JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

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Faculty of Education and Methodology

Faculty Name- JV'n Dr. Md Meraj Alam

Program- BA B.Ed 3rd Semester

Course- Macroeconomics

Digital session name – Classical Theory of Employment

Introduction:

John Maynard Keynes in his General Theory of Employment, Interest and Money published in 1936, made a frontal attack on the classical postulates. He developed a new economics which brought about a revolution in economic thought and policy.

The General Theory was written against the background of classical thought. By the "classicists" Keynes meant "the followers of Ricardo, those, that is to say, who adopted and perfected the theory of Ricardian economics." They included, in particular, J.S. Mill, Marshall and Pigou.

Keynes repudiated traditional and orthodox economics which had been built up over a century and which dominated economic thought and policy before and during the Great Depression. Since the Keynesian Economics is based on the criticism of classical economics, it is necessary to know the latter as embodied in the theory of employment.

The Classical theory of Employment.

The classical economists believed in the existence of full employment in the economy. To them, full employment was a normal situation and any deviation from this regarded as something abnormal. According to Pigou, the tendency of the economic system is to

automatically provide full employment in the labour market when the demand and supply of labour are equal.

Unemployment results from the rigidity in the wage structure and interference in the working of free market system in the form of trade union legislation, minimum wage legislation etc. Full employment exists “when everybody who at the running rate of wages wishes to be employed.”

Those who are not prepared to work at the existing wage rate are not unemployed because they are voluntarily unemployed. Thus full employment is a situation where there is no possibility of involuntary unemployment in the sense that people are prepared to work at the current wage rate but they do not find work.

The basis of the classical theory is Say’s Law of Markets which was carried forward by classical economists like Marshall and Pigou. They explained the determination of output and employment divided into individual markets for labour, goods and money. Each market involves a built-in equilibrium mechanism to ensure full employment in the economy.

Assumptions

The classical theory of output and employment is based on the following assumptions:

- There is the existence of full employment without inflation.
- There is a laissez-faire capitalist economy without government interference.
- It is a closed economy without foreign trade.
- There is perfect competition in labour and product markets.
- Labour is homogeneous.
- Total output of the economy is divided between consumption and investment expenditures.
- The quantity of money is given and money is only the medium of exchange.
- Wages and prices are perfectly flexible.
- There is perfect information on the part of all market participants.
- Money wages and real wages are directly related and proportional.
- Savings are automatically invested and equality between the two is brought about by the rate of interest
- Capital stock and technical knowledge are given.

- The law of diminishing returns operates in production.
- It assumes long run.

Explanations of the theory

The determination of output and employment in the classical theory occurs in labour, goods and money markets in the economy.

Say's Law of Markets:

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.

If there is general overproduction in the economy, then some labourers may be asked to leave their jobs. The problem of unemployment arises in the economy in the short run. In the long run, the economy will automatically tend toward full employment when the demand and supply of goods become equal.

When a producer produces goods and pays wages to workers, the workers, in turn, buy those goods in the market. Thus the very act of supplying (producing) goods implies a demand for them. It is in this way that supply creates its own demand.

Determination of Output and Employment:

In the classical theory, output and employment are determined by the production function and the demand for labour and the supply of labour in the economy. Given the capital stock, technical knowledge and other factors, a precise relation exists between total output and amount of employment, i.e., number of workers. This is shown in the form of the following production function: Q=f (K, T, N)

where total output (Q) is a function (f) of capital stock (K), technical knowledge (T), and the number of workers (N)

Given K and T, the production function becomes Q = f (AO which shows that output is a function of the number of workers. Output is an increasing function of the number of workers, output increases as the employment of labour rises. But after a point when more workers are employed, diminishing marginal returns to labour start.

This is shown in Fig. 1 where the curve Q = f (N) is the production function and the total output OQ_1 corresponds to the full employment level N_F. But when more workers N_fN_2 are

employed beyond the full employment level of output OQ_1, the increase in output Q_1Q_2 is less than the increase in employment N_1N_2.

