MODULE—II Theory of Employment

Classical Theory of Employment; **Subject Code; P18ECC102**

The classical economists believed that there was always full employment in the economy. In case of unemployment, a general cut in money wages would take the economy to the full employment level. This argument is based on the assumption that there is a direct and proportional relation between money wages and real wages.

Principles of Classical Theory of Employment:

The classical theory of employment is based on the following principles:

(1) Say's Law of Market.

(2) Equilibrium in the Labor Market.

(3) Classical Analysis of Price and Inflation.

The J. B. Say's Law of Market: Proposition, Implication

Say's law of markets is the core of the classical theory of employment. An early 19th century French Economist, J.B. Say, enunciated the proposition that "supply creates its own demand." Therefore, there cannot be general overproduction and the problem of unemployment in the economy.

On the other hand, if there is general overproduction in the economy, then some labourers may be asked to leave their jobs. There may be the problem of unemployment in the economy for some time. In the long-run, the economy will automatically tend toward full employment.

In Say's words, "It is production which creates markets for goods. A product is no sooner created than it, from that instant, affords a market for other products to the full extent of its own value. Nothing is more favorable to the demand of one product, than the supply of another." This definition explains the following important facts about the law.

Production Creates Market (Demand) for Goods:

When producers obtain the various inputs to be used in the production process, they generate the necessary income. For example, producers give wages to labourers for producing goods. The labourers will purchase the goods from the market for their own use. This, in turn, causes the demand for goods produced. In this way, supply creates its own demand.

Barter System as its Basis:

Say’s law, in a very broad way, is, as Prof. Hansen has said, “a description of a free-exchange economy. So conceived, it illuminates the truth that the main source of demand is the flow of factor income generated from the process of production itself. Thus, the existence of money does not alter the basic law.

General Overproduction Impossible:

J.S. Mill supported Say’s views regarding the impossibility of general overproduction and general unemployment. According to him, Say’s law of markets does not consider the possibility of general overproduction and also rejects the possibility of decrease in the demand of goods produced in the economy. By employing more factors of production, there is an increase in the level of employment and therefore profits are maximized.

Saving-Investment Equality:

Income accruing to the factor owners in the form of rent, wages and interest is not spent on consumption but some proportion out of it is saved which is automatically invested for further production. Therefore, investment in production is a saving which helps to create demand for goods in the market. Further, saving-investment equality is maintained to avoid general overproduction.

Rate of Interest as a Determinant Factor:

Say’s law of markets regards the rate of interest as a determinant factor in maintaining the equality between saving and investment. If there is any divergence between the two, the equality is maintained through the mechanism of the rate of interest.

Labour Market:

Prof. Pigou formulated Say's law in terms of labour market. By giving minimum wages to labourers, according to Pigou, more labourers can be employed. In this way, there will be more demand for labour. As pointed out by Pigou, "with perfectly free competition…there will always be at work a strong tendency for wage rates to be so related to demand that everybody is employed."

Propositions and Implications of the Law:

Say's propositions and its implications present the true picture of the market law.

These are given below:

1. Full Employment in the Economy:

The law is based on the proposition that there is full employment in the economy. Increase in production means more employment to the factors of production. Production continues to increase until the level of full employment is reached. Under such a situation, the level of production will be maximum.

2. Proper Utilization of Resources:

If there is full employment in the economy, idle resources will be properly utilized which will further help to produce more and also generate more income.

3. Perfect Competition:

Say's law of market is based on the proposition of perfect competition in labour and product markets.

Other conditions of perfect competition are given below:

(a) Size of the Market:

According to Say's law, the size of the market is large enough to create demand for goods. Moreover, the size of the market is also influenced by the forces of demand and supply of various inputs.

(b) Automatic Adjustment Mechanism:

The law is based on this proposition that there is automatic and self-adjusting mechanism in different markets. Disequilibrium in any market is a temporary situation. For example, in capital market, the equality between saving and investment is maintained by the rate of interest while in the labour market the adjustment between demand and supply of labour is maintained by the wage rate.

