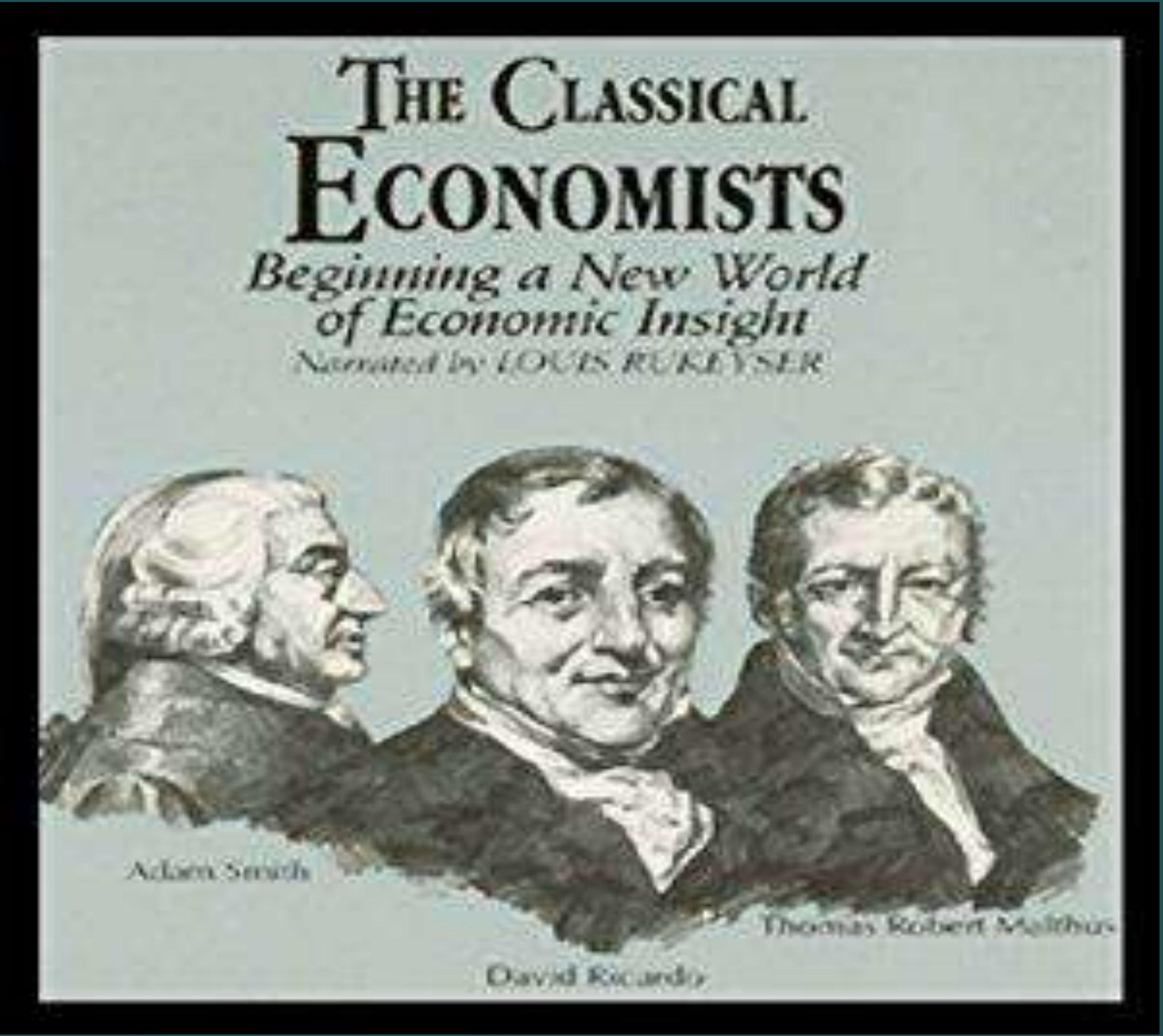

The Classical Theory of Income And Employment

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THEORIES OF INCOME AND EMPLOYMENT

