UNIT 13  FACTOR MARKET AND
PRICING DECISIONS

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13.0 OBJECTIVES

After learning about the different market structures viz. Perfect Competition
Monopoly, monopolistic competition and oligopoly in Unit 9 to 12 which
explain the different equilibrium conditions of price and output in the product
market, this unit introduces the concept of factor market i.e. the market for
factors of production in an economy. This unit will develop your understanding
about how factor markets operate distinctly from product markets, how pricing
decisions take place in factor markets and how returns to factors of production
are determined.

After going through this unit, you will be able to:

•  state the concept of a factor market;
•  explain the demand and supply mechanisms in factor markets;
•  discuss marginal productivity theory of factor pricing;
•  articulate pricing decisions for a factor and; and
•  determine returns to factors of production viz. Wages, interest, rent and
  profit.

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13.1 INTRODUCTION

Any platform that facilitates sale and purchase of a good or service is known as a market. In order to produce goods and services, factors of production are required. Just like product and service markets, factors of production of an economy also have their markets. Markets are required to determine their demand, supply and market prices. The primary four factors of production are land, labour, capital and entrepreneurship. This unit explains briefly the essence, importance and operations of land, labour and capital market and the last two units of this block provide detailed explanation on labour and land markets.

To begin with, it is important to understand why there is a need for factor markets. For understanding this, there is a need to understand the importance of factors of production in an economy. As the name suggests, ‘factors’ of production are important entities in the process of production without which production cannot take place. It is not possible to produce a computer without a machine (capital), not possible to produce software without an IT professional (labour) and not possible to produce anything without some space for production (land) where capital and labour are engaged through an IT employer (entrepreneur). All four factors of production are required in an economy for production to take place irrespective of the fact whether what is getting produced is a product or a service. However the ratios in which factors of production are used can differ as per production requirements and advancement of technology. In the era of artificial intelligence, virtual markets and robots, production process using the above technologies are likely to become more capital intensive (and less labour intensive).

Having understood the importance and dynamics of factor markets in an economy, the following sub-sections will throw light on the meaning of factor markets and theories of factor market pricing.

13.2 MEANING OF FACTOR MARKETS

Factor markets are the markets where sale and purchase of factors of production like land, labour and capital takes place. These factors of production, along with entrepreneur, interact to produce goods and services in an economy. The broad characteristics and meaning of these factors of production has been outlined below:

i) Land: It is a physical/tangible factor of production and is a stock concept. It consists of the total physical resources that are available. Land not just includes ground, but also includes the forests, water resources, soil, minerals, mines, etc.

ii) Labour: It is an intangible factor of production as labour services are endowed with a labourer and cannot be separated from him. The effort used by households for production purposes, whether manual or intellectual, is known as labour. Labour is a flow concept.

iii) Capital: It is a tangible factor of production and refers to all forms of machinery, buildings, transport services, etc. that are used in the production process.

iv) Entrepreneurship: This refers to the intangible abilities of an entrepreneur to conduct and organise the production process for producing goods and services.
Generally, households own or control these factors of production and sell them to producers. Households provide their services as labour and earn wages in return. They also mobilise their savings for buying physical capital and also own land. Some households also have members with entrepreneurial skills and act as entrepreneurs. Households earn by selling these factors of production in the factor markets and thus contribute positively to the production process. This interaction can be shown through a circular flow of income and spending between households and firms in Fig. 13.1 given below.

Fig. 13.1: Circular flow of factors of production and goods & services between households and firms in a simple two-sector economy

### 13.3 CONCEPT OF DEMAND AND SUPPLY OF A FACTOR

As a student of microeconomics, you may already be well-versed with the concepts of demand and supply. The concepts and the laws of demand and supply that you have previously studied apply largely to the goods market. In order to understand the demand and supply of a factor, it is important to understand the inter-relationship between the goods market and factor markets.

