

## Compensating Differentials

Clone Economy:

Identical abilities and preferences. Wages must equalize nonpecuniary differences in jobs. No envy; in fact everyone is indifferent over all jobs, given the equalizing differences in wages.

This economy will still need farmers, veterinarians, carpenters, gravediggers, engineers, dentists, secretaries, factory workers, bus drivers, air traffic controllers, teachers, coal miners, computer programmers, firefighters, garbageworkers, etc. They will all be identical, but they must be paid different wages.

There should be no inter-industry differential, but there will be geographic differences.

If abilities are identical but preferences differ, then there will still be no envy, but now the typical situation will be that each worker strictly prefers his job over all others, given the pattern of wages. That is, there are equalizing differences at the margin, but infra-marginal workers collect a surplus. If you particularly enjoy working as a veterinarian then you would be willing to work in this job for much less than you get paid in equilibrium, but if wages were reduced others would leave (or not enter) the occupation, and there would be excess demand.

This is an equilibrium where A hires B to do his dirty work, but from B's point of view, A is doing the dirty work. For example, one might be a veterinarian, while the other is a farmer. Or one might be a dentist, while the other is a lawyer.

Think of the difficulty of planning these decisions from a central office: millions of people to be allocated to jobs every year.

If innate abilities are identical, but some occupations require training, then the present value of net lifetime wages will equalize differences in jobs.

If preferences are identical but abilities differ, there will be rents where abilities are scarce. Look at the equilibrium where there is no constraint on ability, and ask whether there are enough qualified people to allow this equilibrium. If not, there will be rents. If the ability is not scarce in equilibrium, it will not command a rent. Not many people can play basketball well enough to make their high-school team, but even those who do make the team are not scarce enough to get rents, with a few exceptions. There are many good actors and comedians, but few are good enough.

If one comedian is very funny, and two other comedians are just funny, you would probably much

prefer to watch the best one, rather than the other two. In other words there is no good substitute for the best performer. This is why superstars get huge rents.

55000 workers. Demand curves in both WI and AK given by  $w = 40 - L$ , where  $L$  is measured in 000. First suppose eq. diff is \$5 for everyone, then suppose that it varies uniformly between 0 and \$11. In both cases the equilibrium sends 25000 to AK, with 30000 in WI.

### **Implications:**

Diversity is beneficial. Given a choice between a clone economy and an economy with diverse preferences, pick the diverse economy, because others will pay more for what you like to do, and you will pay less for what you don't like to do. For example, clone the person with a \$3 differential. The equilibrium would be  $w_1 = 14, w_2 = 11$ . In the diverse economy, this person is working in market 1, at a wage of 15. Similarly, if the \$9 person is cloned, the equilibrium will be  $w_1 = 17, w_2 = 8$ . In the diverse economy this person works in market 2 at  $w_2 = 10$ . People further from the margin gain more.