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FOR:

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BUSINESS ECONOMICS

KEYNESIAN THEORY OF EMPLOYMENT

- In his book “**The General theory of Employment Interest and Money**” Lord Keynes rejected the classical theory of employment. He has provided a new independent explanation on macroeconomic level by thinking about variables like total income, level of employment total investment etc. in a different manner.

THE OUTLINE OF THE THEORY –

- Keynesian theory is basically an analysis of income output and employment. The central theme of his theory is that total employment depends upon total or aggregate demand in the economy.
- In an advanced capitalist economy the level of employment depends upon the level of aggregate **effective demand**. Effective demand refers to the total demand of the community. Effective demand refers to the flow of total expenditure in the economy at a particular level of employment. This flow determines the flow of income because one man's expenditure is another man's income. The flow of expenditure also represents the value of total output. Total expenditure consists consumption expenditure and investment expenditure.

EFFECTIVE DEMAND

- Effective demand = Aggregate expenditure = Aggregate income = Value of output

$$\bullet E.D = C + I + G$$

OR

$$\bullet Y = C + I + G$$

- Effective demand depends upon aggregate demand and aggregate supply function.

AGGREGATE DEMAND FUNCTION (ADF)

- ADF is a schedule of various amounts of money which the entrepreneurs in an economy expect from the sale of their output at different levels of employment.

Level of Employment	Price in Rs. {crs.}
1 Lakh	175
2 Lakh	250
3 Lakh	325
4 Lakh	400
5 Lakh	475
6 Lakh	550

AGGREGATE SUPPLY FUNCTION [ASF]-

- ASF is a schedule showing different amounts of money which the entrepreneurs must get from the sale of output from various levels of employment. This is equal to cost of production including normal profits.

Level of Employment	ASP in Rs crores
1 Lakh	100
2 Lakh	200
3 Lakh	300
4 Lakh	400
5 Lakh	500
6 Lakh	600

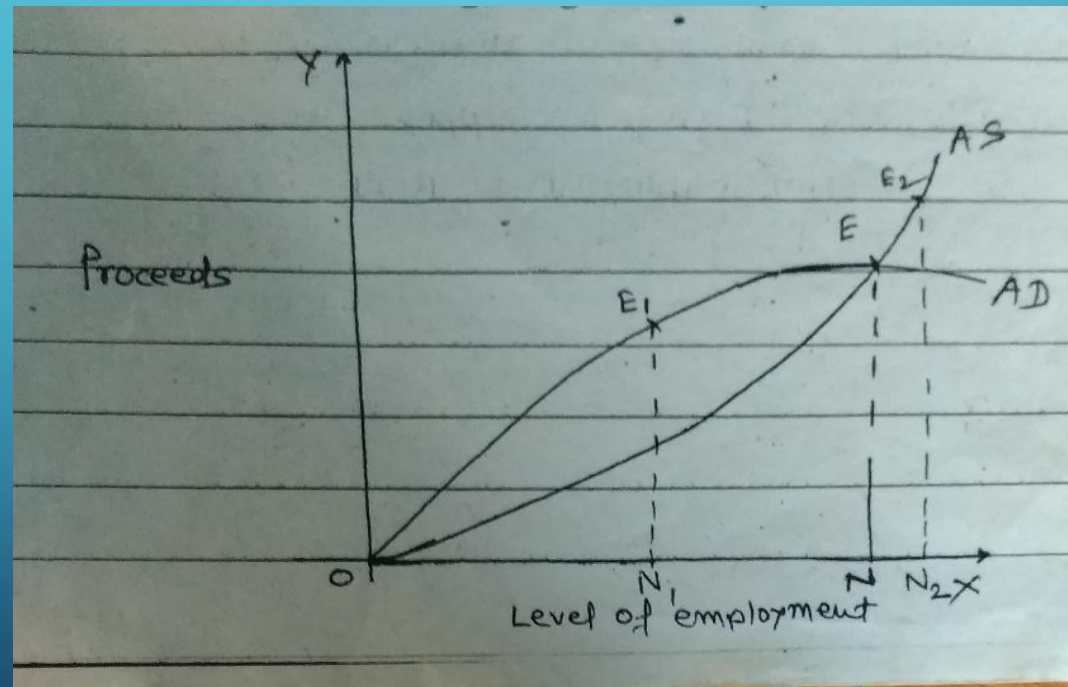
DETERMINATION OF EFFECTIVE DEMAND

- In the economy the level of employment is determined by the point of intersection between AD and AS function/curves. This is also the point of effective demand. This can be explained with the help of a schedule and

Employment (In lakhs)	ADP (Rs. Crores)	ASP (Rs. Crores)
1	175	100
2	250	200
3	325	300
4	400	400
5	475	500
6	550	600

