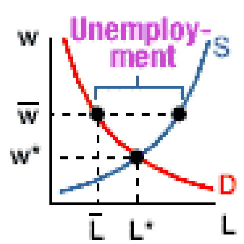
Theory of Efficiency Wages

Key Concepts

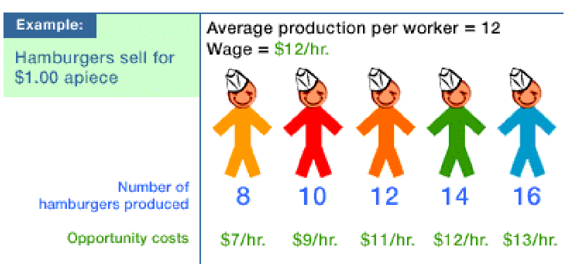
- The **efficiency wage** is the wage above equilibrium that firms voluntarily pay to increase productivity and profits.
- The actions of government, **labor unions**, or firms can also cause wages to rise above labor market equilibrium.
- The efficiency wage influences the quality of labor by motivating workers, increasing worker morale and productivity, attracting skilled workers, and reducing employee turnover.

The efficiency wage



By paying an **efficiency wage**, firms can keep the most productive workers and increase their profits. When a firm pays above the equilibrium wage, however, more people will apply for jobs and create unemployment, as seen in the graph on the left.

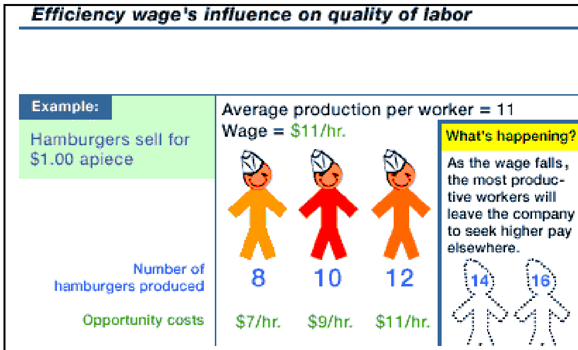
Efficiency wage's influence on quality of labor



Consider the example on the left. Each worker has a different level of productivity, but the employer is unable to discern directly the most productive from the least.

If this firm is producing an average of 12 hamburgers that sell for $1 each, its total revenue is $12. To break even, this firm can afford to pay a wage of only $12/hour.

The most productive worker's **opportunity cost** is $13/hour, so he decides to seek higher-paying employment elsewhere.

<table>
<tr>
<td>
</td>
<td>When the most-productive worker leaves the firm, the average production falls to 11 hamburgers. To break even, the firm now can afford a wage of only $11/hour. As a result, the second most-productive worker leaves to seek other employment.</td>
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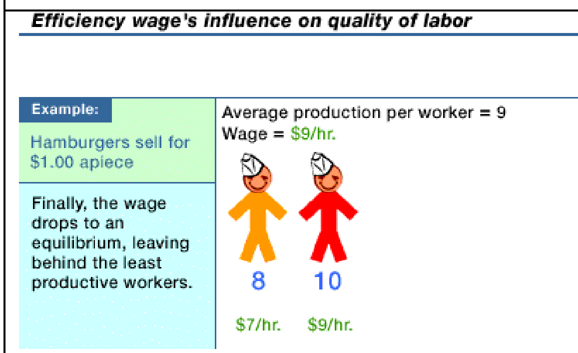
<td>
</td>
<td>The wage continues to drop to an equilibrium level of an average of 9 hamburgers and a wage of $9/hour. At this wage, the remaining employees choose to stay at this firm.

Notice, however, that these are the two least-productive workers and the firm's total revenue has dropped from $12 to $9.

This firm might have found it profitable to pay an efficiency wage. By paying a wage above equilibrium, a firm can influence the quantity as well as the quality of labor.</td>
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<tr>
<td colspan="2">Higher wages boost employee morale and increase worker productivity. Firms that pay an efficiency wage attract skilled workers and reduce employee turnover. The influence of the efficiency wage can affect the quality of labor a firm employs.</td>
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