Theory of Employment

Types of Unemployment:

(a) **Structural Unemployment:** It is also known as Marxian unemployment or long-term unemployment. It is due to slower growth of capital stock in the country. The entire labour force cannot be absorbed in productive employment, because there are not enough instruments of production to employ them.

(b) **Seasonal Unemployment:** Seasonal unemployment arises because of the seasonal character of a particular productive activity so that people become unemployed during the slack season. Occupations relating to agriculture, sugar mills, rice mills, ice factories and tourism are seasonal.

(c) **Frictional Unemployment:** It arises when the labour force is temporarily out of work because of perfect mobility on the part of the labour. In a growing and dynamic economy, in which some industries are declining and others are rising and in which people are free to work wherever they wish, some volume of frictional unemployment is bound to exist. This is so because it takes some time for the unemployed labour to learn new trades or to shift to new places, where there is a demand for labour. Thus, frictional unemployment exists when there is unsatisfied demand for labour, but the unemployed workers are either not fit for the jobs in question or not in the right place to meet this demand.

(d) **Cyclical Unemployment:** It is also known as Keynesian unemployment. It is due to deficiency of aggregate effective demand. It occurs when business depression occurs. During the times of depression, business activity is at low ebb and unemployment increases. Some people are thrown out of employment altogether and others are only partially employed. This type of unemployment is due to the fact that the total effective demand of the community is not sufficient to absorb the entire productive of goods that can be produced with the available stock of capital. When the businessmen cannot sell their goods and services, their profit expectations are not fulfilled. So the entrepreneurs reduce their output and some factors of production become unemployed.

(e) **Disguised Unemployment:** Disguised unemployment is the most widespread type of unemployment in under-developed countries. In under-developed countries, the stock of capital does not grow fast. The capital stock has not been growing at a rate fast enough to keep pace with the growth of population, the country's capacity to offer productive employment to the new entrants to the labour market has been severely limited. This manifests itself generally in two ways:

(i) the prevalence of large-scale unemployment in the urban areas; and

(ii) in the form of growing numbers engaged in agriculture, resulting in *'disguised unemployment'*.

In disguised unemployment, there is an existence of a very backward agricultural economy. People are engaged in production with an extremely low or zero marginal productivity. Since the employment opportunities in non-agricultural sector are not sufficient, therefore, most of the workers are bound to work in agricultural sector. This gives rise to the concept of *'disguised unemployment'*, in which people are unwillingly engaged in occupations, where their marginal productivity is very low.

Theories of Employment:

The theories of employment are broadly classified into two:

(a) Classical theory of employment
(b) Keynesian theory of employment.

The classical theory assumed the prevalence of full employment. The 'Great Depression' of 1929 to 1934, engulfing the entire world in widespread unemployment, low output and low national income, for about five years, upset the classical theorists. This gives rise to Keynesian theory of employment.

Classical Theory of Employment:

The term *'classical economists'* was firstly used by Karl Marx to describe economic thought of Ricardo and his predecessors including Adam Smith. However, by *'classical economists'*, Keynes meant the followers of David Ricardo including John Stuart Mill, Alfred Marshal and Pigou. According to Keynes, the term *'classical economics'* refers to the traditional or orthodox principles of economics, which had come to be accepted, by and large, by the well known economists by then. Being the follower of Marshal, Keynes had himself accepted and taught these classical principles. But he repudiated the doctrine of laissez-faire. The two broad features of classical theory of employment were:

(a) The ***assumption of full employment*** of labour and other productive resources, and

(b) The ***flexibility of prices and wages*** to bring about the full employment

(a) Full employment:

According to classical economists, the labour and the other resources are always fully employed. Moreover, the general over-production and general unemployment are assumed to be impossible. If there is any unemployment in the country, it is assumed to be temporary or abnormal. According to classical views of employment, the unemployment cannot be persisted for a long time, and there is always a tendency of full employment in the country. According to classical economists, the reasons for unemployment are:

(i) Intervention by the government or private monopoly,
(ii) Wrong calculation by entrepreneurs and inaccurate decisions, and
(iii) Artificial resistance.

