

Lecture 10

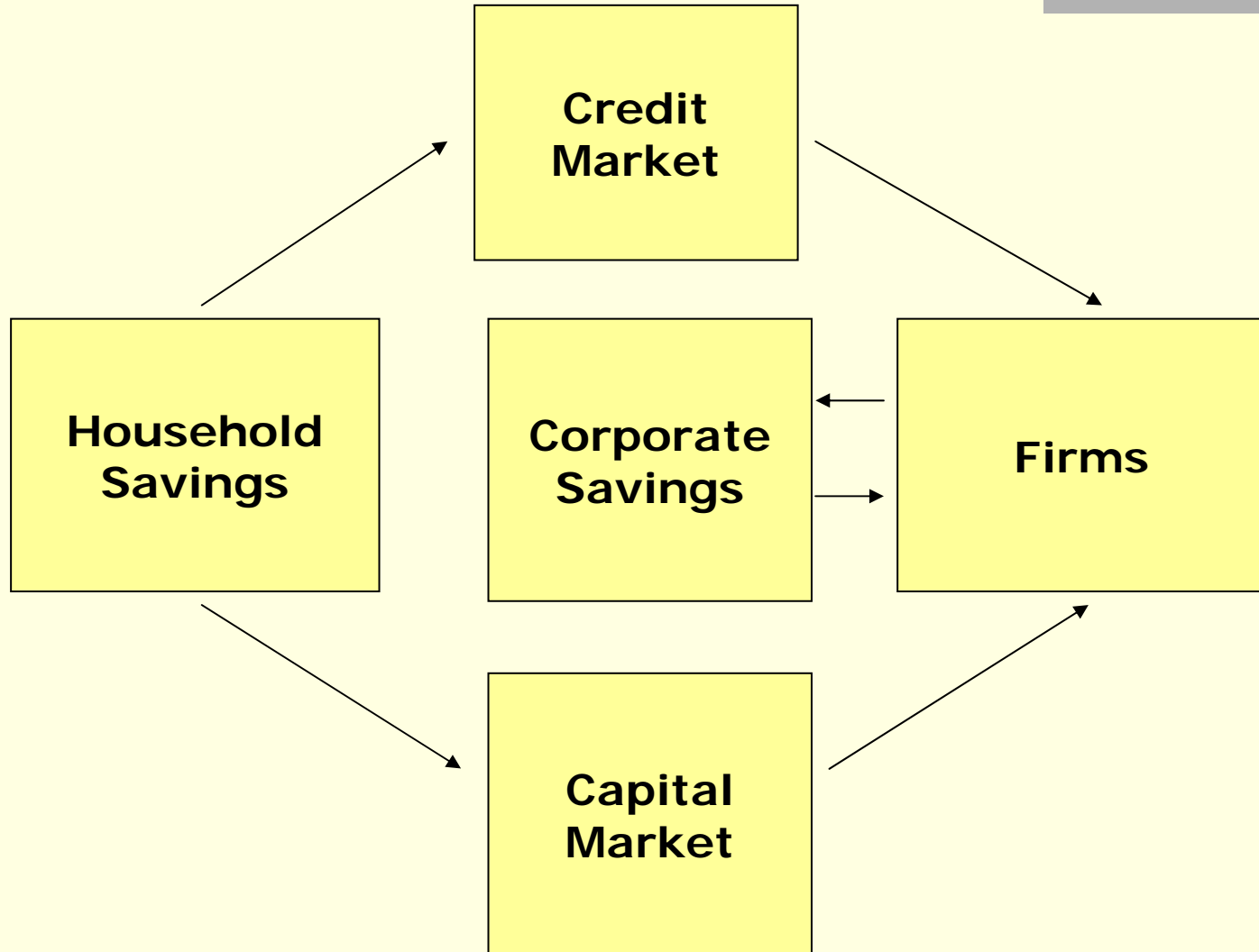
Capital and Savings

(Based on Chapter 11 of Perkins et al.)