(c) Role of Money as Neutral:

The law is based on the proposition of a barter system where goods are exchanged for goods. But it is also assumed that the role of money is neutral. Money does not affect the production process.

4. Laissez-faire Policy:

The law assumes a closed capitalist economy which follows the policy of laissez-faire. The policy of laissez-faire is essential for an automatic and self-adjusting process of full employment equilibrium.

5. Saving as a Social Virtue:

All factor income is spent in buying goods which they help to produce. Whatever is saved is automatically invested for further production. In other words, saving is a social virtue.

Assumptions of the Say's Law of Market:

The classical model is based mainly on the following four assumptions:

(1) Pure competition exists. No single buyer or seller of commodity or an input can affect its price.

(2) Wages and prices are flexible. The wages and prices of goods are free to move to whatever level the supply and demand dictate.

(3) Self-interest. People are motivated by self-interest. The businessmen want to maximize their profits and the households want to maximize their economic wellbeing.

(4) No government interference. There is no necessity on the part of the government to intervene in the business matters.

Diagram/Figure:

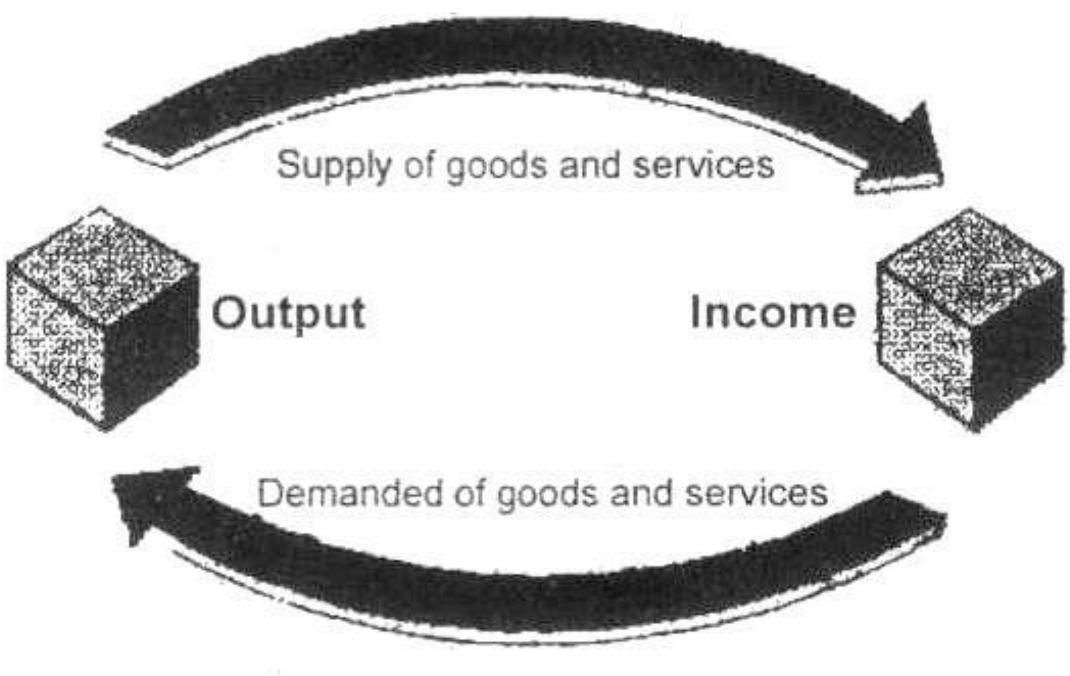

Fig: 32.1

Say's Law is explained with the help of simplified circular flow in figure 32.1. Says Law means that supply creates its own demand for goods and services. The income persons receive from output is spent to purchase goods and services produced by others. The very act of supplying certain level of goods and services necessarily equals the level of goods and services demanded. For the economy as a whole, total production therefore equals total income.