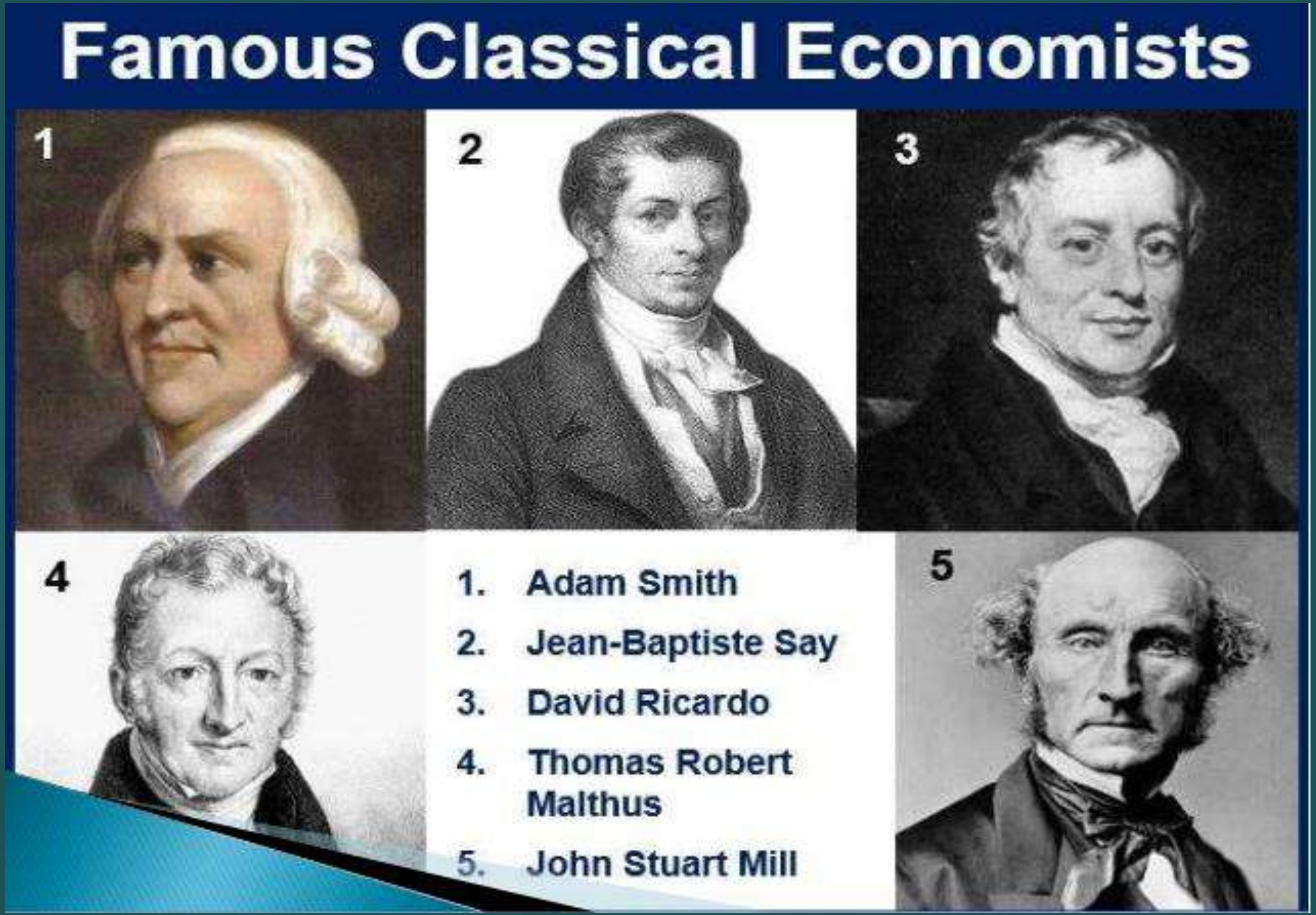
Determination of income and employment is important part of macroeconomics(आय और रोज़गार का निर्धारण)

In Capitalist economies(free market economies) two theories of income and employment

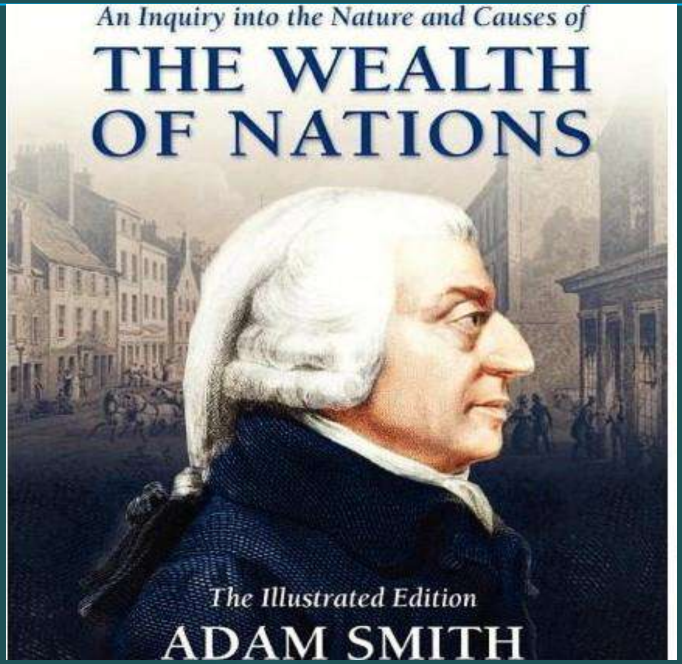
(किसी भी पूंजीवादी अर्थव्यवस्था में रोज़गार निर्धारण क दो सिद्धान्त हैं

- Classical theory of employment :
- Keynesian theory of employment:

Who are classical economists ?
1776 -1890 18th 19th century



The word classical was associated with Karl Marx. In Latin classical means "the best" Keynes used this word classical.



According To Classical Economists

"Full Employment Is Normal Feature of Capitalist Economies"

In economics terminology, full employment signifies the market condition where the demand for labor is equivalent to the supply of labor at prevailing wage rate .

Demand for labour (D_L)= Supply of Labour (S_L)

Therefore, full employment is the employment level at which every individual who desires to work at the prevalent wage rate gets work .

If DL<SL → Unemployment but rare phenomenon

Wage rate will change to make DL=SL

$D_L < S_L$ → UN → ↓Wage rate → ↑ S_L

$D_L = S_L$ Full employment is achieved

But full employment does not mean zero unemployment . Even at full employment there may exist some unemployment

Full employment mean absence of involuntary unemployment

(जिसमे अन्य सभी प्रकार की बेरोजगारी पाई जाएगी पर अनैच्छिक बेरोज़गारी नहीं पाई जाएगी ।)

Types of unemployment at full employment

- **Voluntary unemployment (एच्छिक बेरोज़गारी)**

Voluntary unemployment when a worker decides to leave a job because it is no longer financially fulfilling. Workers are not willing to work at prevailing wage rate.

