Lecture 1: Wages Theories (part 1)

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For Students of 1 Master, HRM

Course: Wages and incentives systems

Learning Objectives

- To further understand the concept of wages
- To understand different Theories of wages
- To know the relation between Labor and Wages

Basic concepts

Wages Definition

- Wages in the widest sense mean any economic compensation paid by the employer under some contrast to his workers for the services rendered by them.
- in the narrower Sense wages are the price paid for the services of labor in the process of production and include only the performance wages or wages proper. They are composed of two parts - the basic wage and other allowances.

Basic wage

- The basic wage is the remuneration, by way of basic salary and allowances, which is paid or payable to an employee in terms of his contract of employment for the work done by him.

Allowances

- Allowances are paid in addition to the basic wage to maintain the value of basic wages over a period of time. Such allowances include holiday pay, overtime pay, bonus and social security benefits. These are usually not included in the definition of wages.

The Natural Wage

- The classical economics generally used the term "natural wage" to indicate an amount of money. But the objective of theory wages is to determine the 'natural' level of real wage, to which a certain money wage must correspond once the prices of goods consumed by the workers are determined.

The Demand for Labor

- The ‘demand for labor' in the classical authors meant a single quantity (the number of working hours or workers required by capitalist entrepreneurs).

The Supply of labor

- In current economic language the supply of labor (or labor force, in statistical surveys) is the number of workers (or hours of work) offered at the current wage. Statistically, that number comprises employed people plus those who are out of employment but actively seeking work.
- For the classical economists, on the other hand, the labor supply is identified with the population belonging to those social classes which can get the income they need to live only by selling their labor.

Unemployment

- The unemployed, as currently defined, are people out of work and actively seeking it.
- The classical economists was often indicated by other terms such as 'idle'. They included :

- people actually seeking jobs
- underemployed laborers wanting to work more days or hours,
- those who had become vagrants, beggars or criminals.
- They also included sections of the population such as women or children, who might or might not be actively seeking jobs but who would readily offer their services whenever the opportunity arose.

Traditional Theories of Wage:

Theories of Wages

1. Adam Smith's Contributions

- The Scottish economist and philosopher Adam Smith, in *The Wealth of Nations* (1776), failed to propose a definitive theory of wages, but he anticipated several theories that were developed by others.
- Smith thought that wages were determined in the marketplace through the law of supply and demand. But he gave no precise analysis of the supply and demand for labor.
- Workers and employers would naturally follow their own self-interest.

Adam Smith's Contributions

- He did, however, prefigure important developments in modern theory by arguing that the quality of worker skill was the central determinant of economic progress.
- Moreover, he noted that workers would need to be compensated by increased wages if they were to bear the cost of acquiring new skills—an assumption that still applies in contemporary human-capital theory.

Adam Smith's Contributions

- Smith also believed that in the case of an advancing nation, the wage level would have to be higher than the subsistence level in order to spur population growth, because more people would be needed to fill the extra jobs created by the expanding economy.

2. The Subsistence Theory of Wages

- The subsistence theory of wages was first formulated by **Physiocratic School of French economists** of 18th century. Further, this theory was developed and improved upon by the German economists**. Lasalle** styled it as the **Iron Law of Wages** or the **Brazen Law of Wages**. Ricardo and Malthus also contributed to the theory of wages. **Karl Marx** made it the basis of his theory of exploitation.

The Subsistence Theory Assumptions

According to Ricardo, this theory is based on the following two assumptions:

- **a. Population increases at a faster rate.**
- **b. Food production is subject to the law of diminishing returns.**

The Subsistence Theory Analysis

- According to this theory, wages of a worker in the long run are determined at that level of wages which is just sufficient to meet the necessaries of life. This level is called the subsistence level. The classical economists called it the neutral level of wages.

The Subsistence Theory Analysis

- Wages of labor are equal to subsistence level in the long ran. If wages fall below this level, workers would starve. It will reduce their supply. Thus, the wage rate will rise to the subsistence level. On the other hand, if wages tend to rise above the subsistence level, workers would be encouraged to bear more children which will increase the supply of workers, which in turn will bring wages down to the subsistence level.
- **It can be shown with the help of the following figure:**

In Fig. 1 demand and supply of labor has been measured on OX-axis and wage rate on OY-axis. OW is the subsistence level of wages. At OW wage rate supply of labor is perfectly elastic. Since, supply of labor is perfectly elastic, wage rate neither can fall below OW nor can increase above the level of OW. Although demand increases from DD to D1D1 yet the wage rate remains the same at OW.

