Psychological Law of Consumption : An Introduction

To study the relationship between income and consumptions, Prof. Keynes developed on law called as Keynes's Fundamental law of consumption. According to the law, consumption depends upon income and the relationship between income and consumption is determined by human psychology. That is why Prof. K. K. Kurihara has called this law as 'psychological law of consumption'. This law makes the basis not of Keynesian Economics only but also of Post Keynesian Economics. Infact, it has become a major tool of macro economic analysis. Many economists like Prof. Hanson, Prof. Harris and Prof. G. Ackley have appreciated Prof Keynes because of this law. Let us study this law in detail.

Law : Its Statement

In the words of Keynes, "The psychology of the community is such that when aggregate real income is increased; aggregate consumptions is also increased, but not by so much as income".

Stating this law, Prof Keynes further remarks

"The fundamental psychological law upon which we are entitled to depend upon with great confidence both a priori from our knowledge of human nature and the detailed facts of experience, is that men are disposed as a rule and on the average to increase their consumptions as their income increases but not by as much as the increase in income."

Law : Its Three Propositions

Keynes' psychological law, related to consumption, has three propositions:

(a) When aggregate income aggregate consumption also moves up, but by somewhat smaller amount.

This means that when income increases the necessities related to consumption also increase. But when the level of income reaches very high then at that level most of consumption needs are already satisfied. So at that level, with an increase in income, the consumption does not increase in the same proportion. In other words,

$$\Delta C < \Delta Y \text{ or } \frac{\Delta C}{\Delta Y} < 1$$

i.e., Marginal propensity to consume will be always positive. With an increase in income consumption must increase. But at a high income level MPC will be less and at a low income level MPC will be more.

(b) An increment of income is divided in certain ratio between consumption and saving.

This proposition has actually been taken from the first proposition. When the increase in consumption expenditure is less the increase then it is very much clear that some portion of income has taken the shape of savings. In other words

When $Y = C + S$

Then $\Delta Y = \Delta C + \Delta S$

The change in income will be equal to the change in consumption and savings. Because

$$\frac{\Delta C}{\Delta Y} < 1 \text{ and } \frac{\Delta C}{\Delta Y} + \frac{\Delta S}{\Delta Y} = 1 \text{ i.e., MPC + MPS = 1}$$

When M. P. C. is less than one then the remaining part of income will certainly be equal to savings and when the income increase, it automatically gets divided between ΔC and ΔS.

(c) An increase in income is unlikely to lead either to less consumption or less saving.

This last proposition tells about the short-run constancy of consumptions function. According to this proposition this is not logical that with an increase in income there comes a fall in consumption or saving than before.

Law : Its Explanation by Table

These propositions can be explained with the help of the following schedule and diagram:

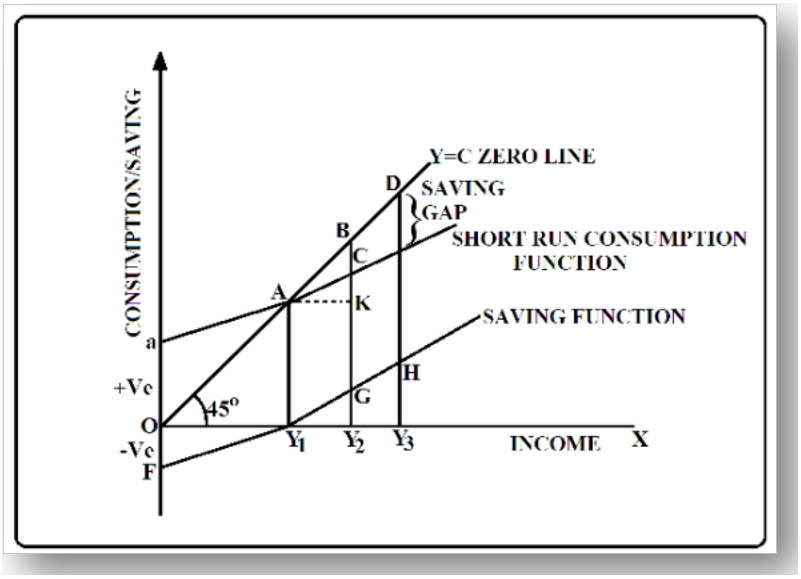
Income (Rs) Y	Consumption (Rs) C	Saving (Rs) S
0	100	-100
100	150	-50
200	200	-0
300	250	50
400	300	100
500	350	150
600	400	200
700	450	250

From the table, it is quite clear that:

1. As income, consumption also increases but the increase in consumption is less than the increase in income.
2. The increase in income is divided between consumption and saving. When income increases from rupees 300 i.e., then there is an increase in income of rupees 100 then the increase in consumption is only of rupees 50. At the same time the increase in saving is rupees 50.
3. With an increase in income both consumption and savings increase. As we have assumed the marginal propensity to consume to be constant at 0.5 in the short-run, so every time, with a unit increase in income, consumption increases by 0.5 and savings also increase by 0.5.

Law : Its Diagrammatic Presentation

The above given propositions can be explained with the help of a diagram also:



In the above diagram, consumption function, saving function and 45° line are shown. Consumption function is of short-run nature. Saving function is determined from consumption by the method described already.

45° line passes through X-axis and Y-axis. In other words, all the points on this line are equidistant from both X-axis and Y-axis. As we measure income along X-axis and consumption along Y-axis so at all the points of 45° line income is equal to consumption, i.e., on this savings are zero. That is why this line is also called as zero saving line.

Let us explain three propositions from this graph.

I.When income increases from OY_1 to OY_2 consumptions increases from AY_1 to CY_2

Increase in Consumption = Y_1Y_2 = AK = BK

From the diagram, it is clear that BK > CK

In other words, with an increase in incomes but the increase in consumption is less than the increase in income.

II. The increase in income is divided between consumptions and savings. When income increase from $OY_1$to OY_2, consumption increases from AY_1 to CY_2 and brings increases from 0 to GY_2

Increase in income = Y_1Y_2 = AK = BK

Increase in consumption = CY_2 - AY_1 = CK

Increase in savings = GY_2 = BC

From the diagram it is clear that BK = CK + BC

Increase in income = Increase in consumption + Increases in savings.

Means $\Delta Y = \Delta C + \Delta S$

III. With an increase in come, both consumption and saving increase. It is very much clear from fig. When income increases from OY_2 to OY_3 then consumption increases from CY_2 to EY_3. At that time savings increase from GY_2 to HY_3. From the diagram it is clear that with an increase income, then levels of consumption and savings increase than before.

In other words,

$$EY_3 > CY_2$$

$$HY_3 > GY_2$$

$$DE > BC$$

The third proposition tells that with a continuous increases in income the gap between income and consumption goes on increasing i.e., savings go on increasing. The distance between 45° line and consumption function is called saving Gap. This gap goes on increasing with an increasing with an increase income.