CLASSICAL, NEO-CLASSICAL AND BARGAINING THEORIES OF WAGE DETERMINATION

Some of the most important theories of wages are as follows: 1. Wages Fund Theory 2. Subsistence Theory 3. The Surplus Value Theory of Wages 4. Residual Claimant Theory

1. Wages Fund Theory:

This theory was developed by Adam Smith (1723-1790). His theory was based on the basic assumption that workers are paid wages out of a pre-determined fund of wealth. This fund, he called, wages fund created as a result of savings. According to Adam Smith, the demand for labour and rate of wages depend on the size of the wages fund. Accordingly, if the wages fund is large, wages would be high and vice versa.

2. Subsistence Theory:

This theory was propounded by David Recardo (1772-1823). According to this theory, "The labourers are paid to enable them to subsist and perpetuate the race without increase or diminution". This payment is also called as 'subsistence wages'. The basic assumption of this theory is that if workers are paid wages more than subsistence level, workers' number will increase and, as a result wages will come down to the subsistence level.

On the contrary, if workers are paid less than subsistence wages, the number of workers will decrease as a result of starvation death; malnutrition, disease etc. and many would not marry. Then, wage rates would again go up to subsistence level. Since wage rate tends to be at, subsistence level at all cases, that is why this theory is also known as 'Iron Law of Wages'. The subsistence wages refers to minimum wages.

3. The Surplus Value Theory of Wages:

This theory was developed by Karl Marx (1849-1883). This theory is based on the basic assumption that like other article, labour is also an article which could be purchased on payment of its price i e wages. This payment, according to Karl Marx, is at subsistence level which is less than in proportion to time labour takes to produce

items. The surplus, according to him, goes to the owner. Karl Marx is well known for his advocation in the favour of labour.

4. Residual Claimant Theory:

This theory owes its development to Francis A. Walker (1840-1897). According to Walker, there are four factors of production or business activity, viz., land, labour, capital, and entrepreneurship. He views that once all other three factors are rewarded what remains left is paid as wages to workers. Thus, according to this theory, worker is the residual claimant.

5. Taussig's Theory of Wages:

Taussig, an American economist, modified the marginal productivity theory. According to him, the marginal output generated by a worker is not completely provided to him in terms of wages. This is because the manufacturing of a product takes time and labor needs wages during the manufacturing process.

In such a case, the employer pays wages to labor from his/her own capital. Therefore, the employer does not provide the actual amount of marginal product to the labor. The employer deducts a certain percentage from the total output to compensate the amount that he/she pays to the labor during the production process. The amount is reduced from the total output at the prevailing rate of interest.

Therefore, wages can be calculated as follows:

Wages = Total product of labor deducted amount (to compensate)

Since most of the classical theories are faulty and not suitable for determining the wage level. Therefore, several modern economists together worked and gave a theory for determining the level of wages. This theory is known as modern theory of wages.

Marginal Productivity Theory of Wage Determination

The marginal productivity theory of wage states that the price of labour, i.e., wage rate, is determined according to the marginal product of labour. This was stated by the neo-classical economists, especially J. B. Clark, in the late 1890s.

The term marginal product of labour is interpreted here in three ways: marginal physical product of labour (symbolized by MPP_L), value of the marginal product of labour (symbolized by VMP_L) and marginal revenue product of labour (symbolized by MRP_L). When marginal product of labour is expressed in money terms we obtain VMP_L. MRP_L is the change in total revenue following a change in the employment of labour. Marginal productivity theory of wage states that wage of labour equals VMP_L (= MRP_L). Employer will employ labour up to the point until market wage equals labour's value of the marginal product (VMP) and marginal revenue product (MRP).

The important assumptions of this theory are:

i. Perfect competition prevails in products market and in labour market. Perfect competition in product market implies that products are homogeneous and the price of the goods is given for all firms in the market. Perfect competition in labour market also implies that labour as well as firms behave as **'wage-takers'**; no one can influence the wage rate.

Consequently, labour supply curve, S_L, becomes perfectly elastic. Since wage rate does not change, labour supply curve incidentally, becomes the average cost curve of labour (AC_L) and it coincides with the marginal cost curve of labour (MC_L).

ii. Law of variable proportions operates.

iii. The firm aims at profit-maximization.

iv. All labourers are homogeneous and are divisible.

v. Labour is mobile and is substitutable to capital and other inputs.

vi. Resources are fully employed.

Wage rate will be determined by the interaction of demand and supply curves of labour in the market. Labour demand curve is explained by the VMP_L curve. Since perfect competition exists in the product market, VMP_L curve coincides with the MRP_L curve. $VMP_L = MRP_L$ curve is the firm's demand curve for labour.

