UNIT – II

Employment: classical and Keynes

Say · Classical · Effective demand · Consumption

Explanatory Lecture Slides

Economic Theory & Public Finance · Major-3 · Semester III

ECONOMIC THEORY & PUBLIC FINANCE

LEARNING OBJECTIVES

Topics covered in this unit

- **01** State Say’s law and its limit
- **02** State the classical theory of employment
- **03** State Keynes’s principle of effective demand
- **04** Define APC, MPC, APS, MPS
- **05** Place the consumption function
- **06** Say why this is a public-finance paper’s unit

How this unit is organised

01	02	03	04	05	06
Say’s law	Classical employment	Keynes	Consumption function	MPC and multiplier hint	Policy hook

Say's law

Supply creates its own demand. A general glut is impossible; money is a veil.

- Identity: the income from producing X is spent on X-or-something.
- Holds in a barter world of flexible prices. Fails when people hoard money (Keynes's rest on the monetary theory of production).

Say's law

CLAIM

- No general over-production.

BREAKS WHEN

- Money is held idle.
- Wages/prices are sticky.

Classical theory of employment

Full employment is the norm. The labour market clears at a flexible real wage. Any unemployment is voluntary or frictional.

- Pigou: cut real wages, employment rises. The Treasury View: public spending crowds out private spending one-for-one.
- KSLU 10-mark: assumptions (flexible wages/prices, full information, no liquidity trap) + two criticisms.

Classical theory of employment

ASSUMES

- Flexible w and P.
- Interest clears S and I.

FAILS IN

- 1930s.
- Wage-floor statutes.
- Depression psychology.

Keynes — effective demand

Employment is set by the point where aggregate demand = aggregate supply. That point need not be full employment.

- AD = C + I (+ G + NX). AS is the Z-curve of proceeds needed to employ N workers.
- The General Theory (1936) is the book; effective demand is the 16-mark phrase.
- Involuntary unemployment is possible and is the point of the theory.

Keynes — effective demand

AD

- What buyers will spend.

AS

- What firms must receive to hire N.

Consumption function

$C = a + bY$. a is autonomous consumption; b is MPC.

- Psychological law: as income rises, consumption rises, but not as fast — $MPC < 1$.
- $APC = C/Y$; $MPC = \Delta C/\Delta Y$. $APS + APC = 1$; $MPS + MPC = 1$.
- A 6-mark that must have the identities.

Consumption function

MUST WRITE

- $C = a + bY$.
- $0 < MPC < 1$.

SHIFT OF C

- Wealth, rate of interest, taxes, expectations, distribution.

From MPC to the multiplier (preview)

$k = 1/(1-MPC) = 1/MPS$. A rupee of I (or G) raises Y by k rupees if spare capacity exists.

- This is why a Budget stimulus can raise NI — Unit V's public expenditure is not a leak; it can be an injection.
- Limits: full employment, imports, taxes, crowding-out. Always add one limit.

From MPC to the multiplier (preview)

FORMULA

- $k = 1/(1-b)$.

LIMIT

- Open economy.
- Full capacity.
- Crowding out.

Policy hook for a law student

MGNREGA, counter-cyclical spending, FRBM escape clauses in a slump — Keynes in a statute.

- Art. 41 (right to work, as a DPSP) is not a Keynesian identity, but it is why the State may spend in a slump.
- Do not call every scheme ‘Keynesian’; show spare capacity or you are just inflating.

Policy hook for a law student

STATUTE

- MGNREGA 2005.
- FRBM escape.

DPSP

- Art. 41.
- Art. 38.

Consumption function

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- $APC = C/Y$; $MPC = \Delta C/\Delta Y$. $APS + APC = 1$; $MPS + MPC = 1$.
- A 6-mark that must have the identities.

LANDMARK AUTHORITIES

Cases a KSLU answer should name

CASE

Olga Tellis v BMC

(1985) 3 SCC 545

Livelihood as Art. 21 — employment is not only an aggregative curve.

CASE

Sanjit Roy v State of Rajasthan

(1983) 1 SCC 525

Below-minimum ‘famine relief’ wages — the State as employer cannot undercut its own floor.

CASE

Municipal Council Ratlam v Vardichan

(1980) 4 SCC 162

Public spending as a duty, not a favour — a judicial cousin of public expenditure.

STATUTE / SECTION MAP

Provisions & materials to quote

Art. 41	Public assistance in unemployment — the DPSP of this unit.
MGNREGA 2005	A statutory demand-floor in rural labour markets.
Minimum Wages / Code o	A legal floor the classical model treats as a ‘distortion’.
FRBM Act 2003	Room (and limits) for counter-cyclical G.
Art. 21	Livelihood after Olga Tellis — employment with a rights face.

WRITE IT IN THE HALL

10 / 16-mark frames from this unit

Q1 Explain Say’s law of markets. What are its limitations?

Q2 Examine the classical theory of employment.

Q3 Explain Keynes’s theory of effective demand.

Q4 Define APC, MPC, APS and MPS. How is the consumption function specified?

BEFORE YOU CLOSE THE FILE

Unit recap

1. Say: supply creates demand — until money is hoarded.
2. Classical: full employment by wage flexibility.
3. Keynes: effective demand can stop short of full employment.
4. $C = a + bY$; $k = 1/(1-MPC)$.
5. Always add a statutory hook (MGNREGA / FRBM / Art. 41).