Page No.:

Date:

Class B.Com-I.

Subject: Business Economics and Environment.

Paper : II

Unit : V

Topic : Factor Pricing: (Marginal Productivity Theory of Distribution)

Lecture Sequence No : 3

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Marginal productivity Theory of Distribution :-

The theory epplains how the prices of the various factors of production would be determined under conditions of perfect competition and full employment.

Acc. to the Marginal productivity Theory, the price of any factor will be equal to the value of its marginal product.

eg: we know that a consumer will demand a commodity up to the point which its marginal utility is proportional to the price he pays for it. Similarly, a firm will go on employing more and more units of a factor until the price of the factor is equal to the value of marginal product. This is equal to the value of the additional product, which as employer gets when he employs an additional unit of that factor, the supply of all other factor remaining constant.

~~Conclusion~~ Acc. to Mark Blaug: "The marginal productivity theory contends that in equilibrium each productive agent will be rewarded in accordance with its marginal productivity".

ie. Entrepreneur works for profit, he can only pay a price for a factor which he finds just worthwhile. He cannot afford to pay more than its marginal productivity. Nobody will accept less than marginal productivity. That is how marginal productivity determines the remuneration or the price of a factor of production.

Subject

The marginal productivity theory of distribution, as development by J.B Clark at the end of the 19 century provides a general explanation of how the price (of the earning) of a factor of production is determined.

Assumptions of the theory:-

① Perfect competition in both product and factor markets:

The theory assumes the perfect competition in both product and factor markets. It means that both the price of the product and the price of factor (eg labour) remain unchange.

② Operation of the law of diminishing returns:

The theory assumes that the marginal product of a factor would diminish as additional units of the factor are employed while keeping other factors constant.

③ Homogeneity and divisibility of the factor:

All the units of a factor are assumed to be divisible and homogeneous. It means that a factor can be divided into small unit and each unit of it will be of the same kind and of the same quality.

④ Operation of the law of substitution:

The theory assumes the possibility of the substitution of different factors. It means that the factors like labour, capital

Subject ______ MON TUE WED THR FRI SAT SUN

and others can be freely and easily substituted for one another.

(5) Profit maximisation

The employer is assumed to employ the different factors in such a way and in such a proportion that he gets the maximum profits. This can be achived by employing each factor upto that level at which the price of each is equal to the value of its marginal product.

(6) Full employment of factors.

The theory assumes full employment for factors. Otherwise each factor cannot be paid in accordance with its marginal product. If some units of a particular factor remain unemployed, they would be then willing to accept the employment at a price less than the value of their marginal product.

(7) Exhaustion of the total product.

The theory assumes that the payment to each factor according to its marginal productivity completely exhausts the total product, leaving neither a surplus nor a deficit at the end

(8) Behaviour of consumer should be rational

(9) Perfect mobility of factor of production.