The economy is assumed to be self-adjusting and perfectly competitive economy. It is the economy in which the relative values of goods and services are determined by the general relations of demand and supply. The pricing system serves as the planning mechanism.

(b) Flexibility of prices and wages:

The second assumption of full employment theory is the flexibility of prices and wages. It is the flexibility of prices and wages which automatically brings about full employment. If there is general over-production resulting in depression and unemployment, prices would fall as a result of which demand would increase, prices would rise and productive activity will be stimulated and unemployment would tend to disappear. Similarly, the unemployment could be cured by cutting down wages which would increase the demand for labour and would stimulate activity. Thus, if the prices and wages are allowed to move freely, unemployment would disappear and full employment level would be restored. Further, the classical economists treated money as mere exchange medium. They ignored its role in affecting income, output and employment.

Say's Law:

1. Say's Law is the foundation of classical economics. Assumption of full employment as a normal condition of a free market economy is justified by classical economists by a law known as *'Say's Law of Markets'*.

2. It was the theory on the basis of which classical economists thought that general over-production and general unemployment are not possible.

3. According to the French economist J. B. Say, supply creates its own demand. According to him, it is production which creates market for goods. More of production, more of creating demand for other goods. There can be no problem of over-production.

4. Say denies the possibility of the deficiency of aggregate demand.

5. The conceived Say's Law describes an important fact about the working of free-exchange of economy that the main source of demand is the sum of incomes earned by the various productive factors from the process of production itself. A new productive process, by paying out income to its employed factors, generates demand at the same time that it adds to supply. It is thus production which creates market for goods, or supply creates its own demand not only at the same time but also to an equal extent.

6. According to Say, the aggregate supply of commodities in the economy would be exactly equal to aggregate demand. If there is any deficiency in the demand, it would be temporary and it would be ultimately equal to aggregate supply.

Therefore, the employment of more resources will always be profitable and will take to the point of full employment.

7. According to Say's Law, there will always be a sufficient rate of total spending so as to keep all resources fully employed. Most of the income is spent on consumer goods and a par of it is saved.

8. The classical economists are of the view that all the savings are spent automatically on investment goods. Savings and investments are interchangeable words and are equal to each other.

9. Since saving is another form of spending, according to classical theory, all income is spent partly for consumption and partly for investment.

10. If there is any gap between saving and investment, the rate of interest brings about equality between the two.

Basic Assumptions of Say's Law:

(a) Perfectly competitive market and free exchange economy.

(b) Free flow of money incomes. All the savings must be immediately invested and all the income must be immediately spent.

(c) Savings are equal to investment and equality must bring about by flexible interest rate.

(d) No intervention of government in market operations, i.e., a laissez faire economy, and there is no government expenditure, taxation and subsidies.

(e) Market size is limited by the volume of production and **aggregate demand is equal to aggregate supply.**

(f) It is a **closed economy.**

Pigou's Theory:

1. According to Professor Pigou, the unemployment which exists at any time is because of the fact that changes in demand conditions are continually taking place and that frictional resistances prevent the appropriate wage adjustment from being made instantaneously.

