

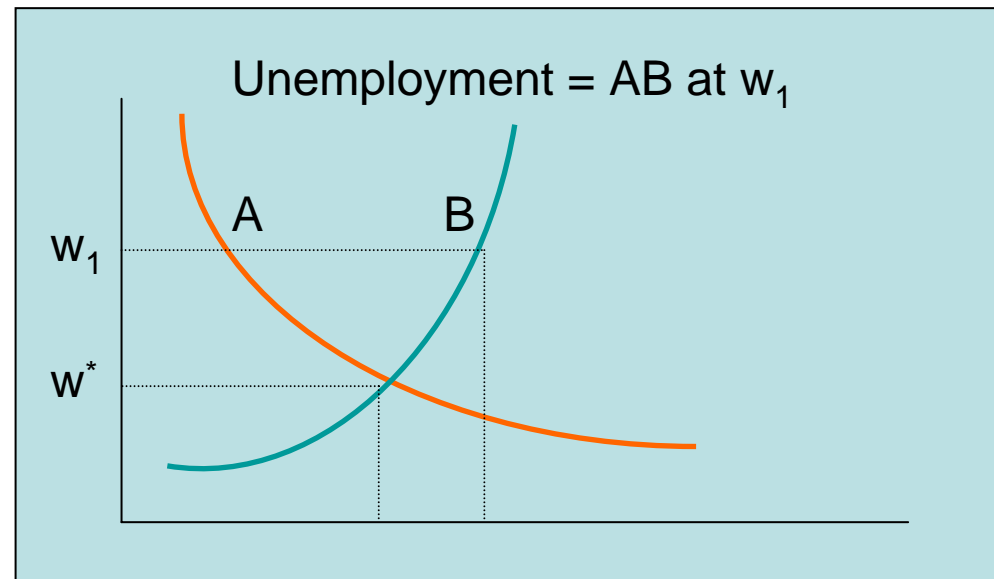
Efficiency Wages

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Unemployment

- Why are some people unemployed?
- Because wages are “too high”



Why are wages too high?

- Because employers deliberately pay wages which are higher than the market clearing wage
- They do this because:
 - Higher wages induce workers to put in more effort
 - Higher wages generate unemployment and make the threat of being fired credible
- Wages paid with these two motives are known as “efficiency wages”

Workers

- Workers can choose their ‘effort’ and they put in more effort when they are *motivated* to do so
- In the absence of motivation, workers will *shirk*.
- Even if they are caught shirking and *fired*, they can easily find another job if there is no unemployment
- One way for employers to provide motivation is to *pay more* than other employers
- Another way is to *fire* those who are shirking. But firing will only be effective if it is difficult to find another job

