Socio-Economic impact assessment

THEORY OF EMPLOYMENT

TYPES OF UNEMPLOYMENT

(a) **Structural Unemployment:** It is also known as Marxian unemployment or long-term unemployment. It is due to slower growth of capital stock in the country. The entire labour force cannot be absorbed in productive employment, because there are not enough instruments of production to employ them.

(b) **Seasonal Unemployment:** Seasonal unemployment arises because of the seasonal character of a particular productive activity so that people become unemployed during the slack season. Occupations relating to agriculture, sugar mills, rice mills, ice factories and tourism are seasonal.

(c) **Frictional Unemployment:** It arises when the labour force is temporarily out of work because of perfect mobility on the part of the labour. In a growing and dynamic economy, in which some industries are declining and others are rising and in which people are free to work wherever they wish, some volume of frictional unemployment is bound to exist. This is so because it takes some time for the unemployed labour to learn new trades or to shift to new places, where there is a demand for labour. Thus, frictional unemployment exists when there is unsatisfied demand for labour, but the unemployed workers are either not fit for the jobs in question or not in the right place to meet this demand.

(d) **<u>Cyclical Unemployment:</u>** It is also known as Keynesian unemployment. It is due to deficiency of aggregate effective demand. It occurs when business depression occurs. During the times of depression, business activity is at low ebb and unemployment increases. Some people are thrown out of employment altogether and others are only partially employed. This type of unemployment is due to the fact that the total effective demand of the community is not sufficient to absorb the entire productive of goods that can be produced with the available stock of capital. When the businessmen cannot sell their goods and services, their profit expectations are not fulfilled. So the entrepreneurs reduce their output and some factors of production become unemployed.

(e) **<u>Disguised Unemployment:</u>** Disguised unemployment is the most widespread type of unemployment in under-developed countries. In under-developed countries, the stock of capital does not grow fast. The capital stock has not been growing at a rate fast enough to keep pace with the growth of population, the country's capacity to offer productive employment to the new entrants to the labour market has been severely limited. This manifests itself generally in two ways:

(i) the prevalence of large-scale unemployment in the urban areas; and
(ii) in the form of growing numbers engaged in agriculture, resulting in *'disguised unemployment'*.

In disguised unemployment, there is an existence of a very backward agricultural economy. People are engaged in production with an extremely low or zero marginal productivity. Since the employment opportunities in non-agricultural sector are not sufficient, therefore, most of the workers are bound to work in agricultural sector. This gives rise to the concept of *'disguised unemployment'*, in which people are unwillingly engaged in occupations, where their marginal productivity is very low.

THEORIES OF EMPLOYMENT

The theories of employment are broadly classified into two:

(a) Classical theory of employment

(b) Keynesian theory of employment.

The classical theory assumed the prevalence of full employment. The 'Great Depression' of 1929 to 1934, engulfing the entire world in widespread unemployment, low output and low national income, for about five years, upset the classical theorists. This gives rise to Keynesian theory of employment.

Classical Theory of Employment:

The term *'classical economists'* was firstly used by Karl Marx to describe economic thought of Ricardo and his predecessors including Adam Smith. However, by *'classical economists'*, Keynes meant the followers of David Ricardo including John Stuart Mill, Alfred Marshal and Pigou. According to Keynes, the term *'classical economics'* refers to the traditional or orthodox principles of economics, which had come to be accepted, by and large, by the well known economists by then. Being the follower of Marshal, Keynes had himself accepted and taught these classical principles. But he repudiated the doctrine of laissez-faire. The two broad features of classical theory of employment were:

(a) The ***assumption of full employment*** of labour and other productive resources, and

(b) The ***flexibility of prices and wages*** to bring about the full employment

(a) Full employment:

According to classical economists, the labour and the other resources are always fully employed. Moreover, the general over-production and general unemployment are assumed to be impossible. If there is any unemployment in the country, it is assumed to be temporary or abnormal. According to classical views of employment, the unemployment cannot be persisted for a long time, and there is always a tendency of full employment in the country. According to classical economists, the reasons for unemployment are:

(i) Intervention by the government or private monopoly,

(ii) Wrong calculation by entrepreneurs and inaccurate decisions, and

(iii) Artificial resistance.

The economy is assumed to be self-adjusting and perfectly competitive economy. It is the economy in which the relative values of goods and services are determined by the general relations of demand and supply. The pricing system serves as the planning mechanism.