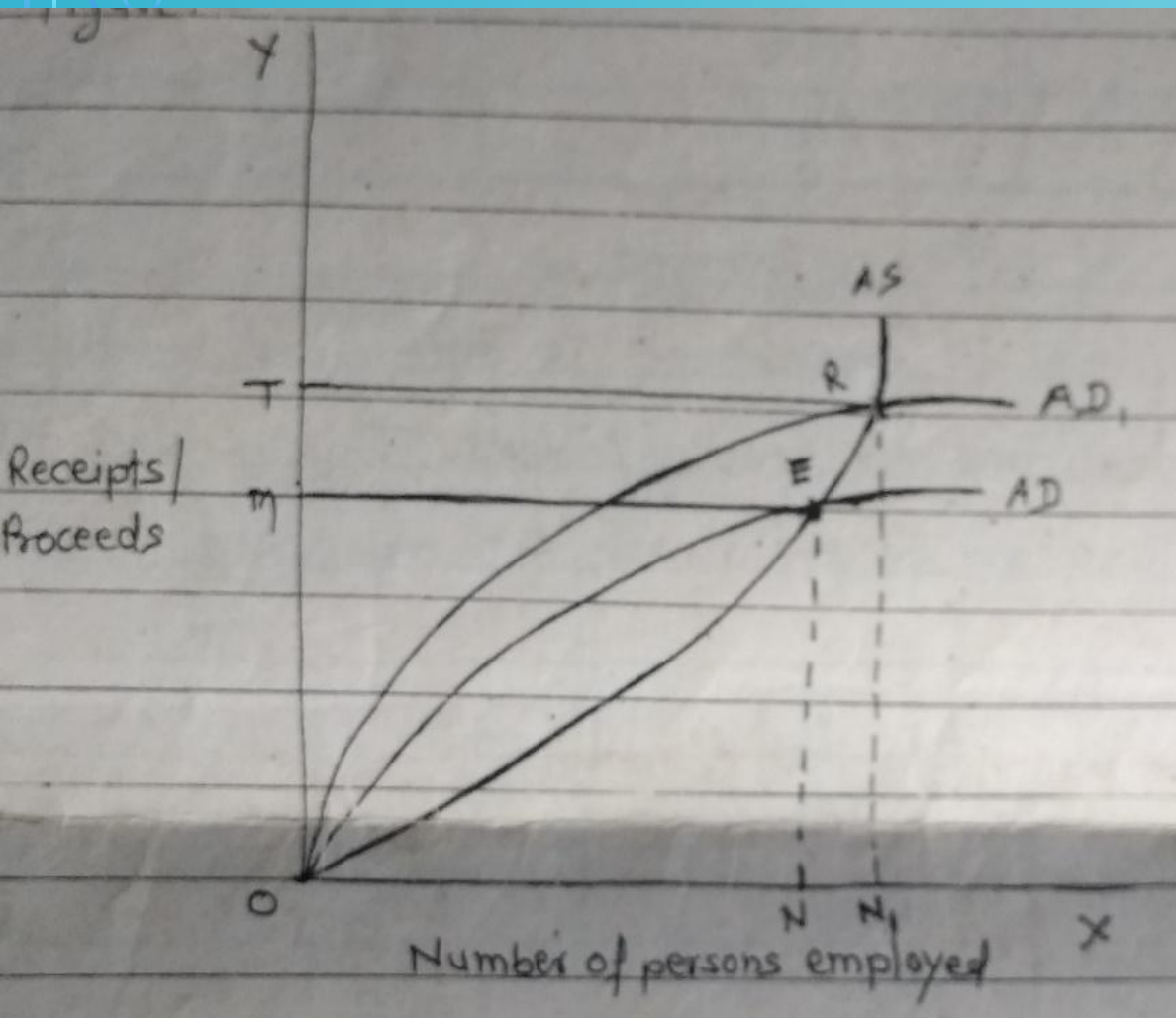
THE EQUILIBRIUM LEVEL OF EMPLOYMENT

- The equilibrium level of employment is 4 lakhs when $ADP=ASP=400$ Rs. Crores.
- The determination of effective demand and the equilibrium level of employment are shown in the following figure



UNDER EMPLOYMENT EQUILIBRIUM –

- It is not necessary that the equilibrium level of employment is always at full employment. **Equality between aggregate demand and aggregate supply does not necessarily indicate the full employment.** The economy can be in equilibrium at less than full employment or in other words an under employment equilibrium can exist.
- Under employment equilibrium can be explained with the help of figure.



This unemployment will be removed and full employment equilibrium will be reached if through increases in investment demand or increase in consumption or increase in both aggregate demand curve shifts upward so that it intersects the aggregate supply curve at point R. It will be seen that the intersection of aggregate demand and aggregate supply curves at point R equilibrium is established at full employment level ON_1 .

CRITICISM OF KEYNESIAN THEORY OF EMPLOYMENT –

- **Aggregative in nature** – The theory deals with aggregate concepts like aggregate consumption total investment total output etc. These aggregates may be mislead because these do not explain the economic problems of individual units.
- **Effective Demand** – According to the theory employment is depend on effective demand. But critics urge that employment may be depend on skill invention and techniques as well.

- **Ignores Long Run Problem** – The theory deals with short run. Keynes himself said “In future we are all dead.” The limitation of the theory is that it does not explain how to solve the long run problems of the dynamic economy.
- **Theory is not general** – The critics say that principle of effective demand is not applicable in underdeveloped countries where the problem is of inelastic supply and not of deficiency of aggregate demand. Its application is limited to developed nations

- Does not provide comprehensive solution of unemployment –
- The theory deals with only cyclical unemployment. Keynes did not attempt to solve frictional, technological, chronic unemployment of underdeveloped countries.
- Relationship between Effective Demand and Employment –
- Critics point out that there cannot be a definite functional relationship between Effective Demand and Employment. In fact everything depends upon the complex inter relationship of wages, prices and money supply. Keynes did not provide any evidence of the functional relationship between Effective demand and Employment.

CONCLUSION –

- Though there are several limitations on the Keynesian Theory, Keynes Contribution to the development of economic theory cannot be underestimated. The principle of effective demand continues to remain an important part of the modern macro-economic analysis.

Thank You!

