

PERMANENT INCOME HYPOTHESIS Prepared by L. C. DOLEY, Associate Professor

Permanent income hypothesis was profounded by Nobel prize winning Economist, Milton Friedman in 1957. Like Duesenberry's Relative Income Hypothesis, Friedman's hypothesis holds that the basic relationship between consumption and income is proportional.

But consumption, according to Friedman, depends neither on absolute income or on relative income but on permanent income, based on expected future income. Thus, he finds a relationship between consumption and permanent income. His hypothesis is then described as permanent income hypothesis. In PIH, the relationship between permanent consumption and permanent

income is shown.

Friedman divides current measured income (income actually received) into two: permanent income (Y_p) and the transitory income (Y_t). Thus, $Y = Y_p + Y_t$. Permanent income may be regarded as the mean income, determined by the expected or anticipated income to be received over a long period of time. On the other hand, transitory income consists of unexpected or windfall rise or fall in income (e.g., income received from lottery or race). Similarly, he distinguishes between permanent consumption (C_p) and transitory consumption (C_t). Transitory consumption may be regarded as the unanticipated spending (e.g., unexpected illness). Thus, measured consumption is the sum of permanent and transitory components of consumption. That is, $C = C_p + C_t$.

Friedman's basic argument is that permanent consumption depends on permanent income. The basic relationship of PIH is that permanent consumption is proportional to permanent income that exhibits a fairly constant APC. That is, $C = kY_p$ where k is constant and equal to APC and MPC.

While reaching the above conclusion, Friedman assumes that there is no correlation between Y_p and Y_t , between Y_t and C_t and between C_p and C_t . That is $R_{Y_t, Y_p} = R_{Y_t, C_t} = R_{C_p, C_t} = 0$.

Since Y_t is uncorrected with Y_p , it then follows that a high or low transitory income. For the entire group of households from all income groups transitory incomes would cancel each other out so that average transitory income would be equal to zero. This is also true for transitory components of consumption. Thus for all the families taken together the average transitory income and the average transitory consumption are zero. That is, $Y_t = C_t = 0$, where Y and C are the average values. Now it follows that $Y = Y_p$ and $C = C_p$.

Let us consider some families, rather than the average of all families, with above-average measured incomes. This happens because these families had enjoyed unexpected incomes thereby making transitory incomes positive and $Y_p < Y$. Similarly, for a sample of families below-average measured income, transitory incomes become negative and $Y_p > Y$.

Now, we are in a position to resolve the apparent conflict between the cross-section and the long-run time-series data to show a stable permanent relationship between permanent consumption and permanent income.

The line $C_p = kY_p$ in the Fig. 1 shows the proportional relationship between permanent consumption and permanent income. This line cuts the CSR line at point L that corresponds to the average measured income of the population at which $Y_t = 0$. This average measured income produces average measured and permanent consumption, C_p .

Let us first consider a sample group of population having an average income above the population average. For this population group, transitory income is positive. The horizontal difference between the short-run and long-run consumption functions (point N and B and points M and A) describes transitory income. Measured income equals permanent income at that point at which these two consumption functions intersect, i.e., point L in the figure where transitory income is zero.

For a sample group with average income above the national average measured income (Y_1) exceeds permanent income (Y_p). At (C_{p1}) level of consumption (i.e., point B) average measured income for this sample group exceeds permanent income, Y_p . This group thus now has a positive average transitory income.

Next, we consider another sample group of population whose average measured income is less than the national average. For this sample group, transitory income component is negative. At C_{p2} level of consumption (i.e., point A lying on the CSR) average measured income falls short of permanent income, Y_p . Now joining points A and B we obtain a cross-section consumption function labelled as CSR. This consumption function gives an MPC that has a value less than long-run proportional consumption function, $C_p = kY_p$. Thus, in the short-run, Friedman's hypothesis yields a consumption function similar to the Keynesian one, that is, MPC, APC.

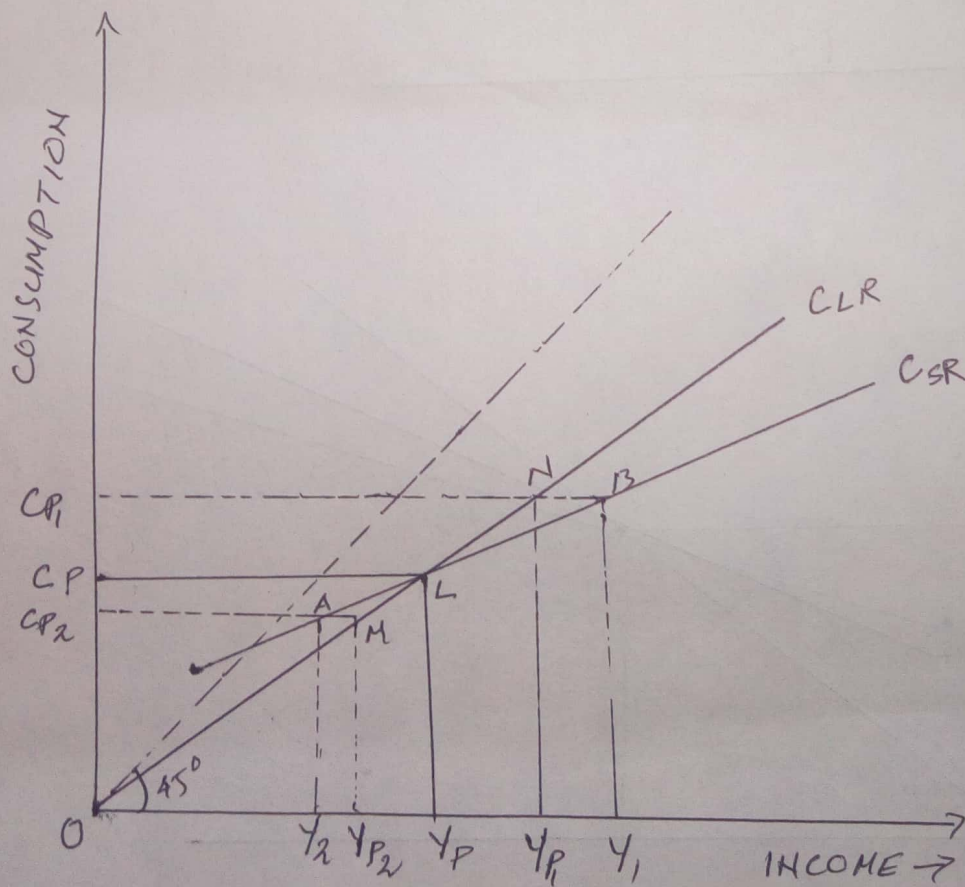


Fig. 1