Journal of Econometrics 2 (1974) 195–198. © North-Holland Publishing Company

BOOK REVIEWS

T. Mayer, Permanent income, wealth, and consumption: A critique of the permanent income theory, the life cycle hypothesis, and related theories (University of California Press, Berkeley, 1973).

Given the sheer volume of empirical work on consumption theories, most authors don't even dare a systematic evaluation of other tests related to theirs. Rather, they proceed undaunted by the fact that numerous studies of a comparable nature have been performed. In this regard Mayer's book is a contribution because by and large he has done an excellent job of tracking down an enormous number of studies, many of which are rather inaccessible, and giving a short precis of their model, data and results obtained. This work, combined with the index, allows one to learn of the research by different authors as well as the tests performed on various concepts in consumption theory. For example, if one wants to know what research has been done on the proportionality hypothesis, he can get off to a pretty good start by examing the 62 entries under this subject given in the index. These entries will turn up the major and most well-known tests for the casual student of consumption function studies and will also provide the connoisseur with new surprises (though Margaret Reid may know each and every one).

The review of the existing theories is generally adequate, but what is advanced as the 'standard income theory' seems to be a minor benefit. As Mayer notes, it is not really a theory per se but a 'convenient way of specifying that the truth lies between the measured income theories on the one hand and the full permanent income theory on the other'. Yet it seems wise to avoid even labelling it as a separate theory. It would be as though texts on the theory of the firm contained a model of 'monopolition' which had no particular conceptual content but was deemed necesary to reflect the fact that most markets are in between the extremes set forth by the monopoly model and the 'full' competitive theory. Thus, it is not surprising that no analytical gain is realized from this new terminology which is used throughout the book. For example, in the introduction to his section on permanent income proxies, assessment of the empirical evidence is cast in the framework of the permanent and measured income theories. As noted, 'it is convenient to have [these] anchor points'. Perhaps other readers won't be bothered, but I found annoying the repeated labelling of something as a theory which was not.

Because Mayer covers a large number of studies the treatment of various studies is unlikely to receive unanimous agreement by the reader, and a few inconsistencies can be spotted. In a seven page table (table 15) he summarizes a large number of different tests of the consumption models in terms of the evidence they provide for the permanent income theory, the relative income theory, and the standard income theory or other wealth theories. In discussing this table it is argued that the work by Robert Holbrook in his dissertation strongly supports the standard income theory. Another study by Holbrook and Stafford (*Econometrica*, 1971) is summarized as providing 'no usable evidence'. This is difficult to reconcile with Mayer's contention that the latter results 'appear to provide strong support for the full permanent income theory. They support the proportionality hypothesis and the zero propensity to consume transitory income'. Despite the fact that this study conformed as closely as possible to Friedman's recommended definitions (*A Theory of the consumption function*, p. 116), the reason given for dismissing the results is that the data are inadequate (because we did not completely account for services of durables other than automobiles – they were not in the data). Yet Holbrook's dissertation, which is listed in the table as providing strong confirmation of the standard income theory, used precisely the same data.

There are a few other flaws which can be spotted throughout the book. It is argued that 'it is the hallmark of transitory income that it is positive in one period and negative in the other, when Mayer proceeds to average income over several years to obtain a measure of permanent income. But Friedman has clearly argued that there is positive serial correlation in transitory income (*Measurement in economics*, p. 62), and this has been verified in other studies (e.g., Holbrook-Stafford).

Apart from the problems mentioned above, the book contains a credible job of presenting the case that the bulk of empirical evidence supports an intermediate position between measured income theories and PIH-LCH theories. But this does not weaken the theories since the purpose of a theory is to suggest tendencies rather than define absolute results even though formal theory is necessarily presented in an unequivocal fashion. This can be exemplified by the Life Cycle Hypothesis which, according to Mayer, performs very poorly. Yet important forms of economic behavior cannot be interpreted in a coherent fashion without this theory; the existence of pension funds, as Mayer admits, is evidence of life cycle smoothing of consumption.

The book focuses very closely on interpreting the existing evidence (including a number of studies performed by Mayer for this volume) rather than casting a wider net and trying to identify new effects. This has both benefits and costs. On the benefit side it allows concentration on a systematic review of a rather limited number of propositions, but on the cost side it has the problems associated with a rather narrow perspective. Consider three examples:

One of the motivations of the consumption theories and the empirical research is to cast light on macroeconomic problems. Friedman has argued that transitory income is saved, but in the broader definition saving includes the non-depreciated part of durable purchases in a given period of time as well as financial saving. In the context of an income–expenditure framework this distinction is of great importance, but nowhere does the book address itself to the question of what happens to transitory income which is not consumed. The distinction between the marginal propensity to spend and the marginal propensity to consume is a very important one but is given no systematic treatment.

If Mayer believes the 'new' theories to have performed weakly concerning the proportionality hypothesis, how is the apparent constancy of the long run saving rate to be reconciled?

Most of the microeconomic theory for the M-B-A models was proposed with an eye to deriving an *aggregate* consumption function, but when micro behavior is examined some obvious modifications should be attempted. What is termed the family unit is used in the model as though family composition were fixed, but whose lifetime consumption is being smoothed? The husband's and wife's or the husband's and wife's plus their anticipated children? To examine micro saving behaviour in the life cycle model, some framework should be devised to treat these issues – the need to do so is given by the empirical fact that young couples without children have much more net assets than young couples with children present, and this implies that saving rates depend on current and expected family composition. The task of formally altering the life cycle model to account for this is definitely non-trivial, but failure to do so is likely to confound empirical results even though the same basic forces of life cycle smoothing and inter-generational loans implied by the LCH are operating.

In summary, Mayer's book is certainly worth reading. The limitations suggested above should not detract from the fact that much effort has been expended on summarizing concisely what has been done. Another major asset is the cross referencing of the wide variety of studies as they bear on the different issues raised by the different consumption hypotheses.

Frank P. Stafford
The University of Michigan