Pre-Class Response for Lecture 7:

Read the following summary of three studies on the Permanent Income Hypothesis: *see below*.

Question: Based on the information you have, how might you explain the discrepancy between these three studies? Name one issue that might come up with each. Some things to think about include:

- What is being counted as "transitory income" in each of these? What is being counted as "consumption"? Are these in line with the meaning of these terms in the PIH?
- Are you worried about internal/external validity?
- Are you worried about construct validity?
- Are you worried about spillovers?

One implication of the Permanent Income Hypothesis is that if someone receives “windfall” income (that is, unexpected and transitory income), they will save most of it, rather than spending it on consumption. Here are short descriptions of three studies that attempted to test whether or not this is the case. (Note that these are not randomized experiments – these are based on observational data).

Study 1. (Klein and Liviatan, 1957). This study looked at data from a 1953 UK survey on savings behavior in retired people. They counted “windfall income” as things like “life insurance benefits, gambling winnings, cash gifts, cash legacies, postwar credits, and other lump-sum transfers of money,” and they considered how much money people saved. After controlling for variables like net income, age, and liquid assets (aka, how much money you have lying around to spend), they find that the effect of windfall income on savings is actually *negative*, meaning that people spend more from a dollar of windfall income than from a dollar of permanent income. Their estimates imply that for every dollar someone got in windfall income, they spent about 92 cents of it. The authors concluded that this is evidence **against** the Permanent Income Hypothesis.

Study 2. (Kreinin, 1961). This study looked at data from the Israeli survey of family savings in the late 1950s. Some Israeli families received up to 3000 Israeli pounds in restitution payments from Germany, and the study looked at their spending/saving behavior following this windfall. (For context, the average disposable income in these families was about 3400₤). After controlling for the level of permanent income, the study found that given a dollar of this windfall income, families would only spend about 17 cents of it (if you include durable goods, like a house or a car), and even less if you don’t include durable goods. The author concluded that this was evidence **for** the Permanent Income Hypothesis.

Study 3. (Bodkin, 1959). This study looked at WWII veterans in the 1950 Bureau of Labor Statistics Survey of Consumer Expenditure. In 1949, the government (unexpectedly) announced that certain WWII veterans would receive life insurance payouts, which were paid out in 1950. After controlling for the level of permanent income, the study concluded that given one dollar of this windfall income, veterans spent about 96 cents of it if you include durable goods; or 72 cents if you don’t include durable goods. The author concluded that this was evidence **against** the Permanent Income Hypothesis.

Question: Based on the information you have, how might you explain the discrepancy between these three studies? Name one issue that might come up with each. Some things to think about include:

- What is being counted as “transitory income” in each of these? What is being counted as “consumption”? Are these in line with the meaning of these terms in the PIH?
- Are you worried about internal/external validity?
- Are you worried about construct validity?
- Are you worried about spillovers?