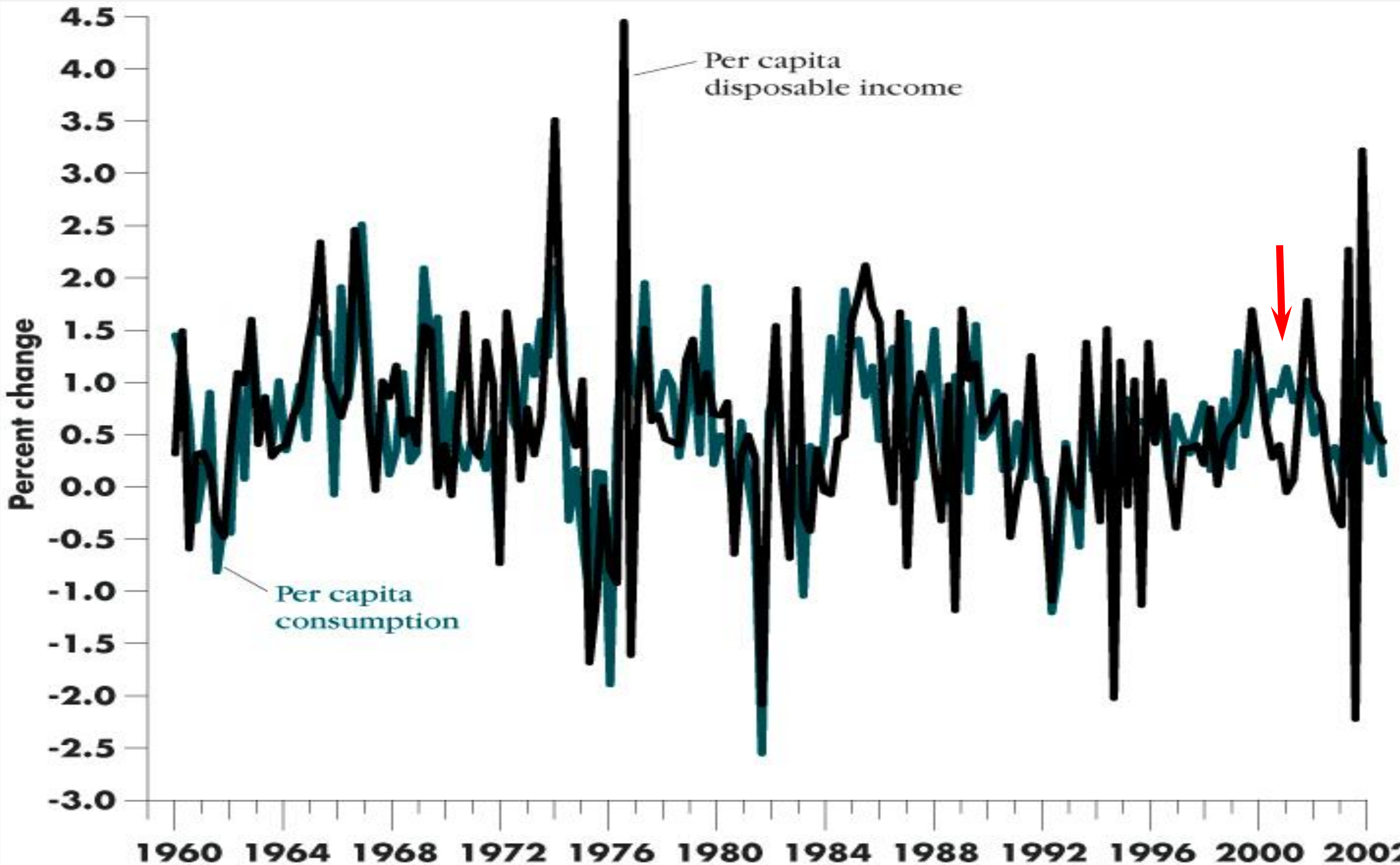
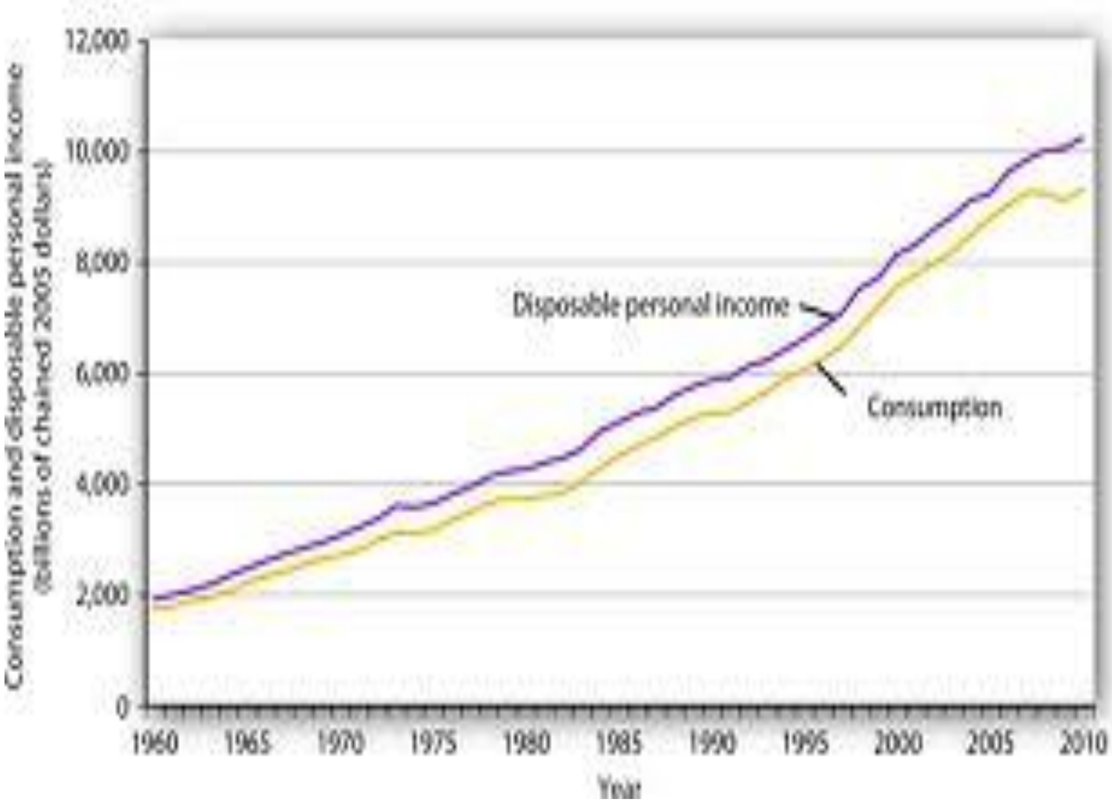
