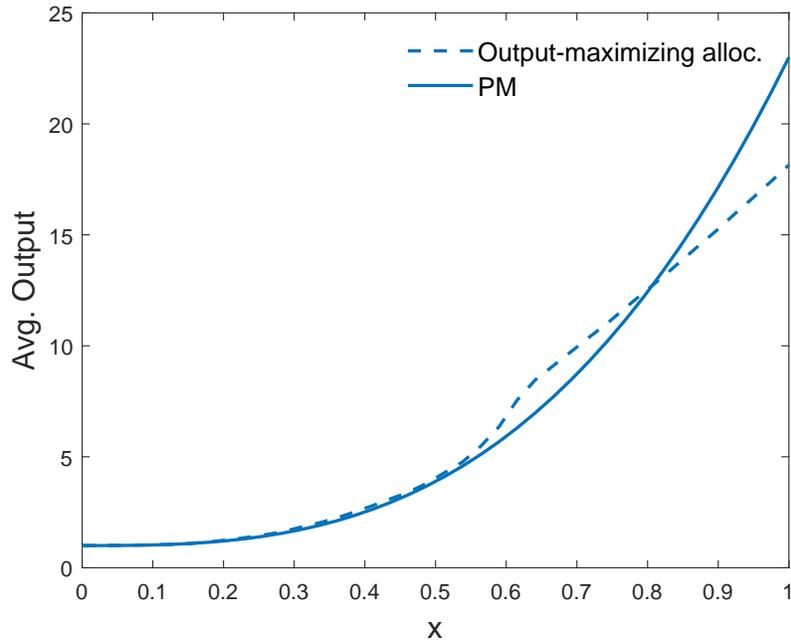


Notes: This figure shows the densities of matches in the steady state equilibrium (left) and in the output-maximizing allocation (right). The values of the densities are shown in the colored bars.

By comparing the aggregate output on the left against that on the right, we estimate that the missing output due to misallocation amounts to 2.8% of total output in the steady state economy. Indeed, as workers and firms face search frictions, they accept a wide range of matches around the ideal ones, which, while optimal from their own perspectives, create mismatch and lower the allocative efficiency of the labor market.

How are the gains in output distributed among workers by reallocating every worker to the “right” job? In Figure 1.10, we compare average levels of output per worker by worker type in the steady state equilibrium (solid line) against those in the output-maximizing allocation (dashed line).

Figure 1.10: Average Output by x : Equilibrium vs. Output-maximizing Allocation



Notes: This figure shows the average output per worker for each worker type x . The solid line shows the levels according to the steady state allocation, while the dashed line shows the levels according to the output-maximizing allocation.

Perhaps a bit surprisingly, average productivity in the steady state equilibrium is even higher for most worker types, except for the very high-skilled workers. However, remember that while inefficient from the whole labor market's standpoint, mismatch provides most workers the opportunity to be over-matched, which increases their own productivity. This comparison shows that the output cost of labor misallocation stems mostly from the under-matches of high-skilled workers, which is partially offset by the higher productivity of lower-skilled workers.

In Appendix A.4.2, we provide an estimation of the extent of labor misallocation due to workers' precautionary motive by conducting an alternative accounting exercise where all workers are assumed to follow the search strategy of the wealthiest among their own productive types. As wealthy workers are well-insured against unemployment risks, they should in principle behave as if there is no precautionary motive. This exercise suggests that absent workers' precautionary motive in job search, overall labor productivity would be 0.15% higher.

1.5.6 Policy Experiment: Subsidy for Young Workers

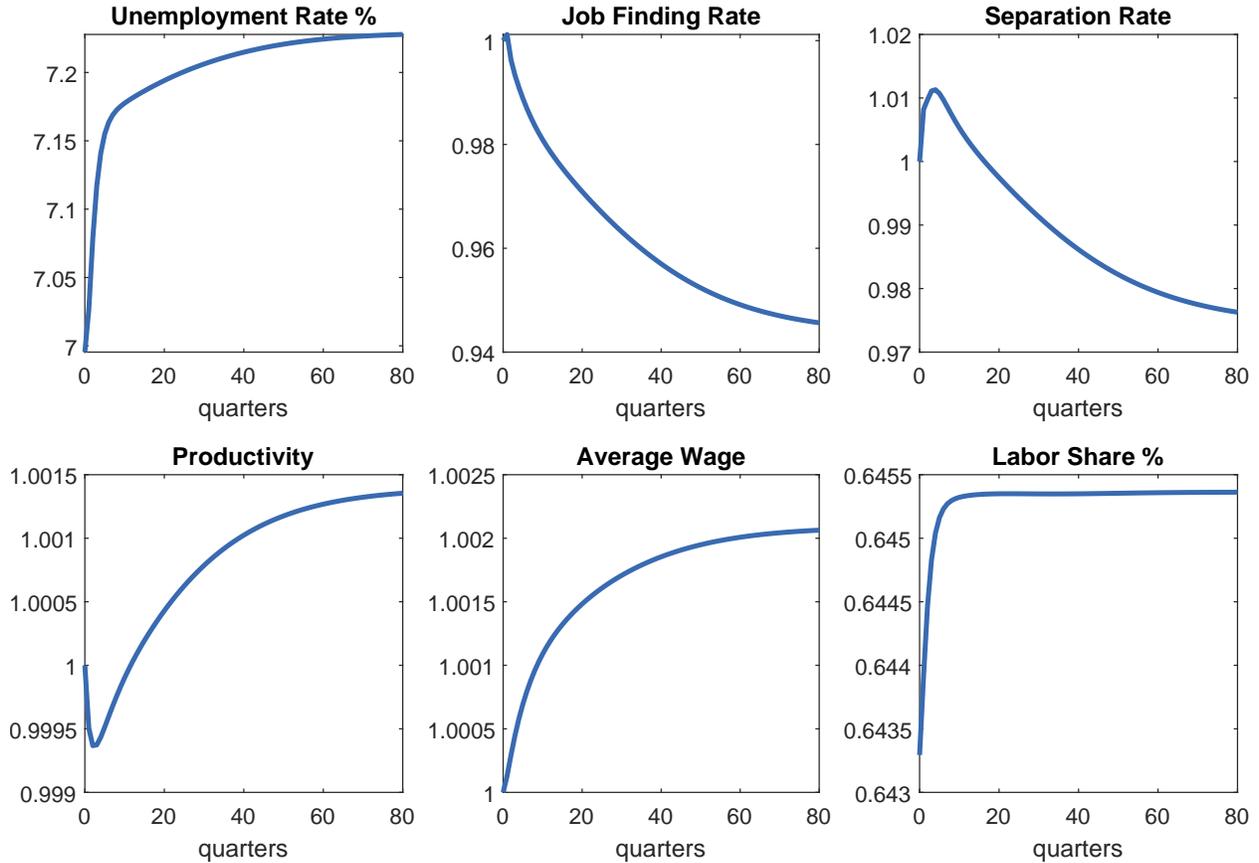
In the baseline economy, workers enter the economy with zero liquid wealth and are thus subject to strong precautionary mismatch motive. These young workers form a big part of the bottom 1% in their respective skill groups' liquid wealth distributions, and in Section 1.5.5 we showed that they tend to have lower productivity. In light of this finding, we consider an experiment which provides all young workers entering the labor market some liquidity which is paid for by a lump-sum tax imposed on the whole population. We impose this tax financing scheme in order to minimizing the distortion on the incentive to work by incumbent workers.

We assume that young workers receive an amount equal to the average liquid wealth level in the baseline economy, denoted by \bar{w}^{PM} , which is roughly half of average annual earnings according to our calculation from the SCF. In our calibration, $\delta = 1/180$ of the population get replaced by new workers every quarter. Therefore to balance the budget, the government needs to collect an amount equal to $\delta\bar{w}^{PM}$, which is roughly 0.28% of average annual earnings in the baseline equilibrium from each worker.

To get a sense of how long it would take to reach the new equilibrium were the government to implement the policy today, as well as what the new equilibrium looks like, we plot the transition path starting from the baseline equilibrium in Figure 1.11. Twenty years after the initiation of the policy, the economy has mostly reached the new steady state. The new steady state is characterized by a lower job finding rate, as young workers enter the economy with new savings and thus become more patient in their job search. Separation rate is also lower in the new economy as the overall quality of job matches improve. Consequently, unemployment rate is higher in the new steady state. As sorting improves in the labor market, labor productivity increases, and so does the average wage. Finally, since there are fewer wealth-poor workers who are inefficiently matched with jobs in which they receive low wages, overall labor share of the economy also increases.

Another effect of the subsidy policy that we expect is changes in the within-group earnings and productivity gap between the wealthy and the wealth-poor, as young workers tend to be the wealth-

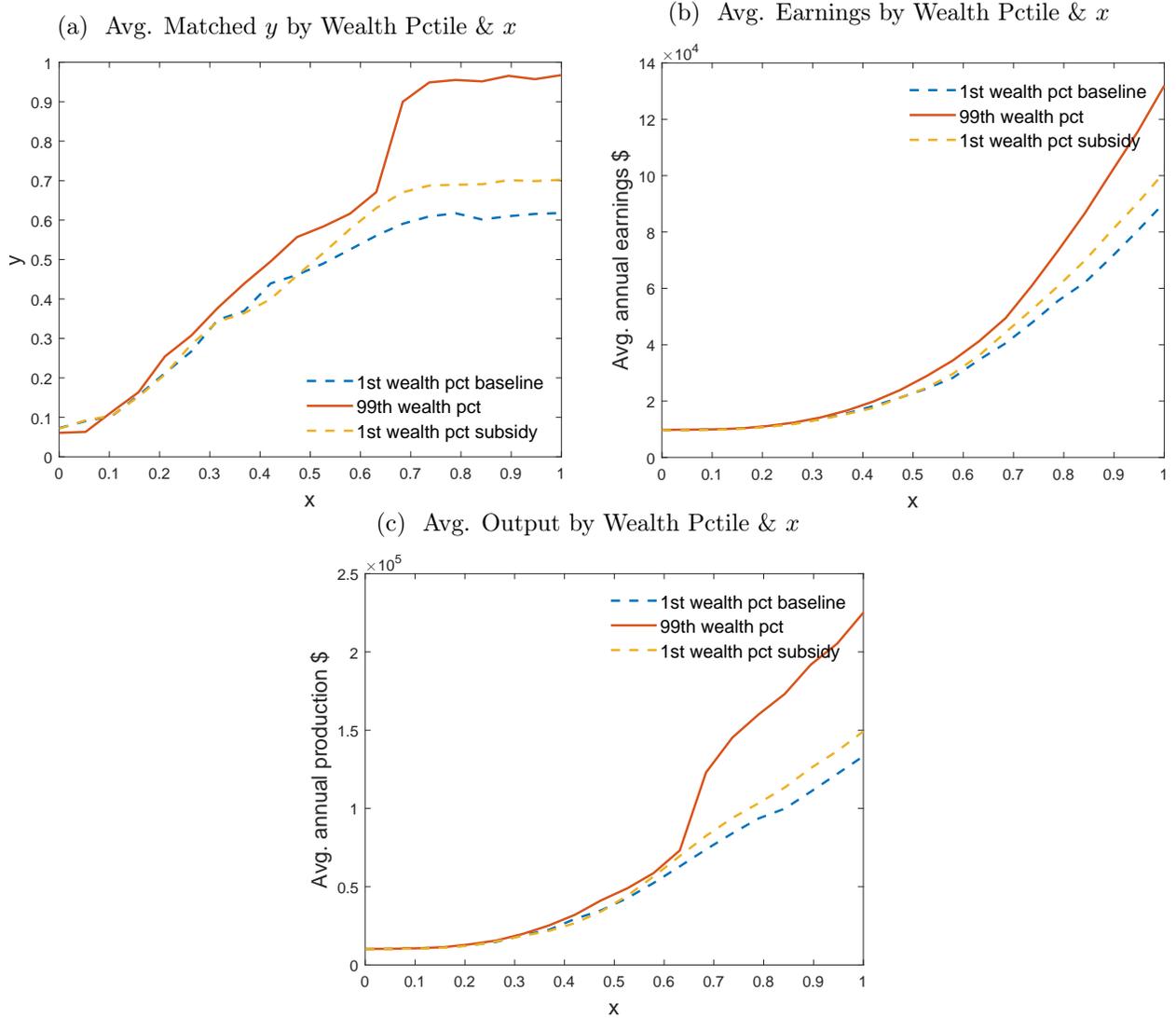
Figure 1.11: Transition Path to the Equilibrium with Subsidy to the Young



Notes: This figure shows the transition paths of economic variables from the baseline steady state to the steady state with permanent redistribution from incumbent workers to labor market entrants.

poorest both in the model and in the data. In Figure 1.12, we plot the average (annualized) earnings and output for the workers in different wealth percentiles within their skill groups. The red solid line and the blue dashed line, which are the same as in Figure 1.8, represent the average earnings and output of workers in the top and bottom 1% of the within-group wealth distribution in the baseline economy, while the yellow dashed line shows those of the bottom 1% in the economy with subsidy. We can see that the subsidy policy works mainly for medium- and high-skilled workers by inducing the wealth-poor within those groups to wait for higher productivity jobs. This in turn reduces the within-group earnings and output gaps for the medium-to-high-skilled worker, as they can now wait long to find higher-ranking jobs. For the highest-skilled workers ($x = 1$), earnings gap shrinks by 30.8%, while productivity gap shrinks by 20.5%.

