Classical Theory of Employment

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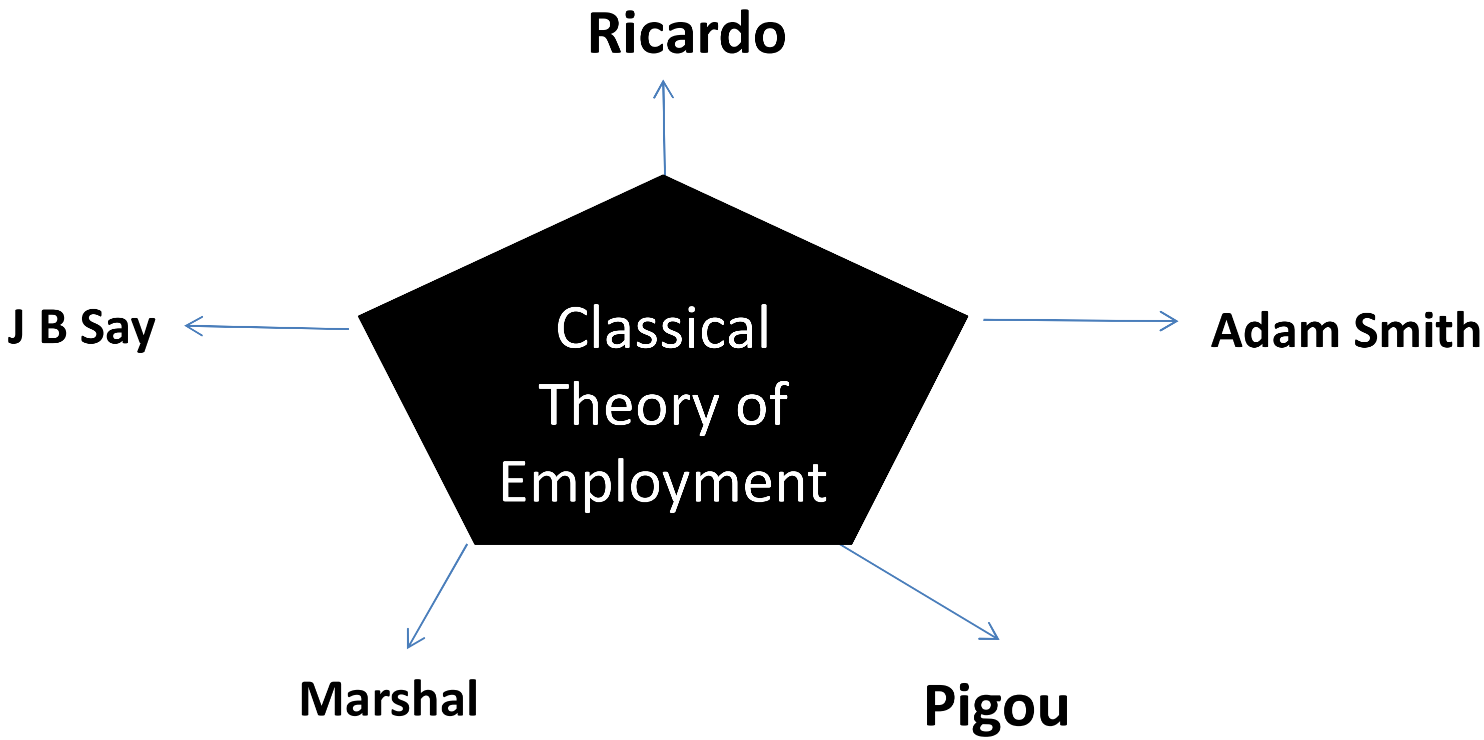
- It is not a theory given by single economist



Introduction to Classical Theory

- Classical economists : Adam smith, Ricardo, Edge Worth, Pareto, J.B Say and Marshal etc

- According to these economists there is always full employment in the economy.

- The classical believed in "Laissez-faire Economy"

Means a free enterprise economy.

Full employment

- Existence of full employment in the economy.
- Full employment was a normal situation and any deviation from this regarded as something abnormal.
- If there is unemployment, it will be for short period only.
- Unemployment means demand for labour is less than its supply. As a result wages will fall and demand for labour will rise.
- It will rise till demand for labour becomes equal to supply.
- There will be **full employment** in economy then.

Full employment

- Lerner says, " ***Full employment*** is a situation in which all those who are able to and want to work at the existing rate of wage get work without any undue difficulty."

