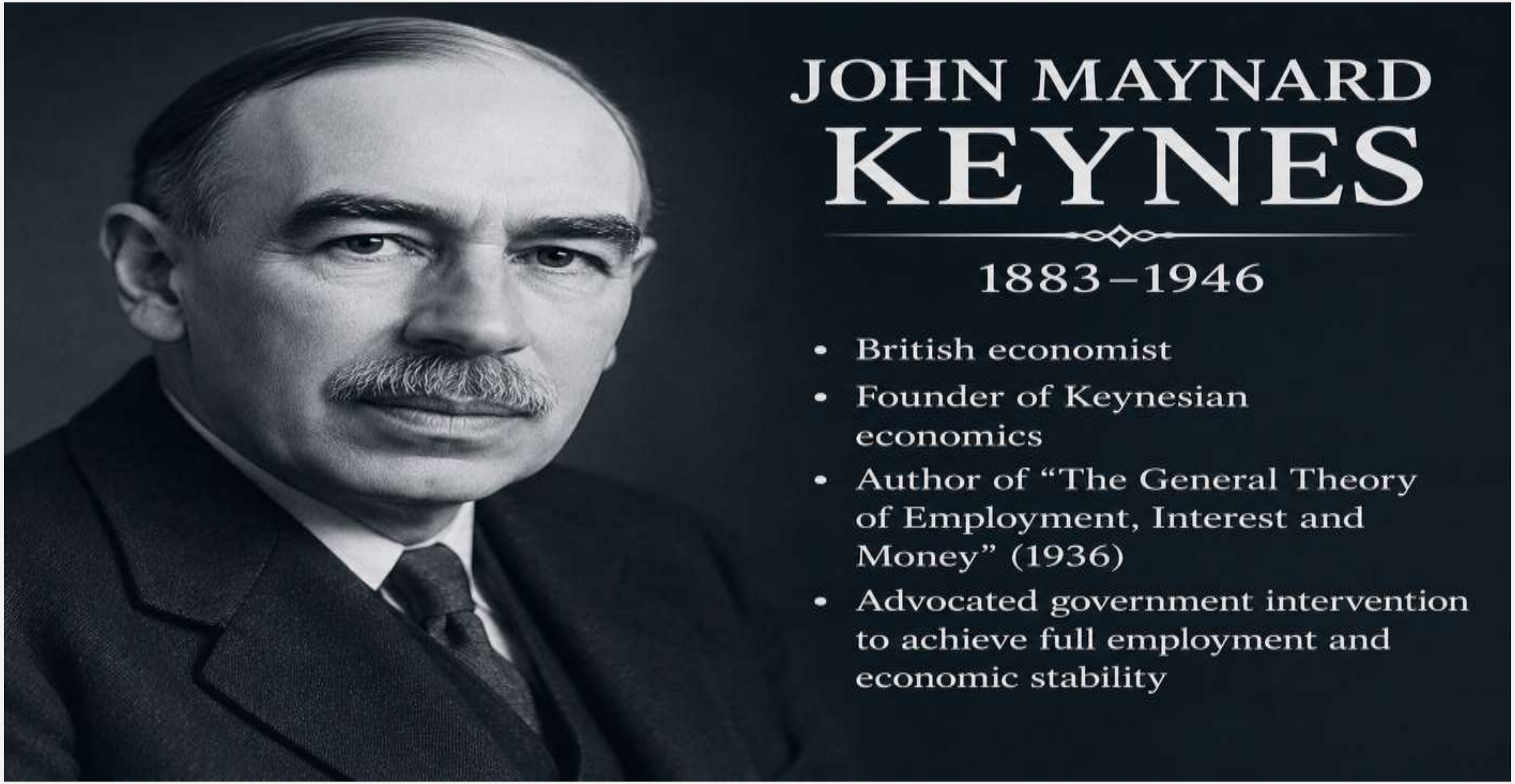
CONSUMPTION FUNCTION



CONSUMPTION FUNCTION

- **The ultimate objective of Keynes theory is to explain what determines the volume of employment**
- **Consumption Function is perhaps the single most important contribution of Keynes to modern Macroeconomics**
- **. The relationship between consumption and income is termed as Consumption Function or the propensity to consume**
- **According to the principle of consumption function, employment can increase only with an increase in investment**

Assumptions of Keynes's consumption function

1. **He considers consumption as a function of current income - He assumes that the psychological and institutional factors like income distribution, price level, population growth, fashion, tastes, habits, etc., do not change significantly in the short run**
2. **Assumes the existence of normal circumstances - extraordinary circumstances like war, revolution, hyperinflation, etc., do not exist.**
3. **Existence of a Laissez-faire economy-He assumes an atmosphere of ‘laissez-faire’ with respect to people’s choice between spending and saving.**

