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THE CONSUMPTION FUNCTION

→ Keynesian Consumption function
→ Absolute Income Hypothesis → Current income
→ Lifecycle Hypothesis
→ Permanent income hypothesis → Permanent income
→ Relative income hypothesis →

- All hypothesis consider income as the determinant.

- One of the most important factor for an economy's growth is its consumption expenditure in goods and services.

- A/c to Keynes, MPC decreases as income increases. ∴ Prosperous ~~or~~ economies face lower MPCs & can therefore suffer from stagnation.

* Absolute Income Hypothesis
(Psychological law of consumption or Keynesian Consumption func^n).

$Y_d = C + S$

$C = a + b Y_d$

~~$C = a + b Y_d$.~~

C = Current consumption

→ ~~func^n of~~ Linear func^n of current absolute disposable income.

a = autonomous consumption.

b = marginal propensity to consume

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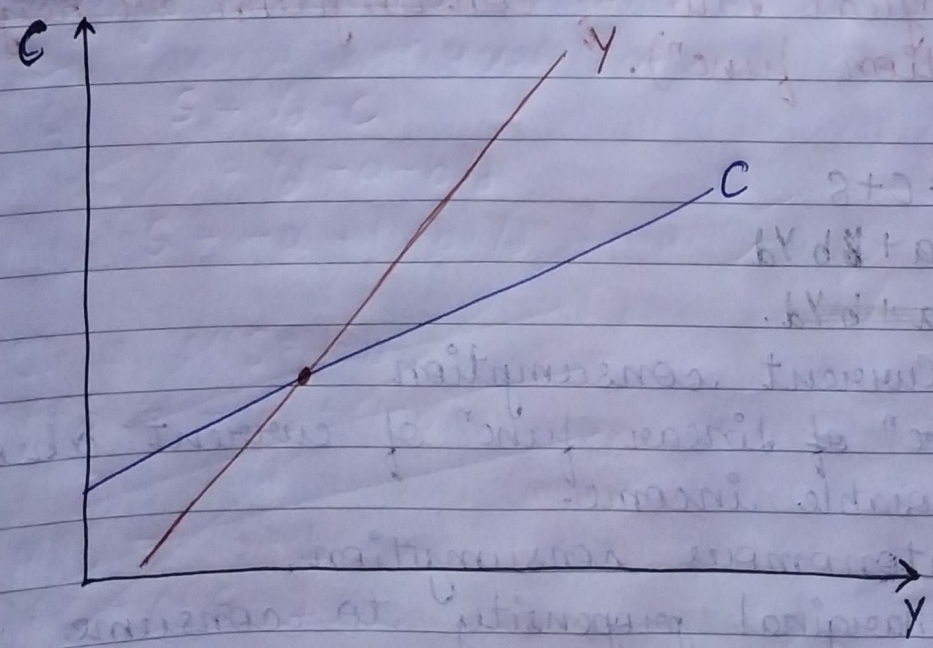
Y_d = Current disposable income

$Y_d = Y - tax + transfers$

- Absolute income refers to the income of the indivisual not relative to any other individual.

- Keynes relied on the psychological law that the satisfaction of "immediate primary needs" is a stronger motive for consumption than "accumulation".

- For example, if a millionaire and a welfare recipient each received $500, the millionaire would likely just add the money to her savings account since her primary needs are already met. The welfare recipient, on the other hand, would likely immediately spend the money on food, clothing and shelter.



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- Autonomous consumption
A change in autonomous consumption is unrelated to income and causes a shift in AE.

a → Independent of income.
When factors other than income will change, then a may change.

autonomous
Factors affecting consumption:

i) Wealth: Wealth is a stock variable, whereas income is a flow variable. Wealth is the stock possessed by an individual.

ii) Credits: Borrowing from the banks.

Dissavings involve withdrawing of the past savings or borrowing from bank.
If bank credits are available, a will increase otherwise a will cease to exist or be very less.

iii) ~~Expectations~~:

iii) Expectations: Consumption in the current period will depend upon the expectation about the future prices or future income.

iv) Age: Regardless of income, consumption can vary across age groups.

v) Price levels: When price falls, real wealth in terms of savings will increase leading to

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increased autonomous consumption.

↓PL → ↑ real wealth (savings)

~~↑PL~~ ⇔

↓PL → ↑NX

- Export will increase & import will decrease, ∴ there will be a rise in consumption of domestic goods.
- The above factors will affect the position of the consumption function.

Properties:

- Value of MPC is constant.
- $0 < MPC < 1$.
- $APC = \frac{a}{Y_d} + b. > MPC$

Savings function

$$S = Y_d - C$$
$$= Y_d - a - bY_d$$
$$S = -a + (1-b)Y_d$$

- Thus $MPS = 1-b$.
- $APS = -\frac{a}{Y_d} + (1-b)$
- $MPC + MPS = 1$
- $APC + APS = 1$.

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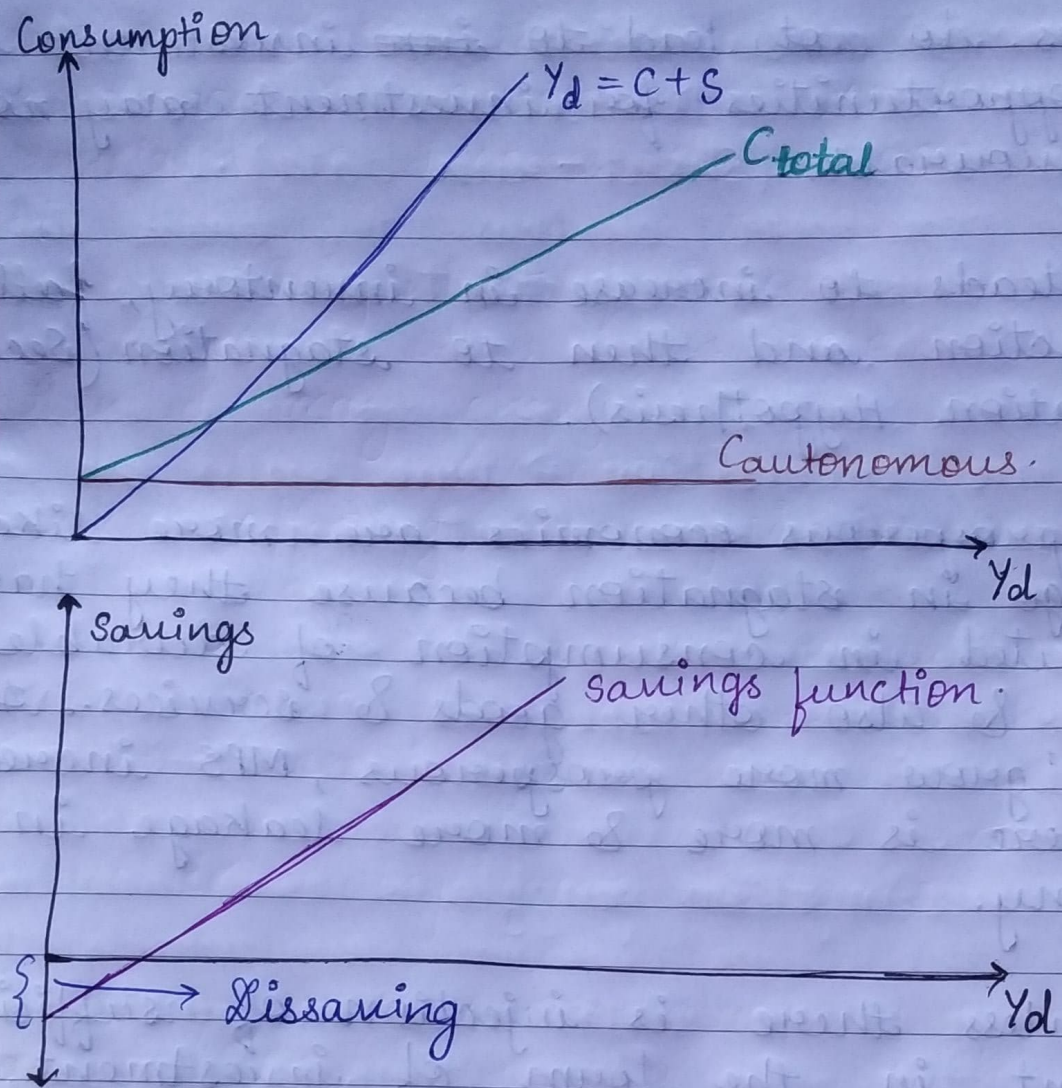

