Reservation Wage in Labor Economics

Name

Institution

Author Note

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Labor economics has a concept of reservation wage that defines the ability, willingness and readiness of an individual to take or reject an employment opportunity (Caliendo, Lee, & Mahlstedt, 2017). As demonstrated by founding fathers of economics, it refers to the lowest wage an individual in search of an employment opportunity is willing to accept. Reservation wage plays a significant role in the theory of labor market. It helps in the definition and description of the theoretical models that include job search, supply of labor and labor market participation. Even though reservation wage is significant for the labor market theory, there is a research gap on the relation between an individual and ultimate reservation wages.

Reservation wage is the wage rate that influences an individual to enter the labor force. It refers to the highest wage considering which an individual makes a decision not to work or the lowest wage that entices a person to work. Reservation wage is affected by the following factors: unemployment insurance, welfare/income maintenance benefits, income of spouses, non-labor income, cost of movement and other costs (Caliendo et al., 2017).

In order to understand the reservation wage in relation to labor, economics considers expected salaries, future employment and wages. There exists a relation between the current reservation wage of an individual and expected market wages. Also, upcoming jobs and salaries are linked to the reservation wage in the market.

Often, in labor market, a decision by a job seeker to search for an opportunity has an impact on the reservation wage. Job search leads to a lower reservation wage than the expected salary. Most economists consider reservation wage as a significant factor that models critical aspects of the labor market. It typically influences the theory of optimal job search by shaping the job search behavior and trends. Also, it defines a concept for labor supply decisions modeling by controlling one's transition from the unemployed category of the population to the employed one.

The duration of unemployment correlates with the reservation wage. Two macroeconomic theories state that a more extended period of unemployment is caused by a higher reservation wage. An individual with low reservation wage tends to secure their employment opportunity early as opposed to the job seekers with high reservation wage. It, therefore, models the ability of job seekers to acquire job opportunities. Approaches such as calculation of the elasticity of the reservation wage about the rate of job offers arrival and instrumental variables (IV) have helped to explore the relationship between the duration of unemployment and the reservation wages. The above-mentioned method is applicable to the econometric analysis to determine the unemployment duration among job seekers.

Expected wage as a component of the econometric analysis plays a role in the labor market as well. It affects the reservation wage by influencing the relationship between it and the duration of unemployment.

Impact of the Increase in Non-Labor Income on Reservation Wage

The rising non-labor income has an increasing impact on the reservation wage. Considering the theories of job search, an increase in income not associated with labor reduces the urge to search for employment opportunity, thus motivating a job-seeker to have a reservation wage higher than the normal wage.

An increase in income comes with a substitution effect that influences the numbers of hours an individual is willing to spend working. Therefore, instead of looking for an employment opportunity, a person allocates more time for leisure (Koenig, Manning, & Petrongolo, 2016).

Duration of Search

The reservation wage and unemployment period have a correlated relationship. A higher reservation rate leads to an increased period of unemployment or job search (Constant, Krause, Rinne, & Zimmermann, 2017).

References

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