Factors Affecting the Consumption Function

The following points highlight the eight main factors that influence the consumption function. The factors are:

1. The Rate of Interest
2. Sales Effort
3. The Volume of Wealth
4. Terms of Consumer Credit
5. Deferred Payment
6. Psychological Factors
7. Structural Factors
8. Fiscal Policy.

1. The Rate of Interest

Classicists assumed that consumption or saving depends on the rate of interest. They believed that an increase in interest rate encourages saving and, thus, consumption is discouraged. However, there is another way to explain consumption/saving and interest rate relationship. A rise in interest rate means a decline in the money value of bonds. This tends to discourage consumption propensities of bond-holders.

2. Sales Effort

The money value of fixed interest bearing assets falls when its interest rate rises. This makes owners of these assets poorer and will discourage consumption. Or at a high rate of interest, preference for bond tends to rise. This will induce people to consume less. Anyway, rate of interest may not be considered as a significant factor influencing consumption decisions as empirical evidence suggests a weak link between interest rate and consumption.

3. The Volume of Wealth

The total wealth position of consumers is considered as an important determinant of consumption. Wealth like shares, bonds, house property, etc., influence consumption decisions. Owners of these assets do not have enough preference for these assets. That is why their desire to save is less since they Eire already the owners of these assets.People who do not own assets intend to save more and consume less now in order to have assets in future. In other words, property-owners have the greater desire to consume while desire to save is the greatest to the people who do not own assets. Such is known as Pigou effect, after the name of the classical economist A. C. Pigou. Pigou effect states that the more saving a man has, the less the strength of his desire to save more. If two men have identical tastes and incomes, but one has already acquired huge wealth, his incentive to increase current savings will be less than the other one who is yet to enjoy large property. According to Pigou, propensity to consume depends on the real value, and not on money value, of cash balances or liquid assets. The nominal value of cash balances or wealth rises or falls with the fall or rise in general price level.

4. Terms of Consumer Credit

The hire- purchase system of buying durable consumer goods has become popular in these days. However, such spending greatly depends on the terms and conditions of credit. If consumer credit is available on reasonable terms, some sort of spending spree will develop. However, it is agreed that the interest rate on installment buying is of relatively less significance than the size of required down-payments, the length of the period over which the balances must be repaid.

5. Deferred Payment

Sometimes, particularly during war time, consumer spending declines due to restraint on spending. Once such restraints are removed, backlog of pent-up consumer demand might get exposure leading to a rise in spending.

6. Psychological Factors

Psychological or subjective factors that remain constant in the short run determine the form of the consumption function. These factors are listed below. Keynes attached importance to the psychological or subjective factors which consist of basic values, attitudes, states of mind, etc. These are not quantifiable or specific like economic factors.

Motives behind consumption, according to Keynes, are enjoyment, short-sightedness, generosity, miscalculation, extravagance, and ostentation. However, these elements do not change significantly in the short run. Despite this, these subjective and cultural factors are capable of changing the shape and the level of the function. Of all these subjective factors, expectations and attitudes of consumers do play an important role. Rational behavior suggests that a consumer who expects a rise in income or in the price level may consume more than who expects no such change in near future. Again, among similar individuals (same age) with the same level of incomes, it may be found that some individuals consume more than others because of the differences in their attitudes towards thrift.

7. Structural Factors

Structural factors like income distribution, demographic factors, etc., do have some bearing on the aggregate consumption spending in the long run. The first important structural factor is the income distribution. It is said that the marginal propensity to consume (MPC) is high of low-income families and low for high-income families. Now if there is a redistribution of income in favor of the poor-income families, aggregate consumption would rise since the MPC of these people is high.

Secondly, demographic factors are responsible for differences in consumption spending with identical incomes. Demographic factors include size of family, stage in the family life cycle, place of residence, occupation, race, etc. It is true that large families or families with more children and aged persons consume more than small families. However, in the short run analysis, these demographic factors can be ignored.

8. Fiscal Policy.

Ex-expenditure programmes of the government can influence consumption spending. If rich people are asked to pay more taxes and if these revenues are given as subsidies to poor people, aggregate consumption would rise. High taxes curtail consumption by reducing disposable income. Now, if subsidies like flood relief, old-age pension, distribution of food-grains at a subsidized rate, etc., are given, definitely consumption spending of the recipient of these subsidies would rise. These are the people whose MPC is high. Thus, tax- expenditure programme shifts the consumption function through redistribution of income.