Lecture 2: Firms and Employees

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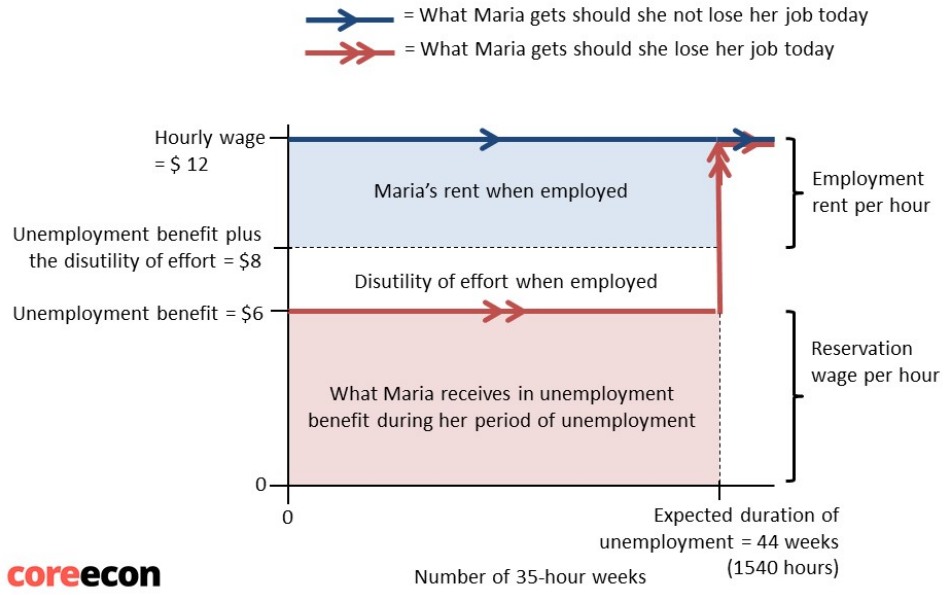
EC566 | Macroeconomics for Business

Employment Rents

- Cost of loosing a job
  - The difference between value of job and the next best option
- Depends on
  - wage, medical benefits, ...
  - disutility of work (function of effort),
  - unemployment benefits (if exists)
  - duration of potential unemployment
  - stigma of unemployment,
  - other available employment opportunities
- Reservation wage = value of next best option
- Employment rent = wage - reservation wage - distutility of effort

Figure 6.3. Maria's employment rent for a given level of effort and a $12 wage, in an economy with an unemployment benefit of unlimited duration.



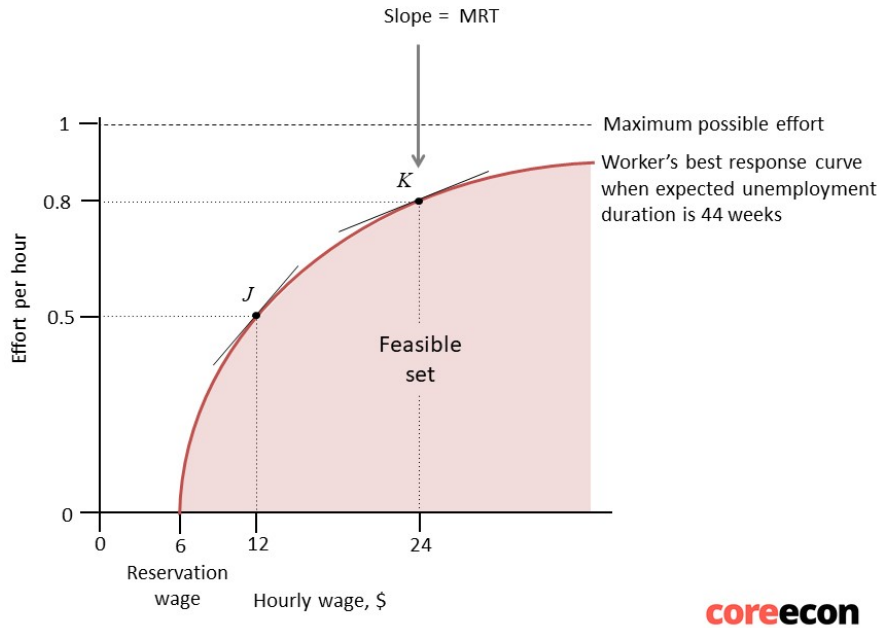
Employment rent = $(12 - 2 - 6) \times 35 \times 44 = 6160$

Labor Discipline Model

Worker's best response

- For a given wage offered, the optimal effort exerted by the workers
- Say wage rate = $12
  - Why would'nt a worker exert more effort than .5?
  - Why would'nt a worker exert less effort than .5?
- Feasible set:
  - Wage and effort pairs that a firm can get from its employees
- Slope of the best response curve = MRT
  - MRT stands for marginal rate of transformation

Figure 6.4. The employee's best response to the wage.



