1. **Theory & Determination of Income and Employment**

**(Classical and Keynesian Theory)**

**Points to be remembered:**

* **Employment (توظيف):** A situation when a person is able and willing to take up a job and gets employed.
* **Full Employment (كامل التوظيف):** A situation where all those workers who are able and willing to work get employment.
* **Under Employment (تحت التوظيف):** A situation when people are engaged in jobs but they do not get these jobs according to their capabilities, efficiency and qualifications.
* **Unemployment (بطالة):** A situation when a person is willing to work but does not get opportunity to work.
* **Involuntary Unemployment (البطالة القسرية):** A situation when the workers are willing to work under any conditions and at any wage rate but they fail to get employment.
* **Voluntary Unemployment (البطالة الطوعية):** When the economy offers employment opportunities to the workers, but they themselves are not willing to take up jobs because the employment conditions such as wage rate, location, promotional avenues, physical environment, attitude of the employer, etc., do not suit them.
* **Cyclical Unemployment (البطالة الدورية):** It is caused by slackness in business conditions. During depression, investment activities get discouraged. Contraction in business activities renders large numbers of workers unemployed.
* **Technological Unemployment (البطالة التكنولوجية):** It is generally found in the advanced countries. The main cause of this unemployment is the introduction of the new technology.
* **Frictional Unemployment (البطالة الاحتكاكية):** It is a temporary unemployment which exists during the period of the transfer of labor from one occupation to another.
* **Structural Unemployment (البطالة الهيكلية):** It is the result of the backwardness and underdevelopment of an economy.
* **Disguised Unemployment (البطالة المقنعة):** When more workers are engaged in a work than actually required to work, it is called disguised unemployment.
* **Equilibrium level of employment (مستوى التوازن للعمالة):** level of employment where aggregate demand equals aggregate supply.
* **Full employment level (مستوى التوظيف الكامل):** the level of employment where all the available supply of labour is gainfully employed.
* **Excess demand (الطلب الزائد):** when aggregate demand exceeds aggregate supply at full employment level.
* **Deficient demand (الطلب ناقص):** when aggregate demand falls short of aggregate supply at full employment level.
* **Inflationary gap (فجوة تضخمية):** it occurs as an excess of anticipated expenditure over available output at full employment level.
* **Deflationary gap (الفجوة الانكماشية):** it occurs as an excess of available aggregate output over anticipated aggregate expenditure.
* **Ex- ante saving (**السابقين عليه سابقا الادخار**):** Ex- ante saving is what the savers plan (or intend) to save at different levels of income in an economy. It is also known as intended saving or planned saving.
* **Ex- post saving (**آخر سبيل توفير**):** It refers to actual or realized saving in an economy during a year.
* **Ex- ante Investment (**السابقين أنتي الاستثمار**):** Ex- ante investment is what the investors plan (or intend) to invest at different levels of income in an economy. It is also known as intended investment or planned investment.
* **Ex- post investment (**استثمار آخر السابقين**):** It refers to actual or realized investment in an economy during a year.

**Classical Theory of Income and Employment:**

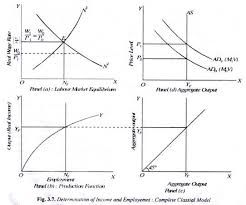
Old classical economists like Adam Smith, Ricardo, J. B. Say, J. S. Mill, and N. Senior believe in *laissez faire* policy (no government intervention in any economic activities) developed the classical theory of employment. This theory states that full employment is a normal feature of a capitalist economy. The classical theory of employment rules out the possibility of unemployment in a free market economy. The economy would always be in a full employment equilibrium.

The classical theory of employment is based on the following assumptions:

* The Say’s law of market;
* Flexibility (مرونة) of the interest rates;
* Flexibility of the wage rates.

According to ***Say’s Law of Market***, “The supply creates its own demand”. It is an automatic mechanism which establishes equilibrium between aggregate demand and aggregate supply.

The implication of the classical system is that there will never be a possibility of over- production or under- production in the economy.

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During the Great Depression of 1930s, the Classical Theory of Employment failed miserably.

Prof. J. M. Keynes developed a new theory of employment in his book “*General Theory of Employment, Interest and Money*” published in 1936.

Keynesian theory of employment is based on the concept of effective demand. Keynes states that *demand creates its own supply*.

