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THEORETICAL BASIS OF THE INSTITUTIONAL EXPLANATION OF THE CONSUMPTION FUNCTION

The article analyzes the problems of consumption volumes in different stages of economic development from institutional point of view. Ideas about consumption propensity over time are reviewed, overvalued, supplemented in the course of time alongside with other approaches. Economists believe that the changes in average propensity to consume could be expected by the influence of institutional factors.

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The volume of consumption is of great importance in the economy and determines the volumes of production, rates of economic growth and development. Sometimes ideas about consumption propensity over time are reviewed, overvalued, supplemented in the course of time alongside with other approaches.

Even theorists, who accept that the consumption propensity is a constant value, do not deny that it can be changed over time. Particularly, in 1929-1941 propensity to consume was 0.73 in the USA, in 1970-ies it was 0.64 in GFR, and in 1990-ies it was 0.62 in Russia.¹ According to the institutionalists it is the product of the institutional differences between countries. More output of time was included in the researches of S. Kuznets. Particularly, propensity to consume strived to 0.86 for 1869-1938 in the USA. It arose more interest among the specialists towards the theory of Keynes. There were three possible versions among the cause- effect explanations: 1. the impact of the relative income, 2. permanent income value, 3. life cyclicality.

According to D. Duisenberg, the consumption level includes the psychological factor and it is determined alongside with the society development at the same time with competitive relations inside the social group in which high quality of life and the simulation tends are the cores.

According to M. Freedman the household incomes are subjected to more and more fluctuations in comparison with expenses done by them. The consumption expenditures were observed through the factor dependence not at the level of the current income but at the average income. According to this idea when getting a maximum income in the certain period of time the household later also tries to build its consumption by adjusting it to the consumption level of the following income.

At last the research of the Nobel Prize winner (1985) F. Modigliani is built on the principle that the level of the household expenditure depends not only on the current level of the income but also on the income level expected in the course of life.

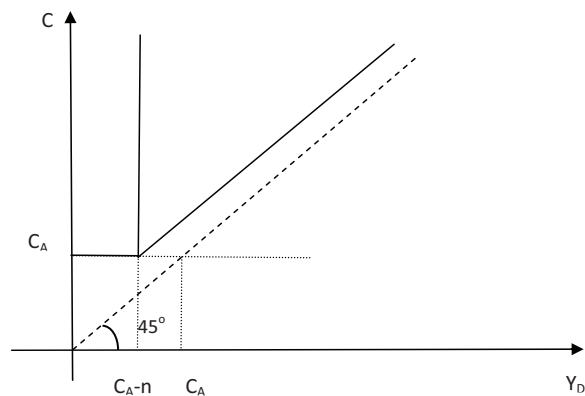
Besides the economists believe that the changes in average propensity to consume could be expected by the influence of institutional factors.²

Thus, equilibrium in the economy is established by

the interaction of various cause-effects factors as investments, propensities to consume and save. According to Keynes the classical “invisible hand” cannot provide equilibrium in economy in the case of full employment.

Let us observe the consumption function in the linear dependence with the disposable income. $C=C_A+kY_D$

Picture 1



If: $0 < Y_D < C_A - n$

1. If $K = 0$ then $C = C_A$
2. If $K \rightarrow \infty$, C coincides with the axis of the ordinate
3. If $\infty > K > 0$, then $C > C_A$
4. If $-\infty < K < 0$, then $C < C_A$

In the next interval “ C_A ” level is considered to be over-
come”.

The rectilinear equation having K angular coefficient and passing through $(C_A - n; C_A)$ point is the following:

$$C = K Y_D - K C_A + K n + C_A$$

When $Y_D > C_A - n$

1. If $-\infty < K < 0$ then $C < C_A$
2. If $0 < K < 1$ then $C = kY_D - KC_A + Kn + C_A$

In this case let us represent the coordinates of the consumption function and $Y_D = C$ rectilinear intersection point. The latter actually corresponds to the “condition” of equilibrium provided in the theory of Keynes. For this reason the following equations system should be solved:

$$\begin{cases} C = Y_D \\ C = kY_D - KC_A + Kn + C_A \\ Y_D = (Kn - KC_A + C_A) / (1 - K) \end{cases}$$

¹ M. Mashkovski, “Macroeconomics”, Moscow, 2004, pg. 55-56
² Barr R., “Political Economy”, V 2 T. Moscow 1994, T. 2 pg. 420

It proceeds from the equilibrium requirements that

$$C = Y_D; \quad C = (K n - KC_A + C_A) / (1 - K)$$

3. If $K=1$ then $C = n + Y_D$

4. If $\infty > K > 1$ then $C = kY_D - KC_A + K n + C_A$

5. $K \rightarrow \infty$ then the function graph determining the dependence of consumption from disposable income is vertical to the disposable income axis: $Y_D = C_A - n$

In the Keynesian theory the tax burden relieve or the deficit financing of the government purchases was considered to be the way out in the case of minimum level of the consumption volume recorded in recession period.