- Implications

- As an economy prospers, income goes up and so does the savings rate (APS).

- Thus prosperity leads to stagnation.

Reasons:

- As Y goes up, APC goes down and APS goes up. Thus, consumption expenditure falls leading to fall in AD.

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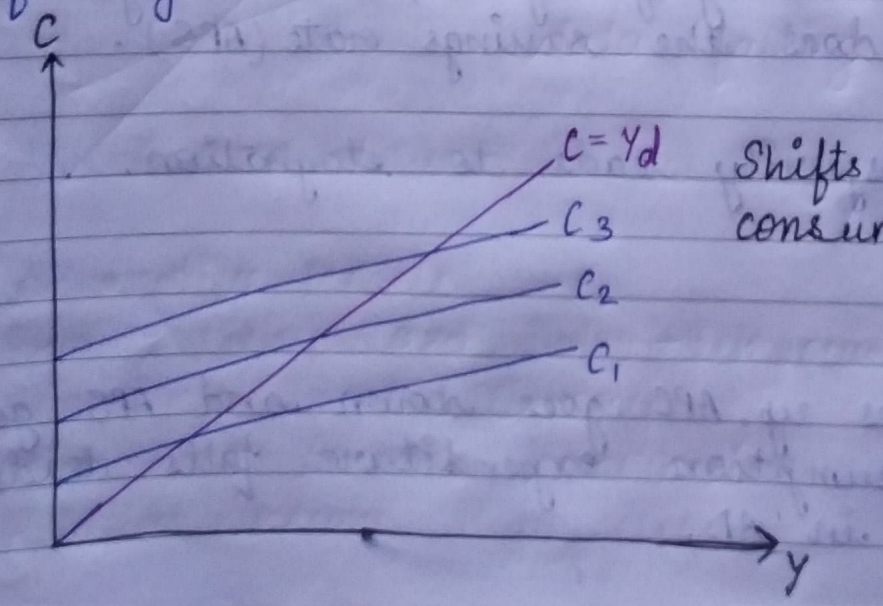
- Savings do not lead to ~~inno~~ investment as the opportunities for investment may not be favourable.
- This leads to increase in inventory, fall in production and then to stagnation (Secular Stagnation Hypothesis).
- The prosperous economies are more likely to go in stagnation because they have saturated in consumption of durable goods & also other goods & services. As they grow more prosperous, MPS increases & there is more & more leakage in the economy.
- So, unless there is injection of sufficient amount in the form of investment, the economy is bound to face recession due to deficiency in demand given supply. In such a situation, there is a need for govt. intervention.



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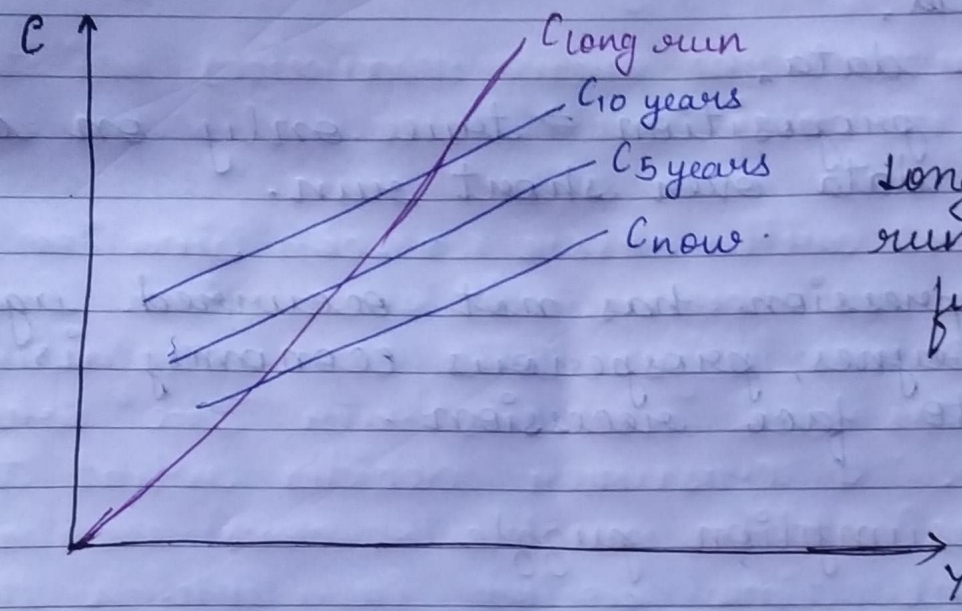
The shift factor of consumption curve may keep changing with time.

In the long-run $C = by$.
In the short-run $C = a + by$



Long run & short run consumption functions.

- Early Empirical Successes: Results from Early Studies

- Households with higher incomes:
  MPC > 0
  ∴ MPC < 1
  APC ↓ as Y ↑

- Very strong correlation between income and consumption ⇒ income seemed to be the main determinant of consumption.

