

Human Capital: The basic Theory

Ch 6



Introduction

- Human Capital theory is the basis for pay and turnover
- Training may improve productivity, but training is costly, and trained people may leave just after receiving training
 - ▶ remedy?: pay them more so that they don't leave, other ways of tying workers to the firm?
- Is it possible to structure rewards so that both workers and shareholders are better off
- What kind of training should be given?

Formal Schooling

- More educated earn more than less educated
- The theory of Human Capital developed by Gary Becker
- To stay in school or not?
 - ▶ Higher educated usually earn more than less educated, but over fewer years
 - ▶ the costs are direct cost and foregone earnings
 - ▶ example: Earnings with high school diploma: K
as dropout one year before: J
 - ▶ the investment criteria: the cost and forgone earnings should be less than the NPV of the income flow.
 - ▶ What does public subsidies do to the investment balance?
 - ▶ The role of the pay back period.
- The optimal investment rule
- The role of the interest rate and risk
- The role of opportunity costs

Formal Schooling (*continued*)

- The role of working life
 - ▶ Expected length of working life, T
 - gender differences
 - using the education for different purposes
- The Theory and the real world
 - ▶ Are people really conscious about the return to education
 - ▶ Overall return in Scandinavia:
- Non-pecuniary benefits of schooling

On-the-job training

- General on-the-job training
 - ▶ increases the productivity in this firm and in other similar firms as well
- Firm-specific on-the-job training
 - ▶ increases the productivity in the firm where the training is going on
- General training: Who pays and who benefits?
 - ▶ General training: suppose the firm makes the investment that raises productivity
 - _____
 - Who will pay for the training? _____
 - ▶ In practice, apprentices receive a lower wage,
 - ▶ In practice, trainees receive a lower wage while being trained, but receive a higher wage in subsequent periods.
- Specific training: Who pays and who benefits?
 - ▶ The value inside and outside the firm differs
 - ▶ Inside: the employer can pay up to the new productivity per hour
how to obtain that?
 - ▶ outside: the alternative wage
 - ▶ the more specific training the more attached to the firm
old and young workers

The choice between job-specific and general training

- two schemes:
- general training: increasing over the life time
 - ▶ wage profiles for investors versus noninvestor
 - ▶ investor has a lower starting point, but overtakes quickly the noninvestor
 - ▶ age-earnings profile is concave
 - ▶ when to stop investing?
 - ▶ gender differences?
 - ▶ workers are paid the value of their actual productivity - if not they will get an outside offer
 - ▶ The firm does not have to decide which workers to train and which not. Why?
- Examples
 - ▶ Young attorneys
 - ▶ Apprenticeships

The choice between job-specific and general training (*continued*)

- specific training:
- skills can only be used in this firm
 - ▶ 1. the firm offers to pay the investment, and expect to harvest, but
 - ▶ 2. the person might leave, leaving the cost to the firm of training a new person, therefore the firm will pay a little more than the wage outside
 - ▶ later, the value to the firm is higher than the wage.
 - ▶ Why does the worker not quit?
 - ▶ Why should the firm be interested in keeping the worker?
- usually paid more than productivity in the beginning, the firm is investing. "split-the-difference"
 - ▶ What is the best scheme?
- Workers with specific training get an attachment to the firm,
 - ▶ but less attached when young
 - ▶ more senior people have usually a large element of specific hc
 - ▶ Workers with more general training do not get a similar attachment

The choice between job-specific and general training (*continued*)

- The workers who plan to stay for long will choose the firm that offers most specific training, or is it that those who invest most will also stay longest?
- Whom to train? And who wants to obtain training?
- Conclusions:
 - ▶ Specific training: workers and firms share the costs and the benefits of training. Reduces turnover
 - ▶ Those most interested in investing in firm-specific training are those who plan to stay for a long period/or the best educated
 - ▶ Workers may not always have the best information about their departure probabilities and because the firm bears costs when a worker may leave, the firm may play an active role in selecting workers for firm-specific training

"last words" on human capital

- Legal issues around contracts
 - ▶ contracts that prohibit future employment by competitors
 - ▶ lay off protection
- Determining the difference between specific and general hc
 - ▶ the difference in return to experience and tenure tell us that the training is general?
 - high turnover rates tell us that HC is general, if it is low, then the wages are probably higher here than elsewhere, telling us that the HC content is more specific
 - hiring insiders versus outsiders: if most of the skills required are general, there is no loss employing from outside. (big banks)
 - If there is systematic higher productivity attached to workers who have been in the firm for long time there is more firm-specific capital