Figure 1.12: Labor Market Outcomes of the Wealth-Poor with vs. without Subsidy



Notes: This figure shows the labor market outcomes of workers in the top and bottom wealth percentiles in their respective productivity groups, with and without the redistribution policy. The blue dashed lines show the outcomes for the poorest workers within their productivity groups in the baseline steady state equilibrium, while the blue dashed lines show those for the poorest workers in the equilibrium with redistribution policy.

1.6 Conclusion

In this paper we aim to study how workers’ wealth holdings affect the allocation of workers to firms. We develop a framework with two-sided heterogeneity, search frictions and incomplete markets, where workers need to adjust their job acceptance strategies to self-insure against unemployment shocks. Sorting occurs in equilibrium as workers and firms of different productivity types need to mutually agree to form matches. We find both theoretically and empirically that under precautionary motive, wealth-poor workers speed up job search by accepting a wider range of jobs at the cost of lower payoffs, reducing allocative efficiency of the labor market. We name this phenomenon “precautionary mismatch”.

An important takeaway from our model is that while the precautionary mismatch motive is optimal from individual workers’ standpoint, it tends to lower the allocative efficiency of the labor market as reallocation of mismatched workers to their respective perfectly-matched jobs increases overall productivity. The tension between agents’ optimization decisions and labor market allocative efficiency stems from market incompleteness, and leaves open the room for policies aimed at providing better consumption insurance to impact labor market productivity.

To our knowledge, our model is among the first ones to study frictional labor market sorting in an incomplete-markets model. A model with so much heterogeneity would in principle be rather difficult to compute, let alone to estimate. We overcome this challenge by casting our model in continuous time based on the technique introduced by Achdou et al. (2022), so that the problem boils down to solving systems of linear differential equations where we can take advantage of the sparsity of the resulting matrix to speed up computation. Furthermore, using continuous time representation we can also express wages using already-computed equilibrium objects, which further reduces the complexity of equilibrium computation.

We calibrate our model to match the U.S. economy and estimate that the loss of earnings and productivity due to a lack of wealth holdings can be substantial, especially for skilled workers. If we could reallocated workers to the “right” jobs, total output would increase by about 3%. We conduct

an experiment through the lens of our model in which we provide wealth transfers to young workers entering the labor market, who are the wealth-poorest both in the model and in the data. We find that such a policy would be successful at improving labor productivity by inducing young, high-skilled workers to wait for higher productivity matches, which in turn leads to higher wages and consumption. Future work should continue to explore the optimal policies to provide consumption insurance and improve labor market sorting, as well as the welfare implications of such policies.

CHAPTER 2

Expenditure Risks and High-Cost Consumer Credit

2.1 Introduction

It has been well-documented that a large share of the US population hold very little wealth, and the reasons behind this phenomenon have been at the center of discussions by many researchers and policymakers. Furthermore, a non-trivial fraction of the wealth-poor face extremely high cost of borrowing and often have to resort to payday loans and pawn shop loans to address their financial needs. For example, a typical payday loan would charge an APR or more than 300% for a duration of 2 weeks (CFPB (2013)). Answering why so many households fail to accumulate sufficient wealth, especially in the face of such high marginal returns, is apparently a more challenging yet equally important endeavor.

The consumption-savings literature provides three main explanations for the substantial wealth inequality observed in the data: income risks (e.g. Castañeda, Díaz-Giménez and Ríos-Rull (2003)), return heterogeneity (e.g. Hubmer, Krusell and Smith. (2021)) and preference heterogeneity (e.g. Krusell and Smith (1998)). However, these explanations might not be sufficient when it comes to explaining the demand for high-cost credits among wealth-poor households. First, as documented by Aguiar et al. (2021), poor households tend to have more volatile income, which increases the incentive for accumulating precautionary savings. Furthermore, as borrowers of high-cost credits face extremely high interest rates, they should in principle prefer to substitute current consumption for future consumption by increasing their savings. Lastly, to rationalize borrowing at interest rates as high as those charged by payday loans, one would possibly need to assume an extremely high discount rate for these households. In order to understand the demand for credits that are so costly to borrow, it would thus be necessary to take a closer look at households who experience financial difficulties and see whether they are different from others in terms of consumption-savings behavior.

In this paper, I aim to unveil the reasons behind the need for high-cost consumer credits. Using the

SCF and the PSID, I find that households often fail to fully foresee and control their expenditures. In particular, borrowers of high-cost credits such as payday loans are more likely to experience events leading to unexpected expenses. These households resort to high-cost credits when they need to finance larger-than-expected expenses but have depleted other ways to smooth consumption, such as their own savings and less costly credit options. Moreover, it is likely that these unexpected expenses stem from particular spending categories, such as medical costs as well as vehicle and home repairs, as expenditures in these categories tend to be less correlated with income fluctuations and much more volatile than income. This is in line with survey findings by CFPB (2020), in which households claim these expenses as main reasons for their difficulties in paying bills or other expenses.

Motivated by these findings, I therefore construct a measure of expenditure shocks based on variations in medical and repair costs in the PSID, and examine their effects on households' consumption-savings behavior. I find that those who experience large expenditure shocks exhibit patterns of consumption growth and savings rate that are very different from predictions of standard consumption-savings models. More precisely, while standard incomplete markets models predict higher consumption growth and savings rate for borrowing-constrained households, my evidence shows that these households would have flat or even lower consumption growth and savings rate when confronted with large expenditure shocks. As a result, these expenditure shocks lead to more front-loaded consumption and impede wealth accumulation.

Through these findings I aim to highlight the importance of incorporating expenditure shocks into consumption-savings models in order to understand the demand for high-cost credits among wealth-poor families. It remains an open question how the expenditure shocks can be modelled in a way that is consistent with the empirical findings in this paper and has substantive interactions with other household decisions, enabling the model to explain the behavior of both of high-cost credit borrowers and the rest of the population who follow patterns predicted by standard models. I briefly outline how a model could be formulated to address this question.

The rest of the paper is organized as follows. In Section 2.2, I describe the data used for empirical

analysis and highlight some key features of the data. Section 2.3 presents empirical findings regarding the link between the demand for high-cost credits and expenditure shocks as well as the effects of expenditure shocks on consumption-savings behavior. In Section 2.4, I discuss why it is necessary to incorporate expenditure shocks into consumption-savings models to explain high-cost borrowing, and outline how such expenditure shocks could potentially be modelled. Section 2.5 concludes.

2.2 Data

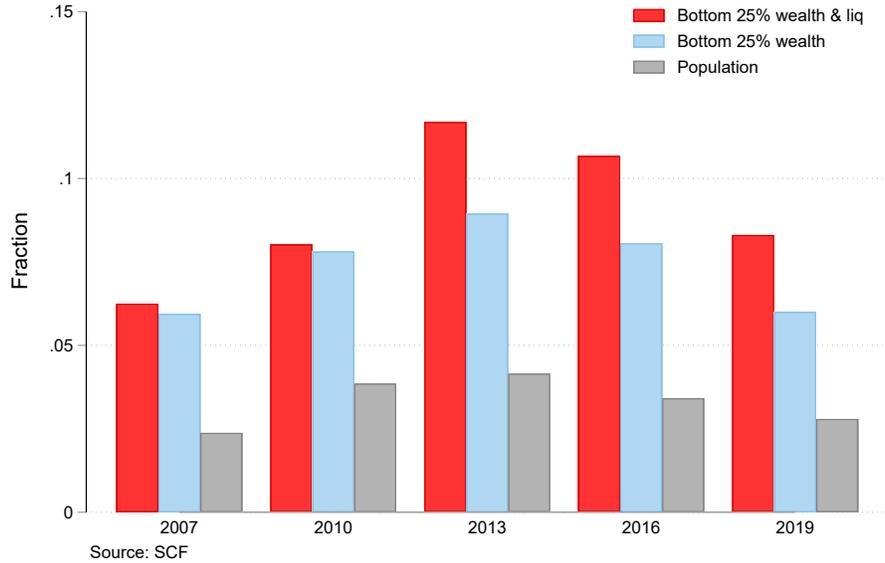
2.2.1 The Survey of Consumer Finances (SCF)

The SCF is a cross-sectional survey conducted every 3 years on households that are representative of the US population, with rich information about their income, wealth, saving/borrowing behavior, and demographic characteristics. From 2007 onward, the SCF began collecting information about payday borrowing, which is of key interest to this paper. The sample I use for empirical analysis is thus based on 5 rounds of surveys from 2007 to 2019.

A non-trivial fraction of the population borrow high-cost loans such as payday loans, and demand for such loans is more pervasive among the wealth-poor. Figure 2.1 shows the proportions of households having borrowed payday loans in the past 12 months at each wave of the survey, with the grey bars representing the shares among the whole population, blue bars the shares among households in the bottom 25th wealth percentiles, and red bars the shares among households in the bottom 25th percentiles of both net worth and liquid wealth distributions. Over the sample period, 2-3% of households in the whole population had borrowed payday loans in the 12 months leading up to the survey, while that number goes up to almost 10% for households at the lowest quartiles of both net worth and liquid wealth distributions.

The SCF data shows remarkable differences between payday borrowers and the rest of the population in terms of demographic characteristics, financial conditions as well as consumption-saving behavior. I highlight the comparison between borrowers vs. non-borrowers along these dimensions in Table 2.1.

Figure 2.1: Shares of Payday Borrowers in Different Subsets of the Population



Notes: This graph shows the shares of households having borrowed payday loans in the past 12 months among the whole population (grey), households in the bottom 25th wealth percentiles (blue), and households in the bottom 25th percentiles of both net worth and liquid wealth distributions (blue).

The most striking differences between the two groups are their financial conditions, especially their balance sheets. While the earnings of payday borrowers are slightly less than a half of non-borrowers', their checking accounts are only less than 1/5 the size of non-borrowers'. On the liability side, payday borrowers tend to owe much more relative to their earnings than non-borrowers, which results in a negative average liquid wealth position. This is consistent with the findings by Bhutta et al. (2015) that applicants of payday loans tend to have exhausted their credit card limit.

One may wonder why the gap in liquid wealth positions dwarf the earnings differentials, especially since there is a high return for borrowers to save given the high interest rates they face. A potential explanation, which I will explore later in Section 2.3, comes from their spending behavior. A 9 p.p. higher share of respondents among borrowers claim that their households' expenses are unusually high compared to what they would expect in a normal year, and that share is 19 p.p. higher for households claiming that their overall spending is higher than total income in the previous year. During these episodes of unusually high, and perhaps unexpected expenses, households might be

Table 2.1: Characteristics of Payday Borrowers vs. Non-borrowers

| | Non-borrowers | Borrowers |
|-----------------------------|---------------|-----------|
| <i>Demographics</i> | | |
| Age | 43.2 | 41.5 |
| Minority (%) | 30.7 | 47.3 |
| Years educ | 9.4 | 8.7 |
| <i>Financial conditions</i> | | |
| HH annual earnings (\$) | 85,715.7 | 38,779.5 |
| Ckng acct bal (\$) | 6,667.9 | 1,153.8 |
| Liquid wlth (\$) | 10,167.0 | -17,630.8 |
| Net worth (\$) | 581,783.8 | 44,129.4 |
| <i>Spending behavior</i> | | |
| Expenses unusually high (%) | 28.9 | 37.8 |
| Total spending > Income (%) | 15.0 | 33.5 |
| Share (%) | 97.6 | 2.4 |

Notes: Source: 2007-2019 SCF. This table shows the characteristics of payday borrowers and non-borrowers aged between 18 and 64. All dollar values are in 2009 dollars.

compelled to dis-save in spite of potentially high cost of borrowing.

2.2.2 The Panel Study of Income Dynamics (PSID)

I use the PSID to uncover sources of the unexpected expenses and study their impacts on households consumption-savings decision, as the PSID has a reasonably long panel and provides a rich set of information about household income, wealth and different components of their consumption expenditure. I use the nationally representative sample ¹⁶ starting from 1999 since it was the first wave collecting information about household balance sheets. Following Aguiar et al. (2021), I define liquid wealth as liquid assets net of liquid debts, where liquid assets consist of checking, saving and money market accounts and stocks not in pension funds, and liquid debts consist of credit card debts, student loans, medical or legal bills, or loans from relatives. Household income is measured on an after-tax basis, and taxes are estimated using TAXSIM.

A comprehensive set of information about household expenditure is also available from the PSID

¹⁶The Survey Research Center sample and the immigrant sample.

starting from 2005. Total household expenditure can be divided into the following broad categories: food, clothing, education, health care, child care, housing, transportation, trips and other recreational expenses, and can be further decomposed into subcategories. For example, health care expenditures can be further decomposed into expenditures for hospital and nursing home, doctor, prescription drugs and insurance. As will be shown in Section 2.3, I construct a measure of expenditure shocks based on some of these subcategories which are likely to be less predictable and study its properties.

2.3 Empirical Results

2.3.1 Determinants of Payday Borrowing

Section 2.2 documents the distinct characteristics of payday borrowers. In this section, I examine in more detail the conditions under which households borrow payday loans. The baseline regression model can be characterized by the following equation

$$\Pr(\textit{payday}_{i,t} = 1) = F(\alpha_0 + \alpha_1 \textit{poorhtm}_{i,t} + \mathbf{X}'_{i,t} \beta) \quad (2.1)$$

where $F(x) = e^x / (1 + e^x)$ represents the cumulative logit function. I use logit regression instead of OLS as the dependent variable takes on binary values: *payday* is a dummy which equals 1 if the household borrowed payday loans in the past year. The main explanatory variable *poorhtm* is a dummy of whether the households' were poor hand-to-mouth at the borrowing constraint, as defined by Kaplan and Violante (2014). In their paper, households are characterized as poor hand-to-mouth at the borrowing constraint if they have negative net worth and their liquid wealth positions hit the borrowing limit, where the borrowing limit is set as 74% of quarterly labor income, or equivalently 18.5% of annual labor income. These households are limited in their ability to smooth consumption. \mathbf{X} represents a set of controls including quadratic functions of age and years of education, marital status, sex, numbers of children, race dummies, and year fixed effects.

