

# **Household Consumption, Household Incomes and Living Standards<sup>1</sup>**

## **A review of related recent research activities**

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This report on recent research activities in the fields of consumption, income and living standards departs from the aims of a project within the EQUALSOC-Network, doing comparative research on 'Household Consumption and Incomes' as measures of living standards based on data from Household Budget Surveys. Substantial analyses will focus on patterns and structural changes of expenditures, the distributions and inequalities of household incomes and expenditures – including poverty - and the way they might be related and associated. Other questions to be addressed within this project are – for example - the extent to which expenditures and consumption levels and patterns are being determined by household income as compared to other variables like household composition and family type, place of residence, or employment status of household members as factors explaining levels and structures of expenditures. In addition to this the project also aims to explore the potential of Household Budget Surveys as a data base for comparative empirical social and economic research from a methodological point of view. This includes for example checks of comparability as well as the assessment of the reliability of information on income and expenditures within the Household Budget Surveys.

Rather than attempting to present a comprehensive and detailed state of the art report for the whole field of consumption expenditures, income and living standards – which would neither be feasible nor useful for our purposes - the following review of research

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<sup>1</sup> This review has been written as part of the EQUALSOC-Project "Household Consumption and Incomes in Comparative Perspective".

activities will depart from the project's research aims and thus focus primarily on recent research on household expenditures and how they relate to household income as well as other characteristics of private households and household members.

Household expenditures as they result from budget limitations at the one hand and choices based on needs, demand, preferences etc. on the other may be regarded as manifestations of economic and social inequalities as well as cultural differences and social distinctions. Studying the patterns, disparities and determinants of household expenditures and their changes across time by making use of large scale population surveys thus seem to be promising in various respects:

- at a most general level it may provide insights into general consumption behaviour as a major source of human well-being and respective choices and restrictions;
- investigating household expenditures and consumption patterns is considered to be key for the monitoring and explanation of inequalities and changes in material living standards and general welfare;
- studying expenditures and consumption behaviour of private households also seems to be an important and promising strategy to extend and supplement mainstream approaches of studying inequality as a key topic of sociological and economic research.

Surprisingly, issues related to household expenditures and consumption have been disregarded in sociology and particularly empirical sociological research to a large degree, although family and household budget data used to be a frequently used source of empirical knowledge in the early days of the discipline<sup>2</sup>. Some observers and commentators of developments in sociological research thus conclude that consumption has been strongly neglected in sociological research (Rosenkranz, Schneider 2000) or even speak of the sociology of consumption as a "forgotten

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<sup>2</sup> See for example Halbwachs (1912) or Jahoda, Lazarsfeld, Zeisel (1933). The latter study even uses an equivalence scale to transform households of different sizes and structures into comparable "consumer units" (see page 20 of the english edition, published by Aldine et al., Chicago 1971).

discipline" (Wiswede 2000)<sup>3</sup>. In recent years consumption has returned to the sociological agenda, but the majority of respective studies are dealing with consumption from a specific perspective only. Following the traditions set by Simmel, Veblen and – much later – Bourdieu, current mainstream sociology of consumption is primarily interested in and preoccupied with the social and symbolic functions of purchasing and consuming goods and services<sup>4</sup>. In other words, the subject of this sort of sociological research is the "conspicuous" and "status-" or "lifestyle-seeking consumption", while the – at least in quantitative terms much more important – "ordinary" (Gronow/Warde 2001) or everyday-consumption has been largely neglected<sup>5</sup>. Moreover, this research is almost exclusively based on qualitative rather than quantitative methodologies.

As a consequence, there are only few empirical sociological studies available as yet regarding the structure and inequalities of household expenditures and consumption at the national level (e.g. Bögenhold, Fachinger 2000; Langlois 2000, 2002, 2003; Noll, Weick 2005a, 2005b, 2005c) and almost no comparative research activities in this field at all.

As one would expect, research on household expenditures and consumption is much more common and popular among economists and looks back to a long tradition in economics<sup>6</sup>. This is not surprising at all since consumption may be considered as the ultimate purpose of economic behaviour and thus plays a major role in economic theory, e.g. the microeconomic theory of the household.

