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## **Value-based performance and its decomposition into direct price and quantity effects**

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## Abstract

Based on the idea that in real markets firms have some freedom to set their output prices and negotiate input unit costs, this paper introduces a new approach for value-based performance decomposition as the product of direct price and quantity effects. Our framework relies on the axiomatization of a value transformation set on which quantity, price and value distance functions can be defined. The methodology developed allows for various degrees of dependency between quantity and price as well as for different degrees of freedom in price setting. The value-based performance decomposition can encompass all traditional measures such as cost, revenue, profit and profitability efficiencies. An application on French cattle farms illustrates the appeal of our approach for practitioners.

## Highlights

- Calculation of a direct price effect based on a comparison of prices among similar firms
- Value decomposition respects the product test
- Possibility to consider various degrees of dependency between the quantity and the price
- Generalization of traditional quantity and more recent price distance functions
- Extensions of this methodology include cost, revenue, profit and profitability measures

**Keywords:** Data envelopment analysis, value transformation set, value-based performance, direct price efficiency.

**JEL Classification:** D24; C43

## Introduction

The overall financial performance of a business can be approached by various measures. Most of the time, performance is gauged by comparing the revenue or the turnover to production costs generated by the firm's activity. This difference between revenue and cost can be calculated either as a subtraction such as profit, or as a ratio such as the profit rate also called profitability. Other measures are closely related to these two prior basic indicators such as the profit to cost ratio or the popular return to asset.

All these financial performance indicators are computed from variables expressed in value terms and thus combine two sources of change: a quantity effect and a price effect (Diewert, 2005). More precisely, it is common to decompose profitability into a quantity effect measured by a productivity ratio index such as Total Factor Productivity (TFP) and a price effect resulting from a ratio index between output and input prices, named Price Recovery (PR), as in OECD (2001) or in Balk (1998; 2003; 2008). The firm's overall financial performance is therefore the result of an achievement in terms of productivity associated with a return in terms of margin or price recovery. The former measures the capacity of a firm to generate quantities of outputs per unit of inputs, the latter measures the ability to generate a mark-up on sales per euro of expenditure on inputs. Hence, from a strategic business perspective, prices play a key role in evaluating overall financial performance, a role that is complementary to that played by quantity choices. A selling price advantage can indeed be the result of a differentiation strategy stemming from marketing and product development skills. A competitive advantage in terms of input price can originate from the bargaining power of a company benefiting from economies of scale and/or developing a vertical integration policy. For that reason, an analytical framework integrating both price and quantity dimensions seems necessary to better analyze the firm's profitability and its quantity and price components.

Economic and statistical literatures have established analytical tools studying joint price and quantity effects on cost, revenue or profitability. Among the pioneering works developed both at the firm level and at the industry or macroeconomic levels, one can cite Davis (1955), Kendrick (1961), Kendrick and Creamer (1965), Vincent (1961), CERC (1980), Templé (1971), Courbis and Templé (1975). On this subject, Grifell-Tatjé and Lovell (2015) conducted a comprehensive and accurate literature review. The works listed by the two authors all insist on the fact that economic progress is not only synonymous with quantitative productivity gains. The latter's distribution among the different stakeholders through price advantages is also an essential part of the story. In other words, growth and distribution of productivity gains are the two inseparable sides of the same coin. In this respect, the two authors insist on the necessity to consider both dimensions when evaluating financial performance. Another significant contribution of Grifell Tatjé and Lovell (2015) is that they have succeeded in building a bridge between the pioneering works of the 1950s and 1960s relating to the distribution of productivity gains through price changes and the current approaches to productive efficiency.

The latter type of literature is devoted to business performance evaluation based on indicators (efficiency scores) that involve estimating a best practice production frontier (benchmark). For an observed practice, the gap to the frontier (efficiency score) is evaluated with a distance function defined from an axiomatic describing the production possibility set or the underlying technology. Numerous textbooks and academic papers have been dedicated to the assessment of productive performance. Among many others, one can cite Coelli, Prasada Rao and Battese

(2005) as an introductory text on measuring efficiency scores through empirical and theoretical productivity indexes based on distance functions. Other textbooks, starting from basic models, develop more in depth theoretical and empirical advances on the subject such as Färe et al. (1985), Charnes et al. (1994), Fried et al. (2008) to name just a few.

Nevertheless, within benchmarking analysis general frame, the different concepts of efficiency, whether technical, allocative, cost, revenue, or profit efficiency, do not consider a possible endogenous price determination via pricing choices that would complement productivity growth objectives. Technical efficiency only gauges the potential increase of output quantities (reduction in input quantities) for a given level of input quantities (output quantities). Although, Farrell (1957) introduced cost and allocative efficiencies by considering prices, these concepts measure the producer's aptitude to allocate quantities of resources according to their own respective prices which are considered as given and/or exogenous. Thus, no price comparison between producers is offered.

To circumvent this drawback, Tone (2002) presented a new form of allocative and cost efficiencies based on a "value" production technology. Sahoo et al. (2014) followed this direction and relaxed the price taker assumption. They recommended using a "value" directional distance function based on a technology set covering all possibilities of costs and revenues. However, despite the undeniable contribution of these latest measures, they are still based on a reallocation behavior at the firm level for a given system of relative prices.

More recently, Ayouba et al (2019) identified a concept that could be qualified as an indirect price advantage. For this, they compare two productive efficiency scores: a traditional one calculated with input and output quantities and a second one based on the respective cost and revenue values. The ratio of the two scores representing a sort of "indirect price advantage" has a useful economic interpretation as the profitability efficiency resulting from a more advantageous price environment. This new indicator completes the picture provided by the allocative efficiency as it highlights producers' opportunities arising from a better price environment.

Camanho and Dyson (2008) also departed from the assumption of fixed prices in the cost efficiency estimation reflecting only management skills in input quantities but ignoring price differences among producers. To overcome the drawbacks of cost and allocative efficiencies, they proposed a model aiming to measure both quantity and price components of cost efficiency. Yu (2020) developed a similar approach to decompose profit efficiency including a price efficiency component. However, this decomposition, which is based on the work of Camanho and Dyson (2008) uses the "best prices" observed in the sample and does not contain a genuine comparison of prices. For inputs, the "best price" is the minimum price for that input observed in the sample. Similarly, the "best output" price is the highest price for that output. Note that the underlying hypothesis is that of complete independence between input/output quantities and their prices. Moreover, this approach does not consider the specificity of each firm concerning its inputs/output price mix.

To conclude, allocative efficiency makes sense only for analysis in which prices are given. Or, in the words of Portela and Thanassoulis (2014): "In fact traditional allocative efficiency notions are not meaningful when prices are not exogenous as the idea of optimizing input (or output) mix for that matter for given prices breaks down." (p. 38). However, this traditional measure loses its appeal when firms do have some room for decision regarding their input prices. Therefore, a new concept must be introduced that captures explicitly the firm's freedom to set its prices.

Only recently, Portela and Thanassoulis (2014) analyzed cost efficiency with both input prices and quantities as decision variables. They included a price effect within the decomposition of cost efficiency scores. However, by considering prices and quantities as completely independent from one another, they naturally obtain the lowest prices in each input dimension as the optimal solution. To avoid this, they have to use exogenously fixed price limits, which represent a mitigated solution. The main issue in this approach is, in our opinion, that price efficiency determination is not related to the evaluated DMU.

The present paper contributes to this literature by introducing a decomposition of value-based performance into a direct quantity effect and a direct price effect based on an axiomatic approach of the value transformation set. From an operational point of view, one can identify the sources of possible increase in profitability for each input and output variable. They are to be found both in an improved quantity management and in a search for new price opportunities.

Contrasting to the previous indirect price advantage which was deduced from the comparison of a value indicator with a quantity one, our value decomposition allows us to obtain a direct quantity effect and a direct price effect. Moreover, these two components satisfy the product test meaning that the value-based performance is strictly equal to their product. This contribution is worth underlining since the theoretical decompositions of profit efficiency proposed in the recent literature satisfy this property only under very restrictive assumptions. For example, Grifell-Tatjé and Lovell (2015) have shown that the combination of a Malmquist productivity index and a Könus price recovery index could at best only approximate the profitability change. Later, they established that these theoretical indexes need to be weighted by other effects of output/input mixes for both price and quantity variables to obtain that the product test is satisfied (Grifell-Tatjé, Lovell, 2020).

The organization of this paper is as follows. Section 2 begins by positioning the objective of our analytical framework precisely. First, in the case of cost minimization, we present the axiomatic of value transformation sets and their associated distance functions. Second, we derive the cost efficiency decomposition into quantity and price components for each input variable and the mathematical programs necessary for estimations. Third, we compare our model to other known distance functions in the literature. Finally, we extend the analysis to the revenue and profitability maximization cases. Section 3 develops an application on French cattle farms to illustrate the contribution of our approach for practitioners. After presenting the data and defining the selected variables, a first point focuses on a real case study and comments in detail on all the different elements of profit efficiency. Then, results are presented at the sample level, illustrating the importance of price-related decisions in profitability optimization.

## **2. Theoretical developments for joint price and quantity technology**

As mentioned above, our framework compares quantities and prices between two situations that can be identified either as temporal change, a gap between two firms or, a gap between a targeted objective and an observed result. In this research, we refer to the latter situation and depending on the objective chosen for the company, i.e., cost minimization, revenue, profit or profitability

maximization, we will define the so-called “basic or observed situation” through the subscript “o” and the optimal situation to be reached with the superscript “\*”.

To model production analysis, we consider vectors of output quantities  $\mathbf{y} \in \square_+^R$  and their corresponding output prices  $\mathbf{p} \in \square_+^R$  with  $R = \{1, \dots, r, \dots, R\}$  that can be produced from a set of vectors of input quantities  $\mathbf{x} \in \square_+^I$  and their corresponding input prices  $\mathbf{w} \in \square_+^I$  with  $I = \{1, \dots, i, \dots, I\}$ .

A production plan is a quadruplet  $(\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p}) \in \square_+^I \times \square_+^I \times \square_+^R \times \square_+^R$ . In the following, we assume that some quantities can be null but that the total cost of production is strictly positive ( $C = \mathbf{w}^T \mathbf{x} > 0$ ).

