Keynes's Theory of Consumption:
Keynes in his "General theory", published in 1936, laid the foundations of modern macroeconomics. 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, his theory of consumption is also known as absolute income theory of consumption.

Keynes put forward a psychological law of consumption, according to which, as income increases consumption increases but not by as much as the increase in income. In other words, marginal propensity to consume is less than one.
1> MPC>0

While Keynes believed that there are many other factors including interest rate and wealth that influenced the level consumption expenditure, he emphasized that it is the current level of income on which the consumption spending of an individual and the society depends.

About consumption behaviour, Keynes makes three points.

First, he suggests that consumption expenditure depends mainly on absolute income of the current period, that is, consumption is a positive function of the absolute level of current income. The more income in a period one has, the more is likely to be his consumption expenditure in that period. In other words, in any period the rich people tend to consume more than the poor people do.

Secondly, Keynes points out that consumption expenditure does not have a proportional relationship with income. According to him, as the income increases, consumption increases but not in the same proportion. The proportion of consumption to income is called average propensity to consume (APC). **Thus, Keynes argues that average propensity to consume (APC) falls as income increases.**

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

$C = a + bY_d$

where C is consumption expenditure and Y_d is the real disposable income which equals gross national income minus taxes, a and b are constants, where **a is the intercept term, that is, the amount of**

consumption expenditure at zero level of income. Thus, a is autonomous consumption. **The parameter b is the marginal propensity to consume** (MPC) which measures the increase in consumption spending in response to per unit increase in disposable income. Thus
MPC = $\Delta C / \Delta Y$

Since the average propensity to consume falls as income increases, the marginal propensity to consume (MPC) is less than the average propensity to consume (APC). The Keynesian consumption function is depicted in Figs. 6.3.

In Fig. 6.3 we have shown a linear consumption function with an intercept term. In this form of linear consumption function, though marginal propensity to consume ($\Delta C / \Delta Y$) 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 Y_1 and Y_2 respectively. The straight line OB drawn from the origin indicating average propensity to consume at higher income level Y_2 has a relatively less slope than the straight line OA drawn from the origin to point A at lower income level Y_1.

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. This result also follows from the studies of family budgets of various families at different income levels. 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. On the basis of this increasing proportion of saving with the increase in income and consequently, the emergence of the problem of demand deficiency, some Keynesian

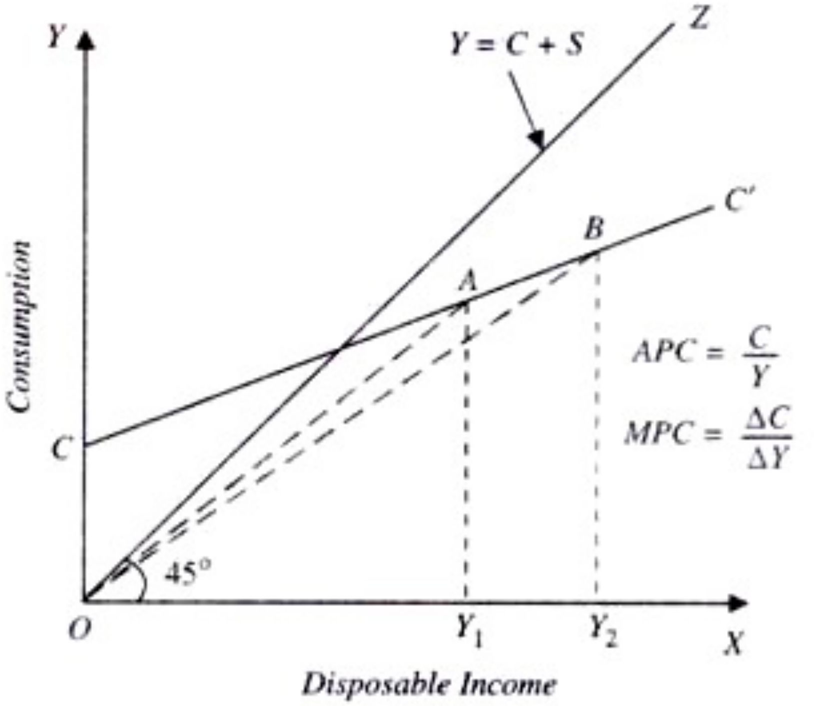

Fig. 6.3. *Consumption Function: Declining Average Propensity to Consume*

economists based the theory of secular stagnation on the declining propensity to consume.