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The Expected or permanent Income Hypothesis

The theory of the permanent Income Hypothesis was propounded by the economist Milton Friedman in 1957. On the basis of consumer's expectations of incomes, Milton Friedman has developed the permanent Income Hypothesis. Friedman distinguishes between the permanent income which directs the consumption behaviour of the community and the actual or measured income that is received by the consumers in any given time period. Friedman rejects the use of "current income" as the determinant of consumption expenditure and instead divides both consumption and income into "permanent" and "transitory" components, so that

$$Y = Y_p + Y_t$$

$$\text{and } C = C_p + C_t$$

where p refers to permanent and t refers to transitory income Y and consumption C .

permanent income is defined as "The amount which the consumer unit could consume (or believes that it could) while maintaining its wealth intact." It is the main income of a family unit which in turn depends on its time-horizon and foresightedness. The permanent income is that part of measured income which is regarded as stable. Y being the consumer's measured income or current income, it can be larger or smaller than this permanent income in any period. The measured income is the observed income of the individual.

(2)

The difference between measured and permanent income is known as transitory income (Y_t).

Such differences between measured and permanent income are due to the transitory component of income (Y_t). Transitory income may rise or fall with windfall gains or losses and cyclical variations. If the transitory income is positive due to a windfall gain, the measured income will rise above the permanent income. If the transitory income is negative due to theft, the measured income falls below the permanent income. The transitory income can also be zero in which case measured income equals permanent income.

permanent consumption is defined as,

"The value of the services that it is planned to consume during the period in question. Measured consumption is also divided into permanent consumption (C_p) and transitory consumption (C_t). Measured consumption (or current consumption) may deviate from or equal permanent consumption depending on whether the transitory consumption is positive, negative or zero, permanent consumption is a multiple (k) of permanent income Y_p :

$$C_p = k Y_p$$

and $k = f(r, w, u)$

Therefore, $C_p = k(r, w, u) \cdot Y_p$

where k is a function of the rate of interest (r), the ratio of property and non-property income

to total wealth or national income (w), and the consumer's propensity to consume (u). The $C_p = k(x, w, u) \gamma_p$ is the true consumption function suggested by Friedman. This equation tells us that over the long-period consumption increases in proportion to the change in γ_p . This is attributable to a constant $k (= \frac{C_p}{\gamma_p})$ which is independent of the size of income, Thus k is the permanent average propensity to consume. The propensity to consume has been influenced by three factors. First, there has been a sharp decline in the farm population which as it tended to increase consumption with urbanisation, this has tended to increase k . Second, there has been a sharp decline in the size of families, it has led to increase the savings and reduction in consumption thereby reducing the value of k . Third, larger provision by state for social security. This has reduced the need for keeping more in savings, it has increased the tendency to consume more resulting in the rise in the value of k .

To test this hypothesis Friedman makes four assumptions:-

- ① It is assumed that there is no correlation between transitory and permanent income.
- ② There is no correlation between permanent and transitory consumption.

(4)

(3) There is no correlation between transitory consumption and transitory income

(4) Only differences in permanent income affect consumption systematically.

These assumptions give the explanation of the cross-section result (short-run) that $MPC < APC$. The cross-sectional results of Friedman's theory give a linear and proportional consumption function. We get a measured short-run consumption function in the form:

$C = a + by$ where by measures the difference in consumption associated with differences in income. The value of by in the hypothesis is taken as $by = k \cdot py$ where py is the proportion of difference in measured income attributable to a difference in permanent income, and k is the ratio of permanent consumption to permanent income which is a constant,

$APC = MPC$. This gives us the proportional long-run consumption function, $by = k \cdot py$.