

# Permanent Income Model

Jesse Perla

University of British Columbia

January 27, 2021

## 1 Permanent Income Model

### 1.1 Basic Setup

This started with Friedman in the 1950s, and was done in rational expectations with Hall in the late 70s.

- Agent has an (exogenous) deterministic income  $\{y_{t+j}\}_{j=0}^{\infty}$  and (initially exogenous) savings  $F_t$ .
- Chooses sequence of consumption to maximize the PDV of utility of consumption  $u(c_t)$  for all  $t$
- That is: at time  $t$ , solves (given exogenous  $\{y_{t+j}\}$  and  $F_t$ ):

$$\max_{(c_{t+j})_{j=0}^{\infty}} \left\{ \sum_{j=0}^{\infty} \beta^j u(c_{t+j}) \right\} \quad (1)$$

$$\text{s.t. } \sum_{j=0}^{\infty} \underbrace{\left(\frac{1}{R}\right)^j}_{\text{discounting with interest rate}} \left( \underbrace{y_{t+j}}_{\text{labor income}} - \underbrace{c_{t+j}}_{\text{consumption}} + \underbrace{F_t}_{\text{assets}} \right) = 0 \quad (2)$$

where  $\beta \in (0, 1)$  is the discount factor and  $R > 1$  is the gross interest rate  
i.e. Future assets would pay for any difference between earnings and labor income (when discounted)

### 1.2 Lagrangian

$$\mathcal{L} = \sum_{j=0}^{\infty} \beta^j u(c_{t+j}) + \lambda \left[ \sum_{j=0}^{\infty} \left(\frac{1}{R}\right)^j (y_{t+j} - c_{t+j}) + F_t \right] \quad (3)$$

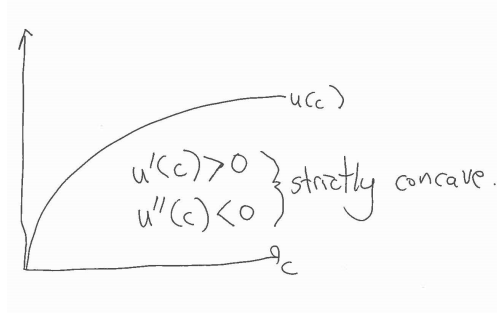


Figure 1: Strictly Concave Utility Function

Note:

- Infinite number of variables  $\{c_{t+j}\}_{j=0}^{\infty}$  and one constraint
- The constraint is a lifetime budget constraint

- First Order Necessary Condition(FONC):

$$c_{t+j} : \beta^j u'(c_{t+j}) - \lambda R^{-j} = 0 \quad (4)$$

$$\Rightarrow u'(c_{t+j}) = \left(\frac{1}{\beta R}\right)^j \cdot \lambda, \forall j \quad (5)$$

- For example:

If  $R = \frac{1}{\beta}$ , then  $u'(c_{t+j}) = \left(\frac{1}{\beta R}\right)^j \cdot \lambda = \lambda, \forall j$

i.e. slope at  $c_{t+j} = \lambda$ , which means the marginal utility is constant

$\Rightarrow c_{t+j}$  is constant for all  $j$

$\Rightarrow \bar{c} = c_{t+j} = u'^{-1}(\lambda)$

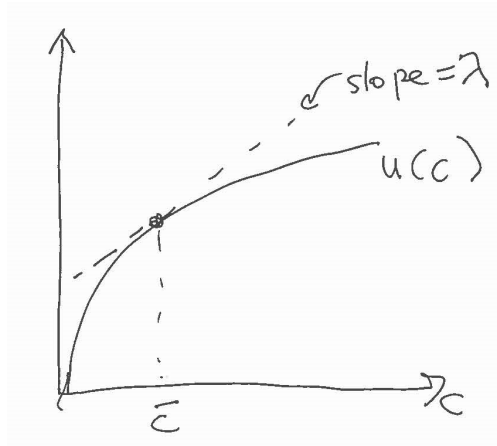


Figure 2: Lagrange Multiplier = Slope at Choice

- Take Budget constraint:

$$\sum_{j=0}^{\infty} R^{-j} c_{t+j} = F_t + \sum_{j=0}^{\infty} R^{-j} y_{t+j} \quad (6)$$