I further extend the baseline model to incorporate additional variables describing household financial

conditions and spending behavior. Table 2.2 reports the coefficients of interest from Equation 2.1 as well as its extensions.¹⁷ In particular, *turndown* is a dummy of whether the respondents had at least one credit applications turned down in the past 12 months, *expensehi* is a dummy of whether the respondent claims to have unusually high expenses in the past year, and *negsave* is a dummy of whether total expenditure exceeds total income in the past year.

Table 2.2: Determinants of Payday Borrowing

| | (1) | (2) | (3) | (4) |
|------------------|---------------------|---------------------|---------------------|---------------------|
| <i>poorhtm</i> | 0.744*** (0.090) | 0.472*** (0.092) | 0.389*** (0.088) | 0.300*** (0.089) |
| <i>turndown</i> | | 1.433*** (0.058) | 1.406*** (0.058) | 1.338*** (0.058) |
| <i>expensehi</i> | | | 0.299*** (0.054) | 0.195*** (0.053) |
| <i>negsave</i> | | | | 0.704*** (0.064) |
| Observations | 28,938 | 28,938 | 24,521 | 24,521 |
| Pseudo R^2 | 0.081 | 0.126 | 0.123 | 0.133 |

Notes: Source: 1998-2019 SCF. Controls include quadratic functions of age and years of education, marital status, sex, numbers of children, race and year dummies. Multiple imputation and sample variability errors are corrected using the *SCFCOMBO* command in Stata.

The coefficients in Table 2.2 reflect the effect of each explanatory variable on the log odds of payday borrowing.¹⁸ All coefficients of interest are highly statistically significant, revealing that payday borrowing tend to happen when (1) households have low liquidity; (2) they are unable to increase their borrowing limits through the standard credit market; (3) they experience unexpected expenses which increase their total spending, and (4) the unexpected expenses are large enough so that their incomes during the period are insufficient for all expenses. This finding is consistent with the results

¹⁷Coefficients are estimated using the Stata command *SCFCOMBO* developed by Pence (2005) to account for multiple imputation errors and sample variability errors in the SCF data. For details, see https://www.federalreserve.gov/econres/files/Standard_Error_Documentation.pdf.

¹⁸If the probability of an event happening is p , then the log odds is $\log\left(\frac{p}{1-p}\right)$, which is strictly increasing for $p \in (0, 1)$.

from Saldain (2018), who instead uses the same data to study the differential propensities of these financial conditions among payday borrowers and non-borrowers.

Note that while unexpected expenses have been explored here as a potential reason for borrowing high-cost credits, I do not intend to rule out alternative explanations such as a lack of financial literacy or self control. In fact, these traits might also induce households to make more mistakes in purchases, which in turn leads to expenses that are larger than planned. To examine the causes and consequences of unexpected expenses, one needs to go beyond the SCF and take a close look at the consumption patterns of different households, and understand the underlying reasons for unexpected expenses.

2.3.2 Sources of Unexpected Expenditure

A natural follow-up question is, therefore, what are the causes of the large unexpected expenditure that these households claim to experience? The Consumer Financial Protection Bureau (CFPB), through the Making Ends Meet Survey series, provides some insights on the reasons underlying households' financial difficulties. In the surveys, households are asked the reasons for having difficulty paying for bills or expenses. A summary of the responses in CFPB (2020) is shown in Table 2.3.

Table 2.3: Reasons for Financial Difficulty

| Reasons | % of respondents | Event was unexpected (%) |
|---|------------------|--------------------------|
| Medical expenses or fees | 48 | 85 |
| Loss of job or other income | 33 | 78 |
| Auto repair | 31 | 87 |
| Helping children, parents, or other family members | 27 | 84 |
| Home repair | 20 | 81 |
| Loss of income from illness | 20 | 87 |
| No event | 28 | |

Notes: This table shows the most common reasons for households' difficulties in paying for bills and expenses. Source: CFPB "Insights from the Making Ends Meets Survey" (2020).

Most of the respondents in the survey point to at least one events that caused financial difficulty. The most common reasons for increases in expenses are medical expenses, auto repairs and home repairs, and most respondents claim that these events are unexpected.

Using the PSID, I document more formally the properties of these categories of expenditure. The panel feature of PSID allows me to calculate changes in expenditure by the same households over time and examine their co-movements with other characteristics of the households. Motivated by the CFPB survey, I separate out medical expenses (doctors, hospital & prescription drug costs), auto repairs and home repairs from their respective main categories (health care, transportation and housing). I then look at the correlations of these subcategories with income as well as their volatility.

To fix ideas, it proves helpful to introduce some notations first. Let $C_{i,j,t}$ denote the real expenditure by household i in subcategory j in year t , and let $Y_{i,t}$ denote total income (labor plus asset income net of social security contributions) received by household i in year t . Furthermore, let $\Delta_{i,j,t}^c \equiv \log(C_{i,j,t}) - \log(C_{i,j,t-2})$ and $\Delta_{i,t}^y \equiv \log(Y_{i,t}) - \log(Y_{i,t-2})$ be the log differences in $C_{i,j,t}$ and $Y_{i,t}$ between years $t - 2$ and t respectively.¹⁹

Next, for each household i and subcategory j , I calculate within the sample period (1) the correlation between $\Delta_{i,j,t}^c$ and $\Delta_{i,t}^y$, and (2) the ratio of the standard deviation of $\Delta_{i,j,t}^c$ over that of $\Delta_{i,t}^y$. A substantial amount of heterogeneity exists in these statistics among households due to their idiosyncratic lifetime events and preferences. Therefore I take the median of these statistics and focus on the comparison between different categories of expenditure.

Figure 2.2 shows the median correlation between expenditure growth and income growth among households for each subcategory of expenditure. Education, vehicle repair, home repair and medical costs have much lower correlation with income, compared with food, recreation and housing.²⁰

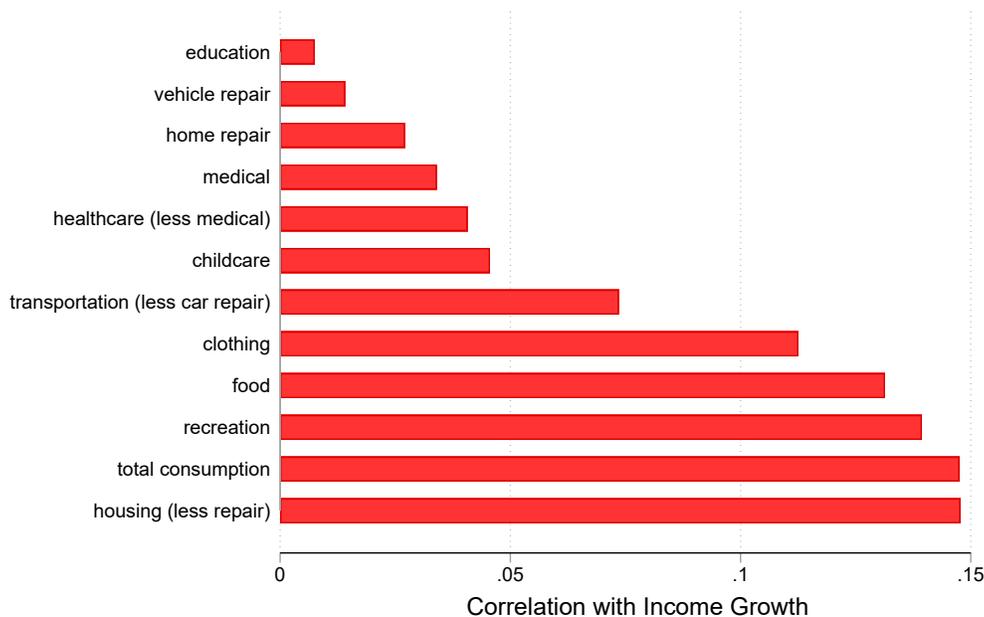
This suggests that the three types of expenses of interest in the CFPB survey are possibly driven

¹⁹Growth rates are calculated in 2-year intervals since the PSID waves are updated biennially in the sample period.

²⁰Education is not very correlated with income possibly because most educational expenses are made before workers enter the labor market.

by something independent of income realizations. Although irrelevance with income does not necessarily prove that these expenses are not expected by households, it is a necessary condition for the lack of predictability.

Figure 2.2: Correlations of Expenditure Growth with Income Growth



Source: PSID 1999-2017

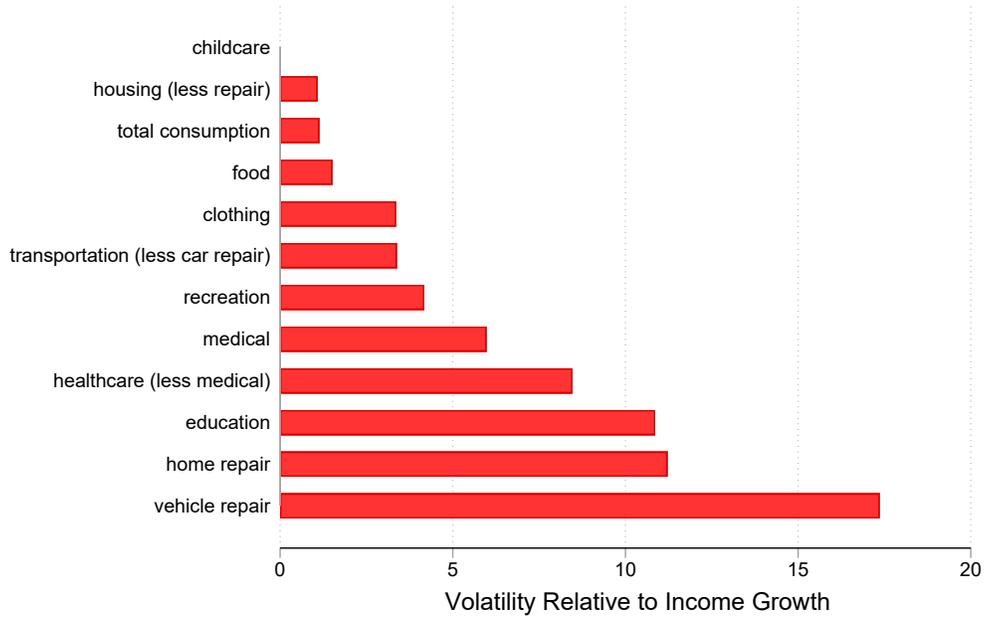
Notes: This graph shows the median among all households of $corr(\Delta_{i,j,t}^c, \Delta_{i,t}^y)$ for each subcategory of expenditure j .

That being said, an expense would be inconsequential for the households' financial well-being in spite of its unpredictability if it is small relative to income. Therefore it proves useful to also look at how volatile these expenses are. Figure 2.3 shows the median volatility of each subcategory relative to income growth among all households. A level above 1 means that expenditure in the subcategory tends to be more volatile than income.

For average households, vehicle repair and home repair costs are indeed the most volatile: expenses in these two categories are over 10 times more volatile than income, while medical expenses are also over 5 times more volatile than income.

The two facts above suggest that the three subcategories of interest are unlike the other ones which

Figure 2.3: Volatility of Expenditure Growth Relative to Income Growth



Source: PSID 1999-2017

Notes: This graph shows the median among all households of $\sigma(\Delta_{i,j,t}^c)/\sigma(\Delta_{i,t}^y)$ for each subcategory of expenditure j .

households have more control of (e.g. food, clothing) and are thus more likely to be the sources of expenditure shocks, which many households have quoted as the main reason for financial difficulty. This is consistent with the CFPB survey results.

2.3.3 Expenditure Shocks and Consumption-Savings

To further unveil the reasons why expenditure shocks leads to demand for high-cost credits, I construct a measure of expenditure shocks based on medical, vehicle repair, and home repair expenses, and examine how occurrence of expenditure shocks affect households' consumption-savings behavior, especially at the borrowing constraint. In particular, I look at the effect of expenditure shocks on consumption growth and savings rate at the borrowing constraint, as these two outcomes reflect the success of wealth building and thus the extent to which households can avoid the borrowing constraint.

Let $\chi_{i,t}$ denote the sum of medical and vehicle repair costs.²¹ The first regression, which studies how expenditure shocks affect consumption growth, can be specified by the following equation

$$\Delta_{i,t}^{c,nd} = \alpha_0 + \alpha_1 \text{poorhtm}_{i,t} + \alpha_2 \text{poorhtm}_{i,t} \times \Delta_{i,t}^x + \mathbf{X}'_{i,t} \beta + \epsilon_{i,t} \quad (2.2)$$

where $\Delta_{i,t}^{c,nd} \equiv \log(C_{i,t+2}^{nd}) - \log(C_{i,t}^{nd})$ is the change in logged non-durable consumption between years t and $t + 2$, and $\Delta_{i,t}^x \equiv \log(\chi_{i,t}) - \log(\chi_{i,t-2})$ is the change in logged medical and repair costs between years $t - 2$ and t . \mathbf{X} represents the same set of demographic controls that are used in Equation 2.1. Table 2.4 reports the coefficients of interest, i.e. α_1 and α_2 , from Equation 2.2.