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(2) Equilibrium in the Labor Market:

Another feature of the classical theory of employment is in its belief that that if real wages of the workers are flexible in the labor market, then the economic system automatically adjusts itself at the level of full employment. According to **A. C. Pigou:**

"The equilibrium level of employment is determined by the demand for and supply of labor in the labor market. So far the demand for labor is concerned, it is the decreasing function of higher wages. This means that at higher wages, the firms will employ less units of workers. As the real wage rates fall, then more units of workers are demanded by the firms".

As regards the supply of labor, it is the increasing functions of real wages. This means that at higher wage rates, more workers will be willing to work. The equilibrium level of employment which is the full employment level is determined by the equation of demand for and supply of labor. The classical theory of employment is now explained with the help of diagram.

Diagram/Figure:

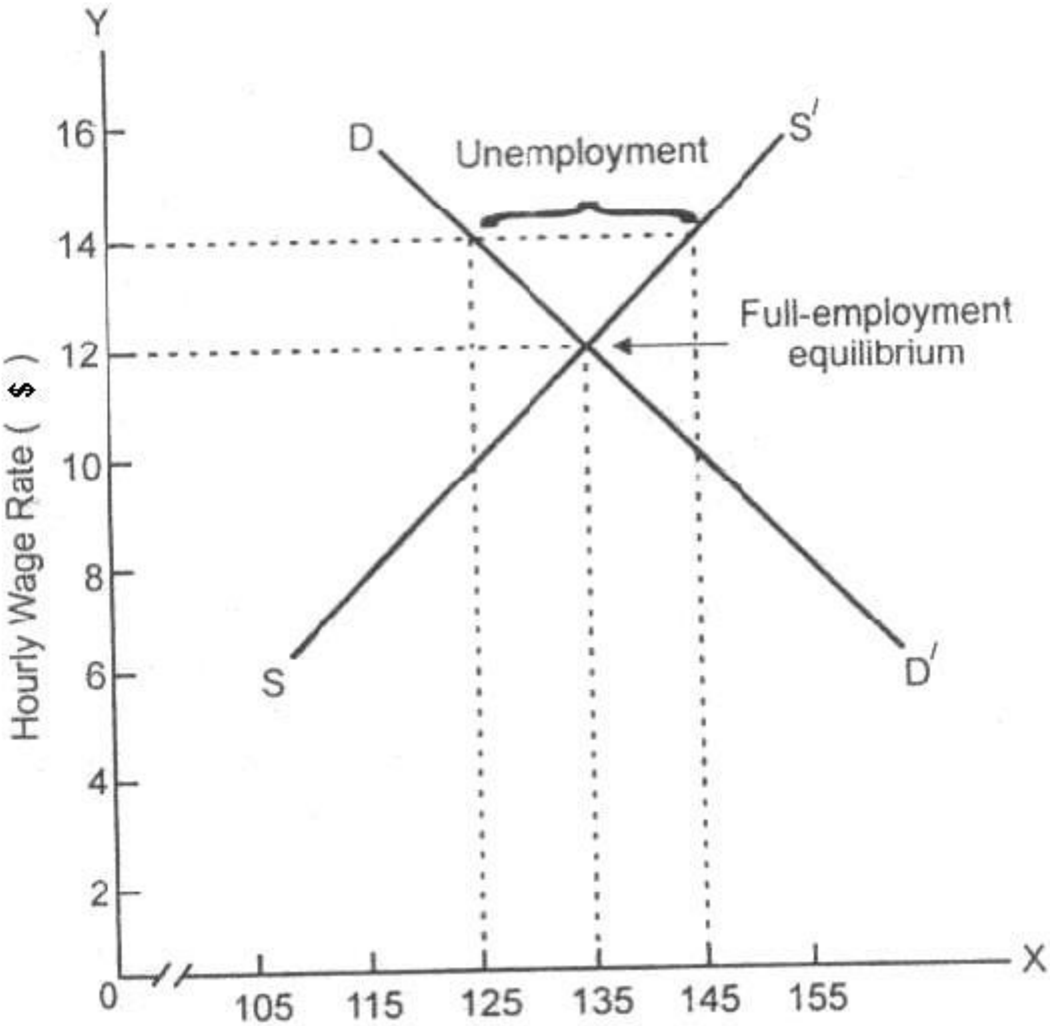

Fig: 32.2

In the Fig. 32.2, the labor demand curve DD/ shows the total quantity of workers that firms plan to hire at each possible real wage rates. The labor supply curve SS/ shows the total quantity of workers that households plan to supply at each possible wage rate. The labor demand curve DD/ and the labor supply curve SS/ interact to determine the level of employment.

