Compensating Wage Differentials

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A. The General Concept

Of the many ideas of Adam Smith that have stood the test of time, few have weathered better or are still more relevant than the idea of compensating wage differentials. This idea is set forth in Chapter X, Book I, of The Wealth of Nations, "Of Wages and Profit in the Different Employments of Labor and Stock," and particularly in Part I of the Chapter.

The basic idea of compensating differentials follows from the first two sentences:

The whole of the advantages and disadvantages of the different employments of labor and stock must, in the same neighborhood, be either perfectly equal or constantly tending to equality. If in the same neighborhood, there was any employment evidently either more or less advantageous than the rest, so many people would crowd into it in the one case, and so many would desert it in the other, that its advantages would soon return to the level of other employments.

If the nonpecuniary advantages of different employments are unequal, then the pecuniary rewards must be unequal in the opposite direction to preserve the equality of total advantages. These offsetting pay differentials are now called "compensating differentials," or "equalizing differentials," terms that were not used by Smith. The distinguishing characteristic of a true compensating differential is that it will not be eroded by perfect mobility of labor—it will exist even in long-run competitive equilibrium.

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The shift in the focus of economists' attention away from the whole of the advantages and disadvantages of an employment to the money wage, and to the reflection in this wage of the nonpecuniary aspects of the job, arises first from recent concern with systematic measurement of economic magnitudes and second, from the development of the concept of supply curves of labor, which plot employment against money wages. Nonpecuniary advantages or disadvantages can be highly varied, and have no common denominator other than their reflection in the wage rate. However, recent changes in terminology and analytical technique do not diminish the importance of the original concept, which is still with us in a slightly different guise.

The examples given in the Wealth of Nations all refer to earnings in different occupations and to the choice of occupation by workers. It should, of course, be clear that the concept of compensating differentials has much broader applicability. It can be used to explain differences in wages within an occupation between employers, between industries, and between geographic locations.

It is sometimes thought that the reasoning behind the concept of compensating differentials is circular or tautological. Thus a well-known contemporary author writes:

"When confronted by the awkward fact that people do not always seek the better paid job, even when they know it is there, the economist has always resorted to the argument that we do not maximize money, but net satisfactions. . . . Once the assumption that man maximizes money is replaced by the assumption that he maximizes net satisfactions which are not specified, no predictions of his market behaviour can be made." 1

To the extent that this passage is directed against Smith, it can be faulted in two respects. First, the concept of net advantage or net satisfactions did not arise as a way of covering up deficiencies in the predictive power of a theory of monetary maximization. On the contrary, the concept of net advantage is the original one, and lapses into a theory of monetary maximization came later, as a result of the difficulties of measuring nonmonetary factors. Second, whatever the deficiencies of neoclassical economists in failing to specify the components of net advantage, these deficiencies cannot be blamed on Smith. He specified in detail the five factors that in his view constituted the nonmonetary advantages and disadvantages of employment, and we shall turn to these in a moment.  \[2/\]

Nevertheless, Walker's passage gives rise to an important caution. The concept of net advantage does not in itself constitute a testable or refutable hypothesis. Rather it is a framework that leads to the formulation of testable hypotheses, which are of the form of "x or y or z is a net disadvantage or advantage of employment." These specific hypotheses are of more or less value depending first on how well they stand up against the evidence and second on how general they are—how broadly they are applicable across time and space. One would not expect the components of net advantage to be exactly the same in 1976 as in 1776. What is remarkable, however, is the extent to which Adam Smith's original list is still relevant.

It is well known that Smith's argument in Chapter 10 was to some extent suggested by Chapters 7 and 8 of Richard Cantillon's *Essai sur la Nature du Commerce en General*, which had been published in 1755.\(^3\)

However, too much stress should not be put on Smith's indebtedness. Cantillon's chapters are very short (one page each). The principal arguments of Chapter 10 of the *Wealth of Nations* are present, but only in an embryonic form. Smith both develops them in much more detail and links them together in a far more systematic way.

We now proceed to the discussion of the components of net advantage identified by Smith.

