SES'S L.S.RAHEJA COLLEGE OF ARTS AND COMMERCE

Course: Economics II Unit: III Prepared by: Rahul Dandekar

Important Concepts

Following table shows four factors of production and the reward that they get for contributing to the process of production.

Factors of production	**Reward**
Land	Rent
Labour	Wages
Capital	Interest
Entrepreneur	Profit

1) Marginal productivity theory of distribution.

The marginal productivity theory of distri-bution, as developed by J. B. Clark, at the end of the 19th century, provides a general explanation of how the price (of the earnings) of a factor of production is determined. In other words, it suggests some broad principles regarding the distribution of the national income among the four factors of production. According to this theory, the price (or the earnings) of a factor tends to equal the value of its marginal product. Thus, rent is equal to the value of the marginal product (VMP) of land; wages are equal to the VMP of labour and so on. The neo-classical economists have applied the same principle of profit maximization (MC = MR) to determine the factor price. Just as an entrepreneur maximizes his total profits by equating MC and MR, he also maximizes profits by equating the marginal product of each factor with its marginal cost.

2) Ricardian Theory of Rent

David Ricardo, an English classical economist, propounded a theory to explain the origin and nature of economic rent. He defined rent as "that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil." In his theory, rent is nothing but the producer's surplus or differential gain and it is found in land only.

3) Modern Theory of Rent

Modern theory of rent is an amplified and modified version of Ricardian theory of Rent. It was first of all discussed by J.S. Mill and after that developed by economists like Jevons, Pareto, Marshall, Joan Robinson etc. According to modern theory, economic rent is a surplus which is not peculiar to land alone. It can be a part of income of labour, capital, entrepreneur. According to modern version rent is a surplus which arises due to difference between actual earning and transfer earning.

Rent = Actual Earning-Transfer Earning.

4) Transfer Earning

In this universe, each factor of production has varied uses. When we transfer one factor from one use to another, we have to sacrifice the income earned by it from its earlier use. Sacrifice of earning is called transfer earning. Basically, the concept of transfer earning in economics is introduced by Prof. Benham. According to him, "The amount of money which any particular unit could earn in its best paid alternative use is sometimes called its transfer earnings." A similar idea was developed by Pigou. Different economists consider transfer earnings as that amount of money which any particular unit could earn in its best paid alternative use.

5) Quasi Rent

The concept of quasi-rent was given by Alfred Marshall. He defined quasi rent as surplus earnings generated by the factors of production, except land. The earnings from machines and instruments are termed as quasi-rent. The quasi-rent refers to the income produced when the demand for products increases suddenly.

6) Modern Theory of Wages

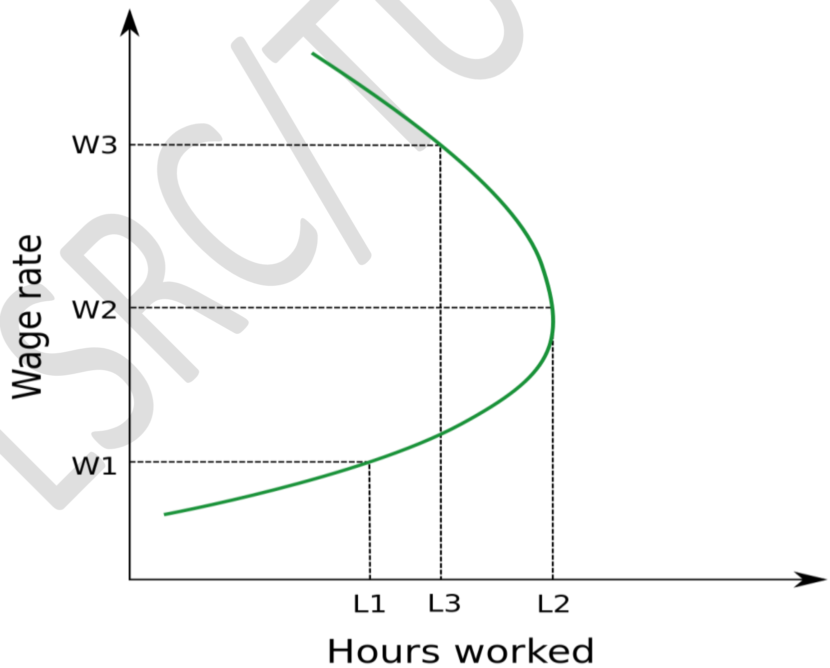
According to the modern theory of wages, wages are the price of services rendered by a labor to the employer. As products the prices are determined with the help of demand and supply curve. Similarly, the wages (prices of services rendered by labor) is also obtained with the help of demand and supply of labor. Therefore, for the determination of wage level, it is necessary to study the demand for labor, supply of labor, and the interaction between them.

