

Topic – Absolute Income Hypothesis

Dr. Nandini Katti



Unit by Nandini katti -This work is licensed under a [Creative Commons Attribution-NonCommercial-ShareAlike 4.0 International License](https://creativecommons.org/licenses/by-nc-sa/4.0/).

KEYNESIAN – ABSOLUTE INCOME HYPOTHESIS

- **John M. Keynes: Absolute Income Hypothesis**

Consumption is a linear function of disposable personal income,

$$C = C + cY$$

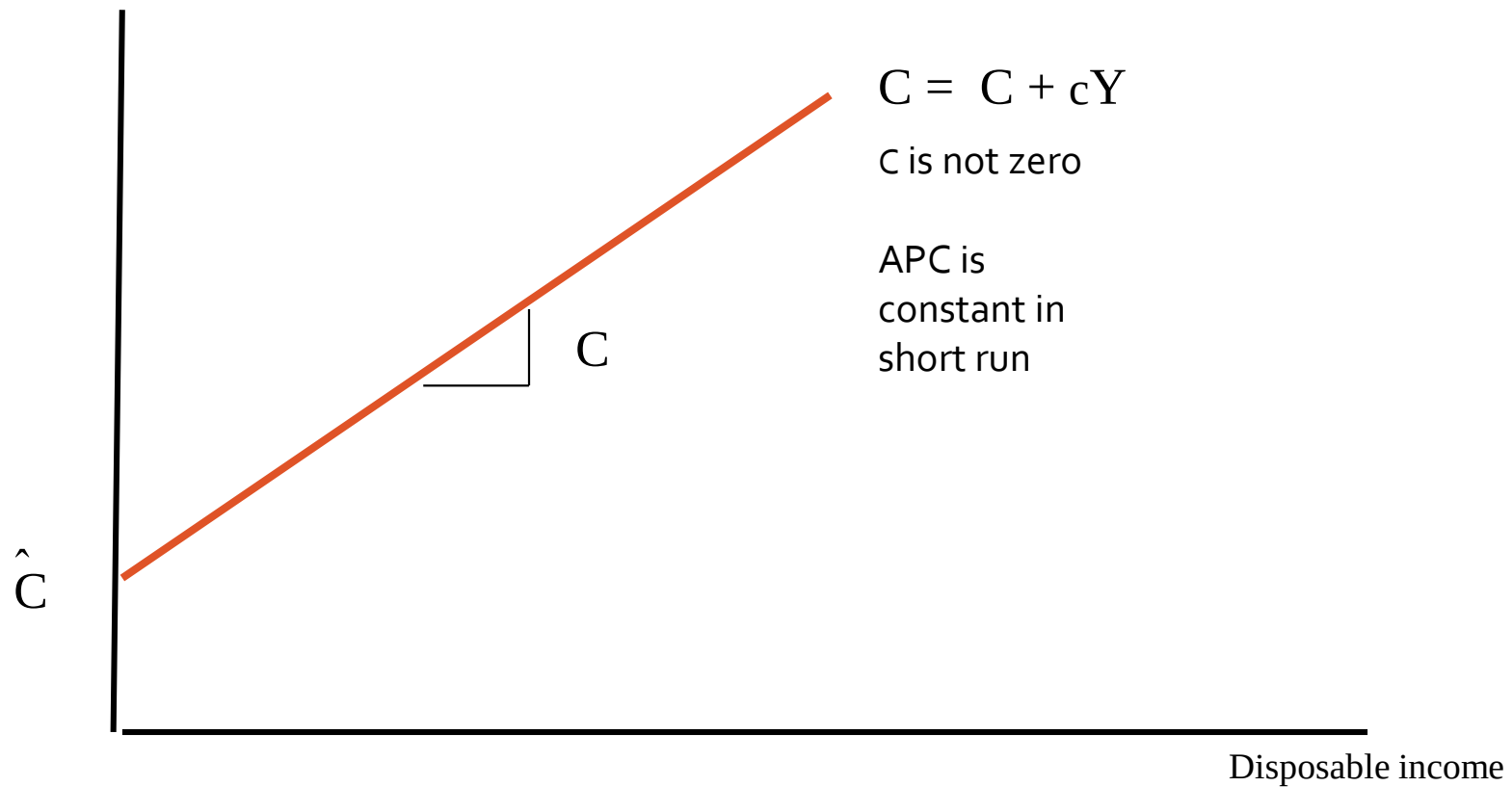
- C = consumption expenditure
- Y = disposable income
- C = autonomous consumption (intercept of the line)
- c = marginal propensity to consume (slope of the line)

