Comprehensive Insights into LCPIH and Its Critique of Marginal Propensity to Consume

The debate between the Keynesian concept of marginal propensity to consume (MPC) and the Life Cycle/Permanent Income Hypothesis (LCPIH) started in the 1960-1970s with the new perspectives offered by LCP and PIH. LCH and PIH emerged after the criticism MPC faced and they tried to explain long-term consumption behaviors as MPC lacked alignment with empirical data on different timelines. This essay will explain the tenets of the marginal propensity to consume, the Life Cycle Hypothesis (LCH), and the Permanent Income Hypothesis (PIH). It will explain why LCH and PIH are referred together as LCPIH while noting their differences, and most importantly, it will highlight LCPIH's criticism of MPC and explain their economic policy implications.

The Marginal Propensity to Consume (MPC) is a fundamental concept in Keynesian economics. It stands for the fraction of additional income people are willing to spend. This simplified idea assumes individuals will spend the same ratio of their income on consumption at every level of income. The constant increase in consumption with increased income means a substantial stimulus in economic activity due to increased demand resulting from increased output, a notion known as the multiplier effect. This would mean an increase in consumption proportional to the Gross Domestic Product. Its core assumption is that consumption is influenced only by short-term changes in income. MPC aligns with the empirical data of short-term consumption behavior of individuals. It is a powerful tool to understand the immediate impact of changes in income, and it is helpful in creating policies to stimulate short-term economic activities. It has been largely criticized as MPC is assumed to be constant even though the empirical data suggest that the rate of savings increases as the level of economic power increases: the poor will not have enough resources to spend on savings after purchasing essential goods. The criticism of its failure to understand long-term consumption trends and account for the instability between incomes will be discussed in the upcoming parts of the essay.

The Life Cycle Hypothesis (LCH) claims that people plan their consumption and savings over their entire life span. LCH divides the life of an individual into three stages based on their saving profiles: youth, middle age and old age. Youth is the stage where the individual doesn't have much in savings and spends more than her income, creating debt. Middle age is her peak earning years, in this stage she pays off the debt of her youth as well as accumulating savings for her retirement. Lastly in her old age, her income falls because of retirement and she uses her savings, a stage known as "dissaving". This highlights the importance of considering the entire lifetime when analyzing consumption patterns and creates a normal distribution for the saving patterns of an individual for their lifetime. A key assumption of this hypothesis is the smooth consumption people have throughout their lives. The LCH created by Franco Modigliani acknowledges that poorer individuals have higher MPCs compared to wealthier individuals, therefore this is a hypothesis which doesn't take MPC as constant on the contrary to the Keynesian MPC concept. LCH anticipates consumption patterns based on expected lifetime income rather than short-term income changes affecting consumption habits. LCH aligns well with the observed data of saving patterns and successfully explains the long-term consumption behavior of individuals across different age groups. It also accounts for the desire to have constant consumption and acknowledges the long-term planning for consumption. However, it also assumes perfect foresight, which may not be a realistic assumption considering the unpredictability of real-world income changes and imperfect information. It also disregards accumulated wealth, by considering only one lifetime, it eliminates the possibility of inheritance.

Milton Friedman offered another version of the consumption function, called The Permanent Income Hypothesis (PIH). This hypothesis suggests that consumption behaviors are based on individuals' perceived permanent income, which includes stable sources of income. Similar to LCH, PIH aims for smooth consumption despite temporary fluctuations in income. Milton Friedman characterized PIH by differentiating between permanent and temporary incomes. Individuals adjust their consumptions based on the changes in their permanent income while short-term income changes have a very limited effect on behavior. Contrary to LCH, PIH assumes that individuals make decisions considering their heritages as well as their personal consumptions, extending Modigliani's use of life expectancy to infinity. It also contrasts LCH as it doesn't separate individuals into groups based on their demographics or focus on the motives behind saving. PIH fits with the observed responses to permanent changes in income which can be exemplified with inheritance or career advancements. It is also successful in understanding the goals of stability in consumption habits over time. Similar to LCH, PCH also assumes perfect foresight and rational expectations which may divert from reality as individuals do not have perfect knowledge or be able to accurately predict their permanent income.

Despite their differences, LCH and PIH are referred together as the Life Cycle/Permanent Income Hypothesis (LCPIH). This stems from their mutual focus on long-run consumption habits, both of them also focus on smooth consumption. They emerged only a few years apart and answered similar questions, and they can be thought of as complementary, as they provide a comprehensive framework to explain consumption behaviors. LCPIH is extremely important as it provides a framework to create long-term policies which align with the empirical data. However, critics of the LCPIH suggest that it remains difficult to actualize as measuring permanent income is difficult, they oversimplify individual preferences and they fall short in explaining short-term economic fluctuations as they only answer the questions for long-term behaviors.

LCPIH criticizes MPC for only answering questions regarding short-term consumption habits. It argues that MPC underestimates the importance of planning for the future in shaping consumption decisions and overlooks the differences between economic levels while lacking intuition on the effect of expected lifetime income and permanent income on consumption decisions. It also points out MPC’s failure to explain saving habits. LCPIH’s critique is important due to its implications on economic policy design. Understanding the shortcomings of a model is important when implementing policies, this paves the way for better designed short-term policy design. LCPIH also contributes to the long-term policy designs by explaining long-term consumption patterns and the distinction between permanent and temporary income, allowing for more targeted policies, and influencing monetary or fiscal policies to be intentional of their effects on the long-term. Fiscal policies aimed at stimulating aggregate demand through temporary income boosts may have less impact if individuals believe them to be temporary as they will adjust their consumptions accordingly, which can be explained by the lifetime assumption of LCPIH and the temporary income changes assumption in PIH. LCPIH suggests that a policy which can permanently increase income would be more beneficial such as infrastructure investments. Similarly, monetary policies such as increasing the interest rate may not yield the expected result if individuals focus on their long-term income.

In conclusion, the “Keynesian” marginal propensity to consume idea, the Life Cycle Hypothesis (LCH) and the Permanent Income Hypothesis (PIH) are all important to understand consumption behaviors. They focus on different aspects and different timelines, and only when an individual thinks of them in a holistic way can she explain the behavior of economic agents. Being able to explain the behaviors of the agents is incredibly important considering this information enables the creation of economic policies which successfully accomplish the goals of the government.

References

https://mises.org/library/central-fallacy-keynesian-economics-0
https://rtuassam.ac.in/online/staff/classnotes/files/1627049487.pdf
https://www.wallstreetmojo.com/life-cycle-hypothesis/#
https://www.investopedia.com/terms/c/consumptionfunction.asp
https://www.investopedia.com/terms/l/life-cycle-hypothesis.asp

Zeynep Girginer
2021300060