POLICY BRIEF

Habits, Rule-of-Thumb Consumption and Useful Public Consumption in sub-Saharan Africa: Theory and New Evidence

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Abstract

I derive and estimate a structural consumption model for a panel of 34 sub-Saharan African countries from 1960–2018 to uncover three important aggregate consumption behaviours: habit formation, rule-of-thumb consumption, and the complementarity of government consumption in private utility. The following findings emerge: (1) There is evidence of habit formation in consumption. (2) Approximately 38% of consumers follow the rule of thumb of consuming their current income. This rule-of-thumb consumption behaviour in the data is driven by the period before the mobile

money era that emerged post-2000s. (3) Public consumption *complements* private consumption in an Edgeworth-Pareto sense. This suggests that increases in government consumption can stimulate aggregate demand via a positive marginal utility channel.

Introduction

Knowledge of the aggregate consumption behaviour of household agents is central in informing the design, implementation, mediation, and effectiveness of fiscal and monetary policy. For example, whether households internalize government consumption as a complement in the Edgeworth-Pareto sense is central to fiscal policy effectiveness. In this scenario, an increase in government consumption generates positive externalities that raises the marginal utility of private consumption. This increases private consumption, thereby offsetting the standard wealth effect induced by the rise in government consumption financed with taxes or deficits. The opposite effect applies when private and public consumption are substitutes. Other important characteristics, such as habit formation and rule-of-thumb behaviour by some consumers have important implications for both monetary and fiscal policy effectiveness (see, Bilbiie, 2008; Bouakez and Rebei, 2007; Caldara and Kamps, 2017; Fuhrer, 2000; Ganelli and Tervala, 2009; Monteiro et al., 2013; Morita, 2015). Despite its relevance to policy, systematic evidence of aggregate consumption behaviour in sub-Sahara Africa (SSA) remains scant.

This paper provides new and systematic insights into the aggregate consumption behaviour in SSA countries by uncovering: (1) the degree of habit formation; (2) whether public and private consumption are Edgeworth complements or substitutes in private utility; and (3) rule-of-thumb consumption behaviour. Specifically, we derive a structural consumption equation from a tractable consumption model with rule-of-thumb agents and a generalized utility function, which allows for habit formation and the direct role of government consumption in private utility. We then use dynamic panel methods to estimate the key parameters of the model for 34 SSA countries.

Investigating aggregate consumption behaviour in SSA countries is of first-order importance for policy and its relevance can be contextualized as follows: First, consider the concept of a direct role for government consumption private utility and, hence, Edgeworth complementarity (or substitutability) between private and government consumption. One example is public education, traditionally a major component of public consumption in developing countries. Scaling up public education services can induce an increase in private demand for textbooks, pencils, or school uniforms (Ercolani and Azevedo, 2014). Nonetheless, increased spending in public education can also reduce the demand for private schools or tutors. Furthermore, an increase in public health services, another important component of public consumption in

developing countries, can induce good health, lower child mortality, and raise the life expectancy all, which generate positive externalities that can lead to investment in the education of healthy children. Beyond these traditional components of public consumption, pure public goods (i.e., goods that cannot be easily provided by the private sector) such as defense and public order and justice can induce positive externalities. For instance, government spending on public order can ensure the absence of widespread criminal and political violence. This can lead to an increase in economic activity in the private sector and increase the current and anticipated standard of living in developing countries (Francois and Mata, forthcoming). These simple examples suggest that, on aggregate, public consumption may not be wasteful but can be useful instead, i.e., by entering a private utility directly. Hence, public consumption can substitute for or complement private consumption in an Edgeworth-Pareto sense depending on its composition. Consequently, an understanding of whether public consumption is an Edgeworth substitute or a complement to private consumption in private utility is critical in altering the standard wealth effect channel that follows an increase in government consumption financed with taxes.

Through a positive marginal utility channel, an increase in government consumption can directly increase private consumption if the two consumption goods are Edgeworth complements (Bouakez and Rebei, 2007). This is important, because if the degree of complementarity is high enough, the positive marginal utility of private consumption can offset, and possibly outweigh, the standard negative wealth effect arising from financing the increase in public consumption with taxes. The opposite occurs when private and public consumption are Edgeworth substitutes. Uncovering this private-public consumption relationship in private utility can therefore help inform the effective design of fiscal policy involving government consumption. That is, under a scenario where private and government consumption are Edgeworth substitutes, countries facing fiscal consolidation may experience some degree of demand-side offset to the cuts in public consumption; hence, leading to a subsequent moderation in the effect of austerity on real GDP. Conversely, Edgeworth complementarity, will reinforce the negative effect of fiscal consolidation on output.