- Objections

- Found valid in cross-sectional data only.:

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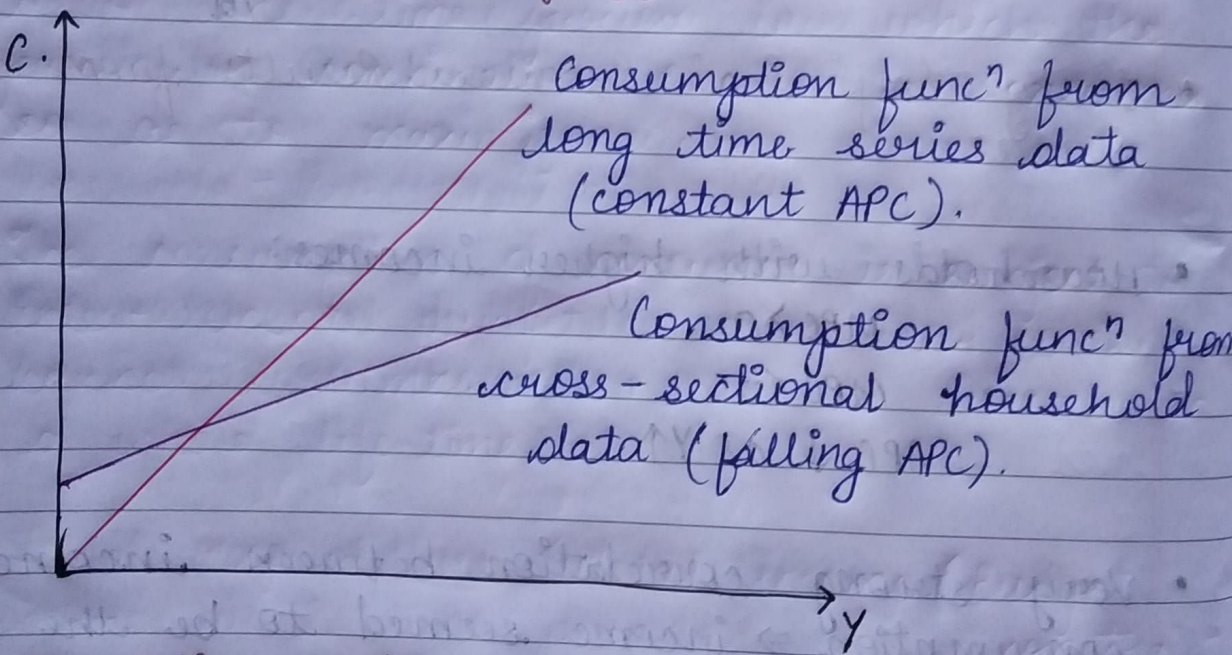
- Income & consumption data collected for a time-period for a small cross-section of population. (short-run data).
- Kuznets found a constant APS using time series data.
  Long-run data.
  Keynesian proposition ⇒ true only on cross-sectional data over short run.
- Great depression has not occurred again. A/c to Keynes, prosperous economy is bound to face recession.
- The consumption puzzle



Alternative Models

→ Irving Fisher and Inter-temporal choice
→ Life Cycle Income Theory
→ Permanent Income hypothesis
→ Relative Income Hypothesis

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* Life Cycle Income Theory: Modigliani, Ando and Brumberg.

- Consumption depends on a person's life-time income and not on the current income.

Irving Fisher and Intertemporal Choice.

- The basis for much subsequent work on consumption.
- Assumes consumer is forward-looking and chooses consumption for the present and future to maximize lifetime satisfaction.
- It is similar to maximizing utility given income. The consumer chooses a basket of goods that maximizes his/her utility.
- Consumer's choices are subject to an intertemporal budget constraint, a ~~total~~ measure of the total resources available for present and future consumption.
- A consumer chooses a basket of goods in order to maximize life-time utility not just current-utility.
- Combination of goods C_1 and C_2 (goods consumed in time periods 1 & 2) is consumed given the total income pattern

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in a lifetime in order to maximize utility or satisfaction.

- These consumer choices are ~~based on~~ subject to Inter-temporal budget constraint.
- The consumer not only maximizes utility over goods but also over time.
- ∴ Consumer will choose a combination of goods to be consumed over time in order to maximize utility or satisfaction over goods as well as over the whole life-time. ∴ A consumer decides what to consume & how much to consume and also the time period in which the particular combination should be consumed so as to maximize utility.
- The consumption of consumer is subject to inter-temporal budget constraint, A consumer cannot consume more than its income in a whole life-time.

Total expenditure ≤ Total income. (Budget constraint)

Inter-temporal utility - Utility in a time period or wrt time.

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- ∴ Inter-temporal utility has to be maximized subject to the ~~it~~ inter-temporal budget constraint. i.e. subject to the resources or income earned.

- The basic two-period Model

- Period 1: the present
  Period 2: the future

- Notation:
  Y_1 is income in period 1.
  Y_2 is income in period 2.
  C_1 is consumption in period 1.
  C_2 is consumption in period 2.

- Any consumer is forward looking & wants to maximize inter-temporal utility subject to inter-temporal budget constraint.

Deriving the intertemporal budget constraint

- In the first period:
  $S = Y_1 - C_1$
- Savings in time period-1 can be consumed in time-period 2. ∴ S can be added to the income of time-period 2.
- If $S<0$, if the consumer borrows in period 1, ∴ consumer is consuming more than what he is earning in time period 1.

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- $S > 0$, if the consumer consumes less than income in time period 1.
- Period 2 budget constraint:

$$C_2 = Y_2 + (1+r)S$$

- Here consumption equals the accumulated savings including the interest earned + income in period II.
  i.e. in period II, income of period II & income transferred from period I to II (i.e. savings increased by rate of interest can be used).

- To derive the consumer's budget constraint, combine the above two equation and solve it for C_2.

$$C_2 = Y_2 + (1+r)(Y_1 - C_1)$$

- Rearrange to put C terms on one side and Y terms on the other:

$$(1+r)C_1 + C_2 = Y_2 + (1+r)Y_1$$

- Total consumption in 2 time periods = Total income in 2 time periods.