For example:

If  $R = \frac{1}{\beta}$  solve for  $\bar{c}$

$$\bar{c} = \underbrace{(1 - \beta)}_{\substack{\text{marginal propensity} \\ \text{to consume} \\ \text{out of wealth}}} \left[ \underbrace{\sum_{j=0}^{\infty} \beta^j y_{t+j}}_{\substack{\text{PDV of} \\ \text{human} \\ \text{wealth}}} + \underbrace{F_t}_{\substack{\text{Financial} \\ \text{wealth}}} \right] \quad (7)$$

### 1.3 Manipulating the budget constraint

$$\text{At time } t: \sum_{j=0}^{\infty} R^{-j} y_{t+j} + F_t = \sum_{j=0}^{\infty} R^{-j} c_{t+j} \quad (8)$$

$$\text{At time } t+1: \sum_{j=0}^{\infty} R^{-j} y_{t+j+1} + F_{t+1} = \sum_{j=0}^{\infty} R^{-j} c_{t+j+1} \quad (9)$$

Multiply the time  $t + 1$  equation by  $\frac{1}{R}$ , write out terms,

At time  $t$  :

$$F_t + y_t + R^{-1} y_{t+1} + R^{-2} y_{t+2} + \dots = c_t + R^{-1} c_{t+1} + R^{-2} c_{t+2} + \dots \quad (10)$$

At time  $t+1$ , then

$$R^{-1} F_{t+1} + \dots + R^{-1} y_{t+1} + R^{-2} y_{t+2} + \dots = R^{-1} c_{t+1} + R^{-2} c_{t+2} + \dots \quad (11)$$

Subtracting equations, most terms were canceled out:

$$F_t - R^{-1} F_{t+1} + y_t = c_t \quad (12)$$

$\Rightarrow$

$$\boxed{\underbrace{F_{t+1}}_{\text{next periods wealth}} = \underbrace{R}_{\text{gross interest rate}} \left[ \underbrace{F_t}_{\text{this period wealth}} + \underbrace{y_t - c_t}_{\text{savings}} \right]} \quad (13)$$

Note: Sometimes define  $1 + \underbrace{r}_{\text{net interest rate}} \equiv \underbrace{R}_{\text{gross interest rate}}$

So an equivalent form of the Permanent Income Hypothesis is:

$$\max_{\{c_t, F_{t+1}\}_{t=0}^{\infty}} \left\{ \sum_{t=0}^{\infty} \beta^t u(c_t) \right\}, F_0 \text{ is given} \quad (14)$$

$$\text{s.t. } F_{t+1} = R(F_t + y_t - c_t), t = 0, \dots, \infty, \quad (15)$$

Note:

- In addition, it will require a variation of  $\lim_{T \rightarrow \infty} \beta^{T+1} F_{T+1} \geq 0$ , (Transversality Condition, No Ponzi-condition, etc.)
- i.e. Agent cannot asymptotically have debt. We will ignore this constraint for now.
- There are period-by-period budget constraints.
- Chooses consumption and savings for next period.
- R is the gross rate of return on assets.

**Lagrangian for Lagrange Multipliers  $\hat{\lambda}_t$  on budgets:**

$$\mathcal{L} = \sum_{t=0}^{\infty} \beta^t u(c_t) + \sum_{t=0}^{\infty} \hat{\lambda}_t [R(F_t + y_t - c_t) - F_{t+1}] \text{ where } \hat{\lambda}_t \text{ is LM on budget constraints} \quad (16)$$

Writing out portions of the sequence:

$$\mathcal{L} = \dots + \beta^t u(c_t) + \beta^{t+1} u(c_{t+1}) + \hat{\lambda}_t [R(F_t + y_t - c_t) - F_{t+1}] + \quad (17)$$

$$\hat{\lambda}_{t+1} [R(F_{t+1} + y_{t+1} - c_{t+1}) - F_{t+2}] + \dots \quad (18)$$