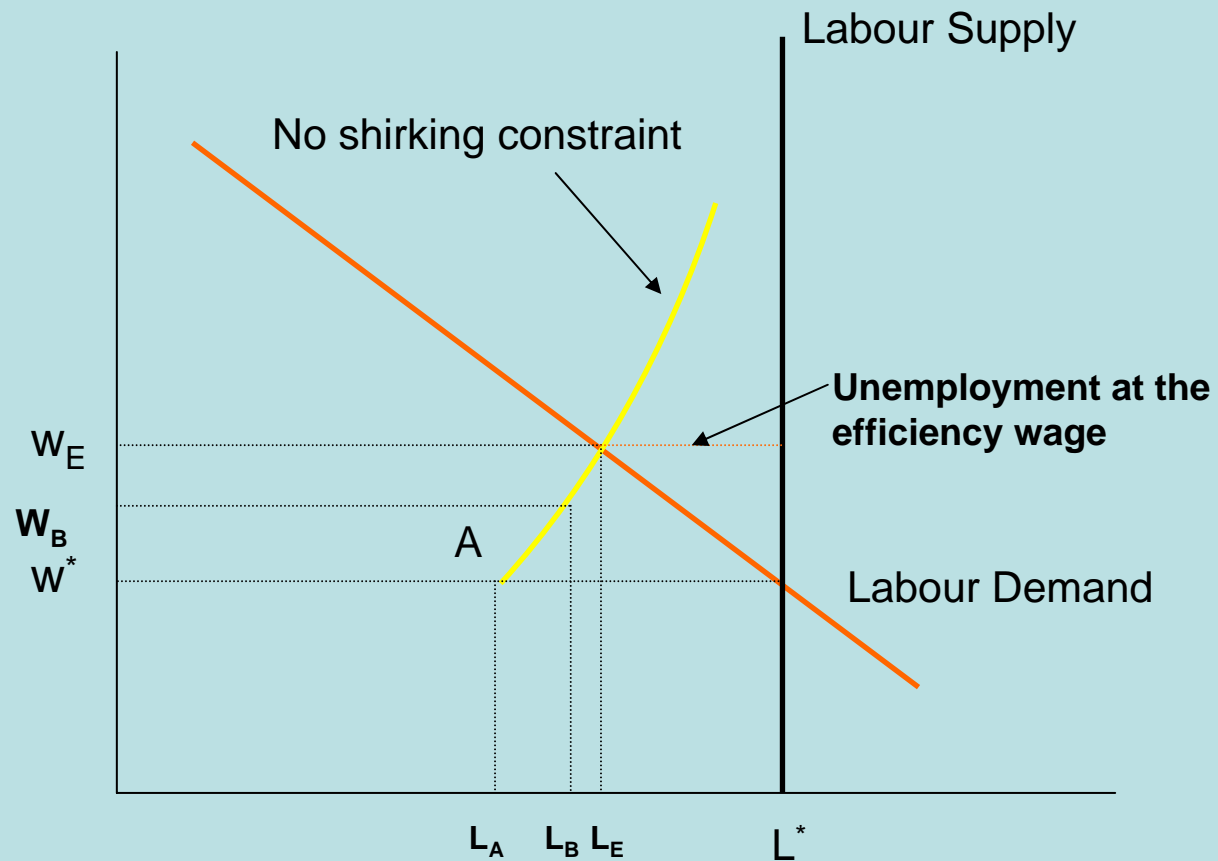
Motivation

- Workers provide effort because to be found shirking and, therefore, fired is costly, because:
 - of the loss of ‘higher than market’ wages
 - with a positive unemployment rate, it is difficult to find another job
- Workers are motivated, therefore, by:
 - the *carrot* of higher wages
 - by the *stick* of dismissal
- For the stick to work, unemployment is necessary

Employers

- The effort that the worker puts in is not observable by the firm
- So, it has two options
 - it can motivate workers by providing a wage higher than the market clearing wage
 - it can monitor the effort of the worker and threaten to fire those whose effort is unacceptably low.
- The higher the current rate of unemployment, and the higher the wage paid over the market wage, the more effective will be the threat of dismissal

The NSC curve shows the minimum wage required for workers not to shirk



No shirking constraint

- Effort depends upon wages and unemployment

$$e = f(w, u)$$

where: $(\partial e / \partial w) > 0$ $(\partial e / \partial u) > 0$

- No shirking occurs when $e = e^{\max}$

$$e^{\max} = f(w, u)$$

- NSC is the w, u combinations that yield e^{\max}

Wage-Unemployment combinations for no shirking

- To get no shirking at w^* , requires a high level of employment
- To ensure no shirking at w^* , employers will only use L_A amount of labour creating unemployment of $L^* - L_A$

$$e^{\max} = f(w^*, L^* - L_A)$$

- As the wage rises above w^* , smaller amounts of unemployment are needed to ensure $e = e^{\max}$

Equilibrium

- At w^E , the amount of labour needed to ensure no shirking = amount of labour demanded
- Unemployment is $L^* - L_E$
- So, $e^{\max} = f(w^E, L^* - L_E)$