- Spencer says, " **Full employment** is a situation in which everyone who wants to work is working except those who are *frictionally* and *structurally unemployed."*

- *Frictional unemployment: This kind of unemployment is associated with the changing of jobs in dynamic economy. This is temporary unemployment due to immobility of labour, shortage of raw material, shortage of power, break down of machinery etc.*

Full employment

- ***Structural unemployment***: It results from long term decline of certain industries. It arises when other factors of production like land and capital are short in supply. There may be various other reasons also.

- Note: All those workers who are voluntarily unemployed come under category of **<u>Voluntary unemployment</u>**.

- Hansen says, " Full employment implies absence of *involuntary unemployment*."
- Involuntary unemployment means people are ready and willing to work at prevailing wage rate but they they do not get any work.

Assumptions of Classical Theory

- Every man is rational who wants to get maximum satisfaction.
- Economy is free from any kind of interference by the state.
- There is perfect competition in product, labour and money market.
- Economy is closed.
- There is flexibility in wages, rate of interest and prices.
- Technology is constant.
- Money is only a medium of exchange.

Assumptions of Classical Theory

- The quantity of money is given.
- There is a direct and proportional relation between money wage and real wage.
- Total output of the economy is divided between consumption and investment expenditure.
- Labour is homogeneous.
- Saving is equal to investment.
- Law of diminishing marginal returns is applicable in agricultural sector.

Wage Price Flexibility

Classical economist believed in full employment situation

In case of unemployment, a general wage cut in money wages would take
the economy to the full employment situation

