Classical Theory: Income, Output and Employment

Introduction

Classical economics dominated the mainstream of economic thinking from the late 18th century until the 1930's. Its chief proponents were Adam Smith, J.B. Say and David Ricardo. The classical scheme of thinking assumes operation of free enterprise and free price mechanism leading to automatic adjustments in all the markets.

The classicists believed in the existence of full employment in the economy and a situation less than full employment was regarded as abnormal necessary to have a special theory of employment. The classical analysis was based on Say's Law of Markets that "supply creates its own demand." They thus ruled out the possibility of over production. The classical economics was based on the laissez-faire policy of a self· adjusting economic system with no government intervention. In this unit you will learn about the Classical Theory of Income, Output and Employment.

Concepts Related to Classical Theory

Full Employment: An economy is said to be in full employment when its entire labour force is gainfully employed. Labour force is that part of the population of the country which is physically and mentally able and at the same time willing to work.

Nominal Wage vs. Real Wage: Nominal wage is what a worker receives in the form of money. Real wage is what a worker can buy from the nominal wage.

Real wage = Nominal wage w = Price level p

Real Rate of Interest: Nominal rate of interest is the rate which the lender receives from the borrower in money. Real rate of interest is rate accruing after adjustment of inflation.

(Rate of interest = ROI)

Real ROI = Nominal ROI – rate of inflation

Value of Marginal Product of Labour (VMPL): VMPL equals MPL multiplied by the price of the product (P) the labour produces.

$VMPL = MPL \times P = MPL \times AR$

It is distinguished from 'Marginal Revenue Product of Labour (MRPL), which equals $MPL \times MR$. Since in case of perfect competition in the product market MR=AR, VMPL=MRPL.

Aggregate Demand and Aggregate Supply: Aggregate demand is the total value of final goods and services that all sections of the economy taken together are planning to buy at a given level of income during a period of time. Aggregate supply is the value of final goods and services planned to be produced in an economy during a period.

Supply of Money: Money supply of a country is the stock of money on a specific day. This is the sum of currency held outside banks and chequable deposits. This is the money which can be directly used for transactions.

Say's Law

Say's law of market states that ' supply creates its own demand'. If goods are produced then there will automatically be a market for them. This means that there cannot be a general 'overproduction' or 'glut' in an economy that is based on a market system of production and exchange. Correspondingly, there cannot be a deficiency in aggregate demand. Each person's production constitutes his or her demand for other goods; hence, for the entire community, aggregate demand equals aggregate supply.

Assumptions of Say's Law

Say's law is based upon the following assumptions: The amount of labour and capital can be raised in a free enterprise system based on price mechanism.

In an expanding economy new firms and labourers can have easy entry by offering their products in exchange without dislocating the position of existing firms and labourers.

The size of market is capable of expansion.

All savings are automatically invested, i.e., savings always equals investment.

The Government does not interfere in the functioning of the economy.

Implications of Say's Law

Since there is automatic adjustment between production and consumption, there is no need for the government to interfere in the functioning of economic system. Any interference by the government in the automatic functioning of the economic system will simply create imbalances and disequilibria. When the unemployed resources are employed, they lead to more production which covers their own costs. Hence, the economy will operate at the level of full employment.

The mechanism of interest flexibility brings about an equality between savings and investment.

The mechanism of wage- flexibility brings about full employment.

The Basic Features of the Classical System

There are three basic features. First, the classical model is called full employment model. Second, the labour, product and capital markets are interrelated markets. Third, there is simultaneous equilibrium in all the markets.

It is called "full employment model" because the classical economists believed that free market forces of demand and supply lead to full employment of resources through automatic adjustments in overall price level (output market), wage rates (labour market) and interest rate (capital market). The entire economy is in full employment equilibrium because all markets are interrelated and what happens in one market will have impact in other markets.