Discussion of "Consumption Wedges: Measuring and Diagnosing Distortions Gaps"

by Indarte, Kluender, Malmendier, and Stepner

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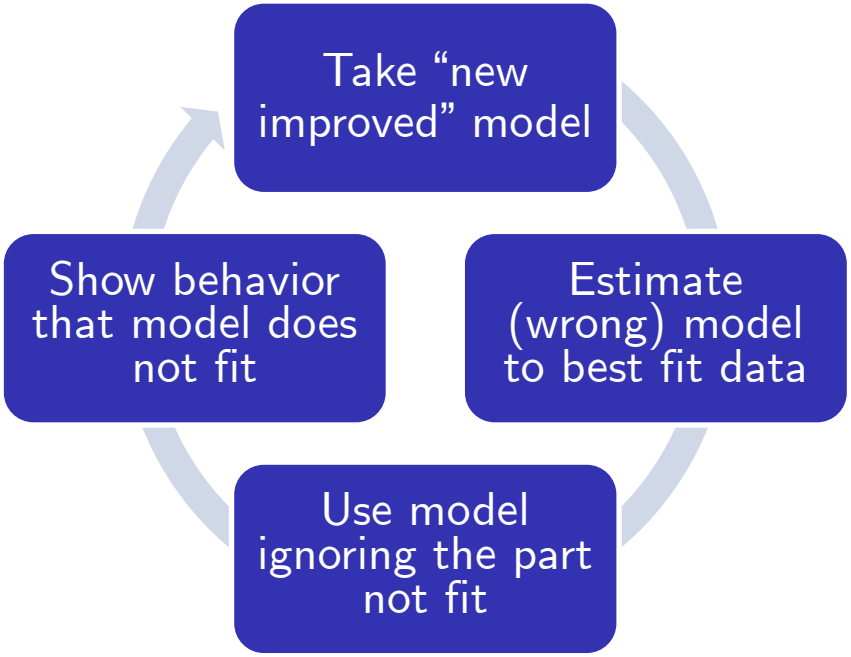
The idea of this paper

Most research on consumption



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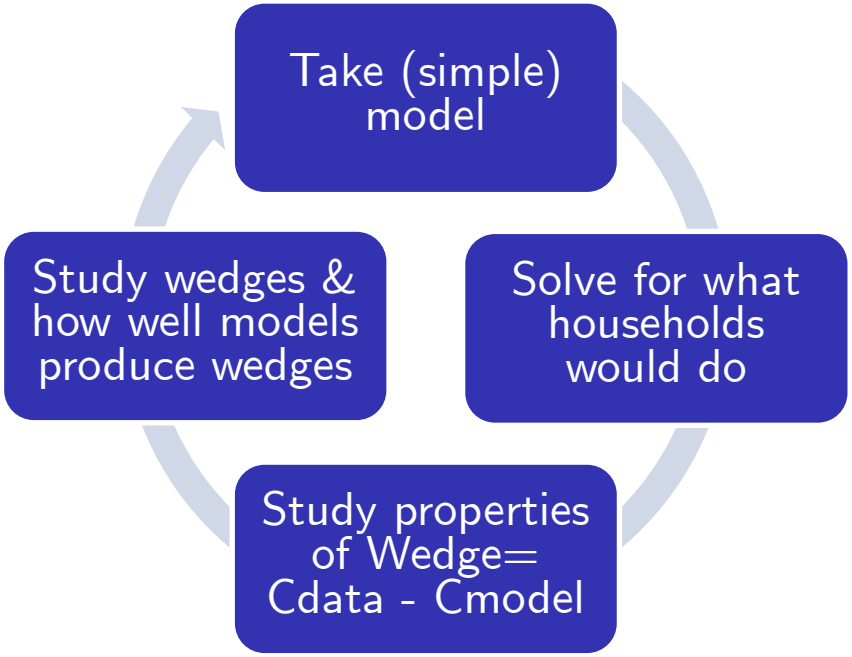


Overview of Paper

Goal: quantify and diagnose "distortions" in household consumption behavior

1. Define a consumption wedge =

   measured level of consumption

   minus

   optimal consumption implied by a simple consumption smoothing problem with **subjective beliefs**