CONCEPT OF CONSUMPTION FUNCTION

- It shows the ‘functional relationship between two aggregates,
- total consumption
- gross national income

$$C = f(Y) \qquad \text{............ (I)}$$

- C = Consumption, Y = Income and f = functional relation

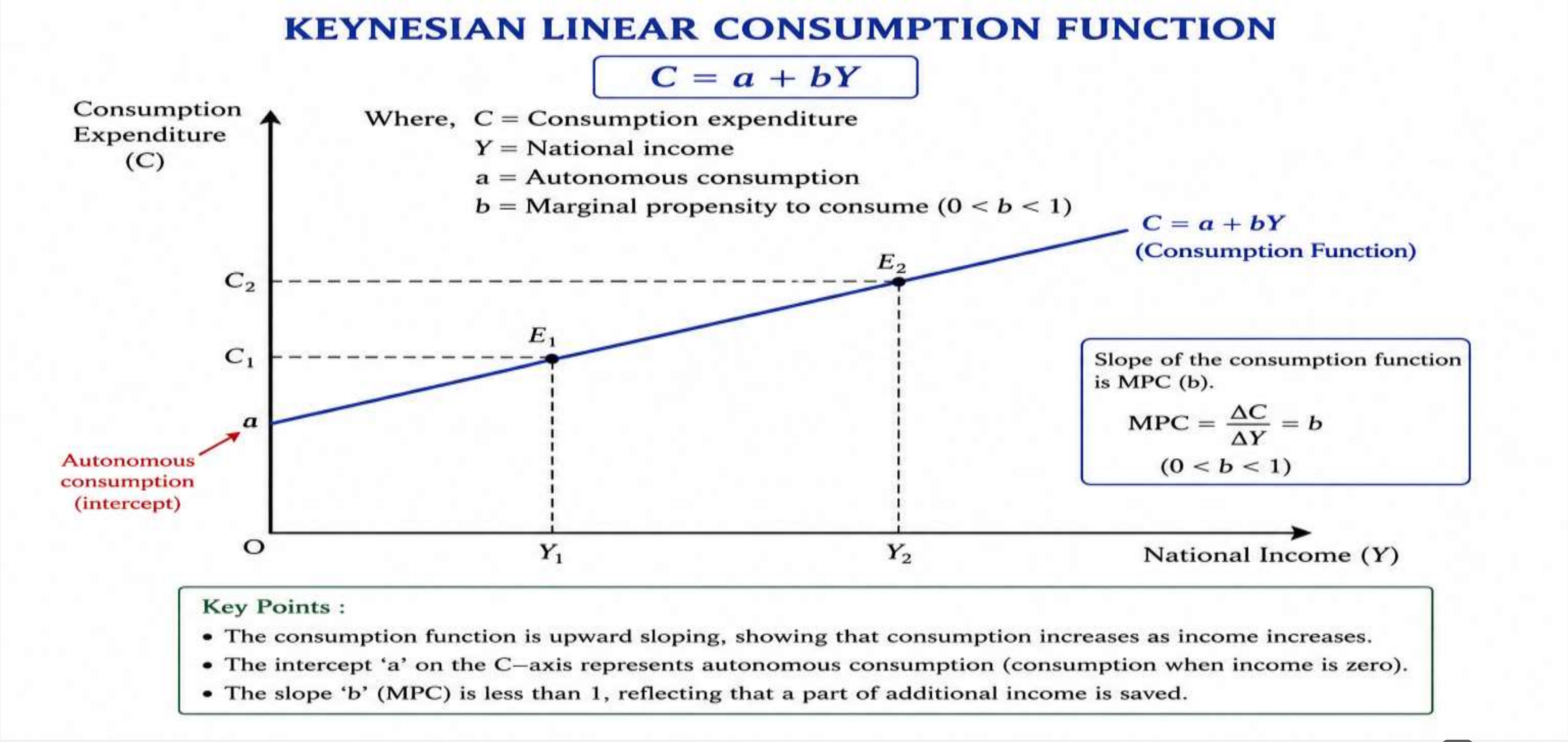
- In linear form the consumption function is expressed as

