Quadrant II- Transcript

Paper code- ECO0115

Module name – theories of wage determination

Module No. – 53

Old theories of wage determination

1. The subsistence theory of wages

- This theory, also known as 'Iron Law of Wages," was propounded by David Ricardo
- According to this theory, the wages that are paid to workers must be just enough to cover his bare needs of subsistence. If the workers are paid less than the subsistence wage, there will be starvation and death and it will result in shortage of supply of labour.
- The theory was based on the assumption that if the workers were paid more than subsistence wage, their numbers would increase as they would procreate more; and this would bring down the rate of wages.
- In economics, the subsistence theory of wages states that wages in the long run will tend to the minimum value needed to keep workers alive.
- The justification for the theory is that when wages are higher, more workers will be produced, and when wages are lower, some workers will die, in each case bringing supply back to a subsistence-level equilibrium

2. The standard of living theory

- According to this theory the wage rate should be determined on the basis of standard of living of workers.
- The wages change according to change in the standard of living of workers.
- The wage rate should be determined on the basis of the minimum needs of workers including the necessaries, comforts and luxuries of life to whom workers have accustomed.
- The wage rate should be suffice to maintain a given standard of living of a worker to which he is accustomed.
- If the wage rate is higher than the standard of living of workers there will be more marriages, more children and the supply of labour will increase and thereby the wage rate will be brought down to the standard of living

- if the wage rate is less than the standard of living there will be less marriages, less children and the supply of labour will be reduced thereby the wage rate will increase to the standard of living of workers.

3.The wage fund theory

- The theory was developed and propounded by Professor J.S. Mill.
- According to this theory wage rate is determined by the ratio of wage fund and the population. The population means the number of workers employed. An entrepreneur keeps a part of his capital for the payment to worker which is called wage fund and this fund is fixed.
- Wage fund being fixed the wage rate depends upon the number of workers.
- More the workers low will be the wage rate and less the number of workers high will be the wage rate. Thus, there is inverse relationship between the wage rate and number of workers.
- 4. Residual Claimant Theory of Wages:
- The theory was propounded by an American economist F.A. Walker.
- According to Professor Walker the total production of an industry is distributed among land, labour, capital and entrepreneur in the form of rent, wages, interest and profit.
- When the rent, interest and profit are distributed among landlord, capitalist and entrepreneur, the remaining share goes to labour which is residual claimant.
- Thus, after the payment of rent, interest and profit from output whatever the residual share is wages

<u>Recent theories of wages</u>

1. The marginal productivity theory of wages

- This theory explains how wages are determined under conditions of perfect competition. According to the marginal productivity theory, wages will be equal to the value of the marginal product of the labour.
- As an employer goes on employing more and more units of labour, it’s marginal product will fall because of the law of diminishing marginal returns.
- So he will employ labour up to point where the wages he pays are equal to the value of the marginal product of labour. All units are assumed to be uniform.
- So the productivity of the marginal unit of labour determines the rate at which wages are to be paid to all units of labour

2. The market theory of wages

The market theory looks at wages as the price of labour. Like all other prices wages are determined by the market forces of supply and demand.

- The supply of labour generally refers to the total number of people available for work.
- Classical economists argue that wages—the price of labor—are determined (like all prices) by supply and demand. They call this the market theory of wage determination. When workers sell their labor, the price they can charge is influenced by several factors on the supply side and several factors on the demand side. The most basic of these is the number of workers available (supply) and the number of workers needed (demand).
- If employers (demand) cannot find enough workers to meet their needs, they will keep raising their wage offers until more workers are attracted. If workers are in abundance (supply), wages will fall until the surplus labor decides to go elsewhere in search of jobs. When supply and demand meet, the equilibrium wage rate is established

3. The demand for labour

- Demand for labour is derived demand. Modern production is carried on largely on the basis of anticipation of demand for goods.
- During good trade demand for labour will be more.
- If capital is cheap, the employer will try to substitute capital for labour. When there is increase in investment, there will be increase in demand for labour.
- There is geographical immobility of labour. There may be shortage in the supply of certain categories of labour (e.g. doctors, engineers). In some industries, the supply of labour is controlled by trade unions.

4. The bargaining theory of wages

- The bargaining theory of wages takes note of the influence of trade unions on wages through collective bargaining.
- According to this theory, the level of wages in an industry depends on the bargaining strength of the trade union concerned.
- The strength of trade unions depends upon many things like the size of its membership, the size of its fighting fund and it’s ability to cause dislocation in the industry and the economy through strike.
- During periods of full employment and good trade, trade unions will be in a strong position and during depression marked by bad trade and mass unemployment; trade unions will be in weak position.