CHAPTER 8 - COMPENSATING WAGE DIFFERENTIALS AND LABOR MARKETS

Chapter 8 introduces students to the concept of compensating wage differentials. Following the practice in earlier chapters, it seeks to move students from concepts they are familiar with to new concepts and tools. Again, the analysis begins with a *verbal* exposition of occupational choice and the wage outcomes that flow from this choice when jobs differ along nonpecuniary dimensions. Once the essential assumptions and predictions of economic theory in this context are explained, we introduce students to a graphic analysis that is intended to yield additional insights. The graphic analysis of the issue of occupational choice is also intended to provide students with a tool for analyzing the effects of government policies on the labor market.

We first apply the concepts of hedonic theory to a "bad" job injuries. Policy implications are related to occupational safety and health legislation. We then apply the theory to an analysis of how elements in the employment "package" on which employees place a *positive* value affect the wage rate. The application in this section of the chapter relates to the regulation of employee benefits, particularly pensions.

For those who wish to enrich the coverage in Chapter 8, we have added an appendix that analyzes worker choice of jobs that have different probabilities of layoff. This appendix offers another application of the theory of compensating wage differentials to an interesting policy problem, and in so doing elucidates certain issues not commonly understood. The analysis also introduces the student to the notions of "risk aversion" and the willingness to pay for insurance ("certainty").

List of Major Concepts

1. In the context of full information and choice, worker behavior will generate compensating wage differentials for job characteristics that are unpleasant or costly.

2. Compensating differentials play a dual role in allocating labor to unpleasant jobs and in compensating those who accept unpleasant work.

3. The prediction that there will exist compensating wage differentials for unpleasant work rests on assumptions of utility maximization, worker information, and worker mobility.

4. Employee preferences are graphically expressed in the concavity and slope of indifference curves.

5. Employers with different costs of eliminating unpleasant job characteristics can be graphically represented.

6. A market equilibrium curve (or offer curve) is derived from the zero-profit isoprofit curves of the employers in the market.

7. If the market is working properly, employees who are least averse to an unpleasant job characteristic become employed with firms that find it most expensive to eliminate that characteristic.

8. The theory of compensating differentials can only be tested using techniques that control for other influences on job characteristics.

9. Government attempts to regulate the outcome of labor market decisions that are made in a perfectly functioning market could lead to a reduction of utility for the workers the government is intending to help.

10. Government intervention into the labor market can increase worker utility if the market is not functioning perfectly (that is, if not all costs or benefits of the decision are borne by those making them).

11. The mix of wages and benefits in the compensation package depends on both *employee* preferences and the trade-offs *employers* are willing to make.

12. (Appendix) Some job characteristics normally considered bad may be considered good by some workers (layoffs may be preferred if they are known in advance).

13. (Appendix) There are two issues relating to the undesirable characteristics of layoffs: the degree to which yearly layoffs (known in advance) *constrain* a worker's hours of work to lie below those otherwise desired, and the degree to which layoffs cause the worker's income each year to fluctuate.

14. (Appendix) The concept of risk aversion is related to the hypothesis that the expected utility of a level of income ($X) received with *certainty is* greater than the expected utility of a stream of income that may fluctuate over time but yield an expected yearly value of $X.