For example, in the particular case of profitability or profit rate maximization, the gap between the observed and optimal situations is measured by the following value index  $\pi$  resulting from the product of a quantity effect and a price effect:

$$\pi = \frac{\pi_o}{\pi^*} = \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*} \right) = \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{p}^{*T} \mathbf{y}^*} \right) \left( \frac{\mathbf{p}^{*T} \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}^{*T} \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*} \right) \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*} \right) \quad (1).$$

From equation (1), one can note that the last term is the product of two large brackets. The first one measures a quantity TFP index since only the quantities of outputs and inputs change while prices are fixed. Similarly, the second bracket measures a price recovery index. Here, input and output price effects are identified as Laspeyres indexes based on observed quantities while input and output quantity effects based on optimal prices are related to Paasche indexes. Alternatively, we could have decomposed the profitability index between Paasche price effects weighing price changes by the optimal quantities and Laspeyres quantity effects weighing quantity changes by the observed prices (equation (2)). Finally, profitability is also equal to the product of the geometric means of these Laspeyres and Paasche quantity or price components according to a Fisher-type decomposition (cf. equation (3)).

$$\pi = \frac{\pi_o}{\pi^*} = \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{p}^{*T} \mathbf{y}^*} \right) \left( \frac{\mathbf{p}_o^T \mathbf{y}^*}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*} \right) \quad (2),$$

$$\pi = \frac{\pi_o}{\pi^*} = \left[ \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{p}^{*T} \mathbf{y}^*} \right) \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{p}^{*T} \mathbf{y}_o} \right) \right]^{1/2} \left[ \left( \frac{\mathbf{p}_o^T \mathbf{y}^*}{\mathbf{p}^{*T} \mathbf{y}^*} \right) \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{p}^{*T} \mathbf{y}_o} \right) \right]^{1/2} \left[ \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \right]^{1/2} \left[ \left( \frac{\mathbf{p}_o^T \mathbf{y}^*}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \right]^{1/2} \left[ \left( \frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*} \right) \left( \frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*} \right) \right]^{1/2} \left[ \left( \frac{\mathbf{p}^{*T} \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \left( \frac{\mathbf{p}^{*T} \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o} \right) \right]^{1/2} \quad (3).$$

Since such indexes need to be calculated under a hypothesis of optimal behavior, it is necessary first to define them theoretically thanks to a value transformation set which considers both the

quantities and the prices of outputs and inputs characterizing the different production plans to evaluate.

We define the value transformation set  $V$  as the set of feasible production plans  $(\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p})$  where the output quantity vector  $\mathbf{y}$  sold at corresponding vector output price  $\mathbf{p}$  can be produced by input quantity vector  $\mathbf{X}$  bought at input price vector  $\mathbf{W}$ .<sup>1</sup> Mathematically,  $V$  is defined as:

$$V = \left\{ (\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p}) \in \square_+^I \times \square_+^I \times \square_+^R \times \square_+^R : \mathbf{x} \text{ purchased at price } \mathbf{w} \text{ can produce } \mathbf{y} \text{ sold at price } \mathbf{p} \right\} \quad (4)$$

The above equation (4) inspires several comments. In the following, we suppose, as it is traditionally the case, that a technological relationship links input quantity to output quantity. Thus, for a given level of output quantity  $y$ , some input quantities  $x$  are not feasible. Moreover, our setting adds a new dimension which is the price space. From that perspective, we suppose that, to get some necessary quantity of input  $x$ , it is necessary to purchase it at some minimum price  $w$ . More precisely, assuming that inputs are rare, then they can only be purchased at a strictly positive minimum price. It follows that all values below the minimum price are infeasible for the given quantity of  $x$ . In the same way, output being a merchant good, there also exists a maximum price  $p$  above which selling is no longer feasible. These economic considerations structure the feasibility of the quadruplet  $(\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p})$ .

In particular, if we observe a population of  $N$  DMUs with corresponding production plans  $(\mathbf{x}_n, \mathbf{w}_n, \mathbf{y}_n, \mathbf{p}_n) \forall n = 1, \dots, N$ , then these productions plans are obviously feasible and:

$$(\mathbf{x}_n, \mathbf{w}_n, \mathbf{y}_n, \mathbf{p}_n) \in V \quad \forall n = 1, \dots, N \quad (5).$$

Two specific subsets can be defined from  $V$  :

$$L(\mathbf{y}, \mathbf{p}) = \left\{ (\mathbf{x}, \mathbf{w}) \in \square_+^I \times \square_+^I : (\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p}) \in V \right\}, (\mathbf{y}, \mathbf{p}) \in \square_+^R \times \square_+^R \quad (6),$$

$$P(\mathbf{x}, \mathbf{w}) = \left\{ (\mathbf{y}, \mathbf{p}) \in \square_+^R \times \square_+^R : (\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p}) \in V \right\}, (\mathbf{x}, \mathbf{w}) \in \square_+^I \times \square_+^I \quad (7).$$

Thus, the first equation (6) can be used for cost minimization approach, while the second one, (7) is useful for revenue maximization. The following three subsections deal with cost minimization and we will extend our analysis to encompass revenue, profit and profitability optimization in subsection 2.4.

## 2.1 A unified cost minimization approach

The input set  $L(\mathbf{y}, \mathbf{p})$  defined in equation (6) is more restrictive than the traditional input requirement set  $L(\mathbf{y})$  since it includes all feasible input price and quantity couples that allow to produce an output price and quantity couple. Compared to a traditional framework, prices are not exogenous and clearly represent choice variables for a DMU. Consider two DMUs  $A$  and  $B$ , both producing an identical output couple  $(\mathbf{y}, \mathbf{p})$  with their associated production plans  $(\mathbf{x}_A, \mathbf{w}_A)$  and

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<sup>1</sup> In what follows, for simplicity of notations, we drop the  $R$  dimension for the output vectors and the  $I$  dimension for the input vectors.



$(\mathbf{x}_B, \mathbf{w}_B)$  where  $\mathbf{x}_A < \mathbf{x}_B$  and  $\mathbf{w}_A > \mathbf{w}_B$ . From a traditional perspective, DMU  $B$  would be dominated by DMU  $A$  since it uses a greater quantity of input than  $A$ . However, from our perspective, none of the DMUs dominates the other. For example, DMU  $B$  could benefit from its bargaining power with its suppliers to obtain a lower price for its input ( $\mathbf{w}_B < \mathbf{w}_A$ ). Another example would be the case where production plan  $A$  uses a better-quality input which is more expensive.<sup>2</sup> These two examples point towards the importance of considering simultaneously price and quantity decisions. Substitution between input price and quantity may reflect differences in imperfections described in the Introduction. At this stage, it is noteworthy to highlight that our approach targets uniquely feasible practices without introducing any economic behavior assumption for producers such as cost optimization. This will only be done at the end of the paragraph when we introduce the distance functions D.1-D.6.

Following the axiomatic approach of Shephard (1953, 1970), we add structure to value transformation subsets by imposing several axioms. As the different sets are interrelated, they inherit their properties from each other. Here, we start from  $L(\mathbf{y}, \mathbf{p})$ .

A1  $L(\mathbf{0}, \mathbf{p}) = \square'_+ \times \square'_+, (0, \mathbf{w}) \notin L(\mathbf{y}, \mathbf{p})$  for  $\mathbf{y} \geq 0$ .<sup>3</sup>

A2.i  $(\mathbf{x}, \mathbf{w}) \in L(\mathbf{y}, \mathbf{p})$  and  $\mathbf{x}' \geq \mathbf{x}$  imply  $(\mathbf{x}', \mathbf{w}) \in L(\mathbf{y}, \mathbf{p})$ .

A2.ii  $(\mathbf{x}, \mathbf{w}) \in L(\mathbf{y}, \mathbf{p})$  and  $\mathbf{w}' \geq \mathbf{w}$  imply  $(\mathbf{x}, \mathbf{w}') \in L(\mathbf{y}, \mathbf{p})$ .

A3.i  $\mathbf{y}_2 \geq \mathbf{y}_1 \geq 0 \in$  imply  $L(\mathbf{y}_2, \mathbf{p}) \subset L(\mathbf{y}_1, \mathbf{p})$ .

A3.ii  $\mathbf{p}_2 \geq \mathbf{p}_1 \geq 0 \in$  imply  $L(\mathbf{y}, \mathbf{p}_2) \subset L(\mathbf{y}, \mathbf{p}_1)$ .

A4  $(\mathbf{x}_a, \mathbf{w}_a), (\mathbf{x}_b, \mathbf{w}_b) \in L(\mathbf{y}, \mathbf{p})$  and  $0 \leq \alpha \leq 1$  imply  $(\alpha \mathbf{x}_a + (1-\alpha)\mathbf{x}_b), \alpha \mathbf{w}_a + (1-\alpha)\mathbf{w}_b) \in L(\mathbf{y}, \mathbf{p})$ .

A1 states that it is possible to produce a null output quantity from any nonnegative inputs, but it is not possible to produce positive output from a null input vector. A2.i implies the strong disposability of inputs quantity. It is always feasible to produce the same level of output sold at the same price with greater inputs quantity at a given input price. A2.ii deals with the strong disposability of input prices. While we assume that a minimum price can exist for any quantity of input, it is however possible to buy the same quantity of input at a higher price and therefore produce the same level of output at the given output price. A3.i implies the disposability of output quantity. It states that she who can do more can do less, or formally, if an input vector  $(\mathbf{x}, \mathbf{w})$  yields an output vector  $(\mathbf{y}_2, \mathbf{p})$  then it can also yield any output vector  $(\mathbf{y}_1, \mathbf{p})$  with

<sup>2</sup> A valid theoretical objection to this approach is the following: whenever inputs have different qualities then they should be considered as distinct inputs in a traditional framework. However, in practice, differences of quality are never contained in the description of input quantities which are undistinguishable in that dimension. On the contrary, differences are often conveyed in the prices and our approach seems more appropriate in this context.

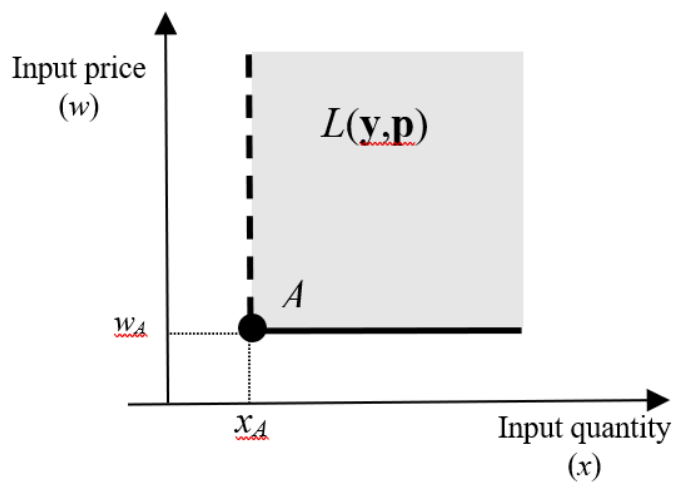
<sup>3</sup> In the rest of the article, the vector notations  $\geq$  and respectively  $\succeq$  have the following meanings:

$$\mathbf{u} \geq \mathbf{v} \Rightarrow u_i \geq v_i, i = 1, 2, \dots, n.$$

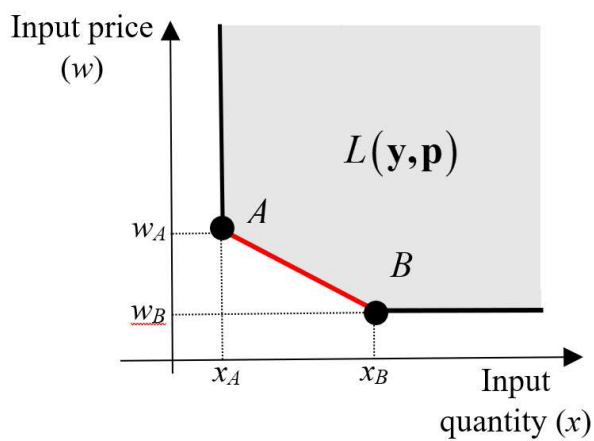
$$\mathbf{u} \succeq \mathbf{v} \Rightarrow u_i \geq v_i, i = 1, 2, \dots, n, \mathbf{u} \neq \mathbf{v}.$$

$\mathbf{y}_1 \leq \mathbf{y}_2$  A3.ii involves strong disposability for output price meaning that if an input vector  $(\mathbf{x}, \mathbf{w})$  yields an output vector  $(\mathbf{y}, \mathbf{p}_2)$  then it can also yield any output vector  $(\mathbf{y}, \mathbf{p}_1)$  with  $\mathbf{p}_1 \leq \mathbf{p}_2$ . A4 is a convexity assumption defined on input quantities and prices. While convexity in quantities traditionally reflects the law of diminishing marginal rate of substitution between inputs, this convexity between quantity and price echoes to the law of demand which states that quantity purchased varies inversely with price. Convexity is also a very useful mathematical assumption whenever the dimension of the input/output space is high by allowing combinations of observed DMUs with various levels of activities. However, it can be rejected in special circumstances and a free disposal hull (FDH) technology can be used instead by ignoring A4 (Deprins et al., 1984). Finally, other properties such as returns to scale can be added or more mathematical properties to ensure that input sets are bounded, closed and well-defined.

