Econ 2152 – Chapter 9

Increase in current period income

- Increases current consumption
- Increases future consumption
- Increases savings
- The endowment point shifts to E2

Smoothing Consumption

- If all consumers smooth their consumption then aggregate consumption should be relatively smooth relative to aggregate income
- Consistent with the data
- Consumption of durables MORE variable than aggregate income, but nondurables and services LESS variable than income

Increases in future income or decreases in future taxes

- C increases
- C' increases
- S falls
- Only income effect (pure income change)
- In this graph, the consumer turns into a borrower

Temporary vs Permanent changes in Income

- If income increases temporarily in the current period, since both future and current consumption increase (smoothing), then savings will increase in the current period to finance future consumption increasing.
- If income increases permanently, savings <u>MAY</u>: not need to change since income increases in BOTH periods: depends on how much each period increases.
- C increases *more* if Y increases in BOTH periods, therefore savings would increase *less* than if Y increased in only period 1.
- Another idea: if Y increased a lot and Y' increased a little, then C and C' would both increase a lot so that S would need to increase in period 1 to pay for C' increase.
- So savings could increase, stay the same or decrease

Lender – Net effect

- Current consumption ????
- Future consumption increases
- Savings ??
- It depends on which effect is greater
- If sub> income, Consumption decreases and Savings increases
- If income>sub, Consumption increases and savings decreases
- In this graph sub=income since consumption and savings do not change

Borrower-Net effect
- Current consumption decreases
- Future consumption ???
- Savings increases
- If sub>income, future consumption increases
- If income>sub, future consumption decreases
- In this graph sub> income since C’ rises

Ricardian Equivalence
- Bad
- A tax cut right now setting an offset of tax increase in the future is highly unlikely

NNP = GDP –

Sub is prices
Income is the potential income