- Finally, divide through by $(1+r)$:

Present value of total consumption = Present value of total income

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The intertemporal budget constraint

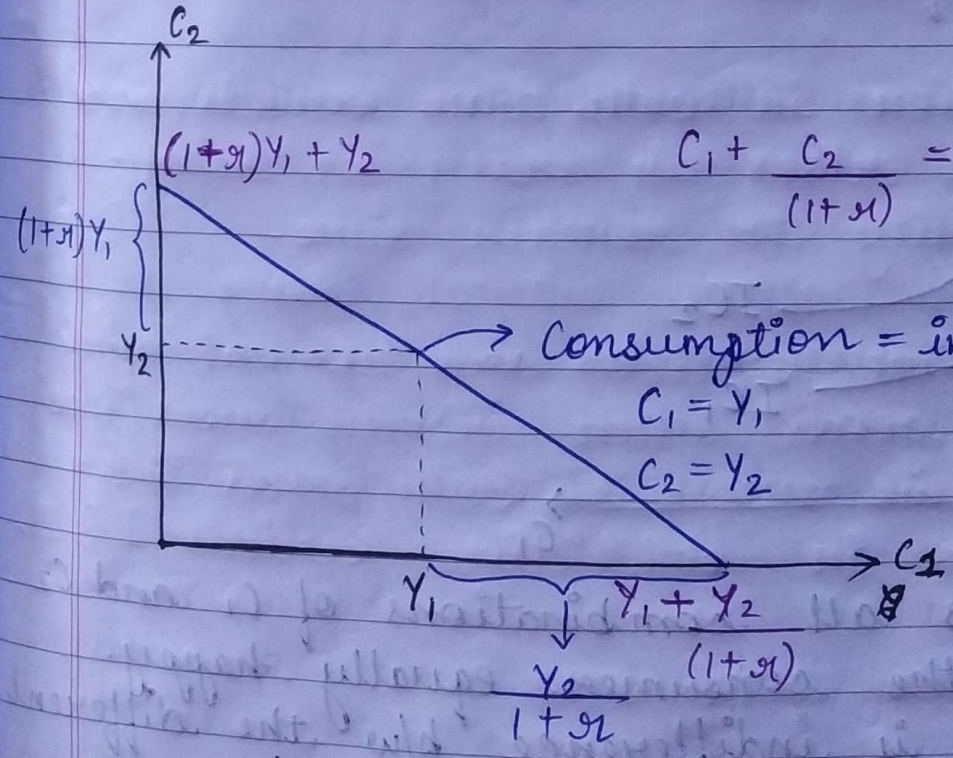
$$C_1 + \frac{C_2}{1+r} = Y_1 + \frac{Y_2}{1+r}$$

- $\frac{C_2}{1+r}$ → Present value of consumption in period-II i.e. consumption in period II discounted by the interest rate

similarly $\frac{Y_2}{1+r}$ → present value of income in period -II.

- $C_1 + \frac{C_2}{1+r}$ ⇒ present value of total consumption
- $Y_1 + \frac{Y_2}{1+r}$ ⇒ present value of total income.
- If there are n-time periods

$$C_1 + \frac{C_2}{1+r} + \frac{C_3}{(1+r)^2} + \cdots + \frac{C_n}{(1+r)^n} = Y_1 + \frac{Y_2}{(1+r)} + \frac{Y_3}{(1+r)^2} + \cdots + \frac{Y_n}{(1+r)^n}$$



$$C_1 + \frac{C_2}{(1+r)} = Y_1 + \frac{Y_2}{(1+r)}$$

Consumption = income in both time periods.

$C_1 = Y_1$

$C_2 = Y_2$

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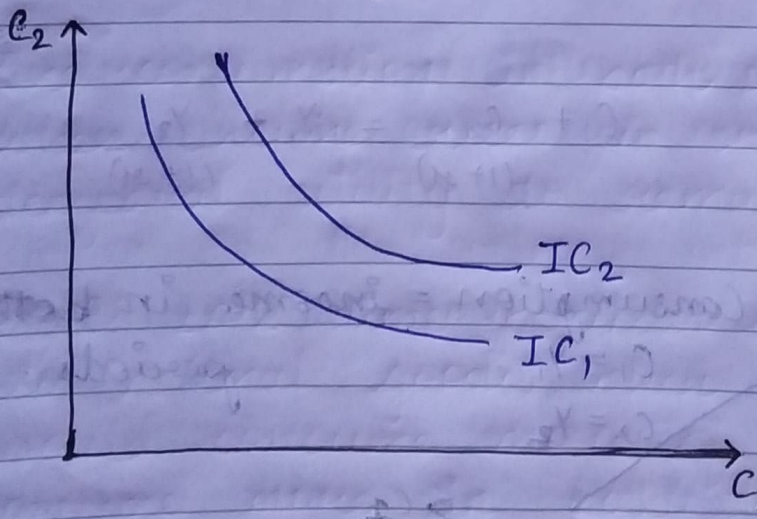
- y-intercept: $C_2 = (1+r)Y_1 + Y_2 \Rightarrow$ if the consumer consumes the whole income of 2 time-periods in period -II.
- x-intercept: $C_1 = Y_1 + \frac{Y_2}{(1+r)} \Rightarrow$ if the consumer consumes the whole income of 2 time-periods in period -I.
- The budget constraint shows all combinations of C_1 and C_2 that just exhaust the consumer's resources.
- The slope of the budget line equals: $\frac{(1+r)Y_1}{Y_1}$ or $\frac{Y_2}{\frac{Y_2}{(1+r)}}$ i.e. $(1+r)$.

Consumer Preferences



- An IC shows all combinations of C_1 and C_2 that make the consumer equally happy.
∴ A consumer is indifference b/w the different

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combinations on the IC.

- Here, instead to taking two commodities on the different axes, we take consumption in 2 time-periods. i.e. C_1 & C_2 on the two axes.

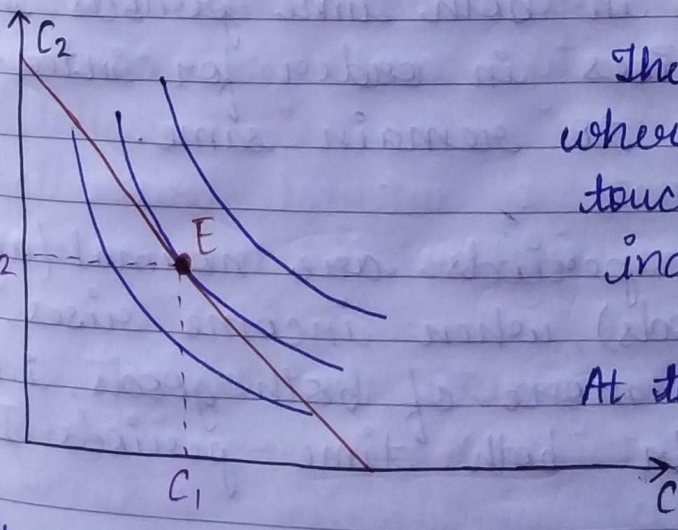
- Higher indifference curves represent higher levels of happiness or utility.

Marginal Rate of Substitution (MRS): The amount of C_2 consumer would be substituting for one unit of C_1.

- The slope of an indifference curve at any point equals the MRS at that point.

- MRS is -ve.

~~Optimal~~ Optimization



The optimal (C_1, C_2) is where the budget line just touches the highest indifference curve.

At the optimal point, MRS = 1+r.