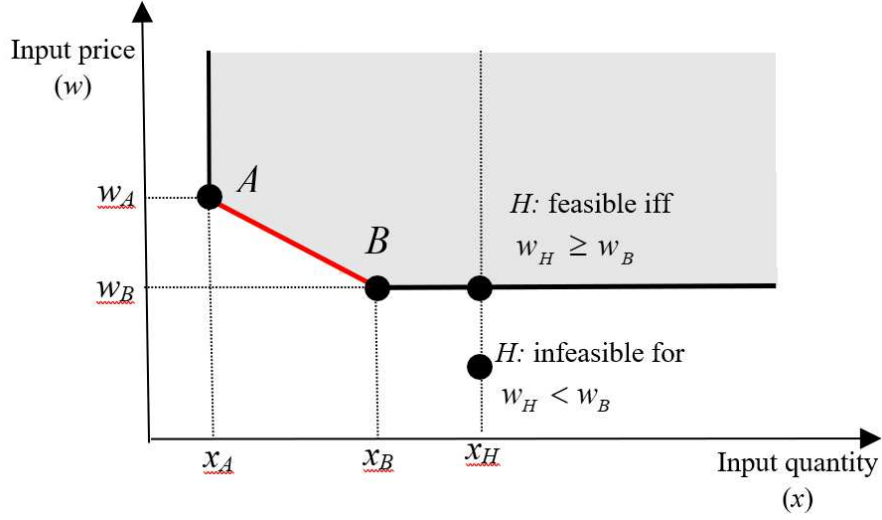
Figures 1 a.-c. below illustrate how, starting from two observed DMUs ( $A$  and  $B$ ), the input set can be structured thanks to axioms A1-4. Note that for the time being, our analysis focuses solely on feasible practices without considering any assumption regarding observed DMUs' economic behavior, such as cost minimization. In figure 1.a we study the situation of an observed DMU  $A$  which produces a single output quantity and price couple  $(\mathbf{y}, \mathbf{p})$  with the unique input  $x$  purchased at price  $w$ . Thus, by the free disposability of input quantities conditional on the input price (Axiom A2.i), the horizontal ray in  $A$  delimits all input quantities  $x \geq x_A$  that are feasible given the input price  $w_A$ . Note that the difference between the input set  $L(\mathbf{y}, \mathbf{p})$  and the conventional set  $L(\mathbf{y})$  is that the free disposability of input quantities is, in the former case, conditional on the input price. In the same way, the dashed vertical ray in  $A$  delimits all input prices  $w \geq w_A$  which are feasible given the input quantity  $x_A$  (Axiom A2.ii). By applying Axioms A2.i-ii for points  $A$  and  $B$  we obtain the continuous vertical ray in  $A$  and the continuous horizontal ray in  $B$  in figure 1.b. This figure also illustrates the usefulness of the convexity assumption A4 which depicts how two observed DMUs  $A$  and  $B$ , each producing the same output couple  $(y, p)$  can be connected to one another to deduce other unobserved but feasible situations. By applying Axiom A4 we obtain the continuous segment  $[AB]$ . Starting from observed situations, one can infer all feasible practices, even if they have not been observed in reality. They are all to be found in the shaded space in the Figure 1.b. To illustrate this point, suppose the case of a hypothetical DMU  $H$  which uses an input quantity  $x_H \geq x_B$ . In a conventional setting  $L(\mathbf{y})$ ,  $H$  would be feasible, whatever its input price, simply by the disposability assumption on input quantity. In  $L(\mathbf{y}, \mathbf{p})$   $H$  is feasible if and only if its input price  $w_H \geq w_B$ . Otherwise, in the absence of a real-life observation of some DMU producing  $x_H$  at an input price lower than  $w_B$ ,  $H$  is infeasible.



a. Free disposability of input quantities conditional on input price & Free disposability of input prices conditional on input quantity (axioms A2.i-ii)



b. Convexity of input quantities & prices (axiom A4)



c. Comparison between  $L(\mathbf{y})$  and  $L(\mathbf{y}, \mathbf{p})$

Figure 1. Illustration of  $L(\mathbf{y}, \mathbf{p})$  with assumptions A1-4.

In (6), the definition of  $L(\mathbf{y}, \mathbf{p})$  assumes that input quantities and their prices are possibly dependent on each other. This is common sense since they were retrieved from observed, real-life DMUs. However, in some special circumstances, this assumption can be relaxed if we consider that, for the same input, its price and quantity can be independent from one another. In that case, two sub-technologies are considered, one based on input quantities, the other based on input prices. The resulting technology is the intersection of the two sub-technologies.

$$L_x(\mathbf{y}, \mathbf{p}) = \{(\mathbf{x}, \mathbf{w}) \in \square_+^I \times \square_+^I : \mathbf{x} \text{ is compatible with } (\mathbf{y}, \mathbf{p})\}, \forall \mathbf{w} \in \square_+^I \quad (8),$$

$$L_w(\mathbf{y}, \mathbf{p}) = \{(\mathbf{x}, \mathbf{w}) \in \square_+^I \times \square_+^I : \mathbf{w} \text{ is compatible with } (\mathbf{y}, \mathbf{p})\}, \forall \mathbf{x} \in \square_+^I \quad (9),$$

$$L'(\mathbf{y}, \mathbf{p}) = L_x(\mathbf{y}, \mathbf{p}) \cap L_w(\mathbf{y}, \mathbf{p}) \quad (10).$$

Axioms A.1, A2.i, A3.i and A3.ii are associated to  $L_x(\mathbf{y}, \mathbf{p})$ . The convexity axiom A4 is replaced by quantity convexity:

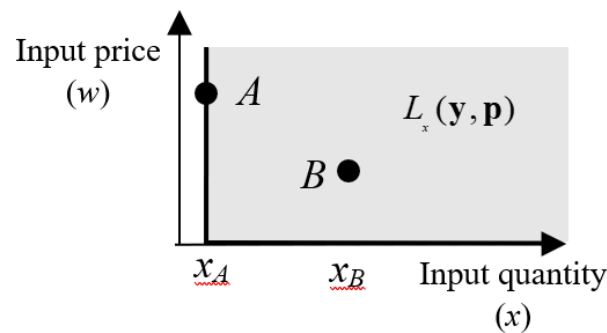
$$\text{A4.i } (\mathbf{x}_1, \mathbf{w}) \in L_x(\mathbf{y}, \mathbf{p}), (\mathbf{x}_2, \mathbf{w}) \in L_x(\mathbf{y}, \mathbf{p}) \text{ and } 0 \leq \alpha \leq 1 \text{ imply } (\alpha \mathbf{x}_1 + (1-\alpha)\mathbf{x}_2, \mathbf{w}) \in L_x(\mathbf{y}, \mathbf{p}).$$

Axioms A.1, A2.ii, A3.i and A3.ii are associated to  $L_w(\mathbf{y}, \mathbf{p})$ . The convexity axiom A4 is replaced by price convexity:

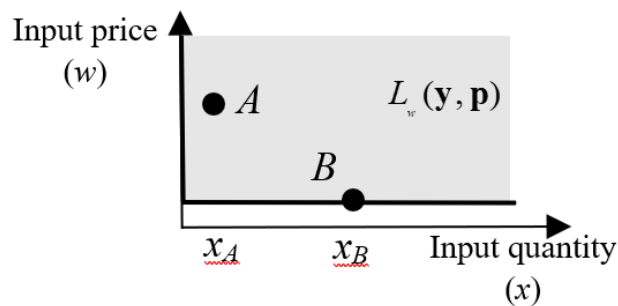
$$\text{A4.ii } (\mathbf{x}, \mathbf{w}_1) \in L_w(\mathbf{y}, \mathbf{p}), (\mathbf{x}, \mathbf{w}_2) \in L_w(\mathbf{y}, \mathbf{p}) \text{ and } 0 \leq \alpha \leq 1 \text{ imply } (\mathbf{x}, \alpha \mathbf{w}_1 + (1-\alpha)\mathbf{w}_2) \in L_w(\mathbf{y}, \mathbf{p}).$$

The input quantity subset  $L_x(\mathbf{y}, \mathbf{p})$  and input price subset  $L_w(\mathbf{y}, \mathbf{p})$ , as well as the resulting alternative value input set  $L'(\mathbf{y}, \mathbf{p})$  are illustrated in figures 2.a-c. In the first one, two observed

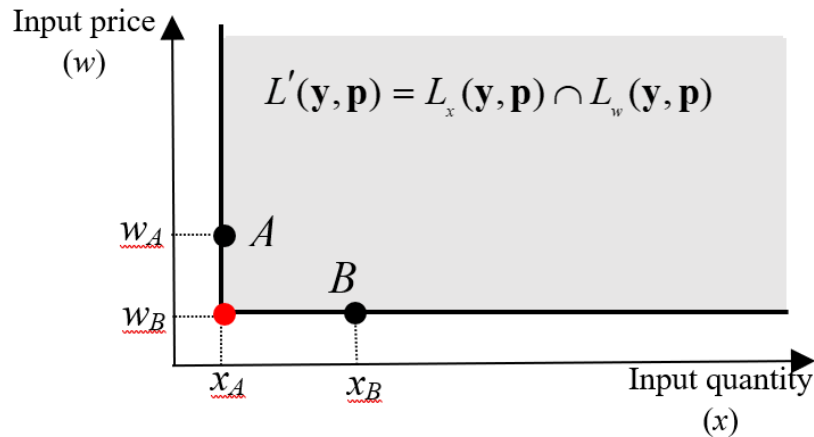
DMUs  $A$  and  $B$  produce the same single output couple  $(\mathbf{y}, \mathbf{p})$  with input quantities  $x_A$  and respectively  $x_B$ , where  $x_A < x_B$  and respectively with input prices  $w_A$  and  $w_B$ , where  $w_A > w_B$ . Free disposability of input quantity for DMU  $A$  means that the same output couple  $(\mathbf{y}, \mathbf{p})$  can be obtained from any input quantity greater than  $x_A$ , whatever the input price. Moreover, convexity of input quantities allows to obtain all feasible production plans for which quantity is comprised between  $x_A$  and  $x_B$  and for whatever price. This is illustrated in figure 2.a. In the same way, figure 2.b depicts free disposability of input price for DMU  $B$  meaning that the same output couple  $(\mathbf{y}, \mathbf{p})$  can be obtained from any input price greater than  $w_B$ , whatever the input quantity. Input prices convexity assumption leads to determine all feasible (and unobserved) production plan whose prices are between  $w_A$  and  $w_B$  for whatever input quantity used. Finally, figure 2.c illustrates the intersection of the two previously defined spaces leading to the alternative value input set  $L'(\mathbf{y}, \mathbf{p})$ .