Table 2.4: Effect of Expenditure Shocks on Consumption Growth

| | $\Delta^{c,nd}$ | | |
|------------------------------------|-----------------|-----------|---------|
| | coefficient | std. err. | p-value |
| <i>poorhtm</i> | 0.020** | 0.009 | 0.022 |
| <i>poorhtm</i> \times Δ^x | -0.015*** | 0.003 | 0.000 |

Notes: This table shows the coefficients of *poorhtm* and its interaction with Δ^x from the regression specified by Equation 2.2. Source: 1999-2017 PSID. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Results from Table 2.4 indicate that (non-durable) consumption growth are indeed higher at the borrowing constraint, consistent with predictions from standard incomplete markets models. However, growth rates tend to be significantly lower if households experience expenditure shocks $\Delta^x > 0$ and would be flat or even lower if the expenditure shocks are sufficiently large, an effect that is absent in standard models.

Next, I examine the effect of expenditure shocks on saving rate. Define saving rate as $s_{i,t} \equiv (Y_{i,t} - C_{i,t})/Y_{i,t}$, where $C_{i,t}$ denotes total expenditure (both durable and non-durable). A higher saving rate implies that wealth grows more in the following period. The second regression can be specified by the following equation

$$s_{i,t} = \alpha_0 + \alpha_1 \text{poorhtm}_{i,t} + \alpha_2 \text{poorhtm}_{i,t} \times \Delta_{i,t}^y + \alpha_3 \text{poorhtm}_{i,t} \times \Delta_{i,t}^x + \mathbf{X}'_{i,t} \beta + \epsilon_{i,t} \quad (2.3)$$

²¹Home repair costs are not included in the baseline results due to a shorter panel. However, the results below are qualitatively the same if I include home repair.

where again Δ^y is the growth in logged income between years $t - 2$ and t . Table 2.5 reports the coefficients α_1 , α_2 and α_3 from equation 2.3.

Table 2.5: Effect of Expenditure Shocks on Saving Rates

| | s | | |
|------------------------------------|-------------|-----------|---------|
| | coefficient | std. err. | p-value |
| <i>poorhtm</i> | -0.164*** | 0.022 | 0.000 |
| <i>poorhtm</i> \times Δ^y | 0.642*** | 0.044 | 0.000 |
| <i>poorhtm</i> \times Δ^x | -0.025*** | 0.008 | 0.002 |

Notes: This table shows the coefficients of *poorhtm* and its interactions with Δ^x and Δ^y from the regression specified by Equation 2.3. Source: 1999-2017 PSID. * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

The first two coefficients confirm predictions from standard models of consumption and savings: households dis-save when hit by a bad income shock, until they reach a binding borrowing constraint. The third coefficient, however, indicates that when households face an unexpected increase in medical bills or repair costs, they continue to save less rather than reducing spending in other categories. This result is also absent in standard models.

Taken together, these facts highlight the role expenditure shocks play in the borrowing behavior of the poor. While poor households have strong incentive to build their wealth, their wealth accumulation is often disrupted by the repeated occurrence of expenditure shocks, which force them to dis-save and return to their initial wealth level. It is therefore possible that households demand high-cost credits due to bad luck, even if they are perfectly time-consistent and rational.

2.4 Discussion

The findings in Section 2.3.3 provide some insights into why standard incomplete markets (SIM) models as in e.g. Aiyagari (1994), Bewley (1977) and Huggett (1993) should be modified by incorporating expenditure shocks in order to understand the behavior of high-cost credit borrowers. Note in a SIM model, the Euler equation is typically expressed by

$$u'(c_t) \geq \frac{1+r}{1+\rho} E_t u'(c_{t+1}) \tag{2.4}$$

where $u(\cdot)$ is households' utility function, ρ is households' subjective discount rate and r is the interest rate. When the borrowing constraint is loose, the Euler equation 2.4 holds with equality and consumption growth is thus driven by $(1+r)/(1+\rho)$ as well as income realizations in each period. For households facing low income realizations today, they smooth their consumption by dis-saving and keeping their consumption high relative to their low income realizations. On the other hand, when interest rate is high (e.g. when households borrow high-cost credits), households face a high return from savings and are willing to substitute current consumption for future consumption. This results in high saving rates, which would always be positive if the interest rate is so high that the intertemporal substitution incentive dominates the consumption smoothing incentive.

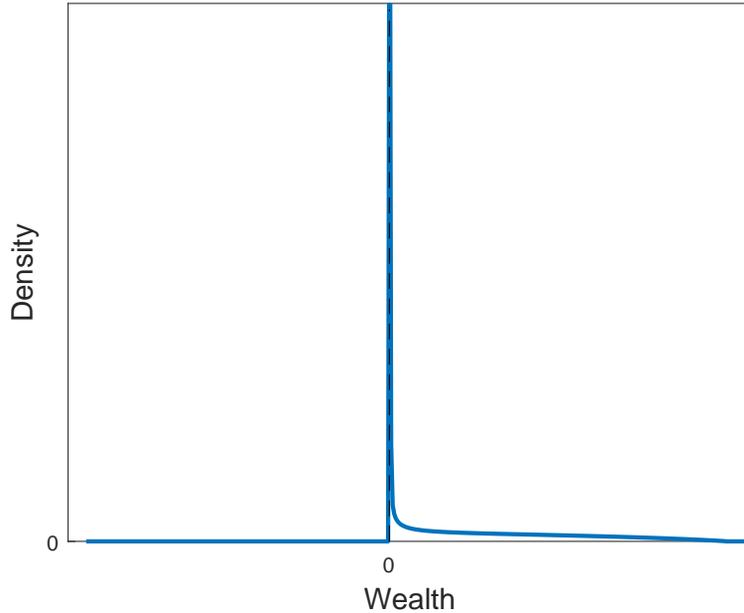
Furthermore, consumption growth is even higher at the borrowing constraint. When the borrowing constraint is binding, the Euler equation 2.4 holds with inequality, so that marginal utility today is high relative to tomorrow. A high marginal utility today means that c_t is low relative to future consumption c_{t+1} , which means higher expected consumption growth.

Figure 2.4 shows the distribution of wealth in SIM models where income follows a Markov process with three income types and where interest rate for borrowing r^{borrow} is much higher than the discount rate ρ , while interest rate for saving r^{save} is lower than the discount rate. The distribution has a spike at the point where wealth is zero and has a positive mass to the right. However, the mass is 0 to the left of the zero-wealth point as no households choose to dis-save when the interest rate is particularly high.

Results from Tables 2.4 and 2.5 confirm that absent expenditure shocks, household would behave in the same way as predict by the SIM models. On the other hand, household who frequently draw large expenditure shocks are unable to save and thus face repeated needs to borrow, even if interest rates are high.

Expenditure risks have been modelled in a number of papers, such as Chatterjee et al. (2007), Livshits et al. (2007), Miranda-Pinto et al. (2022) and Saldain (2022), albeit with different approaches. In Chatterjee et al. (2007) and Livshits et al. (2007), expenditure shocks are modelled

Figure 2.4: Wealth Distribution in SIM models where $r^{borrow} \gg \rho > r^{save}$



Notes: This graph shows the wealth distribution in SIM models where the interest rate on borrowing is much higher than the discount rate, which is in turn higher than the interest rate on saving.

as negative wealth shocks: when medical costs arise for example, households are obliged to pay the bill in full, unless they choose to file for bankruptcy. An alternative method introduced by Miranda-Pinto et al. (2022) incorporates stochastic “consumption thresholds” into an otherwise standard Bewley (1977) incomplete markets model, and households adjust their total consumption in response to changes in the thresholds. The utility function allowing for consumption thresholds is modeled in the following way

$$U(C) = f(C) - \lambda \max\{\chi - C, 0\} \quad (2.5)$$

where $f(C)$ is a standard CRRA utility, $\lambda \gg 0$, and the consumption threshold χ follows an $AR(1)$ process. Consumption below the threshold χ leads to large utility costs, so that when χ is high relative to income, households would rather dis-save than letting consumption drop below the threshold and paying large utility costs. Note that adding expenditure risks to standard income risks raises households’ precautionary savings motive ex-ante, so that on average households tend to hold more wealth relative to an economy without expenditure shocks. However, some households

might receive persistently bad income and consumption threshold draws ex-post, which necessitates borrowing in spite of high interest rates. Following this approach, Saldain (2022) studies the trade-offs of payday lending regulation in an economy where demand for payday loans results from both expenditure shocks and temptation. Regulators thus need to weigh the benefit of payday loans for smoothing out expenditure shocks against the harm of over-borrowing caused by self-control problems.

This paper, among some others, documents that demand for high-cost credits is higher in socially-disadvantaged groups. These households also turn out to be the ones that are more susceptible to expenditure risks. Table 2.6 shows the average variances of household-level expenditure shocks in different demographic groups. I compare households along three different dimensions: (1) whether the household head has a college degree; (2) whether the household head belongs to a ethnic minority group, and (3) whether the average household income is at the top or bottom half of the income distribution. As the table shows, households headed by individuals without college degrees and from ethnic minority backgrounds, whose lifetime incomes fall within the lower half of the population, are subject to more volatile risks in expenditure.

Table 2.6: Volatility of Expenditure Shocks by Demographic Groups

| Demographic group | avg $\sigma_{\Delta^x}^2$ | p-value |
|-------------------|---------------------------|---------|
| College | 3.88 | 0.00 |
| No college | 5.71 | |
| White | 4.46 | 0.00 |
| Minority | 8.12 | |
| High avg income | 3.05 | 0.00 |
| Low avg income | 6.35 | |

Notes: Source: 1999-2017 PSID. This table shows the average within-household variance of expenditure shocks Δ^x in different groups of the population. The third column shows the p-value of tests of equal variance between two demographic groups.

The link between unexpected expenses and medical costs as well as repairs suggests that inadequate maintenance of crucial household assets, such as health, housing and vehicles, could lead to high expenditure risks. Households in financial difficulty, who tend to come from socially-disadvantaged

backgrounds, might find it impossible to invest in these assets as the costs involved are substantial, which further increases their exposure to expenditure shocks.

The analysis in this section is intended to serve as a motivation for future research on household expenditure risks and financial health. To my knowledge, the existing literature on household consumption-saving decisions and consumer credit tend to model expenditure shocks as a exogenous process which is ex-ante identical for all households. In such models, being financially-constrained results from bad luck, and household decisions have no impact on the realization of income and expenditure shocks. However, it is well possible that households could influence their exposure to shocks by having more regular maintenance of their health, housing and other assets that are crucial to their well-being. A model which allows for interactions between expenditure risks and household choices not only elucidates the drivers of high-cost credit demand among wealth-poor households, but also facilitates consideration of the efficacy of various social policies in shielding these households from expenditure risks and promoting sustainable financial well-being.

2.5 Conclusion

The main contributions of this paper are to (1) unveil the conditions under which borrowing of high-cost credits, such as payday loans, occur; (2) explore the sources of expenditure shocks, namely medical and repair costs, which drive the demand for high-cost credits among wealth-poor households, and (3) document the effects of those expenditure shocks on household consumption-savings behavior. The empirical findings suggest that a model of consumption-savings with expenditure shocks can go a long way in explaining the borrowing behavior of the poor.

Households from different backgrounds are exposed to expenditure shocks to different extents. For example, a household with healthy members and well-maintained housing and vehicles are less likely to experience these shocks. However, poor households may simply not have enough resources to achieve that level of stability. Therefore, future research should study the interplay between household decisions, in particular maintenance of health and other crucial household assets, and exposure to expenditure risks. In doing so, one could better understand the reasons under the financial challenges experienced by many households, as well as the types of investments needed to mitigate such challenges.

Such a model will also allow us to study a wide range of new policy questions. For example, are fiscal stimulus payments currently in place actually helpful for households' lifetime well-being, or are these payments just temporary relief for households in deep financial trouble due to their susceptibility to expenditure shocks? Answering these questions will help us design better policies geared towards improving financial health of poor households, in particular by giving them more control over their expenditure.

APPENDIX A

Appendix

A.1 Mathematical Appendix

A.1.1 Derivation of HJB Equations

Consider the discrete time problem with period length of Δ

$$\begin{aligned}
 W(a, x, y) = \max_c & u(c) \Delta + \frac{1}{1 + \rho\Delta} \left\{ \underbrace{\Delta\sigma U(a', x)}_{\text{exogenous separation}} + \right. \\
 & \left. + (1 - \Delta\sigma) \max [W(a', x, y), \underbrace{U(a', x)}_{\text{endogeneous separation}}] \right\} \\
 \text{s.t. } & a' = a + (ra + \omega(a, x, y) - c) \Delta
 \end{aligned}$$

Consider acceptable matches $W(a, x, y) \geq U(a, x)$. As $\Delta \rightarrow 0$, $a' \rightarrow a$, continuity will preserve that $W(a', x, y) \geq U(a', x)$.

We can take the max operator off for small Δ

$$\begin{aligned}
 W(a, x, y) = & u(c^e) \Delta + \frac{1}{1 + \rho\Delta} \left\{ \Delta\sigma U(a + (ra + \omega - c^e) \Delta, x) \right. \\
 & \left. + (1 - \Delta\sigma) W(a + (ra + \omega - c^e) \Delta, x, y) \right\}
 \end{aligned}$$

Multiply both sides by $(1 + \rho\Delta)$, subtract W , and then divide them by Δ

$$\begin{aligned}
 \rho W(a, x, y) = & u(c^e) (1 + \rho\Delta) + \frac{1}{\Delta} [W(a + (ra + \omega - c^e) \Delta, x, y) - W(a, x, y)] \\
 & + \sigma [U(a + (ra + \omega - c^e) \Delta, x) - W(a + (ra + \omega - c^e) \Delta, x, y)]
 \end{aligned}$$

Take the limit $\Delta \rightarrow 0$,

$$\rho W(a, x, y) = u(c^e) + \underbrace{(ra + \omega - c^e)}_{\dot{a}} W_a(a, x, y) + \sigma [U(a, x) - W(a, x, y)]$$

Other value functions can be derived similarly.