PROPERTIES OF CONSUMPTION FUNCTION

- Consumption is determined by current income
- Marginal propensity to consume ($MPC = \Delta C / \Delta Y$) is between zero and one ($0 < c < 1$)
- Average propensity to consume ($APC = C / Y$) falls as income rises

SHORT RUN CONSUMPTION FUNCTION

Consumption expenditure

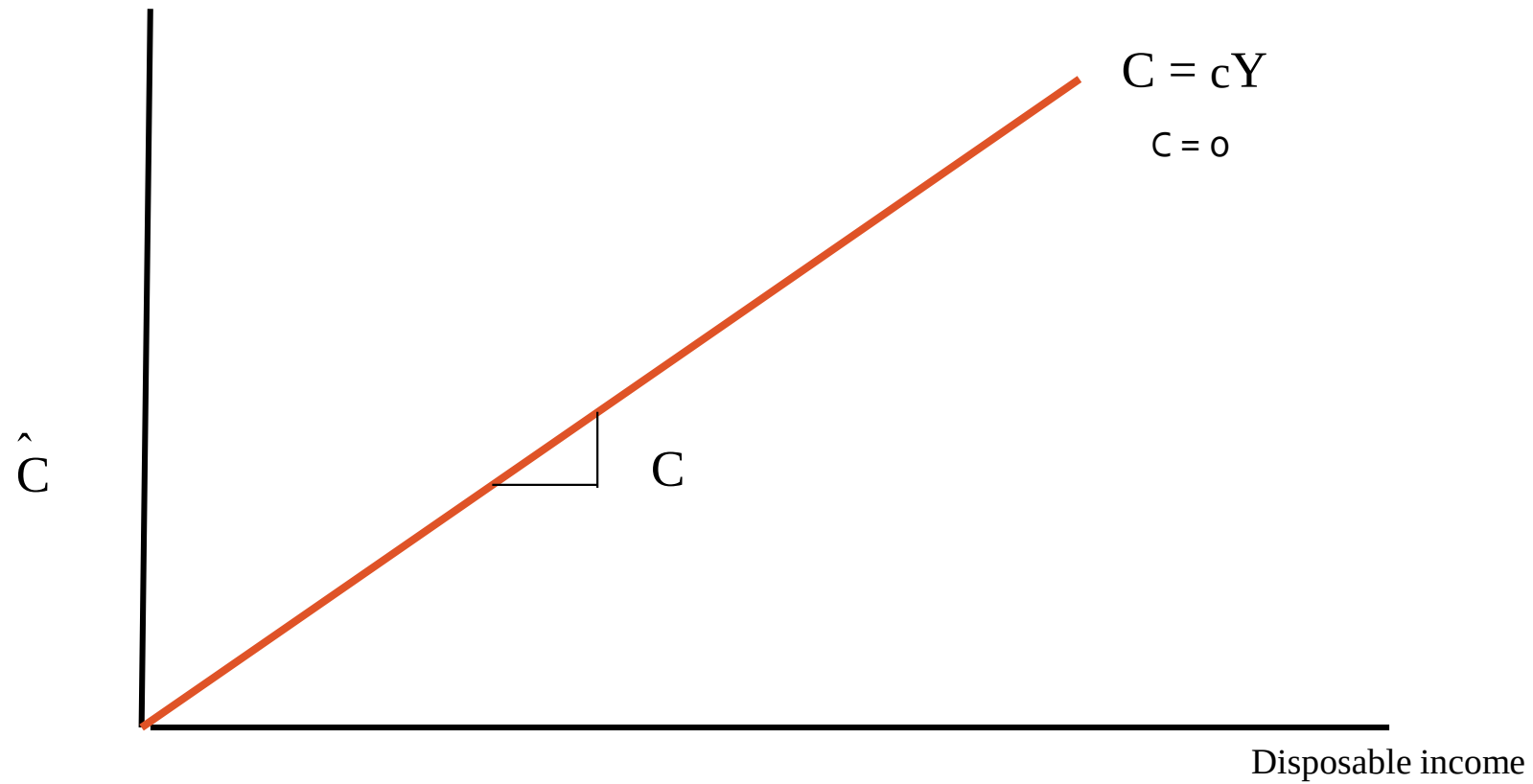


SHORT RUN CONSUMPTION FUNCTION

- Empirical Evidence shows
- High income families have a higher marginal propensity to save
($MPS = 1 - MPC$)
- High income families have a higher average propensity to save
($APS = 1 - APC$);
- APC falls with the level of incomeIn the long-run, autonomous consumption falls to zero($C = 0$)

LONG RUN CONSUMPTION FUNCTION

Consumption expenditure



IRVING FISHER: INTERTEMPORAL CHOICE

- Consumption decisions are based on **current** and **future** income
- Current period income = current income plus present value of future income:
 - $Y_1 + Y_2 / (1 + r)$, where r is a discount rate
- Future period income = future income plus future value of current income:
 - $Y_2 + (1 + r)Y_1$

LIFE CYCLE ASSUMES

- Life cycle consumption functions assume that households consider not just the current flow of income but the present value of lifetime income.
- Consider a stream of income received over time $\{y_0, y_1, \dots, y_T\}$.
- This is equivalent in value to a certain amount of current income,
- $pvy < y_0 + y_1 + \dots + y_T$.
- Funds available today are worth more than equivalent funds which are not available until the future.

PRESENT VALUE

- Reason: Today can earn interest -

Q: How much do you need today to have Y_t in t periods.

Answer: $Y_t / (1+r)^t$

- A future payment discounted by the interest rate raised by the number of periods that must be waited until the payment is made is called the present value

PRESENT VALUE OF A STREAM OF PAYMENTS