**Derived Demand**

Let us consider the demand for office space by a data analytics firm. A data analytics company generally requires a rented office space for its analysts, programmers, managers and other workers. Similarly a bakery owner requires space for producing and selling bakery products. In each geographical area, there would be a downward sloping demand curve for office space whose rental is linked to the quantity of office space demanded by firms i.e. the lower the rental price, the higher is the demand of firms for office space. An important distinction between demand for goods and demand for factors is with regards to utility. While on one hand, consumers demand goods as they derive utility from its consumption, on the other hand firms do not demand factors of production for satisfaction of utility but for the purpose of conducting production operations using the four factors of production. The purpose is to maximise revenue and gains from production using factors of production. Moreover the demand for factors of production is dependent on the demand for goods and services from the consumers. Higher is the demand for goods,
higher would be the demand for factors of production and vice-versa. Economists therefore regard demand for factors of production shown in Fig. 13.2 given below as a derived demand.

**Interdependent demand**

As explained earlier, you may recall that production cannot take place using a single factor of production. It takes place through an interaction of different factors of production. Imagine a producer who wants to produce gold jewellery. This producer would require services of designers (labour), office space for conducting production process (land) and some machinery for moulding and heating metals (capital). It is to be noted that interdependence in production leads to interdependence in productivities of factors of production. Thus productivity of labour would get directly affected if the casting or rolling machine used in making gold jewellery gets jammed for two days. In effect, it is the interdependence of productivities of land, labour and capital that makes distribution of factor incomes a complex task. In order to estimate the contributions of the different factors of production in the process of production, the concept of marginal productivity is used wherein the marginal productivity of each factor of production is calculated and used for determination of returns to them.

**Marginal Physical Product (MPP), Value of Marginal Product (VMP) and Marginal Revenue Product (MRP)**

The marginal physical product (MPP) of a factor of production (like labour) is the additional output produced when an extra unit of that factor of production (worker) is added, other factors of production remaining constant.

\[
MPP = \frac{\text{Change in Total product}}{\text{Change in number of units of factor of production}}
\]

The concept of value of marginal product also known as marginal value product refers to the value of output as estimated using information on market prices. Thus when price of a product is multiplied with the marginal physical product of a factor of production, one can derive value of marginal product.

\[
VMP = \text{Price of output} \times \text{Marginal Physical Product of factor}
\]

Marginal revenue product is the additional revenue due to highering of an additional of worker.
MRP = Change in Total revenue / change in number of units of a factor of production

OR

MRP = Marginal revenue × Marginal physical product

These concepts can be easily understood using an illustration of a firm making decisions on how many workers to hire. The Table 13.1 shows the hypothetical case of a bread manufacturer with given factors of production. Information on workers who are variable factors of production is given. In order to calculate value of marginal product, information on market price of bread is given as Rs.10.

<table>
<thead>
<tr>
<th>Units of Workers</th>
<th>Total Product (TP)</th>
<th>Marginal Product (MPP)</th>
<th>Market Price of Bread</th>
<th>Value of Marginal Product (VMP)</th>
<th>Total Revenue (TR)</th>
<th>Marginal Revenue (MR)</th>
<th>Marginal Revenue Product (MRP)</th>
</tr>
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<tbody>
<tr>
<td>0</td>
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</tbody>
</table>

As you can see in the above table, the entries in the VMP column are identical to the entries in the MRP column. However this is taking place due to the assumption of perfect competition where price is equal to marginal revenue. The entries would change in case of imperfectly competitive markets.

Demand for Factors of Production

Demand curve of factors of production can differ depending upon the type of market structure we are discussing. We have discussed examples of perfectly competitive market structure so far and observed that in such a market VMP is equal to MRP. Here VMP gives information about the maximum number of factors that may be hired. As VMP refers to the value addition of each worker in the production process, it can be inferred that in perfectly competitive markets, it is the VMP (as well as MRP) curve which reflects the demand curve of a perfectly competitive firm. Thus VMP as well as MRP curve becomes the demand curve for a factor of production. This also implies that factors which affect the MRP of a firm would also affect the demand curve for the factor. Factors which may affect MRP of a firm are substitutability of a factor by other factors, change in demand for finished product as well as the total cost incurred on a factor of production.