$$C = a + Cy \qquad \text{............... (II)}$$

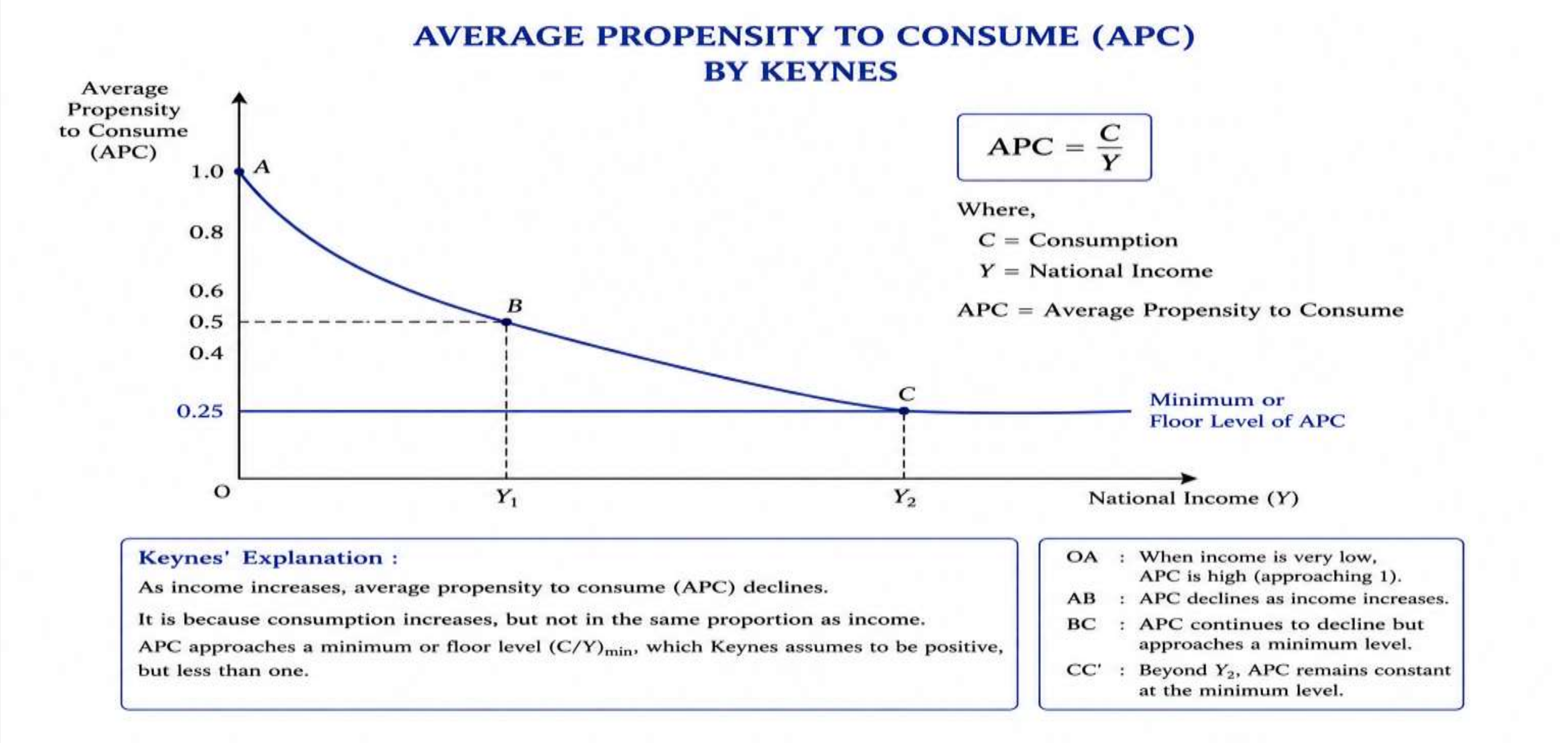
CONCEPT OF CONSUMPTION FUNCTION

- **it shows that consumption = ‘a’,**
- **‘a’ = autonomous consumption when Income = zero , plus Cy**
- **Cy = constant proportion of Income**
- **even if Income = Zero , the Consumption will not be Zero,**
- **it will be equal to ‘a’**
- **in equation (II) ‘c’ = MPC, and it is constant at all levels of Income.**
- **However, the APC falls steadily as Income rises.**