Beyond its immediate implications for fiscal policy, Edgeworth complementarity/substitution has direct and indirect implications for foreign aid effectiveness. A unique characteristic of SSA economies is their dependence on foreign aid to fund government expenditures, i.e., government consumption and investment. The role of Edgeworth complementarity/substitutability in mediating the economy-wide impact of changes in aid provides an additional and important motivation for uncovering whether government consumption is useful in private utility and what its relationship is with private consumption. Specifically, when public and private consumption are Edgeworth substitutes, an increase in aid-financed public consumption generates a fall in the marginal utility of private consumption, which negatively impacts aggregate demand. This negative impact, via the marginal utility channel, can diminish the well-

known positive effect of aid on output induced by public investment. Moreover, in the presence of general fungibility – defined as the share of aid that ends up financing an increase in government consumption rather than the intended increase in government investment – the negative impact generated by Edgeworth substitutability will be further exacerbated (Dawood and Francois, 2018). If public consumption instead complements private consumption in utility, an increase in government consumption funded directly or indirectly by foreign aid will reinforce the positive effect of aid induced by aid-funded public investment. This can lead to a larger increase in the macroeconomic impact of aid on output.

Second, consider the idea of the presence of habit formation in private utility. Allowing habits in private agents' utility has been widely shown to help the workhorse general equilibrium models fit the data better (Fuhrer, 2000). Specifically, Fuhrer shows that by including a habit consumption specification in a monetary policy model, the responses of both spending and inflation to monetary policy actions are significantly improved by this modification. Furthermore, the growth literature supports habit formation models. More precisely, an important phenomenon that has widely been investigated in the growth literature is the finding that growth Granger causes savings, which is essential for capital formation and economic development. The finding that growth Granger causes savings strongly violates the permanent income hypothesis (PIH). This is because a PIH consumer would save less today in the face of strong growth that augments lifetime resources (Fuhrer, 2000). Conversely, when habits are present, it suggests that agents will sluggishly increase their consumption to positive income shocks implying some degree of consumption smoothing (Carroll and Weil, 1994). Hence, growth in income can exceed consumption growth in the short run, thereby raising savings, while private agents gradually respond to the increase in income. Beyond these points, the presence of habits has also been shown to have important implications for tax policy and asset pricing models (see Bernasconi et al., 2020 and Fuhrer, 2000, for a fuller discussion).

Third, several SSA countries face socioeconomic issues including, but not limited to, poverty and lack of access to financial and banking services. It is therefore only natural to assume a priori that there is a sizable fraction of the region's population that follows rule-of-thumb consumption behaviours (also known as hand-to-mouth or non-Ricardian agents). Uncovering the size of rule-of-thumb agents can shed light on how strong the Ricardian equivalence holds in SSA countries; hence, informing policy makers of the effectiveness of an expansionary fiscal policy involving changes in government consumption. Non-Ricardian agents consume all their current income and cannot borrow or save. Thus, their presence weakens the standard Ricardian equivalence, which arises following an increase in government spending financed with taxes (or a deficit).

As wages rise after an increase in government consumption, these hand-to-mouth consumers raise their consumption. If the fraction of non-Ricardian households is large enough, it can generate a net positive response for consumption following the increase in government consumption (Galí et al., 2007). On the monetary policy side, several studies have shown that the presence of rule-of-thumb households, if large enough, can impact monetary policy design and effectiveness (see Bilbiie, 2008; Colciago, 2011; Galí et al., 2004; Rossi, 2014). For example, Galí et al. (2004) discuss the standard Taylor principle becoming too weak a criterion for stability when the share of rule-of-thumb consumers is large. Galí and co-authors point out that the size of the inflation coefficient that is required to rule out multiple equilibria is an increasing function of the weight of rule-of-thumb consumers in the economy. Conversely, Bilbiie (2008) shows that in the presence of a high fraction of rule-of-thumb agents, determinacy may require passive monetary policy, whereby the central bank lowers the real interest rate in response to positive inflation. With the steady growth in the use of rule-based monetary policies in African economies (see O'Connell, 2012, for a discussion), knowledge of the size of rule-of-thumb agents from a macro-perspective will be necessary and important in designing monetary policy.