Does VMP as well as MRP curve give the market demand of a factor? A single MRP curve would not give the market demand for a factor as it reflects demand only for a single firm. Thus aggregation of the MRP curves of all the firms of the industry would give industry wide market demand for a factor. In addition to this, if the market demand for a factor for all the industries is added, then one can derive the aggregate market demand curve for a factor of production.
Supply of Factors of Production

Most factors of production are privately owned in a free market economy. Moreover decisions on supply of factors of production like labour, capital and land are governed by a number of economic and noneconomic factors. The important determinants of labour supply are the price of labour and demographic factors such as age, gender, education and family structure. Factors that affect the supply of land are mostly the one that affects the quality such as conservation and change in settlement patterns. Factors that affect the supply of capital are past investments made by businesses, households and governments.

The supply curve for all inputs may slope positively or be vertical. In some cases, it may have even a negative slope. To begin with as the supply of land is fixed, the supply curve of land has a vertical shape. As the supply of capital is directly affected by a change in its returns, higher the returns, higher would be the supply of capital. Thus the supply curve of capital is positively sloped.

Fig. 13.4

**LAND MARKET**

- Rent
- Quantity of Land

**CAPITAL MARKET**

- Interest
- Quantity of Capital

**LABOUR SUPPLY IN THE SHORT-RUN**

- Wages
- Quantity of Labour

**LABOUR SUPPLY IN THE LONG-RUN**

- Wages
- Quantity of Labour
LABOUR MARKET

On the other hand, the supply curve of labour is either positively sloped in the short-run or backward-bending in the short-run. Reasons for the backward bending shape of the labour supply curve have been discussed in detail in the next unit. The interaction of the demand curves of factors of production and the supply curves of factors determines their equilibrium price level.

Check Your Progress 1

1) What do you understand by the term factor pricing? What are factor markets?
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2) Is demand for capital a derived demand? Explain the concept of interdependent demand also.
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3) How is the equilibrium determined in factor markets?
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13.4 FACTOR PRICING BY MARGINAL PRODUCTIVITY THEORY

So far you have studied that households provide the different factors of production used in the production process and how their demand and supplies are determined. You may be curious to understand that how owners of factors of production get paid for the factors they provide. For understanding this process, it is important to understand marginal productivity theory of income distribution.

The theory of marginal productivity of income distribution analyses the way the national income gets distributed among the different factors. The theory says that returns to a factor are directly determined by their marginal product of that factor. This occurs due to the competition among numerous landowners, labourers and capital-owners. Another fundamental point about the distribution theory is that the demands for various factors of production are derived from the revenues that each factor yields on its marginal product. The profit maximising firms would choose factor combinations according to their marginal revenue products.

13.5 DETERMINATION OF RETURNS TO A FACTOR

A) RENT

Land is such a factor of production whose total supply is fixed. The demand for land is also a derived demand. Suppose a particular piece of land is being used
to grow soyabean. If the demand for soyabean increases in the market, the demand for land for growing soyabean would also increase. However as supply of land is fixed, an increase in the demand for land would increase the rental rate of land.

Fig. 13.5: Equilibrium in Land market

As per the Fig. 13.5, R* is the equilibrium rental rate of land which has been determined by the interactions between demand and supply of land. The various theories of rent have been provided in Unit 15.

B) WAGES

Wages are the price of labour supplied. In competitive markets wages are equal to the marginal product of labour. Wages are in equilibrium when the downward sloping labour demand curve crosses the upward sloping labour supply curve. When due to an external shock, there is lower demand for the product of the industry, then there is a fall in the price of product. Due to this, the value of marginal product of labour (VMP) would also fall resulting into lower wages for the labour. Conversely, a surge in the demand for product of an industry would raise the prices. This, in turn, would increase the value of marginal product of labour leading to a rise in wages. This mechanism has been explained in the Fig. 13.6.

