

Chapter 18 – The Markets for Factors of Production

Factors of Production and Factor Markets

- **Factors of production:** the inputs used to produce goods and services.
 - Labor
 - Land
 - **Capital:** the equipment and structures used to produce goods and services.
- Prices and quantities of these inputs are determined by supply & demand in factor markets.

Two Assumptions

1. We assume all markets are competitive.

The typical firm is a price taker

- in the market for the product it produces
- in the labor market

2. We assume that firms care only about maximizing profits.

- Each firm's supply of output and demand for inputs are derived from this goal.

Our Example: Farmer Jack

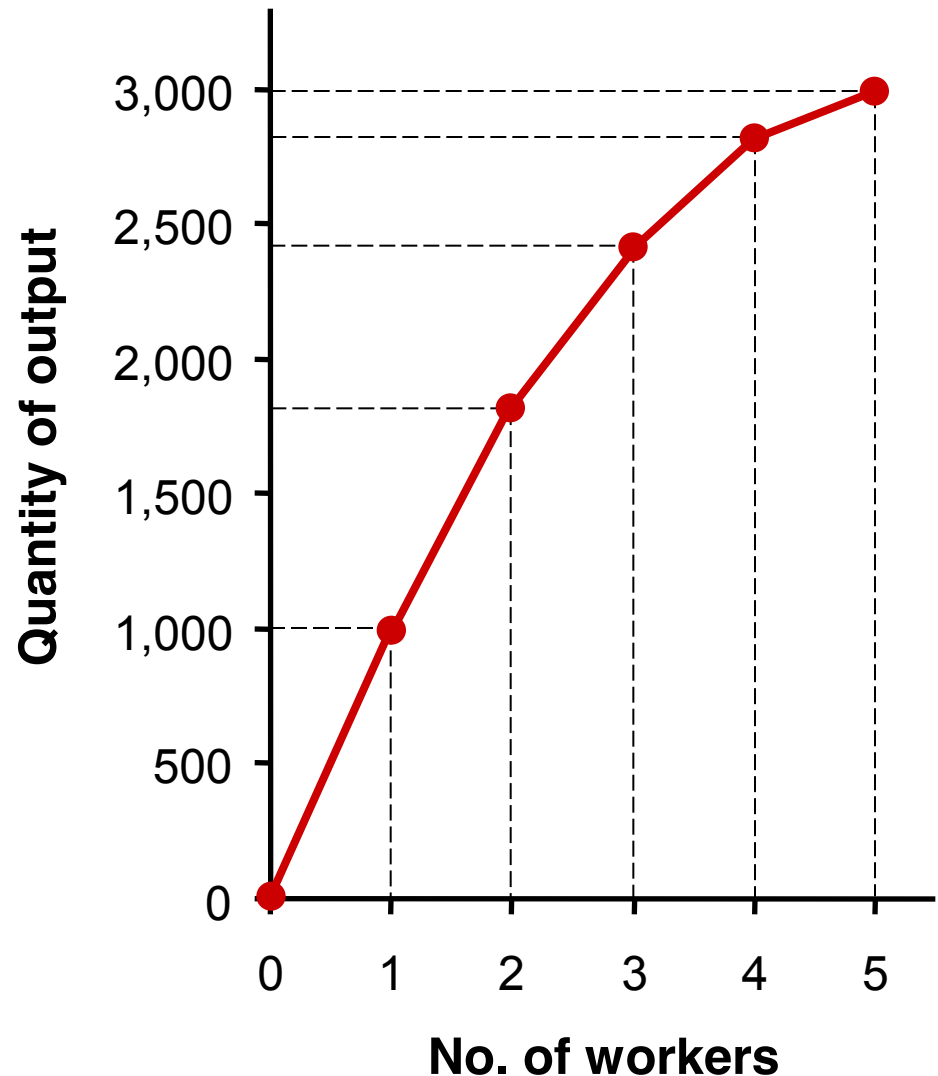
- Farmer Jack sells wheat in a perfectly competitive market.
- He hires workers in a perfectly competitive labor market.
- When deciding how many workers to hire, Farmer Jack maximizes profits by thinking at the margin:
 - If the benefit from hiring another worker exceeds the cost, Jack will hire that worker.