Effective demand means the level of income where aggregate demand and aggregate supply are equal.

Prof. J. M. Keynes used the approach of aggregate demand and aggregate supply for the determination of full employment equilibrium.

**Aggregate Demand (الطلب الكلي):**

The total demand for goods and services in an economy in a year’s time is called aggregate demand. It is expressed in terms of total expenditure of the community.

Goods and services are demanded for two purposes- (1) Consumption, and (2) Investment.

Consumption is of two types: private (household) consumption and public (government) consumption. Similarly, investment is also of two types: private (household) investment and public (government) investment.

Aggregate Demand (AD) = Consumption Demand (C) + Investment Demand (I)

AD = C + I

Y = C + I

**Aggregate Demand Schedule:**

The aggregate demand schedule can be drawn by aggregating- aggregate consumption (C) and aggregate investment (I) at different levels of income.

Consumption depends on income (Y), propensity to consume (c) and many other factors.

C = a + cY

**Relationship between Income and Consumption:**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  | | --- | --- | | ***(SR ‘000 Crores)*** | | | **Income** | **Consumption** | | 0 | 20 | | 10 | 25 | | 20 | 30 | | 30 | 35 | | 40 | 40 | | 50 | 45 | | 60 | 50 | |  |

**Aggregate Investment:**

It is of two types- autonomous investment and induced investment.

**Autonomous Investment:** It is that expenditure on capital formation which is undertaken independently of the level of income.

**Induced Investment:** It is expenditure both on fixed assets and on the stocks that are required if the economy is to be able to produce a bigger output as aggregate demand rises.

Here, we assume that only investment expenditure that is incurred in the economy is in the form of autonomous investment.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  | | --- | --- | | ***(SR ‘000 Crores)*** | | | **Income** | **Investment** | | 0 | 20 | | 10 | 20 | | 20 | 20 | | 30 | 20 | | 40 | 20 | | 50 | 20 | | 60 | 20 | |  |

Aggregate demand schedule can be derived by adding consumption schedule and investment schedule.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
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| |  |  |  |  | | --- | --- | --- | --- | | **Income (Y)** | **Consumption (C)** | **Investment (I)** | **Aggregate Demand (AD = C + I)** | | 0 | 20 | 20 | 40 | | 10 | 25 | 20 | 45 | | 20 | 30 | 20 | 50 | | 30 | 35 | 20 | 55 | | 40 | 40 | 20 | 60 | | 50 | 45 | 20 | 65 | | 60 | 50 | 20 | 70 | |  |

**Components of Aggregate Demand:**

There are four major components of aggregate demand-

1. Household consumption expenditure (C);
2. Government final consumption expenditure (G);
3. Private and public investment expenditure (I); and
4. Net export (X-M)

**Symbolically,**

AD = C + I + G + (X-M)

**Aggregate Supply:**

It refers to the money value of all goods and services produced in a country in a year’s time. It, in fact, refers to the national income of a country because it is the money value of all goods and services produced in a year’s time.

Aggregate Supply = Domestic Product = Total Factor Incomes = National Income

Aggregate Supply (AS) = Consumption (C) + Saving (S)

Y = C + S

**Aggregate Supply Schedule:**

Aggregate supply schedule can be formed by aggregating consumption expenditure and savings at different levels of income.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
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| |  |  |  |  | | --- | --- | --- | --- | | **Income (Y)** | **Consumption (C)** | **Savings (S)** | **Aggregate Supply (AS = C + S)** | | 0 | 20 | -20 | 0 | | 10 | 25 | -15 | 10 | | 20 | 30 | -10 | 20 | | 30 | 35 | -5 | 30 | | 40 | 40 | 0 | 40 | | 50 | 45 | 5 | 50 | | 60 | 50 | 10 | 60 | | 70 | 55 | 15 | 70 | |  |

**Determination of Equilibrium:**

Determination equilibrium of an economy can be studied by two approaches:

1. As equality of aggregate demand and aggregate supply; and
2. As equality of saving and investment.

**AS and AD Approach:**

Equilibrium level of income is determined where aggregate demand curve cuts aggregate supply. In other words, the level of income will be in equilibrium where aggregate demand is equal to aggregate supply.

