"Consumption is determined by Income"

Consumption is defined as consumer spending on goods and services over a certain period of time. In this case, disposable income is used as this is the aggregate amount of money a person earns during a given period. There are a number of factors which determine how much a household consumes. The relationship between consumption and these factors is called the consumption function. The most important factor of consumption is disposable income but other factors can bring around significant changes in consumption.

One factor of consumption is the amount of wealth a household has. A household is constituted of the general public as distinct from a firm or business. In common parlance the general public is often called consumers Wealth is made up of physical wealth and monetary wealth. Physical wealth is durable items such as cars, houses and furniture whereas monetary wealth is made up of cash, shares and pension rights. If the wealth of a household increases then consumption is expected to increase, this is known as the wealth effect.

Another factor of consumption is inflation. This increases the general level of prices and has two effects on consumption. Firstly, if households expect prices to be higher in the future then they will be tempted to bring forward their purchases. Thus a household's anticipation of inflation can increase consumption and reduce saving. However, this may be outweighed by the effect of inflation on wealth. Rising inflation tends to erode the real value of monetary wealth. Households react to this by trying to save as much as possible and so consumption is reduced. The negative effect of inflation on consumption caused by the eroding of real monetary wealth more than offsets the positive effect on consumption caused by earlier purchases.

Much of the money to buy durables, e.g. cars, comes from credit finance and so an increase in the rate of interest increases the monthly payments for these goods. This means that, effectively, the price of the goods has increased. Households react to this by reducing their demand for durables and so cutting their consumption. Many households also have borrowed money to purchase houses. Increased interest rates lead to increased mortgage repayments. Again, this will reduce the amount of a household's disposable income thereby directly cutting the spending on payments for other items and, perhaps, more importantly, discouraging households from borrowing more money to finance purchases of consumer durables. This leads to a fall in consumption.

The interest rate affects the availability of credit as it determines the price of credit, so making credit more available will increase consumption.

Expectations of increases in prices tend to encourage households to bring forward their purchases thus increasing consumption. Expectations of large increases in real income tend to encourage households to increase spending by borrowing more. If households expect economic conditions to be harsher in the near future then consumption will be reduced in the present.

Young people and old people tend to spend a higher proportion of their income than those who are middle aged. Young people tend to spend all of their income and move into debt when setting up a family and buying a home. In middle age, the cost of homemaking declines as a proportion of income. With more income available,

households often choose to maximise savings in preparation for retirement. Following retirement saving stocks are reduced in order to supplement pensions. Therefore, a change in the age composition of the economy may lead to a change in the rate of consumption and saving. The greater the proportion of young and old households to middle-aged households in an economy, the greater will be the level of consumption.

The Keynesian consumption function lays emphasis on the relationship between planned current consumption and current disposable income. Other factors, especially the availability of credit, can have a big impact on the expenditure on consumer durables. However, in the short term at least, income is the most significant factor determining the level of consumption. Changes in wealth and changes in the rate of interest have little impact on short term consumption. This means that the consumption function is relatively stable and so it is not subject to frequent large scale shifts. Over the past 60 years, there does not seem to be any indication that households are reducing their likelihood to consume as income increases; therefore Keynes has been proved wrong.

Franco Modigliani and Albert Ando suggested that current consumption is not based on current income. Instead, households form a view about their likely income over the whole of their lifetimes and base their current spending decisions on that. During middle age, households tend to be net savers as they are paying off loans accumulated when they were younger and saving for retirement. During retirement they spend more than they earn, running down their savings. This is known as the life cycle hypothesis.

The permanent income hypothesis was developed by Milton Freedman and this theory, in many ways, builds on the insights of the life cycle hypothesis. Freedman argued that households base their spending decisions not on current income but on their permanent income. Permanent income is the average income over a lifetime. This can be influenced by a number of factors.

One factor is that an increase in wealth will increase the ability of households to spend money. Hence a rise in wealth will increase actual consumption over a lifetime. Another factor is that an increase in interest rates tends to lower both stock and share prices. This leads to a fall in wealth, permanent income and current consumption. An increase in interest rates also leads to future incomes being less valuable. An unexpected rise in wages will lead to an increase in permanent income.

Freedman argued that the long run average propensity to consume (APC), the amount of income spent, was that households spend all their income over their lifetimes. Hence, APC is stable. In the short run, however, wealth and interest rates change. Measured income also changes and much of this is unexpected. Income which households receive but don't expect to earn is called transitory income. Initially, transitory income will be saved, as households decide what to do with the money. Then it is incorporated into permanent income. This theory contradicts the Keynesian hypothesis that current consumption is a stable function of current income.

Generally the relationship between consumption and income is positive but not perfectly. Income is the most significant factor when concerning consumption but other factors are enough to play a significant role when the determinants of consumption are involved.