

Consumption and Habits: Evidence from Panel Data

Reading Notes IV

Econ 613

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[Carrasco et al. \[2005\]](#) proposes a test for the presence of habit formation in consumption decisions using household panel data. This paper builds on the test of Meghir and Weber (1996) and shows the importance of accounting for fixed effects when testing for the presence of habit formation in consumption decisions. [Carrasco et al. \[2005\]](#) benefit from the eight-consecutive quarters of the Spanish Continuous Family Expenditure (SCFE) Survey, which allows them to take into account the time invariant unobserved heterogeneity across households. If fixed effects are not considered, they find evidence of intertemporally separable preferences. However, this result is not robust once they control for time invariant unobserved heterogeneity across households: in this case, a significant role of habit formation is found. Moreover, this paper adds to the micro-based studies on habit formation and overcomes potential problems in previous studies.

[Carrasco et al. \[2005\]](#) build on a test proposed by Meghir and Weber (1996). This paper studies three non-durable goods: food, transport, and services. Under the model, households are assumed to maximize the present discount of a lifetime utility and are subject to standard dynamic budget constraints and liquidity constraints. [Carrasco et al. \[2005\]](#) model preferences as flexible direct translog preferences allowing for time non-separabilities and preference shocks. The model is estimated by generalized method of moments (GMM).

In the empirical part, [Carrasco et al. \[2005\]](#) use 1985-1995 ECPF panel data and their final sample includes 2,606 observations (1,499 households). The paper reports estimates of the MRS and Euler equation in levels and the estimates of the presence of dynamics in the MRS and Euler equations after controlling for time invariant unobserved heterogeneity. The results show that if fixed effects are not considered, there are intertemporally separable preferences. Once fixed effects are controlled, the results yield evidence of habit formation for food consumption and services. Findings also suggest it is difficult to reject the equality of the coefficients obtained from the MRS and Euler equations.

To summarise, [Carrasco et al. \[2005\]](#) use ECPF data and find that it is important to control for correlated heterogeneity (“fixed effects”). Once controlling that, they find evidence of habit formation in all three goods. However, this paper does not consider a full demand system, only

the three goods, food at home, transport and services. It would also be interesting to look at the full demand system.

References

Carrasco, Raquel, José M. Labeaga, and J. David López-Salido, "Consumption and Habits: Evidence from Panel Data," *The Economic Journal*, 2005, 115 (500), 144–165.