– Measured consumption from flows in account-level data

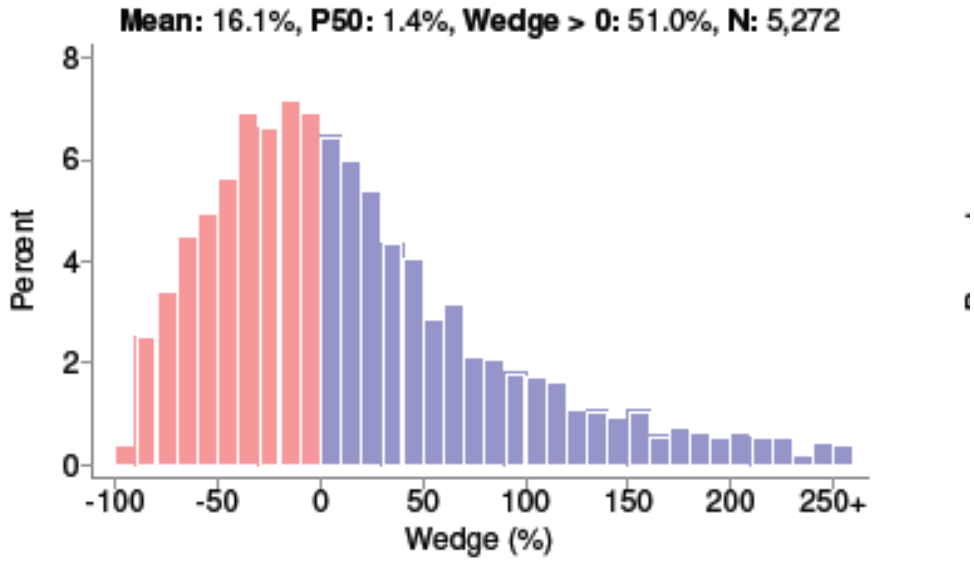
– Subjective beliefs from survey responses to a large set of questions about expected future values

– Model is **simple** homogeneous preferences, no constraints, one asset, no bequest, no family size changes, etc.

2. Study distribution of consumption wedges and compare to richer structural models

Main findings

1. Large, heterogeneous consumption wedges
   - Median wedge ≈ 40% of frictionless consumption; median wedge ≈ 0
   - Only 13% of consumers near frictionless benchmark
2. Both over- and under-consumption
   - 51% over-consume, 49% under-consume
   - Rules out borrowing constraints or present bias alone



Main findings

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2. Both over- and under-consumption
   - 51% over-consume, 49% under-consume
   - Rules out borrowing constraints or present bias alone
3. Beliefs and "distortions" both matter
   - FIRE benchmark explains ~57% of consumption variation
   - Subjective beliefs: ~23%; residual distortions: ~20%
4. Wedges suggest evidence for inertia and present bias
   - Wedges positively correlated with MPCs, distress, and commitments
   - Structural models with present bias + constraints or adjustment costs fit best

Like Euler equation errors but in levels – very neat!

Comment 1: Measuring C

Consumption from payments in account level data

- Payments ≠ expenditures ≠ consumption
- Pure measurement:
  - Model wants non-durable, but what is Amazon or Walmart
  - Buying the same thing by cash vs. check vs. card
- Payments is not expenditure
  - Payment for car does not equal expenditure on car due to auto loan
  - Use of credit in general: BNPL, credit cards debt, not sure quite
- In the model, there are no durables. With durables, model is about C not consumption expenditure
  - Car purchase with loan or purchase outright vs. lease
  - Purchase vs. license use
- There is noise in wedges, don't take variance too seriously
- Sample: Households looking for payday loan-ish debt

Comment 2: Model is simple

First-order linearization of the Euler equation **is the same as assuming quadratic utility.**

The model is a certainty equivalent model

This is a **very simple** baseline model

My conjecture: this method is useful, but for diagnosing next steps for **cutting edge model**.

Comment 3: Subjective beliefs

Big news: Taking subjective beliefs quantitatively seriously is quantitatively helpful!

Pool player example

- Model is wrong – not all balls go in
- But adding player answers to how many Joules and what torque etc. would make model worse!

Comment 4: Driving fact $C \approx \Phi Y$?

