Study Material

Subject: - Micro Economics

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Unit-4

Topics:-

- Theory of Rent, Theory of Wages, Theory of Profit and Theory of Interest.

Ricardian Theory of Rent:-

David Ricardo (British Economist) gave his theory of rent in his Book, "Principles of Political Economy and Taxation." According to him, Economic rent is the price paid for the use of services of land. Rent as the portion of the produce earth which paid to the land lord for the use of original and indestructible power of the soil. One thing keep in mind always by him rent also arises due to the difference in the fertility of land.

Ricardian rent is also known as pure rent. The true economic rent is not only a payment for the use of land. It excludes interest on landlord's investment.

Assumptions:-

- The supply of land is limited/Fixed.
- There is difference in the fertility of land.
- There is marginal or no rent land in the economy.
- Land has original and indestructible powers of soil.
- The demand for agricultural products increases with population growth.

- There is perfect competition in the economy.
- The law of diminishing returns or increasing costs operates in agriculture applies and it has only one use, i.e. cultivation
- There is perfect competition in product market.

Explanation of Ricardian Theory:-

The quantity of land is limited and so is its productiveness, and it is not uniform in quality. If the superior land will not support the population, resource must be made to inferior lands and the produce is thus raised at different costs. The differential advantage of the superior land over the inferior gives rise to economic rent. The amount of rent is determined by the degree of the differences in productivities of land.

Determination of Rent:-

Rent can be determined under two situations

A). Extensive Cultivation:- It refers to the system of cultivation where in more land is used to increase production. The rent in Extensive Cultivation-

According to Ricardo, "All the units of land are not to the same grade, they differ in fertility and location. The application of the same amount of labour, capital and other cooperating give rise to difference in productivity. This difference in productivity or the surplus which arises on the superior units of land over the inferior units is an economic rent.

B).Intensive Cultivation:- It refers to the system of cultivation where large amount of labour and capital are used in same piece of land for increasing production. The rent in Intensive cultivation-

The surplus or economic rent also arises to the land cultivated intensively; this occurs due to the operation of the famous law of diminishing returns.

Criticism:-

- The fertility of land is neither original nor indestructible.

- Marginal or no rent land.
- Every land has some fertility.
- Perfect competition.
- Alternative use of land.
- Rent is not due to fertility but due to scarcity.

Quasi-Rent

The concept of **Quasi-rent owes its origin to Prof. Alfred Marshall**. He defined Quasi-rent as surplus earning generated by the factors of production except land. So the earning from machines and instruments are termed as Quasi-rent. The quasi-rent refers to the income produced when the demand for products increases suddenly.

In the view of Alfred Marshall a differential surplus which arises from a factor of production, whose supply is fixed for all time to come should be named as rent but a temporary gain which a factor or production earns due to temporary limitation of its supply should be called Quasi-rent. Quasi-rent is a temporary gain which is earned by a factor of production due to the temporary limitation of its supply.

In short period of time, in quasi-rent the supply of factors is temporary and can be increased or decreased after some time, such as machine where as in economic rent, the supply of factor is fixed such as land. Therefore the total earnings generated from the short run instrument/equipment are termed as Quasi-rent.

Quasi-rent can also be expressed in terms of revenue which is as fallow-

Quasi-rent = Total Revenue – Total Variable Cost

Or

(Q.R =T.R – T.V.C)

In the long run, all the costs are considered as Variable cost. In long run, the equilibrium can be attained when total revenue is equal to total cost. In such a case there is no Quasi-rent.

Theory of Wages

Subsistence Theory of Wages - David Ricardo (1772-1823)

Wages Fund Theory - Adam Smith (1723-1790)

Residual Claimant Theory - Francis A. Walker

Marginal Productivity Theory - J.B. Clark (1870-1914)

Bargaining Theory of Wages - John Davidson

Surplus Value Theory - Karl Marx (1818-1883)

Subsistence Theory of Wages

It is known as **Iron Law of wages propounded by David Ricardo (1772-1823).** He was of the opinion that the laborers are paid so as to enable them to subsist and perpetuate the race without increase or demotions.

Assumptions:-

- Law of diminishing returns applies to the Industry.
- Population increases or decreases on the basis of subsistence wages paid to the workers.
- Labour demand constant.
- No wage differentials.

Wages Fund Theory

It was developed by Adam Smith (1723-1790). On the basis his assumption states that wages are paid out of the predetermined fund of wealth which lay surplus as saving. If fund is large, wages should be high and if it is small wages should be reduced. Demand for Labour and wages paid are determined by the size of the fund. Francis A. Walker attacked/criticized the Wages Fund Theory.

