

The Relationship between Economics and Household Consumption

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ABSTRACT

The aim of this article is to identify relationship between economics and household consumption. A household consists of one or more people who live in the same dwelling and share meals. It may also consist of a single family or another group of people. Consumption, defined as spending for acquisition of utility, is a major concept in economics and is also studied in many other social sciences. It is seen in contrast to investing, which is spending for acquisition of future income. In their studies of consumption, economists

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generally draw upon a common theoretical framework by assuming that consumers base their expenditures on a rational and informed assessment of their current and future economic circumstances. People in different position in respect to income have systematically different structures of consumption. The rich spend more for each chapter in absolute terms, but they spend a lower percentage in income for food and other basic needs.

INTRODUCTION

A household consists of one or more people who live in the same dwelling and share meals. It may also consist of a single family or another group of people [1]. A dwelling is considered to contain multiple households if meals or living spaces are not shared. The household is the basic unit of analysis in many social, microeconomic and government models, [2] and is important to economics and inheritance.[3] Household models include families, blended families, shared housing, group homes, boarding houses, houses of multiple occupancy (UK), and single room occupancy (US). In feudal societies, the Royal Household and medieval households of the wealthy included servants and other retainers

The consumption of goods and services is a primary component of economic wellbeing and, as such, a primary indicator of living standards. Wealth and income are available to support consumption, today and in the future (through the saving that income generates). Income, consumption and wealth are three dimensions of the broader concept of economic well-being,

and it is important to understand the relationships between them. Everything else being equal, a person with a higher level of consumption is regarded as having a higher level of economic well-being than someone with a lower level of consumption. Consumption needs can be met through the spending of income, through the running down of wealth, and through borrowing. Production, in the market and at home, supports consumption. As noted by [4]: "Consumption is the sole end and purpose of all production and the welfare of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer." Since Smith wrote in the 18th century, there has been much focus on consumption and how to value and measure it. Studies in the economics literature have linked food consumption with food expenditures and home production [5]. Some researchers have estimated consumption using expenditure data and information on durables [6], while others have focused on nondurable expenditures as a measure of consumption [7]. In other cases, total

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household expenditures are used as a measure of consumption [8]. There have also been studies valuing the flow of services from owner-occupied housing from household survey data and national accounts [9].

The ICW Framework incorporates the concept of consumption expenditure as a valuation of the consumption of all goods and services, both those produced within households and those purchased in the market. The concept of consumption in the ICW Framework is developed in parallel with the concepts of income and wealth so as to allow integration of the three types of measures, enabling a comprehensive and in-depth analysis of the various dimensions of economic well-being.

Consumption, defined as spending for acquisition of utility, is a major concept in economics and is also studied in many other social sciences. It is seen in contrast to investing, which is spending for acquisition of future income.

In economics, consumption is the use of goods and services by households. Consumption is distinct from consumption expenditure, which is the purchase of goods and services for use by households. Consumption differs from consumption expenditure primarily because durable goods, such as automobiles, generate an expenditure mainly in the period when they are purchased, but they generate "consumption services" (for example, an automobile provides transportation services) until they are replaced or scrapped.

The trade-off for households between consumption and savings also responds to prices, both those of financing (interest rates) and those of goods and services [10]. In IFs, both of those prices in turn respond to levels of inventories in the production/consumption sectors (called stocks (ST) inside IFs). Consumption is defined in part by comparison to production. In the tradition of the Columbia School of Household Economics, also known as the New Home Economics, commercial consumption has to be analyzed in the context of

household production. The opportunity cost of time affects the cost of home-produced substitutes and therefore demands for commercial goods and services. The elasticity of demand for consumption goods is also a function of who performs chores in households and how their spouses compensate them for opportunity costs of home production [11].

Different schools of economists define consumption differently. According to mainstream economists, only the final purchase of newly produced goods and services by individuals for immediate use constitutes consumption, while other types of expenditure in particular, fixed investment, intermediate consumption, and government spending are placed in separate categories (see Consumer choice). Other economists define consumption much more broadly, as the aggregate of all economic activity that does not entail the design, production and marketing of goods and services (e.g. the selection, adoption, use, disposal and recycling of goods and services).