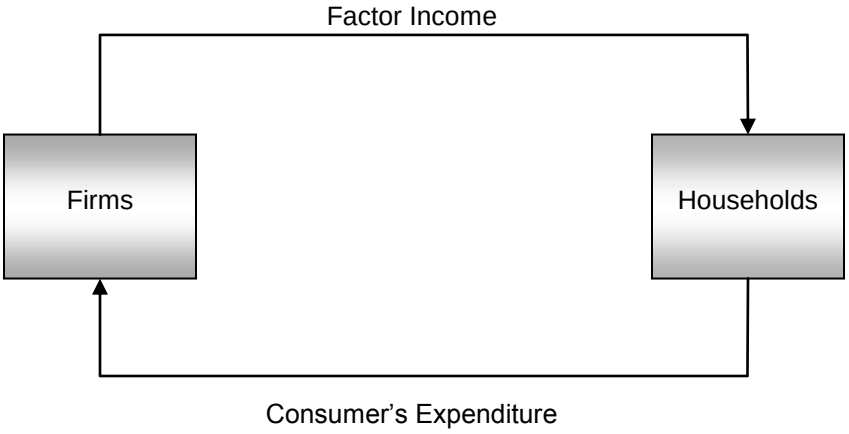
2. Thus, according to classical theory, there could be small amounts of *'frictional unemployment'* attendant on changing from one job to another but there could not be *'involuntary unemployment'* for a long period.

3. According to Professor Pigou, if people were unemployed, wages would fall until all seeking employment were in fact employed.

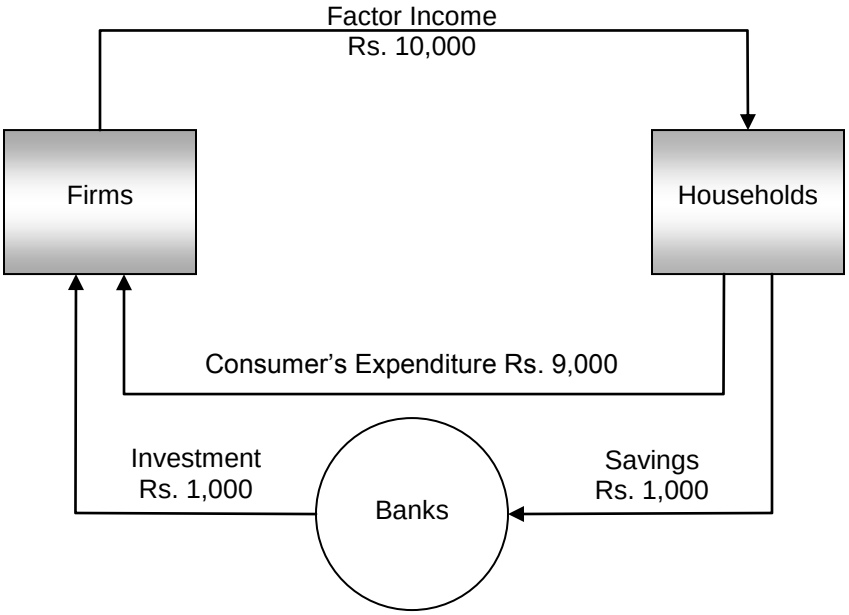
4. Involuntary unemployment which was found at times of depression was because of the fact that wages were kept too high by the actions of labour unions and governments. Therefore, Professor Pigou advocated that a general cut in money wages at a time of depression would increase employment.

5. According to Pigou, perfectly elastic wage policy would abolish fluctuations of employment and would ensure full employment.

6. The of the economy as described by the classical theory is depicted as follows:



Suppose the consumer saves 10% of his income. The result will be firm's receipts fall by the same proportion. Profit will fall and the firm will tend to react by reducing the output and hence reducing the employment and income. Therefore, to avoid this problem the savings are channelled to firms through banking.



Criticism of Classical Theory:

1. ***Supply may not create its own demand*** when a part of the income is saved. Aggregate demand is not always equal to aggregate supply.

2. ***Employment in a country cannot be increased by cutting general wages.***

3. ***There is no direct relationship between wages and employment.***

4. ***Interest rate adjustments cannot solve savings-investment problem.***

5. Classical economists have made the economy completely self-adjusting and self-reliant. ***An economy is not so self-adjusting and government intervention is unobvious.***

6. Classical economists have made the wages and prices so much flexible. ***In practical, wages and prices are not so flexible. It will create chaos in the economy.***

7. ***Money is not a mere medium of exchange.*** It has an essential role in the economy.