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<sup>3</sup> Although this observation may be true in general, in Germany sociological research on consumption seems to be even less developed than in countries like France, Britain or the United States.

<sup>4</sup> See e.g. Baudrillard 1998; Corrigan 1997; Featherstone 1987; 1991;

<sup>5</sup> "...a great deal of consumption in fact takes place inconspicuously as a part of the ordinary, everyday decision-making of millions of individual consumers. ›ordinary‹ consumption ...is not oriented particularly towards individual display. Rather it is about convenience, habit, practice, and individual responses to social norms and institutional contexts" (Jackson, Michaelis 2003: 31)

<sup>6</sup> For an instructive review of "The Early History of Empirical Studies of Consumer Behavior" see Stigler (1954).

From our point of view the longstanding debate among economists on whether incomes, expenditures or consumption are better indicators of welfare or well-being is of major interest<sup>7</sup>. The perhaps most central line of argumentation in favour of expenditures follows the so-called “permanent income hypothesis” (Friedman 1957), arguing that household expenditures are more stable across time than current incomes, which may fluctuate considerably, not only for groups like the self-employed and employees with temporary jobs, but also due to certain life events or other causes like running up or down savings or debt. Expenditures are thus supposed to better reflect “long-term” or “permanent” income and are from this point of view considered to be a better measure of economic well-being and respective inequalities<sup>8</sup>: “...if spending is maintained at a more constant level over time even while incomes are fairly volatile, it may be that spending is a better representation of an individual’s average ...income. If so, then disparities in expenditure tell us something about permanent inequalities in living standards and well-being that variation in income cannot” (Brewer, Goodman, Leicester 2006: 2).

It is important to note however that expenditures are not necessarily identical with consumption, which may even be a better indicator of well-being, for various reasons. Among them is the possibility of consumption without expenditures - at least within the same period. One example for consumption without expenditures is the case of households consuming housing after having payed off mortgages<sup>9</sup>. Another example is

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<sup>7</sup> For recent contributions to this debate see e.g. Brewer, Goodman, Leicester (2006); Goodman, Oldfield (2004); Mitrakos, Tsakoglou (1998); Sabelhaus, Schneider (1997); Slesnick (2001);

<sup>8</sup> See e.g. also Atkinson (1998: 32): „On a standard of living approach, it may appear self-evident that consumption should be the variable studied“, Zaidi / de Vos (2001: 369): „Consumption can be argued to be a more relevant measure when one is interested in assessing standards or levels of living“, and Meyer / Sullivan (2006: 2): “Conceptual arguments as to whether income or consumption is a better measure of the material well-being of the poor almost always favor consumption”.

<sup>9</sup> More generally this means that “current-out-of-pocket expenditures may therefore provide an inaccurate picture of the service *flow* provided by a consumer unit’s *stock* of consumer durables..., spending on new automobiles is included in expenditures, but the consumption value of the existing stock is not” (Cutler et al.1991)

the consumption of non market goods and services (home production as well as public goods and services). And last but not least households may consume from stocks of goods bought in previous periods. While it thus seems to be important to be aware of the fact that expenditures do not necessarily reflect a household's total consumption level, expenditures may still be used as a better proxy of its living standard than income.

As the literature reveals, a considerable part of the research on expenditures and consumption is empirical in nature, but little comparative research has been done in this field yet<sup>10</sup>. Obviously most of recent research on household expenditures has been carried out in the United States, where these issues obviously attract new and growing interest. In comparison, there is much less recent research addressing these issue in Europe. As it seems, the Institute for Fiscal Studies (London) is one of the few institutes in Europe, where issues of household expenditures and consumption are part of a longer term research programme; most of this research refers however to the U.K. only.

