

Consumption Externalities and Capital Accumulation in an Overlapping Generations Economy

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Abstract

This paper extends the standard overlapping generations model of capital accumulation by introducing consumption externalities. It is assumed that each generation's felicity depends on the social level of benchmark consumption as well as on its own consumption. Since the benchmark consumption is represented by the average consumption of all agents, the contemporaneous consumption externalities are determined by both intragenerational and intergenerational interactions among the consumers. Given this setting, we show that even in a simple model with a logarithmic utility function, the presence of consumption externalities may significantly affect the dynamic behavior and steady-state characterization of the economy. We also reveal that the same conclusion holds in an endogenous growth setting in which production externalities sustain unbounded growth.