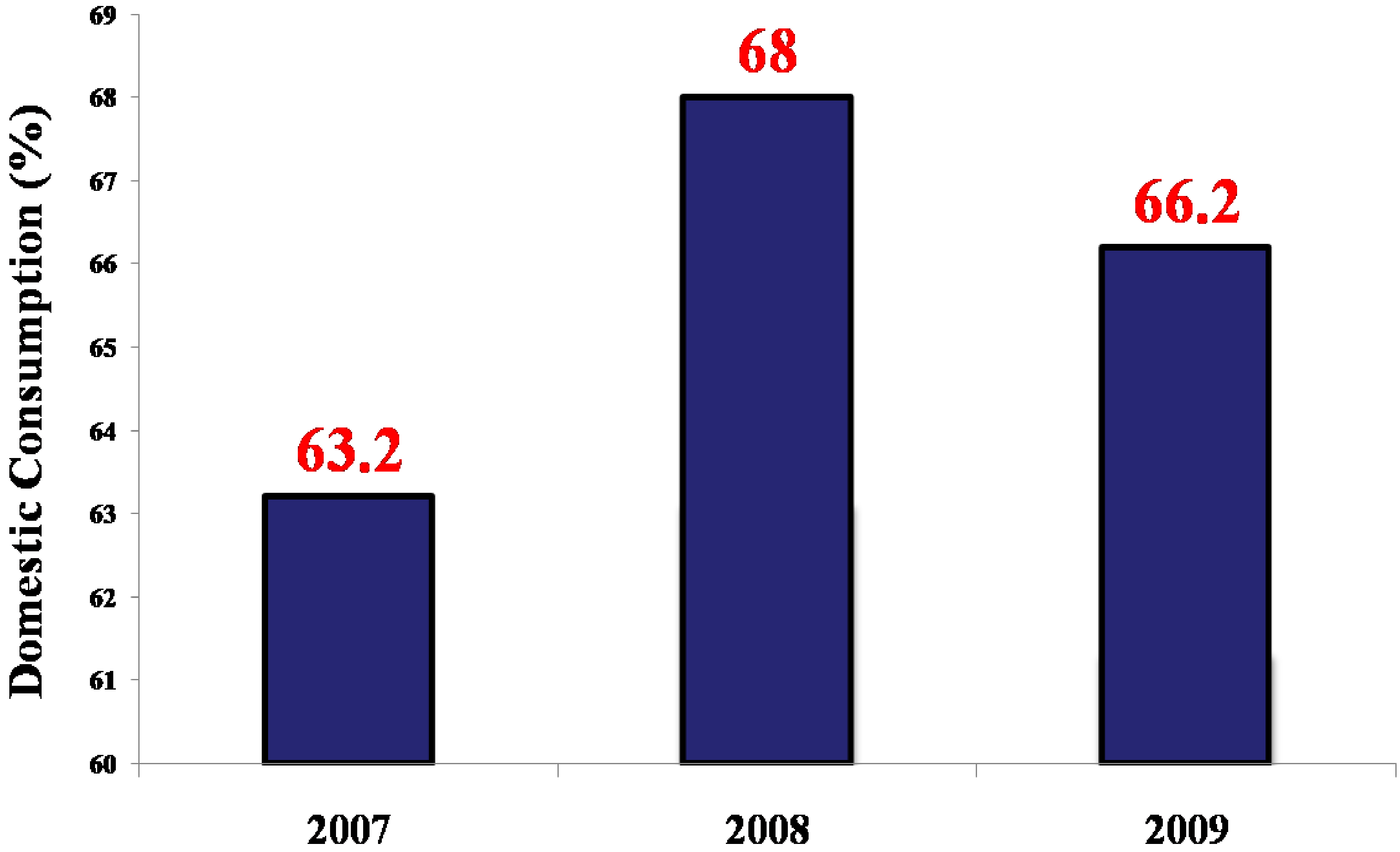
Per Capita Consumption and Disposable Income in the US (1959-2002)




