

A New Approach for the Old and New Consumption Puzzles

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Abstract:

This paper presents a new approach to tackling new and old consumption puzzles. This study, therefore, initially reconsiders the old consumption puzzle in light of the new developments and evidence as well as points to a new puzzle derived from the post-war US experience. The old puzzle was based on the fundamental finding of Kuznets in the 1940s –based on the aggregate consumption data– that average propensity to consume (APC) was fairly stable over the long-run and this finding was not in line with the prediction of the standard Keynesian consumption function that APC falls when income rises as confirmed with the early findings from cross-sectional data and short time series data. With the development of the new theories in the 1950s –the life-cycle (LC) and permanent income hypothesis (PIH)– the old puzzle was believed to be solved in favor of the Kuznetsian long-run consumption function which assumes that consumption is proportional to income and hence it has a fixed APC. This study presents new evidence that challenges a common belief among many economists that that consumption is proportional to (permanent) disposable income and APC is constant over long periods of time. It also introduces the continuous regime-switching co-trending for analyzing such evolving macroeconomic relations. Our empirical results indicate that the APC systematically varies with the changes in relative income in the US over the period 1946-2017 and hence income inequality is a fundamental determinant of APC over the long-run. Our main findings are in line with the key –but frequently ignored– ideas put forward by J. S. Duesenberry and T. Veblen.

Keywords: Time series analysis, Continuous regime-switching co-trending; Common HP trend; Consumption Function; Consumption Puzzle.

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