Laws Of Returns

The table explains the following three stages of returns to scale:

1. Increasing Returns to Scale:

Increasing returns to scale or diminishing cost refers to a situation when all factors of production are increased, output increases at a higher rate. It means if all inputs are doubled, output will also increase at the faster rate than double. Hence, it is said to be increasing returns to scale. This increase is due to many reasons like division external economies of scale. Increasing returns to scale can be illustrated with the help of a diagram 8.

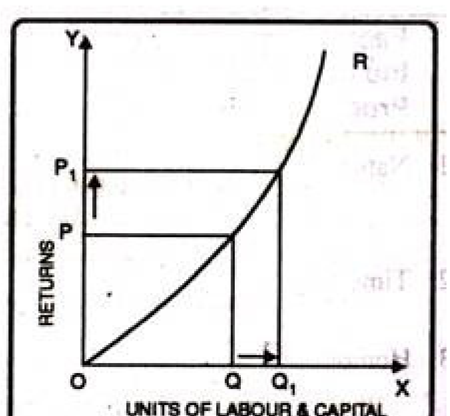

Fig 8.

In figure 8, OX axis represents increase in labour and capital while OY axis shows increase in output. When labour and capital increases from Q to Q_1, output also increases from P to P_1 which is higher than the factors of production i.e. labour and capital.

2. Diminishing Returns to Scale:

Diminishing returns or increasing costs refer to that production situation, where if all the factors of production are increased in a given proportion, output increases in a smaller proportion. It means, if inputs are doubled, output will be less than doubled. If 20 percent increase in labour and capital is followed by 10 percent increase in output, then it is an instance of diminishing returns to scale.

The main cause of the operation of diminishing returns to scale is that internal and external economies are less than internal and external diseconomies. It is clear from diagram 9.

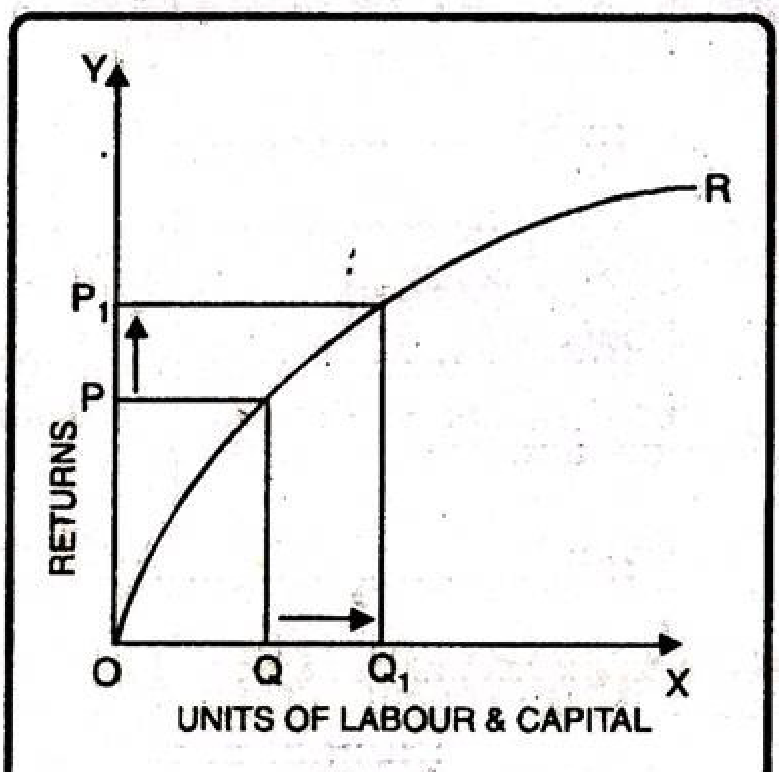

Fig. 9.

In this diagram 9, diminishing returns to scale has been shown. On OX axis, labour and capital are given while on OY axis, output. When factors of production increase from Q to Q_1 (more quantity) but as a result increase in output, i.e. P to P_1 is less. We see that increase in factors of production is more and increase in production is comparatively less, thus diminishing returns to scale apply.