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Flow Chart



Theories of Household Savings

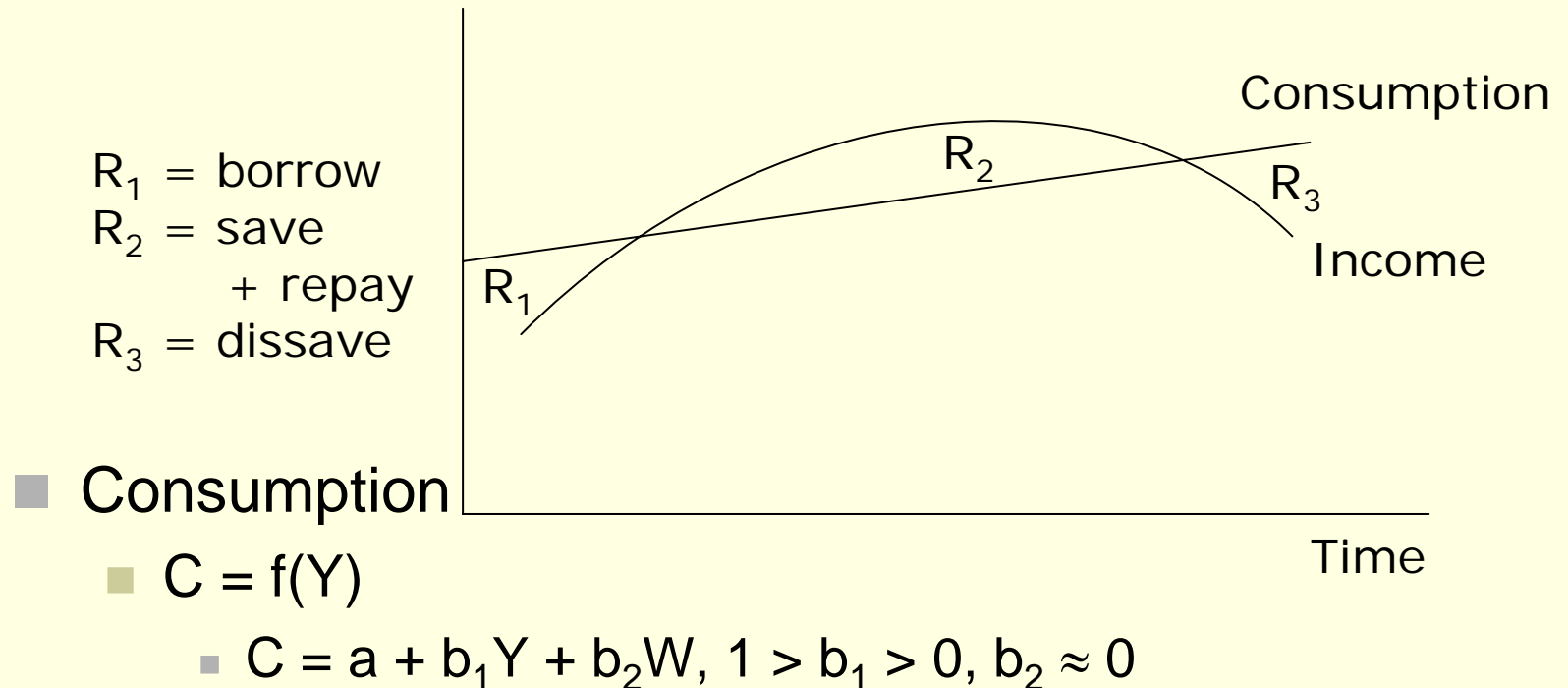
- Life cycle hypothesis
 - Ando and Modigliani [AER, v. 53, n. 1, p. 55-84]
 - Ando and Modigliani [AER, v. 54, n. 2, p. 111-113]
- Permanent income hypothesis
 - Friedman
- Duesenberry hypothesis

Basic Assumption

- Current consumption does not depend on current income alone.
 - Consumption smoothing over lifetime.
- Formal treatment.
 - Two periods (1 and 2)
 - $\max U(C_1, C_2)$
 - sub

$$C_1 + \frac{C_2}{(1+r)} = Y_1 + \frac{Y_2}{(1+r)}$$

Life Cycle Hypothesis 1



Life Cycle Hypothesis 2

- Implication
 - Consumption smoothing

- What would happen to aggregate household savings if there is population aging?
 - What will be the impact on the capital market?
 - What would be the net impact on aggregate household savings?