Carroll (1994), "How Does Future Income Affect Current Consumption?" Also studies the level of consumption

- Wealth and income (PSID) and consumption (CEX) **by group**
- Level of consumption explained by current labor income, and unrelated to difference between current income and future income

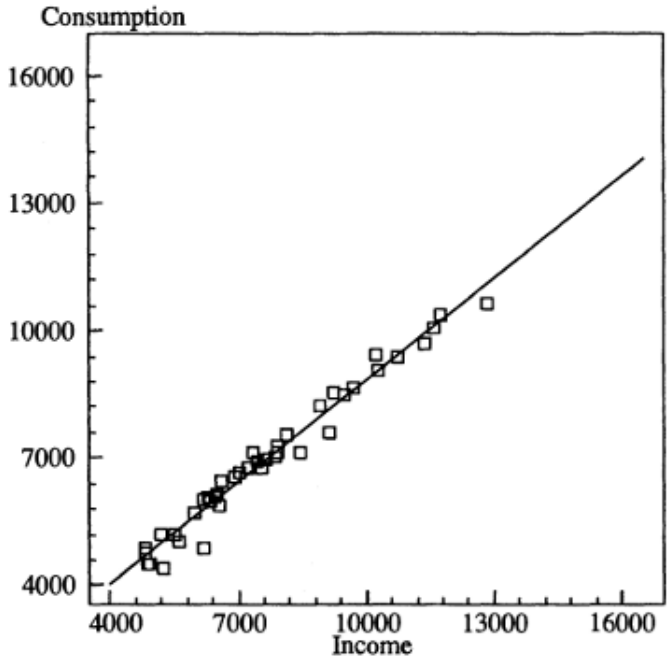

FIGURE III
Consumption versus Income by Group

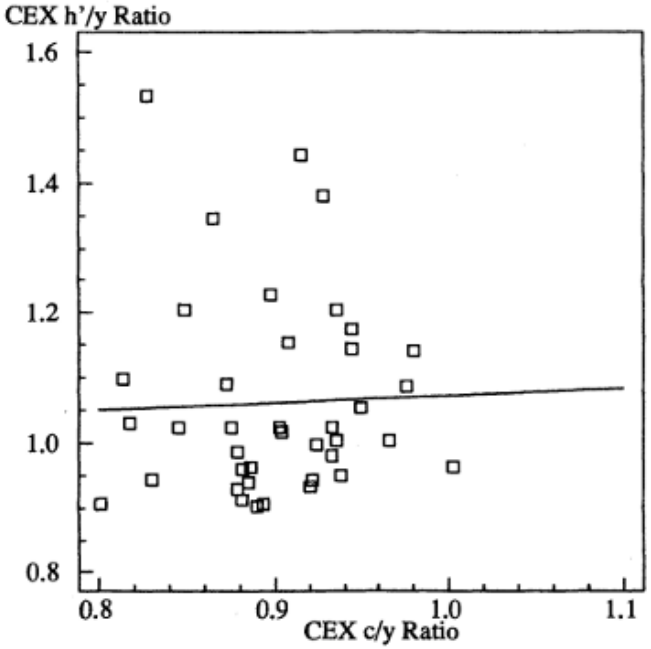

FIGURE IV
Ratio of Future to Current Income versus Ratio of Consumption to Current Income, by Group

Comment 4: Driving fact $C \approx \Phi Y$?

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   - Wealth and income (PSID) and consumption (CEX) by group
   - Level of consumption explained by current labor income, and unrelated to difference between current income and future income
   - (Log) level of consumption related to current income, not PDV of future income or current wealth

CEX Regressions of Consumption on Current Income and Future Income

Regression	Income projection method	Age group	Constant	Current income y	Future Income h	Wealth w	Number of obs.
1	1	25–34	1174 [275]	0.705*,† [0.062]	0.0019† [0.0020]	−0.007 [0.009]	1788

Comment 5: Driving fact $C \approx \Phi Y$?