Labor Market Equilibrium

Demand & supply of labour is function of wage rate

Demand for labour is decreasing function of wage rate

Supply of labour is increasing function of wage rate

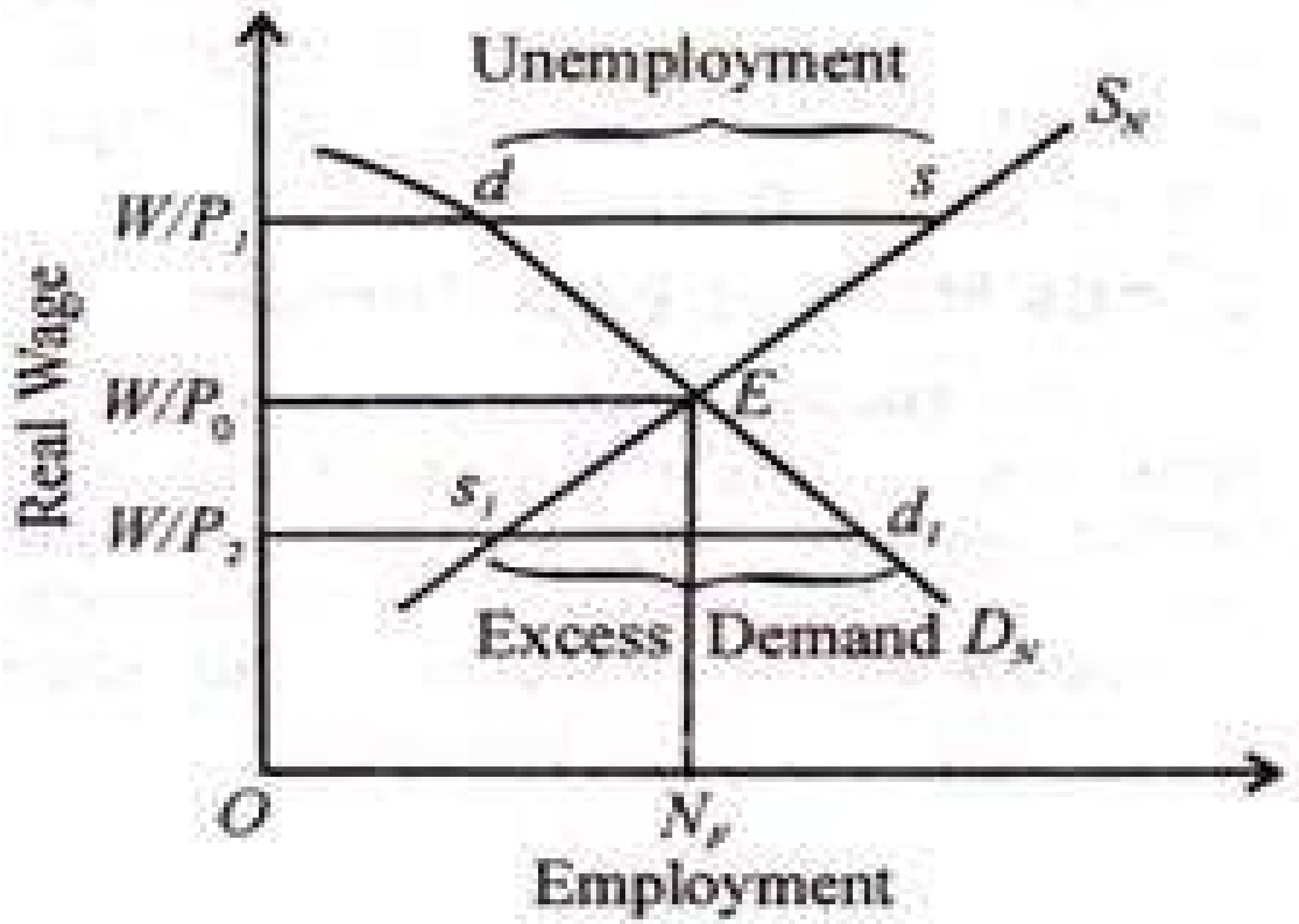

Unemployment
S_N
d
s
W/P$_1$
Real Wage
W/P$_0$
E
s_1
d_1
W/P$_2$
Excess Demand
D_N
O
N_F
Employment