FOC( $c_t$ ): Use these terms,

$$0 = \beta^t u'(c_t) - \hat{\lambda}_t R \Rightarrow \hat{\lambda}_t R = \beta^t u'(c_t) \quad (19)$$

FOC( $F_{t+1}$ ):

$$0 = -\hat{\lambda}_t + \lambda_{t+1}R \Rightarrow \frac{\lambda_{t+1}}{\hat{\lambda}_t} = \frac{1}{R} \quad (20)$$

Take (19) at time  $t+1$  and at time  $t$ :

$$\frac{\beta^{t+1}}{\beta^t} \frac{u'(c_{t+1})}{u'(c_t)} = \frac{\lambda_{t+1} \cdot R}{\hat{\lambda}_t \cdot R} \quad (21)$$

Use (20)

$$\beta \frac{u'(c_{t+1})}{u'(c_t)} = \frac{1}{R} \Rightarrow \quad (22)$$

$$\boxed{u'(c_t) = \beta R u'(c_{t+1}) \text{ (Euler equation)}} \quad (23)$$

Note in (19), let  $\lambda_t \beta^t \equiv \hat{\lambda}_t$  (just new definition for  $\lambda_t$ ), then  $\lambda_t \beta^t R = \beta^t u'(c_t) \Rightarrow u'(c_t) = R \lambda_t$ .

These are present-value Lagrange multipliers and can be stationary instead of exponentially shrinking (i.e., if  $c_t \rightarrow \bar{c}$ ).

### Alternative Lagrangian (Generally Preferred)

Directly group the  $\lambda_t$  inside sum,

$$\mathcal{L} = \sum_{t=0}^{\infty} \beta^t [u(c_t) + \lambda_t [R(F_t + y_t - c_t) - F_{t+1}]] , \text{ inside sum } \lambda_t \text{ is the same as } \lambda_t \beta^t \equiv \hat{\lambda}_t \quad (24)$$

$$\mathcal{L} = \dots + \beta^t [u(c_t) + \lambda_t [R(F_t + y_t - c_t) - F_{t+1}]] + \quad (25)$$

$$\beta^{t+1} [u(c_{t+1}) + \lambda_{t+1} [R(F_{t+1} + y_{t+1} - c_{t+1}) - F_{t+2}]] + \dots \quad (26)$$

$\frac{\partial}{\partial c_t} :$

$$\beta^t [u'(c_t) - \lambda_t R] = 0 \Rightarrow u'(c_t) = R \lambda_t \quad (27)$$

$\frac{\partial}{\partial F_{t+1}} :$

$$-\beta^t \lambda_t + \beta^{t+1} R \lambda_{t+1} = 0 \Rightarrow \frac{\lambda_{t+1}}{\lambda_t} = \frac{1}{\beta R} \quad (28)$$

Take (27) divided at  $t$  and  $t + 1$

$$\frac{u'(c_{t+1})}{u'(c_t)} = \frac{\lambda_{t+1}}{\lambda_t} \text{ (These are called "present-value lagrange multipliers")} \quad (29)$$

$$= \frac{1}{\beta R} \text{ from (28)} \quad (30)$$

$\Rightarrow$

$$\boxed{u'(c_t) = \beta R u'(c_{t+1}) \text{ (Identical Euler equation)}} \quad (31)$$

- Recall that Budget constraints need to be held. Could use either the  $\infty$  number of period-by-period constraints, or lifetime budget constraint:

$$\boxed{\sum_{j=0}^{\infty} \left(\frac{1}{R}\right)^j c_{t+j} = F_t + \sum_{j=0}^{\infty} \left(\frac{1}{R}\right)^j y_{t+j}} \quad (32)$$

With this and Euler Equation, may not need to solve for intermediate  $F_{t+1}$  choices, though could at end.

## 2 Finite Horizon

### 2.1 Finite Horizon (Formally)

Die at  $T > 0$ , i.e. no utility from consumption.

