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BA Economics Honours | Semester V | Calicut University

Advanced Microeconomics

Course Code: ECO5CJ301 • Module 1

Module I: Market for Factor Inputs

Factor market analysis investigates how prices and employment levels of productive factors—labor, capital, land, and entrepreneurship—are determined under varying market structures. Unlike the demand for consumer goods, factor demand is fundamentally a **derived demand**, originating from consumer demand for the final output that those factors cooperate to produce.

Unit 1, 2 & 3: Competitive Factor Markets and Marginal Revenue Product

In a perfectly competitive factor market, individual firms are price takers facing a horizontal factor supply curve at the prevailing market factor price (w).

- **Single Variable Input Case:** A profit-maximizing firm employs labor up to the point where the **Marginal Revenue Product of Labor (MRP_L)** equals the marginal factor cost (wage w):

  > **Competitive Wage Rule**
  >
  > $$MRP_L = MR \times MP_L = P \times MP_L = VMP_L = w$$
  >
  > Where: MRP_L = Marginal Revenue Product of labor, VMP_L = Value of Marginal Product of labor ($P \times MP_L$), and w = Competitive market wage.

  where VMP_L is the Value of Marginal Product (since $P = MR$ under perfect competition in the output market). As labor employment expands, diminishing marginal returns cause MP_L to decline, generating a downward-sloping factor demand curve.
- **Several Variable Inputs Case:** When multiple factors (labor *L* and capital *K*) are variable, a reduction in the wage rate triggers two interacting effects:
  1. *Substitution Effect:* The firm substitutes cheaper labor for capital, moving along an isoquant.
  2. *Output Effect:* Lower factor costs shift the marginal cost curve downward, inducing higher equilibrium output, which further increases the demand for both capital and labor.

  Consequently, the long-run factor demand curve is more price-elastic than the short-run factor demand curve.
- **Market Equilibrium:** Industry factor demand is derived by horizontally summing individual firm factor demands (adjusted for product price feedback effects as industry output expands), intersecting market factor supply at equilibrium wage w^* and employment L^*.

Unit 4 & 5: Factor Markets with Monopoly and Monopsony Power

Market imperfections profoundly alter factor pricing and factor employment:

- **Monopoly Power in the Product Market:** When a firm holds monopoly power in selling its output ($MR < P$), the demand for labor is governed by $MRP_L = MR \times MP_L$, which lies strictly below $VMP_L = P \times MP_L$. The profit-maximizing condition is:

Competitive Wage Rule

$$MRP_L = w < VMP_L$$

Where: MRP_L = Marginal Revenue Product of labor, VMP_L = Value of Marginal Product of labor ($P \times MP_L$), and w = Competitive market wage.

This divergence represents *monopolistic exploitation of labor* (as formulated by Joan Robinson), where workers are paid a wage equal to their marginal revenue contribution but less than the physical value of their output to society.

- **Monopsony Power in the Factor Market:** When a single buyer dominates the factor market (e.g., a dominant mining company in an isolated town), the monopsonist faces an upward-sloping labor supply curve ($w(L)$). Consequently, the **Marginal Expenditure (ME)** on labor exceeds the average expenditure (wage):

Monopsonist Marginal Wage Rule

$$ME = w(L) + L \cdot \frac{dw}{dL} > w$$

Where: ME = Marginal expenditure of labor, $w(L)$ = Supply curve wage rate, and (dw/dL) = Slope of labor supply curve. Since supply slopes upward, $ME > w$.

To maximize profit, the monopsonist sets $ME = MRP_L$. The firm employs labor L_{m} (where $ME = MRP_L$) but pays wage w_{m} from the labor supply curve. Because $w_m < ME = MRP_L$, the monopsonist exerts *monopsonistic exploitation*, resulting in both sub-optimal employment and depressed wages relative to competitive equilibrium ($L_m < L_c$ and $w_m < w_c$).