- **Frictional unemployment (संघर्षात्मक बेरोज़गारी):people between the jobs**

occurs when workers leave their old jobs but haven't yet found new ones. refers to workers who are in between jobs

Frictional unemployment also occurs when students are looking for first job

Frictional unemployment is short-term and a natural part of the job search process.

Full employment unemployment

- **Structural Unemployment(संरचनात्मक बेरोज़गारी):**

Structural unemployment exists when shifts occur in the economy that creates a mismatch between the skills workers have and the skills needed by employers. Every worker is different; every job has its special characteristics and requirements.

Unemployment that results from a mismatch between worker qualifications and the characteristics employers require is called structural unemployment. Even if the number of employees firms demand equals the number of workers available, people whose qualifications do not satisfy what firms are seeking will find themselves without work.

- ❑ **Cyclical Unemployment/Demand deficient unemployment**
- ❑ **चक्रीय बेरोज़गारी**

Cyclical unemployment is caused by the contraction phase of the business cycle. That's when the demand for goods and services falls dramatically.

Cyclical unemployment creates more unemployment. The laid-off workers have less money to buy the goods and services they need. That further lowers demand.

- ❑ **Seasonal Unemployment(मौसमी बेरोज़गारी)**

seasonal unemployment as another type of unemployment. As its name suggests, seasonal unemployment results from regular changes in the season. Workers affected by seasonal unemployment include resort workers, ski instructors, and ice cream vendors etc

Classical Theory Of Income, Output And Employment Is Based On The Following Assumptions

- Rational human being motivated by self interest
- There is a normal situation of full employment.
- There is a laissez faire capitalist economy without foreign trade.

  No interference of Govt. Automatic adjustment
- There is perfect competition in labour, money and product market .

  e.g. in labour market labour is homogeneous.

Under conditions of perfect completion, flexibility of wages tends to establish full employment. Reduction in wages can increase employment

Assumptions

- Money has only one function i.e medium of exchange.
- Only two sectors in the economy Consumption and business (C+I)
- Wages,rate of interest and prices are flexible.
- equality between Saving and investment .

$S = f(r)$

$I = f(r)$

$$S=I$$

If $S>I$ interest rate will decrease causing low saving and high I

- Money wages and real wages are directly related and this relationship is proportional.
- Production is subject to law of diminishing returns (in short run all factor of production are constant only labour is variable factor
- Capital stock and technological knowledge are given in the short run.

Assumptions

- Money wages and real wages are directly related and this relationship is proportional.

$$\text{Real wage} = \frac{\text{Money wage}}{\text{price}}$$

↑ money wage ⟶ ↑ Real wage

if money wage doubles real wage will be double

- Production is subject to law of diminishing returns (in short run all factor of production are constant only labour is variable factor .

$Q= f(L . \bar{K})$ to increase production producer has to increase labour

When more and more labour is used to increase production Output will increase but at decreasing rate

Units of labor	Output(Q) (Total product (TP)
1	4
2	7
3	9

Marginal productivity Of labor (MP_L)=TPn-TPn-1
4
3
2

Determination of income and employment

In any Capitalist economies(free market economies)

Level of output depends on level employment

And level of employment(full employment) determined in labor market where Demand for labor =supply of labor

DL = SL

level of income /output = f(labour, capital ,technology) f(N, $\bar{K}$, $\bar{T}$)

in short run All other factors are constant labor is the only variable factor. So production depends on labour(employment)

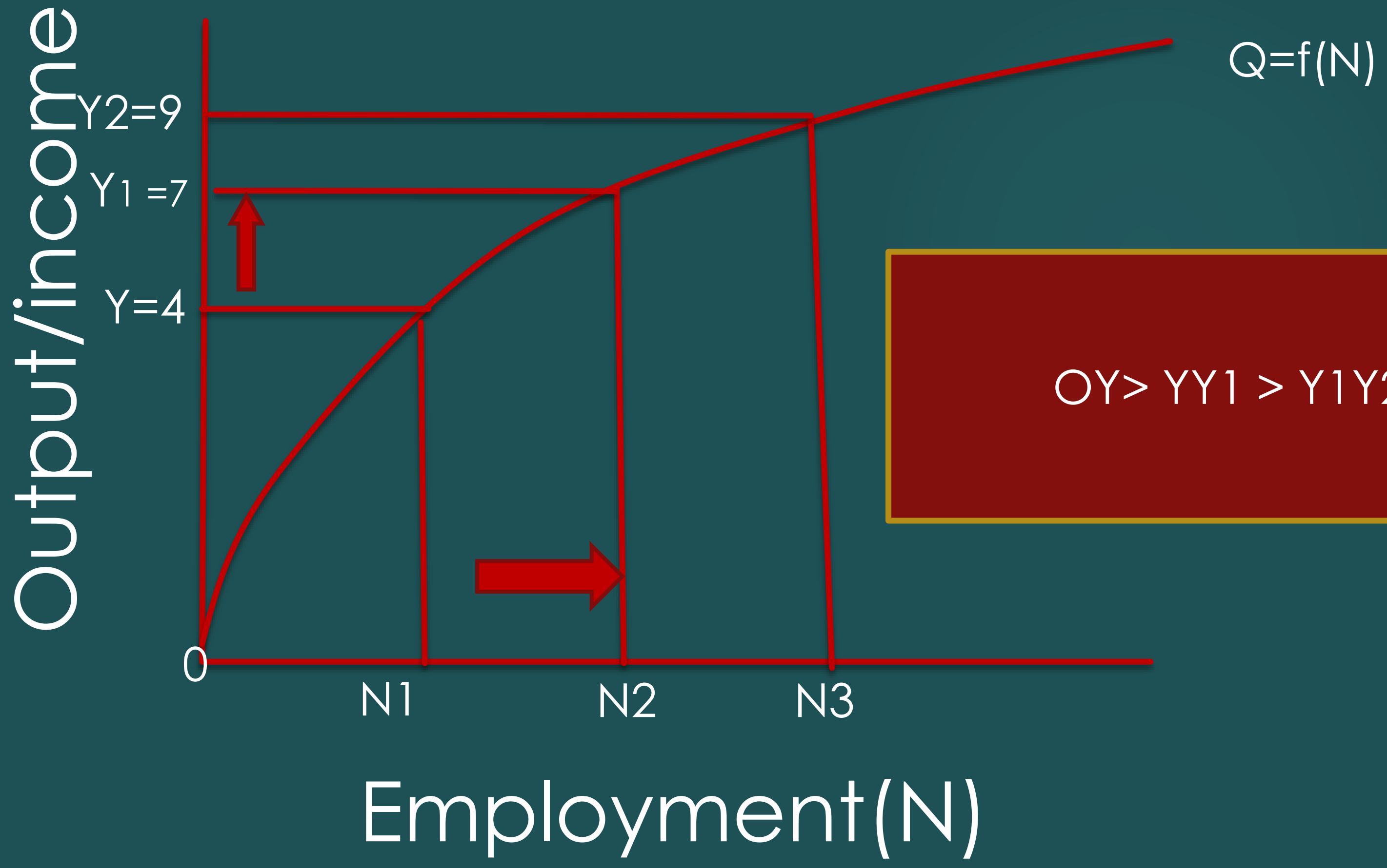
level of income = f(employment)