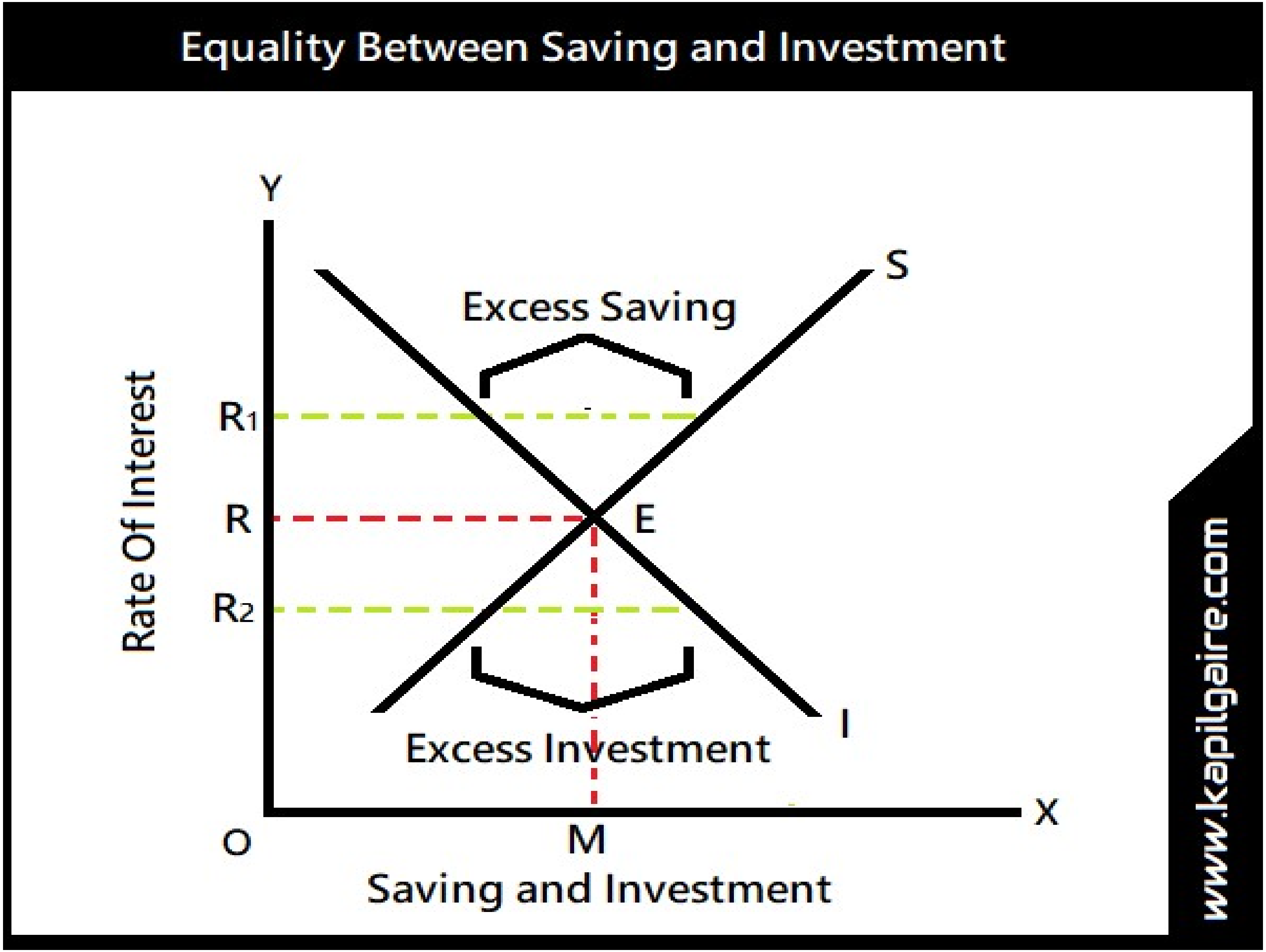
Fig. 2

Goods Market Equilibrium

Saving equals Investment

Saving & Investment both Are the function of interest rate

If Interest Rate is high there will be more saving and less investment


Equality Between Saving and Investment
Y
S
Excess Saving
Rate Of Interest
R1
R
E
R2
I
Excess Investment
O
M
X
Saving and Investment
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Determination of Output and Employment

- According to this theory, income and employment are determined by production function and equilibrium between demand and supply of labour.
- Production depends on the level of employment.
- Level of employment refers to equilibrium of demand and supply of labour in the economy.
- Full employment is a normal feature in a capitalist economy.
- There may be unemployment for short period in an economy but self adjusting forces in the economy will restore full equilibrium.

Classical Model of Employment

1. $Y = f(\bar{K}N)$ Production Function
2. $S_L = f(W/P)$ Supply of Labour
3. $D_L = f(W/P)$ Demand for Labour
4. $S_L = D_L$, Equilibrium in labour Market
5. $S = f(r)$ Saving Function
6. $I = f(1/r)$ Investment Function
7. $S = I$, Equilibrium in Capital Market
8. $MV = PT$ or $P = f(M)$ Money Market

Interpretation of Equations

- In short period, Total output / income depends on level of employment (N).
- There is direct relationship between supply of labour and real wages
- There is inverse relationship between demand for labour and real wages.
- There is direct relationship between saving and rate of interest.
- There is inverse relationship between investment and rate of interest.
- There is direct relationship price level and supply of money. Money is demanded for transaction purposes only

Production Function

$$Y = f(\bar{K}N)$$

- Production function exhibits diminishing return to scale.
- Marginal Product of Labour (MP_L) is slope of PF.
- Slopes become negative.

Demand for Labour

- Firms are the purchaser of labour service;
- Under PC firm choose output level that maximise profit;

MR=P

- When labour is only variable factor, additional cost is MC of labour;
- MC of labour equal to Money wage divided by number of unit of output is produced;
- Additional unit of labour employed is MP_L

Demand for Labour

$$MC = \frac{W}{MP_L}$$

$$P = MC$$

$$P = \frac{W}{MP_L}$$

$$MP_L = \frac{W}{P}$$

$$MP_L.P = W$$

$\boldsymbol{Aggregate\ Labour\ demand\ function}\ \ D_L = \mathrm{f}(\frac{W}{P})$ (-)