7) Collective Bargaining

Collective bargaining is a process of negotiation between employers and a group of employees aimed at agreements to regulate working salaries, working conditions, benefits, and other aspects of workers' compensation and rights for workers. The interests of the employees are commonly presented by representatives of a trade union to which the employees belong. The collective agreements reached by these negotiations usually set out wage scales, working hours, training, health and safety, overtime, grievance mechanisms, and rights to participate in workplace or company affairs.

8) Backward bending supply curve of labour

In economics, a backward-bending supply curve of labour, or backward-bending labour supply curve, is a graphical device showing a situation in which as real (inflation-corrected) wages increase beyond a certain level, people will substitute leisure (non-paid time) for paid work time and so higher wages lead to a decrease in the labour supply and so less labour-time being offered for sale. The "labour-leisure" tradeoff is the tradeoff faced by wage-earning human beings between the amounts of time spent engaged in wage-paying work (assumed to be unpleasant) and satisfaction-generating unpaid time, which allows participation in "leisure" activities and the use of time to do necessary self-maintenance, such as sleep. The key to the tradeoff is a comparison between the wage received from each hour of working and the amount of satisfaction generated by the use of unpaid time. Such a comparison generally means that a higher wage entices people to spend more time working for pay; the substitution effect implies a positively sloped labour supply curve. However, the backward-bending labour supply curve occurs when an even higher wage actually entices people to work less and consume more leisure or unpaid time.



9) Classical Theory of Interest

According to the classical theory, interest is the price paid for saving of capital. Like the value of other things, the price of saving is determined by its demand for and supply of savings. Therefore, for the determination of interest, it is necessary to study the demand for saving, supply of saving, and the interaction between them.

10) Loanable Funds Theory of Interest

In economics, the loanable funds doctrine is a theory of the market interest rate. According to this approach, the interest rate is determined by the demand for and supply of loanable funds. The term loanable funds includes all forms of credit, such as loans, bonds, or savings deposits.

11) Risk and Uncertainty Theory of Profit

The risk bearing theory was developed by the American economist prof. Hawley in his book Enterprise and productive process published in 1907. According to this theory profit is a reward for risk bearing. A refinement was however made by prof. knight in Hawley's risk bearing theory of profit. According to prof. knight pure profit are linked with uncertainty and risk bearing. He classifies risk in to (1) INSURABLE RISKS AND (2) NON- INSURABLE RISKS.

12) Innovation Theory of profit

The Innovation Theory of Profit was proposed by Joseph. A. Schumpeter, who believed that an entrepreneur can earn economic profits by introducing successful innovations. In other words, innovation theory of profit posits that the main function of an entrepreneur is to introduce innovations and the profit in the form of reward is given for his performance. According to Schumpeter, innovation refers to any new policy that an entrepreneur undertakes to reduce the overall cost of production or increase the demand for his products.

Important Questions

1) Discuss Marginal Productivity Theory of Distribution.

2) Explain Ricardian Theory of Rent in detail.

3) Elucidate Modern Theory of Rent.

4) Discuss Modern Theory of Wages.

5) Discuss Knight's theory of Profit.

6) Explain Innovation Theory of profit in detail.

7) Discuss Classical Theory of Interest.

8) Explain Loanable Funds Theory of Interest.

9) Write short note on following
    a) Quasi Rent
    b) Risk and Uncertainty
    c) Backward bending supply curve of labour
    d) Collective Bargaining