Our Example: Farmer Jack

- Cost of hiring another worker:
the wage – the price of labor
- Benefit of hiring another worker:
Jack can produce more wheat to sell,
increasing his revenue.
- The size of this benefit depends on Jack's **production function**: the relationship between the quantity of inputs used to make a good and the quantity of output of that good.

Farmer Jack's Production Function

L (no. of workers)	Q (bushels of wheat per week)
0	0
1	1000
2	1800
3	2400
4	2800
5	3000



Marginal Product of Labor (MPL)

- **Marginal product of labor:** the increase in the amount of output from an additional unit of labor

$$MPL = \frac{\Delta Q}{\Delta L}$$

where

ΔQ = change in output

ΔL = change in labor

The Value of the Marginal Product

- Problem:
 - Cost of hiring another worker (wage) is measured in dollars
 - Benefit of hiring another worker (MPL) is measured in units of output
- Solution: convert MPL to dollars
- **Value of the marginal product:** the marginal product of an input times the price of the output

$$\begin{aligned} VMPL &= \text{value of the marginal product of labor} \\ &= P \times MPL \end{aligned}$$

ACTIVE LEARNING 1

Computing MPL and VMPL

$P = \$5/\text{bushel}$.

Find **MPL**
and **VMPL**,
fill them in the
blank spaces
of the table.

Then graph
a curve with
VMPL on the
vertical axis,
L on horiz axis.

L (no. of workers)	Q (bushels of wheat)	MPL	VMPL
0	0		
1	1000		
2	1800		
3	2400		
4	2800		
5	3000		

ACTIVE LEARNING 1

Answers

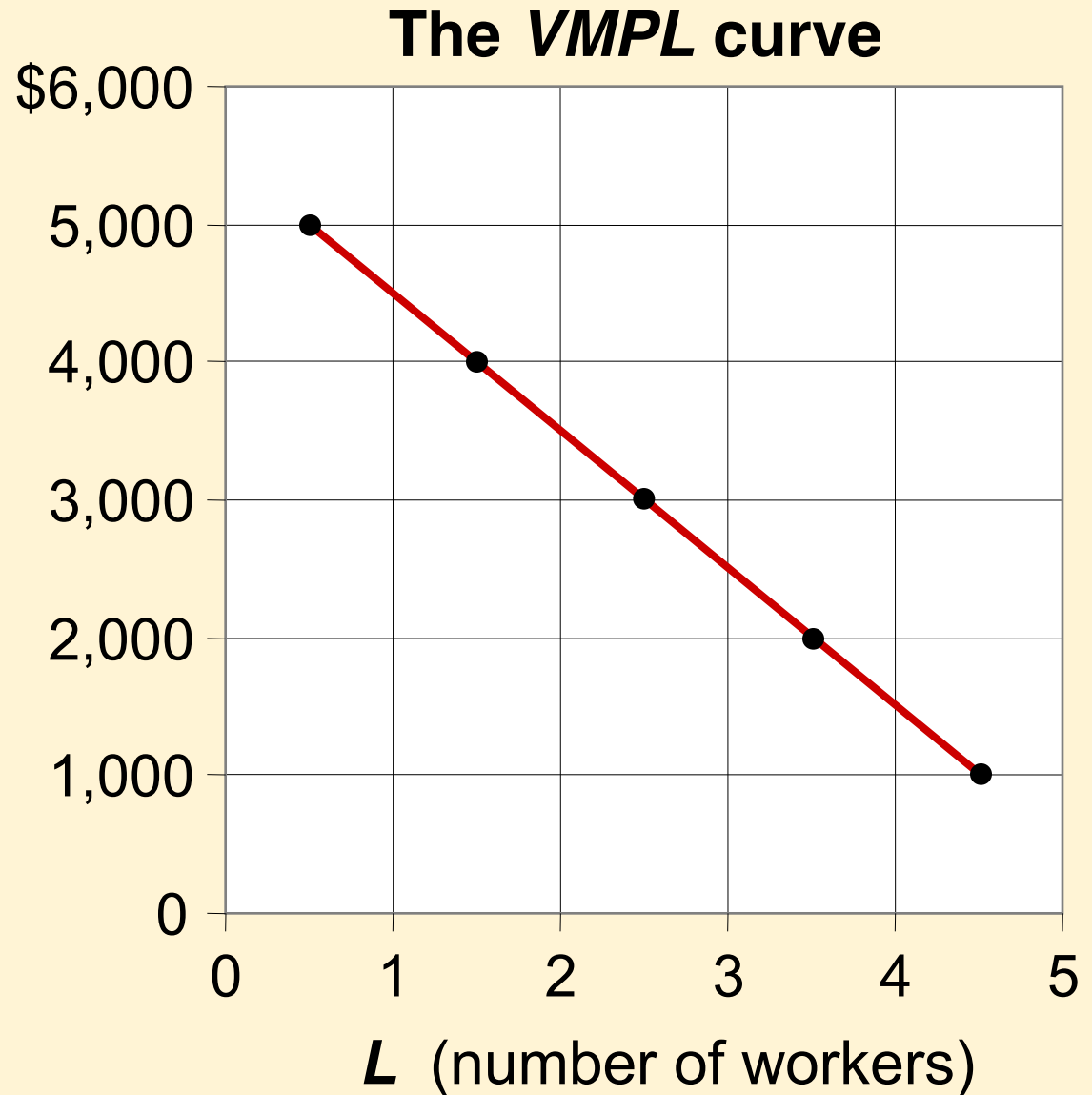
Farmer Jack's production function exhibits **diminishing marginal product**: MPL falls as L increases. This property is very common.

