

Ch. 8: Household Decisions

- 8.1 Consumption and Saving: the Present vs the Future
- 8.2 The Effects of Changes in Income and Wealth on C and S
- 8.3 The Life-Cycle Model (C-S Decision over lifetimes)
- 8.4 The Real Interest Rate and the C-S Decision
- 8.5 The Income-Leisure Trade-Off
- Want to examine in more detail household decisions to:
 - consume
 - save
 - work

8.1: C and S - Present and Future

- Why do people save?
- Let's model the C-S trade-off
- Assumptions:
 - (1) two-period life
 - (2) Y_1 and Y_2 given
 - (3) the real interest rate is given

Two-Period Problem

- Notation
- Budget Constraint - defines the combinations of current and future consumption given current and future income, current wealth and the real interest rate
- Budget Line - graphs the budget constraint
What is its slope?
- Present Values $PVLR = PVLC$

Consumer Preferences

- Budget Line: Possible combinations of present and future consumption - what point will the individual choose?
- Preferences - summarized by Utility (a measure of satisfaction or well-being)
- Indifference Curves - combinations of present and future C that yield the same level of utility

Indifference Curves

- Downward sloping
- Curves are bowed toward the origin - C smoothing over time - see Fig 8.2
- Higher levels of utility outwards from the origin
- Curves never cross - why?
- Use indifference curves and the budget line to find the point of optimal 2-period consumption

8.2 Changes in Wealth and Income

- Changes in Income - shift the budget line along the current C axis by the PV of additional income
- Changes in Wealth - shift the budget line along the current C axis by the amount of additional wealth
- What are the impacts of these changes on current saving?

Other Issues

- The Permanent Income Theory
- Ricardian Equivalence
- Borrowing Constraints

8.3 The Life-Cycle Model

- An extension of the two-period model
- Developed by Franco Modigliani
- Basis: Individuals smooth consumption over the lifecycle - since income varies over the lifecycle, people will save and dissave at various stages
- What is the impact of a bequest motive?

8.4 The Real Interest Rate

- What is the impact of a rise in the real interest rate on the consumer's C-S decision?
- Substitution Effect: a higher rate makes C in the future cheaper relative to C today - C today falls
- Income Effect: In response to a change in r
 - Lenders increase C and decrease S
 - Borrowers decrease C and increase S

8.5 Supply of Labour

- The Labour-Leisure Trade-Off
- Price of Leisure - real wage (opportunity cost)
- Impact of a rise in the real wage:
 - (1) Substitution Effect
 - (2) Income Effect
- Empirical Results