

Sample Answer

Q.4 (a) 2000 Higher Level

The marginal efficiency of capital is the MRP of an extra unit of capital less its cost.

$$\boxed{\text{MEC} = \text{MRP of Capital} - \text{Cost of Capital}}$$

The marginal efficiency of capital may fall for the following reasons:

- (i) If the selling price of the finished good declined this would lead to lower revenue for the firm. This would reduce the MRP of each extra unit of capital employed and would lead to a fall in the MEC of capital.
- (ii) If the MPP (Marginal Physical Product) of each extra unit of capital decreased. A fall in the MPP of capital could be due to the firm using old or worn-out machinery. This fall in output would lead to a lower MRP as MRP depends on the MPP.
- (iii) If the cost of capital increased (assuming MRP remains the same), this would lead to a fall in the Marginal Efficiency of Capital. A higher cost of capital could be caused by inflation in the price of machinery and capital goods or a shortage of these capital goods.