Heterogeneous preferences and risk sharing at household level in China

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Summary

This paper investigates the degree of risk sharing across households in China with heterogeneous risk and time preferences from the late 1990s to early 2010s. Standard tests assume homogeneous preferences across households, which may bias the true risk sharing degree if, in reality, preferences correlate with variations of household income. We use household data from the China Health and Nutrition Survey (CHNS) and China Family Panel Studies (CFPS) to show that, in China, the incomes of less risk-averse and less-patient households correlate more positively with the aggregate risk. The standard test, which ignores this correlation, shows about 30% of household income shocks would pass through to household consumption. However, this number reduces to around 3% and becomes insignificant when preferences heterogeneity is accounted for. By comparing this result with that of the US, we find that the degree of risk sharing across households in China is similar to that in the US.

We further argue that this improvement of risk sharing from the standard test to tests incorporating preferences heterogeneity is due to the institutional changes and labour market reforms that took place during the mid-1990s and early 2000s. These reforms gave individuals more freedom in their labour market choices, which makes preference heterogeneity more relevant in economic analysis, as people can choose occupations more aligned to their preferences. We then use the Research Center on the Rural Economy (RCRE) Fixed Point Rural Household Survey data to provide empirical evidence of the effect of reforms on household risk sharing.