

CONSUMER THEORY

by

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Consumer theory

Few efforts have been made by Post Keynesians to explain how consumers make choices. Does that mean that Post Keynesians accept the neoclassical axioms of consumer choice? The answer is no. Although there have been few contributions on consumer behaviour by Post Keynesian authors, there is a certain degree of coherence among them. The few pieces that exist -- by well-known Post Keynesians such as Joan Robinson, Luigi Pasinetti, Edward Nell, and Alfred Eichner -- fit, like a puzzle, with the rest of Post Keynesian theory. These pieces must however also be tied to the work of various Institutionalists, social economists, marketing specialists, and even dissident mainstreamers.

The common ground of Post Keynesian consumer theory can be presented under the form of six principles (Lavoie 1994). They are:

- (i) The principle of procedural rationality;

- (ii) The principle of satiable needs;
- (iii) The principle of separability of needs;
- (iv) The principle of subordination of needs;
- (v) The principle of the growth of needs;
- (vi) The principle of non-independence.

The principle of *procedural rationality* asserts that agents lack perfect knowledge and the ability to process a large amount of information. Agents devise means to avoid complex calculations and considerations, and procedures enabling decisions to be taken despite incomplete information. These means and procedures include rules of thumb, the acceptance of social conventions, and reliance on the hopefully better informed opinion of others. Seen from the perspective of neoclassical substantive rationality, procedural rationality may seem to be *ad hocery*, but procedural responses are the only sensible answer to an environment characterized by bounded knowledge and computational capabilities, time constraints and fundamental uncertainty. It could also be called the principle of *reasonable rationality* [see the entries on *Non-ergodicity* and *Risk and uncertainty*].

In the case of consumer behaviour, it has long been established by marketing specialists that consumer choice usually involves very simple procedures (Earl, 1986, p.58). Very often there is no decision process to speak of: purchases are made on recommendations, in conformity to social norms, with the consideration of few alternatives, and on the basis of few criteria. Some of the procedures that we follow are conscious -- we may then speak of rules or conventions **B** while others are unconscious; we may refer to them as habits or routines, as in the case of a large part of our repetitive spending on non-durable consumption goods.

The second principle, that of *satiable needs*, can be likened to the neoclassical principle of diminishing marginal utility, but it takes a particular meaning in the Post Keynesian theory of the consumer. Here satiation arises with positive prices and finite income. There are threshold levels of consumption beyond which a good, or its characteristics, bring no satisfaction to its consumer. Beyond the threshold, no more of the good will be purchased, regardless of its price.

One has to carefully distinguish wants from needs, as do Lutz and Lux (1979). There is a hierarchy of needs, where some are more basic than others, which implies that they must be fulfilled in priority. In that sense all needs are not equal. Some needs are bound to be satiated much earlier than others. Needs are subject to a hierarchic classification and are the motor of consumer behaviour. By contrast, wants evolve from needs. They can be substituted for each other and constitute **A**the various preferences within a common category or level of need@ (Lutz and Lux, 1979, p.21). This leads to the next two principles of a Post Keynesian consumer theory.

The principle of the *separability of needs* asserts that categories of needs or of expenditures can be distinguished from each other. In the case discussed by Kevin Lancaster, with goods described by a matrix of consumption technology with various characteristics, a separate need will be associated with a submatrix of goods and characteristics arising out of a decomposable matrix. The principle of the separability of needs is illustrated by the widely-used econometric models of consumer demand, which assume that broad categories of expenditures enter separately into the overall utility function. In the utility-tree approach, the principle of separability is pushed one step further, since these broad categories

of expenditures are further subdivided into several branches.

The separability of needs allows the consumer to divide the decision-making process into a series of smaller multi-stage decisions. The consumer first makes an allocation of his budget among needs, and then spends that allocation among the various wants or subgroups of each need, independently of what happens for the other needs. Changes in the relative prices of goods within a given category of wants will have no effect on the budget allocation between various needs, while a fall in the overall price of a group of goods corresponding to a given need will have repercussions on the budget allocation of all needs. The principle of the separability of needs imposes substantial restrictions on the neoclassical principle of price substitution, since separability limits severely the degree of substitutability between goods in different groups. Indeed, a substantial amount of empirical evidence shows that general categories of consumption expenditures have quite negligible own-price elasticities and cross-elasticities.

Further restraints may be added if one goes beyond the principle of separability of needs, by introducing a fourth principle, the principle of the *subordination of needs*. With this principle, utility cannot be represented by a unique catch-all utility measure; it can only be represented by a vector. The principle of the subordination of needs is often associated with the notion of a *pyramid* of needs -- a *hierarchy* of needs -- as described by the humanistic school of psychology (Lutz and Lux 1979). The integration of the principles of separability and subordination leads to Nicholas Georgescu-Roegen's principle of *irreducibility*. Needs are irreducible.

