Necessary Luxuries: A New Social Interactions Model, Applied to Keeping Up With the Joneses in India

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Abstract

We propose a new model that introduces peer effects into existing utility models of perceived needs. This combination introduces obstacles to obtaining identification that differ both from standard consumer demand and from standard models of peer effects. These obstacles arise from required nonlinearities in utility, from features of standard consumption survey data, and from heterogeneity that requires group level fixed or random effects. We first provide identification and an associated estimator for a new generic peer effects model that allows for nonlinearities, fixed effects, and the data feature that only a small number of the members of each peer group are observed. We then extend this model to our consumer demand application. We obtain estimates of the dollar costs of what is spent on keeping up with others in one's group. These estimates have important tax policy implications, since the larger these peer effects are, the smaller are the welfare gains associated with tax cuts.

Keywords: both

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