- At the optimal point, the consumer gets the consumption of period I & II so as to

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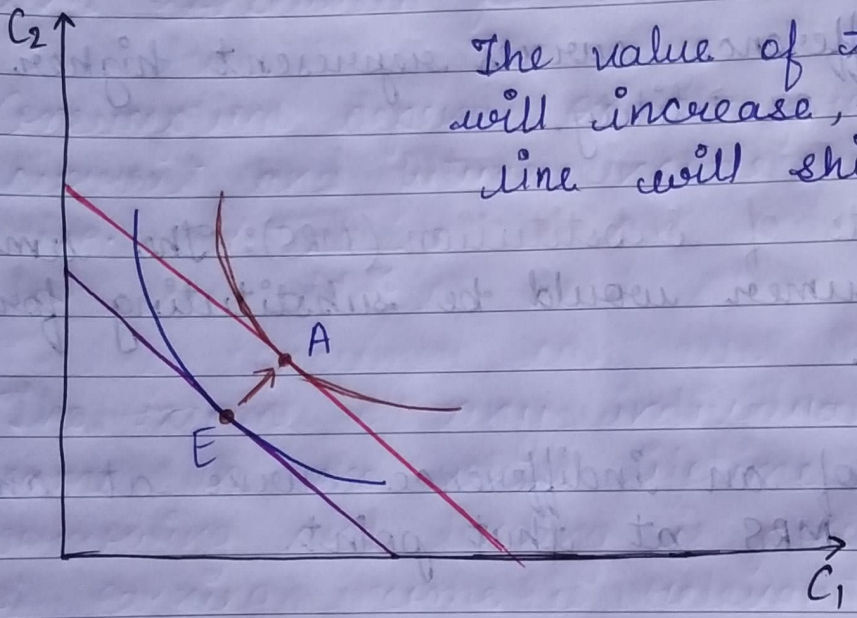
- maximize inter-temporal utility

How C responds to changes in Y.

- An increase in Y_1 or Y_2 shifts the budget line outward.



The value of the intercepts will increase, ∴ the budget line will shift outwards.

- Provided they are both normal goods, C_1 & C_2 both increase, when income rises.

- The consumption in both time periods increase when income rises in order for inter-temporal utility to remain same.

- If both time periods are normal (analogous to normal goods), when income rises, one would consume more of both goods, i.e. consume more in both time periods I & II.

~~Whereas, if one good~~

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- whereas, if time-period I superior to time period II (analogous to goods), then when income will rise, one will consume more in period I as compared to period II. which period is considered superior or inferior may vary from individual to individual.

- Some people may consume more today while some people may consume less today to save more future.

- Increase in nominal income or decrease in price will lead to increase in real income and shifting of budget line to right.

- The change in consumption in the diff time periods, will depend on the preference or superiority of the time periods over one another.

- If C_2 is superior to C_1, then new eq. is to the left of A, if C_1 is superior to C_2, new eq. will be to the right of A.

- Keynes vs Fisher.

- Keynes:
current consumption depends only on current income.

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- Fisher:
- Current consumption depends on the resource the consumer expects over his lifetime.
- The timing of income generation is irrelevant because the consumer can borrow or lend between periods.
- Consumption depends on the present value of current and future incomes.
  i.e. $Y_1 + \frac{Y_2}{1+r}$
- The income of any individual is not the same in the whole lifetime, ∴ if borrowing and lending is possible, the timing of earning income is irrelevant.

How C responds to changes in r

- Interest rate is the award for saving which is itself opportunity cost for consumption.
- Higher is the rate of interest, lower is the consumption and higher is the saving.
- An increase in r pivots the budget line around the point (Y_1, Y_2).
- Initially point of eq. was A.

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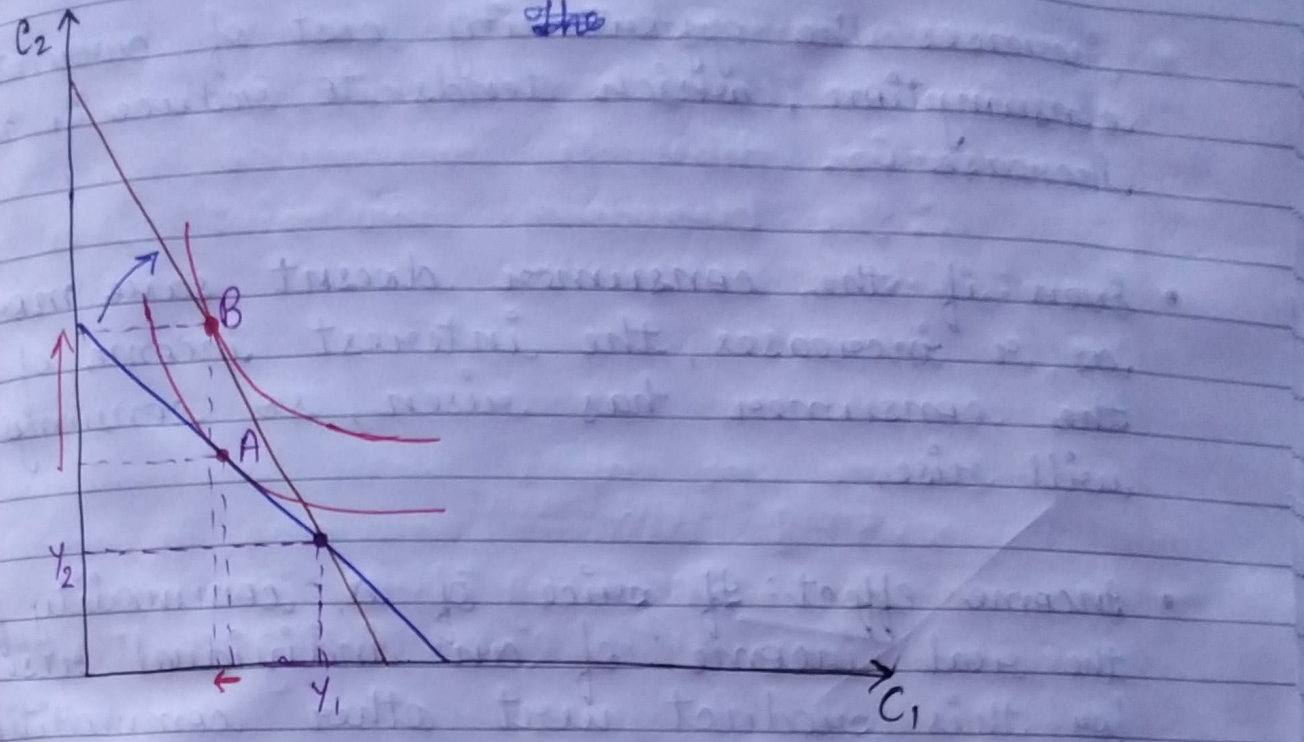

- There is a rise in r and budget constraint line changes. And the new eq. is at point B.
- Budget constraint line has become steeper.
- When price of the commodity on x axis falls, the budget line becomes flatter as more amount of x can be bought with the same level of income.
- When r increases, the reward for savings increase, the opportunity cost for consumption in period - I will rise. ∴ One would consume less in period - I & more in period - II. i.e. the consumer will save more in period - I.
- If consumer is a saver, the rise in r makes him better off, which tends to increase consumption in both periods. The rise in r

increases the opportunity cost of current consumption, which tends to reduce C_1 and increase C_2.