**Example:**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
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| (SR ’000 Million)   |  |  |  | | --- | --- | --- | | Income (Y) | Aggregate Demand (AD= C+I) | Aggregate Supply (AS= C+S) | | 0 | 40 | 0 | | 10 | 45 | 10 | | 20 | 50 | 20 | | 30 | 55 | 30 | | 40 | 60 | 40 | | 50 | 65 | 50 | | 60 | 70 | 60 | | 70 | 75 | 70 | | **80** | **80** | **80** | | 90 | 85 | 90 | | 100 | 90 | 100 | |  |

**If Aggregate Demand is not equal to Aggregate Supply:**

|  |  |  |
| --- | --- | --- |
| **Aggregate Demand (AD) =** | **Aggregate Supply (AS)** | |
|  |  | |
| If AD > AS | If AD < AS | |
| ↓ | ↓ | |
| Increase in employment of factor services | Decrease in employment of factor services | |
| ↓ |  | |
| Increase in the level of output of goods and services | Decrease in the level of output of goods and services | |
| ↓ | ↓ | |
| Ultimately AD = AS | Ultimately AD = AS | |
| https://encrypted-tbn2.gstatic.com/images?q=tbn:ANd9GcQuc_6F-16hpG-n52_G3LcK3YCyfyVYecysEDhSau5pokSXKbbwDQ | | https://encrypted-tbn2.gstatic.com/images?q=tbn:ANd9GcSFK2fSf5f75RsJaOcyk1g8NPaOWLzAWPlBOVwAYnN7jVPJfNbrvQ |

**Alternative Approach to Equilibrium (Saving and Investment Approach):**

Since, AD is:

Y = C + I, ……………………………………… (1)

And,

AS is:

Y = C + S, …………………………………….. (2)

By putting together equations (1) and (2), we get

C + I = C + S

Hence,

I = S

i.e., aggregate investment equals aggregate saving in the economy.

**Diagrammatic Presentation:**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  | | --- | --- | --- | --- | | **Income (Y)** | **Consumption (C)** | **Saving (S)** | **Investment (I)** | | 0 | 20 | -20 | 20 | | 10 | 25 | -15 | 20 | | 20 | 30 | -10 | 20 | | 30 | 35 | -5 | 20 | | 40 | 40 | 0 | 20 | | 50 | 45 | 5 | 20 | | 60 | 50 | 10 | 20 | | 70 | 55 | 15 | 20 | | **80** | **60** | **20** | **20** | | 90 | 65 | 25 | 20 | | 100 | 70 | 30 | 20 | |  |

Equilibrium level of employment (or income) is determined by the intersection of the aggregate demand and aggregate supply schedule.

*The classical economists* held the view that this equilibrium level of employment would be full employment level. There will be no involuntary unemployment either of labour or of capital. If there were to be any unemployment resources, wage rates and interest rates would move. Movement in the wage rates and interest rates would serve to bring full employment in the economy.

Prof. J. M. Keynes did not agree with this view of the classical economists. He gave three types of equilibrium situations:

1. Equilibrium at full employment level;
2. Equilibrium at less than full employment level;
3. Equilibrium at more than full employment level;

***Equilibrium at full employment level:*** this will obtain when the equality of AD and AS occurs at a level where at the available resources are gainfully employed.

***Equilibrium at less than full employment level (Deflationary gap):*** this will occur when the aggregate demand is not sufficient to absorb all those who seek employment. Clearly, there will be involuntary unemployment in the economy. This would have been caused by deficient demand.

***Equilibrium at more than full employment level (Inflationary gap):*** this will occur when the available resources in the economy are not sufficient to meet the aggregate demand for goods and services. Clearly, this situation is caused by excess demand in the economy.

|  |  |
| --- | --- |
| **[Output and Income](http://www.economicsdiscussion.net/wp-content/uploads/2014/02/clip_image002_thumb21.jpg)** | http://www.economicsdiscussion.net/wp-content/uploads/2014/02/clip_image002_thumb22.jpg |

**Causes of Excess Demand (*Inflationary gap*) and Deficient Demand (*Deflationary gap*):**

|  |  |
| --- | --- |
| **Causes** | |
| **Of Excess Demand** | **Of Deficient Demand** |
| * Government expenditure > Government revenue | * Government expenditure < Government revenue |
| * Increase in autonomous investment | * Cut in autonomous investment |
| * Surplus on balance of payments | * Deficits in balance of payments |
| * Increase in capital formation | * Cut in capital formation |

**Effects of Excess Demand:**

In case of excess demand, the planned aggregate expenditure is more than the planned aggregate output. All the available resources are already fully employed. Therefore, there is no chance to increase the level of employment further.