The following sections will present a more detailed overview of research activities related to four issues:

- Research on expenditure patterns, their changes across time and their associations with household characteristics
- Research on the distribution and inequalities of income and expenditures in comparison
- income vs. expenditure based poverty measurement and analysis
- methodological issues related to Household Budget Surveys

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<sup>10</sup> The DEMPATEM-Project (Demand Patterns and Employment Growth) is one of the few comparative research projects that have explicitly addressed household expenditures and consumption patterns (Schettkat/Yocarini n.y.). This comparative project, however, was primarily focused on the employment impact of different demand patterns and thus addressed the structures, inequalities and changes in household expenditures only from a special point of view.

## **Expenditure Patterns, their Changes Across Time and Associations with Household Characteristics**

Research questions concerning expenditure patterns, their changes across time and their determinants include the following:

- What are the general changes in expenditure structures and consumption patterns across time?
- To which extent are expenditures and consumption levels and patterns being determined by household income as compared to other variables?
- What is the role of variables like household composition and family type, place of residence, or employment status of household members as factors explaining levels and structures of expenditures?
- How different are levels and patterns of expenditures across socio-economic groups, particularly income groups (e.g. poor vs. well-off households)
- Are differences between socio-economic groups converging or diverging across time?
- How do consumption levels and patterns differ and change across the life course?

Although there is a long history of research on patterns of household expenditures and their changes across time, which goes back to the 19<sup>th</sup> century and the famous work by Ernst Engel and others, these questions have attracted surprisingly little attention in recent years. Those studies available are usually focusing on single countries and are addressing levels and structures of consumption and respective trends of change (e.g. Blow (o.A.); Blow, Oldfield (2004); van Deelen, Schettkat (2004), Herpin, Verger (2000 a, b); Gardes, Starzec (2004); Kutsar, Trumm (2006). Another strand of research addresses questions of how consumption patterns are being determined by household income, household composition and other households characteristics (e.g. Deaton et al. 1989; Langlois 2003, 2005; Noll, Weick 2006a) as well as related methodological issues (Blow et al. 2004).

A new and innovative aspect of research on expenditure patterns concerns the allocation of expenditures within the household. This question on 'who buys and gets

what' has been addressed in a recent Danish study (Bonke/Browning 2006), reporting on data that were collected as a supplement to the Danish Expenditure Survey.

International comparative studies on household expenditure patterns are quite rare, although Houthakker (1957) has addressed this issue as early as in the 1950s. Eurostat publishes descriptive reports on the classes of goods and services for which private households in the EU Member States spend their financial resources (European Communities 2002; Puente 2005). As it seems, more analytical comparative research has been done as part of very few projects only, as for example the Dempatem Project<sup>11</sup> (Dufour, et al. 1999; Kalwij, Machin2004)).

Overall, the potential of analysis provided by the HBS micro-data-files, which are available for many countries, as well as modern techniques auf data analysis doesn't seem to have been fully utilised as yet concerning the above mentioned research questions, neither at national nor at international comparative level.

### **Distribution and Inequalities of Income and Expenditures**

A further strand of research – almost exclusively in economics – concerns issues of the distribution and inequalities of income and expenditures: What are the relations of household incomes and expenditures, are there significant differences between the distributions of household expenditures and household incomes and how do changes in the distribution of income relate to (or transform into) changes in the distribution of household expenditures? If there are significant differences between the distributions of incomes and expenditures, questions concerning the inequality of living standards may be answered differently depending on whether respective analyses are using incomes or expenditures as level of living indicators.

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<sup>11</sup> See footnote 9.

Respective issues have been widely addressed under titles like “Trends in Economic Inequality in the United States: Income versus Expenditures versus Material Well-being” (Mayer, Jencks 1993); “United States Inequality through the Prisms of Income and Consumption” (Johnson, Smeeding, Torrey 2004), “Using expenditures to measure the standard of living in the United States: does it make a difference?” (Johnson 2004), or “Measuring the distribution of well-being: why income and consumption give different answers” (Sabelhaus, Schneider 1997)<sup>12</sup>. One of the most eminent – although not undisputed - studies in this field of research is Daniel Slesnick’s (2001) book on living standards and their distribution in the United States. The study reveals significant differences between the distributions of income and expenditures, which may even lead to different assessments of trends in the inequality of living standards. Other research in this field concerns e.g. questions of whether and how earnings or income inequalities (Attanasio et al. 2002; Krueger, Perri 2002) transform into inequalities of spending and how incomes and expenditures relate for particular groups within the population (e.g. Charles et al. 2006b; Wang 1995).