- Even if the consumer doesn't save more, as r increases, the interest income of the consumer has risen, so consumption will rise.

- Income effect: If price of a commodity falls, the real income of an individual rises for this product wrt other commodities. ∴ the consumer can use the increased real income to consume more of both the commodities.

- Substitution effect: If price of x falls while the price of y remaining unchanged, the consumer may substitute y for x. i.e.: consume more of x, less of y.

- Both income & substitution effects ⇒ C_2 ↑ whether C_1 rises or falls depends on the relative strength (size) of the income & substitution effect.

- Consumption in period - I will also increase, i.e., C_1 if we consider it to be a normal good. But if C_1 is an inferior then consumer may give more preference to C_2, because income effect for C_2 will be -ve which

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- implies that consumer will consume more in period II than period I. As the opportunity cost for C_1 has risen, the consumers may substitute C_2 in place of C_1.

- ∴ Substitution effect is always -ve, income effect may be -ve or +ve, ∴ relative strength of both effects will decide whether C_1 will rise or fall.

- We treat consumption in both periods as normal goods, ∴ C_1 is also likely to rise.

Constraints on Borrowing

- In Fisher's theory, the timing of income is irrelevant because the consumer can borrow and lend across periods.

- Example: If consumer learns that her future income will increase, she can spread the extra consumption over both periods by borrowing in the current period.

- However, if consumer faces borrowing constraints or "liquidity constraints", then she may not be able to increase current consumption and her consumption may behave as in the Keynesian theory (current consumption depends on current income) even though she is rational & forward-looking.

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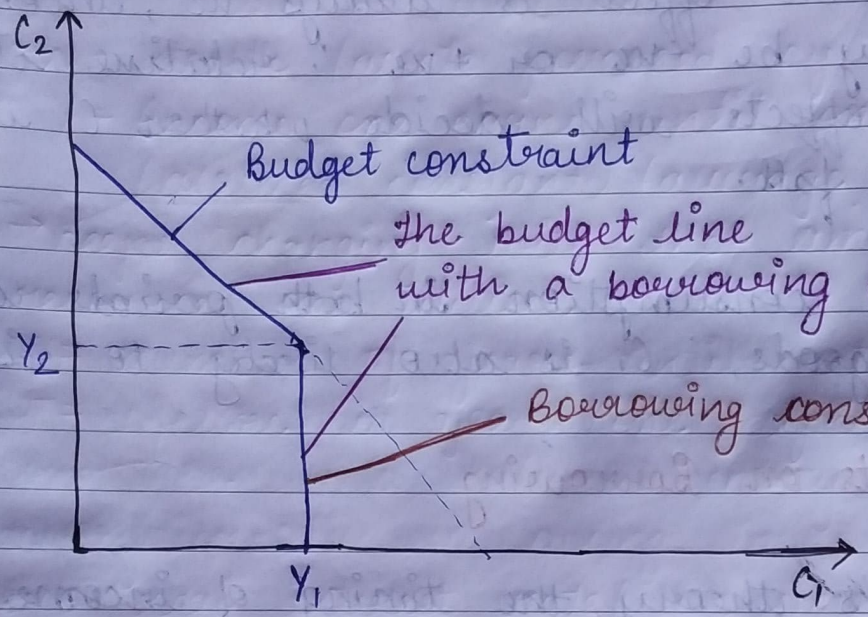
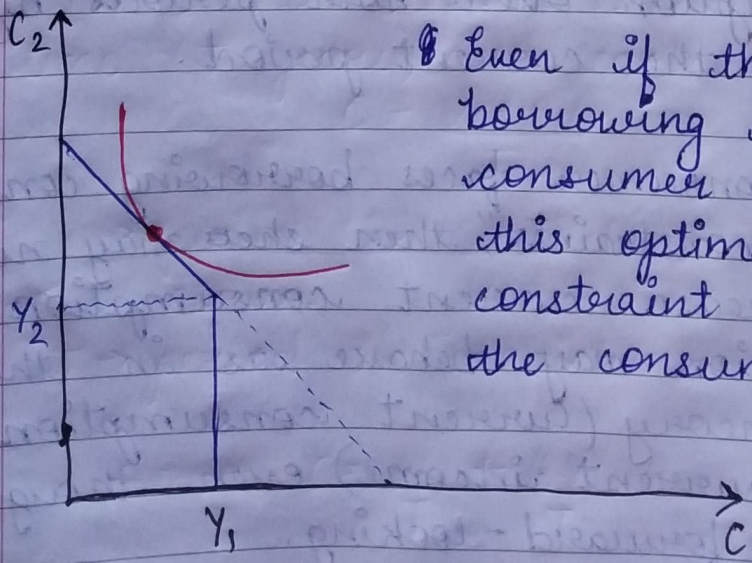
- If the consumer cannot borrow any money in time-period 1, then he/she cannot spend more than Y_1 in period 1.
  ∴ The borrowing constraint takes the form: $C_1 \leq Y_1$.



- Consumer optimization when the borrowing constraint is not binding.

- The borrowing constraint is not binding if the consumer's optimal $C_1 < Y_1$.



Even if there had not been borrowing constraint, the consumer would have got this optimal ∴ the borrowing constraint is not affecting the consumer's optimal.

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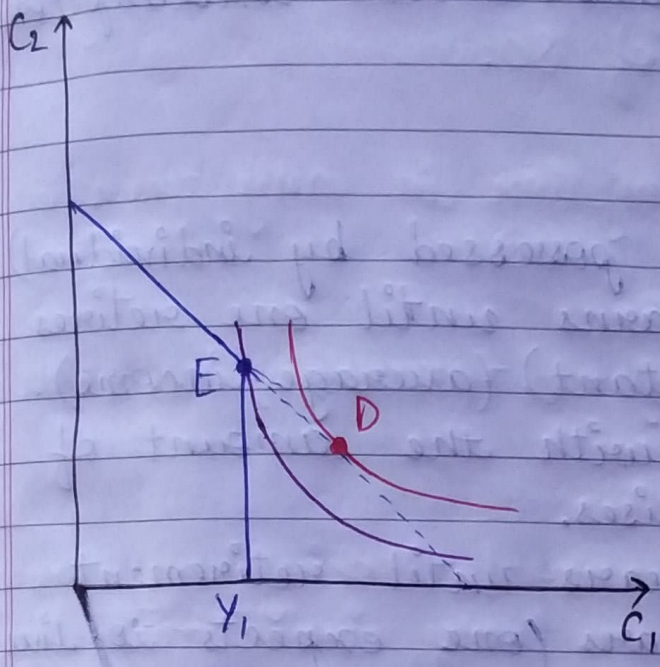
- Consumer optimization when the borrowing constraint is binding.



