

Stimulative Effects of Transitory Versus Permanent Tax Cuts. Consider a buffer stock model like the one presented in class but with a permanent ‘payroll’ wage tax so that the employed consumer’s income is wage income times the untaxed proportion λ . This model relates the ratio of consumption to permanent income, $c = C/(\lambda W)$, to the ratio of market resources to permanent income $m = M/(\lambda W)$. Use this model to rank the relative magnitudes (from largest to smallest) of the effects on consumption you would expect from each of the following policies: (1) A transfer of size X targeted to people with large values of m (so the person receives income of $\lambda W + X$); (2) a permanent tax cut targeted to people with large values of m ; (3) a transitory transfer (as described above) targeted to people with small values of m ; (4) a permanent tax cut targeted to people with small values of m . (Your answer will be graded not just on whether you rank the four options correctly, but also on how well you *explain why* you obtain the answer you do. A diagram or two may be helpful in explaining your reasoning).

Answer:

The model implies that the marginal propensity to consume out of permanent changes in income will be fairly high (close to one) for both rich and poor households. However, it implies a much higher MPC out of transitory shocks for poor than for rich households; this is an implication of the concavity of the consumption function.

The correct ordering is (4),(2),(3),(1). The only bit that could possibly be in doubt is whether (4)<(2) but it is certainly true in the limit as the ‘poor’ person approaches $m = 0$ because for that person the MPC approaches 1 and it will be less than 1 for someone with larger m . (You could get full credit if you said that (4) versus (2) was ambiguous).