8. ***The classical theory has failed to explain the occurrence of trade cycles.***

Keynesian Theory of Employment:

Keynes has strongly criticised the classical theory in his book 'General Theory of Employment, Interest and Money'. His theory of employment is widely accepted by modern economists. Keynesian economics is also known as 'new economics' and *'economic revolution'*. Keynes has invented new tools and techniques of economic analysis such as consumption function, multiplier, marginal efficiency of capital, liquidity preference, effective demand, etc. In the short run, it is assumed by Keynes that capital equipment, population, technical knowledge, and labour efficiency remain constant. That is why, according to Keynesian theory, volume of employment depends on the level of national income and output. Increase in national income would mean increase in employment. The larger the national income the larger the employment level and vice versa. That is why, the theory of Keynes is known as *'theory of employment'* and *'theory of income'*.

Theory of Effective Demand:

According to Keynes, the level of employment in the short run depends on aggregate effective demand for goods in the country. Greater the aggregate effective demand, the greater will be the volume of employment and vice versa. According to Keynes, the unemployment is the result of deficiency of effective demand. Effective demand represents the total money spent on consumption and investment. The equation is:

Effective demand = National Income (Y) = National Output (O)

The deficiency of effective demand is due to the gap between income and consumption. The gap can be filled up by increasing investment and hence effective demand, in order to maintain employment at a high level.

According to Keynes, the level of employment in effective demand depends on two factors:

(a) Aggregate supply function, and

(b) Aggregate demand function.

(a) Aggregate supply function:

1. According to Dillard, the minimum price or proceeds which will induce employment on a given scale, is called the *'aggregate supply price'* of that amount of employment.

2. If the output does not fetch sufficient price so as to cover the cost, the entrepreneurs will employ less number of workers.

3. Therefore, different numbers of workers will be employed at different supply prices.

4. Thus, the aggregate supply price is a schedule of the minimum amount of proceeds required to induce varying quantities of employment.

5. We can have a corresponding aggregate supply price curve or aggregate supply function, which slopes upward to right.

(b) Aggregate demand function:

1. The essence of aggregate demand function is that the greater the number of workers employed, the larger the output. That is, the aggregate demand price increases as the amount of employment increases, and vice versa.

2. The aggregate demand is different from the demand for a product. The aggregate demand price represents the expected receipts when a given volume of employment is offered to workers.

3. The aggregate demand curve or aggregate demand function represents a schedule of the proceeds of the output produced by different methods of employment.

Determination of Equilibrium Level of Employment:

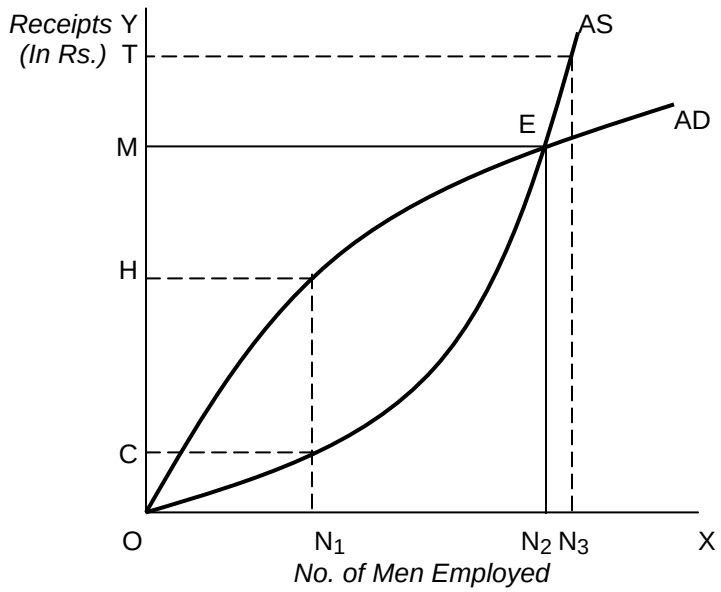


Figure - Determination of Level of Employment

1. In the above diagram, AS curve shows the different total amounts which all the entrepreneurs, taken together, must receive to induce them to employ a certain number of men. If the entrepreneurs are convinced to receive OC amount of money, they will employ ON_1 number of labour.