L (no. of workers)	Q (bushels of wheat)	$MPL = \Delta Q / \Delta L$	$VMPL = P \times MPL$
0	0		
1	1000	1000	\$5000
2	1800	800	4000
3	2400	600	3000
4	2800	400	2000
5	3000	200	1000

ACTIVE LEARNING 1

Answers

Farmer Jack's *VMPL* curve is downward sloping due to diminishing marginal product.



Farmer Jack's Labor Demand

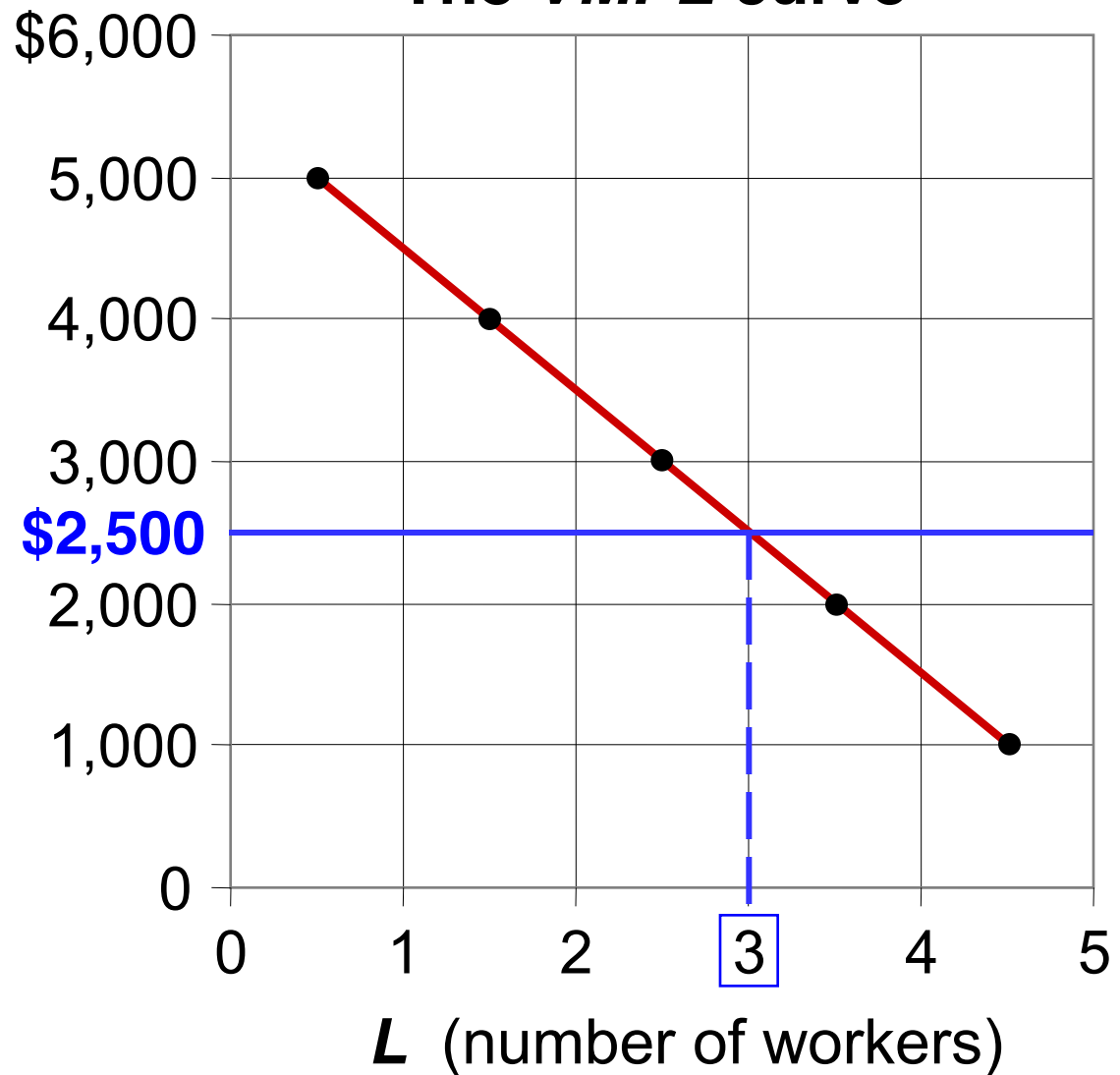
The VMPL curve

