

PSYCHOLOGICAL LAW OF
CONSUMPTION
M.A ECONOMICS, SEMESTER-II,
PAPER-I(UNIT-I).

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- **Psychological Law of Consumption**
- **This law propounded by Keynes explains the relationship between consumption and income.**
- **This is also called Keynes' Fundamental Law of Consumption.**
- **The fundamental psychological law is that, "men are disposed, as a rule and on the average, to increase their consumption, their income increases, but not by as much as the increase in their income."**

- **Thus, Keynes' psychological law of consumption is based on the following propositions:**
- **A. When the total income of a community increases, the consumption expenditure of the community will also increase, but less proportionately.**
- **$\Delta C < \Delta Y$**
- **$MPC < 1$**
- **MPC is positive but less than unity ($0 < MPC < 1$) in normal situation.**
- **This proposition is the core of Keynes psychological law of consumption.**

- **B. An increase in income is divided in some proportion between consumption expenditure and saving. It means that income increases will be partially consumed and partially saved.**
- **$\Delta Y = \Delta C + \Delta S$**
- **C. An increase in income will, thus, lead to an increase in both consumption and savings. This means that with an increase in income in the community, we cannot normally expect a reduction in total consumption or a reduction in total savings.**

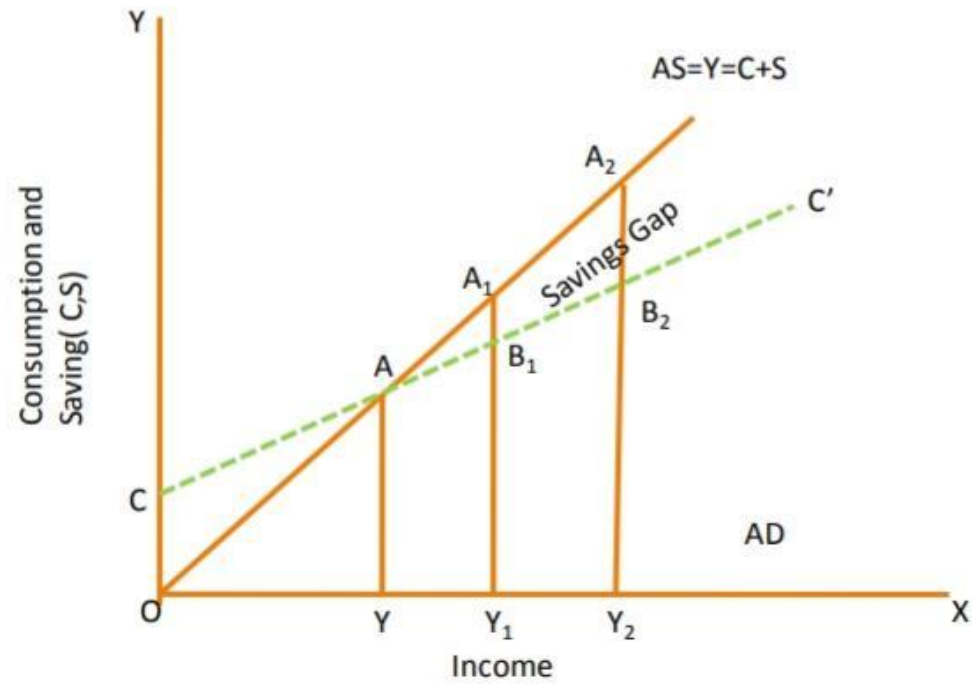


Fig 1 Propositions of Consumption Function

- In above diagram, 45° Line is the aggregate supply curve ($Y = C+S$). At zero level of income consumption is OC . At OY level of income, consumption is AY which is equal to OY savings are zero at point A on consumption curve.
- When income rises from OY to OY_1 consumption also increases from AY to B_1Y_1 but this rise in consumption is less than the increase in income by A_1B_1 . When income increases to OY_1 and OY_2 it is divided into some proportion between B_1Y_1 and B_2Y_2 (consumption) and saving A_1B_1 and A_2B_2 respectively.
- With rise in income to OY_1 and OY_2 , consumption rises to B_1Y_1 and B_2Y_2 . $B_2Y_2 > B_1Y_1 > AY$. Savings also rise. $A_2B_2 > A_1B_1 > \text{zero}$.
- Savings gap increases as increment in consumption is less than the increment in income.

- **Keynes' law is limited by the following assumptions:**

- **1. Constancy of Psychological and Institutional Factors:**

- Propensity to consume will remain stable owing to the constancy of the existing psychological and institutional complexities influencing consumption expenditure.

- **2. Normal Economic Condition**

- General economic conditions are normal and there are no abnormal and extraordinary circumstances such as war, revolution, inflation, etc.

- **3. Laissez-faire Policy:**

- It is assumed that there exists a free capitalist economy, in which there is no government restriction on consumption when income increases.