Likewise, since no additional resources are available, it will not be possible either to increase the level of output.

But, in case, there is already full employment in the economy large aggregate expenditure in the economy would result in a rise in the general price level. Thus, excess demand has a general inflationary potential and that is why excess demand is known as inflationary gap.

**Effects of Deficient Demand:**

In case of deficient demand, the planned aggregate expenditure is less than the planned aggregate output. In this case, there will be tendency to curtail the employment.

Since the aggregate output cannot be absorbed by the aggregate expenditure, the surplus availability of output will result in a fall in the general price level. Thus, deficient demand has a general deflationary potential and that is why it is also known as deflationary gap.

**Measures to Correct Deficient Demand:**

1. *Fiscal policy:*

* Reduction in tax rates; and
* Increase in government expenditure.

1. *Monetary policy:*

* Reduction in bank rate;
* Reduction in reserve ratios; and
* Purchase of government securities.

1. *Export promotion:*

**Measures to Correct Excess Demand:**

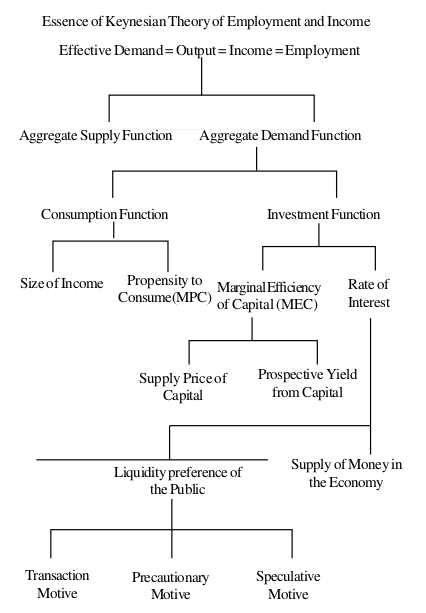
1. *Fiscal policy:*

* Rise in tax rates; and
* Decrease in government expenditure.

1. *Monetary policy:*

* Rise in bank rate;
* Increase in reserve ratios; and
* Sale of government securities.

1. *Import promotion:*

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**Questions for Review**

**Multiple Choice Questions with Answer:**

1. A situation when a person is able and willing to take up a job and gets employed, it is called-

|  |  |
| --- | --- |
| 1. Employment | 1. Full Employment |
| 1. Under Employment | 1. Unemployment. |

1. A situation when people are engaged in jobs but they do not get these jobs according to their capabilities, efficiency and qualifications, it is called-

|  |  |
| --- | --- |
| 1. Employment | 1. Full Employment |
| 1. Under Employment | 1. Unemployment. |

1. A situation when the workers are willing to work under any conditions and at any wage rate but they fail to get employment, it is called-

|  |  |
| --- | --- |
| 1. Voluntary Unemployment | 1. Involuntary Unemployment |
| 1. Cyclical Unemployment | 1. Frictional Unemployment |

1. A temporary unemployment which exists during the period of the transfer of labor from one occupation to another is called-

|  |  |
| --- | --- |
| 1. Voluntary Unemployment | 1. Involuntary Unemployment |
| 1. Cyclical Unemployment | 1. Frictional Unemployment |

1. When more workers are engaged in a work than actually required to work, it is called-

|  |  |
| --- | --- |
| 1. Voluntary Unemployment | 1. Involuntary Unemployment |
| 1. Disguised Unemployment | 1. Frictional Unemployment |

1. Who developed the Classical Theory of Income and Employment?

|  |  |
| --- | --- |
| 1. J. B. Say | 1. J. S. Mill |
| 1. Ricardo | 1. All of the above. |

1. *“The supply creates its own demand”.* This is the famous law of----

|  |  |
| --- | --- |
| 1. Market (*Say’s Law of Market*) | 1. Demand |
| 1. Supply | 1. None of the above. |

1. The book *General Theory of Employment, Interest and Money* was written by----

|  |  |
| --- | --- |
| 1. J. N. Keynes | 1. J. M. Keynes |
| 1. Ricardo | 1. None of the above. |

