JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

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Faculty of Education and Methodology

Faculty Name- JV'n Dr. Md Meraj Alam

Program- BA B.Ed 3rd Semester

Course- Macroeconomics

Digital session name – Determinants of Consumption Function

Introduction:

Keynes mentions two principal factors which influence the consumption function and determine its slope and position. They are (1) the subjective factors, and (2) the objective factors. The subjective factors are endogenous or internal to the economic system. They include psychological characteristics of human nature, social practices and institutions and social arrangements. They "are unlikely to undergo a material change over a short period of time except in abnormal or revolutionary circumstances." They, therefore, determine the slope and position of the C curve which is fairly stable in the short-run. The objective factors are exogenous or external to the economic system. They may, therefore, undergo rapid changes and may cause marked shifts in the consumption function.

1. Subjective Factors:

Keynes's subjective factors basically underlie and determine the form (i.e., slope and position) of the consumption function. As already noted above, the subjective factors are the psychological characteristics of human nature, social practices and institutions, especially the behaviour patterns of business concerns with respect to wage and dividend payments and retained earnings, and social arrangements affecting the distribution of income.

(1) Individual Motives:

There are eight motives "which lead individuals to refrain from spending out of their incomes."

They are:

(i) The desire to build reserves for unforeseen contingencies;

(ii) The desire to provide for anticipated future needs, i.e., old age, sickness, etc.;

(iii) The desire to enjoy an enlarged future income by way of interest and appreciation;

(iv) The desire to enjoy a gradually increasing expenditure in order to improve the standard of living;

(v) The desire to enjoy a sense of independence and power to do things;

(vi) The desire to secure a "masse de Manoeuver" to carry out speculative or business projects;

(vii) The desire to bequeath a fortune; and

(viii) The desire to satisfy a pure miserly instinct.

(2) Business Motives:

The subjective factors are also influenced by the behaviour of business corporations and governments.

Keynes lists four motives for accumulation on their part:

(i) Enterprise, the desire to do big things and to expand;

(ii) Liquidity, the desire to meet emergencies and difficulties successfully;

(iii) Income raise, the desire to secure large income and to show successful management; and

(iv) Financial prudence, the desire to provide adequate financial resources against depreciation and obsolescence, and to discharge debt.

These factors remain constant during the short-run and keep the consumption function stable.

2. Objective Factors:

The objective factors which undergo rapid changes and cause marked shifts in the consumption function are:

1. Change in the Wage Level:

If the wage rate rises, the consumption function shifts upward. The workers having a high propensity to consume spend more out of their increased income and this tends to shift the C curve upward. If, however, the rise in the wage rate is accompanied by a more than proportionate rise in the price level, the real wage rate will fall and it will tend to shift the C curve downward. A cut in the wage rate will also reduce the consumption function of the community due to a fall in income, employment and output. This will shift the curve downward.

2. Windfall Gains or Losses:

Unexpected changes in the stock market leading to gains or losses tend to shift the consumption function upward or downward. For instance, the phenomenal windfall gains due to the stock market boom in the American economy after 1925 led to a rise in the consumption spending of the stock holders by roughly in proportion to the increased income and as a result the consumption function shifted upward. Similarly, unexpected losses in the stock market lead to the downward shifting of the C curve.

3. Changes in the Fiscal Policy:

Changes in fiscal policy in the form of taxation and public expenditure affect the consumption function. Heavy commodity taxation adversely affects the consumption function by reducing the disposable income of the people.

This is what actually happened during the Second World War when the consumption function shifted downward due to heavy indirect taxation, rationing and price controls. On the other hand, the policy of progressive taxation along with that of public expenditure on welfare programmes tends to shift the consumption function upward by altering the distribution of income.

4. Changes in Expectations:

Changes in future expectations also affect the propensity to consume. If a war is expected in the near future, people start hoarding durable and semi-durable commodities in anticipation of future scarcity and rising prices. As a result, people buy much in excess of their current needs and the consumption function shifts upward.

On the contrary, if it is expected that prices are likely to fall in the future, people would buy only those things which are very essential. It will lead to a fall in consumption demand and to a downward shift of the consumption function.

5. Changes in the Rate of Interest:

Substantial changes in the market rate of interest may influence the consumption function indirectly. There are several ways in which the rate of interest may affect the consumption function. A rise in rate to interest will lead to a fall in the price of bonds, thereby discouraging the propensity to consume to the bond holders.

It may also have the effect of substituting one type of assets for another. People may be encouraged to save rather than invest in bonds. In case they are buying durable consumer goods like refrigerators, scooters, etc. on hire-purchase system they will tend to postpone their purchases when the rate of interest rises. They will have to pay more in installments and thus their consumption function will shift downward. Keynes wrote, “Over a long period, substantial changes in the rate of interest probably tend to modify social habits considerably.

Besides, these five factors, Keynes also listed changes in accounting practice with respect to depreciation. This factor has been rejected by Hansen who opines that “it is not a factor which can be thought to change violently in the short-run and it was a mistake for Keynes to include it here. However, we add some of the other objective factors listed by Keynes’s followers.