2. The AD curve shows the different total amounts which all the entrepreneurs, taken together, expect to receive at different levels of employment. If they employed ON_1 level of employment, they expect to receive ON amount of proceeds from the total output.

3. At ON_1 level of employment, the economy is not in equilibrium. Because the total expected amount is greater than the total amount paid:

$$\mathbf{OH > OC}$$

4. The equilibrium level of employment is ON_2, as at this point the AD curve intersects the AS curve or the AD is just equal to AS. The amount of proceeds, i.e., OM which entrepreneurs expect to receive from providing ON_2 number of jobs is just equal to the amount i.e. OM which they must receive if the employment of that number of workers is to be worthwhile for the entrepreneurs.

5. If the situation is such that the total amount of money expected to be received from the sale of output exceeds the amount that is considered necessary to receive, there will be competition among the entrepreneurs to offer more employment and thus, the employment will increase. On the left of N_2, AD is

greater than AS, i.e., the amount expected to be received is greater than the amount considered necessary, there will be competition amount entrepreneurs to employ more labour.

6. Beyond the N_2, the AD curve lies below AS curve, which means that the amount expected by the entrepreneurs is less that the amount they considered necessary to receive. Therefore, the number of persons employed will be reduced in the economy.

7. The slope of AS curve, at first rises slowly and then after a point it rises sharply. It means that at beginning as more and more men are employed, the cost of output rises slowly. But as the amount received by the entrepreneurs increases they employ more and more men. As soon as the entrepreneurs start getting OT amount, they will be prepared to employ all of the workers.

8. The AD curve, in the beginning, rises sharply, but it flattens towards the end. This shows that in the beginning as more men are employed, the entrepreneurs expect to get sharply increasing amounts of money from the sale of the output. But after employment has sufficiently increased, the expected receipts do not rise sharply.

9. Effective demand is that aggregate demand price which becomes 'effective' because it is equal to aggregate supply price and thus represents a position of short-run equilibrium.

10. Effective demand also represents the value of national output because the value of national output is equal to the total amount of money received by the entrepreneurs from the sale of goods and services. The money received by the entrepreneurs from the sale of goods is equal to the money spent by the people on these goods. Hence the equation is:

Effective demand	=	**National income**
	=	**Value of national output**
	=	**National expenditure**
	=	**Expenditure on consumption goods + Expenditure on investment goods**

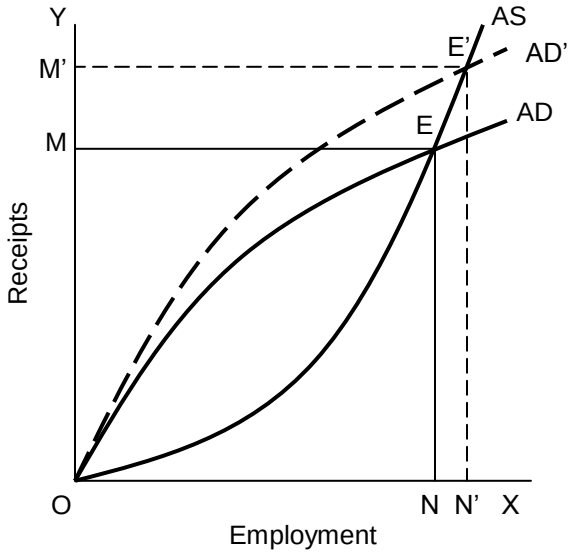
11. It is not necessary that the equilibrium level of employment is always at full employment level. Equality between AD and AS does not necessarily indicate the full employment level. It can be in equilibrium at less that full employment or an under-employment equilibrium.

12. Actually there is always some unemployment in the economy, even in economically advanced countries.

13. According to Keynes, full employment is the level of employment beyond which further increases in effective demand do not increase output and employment.