(b) Flexibility of prices and wages:

The second assumption of full employment theory is the flexibility of prices and wages. It is the flexibility of prices and wages which automatically brings about full employment. If there is general over-production resulting in depression and unemployment, prices would fall as a result of which demand would increase, prices would rise and productive activity will be stimulated and unemployment would tend to disappear. Similarly, the unemployment could be cured by cutting down wages which would increase the demand for labour and would stimulate activity. Thus, if the prices and wages are allowed to move freely, unemployment would disappear and full employment level would be restored. Further, the classical economists treated money as mere exchange medium. They ignored its role in affecting income, output and employment.

Say's Law:

1. Say's Law is the foundation of classical economics. Assumption of full employment as a normal condition of a free market economy is justified by classical economists by a law known as *'Say's Law of Markets'*.

2. It was the theory on the basis of which classical economists thought

that general over-production and general unemployment are not possible.

3. According to the French economist J. B. Say, supply creates its own demand. According to him, it is production which creates market for goods. More of production, more of creating demand for other goods. There can be no problem of over-production.

4. Say denies the possibility of the deficiency of aggregate demand.

5. The conceived Say's Law describes an important fact about the working of free-exchange of economy that the main source of demand is the sum of incomes earned by the various productive factors from the process of production itself. A new productive process, by paying out income to its employed factors, generates demand at the same time that it adds to supply. It is thus production which creates market for goods, or supply creates its own demand not only at the same time but also to an equal extent.

6. According to Say, the aggregate supply of commodities in the economy would be exactly equal to aggregate demand. If there is any deficiency in the demand, it would be temporary and it would be ultimately equal to aggregate supply. Therefore, the employment of more resources will always be profitable and will take to the point of full employment.

7. According to Say's Law, there will always be a sufficient rate of total spending so as to keep all resources fully employed. Most of the

income is spent on consumer goods and a par of it is saved.

8. The classical economists are of the view that all the savings are spent automatically on investment goods. Savings and investments are interchangeable words and are equal to each other.

9. Since saving is another form of spending, according to classical theory, all income is spent partly for consumption and partly for investment.

10. If there is any gap between saving and investment, the rate of interest brings about equality between the two.

Basic Assumptions of Say's Law:

(a) **Perfectly competitive market and free exchange economy.**

(b) **Free flow of money incomes.** All the savings must be immediately invested and all the income must be immediately spent.

(c) **Savings are equal to investment** and equality must bring about by flexible interest rate.

(d) **No intervention of government** in market operations, i.e., a laissez faire economy, and there is no government expenditure, taxation and subsidies.

(e) Market size is limited by the volume of production and **aggregate demand is equal to aggregate supply.**

(f) It is a **closed economy.**

Criticism of Classical Theory:

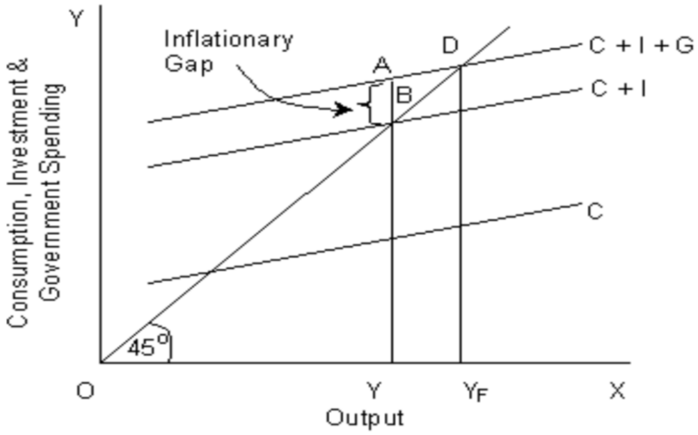
1. ***Supply may not create its own demand*** when a part of the income is saved. Aggregate demand is not always equal to aggregate supply.
2. ***Employment in a country cannot be increased by cutting general wages.***
3. ***There is no direct relationship between wages and employment.***
4. ***Interest rate adjustments cannot solve savings-investment problem.***
5. Classical economists have made the economy completely self-adjusting and self-reliant. ***An economy is not so self-adjusting and government intervention is unobvious.***
6. Classical economists have made the wages and prices so much flexible. ***In practical, wages and prices are not so flexible. It will create chaos in the economy.***
7. ***Money is not a mere medium of exchange.*** It has an essential role in the economy.
8. ***The classical theory has failed to explain the occurrence of trade cycles.***

Keynesian Theory of Employment:

Keynes has strongly criticised the classical theory in his book 'General Theory of Employment, Interest and Money'. His theory of employment is widely accepted by modern economists. Keynesian economics is also known as 'new economics' and *'economic revolution'*. Keynes has invented new tools and techniques of economic analysis such as consumption function, multiplier, marginal efficiency of capital, liquidity preference, effective demand, etc. In the short run, it is assumed by Keynes that capital equipment, population, technical knowledge, and labour efficiency remain constant. That is why, according to Keynesian theory, volume of employment depends on the level of national income and output. Increase in national income would mean increase in employment. The larger the national income the larger the employment level and vice versa. That is why, the theory of Keynes is known as *'theory of employment'* and *'theory of income'*.

