

Permanent-Income Hypothesis

The permanent income hypothesis was formulated by the Nobel Prize winning economist Milton Friedman in 1957. The hypothesis implies that changes in consumption behavior are not predictable, because they are based on individual expectations. This has broad implications concerning economic policy. Under this theory, even if economic policies are successful in increasing income in the economy, the policies may not kick off a multiplier effect from increased consumer spending. Rather, the theory predicts there will not be an uptick in consumer spending until workers reform expectations about their future incomes.

According to the site 'investopedia.com', a permanent income hypothesis is a theory of consumer spending which states that people will spend money at a level consistent with their expected long term average income. The level of expected long term income then becomes thought of as the level of "permanent" income that can be safely spent. A worker will save only if his or her current income is higher than the anticipated level of permanent income, in order to guard against future declines in income.

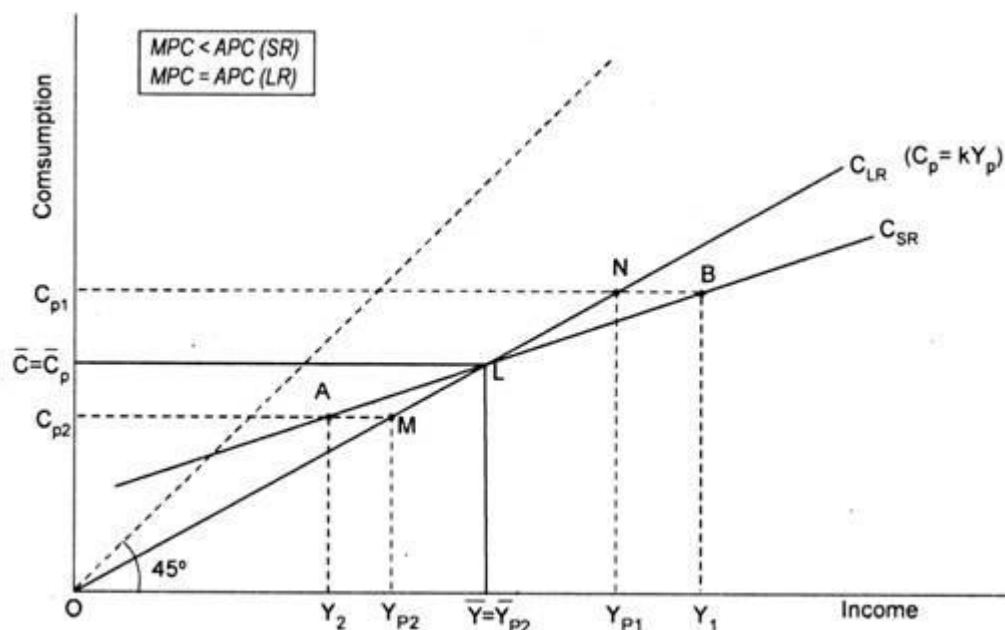


Fig. 3.40: Friedman's Consumption Function

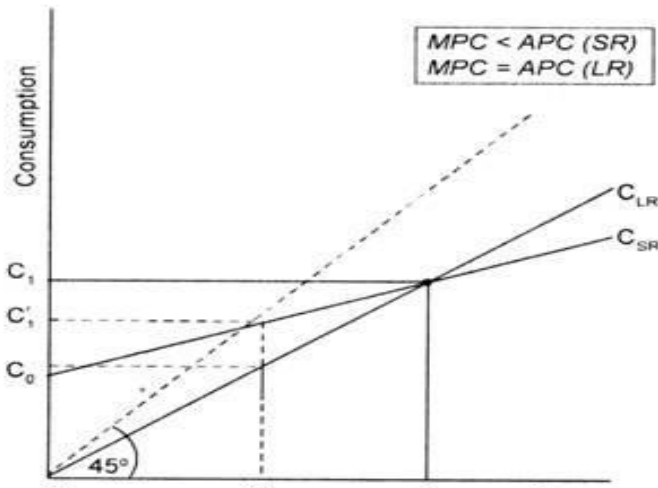
From the figure above, according to the site 'economicsdiscussion.com', illustrates that Friedman's hypothesis holds that the basic relationship between consumption and income is proportional. But consumption, according to Friedman, depends neither on 'absolute' income, nor on 'relative' income, or 'Life-cycle hypothesis' but on 'permanent' income, based on expected future income.

Permanent-income hypothesis theory like the relative income theory, holds that the basic relationship between consumption and income is proportional, but the relationship here is between permanent consumption and permanent income. Thus, quite a different approach to the role of income in the theory of consumer spending has been developed by Milton Friedman. The main point of departure is the rejection of the common concept of current income and its replacement by what he calls permanent income.

The implication of this hypothesis is that if a worker is aware they are likely to receive an income bonus at the end of a particular pay period, it is plausible that their spending in advance of that bonus may change in anticipation of the additional earnings. However it is also possible that workers may choose to not increase their spending based solely on a short-term windfall. They may rather make efforts to increase their savings, based on the expected boost in income. Similar can be said of individuals who are informed they are to receive an inheritance; their personal expenditures could change to take advantage of the anticipated influx of funds but per this theory they may maintain their current spending levels in order to save the supplemental assets. Likewise they may seek to invest those supplemental funds in order to provide long-term growth of their money rather than spend it immediately on disposable products and services.