B. **Agreeableness and Disagreeableness**

Agreeableness and disagreeableness is Smith's term for the first of the five factors that together account for "Inequalities arising from the Nature of the Employments themselves," which is the title of Part I of Chapter 10. The other set of factors is discussed in Part II under the rubric "Inequalities occasioned by the Policy of Europe," and consists of legal barriers to mobility and grants of monopoly.

The terms "agreeableness and disagreeableness" include "the ease or hardship, the cleanliness or dirtiness, the honorableness or dishonorableness of the employment," and these attributes are illustrated by examples such as the following:

"A journeyman blacksmith, though an artificer, seldom earns so much in twelve hours as a collier, who is only a labourer, does in eight. His work is not quite so dirty, is less dangerous, and is carried on in day-light, and above ground."

One can no longer make exactly the same comparison for lack of wage data for blacksmiths. However, in March, 1972 average hourly earnings in coal mining in the United States were $5.22 and in fabricated metal products $3.92, and the work of a coal miner is still dark, dirty, that of and more dangerous than most other occupations. The miner is now a more skilled worker, and some part of his earnings are attributable to the special strength of the mineworkers union, but there is no doubt still a compensating differential involved.

There are many other cases, however, in which one now finds workers doing dirty, dangerous, or disagreeable work at very low wages. I believe these cases to be the result of two sets of forces that Smith did not consider because they were not present in the Britain or France of his day. The first is demand-deficiency unemployment, the second is racial discrimination in employment.

Smith, of course, considers seasonal and casual unemployment as the third of his five factors creating inequalities in wages. However, he could not have known involuntary unemployment of the kind that is present both in modern industrial countries with market economies at the trough of the trade cycle and during government attempts to restrain inflation by curbing aggregate demand. The downward rigidity of money wages prevents the unemployed from securing good jobs by offering to do them for less than the going wage. In such circumstances there may be workers who have been unemployed for long periods who will accept disagreeable work at low wages rather than have no work at all, and this makes compensating differentials unnecessary. The higher the level of liquid assets of the unemployed and the stronger the system of unemployment insurance or other
forms of income maintenance, the weaker the tendency for the unemployed to take disagreeable jobs at low wages. However, it should still be true that compensating differentials will be best observed in periods of full employment.

It follows from this that one should not attempt to preserve the wage structure that emerges in a depression during a subsequent period of very full employment. For example, in the Buffalo, New York area during 1944 there was a critical manpower shortage in foundries. This was aggravated by the fact that unskilled wages in foundries for hot, heavy, dirty work were lower than those in air frame plants for light, clean work. Nevertheless, stabilization authorities were reluctant to alter relative wages and instead relied entirely and unsuccessfully on direct manpower controls.4/

The second basic reason why compensating differentials may not appear for disagreeable work is racial discrimination in employment. In many multiracial societies, including the United States, almost all employment is controlled by the dominant race (whites). There are employer stereotypes of what constitutes "white work" and "black work," which may be closely correlated with the agreeableness to the job. To the extent that blacks are excluded from the agreeable jobs, they increase the supply of labor to the disagreeable jobs and keep down the wages in them. One would therefore expect the rigorous enforcement of legislation against racial discrimination in employment to result in the emergence of larger wage premiums for disagreeable jobs.4/

There is one important respect in which Smith's theory about the agreeableness of jobs is incomplete. He writes throughout as though all workers had identical tastes—as if what is disagreeable to one is disagreeable to all. If this were true, the supply curve of labor to any occupation would be perfectly elastic at a wage rate just enough above or below that of other occupations to reflect the uniform assessment of their nonpecuniary attributes. In this case, relative wages are determined entirely by supply conditions and are invariant in the long run to shifts in the demand for labor among occupations.

Clearly there is no reason, particularly in a society where workers have diverse backgrounds, for unanimity of tastes to be present. Smith writes, "The trade of a butcher is a brutal and an odious business; but it is in most places more profitable than the greater part of common trades." The strength of the language reflects the author's tastes, and no doubt that of many others. But suppose that one percent of workers do not find being a butcher "brutal" or "odious," but on the contrary enjoy it. If the employment of butchers is less than one percent of employment in all trades taken together, it would then clearly be possible to fill all the positions for butchers without any compensating differential.

