4th Sem (M)

The Life Cycle Hypothesis

Ando and Modigliani have formulated a consumption function which is known as Life Cycle Hypothesis. According to this theory, consumption is a function of life time expected income of the consumer. The consumption of the individual consumer depends on the resources available to him, the rate of return on capital, the spending plan and the age at which the plan is made. The present value of his income (or resources) includes income from assets or property and from current and expected labour income.

Assumptions of the Theory:- There are three assumptions of Life cycle Hypothesis :-

1. There is no change in the price level during the life of the consumer.
2. The rate of interest remains stable.
3. The consumer does not inherit any assets and his net assets are the result of his own savings.

The aim of the consumer is to maximise his utility over his lifetime which will, in turn, depend on the total resources available to him during his lifetime. Given the life-span of an individual, his consumption is proportional to these resources. But the proportion of resources that the consumer plans to spend will depend on whether the spending plan is formulated during the early or later years of his life. As a rule, an individual's average income is relatively low at the beginning of his life and also at the end of his life. This is because in the years of his ' life he has little assets, and during the late years his labour income is low. But in the middle of his life that his income, both from assets and labour is high. As a result, the consumption level of the individual throughout his life is somewhat constant or slightly increasing as shown the curve CC_1 in fig-①. The curve Y_0YY_1 shows the individual

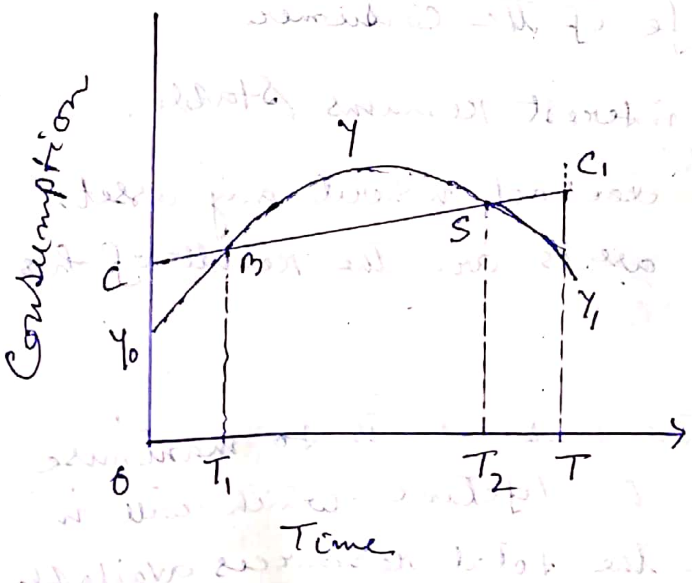

fig-①

Consumer's income stream during his lifetime T. During the early period of his life represented by T_1 in the figure, he borrows CY_0B amount of money to keep his consumption level CB which is almost constant. In the middle years of his life represented by T_1T_2, he saves BSY amount to repay his debt and for the future. In the last years of his life represented by T_2T, he dissaves SC_1Y_1 amount.

On the basis of the life cycle hypothesis, Ando and Modigliani made a no. of studies in order to formulate the short-run and long-run consumption function. A cross-section study revealed that more persons in the low-income groups were at low income level because they were at the end period of their lives. Thus their APC was high. On the other hand, more than average persons belonging to the high-income groups were at high-income levels because they were in the middle years of their lives. Thus their APC was relatively low. On the whole, the APC was falling as income rose thereby showing MPC < APC.

The Ando-Modigliani short-run consumption function is shown by the C_S curve in fig-2. At any given point of time, the C_S curve can be considered as a constant, but its intercept will change as a result of accumulation of assets through savings and this will cause the C_s curve to drift upward to C_s' over time.

The long-run consumption function is C_L, showing a constant APC as income grows along the trend. It is a straight line passing through the origin. The APC is constant over time.

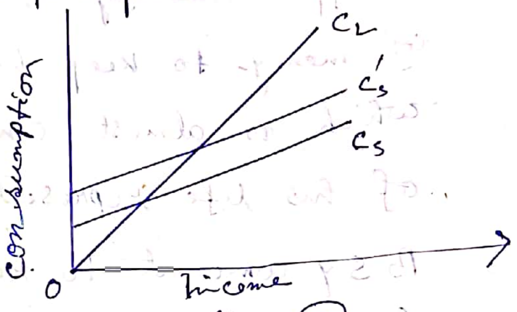

fig. 2

Criticism: The life cycle Hypothesis is not free from certain limitations :—

1. First, the contention of Ando-Modigliani that a consumer plans his consumption over his lifetime is unrealistic because a consumer concentrates more on the present rather than on the future which is uncertain.

2. The life cycle hypothesis pre-supposes that consumption is directly related to the assets of an individual. As assets increase his consumption increases and vice-versa. This is also ~~unwo~~ unwarranted because an individual may reduce his consumption to have larger assets.

3. Consumption depends upon one's attitude towards life; Given the same income and assets, one person may consume more than the other.

This theory includes assets as a variable in the consumption f^n but also explains why MPC < APC in short-run and the APC is constant in the long-run.