1. Keynesian theory of employment is based on the concept of------------

|  |  |
| --- | --- |
| 1. Aggregate Demand | 1. Aggregate Supply |
| 1. Aggregate Demand and Supply both | 1. None. |

1. The investment which is undertaken independently of the level of income is known as----

|  |  |
| --- | --- |
| 1. Autonomous Investment | 1. Induced Investment |
| 1. Public Investment | 1. Private Investment |

1. The components of aggregate demand is/ are------

|  |  |
| --- | --- |
| 1. Household consumption expenditure | 1. Govt final conspt. expenditure |
| 1. Pvt and public invt expenditure | 1. All |

1. Determination equilibrium of an economy can be studied by-----

|  |  |
| --- | --- |
| 1. Equality of AD and AS | 1. Equality of saving and investment |
| 1. Both a and b | 1. None. |

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Q.N.** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** | **11** | **12** |
| **Ans.** | **a** | **c** | **b** | **d** | **c** | **d** | **a** | **b** | **c** | **a** | **d** | **c** |

**Write *T* for True and *F* for False against each of the following statements:**

1. The Classical theory of Income and Employment states that full employment is a normal feature of a capitalist economy.
2. The classical theory of employment rules out the possibility of unemployment in a free market economy.
3. According to classical economists the economy would never be in a full employment equilibrium.
4. Keynesian theory of employment is based on the concept of effective demand.
5. Effective demand means the level of income where aggregate demand and aggregate supply are equal.
6. Classical economists used the approach of aggregate demand and aggregate supply for the determination of full employment equilibrium.
7. Induced investment is expenditure both on fixed assets and on the stocks that are required if the economy is to be able to produce a bigger output as aggregate demand rises.
8. AD = C + I + G + (X-M)
9. Equilibrium level of income is determined where aggregate demand curve cuts aggregate supply.
10. The level of income will be in equilibrium when aggregate demand is greater than aggregate supply.

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Q.N.** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** |
| **Ans.** | **T** | **T** | **F** | **T** | **F** | **F** | **T** | **T** | **T** | **F** |

**Matching Test:**

|  |  |
| --- | --- |
| **Match-I** | **Match-II** |
| 1. Ex- ante Saving | 1. Actual Saving |
| 1. Ex- post Saving | 1. Intended or planed Saving |
| 1. Supply creates its own demand | 1. J. M. Keynes |
| 1. Demand creates its own supply | 1. J. B. Say |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Match-I** | **A** | **B** | **C** | **D** |
| **Match-II** | **2** | **1** | **4** | **3** |

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Match-I** | | | | **Match-II** | | | | | | | |
| 1. Voluntary Unemployment | | | | 1. When more workers are engaged in a work than actually required to work. | | | | | | | |
| 1. Involuntary Unemployment | | | | 1. It is a temporary unemployment which exists during the period of the transfer of labor from one occupation to another. | | | | | | | |
| 1. Frictional Unemployment | | | | 1. A situation when the workers are willing to work under any conditions and at any wage rate but they fail to get employment. | | | | | | | |
| 1. Disguised Unemployment | | | | 1. When the economy offers employment opportunities to the workers, but they themselves are not willing to take up jobs. | | | | | | | |
| **Match-I** | | **A** | | | **B** | | | **C** | | **D** | |
| **Match-II** | | **4** | | | **3** | | | **2** | | **1** | |
| **Match-I** | | | | | | **Match-II** | | | | | |
| 1. When AD > AS | | | | | | 1. Decrease in employment and output | | | | | |
| 1. When AD < AS | | | | | | 1. Increase in employment and output | | | | | |
| 1. When AD = AS | | | | | | 1. Equilibrium level of income and employment | | | | | |
| 1. AS = | | | | | | 1. C + I + G + (X - M) | | | | | |
| 1. AD = | | | | | | 1. C + S | | | | | |
| **Match-I** | **A** | | **B** | | | | **C** | | **D** | | **E** |
| **Match-II** | **2** | | **1** | | | | **3** | | **5** | | **4** |

**Questions with Answers:**

1. **What is employment (توظيف)?**

A situation when a person is able and willing to take up a job and gets employed is called employment.

1. **What is full employment (كامل التوظيف)?**

A situation where all those workers who are able and willing to work get employment.