A.1.2 Nash Bargaining

To derive the wage setting, we start with the discrete time problem with period length of Δ . The value for employed worker of type x with asset a that works at a job of type y for an arbitrarily deviating flow wage w (recognizing that in the following period the wage will go back to the equilibrium bargained wage) satisfies

$$\begin{aligned} \tilde{W}(w, a, x, y) &= \max_c u(c) \Delta + \frac{1}{1 + \rho \Delta} \{ (1 - \Delta \sigma) (1 - \Delta \delta) W(a', x, y) + \Delta \sigma U(a', x) + \Delta \delta \cdot 0 \} \\ \text{s.t. } a' &= a + (\tilde{r}a + w - c) \Delta, \end{aligned}$$

where $\tilde{r} := r + \delta$ is the effective return. Denote the optimal consumption policy by $\tilde{c}^e(w, a, x, y)$.

The Envelop condition delivers

$$\begin{aligned} \tilde{W}_w(w, a, x, y) &= \frac{1}{1 + \rho \Delta} \{ (1 - \Delta \sigma) (1 - \Delta \delta) W_a(a + (\tilde{r}a + w - \tilde{c}^e) \Delta, x, y) \Delta \\ &\quad + \Delta \sigma U_a(a + (\tilde{r}a + w - \tilde{c}^e) \Delta, x) \Delta \}. \end{aligned}$$

Similarly, the value for such a producing job is

$$\tilde{J}(w, a, x, y) = f(x, y) \Delta - w \Delta + \frac{1}{1 + r \Delta} [(1 - \Delta(\sigma + \delta)) J(a', x, y) + \Delta(\sigma + \delta) V(y)],$$

where $a' = a + (\tilde{r}a + w - \tilde{c}^e(w, a, x, y)) \Delta$ is taken as given from the firm's point of view. From the

Envelop theorem, we have

$$\begin{aligned} \tilde{J}_w(w, a, x, y) = & -\Delta + \frac{1}{1+r\Delta} [1 - \Delta(\sigma + \delta)] J_a(a + (\tilde{r}a + w - \tilde{c}^e(w, a, x, y)) \Delta, x, y) \\ & [1 - \tilde{c}_w^e(w, a, x, y)] \Delta. \end{aligned}$$

Under Nash bargaining, the wage policy is determined by

$$\omega(a, x, y) = \arg \max_w \left[\tilde{W}(w, a, x, y) - U(a, x) \right]^\eta \left[\tilde{J}(w, a, x, y) - V(y) \right]^{1-\eta}.$$

The first order condition for the bargaining problem is

$$\eta \left[\tilde{J}(w, a, x, y) - V(y) \right] \tilde{W}_w(w, a, x, y) + (1 - \eta) \left[\tilde{W}(w, a, x, y) - U(a, x) \right] \tilde{J}_w(w, a, x, y) = 0.$$

It is helpful to recognize that as $\Delta \rightarrow 0$,

$$\frac{\tilde{J}_w(w, a, x, y)}{\tilde{W}_w(w, a, x, y)} \rightarrow \frac{J_a(a, x, y) - 1}{W_a(a, x, y)}.$$

This could be easily seen if one plugs in the expressions for \tilde{J}_w and \tilde{W}_w derived from the Envelop theorem.

Lemma A.1.1.

$$\lim_{\Delta \rightarrow 0} \frac{\tilde{J}_w(w, a, x, y; \Delta)}{\tilde{W}_w(w, a, x, y; \Delta)} = \frac{J_a(a, x, y)}{W_a(a, x, y) - 1}.$$

Proof. Plug in the expressions for \tilde{J}_w and \tilde{W}_w derived before,

$$\begin{aligned} \frac{-\tilde{J}_w}{\tilde{W}_w} &= \frac{\Delta - \frac{1}{1+r\Delta} (1 - \Delta\sigma) J_a(a + (ra + w - \tilde{c}^e(w, a, x, y)) \Delta, x, y) (1 - \tilde{c}_w^e(w, a, x, y)) \Delta}{\frac{1}{1+\rho\Delta} \{(1 - \Delta\sigma) W_a(a + (ra + w - c) \Delta, x, y) \Delta + \Delta\sigma U_a(a + (ra + w - c) \Delta, x) \Delta\}} \\ &= \frac{(1 + r\Delta) - (1 - \Delta\sigma) J_a(a + (ra + w - \tilde{c}^e(w, a, x, y)) \Delta, x, y)}{\{(1 - \Delta\sigma) W_a(a + (ra + w - c) \Delta, x, y) + \Delta\sigma U_a(a + (ra + w - c) \Delta, x)\}} \times \frac{1 + \rho\Delta}{1 + r\Delta} \\ &\rightarrow \frac{1 - J_a(a, x, y)}{W_a(a, x, y)} \end{aligned}$$

as $\Delta \rightarrow 0$, where $\lim_{\Delta \rightarrow 0} \tilde{c}_w^e(w, a, x, y; \Delta) = 0$ is proved in Proposition 5. □

Now we can rewrite the Nash solution

$$\eta \frac{J(a, x, y) - V(y)}{1 - J_a(a, x, y)} = (1 - \eta) \frac{W(a, x, y) - U(a, x)}{W_a(a, x, y)}$$

as

$$\eta \frac{rJ(a, x, y) + (\rho - r)J(a, x, y) - \rho V(y)}{1 - J_a(a, x, y)} = (1 - \eta) \frac{\rho W(a, x, y) - \rho U(a, x)}{W_a(a, x, y)}$$

Plug in the HJB equation of rJ and ρW :

$$\begin{aligned} \eta \frac{f(x, y) - \omega(a, x, y) + (\tilde{r}a + \omega - \tilde{c}^e) J_a(a, x, y) + (\rho - r) J(a, x, y) - \rho V(y)}{1 - J_a(a, x, y)} \\ = (1 - \eta) \frac{u(c) + (\tilde{r}a + \omega - \tilde{c}^e) W_a(a, x, y) - (\rho + \delta) U(a, x)}{W_a(a, x, y)} \end{aligned}$$

Collecting terms, we obtain the following wage equation

$$\begin{aligned} \omega(a, x, y) = \eta \frac{f(x, y) + ((r + \delta)a - \tilde{c}^e) J_a(a, x, y) + (\rho - r) J(a, x, y) - \rho V(y)}{1 - J_a(a, x, y)} \\ - (1 - \eta) \frac{u(\tilde{c}^e) + ((r + \delta)a - \tilde{c}^e) W_a(a, x, y) - (\rho + \delta) U(a, x)}{W_a(a, x, y)} \end{aligned} \quad (\text{A.1})$$

A.1.3 Additional Proofs

Proposition 5. $\lim_{\Delta \rightarrow 0} \tilde{c}_w^e(w, a, x, y; \Delta) = 0$.

Proof. This is true because the optimal consumption policy is characterized by its first order condition

$$u'(\tilde{c}^e) = \frac{1}{1 + \rho\Delta} \{(1 - \Delta\sigma) W_a(a + (ra + w - \tilde{c}^e)\Delta, x, y) + \Delta\sigma U_a(a + (ra + w - \tilde{c}^e)\Delta, x)\}.$$

Notice that as $\Delta \rightarrow 0$, the limiting FOC becomes $\lim_{\Delta \rightarrow 0} u'(\tilde{c}^e) = W_a(a, x, y)$. Under mild technical

conditions,

$$\lim_{\Delta \rightarrow 0} \frac{\partial \tilde{c}^e}{\partial w} (w, a, x, y; \Delta) = \frac{\partial}{\partial w} \lim_{\Delta \rightarrow 0} \tilde{c}^e (w, a, x, y; \Delta) = \frac{\partial}{\partial w} u'^{(-1)} (W_a(a, x, y)) = 0.$$

□

A.1.4 Proof of Proposition 1

Proof. From the discussion before, we know that Nash bargaining implies the following relationship for the adjusted match surplus could be written as

$$\frac{W(a, x, y) - U(a, x)}{W_a(a, x, y)} = \eta \hat{S}(a, x, y).$$

Worker optimization gives rise to the first order condition such that $W_a(a, x, y) = \mathbf{u}'(c^e(a, x, y)) > 0$. Therefore, whether a match is formed or not, i.e., whether $\hat{S}(a, x, y) > 0$ is equivalent to whether $W(a, x, y) - U(a, x) > 0$.

Consider a such that $W(a, x, y) - U(a, x) = 0$, i.e., a marginally acceptable match. Define $\Delta(a; x, y) := W(a, x, y) - U(a, x)$. Differentiate both sides with respect to wealth a :

$$\Delta_a = W_a - U_a = \mathbf{u}'(c^e) - \mathbf{u}'(c^u),$$

where the arguments are suppressed for simplicity. It is obvious that for acceptable matches, $c^e > c^u$. Since the flow utility exhibits the usual concavity property $\mathbf{u}'' < 0$, it must be that $\Delta_a = \mathbf{u}'(c^e) - \mathbf{u}'(c^u) < 0$.

Therefore, for any $a' > a$ we will have $\hat{S}(a', x, y) < 0$ and for any $a'' < a$ we will have $\hat{S}(a'', x, y) > 0$.

□

A.1.5 Proof of Proposition 2

Proof. Consider $a > a'$. From Proposition 1 we know that $\Phi(a, x, y) \subset \Phi(a', x, y)$. Therefore the job finding rate of the worker of type x with wealth a is

$$\begin{aligned}\pi_{ue}(a, x) &= p(\theta) \int \frac{d_v(y)}{v} \Phi(a, x, y) dy \\ &\leq p(\theta) \int \frac{d_v(y)}{v} \Phi(a', x, y) dy \\ &= \pi_{ue}(a', x)\end{aligned}$$

□

A.1.6 Proof of Proposition 4

Proof. Total differentiating $W_a(a, x, y)$, we have

$$dW_a(a, x, y) = W_{aa}(a, x, y) dt$$

Apply the Envelope theorem to employed value $W(a, x, y)$ with respect to a ,

$$\rho W_a(a, x, y) = \sigma [U_a(a, x) - W_a(a, x, y)] + \dot{a} W_{aa}(a, x, y) + [r + \omega_a(a, x, y)] W_a(a, x, y).$$

Note that $W_a(a, x, y) = u'(c^e(a, x, y))$ and $U_a(a, x) = u'(c^u(a, x))$ by FOCs

$$u''(c^e) dc^e = (\rho - r - \omega_a) u'(c^e) dt - \sigma [u'(c^u) - u'(c^e)] dt$$

Rearrange

$$\underbrace{-\frac{u''(c^e) c^e}{u'(c^e)}}_{\text{relative risk aversion}} \cdot \underbrace{\frac{dc^e/dt}{c^e}}_{\text{consumption growth}} = r - \rho + \omega_a + \sigma \left[\frac{u'(c^u)}{u'(c^e)} - 1 \right]$$

Similarly, total differentiating $U_a(a, x)$, we have

$$dU_a(a, x) = U_{aa}(a, x) [ra + b - c^u] dt$$

Apply the Envelope theorem to unemployed value $U(a, x)$ with respect to a

$$\rho U_a(a, x) = p(\theta) \int \frac{d_v(y)}{v} [W_a(a, x, y) - U_a(a, x)]^+ dy + \dot{a} U_{aa}(a, x) + r U_a(a, x)$$

Plugging in FOCs

$$u''(c^u) dc^u = (\rho - r) u'(c^u) dt - p(\theta) \int_{B(a, x)} \frac{d_v(y)}{v} [u'(c^e) - u'(c^u)] dy dt$$

Rearrange

$$-\frac{u''(c^u) c}{u'(c^u)} \cdot \frac{dc^u/dt}{c} = r - \rho + p(\theta) \int_{B(a, x)} \frac{d_v(y)}{v} \left[\frac{u'(c^e)}{u'(c^u)} - 1 \right] dy$$

□

A.2 Algorithmic Appendix

A.2.1 HJB Equations

Rewrite $W(a, x, y)$ as the employed value, and $U(a, x)$ as the unemployed value. The HJB equations are $(\rho + \delta)W(w, a, x, y) - > c_w$

$$(\rho + \delta)W(a, x, y) = \max_c u(c) + \sigma [U(a, x) - W(a, x, y)] + \tilde{\sigma} [U(a, x) - W(a, x, y)]^+$$

$$+ (ra + \omega(a, x, y) - c) W_a(a, x, y)$$

$$(\rho + \delta)U(a, x) = \max_c u(c) + p(\theta) \sum_k \frac{d_v(k)}{v} [W(a, x, y_k) - U(a, x)]^+ + (ra + b(x) - c) U_a(a, x)$$

with the first order conditions $u'(c) = W_a(a, x, y)$ and $u'(c) = U_a(a, x)$ respectively. The FD approximation to the HJB equations are

$$\begin{aligned}
(\rho + \delta)W(a_i, x_j, y_k) = & u(c_{i,j,k}) + \sigma [U(a_i, x_j) - W(a_i, x_j, y_k)] + \tilde{\sigma} [U(a_i, x_j) - W(a_i, x_j, y_k)]^+ \\
& + (ra_i + \omega(a_i, x_j, y_k) - c_{i,j,k}) W_a(a_i, x_j, y_k)
\end{aligned} \tag{A.2}$$

$$\begin{aligned}
(\rho + \delta)U(a_i, x_j) = & u(c_{i,j}) + p(\theta) \sum_k \frac{d_v(k)}{v} [W(a_i, x_k, y_k) - U(a_i, x_j)]^+ \\
& + (ra_i + b(x_j) - c) U_a(a_i, x_k)
\end{aligned} \tag{A.3}$$

Similarly, write producing firms' HJB equations as

$$\begin{aligned}
rJ(a_i, x_j, y_k) = & f(x_i, y_k) - \omega(a_i, x_j, y_k) + (\sigma + \delta) [V(y_k) - J(a_i, x_j, y_k)] + \tilde{\sigma} [V(y_k) - J(a_i, x_j, y_k)]^+ \\
& + (ra_i + \omega(a_i, x_j, y_k) - c) J_a(a_i, x_j, y_k)
\end{aligned} \tag{A.4}$$

and vacant firms' HJB equations as

$$rV(y_k) = q(\theta) \sum_i \sum_j \frac{d_u(a_i, x_j)}{u} [J(a_i, x_j, y_k) - V(y_k)]^+ \tag{A.5}$$

A.2.2 Upwind Scheme

To compute the HJB equations, we need to approximate the derivatives of value functions numerically. Here we follow Achdou et al. (2022) and use the upwind scheme. The idea is to basically use the forward difference approximation whenever savings policy is positive, and backward difference whenever savings is negative.