The Residual Claimant Theory

This theory is developed by Francis A. Walker. According to him there are (04) four factors of production like land, labour, capital and entrepreneurship. Labour is the residual claimant.

This theory does not explain how trade unions are able to increase the wages. It does not consider the role of labour in productivity.

Marginal Productivity Theory

This theory was advocated by Philips Henry and J. Bates Clark. According to him, "Wages are based upon an entrepreneur’s estimate of the value that will probably be produced by the last or marginal worker.

It assumes that wages that wages depend upon the demand for and supply of labour. Workers are paid what they are economically worth. The result is that the employer has a larger share in profit as has not pay to the non- marginal workers.

The Bargaining Theory of Wages

This theory is given by John Davidson. On the basis of this theory Wages are determined by the relative bargaining power of workers or trade unions and of employers. When the Trade Union is involved, basic wages, fringe benefits, job differentials and individual differences tend to be determined by the relative strength of the organization and the trade union.

The Surplus Value Theory

This theory is given by Karl Marx. In his opinion the labour is an article of commerce, which could be purchased on payment of "subsistence price". Price of any product is determined by the labour time needed for producing it. The labour is not paid in proportion to the time spent on work, but much less, and the surplus went over, to be utilized for paying other expenses.

Theory of Profit

Definition of a Profit

Profit is the reward for entrepreneurial ability and goes to the entrepreneur of the firm. It is regarded as an incentive for undertaking entrepreneurial function. It is regarded as a reward for risk taking.

According to Von Thunen," Profit is the residual after deduction of interest, insurance for risk and wages of management."

Characteristics of Profit

- Profit is the residual income.
- Profit is always uncertain and in determinant.
- Profit always bears dynamic fluctuation.
- Profit may be positive, negative or zero.
- Profit occurs by keeping total cost below total revenue.
- It is the ability of entrepreneur i.e. able entrepreneur will earn more profit.

Types of Profit

1. Gross Profit: - Gross profit or total profit is that residual income which accrues to an entrepreneur when he excludes total explicit cost from total revenue or total sales proceeds of the firm. Explicit cost means visible cost of production which includes cost of raw material, wages, salary, power etc. In other words, it is the difference between total revenue and total explicit cost.

2. Net profit/ Economic Profit: - It is reward paid to the entrepreneur for taking risk in the process of production, bearing uncertainty and reward for new innovation. In other words, it is that residual income which accrues to the entrepreneur when we deduct explicit and implicit cost from total revenue. Implicit cost is also called invisible cost of production, which includes advertising cost, transport cost etc.

3. Normal Profit: - This concept was propounded by Alfred Marshall. It includes the production cost of the representative firm. According to this concept, the firm is able to recover cost only.

4. Super Normal Profit: - Whatever income accrues over and above normal profit is called Super Normal Profit. It accrues to the entrepreneur when he succeeds in keeping total cost below total revenue. In other words, when average revenue is greater than average cost, the firm incurs super normal profit or abnormal profit.

Theories of Profit

1. Rent Theory of Profit:- This theory was given by American Economist Francis L. Walker, which is based on concept of net profit. Prof. Walker has compared his theory with that Ricardian theory. According to him Profit is the rent of ability and like rent; profit also does not enter into price.

Criticism:-

1. Profit does not always arise due to ability; other factors (macro variable) are also responsible for getting profit.

2. Rent is generally positive and in some cases it may be even zero, while profit may be positive, zero and even negative.

3. Profit arises in a dynamic economy, where changes take place continuously and not in a static economy.

4. This is a short period theory where profit enters into price, which is not possible in the long period.

Wage Theory of Profit:-

This theory was given by American economist Taussig which is well supported by Davenport. According to this theory, profit is similar to wage, which is given to the entrepreneur for the services rendered by him in the business. This theory explains the similarity between labour and entrepreneur. Just as labour get wages for the services rendered in the business, an entrepreneur profit in the business for providing services in the business. Thus this theory give emphasis that profit is a type of wage for the entrepreneur. But this theory has ignored the fact that a labour does not undertake any risk whereas, an entrepreneur always undertakes risk so he is liable to have profit. This theory also ignores that a labour will always get wages under all circumstances i.e. wages are always positive but this is not applicable in case of profit because profit may be positive, zero or negative.

Criticism:-

1. Wages are always positive, but it is not essential that profit is always positive. It may be positive, zero or even negative in dimension.

2. Labour and entrepreneur are not similar. Labour is generally performing physical task whereas entrepreneur is undertaking mental exercise.

