

Endogeneity in the Demand for Wine: Is there a Problem?

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Almost by definition demand and price are simultaneously determined. Estimation of elasticities and other characteristics may be sensitive to any endogeneity present and in recent work on demand systems the problem of endogeneity has been largely ignored and attention focussed on other aspects of these models.

This paper will consider how to deal with endogeneity in a Modified Almost Ideal Demand system, and compare the implications of using different approaches. The data set will be quarterly for the United Kingdom.

The suggested solution to this kind of problem is to use instrumental variables. However, any instruments considered must be tested for suitability within a system model, and their appropriateness assessed.

Homogeneity of price effects may be particularly sensitive to the instruments to be used as some variables will enter linearly while others non-linearly.

Encompassing tests will also be used to assess the final models, and an overall ranking of the various models will be given, and the impact of endogeneity assessed.