Define the forward difference and backward difference as

$$W_{a,F}(a_i, x_j, y_k) = \frac{W(a_{i+1}, x_j, y_k) - W(a_i, x_j, y_k)}{\Delta_a}$$

$$W_{a,B}(a_i, x_j, y_k) = \frac{W(a_i, x_j, y_k) - W(a_{i-1}, x_j, y_k)}{\Delta_a}$$

$$\bar{W}_a(a_i, x_j, y_k) = u'(ra_i + w(a_i, x_j, y_k))$$

We use the ‘‘upwind scheme’’. From the first order condition we can get $c = (u')^{-1} W_a(a, x, y)$.

Define

$$s_{i,j,k,F}^W = ra_i + w(a_i, x_j, y_k) - (u')^{-1}(W_{a,F}(a_i, x_j, y_k))$$

$$s_{i,j,k,B}^W = ra_i + w(a_i, x_j, y_k) - (u')^{-1}(W_{a,B}(a_i, x_j, y_k))$$

and approximate the derivative as follows

$$\begin{aligned} W_a(a_i, x_j, y_k) &= W_{a,B}(a_i, x_j, y_k) \mathbf{1}_{\{s_{i,j,k,B}^W < 0\}} + W_{a,F}(a_i, x_j, y_k) \mathbf{1}_{\{s_{i,j,k,F}^W > 0\}} \\ &\quad + \bar{W}_a(a_i, x_j, y_k) \mathbf{1}_{\{s_{i,j,k,F}^W < 0 < s_{i,j,k,B}^W\}}. \end{aligned} \quad (\text{A.6})$$

The derivative of firms’ HJB J_a is approximated in the same way.

Since W is concave in a , we have $s_{i,j,k,F}^W < s_{i,j,k,B}^W$, then at some point i we have $s_{i,j,k,F}^W < 0 < s_{i,j,k,B}^W$, in which case we set savings to 0. Plugging the expression (A.6) into the discretized HJB equation (A.2), then the HJB equation can be written as

$$\begin{aligned} (\rho + \delta)W_i^{jk} &= u(c_i^{jk}) + \sigma [U_i^j - W_i^{jk}] + \tilde{\sigma} [U_i^j - W_i^{jk}]^+ \\ &\quad + \underbrace{\frac{W_{i+1}^{jk} - W_i^{jk}}{\Delta_a}}_{W_{a,F}} s_{i,F}^{jk,W+} + \underbrace{\frac{W_i^{jk} - W_{i-1}^{jk}}{\Delta_a}}_{W_{a,B}} s_{i,B}^{jk,W-} \end{aligned}$$

Let $\sigma_i^{jk} = \sigma$ if no endogenous separation, and $\sigma_i^{jk} = \sigma + \tilde{\sigma}$ otherwise. In matrix notation

$$\begin{aligned}
(\rho + \delta)W_i^{jk} &= u(c_i^{jk}) + \sigma_i^{jk} [U_i^j - W_i^{jk}] \\
&+ \frac{1}{\Delta_a} \begin{bmatrix} -s_{i,B}^{jk,W-}, & s_{i,B}^{jk,W-} - s_{i,F}^{jk,W+}, & s_{i,F}^{jk,W+} \end{bmatrix} \begin{bmatrix} W_{i-1}^{jk} \\ W_i^{jk} \\ W_{i+1}^{jk} \end{bmatrix}
\end{aligned} \tag{A.7}$$

Similarly define

$$\begin{aligned}
(\rho + \delta)U_i^j &= u(c_i^j) + p(\theta) \sum_k \frac{d_v(k)}{v} [W_i^{jk} - U_i^j]^+ \\
&+ \frac{1}{\Delta_a} \begin{bmatrix} -s_{i,B}^{j,U-}, & s_{i,B}^{j,U-} - s_{i,F}^{j,U+}, & s_{i,F}^{j,U+} \end{bmatrix} \begin{bmatrix} U_{i-1}^j \\ U_i^j \\ U_{i+1}^j \end{bmatrix}
\end{aligned} \tag{A.8}$$

and

$$\begin{aligned}
rJ_i^{jk} &= f^{jk} - \omega_i^{jk} + (\sigma_i^{jk} + \delta) [V^k - J_i^{jk}] \\
&+ \frac{1}{\Delta_a} \begin{bmatrix} -s_{i,B}^{jk,W-}, & s_{i,B}^{jk,W-} - s_{i,F}^{jk,W+}, & s_{i,F}^{jk,W+} \end{bmatrix} \begin{bmatrix} J_{i-1}^{jk} \\ J_i^{jk} \\ J_{i+1}^{jk} \end{bmatrix}
\end{aligned} \tag{A.9}$$

A.2.3 Implicit method

Let \mathbf{W} denote the vector that stacks all value functions together. The implicit method updates the value functions in the following way:

$$\frac{1}{\Delta} (\mathbf{W}^{n+1} - \mathbf{W}^n) + (\rho + \delta)\mathbf{W}^{n+1} = \tilde{\mathbf{u}}(\mathbf{W}^n) + \mathbf{A}(\mathbf{W}^n)\mathbf{W}^{n+1}$$

which gives

$$\begin{aligned} & \left(\left(\rho + \delta + \frac{1}{\Delta} \right) \mathbf{I} - \mathbf{A}(\mathbf{W}^n) \right) \mathbf{W}^{n+1} = \tilde{\mathbf{u}}(\mathbf{W}^n) + \frac{1}{\Delta} \mathbf{W}^n \\ \Rightarrow \mathbf{W}^{n+1} &= \left(\left(\rho + \delta + \frac{1}{\Delta} \right) \mathbf{I} - \mathbf{A}(\mathbf{W}^n) \right)^{-1} \left(\tilde{\mathbf{u}}(\mathbf{W}^n) + \frac{1}{\Delta} \mathbf{W}^n \right) \end{aligned}$$

Stack the value \mathbf{W} where we first loop over assets a_1, \dots, a_{N_a} , then over worker skills x_1, \dots, x_{N_x} , and then finally over firm type y_1, \dots, y_{N_y} in the outer loop. In particular, let

$$\mathbf{W} = \begin{pmatrix} \mathbf{W}_1^{11} \\ \mathbf{W}_2^{11} \\ \vdots \\ \mathbf{W}_{N_a}^{11} \\ \mathbf{W}_1^{21} \\ \vdots \\ \mathbf{W}_{N_a}^{N_x N_y} \\ \mathbf{U}_1^1 \\ \mathbf{U}_2^1 \\ \vdots \\ \mathbf{U}_{N_a}^1 \\ \mathbf{U}_1^2 \\ \vdots \\ \mathbf{U}_{N_a}^{N_x} \end{pmatrix}$$

The matrix $\mathbf{A}(\mathbf{W}^n)$ has three components: one with respect to asset accumulation (the last terms of equations (A.7) and (A.8)), another with respect to job separation $\sigma_i^{jk} [U_i^j - W_i^{jk}]$, and the last one with respect to job matching $p(\theta) \sum_k \frac{d_v(k)}{v} [W_i^{jk} - U_i^j]^\dagger$, which we denote as \mathbf{A}_1 , \mathbf{A}_2 and \mathbf{A}_3 respectively, then $\mathbf{A}(\mathbf{W}^n) = \mathbf{A}_1 + \mathbf{A}_2 + \mathbf{A}_3$ such that

$$\mathbf{A}_1 = \begin{bmatrix} \mathbf{A}_{1e} & 0 \\ 0 & \mathbf{A}_{1u} \end{bmatrix}$$

$$\mathbf{A}_{1e} = \begin{bmatrix} \beta_1^{11,W} & \gamma_1^{11,W} & 0 & \cdots & 0 \\ \alpha_2^{11,W} & \beta_2^{11,W} & \gamma_2^{11,W} & 0 & \cdots \\ 0 & \alpha_3^{11,W} & \beta_3^{11,W} & \gamma_3^{11,W} & 0 \\ \vdots & \ddots & \ddots & \ddots & \ddots \\ 0 & \ddots & \ddots & \alpha_{Na}^{NxNy,W} & \beta_{Na}^{NxNy,W} \end{bmatrix}$$

$$\mathbf{A}_{1u} = \begin{bmatrix} \beta_1^{1,U} & \gamma_1^{1,U} & 0 & \cdots & 0 \\ \alpha_2^{1,U} & \beta_2^{1,U} & \gamma_2^{1,U} & 0 & 0 \\ 0 & \alpha_3^{1,U} & \beta_3^{1,U} & \gamma_3^{1,U} & 0 \\ \ddots & \ddots & \ddots & \ddots & \ddots \\ 0 & \cdots & 0 & \beta_{Na}^{Nx,U} & \gamma_{Na}^{Nx,U} \end{bmatrix}$$

where

$$\alpha_i^{jk,W} = \frac{-s_{i,B}^{jk,W-}}{\Delta_a}$$

$$\beta_i^{jk,W} = \frac{s_{i,B}^{jk,W-} - s_{i,F}^{jk,W+}}{\Delta_a}$$

$$\gamma_i^{jk,W} = \frac{s_{i,F}^{jk,W+}}{\Delta_a}$$

and analogously for the unemployed coefficients.

$$\mathbf{A}_2 = \begin{bmatrix} -\sigma_1^{11} & 0 & \cdots & 0 & & 0 & \sigma_1^{11} & 0 & \cdots & 0 \\ 0 & -\sigma_2^{11} & 0 & 0 & & \vdots & 0 & \sigma_2^{11} & 0 & 0 \\ \vdots & \ddots & \ddots & \vdots & & \vdots & \vdots & \ddots & \ddots & \vdots \\ 0 & 0 & \cdots & -\sigma_{N_a}^{11} & & \vdots & 0 & \cdots & 0 & \sigma_{N_a}^{11} \\ \vdots & \ddots & \ddots & \ddots & \ddots & \vdots & \sigma_1^{21} & 0 & \cdots & 0 \\ \vdots & & & & & \vdots & 0 & \sigma_2^{21} & 0 & 0 \\ \vdots & & & & & \vdots & \vdots & \ddots & \ddots & \vdots \\ \vdots & & & & & \vdots & 0 & \cdots & 0 & \sigma_{N_a}^{21} \\ \vdots & & & & & \vdots & \sigma_1^{N_x N_y} & 0 & \cdots & 0 \\ \vdots & & & & & \vdots & 0 & \sigma_2^{N_x N_y} & 0 & 0 \\ \vdots & & & & & \vdots & 0 & \vdots & \ddots & \vdots \\ 0 & \cdots & \cdots & \cdots & \cdots & 0 & -\sigma_{N_a}^{N_x N_y} & 0 & \cdots & 0 & \sigma_{N_a}^{N_x N_y} \\ 0 & \cdots & \cdots & \cdots & \cdots & \cdots & \cdots & \cdots & \cdots & \cdots & 0 \\ \vdots & \ddots & \vdots \\ 0 & \cdots & \cdots & \cdots & \cdots & \cdots & \cdots & \cdots & \cdots & \cdots & 0 \end{bmatrix}$$

where each diagonal submatrix corresponds to a loop over asset states a_1, \dots, a_{N_a} and worker skills x_1, \dots, x_{N_x} . The bottom part is a matrix of $N_1 \times N_2$ zeros where $N_1 = N_a \times N_x$ and $N_2 = N_a \times N_x \times (N_y + 1)$.

$$\mathbf{A}_3 = p(\theta) \times \begin{bmatrix} 0 & \cdots & \cdots & \cdots & 0 \\ \vdots & \ddots & \ddots & \ddots & \vdots \\ 0 & \cdots & \cdots & \cdots & 0 \\ \mathbf{A}_{31} & \mathbf{A}_{32} & \cdots & \mathbf{A}_{3N_y} & \mathbf{A}_{3N_y+1} \end{bmatrix}$$

where

$$\mathbf{A}_{3k} = \begin{bmatrix} d_v^k \mathbf{1}_1^{1k} & 0 & \cdots & \cdots & \cdots & 0 \\ 0 & d_v^k \mathbf{1}_2^{1k} & \ddots & \ddots & \ddots & \vdots \\ \vdots & \ddots & \ddots & \ddots & \ddots & \vdots \\ \vdots & \ddots & \ddots & d_v^k \mathbf{1}_{N_a}^{1k} & \ddots & \vdots \\ \vdots & \ddots & \ddots & \ddots & \ddots & \vdots \\ 0 & \cdots & \cdots & \cdots & 0 & d_v^k \mathbf{1}_{N_a}^{N_x k} \end{bmatrix}$$

$$\mathbf{1}_i^{jk} = \begin{cases} 1 & \text{if } W(a_i, x_j, y_k) > U(a_i, x_j) \\ 0 & \text{otherwise} \end{cases}$$

and

$$\mathbf{A}_{3N_y+1} = \begin{bmatrix} -\sum_k d_v^k \mathbf{1}_1^{1k} & 0 & \cdots & \cdots & \cdots & 0 \\ 0 & -\sum_k d_v^k \mathbf{1}_2^{1k} & \ddots & \ddots & \ddots & \vdots \\ \vdots & \ddots & \ddots & \ddots & \ddots & \vdots \\ \vdots & \ddots & \ddots & -\sum_k d_v^k \mathbf{1}_{N_a}^{1k} & \ddots & \vdots \\ \vdots & \ddots & \ddots & \ddots & \ddots & \vdots \\ 0 & \cdots & \cdots & \cdots & 0 & -\sum_k d_v^k \mathbf{1}_{N_a}^{N_x k} \end{bmatrix}$$

and the top part is a matrix of $N_1 \times N_2$ zeros where $N_1 = N_a \times N_x \times N_y$ and $N_2 = N_a \times N_x \times (N_y + 1)$.

