

LECTURE 9.5

INTERNAL LABOUR MARKETS

INTERNAL LABOUR MARKETS

Firms use internal labour markets to fill vacancies within the firm. Why use internal labour markets?

- Easier than external hiring
- Information asymmetries are largely resolved
- Provide greater incentive for individuals to invest in firm specific human capital
- Motivation – long term relationships can encourage individuals to work hard
- Learning benefits for the employer and the employee.

INTERNAL LABOUR MARKETS

In a long-term relationship, employees look beyond their immediate payoff.

Suppose that a firm does not pay the market wage *initially*, but that compensation increases over time. What is important is the net present value (NPV) of the earnings profile: the career earnings path.

There are at least three ways that firms can retain workers and encourage effort:

- Efficiency wages: pay above market rates
- Upwards sloping earnings profiles: offer pay rises for seniority to encourage retention
- Promotions: offer promotions to productive workers

INTERNAL LABOUR MARKETS – EFFICIENCY WAGES

To encourage effort and loyalty, firms may offer efficiency wages: wages above the market rate.

Rationale:

- suppose effort is costly to monitor
- to induce effort, offer high wages
- combine with light or probabilistic monitoring
- and threaten termination for poor effort
- with above-market wages, workers are motivated to work hard to avoid termination

INTERNAL LABOUR MARKETS – EFFICIENCY WAGES

Example:

- One period model.
- Workers prefer to shirk. Cost of working hard is \$50.
- The outside market wage is w . The firm offers wage $\hat{w} > w$.
- The firm can detect shirking with probability p

Therefore we expect the employee to work hard if.

$$\begin{aligned}\hat{w} - \$50 &> pw + (1 - p)\hat{w} \\ p(\hat{w} - w) &> \$50\end{aligned}$$

So how to discourage shirking? Offer a higher wage \hat{w} or monitor more carefully.

INTERNAL LABOUR MARKETS – EFFICIENCY WAGES

Benefits of efficiency wages:

- Attracting better employees
- Building better employee commitment. Workers are less likely to quit. Firms may be more likely to offer training.
- Create a greater perception of equity. Employees may feel that an employer is 'sharing' the surplus fairly.
- Greater productivity.

INTERNAL LABOUR MARKETS – EFFICIENCY WAGES

Is there any evidence that firms pay efficiency wage?

The Ford Motor company is often cited as the classic example.

- With introduction of assembly lines, large workforce of relatively unskilled labour that exhibited high rates of turnover (370%); high absenteeism. In 1913, wages rates were about \$2.50 per day.
- From January 1914 wage rates increased to \$5.00 per day for workers who had been employed for 6 months or more.

The effect?

- Quit rate fell by 87%, discharges fell by 90%, and absenteeism fell by 75%.
- There were other factors at work, but nonetheless is a lesson in the incentive provided by higher wages.

