

UNEQUAL BUSINESS CYCLES

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Abstract

Standard incomplete-markets (SIM) models predict that the consumption of low-skilled households is more cyclical relative to the consumption of high-skilled because they hold fewer liquid assets and experience larger income changes. I use the Consumer Expenditure Survey (CEX) to document that the opposite is true in the data: over the Business Cycles, lower-skilled workers experience smaller consumption changes. I also show that this different consumption cyclicalities is explained by the fact that high-skilled households consume relatively more luxuries. Motivated by these facts, I extend the SIM model to allow for non-homothetic preferences over goods. To discipline the non-homotheticity in preferences, I exploit cross-sectional data from CEX on how the consumption share of luxuries and necessities varies with income. The model reproduces the observation that consumption is more cyclical for high-skilled workers because these workers spend a larger share of their income on luxuries, which are easier to substitute over time. The model also predicts higher welfare costs of recessions for low-skilled workers, despite their lower consumption declines.

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