Class B.Com-I.

Subject: Business Economics and Environment.

Paper : II

Unit : V

Topic : Factor Pricing: Modern Theory of Distribution.

Lecture Sequence No : 6

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Modern Theory of Distribution:
OR
Demand and Supply Theory of Factor price Determination:

Meaning:

The modern theory of factor pricing provides a satisfactory explanation of the problem of distribution. It is known as the demand and supply theory of distribution. Prices paid for productive services are like any other price and they are basically determined by demand and supply conditions.

Demand for a Factor:

Let us first consider the demand side. In the first place, we should remember that the demand for a factor of production is not a direct demand it is an indirect or derived demand. It is derived from the demand for the produce. that the factor produces.

For instance, labour does not satisfy our wants directly. We want labour for the sake of the goods that it produces. It follows therefore, that if the demand for goods increases, the demand for the factors which help to produce these goods will also increase.

Also, if the demand for goods is elastic or inelastic, the demand for the factors too will be elastic or inelastic.

The demand for a factor of production

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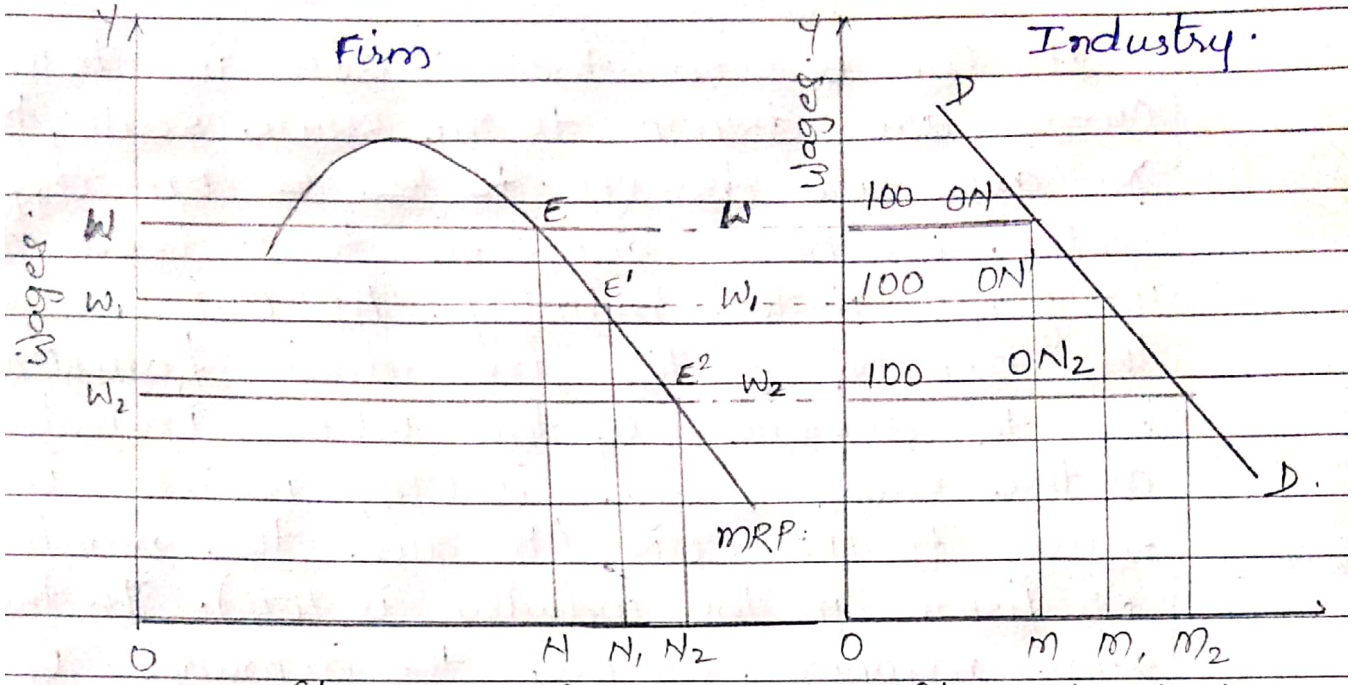
will also depend on the quantity of the other factors required in the process. Generally speaking, the demand price for a given quantity of a factor of production will be higher; the greater the quantities of the cooperating productive services. If more of a factor of production is employed, the marginal productivity of the factor will fall and the lower will be the demand price for the unit of a productive service. This is another rule connected with the demand for a factor of production.

The demand price of a factor of production also depends on the value of the finished product in the production of which the factor is used. The demand price will generally be greater, the more valuable is the finished product in which the factor is used. Also the more productive the factor, the higher will be the demand price of a given quantity of the factor.

The demand for the employer for a factor depends on its marginal revenue productivity (in short marginal productivity) and the quantity of the factor that a firm will employ will depend on the prevailing wage level. That is more labour will be employed if wages are low and less if wages are high.



Demand for the factor:

As per the figure the position of a firm regarding the employment of a factor, say labour. When the wage is OW, the firm is a equilibrium at the point E and the demand for the factor is ON, Similarly at OW_1 wage the demand is ON_1 and at OW_2 the demand is ON_2. MRP. (marginal revenue productivity) curve is the demand curve for a factor of production by an individual firm.

But for determining the price of a factor it is not the demand of the individual firm for it that matters. What matters is the total demand ie total demand of all firm in the industry. The total demand curve is derived by the lateral summation of the marginal revenue productivity curves of all the firm. This curve DD is shown in the fig. above.

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It can be seen that Y axis in both curves are drawn to the same scale, but X axis are drawn ~~to the~~ so on different scales. We have supposed that there are 100 firms in the industry. At OW wage, the demand of the individual firm is ON but the demand of the whole industry at the same wages is OM, which is equal to 100 ON (because the number of firms in the industry is 100). In the same manner, at OW_1, the demand of the firm is ON, but of the entire industry OM, which is equal to 100 ON, and at OW_2, the demand of the firm is ON_2 and that of the industry OM_2 which is equal to 100 ON_2.

It can be seen that the demand curve DD slope downward to the right. The reason is that MRP curve, whose summation is represented by DD, also slopes down similarly to the right in the relevant portion. This means that according to the law of diminishing marginal productivity, the more a factor is employed the lower is the ~~no~~ marginal productivity. This is all about the demand side.