a. Free disposability and convexity of input quantities in the subspace  $L_x(\mathbf{y}, \mathbf{p})$  (axioms A1, A2.i, A3.i-ii, and A4.i)



b. Free disposability and convexity of input quantities in the subspace  $L_w(\mathbf{y}, \mathbf{p})$  (axioms A1, A2.ii, A3.i-ii, and A4.ii)



c. Value input set  $L'(\mathbf{y}, \mathbf{p})$  obtained at the intersection between subsets  $L_x(\mathbf{y}, \mathbf{p})$  and  $L_w(\mathbf{y}, \mathbf{p})$

**Figure 2. Illustration of  $L'(\mathbf{y}, \mathbf{p})$  with assumptions A1, A2.i-ii, A3.i-ii, and A4.i-ii.**

In  $L_x(\mathbf{y}, \mathbf{p})$ , efficient production plans minimize the necessary input quantities to produce  $(\mathbf{y}, \mathbf{p})$  whatever the input prices. In parallel, in  $L_w(\mathbf{y}, \mathbf{p})$ , the optimization targets input prices independently of their respective quantities. The intersection shows that the efficient production plan is characterized by the minimal input quantity observed associated with the minimal input price. Obviously, it is most likely that this efficient production plan is not observed but that it is constructed based on the assumption that all DMUs have access to the same input prices whatever their respective quantities. This clearly characterizes prices independence from quantities and this model can be interpreted as a theoretical standard for frictionless markets with perfect information and without any form of bargaining power. In this respect, axioms A4 and respectively A4.i-ii represent two extreme cases under which convexity can be approached in a value-transformation set. In between, one can consider a plethora of intermediary cases along the assumptions made. For example, rather than taking the mean between the two DMUs' prices, one could have preferred a weighted average with the weights given by the input quantities. This being said, in a DEA approach, the DMU is evaluated under the most favorable conditions when Axiom A4 is used. Obviously, the same DMU will be evaluated under the least favorable conditions when axioms A4.i-ii are used. Another advantage of using Axiom A4 is that it allows for an interpretation in terms of production in time, cf. Shephard (1970). Indeed, one can consider that both DMUs A and B produce their output couple  $(\mathbf{y}, \mathbf{p})$  over some period of time, say a year. A convex combination between the two DMUs in line with the Assumption A4 can be interpreted as a possible combination of the activity of the DMU A for the first six months with the activity of the DMU B for the remaining six months. One would thus get a "theoretical" DMU producing the same output couple  $(\mathbf{y}, \mathbf{p})$  with an input quantity that is exactly the arithmetic mean of the two DMU's input quantities and, respectively, input prices.

Our preference clearly goes to the first approach where we assume that input quantities and their prices are somehow interrelated. In a real world, prices may convey information such as quality,

supplier market power, transaction costs... Or, the traditional analysis based on  $L(\mathbf{y})$ , by considering prices as exogenous, immediately excludes these effects. Independency between input quantities and input prices, such as implied by  $L'(\mathbf{y}, \mathbf{p})$  is another alternative which refutes input prices heterogeneity among DMUs while allowing for heterogeneity regarding the level of activity and output price  $(\mathbf{y}, \mathbf{p})$ . Finally,  $L(\mathbf{y}, \mathbf{p})$  is more encompassing by allowing substitution between price and quantity.

By considering a sample of  $K$  observed DMUs issued from a population  $N$ , a DEA-type value transformation set can be defined from the property that all observed DMUs are feasible and from axioms A1-A4 following Banker et al. (1984). Under variable returns to scale, this is equivalent to:

$$L(\mathbf{y}, \mathbf{p}) = \left\{ (\mathbf{x}, \mathbf{w}) : \begin{aligned} & \sum_{k=1}^K \mu_k y_{k,r} \geq y_r \quad \forall r = 1, \dots, R \\ & \sum_{k=1}^K \mu_k p_{k,r} \geq p_r \quad \forall r = 1, \dots, R \\ & \sum_{k=1}^K \mu_k x_{k,i} \leq x_i \quad \forall i = 1, \dots, I \\ & \sum_{k=1}^K \mu_k w_{k,i} \leq w_i \quad \forall i = 1, \dots, I \\ & \sum_{k=1}^K \mu_k = 1, \mu_k \geq 0 \quad \forall k = 1, \dots, K \end{aligned} \right\} \quad (11)$$

The alternative input set  $L'(\mathbf{y}, \mathbf{p})$  is modeled by considering the intersection of two input sets based on quantity and price respectively. The corresponding DEA-type production possibility set can be defined by:

$$\begin{aligned}
L'(\mathbf{y}, \mathbf{p}) = \left\{ (\mathbf{x}, \mathbf{w}) : \right. & \sum_{k=1}^K \mu_k y_{k,r} \geq y_r \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \mu_k p_{k,r} \geq p_r \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \mu_k x_{k,i} \leq x_i \quad \forall i = 1, \dots, I \\
& \sum_{k=1}^K \mu_k = 1, \mu_k \geq 0 \quad \forall k = 1, \dots, K \\
& \sum_{k=1}^K \lambda_k y_{k,r} \geq y_r \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \lambda_k p_{k,r} \geq p_r \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \lambda_k w_{k,i} \leq w_i \quad \forall r = 1, \dots, I \\
& \sum_{k=1}^K \lambda_k = 1, \lambda_k \geq 0 \quad \forall k = 1, \dots, K \\
& \sum_{k=1}^K \mu_k y_{k,r} = \sum_{k=1}^K \lambda_k y_{k,r} \quad \forall r = 1, \dots, R \\
& \left. \sum_{k=1}^K \mu_k p_{k,r} = \sum_{k=1}^K \lambda_k p_{k,r} \quad \forall r = 1, \dots, R \right\} \tag{12}.
\end{aligned}$$

In (12), two sets of activity variables  $(\boldsymbol{\mu}, \boldsymbol{\lambda})$  are used. For a given level of output quantities and prices  $\left( \sum_{k=1}^K \mu_k y_k, \sum_{k=1}^K \mu_k p_k \right) = \left( \sum_{k=1}^K \lambda_k y_k, \sum_{k=1}^K \lambda_k p_k \right)$ , all feasible production plans are defined independently for input quantities and, respectively, input prices. It is worth to note that the use of  $L'(\mathbf{y}, \mathbf{p})$  instead of  $L(\mathbf{y}, \mathbf{p})$  does not lead to the somewhat trivial result of taking the “best prices” in the sample since  $L_w(\mathbf{y}, \mathbf{p})$  is conditional on the level of output quantities and prices. This contrasts with the approach proposed by Portela and Thanassoulis (2014).

Based on  $L(\mathbf{y}, \mathbf{p})$  or  $L'(\mathbf{y}, \mathbf{p})$ , a number of distance functions can be defined in order to measure technical, price or cost efficiencies. Depending on the context, one can either include in the model all quantity and price dimensions or exclude some of them. The following distance functions are defined indiscriminately on  $L(\mathbf{y}, \mathbf{p})$  or  $L'(\mathbf{y}, \mathbf{p})$ :

$$D.1 \quad D_q^i(\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p}) = \min_{\beta \geq 0} \{ \beta : (\beta \mathbf{x}, \mathbf{w}) \in L(\mathbf{y}, \mathbf{p}) \}$$

$$D.2 \quad D_p^i(\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p}) = \min_{\theta \geq 0} \{ \theta : (\mathbf{x}, \theta \mathbf{w}) \in L(\mathbf{y}, \mathbf{p}) \}$$

$$D.3 \quad D_{q,p}^i(\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p}) = \min_{\rho \geq 0} \{ \rho : (\rho \mathbf{x}, \rho \mathbf{w}) \in L(\mathbf{y}, \mathbf{p}) \}$$



$$D.4 \ D_{uq}^i(\mathbf{x}, \mathbf{y}) = D_q^i(\mathbf{x}, \infty, \mathbf{y}, \mathbf{0}) = \min_{\beta \geq 0} \{ \beta : (\beta \mathbf{x}, \infty) \in L(\mathbf{y}, \mathbf{0}) \}$$

$$D.5 \ D_{up}^i(\mathbf{w}, \mathbf{y}) = D_p^i(\infty, \mathbf{w}, \mathbf{y}, \mathbf{0}) = \min_{\theta \geq 0} \{ \theta : (\infty, \theta \mathbf{w}) \in L(\mathbf{y}, \mathbf{0}) \}$$

$$D.6 \ C(\mathbf{y}, \mathbf{p}) = D_c^i(\mathbf{y}, \mathbf{p}) = \min_{\mathbf{w}, \mathbf{x} \geq 0} \{ \mathbf{w}^T \mathbf{x} : (\mathbf{x}, \mathbf{w}) \in L(\mathbf{y}, \mathbf{p}) \}$$

Distance functions D.1 to D.6 are computed from optimization programs. D.1 to D.5 are solutions to linear programs while D.6 is estimated through a non-linear optimization program. D.1 is a quantity measure, but which is conditional on prices. D.2 is a price measure conditional on quantities. D.3 is a new type of efficiency. It is a combined “quantity/price” radial efficiency that ensures for efficient DMUs that no other DMU could use less inputs quantity at a lower price. D.4 and D.5 define distance functions unconditional on prices and, on quantities respectively. Finally, D.6 defines cost functions. Contrary to the traditional cost function, input prices are no longer exogenous. Output prices can be included or not, depending on the context. Input quantity and price can be considered either jointly or independently, following the choice of  $L(\mathbf{y}, \mathbf{p})$  or  $L'(\mathbf{y}, \mathbf{p})$ . For a given DMU  $o$  with a corresponding production plan  $(\mathbf{x}_o, \mathbf{w}_o, \mathbf{y}_o, \mathbf{p}_o)$ , the following nonlinear program computes the minimal cost function  $C(\mathbf{y}_o, \mathbf{p}_o)$  based on  $L(\mathbf{y}, \mathbf{p})$ :

$$\begin{aligned}
C(\mathbf{y}_o, \mathbf{p}_o) &= D_c^i(\mathbf{y}_o, \mathbf{p}_o) = \min_{\tilde{\mathbf{w}}, \tilde{\mathbf{x}}, \boldsymbol{\mu}} \sum_{i=1}^I \tilde{w}_i \tilde{x}_i \\
\sum_{k=1}^K \mu_k y_{k,r} &\geq y_{o,r} \quad \forall r = 1, \dots, R \\
\sum_{k=1}^K \mu_k p_{k,r} &\geq p_{o,r} \quad \forall r = 1, \dots, R \\
\sum_{k=1}^K \mu_k x_{k,i} &\leq \tilde{x}_i \quad \forall i = 1, \dots, I \\
\sum_{k=1}^K \mu_k w_{k,i} &\leq \tilde{w}_i \quad \forall i = 1, \dots, I \\
\sum_{k=1}^K \mu_k &= 1 \\
\mu_k &\geq 0 \quad \forall k = 1, \dots, K \\
\tilde{x}_i, \tilde{w}_i &\geq 0 \quad \forall i = 1, \dots, I
\end{aligned} \tag{13}$$

## 2.2 Various decompositions of cost efficiency

Two types of decompositions are introduced and discussed here. Firstly, we show that cost efficiency, based on the optimal cost level implied by direction function D.6 and obtained through program (13) can be decomposed as the product of a quantity and a price effect. In the second paragraph, we show that these decompositions can be pursued further at the input level. Thus, for each input considered, we can determine their respective quantity and price effects.