Suppose wage
 $W = \$2500/\text{week}$.

How many
workers should
Jack hire?

Answer: $L = 3$

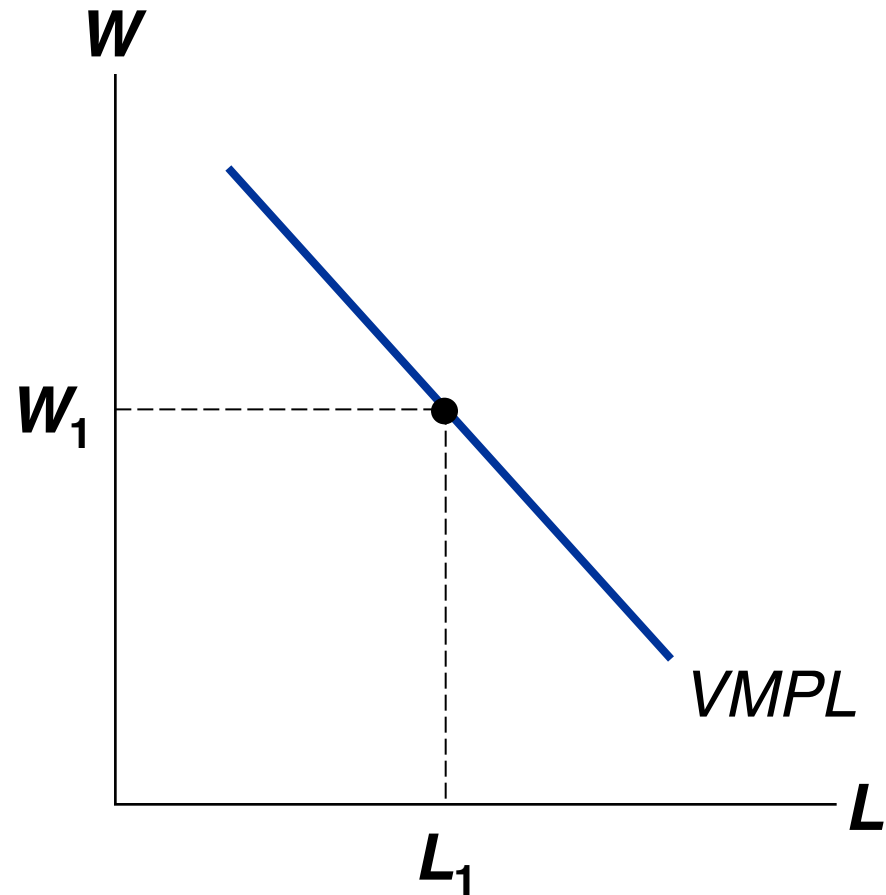
At any ~~single~~ L ,
can increase profit
by hiring another
worker.



VMPL and Labor Demand

For any competitive, profit-maximizing firm:

- To maximize profits, hire workers up to the point where $VMPL = W$.
- The $VMPL$ curve is the labor demand curve.

