Keynesian consumption function.

KEYNES' PHYCHOLOGICAL LAW OF CONSUMPTION

- ▲ The law states that "men are disposed, as a rule, and on the average, to increase their consumption as their income increases but not by as much as the increase in their income"

- ▲ It is also known as "Propensity to Consume"

- ▲ It is called as Consumption Function

Three related Propositions

1. When Income increases, consumption expenditure also increases but by a smaller amount

2. The increased income will be divided in some proportion between consumption expenditure and saving

3. An increase in income is unlikely to lead to less spending or less saving than before

¶ When INCOME increases, CONSUMPTION also increases, but not to the same extent as the increase in INCOME

¶ Consumer spending differs from investment spending is in such a way that the consumer makes his purchases to satisfy his or that his family's needs directly

CONSUMPTION FUNCTION

- Expresses the relationship between INCOME (Y) & CONSUMPTION(C)

- $Y=C+I$

  amount of consumer expenditure made at a given level of income(Y)

- Symbolically, $C=f(Y)$

- **Consumption Schedule**: Tabular representation of various amounts of consumption expenditure corresponding to different levels of income

TABLE SHOWING CONSUMPTION FUNCTION

Disposable Income	Consumption(C)	Saving (S)
100	80	20
120	95	25
140	110	30
160	125	35
180	140	40
200	155	45
220	170	50
240	185	55

CONSUMPTION FUNCTION CURVE
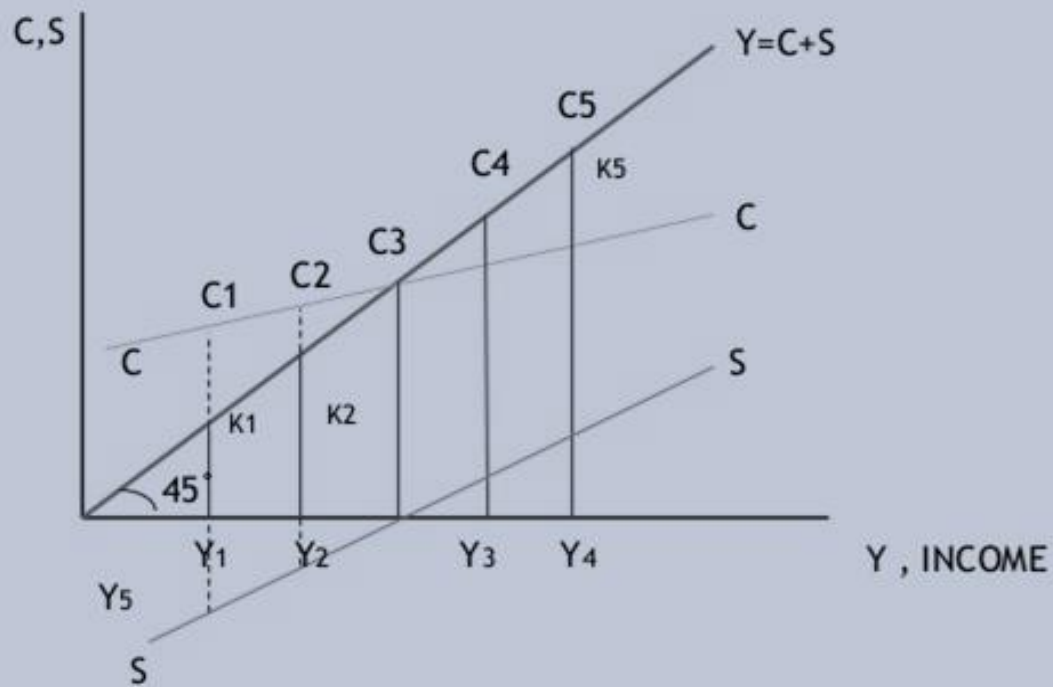
Marginal Propensity to consume	Average Propensity to Consume
⊙ Ratio of a small change in the consumption as a result of a small change in income	⊙ Ratio of absolute consumption to absolute income at a particular time
⊙ MPC$=\dfrac{\Delta C}{\Delta Y}$	⊙ APC$=\dfrac{C}{Y}$
⊙ MPS=1-MPC	⊙ APS= 1-APC

ASSUMPTIONS

- It assumes a constant Psychological and Institutional complex which means that income distribution, tastes, habits, social customs, price movements, population growth, etc remain constant and consumption depends on income

- It assumes the existence of normal conditions. The law does not operate in abnormal conditions like war, revolution or hyperinflation.