The latter is especially relevant for practitioners or decision-makers interested in identifying potential sources of better cost efficiency.

*a) Decomposition of cost efficiency into quantity and price components*

$C(\mathbf{y}, \mathbf{p})$  developed in (13), is a basis for defining a value-based performance by computing the minimal cost to achieve a level of activity conditional on output selling price. Naturally, the cost value efficiency (CVE) is defined as the ratio of minimal cost to observed cost:

$$CVE(\mathbf{x}_o, \mathbf{w}_o, \mathbf{y}_o, \mathbf{p}_o) = \frac{C^*}{C} = \frac{C(\mathbf{y}_o, \mathbf{p}_o)}{\mathbf{w}_o^T \mathbf{x}_o} = \frac{\mathbf{w}^{*T} \mathbf{x}^*}{\mathbf{w}_o^T \mathbf{x}_o} \quad (14).$$

Quantities and prices are jointly optimized in the objective of minimizing total cost. Contrary to the efficiency measures defined through D.1 to D.5, where mixes of input quantities and prices are kept constant (they are contracted radially), the cost value efficiency in (14) allows variations in mixes through reallocations of input quantities and prices. At the optimal solution of (13), the benchmark for the evaluated DMU<sub>o</sub> can show lower or higher inputs quantities and/or prices.

In traditional economic literature on indices, value decomposes in a quantity and a price component. Since D.6 is the most comprehensive efficiency measure obtained by optimizing both input quantities and their prices, it is useful to decompose it into quantity and price efficiency measures. All the necessary information can be extracted from (13):

A Laspeyres input quantity effect is defined as:  $E_X^{La} = \frac{\mathbf{w}_o^T \mathbf{x}^*}{\mathbf{w}_o^T \mathbf{x}_o}$

A Paasche input quantity effect is defined as:  $E_X^{Pa} = \frac{\mathbf{w}^{*T} \mathbf{x}_o}{\mathbf{w}^{*T} \mathbf{x}_o}$

A Laspeyres price effect is defined as:  $E_W^{La} = \frac{\mathbf{w}^{*T} \mathbf{x}_o}{\mathbf{w}_o^T \mathbf{x}_o}$

A Paasche price effect is defined as:  $E_W^{Pa} = \frac{\mathbf{w}^{*T} \mathbf{x}^*}{\mathbf{w}_o^T \mathbf{x}^*}$

Quantity and price efficiency measures are then computed as Fisher indexes:  $E_X^F = \sqrt{E_X^{La} E_X^{Pa}}$  and  $E_W^F = \sqrt{E_W^{La} E_W^{Pa}}$ . We can readily verify that:

$$CVE(\mathbf{x}_o, \mathbf{w}_o, \mathbf{y}_o, \mathbf{p}_o) = E_X^F \times E_W^F \quad (15).$$

To sum up, we have defined a value-based performance measure based on a value transformation technology with endogenous prices and quantities. This value-based performance is the result of the combination of a direct quantity effect and a direct price effect.

b) *Decomposition of quantity and price effects by input variables*

A significant advantage of our approach is that it also enables to derive specific effects by input variables. For this, we introduce D.7 as follows:

$$D.7 \quad C(\mathbf{y}, \mathbf{p}) = D_{c_{bis}}^i(\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p}) = \min_{\beta, \theta \geq 0} \left\{ \sum_{i=1}^I \theta_i w_i \beta_i x_i : (\beta \square \mathbf{x}, \theta \square \mathbf{w}) \in L(\mathbf{y}, \mathbf{p}) \right\} \quad (16).$$

We notice that D.6 and D.7 are equivalent by directly verifying that there exist  $\theta_i, \beta_i \geq 0$  with  $i=1, \dots, I$ , such that for each  $w_i, x_i \geq 0$  with  $i=1, \dots, I$ , we have that  $\tilde{w}_i = \theta_i w_i$  and  $\tilde{x}_i = \beta_i x_i$ .

In (16), specific input scores are introduced in the spirit of a Färe-Lovell measure. The corresponding optimization program is given by:

$$\begin{aligned} C(\mathbf{y}_o, \mathbf{p}_o) &= D_{c_{bis}}^i(\mathbf{x}_o, \mathbf{w}_o, \mathbf{y}_o, \mathbf{p}_o) = \min_{\beta, \theta, \mu} \sum_{i=1}^I \theta_i w_{o,i} \beta_i x_{o,i} \\ &\sum_{k=1}^K \mu_k y_{k,r} \geq y_{o,r} \quad \forall r=1, \dots, R \\ &\sum_{k=1}^K \mu_k p_{k,r} \geq p_{o,r} \quad \forall r=1, \dots, R \\ &\sum_{k=1}^K \mu_k x_{k,i} \leq \beta_i x_{o,i} \quad \forall i=1, \dots, I \\ &\sum_{k=1}^K \mu_k w_{k,i} \leq \theta_i w_{o,i} \quad \forall i=1, \dots, I \\ &\sum_{k=1}^K \mu_k = 1 \\ &\mu_k \geq 0 \quad \forall k=1, \dots, K \\ &\beta_i, \theta_i \geq 0 \quad \forall i=1, \dots, I \end{aligned} \quad (17).$$

Since D.6=D.7, (13) and (17) are strictly equivalent, the cost value efficiency can be rewritten as:

$$CVE(x_o, w_o, y_o, p_o) = \frac{C^*}{C_o} = \frac{\mathbf{w}^* \mathbf{x}^*}{\mathbf{w}_o^T \mathbf{x}_o^T} = \frac{\sum_{i=1}^I \theta_i \beta_i w_{o,i} x_{o,i}}{\sum_{i=1}^I w_{o,i} x_{o,i}} \quad (18).$$

For each input  $i=1, \dots, I$ ,  $\beta_i \stackrel{>}{\leq} 1$  and  $\theta_i \stackrel{>}{\leq} 1$  are the necessary changes in quantities and prices, respectively, to achieve the minimum cost.

## 2.3 Links with existing models in the literature

Our general framework encompasses many existing models developed in the literature. Below we show the relationships that can be established between our model and the traditional approach regarding input quantity and more recent ones dealing with input price distance functions.

### a) Traditional input quantity distance function

First, traditional input distance functions arise from the unconditional quantity distance function D.4. For a given DMU<sub>o</sub> with corresponding production plan  $(\mathbf{x}_o, \mathbf{w}_o, \mathbf{y}_o, \mathbf{p}_o)$ , by setting  $\mathbf{p}_o = 0$  and  $\mathbf{w}_o = \infty$  in D.1, we get the unconditional quantity distance function D.4 which is computed equivalently by:

$$\begin{aligned}
 D_{uq}^i(\mathbf{x}_o, \infty, \mathbf{y}_o, \mathbf{0}) &= \min_{\beta, \mu} \beta \\
 \sum_{k=1}^K \mu_k y_{k,r} &\geq y_{o,r} \quad \forall r = 1, \dots, R \\
 \sum_{k=1}^K \mu_k p_{k,r} &\geq 0 \quad \forall r = 1, \dots, R \\
 \sum_{k=1}^K \mu_k x_{k,i} &\leq \beta x_{o,i} \quad \forall i = 1, \dots, I \\
 \sum_{k=1}^K \mu_k w_{k,i} &\leq \infty \quad \forall i = 1, \dots, I \\
 \sum_{k=1}^K \mu_k &= 1 \\
 \mu_k &\geq 0 \quad \forall k = 1, \dots, K \\
 \beta &\geq 0
 \end{aligned}
 \quad \text{or} \quad
 \begin{aligned}
 D_q^i(x_o, y_o) &= \min_{\beta, \mu} \beta \\
 \sum_{k=1}^K \mu_k y_{k,r} &\geq y_{o,r} \quad \forall r = 1, \dots, R \\
 \sum_{k=1}^K \mu_k x_{k,i} &\leq \beta x_{o,i} \quad \forall i = 1, \dots, I \\
 \sum_{k=1}^K \mu_k &= 1 \\
 \mu_k &\geq 0 \quad \forall k = 1, \dots, K \\
 \beta &\geq 0
 \end{aligned} \quad (19).$$

As shown in (19), the traditional input distance function for computing technical efficiency is just a special case of D.1.

### b) Input price efficiency

D.5 follows the same line for price efficiency. The unconditional price efficiency defined by  $D_{ip}^i(\mathbf{w}, \mathbf{y}) = D_p^i(\infty, \mathbf{w}, \mathbf{y}, 0)$  is computed equivalently by:

$$\begin{aligned}
D_{up}^i(\infty, \mathbf{w}_o, \mathbf{y}_o, 0) &= \min_{\beta, \mu} \beta \\
\sum_{k=1}^K \mu_k y_{k,r} &\geq y_{o,r} \quad \forall r = 1, \dots, R \\
\sum_{k=1}^K \mu_k p_{k,r} &\geq 0 \quad \forall r = 1, \dots, R \\
\sum_{k=1}^K \mu_k x_{k,i} &\leq \infty \quad \forall i = 1, \dots, I \\
\sum_{k=1}^K \mu_k w_{k,i} &\leq \beta w_{o,i} \quad \forall i = 1, \dots, I \\
\sum_{k=1}^K \mu_k &= 1 \\
\mu_k &\geq 0 \quad \forall k = 1, \dots, K \\
\beta &\geq 0
\end{aligned}
\quad \text{or} \quad
\begin{aligned}
D_p^i(\mathbf{w}_o, \mathbf{y}_o) &= \min_{\beta, \mu} \beta \\
\sum_{k=1}^K \mu_k y_{k,r} &\geq y_{o,r} \quad \forall r = 1, \dots, R \\
\sum_{k=1}^K \mu_k w_{k,i} &\leq \beta w_{o,i} \quad \forall i = 1, \dots, I \\
\sum_{k=1}^K \mu_k &= 1 \\
\mu_k &\geq 0 \quad \forall k = 1, \dots, K \\
\beta &\geq 0
\end{aligned} \quad (20).$$

The right hand side of (20) is the price efficiency model used by Griffell-Tatje and Lovell (2020) in order to estimate a Könus input price index.