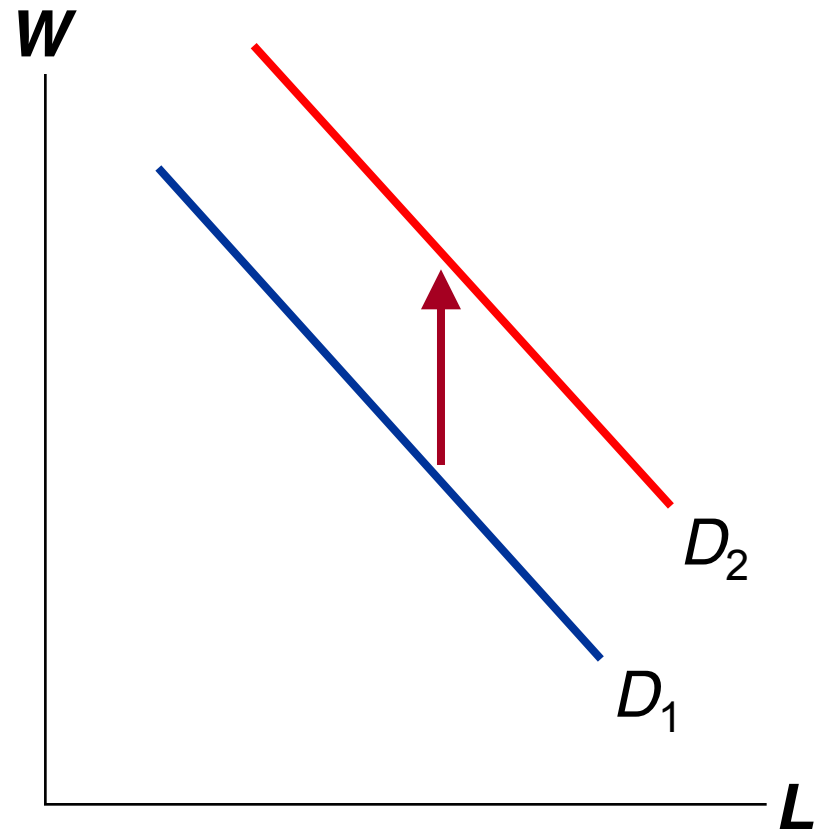


Shifts in Labor Demand

Labor demand curve
= $VMPL$ curve.

$$VMPL = P \times MPL$$

Anything that
increases P or
 MPL at each L
will increase
 $VMPL$ and shift
labor demand curve
upward.



Things that Shift the Labor Demand Curve

- Changes in the output price, P
- Technological change (affects MPL)
- The supply of other factors (affects MPL)
 - Example:
If firm gets more equipment (capital),
then workers will be more productive;
 MPL and $VMPL$ rise, labor demand shifts
upward.

The Connection Between Input Demand & Output Supply

- Recall: **Marginal Cost (MC)**
 - = cost of producing an additional unit of output
 - = $\Delta \mathbf{TC} / \Delta \mathbf{Q}$, where TC = total cost
- Suppose $W = \$2500$, $MPL = 500$ bushels
- If Farmer Jack hires another worker,
 - $\Delta \mathbf{TC} = \$2500$, $\Delta \mathbf{Q} = 500$ bushels
 - $MC = \$2500 / 500 = \5 per bushel
- In general: $MC = W / MPL$

The Connection Between Input Demand & Output Supply

- In general: $MC = W/MPL$
- Notice:
 - To produce additional output, hire more labor.
 - As L rises, MPL falls...
 - causing W/MPL to rise...
 - causing MC to rise.
- Hence, *diminishing marginal product and increasing marginal cost are two sides of the same coin.*

The Connection Between Input Demand & Output Supply

- The competitive firm's rule for demanding labor:

$$P \times MPL = W$$

- Divide both sides by MPL :

$$P = W/MPL$$

- Substitute $MC = W/MPL$ from previous slide:

$$P = MC$$

- This is the competitive firm's rule for supplying output.
- Hence, *input demand and output supply are two sides of the same coin.*

