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How Americans Respond to Idiosyncratic and Exogenous Changes in Household Wealth and Unearned Income

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On average, an extra dollar of unearned income in a given period reduces pre-tax labor earnings by about 50 cents, decreases total labor taxes by 10 cents, and increases consumption by 60 cents.

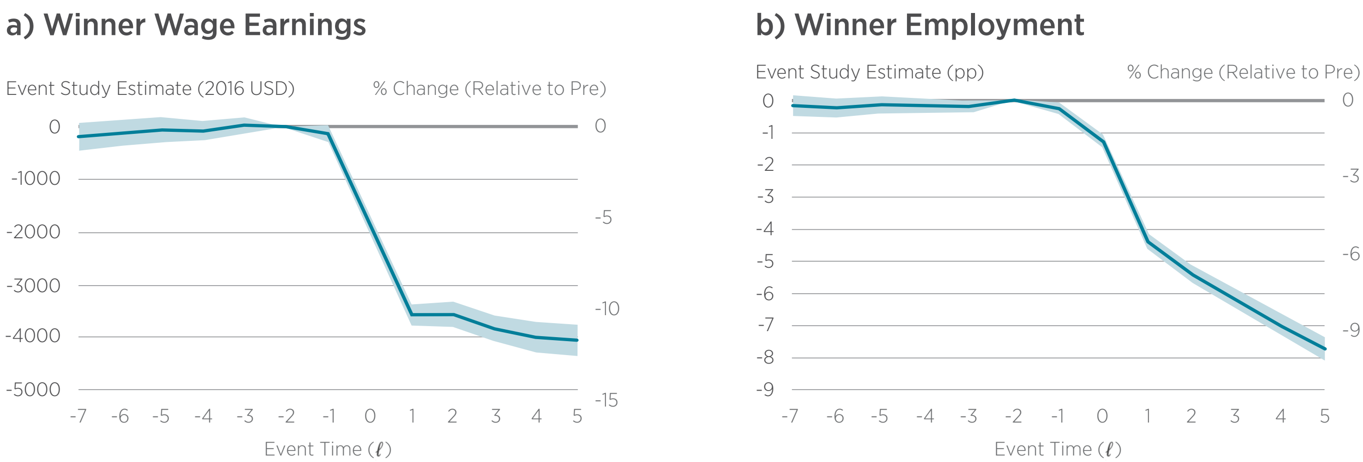
How do Americans respond to receiving an unexpected financial windfall or, in economic parlance, an idiosyncratic and exogenous change in household wealth and unearned income? For example, do they work less? And how much of the windfall do they spend? The answers to these and other questions matter as policymakers consider the income and wealth effects of policies ranging from taxation to a universal basic income (UBI).

Researchers have long struggled to find variation in wealth or unearned income that is both as good as random and specific to an individual as opposed to economy-wide. Such variation is necessary to isolate the effects of changes in wealth or unearned income, holding fixed other determinants of behavior such as preferences and prices. The authors address this challenge by analyzing a wide range of individual and household responses to lottery winnings between 1999 and 2016, and then exploring the economic, and policy, implications.

Their primary findings are three-fold:

- First, the authors find significant and sizable wealth and income effects. On average, an extra dollar of unearned income in a given period reduces pre-tax labor earnings by about 50 cents, decreases total labor taxes by

Figure 1 • Median Household Resilience by Income Quintile



Note: This figure presents estimates of the impact of winning a lottery on two outcomes. Please see the working paper for panels that illustrate four additional outcomes, and for further details on how these data were estimated.

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10 cents, and increases consumption by 60 cents. These effects differ across the income distribution, with households in higher quartiles of the income distribution reducing their earnings by a larger amount.

- Next, the authors develop and apply a rich life-cycle model in which heterogeneous households face non-linear taxes and make earnings choices both in terms of how many people work (extensive margin) and how much a given number of people work, on average (intensive margin). By mapping their model to their estimated earnings responses, the authors obtained informative bounds on the impacts of two policy reforms: an introduction of UBI and an increase in top marginal tax rates.

- Finally, this work analyzes how additional wealth and unearned income affect a wide range of behavior, including geographic mobility and neighborhood choice, retirement decisions and labor market exit, family formation and dissolution, entry into entrepreneurship, and job-to-job mobility.

As an example of this work's insight into policymaking, the authors' comprehensive and novel set of analyses demonstrates that the introduction of a UBI will have a large effect on earnings and tax rates. Even if one abstracts from any disincentive effects from higher taxes that are needed to finance a UBI, each dollar will reduce total earnings by at least 52 cents and require an increase in tax rates that is roughly 10 percent higher than what would have been in the absence of any behavioral earnings responses. For example, given average household earnings of roughly $50,000, a UBI of $12,000 a year would reduce average household earnings by more than $6,000 and require an earnings surcharge of approximately 27 percent on all households, out of which 2.5 percentage points is due to the behavioral response.

Another example of this work's application reveals the effect of a financial windfall on people's decision to move. Winning a lottery leads to an immediate, one-off increase in the annual moving rate of approximately 25 percent. Lower-income households, younger households, and renters constitute the groups that are most responsive to a change in wealth in terms of geographic mobility. One striking finding is that households do not systematically move to neighborhoods that are typically-measured (using local-area opportunity indices, poverty rates, and educational attainment) as having higher quality. This is true even for parents with young kids. This finding indicates that pure unconditional cash transfers do not lead households to systematically move to locations of higher quality, suggesting that non-financial barriers must play a big role.