Similarly, let \mathbf{J} denote the vector that stacks all firm value functions together, and $\mathbf{\Pi}$ denote the vector of firm flow profits. The implicit method updates firms' value functions in the following way

$$\frac{1}{\Delta} (\mathbf{J}^{n+1} - \mathbf{J}^n) + r\mathbf{J}^{n+1} = \mathbf{\Pi} + \mathbf{B}(\mathbf{W}) \mathbf{J}^{n+1}$$

The matrix $\mathbf{B}(\mathbf{W})$ also has three components: one with respect to workers' asset accumulation (hence the dependence on \mathbf{W}), another with respect to job separation $(\sigma_i^{jk} + \delta) [V^j - J_i^{jk}]$, and the last one with respect to worker matching $q(\theta) \sum_i \sum_j \frac{d_u(i,j)}{u} [J_i^{jk} - V^j]^+$. Note that the first

component is exactly the same as \mathbf{A}_1 , so we get it for free once we have finished workers' system of PDEs.

The next two components can be constructed in an analogous way to \mathbf{A}_2 and \mathbf{A}_3 and we therefore omit the details.

A.2.4 Stationary Density

Recall the Kolmogorov Forward (KF) equations for density:

$$\begin{aligned}
0 &= -\frac{\partial}{\partial a} [s^W(a, x, y) d_m(a, x, y)] - \{\sigma + \delta + \tilde{\sigma}[1 - \Phi(a, x, y)]\} d_m(a, x, y) \\
&\quad + p(\theta) \frac{d_v(y)}{v} \Phi(a, x, y) d_u(a, x) \\
0 &= -\frac{\partial}{\partial a} [s^U(a, x) d_u(a, x)] - \int p(\theta) \frac{d_v(y)}{v} \Phi(a, x, y) d_u(a, x) dy - \delta d_u(a, x) \\
&\quad + \sigma \int d_m(a, x, y) dy + \tilde{\sigma} \int [1 - \Phi(a, x, y)] d_m(a, x, y) dy + \delta d_x \cdot \mathbb{1}\{a = 0\}
\end{aligned}$$

together with the condition that density integrates to 1:

$$1 = \int_{\underline{a}}^{\infty} d_m(a, x, y) da dx dy + \int_{\underline{a}}^{\infty} d_u(a, x) da dx$$

as well as

$$\begin{aligned}
d_x &= \int_{\underline{a}}^{\infty} d_m(a, x, y) da dy + \int_{\underline{a}}^{\infty} d_u(a, x) da \\
d_y &= \int_{\underline{a}}^{\infty} d_m(a, x, y) da dx + d_v(y)
\end{aligned}$$

which can be discretized as

$$\begin{aligned}
0 &= -\frac{\partial}{\partial a} [s_i^{jk,W} d_i^{jk,W}] - (\sigma_i^{jk} + \delta) d_i^{jk,W} + p(\theta) \frac{d_v^k}{v} \mathbb{1}_i^{jk} d_i^{j,U} \\
0 &= -\frac{\partial}{\partial a} [s_i^{j,U} d_i^{j,U}] - p(\theta) \sum_{k=1}^{N_y} \frac{d_v^k}{v} \mathbb{1}_i^{jk} d_i^{j,U} + \sigma_i^{jk} \sum_{k=1}^{N_y} d_i^{jk,W} + \delta \mathbb{1}\{i = 1\} \sum_{i'} \left(d_{i'}^{j,U} + \sum_k d_{i'}^{jk,W} \right)
\end{aligned}$$

and

$$\begin{aligned}
1 &= \sum_{i=1}^{N_a} \sum_{j=1}^{N_x} \sum_{k=1}^{N_y} d_i^{jk,W} \Delta_a \Delta_x \Delta_y + \sum_{i=1}^{N_a} \sum_{j=1}^{N_x} d_i^{j,U} \Delta_a \Delta_x \\
d_x^j &= \sum_{i=1}^{N_a} \sum_{k=1}^{N_y} d_i^{jk,W} \Delta_a \Delta_y + \sum_{i=1}^{N_a} d_i^{j,U} \Delta_a \\
d_y^k &= \sum_{i=1}^{N_a} \sum_{j=1}^{N_x} d_i^{jk,W} \Delta_a \Delta_x + d_v^k
\end{aligned} \tag{A.10}$$

A.2.5 Upwind Scheme

For the derivatives, we again use the forward scheme

$$\begin{aligned}
0 &= - \frac{d_i^{jk,W} s_{i,F}^{jk,W+} - d_{i-1}^{jk,W} s_{i-1,F}^{jk,W+}}{\Delta_a} - \frac{d_{i+1}^{jk,W} s_{i+1,B}^{jk,W-} - d_i^{jk,W} s_{i,B}^{jk,W-}}{\Delta_a} \\
&\quad - \left(\sigma_i^{jk} + \delta \right) d_i^{jk,W} + p(\theta) \frac{d_v^k}{v} \mathbb{1}_i^{jk} d_i^{j,U} \\
0 &= - \frac{d_i^{j,U} s_{i,F}^{j,U+} - d_{i-1}^{j,U} s_{i-1,F}^{j,U+}}{\Delta_a} - \frac{d_{i+1}^{j,U} s_{i+1,B}^{j,U-} - d_i^{j,U} s_{i,B}^{j,U-}}{\Delta_a} \\
&\quad - p(\theta) \sum_{k=1}^{N_y} \frac{d_v^k}{v} \mathbb{1}_i^{jk} d_i^{j,U} + \sigma_i^{jk} \sum_{k=1}^{N_y} d_i^{jk,W} + \delta \mathbb{1}\{i=1\} \sum_{i'} \left(d_{i'}^{j,U} + \sum_k d_{i'}^{jk,W} \right)
\end{aligned}$$

Collecting terms, we have

$$\begin{aligned}
0 &= d_{i-1}^{jk,W} \alpha_{i-1}^{jk,W} + d_i^{jk,W} \beta_i^{jk,W} + d_{i+1}^{jk,W} \gamma_{i+1}^{jk,W} + p(\theta) \frac{d_v^k}{v} \mathbb{1}_i^{jk} d_i^{j,U} \\
0 &= d_{i-1}^{j,U} \alpha_{i-1}^{j,U} + d_i^{j,U} \beta_i^{j,U} + d_{i+1}^{j,U} \gamma_{i+1}^{j,U} + \sigma_i^{jk} \sum_{k=1}^{N_y} d_i^{jk,W} + \delta \mathbb{1}\{i=1\} \sum_{i'} \left(d_{i'}^{j,U} + \sum_k d_{i'}^{jk,W} \right)
\end{aligned}$$

where

$$\begin{cases} \alpha_{i-1}^{jk,W} = \frac{s_{i-1,F}^{jk,W+}}{\Delta_a} \\ \beta_i^{jk,W} = \frac{s_{i,B}^{jk,W-} - s_{i,F}^{jk,W+}}{\Delta_a} \\ \gamma_i^{jk,W} = -\frac{s_{i+1}^{jk,W-}}{\Delta_a} \end{cases} - \delta \begin{cases} \alpha_{i-1}^{j,U} = \frac{s_{i-1,F}^{j,U+}}{\Delta_a} \\ \beta_i^{j,U} = \frac{s_{i,B}^{j,U-} - s_{i,F}^{j,U+}}{\Delta_a} \\ \gamma_i^{j,U} = -\frac{s_{i+1}^{j,U-}}{\Delta_a} \end{cases} - p(\theta) \sum_{k=1}^{N_y} \frac{d_v^k}{v} \mathbb{1}_i^{jk}$$

Let \mathbf{d} be the stacked vector of densities (arranged in the same order as \mathbf{W}), then the KF equations expressed using the upwind scheme can be written as

$$\tilde{\mathbf{A}}\mathbf{d} = 0 \tag{A.11}$$

where $\tilde{\mathbf{A}}$ is related to the transpose of \mathbf{A} , the matrix that was defined in the implicit method in Section A.2.3. Following the construction of \mathbf{A} , we can also write $\tilde{\mathbf{A}}$ as the sum of a component due to asset accumulation, a component due to job separation (and exiting the economy), and a component due to job finding. Note that unlike the setup in Achdou et al. (2022) where the KF equations are directly the transpose of the HJB equations, here we need to rewrite the job separation and exiting component of the matrix as the exit shocks (which happens at Poisson rate δ) leave workers with 0 continuation value so is in essence equivalent to increasing workers' discount rate ρ by δ , while for the worker flow equations, the exit shocks reallocate workers to the unemployed state with 0 assets. To make the adjustment, simply subtract the diagonal elements of \mathbf{A}_2 by δ , increase the elements corresponding to the transition from employed state (i, j, k) and unemployed state (i, j) to $(1, j)$ by δ , and transpose the matrix.

To solve the problem of equation (A.11) subject to the constraints (A.10), we can do the following. Fix (1) either $d_i^{jk,W}$ or $d_i^{j,U}$ to be 0.1 (or any other non-zero number) for arbitrary (i, j, k) ; (2) then solve the system for some \tilde{d} and then to renormalize

$$d_i^{jk,W} = \tilde{d}_i^{jk,W} / \left(\sum_{i=1}^{N_a} \sum_{j=1}^{N_x} \sum_{k=1}^{N_y} \tilde{d}_i^{jk,W} \Delta_a \Delta_x \Delta_y + \sum_{i=1}^{N_a} \sum_{j=1}^{N_x} \tilde{d}_i^{j,U} \Delta_a \Delta_x \right)$$

and

$$d_i^{j,U} = \tilde{d}_i^{j,U} / \left(\sum_{i=1}^{N_a} \sum_{j=1}^{N_x} \sum_{k=1}^{N_y} \tilde{d}_i^{jk,W} \Delta_a \Delta_x \Delta_y + \sum_{i=1}^{N_a} \sum_{j=1}^{N_x} \tilde{d}_i^{j,U} \Delta_a \Delta_x \right).$$

A.3 Data and Empirics Appendix

A.3.1 Construction of Worker and Firm Types

This section describes the method to construct multi-dimensional worker skills and job skill requirements, used by Lise and Postel-Vinay (2020).

We create 2-dimensional worker skill bundles and job skill requirement bundles using a data set combining NLSY79 job history and O*NET, following Lise and Postel-Vinay (2020).

For jobs, we

- match weekly NLSY79 job record to O*NET data which contains measures of a variety of job skill descriptors
- take the first 2 principal components of these measures in the panel
- recombine the 2 principal components so that they satisfy the following exclusion restrictions: (1) the *mathematics* measure only reflects cognitive skill requirements; (2) the *mechanical knowledge* scores only reflects manual skill requirements
- normalize the skill requirements so that each component lies in $[0, 1]$

For workers, we

- use all 10 components of individual ASVAB test scores and a measure of health (BMI)
- take the first 2 principal components of these measures
- recombine them so that (1) the ASVAB *mathematics knowledge* score only reflects cognitive skills; (2) the ASVAB *automotive and shop information* score only reflects manual skills
- normalize the skill measures so that each component lies in $[0, 1]$

In the analysis above, we only use the first component, i.e. cognitive skill/skill requirement.

