



A study of Keynes' Psychological law of consumption – implications of the law

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Abstract

The body of scientific knowledge can be reduced to a “set of laws that are both general and robust enough to be useful in describing and predicting behavior. These laws can be applied to describe and predict the actions of a wide range of entities, including physical objects (such as the orbits of the planets), invisible forces (such as electricity), economies (why some thrive while others stagnate), and even individuals (education as deliberate investment in human capital). Engel's law, the rule of demand (the downwardly sloping demand curve), the law of scattered quantities relative to prices, and the law for price elasticities are the four empirical regularities in consumer behavior that are identified in this work.

Keywords: Autonomous Consumption, Consumption, Consumption Function, Income, Saving, Short-run

Introduction

Humans engage in consumption when they exhaust the usefulness of commodities and services in meeting their needs and desires. The consumption function, on the other hand, illustrates the connection between a country's GDP” and consumer spending. Income and want to spend are the two most important determinants of consumption. A country's propensity to consume refers to its propensity to spend its revenue. The price level, interest rate, and readiness to save that influence consumers' inclination to buy don't change in the near term. Therefore, in the near future, spending is directly proportional to income. Once again, Keynes (1936) contends that the level of national income is the primary determinant of the level of national consumption. As a result, changes in disposable income have a direct impact on household spending. This means that, in the short-term, consumer spending is directly proportional to household income. For this reason, $C = f(Y)$ Since Keynes worried about the impact of spending on the economy in the near term. $C = a + bY$ is the form of the consumption function used by Keynesians. Interception term (independent consumption), slope of consumption function (marginal willingness to spend), and discretionary income (Y) equal consumption (C). Two categories of short-term consumption have been identified. The first kind of consumption is known as



autonomous consumption (a), and it exists even if there is no income (Y). Another is that a person's bY, or induced consumption, is proportional to their Y income. A theoretical and practical understanding of the consumption function is essential for developing macroeconomic policy (investment, saving, unemployment, policies to control the economic fluctuation). So, Prof. A. H. Hansen has said that Keynes's consumption function is a game-changing development in economic theory. Say's Law of the Market is defined as "supply produces its own demand" in the book *General Theory of Employment, Interest, and Money* (Keynes 1936). Therefore, economic overproduction and joblessness are impossible. The Keynesian consumption function, on the other hand, predicts that rising income leads to a smaller rise in consumption. As a result, savings is the amount set aside that is not used immediately. Because of this void, there is a possibility that not all manufactured goods are sold and that demand is low. As a matter of fact, the money generated by any given supply or production is always precisely proportional to the output generated. However, not all income is spent, and there is no assurance that savings will equal investment. When income is sufficient to support full employment, but investment falls short of closing the savings gap, effective demand falls short. Overproduction and high unemployment are the inevitable results of a capitalist economic system. So, the analysis of the consumption function disproves say's law. The idea of propensity to spend is crucial in determining the specific amount of income and employment. Investment spending is necessary to make up for the difference between income and consumption if a certain level of income and employment are to be maintained; without it, the effective demand would be insufficient. Since the consumption function in the short term is constant, the capitalist economy's ebbs and flows are caused by the ebbs and flows of investment demand. Keynes's investment or income multiplier is derived from the notion of propensity to spend, and the multiplier theory has enormous relevance in formulating macroeconomic policy. This multiplier's true strength is proportional to the inverse of the marginal propensity to spend, or (MPC). Therefore, $K = \frac{1}{1 - MPC} * K$, where MPC and MPS are the marginal propensities to spend and save, respectively. According to this idea of multiplier, a rise in investment results in a rise in income, production, and employment of a number of times that number. On the other hand, Stonier and Hague (1972) claim that when MPC equals one, i.e. when all of the income increase is spent, no savings occur. The multiplier's size will be infinite in this situation. Over the near term, the marginal efficiency of capital (MEC) has a significant impact on the investment level. However, MEC is just the anticipated



rate of return on investment that will be based on the anticipated level of future consumption. It has been shown that there is no correlation between changes in income and changes in consumption. When a result, MEC fall as aggregate demand falls short of consumption. The consumption function also helps to describe the business cycle. Since the marginal propensity to spend is smaller than one and the average inclination to consume decreases with rising income, it follows that. In this case, rising income and productivity are not sufficient to sustain a similarly high level of growth in consumer demand. Investment was hurt as a result of the lack of total demand. “As a consequence economic growth swings down from the top. Also, the ratchet effect concept states that as a country's revenue drops, people's spending habits don't change drastically. This occurs when individuals want to keep their consumption levels as high as they were before. Over the course of a business cycle, capital assets always depreciate and must be replaced, and this wear and tear eventually spurs investment to finance this process. The economy was able to recover from a recession thanks, in part, to the Keynesian investment multiplier. Nonetheless, the life cycle hypothesis argues that consumption at any one moment is determined not by the income available at that time but by the predicted income available over the course of an individual's whole lifespan. This time, the permanent income hypothesis argues that future predicted income, rather than the present amount of income, is the primary determinant of consumption. And yet, the consumption function is crucial to the design of macroeconomic strategies. It's possible that using a certain model of the consumption function to determine national macroeconomic policy will be incorrect because of peculiar assumptions that may be true in that country. In light of this, an attempt has been made in this research to adapt the standard brief consumption function to account for country-specific factors.

