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Lecture 10 & 11

Economic Principles applied to the Organization of Farm Business



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1. Cost Principle

$$TC = VC + FC$$

$$\text{Net Revenue} = TR - TC$$

(A) In the short run: Gross revenue (GR) must cover the VC. Maximum net revenue is obtained when $MC = MR$. If $GR < TC$ but $> VC$, guiding principle should be to keep increasing production as long as $MR > MC$.



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In the short run:

Gross revenue (GR) must cover the VC. Maximum net revenue is obtained when $MC = MR$. If $GR < TC$ but $> VC$, guiding principle should be to keep increasing production as long as $MR > MC$ $Y=f(X_1, X_2, X_3, \dots, X_n)$ where Y is output, $X_1, X_2, X_3, \dots, X_n$ are inputs. It, however, does not tell which inputs are fixed and which are the variable ones.



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In the long Run:

GR should be $> VC + FC = TC$. For taking production decision in such a situation, one should go on using resources as long as added returns remain greater than added total costs. Here, the object is to maximize profits instead of minimizing the losses.



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2. Law of Equi- Marginal Returns (Special case of substitution)

When resources are unlimited, farmer can produce all products under the rule,

Added returns $>$ Added costs



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- **But resources are limited**, expansion of one enterprise requires contraction of other. The big question is which enterprise combination will give the greatest income? Such an optimum choice of enterprises is made based on the principle of equi-marginal return or the opportunity cost principle. Profit will be the greatest if each unit of labour, capital and land is used where it adds the most to the returns. In other words, this principle lays down:



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- **the best combination of enterprises or practices** will be where limited resources are allocated in a manner that one cannot change the use of a simple unit without reducing the income. Thus, the resources should be used where they give not the highest average returns but the greatest marginal returns. Thus, the best combination of enterprises is obtained not when we select profitable crops but most profitable crops. The profitability of an enterprise depends on the price of the product, the direct costs



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3. Opportunity Cost Principle:

When resources are limited and there are more than one enterprise where farmer can invest. When resources are used in one product some alternative is always forgone. The opportunity cost is the value of next best alternative forgone. The value of one enterprises sacrificed is the cost of producing another enterprise.



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This principle thus refers to the advantages (returns) which might have been obtained from any factor if it had not been used in producing that commodity, but would have been used for other next best purpose. Thus, it is the cost equivalent to the returns from next best alternative forgone.



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4. Time Comparison Principle

- There are two types of investments: (1) Investments on operating inputs & (2) Investment on capital assets (land, farm building, machinery, equipment, etc). Analysis of these investments involves not only the comparison of costs and returns associated with it, but also the timings of occurrence of costs & returns. The costs & returns from investments in operating resources occur with a production period of a year or less.