14. At the point of intersection of AS and AD, the entrepreneurs are maximising their profits. The profit will be reduced if volume of employment is more or less that this point. Even if the point does not represent full employment.

15. AD and AS will be equal at full employment only if the investment demand is sufficient to cover the gap between the AS price and consumption expenditure. The typical investment falls short of this gap. Hence the AD curve and AS curve will intersect at a point less than full employment, unless there is some external change.



16. In the above diagram, in this situation of aggregate supply (AS), ON' number of men were seeking employment, whereas only ON number of men could secure employment.

17. In this situation, the economy has not yet reached the full employment level, and there are still NN' number of workers unemployed in the economy.

18. If the favourable circumstances push the economy and the AD increases so much that the entrepreneurs now find it worthwhile to employ ON' men at the equilibrium point E', where the economy is in full employment level.

19. The situation in which the economy is in equilibrium at the level of full employment is called the 'optimum situation'.

20. The root cause of the under-employment equilibrium is the deficiency of AD. This deficiency is due to the fact that there is a gap between income and consumption. As income increases consumption increases but not

proportionately. If the investment is increased sufficiently to cover this gap, there can be full employment. Hence the gap between income and consumption and insufficiency of investment to this gap are responsible for under-employment equilibrium.

Comparison between Classical and Keynes' Theories:

(a) Equilibrium at full employment:

(i) According to classical theory, the economy can only be in a state of equilibrium at full employment level. Any deviation from full employment would be of short period.

(ii) Keynes' theory is of the viewpoint that an economy can be in equilibrium even at less than full employment level. There is a small possibility of full employment in a country.

(b) Macro vs. Micro:

(i) The classical economic theory dealt with individual aspects of the economy, and relates to microeconomics.

(ii) Keynes' theory relates to macroeconomics which studies the economy as a whole.

(c) Aggregates vs. Innumerable decisions:

(i) The classical economic theory studies the economic system in terms of innumerable decision making units, for example, producers' equilibrium and consumers' equilibrium.

(ii) Whereas, the Keynes' theory deals with aggregates, for example, aggregate supply and aggregate demand.

(d) Wages and employment:

(i) Classical economists believed that a state of full employment could be brought about through cuts in money wages.

(ii) According Keynes, lowering wages will reduce the aggregate income and so effective demand which in turn reduce the level of employment in an economy.

(e) Interest:

(i) According to classical theorists, interest is the reward for 'waiting' or for time preference.

(ii) According to Keynes, interest is a reward for parting with liquidity.

(f) Rate of interest:

(i) According to classical theory, the rate of interest is determined by the interaction of savings and investment.

(ii) According to Keynesian theory, the rate of interest is determined at different levels of income.

(g) Statics vs. Dynamics:

(i) The classical theory is based on the conception of static economy.

(ii) The Keynesian theory is based on the conception of dynamic economy.

(h) Full employment theory vs. General theory:

(i) The classical theory relates only to full employment.

(ii) The Keynesian approach is a general theory which has a very wide application at all situations, i.e., unemployment, partial employment and near full-employment.

(i) Theory of money and prices:

(i) The classical economists had segregated the theory of money from the theory of value and output, and dealt with them as if they are unrelated to one another which is actually not the case.

(ii) Keynes' theory is more realistic. He has integrated the theory of money and prices with the theory of income and employment in the country.

(j) Budgeting:

(i) Classical economists believed in orthodox finance and balanced budgets.

(ii) According to Keynes' a country's budget should reflect the financial situation, and should vary in accordance with the requirements. Keynes has not emphasised on balanced budget, because there are several developing countries with deficit budgets dictated by their economic conditions and requirements.

(k) Supply of money:

(i) According to classical economists, increase in money supply would bring about inflation and should be controlled in order to avoid the employment less than full employment.

(ii) Whereas, the Keynes' theory states that an appropriate increase in money supply would increase employment and output and does not necessarily bring inflation.

