Microeconomics

Marginal Productivity Theory

Cat 2

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1. Discuss the marginal productivity theory.

The marginal productivity theory states that in the long run under perfect competition, factors of production would tend to receive a real rate of return which was exactly equal to their marginal productivity.

The main assumptions of the theory are as under:

1. Perfect competition: The marginal productivity theory rests upon the fundamental assumption. This is because it cannot take into account equal bargaining power between the buyers and the sellers.
2. Homogenous factors: This theory assumes that units of a factor of production are homogenous. This simply implies that different units of factors of production have the same efficiency thus the productivity of all workers offering the particular type of labour is the same.
3. Rational behaviour: The theory assumes that every producer desires to reap maximum profits. This is because the organizer is a rational person and he so combines the different factors of production in such a way that marginal productivity from a unit of money is the same in the case of every factor of production.
4. Perfect substitutability: The theory is also based upon the assumption of perfect substitution not only between the different units of the same factor but also between the different units of various factors of production.
5. Perfect mobility: The theory assumes that both labour and capital are perfectly mobile between industries and localities. In the absence of this assumption the factor rewards could never tend to be equal as between different regions or employments.
6. Interchangeability: It implies that all units of a factor are equally efficient and interchangeable. This is because different units of a factor of production are homogenous, since they are of the same efficiency, they can be employed inter-changeable and for instance whether a company employs the fourth or the fifth man his productivity shall be the same.
7. Perfect adaptability: The theory takes for granted that various factors of production are perfectly adaptable as between different occupations.
8. Knowledge about marginal productivity: Both producers and owners of factors of production have means of knowing the value of factors marginal product.
9. Full employment: It is assumed that various factors of production are fully employed with the exception of those who seek a wage above the value of their marginal product.
10. The law of diminishing marginal returns: It means that as units of a factor of production are increased the marginal productivity goes on diminishing.
11. Analyse the relationship between diminishing marginal utility and the demand curve.

According to the law of diminishing marginal utility, as the quantity of a good with a consumer increases marginal utility of the goods to him expressed in terms of money falls. The consumer will be in equilibrium in respect of the quantity of the goods purchased where marginal utility of the goods equals price. Thus, the marginal utility equals price is the condition of equilibrium.

When the price of a good falls, downward sloping marginal utility curve implies that the consumers must buy more of the good so that its marginal utility falls and becomes equal to the new price. It, therefore, follows that the diminishing marginal utility curve implies the downward sloping demand curve, that is, as the price of the goods falls, more of it will be bought.

In the figure the curve MU represents the diminishing marginal utility of the goods measured in terms of money. Suppose the price of the goods is OP . At this price the consumer will be in equilibrium when he purchases OQ, the quantity of the goods, since at OQ, the marginal utility is equal to the given price OP1. If the price of the goods falls to OP1, the equality between the marginal utility and the price will be disturbed. Marginal utility Q, E at the quantity OQ, will be greater than the new price OP1, the consumer must buy more of the goods. It is evident from the figure that when the consumer increases the quantity purchased to OQ, the marginal utility of the goods falls and becomes equal to the new price OP1.

It is thus clear that when the price of the goods falls, the consumer buys more of the goods so as to equate the marginal utility to the lower price. Therefore, it follows that the quantity demanded of a good varies inversely with price.

1. Using clear diagrams, distinguish between indifference curves and the budget lines.

Indifference curve is a line showing all the combinations of two goods which give a consumer equal utility. The consumer would be indifferent to these different combinations.

Example of choice of goods which give consumers the same utility

|  |  |
| --- | --- |
| Apples | Bananas |
| 22  14  10  9  7 | 17  20  26  41  80 |

Table plotted as indifference curve.

Budget line:

A budget line shows the combination of goods that can be afforded with your current income.

References

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