More generally, if tastes differ, we can form a supply curve of labor to an occupation by arranging all of the people who might enter it from left to right along the horizontal axis in order of decreasing preference for this kind of work, or (what is the same thing) increasing supply prices. Thus arranged, they form an upward sloping supply
curve of labor to the occupation. A permanent increase in the demand for labor in this occupation relative to others will now cause a rise in its relative wage in long-run equilibrium.

C. The Difficulty and Expense of Learning the Business

The idea that wages vary with the difficulty and expense of learning an occupation has been an extraordinarily fruitful one, not only for the study of wages but in the broader contexts of capital theory and the theory of economic growth. Smith's initial statement of the theory of human capital could hardly be improved upon in so short a passage:

When any expensive machine is erected the extraordinary work to be performed by it before it is worn out, it must be expected, will replace the capital laid out upon it, with at least the ordinary profits. A man educated at the expense of much labour and time to any of those employments which require extraordinary dexterity and skill, may be compared to one of those expensive machines. The work which he learns to perform, it must be expected, over and above the usual wages of common labor will replace to him the whole expense of his education, with at least the ordinary profit of an equally valuable capital. It must do this too in a reasonable time, regard being had to the very uncertain duration of human life, in the same manner as to the more certain duration of the machine.

It is in this passage and the rest of the section in which it is included that Smith's debt to Cantillon is greatest. However, Cantillon merely suggests that the labor of an artisan or craftsman will be "dear in proportion to the time lost in learning the trade and the cost and risk incurred in becoming proficient." He does not make the separation that Smith does between the repayment of the capital outlay and the return on it.

The revival of interest in the idea of human capital during the 1960's, led by T. W. Schultz and Gary Becker, has provided the impetus for the most important developments in labor economics in the past fifteen years. One may ask how Smith's treatment differs from the much more extensive recent work. A large part of the answer is that much of the recent work is concerned with making precise estimates of the rate of return on different kinds of investment in human capital, or of the present value of such investments, while Smith merely considered general orders of magnitude or directions of wage differences. A second difference is that Smith considers only formal programs of schooling or apprenticeship as investment in human capital, while the recent treatments also include less formal kinds of on-the-job training and learning from experience.

It is one of the strengths of Smith's treatment that he distinguishes implicitly between the time needed to learn an occupation, which would create wage differentials in a state of "perfect liberty," and the time that may be institutionally required. If the latter exceeds the former, as in the case of overlong apprenticeships, the resulting wage differentials are "too large" in the sense that they will include an element of monopoly rent in addition to a normal return on investment.

Judging by the attention given to them in Part II, overlong apprenticeships were the chief way of restricting entry to trades in the late 18th century. However, Smith also refers to the refusal of masters to take

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apprentices and to limits on the number of apprentices to be trained by any one master. Another restrictive device not mentioned by Smith has sometimes been used by craft unions in the United States, which is to fix the wages of apprentices "too high" relative to the wages of journeyman—that is, higher than the ratio of their productivities. This device operates by reducing the willingness of employers to take apprentices.

Smith recognizes clearly that only outlays on training made by workers and their families will be reflected in wage differentials. If training for any occupation is subsidized, the supply of those trained will increase and the private return to the training will be lowered accordingly. It is for this reason that Smith complains of the scholarships and bursaries that draw people into the clergy. The complaint implies that the number of people in an occupation should be entirely determined by the tastes and resources of future workers and by the market demands of individual consumers; it should not be influenced by public policy. This is a view that would find little support today, and least of all among university students and their teachers. A training subsidy is now generally considered justified to the extent that trained people do not receive their whole social product, as may be true for example of research scientists.

D. The Constancy of Employment

The observation that hourly or daily wages vary with the constancy of employment has somewhat narrower applicability than the other sources of compensating differentials. Smith states the case as follows;
In the greater part of manufactures, a journeyman may be pretty sure of employment almost every day in the year that he is able to work. A mason or bricklayer, on the contrary, can work neither in hard frost nor in foul weather, and his employment at all other times depends upon the occasional calls of his customers. He is liable in consequence to be frequently without any. What he earns, therefore, while he is employed, must not only maintain him while he is idle, but make him some compensation for those anxious and desponding moments which the thought of so precarious a situation must sometimes occasion.