- Cyclical consumption function
- Keynes propounded only short run consumption function.
- Cyclical consumption function has following features:
- No proportional relation between consumption and income.
- $C = a + bY$

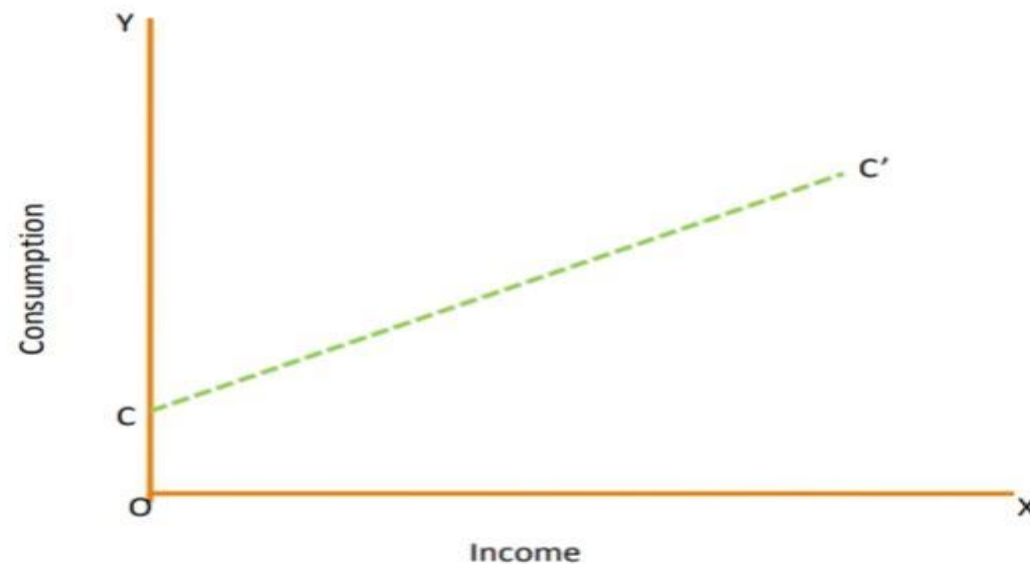


Fig 2 Cyclical Consumption Function

- **CC1 shown in Fig is the short run consumption curve.**

1. Declining MPC and APC

2. APC is greater than MPC

- **B. Secular Consumption Function :**

- **Long run consumption function is called secular consumption function.**

- **This refers to a period of 100 years or more. On the basis of long run statistics,**

- **Kuznets, Duessenberry and Friedman talked of this consumption function.**

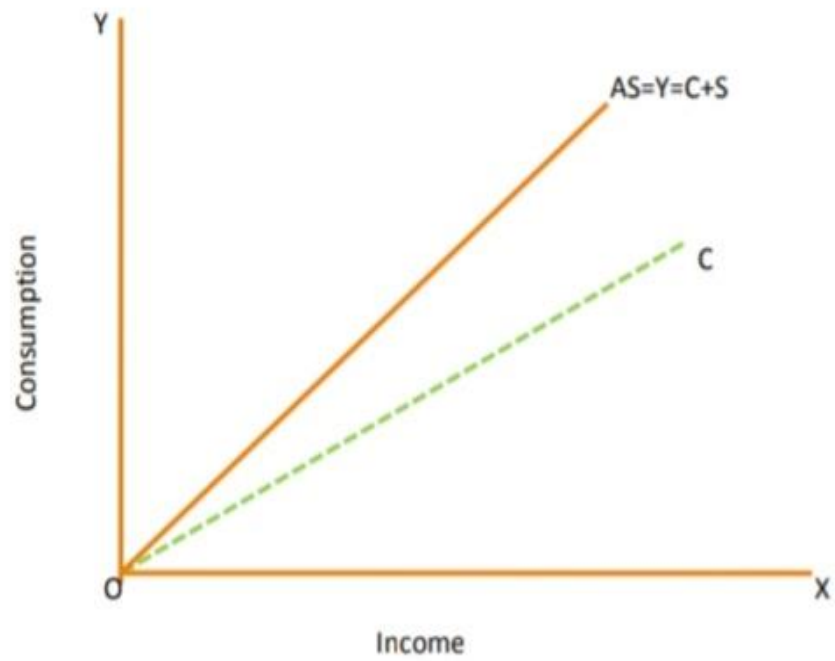


Fig 3 Secular Consumption Function

- **Secular consumption function has following features :**
- **1. Proportional relationship between consumption and income. In the long run consumption rises in the same proportion as the rise in income. $C = by$, OC is the secular consumption function.**
- **2. Constant APC and MPC.**
- **3. APC and MPC are equal.**



- Study Material Reference

- <http://www.yourarticlelibrary.com/economics/psychological-law-of-consumption-assumptions-and-implication/24971>

- MOOC – Principle of Macroeconomics.