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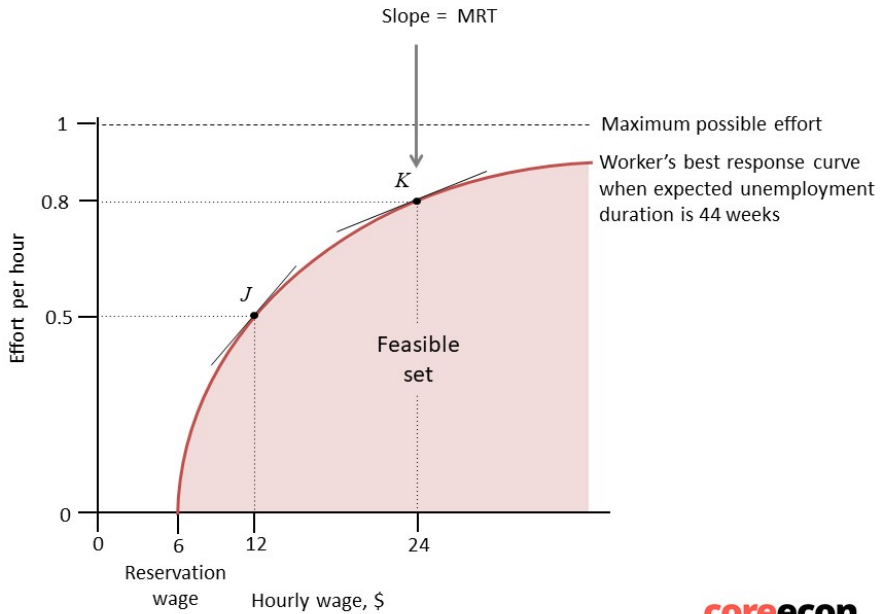
Shape of worker's best response

- Effort at the reservation wage is 0
- Effort is increasing in wage
- Best response function is concave
  - Firms need to increase wage rate more to induce more effort from workers if the initial wage is higher
- For more detail read Leibniz: The worker's best response function

Questions:

- What happens to the best response curve if
  - unemployment duration increases,
  - unemployment benefit decreases?

Figure 6.4. The employee's best response to the wage.



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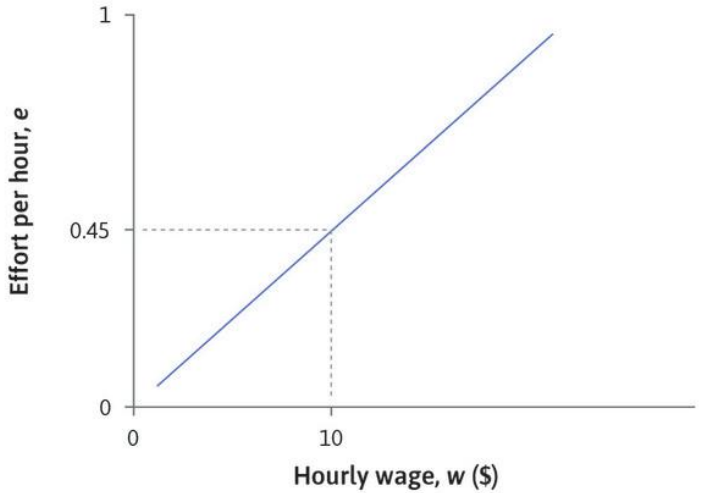
Firm's best response

- A firm's goal is to maximize profits
  - Maximize production
  - Minimize cost
- To maximize production, offer higher wages
  - $\Uparrow$ wages $\Rightarrow \Uparrow$ effort $\Rightarrow \Uparrow$ production
- To minimize cost, offer lower wages
- Trade-off between wages and effort

Isocost lines

How to deal with the wage effort trade-off?

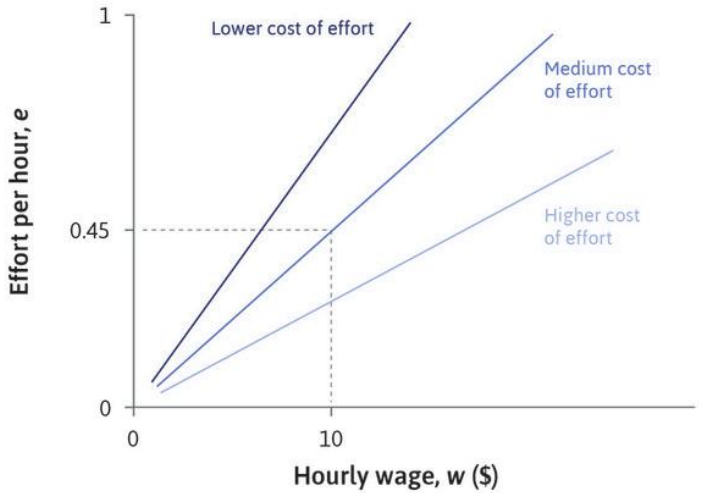
- Minimize cost of effort (effort/wage)
- Cost of effort is the same at all points on an isocost line



Isocost lines

How to deal with the wage effort trade-off?