The last sentence quoted suggests that not only must the daily wage of a mason or bricklayer be higher than that of a journeyman in manufacturing, but that the annual earnings must also be somewhat higher as a kind of risk premium.

Smith's argument still valid and it is still applied to exactly the same trades. I have heard it made many times by Mr. Thomas Murphy, the General President of the Bricklayers, Masons, and Plasterers International Union, though Mr. Murphy tells me that he has never read The Wealth of Nations. Smith's observation that the daily wages of a mason are generally higher than those of a carpenter would be true today in most places in the United States, though not in all. On July 1, 1969 the average union wage rate for bricklayers was $6.06 and for carpenters $5.77 an hour; the rate for bricklayers was higher in fifteen of the twenty-one largest cities.

As with other kinds of compensating differentials, however, that for inconstancy of employment may disappear when there is less than full employment or discrimination against racial or ethnic minorities.
Migratory farm workers who harvest fruits and vegetables in the United States get low daily rates despite the inconstancy of their employment; the great majority of these workers are black or Spanish-speaking.

E. The Trust to be Reposed

Smith’s principle that wages vary with the trust to be reposed in the workman is not of the same sort as the other factors discussed in Chapter 10. The general nature of these is compensate the workman for some disadvantage of the job or for the expense of learning it. The fact that a goldsmith makes more than other workers of equal skill, however, is probably not needed to compensate him because he dislikes being entrusted with precious materials. It is true that some workers may dislike taking responsibility, but it is also true that others enjoy it. Rather the need for a wage premium must arise from a shortage of workmen worthy of such trust.

Paul H. Douglas has interpreted Smith as meaning that the higher wage of those entrusted with valuables is needed to reduce their temptation to be dishonest.2/ It may be doubted that the wage premiums are generally high enough to accomplish much in this direction, though bank employees were doubtless relatively better paid in the 18th century than they are now. In any event, the premium even on this interpretation still is not one that compensates the worker for disutility; it arises on the demand rather than the supply side of the labor market.

If the scarcity of trustworthy workers is the correct interpretation of this factor, then it is only one of a much larger class of rents to scarce or rare talents, including those of "players, opera-singers, opera-dancers, & c.," whom Smith discusses under a different rubric. He attributes some of the rewards of the latter group to the opprobrium attached to exercising such talents for gain. Such opprobrium no longer exists, but the pecuniary rewards for exceptional talents of these kinds are still very high.

The principle of trustworthiness is not discussed at much length in The Wealth of Nations; it is the only case in which the treatment is not clearly superior to Cantillon's. Perhaps Smith himself sensed that this principle was not congruent with the other four.

F. The Probability of Success

Smith's argument that wages vary with the probability of success is the hardest to follow of the five main factors. It begins with the observation that someone trained in one of the mechanic trades is almost certain to succeed in practicing it, but someone trained in a liberal profession is not. In the latter case fairness would require that the gains of the successful few be large enough to repay with interest the training costs of all. Cannan's interpretation of the argument in the footnotes to his edition of the Wealth of Nations seems to be correct; average wages vary inversely with the riskiness of the calling because new entrants have "overweening conceit of their abilities" and overrate their chances of winning one of the few large prizes. It follows that the prizes are not large or numerous enough to create a perfectly fair lottery, and the rate of return on all training for the professions is below that for the mechanic trades.
The portion of the argument that makes it consistent with the first three factors is the portion relating to the public admiration of genius or talent. The receipt of psychic income from fame and distinction is part of the total reward of a successful poet or philosopher, and hence justifies a lower monetary reward.

Smith's main example of people crowding into a profession because of a few large prizes is the law, an example that might still serve. More striking current examples might be the stage or cinema, with hundreds of aspiring actors, actresses, and directors willing to work for little or nothing in summer stock in the hope that their work will lead to discovery and success. The unionization of Broadway and Hollywood prevents this ready supply from bidding down the wages of bit players in the main centers of the entertainment industry.