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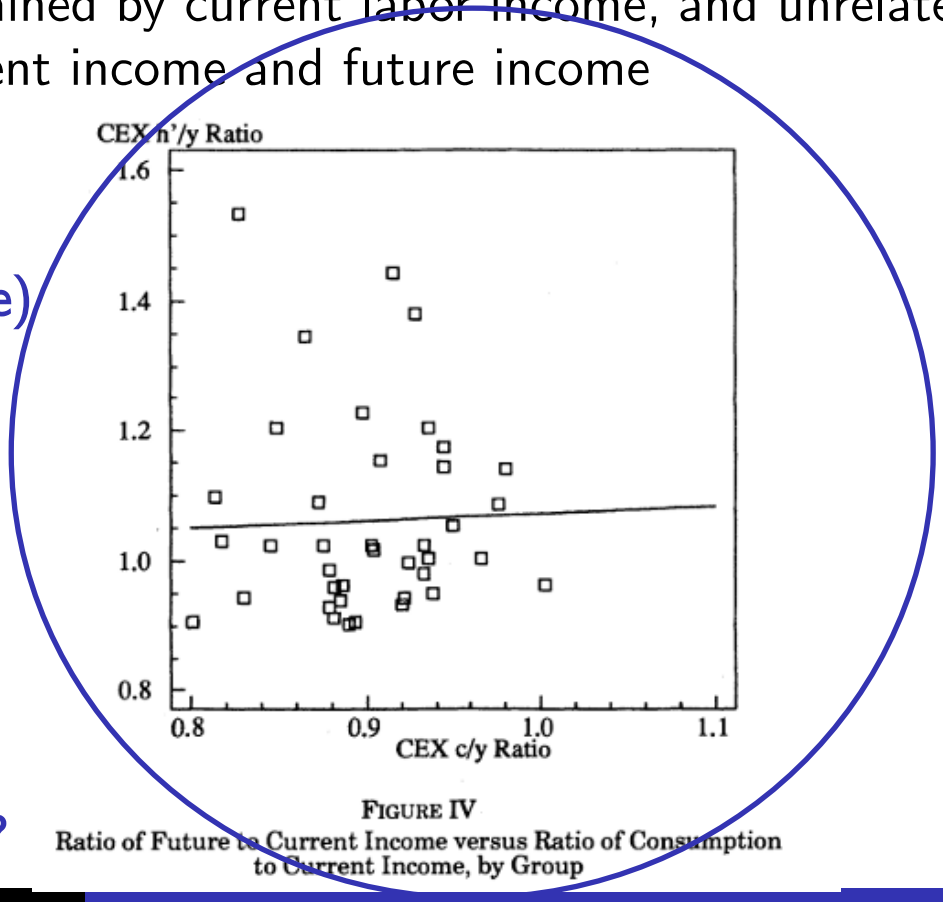
Wedges are C - Φ (Y+these deviations+more)

Maybe smaller wedges for just C - ΦY?

Positive wedge driven by relatively low future income rather than relatively high C?



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Comment 6: Consumption needs

A natural explanation for a negative wedge is precautionary saving/liquidity constraints and low current income

Consumption commitments is the paper's lead interpretation for for positive wedges

I interpret a big one as **time variation in consumption needs**

– Did you get married that year?

– Paper shows overconsumption associate with day care costs

- I was spending an Audi sports car a year on daycare before they went to elementary school!
- Our models do not have time-variation in that value of spending, but the real world has a lot
- That should NOT make us think about distortions or completely different model, and second-order for aggregation (but matters for precautionary saving)

– The term "distortion" is not a good term for this (& others)

Comment 4: "Distortions"

- I dislike the term "distortions" for the wedge
  - These include omitted preference heterogeneity, family size dynamics, variation in debt capacity and costs, spending needs, bequest, expected inheritances, etc.
- Applying this method to a cutting edge model can tell us how to improve that model

Conclusion

1. This is an innovative method for taking the level of consumption in data and models seriously
2. This is a potentially useful method for comparing models
   - Example: subjective beliefs data improves the fit of the basic model
   - A levels version of Euler equation errors
3. To what extent are wedges due to future Y differences given $C \approx \Phi Y$ behavior?
   - This is a question about model, illustrating why level C and wedges are useful
4. Wedges are not "distortions" and preferences for C matter
5. I think this innovative method is best used for the cutting edge model not the simple one in the paper (which is still a useful illustrative exercise)