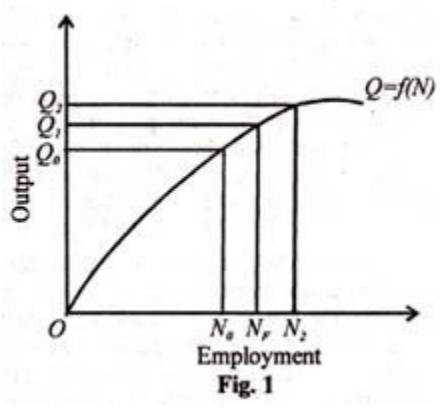

Fig. 1

Source: Internet

Labour Market Equilibrium:

In the labour market, the demand for labour and the supply of labour determine the level of output and employment. The classical economists regard the demand for labour as the function of the real wage rate: $D_N = f(W/P)$

Where D_N = demand for labour, W = wage rate and P = price level. Dividing wage rate (W) by price level (P), we get the real wage rate (W/P).

The demand for labour is a decreasing function of the real wage rate, as shown by the downward sloping D_N curve in Fig. 2. It is by reducing the real wage rate that more workers can be employed.

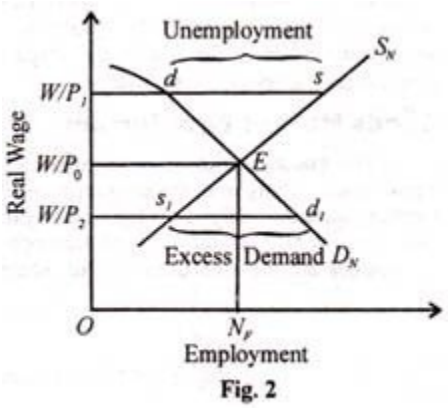

Fig. 2

Source: Internet

The supply of labour also depends on the real wage rate: $S_N = f(W/P)$, where S_N is the supply of labour. But it is an increasing function of the real wage rate, as shown by the upward sloping S_N curve in Fig. 2. It is by increasing the real wage rate that more workers can be employed.

When the D_N and S_N curves intersect at point E, the full employment level N_F is determined at the equilibrium real wage rate W/P_0. If the wage rate rises from WP_0 to WP_1 the supply of labour will be more than its demand by ds.

Now at W/P_1 wage rate, ds workers will be involuntary unemployed because the demand for labour (W/P_1-d) is less than their supply (W/P_1-s). With competition among workers for work, they will be willing to accept a lower wage rate. Consequently, the wage rate will fall from W/P_1 to W/P_0.

The supply of labour will fall and the demand for labour will rise and the equilibrium point E will be restored along with the full employment level N_r On the contrary, if the wage rate falls from W/P_0 to WP_2 the demand for labour (W/P_2-d_1) will be more than its supply (W/P_2-s_1). Competition by employers for workers will raise the wage rate from W/P_2 to W/P_0 and the equilibrium point E will be restored along with the full employment level N_F.

Wage Price Flexibility:

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.

When money wages are reduced, they lead to reduction in cost of production and consequently to the lower prices of products. When prices fall, demand for products will increase and sales will be pushed up. Increased sales will necessitate the employment of more labour and ultimately full employment will be attained.

Pigou explains the entire proposition in the equation: $N = qY/W$. In this equation, N is the number of workers employed, q is the fraction of income earned as wages, Y is the national income and W is the money wage rate. N can be increased by a reduction in W. Thus the key

to full employment is a reduction in money wage. When prices fall with the reduction of money wage, real wage is also reduced in the same proportion.

As explained above, the demand for labour is a decreasing function of the real wage rate. If W is the money wage rate, P is the price of the product, and MP_N is the marginal product of labour, we have $W=P \times MP_N$ or $W/P = MP_N$

Since MP_N declines as employment increases, it follows that the level of employment increases as the real wage (W/P) declines. This is explained in Figure 3. In Panel (A), S_N is the supply curve of labour and D_N is the demand curve for labour. The intersection of the two curves at E shows the level of full employment N_F and the real wage W/P_0.

If the real wage rises to W/P_1, supply exceeds the demand for labour by sd and N_1N_2 workers are unemployed. It is only when the wage is reduced to W/P_0 that unemployment disappears and the level of full employment is attained.

