

Course: ECON 613

Name: Yuqi Zhou

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### **Reading Notes of "CONSUMPTION AND HABITS: EVIDENCE FROM PANEL DATA"**

The paper aims to test the existence of habit formation in consumption decisions by using household panel data. Previous work found the mismatch between the predictions from models that assume intertemporally separable preferences and the evidence in real life. Economists realized the influence of unobserved heterogeneity of each household and incorporated time formation, an approach of modeling time dependence in preferences. In this paper, the author uses the test designed by Meghir and Weber (1996) on a Spanish panel data that spans eight quarters and calculates the MRS and Euler equations between commodities. The findings confirm the necessity of accounting for fixed effects when interpreting consumption decisions.

The author uses Continuous Family Expenditure Survey from 1985 to 1995. ECPF is a rotating panel based survey and documents interviews for roughly 3,200 households. It can follow eight consecutive quarters of a household, thus ruling out the fixed effects by a proper transformation of the empirical specification is plausible. The study is limited to food, transport and services. The author applies GMM to present both estimates. First set contains MRS and Euler equation estimates in levels and second set represents the results examines the presence of dynamics in the MRS and Euler equations after controlling the fixed effects. The paper also uses Sargan tests for instrumental validity to discover the possible correlated heterogeneity in the level estimates. The author also calculates income, price inelasticities, the elasticities of substitution, and the degree of habit formation to back up the findings. Based on results given by MRS and Euler equations, when the time invariant unobserved heterogeneity is neglected, preferences are intertemporally separable. After fixed effects are controlled, the habit formation shows up for food consumption and services, and correlation between the instruments and the error terms are detected insignificant in Sargan test.

In conclusion, the author presents the importance of considering unobserved heterogeneity across households that do not change through time. The paper matches the prediction models to empirical evidence by introducing the time formation into the model; a more suitable dataset is used as well. Furthermore, since it is a panel data, we may apply VARMA model from time series to this data and see the determinants as well as trend.