- Households earn a stream of income over their lifetime.
- $\{y_0, y_1, \dots, y_T\}$.
- Present value of an income stream is the sum of the present values of each payment
- $P_{vy} = y_0 + y_1 / (1+r) + y_2 / (1+r)^2 + \dots + Y_t / (1+r)^t$

CONCLUSION ON KEYNESIAN THEORY

- The decision of the household to spend money on goods is a simultaneous decision not to save this money in the form of financial assets.
- A decision not to save money for the future is simultaneously a decision not to have that wealth available in the future to purchase consumption goods.
- The consumption decision is based on a trade-off between the welfare gained from consumption today and welfare from consumption based in the future.
- The first theory is the absolute income hypothesis. This theory was postulated by Keynes.
- According to this hypothesis, consumption depends on the current level of disposable income.

- Disposable income refers to the total amount of income available for use by households or the after tax personal income.
- This theory also argues that consumption is directly but not proportionately related to the current level of aggregate disposable income.
- This therefore implies that the average propensity to consume (APC) declines with increase in income.
- Average propensity to consume is described as the proportion of income that goes to consumption.
- The unproportionate change in consumption, is based on the argument that the consumer's reaction to change is not instant but gradual.
- This is because the change in income may not be permanent.
- It can therefore be concluded that consumption over time does not only depend on income over time but also the previous level of consumption.

FRANCO MODIGLIANI: LIFE CYCLE HYPOTHESIS

- Consumption depends on income and wealth
- C = Consumption expenditure
- W = Consumer wealth
- R = Length of productive life time
- T = Years of life

