Econ 613 Reading Note #4

CONSUMPTION AND HABITS: EVIDENCE FROM PANEL DATA

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This paper confirms the existence of habit formation in consumption decisions using ECPF households data. Data up to eight consecutive quarters allows to accomplish fixed effects and results emphasize the importance of accounting for time invariant unobserved heterogeneity. Based on estimations of the intertemporal Euler conditions and the within period MRS between goods in three nondurable goods model, this paper shows the presence of habit formation according to the MRS for food and services, and Euler equations for food.

The theoretical model is based on Meghir and Weber (1996), and the MRS and Euler equation is derived from a flexible direct translog utility function modified to allow for time non-separabilities and preference shocks. For estimation, two models for food/services and transport/service are estimated under GMM model. In data processing, this paper estimates the seasonal regression to verify the autoregressive effects and checks the time dependence of consumption in the structural model.

In estimation in levels, results verify the validity of instruments and the absence of serial correlation in the residuals of the equations in levels. Furthermore, the results show that preferences are intertemporal separate from the evidence for the lagged and lead variables in both MRS and Euler equation. The structural model results show that the coefficients of food and service are significant in the MRS model and the coefficient of food is significant in the Euler equation model, indicating the existence of habit formation. In conclusion, (1) Without considerations of invariant unobserved heterogeneity, preferences are intertemporally separable. (2) After controlling the fixed effects, it is showed the existence of habit formation in consumption. The large Sargan tests of overidentifying restrictions indicates no misspecification with the insignificant correlation between instruments and error terms. (3) The results obtained using the intertemporal Euler conditions indicates dynamics for food. (4) When focusing on the particular households, there is non-separabilities in the Euler equation.