**KEYNES' APPROACH OF AGGREGATE EFFECTIVE DEMAND AND DETERMINATION OF INCOME**

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John Maynard Keynes was a prominent economist whose work laid the foundation for modern macroeconomics. His approach to aggregate effective demand and the determination of income is a central aspect of Keynesian economics.

Keynes put forwarded the theory of aggregate effective demand and income in his book “The General Theory of Employment, Interest and Money” published in 1936. Keynes first of all criticized the classical theories which were based on the assumption of full employment and long run. According to him it is not possible to achieve full employment automatically in real world and in the long run we are all dead; hence problems be solved in the short run only.

Keynes maintained that in a closed economy aggregate effective demand is the determinant of employment, output and income of an economy. At equilibrium employment, output and income are equal. His theory is based on the following assumptions-

1. The economy is closed.
2. There is perfect completion in the market.
3. Government plays active role in economic affairs.
4. The law of diminishing return operates.
5. The economic activities are confined to short run.

According to Keynes effective demand is the point at which aggregate supply of an economy is equal to aggregate demand. Thus aggregate supply function and aggregate demand function are the two main determinant of aggregate effective demand.

Aggregate Supply Function: Aggregate Supply Function (ASF) is a schedule of the various amount of money which the entrepreneur in an economy must receive from the sale of output at varying levels of employment. In another words aggregate supply is the supply of goods and services produced in an economy at a given overall price in a given period. Keynes assumed ASF as given in short run and aggregate demand is the most important factor determining the effective demand. Aggregate Supply is the lateral summation of consumption expenditure and saving of an economy. Symbolically –

AS= C + S ……(i)

The shape of ASF is the increasing function of employment. In the beginning ASF rises slowly because employment will increase rapidly at first as amount received from selling of output of the economy rose from zero. Here the cost of production will not initially rise rapidly. Later on, AS curve rise progressively as employment increases. Because at higher levels of employment cost of production will rise more rapidly. When the stage of full employment is reached AS curve becomes vertical straight line because increase in receipts will not increase employment.

Aggregate Demand Function: Aggregate Demand Function (ADF) is the amount of money which the entrepreneur expects to get from the sale of output at varying levels of employment. In short aggregate demand is the total amount of demand for all finished goods and services produced in an economy. Aggregate demand is also called aggregate expenditure which has the following components-

1. Consumption Expenditure (C)
2. Investment Expenditure (I) and
3. Government Expenditure (G)

Thus the Keynesian Aggregate Demand (AD)= C+ I+ G…..(ii)

Consumption Expenditure(C): The lateral summation of expenditure made on consumption of private goods and services for personal satisfaction is called consumption expenditure. The size of income and propensity to consume are the two main determinants of consumption expenditure.

 Investment Expenditure (I): The expenditure incurred on buying goods and services (machinery, tools etc.) to create and accumulate productive assets is called investment expenditure. Marginal Efficiency of Capital (MEC) and rate of interest are the determinants of investment of an economy.

 Government Expenditure: Government expenditure refers the expenditure made on public goods and services.

 In a closed economy –

 AD= C+ I….(iii)

AD curve first rises steeply, but this rapidly tends to slacken at the higher levels of employment. It implies that expected receipts increases rapidly in the initial stages of rise in employment but gradually this increase slows down when employment reaches higher levels. Because when income and employment are at low levels, the community is poor enough to save much of its earnings. But at the high level of income, MPS becomes very small, for which AD curve becomes flatter.

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| EMLOYMENT(N)(in lakh workers ) |  ADF (crore Rs) |  ASF (crore Rs) |
| 1 | 10 | 4 |
| 2 | 20 | 9 |
| 3 | 28 | 19 |
| 4 | 34 | 34 |
| 5 | 38 | 55 |

Following chart and figure explains the determination of effective demand, output, employment and income according to Keynes-

 In chart at 4 lakh employment of workers AD=AS= 34 Lakh. This is the point of effective demand.

AS

 In figure x-axis measures income, output and employment and y-axis measures aggregate demand and supply. AD, AD1and AD2 are Keynesian aggregate demand curves. AS is the aggregate supply curve. It has two segments – first from O to F which slopes upward from origin and the second from F onwards which is vertical.

At E AD intersects AS and become equal to each other. Thus E is the point of effective demand and N is the equilibrium level of employment which is also the income. If Na is the level of employment, AD exceeds AS. Therefore employment will increase. In figure Nf is the level of full employment. Thus though the economy reach equilibrium at E, there exists NNf amount of unemployment. Therefore Keynesian equilibrium is called underemployment equilibrium.

If aggregate demand shifts to AD1, new equilibrium will be established at F and ONf level of employment will be determined. ONf is the full employment level. As soon as full employment level is reached, aggregate supply function becomes vertical. In the vertical range of aggregate supply curve, increase in aggregate demand to AD2 will only increase the cost, but level of employment cannot be increased.