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Marginal Productivity Theory of Wages

According to the Marginal Productivity Theory, wages will be equal to the value of marginal productivity of labour. The marginal productivity theory is based on the following assumptions:

i) It assumes the existence of perfect competition.

ii) All labourers are homogenous in character.

iii) The theory is based on the law of diminishing marginal returns.

iv) It assumes that different factors can substitute each other.

According to this theory, wage is equal to the value of marginal product. If the marginal product is more than the wages, then it will be profitable to engage more number of labourers. This is because the total revenue earned due to additional employment is more than the total cost of engaging them. But due to the operation of law of diminishing marginal return, the marginal value product will decline, if labour is engaged beyond a marginal value product, then it will be unprofitable to engage more labourers and hence, their engagement will be reduced until wages are equal to the marginal value product.

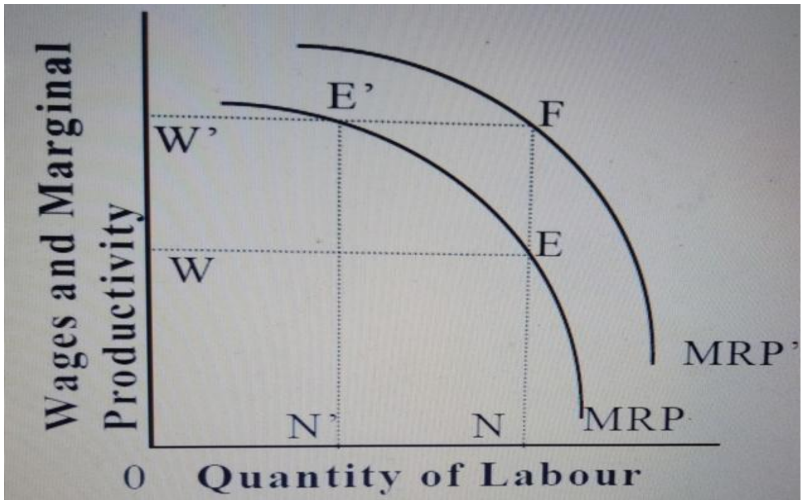

Fig.6.5 ***Determination of Wages***

In the figure 6.5, If ON is the available supply of labour, OW is the equilibrium wage rate. Now, if the wage rate is increased to OW' by a collective bargaining of trade unions, NN' number of workers become unemployed. Thus, trade unions cannot enhance wages without creating unemployment. But, if the rise in wage brings about a sufficient increase in efficiency and productivity so that the marginal productivity curve shifts upward (MRP'), then unemployment will not be created.

Criticism:

1. Labourers may not be uniform in quality.
2. This theory ignores supply side of the labourers.
3. The individual entrepreneur may operate without the knowledge on law of diminishing marginal return

Demand-Supply Theory of Wages

According to this theory, wages are determined by the forces of demand and supply of labour. When there is a perfect competition in labour market, wage rate is determined by the equilibrium between the demand for and supply oflabour.

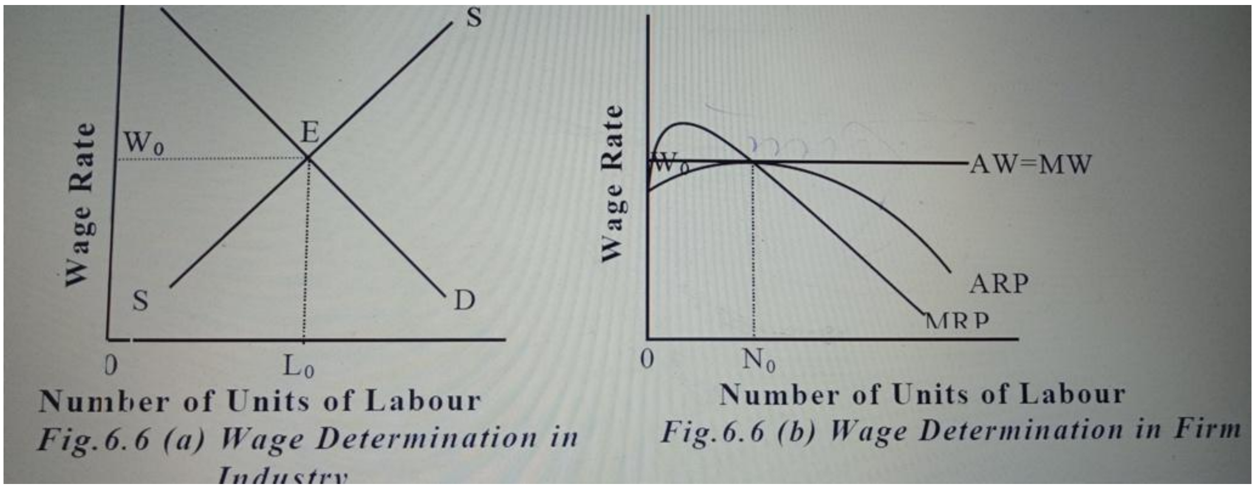

Fig.6.6 (a) Wage Determination in Industry

Fig.6.6 (b) Wage Determination in Firm

The wage determination in the industry is depicted in the fig.6.6 (a). The producer will employ more units of labour at lower wage rates. Demand for labour is governed by the marginal revenue product of labour (MRP). Hence, the demand curve for labour slopes downward from left to right. However, there is a positive relationship between wage rate and supply of labour, i.e., higher the wage rate, more will be the supply of labour and vice-versa. At the point E, where demand for labour equals supply of labour, the wage rate (OWO) gets determined. Thus, in equilibrium, OLo units of labour will be employed at the wage rate of OWo. In the long run, wage rate under perfect competition=MRP=ARP. Since marginal revenue product (MRP) and average revenue product (ARP) are equal only at the former’s highest point, the equilibrium employment of labour by the firms in the long run will be corresponding to the highest point of the marginal productivity curve as shown in the figure 6.6 (b). In this, the firm has to accept the market wage OW0 settled by the industry. Therefore, in this long run equilibrium situation, wage rate, OW=MRP=ARP.