In the $C_A C_E$ segment, when the expansion period in the economy is observed, it was important to reduce the marginal utility of the money among the “rentier” or the rich by means of wealth redistribution.

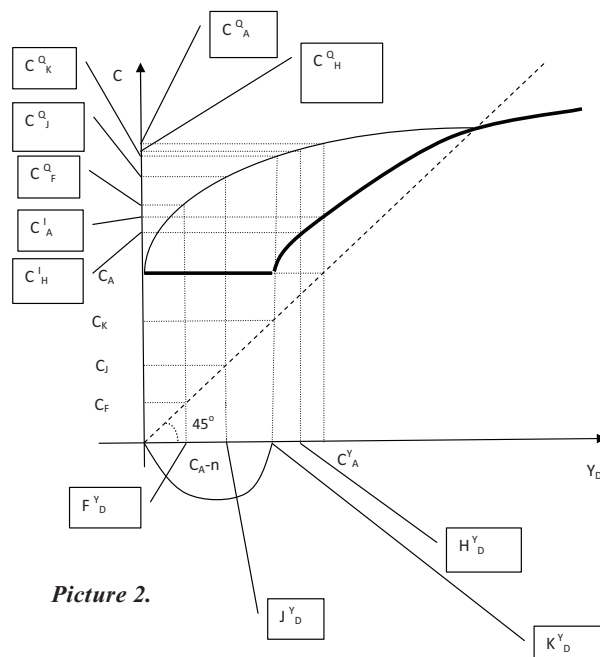
To maintain the economy at the full employment level C_E and to avoid further negative situations it was necessary to increase the investments opportunities. As since in comparison with $C_A C_E$ segment the households prefer to preserve financial resources in cash. Later on slowdown of business activities were observed. In order to avoid all these it was necessary to increase the amount of money. In this case real interest rate would be reduced in the economy and broad member of the society would not be interested in keeping their savings in cash. In the result the $C = C_A + C(Y)$ curve was coming closer to $Y = C$ curve as possible and an attempt was made to establish an equilibrium in the preferable highest segment in the intersection point for $C = C_A + C(Y) \sim Y = C$ curves.

The consumption function could be expressed through non linear dependence from disposable income and in practice it could have the below mentioned form. Let us show the differences in consumption value in the case of the same disposable income through Keynes and classical explanations. According to the main psychological law of Keynes people are more inclined to increase the consumption along with the income increase although not with the same size with which the income increased.³ In this regard it is remarkable that the human’s “psychology” is that in the case of income lower than cost of living the consumption will not exceed that value. (Picture 2.)

Let us suppose that in the income interval $CA - n$ the value of consumption will not increase continuously and will be equal to the autonomous consumption value of CA .

According to the classical theory in the case of F_D^Y, J_D^Y, K_D^Y values of income the consumption will be C_F, C_J, C_K and according to Keynes theory it will be C_F^O, C_J^O, C_K^O . In accordance with the classical theory the income and the consumption values will be equal and according to the Keynes theory the consumption value will increase corresponding to the income increase.

In practice in terms of all the above mentioned values



Picture 2.

of income, the consumption could be equal to C_A . When the income values approach the vital C_A living cost value, the increase in consumption becomes evident.

For example: according to the Keynes theory in the case of H_D^Y, C_A^Y values of income, the consumption accordingly will be C_H^O, C_A^O and in some cases the consumption may be C_H^I, C_A^I . The difference between the consumption value C_H^O, C_A^O and accordingly C_H^I, C_A^I value can be explained through slow paces of the economy “recovery”.

Finally, in some economic situations in some stages of economic growth and development, for example the difference between the consumption value C_K and autonomous consumption value C_A by percentage points could coincide with the difference of the consumption value C_H^I and the autonomous consumption value C_A . Although in the first case the exceed of consumption over the income value is explained through decrease in savings, occurred debts, in the second case with the economy recovery, increased volumes of credit and leasing transactions.

References:

1. M. Mashkovski, “Macroeconomics”, Moscow, 2004, pg. 55-56
2. Barr R., “Political Economy”, V 2 T. Moscow 1994, T. 2 pg. 420
3. J.M. Keynes, The General Theory of Employment, Interest and Money. 2002, Book III The Propensity to Consume

3 J.M. Keynes, The General Theory of Employment, Interest and Money. 2002, First published, Macmillan Cambridge University Press, for Royal Economic Society in 1936; Book III The Propensity to Consume. <http://www.marxists.org/reference/subject/economics/keynes/general-theory/ch08.htm>