A special aspect of the question of how household incomes and household expenditures relate to each other concerns a problem that has been referred to as “overspending”: Several studies have shown for various countries (e.g. Meyer, Sullivan 2003 for the U.S., Brewer, Goodman, Leicester 2006 for the U.K; Noll, Weick 2005a and 2007 for Germany) that households’ total expenditures may and actually do – at least for certain periods of time - exceed their net household incomes. As we know from these studies, the phenomenon of “overspending” is not only, but particularly prevalent among low income households. This raises questions about whether the observed phenomenon is a real one or whether it is due to errors in the measurement of household income and/or expenditures, and if it is real, how widespread it is in

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<sup>12</sup> See also Attanasio et al. (2006); Bögenhold and Fachinger (2000); Dhawan-Biswal (2002); Goodman and Oldfield (2004); Noll and Weick (2005b); Sierminska and Garner (2002);



different populations, under which conditions households tend to overspend, and how they finance overspending<sup>13</sup>. Obviously these are very crucial – and not least politically relevant - questions, which have not yet been frequently addressed in empirical research. A very recent paper on “Overspending – Who, Why, and How” (Charles, Li, Schoeni 2006) presents first instructive empirical evidence for the United States, but due to differences in spending behaviour it is certainly questionable whether the results will hold true for European countries as well.

Overall, it seems again as if – with a few exceptions (e.g. Noll/Weick 2006) - this research concerning distributional differences and associations between incomes and expenditures is much more frequent in North America than in European countries, particularly in recent years.

### **Poverty Research**

Poverty research – focusing on a specific aspect of the more general question concerning the distribution and inequalities of incomes and expenditures – looks back to a longer debate on whether poverty measures should be based on incomes or expenditures. However, there is obviously a renewed interest in the implications and consequences of following the one or the other approach and which one may be considered more appropriate. A most recent example of the new interest in expenditure based measurement of poverty as an alternative to or enhancement of income based measurement is a report on “Household Spending in Britain – What Can it Teach Us about Poverty?” (Brewer, Goodman, Leicester 2006), which demonstrates, that following the one or the other approach may lead not only to significantly different results in terms of the amount, structures and changes of poverty, but also to different policy conclusions. According to a study for the U.S. by Slesnick (2001), the

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<sup>13</sup> Noll and Weick (2007) find for Germany, that the share of ‘overspenders’ among the income poor (< 50 % median) amounts to 55 %. They also present evidence that most of the overspending is financed by eating up savings.

two approaches may even reveal different trends in poverty<sup>14</sup>. Particularly in the U.S. the issue of expenditure based poverty measurement currently seems to rank high on the research agenda as can be seen from a number of recent research papers (e.g. Garner, Short 2006; Hurd, Rohwedder 2006; Mayer 2004; Meyer, Sullivan 2003; Meyer, Sullivan 2004; Meyer, Sullivan 2006; Smeeding 2004) and several conferences<sup>15</sup> addressing this issue. In their most recent study on “Household spending in Britain” Brewer et al. (2006: 1) conclude that “although there has been much recent emphasis on the advantages of measures of household expenditures in assessing household welfare in more academic circles, this has yet to work its way into the mainstream poverty measurement debate”.