Consumption and disposable personal income
(billions of chained 2005 dollars)
12,000
10,000
8,000
6,000
4,000
2,000
0
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
Year
Disposable personal income
Consumption

Gross Domestic Consumption in India



Consumption Function

(Behavioral Function)

Consumption constitutes a very high proportion of aggregate demand in the economy. And consumption demand in an economy is generally quite *stable* — fluctuations in consumption are proportionately *smaller* than the fluctuations in GDP.

MPC $\left[\dfrac{dC}{dY} \text{ or } \dfrac{\Delta C}{\Delta Y}\right]$: Increase in consumption due to per unit increase in income.

Keynesian model suggests a high value of MPC.

Keynes had put high importance on the consumption demand of an economy.

APC $\left[\dfrac{C}{Y}\right]$: Consumption per unit of income.

Absolute Income Hypothesis (AIH)

"The fundamental psychological law … is 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" — *John Maynard Keynes* **(1936, p. 96).**

The Keynesian Theory

Consumption is a *linear* function of disposable income.

$$C = a + bY_D \quad a \rangle 0 \;\text{ and }\; 0 \langle b \langle 1$$

where C is consumption, Y_D is disposable income, ***b*** is the *marginal propensity to consume*.

$$\frac{C}{Y_D} = \frac{a}{Y_D} + b \quad \Rightarrow \text{APC} - \text{MPC} \rangle 0$$

Keynes's Conjectures

- APC falls as income rises. Rich people save a higher proportion of their income than the poor.
- MPC lies between 0 and 1; i.e. $0 < MPC < 1$. There is empirical evidence that wealthier people have a lower MPC than the poor.
- Income is the primary determinant of consumption and that the interest rate does not have any important role – stark contrast to the beliefs of the classical economists. Keynes did not have interest rate in his formulation of consumption function.

Keynes's conjectures were questioned and found erroneous.

Simon Kuznets (1942) found APC to be remarkably *stable* from decade to decade, despite large increases in income over his study period (1869-1929).

AIH (The Keynesian Consumption Theory)

Keynes hypothesized that consumption demand has two components: *autonomous* and *induced* consumption.

The corollary of the Keynesian consumption function provides the saving function:

(i) MPS is (1–*b*); and

(ii) APS *increases as income increases*.

Note that, MPC + MPS = 1 and APC + APS = 1.

Rich people and rich countries have high saving rates in comparison to poor people and poor countries.