ECON 613

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Reading Notes 4: Carrasco, Labeaga, Lopez-Salido

The paper explores the habit formation for consumption across three goods: food, transportation, and service. Using panel data from Spanish household consumption behavior across eight consecutive periods, which accounts for the unobserved heterogeneity of households and allows paper to analyze relative consumption ratio and within- period marginal rate of substitution (MRS) between the three goods mentioned above. This paper is not the first one studying consumption habit and preference development, many previous papers also did similar studies. However, many use aggregate data and thus suffer from aggregation problems. For those that use panel data, discussions usually focus on one specific good or over a shorter time span. This paper uses a data set with eight consecutive quarters and across three types of typical household consumption goods and provides additional evidence and validations for conclusions derived from previous paper on consumption habits. With this summary in mind, for the rest of the reading notes, I will first introduce the data and methods used in this paper. I will then summarize the key findings. Lastly, I will share my thoughts on the paper and discuss its limitations.

The data comes from Continuous Family Expenditure Survey, reporting interviews of one-eighth of the 3,200 Spanish households pool each quarter from 1985 to 1995. Due to the rotating panel, each household can only be followed for eight quarters maximum. After cleaning out households reporting zero expenditure for either food, transportation, or service, and those with missing values generated for Euler’s equation in differences, the final dataset composed of 2606 households, representing 1499 households.

Based on the data, the model wants to examine change in utility function for each good for all periods. This utility function is composed of three parts. The first part is the good’s utility by itself given the consumption. The second part is the consumption utility in response to consumption of another good. The last part is the consumption utility in response to the previous quarter’s consumption. Based on the function here, habitual preference is shown when MRS is negative for time t+1. Intuitively, this can be understood as displease with changes in consumption due to habit formation. Thus, whether there are serial correlations between three goods and across time is the key to analysis.

Using the model described above, after controlling for fixed effects, we observed habit formation for food and service consumption. However, without controls or limiting the samples to households with heads under 40 years old yield difference findings with no dynamic in MRS. Besides the conclusion to the questions paper attempt to answer, the consumption habit development, the results show us the importance of proper treatment of unmeasured variables as “they les could give rise to a relationship between future and past consumption due solely to uncontrolled heterogeneity” (Carrasco et al. 2005).

After reading the paper, the inconsistency of results under different data constraints certainly give rise to the uncertainty of the final results obtained. This is concerning. Just as the paper points out in its conclusion section, individuals might have different propensity of consumption at each period independent of previous period’s level of consumption. I want to add additional problems with the data here. While finding dynamics MRS is important, I wonder if the evidence of negative MRS across periods is really the evidence for habit. Afterall, given budget constraints, which are unlikely to change significantly within two years for an average household, can stability of food, transportation, and service consumption really reflect habits? After all, there is a level of requirement for each. I believe data with households of gradual change in wealth (or sudden jump in wealth) across a few years would be a better reflection of habit if there is a clear connection between previous consumption and current.

Work Cited:

Carrasco, R., Labeaga, J. M., & López-Salido, D. (2005). Consumption and Habits: Evidence from Panel Data. *The Economic Journal*, *115*(500).