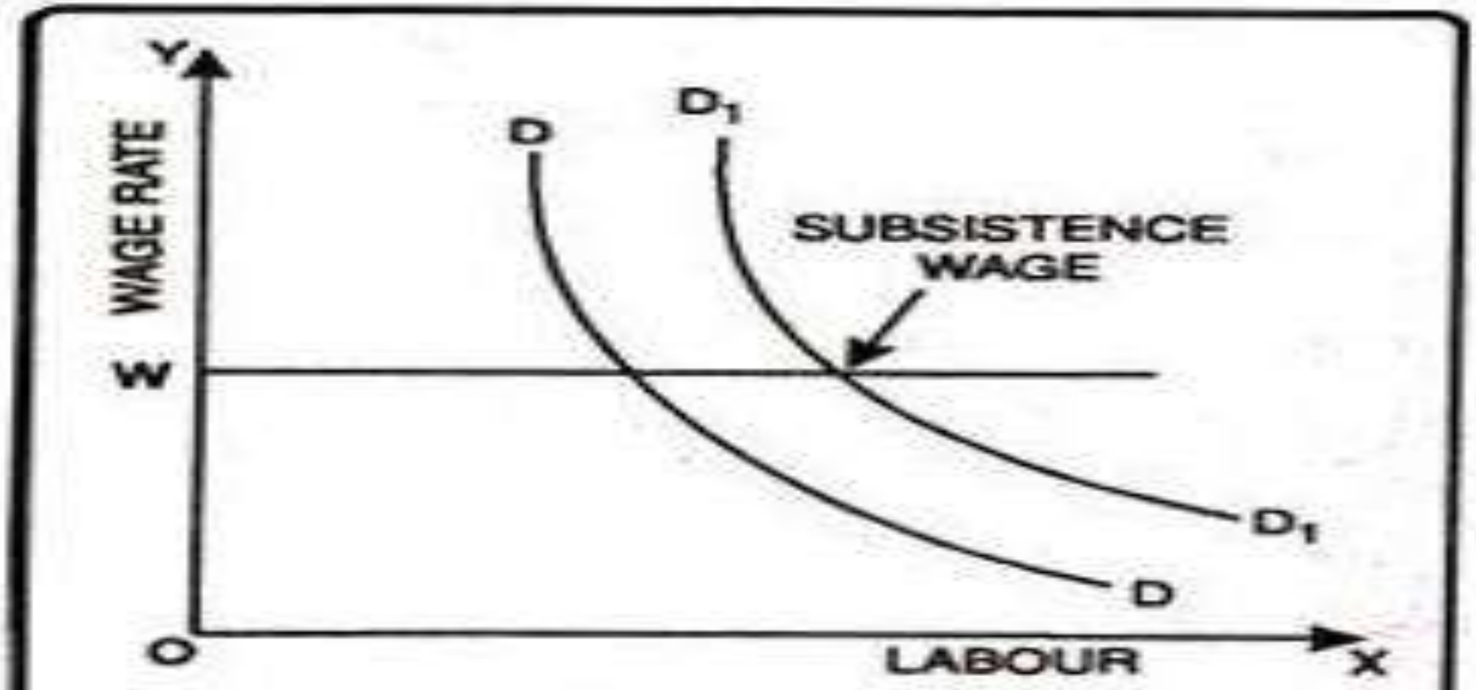

Fig. 1.

The Subsistence Theory Criticism

- **One Sided Theory:** This theory examines the wage determination from the side of supply and ignores the demand side.
- **Pessimistic:** Subsistence theory of wages is highly pessimistic for the working class. It presents a dark picture of the future of the society.
- **Long Period:** This theory is based on the assumption of long run. It does not explain the determination of wages at a particular period of time.
- **No Historical Evidence:** This theory has been criticized on the grounds that it has not been correct in conclusions. The case of western countries is different from the conclusions of this theory.
- **No Difference in Wages:** This theory explains that all the workers get equal wages. As we know, the workers differ in their productivity, and hence, the difference in their wages is natural.

3. Marginal Productivity Theory of Wages

- This theory was first of all propounded by Thunnen. Later on, economists like Wicksteed, Walras, J.B Clark etc. modified the theory.
- The marginal productivity theory states that labor is paid according to his contribution in production.
- Marginal productivity of labor refers to change in total revenue by putting one more laborers, keeping all the other factors constant.
- Dooley "As a result of competition between employees for labor and between workers for employment, a wage-rate is determined that is equal to the marginal productivity of the labor-force, the employers as a whole are willing to employ.

Marginal Productivity Theory Assumptions

- 1. All laborers are equally efficient.
- 2. Constant technology
- 3. Perfect competition prevails both in factor and product markets.
- 4. There is full employment in the economy.
- 5. Law of diminishing marginal returns apply on the marginal productivity of labor.
- 6. Labor is perfectly mobile.

Marginal Productivity Theory Analysis

- Under the conditions of perfect competition, wages are determined by the value of marginal product of labor.
- Value of marginal product of labor is the price which the marginal product can fetch in the market.
- Under the conditions of perfect competition, an employer will go on employing more laborers but, due to the operation of the law of diminishing returns, the marginal product of labor will diminish until a point comes when the value of the increase in the product will be equal to the wages paid to that laborer.

Marginal Productivity Theory Criticism

- **1. Unrealistic Assumptions:** The foremost defect of the theory is that it is based on unrealistic assumptions like perfect competition, homogeneous character of labor etc. All these assumptions do not prevail in the real world.
- **2. Incomplete:** Again, this theory fails to take into account that labor is also a function of wages. Less productivity may be the effect of low wages which adversely affects the efficiency of labor and in turn reduces the labor productivity. Thus, the theory is incomplete in all respects.
- **3. Static Theory:** Lord J.M Keynes criticized the theory as it is based on static conditions. It is only true when there occurs no changes in the economy. But in real practice it cannot be so. Change is the law of nature, though it may come gradually.

