Chapter - 8

Theory of Employment

Introduction:

According to classicists, there will always be full employment in a free enterprise capitalist economy because of the operation of Say's Law and wage-price flexibility. This classical theory came under severe attack during the Great Depression years of 1930s at the hands of J. M. Keynes. He rejected the notion of full employment and instead suggested full employment as a special case and not a general case. Full employment is a temporary phenomenon, an astrological coincidence.

He claimed his theory to be 'general', i.e., applicable at any point of time. That is why he christened his epoch-making book: The General Theory of Employment, Interest and Money (1936). Thus, Keynes' theory is "general". In this book, he not only criticized the classical macroeconomics, but also presented a 'new' theory of income and employment. He is often described by economists as a revolutionary one in the sense that it was Keynes who salvaged the capitalist economy from destruction in the 1930s. Critics, however, label him as a 'conservative revolutionary'.

Keynes' theory of employment is a demand-deficient theory. This means that Keynes visualized employment/unemployment from the demand side of the model. His theory is, thus, known as demand-oriented approach, as opposed to the classical supply side model. According to Keynes, the volume of employment in a country depends on the level of effective demand of people for goods and services. Unemployment is attributed to the deficiency of effective demand.

It is to be kept in mind that Keynes' theory is a short run theory when population, labor force, technology, etc., do not change. Once Keynes remarked that since "in the long run we are all dead", it is of no use to present a long run theory. In view of this, one can argue that the volume of employment depends on the level of national income/output. Higher (lower) the level of national output higher (lower) is the volume of employment. Thus, Keynesian theory of employment determination is also the theory of income determination.

Meaning of Effective Demand:

Keynes' theory of employment is based on the principle of effective demand. In other words, level of employment in a capitalist economy depends on the level of effective demand. Thus, unemployment is attributed to the deficiency of effective demand and to cure it requires the increasing of the level of effective demand.

By 'effective' demand, Keynes meant the total demand for goods and services in an economy at various levels of employment. Total demand for goods and services by the people is the sum total of all demand meant for consumption and investment. In other words, the sum of consumption expenditures and investment expenditures constitute effective demand in a two-sector economy.

In order to meet such demand, people are employed to produce all kinds of goods, both consumption goods and investment goods. However, to complete our discussion on effective demand, we need another component of effective demand, the component of government expenditure. Thus, effective demand may be defined as the total of all expenditures, i.e. C + I +G Where,

- C stands for consumption expenditure,
- I stands for investment expenditure, and
- G stands for government expenditure.

Here we ignore government expenditure as a component of effective demand. According to Keynes, the level of employment is determined by the effective demand which, in turn, is determined by aggregate demand function or aggregate demand price and aggregate supply function or aggregate supply price. In Keynes' 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."

Assumption:

The principle of effective demand is based on the following assumptions:

1. There is existence of closed economy, ignoring the effect of foreign trade.
2. There is operation of the law of diminishing returns.
3. Perfect competition exists in market.
4. He assumes that labor has money illusion. It means that a worker feels better when his wages doubles even when prices also double, thus leaving his real wage unchanged.
5. The government is assumed to have no part play either as taxer or a spender, i.e. the fiscal operations of the government are not explicitly recognized.
6. Less than full employment equilibrium is possible in short period.

Aggregate Supply (AS):

Employers hire and purchase various inputs and raw materials to produce goods. Thus, production involves cost. If sales revenue from the sale of output produced exceeds cost of production at a given level of employment and output, the entrepreneur would be induced to employ more labor and other inputs to produce more.

At any given level of employment of labor, aggregate supply price is the total amount of money that all entrepreneurs in the economy expect to receive from the sale of output produced by given number of laborers employed. For each particular level of employment, there is an aggregate supply price. Here, by 'price' we mean the amount of money received from the sale of output, i.e., sales proceeds.

Thus, aggregate supply price refers to the proceeds from the sale of output at each level of employment and there are different aggregate supply prices for different levels of employment. If this information is expressed in a tabular form, we obtain "aggregate supply price schedule" or aggregate supply function. The aggregate supply function is a schedule of the minimum amounts of proceeds required to induce varying quantities of employment. Simply, it shows various aggregate supply prices at different levels of employment. Plotting this information graphically, we obtain aggregate supply curve.

According to Keynes, aggregate supply function is an increasing function of the level of employment. Aggregate supply (AS) curve slopes upward from left to right because volume of employment increases with the increase in sale proceeds. But there is a limit to increase output level. This is called full employment level of output beyond which output cannot be increased, it is because of full employment that AS curve becomes vertical or perfectly inelastic. This means that the level of employment cannot exceed full employment (L_F) level even by increasing aggregate supply price. This is shown in Figure below.

Aggregate Demand (AD):

Aggregate demand or aggregate demand price is the amount of money or price which all entrepreneurs expect to receive from the sale of output produced by a given number of labor employed. Or it refers to the expected revenue from the sale of output at a particular level of employment. Each level of employment is associated with a particular aggregate supply price and there are different aggregate demand prices for different levels of employment.

Like the aggregate supply schedule, aggregate demand schedule shows the aggregate demand price for each possible level of employment. Plotting the aggregate demand schedule we obtain aggregate demand curve as there is a positive relation between the level of employment and aggregate demand price, i.e., expected sales receipts. This is shown in Figure below. It rises from left to right.