Need additional constraint so they do not die in debt:

$$\max_{\{c_t, F_{t+1}\}_{t=0}^T} \left\{ \sum_{t=0}^T \beta^t u(c_t) \right\} \quad (33)$$

$$\text{s.t. } F_{t+1} = R(F_t + y_t - c_t) \text{ for } t = 0, \dots, T \quad (34)$$

$$F_{T+1} \geq 0 \text{ (weakly positive assets at death)} \quad (35)$$

$$F_0 \text{ given} \quad (36)$$

Multipliers: Use present value constraints:

$$\lambda_0 \cdots \lambda_T \text{ on first constraints} \quad (37)$$

$$\lambda_{T+1} \text{ on last constraint} \quad (38)$$

i.e. total of  $T + 2$  constraints

$$\mathcal{L} = \sum_{t=0}^T \beta^t [u(c_t) + \lambda_t [R(F_t + y_t - c_t) - F_{t+1}]] + \underbrace{\beta^{T+1} \lambda_{T+1}}_{\substack{\text{terminal} \\ \text{constraint} \\ \text{present value}}} F_{T+1} \quad (39)$$

$\hat{\lambda}_{T+1} \equiv \beta^{T+1} \lambda_{T+1}$

FOC( $c_t$ ):

$$u'(c_t) = R\lambda_t, \text{ for } t = 0, \dots, T \quad (40)$$

$$\text{i.e. die at } T+1, \text{ no utility} \Rightarrow \frac{u'(c_{t+1})}{u'(c_t)} = \frac{\lambda_{t+1}}{\lambda_t}, \forall t \leq T-1 \quad (41)$$

FOC( $F_{t+1}$ ), for  $t < T$ :

$$0 = -\lambda_t + \lambda_{t+1}\beta R \Rightarrow \lambda_t = \beta R\lambda_{t+1} \quad (42)$$

FOC( $F_{T+1}$ ):

$$0 = -\beta^T \lambda_T + \beta^{T+1} \lambda_{T+1} \Rightarrow \lambda_T = \beta \lambda_{T+1} \quad (43)$$

With  $\underbrace{\beta^{T+1} F_{T+1} \lambda_{T+1} = 0, \lambda_{T+1} \geq 0}_{\substack{\text{Since inequality constraint} \\ \text{Need complementarity slackness}}}$

**Does terminal constraint bind?** (By Contradiction)

Assume not, i.e.  $\lambda_{T+1} = 0 (\Rightarrow F_{T+1} > 0)$ . Then from (43),  $\lambda_T = 0$ , and from (42)  $\lambda_t = 0$  for all  $t$ .

So if it does not bind at time  $T+1$ , it never binds. Only possible if  $u'(c_t) = 0 \forall t$ , which is a contradiction. Hence,  $F_{T+1} = 0$  (unless there is a budget feasible satiation point where  $u'(c_t) = 0$  for all  $t$ . e.g. Quadratic utility with enormous budgets.)

## 2.2 Period Budget Constraints and Lifetime Budget Constraints

See a derivation of Appendix B when takes the

$$F_{t+1} = R(F_t + y_t - c_t), \forall t = 0, \dots, T \quad (44)$$

$$F_{T+1} = 0 \quad (45)$$

and finds

$$\boxed{\underbrace{\sum_{j=0}^{T-t} R^{-j} c_{t+j}}_{\text{PDV of consumption}} = \underbrace{\sum_{j=0}^{T-t} R^{-j} y_{t+j}}_{\text{PDV of labor income}} + \underbrace{F_t}_{\text{Financial wealth}}} \quad (46)$$

If  $T \rightarrow \infty$ , then we see that this is identical to (2). This result provides somewhat of the opposite direction to Section 1.3, where we show that the sequential constraints imply the lifetime budget constraint (under conditions on what happens to  $F_T$  as  $T \rightarrow \infty$ ).

### 2.3 Summary of Equations

$$u'(c_t) = \beta R u'(c_{t+1}), \forall t = 0, \dots, T-1 \quad (47)$$

$$F_{t+1} = R(F_t + y_t - c_t), \forall t = 0, \dots, T \quad (48)$$

$$F_{T+1} = 0, F_0 \text{ given} \quad (49)$$

Given :  $F_0, \{y_t\}_{t=0}^T$ , find  $\{c_t\}_{t=0}^T$ . How?

