Keynesian Consumption function

The concept of consumption function plays an important role in Keynes' theory of income and employment. According to Keynes, of all the factors it is the current level of income that determines the consumption of an individual and also of society. Keynes laid stress on the absolute size of current income as a determinant of consumption, for which his theory of consumption is also known as absolute income theory of consumption.

The Keynes' consumption function can be expressed in the following form:

$C = a + bY_d$

where

C = consumption expenditure

Y_d =The real income

a =The constant parameter which reflects autonomous consumption, i.e. the amount of consumption expenditure at zero level of income

b= The constant parameter which reflects the marginal propensity to consume (MPC) which measures the increase in consumption spending in response to per unit increase in disposable income. Mathematically: b= MPC = $\Delta C/\Delta Y$.

The Keynesian concept of consumption function stems from the fundamental psychological law of consumption which states that there is a common tendency for people to spend more on consumption when income increases, but not to the same extent as the rise in income because a part of the income is also saved. The **fundamental psychological law of consumption is based on three propositions with respect to consumption** behaviour**.**

1. When the total income increases, the consumption expenditure of the community will also increase, but less proportionately. In economic terms, this means that Marginal Propensity to Consume is less than one but greater than Zero (i.e 1> MPC>0).

2. An increment of income will be divided in some ratio between saving and consumption.

3. An increase in income will, thus, lead to an increase in both consumption and savings.

The Keynesian consumption function is depicted in below figure:

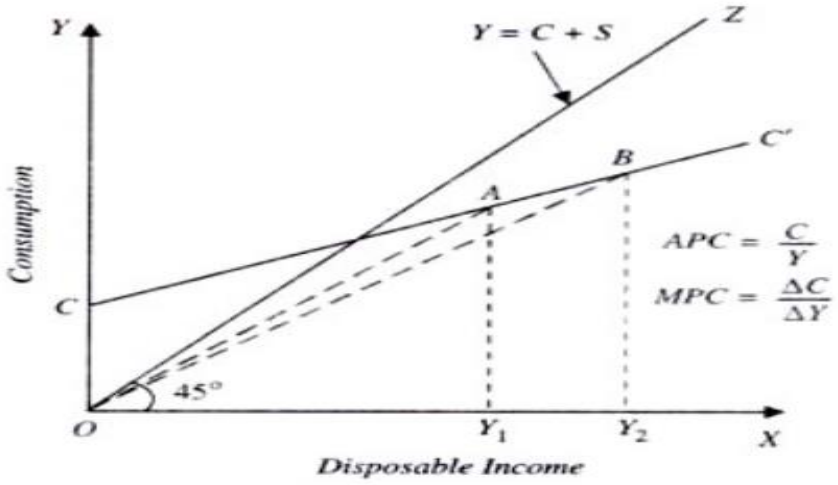

Fig. 6.3. *Consumption Function: Declining Average Propensity to Consume*

In above figure, we have shown a linear consumption function with an intercept term. In this form of linear consumption function, though marginal propensity to consume (ΔC/ΔY) is constant, average propensity to consume is declining with the increase in income as indicated by the slopes of the lines OA and OB at levels of income Y1 and Y2 respectively. The straight line OB drawn from the origin indicating average propensity to consume at higher income level Y2 has a relatively less slope than the straight line OA drawn from the origin to point A at lower income level Y1.

The decline in average propensity to consume as the income increases implies that the proportion of income that is saved increases with the increase in national income of the country. The fraction of income spent on consumption by the rich families is lower than that of the poor families. In other words, the rich families save a higher proportion of their income as compared to the poor families.

The assumption of diminishing average propensity to consume is a significant part of Keynesian theory of income and employment. This implies that as income increases, a progressively larger proportion of national income would be saved. Therefore, to achieve and maintain equilibrium at full-employment level of income, increasing proportion of national income is needed to be invested. If sufficient investment opportunities are not available, the economy would then run into trouble and in that case it would not be possible to maintain full employment because aggregate demand will fall short of full-employment output.