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Prudence, risk aversion, and the demand for life insurance

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Abstract

We estimate the effect of household wealth on the demand for life insurance using survey data from a broad cross-section of the USA. This procedure allows us to test the Pratt-Arrow hypothesis of decreasing absolute risk aversion (DARA). Additionally, we estimate the relative magnitude of prudence, the propensity to take precautions when faced with risk. We find that life insurance purchases increase with wealth, and that on average American households exhibit about 94 per cent as much prudence as risk aversion. On the basis of this evidence, we reject the DARA hypothesis.

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