<u>labor market equilibrium</u> $D_L = S_L$ → Full employment

Law of diminishing returns operates in production

Units of labo (employment)	Output(Q) (Total product (TP)
1	4
2	7
3	9

Income /output depends on level of employment



OY> YY1 > Y1Y2

Level of employment is determined in labour market

Where

$D_L = S_L$

Full employment

All the markets of the economy are in equilibrium

" 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."

Demand for labour :

Firms are the buyer of labour service

labour services are used because of its productivity (उत्पादकता के कारण की जाती है)

Under Perfect Competition to maximize profit labour is used upto the point where

Wage rate = labor's productivity

$W = MRP_L$ ($MRP_L = MPP_L \times MR$) (Monetary terms)

Producer will like to pay the wages =productivity of labour

Under perfect competition P=AR=MR

$W = MPP_L \times P$

$MPP_L = W/P$ {Physical terms)

Money Wage(W)= MRP_L

Labour is demanded up to the point where

MPPL= W/P

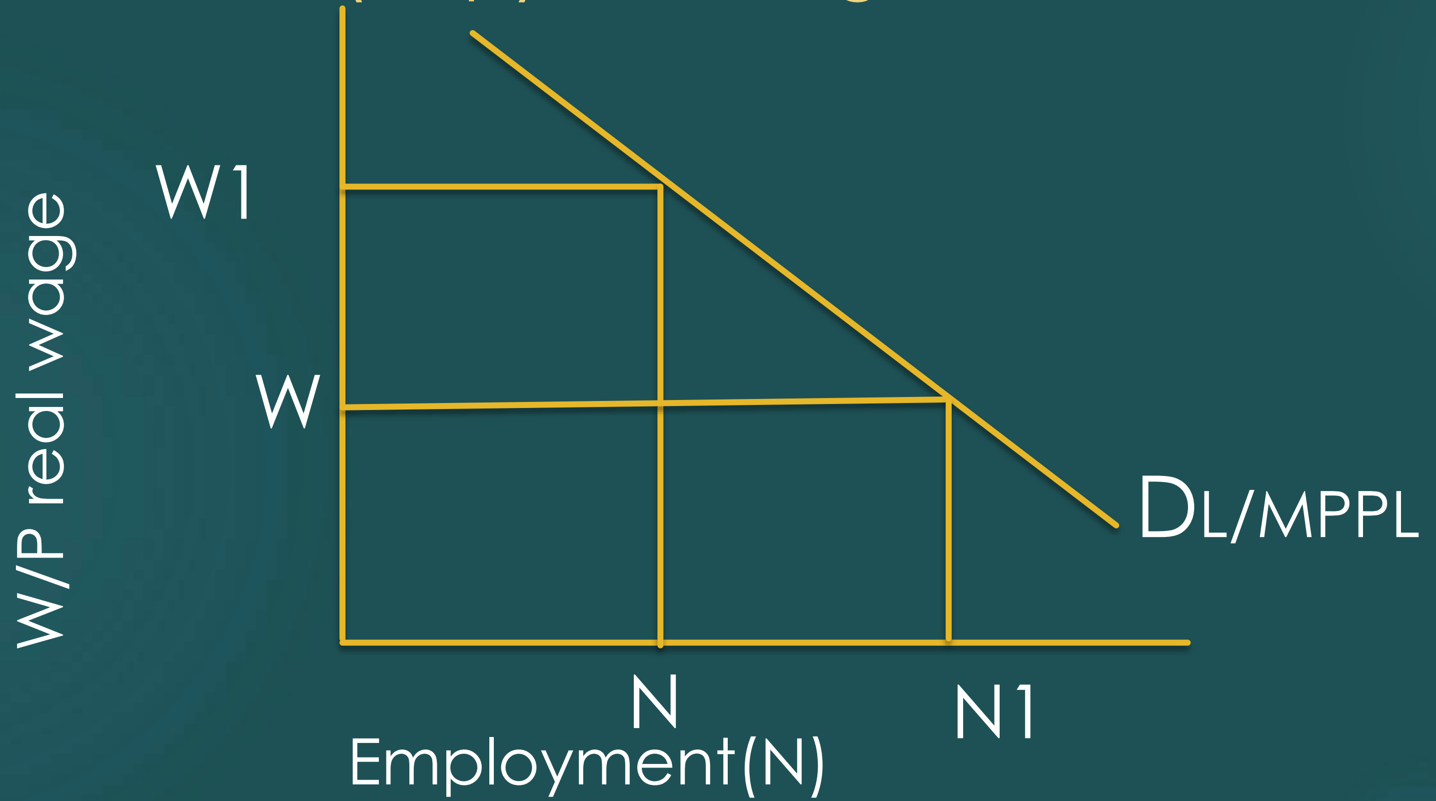
W/P(real wage)= MPP_L

Demand for labour =f(w/p) real wage

Demand for labour : As more more labor is used ttheir productivity declines so more labour will be demanded when real wage is low

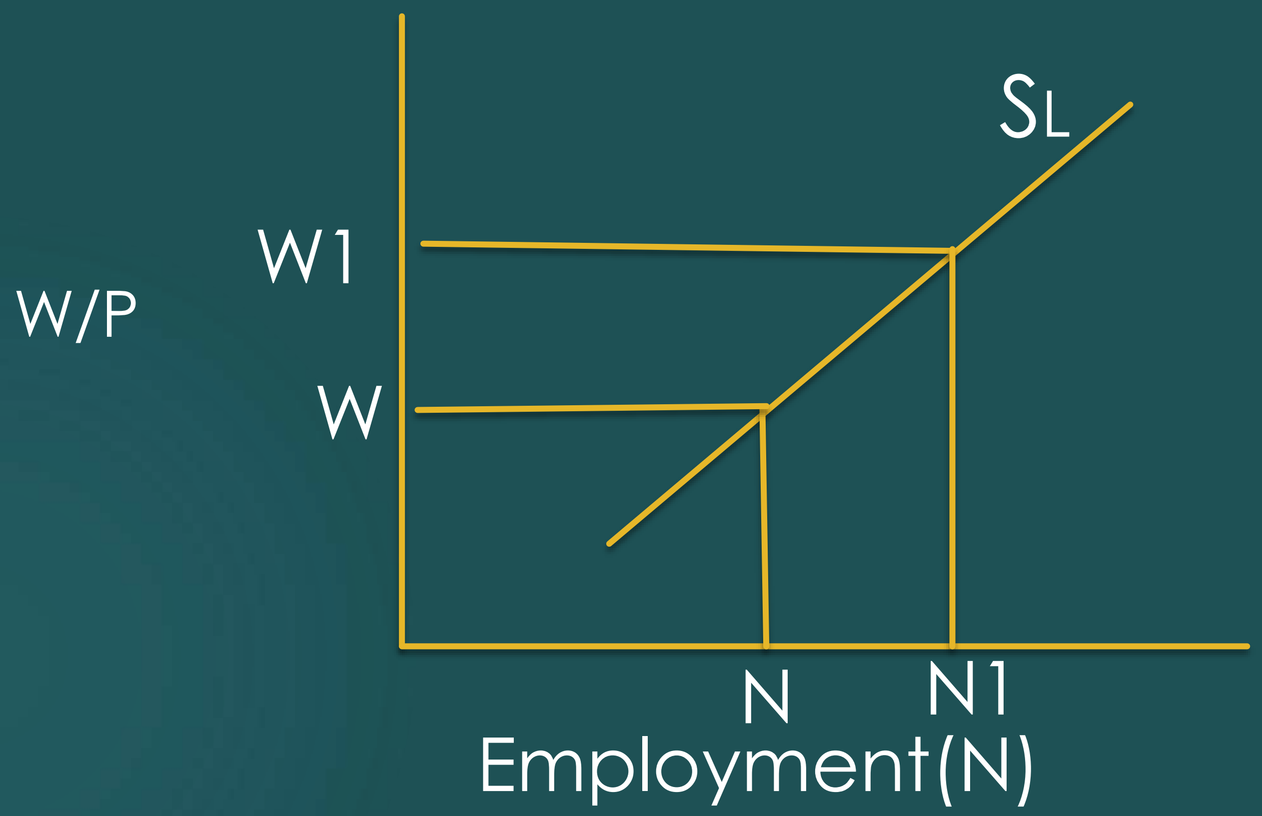
More labor → Low MPP_L (MPP_L W/P(real wage)
More will be demanded when real wage is low

