

Consumption and Subjective Expectations: Empirical Evidence and Structural Estimation

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Abstract:

This paper aims to deepen our understanding how households' consumption-savings decisions are shaped by their subjective earnings expectations. Using the Italian Household Survey of Income and Wealth, we document that households' consumption expenditures depend on their subjective earnings expectations - even after conditioning on realized earnings and wealth. To rationalize this novel fact, we develop a standard-incomplete markets model in which households receive private signals on their future earnings realizations. We use indirect inference to structurally estimate the model. We find that households are well informed about their future earnings and that subjective expectations are more relevant for the consumption choices of households in the left tail of the wealth distribution. At the borrowing limit, however, low income households behave hand-to-mouth, while middle and high income households respond strongly to their private information on future earnings.