Fig. 13.6: Equilibrium in Labour Market

The determination of wage rates is however different in case of perfectly competitive and imperfectly competitive markets as you would see in Unit 14.
C) INTEREST

Capital is a factor of production made by human beings. The cost of using capital services is known as the rental rate for capital and the returns to the owners of capital is known as interest. Interest is a reward for the services of capital. Rental rate of capital is the opportunity cost of holding capital. Unlike labour, capital goods can be bought and sold and have an asset price. Buying a car for Rs.10 lakh entitles one to use it for a number of transport services in future directly or by renting it to someone. The price of an asset is the sum for which the capital asset can be purchased outright. The required rental rate of capital depend on three things: the price of capital good, the real interest rate and the depreciation rate. The price of capital good depends on the interactions between demand and supply of capital goods. In general, the price of capital assets and services is higher when the anticipated rental stream is higher or the interest rate is lower. Both of these raise the present value of the future rental streams of capital. The real interest rate depends on the prevailing rate of inflation and the nominal interest rate. The difference between the nominal rate of interest and the rate of inflation is known as real interest rate. Depreciation depends largely on technology and also on how fast the machine wears out with usage and time.

Theories of Interest

There are a number of theories, which seek to determine the rate of interest. These theories try to explain the phenomenon of interest in terms of different set of variables.

i) Loanable Funds Theory

This theory relies on demand for borrowings and supply of loanable funds to determine the rate at which transaction will take place. It assumes that at any moment of time there will be some people who would spend less than their current income (savers) and others who plan to spend more than their income. The former will constitute the supplies of loanable funds while the latter constitutes the group which demands such funds. The rate at which demand for funds equals supply of funds will be the rate of interest. Such a situation is depicted in Fig 13.7.

![Fig. 13.7](image)

Fig. 13.7 Presents a simple demand and supply curve diagram you are so familiar by now. The curve DD is demand curve for the funds. This shows
amounts the borrowers would like to borrow at different rates of interest. Likewise, the amounts all the savers in the society are willing to save and lend are shown by supply curve marked SS. The intersection of these two at point E gives us equilibrium rate of interest \( r_e \) and the quantity \( Q_E \) that will be borrowed and lent at that rate.

At \( r_e \) rate of interest, \( Q_E \) quantity of funds is borrowed (and lent). Note that demand for funds may arise on account of any three of the following:

a) Investment demand, b) consumption demand and c) financial demand. It is more likely to be a composite of all the three demands.

Similarly, we can say that supply of funds may arise from net savings, de-hoarding of past savings and also from new creation of money.

ii) **Liquidity-Preference Theory**

Keynes had developed this approach and he related demand for money and rate of interest to aggregate level of income in the society. In his formulation demand for liquid money would depend on transaction, precaution or speculation, given the level of income. But supply of money was policy determined variable. The rate of interest was thus determined by interaction of a demand function with a given supply of money. However, in his approach, the rate of interest has nothing to do with determination of rate of remuneration of factor of production.

iii) **Time Preference Approach**

Irving Fisher developed this approach. His idea was that consumer tries to compare present consumption and future consumption. The rate at which future consumption can substitute for present consumption (and vice-versa) will be marginal rate of substitution between present and future consumption. This is called the rate of time preference. It shall be equal to slope of indifference curve between present and future consumption.

### D) PROFITS

We regard entrepreneurship to be the fourth economic factor of production. Recall that an entrepreneur brings together land, labour and capital and thus facilitates production. Her role in production is clear. If other factors of production are not brought together, there may not be any production at all. In capitalist system, the possibility of profit becomes key determinant of whether an activity will be undertaken or not. Even under various non-capitalistic forms of organisation, profit may serve as a benchmark for efficiency of firm or efficiency of some innovation or technological change. Thus, in all situations, if a firm is making larger profit compared to some other similarly placed firm, it must be more efficient or must be using either better resources or better techniques. But decision like introduction of better techniques involves some risk as well. Hence, often attempts are made to relate profit to elements of uncertainty and risk. To understand her role, we can divide entrepreneurial functions into two parts:

a) Organisation and
b) Risk bearing

a) **Organisation:** This consists of routine day-to-day activities associated with a business organisation and is called management. We find that these days, most companies are being managed by professional
managers, who receive salaries and other benefits. Such an arrangement places a part of entrepreneurship at par with labour.

b) **Risk Bearing:** Every business activity runs some risk of failure in the market. This arises because of uncertainty of marketplace, natural causes, political factors etc. If a business fails, the entrepreneur loses substantial parts of investment. Thus, risk of loss is always present. However, some activities like introducing a new product, using a new technology etc., involve much greater risks and reward for these activities must be higher. Otherwise, these would not be undertaken. Hence it is said that profits are reward for risk bearing.