- The optimal choice is at point D. But since the consumer cannot borrow, the best he can do is point E. ∴ In this case, the borrowing constraint is binding.

- The Life-Cycle Hypothesis (Franco Modigliani (1950s))

- Fisher's model says that consumption depends on lifetime income, and people try to achieve smooth consumption.

- The LCH says that income varies systematically over the phases of the consumer's "life cycle".

- Saving allows the consumer move income from times when it is low to when it is high to achieve smooth consumption.

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When income is high, consumer may save & when income is low, consumer may dissave.
∴ Consumers will have smooth consumption.

- The basic Model:

W = Wealth (assets possessed by individual)
Y = Income one earns until one retires (assumed constant) (average income).
→ Keeps changing with the amount of resources one utilises.
R = number of years until retirement
T = lifetime in years (one expects to live).

Assumptions:
- zero real interest rate (for simplicity)
- consumption-smoothing is optimal.

Lifetime resources = W + (R X Y).

To achieve smooth consumption, consumer divides her resources (W+RY) equally over time (T years) and each year consumes

$$C = \frac{W+RY}{T}$$

R → period in which a consumers earns.
T → period in which a consumer lives.

$$C = \frac{W}{T} + \frac{(RY)}{T}$$

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$$C = \left(\frac{1}{T}\right)W + \left(\frac{R}{T}\right)Y.$$

$$APC = \frac{1}{T}\left(\frac{W}{Y}\right) + \frac{R}{T}\left(\frac{Y}{Y}\right) = \left(\frac{1}{T}\right)\frac{W}{Y} + \frac{R}{T}$$

$\frac{1}{T}$ → MPC wrt wealth.

$\frac{R}{T}$ → MPC wrt income.

The Y in numerator may be treated as average Y.

- Example: If the consumer expects to live for 50 years more and works for 30 years of them, then $T = 50$ and $R = 30$.
  Then her consumption function is
  $$C = 0.02W + 0.6Y$$
  The T* is taken the part of life in which the individual is capable of decision-making for themselves. If the consumer expects to live for 80 years, initial 30 years are not taken & T becomes 50.

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

where

$\alpha = \left(\frac{1}{T}\right)$ is the marginal propensity to consume out of wealth.

$\beta = \left(\frac{R}{T}\right)$ is the marginal propensity to consume out of income

$\alpha = 1/T = 0.02$ $\beta = R/T = 30/50 = 0.6$

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- A person starts working when she is 30 years old, works till 65, earns an average annual income of Rs 500000 and expects to die at the age of 80.
- By LCT, her consumption in any year b/w 30 to 80 years

$$\frac{65-30}{80-30}(500000) = 0.7(500000) = \text{Rs } 350000/\text{year}$$

- Consumers, being forward looking are expected to behave this way. Every individual consumer is a rational entity and ~~not~~ rationality lies in giving importance to each time period in which an individual likes to earn income, ~~and~~ and ~~the~~ spending it in the whole lifetime.
- If this person earns Rs 300000 annually when she is 30-40 years, Rs 450000 when she is 40 to 55 years and Rs 600000 when she is 55 to ~~60~~ 65 years, annual consumption will be

$$\frac{65-30}{80-30}\left[\frac{300000\times10 + 450000\times15 + 600000\times10}{10+15+10}\right]$$

$$= 0.7(450000) = \text{Rs } 315000 \text{ per year.}$$

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- The expectation about the future income, is always a guiding principle to how much to consume today. and also how much to consume today is based upon how much we can borrow. Borrowings & lendings are based upon the expectations of the bank.

- If the said persons wins a lottery of Rs 1000000 when she is 60, her annual consumption will increase by

$$\frac{1000000}{80-30} = \text{Rs } 20000 \text{ per year}$$

- If she gets promotion at the age of 50 and her salary increases by Rs 100000 ~~per~~ per annum, her annual consumption will rise by

$$\frac{100000 \times 15}{80-30} = \text{Rs } 30000/\text{year}.$$

- If her annual net wealth is Rs 100000, her consumption will increase by

$$\frac{100000}{80-30} = \text{Rs } 2000 \text{ per year}.$$

- Implications:

- For any given level of wealth, the model yields a conventional consumption function.

- However, the intercept is not a fixed value.

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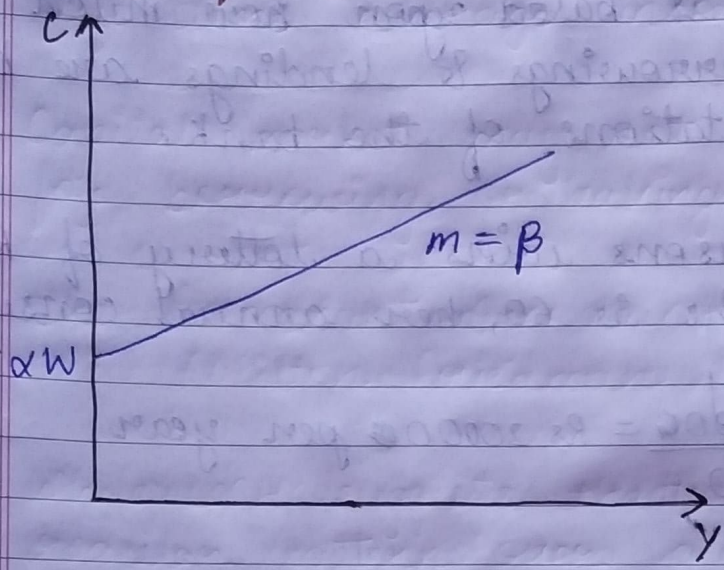
Intercept is αW and thus depends on wealth

The Life-Cycle Consumption function



- The LCH can solve the consumption puzzle:
- The APC implied by the life-cycle consumption function is

$$\frac{C}{Y} = \alpha\left(\frac{W}{Y}\right) + \beta$$

- In the short-run, across households, wealth does not vary as much as income, so high income households experience low APC. i.e APC tend to decrease with increase in income.
- In the long-run, aggregate wealth and income grow together, resulting in constant W/Y and constant APC.