Advanced Theoretical Formulations and Empirical Frameworks (Analytical Division 1)

The theoretical structures established in this module carry far-reaching implications for empirical economic research, institutional policymaking, and dynamic market equilibrium. In contemporary economic analysis, economists employ sophisticated econometric models, institutional diagnostic frameworks, and comparative historical evaluations to rigorously assess the validity of core assumptions and their real-world outcomes across developing and advanced economies.

Empirical Methodology, Identification Strategies, and Econometric Estimation

Empirical validation of economic models necessitates the rigorous treatment of endogeneity, omitted variable bias, and measurement error. Whether analyzing consumer behavior, firm cost structures, fiscal multipliers, or monetary transmission mechanisms, applied researchers utilize instrumental variables (IV), difference-in-differences (DiD), synthetic control methods, and regression discontinuity designs (RDD) to isolate causal relationships from mere statistical correlation.

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accordance with the Lucas Critique. Consequently, contemporary applied economics bridges micro-foundations with aggregate macroeconomic phenomena through dynamic stochastic general equilibrium (DSGE) modeling and micro-econometric panel estimations.

Comparative Institutional Analysis, Market Failures, and Policy Governance

Economic outcomes are fundamentally mediated by institutional architectures, legal property rights regimes, and regulatory governance. In emerging market economies such as India, market imperfections—including asymmetric information, transaction costs, infrastructural bottlenecks, and credit constraints—often necessitate nuanced policy interventions that differ substantially from textbook laissez-faire predictions.

Analytical Dimension	Orthodox / Classical Perspective	Heterodox / Institutional Framework	Empirical Policy Manifestations in India
Market Efficiency	Markets clear instantaneously; price mechanism allocates resources optimally without systemic friction.	Markets are prone to structural failures, information asymmetry, and coordination coordination failures.	Targeted regulatory oversight, public investment in infrastructure, and social safety nets.
Behavioral Motivation	Hyper-rational agents maximizing expected utility with complete cognitive computational capacity.	Bounded rationality, behavioral heuristics, loss aversion, and institutional anchoring effects.	Choice architecture, behavioral nudges (NITI Aayog initiatives), and consumer financial protection mandates.
State Intervention	State role restricted to core public goods, contract enforcement, and national defense (minimalist state).	State acts as developmental catalyst, risk-absorber of last resort, and promoter of equitable distribution.	Strategic industrial policy (PLI schemes), counter-cyclical fiscal intervention, and universal public services.
Distributional Equity	Factor rewards reflect marginal productivity; distribution is secondary to allocative efficiency.	Power asymmetries, bargaining power, and historical wealth accumulation shape distribution.	Progressive fiscal transfers, land reforms, and affirmative human capital investments.
Technological Progress	Exogenous technological shocks arriving randomly (Solow neoclassical growth model).	Endogenous technological innovation driven by R&D, human capital, and intellectual property institutions.	National Innovation Foundation, Startup India, and public digital infrastructure (India Stack / UPI).

Comprehensive Empirical Analysis: The Kerala Model and Sub-National Development

In the context of the Indian economy and sub-national development paradigms, the Kerala Model of Development provides a seminal empirical case study illustrating the complex trade-offs between social development and economic growth. Characterized by high physical quality of life indicators—including near-universal adult literacy, high life expectancy, and low infant mortality rates comparable to advanced Western economies—achieved despite historically modest per capita state domestic product, Kerala demonstrates the transformative power of public social expenditure, agrarian land reforms, and decentralized local governance (Panchayati Raj institutions).

However, contemporary economic analysis also highlights structural challenges confronting this development paradigm: high educated unemployment, fiscal constraints stemming from escalating public debt servicing and pension obligations, and heavy reliance on external remittance inflows from migrant workers in the Persian Gulf. Sustaining this high-welfare equilibrium necessitates transitioning toward a knowledge-driven economy, incentivizing high-tech manufacturing, and mobilizing sustainable sub-national fiscal resources.

Policy Synthesis and Analytical Evaluation

Policy formulation in dynamic economic environments must therefore synthesize foundational deductive reasoning with robust inductive empirical inquiry. Economists must continuously evaluate the balance between market incentives and regulatory governance, ensuring that institutional frameworks promote both productive efficiency and distributive social justice.

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