### c) Other approaches regarding input price efficiency

Camanho and Dyson (2008) and Portela and Thanassoulis (2014) also rejected exogeneity of prices and proposed different models to measure price efficiency. Portela and Thanassoulis (2014) analyzed cost efficiency with both prices and input quantities as decision variables and showed that their models can encompass the different scenarios of price setting suggested in Camanho and Dyson (2008). We show here that our approach can be related and differentiated from the general model of Portela and Thanassoulis (P&T in the following). We present their model (3) p. 38 in our notations in (21) to facilitate the comparison.

$$\begin{aligned}
& \min_{\theta, \beta, \mu, \lambda} \sum_{i=1}^I \theta_i w_{o,i} \beta_i x_{o,i} \\
& \sum_{k=1}^K \mu_k y_{k,r} \geq y_{o,r} \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \mu_k x_{k,i} \leq \beta_i x_{o,i} \quad \forall i = 1, \dots, I \\
& \sum_{k=1}^K \mu_k = 1, \quad \mu_k \geq 0 \quad \forall k = 1, \dots, K \quad (21) \\
& \sum_{k=1}^K \lambda_{k,i} w_{k,i} \leq \theta_i w_{o,i} \quad \forall i = 1, \dots, I \\
& \sum_{k=1}^K \lambda_{k,i} = 1 \quad \forall i = 1, \dots, I, \\
& \lambda_{k,i} \geq 0 \quad \forall k = 1, \dots, K, \forall i = 1, \dots, I, \\
& \theta_i^{\min} \leq \theta_i \leq \theta_i^{\max} \quad \forall i = 1, \dots, I
\end{aligned}$$

Note that so far, our main approach introduced in (17) relies on  $L(\mathbf{y}, \mathbf{p})$  where we assume a dependency relationship between quantity and price for each DMU while P&T in (21) work on a set comparable to  $L'(\mathbf{y}, \mathbf{p})$  where optimal input quantities and prices are independent from one another. Therefore, while we use the same activity variables, they use two sets of activity variables for quantity and price respectively. Moreover, the latter set is input- but also DMU-specific (activity variables in the price dimension  $\lambda_{k,i}$  are defined for each input  $i$ ). Thus, in their program, optimal prices are naturally selected as the lowest ones in each input dimension but moreover, they may also come from different DMUs. Consequently, the optimal input prices are simply the minimal prices observed in the sample. In order to overcome this drawback, Portela and Thanassoulis (2014) introduce an upper and lower limit  $(\theta_i^{\min}, \theta_i^{\max})$  on the price efficiency score. However, we argue that this is mostly an artifice since only two things can happen. Either the limits are not reached and the solution is set at the minimal observed prices or, in the alternative case, one of the limits is active and the optimal price will be set at this exogenous limit. In the second case, the optimal solution is therefore set by the researcher.

The main difference between our approach and P&T is that, in their model, the price efficiency is completely independent from any exogenous characteristic of the evaluated DMU. Starting from an economic definition of a value transformation set as we did, a model based on  $L'(\mathbf{y}, \mathbf{p})$  that can fit with P&T approach is given in (22). Here, input prices are entirely unrelated to input quantities as in P&T but they are linked to the level of evaluated DMU's output quantity and price. Therefore, for each level of output quantity and its price, an optimal vector of input prices is determined and is no longer set at the minimal observed prices or the exogenously fixed lower bound  $\theta_i^{\min}$ .

$$\begin{aligned}
& \min_{\theta, \beta, \mu, \lambda} \sum_{i=1}^I \theta_i w_{o,i} \beta_i x_{o,i} \\
& \sum_{k=1}^K \mu_k y_{k,r} \geq y_{o,r} \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \mu_k p_{k,r} \geq p_{o,r} \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \mu_k x_{k,i} \leq \beta_i x_{o,i} \quad \forall i = 1, \dots, I \\
& \sum_{k=1}^K \mu_k = 1, \mu_k \geq 0 \quad \forall k = 1, \dots, K \\
& \sum_{k=1}^K \lambda_k y_{k,r} \geq y_{o,r} \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \lambda_k p_{k,r} \geq p_{o,r} \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \lambda_k w_{k,i} \leq \theta_i w_{o,i} \quad \forall i = 1, \dots, I \\
& \sum_{k=1}^K \lambda_k = 1, \lambda_k \geq 0 \quad \forall k = 1, \dots, K \\
& \sum_{k=1}^K \mu_k y_{k,r} = \sum_{k=1}^K \lambda_k y_{k,r} \quad \forall r = 1, \dots, R \\
& \sum_{k=1}^K \mu_k p_{k,r} = \sum_{k=1}^K \lambda_k p_{k,r} \quad \forall r = 1, \dots, R
\end{aligned} \tag{22}$$

## 2.4 Extension to revenue, profitability and profit

This last sub-section extends the analysis to output sets and to profit optimization. From a conceptual and technical point of view, the framework developed for the inputs dimension is readily extended to definitions of  $P(\mathbf{x}, \mathbf{w})$ ,  $P'(\mathbf{x}, \mathbf{w})$ ,  $D^o(\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p})$ ,  $R(\mathbf{x}, \mathbf{w})$  and  $RVE(\mathbf{x}, \mathbf{w}, \mathbf{y}, \mathbf{p})$ .

A deeper discussion regarding profitability is necessary. In the cost analysis, output quantities and their prices are considered as exogenous while, equivalently, in the revenue analysis, it is the inputs quantities and their prices which are fixed. But this is no longer the case for profitability optimization with endogenous input and output prices and respectively quantities where there are no more exogenous variables to count on. In a traditional framework, based on quantities only, input and output prices represent the exogenous information for profit maximization. Here, as prices are also endogenous, the problem of profitability maximization seems irrelevant. If DMUs control their prices and quantities, no limit is given to profit optimization without an exogenous constraint. For real-world applications based on a DEA-type framework, the solution to the profitability maximization problem is not impossible but trivial. All DMUs in the sample would

be compared to the same benchmark, which is necessarily the observed DMU with the highest profit rate. However, profitability maximization implies drastic changes for the DMU and is often considered as a long-term ideal standard rather than a useful benchmark in the short-run. For example, the size and the input/output mix of the DMU at profit maximizing production plan can be radically modified. It is not the case for input cost optimization where the level of output is maintained or, for equivalent output revenue maximization, where input quantities are given. A reasonable solution for profitability optimization is to fix the size of the DMU. The size can be gauged by the level of one or the other input or output. Whenever it makes sense to consider one fix or quasi-fix input or output, the problem of profitability maximization regains interest because it optimizes profit for each level of the fix factor considered. Since firms are heterogenous in size or in a fix factor, they will no longer be altogether compared to the maximum observed profitability. The corresponding optimization program is derived below where  $\bar{\mathbf{x}}$  is a vector of  $J$  inputs considered as fixed ( $J \in I$ ):

$$\begin{aligned}
\pi^*(\bar{\mathbf{x}}_o) = D_{\pi_{rate}}(\mathbf{x}_o, \bar{\mathbf{x}}_o, \mathbf{w}_o, \mathbf{y}_o, \mathbf{p}_o) &= \max_{\alpha, \gamma, \beta, \theta, \mu} \frac{\sum_{r=1}^R \gamma_r p_{o,r} \alpha_r y_{o,r}}{\sum_{i=1}^{I \setminus \{j=1, \dots, J\}} \theta_i w_{o,i} \beta_i x_{o,i} + \sum_{j=1}^J \theta_j w_{o,j} \bar{x}_{o,j}} \\
\sum_{k=1}^K \mu_k y_{k,r} &\geq \alpha_r y_{o,r} \quad \forall r = 1, \dots, R \\
\sum_{k=1}^K \mu_k p_{k,r} &\geq \gamma_r p_{o,r} \quad \forall r = 1, \dots, R \\
\sum_{k=1}^K \mu_k x_{k,i} &\leq \beta_i x_{o,i} \quad \forall i = 1, \dots, I \setminus \{j = 1, \dots, J\} \\
\sum_{k=1}^K \mu_k w_{k,i} &\leq \theta_i w_{o,i} \quad \forall i = 1, \dots, I \\
\sum_{k=1}^K \mu_k \bar{x}_{k,j} &= \bar{x}_{o,j} \quad \forall j = 1, \dots, J \\
\sum_{k=1}^K \mu_k &= 1 \\
\mu_k &\geq 0 \quad \forall k = 1, \dots, K \\
\alpha_r, \gamma_r &\geq 0 \quad \forall r = 1, \dots, R \\
\beta_i, \theta_i &\geq 0 \quad \forall i = 1, \dots, I \setminus \{j = 1, \dots, J\}
\end{aligned} \tag{23}$$

Obviously, the above program (23) can be adapted to obtain the optimal profit level rather than the profit rate, by replacing the objective function by:

$$\begin{aligned}
\Pi(\bar{\mathbf{x}}_o) = D_{\pi}(\mathbf{x}_o, \bar{\mathbf{x}}_o, \mathbf{w}_o, \mathbf{y}_o, \mathbf{p}_o) &= \max_{\alpha, \gamma, \beta, \theta, \mu} \sum_{r=1}^R \gamma_r p_{o,r} \alpha_r y_{o,r} - \sum_{i=1}^{I \setminus \{j=1, \dots, J\}} \theta_i w_{o,i} \beta_i x_{o,i} - \sum_{j=1}^J \theta_j w_{o,j} \bar{x}_{o,j} \\
&= \mathbf{p}^{*T} \mathbf{y}^* - \mathbf{w}^{*T} \mathbf{x}^*
\end{aligned} \tag{24}$$



However, we believe that the analysis of profitability is a real concern for DMUs' managers and a real-world lever for action for management decision making. A main advantage of profit rate over its (profit) level counterpart is that comparisons based on the former are independent from the DMUs' size (for a more in depth discussion of ratio-type indices, such as profitability vs difference type ones, such as profit, see Balk, 2003). Obviously, a DMU can achieve a higher profit than its peers simply due its larger size despite a lower profitability. The rest of our analysis will therefore be based on the program (23) whose objective function results in the optimal profitability based on optimal input and output quantities and prices as in:

$$\pi^*(\bar{\mathbf{x}}_o) = \frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*}$$

According to equations (1)-(3), the value profitability efficiency is computed as:

$$\pi = \pi(\mathbf{x}_o, \bar{\mathbf{x}}_o, \mathbf{w}_o, \mathbf{y}_o, \mathbf{p}_o) = \frac{\frac{\mathbf{p}_o \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o}}{\frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*}} \quad (25),$$

and can be decomposed into:

$$\pi = E_Q^F \times E_P^F \quad (26)$$

where  $E_Q^F = \sqrt{E_Q^{La} E_Q^{Pa}}$  and  $E_P^F = \sqrt{E_P^{La} E_P^{Pa}}$

$$\text{and, } E_Q^{La} = \frac{\frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o}}{\frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*}}, \quad E_Q^{Pa} = \frac{\frac{\mathbf{p}^{*T} \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o}}{\frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*}}, \quad E_P^{La} = \frac{\frac{\mathbf{p}_o^T \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o}}{\frac{\mathbf{p}^{*T} \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o}}, \quad E_P^{Pa} = \frac{\frac{\mathbf{p}^{*T} \mathbf{y}_o}{\mathbf{w}_o^T \mathbf{x}_o}}{\frac{\mathbf{p}^{*T} \mathbf{y}^*}{\mathbf{w}^{*T} \mathbf{x}^*}}.$$

The decomposition of the value indicator into a direct quantity effect and a direct price effect presents the advantage of satisfying the product test. This is a notable contribution compared to previous attempts in the literature.