A.3.2 Estimates of the Effect of Wealth on Labor Market Outcomes

Table A.1: Effect of Wealth on Mismatch

| | Under-match | | | Over-match | | | Mismatch magnitude | | |
|--------------------------|----------------------|----------------------|----------------------|------------------|------------------|------------------|----------------------|----------------------|----------------------|
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
| Liquid wealth (\$1,000s) | -0.826*** (0.133) | -0.803*** (0.133) | -0.776*** (0.133) | 0.249 (0.471) | 0.280 (0.473) | 0.331 (0.474) | -0.857*** (0.133) | -0.826*** (0.133) | -0.800*** (0.133) |
| Demographic control | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Experience control | | ✓ | ✓ | | ✓ | ✓ | | ✓ | ✓ |
| Economics control | | | ✓ | | | ✓ | | | ✓ |
| Observations | 4706 | 4706 | 4706 | 1451 | 1451 | 1451 | 6157 | 6157 | 6157 |
| R^2 | 0.256 | 0.260 | 0.265 | 0.0249 | 0.0303 | 0.0318 | 0.204 | 0.206 | 0.209 |

Standard errors in parentheses, * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Notes: All coefficients and standard errors are multiplied by 100. Under-match means mismatch conditional on $y < x$, i.e. the worker is relatively more productive than the matched firm, while over-match means the opposite. Mismatch magnitude means the absolute value of mismatch $|y - x|$. Demographic controls include race, gender, education, ASVAB score, worker productivity x and a quadratic function of age. Experience controls include quadratic functions of work and occupation tenure. Economic controls include region fixed effect and national unemployment rate. Standard errors of coefficients are shown in parentheses.

Table A.2: Effect of Wealth on Labor Market Outcomes

| | Job tenure (months) | | | Logged wages | | | Months unemployed | | |
|--------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
| Liquid wealth (\$1,000s) | 0.391*** (0.067) | 0.384*** (0.067) | 0.341*** (0.067) | 0.011*** (0.001) | 0.010*** (0.001) | 0.010*** (0.001) | 0.330*** (0.081) | 0.384*** (0.081) | 0.364*** (0.081) |
| Demographic control | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Experience control | | ✓ | ✓ | | ✓ | ✓ | | ✓ | ✓ |
| Economics control | | | ✓ | | | ✓ | | | ✓ |
| Observations | 7068 | 7068 | 4706 | 6791 | 6791 | 6791 | 8202 | 8202 | 8202 |
| R^2 | 0.034 | 0.041 | 0.060 | 0.178 | 0.198 | 0.202 | 0.034 | 0.039 | 0.045 |

Standard errors in parentheses, * p<0.10, ** p<0.05, *** p<0.01

Notes: Demographic controls include race, gender, education, ASVAB score, worker productivity x and a quadratic function of age. Experience controls include quadratic functions of work and occupation tenure. Economic controls include region fixed effect and national unemployment rate. Standard errors of coefficients are shown in parentheses.

A.4 Quantitative Results Appendix

A.4.1 Production Functions

Production Function with Vertical Heterogeneity

The production is specified by a CES function:

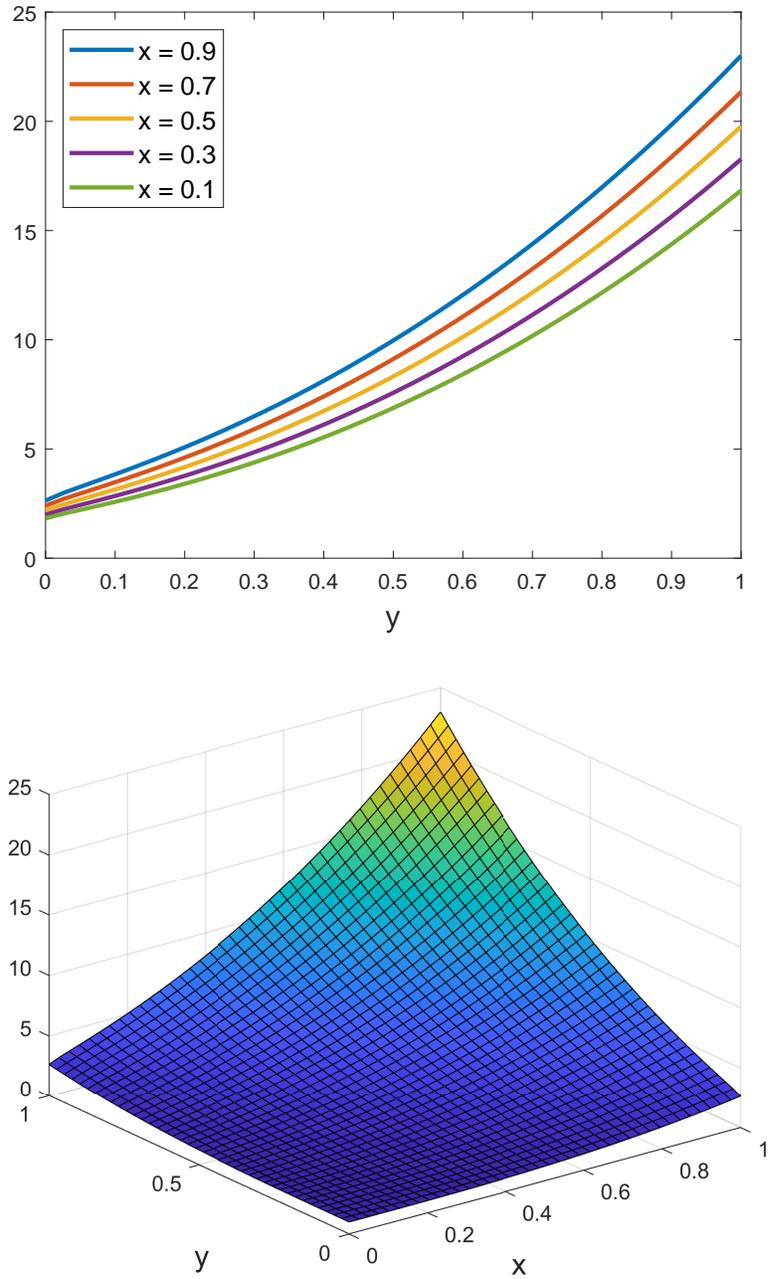
$$f(x, y) = f_0 + f_1 \left(x^\xi + y^\xi \right)^{\nu/\xi}, \quad x, y \in [0, 1]$$

where f_0 controls the level of minimum production, f_1 controls the scale, ξ controls the elasticity of substitution between worker productivity x and firm productivity y , and ν controls the curvature of the production function.

The production function is illustrated in Figure A.1.

Shimer and Smith (2000) shows that the search equilibrium features positive assortative matching if the production function is log-supermodular. This condition is satisfied if we assume $\xi \in (0, 1)$.

Figure A.1: Production Function with Vertical Heterogeneity



Notes: This graph illustrates the production function with vertical heterogeneity, specified by the CES form $f(x, y) = f_0 + f_1 (x^\xi + y^\xi)^{\nu/\xi}$. The first panel shows the function with respect to y at different levels of x . The second panel shows the function in 3-D format.

Production Function with Horizontal Heterogeneity

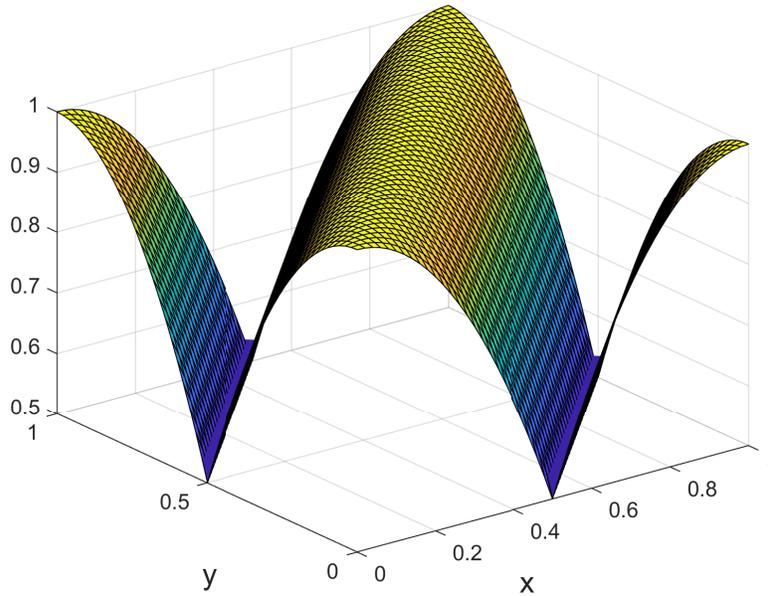
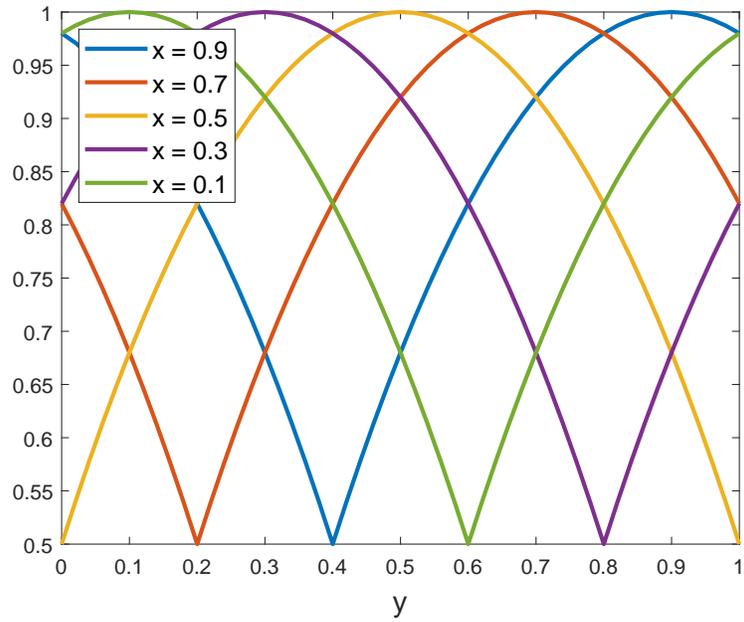
The production function is specified by the following form:

$$f(x, y) = a - b \min(|x - y|, |1 + x - y|, |1 + y - x|)^2, \quad x, y \in [0, 1)$$

In this case, workers and firms are placed on a unit circle, with 0 indicating an arbitrary starting point of the circle and 1 indicating the end point of the circle (and therefore overlaps with 0). Agents are symmetric but not identical to each other: each worker produce the most when matched with a firm located closest to them on the unit circle, and produce less as the distance increases.

The production function is illustrated in Figure A.2.

Figure A.2: Production Function with Horizontal Heterogeneity



Notes: This graph illustrates the production function with horizontal heterogeneity, specified by the circular form $f(x, y) = a - b \min(|x - y|, |1 + x - y|, |1 + y - x|)^2$. The first panel shows the function with respect to y at different levels of x . The second panel shows the function in 3-D format.

A.4.2 Precautionary Mismatch vs. No Precautionary Motive

In this section we estimate the extent of precautionary mismatch (misallocation due to workers' precautionary motive) by conducting an accounting exercise, where all unemployed workers are assumed to search as if they are wealthy, i.e. they follow the search strategy of the wealthiest workers among their own productivity types.

Let all variables with superscript PM denote equilibrium objects under the baseline equilibrium with precautionary mismatch, and variables with superscript NP denote equilibrium objects under the hypothetical scenario where workers search like the wealthiest and thus behave as if they have no precautionary motive.

Let $X \in \{PM, NP\}$ denote the share of employed workers with productivity type x and working at jobs with productivity type y as $s^X(x, y)$. We have

$$s^X(x, y) = \frac{\int_a d_m(a, x, y) da}{\iiint d_m(a, x, y) da dx dy} \in [0, d_w(x)].$$

Then the difference in aggregate labor productivity in the two economies can be expressed as

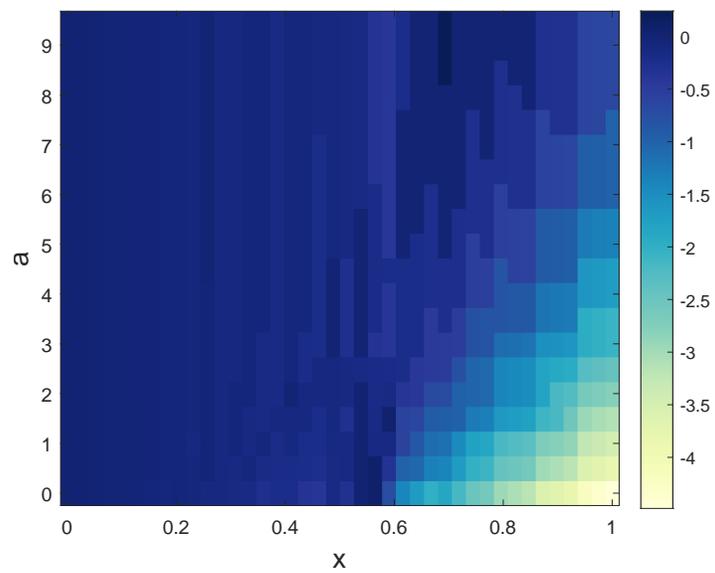
$$\iint f(x, y) s^{PM}(x, y) dx dy - \iint f(x, y) s^{NP}(x, y) dx dy.$$

We can also decompose the aggregate labor productivity difference by workers at different states. For workers with wealth holdings a and productivity type x in the baseline economy, their average difference in productivity compared with the no-precautionary-motive scenario is

$$\frac{\int f(x, y) d_m^{PM}(a, x, y) dy}{\int d_m^{PM}(a, x, y) dy} - \frac{\int f(x, y) s^{NP}(x, y) dy}{\int s^{NP}(x, y) dy}.$$

We plot the productivity difference in Figure A.3. As we can see, the productivity loss due to precautionary motive is concentrated on high-skilled wealth-poor workers, who tend to be young labor market entrants. The overall productivity in the NP economy is around 0.15% higher than the baseline level.

Figure A.3: Productivity Differences between PM and NP Equilibria



Notes: This graph illustrates the average productivity differences of workers in different states between the baseline economy (PM) and the hypothetical case without precautionary motive (NP).

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