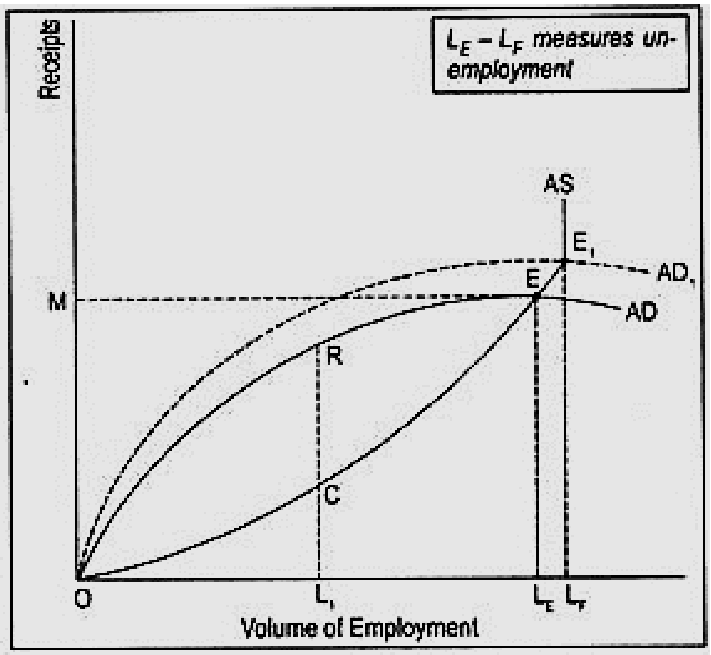
Equilibrium Level of Employment (The Point of Effective Demand):

The level of employment in an economy is determined at that point where the aggregate supply price equals the aggregate demand price. In other words, the intersection of the aggregate supply function with the aggregate demand function determines the volume of income and employment in an economy.

It is, thus, clear that so long as expected sales receipts of the entrepreneur (i.e. aggregate demand schedule) exceed costs (i.e. aggregate supply schedule), the level of employment should be increasing and the process will continue until expected receipts equal costs or aggregate demand curve intersects aggregate supply curve.

Note that the AS curve starts from the origin. If aggregate receipts (i.e. GNP) are zero, entrepreneurs would not hire workers. Likewise, AD curve also starts from the origin. The equilibrium level of employment is determined by the intersection of the AS and AD curves. This is the point of effective demand point E in Figure below. Corresponding to this point, OL_E workers are employed. At the OL_1 level of employment, expected receipts exceed necessary costs by the amount RC. Entrepreneurs will now go on hiring more labor till OL_E level of employment is reached.

At this level of employment, entrepreneurs' expectations of profits are maximized. Employment beyond OL_E is unprofitable because costs exceed revenue. Thus, actual employment (OL_E) falls short of full employment (OL_F). Keynesian system shows two kinds of equilibrium actual employment equilibrium determined by AD and AS curves and underemployment equilibrium.



Keynes made little emphasis to the aggregate supply function since its determinants (such as technology, supply or availability of raw materials, etc.) do not change in the short run. Keynes was examining the possibility of unemployment in a capitalistic economy against the backdrop of Great Depression of the 1930s.

After diagnosing the problem, Keynes recommended policy prescription so as to create more employment in the economy. Indeed, for curing unemployment problem, he did not subscribe to the classical ideas, the supply-oriented policies. Keynes attached great importance to demand stimulating policies to cure unemployment. In other words, Keynes paid emphasis on the aggregate demand function. That is why Keynes' theory is known as a 'theory of aggregate demand'.

Figure above shows the situation of equilibrium at less than full employment level. Actual equilibrium, OL_E, is short of full employment equilibrium, OL_E. Thus, the distance OL_F to OL_E measures unemployment. This is called involuntary unemployment, a situation at which people are willing to work but do not find jobs.

This unemployment, according to Keynes, is due to the deficiency of aggregate demand. This unemployment can be removed by stimulating aggregate demand. Aggregate demand is the sum total of consumption and investment demand or expenditures in the economy. By raising consumption expenditure, level of employment can be raised.

But there is a limit to consumption expenditure. So what is needed is the raising of (private) investment demand. Anyway, an increase in consumption demand and investment demand will raise the level of employment in the economy. The point of effective demand has been changed because of the shifting of AD curve from AD to AD_1 New effective demand is now given by E_1 Corresponding to this point, equilibrium level of employment is OL_F, the level of full employment.

Thus, in Keynes' theory, unemployment is due to the deficiency of effective demand. Only by stimulating effective demand can a higher level of employment be achieved. However, Keynes goes on arguing that equilibrium level of employment will not necessarily be at full employment.

A capitalist economy will always experience underemployment equilibrium, an equilibrium situation less than full employment. Full employment, according to Keynes, can never be achieved. In Keynes' scheme of things, both consumption and investment cannot be raised enough to employ more work force. Therefore, he recommends government to come forward and take appropriate action to cure unemployment problem.

This means that aggregate demand is now the sum total of all consumption, investment and government expenditures. It is because of the multiplier effect of both private investment expenditure and government expenditure, that there will be larger income, output and employment. But equilibrium in the economy will be established at less than full employment situation because of (i) wage rigidity, (ii) interest inelasticity of investment, and (iii) liquidity trap.