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Classical Theory vs. Keynesian Theory of Employment

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ABSTRACT

This research paper is a review paper which studied the classical and Keynesian theory of employment. It is a comparative study between both these approaches.
Classical Economists like Marshall and Pigou believed in the existence of full employment in the economy and considered it a normal situation. This theory is based on Say's Law of Market.
While Keynes criticised the classical theory for the unrealistic assumptions of it in his "General Theory". According to the Keynesian theory, there is under employment equilibrium exists in economy and full employment is an abnormal and accidental situation.
An attempt is made to study both theories in detail in this research paper

Keywords: *Say's law of market, under employment equilibrium, wage price flexibility.*

I. INTRODUCTION

In this essay an attempt is made to review the two theories of employment ,classical theory of employment and Keynesian theory of employment.
Classical theory was propounded prior to 1930 which states that there is always full employment in an economy while Keynes criticized classical concept in his "General theory of employment , interest and money" in 1936.
Both the theories are based on different assumptions like classical theory is based on full employment, flexibility of price and wages etc. While Keynes refutes classical theory assumptions. This paper tries to make a comparison between both these theories.

II. CLASSICAL THEORY

The term classical economists was first time used by Karl Marx to explain the views or opinions of various economists such as Ricardo and Adam Smith.
The classical economists did not propound any specific theory of employment and output . But they have given a lot of assumption which frame the classical theory of employment .
The first assumption is full employment it is the situation in which every individual who desires to work at the prevailing wage rates get employment.
According to them condition of unemployment is a temporary situation and they consider it an abnormal situation.
The basis of the classical theory is Say's Law of markets according to which "supply creates its own demand" .Hence, there can't be overproduction and the problem of unemployment in any economy.
If there is situation of overproduction then some labourers may be asked to leave the job due to which there can be situation of unemployment in the economy.
But in long run supply and demand equalizes each other because wages paid for the work of labour is spend by them on the purchasing or fulfilling their demand.

III. ASSUMPTIONS OF CLASSICAL THEORY

1. Existence of full employment
2. Laissez-faire economy
3. Closed economy
4. Perfect competition in labour and product markets
5. Homogenous labour
6. Capital stock and technical knowledge is given

7. Law of diminishing return operates in production
8. Quantity of money is given and money is only medium of exchange etc.

IV. DETERMINATION OF OUTPUT AND EMPLOYMENT

The basis of classical theory is Say's Law and output–employment determined in money, labour and goods market. According to classical theory, level of outputand employment is determined by the production function and supply and demand of labour. Production is function of capital stock, technical knowledge and number of workers.

Q = f(K,T,N)

Given K and T, output is function of number of workers. Output is an increasing function of number of workers upto a level and after a certain point as more workers are employed diminishing marginal returns to labour start.

V. LABOUR MARKET EQUILIBRIUM

Level of output and employment is determined by supply and demand of labour . The point where supply and demand are equal each other is full employment level. Demand for labour is considered as function of real wage rate.

Dn = f(W/P)

Where Dn = demand for labour, W= wage rate and P= price level.
Demand for labour is the decreasing function of real wage rate while supply of labour is increasing function of real wage rate.

VI. WAGE PRICE FLEXIBILITY

Classical economists believed that cut in money wages would take the economy to full employment level. When money wages are reduced then cost production reduced which results in lower prices of goods ,demand for goods will increase and more more labour would be required to to meet the demand by more production which results more employment.

VII. GOODS MARKET EQUILIBRIUM

Goods market in equilibrium when saving equals investment. If there is any divergence in saving and investment then equality is maintained by rate of interest.

So, S = f(r)

I = f (r)

And S=I

Interest determine the saving and investment equilibrium. Saving is increasing function of rate of interest and investment is decreasing function of rate of interest. If any time I > S then rate of interest rise and if S > I then rate of interest fall, where S = I that is the full employment level point.

VIII. MONEY MARKET EQUILIBRIUM

According to the theory , supply of money determine the price level.
Price level is the function of the money supply: P = f (M)
Point of equilibrium is point where total money supply equals total value of output.

IX. KEYNESIAN THEORY

Keynes vehemently criticised the classical theory for unrealistic assumptions in his General Theory. He criticised the classical theory on following basis:-

1. Underemployment Equilibrium is normal situation in reality, full employment is the abnormal situation.
2. He refuted the Say's law because it is possible that supply create its own demand because people has tendency to save, they don't spend whole amount for purchasing.
3. Equality of saving and investment depends on income level, not on rate of interest.
4. Rejection of Quantity theory of money, increase in supply of money not necessary to bring increment in price level.
5. Money is not neutral.
6. There is not direct and proportional relationship between real wages and money wages.
7. Long run analysis of classical theory is unrealistic because Keynes considered "In long run we all are dead".
8. State intervention is necessary.

According to Keynesian theory employment is depends on effective demand. Effective demand results in output and output results income.
So, Keynes assume employment is a function of income. There are four quantities considered in this theory , effective demand, output, income and employment.
Effective demand is determined by aggregate demand and aggregate supply. **Effective demand refers to the point where AD = AS**
Aggregate demand price refers to expected revenue from the sale of output produced at a particular level of employment.
Aggregate supply price refers to the amount necessary to receive or it can say that it is cost of production which necessary to recover.
Aggregate supply function depends on physical or technical condition of production which can't be changed in short run .
So, employment depends on aggregate demand only and demand also has two components, consumption demand and investment demand. Consumption is function of income as income increase consumption also increase but less than change in income. Propensity to consume is the psychological factor of consumer which is not easy to change in short run.
Thus, investment determine the level of employment. Investment depends on rate of interest and MEC (marginal efficiency of capital) , MEC depend on the supply price of capital assets and their prospective yield. Prospective yield of capital assets depends on psychological factor
So ,can't be dependent on MEC to increase investment. The second determinant is rate of interest which depends on supply and demand of money.

The Keynesian theory also explained in terms of aggregate supply (C+S) and aggregate demand (C+I). According to the theory under employment equilibrium is normal situation in economy because when income increase then consumption also increase but less than income increment, this behaviour of consumption function widen the gap between income and consumption which not possible to fill by the investment in short run.
The theory states that full employment can be achieved but that is an abnormal situation and multiplier effect of increase in investment leads to this situation.

X. CONCLUSION

Classical theory and Keynesian theory both studies the theory of employment on the basis of different assumptions. classical theory was propounded prior the great depression and consider that there is always full employment in economy, there is no state intervention, money is neutral etc.

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While Keynes criticised classical theory in his General theory in 1936. He considered that all the assumptions of classical theory are unrealistic. According to him full employment is an abnormal situation in any country without the intervention of state, money is not neutral and in long run all will be dead means theory consider short run period.

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