ECO111 : Lecture 24

30 September 2024

UNIT 6: THE FIRM: EMPLOYEES, MANAGERS, & OWNERS

Source: Economy, Society, and Public Policy

Firms, Markets, and Division of Labor

- Firms are economic organization in which private owners of capital goods hire and direct labor to produce goods and services for sale on markets to make a profit.
- **Division of labor** is the **specialization** of producers to carry out different tasks in the production process.
- Asymmetric information: information that is relevant to all the parties in an economic interaction, but is known by some and not by others.
- Profit or residual claimant: who claims the profits

Some Basic Concepts

- Share is a part of the assets of a firm that may be traded. It gives the holder a right to receive a proportion of a firm's profit and to benefit when the firm's assets become more valuable.
- There is separation of ownership and control when managers decide on the use of other people's funds.
- There could arise conflict of interest between managers of the firms and owners and/or share holders of the firm.
- In spite all this when modelling firm as an actor, consider that it maximizes profit.
- The ongoing relationship between an employer and employee is the employment relationship.
- There are mutual gains and conflicts in this relationship.

Piece rate work

- Piece-rate work is a type of employment in which the worker is paid a fixed amount for each unit of the product that the worker produces.
- Piece-rate is not wage as it is paid per unit of output and not labor hours.
- A piece-rate provides the employee an incentive to work hard as their payment depends on the produce.
  - Measuring the amount of output an employee is producing particularly in the service sector.
  - Employees mostly work together in a firm.
- Piece-rate work leads to large informal economy.
- Employment contracts are incomplete. Incomplete contract is a contract that does not specify, in an enforceable way, every aspect of the exchange that affects the interests of parties to the exchange.
- Paying the lowest possible is not necessarily the best strategy of firms to minimize the cost of acquiring labor.

Why Do a Good Day's Work

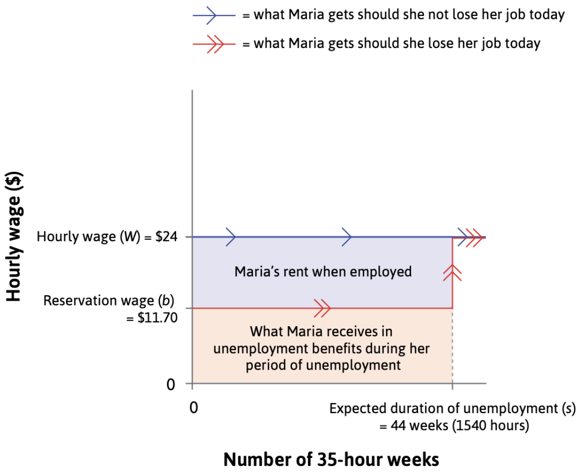
- Given this conflict of interest and incomplete contract why would an employee do a good day's work?
- Not meeting the standards set by the employer and the fear of being fired.
- Setting the wage sufficiently high would provide incentives to workers to work hard.
- Employment rent is the difference between the net value of being employed and the employee's next best alternative, i.e., unemployed.
- Sufficiently large economic rent would ensure a good day's work from the employees.

Reservation Wage

- Reservation wage is what an employee would get in an alternative employment, or from an unemployment benefit o or other support were they not employed in their current job.
- Suppose the unemployment benefit received by Maria for the total s weeks she is unemployed be B.
- The reservation wage, b for Betty is then B/s divided by the number of hours worked in each week when she is employed.
- Suppose Maria receives wage equal to W per unit of hour and works h hours.
- Assume that if she loses her job she remains unemployed for s weeks.
- So every week she loses $Wh - \frac{B}{s}$.
- Her total loss of income in her unemployment spell of s weeks is :

$$Employment\ rent = s(Wh\ -\ \frac{B}{s}) \tag{1}$$

Contd...



= what Maria gets should she not lose her job today
= what Maria gets should she lose her job today
Hourly wage ($)
Hourly wage (W) = $24
Maria’s rent when employed
Reservation wage (b)
= $11.70
What Maria receives in unemployment benefits during her period of unemployment
0
0
Expected duration of unemployment (s)
= 44 weeks (1540 hours)
Number of 35-hour weeks

Work, Effort, & Wages: The Labor Discipline Model

- When the cost of job loss is higher, workers will be willing to work harder to keep their jobs.
- Holding everything else constant (*ceteris paribus*) firms can increase wages as a mechanism to increase the cost of job loss.
- This can be modeled as a game played by the employer and the employees of the firm called the Labor Discipline Model.
- Simplified model of what really happens.
- Consider two players; the owner of the firm and a single employee, Maria.
- The game is sequential and is repeated in each period of employment.

The Labor Discipline Model

1. The employer chooses a wage - based on the knowledge of how Maria responds to a higher or lower wages. Informal contract of hiring her in subsequent periods as long as they work hard.
2. Maria chooses the level of hard work to put in, depending on the wage offered and also taking into account the cost of losing her job.
3. Payoffs for :
   - The employer is the profit.
   - Maria, it is how much she values the wage she receives, taking into account the effort she has expended.

If Maria chooses her work effort as a best response to the employer's offer, and the employer chooses the wage that maximizes his profit given that Maria responds the way she does, their strategies are a Nash equilibrium.