1. **What is under employment (تحت التوظيف)?**

A situation when people are engaged in jobs but they do not get these jobs according to their capabilities, efficiency and qualifications.

1. **What is unemployment (بطالة)?**

A situation when a person is willing to work but does not get opportunity to work.

1. **What do you mean by involuntary unemployment (البطالة القسرية)?**

A situation when the workers are willing to work under any conditions and at any wage rate but they fail to get employment.

1. **What do you understand by the term voluntary unemployment (البطالة الطوعية)?**

When the economy offers employment opportunities to the workers, but they themselves are not willing to take up jobs because the employment conditions such as wage rate, location, promotional avenues, physical environment, attitude of the employer, etc., do not suit them.

1. **What is cyclical unemployment (البطالة الدورية)?**

It is caused by slackness in business conditions. During depression, investment activities get discouraged. Contraction in business activities renders large numbers of workers unemployed.

1. **What is technological unemployment (البطالة التكنولوجية)?**

It is generally found in the advanced countries. The main cause of this unemployment is the introduction of the new technology.

1. **What is frictional unemployment (البطالة الاحتكاكية)?**

It is a temporary unemployment which exists during the period of the transfer of labor from one occupation to another.

1. **What is structural unemployment (البطالة الهيكلية)?**

It is the result of the backwardness and underdevelopment of an economy.

1. **What do you mean by disguised unemployment (البطالة المقنعة)?**

When more workers are engaged in a work than actually required to work, it is called disguised unemployment.

1. **Who are classical economists?**

The old economists such as Adam Smith, J. B. Say, J. S. Mill, Ricardo, etc. who believe in laissez faire policy (non- interference of government in any economic activities) are called classical economists.

1. **What is classical theory of income and employment?**

The Classical theory of income and employment states that full employment is a normal feature of a capitalist economy. The classical theory of employment rules out the possibility of unemployment in a free market economy. The economy would always be in a full employment equilibrium.

1. **What are the assumptions on which the classical theory of income and employment based?**

The classical theory of employment is based on the following assumptions:

* The Say’s law of market;
* Flexibility (مرونة) of the interest rates;
* Flexibility of the wage rates.

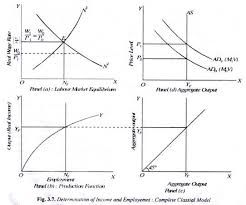
1. **What is *Say’s Law of Market*?**

According to ***Say’s Law of Market,*** “The supply creates its own demand”. It is an automatic mechanism which establishes equilibrium between aggregate demand and aggregate supply.

1. **What is the main implication of classical theory of income and employment?**

The implication of the classical system is that there will never be a possibility of over- production or under- production in the economy. The economy would always be in a full employment equilibrium.

1. **Sketch the Classical theory of income and employment through diagram.**

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1. **Who criticised the classical theory of employment?**

Prof. J. M. Keynes in his famous book “*General Theory of Employment, Interest and Money*” published in 1936, criticised the classical view on employment.

1. **What is modern theory of income and employment?**

**Or, What is Keynesian theory of income and employment?**

Prof. J. M. Keynes developed a new theory of employment in his book “*General Theory of Employment, Interest and Money*” published in 1936. His theory of employment is based on the concept of *effective demand*. Keynes states that *demand creates its own supply*. *Effective demand* means the level of income where aggregate demand and aggregate supply are equal. Prof. J. M. Keynes used the approach of aggregate demand and aggregate supply for the determination of full employment equilibrium.

1. **What is aggregate demand?**

The total demand for goods and services in an economy in a year’s time is called aggregate demand. It is expressed in terms of total expenditure of the community.

Aggregate Demand (AD) = Consumption Demand (C) + Investment Demand (I)

AD = C + I

Y = C + I

1. **What are the components of aggregate demand?**

There are four major components of aggregate demand-

1. Household consumption expenditure (C);
2. Government final consumption expenditure (G);
3. Private and public investment expenditure (I); and
4. Net export (X-M)

**Symbolically,**

AD = C + I + G + (X-M)

1. **What is equilibrium level of employment (مستوى التوازن للعمالة)?**

The level of employment where aggregate demand equals aggregate supply is called equilibrium level of employment.

1. **What is full employment level (مستوى التوظيف الكامل)?**

Thelevel of employment where all the available supply of labour is gainfully employed is called full employment level.

