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Liquidity constraints and labor supply

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1. Introduction and motivation

Imperfections in the functioning of credit markets have been advocated as the reason why households are forced to deviate from their optimal plans and make suboptimal choices. In the literature of life cycle/permanent income, liquidity constraints have been identified as one of the main reasons behind the failure of the life-cycle/permanent income model in explaining the consumption behaviour of households (Attanasio and Weber, 2010; Deaton, 1992). The fact that household consumption tracks income too closely might be imputed to imperfections existing in the credit markets, resulting in a lack of credit availability. Households foreseeing an increase in income, will be forced to delay the consequent growth in consumption until the actual increase in income occurs; this happening because they are not allowed to borrow so as to incorporate the anticipated income increase. Suboptimal choices are then made, as the credit market is far from being perfect.

A large strand of literature has focused on how liquidity constraints can shape households decisions when they are binding, by empirically testing the impact of liquidity constraints on consumption or savings trajectories.[1] Flavin (1981), among others, in a seminal contribution, argues that the significance of predicted changes in income affecting consumption growth is a signal that liquidity constraints are binding. Garcia et al. (1997) show that liquidity constraints are shaping consumption profiles, by highlighting asymmetries in consumption response to income shocks. In other words, if liquidity constraints play a role rather than myopia, consumption should react asymmetrically. Consumption will increase in response to income increases while it should exhibit no sensitivity to income decreases. Jappelli et al. (1998) show that the probability of

[1] A particular aspect of consumption choices that received attention in the economic literature relates to housing consumption. For empirical studies on the effect of credit markets on homeownership see, for instance (Chiuri and Jappelli, 2003) and Trucchi (2015).

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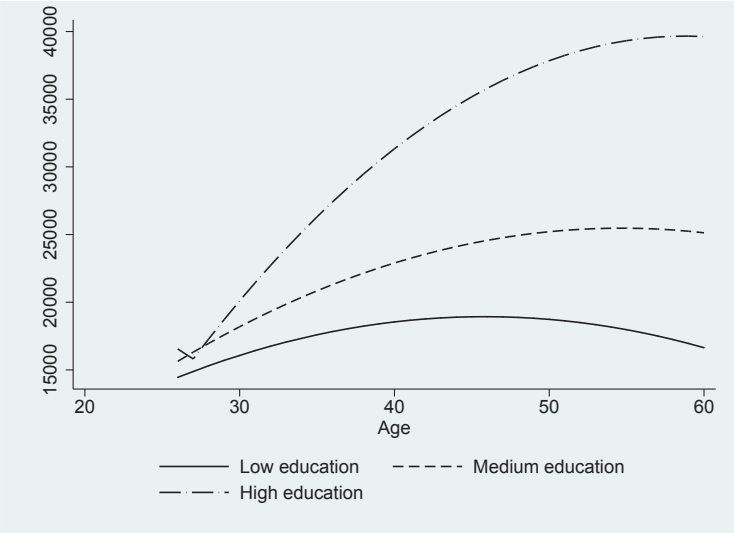

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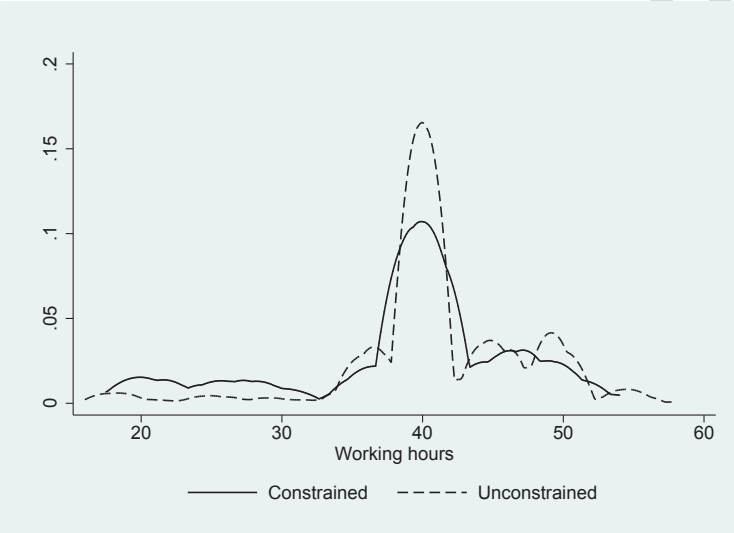

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