- Why do elderly people not dissave all their savings in their old age?
 - Bequests
 - Intergenerational transfers

Permanent Income Hypothesis

- Income
 - Permanent (Y^P)
 - Education, health etc.
 - Transitory (Y^T)
 - Circumstances

- Consumption
 - $C = f(Y^P)$
 - $C = a + b_1 Y^P + b_2 Y^T, 1 > b_1 > 0, b_2 \approx 0$

- Implication
 - Consumption smoothing

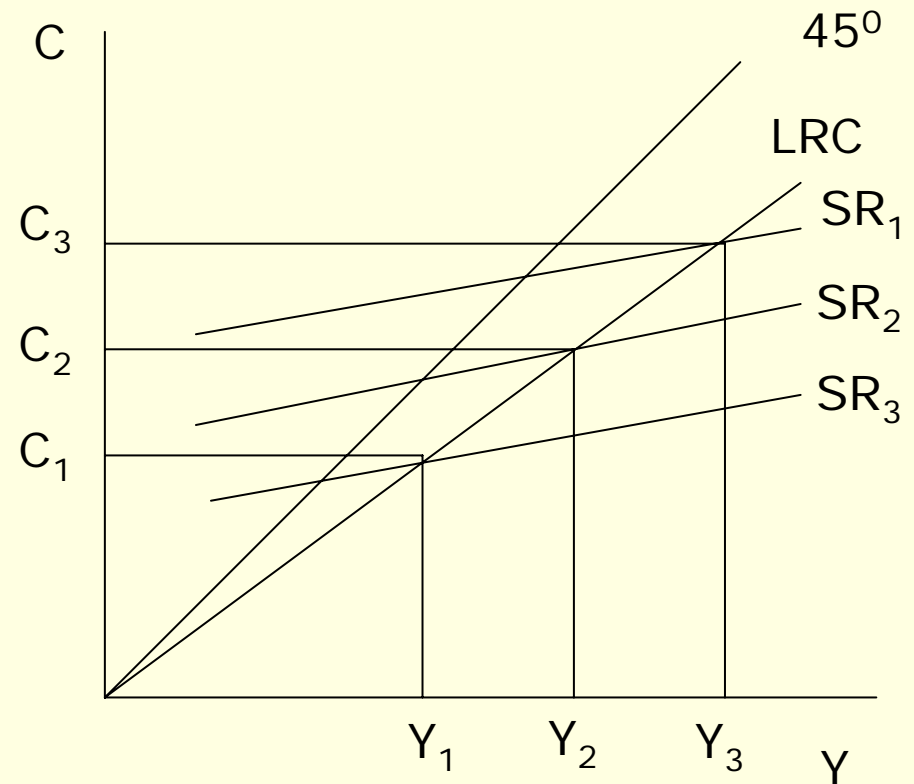
Duesenberry Hypothesis

■ Consumption

- $C_t = a + b_1 Y_t + b_2 Y_{-h}$
- $1 > b_1 > 0$
- $1 > b_2 > 0$

■ Implication

- Consumption of the society as a whole a stable function of income.



Government Saving

- Revenue
 - Direct taxes
 - Supply side theories
 - Indirect taxes
 - Tariff on international trade
 - Lower after GATT

- Expenditure
 - Wage payment
 - Size of the government
 - Investment
 - Subsidies
 - Pressure groups

Ricardian Equivalence

- Ways to meet higher government expenditure in the current period
 - Raise taxes in the future
 - Intertemporal budget constraint
 - Print money in the future
 - Inflation *tax*
 - Borrow and roll over debt
 - Sustainability

Corporate Saving

- Uses

- Dividend to shareholders
- Investment
 - Pecking order hypothesis

- Caveat

- Agency problems
 - Share buyback
 - Acquisition of other companies
 - Free cash flow theory