Theories of output and Employment

Says Law's OF MARKET:-

Meaning : An economic rule that says that production is the source of demand . According to Say's Law , when an individual produces a product or service , he or she gets paid for that work , and is then able to use that pay to demand other goods and services . Say's Law feco is frequently misinterpreted as " supply creates its own demand , " which is evidently false . t ana If it were true , anyone could do whatever they wanted for a living and be successful at it .

Definitions :

J.B. Say : " Supply creates its own demand . "

MAIN PROPOSITIONS OF SAY'S LAW OF MARKET :-

A) Supply creates its own demand:- i.e. , production is the sole cause of demand : Production has a dual effect on an economy - it creates output and also generates factor income . This income is again spent on produced goods [consumption expenditure] . Thus , Output = Income = Expenditure .

B) There is no over - production of goods : Every additional supply creates an equivalent amount of purchasing power which results . in increase in demand . Thus , there can be no general over production as well as no demand deficiency . As a result , there is no possibility of involuntary unemployment . Circular flow of income and expenditure is steadily maintained in the economy .

C) Aggregate Demand always equals

Aggregate Supply : There will always be equality of aggregate demand and aggregate supply as whatever is produced in the economy is automatically demanded . Even if there is temporary divergence between them due to certain reasons , that will be corrected automatically with the self - adjusted mechanism .

ASSUMPTIONS OF SAY'S LAW OF MARKET

1) Free Market : There is free enterprise economy . The government does not intervene in the functioning of the market . Any kind of mismatch between demand and supply in the market will be automatically adjuste in the free market environment without any interface by the government.

2)Perfect Competition : There is perfect competition prevailing in both product market and factor market . Hence , prices of commodities are equal to average cost and factor prices are equal to marginal productivities . Moreover , all the marke participants have required information regarding the market .

3) Optimum Allocation of Resources : The available resources in the economy are optimally allocated in order to maximize production . It is possible only in a free market environment .

4) Absence of any kind Leakage : There is no leakage in the circular flow of money income in the economy . This implies that saving is nothing but another form of spending on capital goods . i.e. , savings are automatically invested . In other words , income is automatically spent on consumption and investment .

5) Saving - Investment Equality : Since the entire amount of saving is automatically invested , there is equality between saving and investment i.e. , saving investment . This is the basic condition of equilibrium in an economy which is maintained by the interest rate flexibility .

6) Long - term Theory : The theory deals with long run time period i.e. , the economy reaches equilibrium in the long run . Even if there is any disequilibrium in the short - run , that will be automatically corrected in the long - run .

7) Market Forces : Both factor prices and commodity prices are determined by the market forces of demand and supply i.e. , market forces play a significant role in determining prices of both factors of production and commodities .

8) Flexibility of wages , interest rate and prices : For automatic adjustment in the economic system , flexibility of wages , interest rate and prices are essential .

) **IMPLICATIONS OF SAY'S LAW OF MARKET**

1)Self - adjusting Mechanism : There is built - in - flexibility in the economic system . As a result , whatever is produced in the economy is consumed automatically . Due to the flexibility in prices , interest rates and wage rates , the self - adjusting mechanism can function smoothly . On the other

hand , government intervention is also not required in order to maintain full employment in the economy .

2) General over production is impossible : There is no question of general over production as additional amount of supply is automatically demanded in the economy .

3) No problem of general unemployment : Since there is no question of general over - production as discussed above , there can be no general unemployment as well . Presence of any temporary unemployment will be automatically absorbed in the due course of time .

4) Money has no direct role : In the functioning of an economy , money does not play any active role . It acts as the medium of exchange . The real flow of goods and services are considered to be more important than the flow of money .

5) Production is more important than consumption : According to Say , ' It is the aim of government to stimulate production ; of bad government to encourage consumption . Once production is happens , automatically there will be consumption .

6) Full employment is possible due to the flexibility of wage ate : One of the important assumptions of Say's law is ' wage flexibility ' . Full employment in the labour market is ensured because of the flexibility of wage rates . When wage rate is lowered , it helps in removing unemployment in the economy .

Keynesian theory of employment:-

Eminent economist of the twentieth century J.M. Keynes in his book , " The General Theory of Employment , Interest and Money " (1936) has propounded modern theory of employment . Keynes opines that full employment is not a normal feature of a developed capitalistic economy . In fact , unemployment situation can be found in every economy . These views of Keynes are based on the experiences of Great Depression . In 1930 almost all capitalistic economies witnessed widespread unemployment as a result of Great Depression .

Explanation of Keynesian Theory of Employment :

According to Keynesian Theory of Employment , in the short period , level of national income or output can be determined either at less than or equal to full employment level . It is because there is no such automatic mechanism in the economy that may keep it always in a state of full employment . Hence , question arises how national income or employment equilibrium is determined .

1) Principle of Effective Demand : The main point related to starting point of Keynes theory of employment is the principle of effective demand . Keynes propounded that the level of employment in the short run is dependent on the aggregate effective demand of products and services . According to him , an increase in the aggregate effective demand would increase the level of employment and vice - versa . Total employment of a country can be determined with the help of total demand of the country .

2) Determination of Effective Demand : Keynes has used two key terms , namely , aggregate demand price and aggregate supply price , for determining effective demand . Aggregate demand price and aggregate supply price together contribute to determine effective demand , which further helps in estimating the level of employment of an economy at a particular period of time . In an economy , the employment level depends on the number of workers that are employed , so that maximum profit can be drawn . Therefore , the employment level of an economy is dependent on the decisions of organisations related to hiring of employee and placing them . The level of employment can be determined with the help of aggregate supply price and aggregate demand price .