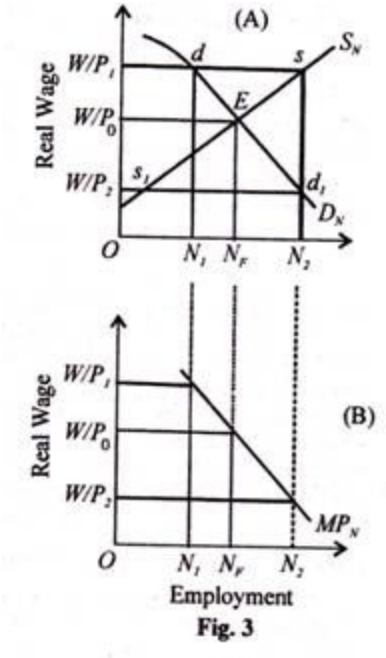

Fig. 3

Source: Internet

This is shown in Panel (B), where MP_N is the marginal product of labour curve which slopes downward as more labour is employed. Since every worker is paid wages equal to his marginal product, therefore the full employment level N_F is reached when the wage rate falls from W/P_1 to W/P_0. Contrariwise, with the fall in the wage from W/P_0 to W/P_2, the demand

for labour increases more than its supply by s_1d_1, the workers demand higher wage. This leads to the rise in the wage from W/P_2 to W/P_0 and the full employment level N_F is attained.

Goods Market Equilibrium:

The goods market is in equilibrium when saving equals investment. At that point of time, total demand equals total supply and the economy is in a state of full employment. According to the classicists, what is not spent is automatically invested.

Thus saving must equal investment. If there is any divergence between the two, the equality is maintained through the mechanism of the rate of interest. To them, both saving and investment are the functions of the interest rate.

$S=f(r)$ …(1)

$I=f(r)$ …(2)

$S = I$

Where S = saving, I = investment, and r = interest rate.

To the classicists, interest is a reward for saving. The higher the rate of interest, the higher the saving, and lower the investment. On the contrary, the lower the rate of interest, the higher the demand for investment funds, and lowers the saving. If at any given period, investment exceeds saving, ($I > S$) the rate of interest will rise.

Saving will increase and investment will decline till the two are equal at the full employment level. This is because saving is regarded as an increasing function of the interest rate and investment as a decreasing function of the rate of interest.

Assuming interest rates are perfectly elastic, the mechanism of the equality between saving and investment is shown in Figure 4 where S is the saving curve and I is the investment curve. Both intersect at E which is the full employment level where at Or interest rate S = I. If the interest rate rises to Or_1 saving is more than investment by ha which will lead to unemployment in the economy.

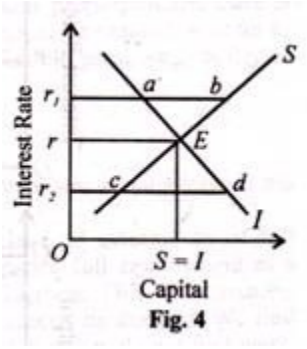

Fig. 4

Source: Internet

Money Market Equilibrium:

The money market equilibrium in the classical theory is based on the Quantity Theory of Money which states that the general price level (P) in the economy depends on the supply of money (M). The equation is MV= PT, where M = supply of money, V= velocity of circulation of M, P = Price level, and T = volume of transaction or total output.

The equation tells that the total money supply MV equals the total value of output PT in the economy. Assuming V and T to be constant, a change in the supply of money (M) causes a proportional change in the price level (P). Thus the price level is a function of the money supply: P = f (M).

The relation between quantity of money, total output and price level is depicted in Figure 5 where the price level is taken on the horizontal axis and the total output on the vertical axis. MV is the money supply curve which is a rectangular hyperbola.

This is because the equation MV = PT holds on all points of this curve. Given the output level OQ, there would be only one price level OP consistent with the quantity of money, as shown by point M on the MV curve. If the quantity of money increases, the MV curve will shift to the right as M_1V curve.

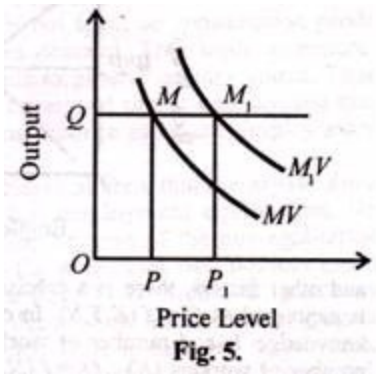

Fig. 5.

Source: Internet

As a result, the price level would rise from OP to OP_1 given the same level of output OQ. This rise in the price level is exactly proportional to the rise in the quantity of money, i.e., $PP_1 = MM_1$ when the full employment level of output remains OQ.