Problem set 4

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Question 1

Consider the problem of a firm in the efficiency wages model. Let's define the effective units of labour $E = e(w)L$. The firm produces using production function $Y = F(E)$.

(i) what are the *choice variables* of the firm in the efficiency wage model? What that implies about the nature of the labour market or the nature of the jobs on offer?

(ii) Derive and interpret the optimality condition of the firm's hiring decision.

(iii) Consider effect on a earthquake which destroys big part of the national stock of capital. What would be response in the labour market? Contrast the effects in Solow model and in Efficiency wages model

(iv) Can you think of some other effects which might affect the effort function either up or down? What will be the effect on unemployment and wages?

Question 2

Suppose that you are suppose to advise the government on how to tackle the unemployment problem. The list of possible policies is following:

- increase number of job centres,

- increase funding to re-training programmes,

- reduce minimum wage,

- increase unemployment benefits.

Discuss what is the effect of each policy on *different types* of unemployment. Try to relate your answers to the models covered in the lectures.