In general, we need computers to solve this problem. See Appendix A for an example algorithm.

## 3 Examples

**Assume we have utility as following:**

$$u(c) = \log(c), T \leq \infty \quad (50)$$

$$\Rightarrow u'(c) = \frac{1}{c} \quad (51)$$

From Euler equation:

$$\frac{1}{c_t} = \beta R \frac{1}{c_{t+1}} \Rightarrow c_{t+1} = \beta R c_t, \text{ for } t = 0, \dots, T \quad (52)$$

$$\Rightarrow c_t = (\beta R)^t c_0 \quad (53)$$

Find  $c_0$  from lifetime budget:



**Example 1:**  $T = \infty$ ,  $y_t = \delta^t y_0$ ,  $F_0 = 0$

Use budget:

$$0 = \sum_{j=0}^{\infty} R^{-j} \left( (\beta R)^j c_0 - \delta^j y_0 \right) \quad (54)$$

$$\Rightarrow c_0 \sum_{j=0}^{\infty} \beta^j = \sum_{j=0}^{\infty} (\delta R^{-1})^j y_0 \quad (\text{assume } |\frac{\delta}{R}| < 1) \quad (55)$$

$\Rightarrow$

$$\boxed{c_0 = (1 - \beta) \cdot \left( \frac{1}{1 - \frac{\delta}{R}} \right) y_0} \quad (56)$$

**Example 2:**  $T < \infty$ ,  $y_t = \delta^t y_0$ ,  $F_0 = 0$

$$0 = \sum_{j=0}^T R^{-j} \left( (\beta R)^j c_0 - \delta^j y_0 \right) \quad (57)$$

$$\Rightarrow c_0 \sum_{j=0}^T \beta^j = \sum_{j=0}^T (\delta R^{-1})^j y_0 \quad (58)$$

$$\text{Use partial geometric sums: } \frac{1 - \beta^{T+1}}{1 - \beta} c_0 = \left[ \frac{1 - \left( \frac{\delta}{R} \right)^{T+1}}{1 - \frac{\delta}{R}} \right] y_0 \quad (59)$$

**Example 3:**  $F_0 = 0$ ,  $T = 70$ ,  $y_t = \begin{cases} \delta^t y_0, t = 0, \dots, 50 \\ 0, t = 51 \dots 70 \end{cases}$

i.e. stop working at 50, die at 70, where  $t$  is the age.

Put into budget:

$$c_0 \sum_{t=0}^{70} R^{-t} (\beta R)^t = \sum_{t=0}^{50} \left( \frac{\delta}{R} \right)^t \cdot y_0 \quad (60)$$

$$\Rightarrow c_0 \cdot \frac{1 - \beta^{71}}{1 - \beta} = \frac{1 - \left( \frac{\delta}{R} \right)^{51}}{1 - \frac{\delta}{R}} y_0 \quad (61)$$

$$(62)$$

⇒ solution:

$$c_0 = \frac{1 - \beta}{1 - \beta^{71}} \cdot \frac{1 - \left(\frac{\delta}{R}\right)^{51}}{1 - \frac{\delta}{R}} \cdot y_0 \quad (63)$$

$$c_t = (\beta R)^t \cdot c_0 \quad (64)$$

$$F_{t+1} = R(F_t + y_0 \delta^t - (\beta R)^t \cdot c_0) \quad (65)$$

can substitute for  $c_0$  to get lifetime savings.