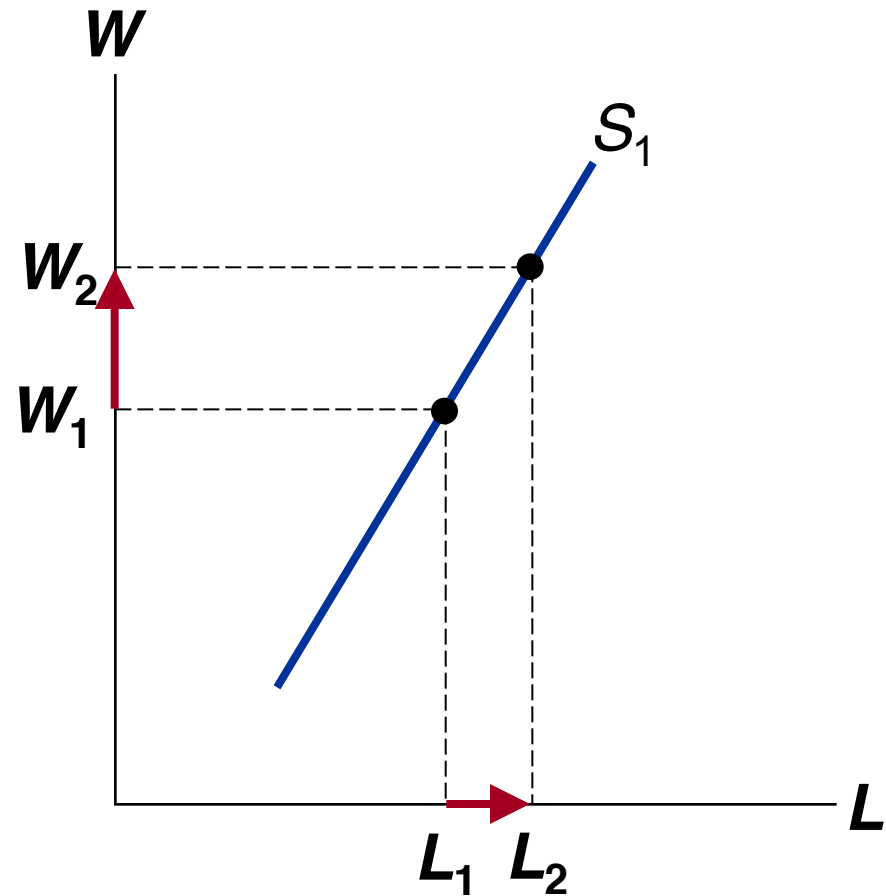
Labor Supply

- Trade-off between work and leisure:
The more time you spend working,
the less time you have for leisure.
- The opportunity cost of leisure is the wage.

The Labor Supply Curve

An increase in W
is an increase in the
opp. cost of leisure.

People respond by
taking less leisure
and by working more.



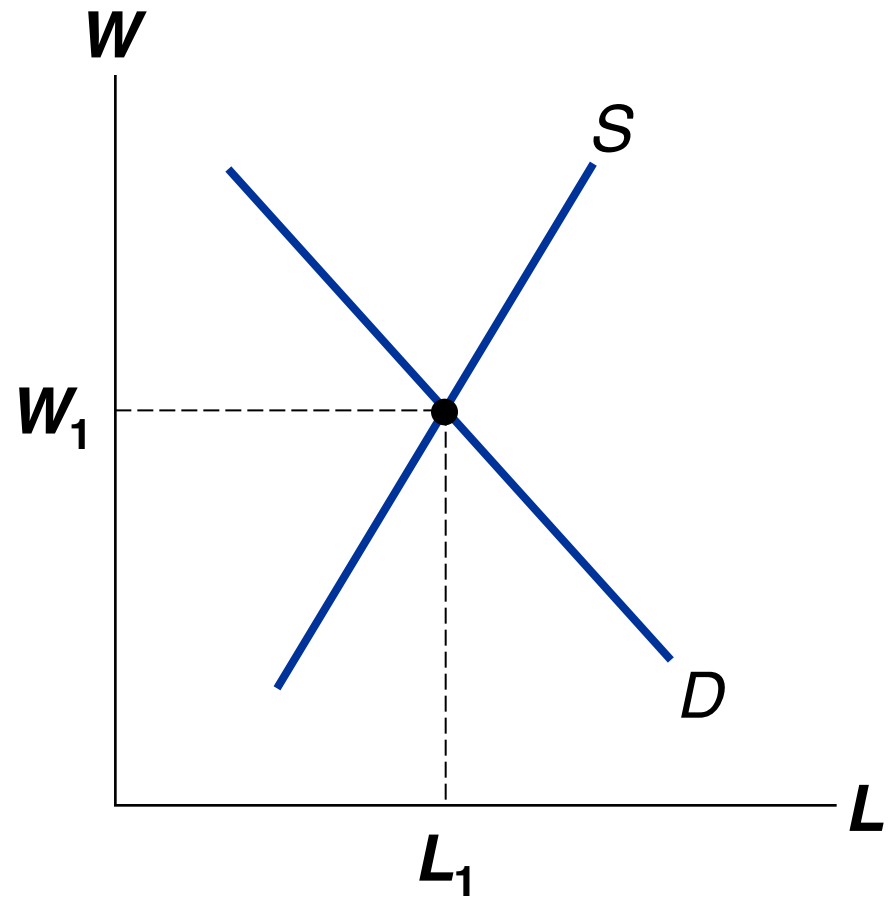
Things that Shift the Labor Supply Curve