CONSUMPTION FUNCTION

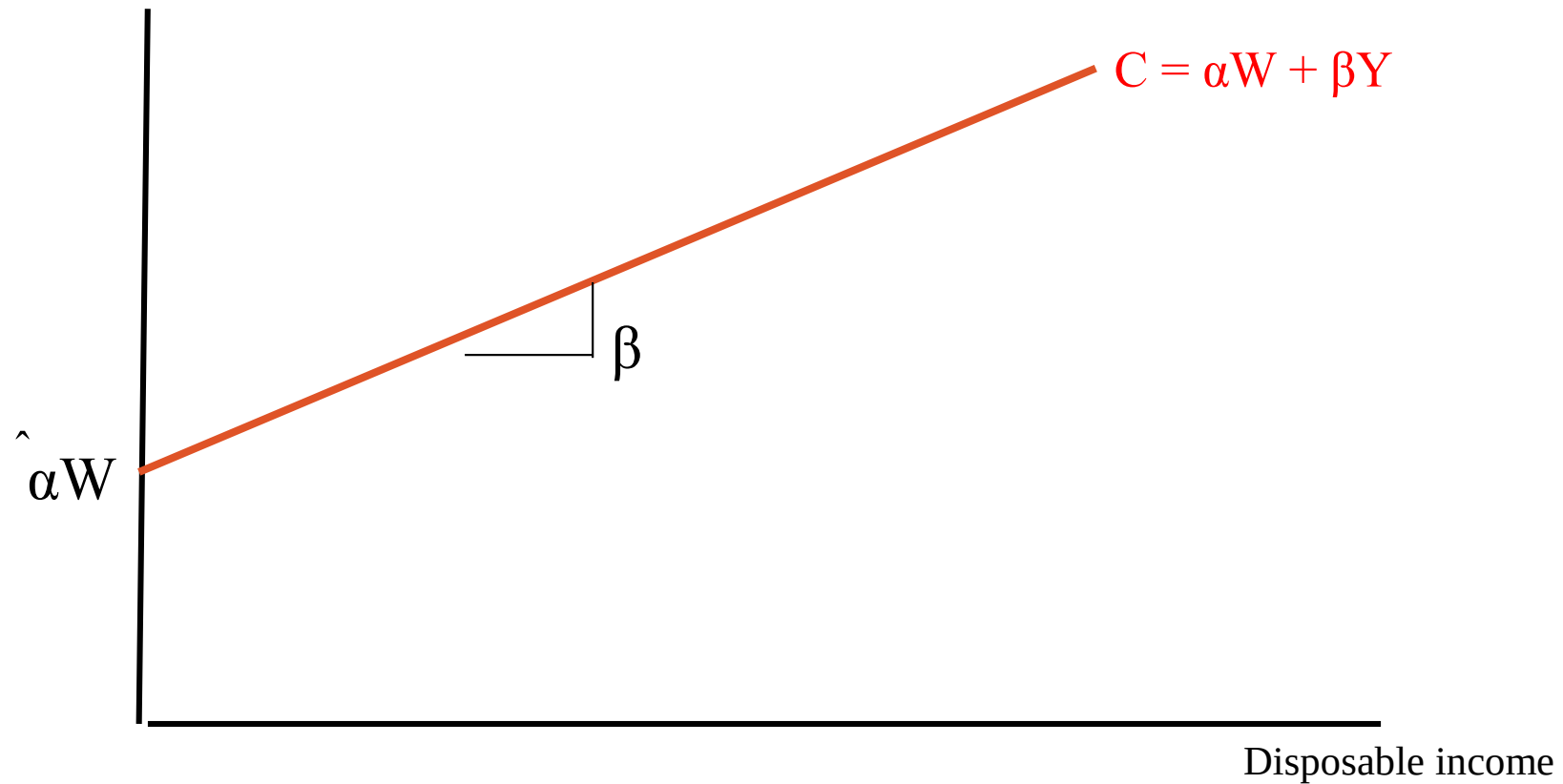
$$C = (W + RY)/T = (1/T)W + (R/T)Y$$

- Define:
- $\alpha = 1/T$ is the MPC out of wealth
- $\beta = R/T$ is the MPC out of income

