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Direct preferences for wealth, the risk premium puzzle, growth, and policy effectiveness☆

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Abstract

In this paper, we consider social status, the spirit of capitalism, fiscal policies, and asset pricing in a stochastic model of growth. With specific assumptions on the production technology, preferences, and stochastic shocks, we derive the explicit solutions to the growth rates of consumption and savings and equilibrium returns on all assets. We further demonstrate how fiscal policies, the spirit of capitalism, and stochastic shocks affect growth, asset pricing, and welfare. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

In neoclassical growth models wealth accumulation is often taken to be solely driven by one's desire to increase consumption rewards. The representative

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agent chooses a consumption path to maximize his discounted utility, which is defined only on consumption. This motive is important for wealth accumulation. It is, however, not the only motive. Because man is a social animal, he also accumulates wealth to gain prestige, social status, and power in the society; see Frank (1985), Cole et al. (1992, 1995), Fershtman and Weiss (1993), Zou (1994, 1995), Bakshi and Chen (1996), and Fershtman et al. (1996). Earlier contributions include Duesenberry (1948), Kurz (1968), and Spence (1974). In these wealth-is-status models, the representative agent has direct preferences for wealth and accumulates wealth not only for consumption but also for wealth-induced status. Mathematically, in light of the new perspective, the utility function can be defined on both consumption, c, and wealth, W: $u(c_t, W_t)$. Another interpretation of these models is in line with the spirit of capitalism in the sense of Weber (1958) and Keynes (1971): capitalists accumulate wealth for the sake of wealth. To cite Weber (1958):

Man is dominated by making of money, by acquisition as the ultimate purpose of his life. Economic acquisition is no longer subordinated to man as the means for the satisfaction of his material needs. This reversal relationship, so irrational from a naive point of view, is evidently a leading principle of capitalism.

Using the wealth-is-status and the-spirit-of-capitalism models, many authors have tried to explain growth, savings, and asset pricing. Cole et al. (1992) have demonstrated how the presence of social status leads to multiple equilibria in long-run growth. Zou (1994, 1995) has studied the spirit of capitalism and long-run growth and showed that a strong capitalist spirit can lead to unbounded growth of consumption and capital even under the neoclassical assumption of production technology. Bakshi and Chen (1996) have explored empirically the relationship between the spirit of capitalism and stock market pricing and offered an attempt towards the resolution of the equity premium puzzle in Mehra and Prescott (1985). They have shown that when investors care about status they will be more conservative in risk taking and more frugal in consumption spending. Furthermore, stock prices tend to be more volatile with the presence of the spirit of capitalism.

On the other hand, Eaton (1981), Turnovsky (1993, 1995), Grinols and Turnovsky (1993, 1994), and Obstfeld (1994) have introduced stochastic tax and stochastic government expenditure into the continuous-time growth and asset-pricing models. Under specific assumptions on the production technology, preferences, and stochastic shocks, they have derived explicit solutions to the growth rates of consumption and savings and equilibrium returns on assets. But these continuous-time stochastic growth models have not explicitly considered the role of social status and the spirit of capitalism in capital accumulation, asset pricing, and growth.

In this paper, we integrate these two trends of growth and asset-pricing literature and consider social status, fiscal policies, and asset pricing in a stochastic model of growth. With specific assumptions on the production