- It assumes the existence of lassiez-Fare Capitalist economies and is in operative in case of socialist economies.

IMPORTANCE OF KEYNES CONSUMPTION FUNCTION

- Vital importance of Investment
- Oversaving gap
- Underemployment Equilibrium

Consumption Function

- Theory of consumption function explain relationship between consumption & income

- As per J.M Keynes, consumption expenditure of household depends mainly on their current income

- Other factors influence like interest rate, taxation, amount of wealth etc.

- As per Keynes, when income increases, consumption increases but in a lesser proportion due to savings factor

- Consumption Function is also known as Propensity to consume

APC & MPC

▸ Consumption function can be explained through Average Propensity to Consume (APC) and Marginal Propensity to Consume (MPC)

▸ APC – ratio of total consumption expenditure to total income

▸ APC = C / Y i.e. Consumption / Income

▸ For instance, C = 60,000, Y = 1,00,000

▸ APC = 60000 / 1,00,000 = 0.6 or 60%

▸ Household spends 60% of its income on consumption

APC & MPC

- MPC – Ratio of change in consumption to change in income

- MPC = $\triangle$ C / $\triangle$ Y i.e. Change in Consumption / Change in Income

- Instance, change in C = 60,000 to 1,00,000 & Y = 1,00,000 to 2,00,000

- MPC = 40,000 / 1,00,000 = 0.4 or 40%

APS & MPS

- Counterparts of APC & MPC are APS & MPS

- APS – Average Propensity to Save

- MPS – Marginal Propensity to Save

- APS = S / Y (S = Savings, Y = Income)

- MPS = $\triangle$ S / $\triangle$ Y (Change in Savings / Change in Income)

- APC +APS = 1 and MPC + MPS = 1

- Rich people have more of MPS compared to poor

- MPC will be greater than MPS

Y	C	APC (C/Y)	APS (S/Y) (1 – APC)	MPC ($\triangle$C/$\triangle$Y)	MPS ($\triangle$S/$\triangle$Y) (1–MPC)
1000	1000	1	0	-	-
2000	1800	1800/2000 = 0.9	0.1	800/1000 = 0.8	0.2
3000	2500	2500/3000 = 0.83	0.17	700/1000 = 0.7	0.3
4000	3000	3000/4000 = 0.75	0.25	500/1000 = 0.5	0.5
5000	3200	3200/5000 = 0.64	0.36	200/1000 = 0.2	0.8

Factors Determining Consumption Function

- 2 types of Factors

  - Objective Factors

  - Subjective Factors – help in more saving rather than spending hence consumption is reduced

Objective Factors

- Size of Income
- Price Level
- Distribution of Income
- Propensity to Save
- Future Expectations
- Taste & Fashion

- Rate of Interest
- Sudden Gains or Losses
- Ownership of Assets
- Corporate Policy (Dividend)
- Fiscal Policy
- Other Factors (Loans)

Subjective Factors

▸ Precaution against illness, accident, unemployment etc.

▸ Future Expectations & Needs

▸ Accumulation of Wealth

▸ Independence

▸ Investment

▸ Speculation

▸

CRITICSMS

- Proportional relationship between consumption and income is not always true

- It neglects other factors that influence , consumer spending such as asset holdings, urbanisation, appearance of new products, etc.

- Expectations and level of aspirations also play an important role in consumer spending