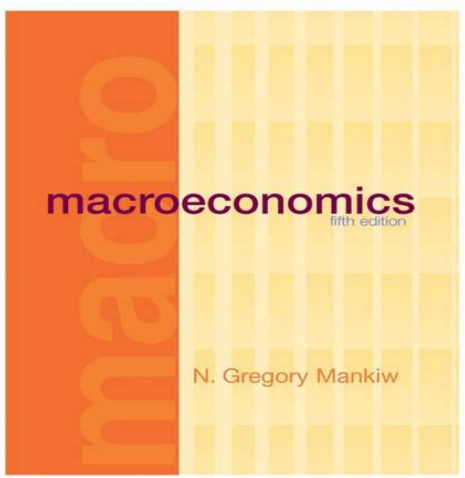
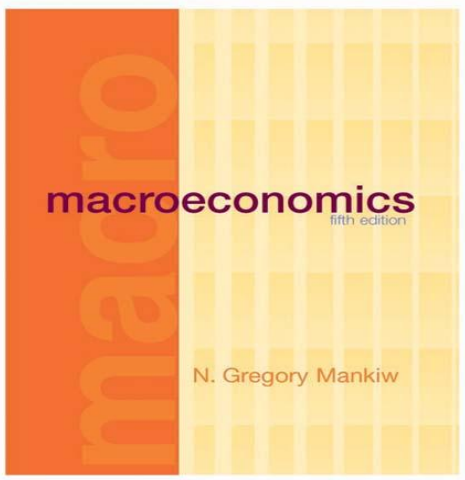
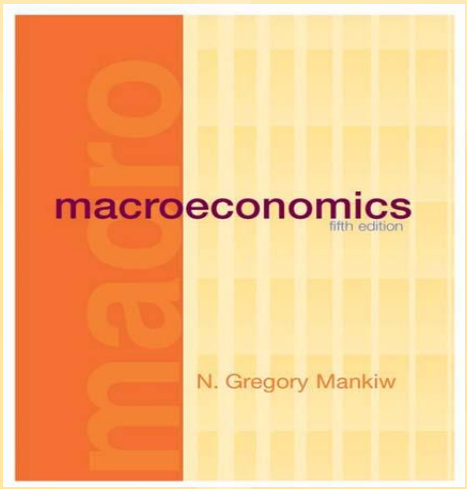
CONSUMPTION



S. Bhattacharyya

D-3/ EC101 / 2025-26





John Maynard Keynes and Consumption Function

The consumption function was central to Keynes' theory of economic fluctuations presented in *The General Theory* in 1936.

- Keynes conjectured that the ***marginal propensity to consume*** is between zero and one. He claimed that the *fundamental law* is that out of every dollar of earned income, people will consume part of it and save the rest.

- Keynes also proposed the ***average propensity to consume*** falls as income rises.

- Keynes also held that income is the primary determinant of consumption and that the interest rate does not have an important role.