3. This theory does not explain the profit which is received by the shareholder, who is not rendering any service.

4. Labour does not undertake any risk, but an entrepreneur undertakes risk so there is no similarity between labour and entrepreneur.

Risk Theory of Profit:-

This theory was propounded by American Economist Hawley in 1907. According to this theory profit is the reward for risk taking. If any entrepreneur in business undertakes risk, he is liable to have profit and if he is not prepared to take any risk, he is not liable to have profit. Thus, this theory is based on the basic principle that higher the risk, higher the profit and lower the risk, lower the profit.

Criticism:-

1. There is no direct relationship between risk and profit.
2. Profit does not arises due to risk taking rather accrues due to avoidance of risk.
3. Profit does not arise due to all types of risk.
4. It does not measure the volume of profit.

Uncertainty Bearing Theory of Profit:-

This theory was propounded by American economist F. H. Knight in the year 1927. According to this theory profit is the reward for bearing uncertainty. This theory also known as Knight's Theory of Profit, as he lays down the difference that profit does not arise from all types of risk. So he divided risk under two heads namely - foreseen and unforeseen risk.

Foreseen risk is those which can be predicted and can be provided for through insurance. It includes risk of fire, threat, etc. whereas unforeseen risk refers to those which can't be predicted and can't be got covered through insurance. Under this we include government policy, business cycles, competitive risk, technical risk etc.

According to Prof. Knight, profit does accrue from all types of risk. It arises due to non-insurable risk. As this risk can't be foreseen and no insurable company is ready to cover these risks, these are called non-insurable risk or uncertainty bearing risk.

Criticism:-

1. Uncertainty bearing is not any factor of production.
2. Profit is not the only the reward for uncertainty bearing.
3. This theory does not measure the volume of profit.
4. This theory explains only sudden and causal explanation of profit.

Dynamic Theory of Profit:-

This theory was propounded by American Economist J.B. Clark. According to him, profit always arises in a dynamic economy and not in a static economy. The basic reason for arising profit in a dynamic economy is continuous changes in the economy.

In case of a Static economy, there is no change in economy. The activities of the previous year will be repeated in current year, as a result price will be equal to its cost and there will be no profit. According to Clark, there are five changes, which are continuously taking place in the dynamic economy and they are responsible to have profit. They are-

A). Continuous change in population.

B). Continuous changes in techniques of production.

C). Continuous changes in supply of capital.

D). Continuous changes in structure of organization.

E). Continuous changes in human wants due to change in taste, preference and habit of the consumer.

In the view of Clark, only those entrepreneurs will survive and develop and get profit who will adopt these changes in order to satisfy consumer needs. Those entrepreneurs who do not accept these changes will not survive and will not get any amount of profit.

Criticism:-

1. Not every change does not bring profit.

2. Static economy does not exist in the real world.
3. This theory does not give any importance to uncertainty bearing and risk taking.
4. It does not measure the volume of profit.

Innovation Theory of Profit:-

This theory was given by American economist J. A. Schumpeter. This theory is very much similar to Dynamic theory of Profit. But instead of adopting the five changes, which are continuously taking place in the economy, this theory stresses more on innovation. By innovation, Schumpeter means adopting new techniques of production, as a result of which production cost would tend to decline and it will lead to increase in profit.

If the firm wants to increase the level of profit, it can do this by two ways- First is it can either increase the price of the product or second is try to reduce cost of production.

The first strategy is not appropriate, due to increase in competition in the market. If the firm increases the price the product, the other rival will not increase the price, as a result, the demand will fall, which will further reduce the profit margin.

The second way is much better way to increase the volume of profit. This profit will arise to the firm continuously, until the firm does not accept this innovation. Thus, it can rightly remark that the profit accrues due to innovation now lapses away.

Thus, this theory explains that profit accrues to the firm only because of innovations and not due to any other reason.

Criticism:-

1. This theory ignores risk factor of the entrepreneur.
2. Profit does not accrue due to innovations only.
3. This theory fails to measure volume of profit.
4. This theory relates to short period only.

Marginal Productivity Theory of Profit:-

This theory explains that reward for each and every factor of production can be decided by marginal productivity of that factor of production. The theory assumes entrepreneurial ability is also factor of production.

According to this theory, the value of entrepreneurial ability i.e. profit is decided by his marginal productivity. As marginal productivity curve for a factor of production is demand curve for that factor, in the same manner marginal productivity curve is demand curve for entrepreneur.

The supply of entrepreneurial ability is scarce, and it depends on how much they earn in an industry or his income i.e. transfer income and opportunity cost. It can't be increased or decreased easily and at once. Able entrepreneur demand is more and earns high profit and vice-versa. Supply being scarce, entrepreneurs earn huge profit due to higher marginal productivity.

