Backgrounder: Scarred Consumption

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1 Research Question

To what extent do past economic experiences (both personal and macroeconomic) affect current consumption, beliefs, future income, and wealth accumulation? Can this behavior be described by standard rational-agent models?

2 Relation to Literature

- Malmendier and Nagel have two papers (2011 and 2015) that find significant effects of living through prior periods of macroeconomic shocks on financial activity and expectations, respectively. Both of these papers also observe similar age effects to what we see in this paper, and use only macro level shocks as explanatory variables, not shocks at the household level.
- Pistaferri (2016) - uses aggregate data to explore possible explanations for why consumption growth has been slower than income and wealth growth since the Great Recession, concluding that financial frictions cannot fully account for this gap and low consumer confidence is likely the primary driver
- Choi, Laibson, Madrian, and Metrick (2009) find that investors who experience rewarding 401(k) outcomes increase their 401(k) savings rate more than investors who have less rewarding experiences, beyond what can be explained by income effects or rational learning.
- Kaustia and Knupfer (2008) find that investors in Finland overweight personally experienced outcomes in future IPO subscriptions.

The primary contribution of this paper is that it can link the actual lived experiences of households directly to their consumption responses, rather than relying on aggregate shocks. It also seems that the majority of the existing literature on this topic (with the exception of the first three papers listed above) examine the role of past experiences on current economic behavior in the contexts of investors and firms, rather than on the consumer side.

3 Identification

$$C_{it} = \alpha + \beta UE_{it} + \psi UEP_{it} + \gamma_0 x_{it} + \eta_t + \varsigma_s + \upsilon_i + \varepsilon_{it} \tag{1}$$

The main empirical specification regresses total consumption on measures of an individual's past unemployment experiences, both macroeconomic (UE_{it}) and personal (UEP_{it}). They include controls for wealth, income, age, race, and certain household characteristics, and include year, state, and household fixed effects.

I have two concerns about the measurement of UEP_{it}. First, there is no discussion of the effect of having multiple earners in a household during an unemployment spell vs. a single earner. Personal unemployment histories are constructed using head of household experiences alone, and thus don't account for the presence (or lack thereof) of other earners within the household (which can vary over time and thus won't be captured by the household fixed effect). Presumably, having more than one source of reliable income at the time of unemployment would both make the spell itself more bearable and would mitigate some concern about future unemployment spells. If this is the case, the "scarring" for a household with multiple earners may not be as severe as for a household with similar prior experiences (for the head of household) but only a single earner. I'm not sure whether this should be included as a control or incorporated as part of the personal past unemployment experience measure, but it seems like giving equal weight to job loss with and without other income streams may mute the overall scarring effect.

I'm also concerned that the personal unemployment measure doesn't do a great job of actually capturing unemployment spells. According to the discussion on page 15, the PSID question used asks about employment status at the time of the survey. Given that the survey is only issued every two years, and that this question asks about current employment status rather than status over the course of the previous year, it seems like many periods of unemployment will not be captured. This is more concerning for short term unemployment than long term, which means the personal unemployment measure could be biased towards longer unemployment spells, which will likely have more of a "scarring" effect than short spells. Given that the authors claim the primary contribution of this paper is that it can look at specific household histories, it seems important to get the construction of this measure right.

4 Other comments

Aside from issues I take with the construction of the personal unemployment experience measure, I do think this is a very interesting paper and the fact that they are able to replicate results in three different datasets is encouraging. This seems like a very important question for policymakers in terms of understanding why consumption can remain low long after recessions end and how to approach a solution.

One further robustness check that I think could be interesting is looking into whether timing of shocks matters, beyond recency bias. Right now, by construction, they give decreasing weight to events further in the past, but it seems plausible to me that economic shocks that occur during childhood/formative years could play a larger role in future beliefs and behaviors than those occurring in midlife. This would perhaps provide an alternative explanation as to why they find stronger effects for young people. It may not be that young people are subject to more recency bias (their current interpretation), but instead that they have less midlife noise that confounds the true effect of shocks during formative years.

Lastly, the authors discuss changes in the quality of goods consumed, but don't directly discuss possible price effects. If prices remain low after periods of recession it's plausible that this could play a role in the decrease in spending, in addition to changes in the quality or quantity of goods consumed. This is something we've discussed in some of the Chase COVID work, though this is likely much more important in the midst of a recession rather than in the years afterward. I don't think this story is especially likely to matter given that unemployment experiences here are measured starting at least two years in the past and also given the results on beliefs about the market for durable goods, but might be worth mentioning.