ECO111 Notes — Unit 6

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Contents

1 Labor Discipline Model

- Reservation wage is at what wage would the worker be indifferent to not having a job and having a job.
- Efforts during work bring disutility
- Best response to wage of Reservation Wage would be to not work
- Worker's best response to a wage offer depends on how long she would expect to be unemployed before getting a new job if she were to lose her job.
- best response curve's derivative is decreasing (double derivative is negative)
- The best response curve is the frontier of the feasible set of combinations of wages and effort the firm can get from its employees.
- The slope of the frontier is the marginal rate of transformation of wages into effort.

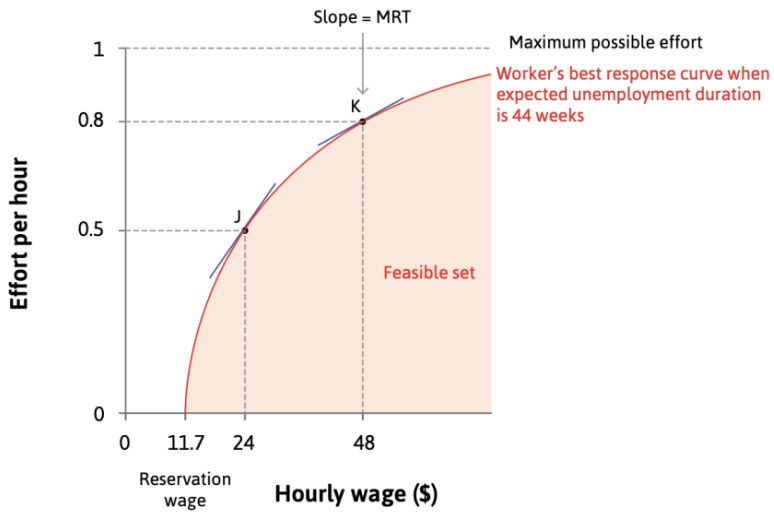

Figure 1: Worker's Best Response Curve for given unemployment duration

2 Iso-Cost Curves

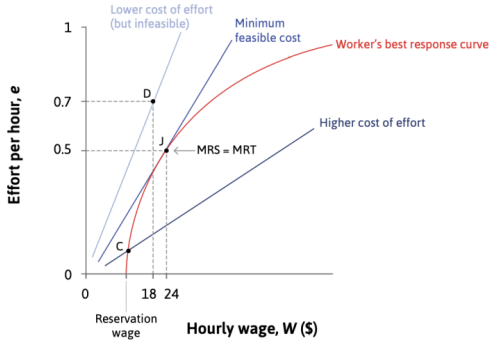

Figure 2: Iso-Cost Curve

- Iso-cost curves joins all the points with the same effort per wage ratio (e/W).
- cost per unit of effort is the same along an iso-cost line, hence employers are indifferent between any points along this curve
- cost per unit of effort is minimized at the tangency point of employer's best response curve and the employer's iso-cost line
- The wage set by the employer following the profit maximization or cost minimization exercise is called the **efficiency wage**

The position of the best response function depends on:

1. The utility of the things that can be bought with the wage.
2. The disutility of effort.
3. The reservation wage.
4. The probability of getting fired, at a given effort level.

Workers are favored by a rightward shift of the best response function.

Employers are favored by a leftward shift of the best response function.