Marginal Productivity Theory Criticism

- **4. One Sided:** It takes into consideration only the demand side and ignores the supply side.
- **5. Fails to determine Wages:** This theory only guides the employer to employ workers up to the level where their marginal productivity equals price. But, it does not tell how the wages are determined.
- **6. Long Period:** The theory concerns itself with the long run. It explains that wages will be equal to MRP in the long run but, the long run like tomorrow never comes. In other words, it does not deal with the short-run.

4. Wage Fund Theory

- Introduced by John Stuart Mill (1891), this theory assumes that there is a fixed wages fund (Lump Sum) which is distributed equally among all the laborers. In other words:

Wage level per worker = Wage Fund (a fixed sum in the short-run)/ No. of Laborers

- Thus, if the fund is large, wages would be high, if it is small wages would be reduced to the subsistence level.

Wage Fund Theory

- J.S. Mill said that wages mainly depend upon the demand and supply of labor or the proportion between population and capital available. The amount of Wages Fund is fixed.
- It is the wages fund which determines the demand for labor.

Wage Fund Theory Advantages

- ➢➢ It puts more emphasis on demand of labor (wages fund) compared to the supply of labor
- ➢➢ It attempts to study wage level in the short-term. It tried to take into account long run too by suggesting wage fund might grow or shrink in the long run but that was not the focal point of the theory.
- ➢➢ The theory generalizes about the general level of wages for an entire economic system, however it can be applied to an employer.
- ➢➢ Just like subsistence theory, this theory also attempts to answer the question of wage level and not of wage structure and differentials.
- ➢➢ In the short run, many organizations, particularly those in the public sector, do allocate a fixed run for payment of wages. However, critics argue that the assumption of a fixed sun itself is wrong as the sum can be increased. Even J.S.Mill also accepted this criticism.

Wage Fund Theory Criticism

- ➢➢ It is not clear from where the wages fund will come
- ➢➢ No emphasis has been given to the efficiency of workers and productive capacity of firms
- ➢➢ This theory is unscientific as wages fund is created first and wages are determined later on. But, in practice, the reverse is true.
- ➢➢ This theory does not explain differences in wages at different levels and in different regions

5. Residual Claimant Theory

- This theory was propounded by Walker. According to this theory, rent and interest are contractual payments. After deducting rent and interest from total product, the employer will deduct his profits. **What remains after deducting rent, interest and profits is wages.** It is possible to increase wages by increasing the total product by improving the efficiency of the workers.

Residual Claimant Theory Criticism

- 1. This theory assumes that the share of landlords, capitalists and entrepreneurs are fixed and it is absolutely wrong.
- 2. It is not the worker who is the residual claimant but the entrepreneur.
- 3. It does not explain the influence of trade union in wage determination.
- 4. The supply side of labor has been totally ignored by the theory.

6. Marxian surplus-value theory

- This theory owes its development to Karl Marx (1818-1883).
- In Marx's estimation, it was not the pressure of population that drove wages to the subsistence level but rather the existence of large numbers of unemployed workers.

Marxian surplus-value theory

- Marx blamed unemployment on capitalists. He renewed Ricardo's belief that the exchange value of any product was determined by the hours of labor necessary to create it.
- Furthermore, Marx held that, in capitalism, labor was merely a commodity: in exchange for work, a laborer would receive a subsistence wage. Marx speculated, however, that the owner of capital could force the worker to spend more time on the job than was necessary for earning this subsistence income, and the excess product—or surplus value—thus created would be claimed by the owner.

Marxian surplus-value theory

- This argument was eventually disproved, and the labor theory of value and the subsistence theory of wages were also found to be invalid. Without them, the surplus-value theory collapsed.

7. Supply and Demand Theory of Wages

- Logically robust and the least refuted, this theory, postulates that if there are few jobs and the supply of workers is high, wages will fall, conversely, if there are lots of jobs and a shortage of workers, wages will rise. In the long run wages will be leveled at a point where demand and supply is equated.

Supply and Demand Theory Assumptions

- a. Employers driven by profits seek to maximize utility or satisfaction.
- b. Both employers and workers have perfect information about job opportunities and wages in the market.
- c. The skills and performance potentials of all workers are identical, and the jobs offered in the market are identical in terms of working conditions and non-wage attributes.
- d. In the labor market, there are infinite employers on the demand side and infinite number of workers on the supply side. These large numbers of workers and employers result in negligible influence of either in the marketplace.
- e. There are no institutional barriers preventing the mobility of workers from one job to another.

Supply and Demand Theory Criticism

- The market forces in the real world do not determine a unique wage rate for each type of job but establish a range with an upper limit and a lower limit.
- The employer has some discretion within this range. The employers or the firm cannot pay more than the upper limit as the profits will be drastically reduced. Paying wage below the lower limit will not attract workers at all. An area of indeterminacy is established between the lower limit and the upper limit within which the firm can formulate its own wage policy.

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Thank you for your attention