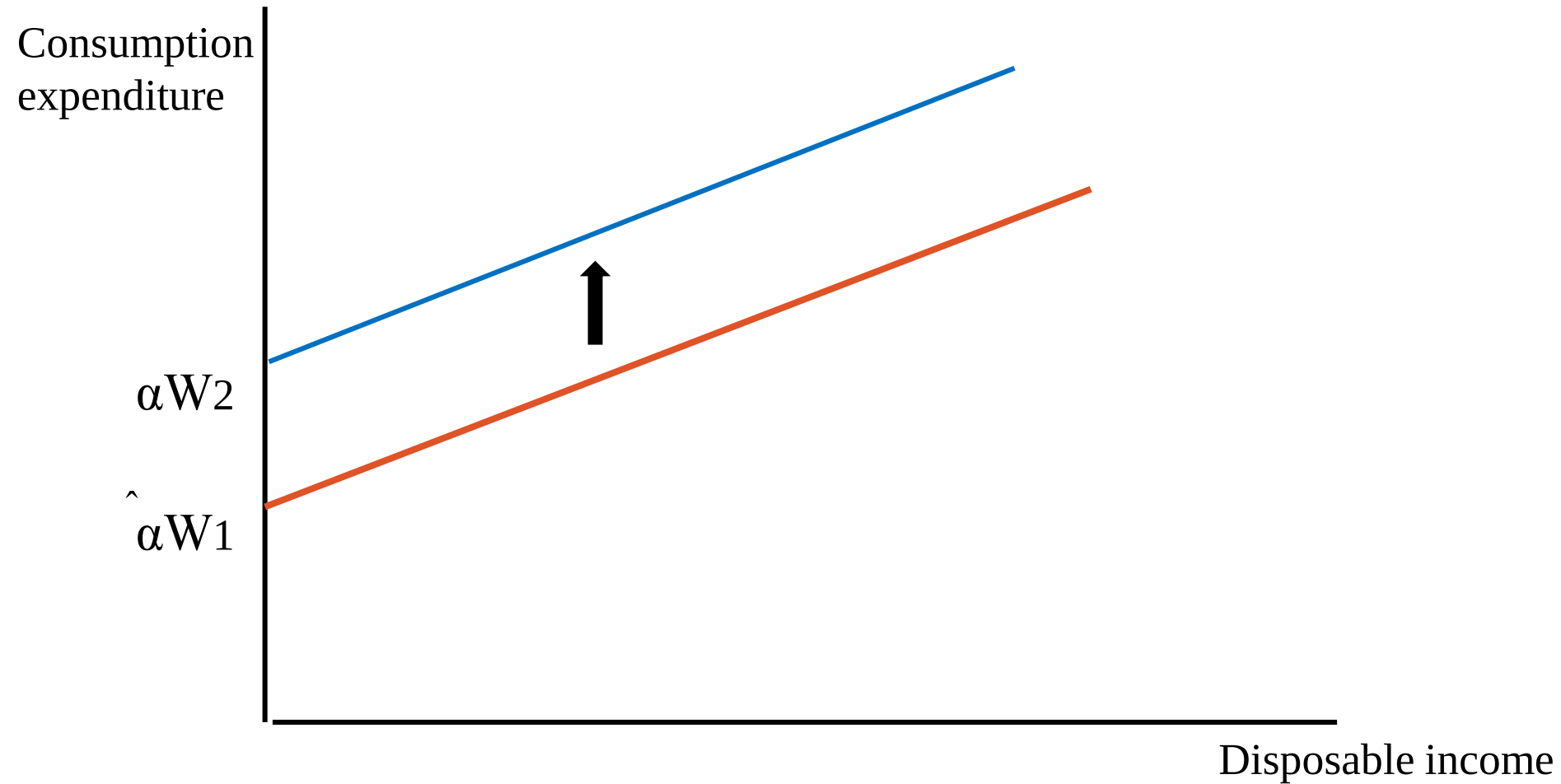
$$C = \alpha W + \beta Y$$

CONSUMPTION FUNCTION

Consumption expenditure



CONSUMPTION FUNCTION

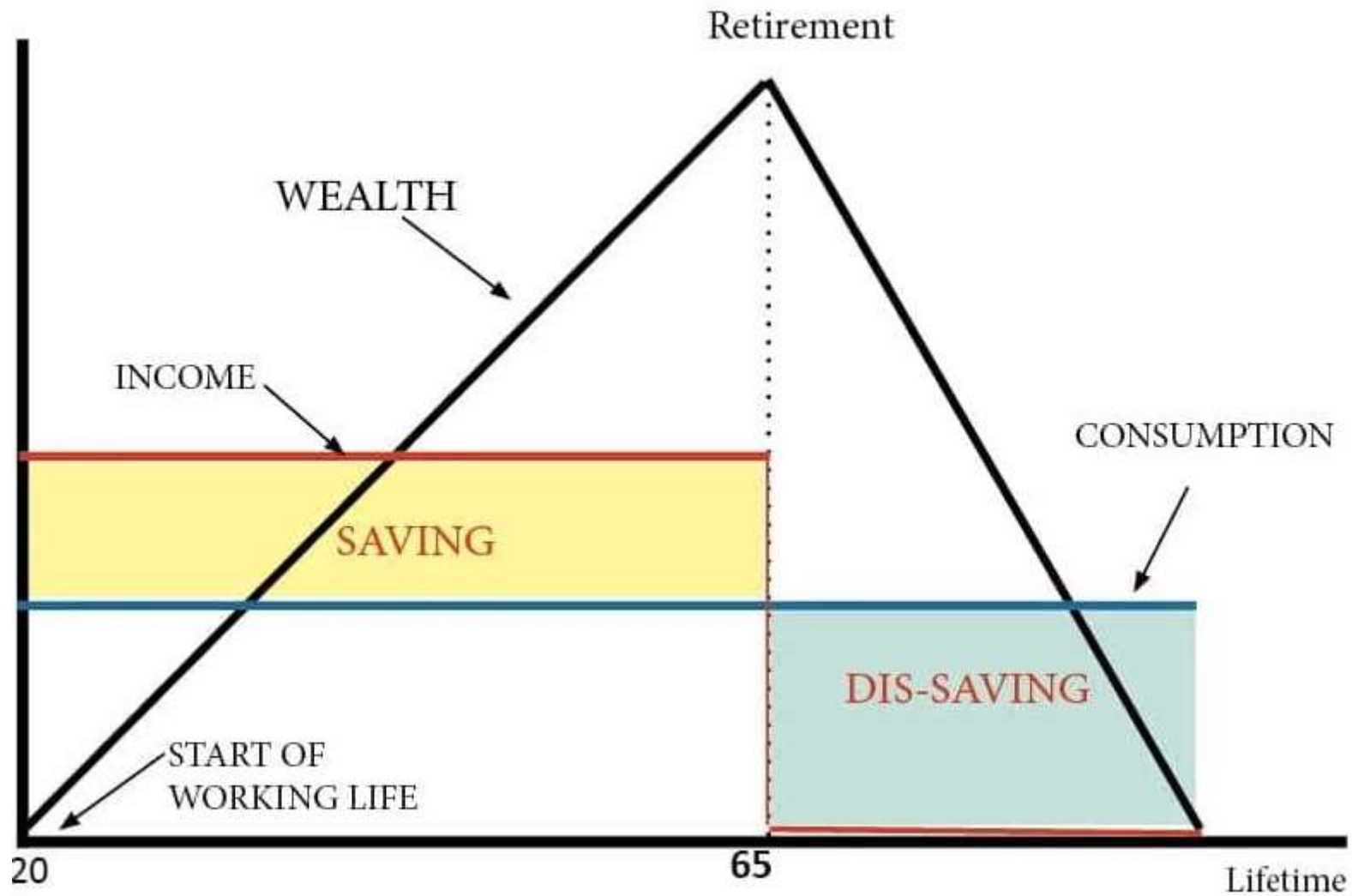


Increased wealth will shift the consumption function upward

CONSUMER BEHAVIOR

- Life Time Consumption spending is a stable function of income
- Consumers save their leftover income
- Consumers accumulate wealth during the productive lifetime
- Consumer finance retirement by dissaving and selling-off their assets

CONSUMER BEHAVIOR OVER THE LIFETIME - MODIGLIANI



MILTON FRIEDMAN: PERMANENT INCOME HYPOTHESIS

- Measured income consists of
- permanent and transitory income;

$$Y = Y_P + Y_T$$

- Permanent income is the average income we make during years of productive life
- Transitory income is the random variation from the average

CONSUMPTION FUNCTION

- Consumption is a function of permanent income

$$C = \alpha YP$$

- Consumers use saving and borrowing to smooth consumption in response to transitory changes in income

DETERMINANTS OF CONSUMPTION



- Combining all the theories,
- we can conclude that consumption depends on

Current income

Expected future income

Wealth

Interest rate