



“Relative concerns for consumption at the top”: An intertemporal analysis for the UK[☆]



Climent Quintana-Domeque^{a,b,*}, Johannes Wohlfart^c

^a University of Oxford, United Kingdom

^b IZA, Germany

^c Goethe University Frankfurt, Germany

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ABSTRACT

This paper investigates whether the consumption of rich households provides a reference point in the intertemporal consumption choices of non-rich households. Using UK household data on food consumption, we estimate the Euler equation implied by a life-cycle model incorporating relative concerns for the consumption of rich households. According to both our OLS and GMM estimates, for the population of non-rich households as a whole, there is no evidence of such relative concerns. We also examine an alternative model of relative concerns in which households overconsume when exposed to higher reference group consumption, and find correlational evidence that this may be the case for food consumed away from home. Finally, we investigate the presence of heterogeneous relative concerns (across county and household characteristics) in both models, finding evidence of relative concerns (for consumption at the top) in counties with relatively low income inequality. This mechanism seems to operate for food consumed away from home.

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1. Introduction

A growing empirical literature in economics documents the importance of relative concerns in consumption choices (Ravina, 2007; Maurer and Meier, 2008; Charles et al., 2009; Kuhn et al., 2011; De Giorgi et al., 2012; Drechsel-Grau and Schmid, 2014; Alvarez-Cuadrado et al., 2015; Bertrand and Morse, 2016). Models of relative concerns assume that consumers care not only about their absolute level of consumption but also about how their own consumption compares to the consumption of their reference group (Quintana-Domeque and Turino, 2016). Recent evidence suggests that comparisons may be directed upwards, i.e. that consumers primarily compare themselves to those with higher income or economic status (Ferrer-i Carbonell, 2005; Senik, 2009; Card et al., 2012; Drechsel-Grau and Schmid, 2014; Bertrand and Morse, 2016). Among others, such mechanisms would have important implications for the effect of increasing top income shares on welfare and

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* Corresponding author at: University of Oxford, Department of Economics, Manor Road Building, Manor Road, Oxford OX1 3UQ, England, United Kingdom.

E-mail address: climent.quintana-domeque@economics.ox.ac.uk (C. Quintana-Domeque).

economic behaviour. This is the first paper that examines the importance of upward-looking relative concerns in a life-cycle model.

Starting from a model of relative concerns along the lines of Galí (1994) and Maurer and Meier (2008) we derive an Euler equation that describes the consumption growth of low- and middle-income (non-rich) households that compare themselves to high-income (rich) households. The model predicts that non-rich households adjust their consumption *growth* in order to smooth their consumption profile relative to the consumption of rich households. We estimate the Euler equation on food consumption data from the British Household Panel Survey (BHPS) over the period 1997–2008. We start by constructing the reference point for a given non-rich household as the average consumption among rich households *in its county of residence*.¹ Later we use a definition that includes demographic characteristics as well.

We find no evidence for an effect of the growth in rich consumption on the consumption growth of non-rich households, at least for the population of non-rich households as a whole. Both OLS and GMM estimates of the Euler equation yield small positive coefficient estimates that are close to zero and statistically insignificant. These findings are robust to alternative definitions of the reference group, the presence of exogenous or contextual effects of reference group characteristics in the sense of Manski (1993), and the interval censoring nature of our consumption data.

We also examine whether the data are consistent with alternative models of upward-looking relative concerns in which exposure to higher reference group consumption can induce households to overconsume.² Instead of adjusting their consumption *growth* as predicted by the life-cycle model, non-rich households may adjust their consumption *levels*. We find correlational evidence for this mechanism for food consumed away from home.

We then investigate whether there are heterogeneous relative concerns (across county and household characteristics) in both the life-cycle model and the alternative model. In particular, for the life-cycle model, we find some evidence for upward-looking relative concerns in counties with relatively low income inequality, consistent with the idea that non-rich households in low inequality areas are more likely to compare themselves to their rich co-residents. We provide evidence that the effect in low inequality counties is driven by food consumed away from home, which is a more visible subcategory of consumption than food consumed at home (Heffetz, 2011). Similarly, we find that the effect for food consumed away from home in the alternative model of relative concerns is driven by households living in low inequality areas.

In using food consumption data for the study of intertemporal consumption choices we follow a long tradition in the literature (Hall and Mishkin, 1982; Zeldes, 1989; Runkle, 1991; Dynan, 2000; Maurer and Meier, 2008; Blundell et al., 2008; Etheridge, 2015). However, this approach, dictated in part by the lack of other appropriate types of consumption data, implies that our findings do not extend to other subcategories of consumption that are perhaps more susceptible to peer effects (Kapteyn et al., 1997; Bertrand and Morse, 2016). One should interpret our findings in this light.

Our study contributes to the literature in at least four ways:

First, we contribute to the literature on upward-looking relative concerns in consumption, an idea that goes back to Veblen (1899) and which was first formalised as the “Relative Income Hypothesis” by Duesenberry (1949). Recently, this idea has attracted new attention, as a number of studies argued that the increase in top income shares was partially responsible for the decline in savings rates among middle-class households in the US (Rajan, 2010; Frank et al., 2014). Bertrand and Morse (2016), using data from the Consumer Expenditure Survey (CEX), provide evidence that higher income and consumption among rich households have induced non-rich households to consume a larger fraction of their income. In a related study, Drechsel-Grau and Schmid (2014) document similar patterns in consumption-savings decisions of German households using data from the German Socio-Economic Panel (GSOEP). While the existing studies have focused on an effect on consumption *levels*, we extend the literature by testing whether upward-looking relative concerns operate in a life-cycle fashion for consumption *growth*. Moreover, since our data contain information on the county of residence, we are able to construct reference groups at a finer geographic granularity than previous studies. Reference groups are defined at the state level in Bertrand and Morse (2016) or at the East-West level in the study on Germany by Drechsel-Grau and Schmid (2014). Finally, when we examine whether higher reference group consumption induces non-rich households to overconsume, the panel structure of our data allows us to remove the impact of time-invariant unobserved heterogeneity. Due to their cross-sectional data, Bertrand and Morse (2016) are not able account for such heterogeneity.

Second, our paper is related to the literature on the estimation of Euler equations with external habits. Most prominently, Maurer and Meier (2008) exploit a social equilibrium condition to identify peer effects and estimate their model on food consumption data from the US Panel Study of Income Dynamics (PSID). Applying a definition of reference groups along demographic dimensions, they find evidence for moderate peer effects in consumption growth.³ The present paper adopts a similar methodology to test the more refined hypothesis of relative concerns for the consumption of high-income households. Our different research question allows us to address two potential problems of these studies. First, identification of the effect of the average behaviour in a group on the behaviour of the units comprising the group is complicated by the so-called reflection problem (Manski, 1993): the units comprising each group might share similar unobserved characteristics or be

¹ Households are classified into rich and non-rich according to the position of the main earner in the county-level earnings distribution as estimated out of the Annual Survey of Hours and Earnings (ASHE).

² Such behaviour would be consistent with myopia (Arrow and Dasgupta, 2009) or with high relative consumption being instrumental to achieving other goals such as finding a job (Frank et al., 2014) or spouse (Hopkins, 2008).

³ Similar contributions are provided by Ravina (2007) and Alvarez-Cuadrado et al. (2015).

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