LINEAR CONSUMPTION FUNCTION



AVERAGE PROPENSITY TO CONSUME

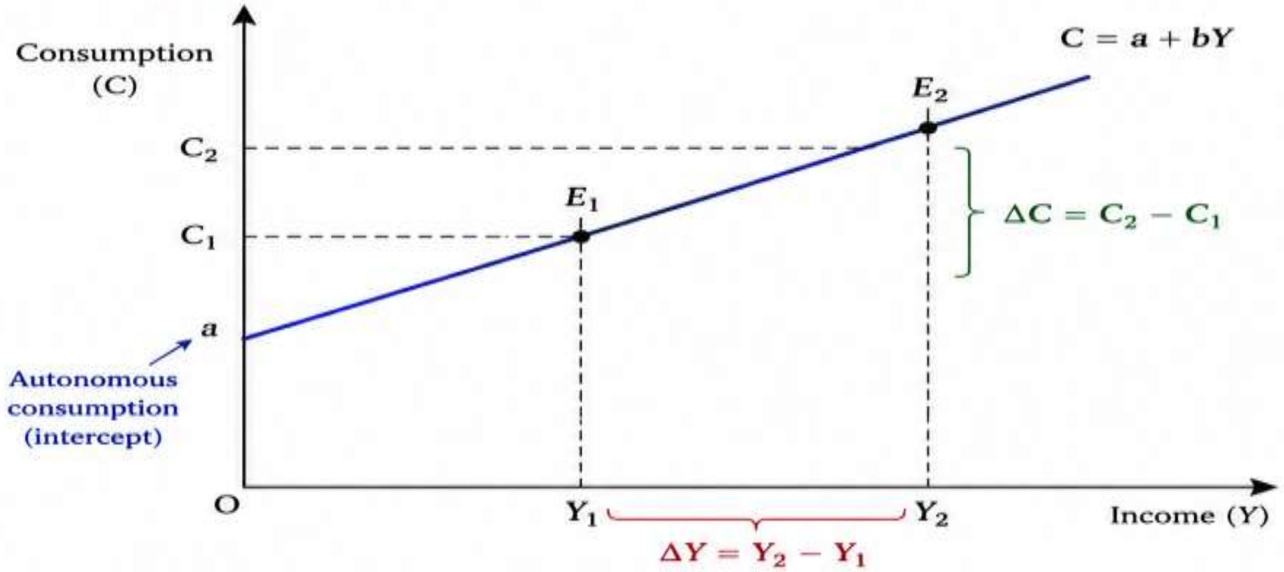


MARGINAL PROPENSITY TO CONSUME

MPC > 0 < 1 : KEYNESIAN UNDERSTANDING

Marginal Propensity to Consume is positive but less than one.

1. Consumption Function



2. Marginal Propensity to Consume (MPC)

$$MPC = \frac{\Delta C}{\Delta Y} = \frac{\text{Change in Consumption}}{\text{Change in Income}} = b$$

By Keynes,

$0 < b < 1$

or MPC > 0 < 1

This means:

- When income increases ($\Delta Y > 0$), consumption also increases ($\Delta C > 0$). $\Rightarrow$ MPC is **positive** (MPC > 0).
- But consumption increases by a smaller amount than the increase in income. $\Rightarrow$ MPC is **less than one** (MPC < 1).

3. Numerical Illustration

Income (Y)	Consumption (C)	Change in Income (ΔY)	Change in Consumption (ΔC)	MPC = $\Delta C/\Delta Y$
$Y_1 = 100$	$C_1 = 60$	–	–	–
$Y_2 = 150$	$C_2 = 90$	$\Delta Y = 50$	$\Delta C = 30$	MPC = 30/50 = 0.6

Here, MPC = 0.6 which satisfies 0 < MPC < 1 (i.e., MPC > 0 < 1).

RELATIONSHIP BETWEEN APC AND MPC

- **According to Keynes, as income increases the MPC increases and the APC falls, but the decline in MPC is greater than the decline in APC.**

- **If the consumption function is linear, the MPC is constant, APC falls as income increases.**

Factors affecting the consumption function

- **Subjective Factors-** subjective factors are endogenous to the economic system and are influenced by the human psychological behaviour . These factors determine the slope and position of the propensity to consume

1. Motive of precaution
2. Motive of foresight
3. Motive of calculation
4. Motive of improvement
5. Motive of independence
6. Motive of enterprise
7. Motive of pride
8. Motive of enterprise
9. Motive of avarice
10. motive of liquidity
11. Motive of financial prudence

Factors affecting the consumption function

- **Objective factors - they are exogenous factors influencing human behaviour**

1. **Windfall gains/loss**
2. **Fiscal policy**
3. **Changes in expectations**
4. **Rate of interest**
5. **Changes in wages**
6. **Changes in net levels of income**

Conclusion

1. **when total income of the community increase, the consumption expenditure of the community also increases**
2. **$Y = C + S$**
3. **$MPS = \Delta S/\Delta Y$**