Smith finds it necessary to distinguish his argument about risk in this section from his earlier discussion of hazardous trades and the constancy of employment. In the earlier sections, workers were risk-averse; bricklayers and masons had to be compensated for the despawing moments in which they considered the risk of unemployment. In this section young workers making occupational choices are risk lovers. The distinction is attempted between risks that are entirely external and those that interact with personal qualities. In concluding his discussion of the low wages of sailors, who underrate the dangers of the sea, Smith writes:
The distant prospect of hazards, from which we can hope to extricate ourselves by courage and address, is not disagreeable to us, and does not raise the wages of labour in any employment. It is otherwise with those in which courage and address can be of no avail. In trades which are known to be very unwholesome, the wages of labor are always remarkably high.

A better reconciliation might have been reached by considering not whether wages are raised at all by risk, but whether they are raised enough. If coal miners overrate their luck, wages in mining may still be higher than in other trades, but by less than enough to compensate for the true risks of death and injury.

Both in the discussion of agreeableness and disagreeableness and in the discussion of the probability of success, Smith discusses occupational hazards as though they were inherent in an occupation and could not be reduced by any deliberate action of the employer. This is, of course, only partially true. No amount of precaution can make mining coal as safe an occupation as banking, but proper equipment and procedures can reduce the accident rate in mining below what it would otherwise be.

We assume that accidents can only be prevented at a cost, and that after some point there are diminishing returns to successive increments of expenditure on accident prevention. The optimal expenditure is one just large enough so that the expected cost of preventing an additional accident exceeds the probable full cost of such an accident if it occurred. A compensating wage differential based on full knowledge of the risks by workers and the full reflection of these risks in wages would give employers the optimal incentive to make expenditures on health and safety, and it is this situation that by Smith's reasoning would prevail in the "unwholesome" trades. On the other hand, where workers
believe that they can extricate themselves from danger "by courage and address," the profit-maximizing employer has insufficient incentive to invest in accident prevention. In such a case the optimal incentives to employers would have to be provided by requiring them to carry workmen's compensation insurance (or to self-insure) under a system in which all costs of accidents are covered by benefits and premiums are directly related to employer experience. Present American workman's compensation laws fail this test because workers cannot recover their full losses in most cases.

G. Some Extensions

So far we have been following very closely the particular factors listed by Smith in defining the causes of inequalities in wages. It is now time to look into the application of his framework to new areas.

One of the most obvious extensions is to differences in the conditions of employment between different employers in the same occupation. Some occupations, such as typists or janitors, are found in a wide variety of industries, and there may be nonpecuniary advantages or disadvantages connected with the industry in which the worker is employed. Thus a typist might prefer to be employed by an insurance company than by a steel mill or an oil refinery. Strictly speaking, this preference has to do with the location of the job rather than the industry of the employer, since presumably there would be no objection to being employed by the headquarters office of an oil or steel company if the office is located in a central business district rather than at the mill or refinery.
A more general kind of locational preference, especially important for female employees, is the preference for an employer who is located near where the employee lives. To work for such an employer saves the worker the time and direct costs of commuting over long distances. For this reason one would expect employers located in residential neighborhoods to pay lower wages than those located in industrial areas or central business districts. In a recent study of the Chicago labor market it was found that employers of female clerical workers located in residential areas paid on average 12¢ an hour less than those located elsewhere. This coefficient is about 6 per cent of the mean wage and comes from multiple regressions in which a number of other factors, including age, experience, and education, were controlled.8/

It is well known that in the United States large establishments pay higher wages on average than small establishments in the same industry.9/ This pattern becomes much weaker when one controls for other factors such as occupational mix and city size that may be correlated with establishment size. Nevertheless, it may still be present.10/

It is not clear whether size-of-establishment differentials where they exist are compensating differentials in a pure sense. It could be that other things equal workers in general prefer small establishments and dislike the formal rules, long chains of command, and more impersonal


9/ See, for example, Richard A. Lester, "Pay Differentials by Size of Establishment," Industrial Relations Vol. 7 (October, 1967).