Review of literature

(Becker et al., 2015) studied Consumption Function discovered that, and The Consumption Function derives from the Fundamental Psychological Law of Consumption, which holds that as money rises, so do people's spending habits. While both income and expenditure have increased, the latter has not increased to the same degree as the former because of increased savings. According to the psychological law of consumption, the household sector of an economy's income directly affects the household sector's spending pattern. The psychology of the society is such that as the aggregate real income grows, aggregate consumption likewise increases, but not as much as income, wrote Keynes, laying the groundwork for the three tenets



of his rule. This is due to the fact that when one's money rises, so do their material needs. Consequently, when people's incomes rise, they start to spend less of it on consumer goods. (Clements, 2019) studied four laws of consumption ” discovered that scientific knowledge can be distilled into a set of laws that are sufficiently general and robust to be useful in describing and predicting behavior, including the behavior of physical objects (such as the orbits of the planets), invisible forces (such as electricity), economies (why some thrive while others languish), and people (education as deliberate investment in human capital). Engel's law, the rule of demand (the downwardly sloping demand curve), the law of scattered quantities relative to prices, and the "law" of -12 for price elasticities are the four empirical regularities in consumer behavior that are identified in this work. For each topic, I summarize relevant literature, provide international examples to clarify how the laws are supposed to function, and provide concrete examples of how they might be put to use.

(I.E., 1936) studied “Keynes’s Theory of Consumption” discovered, and In his 1936 book "General theory," Keynes established the basis for contemporary macroeconomics. Keynes' theory of income and employment heavily relies on the idea of consumption function. Keynes argues that the amount of income is the most important element in determining individual and societal consumption. Keynes's theory of consumption is sometimes referred to as the "absolute income theory of consumption" since he emphasized the importance of absolute levels of current income in determining consumer behavior. Keynes proposed a "psychological rule of consumption" that states that people's spending rises with their income but never to the same extent. The marginal propensity to spend is smaller than one.

(الشعراني & الوزير, 2006) studied “Keynes’ Psychological Law of Consumption: (Assumptions and Implication)” discovered, and The Keynesian concept of consumption function is based on the basic psychological law of consumption, which states that people have a tendency to increase their spending on consumption when their income rises, though not by the same amount as the rise in income itself due to the fact that some of the income is saved. In general, as a society's income rises, so does its consumption and savings. This means that a rise in income will result in more money being spent and saved. This indicates that, as a society's income rises, we cannot generally anticipate a drop in either spending or savings. Increased savings tend to go hand in hand with growing income, whereas decreasing savings tend to go hand in hand with dropping income. When one's income rises or falls, one's savings will rise or fall at a faster pace at the beginning of the income change than at its end.



(Rostam Ali & Mostafizur Rahman, 2015) studied “A Study of Short-run Consumption Function and its Modification with Some Special Assumptions” macroeconomics relies heavily on understanding the connection between a country's income and its consumption, which may be seen using the Income and Consumption function. The current investigation is an attempt to establish a causal link. The research relies on secondary resources, namely the Keynesian short-run consumption function and the psychological law of consumption, as well as the more abstract absolute income theory of consumption. In this research, we investigate Keynes's short-run consumption function (SCF_k) on the supposition that it provides a false basis on which to base macroeconomic policy. In this research, we make several key assumptions about the future and apply them to a new form of the short-run consumption function (SCF_m). Using SCF_m, we can see that overall consumption is less than what we would expect using SCF_k. Therefore, the cost savings from SCF_m exceed those from SCF_k. The authors of this paper postulate that SCF_m, under certain conditions, may be used to precisely determine the level of consumption, saving, and investment necessary to effectively develop macroeconomic policy (policies), which has far-reaching consequences.

(Keynes et al., n.d.) studied “Keynes’s Psychological Law of Consumption discovered that The quantity of aggregate consumption relies mostly on the amount of aggregate income. Men (and women) are predisposed, as a rule and on average, to increase consumption as income increases, but not by as much as the increase in income. This is the fundamental psychological law, upon which we are entitled to depend with great confidence both a priori from our knowledge of human nature and from the detailed facts of experience. Keynes makes three claims regarding consumer behavior in the passage above. First, he argues that current-period consumption is positively related to absolute levels of income, or that consumption is a function of present income. People tend to spend a larger portion of their income on consumption when their income for that time is higher. To rephrase, wealthier individuals have historically consumed more than their poorer counterparts. Keynes argues, secondly, that the ratio of income to consumption is inversely proportional. The percentage of money spent on consumption decreases, in his view, as income rises. Average propensity to consume is a measure of consumer spending relative to income (APC). Therefore, according to Keynes, the APC decreases with rising wealth.

Conclusion



The consumption function illustrates the connection between a country's income and consumption, a relationship with profound implications for macroeconomics. Based on the findings of this research, a new short-run consumption function, dubbed modified short-run consumption function (SCFk), has been designed (SCFm). As income rises, though, SCFk predicts that consumers will begin to spend more freely. Once again, the SCFk APC is greater than the SCFm APC. This is shown by the SCFm, which demonstrates a less overall consumption than the SCFk. In this way, the cost savings from SCFm exceed those from SCFk. If the aforementioned conditions are met in a given nation, then using SCFk to guide economic planning and policymaking is a mistake. With these baseline conditions in place, the SCFm may be used to inform the development and implementation of economic plans and” policies that will have far-reaching effects on the macroeconomy.

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