Economists are particularly interested in the relationship between consumption and income, as modeled with the consumption function [12]. Neoclassical (mainstream) economists generally consider consumption to be the final purpose of economic activity, and thus the level of consumption per person is viewed as a central measure of an economy's productive success. The study of consumption behaviour plays a central role in both macroeconomics and microeconomics. Macroeconomists are interested in aggregate consumption for two distinct reasons. First, aggregate consumption determines aggregate saving, because saving is defined as the portion of income that is not consumed. Because aggregate saving feeds through the financial system to create the national supply of capital, it follows that aggregate consumption and saving behaviour has a powerful influence on an economy's long-term productive capacity. Second, since consumption expenditure accounts for most of national output, understanding the dynamics of aggregate consumption

expenditure is essential to understanding macroeconomic fluctuations and the business cycle.

Microeconomists have studied consumption behaviour for many different reasons, using consumption data to measure poverty, to examine households' preparedness for retirement, or to test theories of competition in retail industries [13]. A rich variety of household-level data sources (such as the Consumer Expenditure Survey conducted by the U.S. government) allows economists to examine household spending behaviour in minute detail, and microeconomists have also utilized these data to examine interactions between consumption and other microeconomic behaviour such as job seeking or educational attainment.

The modeling of the influence of interest rates could be done with the primary target being household savings. We instead represent the impact of rates on consumption, making savings the residual. The impact of interest rates on consumption is via an interest rate multiplier term (IntrMulTermC) that rise or falls over time as a function of the difference between a smoothed interest rate term (SmoothIntr) and a very long-term or highly-smoothed interest rate term (LongTermIntr). That is, as the smoothed interest rate rises above the long-term interest rate, it depresses consumption (and will therefore raise savings). In IFs there is no monetary sector and interest rates are real rates, not nominal ones [14].

Although we could similarly use the real prices of goods and services to affect consumption, the recursive structure of the model means that prices are computed in the supply/demand balance and not available at the time of this adjustment to consumption (the same lag issue affects interest rates, but the lagged values change slowly and using them is not a problem) [15]. To bypass the lag, the implicit price effect on consumption is introduced directly via an additive term reflecting half of excess stocks; the reason for passing through an adjustment of that magnitude is that household

consumption is generally well above have of the total economy. Excess stocks are the difference between actual and desired stocks, which are determined by a stock base (STBase) linked to production and consumption levels and a desired stock level (dstl) as a portion of the stock base. Different schools of economists define production and consumption differently. According to mainstream economists, only the final purchase of goods and services by individuals constitutes consumption, while other types of expenditure in particular, fixed investment, intermediate consumption, and government spending are placed in separate categories (See consumer choice). Other economists define consumption much more broadly, as the aggregate of all economic activity that does not entail the design, production and marketing of goods and services (e.g. the selection, adoption, use, disposal and recycling of goods and services) [16].

Consumption Theory

In their studies of consumption, economists generally draw upon a common theoretical framework by assuming that consumers base their expenditures on a rational and informed assessment of their current and future economic circumstances. This "rational optimization" assumption is untestable, however, without additional assumptions about why and how consumers care about their level of consumption; therefore consumers' preferences are assumed to be captured by a utility function [17]. For example, economists usually assume

- That the urgency of consumption needs will decline as the level of consumption increases (this is known as a declining marginal utility of consumption),
- That people prefer to face less rather than more risk in their consumption (people are risk-averse)
- That unavoidable uncertainty in future income generates some degree of precautionary saving. In the interest of simplicity, the standard versions of these models also make some less-innocuous

assumptions, including assertions that the pleasure yielded by today's consumption does not depend upon one's past consumption (there are no habits from the past that influence today's consumption) and that current pleasure does not depend upon comparison of one's consumption to the consumption of others (there is no "envy").

Within the rational optimization framework, there are two main approaches. The "life-cycle" model, first articulated in "Utility Analysis and the Consumption Function" (1954) by economists Franco Modigliani and Richard Brumberg, proposes that households' spending decisions are driven by household members' assessments of expenditure needs and income over the remainder of their lives, taking into account predictable events such as a precipitous drop in income at retirement. The standard version of the life-cycle model also assumes that consumers would prefer to spend everything before they die (i.e., it assumes there is no bequest motive) [18]. Life-cycle models are most commonly employed by microeconomists modeling household-level data on consumption, income, or wealth.

Macroeconomists tend to use a simplified version of the optimization framework called the "permanent income hypothesis," whose origins trace back to economist Milton Friedman's treatise *A Theory of the Consumption Function* (1957). The permanent income hypothesis omits the detailed treatment of demographics and retirement encompassed in the life-cycle model, focusing instead on the aspects that matter most for macroeconomic analysis, such as predictions about the nature of the consumption function, which relates consumer spending to factors such as income, wealth, interest rates, and the like.