(l) General price level vs. Individual commodity prices.

(m) Level of employment in a community vs. Employment of a particular class of labour.

Significance of Keynesian Theory:

1. Keynes has given a new approach, i.e., ***Macro-approach*** to the field of economics. His theory has several names: theory of income and employment, demand-side theory, consumption theory, and macro-economic theory. In fact, he has brought about a revolution in economic analysis, often known as *'Keynesian Revolution'.*

2. Keynes' theory has ***completely demolished the idea of full-employment*** and forwards the idea of under-employment equilibrium. He states that employment level in the economy can only be increased by increasing investment.

3. The ***new economic tools and techniques*** developed by Keynes have enabled the today's economists to draw correct conclusions on the economic situation of a country. Such tools are consumption function, multiplier, investment function, liquidity preference, etc.

4. Keynes has ***integrated the theory of money with the theory of value and output.***

5. Keynes has first time introduced a ***dynamic economic theory***, in order to depict more realistic situation of the economy.

6. He also states the reasons of excess or deficiency of aggregate demand through ***inflationary and deflationary gap analysis***.

7. Keynes' theory is a general theory and therefore, can be ***applied to all types of economic systems.***

8. Keynes ***influenced on practical policies*** and criticised the policy of surplus budget. He advocated deficit financing, if that sited the economic situation in the country.

9. Keynes has ***emphasised on suitable fiscal policy*** as an instrument for checking inflation and for increasing aggregate demand in a country. He advocated extensive public work programmes as an integral part of government programmes in all countries for expanding employment.

10. He ***advised several monetary controls*** for the central bank, which in turn will act as the instrument of controlling cyclical fluctuations.

11. Keynesian theory has played ***a vital role in the economic development*** of less-developed countries.

12. He ***rejected the theory of wage-cut*** as a means of promoting full-employment.

13. Keynes' theory has given rise to the ***importance of social accounting or national income accounting.***

Criticism on Keynes' Theory:

1. According to Schumpeter, the Keynes theory is a ***depression theory***, which has limited applications.

2. Some socialist or communist economists had said that ***Keynes' theory is dead*** if communism comes. However, even the socialist countries have strived to raise their national income by using Keynesian theory.

3. ***Keynesian theory is not as much dynamic*** and it may more properly be called comparative statics.

4. ***Keynesian theory has ignored microanalysis*** and is not helpful in the solution of the problems of individual firms and consumers.

5. ***Keynes has not given any place to the accelerator principle.***

6. ***It pays excessive attention to money in economic analysis.***

Relevance of Keynes' Theory to Less-Developed Countries (LDCs) (Extended Criticism):

1. The ***Keynesian theory is primarily for fighting depression.*** The assumptions on which Keynesian theory is based are:

   (a) The multiplier, and
   (b) Short-term analysis.

2. In the short-term analysis, Keynes ***assumes that capital equipment, technology, organisation, labour and their efficiency remains constant***. He thinks that the problems relating to employment in developed countries arises only on account of the deficiency of demand.

3. But the problem in case of LDCs is to increase capital equipment, to improve technology and labour efficiency. Solving this ***problem will take a long process***; it cannot be solved in short-run.

4. The developing countries like Pakistan and India, ***the basic cause of unemployment is low rate of savings and investment.***

5. Most of the LDCs are agriculturists and ***the Keynesian approach is industry-oriented.*** Therefore, increase in national income by deficit spending will lead to increase in demand for food. This will raise the prices of food grains. Therefore,

heavy reliance on Keynesian approach could mislead the economists, and can plunge the economy into inflationary spiral.

6. The ***principle of multiplier does not much work in LDCs.*** Suppose new investments are made in the country, increased investment will lead to the establishment of new factories, workers will get employed, income will increase, demand will increase, but it does not guarantee the increase in the supply of goods because there is no excess capacity, and the supply of productive factors is not elastic. Increased income will be absorbed in high prices.