3) Aggregate Supply Price : Aggregate supply price refers to the total amount of money that all organisations in an economy should receive from the sale of output produced by employing a specific number of workers . In simpler words , aggregate supply price is the cost of production of products and services at a particular level of employment . It is the total amount of money paid by organisations to the different factors of production involved in the production of output .

4) Aggregate Demand Price : Aggregate demand price is different from demand for products of individual organisations and industries . The demand for individual organisations or industries refers to a schedule of quantity purchased at different levels of price of a single product . On the hand , aggregate demand price is the total amount of money that an organisation expects to receive from the sale of output produced by a specific number of workers . In other words , the aggregate demand price signifies the expected sale receipts received by the organisation by employing a specific number of workers . Aggregate demand price schedule refers to the schedule of expected earnings by selling the product at different level of employment Mo higher the level of employment , greater the level of output would be . Consequently , the increase in the employment level would increase the aggregate demand price . Thus , the slope of aggregate demand curve would be upward to the right . However , the individual demand curve slopes downward .

5) Determination of Equilibrium Level of Employment : The aggregate demand price and aggregate supply price help in determining the equilibrium level of employment . The aggregate demand price and aggregate supply

price help in determining the equilibrium level of employment.

Assumption of Employment theory

1) Saving and investment function:-

Keynesian theory of employment is based on the assumption that saving depends on income

2) Closed Economy : of Employment is based on the assumption that a deve capitalist economy is a closed economy wherein level of income and emplo Keynesian Theory remains unaffected by the foreign trade .

3) Ignore the Role of Government as a Spender or a Taxer : Keynes General Theory ignores the role of the government as a spender or as a la Keynes has ignored the effect of government sector on aggregate demand .

4) Fixed Prices : Reynes also assumed that factor prices and product prices remain fixed . Change output or income is due to change in aggregate demand expenditure . It is not da total output or ins to change in to change in prices .

5) Excess Excess Capacity is Available : Keynesian Theory also assumed that excess production capacity is available in the industries . It means that production can be increased in response to increase int aggregate demand without there being any increase prices .

6) Labour has Money Illusion : Keynesian Theory of Employment assumes that a misunderstanding is found among the labourers that value of money remains constant . It means that labourers believe that the that the proportion in which money (nominal) wages increase in the same proportion . real wages also increase . Labourers ignore the effect of change in prices .

7) Money also Acts as a Store of Value : Keynesian Theory also assumes that money does not serve as a medium of exchange only but it also acts as a store of value .

8) No Time Lag : Another assumption of Keynesian Theory is that different economic factors get adjusted without any loss of time . The period in which income increases is the period in which consumption and investment also increase .

9) Under - Employment Equilibrium : Keynes assumes that equilibrium is possible even in the condition of under - employment .

KEYNES CRITICISM ON CLASSICAL THEORIES OF EMPLOYMENT:-

John Maynard Keynes published his famous book " General Theory of Employment , Interest and Money " in 1936. In this book , Keynes vehemently criticized the classical theory of employment on the following grounds :

1. Full Employment condition of classical economics is an unrealistic assumption : According to Keynes , there is possibility of underemployment equilibrium condition which he considered as the reality and a normal phenomenon . For him full employment equilibrium situation is an exception which occurs rarely .

2. Classical economics gives undue importance to the long - run : Classical school of economics believed in the long run equilibrium at full emplo nent level through a self - adjusting mechanism . But , Keynes did not give any importance to the long - run phenomenon . According to him , " In the long - run , we are all dead . " He gave more importance to the short - term equilibrium . Present is more important than the happenings of future .

3. Supply does not create its own demand : Keynes refuted Say's law of market which claims that supply creates its own demand . For him Say's law is totally ineffective . In fact , he claimed that it was demand that created its own supply . If aggregate demand in the economy increases , firms produce more to meet that demand and thus , employment increases . Keynes stressed the possibility of overproduction and did not believe in the automatic self - adjustment in the economy .

4. Wage - flexibility is not the solution : Classical economists believed that wage - flexibility is a great measure for promoting employment during recessionary period . But in reality , nobody would be happy with the wage - cut policy . Keynes argued that general wage - cut during depression would reduce the purchasing power of the workers which lead to fall in aggregate consumption . This will further aggravate the problem by reducing the level of employment.

5. Self - adjustment of the economy is not possible : According to Keynes , capitalist system is not self - adjusting and automatic process which would result full employment . Great Depression of 1930s is a proof for that . Government intervention is required through fiscal policy and monetary policy .

6. Saving is a function of income : According to classical economics , saving is a direct function of rate of interest , at higher rate of interest saving will be more and vice versa . Keynes argument is that if a person does not have income , even at higher rate of interest also there will be no increase in saving . Thus according to him , saving is a function of income and there is a direct relationship between saving and income .

7. Rate of interest is not the only determinant of Investment : Investment in an economy is dependent not only on the rate of interest as claimed by the classical economics but it also depends on the marginal efficiency of capital . If there is no positive business expectations or if the business expectation is low , investment will be less even at a very low rate of interest . This simply means , a lower rate of interest cannot increase investment in an economy if productivity of capital is below expectation .