Equation (26) is packed with managerial information regarding the evaluated DMU. The profitability efficiency measure gives a synthetic efficiency index for DMU performance.  $\pi$  is equal to 1 for efficient DMUs. A more meaningful interpretation is  $\left(\frac{1}{\pi} - 1\right)$  which gives the % of potential increase for profit rate. Beyond this synthetic index, managers can clearly identify the sources of improvement between quantity effects and price effects. The decision maker is now informed whether managerial efforts must focus on technical efficiency or price negotiation with clients and/or suppliers. Moreover, each source of strength and weakness can be analyzed in detail. For each output and for each input, a detailed diagnosis in terms of quantity and price is therefore available through this analytical value framework.

### 3. An empirical analysis of the profitability efficiency decomposition

Our empirical study is based on a sample regarding 50 breed suckler cattle farms located in the Charolais-area grasslands (Northern French Massif Central)<sup>4</sup> for the year 2016. Data is collected on hired and family labor, intermediate inputs (cattle feed concentrates, veterinary costs, fertilizer, pesticide, energy, ...), fixed capital depreciation (equipment, livestock buildings, storage structures, ...), land allocation scheme, herd, beef live-weight produced, other products, subsidies, investments and borrowing.

After a description of the variables retained in the underlying value transformation set as well as some descriptive statistics of the sample, we will first develop a case study on a particular farm to illustrate the operational scope of our model to establish a complete diagnosis of profitability efficiency. Finally, synthetic results at the sample level are presented.

#### 3.1. Data and variables

The empirical model retains two outputs and five inputs. The total income is the sum of beef live-weight produced sales and other products (sheep or pig meat, cereals, and oilseeds crops, ...). The total cost includes cattle feed concentrates and other intermediate consumption, land and labor costs as well as fixed capital consumption measured by the depreciation of fixed assets (farm buildings, fixed equipment, machinery and other equipment).

For each farm, the variables beef live-weight produced, concentrate feeding stuffs, land and labor expressed in value terms are decomposed into their respective quantity and unit price components.<sup>5</sup> Total agricultural area is expressed in hectares (ha) assuming that the owned land is paid at an opportunity price equal to the observed cost per hectare of rented land. Finally, labor quantity aggregates family and hired employees converted in full time equivalent persons (FTE). Labor cost is the sum of salaries and social contributions of employees as well as social contributions paid for family staff.

Tables 1 displays the main structural and economic characteristics of the sample. According to figures displayed, these farms are big commercial beef cattle operations which are similar to the observed commercial beef cattle farms in the Farm Accountancy Data Network (FADN, farming type 46 specialist cattle) statistically representative of such French farm businesses (Veysset et al., 2015).

*Table 1. Variables retained in the value transformation technology*

<b>N=50, year=2016</b>	<b>Variables</b>	<b>Mean</b>	<b>Relative standard deviation</b>
<b>Beef production (kg live weight)</b>	$y_1$	54 122	51,1%

<sup>4</sup> We would like to thank the INRAE — Clermont-Theix team and more particularly Michel Lherm and Patrick Veysset for making the data available.

<sup>5</sup> It is quite common that, for certain accounting data of a business, the manager does not have clear information allowing them to separate the value in price and quantity. For these specific variables only available in value, it is still conceivable to include them as such in our model. Obviously, it is not possible to derive their respective price and quantity efficiency components. This flexibility of our analytical framework allows to adapt to real world case studies.

<b>Beef selling price (€/kg)</b>	$p_1$	2,20	10,0%
<b>Beef sales (€)</b>	$R_1=y_1p_1$	118 382	49,7%
<b>Sales of other products (€)</b>	$R_2$	17 871	153,8%
<b>Cattle feed concentrates (Kg)</b>	$x_1$	58 526	127,1%
<b>Cattle feed unit price (€/kg)</b>	$w_1$	0,30	19,2%
<b>Cattle feed expenses (€)</b>	$C_1$	16 651	120,4%
<b>Other intermediate input expenses (€)</b>	$C_2$	94 020	53,6%
<b>Utilized agricultural area (ha)</b>	$x_3$	175	40,9%
<b>Unit cost of land (€/ha)</b>	$w_3$	121,10	23,6%
<b>Land cost (€)</b>	$C_3$	21 048	43,8%
<b>Total labor (FTE)</b>	$x_4$	1,9	34,0%
<b>Unit labor cost (€/FTE)</b>	$w_4$	6 872	62,3%
<b>Labor cost (€)</b>	$C_4$	14 135	90,1%
<b>Fixed capital consumption (€)</b>	$C_5$	28 402	43,6%

On average, farms achieve a turnover of € 136,000 for a total cost of € 174,000 (cf. table 2).<sup>6</sup>

*Table 2. Revenue, cost and profitability ratio*

	<b>Variables</b>	<b>Mean<sup>(1)</sup></b>	<b>Relative standard deviation</b>
<b>Total revenue (€)</b>	$R=R_1+R_2$	136 253	48,0%
<b>Total cost (€)</b>	$C=C_1+C_2+C_3+C_4+C_5$	174 257	51,7%
<b>Profitability</b>	$R/C$	79,31%	16,6%

(1) unweighted individual mean

From table 3, we note that the breeding activity is predominant with over 88% of total sales. On the cost side, more than half is allocated to other intermediate inputs. However, the biggest dispersions between farms are observed for the purchases of concentrated feeds and for the labor cost, both in terms of level (cf. table 1) and relative share (cf. table 3).

<sup>6</sup> Without the subsidies which amount to € 69,000, the average farms would not make a positive profit. The total revenue including subsidies represents 122.7% of the total cost but if the only sales generated directly by the farm activities are considered then the profitability ratio does not exceed 80%.

Table 3. Output revenue shares and input cost shares

	<b>Variables</b>	<b>Mean<sup>(1)</sup></b>	<b>Relative standard deviation</b>
<b>Output shares</b>		100,0%	
<i>Beef sales</i>	$R_1/R$	88,7%	16,8%
<i>Sales of other products</i>	$R_2/R$	11,3%	131,8%
<b>Input shares</b>		100,0%	
<i>Cattle feed expenses</i>	$C_1/C$	8,4%	67,9%
<i>Other intermediate input expenses</i>	$C_2/C$	53,8%	10,9%
<i>Land cost</i>	$C_3/C$	12,6%	25,1%
<i>Labor cost</i>	$C_4/C$	8,0%	55,6%
<i>Fixed capital consumption</i>	$C_5/C$	17,3%	26,8%

(1) unweighted individual mean

### 3.2. Results and analysis

To illustrate the relevance of our model for performing a complete diagnosis in terms of profitability efficiency, we first present the results of a farm specific case in the sample and then we present an aggregate analysis at the sector level. This shows that our framework can serve two purposes: i) providing advice at an individual level for business managers and ii) sketching out a global analysis for the entire sector that policymakers can rely on.

In what follows, we apply the NLP model developed in (23) for the specific evaluated DMU. From the optimal solution of (23)<sup>7</sup> we obtain its optimal profitability level that will lead us to calculate the profitability efficiency defined in equation (25). Moreover, the NLP model in (23) will also provide us with the optimal price and quantity levels for each input and output of the evaluated DMU. With these quantities and prices, we can further compute each component of the decomposition exposed in equation (26). Thus, the price/quantity decomposition in (26) is first computed at the total level and then, it is calculated for each input/output.

The farm chosen for this illustration shows that generally admitted wisdom according to which profitability automatically implies a decrease in input prices can be called into question in a more encompassing analysis where all levers of decision (input and output prices and quantities) are simultaneously considered.

<sup>7</sup> Note that the solution to the optimization problem may not be unique since optimization takes place on a convex polyhedron. However, there is a possibility for one to check empirically whether the proposed solution is unique by considering, in a second stage, the optimal value of the objective function as an additional constraint.

a) *Decomposition of profitability efficiency: a case study*

The evaluated farm generates a turnover of 122,580 € for a total cost of 198,593 € and receives an amount of aids reaching 59,631 €. <sup>8</sup> The share of livestock activity is around 65%.

- Direct total quantity and price effects

Table 4 summarizes the global diagnosis provided by equation (25) through different efficiency scores respectively related to the potential changes in quantities or prices in input/output variables. The value profitability efficiency score of the evaluated DMU is 57.6%, which is an expression of how observed profitability compares to maximum profitability - meaning that the unit is basically achieving around 60% of the maximum. In other words, if the evaluated farm aligns with its benchmark, the profitability ratio could improve by  $+73,6\% = \left(\frac{1}{\pi} - 1\right) = \left(\frac{1}{0.576} - 1\right)$ . The value profitability efficiency score (57.6%) can be further split into a revenue score (70.2%) and a cost score (82.1%). The sharing of revenue efficiency leads to a quantity effect of 75.4% and a price effect of 93.1%, whereas the distribution of cost efficiency resulting in 78.6% for quantities and 104,4% for prices. The total quantity effect is therefore 59.3% (75.4%\*78.6%) whereas the total price effect is 97.2% (93.1%\*104.4%). The fact that the input price efficiency score is greater than the unit implies that, given the quantities used, the evaluated DMU has lower input prices than its benchmark. This last result reveals that its benchmark reaches a higher profitability despite its higher input prices. <sup>9</sup> In addition, one checks that the profitability efficiency score is also the product between the total quantity effect and the total price effect (57.6% = 59.3%\*97.2%).

Another meaningful interpretation of the calculated quantity and price effects is related to equation (1) where the former effect can be regarded as a potential rise in the TFP level by

$$+68,7\% = \left(\frac{1}{E_Q^F} - 1\right) = \left(\frac{1}{0.593} - 1\right)$$

and the latter effect as a smaller increase in the price recovery index by  $+2.9\% = \left(\frac{1}{E_p^F} - 1\right) = \left(\frac{1}{0.972} - 1\right)$ .

*Table 4. Value profitability efficiency score and its distribution between global quantity and price effects*

	<b>Efficiency scores in %</b>		
	<u>Revenue</u>	<u>Cost</u>	<u>Profitability</u>
$\pi$	70.2%	82.1%	57.6%
$E_Q^F$	75.4%	78.6%	59.3%

<sup>8</sup> After the successive reforms of the common agricultural policy, subsidies are now significantly decoupled from the farm output level. They are not included as decision variables in this model maximizing the profitability ratio.

<sup>9</sup> Indeed, in this analysis encompassing both prices and quantities for inputs and outputs and their interlinked relationships, an objective of higher profitability does not necessarily involve lower input prices.