- Changes in tastes or attitudes regarding the labor–leisure trade-off
- Opportunities for workers in other labor markets
- Immigration

Equilibrium in the Labor Market

The wage adjusts to balance supply and demand for labor.

The wage always equals $VMPL$.



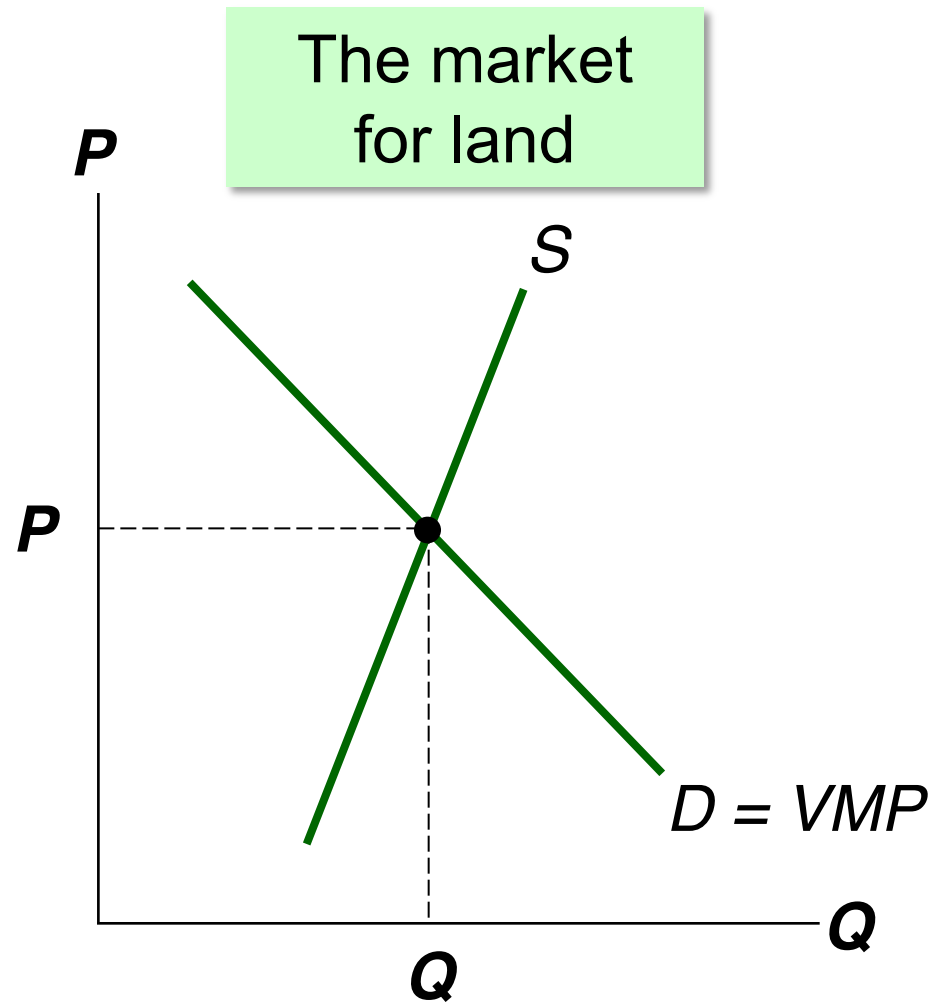
The Other Factors of Production

- With land and capital, must distinguish between:
 - **purchase price** – the price a person pays to own that factor indefinitely
 - **rental price** – the price a person pays to use that factor for a limited period of time
- The wage is the rental price of labor.
- The determination of the rental prices of capital and land is analogous to the determination of wages...