Demand for labour = f(w/p) real wage



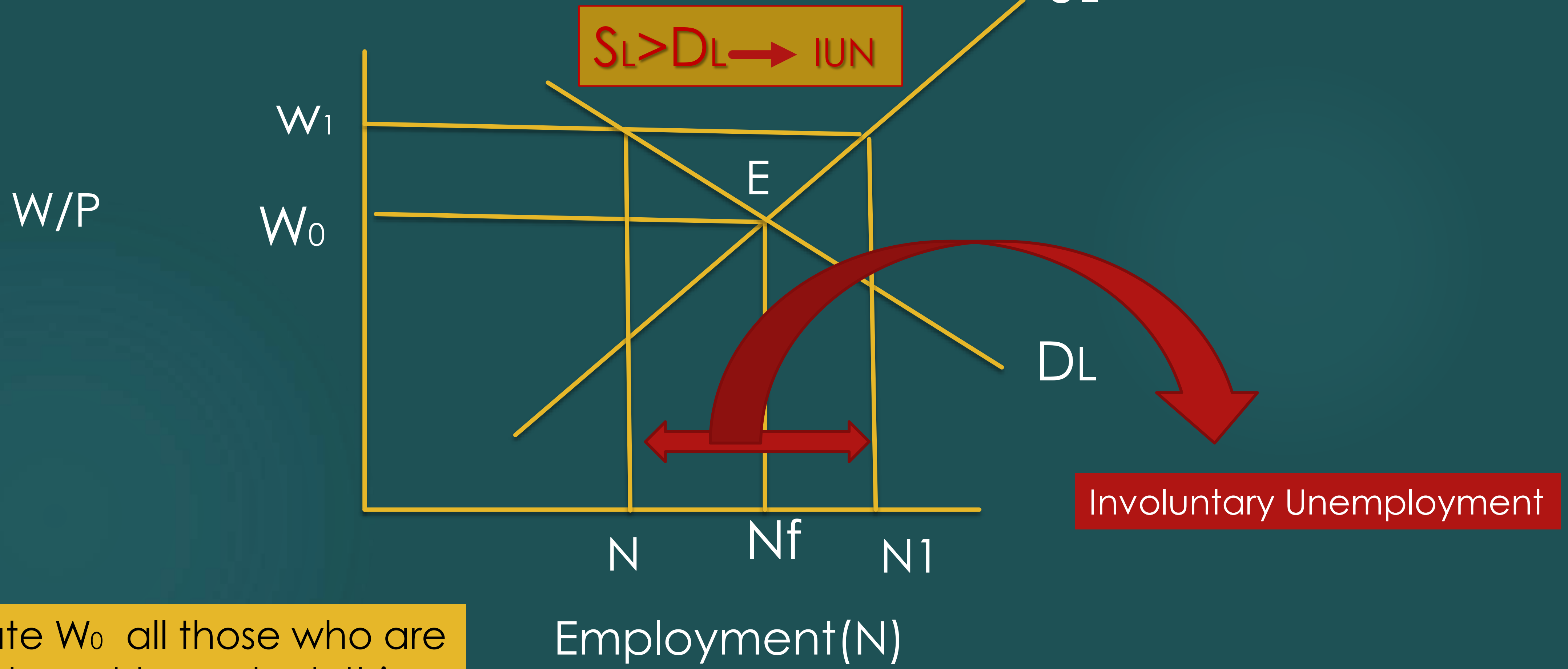
Supply for labour :

Supply of labour = f(w/p) real wage



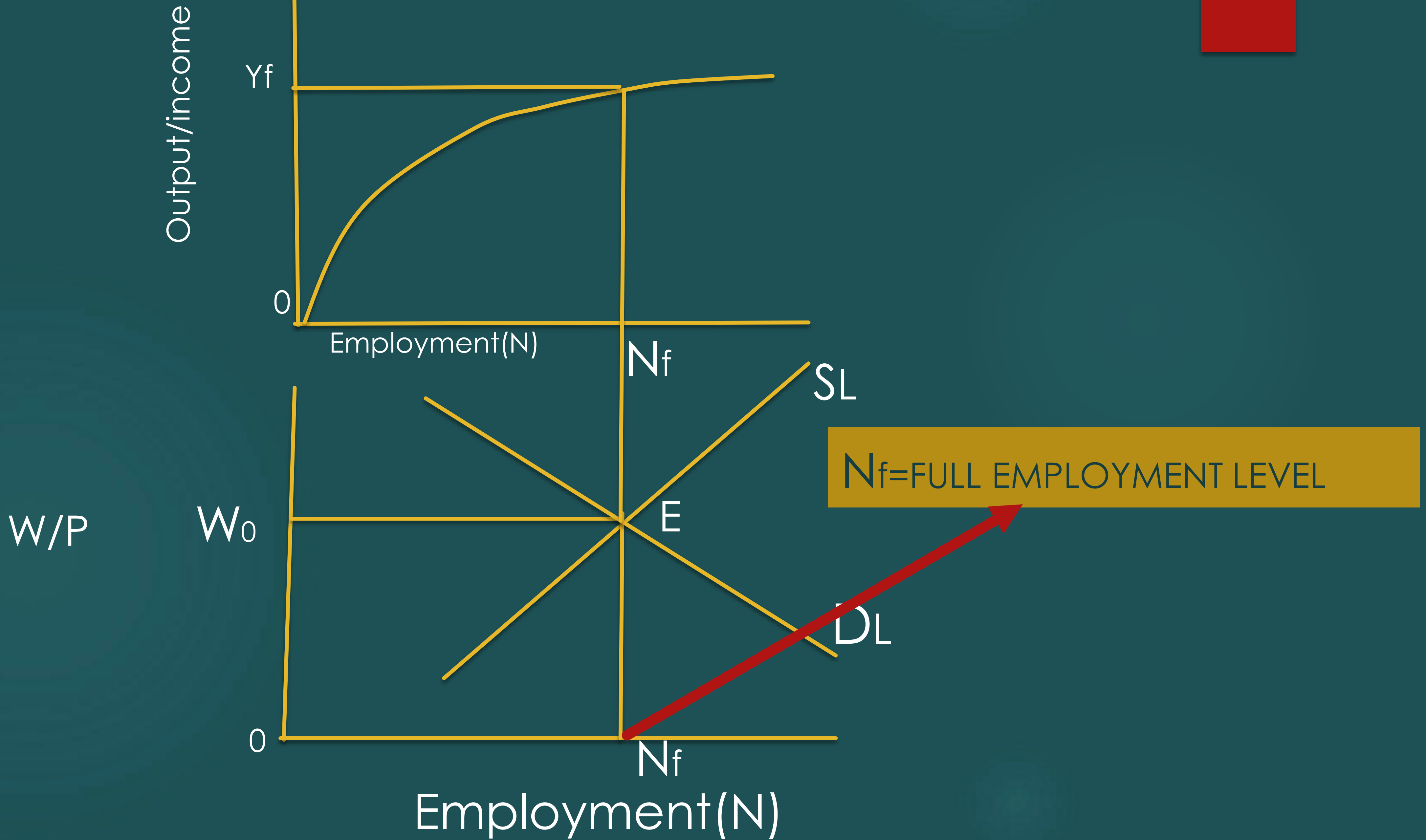
Labour market equilibrium :

