

Question #69425, Economics / Macroeconomics

with the aid of a properly labelled diagram, explain the three main characteristics of the consumption function?

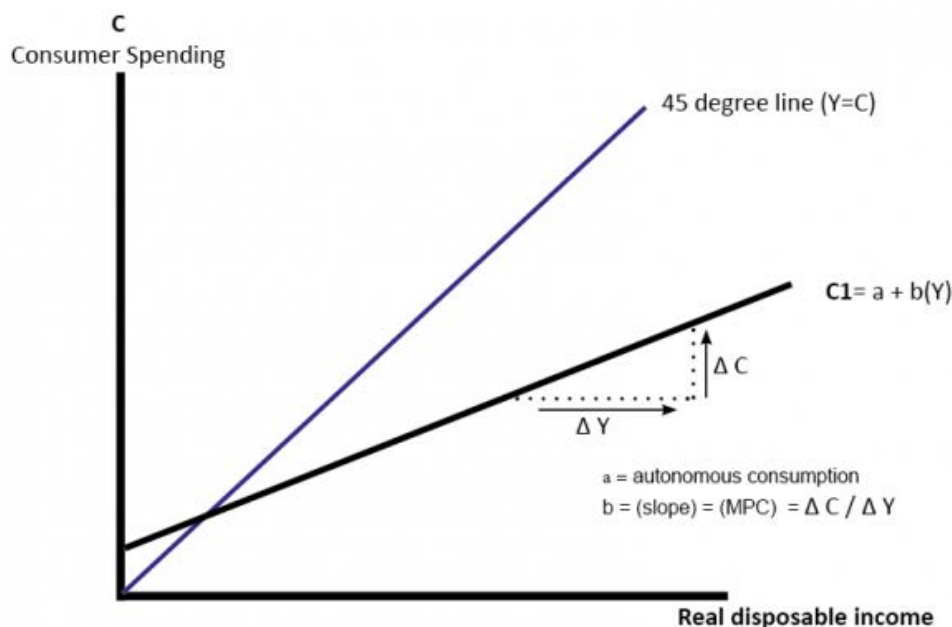
Answer:

Consumption function expresses the level of consumer spending depending on three factors.

Y_d = disposable income (income after government intervention – e.g. benefits, and taxes)

a = autonomous consumption (consumption when income is zero. (e.g. even with no income, you may borrow to be able to buy food))

b = marginal propensity to consume (the % of extra income that is spent). Also known as induced consumption.



$$C = a + b Y_d$$

This suggests consumption is primarily determined by the level of disposable income (Y_d). Higher Y_d , leads to higher consumer spending.

This model suggests that as income rises, consumer spending will rise. However, spending will increase at a lower rate than income.

At low incomes, people will spend a high proportion of their income. The average propensity to consume could be one or greater than one. This means people spend everything they have. When you have low income, you don't have the luxury of being able to save. You need to spend everything you have on essentials.

However, as incomes rise, people can afford the luxury of saving a higher proportion of their income. Therefore, as income rise, spending increases at a lower rate than

disposable income. People with high incomes have a lower average propensity to spend.

Source: <http://www.economicshelp.org/blog/2812/economics/consumption-function-definition/>

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