1) **Accounting Profits and Economic Profits**

An account defines the profit as the difference between total revenue earned during the year and cost (including depreciation) incurred during the same period. The cost comprises payments for raw materials, fuels/energy, wages and salaries, rents, insurance and interests. The depreciation is provided for taking care of wear and tear of capital stock. So the net surplus earned during the year, after meeting the above costs, is called profit by the accountant.

However, such calculations do not seem to account for some implicit costs. Take for example the remuneration to the person when she is actually working for her business. Similarly, companies accumulate some funds of their own in course of time. Should interest of those funds be also calculated and added to the cost? Economic profit will take into account this kind of implicit cost as well. So economic profit will be less than accounting profit by the amount of such implicit costs.

2) **Theories of Profits**

Economists have, over the years, developed several theories regarding profits. For example, Joseph Schumpeter attributed profits to innovation. But Frank Knight associated them with uncertainty.

a) **Profits as Rewards for Innovation**

Schumpeter regards profit a phenomenon, which is related to a dynamic economy only. He identifies five types of changes that lead to economic development or make the society dynamic. These changes are:

i) Introduction of new products

ii) Introduction of new methods of production

iii) Discovery of new raw materials

iv) Discovery of new markets

v) Introduction of new forms of organisation

Innovations are actual application of some new body of knowledge to real business situation. An innovator need not be an inventor. But she uses some invention to change her production function or the relationship between inputs and outputs. Such innovation might be in form of new technique of production, may involve reaching out to new markets, involving all the activities pertaining to marketing etc.

Schumpeter is of the opinion that one who innovates is able to earn more profits, and thus gets more incentive to innovate further. She will soon attract
followers or imitators. These people, very soon catch up with original innovator. As a consequence, she makes more efforts to stay ahead. Thus, innovation leads to profits and profits make it possible to innovate (acting as incentive).

b) **Uncertainty and Profit**

Frank Knight defined profit as the difference between selling price and costs. In such situation profit emerges as a residual. Selling price and costs depend on a host of factors. Some of those can be covered by ‘risk’. Such risks can be anticipated and provisions can be incorporated into the cost structure. Most of predictable risks are ‘insurable’ as well. Hence, company can get an appropriate insurance policy to cover such risks. The premium paid for such policy is included in cost of production. This type of risk condition is completely predictable and discountable. Hence it would be as good or as bad as production under perfect certainty.

But Knight points to another dimension of uncertainty and says that producer is all the time anticipating consumer’s wants and preferences in advance. She must do so, as she has to produce things that can satisfy those swans at a point of time in future. This essentially happens because of time lag involved between anticipation of demand, production and offering goods to consumer. To some extent, future results of her operations to produce things to satisfy that demand are also uncertain. Further, even the manager doing routine organisation work is liable to make error of judgement. Here, she bears uncertainty and risk in the sense of having to protect factors of production against fluctuation in their income from an uncertain market. Thus, the income of entrepreneurs consists of two components, a salary or wage component, which is contractual in nature and another residual income that may fluctuate in response to change in market place. Some economists prefer to call only this second component as ‘profit’.

Thus, we find that one significant difference between other factor incomes and profit. Whereas wage, rent interest are all payments, which have been agreed to and settled in advance, profits cannot be put on a similar footing. Uncertainty leads to fluctuation in both costs and revenue. They may not balance. Thus, ultimately profits are the ‘surplus’ that remain after meting the entire contractual payment obligation.

c) **Profits and Market Structure**

Some economists insist that profit as one generally understood is essentially a result of market imperfections. If perfect competition prevailed, every producer will use same technology, will have perfect knowledge about product, cost and market condition. Such a scenario leads to cost minimisation for all the production. They sell at going market price. All the cost and revenue determinants are perfectly certain. Hence, entrepreneurship is just organisation or day-to-day supervision only. So, profits should drop down to bare minimum or ‘normal’ compensation for supervision etc.