Demand for labour = Supply of labour

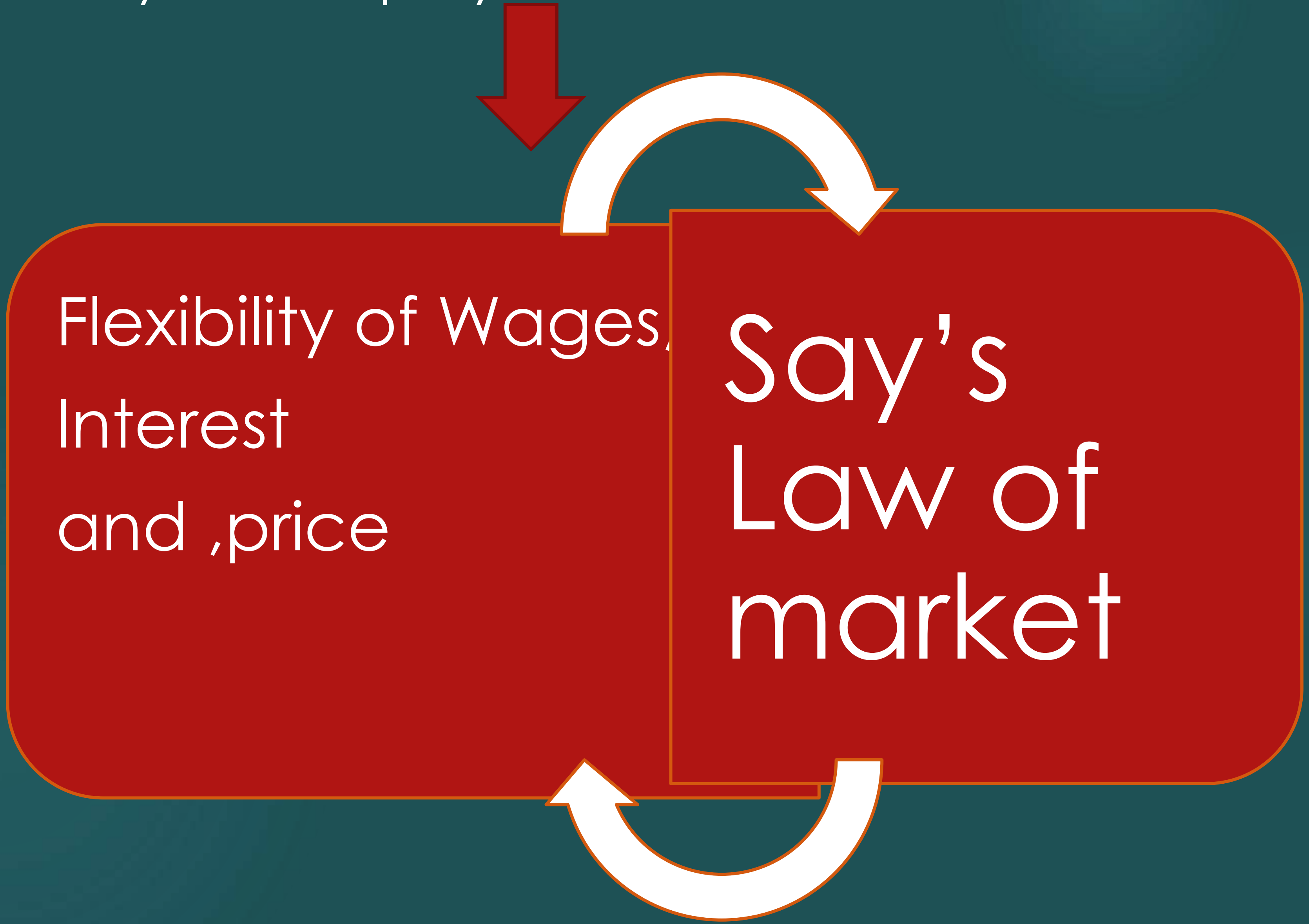


At wage rate W_0 all those who are able to and want to work at this wage rate will get work