Under condition of perfect competition, profits of an entrepreneur tend to equal to his marginal productivity. But when we analysis this theory we find that perfect competition is nowhere found in the real world. Perfect competition is a myth.

Criticism:-

1. This theory assumes all entrepreneur of same type with equal skill is wrong.
2. This theory is one sided. It gives much emphasis on demand side and ignores supply side.
3. This theory is based on assumption of perfect competition and in real practice. (Perfect competition does not Exist)
4. This theory does not consider windfall profit.
5. It is difficult to determine marginal productivity of entrepreneur because in case but in case of a there is only one entrepreneur.

Socialist Theory of Profit:-

This theory was propounded by American Economist Karl Marx. According to this theory, the value of a product is determined by labour itself in involved in the process of production under capitalist economy, major part of total produce is grabbed by capitalist themselves and merely small portion of produce is given away to the labour. Karl Marx called that major portion which is taken away by capitalist as "surplus value". Thus according to this theory, the main reason for accruing profit is exploitation of labour by capitalist or termed as "legalized robbery", as major part of produce is grabbed by capitalist themselves. This will result into division of economy into two parts- Haves and have not's. The first category enjoys at the cost of second. But the second category will struggle due to exploitation and will go for strikes and lockouts. They will demand higher wages and other amenities of life. Therefore, in the long run profit will tends to fall.

Criticism:-

1. This theory explains that labour is the sole factor which is responsible for accruing profit, which is wrong. There are several other factors which are engaged in tempo of production, including labour.
2. Profit is not the outcome of exploitation of labour; rather it is due to the ability of the entrepreneur.
3. This theory ignores the risk taking and uncertainty bearing.
4. This theory does not take into consideration the concept of windfall profit.
5. This theory does not provide any means to measure the volume of profit.

Interest Theory

Liquidity Preference Theory:-

Liquidity preference theory is a model that suggests that an investor should demand a higher interest rate or premium on securities with long-term maturities that carry greater risk because, all other factors being equal, investors prefer cash or other highly liquid holdings.

Liquidity Preference theory refers to money demand as measured through liquidity. John Maynard Keynes introduced liquidity preference theory in his book "The General theory of Employment, Interest, and Money (1936), discussing the connection between interest rates and supply/demand.

In real world terms, the more quickly and as set can be converted into currency, the more liquid it becomes.

The cash money is called liquidity and the liking of the people for cash money is called liquidity preference. According to Keynes people demand liquidity or prefer liquidity because they have three different motives for holding cash rather than bonds etc.

1. Transaction Motive
2. Precaution Motive
3. Speculative Motive

Transaction Motive:-

Day to day transactions is done by individual as well as firms. An individual person has to buy so money things during a day. For this purpose people want to keep some cash money with them. This type of demand for liquidity is for carrying day to day transaction is called for liquidity for transaction motive. So we can say that money need by consumers, businessmen and others in order to complete economic transactions is known as the demand for transactions motive. The demand for money for this purpose is completely interest inelastic. This demand depends upon the following.

1. Size of the income
2. Time gap between the receipts of income
3. Spending habit

Precautionary Motive:-

Every man wants to save something or wants to keep some liquid money with him to meet some unforeseen emergencies, contingencies and accidents. Similarly business firm also want to keep some cash money with them to safeguard their future. This type of demand for liquidity is called demand for precautionary motive. The demand for money for precautionary motive is also completely interest inelastic. This demand depends upon many factors.

1. Size of income

2. Nature of the person
3. Farsightedness

Speculative Motive:-

People want to keep cash with them to take advantage of the changes in the price of bonds and securities. In advanced countries, people like to hold cash for the purchase of bonds and securities when they think it profitable. If the prices of the bonds and securities are expected to rise speculators will like to purchase them. In this situation they will not like to keep cash with them. On the other hand if prices of the bonds and securities are expected to fall people will like to keep cash with them. They will buy the bonds and securities with the cash only when their prices would fall. As a result liquidity preference will be more at lower interest rates.

Loanable Funds Theory:-

The neo-classical theory of interest or loanable funds theory of interest owes its origin to the Swedish economist Kunt Wicksell. Later on, economists like Ohlin, Myrdal, Lindahl, Robertson and J. Viner have considerably contributed to this theory.

According to this theory, rate of interest is determined by the demand for and supply of loanable funds. In this regard this theory is more realistic and broader than the classical theory of interest. The term loanable funds include all forms of credit, such as loans, bonds, or savings deposits. The most common source of loanable funds is form savings of individual or institutions.

Source:-

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