Labour Supply

$$Aggregate\ Labour\ Supply\ function\ \ S_L = \mathrm{f}(\frac{W}{P})\ (+)$$

Equilibrium Output and Employment

$$Y = f(\bar{K}N)$$

$$D_L = \mathrm{f}(\frac{W}{P})$$

$$S_L = \mathrm{f}(\frac{W}{P})$$

$$D_L = S_L$$

Classical Model of Employment

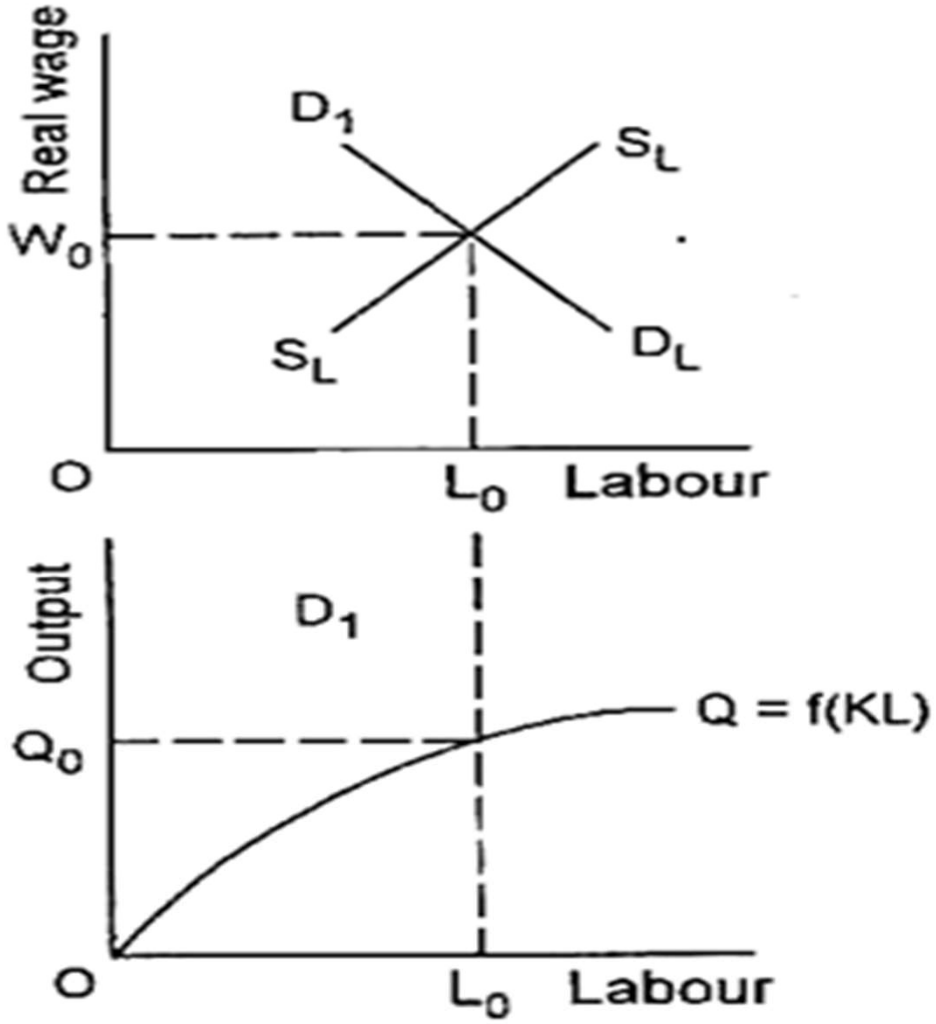

Fig. 1 : Full employment level

Implications of Classical Theory

- Full employment is a normal feature of a capitalist economy.
- Full employment means absence of involuntary unemployment.
- Equilibrium is possible under full employment only.
- General unemployment is not possible.
- By reducing money wages, real wage rate can be reduced. As a result full employment can be achieved.
- Wage rate should be flexible.
- Government should follow a policy of Laissez-faire.
- It is based on Say’s Law. so There is no problem of over production and general unemployment.
- People spend their entire income on consumption and investment.
- Saving and investment are always equal. This equality is brought by changes in rate of interest.

Criticism of Classical Theory

- Say’s law is weak
- Employment can not be increased by general money wage cut.
- Possibility of under-employment equilibrium
- Absence of Automatic Adjustment
- Money is not merely a veil
- Saving and Investment are not interest-elastic.
- Rejection of Laissez-faire policy
- It ignores problems of short period.
- Not based on empirical facts

Criticisms of Classical Theory

John M. Keynes in his **General Theory of Employment, Interest and Money** published in 1936, made a frontal attack on the classical postulates and Say's law of markets.

❑ Criticism

Criticized by J. M. Keynes on the following grounds.

- **Supply does not create its demand**
- **Self-adjustment is not possible.**
- **Money is not neutral**
- **Overproduction is possible.**
- **Need of state intervention.**
- **Saving and investment equality through income**

❑ Criticism

Criticized by J. M. Keynes on the following grounds.

- **Wage-cut is not favorable**
- **Unemployment Situation**
- **Equilibrium level not always the full employment level**
- **Theory is applicable in long run**
- **Employment and output are not functions of wage rate. Employment is a function of effective demand.**

Macroeconomics

Theories and Policies

Richard T. Froyen