**The Keynesian Consumption Function**

As we know, the given aggregate supply in the short run, the level of employment and income is determined by aggregate demand. Aggregate private demand has two main components — (household) consumption demand and (business) investment demand. The nature of and importance of consumption demand, the determinants of such demand as also the factors causing changes in consumption demand.

In truth, demand is a key concept in both microeconomics and macroeconomics. In the former consumption demand is primarily, if not exclusively, a function of price. In the later it is mainly a function of income. The relation between income and consumption was of interest to economists for a long time. But the relation was first explained in a systematic way by J. M. Keynes in 1936. He related consumption to (disposable) income and developed the concept of consumption function on the basis of such relation.

The consumption function relates total consumption to the level of income or wealth and perhaps other variables. Consumption functions are sometimes defined for individual households, but their major role lies in determining total national consumption in a macroeconomic model. The consumption function lies at the heart of Keynesian economics. The reason is that household consumption is the most important component of aggregate demand. So deficiency of consumption demand causes unemployment and depression.

Keynes pointed out that when income increases consumption also increases. But consumption also depends on another factor, known as propensity (tendency) to consume. The key concept is the marginal propensity to consume (henceforth **MPC**). **It indicates how much consumption increases (ΔC) when income increases by a certain amount (ΔY), other things being equal.**

One characteristic of the consumption function is the MPC. It is an important determinant of the stability of the economy in the’ simple Keynesian model of income determination. In general, the smaller the MPC, the more stable is the economy with respect to changes in government spending, investment, net exports, or money.

A related concept is average propensity to consume (**APC**) which is the **ratio of total consumption to total income.** To start with we have to note the difference between the amount of consumption and the consumption function. While the amount of consumption means the level of consumption at a certain level of income, the consumption function is a much broader concept. It is the whole schedule which relates the amount of consumption to different levels of income. Table 7.1 presents a simple consumption function schedule of the Keynesian type.

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The above schedule is an illustration of the consumption function. It shows how consumption demand increases (falls) with increase (decrease) in income. We see that when income is Rs. 100 cr consumption is Rs. 80 cr. If income increases to Rs. 110 cr, consumption increases to Rs. 88 cr. As income increases further to Rs. 150 cr., consumption increases to Rs. 120 cr. Thus, we see that with a given consumption function, the level of consumption is different at different levels of income.

Since disposable income is largely spent on consumption goods and partly saved, consumption rises by less than the rise in income. Thus, when income increases from Rs. 110 to Rs. 120 crore, consumption increases from Rs. 88 cr. to Rs. 96 cr. This means that when income increases by Rs. 10 cr., consumption increases by Rs. 8 cr. and saving increases by Rs. 2 cr. We find the same result for further increase in income.

Consumption depends not only on income but also on the propensity to consume. Propensity to consume depends on such factors such as the rate of interest, the price level, the stock of wealth of the community and so on.

**Keynes assumed all these variables to remain constant in the short run. So the Keynesian consumption function is expressed as**

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where C is- aggregate real consumption and Y is real disposable income (henceforth only income) of an economy. Here C depends on Y or is a function of Y. The causation works from right to left. If income (the independent variable) increases, consumption (the dependent variable) will also increase.

**The Keynesian Theory of Consumption:**

Although the first Nobel Laureate economist Ragnar Frisch coined the term ‘macroeconomics’ in 1933, it was J. M. Keynes who truly built the foundation of modern macroeconomics in 1936. And the consumption function lies at the heart of Keynesian economics, as A. H. Hansen (the so called American Keynes) commented.

In truth, the consumption function plays a very important role in the Keynesian theory of income determination. According to Keynes the level of consumption in a society depends on a number of factors—both objective (i.e., measurable such as the interest rate, the stock of wealth of an individual and also that of society) and subjective (i.e., psychological and not measurable).

However, the most important factor affecting the consumption level of an individual as also of the whole society is the current level of income. Since the main factor influencing consumption demand in Keynes’s theory is the absolute size of current income, his theory is known as the absolute income hypothesis.

Furthermore, Keynes presented a psychological law of consumption. According to the law, as income increases, consumption also increases, though not proportionately.

**Thus MPC is less than one:**

0 < ΔC/ΔY < 1.

**Four points emerge from Keynes’s absolute income hypothesis:**

**1. Role of Absolute Income:**

Consumption depends mainly on the absolute size of current income of an individual or society. Thus, if absolute income increases, consumption expenditure will also increase. This implies that rich people will spend more on consumption goods than poor people.

**2. Non-Proportional Relation:**

In the short run consumption has an autonomous component. For this reason there is non- proportional relation between income (Y) and consumption (C).

**3. Fall in APC:**

If the consumption function is linear, APC falls as income (Y) increases. But MPC remains constant.

**4. The Role of Interest Rate:**

In the short run the rate of interest does not affect consumption demand.

**The Keynesian consumption function takes the following form:**

**C = a + bY**

where C is consumption, Y is disposable income, a is autonomous consumption (which is independent of Y) and b is MPC. So bY is induced consumption, that is, consumption which depends on income. Thus, in the short run C has two components: autonomous and induced.

In Fig. 7.3, APC falls with an increase in income. This means that the proportion income saved increases as income increases. This result is also found in household budget studies. **Poor people spend a high proportion of income on consumption.**

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But rich people save a much higher proportion of their income than poor people. This implies that as income increases, consumption increases less than proportionately and saving increases more than proportionately.

**Implications for the Theory of Income Determination:**

The assumption of declining APC has an important implication for the Keynesian theory of income determination. The Keynesian theory implies that as income continues to increase, larger and larger proportions of income is saved.

Therefore, investment has to increase sufficiently so that the additional saving is offset by an additional investment. Otherwise, the contractionary pressure exerted on income by saving leakage will exceed the expansionary pressure exerted on income by investment injection.

If adequate profitable investment opportunities for investment do not exist in the economy, aggregate demand (i.e., consumption plus investment) will fall short of the level required to produce the full employment level of output.

So, the economy will get stuck in a situation of underemployment equilibrium. Due to deficiency of demand (caused by inadequate investment expenditure) the economy will stagnate. And A.H. Hansen and others developed the theory of secular stagnation or long-term sluggishness. The economy stagnates due to declining APC.

**Short-Run Stability of Consumption Function:**

A related point may also be noted in this context. Consumption depends more on psychological factors such as the desire to save and institutional factors such as the existing pattern of distribution of income and wealth. Such factors do not change much in the short run.

Therefore, the consumption function is fairly stable, as Keynes himself believed. In this context we may also refer to a few notable features of Keynes’s consumption function since it plays a very important role in macroeconomics, mainly in the theory of income determination.

**Some Notable Features of Keynes’s Consumption Function:**

**The most important features of the Keynesian short-run consumption function are the following:**

**1. Positive Income-Consumption Relation:**

The most important determinant of consumption spending in the short run is the absolute level of current income. An increase in national income leads to an increase in consumption. In the short run the rate of interest does not influence consumption demand much, as the classicists thought.

**2. The Value of MPC:**

We know that MPC lies between zero and one (0 < MPC < 1). This follows from Keynes’s psychological law of consumption which states that as income increases by a certain amount, consumption also increases but less than proportionately.

**3. Declining APC:**

According to Keynes APC falls as income increases. The reason is that rich people have a strong propensity to save. So as national income increases, a high proportion of their income is normally saved.

**4. Stability:**

The consumption function remains fairly stable in the short run. It does not shift upward and downward to a new position. This is why Keynes’s theory of income and employment is based on the assumption of a stable consumption function.