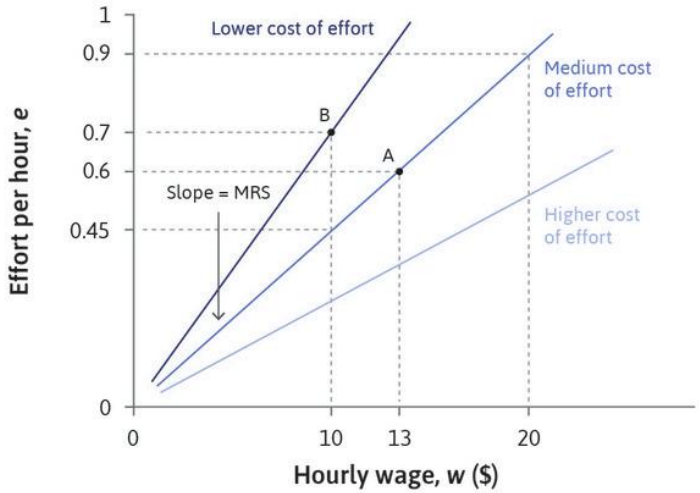
- Minimize cost of effort (effort/wage)
- Cost of effort is the same at all points on an isocost line
- Cost of effort goes down as the isocosts shifts up



Isocost lines

How to deal with the wage effort trade-off?

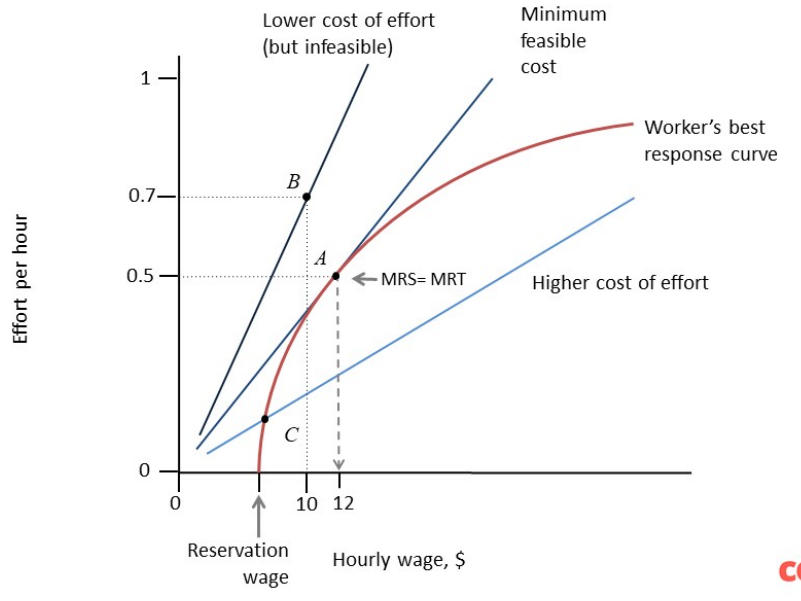
- Minimize cost of effort (effort/wage)
- Cost of effort is the same at all points on an isocost line
- Cost of effort goes down as the isocosts shifts up
- Slope of isocost curve is MRS
    - MRS: marginal rate of substitution



Determination of wages

- Profits are maximized at the steepest isocost line at the minimum feasible cost
    - Equilibrium wage and effort is point A, where MRS = MRT
- Efficiency wage: a wage rate greater than the reservation wage rate

Figure 6.6. The employer sets the wage to minimise the cost of effort.



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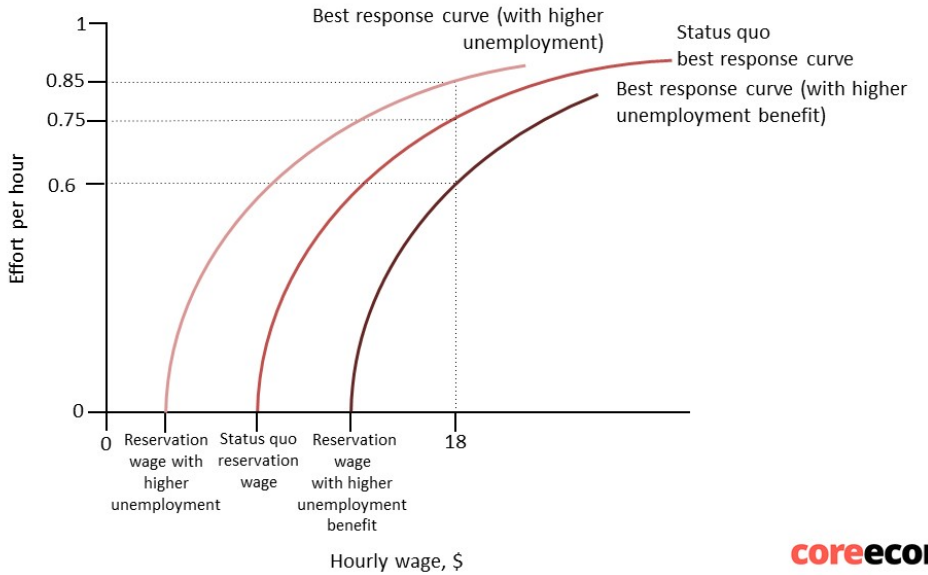
Trend

Figure 6.7. The best response curve depends on the level of unemployment and the unemployment benefit.



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