The Keynesian Consumption Function

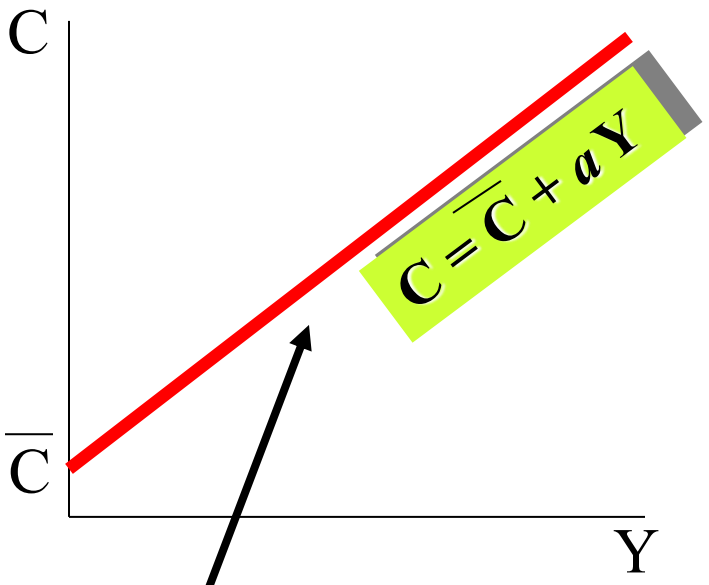
$$C = \overline{C} + aY$$

Consumption spending by households

Autonomous consumption

MPC

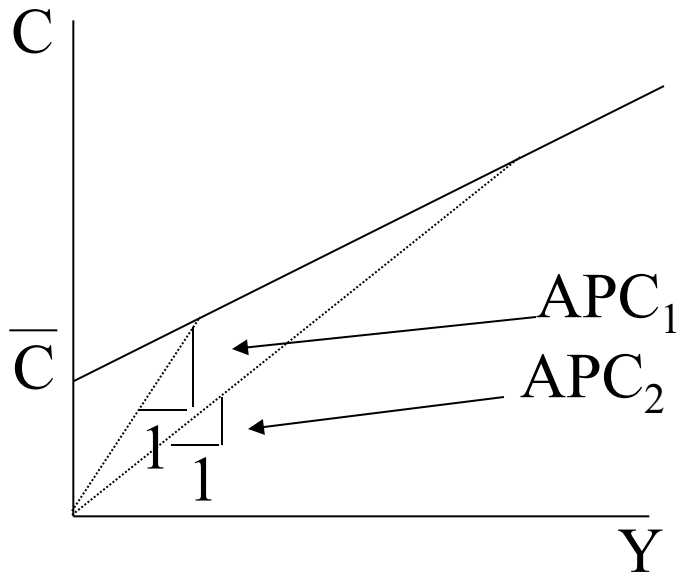
Income



Slope of the consumption function is MPC

The Average Propensity to Consume

$$APC = C/Y = \overline{C}/Y + a$$



The linear consumption function exhibits three properties that Keynes had conjectured.
First, the MPC is between zero and one.
Second, the APC falls as income rises.
Third, consumption is primarily determined by current income.

As Y rises, C/Y falls, and so the average propensity to consume C/Y falls. Notice that the interest rate is not included in this function.

The Marginal Propensity to Consume

To understand the marginal propensity to consume (MPC) consider a shopping scenario. A person who loves to shop probably has a large MPC, let's say (.99). This means that for every *extra* dollar he or she earns after tax deductions, he or she spends $.99 of it. The MPC measures the sensitivity of the change in one variable (C) with respect to a change in the other variable (Y).

Secular Stagnation, Simon Kuznets, and the Consumption Puzzle

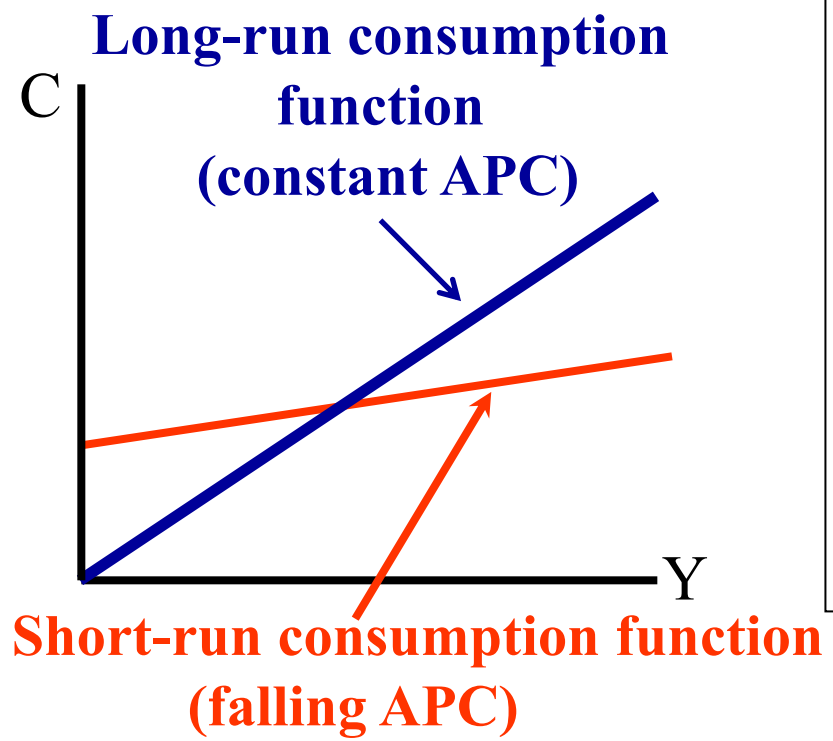
During World War II, on the basis of Keynes' consumption function, economists predicted that the economy would experience what they called *secular stagnation*-- a long depression of infinite duration-- unless fiscal policy was used to stimulate aggregate demand. It turned out that the end of the war did not throw the U.S. into another depression, but it did suggest that Keynes' conjecture that the average propensity to consume would fall as income rose appeared not to hold.

Simon Kuznets constructed new aggregate data on consumption and investment dating back to 1869 and whose work would later earn a Nobel Prize. He discovered that the ratio of consumption to income was stable over time, despite large increases in income; again, Keynes' conjecture was called into question.

This brings us to the consumption puzzle …

The Consumption Puzzle

The failure of the *secular-stagnation hypothesis* and the findings of Simon Kuznets both indicated that the average propensity to consume is fairly constant over time. This presented a puzzle: why did Keynes' conjectures hold up well in the studies of household data and in the studies of short time-series, but fail when long time series were examined?



Empirical studies of short-run household data found a relationship between consumption and income similar to the one Keynes conjectured; the ***short-run consumption function***.

But, studies using long-run time-series data found that the APC did not vary systematically with income; called the ***long-run consumption function***.