This curve slopes downward because of diminishing marginal returns. In Fig. 6.11, $VMP_L = MRP_L = D_L$ represents the firm's demand curve for labour.

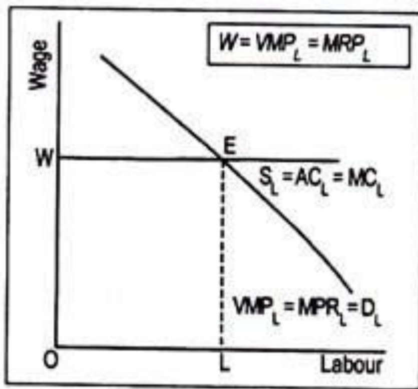

Fig. 6.11: MP Theory of Wage Determination

Further, as perfect competition exists in the labour market, the labour supply, $S_L = AC_L = MC_L$, curve has been drawn perfectly elastic.

In Fig. 6.11, E is the equilibrium point since at this point labour demand equals labour supply. The equilibrium wage rate thus determined is OW. Corresponding to this wage rate, equilibrium level of employment is OL.

Note that for OL amount of labour, $VMP_L = MRP_L$ is LE, which equals wage rate OW. At this going wage rate (i.e., OW) the employer will be maximizing profit by employing OL units of labour. However, less (more) labour will be employed if market wage rate rises above (falls below) OW.

Limitations of Marginal Productivity Theory of Wage:

This neo-classical theory of wage determination is subject to a large number of criticisms. Most of the criticisms of this theory are directed against the assumptions. Most of the assumptions are unrealistic.

i. In the real world, perfect competition does not exist—both in the product market and in the labour market. Imperfect competition is found in all the markets. This theory, therefore, has limited applicability in the real world. If it is applied to the imperfectly competitive market, the workers will be subject to exploitation.

ii. Labour can never be homogeneous— some may be skilled and some may be unskilled. Wage rate of a worker is greatly influenced by the quality of labour. A higher wage rate is enjoyed by the skilled labour compared to the unskilled labour. This simple logic has been totally ignored by the authors of this theory.

iii. Perfect mobility of labour is another unrealistic assumption. Mobility of labour may be restricted due to socio-political reasons.

iv. The marginal productivity theory of wage ignores the supply side of labour and concentrates only on the demand for labour. It is said that labour is demanded because labour is productive. But why labour is supplied cannot be answered in terms of this theory.

This is because of the fact that, at a given wage rate, any amount of labour is supplied. But we know that higher the wage rate, higher is the supply of labour. This positive wage-labour supply relationship has been ignored by the makers of this theory.

v. Full employment of resources is another unrealistic assumption.

vi. This theory, in fact, is not a wage theory but a theory of employment. Wage rate is predetermined. At the given wage rate OW, how many units of labour are supplied can be known from this theory. In this sense, it is a theory of employment and not a theory of wages.

vii. Finally, this theory ignores the usefulness of trade union in wage determination. Trade union, through its collective bargaining power, also influences wage rate in favour of the members of the organization.

bargaining theory of wages

The bargaining theory of wages holds that wages, hours, and working conditions are determined by the relative bargaining strength of the parties to the agreement. Smith hinted at such a theory when he noted that employers had greater bargaining strength than employees. Employers were in a better position to unify their opposition to employee demands, and employers were also able to withstand the loss of income for a longer period than could the employees. This idea was developed to a considerable extent by John Davidson, who proposed in *The Bargain Theory of Wages* (1898) that the determination of wages is an extremely complicated process involving numerous influences that interact to establish the relative bargaining strength of the parties. This theory argues that no one factor or single combination of factors determines wages and that no one rate of pay necessarily prevails. Instead, there is a range of rates, any of which may exist simultaneously. The upper limit of the range represents the rate beyond which the employer refuses to hire certain workers. This rate can be influenced by many factors, including the productivity of the workers, the competitive situation, the size of the investment, and the employer's estimate of future business conditions. The lower limit of the range defines the rate below which the workers will not offer their services to the employer. Influences on this rate include minimum wage legislation, the workers' standard of living, their appraisal of the employment situation, and their knowledge of rates paid to others. Neither the upper nor the lower limit is fixed, and either may move upward or downward. The rate or rates within the range are determined by relative bargaining power.

The bargaining theory is very attractive to labour organizations, for, contrary to the subsistence and wages-fund theories, it provides a very cogent reason for the existence of unions: simply put, the bargaining strength of a union is much greater than that of individuals. It should be observed, however, that historically labourers were capable of improving their situations without the help of labour organizations. This indicates that factors other than the relative bargaining strength of the parties must have been at work. Although the bargaining theory can explain wage rates in short-run situations (such as the existence of certain wage differentials), over the long run it has failed to explain the changes that are observed in the average levels of wages.