Determination of Income and Employment
CLASSICAL MODEL

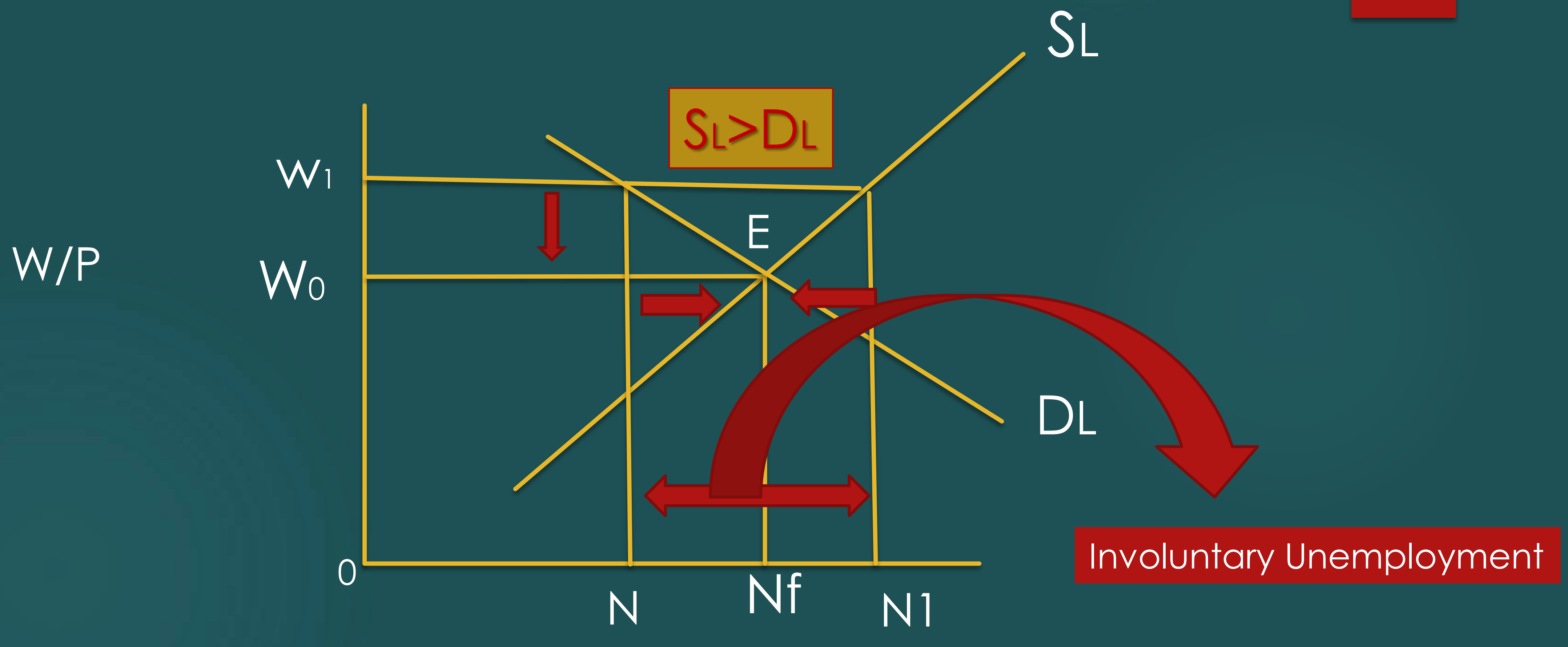


Classical theory of employment is based on two Facts



flexibility of wage rate: Labour market equilibrium :

Demand for labour = Supply of labour



At wage rate W_0 all those who are able to and want to work at this wage rate will get work

Flexibility of interest =goods market equilibrium

Demand for goods=supply of goods

AD=AS (only two sectors in the economy)

$\cancel{C}+I=\cancel{C}+S$

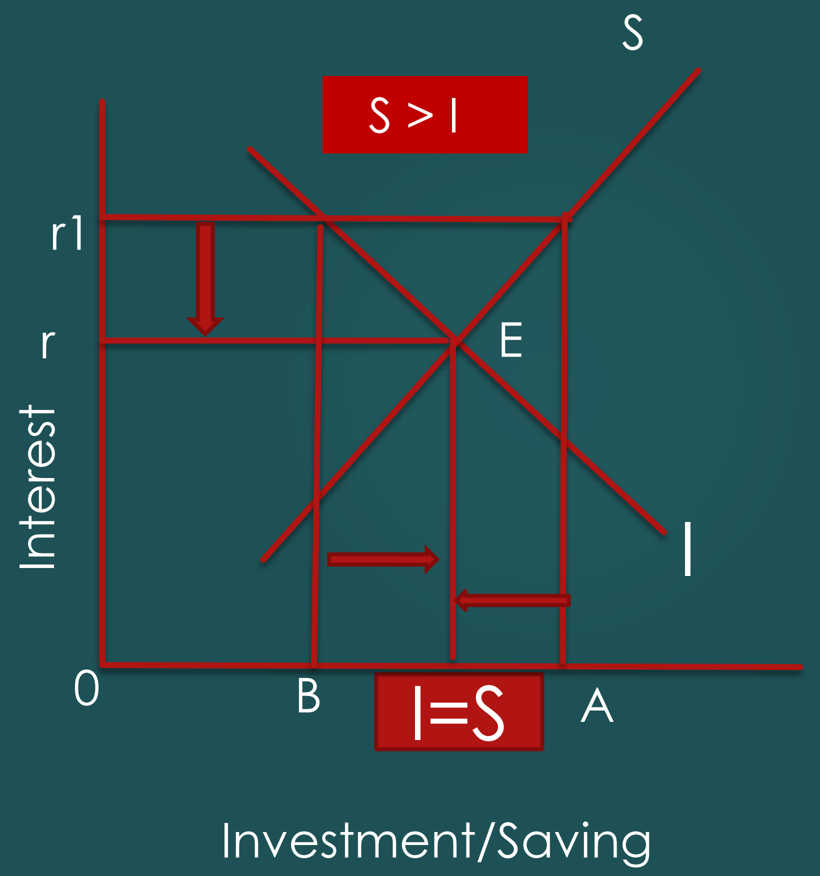
S=I

S=f(r)

↑ r → ↑ s

I=(r)

↑ r → ↓ I



S

Rate of interest is flexible in goods market

Flexibility of price : money market equilibrium

Where

Full employment