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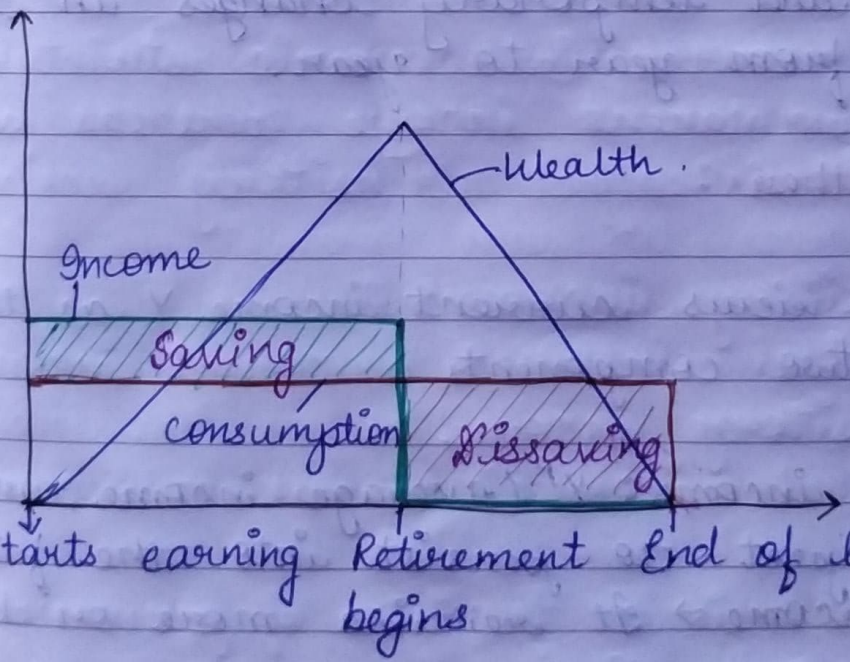
- ~~for~~ For a given wealth, LC consumption func^n behaves similar to what is ~~Keyen~~ Keynes'.
- This holds only in the short run, as wealth is constant.
- In the long run, C function shifts upward that prevents APC to fall as Y increases. As wealth increases, the intercept of the consumption curve increases & ~~the~~ it shifts upward such that APC remains constant.

The LCH implies that saving varies systematically over a person's lifetime.



Initially: Consumers consume more than what they earn.
Middle phase: consume less than what they earn.
End: Dissaving

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- Limitations
- Future incomes are unknown and thus the life time average income may be uncertain
- Capital market may not be quite conducive for borrowing or savings.

* The Permanent Income Hypothesis (Milton Friedman, 1957)

- While LCH suggests that income follows a regular pattern over a person's life time, the PIH emphasizes that people experience random and temporary changes in their income from year to year.

The Hypothesis:

- The PIH views current income Y as the sum of two components
- Permanent income: Y^P (average income, which people expect to persist into the future): Average income → It remains more or less constant over time.
- Transitory income: Y^T (temporary deviations from average income): Random Deviation from Average Income → It can be +ve or -ve & it changes with time

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$$Y = Y_p + Y_t$$

- The salary an individual gets on the basis of his/her education level is permanent income, whereas, good or bad monsoon will affect the transitory income.

- Permanent income can be derived as the weighted average of the current and past incomes, weights declining geometrically.

- Remote past incomes are given lesser weightage than the recent past incomes.

$$Y^p = \alpha Y + \alpha(1-\alpha) Y_{-1} + \alpha(1-\alpha)^2 Y_{-2} + \dots$$

↓ Current income; ↓ Income 1 year previously; ↳ 2 years back.

~~$(1-\alpha) Y^p = \alpha(1-\alpha) Y_{-1} + \alpha(1-\alpha)^2 Y_{-2} + \dots$~~

$$(1-\alpha) Y^p_{-1} = \alpha(1-\alpha) Y_{-1} + \alpha(1-\alpha)^2 Y_{-2} + \dots$$

Subtracting second equation from the first gives

$$\boxed{Y^p = \alpha Y + (1-\alpha) Y^p_{-1}} \quad 0 < \alpha < 1.$$

- This can be called adaptive expectation. We expect something to persist into the future on the basis of the past behaviour.

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- A person predicts his permanent income on the basis of the past income it has earned.
- Permanent income is derived with the help of the past observed data.
- PIH gives the method to predict the future or current income using past incomes, whereas, LCH only talks about future income expectation which is quite uncertain.
- A good education provides permanently higher income. A good monsoon provides ~~trans~~ transitorily higher income.
- Human resource & economic structure affects permanent income whereas pandemic or recessions affect transitory incomes.
- If transitory income < 0
  actual income $<$ permanent income.
  If transitory income > 0
  actual income $>$ permanent income.
- Consumption is a function of permanent income.

$$C = \alpha Y_p$$

- where α is the fraction of permanent income that people consume per year.

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- C is proportional to Y_p.
- Consumers use saving & ~~bor~~ borrowing to smooth consumption in response to transitory changes in income.

  If ~~transit~~ $Y_t > 0$, people will save i.e. saving will increase.
  If $Y_t < 0$, people will borrow

- ∴ the consumption will remain a func" of permanent income.
- Consumers spend their permanent income (salary rise ~~ann~~ annually) and save their transitory income (lottery).

Implications:

- The PIH can solve the consumption puzzle: C depends on Y_p and not on current income.

$$APC = \frac{C}{Y} = \frac{\alpha Y_p}{Y}$$

- APC depends on the ratio of permanent income to current income.

  ~~Y~~ $Y = Y_p + Y_t$.

- When current income rises temporarily above Y_p, APC temporarily falls and vice-versa.

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- To the extent that high income households have higher transitory income than low income households, the APC will be low.
- Savings ratio are high during boom and low during recessions.
- When transitory income is positive, $Y > Y_P$ and $\frac{Y_P}{Y} < 1$.
- Over the long run, income variation is due mainly if not solely to variation in permanent income, which implies a constant APC.
- Transitory income of high income group is expected to be higher than that of the lower income group. Rich people have more sources to gain transitory income compared to poor people.
- There is more possibility for the income of the rich people to rise ∴ APC will fall for rich people as income rises.
- In the long run, $Y_P \approx Y$, in the short run, $Y_P \lesssim Y$.

In the long run, transitory income will be almost zero ∴ $Y_P \approx Y$.
Transitory income is a short-run phenomena

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PIH vs LCH

- In both, people try to achieve smooth consumption in the face of changing current income.
- In the LCH, current income changes ~~cyclea~~ systematically as people move through their life cycle.
- In the PIH, current income is subject to random, transitory fluctuations.
- Both hypotheses can explain the consumption puzzle.
- ∵ APC decreases with increase in income in the short-run but in the long-run, it will remain more or less constant.
- ∵ Secular stagnation or recession are faced in the short run but not in the long run. Decrease in APC will lead to increase in APS.

☆ Relative Income Hypothesis (Dusenberry)

Definition (Relative Income):
Current income relative to the past peak income.
Own income relative to the average income in the neighbourhood/nation.

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- When the income of an individual keeps rising, the consumption of the individual also rises. Then the income reaches the peak value & then starts falling but the individual doesn't reduce its consumption a/c to fall in income as it has become a habit of the consumer to enjoy that standard of living.

- ∴ When income rises, we keep increasing the consumption but when it reaches the peak and falls, the consumer keeps maintaining that standard of living as he/she has got habituated.

- Relative income (income relative to others) is a factor ~~of~~ to determine consumption. The lifestyle or basic consumption pattern of a group having similar relative income is almost same. This is sometimes also called bandwagon effect or neighbourhood effect.