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Memorable consumption ☆

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Abstract

People often consume non-durable goods in a way that seems inconsistent with preferences for smoothing consumption over time. We suggest that such patterns of consumption can be better explained if one takes into account the future utility flows generated by memorable consumption goods—goods, such as a honeymoon or a vacation, whose utility flow outlives their physical consumption. We consider a model in which a consumer enjoys current consumption as well as utility generated by earlier memorable consumption. Lasting utility flows are generated only by some goods, and only when their consumption exceeds customary levels by a sufficient margin. We offer axiomatic foundations for the structure of the utility function and study optimal consumption in a dynamic model. We show that rational consumers, taking into account future utility flows, would make optimal choices that rationalize lumpy patterns of consumption.
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1. Introduction

1.1. Consumption patterns

The conceptual point of departure for modeling intertemporal consumption is a utility function of the form

$$U(c_0, c_1, \dots, c_T) = \sum_{t=0}^{T} \delta^t u(c_t), \tag{1}$$

where c_t is consumption in period t, δ is the (stationary) discount factor, u is the (stationary) utility function, typically assumed to be concave, and T may be finite or infinity. The discounting built into this model creates an incentive to move consumption toward the present, while the ability to earn a return on unspent income creates a countervailing force. These are typically balanced by perfectly smoothing consumption.

In contrast, when asked whether they would prefer an increasing intertemporal consumption stream, such as (10, 12, 14), or the analogous decreasing consumption stream (14, 12, 10), people often prefer the first. Indeed, Kahneman and Tversky (1979) have emphasized that people often react to changes in consumption more than to absolute levels. In line with previous contributions (Helson, 1947; Markowitz, 1952), they suggest that people form reference points and evaluate current consumption relative to these reference points. This idea is consistent with modifications of the standard model according to which the consumer is viewed as maximizing

$$U(c_0, c_1, \dots, c_T) = \sum_{t=0}^{T} \delta^t u(c_t, \Lambda_t), \tag{2}$$

where Λ_t designates a reference point that is determined (at least partially) by past consumption levels $(c_0, c_1, \dots, c_{t-1})$.[1]

Elaborations of the standard model along the lines of (2) encounter difficulties when confronted by an example of a young couple who (not atypically) spend a quarter of their combined annual income on a wedding, as well as similar examples involving vacations, celebrations, and other seemingly nondurable consumption goods. Such a large expenditure at the very beginning of their life as a couple seems to violate the preference for consumption smoothing generated by (1). It also runs contrary to the optimal management of one's reference point that arises out of (2) and a preference for an increasing consumption stream: the more spectacular the honeymoon, the bleaker will future consumption appear in comparison. The literature is less forthcoming with a model in this case. Our view is that (1) and (2) both fail to capture the effect of memorable consumption goods. When a couple gets married, they can already envisage themselves leafing through their wedding albums in the near future, telling their children about their honeymoon in the more distant future, and generally deriving pleasure from their consumption long after it has physically ended. Indeed, the unusually large wedding expenditure is an essential ingredient in generating the utility that the couple will enjoy later—it is important that the festivities lie suffi-

[1] Many reference-point models of consumption assume in addition that people are loss averse, in the sense that losses are felt more keenly than gains, i.e., the left derivative of u in its first argument is larger than the right derivative, when both are evaluated at $c_t = \Lambda_t$. Loss aversion does not play a role in our analysis, and we assume the function u is differentiable.

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