The contribution of this study is therefore threefold: First, it contributes to the stylized empirical facts about aggregate consumption in SSA and pushes the existing literature forward by examining the aggregate household consumption behaviour in a generalized and unified framework. Second, it investigates whether this aggregate consumption behaviour will help uncover "new" channels (e.g., the marginal utility channel of government consumption) of policy effectiveness that have not been studied adequately in the context of SSA. Third, by contributing to the stylized empirical facts about aggregate consumption in SSA, this study would be useful in calibrating workhorse general equilibrium models for monetary and fiscal policy analysis.

The empirical estimates from the study uncover the following: There is evidence of a moderate degree of habit formation (i.e., the estimated habit parameter is less than 0.7 but greater than 0.5). Moreover, there is strong evidence of rule-of-thumb agents, with estimates revealing that about 38% of consumers do not smooth consumption. These two results suggest a strong deviation from the permanent income hypothesis, which is in contrast to older studies such as Raut and Virmani (1989) that focus on developing countries. Lastly, public consumption is an Edgeworth complement to private consumption. This complementarity is in sharp contrast to studies such as those by Evans and Karras (1996) and Dawood and Francois (2018) who, under more stringent model assumptions, find that the two consumption goods are Edgeworth substitutes in developing countries including SSA countries. However, the finding is in line with the results from Karras (1994) who finds that private and government consumption are best described as complementary goods for a mix of countries. Karass concludes that substitutability seems to be the exception and not the rule

in the sample of countries employed for the analysis. These key results are robust under different model specifications and when controlled for age dependency, which proxies for taste shifters in utility. Importantly, the estimated preference relationships uncovered in the baseline results are structurally stable, suggesting that they are not subject to the Lucas critique and hence can be considered as "deep parameters".

Data source

The model is estimated using unbalanced panel data comprising 34 sub-Saharan African countries over the period 1960–2018. The 34 countries in the panel were employed primarily due to data availability. Specifically, except for South Africa where the period for data for the dependent variable (private consumption) spans the whole 1960–2018, data for several countries are sparse with data availability starting in the 1980s and 1990s. Despite these challenges with data scarcity, the number of countries in the sample represents more than 70% of the total number of countries in the region (i.e., 48) and its population. Consequently, the sample is a good representation of the region.

As in Kraay (2014), all the variables are measured in local currency units, and are in real per capita terms of the country. The interest rate variable is the real interest rate. All the data are from the World Development Indicators (World Bank, 2021).

The mean consumption growth over the sample period considered is approximately 10.6%, implying that SSA countries in the sample have witnessed growth in consumption on average. However, the growth rate ranges between -61.2% and 55.74% with a standard deviation of 15.36%. While consumption growth has fallen, on average, in Somalia (-5.4%) and South Sudan (-34%), Lesotho (39.6%), Liberia (18.7%), and Mauritius (20.6%), for example, have on average seen a large growth in private consumption. Government consumption growth has an average value of 14.64% and ranges from -68.7% to 197.2% with a standard deviation of 30.3%.

The large maximum value for government consumption growth is driven by Nigeria, the largest economy in Africa. With a standard deviation of 10.65%, output per capita growth is less volatile compared to private and government consumption growth. Although per capita government consumption has grown on average in several countries, countries such as Somalia, The Gambia, Madagascar, and Somalia have recorded a fall the former. The mean for GDP per capita growth is 8.36% with values ranging from -22.86% to 31.6%. The latter implies that some of the countries in our sample have undergone periods of both substantial economic downturn and upturn in output per worker growth. For example, countries including Burundi, The Gambia, Madagascar, Somalia, and South Sudan have, on average, all recorded a fall in GDP per capita growth. The average change in the real interest rate is 1.03 percentage

points with a standard deviation of 8.3 percentage points. Finally, the change in the age dependency ratio, which is measured as the ratio of people younger than 15 or older than 64 to the working-age population, is -2.88 percentage points on average. This implies that there has been a reduction in the age dependency ratio on average.