In Europe the issue of income vs. expenditure based poverty measurement has been taken up rather early, albeit sporadically, particularly as part of poverty research conducted in the U.K. An interesting theoretical contribution to this debate is an article published by Stein Ringen (1988), where he discusses “direct and indirect measures of poverty”. In his terminology income is an indirect measure of poverty, whereas consumption is a direct one. His critical assessment of income based poverty research concludes that “one needs only to introduce some very simple and tentative information on the standard of consumption to demonstrate the inadequacy of relying on income information alone in the measurement of poverty (Ringen 1988: 363). Atkinson (1998: 32) has argued, that from a standard of living approach, consumption would be the preferable variable, while income would be preferable from a minimum rights approach. McGregor and Borooah (1992) presented an early empirical comparison of income and expenditure based measures of poverty for the U.K., using the Family Expenditure Survey data from 1985. They conclude that the poverty

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<sup>14</sup> For the U.S. this finding has been confirmed in a more recent study by Meyer and Sullivan (2006). Similar results have been found for other countries as well. See e.g. Noll and Weick (2006; 2007) for Germany.

<sup>15</sup> See for example two conferences of the U.S. National Poverty Center in 2004 and 2006 in Washington D.C.

measure based on expenditures is superior to the measure based on income (McGregor, Borooah 1992: 68). A major step forward has been made by a research project conducted at the Erasmus University of Rotterdam as part of the third anti-poverty programme of the European Commission. The results have been published within a comprehensive Eurostat-Report (Hagenaars, de Vos, Zaidi 1994) as well as in various related articles (e.g. Hagenaars, de Vos, Zaidi 1998; Zaidi, de Voos 2001). This report discusses not only the advantages and disadvantages of income vs. expenditure based approaches of poverty measurement, but rather presents for the first time results of detailed comparative micro-data-analyses for the by then 12 EC-Countries using incomes as well as expenditures. The authors came to the conclusion to use expenditure data primarily for pragmatic reasons, arguing “that they are more accurately measured than income data, at least in certain Member States.” (Hagenaars, de Vos, Zaidi 1994: 10). By that time Household Budget Surveys used to be the “only available source of comparable statistics on household resources in all the (12) Member States of the European Community” (Hagenaars, de Vos, Zaidi 1994: 3). Another pragmatic reason to use household expenditures rather than incomes was the fact that a previous Eurostat publication on “Poverty in Figures” (1990) – which was supposed to be used as a baseline - was based on expenditures too. But also from a conceptual point of view, the report presents a number of good reasons in favour of using expenditures as a basis of poverty measurement instead of incomes and why “a snapshot picture of income can be misleading” (Hagenaars, de Vos, Zaidi 1994: 8).

However, after all, this report made use of expenditures as a measure of household resources primarily due to the fact that – according to the authors - reliable, comparable and high quality household income data were lacking for at least some of the European Community Member States by that time. The lack of comparable income data and a respective recommendation of the report to “set up an independent community-wide panel survey on income data” (Hagenaars, de Vos, Zaidi 1994: 195) has prompted Eurostat to establish the “European Community Household Panel

Study” in 1994. As a consequence of the availability of this new data source providing comparative household income data for the EU Member States, in the following years poverty research in Europe was almost exclusively based on income up to recently<sup>16</sup> and the Household Budget Surveys were no longer used as a data base for comparative poverty research. However, since – as has been shown conceptually as well as empirically – relying on income alone may result in an incomplete and even biased picture of poverty, there is good reason for European poverty research to resume the previous approaches and to explore more systematically the relations between poverty of incomes and expenditures in recent years.

### **Methodological Issues Related to Household Budget Surveys**

Many countries around the world regularly carry out Household Budget Surveys (HBS), including all EU member states and the three current candidate countries. HBS are large scale official surveys that collect detailed information on expenditures in private households and also typically collect data on household incomes and the possession of consumer durables, as well as additional characteristics of households and individual household members. Two recent Eurostat reports (2003, 2004) provide detailed information on Household Budget Surveys in all the EU member states. These surveys – although in the past primarily designed to collect information for the calculation of Price-Indexes – thus provide a database, which could be used for all kinds of empirical studies related to issues of household consumption and income. However, their scientific use varies a lot across countries, due to different research traditions, availability of alternative data sources and not least differences in policies giving access to official microdata sets.

One strand of methodological research related to HBS concerns the quality of information collected, with a focus on the information on income and expenditures.

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<sup>16</sup> There were only very few exceptions as for example O’Neill & Sweetman (1999).