How the Rental Price of Land Is Determined

Firms decide how much land to rent by comparing the price with the value of the marginal product (*VMP*) of land.

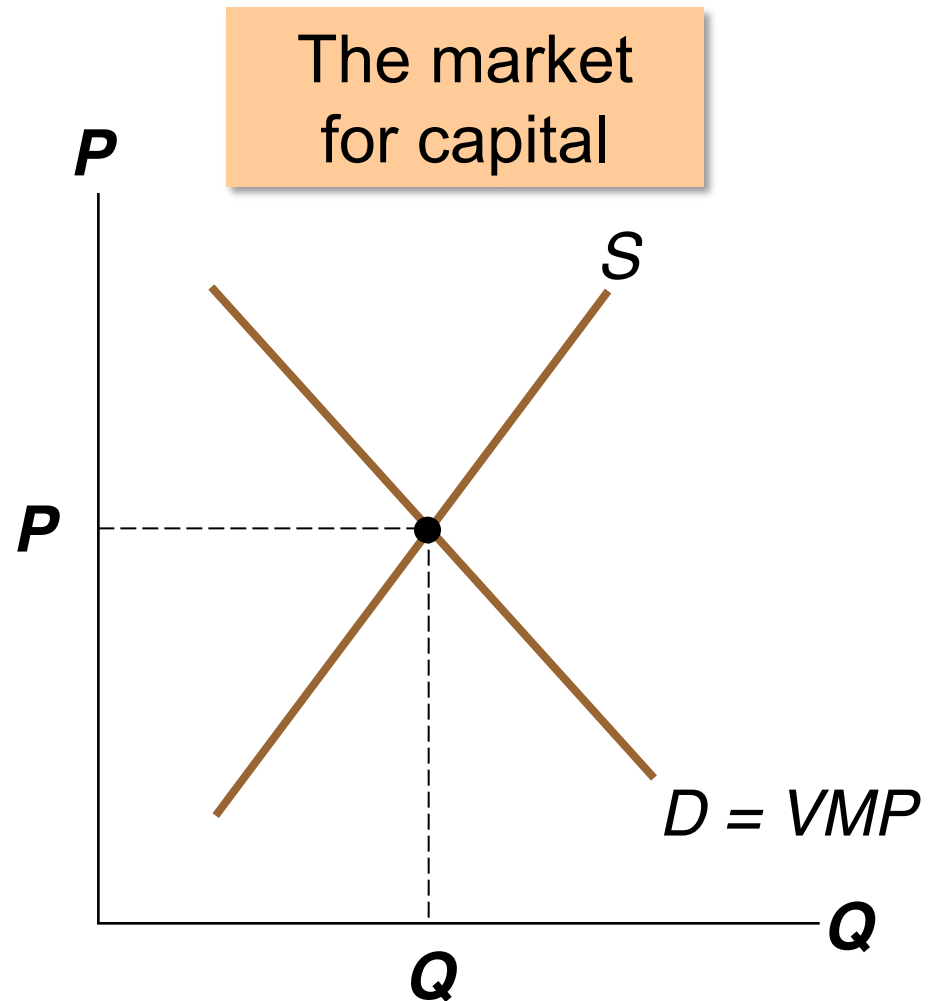
The rental price of land adjusts to balance supply and demand for land.



How the Rental Price of Capital Is Determined

Firms decide how much capital to rent by comparing the price with the value of the marginal product (*VMP*) of capital.

The rental price of capital adjusts to balance supply and demand for capital.



CONCLUSION

- The theory in this chapter is called the **neoclassical theory of income distribution**.
- It states that
 - factor prices determined by supply and demand
 - each factor is paid the value of its marginal product
- Most economists use this theory as a starting point for understanding the distribution of income.
- The next two chapters further explore income distribution and related issues.

SUMMARY

- The economy's income distribution is determined in the markets for the factors of production. The three most important factors of production are labor, land, and capital.
- A firm's demand for a factor is derived from its supply of output.
- Competitive firms maximize profit by hiring each factor up to the point where the value of its marginal product equals its rental price.

SUMMARY

- The supply of labor arises from the trade-off between work and leisure, and yields an upward-sloping labor supply curve.
- The price paid to each factor adjusts to balance supply and demand for that factor. In equilibrium, each factor is compensated according to its marginal contribution to production.
- Factors of production are used together. A change in the quantity of one factor affects the marginal products and equilibrium earnings of all factors.