Perhaps the most important feature of the consumption function for macroeconomics is what it has to say about the marginal propensity to

consume (MPC) when there are changes in income. Economist John Maynard Keynes, who was the first to stress the importance of the MPC in *The General Theory of Employment, Interest, and Money* (1936), believed that up to 90 percent of any increase in current income would translate into an immediate increase in consumption expenditure [19]. However, evidence has shown that Friedman's permanent income hypothesis is much nearer the mark: Friedman asserted that on average only about one-third of any windfall (a one-time unanticipated gain) would be spent within a year. He further argued that a one-for-one correlation between increased income and increased spending would occur only when the income increase was perceived to reflect a permanent change in circumstances.

The modern mathematical versions of the life-cycle and permanent-income-hypothesis models used by most economists bring some plausible refinements to the original ideas. For example, the modern models imply that the marginal propensity to consume out of windfalls is much higher for poor than for rich households. This tendency makes it impossible to determine the impact of a tax cut or government program on consumption spending without knowing whether it is aimed primarily at low-wealth or high-wealth households [20]. The theory further indicates that tax cuts or spending programs (such as extended unemployment benefits) aimed primarily at lower-income households should be considerably more effective at stimulating or maintaining aggregate spending than programs aimed at richer households.

Importance of Consumption

Modern economists give a lot of importance to the level of consumption in the economy because it characterizes the economic system the country currently operates in.

1. The beginning of all economic activity

Consumption is the start of all human economic activity. If a person desires something, he will take action to satisfy this desire. The result of such an effort is

consumption, which also means the satisfaction of human wants.

2. End of economic activities

If, for example, a person desires a sandwich, they will take the effort to make the sandwich. Once it is made, the food is consumed, resulting in the end of an economic activity.

3. Consumption drives production

According to economist Adam Smith, "Consumption is the sole purpose of all production." It means that the production of goods and services is dependent on the level of consumption.

4. Economic theories

The study of consumption theory has helped economists formulate numerous theories such as the Law of Demand, the Consumer Surplus concept, and the Law of Diminishing Marginal Utility. These theories help analysts understand how individual behavior affects the input and output in the economy.

5. Government theories

People in different position in respect to income have systematically different structures of consumption. The rich spend more for each chapter in absolute terms, but they spend a lower percentage in income for food and other basic needs. The percentage values of an aggregation over all the households in a country can thus be used for judging income distribution and the development level of the society. The rich have both higher levels of consumption and savings. In differentiated product markets, the rich can usually buy better goods than the poor. This happens also because they tend to use different decision making rules. In certain conditions, the poor can pay more than the rich to satisfy the same need. In other words, consumption depends on social groups and their behaviours, as well as their proneness to advertising.

Third, one should distinguish "consumption" as use of goods and services from "consumption expenditure" as buying acts. For durable goods this difference is very relevant, since they are used for long time periods.

Consumption habits also help the government formulate theories. The minimum wage rate and tax rate are determined based on the habits of individuals. It also helps the government make decisions on the production of essential and non-essential commodities in a country. It also provides the government with insight into the saving to spending ratio in the economy.

6. Income and employment theory

Consumption plays an important role in the income and employment theory under Keynesian economics as put forth by John Maynard Keynes. Keynesian theory states that if consuming goods and services does not increase the demand for such goods and services, it leads to a fall in production. A decrease in production means businesses will lay off workers, resulting in unemployment. Consumption thus helps determine the income and output in an economy.

CONCLUSION

In this vein, the rich have a much wider cumulative bundle of durable goods purchased over time, so they enjoy a very significantly higher degree of need satisfaction, whereas the poor can suffer deficiencies even in the most basic goods. Conversely, purchased non-durable goods that are not consumed before the deadline are a typical waste (and squander).

Fourth, only newly produced goods enter into the definition of consumption, whereas the purchase of, say, an old house is not considered consumption in macroeconomics, since it was already counted in the GDP of the year in which it was built. Needless to say, for the consumer, both old and new goods provides some need satisfaction.

In microeconomic terms, total consumption expenditure of one household is the sum, over a span of time and across all categories, of the value (i.e. price times quantity) of all varieties of goods and services purchased, where the quantity purchased depends on the consumption average dose times the number of consumption occasions (i.e. seized consumption

opportunities). Macroeconomic consumption is the sum of the consumption of all households, keeping into account that households are not independent from each other but rather communicate and co-variate.

Conversely, consumption is the value of domestic and foreign firms' sales in the domestic market to households (thus excluding business investment and public expenditure)

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