The Essence of Marginal Productivity Theory:

The theory states that the firm employs each factor up to that number where its price is equal to its VMP. Thus, wages tend to be equal to the VMP of labour; interest is equal to VMP of capital and so on. By equating VMP of each factor with its cost a profit- seeking firm maximises its total profits. Let us illustrate the theory with reference to the determination of the price of labour, i.e., wages.

Let us suppose that the price of the product is Rs. 5 (constant) and the wages per unit of labour are Rs. 200 (constant). As the number of factors other than labour remain unchanged, wages represent the marginal cost (MC).

Table :Calculation of MPP, VMP and MRP of a Variable Factor (Labour)

Land	Capital	Labour	Total Product	MPP of Labour	VMP or MRP of Labour	The Wage Rate AW=MW
1 unit	1 unit	1 unit	10 units	×	×	Rs. 20
"	"	2 units	16 "	6 units	Rs. 30	"
"	"	3 units	1 unit	5 units	Rs. 25	"
"	"	4 units	25 units	4 units	Rs. 20	"
"	"	5 units	28 "	3 units	Rs. 15	"
"	"	6 units	30 "	2 units	Rs. 10	"

Table shows that at 2 or 3 labourers, the VMP or MRP of labour is greater than wages; so the firm can earn more profits by employing an additional labour. But at 5 or 6 labourers, the VMP or MRP of labour is less than wages, so it would reduce the number of labourers. But when it employs 4 labourers, the wage rate (Rs. 20) becomes equal to the VMP or MRP of labour (also Rs. 20). Here the firm gets the maximum profits because its marginal cost of labour (or marginal wage Rs. 12) is equal to its marginal revenue (VMP or MRP, Rs. 20).