The liquidity of the individual can play a role in their future income expectations. An individual with no assets may already be in the habit of spending without regard to their income, current or future. Changes over time, however, through incremental salary raises or the assumption of new long-term jobs that bring higher, sustained pay can lead to changes in permanent income. With their expectations elevated, employees may allow their expenditures to scale up in turn.

In conclusion, in its simplest form, the hypothesis states that **changes in permanent income, rather than changes in temporary income, are what drive the changes in a consumer's consumption patterns**. Its predictions of consumption smoothing, where people spread out transitory changes in income over time, departs from the traditional Keynesian emphasis on the marginal propensity to consume. It has had a profound effect on the study of consumer behavior, and provides an explanation for some of the failures of Keynesian demand management techniques. A consumer's permanent income is determined by their assets; both physical (shares, bonds, property) and human (education and experience). These influence the consumer's ability to earn income. The consumer can then make an estimation of anticipated lifetime income. A worker saves only if they expect that their long-term average income, i.e. their permanent income, will be less than their current income.



The relative-income hypothesis

The figure shows Duesenberry's consumption function which is the explanation of short run and long run consumption function. Cyclical rise and fall in income levels produce a non-proportional consumption-income relationship. In the long run as such fluctuations of income levels are get smoothened, one gets a proportional consumption-income relationship.

The absolute-income hypothesis

Keynes' consumption function has come to be known as the 'absolute income hypothesis' or theory. His statement of the relationship between income and consumption was based on the 'fundamental psychological law' which is that the individual consumer determines what fraction of his current income he will devote to consumption on the basis of the absolute level of that income. Other things being equal, a rise in his absolute income will lead to a decrease in the fraction of that Income devoted to consumption.

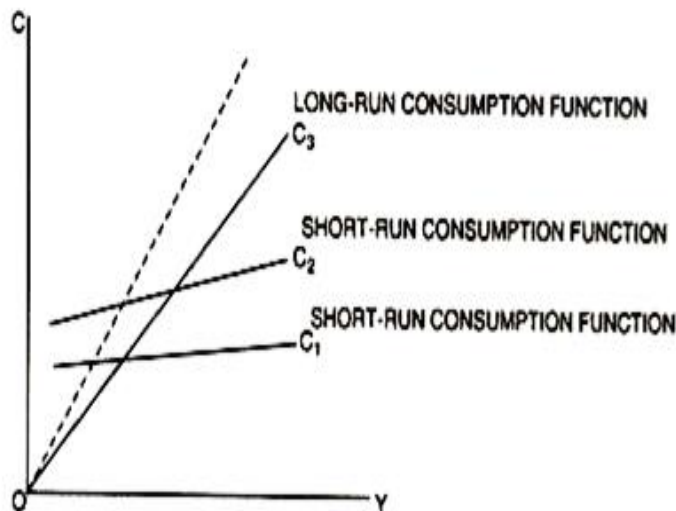


Fig. 13.1

Life-cycle hypothesis

The concept was developed by Franco Modigliani and his student Richard Brumberg. LCH presumes that individuals plan their spending over their lifetimes, taking into account their future income. Accordingly, they take on debt when they are young, assuming future income will enable them to pay the debt off. They then save during middle age in order to maintain their

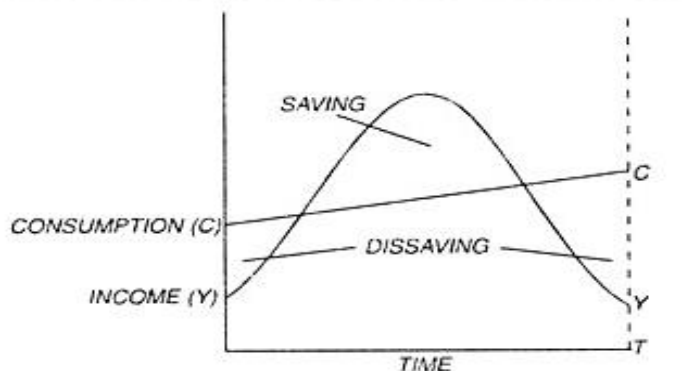


Fig. 6.16 Income and Consumption over the Life Cycle

level of consumption when they retire. This results in a "hump-shaped" pattern in which wealth accumulation is low during youth and old age, and high during middle age.

“Comparing the permanent income hypothesis with the other three hypotheses, we will see that Friedman has emphasized the importance of the word ‘proportional’. While Duesenberry’s relative income hypothesis has propounded that consumption expenditure depends on income of an individual relative to incomes of others rather than the absolute size of his own income. Talking about absolute income hypothesis of Keynes that has the Psychological law involved. Lastly, for the life-cycle hypothesis, spending is different in each varied age.”

References

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