$E_p^F$	93.1%	104.4%	97.2%
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- Direct quantity and price effects per specific inputs and outputs

To finish this particular case study, table 5 presents the decomposition of value profitability efficiency and its different input and output components in both the quantity and the price dimensions. In this empirical application, for one of the outputs (other products) and two of the inputs (other intermediate inputs and respectively, fixed capital consumption) only value data was available. In this case, the least that the model will provide is a value effect. This is the path we follow here. If the researcher can further consider that DMUs in the sample are price takers for that specific input/output, the model will calculate a quantity effect. In this way, the same price is applied to all DMUs and the previous value effect becomes a quantity effect under the price taker behaviour assumption (Färe and Grosskopf, 1985).

For those inputs and outputs for which price and quantity data is available, a full decomposition of the value effect into a price and quantity effect is possible. However, the interpretation of the calculated efficiency scores may be relatively complex as such. While they are indeed necessary to establish the mathematical relations between different quantity and price components of the value profitability efficiency score, a more intuitive presentation of the global results per specific input/output can be achieved through the alternative interpretation in terms of variation.

Indeed, output efficiency scores lower than the unit imply potential increases in outputs, while input efficiency scores below the unit imply potential reductions in these inputs. In order to help the reader, table 5 includes three additional columns containing the potential increases/decreases for each variable. For example, the output quantity efficiency score of 75.4% implies that the evaluated DMU needs to increase its output quantity by  $32.7\% \left( \frac{1}{0.754} - 1 \right)$  in order to reach its benchmark. On the other hand, the input quantity efficiency score of 78.6% implies a decrease in the input quantity by  $21.4\% (1 - 78.6\%)$ .

The potential progress of total revenue can be decomposed as follows. First, a possible growth in the quantity of beef production (+84.9%) then an increase in the selling price per kilo of beef (+9.5%). On the other hand, revenue related to other products should decrease (-68.8%) to allow greater specialization in beef cattle operations (92.3% instead of 65%).

Regarding the potential cost reduction, the main effort should focus on expenditures concerning other intermediate inputs (-34.8%). The cost of land would not vary significantly (+0.1%) but should be accompanied by a deep revision of its quantity and price components. Indeed, the number of hectares would slope down (-23.3%) while its price per hectare would increase (+31.6%). The payment for staff employed should increase very slightly following a workforce preservation<sup>10</sup> coupled with a minor salary increase (+2.2%). Purchases of feed concentrates should marginally rise (+1.3%) according to a growth in price (+2.1%) and a negligible reduction of quantity (-0.8%). Finally, fixed capital spending is expected to go up (+13.9%).

<sup>10</sup> Recall that, in order to make maximization of the profitability ratio non-trivial, i.e. the best observed profitability ratio, we consider labor quantity as a quasi-fixed input. This assumption is in line with farm activity practice.

Table 5. The value profitability efficiency and its total decomposition by variables

	Efficiency Scores			Variations		
	$E_Q^F$	$E_P^F$	$\pi$	Quantity	Price	Value
<b>Outputs</b>	<b>75,4%</b>	<b>93,1%</b>	<b>70,2%</b>	<b>32,7%</b>	<b>7,4%</b>	<b>42,5%</b>
<i>Beef production</i>	54,1%	91,3%	49,4%	84,9%	9,5%	102,4%
<i>Other products</i>	n/a	n/a	320,8%	n/a	n/a	-68,8%
<b>Inputs</b>	<b>78,6%</b>	<b>104,4%</b>	<b>82,1%</b>	<b>-21,4%</b>	<b>4,4%</b>	<b>-17,9%</b>
<i>Cattle feed concentrates</i>	99,2%	102,1%	101,3%	-0,8%	2,1%	1,3%
<i>Other intermediate inputs</i>	n/a	n/a	65,2%	n/a	n/a	-34,8%
<i>Utilized agricultural area</i>	76,7%	131,6%	100,9%	-23,3%	31,6%	0,9%
<i>Total labor</i>	n/a	102,2%	102,2%	n/a	2,2%	2,2%
<i>Fixed capital consumption</i>	n/a	n/a	113,9%	n/a	n/a	13,9%
<b>Total</b>	<b>59,3%</b>	<b>97,2%</b>	<b>57,6%</b>	<b>68,7%</b>	<b>2,9%</b>	<b>73,6%</b>

Based on this analysis, we can therefore diagnose that the main problem of this agricultural business is that the quantities produced are too low and that the input quantities are too high. This is generally in line with the expected conclusions that could be drawn from traditional efficiency analysis based on the quantity dimension. In comparison, the current case study also shows that the price dimension also contributes to the improvement in the DMU's profitability. More specifically, this illustration shows that the benchmark of this DMU, while using a lower quantity of land, have significant higher prices for this input. One possible explanation for this counter-intuitive result could be that the land qualities of the efficient farms composing the benchmark are better than that of the evaluated DMU.

*b) Decomposition of profitability change by specific inputs and outputs: an analysis at the aggregate sample level*

For the entire sample, the profitability score reached 77.3%.<sup>11</sup> This overall performance decomposes by revenue efficiency (102.5%) and cost efficiency (75.4%). These results imply that on average, farms should slightly decrease their turnover (-2.5%) and significantly reduce their cost (-24.6%). The quantity and price components of revenue efficiency are 104.1% and 98.1%, respectively, implying a production decline (-4.4%) and an increase in output price rise (+2%). On the cost side, the quantity component indicates an efficiency of 77.9%, i.e. a decrease in the use of inputs (-22.1%) while the price efficiency is 96.7%, i.e. a decrease in input prices (-3.3%). All in all, the potential increase in the profitability ratio (+29.4%) is mainly explained by a quantity effect increasing the TFP (+22.8%) while the price effect only occurs for a slight growth in price recovery (+5.4%).

Table 6 allows a more detailed analysis of these performance indicators by output and input. It shows that the drop in turnover relates exclusively to the sale of other products (-46.6%), while

<sup>11</sup> Geometrical mean

beef sales expected to increase slightly (+4.2 %) both in quantity (+1.9%) and in price (+ 2.2%). Finally, to improve cost efficiency, all expenditure items are concerned:

- reduction in animal feed purchases in quantity (-34.3%) and in price (-14.2%),
- reduction in the cost of other intermediate consumption (-29.4%),
- reduction of land in quantity (-12.5%) and price (-5.4%),
- reduction in labor unit cost (-15%)
- reduction in consumption of fixed capital (-7.7%)

Table 6. The value profitability efficiency and its total decomposition by variables at the sample level

	Efficiency Scores			Variations		
	$E_Q^F$	$E_P^F$	$\pi$	Quantity	Price	Value
<b>Outputs</b>	<b>104,6%</b>	<b>98,1%</b>	<b>102,5%</b>	<b>-4,4%</b>	<b>2,0%</b>	<b>-2,5%</b>
<i>Beef production</i>	98,1%	97,8%	96,0%	1,9%	2,2%	4,2%
<i>Other products</i>	n/a	n/a	187,1%	n/a	n/a	-46,6%
<b>Inputs</b>	<b>77,9%</b>	<b>96,7%</b>	<b>75,4%</b>	<b>-22,1%</b>	<b>-3,3%</b>	<b>-24,6%</b>
<i>Cattle feed concentrates</i>	65,7%	85,8%	56,4%	-34,3%	-14,2%	-43,6%
<i>Other intermediate inputs</i>	n/a	n/a	70,6%	n/a	n/a	-29,4%
<i>Utilized agricultural area</i>	87,5%	94,6%	82,8%	-12,5%	-5,4%	-17,2%
<i>Total labor</i>	n/a	85,0%	85,0%	n/a	-15,0%	-15,0%
<i>Fixed capital consumption</i>	n/a	n/a	92,3%	n/a	n/a	-7,7%
<b>Total</b>	<b>81,5%</b>	<b>94,9%</b>	<b>77,3%</b>	<b>22,8%</b>	<b>5,4%</b>	<b>29,4%</b>

## 4. Conclusion

The present study seeks to contribute to the existing literature tackling a firm's overall financial performance. Our methodology can be developed to encompass all traditional value indicators, such as cost, revenue, profit and profitability. For our empirical application, we have retained the firm profitability, defined as the ratio between the firm's sales and its costs. As the chosen indicator is a ratio whose terms are expressed in monetary terms (a value), a complete analysis must encompass two dimensions. One of them deals with productivity improvements as a result from a better management in terms of input and output quantities. The other one is the price recovery which reveals the ability to generate a mark-up of output prices with respect to inputs prices. Indeed, prices and quantities play an equally important role for operating businesses strategically. Business literature abounds in strategies meant to provide an edge over competitors in terms of both output prices, i.e. differentiation strategies resulting from skillful marketing and product development and input prices, i.e., scale and/or scope economies, vertical relations. Moreover, economic and statistical literatures have long established that growth and distribution of productivity gains are the two inseparable sides of a same coin.

However, within the general framework of benchmarking analysis, traditional efficiency measures consider prices as being determined exogenously and instead deal exclusively with quantity improvements. Thus, this literature lacks a direct comparison of firms' output and input prices. Some attempts to fill in for this void exist. For example, the use of a value technology is a



way to indirectly consider prices. An indirect price effect has even been introduced in this perspective. But these approaches all lack a direct measure for firms' price efficiencies.

To our knowledge, Portela and Thanassoulis (2014) came closest to this objective. In their cost efficiency measure both input prices and quantities are decision variables. However, while our work and theirs share the same objective, we believe that there are several major distinctions regarding the operationalization of this objective and, consequently, the results obtained with the two measures can be very different from one another. The main difference between these two approaches is related to the fact that, in our baseline model, we assume that prices and quantities are related to one another (resulting, for example, from factor/output demand functions) while in their work, P&T considered prices and quantities as completely independent from one another. The main issue in their approach is, in our opinion, that price efficiency determination is unrelated to the evaluated DMU. In an extension of our baseline cost model we propose to maintain the assumption that input prices remain independent from input quantities as in P&T, but we relate them to the level of the evaluated DMU's output quantity and price. Therefore, for each level of output quantity and its price, an optimal vector of input prices is determined which is no longer set at the minimal observed prices or some exogenously fixed bound.

Given these considerations, our models contribute to the related literature by introducing genuine price efficiency measure which can be adapted to account for both market characteristics (the degree of dependency between prices and quantities) and observed DMU activity. This new decomposition of value-based performance into a direct quantity effect and a direct price effect for each input and output variable is straightforward and, compared to previous attempts in this direction, presents the advantage of satisfying the product test.

Our contribution also has an undeniable high operational value. Indeed, a decision maker can now identify the sources of possible profitability increase levers either through improved quantity management and/or better search for new price opportunities. We have illustrated our approach with a sample of French cattle farms. While one could have expected that in this agricultural sector prices would not play any role at all, our application shows that, although their role is indeed smaller compared to that of quantities, they still represent a lever for action for profitability improvement. This is especially observed in terms of different input prices (labor, animal feed purchases and land). Concerning the outputs, our illustration shows that farmers present the same level of inefficiency in terms of produced quantities as in terms of prices. Efforts should therefore be concentrated in the direction of increasing quantities produced as well as improved selling strategy (alternative short cycle favoring customer proximity, differentiation strategy).

## 5. References

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