LECTURE 9.4

CONTRACTS AND PAY

CONTRACTING OBJECTIVES

Remember that one perspective of the firm is as a series of contracts. One of the most important of these set of contracts is that between the firm and its employees.

A good contract will be one that maximizes the size of the pie to be shared, allowing both the firm and employee to be better off.

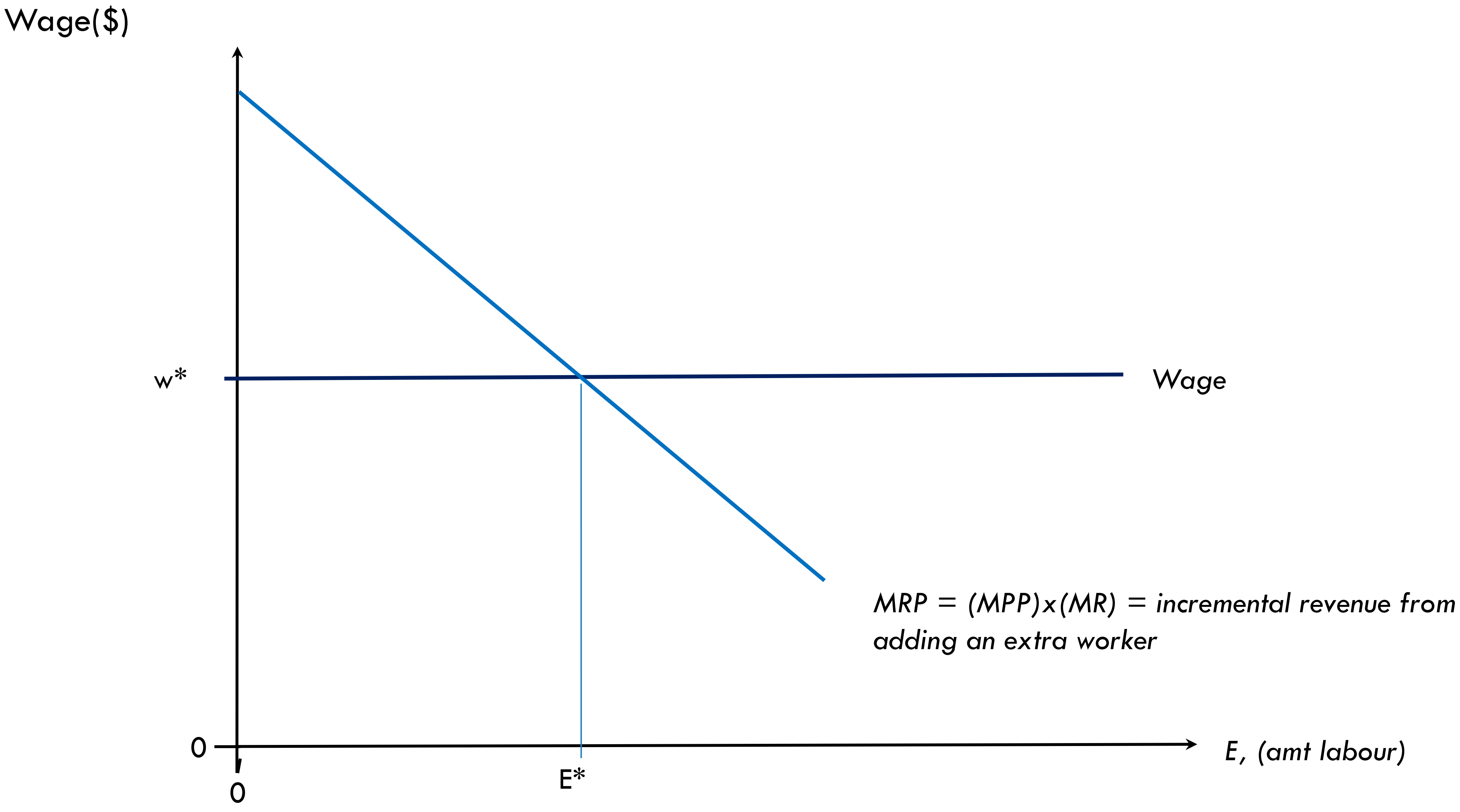
The owner of the firm and the employee must each receive at least their reservation level of utility.

- For the owner of the firm, that is the return on capital of the next most valuable input.
- For the employee, that is the wage in the next best alternative job.

THE LEVEL OF PAY

Consider the basic competitive model. Assume:

- The firm is a price taker in the labour market
- Wages are determined in the competitive market
- No long term contracts, only spot markets
- Homogeneous workers



Wage($)
w*
Wage
MRP = (MPP)x(MR) = incremental revenue from adding an extra worker
0
0
E*
E, (amt labour)

THE LEVEL OF PAY

Workers are, of course, not homogeneous. The value of an employee to a firm depends on:

- General human capital: skills and education that is valued equally by an array of firms.
- Specific human capital: skills and education that is valued more highly by one employer compared to an alternative employer.

THE LEVEL OF PAY

Not all jobs are created equal. Some jobs are dangerous, unpleasant, boring and repetitive.

To attract people to these jobs, we need to pay them more: a ***compensating differential***.

- They force employers to make choices about whether to have higher labour costs or make some other type of adjustment such as improving safety.

Example: Unskilled workers have a choice between two jobs. The first job offers clean and safe working conditions. The second job is in a dirty noisy factory.

- A wage of $15 per hour in both jobs could not be an equilibrium.
- If the second job must pay $17.50 per hour to attract workers, the compensating wage differential is $2.50 per hour.