However, if market is not perfect, firm can determine quantities or prices in such a manner that suits it best. It may involve breaching the condition of perfect information. Firms may devise some innovation and keep it a secret from others. So long as that secret is maintained, the concerned firm continues to earn more than others do.

A.P. Lerner tried to measure the effect of monopoly power over profit. We
know that equilibrium condition for a firm is equality between marginal cost and marginal revenue. When competition is perfect, price (average revenue) is also equal to marginal revenue. Prices tend to deviate from marginal revenue only when competition is no longer perfect. Hence, the difference between price and marginal revenue, that is, \( P - MR \) (or \( P - MC \)) will indicate firms control over market. It is expressed as a fraction of price. Thus, the degree of monopoly is \( (P - MC)/P \). Higher this ratio, higher will be the rate of profits earned by a firm.

### 13.6 ROLE OF FACTOR PRICES IN PRICING DECISION OF THE FIRM

Several factors play a role in the decision making of a firm regarding production of goods and services. The intrinsic factors are cost of production, marketing, product differentiation and objectives of the firm. These factors directly shape the production process of the firm. A firm needs to decide its cost of production which is dependent on the availability and cost of factors of production. A firm also needs to differentiate its product from similar products to increase its demand. The quantity of output to be produced depends on the objectives of the firm. If the objective is to maximise profits, only that much output would be produced where the cost of production is less than the price. Similarly a firm needs to decide its marketing strategy and the expenditure for it. The extrinsic factors are demand, competition, suppliers and economic conditions.

How can a change in factor prices affect the pricing decisions of the firm? Suppose due to a government regulation, there is a rise in minimum wage rates of construction labourers. As wages are an essential part of cost of production of any industry, rise in the minimum wage rate leads to a rise in the cost of production of a real estate firm. In this case, the firm has two alternatives. Either the firm can continue to use the services of the same number of construction labourers and absorb the rise in cost of production or try to substitute some amount of capital for labour. For e.g. in place of using services of 10 labourers to lift the load of cement, the firm may buy a trolley with wheels which may be dragged by 2 labourers. Thus change in the prices of factors of production can alter the pricing decisions as well as production decisions of the firms.

**Check Your Progress 2**

1) What is theory of marginal productivity? How does it explain the process of determination of factor prices?

2) Distinguish between interest and profits as rewards of factors of production.
3) Explain loanable fund theory in 50 words.

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4) What are the main functions of entrepreneur?

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13.7 LET US SUM UP

This unit introduces the concept of factor markets by discussing the meaning and need for factors of production in an economy. There are four factors of production in an economy namely land, labour, capital and entrepreneur. These factors of production are required in the production of goods and services. As demand for factors of production is linked to the demand for goods and services, their demand is derived demand. Moreover more than one factor of production is used in the production process and so their demand is interlinked and interdependent. This interdependency between product and factor markets results into interactions between demand and supply of goods and services. Each factor of production is paid its return for its contribution in the process of production. The returns to land are called rent and it is the price paid for the use of land which is fixed in supply in the short run as well as in long run. The returns to labour are known as wages and both rent and wages are determined through the interaction between demand and supply. Interest is the return to capital. The theories determined the rate of interest are: Loanable fund theory, liquidity – Preference theory, and time Preference approach. Profits are the returns to entrepreneurs for their organisation and management skills used in conducting the production process. Several theories have been developed regarding profits.

13.8 REFERENCES


13.9 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Read Section 13.1 and 13.2 and answer.
2) Read Section 13.3 and answer.
3) Read Section 13.3 and answer.

Check Your Progress 2

1) Read Section 13.4 and 13.5 and answer.
2) Read Section 13.5 and answer.
3) Read Section 13.5 (Interest) and answer.
4) Read Section 13.5 (Profit) and answer.