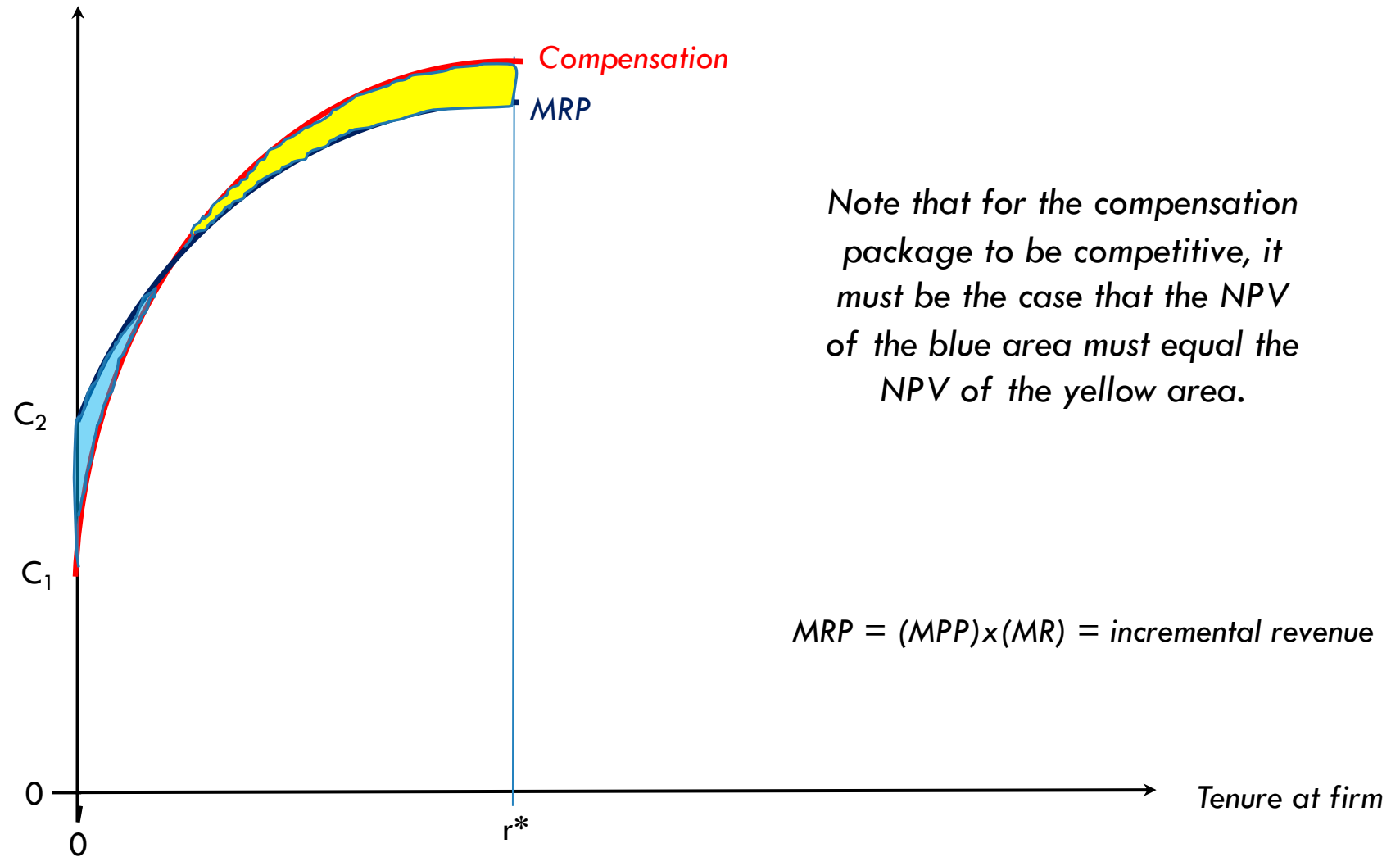
INTERNAL LABOUR MARKETS – JOB SENIORITY

Another common mechanism is to reward seniority.

- In the initial stages of the employment relationship workers are paid below their MRP (underpaid)
- They are paid more than their MRP (overpaid) in later years.

Compensation increases more rapidly than productivity.

Annual compensation and
MRP (\$)



INTERNAL LABOUR MARKETS – JOB SENIORITY

Rationale for workers:

- Workers accept the job because they anticipate future rewards
- Workers are motivated to work hard because of future rewards

Benefits to the firm:

- Selection: high future wages attracts workers who are likely to stay
- Incentives: workers exert effort, lured by later rewards (possibly reducing monitoring costs)
- Incentives: workers are motivated to make firm-specific investments

Potential challenge

- Approach depends crucially on trust. The reputation of the firm will be critical. Will pay really increase with seniority?

INTERNAL LABOUR MARKETS – PROMOTIONS

Firms are typically hierarchical. This provides opportunities for individuals to move up.

Promotion tournaments have the following characteristics:

- Winner is uncertain.
- The winner takes all.
- Promotion is based on **relative** performance rather than absolute measure.

Consider the following model:

The firm encourages effort by linking promotion to effort. For the staff member, they face the following problem:

$$\max_e p(e)(w^* - w) - c(e)$$

Where e is worker effort, $p(e)$ is the probability of getting promoted, w^* is the wage if promoted, w is the wage if not promoted and $c(e)$ is the cost of effort.

INTERNAL LABOUR MARKETS – PROMOTIONS

Benefits of promotion tournaments:

- The prospect of promotion encourages effort
- Adjustable: larger prizes can be used for bigger promotions
- Commits the firm to performance reviews
- Relative performance evaluation filters out firm-wide shocks.

Potential drawbacks:

- Relative performance evaluation can reduce cooperation
- A coarse mechanism: what happens to those who just miss out?
- Promotion leads to more responsibility; not all workers want this