In the case of utility-tree analysis, the first-stage budgeting problem is resolved by assuming that money is allocated first to necessities and then to discretionary needs. There is no substitution between the budget categories apportioned to necessary needs and discretionary ones. All the principles previously invoked culminate in this hierarchy: needs are separable and the most basic needs are first taken care of in their order of priority, until they are satiated at some threshold level.

There have been some formal representations of the above principles. Hierarchical behaviour is known under the name of lexicographic preference ordering, owing to its similarity with searching for a word in a dictionary. Strict lexicographic ordering however is unlikely, and more sophisticated lexicographic approaches have been suggested, with consumers setting targets and threshold, i.e., with the addition of the first principle of Post Keynesian consumer theory, that of satiation (Earl 1986). These non-compensatory ordering schemes are not only reasonable but also compatible with procedural rationality, since a complete utility map is not required. Decisions about the most basic needs can be taken quite independently of the informational requirements of the higher needs. Consumers need know nothing whatsoever about the prices of the goods that are part of the higher needs, and they need not rank alternatives which they cannot attain or which are beyond their satiation levels (Drakopoulos 1994).

Neoclassical authors deny that needs are subject to the principle of subordination. This, it must be presumed, is mainly due to the devastating consequences of the irreducibility of needs for neoclassical theory and its substitution principle. Irreducible needs imply that they are incommensurable and therefore that everything does not have a price. A trade-off is not always possible. The axiom of Archimedes, so popular with choice theorists, does not hold any more (Earl, 1986, p.249), and nor does the axiom of gross substitution (Eichner, 1987, p.632), so often invoked among general equilibrium theorists. This reinforces the arguments of Paul Davidson against the use of such an axiom in macroeconomics.

Having assumed that indeed there exists a hierarchy of needs, how do consumers move up the steps of the pyramid? The basic answer is that individuals move upwards in the hierarchy due to income effects.

Beyond the principle of satiation, lies the principle of the *growth of needs* -- our fifth principle.

When a need has been fulfilled, or more precisely when a threshold level for that need has been attained, individuals start attending to the needs which are situated on a higher plane. There are always new needs to be fulfilled. If they do not yet exist, consumers will create them through innovation, but this may take time (Gualerzi 1998). Needs, however, often require income to be satisfied. To go from one level of need to another dictates an increase in the real income level of the individual. The fulfilment of new needs, and therefore the purchase of new goods or new services, is thus related to income effects. This is the microeconomic counterpart of the Post Keynesian focus on effective demand, that is, on macroeconomic income effects. What is being asserted is that income effects are much more important in explaining the evolution of expenditure on goods than are substitution effects. The latter play only a minor role in a static analysis of consumer behaviour, when similar goods or goods fulfilling the same wants are being considered. Indeed, changes in relative prices have an impact on budget allocation between needs only in so far as they have an impact on real income.

The sixth and last principle is the principle of *non-independence*. The emphasis of traditional theory on substitution effects also has led to the neglect of the learning process in consumption theory. How do consumers rank their new spending opportunities? How do they learn to spend their additional spending power? Consumers watch and copy other consumers. Preferences are not innate, they are acquired by experience and by imitation of the consumption pattern of friends or of people of higher ranks in the consumers' hierarchy. Fads leading to large sales of specific products reaction are thus explained by the informational content of consumption by neighbours, relatives, friends or acquaintances. The impact of socio-economic contact on purchases reinforces the belief that the composition of demand depends on socio-economic classes. Decisions and preferences are not made independently of those of other agents. A household's pattern of consumption will reflect the lifestyle of the other households that constitute its social reference group. Marketing officers, through publicity, will attempt to make sure that households follow the appropriate lifestyle.

Two of the main consequences of this Post Keynesian analysis of consumer choice may now be noted. First, macroeconomic models based on the analysis of income classes and on income effects are a legitimate outgrowth of a Post Keynesian theory of the consumer where price substitution effects are not important or severely constrained to goods which respond to similar characteristics, and where increases or changes in demand are mostly determined by increases in real incomes or changes in consumer preferences. Second, the Post Keynesian theory of consumption, based on the hierarchical nature of needs, is also reminiscent of the classical distinction between necessities and luxury goods and of the Sraffian distinction between basic and non-basic commodities [see the entry *Sraffian economics*]. Under these circumstances, to ignore substitution effects, based on relative prices, appears to be much less disastrous than to ignore income effects and threshold levels.

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