DEPARTMENT OF COMMERCE
D.B. COLLEGE, JAYNAGAR
LALIT NARAYANA MITHILA UNIVERSITY, DARBHANGA (BIHAR)

BY: DR. SHAILESH KR. SINGH
ASSISTANT PROFESSOR (GUEST)

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CORE CONCEPT OF

BUSINESS ECONOMICS & ENVIRONMENT

1. What is Concept of Life Cycle Theory of Consumption?
2. Point out the Permanent Income Theory of Consumption.
3. Briefly explain the Cardinal Vs. Ordinal Utility Approach.
4. Illustrate the Cardinal Utility**?**
5. What is Ordinal Utility?

Life Cycle Theory of Consumption

An important post-Keynesian theory of consumption has been put forward by Modigliani and Ando which is known as life cycle theory. According to life cycle theory, the consumption in any period is not the function of current income of that period but of the whole lifetime expected income. Thus, in life cycle hypothesis the individual is assumed to plan a pattern of consumption expenditure based on expected income in their entire lifetime. It is further assumed that individual maintains a more or less constant or slightly increasing level of consumption.

However, this level of consumption is limited by his expectations of lifetime income. A typical individual in this theory in his early years of life spends on consumption either by borrowing from others or spending the assets bequeathed from his parents. It is in his main working years of his lifetime that he consumes less than the income he earns and therefore makes net positive savings. He invests these savings in assets, that is, accumulates wealth which he consumes in the future years. In his lifetime after retirement he again dis-saves, that is, consumes more than his income in these later years of his life but is able to maintain or even slightly increase his consumption in the lifetime after retirement.

Permanent Income Theory of Consumption: Permanent income theory of consumers' behaviour has been put forward by a well-known American economist, Milton Friedman. Though Friedman's permanent income hypothesis differs from life cycle consumption theory in details, it has important common features with the latter. Like the life cycle approach, according to Friedman, consumption is determined by long-term expected income rather than current level of income.

It is this long-term expected income which is called by Friedman as permanent income on the basis of which people make their consumption plans. To make his point clear, Friedman gives an example which is worth quoting. According to Friedman, an individual who is paid or receives income only once a week, say on Friday, he would not concentrate his consumption on one day with zero consumption on all other days of the week.

Cardinal Vs. Ordinal Utility Approach

Utility refers to the satisfaction that a consumer obtains from the purchase and use of commodities and services. According to economics there are two theories that are able to measure the satisfaction of individuals. These are the cardinal utility theory and the ordinal utility theory. There are a number of differences between the two in the methodologies that they use to measure consumption satisfaction. The article that follows offers a clear explanation on each type of theory and highlights the main differences between cardinal utility and ordinal utility.

Cardinal Utility- Cardinal utility states that the satisfaction the consumer derives by consuming goods and services can be measured with numbers. Cardinal utility is measured in terms of *utils* (the units on a scale of utility or satisfaction). According to cardinal utility the goods and services that are able to derive a higher level of satisfaction to the customer will be assigned higher utils and goods that result in a lower level of satisfaction will be assigned lower utils. Cardinal utility is a quantitative method that is used to measure consumption satisfaction.

Ordinal Utility- Ordinal utility states that the satisfaction the consumer derives from the consumption of goods and services cannot be measured in numbers. Rather, ordinal utility uses a ranking system in which a ranking is provided to the satisfaction that is derived from consumption. According to ordinal utility, the goods and services that offer the customer a higher level of satisfaction will be assigned higher ranks and the opposite for goods and services that offer a lower level of satisfaction. The goods that offer the highest level of satisfaction in consumption will be provided the highest rank. Ordinal utility is a qualitative method that is used to measure consumption satisfaction.