(3) Classical Analysis of Prices and Inflation:

The classical economists were of the view also that price level (P) in the economy is dependent upon the supply of money (M) in the country. The greater the quantity of money, the higher is the price level and vice versa. This analysis of price level was based on the Quantity Theory of Money, which in brief rates that price level (P) is directly related to the quantity of money in circulation in the economy (M).

Keynes Criticism on Say's Law:

The law of J.B. Say was finally falsified and laid to rest with the writings of Lord J.M. Keynes. He in his book, 'General Theory', has severally criticized the Say's Law on the following grounds:

(1) Possibility of deficiency of effective demand. According to Keynes, the classical theory based on Say's Law is unreal. In a competitive market, he says, it is not necessary that all income earned is automatically spent on consumption and investment. A part of income may be saved and may go to increase individual holdings. There may, thus, appear a deficiency in aggregate demand causing overproduction and unemployment in the country.

(2) Pigou's view on wage cuts. Keynes criticizes Pigou's view that a general cut in real wages in times of depression is a cure for unemployment. Keynes is of the opinion that a general cut in real wages may reduce the aggregate demand for goods and deepen depression.

(3) Not a general theory. The Say's Law assumes that micro economic analysis can profitably by applied to the economy as a whole. Keynes rejects this view and says that for the explanation of the general theory of income and employment, the macro economic analysis is required.

(4). saving investment equality. Keynes was never convinced of the classical version that interest elasticity can equate savings and investment. According to him, it is the income and not the rate of interest which is the equilibrium, force between saving and investment.

(5) Monopoly element. Say's Law assumes perfect competition in the economy. Keynes says it is the imperfect competition which in practice prevails in the product and factor markets. The Say's Law is therefore, not operative.

(6). Role of trade unions. In the contemporary capitalist world, the trade unions bargain with the employers for the fixation of wages. The state also fixes minimum wages in certain industries. The classical theory did not attach much importance to these forces and relied more on the theoretical; aspect, J.M. Keynes emphasizes more on the practical side of the theory of employment. In the words of Dillard" the great fault of the classical theory is its irrelevance to conditions in the contemporary capitalist world. In capitalistic economy where widespread unemployment, business cycles, inflation, and other forms of instability constitute the chief problems of public policy, the basic need is for a theory that will diagnose these ills in a manner which will furnish a guide to action for their solution or alleviation. Such a new and more relevant theory has emerged in Keynes General Theory of Employment, Interest and Money.

(7) Short run economics. Keynes rejects Says Law that aggregate demand will always be sufficient to buy what is supplied in the long run. Keynes remarks that "In the long run we are all dead". The length of long run is not clear in Say's Law.

The Principle of Effective Demand: Aggregate Demand and Aggregate Supply

Introduction:

The logical starting point of Keynes's theory of employment is the principle of effective demand.

In a capitalist economy, the level of employment depends on effective demand. Thus unemployment results from a deficiency of effective demand and the level of employment can be raised by increasing the level of effective demand.

1. Effective Demand:

In ordinary parlance, demand means desire. It becomes effective when income is spent in buying consumption goods and investment goods. Keynes used the term 'effective demand' to denote the total demand for goods and services at various levels of employment. Different levels of employment represent different levels of aggregate demand. But there can be a level of employment where aggregate demand equals aggregate supply.

This is the point of effective demand. In Keynes's words, "The value of D (Aggregate Demand) at the point of Aggregate Demand function, where it is intersected by the Aggregate Supply function, will be called the effective demand." Thus according to Keynes, the level of employment is determined by effective demand which, in turn, is determined by aggregate demand price and aggregate supply price.