Conclusion and policy implications

This paper studies household consumption behaviour in sub-Saharan African countries using aggregate consumption data. Under a generalized utility function, we use dynamic panel data techniques to estimate a structural consumption model to uncover: (a) the degree of habit formation, (b) whether public consumption substitutes for or complements private consumption in private utility in an Edgeworth pareto sense, and (c) the rule-of-thumb consumption behaviour of private agents for 34 SSA countries. There is sufficient evidence of a moderate degree of habit formation. Moreover, the results show that there is evidence of rule-of-thumb agents with estimates revealing that about 27%–44% of the fraction of the population do not smooth consumption. These two results suggest a strong deviation from the permanent income hypothesis.

The finding of the presence of rule-of-thumb agents in aggregate consumption data is not surprising. More precisely, SSA comprises several low-income countries and it is likely that fewer people in these poorer countries have access to the banking system and therefore cannot smooth consumption as much as they would desire. However, it is interesting that when we restrict the sample to the post-2000 period where mobile phones and mobile banking have become widespread, we find no evidence of rule-of-thumb behaviour in the aggregate consumption data. Finally, we find that public consumption enters private utility directly, and it is an Edgeworth complement to private consumption implying that an increase in public consumption raises private consumption via a positive marginal utility channel.

The policy implication of the findings are as follows: First, Edgeworth complementarity between public and private consumption suggests that all else being equal, fiscal consolidation involving cuts in government consumption can be self-defeating by decreasing private consumption via a negative marginal utility channel. Conversely, an expansionary fiscal policy involving an increase in government consumption can be effective by offsetting the negative wealth effect through a marginal utility channel of consumption.

From the aid effectiveness perspective, the result that private and public consumption are Edgeworth complements implies that an increase in government consumption due to general fungibility will generate a positive marginal utility of private consumption and reinforce the positive effect of foreign aid for public investment. Consequently,

if present, general fungibility will not have an adverse effect on aid effectiveness. Second, as Galí et al. (2004) discuss, the standard Taylor rule becomes too weak a criterion for stability when the share of rule-of-thumb consumers is large. Galí and co-authors point out that the size of the inflation coefficient that is required to rule out multiple equilibria is an increasing function of the weight of rule-of-thumb consumers in the economy.

The results in this paper suggest that a standard Taylor rule applied to developed countries cannot be applied one-for-one in SSA countries. Instead, monetary policy needs careful designing as the size of rule-of-thumb agents is found to be large. Third, in the context of tax evasion, Bernasconi et al. (2020) show that for a constant level of risk aversion, consumers tend to reduce their levels of tax evasion over time because of habit formation. Furthermore, in the long term, consumers want to keep their standard of living, but they are less willing to bear the risk that payment of a fine will reduce their income and prevent them from consuming at least their habit. The authors show that habit formation has a dampening effect on tax evasion, and heavy fines are more efficient than frequent controls in reducing tax evasion. The results in this paper confirm that the presence of habits in consumption in SSA can help guide effective policies that target tax evasion in the region.

Understanding household behaviour is clearly of first-order importance in both the policy and academic circles. In the context of SSA, this paper has uncovered several important aggregate household behaviours using aggregate consumption data. The use of aggregate data was necessary partly because of the lack of reliable and available micro-data in these countries and because macroeconomic policies often require an understanding of aggregate behaviour. As quality micro-data become available, however, future studies can complement the study in this paper by utilising rich micro-data to re-estimate the key parameters from the consumption model or at least shed light on what factors are driving these aggregate relationships. For example, micro-data will accurately capture the rule-of-thumb behaviour than aggregate data. Moreover, in the context of what role demographics play, micro-data can help shed light on some salient differences of consumption behaviour amongst different groups (e.g., old versus young). The latter can have important implications for policy design, which may include the design of the composition of government consumption.

Relatedly, while the macro data used in this study captures important consumption patterns and comprises both durable and non-durable consumption both of which are important in quantifying habits, it has a limitation of not capturing demographic characteristics and may overestimate habits associated with Ricardian agents (Havranek et al., 2017). Given that the use of macro data rather than micro data is partly due to data availability, future studies can complement this study by revisiting the question of habit formation of Ricardian agents as micro-data become available.

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