<u>Inflationary Gap:</u>

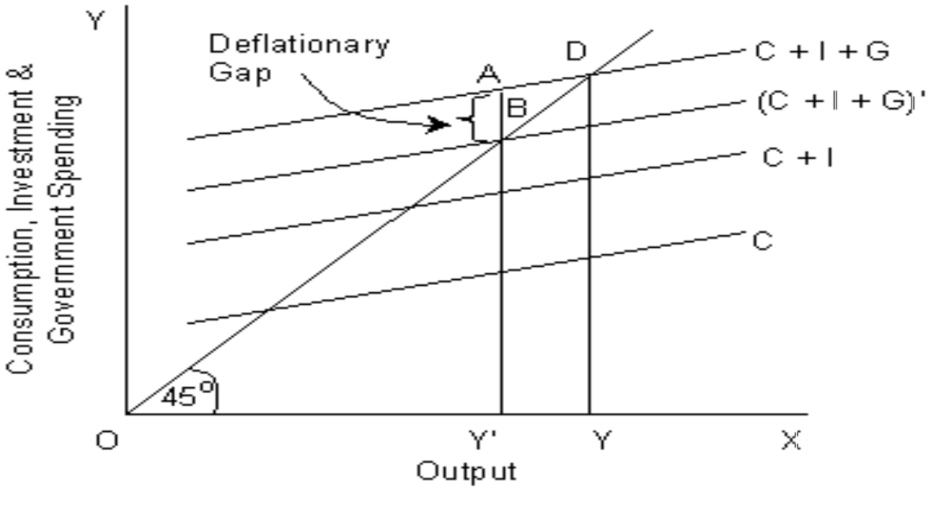
Inflationary gap arises when consumption and investment spending together are greater than the full employment GNP level. This means that people are demanding more goods and services than can be produced. In other words, the implication of inflationary gap is that national income, output and employment cannot rise further. The only consequence of increased demand is that the price level will increase. Or we may say that there will be an inflationary gap if scheduled investment tends to be greater than full employment saving. In a situation like this, more goods will be demanded than the economic system can produce. The result will be that price will begin to rise and an inflationary situation will emerge. Thus, if full employment saving falls short of scheduled investment at full employment (which means that peoples' propensity to spend is higher than the propensity to save), there will be an inflationary gap.



In the above diagram, C + I + G (consumption, investment and government spending) line shows the total expenditure on demand in the economy. At this level, Y is the real output, as shown by the intersection, point D, with the 45° line. Y_F represents a full employment level on real output. Real income of the economy, obviously cannot reach Y. At Y_F, total demand (C + I + G) exceeds total output, leaving a gap AB, which is the inflationary gap in the Keynesian sense.

<u>Deflationary Gap:</u>

The deflationary or recessionary gap is the amount by which the aggregate expenditure falls short of the full employment level of national income. It causes a multiple decline in real NI.



In the above diagram, Y is the total output at full employment level. Let us assume that the total demand is (C + I + G)′ which cuts the 45^o line at B, with real output Y′, AB then is the deflationary gap.

Consumption Function

Propensity to consume is also called consumption function. In the Keynesian theory, we are concerned not with the consumption of an individual consumer but with the sum total of consumption spending by all the individuals. However, in generalizing the consumption behaviour of the whole economy, we have to draw some useful conclusions from the study of the behaviour of a normal consumer, which may be valid for all consumers' behaviour of the economy. Aggregate consumption depends on consumption function or propensity to consume.

The economic term *'consumption'* means the amount spent on consumption at a given level of income. *'Consumption function'* or *'propensity to consume'* means the whole of the schedule showing consumption expenditure at various levels of income. It tells us how consumption expenditure increases as income increases. The consumption function or propensity to consume, therefore, indicates a functional relationship between the aggregates, viz., total consumption expenditure and the gross national income. It is a schedule that expresses relationship between consumption and disposable income.

According to Keynesian theory, following are the factors that influence consumption:

(a) The real income of the individual,

(b) The past savings, and

(c) Rate of interest.

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