Aggregate Demand Price:

"The aggregate demand price for the output of any given amount of employment is the total sum of money or proceeds, which is expected from the sale of the output produced when that amount of labour is employed."

Thus the aggregate demand price is the amount of money which the entrepreneurs expect to get by selling the output produced by the number of men employed. In other words, it refers to the expected revenue from the sale of output produced at a particular level of employment. Different aggregate demand prices relate to different levels of employment in the economy.

"The aggregate demand function," according to Keynes, "relates any given level of employment to the expected proceeds from that level of employment."

Table I shows the aggregate demand schedule.

The table reveals that with the increase in the level of employment proceeds expected rise and at lower levels of employment decline. When 45 lakh people are provided employment the aggregate demand price is Rs 280 cores and when 25 lakh people are provided jobs, it is Rs 240 cores. According to Keynes, the aggregate demand function is an increasing function of the level of employment and is expressed as D

= F (AO, where D is the proceeds which entrepreneurs expect from the employment of N men.

The aggregate demand curve can be drawn on the basis of the above schedule. It slopes upward from left to right because as the level of employment increases aggregate demand price also rises, shown as AD curve in Figure 1.

Table I: Aggregate Demand Schedule

L ve.' of Employment(N) (in Lakhs)	*Aggregate Demand Price(D)* (Rs Crores)
20	230
25	240
30	250
35	260
40	270
45	280
50	290

Aggregate Supply Price:

When an entrepreneur gives employment to certain amount of labour, it requires certain quantities of co-operant factors like land, capital, raw materials, etc. which will be paid remuneration along with labour. Thus each level of employment involves certain money costs of production including normal profits which the entrepreneur must cover.

"At any given level of employment of labour aggregate supply price is the total amount of money which all the entrepreneurs in the economy, taken together, must expect to receive from the sale of the output produced by that given number of men, if it is to be just worth employing them."

Table II shows the aggregate supply schedule;

Table II: Aggregate Supply Schedule

Level of Employment(N) (in lakhs)	*Aggregate Supply Price(Z)* (Rs crores)
20	215
25	230
30	245
35	260
40	275
40	290
40	305

The above table reveals that the aggregate supply price rises with the increase in the level of employment. If entrepreneurs are to provide employment to 20 lakh workers, they must receive Rs 215 crores from the sale of the output produced by them.

Determination of Effective Demand:

Two determinants of effective demand separately and now are in a position to analyse the process of determining the level of employment in the economy. The level of employment is determined at the point where the aggregate demand price equals the aggregate supply price.

So long as the aggregate demand price is higher than the aggregate supply price, the prospects of getting additional profits are greater when more workers are provided employment. The proceeds expected (revenue) rise more than the proceeds necessary (costs).

This process will continue till the aggregate demand price equals the aggregate supply price and the point of effective demand are reached. This point determines the level of employment and output in the economy. The point of effective demand is, however, not necessarily one of full employment but of underemployment equilibrium.

Two determinants of effective demand, Keynes regards the aggregate supply function to be given because it depends on the technical conditions of production, the availability of raw materials, machines etc. which do not change in the short run.

It is, therefore, the aggregate demand function which plays a vital role in determining the level of employment in the economy. According to Keynes, the aggregate demand function depends on the consumption function and investment function.

The cause of unemployment may be a fall in either consumption expenditure or investment expenditure, or both. The level of employment can be raised by increasing either consumption expenditure or investment expenditure, or both. Thus, it is the aggregate demand function which is the “effective” element in the principle of effective demand. Prof. Dillard regards this as the core of the principle of effective demand.

Table III shows that so long as the aggregate demand price is higher than the aggregate supply price, it is profitable for entrepreneurs to employ more workers, when they expect to receive Rs 230 crores, Rs 240 crores and Rs 250 crores than the proceeds necessary amounting to Rs 215 crores, Rs 230 crores and Rs 245 crores, they will provide increasing employment to 20 lakh, 25 lakh and 30 lakh workers respectively.