Examples of respective studies are those by Attanasio et al. (2004) and Battistin (2004), both for the U.S. Consumption Expenditure Survey.

Blow et al. (2004) treat more comprehensively “methodological issues on the analysis of consumer demand patterns over time and across countries”. An important methodological issue of the analysis of expenditure data from HBS is the so-called “zero value problem”, which refers to the fact that households did not purchase certain kinds of goods and services within the limited period of data collection<sup>17</sup>. Since such “zero values” may result from different sorts of reasons (e.g. people don’t buy a certain item, because they had bought it already in a previous period, or they don’t buy it because they are not able to afford, or they don’t buy it, because it does not meet their preferences) models based on expenditure data without correcting for the “zero value problem” may be biased. Among the techniques used to correct for this problem, the ones developed by Tobit and Heckman are the most popular.

Another methodological issue of major importance, is the treatment of housing costs of home owners and the calculation of a so-called “imputed rent”: “Persons who own the dwelling in which they live are treated as owning ‘unincorporated enterprises’ that produce housing services that are consumed by the households to which the owner belongs. The housing services produced are deemed to be equal in value to the rentals that would be paid on the market for accommodation of the same size, type and quality” (Kamanou, Ward, Havinga 2005: 41f) and are thus being added to the households’ net income and expenditures. This practice “represents an attempt to capture the real differences in living standards between a household paying rent and another in owner-occupied housing on which no debt is outstanding” (Atkinson et al.

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<sup>17</sup> The ‘zero value problem’ is of course the more severe the shorter the period of observation, which varies considerably across the national Household Budget Surveys.

2005: 110)<sup>18</sup>. Problems arise not only from the fact, that the imputed rent may differ considerably from the actual value of “housing services” due to the method applied for calculating the imputed rent<sup>19</sup>. It is also important to note, that “the rent imputed to the household is not in fact equivalent to cash income actually received, in that it cannot be used to meet other expenditure needs” (Atkinson et al. 2005: 110). It thus seems to be at least debatable whether analyses of the income distribution and poverty should generally be based on data including “imputed rent” for home owners. Moreover it also seems as if the concept of “imputed rent” does not take the specific distribution of housing expenses and respective benefits of home owner across the life course adequately into account.

Due to the fact that the U.S. Panel Study of Income Dynamics had included questions on household expenditures some years ago, there are also new research activities comparing the information from the PSID and the Consumption Expenditure Survey (Charles et.al. 2006) aiming to cross validate the results.

Despite their richness, however, HBS data – with some exceptions - have been little used for comparative European research so far. The reason may lie partly in difficulties of accessing and pooling national HBS data sets across countries. A more serious deterrent, however, may be a concern about the real comparability of the data, a concern that is difficult to clear up in view of the complexity and unwieldiness of HBS data. Some research on the comparability of HBS data across the EU-12 countries has been done as part of the European poverty project mentioned above (Zaidi 1991). However, this review does neither cover the 13 member states added since, nor does it account for the important changes in the design of HBS introduced meanwhile.

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<sup>18</sup> Following this logic one may argue that also the service flows provided by any other consumer durables were supposed to be taken into account similarly, which however is actually not the case.

<sup>19</sup> For discussions of the methodologies of calculating imputed rents and analyses of the impact of including imputed rent on the income distribution see e.g. Frick and Grabka (2000) and Fahey, Maître and Nolan (2004).

Responsibility for the HBS lies at national level in each country. While there is no legal basis for an EU role in this area, Eurostat has worked informally with the national statistical services of the member states both to pre-harmonise HBS instruments and methods and to post-harmonise HBS results (Eurostat 2003, 2004). Eurostat also compiles a pooled HBS data set for its own use. However, it is unclear to outside researchers how far these efforts have succeeded in producing real similarity and comparability in the data, and the surveys continue to be used mainly for analyses at national level. To be used for comparative analysis the national data need to be thoroughly assessed for comparability of concepts, classifications, sampling procedures etc. and to be adjusted as far as possible where necessary.

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