

Windfall Income and Consumption: Comment

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Two recent publications in this *Review* have examined the magnitude of the marginal propensity to consume windfall income. The present writer, working with data based on the B.L.S. Survey of 1950, found that the National Service Life Insurance dividend payments of that year were largely spent by their recipients [2]. The regression coefficient estimates of the marginal propensity to consume this receipt were .97 or .72, depending upon whether durable goods expenditure was included in or excluded from the concept of consumption. Mordechai E. Kreinin, using the Israeli Survey of Family Savings of 1957-58, observed a weak tendency to spend restitution payments (from West Germany) on the part of the recipients [3]. Kreinin estimated that the relevant marginal propensity to consume was .17 if durables were included in consumption and .16 if they were excluded. Thus the conclusions of these two studies, which seemingly focus on the same type of income receipt, appear diametrically opposed.

Several surface explanations come to mind, and these will be discussed below. In this note, however, I shall argue that the principal explanation of the differing results is to be found in certain institutional features surrounding the restitution payments received by Israeli residents. In particular, it will be contended that the foreign exchange regulations pertaining to these payments provided a powerful incentive for the recipients *not* to spend these receipts, but to hold them instead in liquid assets in the form of foreign exchange.

During the years 1957 and 1958 (the period of Kreinin's study), some moderately complicated regulations governed the way in which Israeli residents could dispose of their restitution receipts.¹ If these payments (originally

¹The discussion in this paragraph is based on K. Yaacobi's letter to the author [5]. The original statement of these regulations appeared in directives issued to Israeli commercial banks. These directives, which of course were written in Hebrew, have not been translated into English.

in West German marks) were converted into Israeli pounds, there was no restriction on the use of these receipts. But Israeli citizens were free to spend abroad, at the time of payment or in the future, only one-fifth of their total receipts, either for imported goods for personal use or for travel expenses abroad. In addition, recipients were allowed to spend, on foreign travel, a maximum of \$1200 per person (a member of the immediate family) in any one year. The remaining four-fifths had to be converted into Israeli pounds, either immediately or at some future date. If the recipient elected immediate conversion, a 20 per cent premium over the official exchange rate was paid, in the form of government securities. If the recipient (presumably anticipating a future devaluation) wished to convert these funds at a later date, he was required to deposit them in a special account. If the recipient wished to purchase foreign securities, the regulations required him to finance this placement out of the unrestricted (the 1/5) portion of his receipt.

It seems likely that these regulations would have led the recipients to have saved their restitution payments or at least to have deferred the associated consumption. Indeed, economic pressures to defer immediate consumption existed for both portions of these receipts. The restricted (the 4/5) portion might have been saved, by at least some recipients, in anticipation of a devaluation of the Israeli pound, as it was well known that the official exchange rates overvalued the currency (relative to either its purchasing power or a free market rate). The fact that there was a 20 per cent premium on immediate conversion suggests that the authorities wished to take some action against this type of speculative motive, without, however, coercing the recipients into an immediate conversion. Furthermore, when the devaluation finally came, on February 9, 1962, the depreciation of the Israeli pound was considerably greater than 20 per cent [4, p. 1]. (The official exchange rate went from 1.8 Israeli pounds per dollar to 3.0 Israeli pounds per dollar.) Thus, it seems likely that the overvaluation of the exchange rate induced at least some of the recipients of these restitution payments to defer immediate conversion and hence to forego, in large measure, immediate consumption.² Kreinin's sample (employed salary recipients, ages 20-55) might be expected to have been reasonably sophisticated in financial matters and hence aware of such a possibility. The estimate of the Bank of Israel that 45 per cent of the restitution payments went into liquid assets is also consistent with this supposition [1] [3, paraphrased, pp. 388-89].

Moreover, there were economic pressures to defer consumption out of the unrestricted (the 1/5) portion of the restitution payments. With foreign exchange restrictions, an individual recipient would not have been able to obtain in the future unlimited foreign exchange for personal use. Consequently, he might have deferred consumption out of at least a fraction of this portion, also. (For example, the recipient might have saved these funds for use on a

²The decision to forego immediate conversion of the restitution funds could have been accompanied by increased consumption, if the recipient possessed a large enough holding of liquid assets and if in addition he regarded his nonconverted restitution fund as a reasonable substitute for these liquid assets. But this would appear to be a rather special case.

trip abroad at a later date.) In addition, the unrestricted portion of the restitution payments would have constituted, for many of the recipients, the only foreseeable opportunity to obtain foreign securities. For this reason, also, the foreign exchange restrictions may have encouraged some saving out of even the unrestricted portion of the restitution payments.

The superficial differences between the Bodkin and Kreinin studies deserve perhaps a quick mention. Kreinin's restitution recipients had, as a group, experienced many hardships (and worse) during an earlier period of their lives. It seems quite likely that such experiences would make individuals cautious, alert to adverse possibilities, and hence less likely to spend a one-time receipt than would be likely for a group of young American veterans. Secondly, the restitution payments might be considered different in character (as well as in magnitude) from the National Service Life Insurance dividends. The restitution payments might be considered analogous to insurance receipts, as they were intended to be a partial compensation (or, as the name states, restitution) for losses sustained by the individual in the past. Thus, some individuals might have regarded their receipts as similar to a return of capital and hence might have been less prone to consume out of such a receipt. Finally, casual observation suggests that the typical restitution payment was not a surprise to the recipient at the time of payment, but had been the subject of some prior negotiation. Thus, some skepticism as to whether these receipts qualify as a "windfall" seems justified. By contrast, as the author has already argued [2], the period between the announcement of the National Service Life Insurance dividend and the actual payments appears to have been very short.

In summary, the differing results found by Kreinin and Bodkin may be largely attributable to the foreign exchange regulations governing restitution payments received by Israeli residents. It seems quite clear that these regulations created strong incentives to save these receipts or at least to postpone immediate consumption financed by them. For this reason, Kreinin's analysis may be regarded as a rather weak test of the relevant strand of Milton Friedman's permanent income hypothesis.

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5. K. YAACOBI, letter to Ronald G. Bodkin, Jan. 8, 1963.

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