Table III: Schedule of Aggregate Demand and Aggregate Supply Prices

Level of Employment(N) (in lakhs)	*Aggregate supply Price(Z)* (Rs crores)	*Aggregate Demand Price(D)* (Rs crores)	
		Old	New
20	215	230	235
25	230	240	245
30	245	250	255
35	260	260	265
40	275	270	275
40	290	280	285
40	305	290	295

Figure 1 illustrates the determination of effective demand where AD is the aggregate demand function and AS the aggregate supply function. The horizontal axis measures the level of employment in the economy and the vertical axis the proceeds expected (revenue) and the proceeds necessary (costs).

The two curves AD and AS intersect each other at point E. This is effective demand where ON workers are employed. At this point, the entrepreneurs' expectations of profits are maximised. At any point other than this, the entrepreneurs will either incur losses or earn subnormal profits.

At ON_1 level of employment, the proceeds expected (revenue) are more than the proceeds necessary (costs), i.e., $RN_1 > CN_1$. This indicates that it is profitable for the entrepreneurs to provide increasing employment to workers till ON level is reached where the proceeds expected and necessary equal at point E.

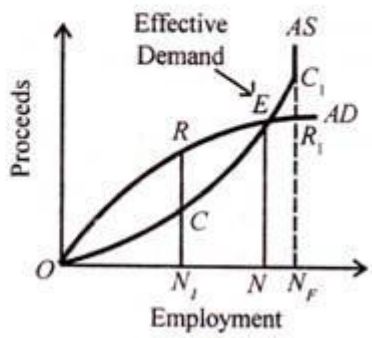

Fig. 1.

It would not be, however, profitable for the entrepreneurs to increase employment beyond this to N_F level because the proceeds necessary (costs) exceed the proceeds expected (revenue), i.e., $C_1N_F > R_1N_F$ and they incur losses. Thus E, the point of effective demand, determines the actual level of employment in the economy which is of underemployment equilibrium.

2. Importance of Effective Demand:

The principle of effective demand is the most important contribution of Keynes. It is the soul of the Keynesian theory of employment. Dr Klein attributes the Keynesian revolution solely to the development of a theory of effective demand.

1. Determinant of Employment:

Effective demand determines the level of employment in the economy. When effective demand increases, employment also increases, and a decline in effective demand decreases the level of employment. Thus unemployment is caused by a deficiency of effective demand.

Effective demand represents the total expenditure on the total output produced at an equilibrium level of employment. It indicates the value of total output which equals national income. National income equals national expenditure. National expenditure consists of expenditure on consumption goods and investment goods.

Thus the main determinants of effective demand and the level of employment are consumption and investment. In brief, Effective Demand = Value of National Output = Volume of Employment = National Income = National Expenditure = Expenditure on consumption goods + Expenditure on investment goods.

2. Repudiation of Say's Law and Full Employment Thesis:

The principle of effective demand repudiates Say's law of markets that supply creates its own demand and that full employment equilibrium is a normal situation in the economy. This principle points out that underemployment equilibrium is a normal situation and full employment equilibrium is accidental.

In a capitalist economy, supply fails to create its own demand because the whole of the earned income is not spent on the consumption of goods and services. Moreover, the decisions to save and invest are made by different people.

The **Pigovian** view that full employment can be achieved by a reduction in money wage-cut is also repudiated by this principle. A money wage-cut will bring about a reduction in expenditure on goods and services leading to a fall in effective demand and hence in the level of employment.

3. Role of Investment:

The principle of effective demand highlights the significant role of investment in determining the level of employment in the economy. The two determinants of effective demand are consumption and investment expenditures. When income increases consumption expenditure also increases but by less than the increase in income.

4. The Paradox of Poverty in the midst of Potential Plenty:

The importance of effective demand lies in explaining the paradox of poverty in the midst of potential plenty in modern capitalism. Effective demand is mainly determined by the aggregate demand function.

A fundamental principle is that when income increases consumption also increases but less than proportionately (i.e., the marginal propensity to consume is less than one). This creates a gap between income and consumption which must be filled up by the required investment expenditure.