1. **What is excess demand (الطلب الزائد)?**

When aggregate demand exceeds aggregate supply at full employment level, it is called excess demand.

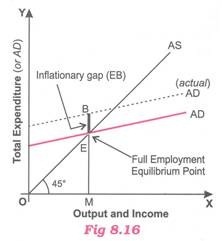
1. **What is deficient demand (الطلب ناقص)?**

When aggregate demand falls short of aggregate supply at full employment level, it is called deficient demand.

1. **What is inflationary gap (فجوة تضخمية)?**

It occurs as an excess of anticipated expenditure over available output at full employment level.

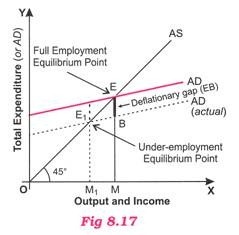
1. **How you can show the inflationary gap diagrammatically?**

**[](http://www.economicsdiscussion.net/wp-content/uploads/2014/02/clip_image002_thumb21.jpg)**

1. **What is deflationary gap (الفجوة الانكماشية)?**

It occurs as an excess of available aggregate output over anticipated aggregate expenditure.

1. **How you can show the deflationary gap diagrammatically?**



1. **What are autonomous and induced investment?**

**Autonomous Investment:** It is that expenditure on capital formation which is undertaken independently of the level of income.

**Induced Investment:** It is expenditure both on fixed assets and on the stocks that are required if the economy is to be able to produce a bigger output as aggregate demand rises.

1. **What is aggregate supply?**

It refers to the money value of all goods and services produced in a country in a year’s time. It, in fact, refers to the national income of a country because it is the money value of all goods and services produced in a year’s time.

Aggregate Supply = Domestic Product = Total Factor Incomes = National Income

Aggregate Supply (AS) = Consumption (C) + Saving (S)

Y = C + S

1. **What are ex- ante saving and ex- post saving?**

**Ex- ante saving:** Ex- ante saving is what the savers plan (or intend) to save at different levels of income in an economy. It is also known as intended saving or planned saving.

**Ex- post saving:** It refers to actual or realized saving in an economy during a year.

1. **What are ex- ante investment and ex- post investment?**

**Ex- ante Investment:** Ex- ante investment is what the investors plan (or intend) to invest at different levels of income in an economy. It is also known as intended investment or planned investment.

**Ex- post investment:** It refers to actual or realized investment in an economy during a year.

1. **How the Keynesian theory of income and employment is determined through aggregate demand and aggregate supply? Explain it through diagram.**

Equilibrium level of income is determined where aggregate demand curve cuts aggregate supply. In other words, the level of income will be in equilibrium where aggregate demand is equal to aggregate supply.

**Example:**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| (SR ’000 Million)   |  |  |  | | --- | --- | --- | | Income (Y) | Aggregate Demand (AD= C+I) | Aggregate Supply (AS= C+S) | | 0 | 40 | 0 | | 10 | 45 | 10 | | 20 | 50 | 20 | | 30 | 55 | 30 | | 40 | 60 | 40 | | 50 | 65 | 50 | | 60 | 70 | 60 | | 70 | 75 | 70 | | **80** | **80** | **80** | | 90 | 85 | 90 | | 100 | 90 | 100 | |  |

**If Aggregate Demand is not equal to Aggregate Supply:**

|  |  |  |
| --- | --- | --- |
| **Aggregate Demand (AD)** | **= Aggregate Supply (AS)** | |
|  |  | |
| If AD > AS | If AD < AS | |
| ↓ | ↓ | |
| Increase in employment of factor services | Decrease in employment of factor  services | |
| ↓ | ↓ | |
| Increase in the level of output of goods and services | Decrease in the level of output of goods and services | |
| ↓ | ↓ | |
| Ultimately AD = AS | Ultimately AD = AS | |
| https://encrypted-tbn2.gstatic.com/images?q=tbn:ANd9GcQuc_6F-16hpG-n52_G3LcK3YCyfyVYecysEDhSau5pokSXKbbwDQ | | https://encrypted-tbn2.gstatic.com/images?q=tbn:ANd9GcSFK2fSf5f75RsJaOcyk1g8NPaOWLzAWPlBOVwAYnN7jVPJfNbrvQ |

1. **Sketch the essence of Keynesian theory of income and employment.**