**Example in special case:**  $\beta R = 1 \Rightarrow c_t = c_0, \forall t$ . Constant consumption

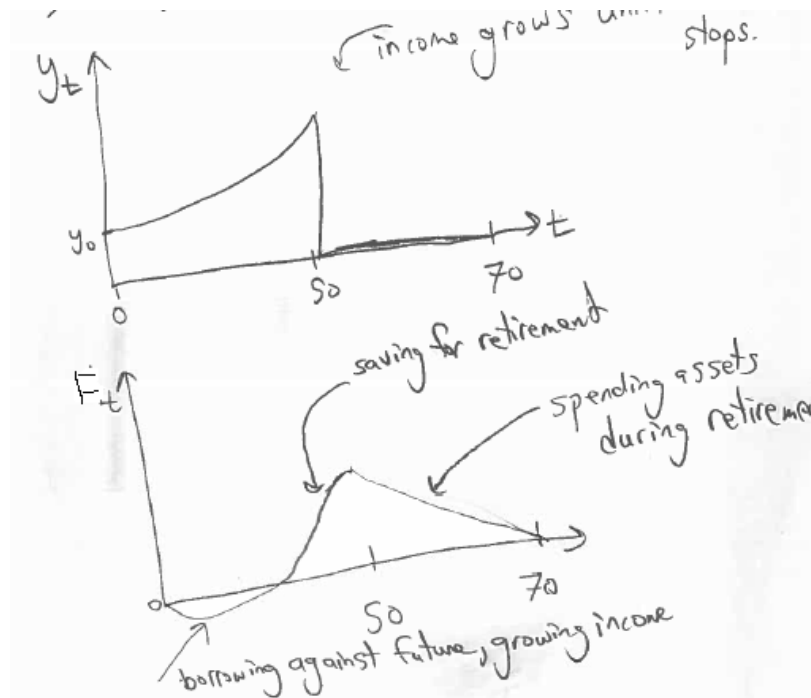


Figure 3:  $\beta R = 1$

## A Shooting Method

**An iterative approach:** Iterative approach:

1. If we knew  $c_0$ , then since we know  $F_0$ 
  - (a) Use (47) to find  $c_1$
  - (b) Use (48) to find  $F_1$
2. Repeat for  $\{c_2, F_2\}$ , etc. to  $T - 1$

3. Use (48) with  $c_T, F_T$  to get  $F_{T+1}$ ,
4. Check (49) satisfied or not.

### Convergence of the Iterative solution:

1. Guess  $c_0$
2. Find sequence using the above steps to get  $F_{T+1}$
3. If  $F_{T+1} > 0$ , raise  $c_0$  and try again. If  $F_{T+1} < 0$ , lower  $c_0$  and try again.
4. Stop when  $F_{T+1} \approx 0$

## B Lifetime Budget Constraint Derivation

We could use:

$$F_{t+1} = R(F_t + y_t - c_t), \forall t = 0, \dots, T \quad (\text{B.1})$$

$$F_{T+1} = 0 \quad (\text{B.2})$$

Alternatively, work backwards from  $T$ :

$$0 = R(F_T + y_T - c_T) \Rightarrow c_T - y_T = F_T \quad (\text{B.3})$$

Then for  $T - 1$ :

$$F_T = R(F_{T-1} + y_{T-1} - c_{T-1}) \quad (\text{B.4})$$

$$\Rightarrow \text{using previous result, } c_T - y_T = R(F_{T-1} + y_{T-1} - c_{T-1}) \quad (\text{B.5})$$

$$\Rightarrow F_{T-1} = c_{T-1} - y_{T-1} + \frac{1}{R}(c_T - y_T) \quad (\text{B.6})$$

At  $t = T - 2$ :

$$F_{T-1} = R(F_{T-2} + y_{T-2} - c_{T-2}) \quad (\text{B.7})$$

$$\Rightarrow c_{T-1} - y_{T-1} + \frac{1}{R}(c_T - y_T) = R(F_{T-2} + y_{T-2} - c_{T-2}), \text{ etc.} \quad (\text{B.8})$$

Finally, repeat until  $F_0$ :

$$F_0 = \sum_{t=0}^T \left(\frac{1}{R}\right)^t [c_t - y_t] \quad (\text{B.9})$$

More generally, starting at any  $t$ ,

$$\underbrace{\sum_{j=0}^{T-t} R^{-j} c_{t+j}}_{\text{PDV of consumption}} = \underbrace{\sum_{j=0}^{T-t} R^{-j} y_{t+j}}_{\text{PDV of labor income}} + \underbrace{F_t}_{\text{Financial wealth}} \quad (\text{B.10})$$

Compare to the lifetime budget constraint