10/ See Rees and Shultz, op.cit., pp. 184-89.
management that are characteristic of large establishments. On the other hand, establishment size could still be acting as a proxy for some other factors not adequately controlled in existing studies. For example, other things equal a large establishment will have to draw its work force from a wider geographical area than a small one, and must therefore at the margin offer workers a larger premium to cover the costs of getting to work.

A very clear example of compensating differences in wages between employers is present in the market for university teachers in the United States, where individual universities are free to set their own salary scales. Persistently over many years, the universities with the highest prestige have offered the lowest starting salaries for new Ph.D.'s, and despite this have generally succeed in recruiting many of the ablest new entrants to the market. This may be true in part because the employers have a rather clearly defined prestige ranking and this prestige enters directly into the utility function of the teacher. Perhaps more important is that a new faculty member will learn more at a university where much research is going on in his field and where the senior faculty members are known for the quality of their research. This on-the-job training will improve his future productivity and perhaps his earnings in future jobs. The negative salary differential could then be viewed as a kind of payment for greater postdoctoral investment in human capital.

Recent work on racial discrimination in labor markets also makes use of the concept of compensating differentials. Three cases are generally 11/ For two quotations that express worker preferences for small plants because they facilitate good interpersonal relations and friendliness, see Lloyd C. Reynolds and Joseph Shister, *Job Horizons* (New York: Harper and Brothers, 1949), p. 16. It is, of course, hard to know how representative such examples are.
distinguished (a) where the employer discriminates against black employees; (b) where white employees discriminate against black colleagues; and (c) where white customers discriminate against services performed by black workers. In the second of these cases, it is argued that employers of integrated workforces will have to offer white employees or all employees a wage premium above the wage paid by employers of whites only to offset the dislike of white workers for working with blacks. However, I am not aware of a case in which a wage premium for integrated as compared with all-white work forces has been identified in wage data.

The desire for a wage premium to compensate for the race of one's colleagues is not inherently rational like the desire to be compensated for danger, noise, dirt, or other adverse physical working conditions. There is therefore no reason to assume that such tastes cannot be changed by education, legislation, or similar measures.

As the preceding discussion suggests, the notion of compensating differentials can be applied among the employees of a single employer, and other examples are not hard to find. Where a factory or other establishment works shifts, it is customary to pay a premium for the second or third shift relative to the day shift, particularly if workers are not rotated among shifts. The premiums compensate shift workers for such costs as having different schedules from their families.

The case of compensation within the workforce of a single employer is of particular interest because it involves a different kind of evidence

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to determine if a differential is of the appropriate size. Where a differential is paid to all the workers in an establishment, or all those in an occupation, a differential that is too small should result in unfilled vacancies persisting over considerable periods or in a poorly qualified workforce, while one that is too large would result in an excess supply of qualified applicants even in periods of full employment. The evidence of inappropriate internal differentials would consist of a peculiar distribution of the workforce. For example, if workers are permitted to choose shifts on the basis of seniority, too small a differential would result in almost all senior workers choosing the day shift, while too large a differential would lead almost all senior workers to choose the night shift. On this kind of evidence most shift differentials in the United States would be judged too small, and the usual overtime premium of 50 per cent generally too large.

Where wage premiums for working under disagreeable or dangerous conditions are established by collective bargaining rather than by market forces, it becomes very difficult to determine whether they are of appropriate size. The trade unions in the construction industry in the United States have obtained many such premiums, and these will differ substantially from place to place both in nature and amount. Premiums are established for working on high structures, for working with unpleasant substances such as creosote, or even for working directly under a helicopter. On the whole, these premiums seem more likely to be too large than too small.

The argument of Part I of Chapter 10 does not deal with geographical differences in wages because these had already been covered in Chapter 8,
"Of the wages of labor." One might expect the principle of compensating differentials to operate among places as well as among occupations, so that real wages would be lower in a place with an agreeable climate than in one whose climate is harsh and unpleasant. Smith, however, observed that money wages varied much more than the price of consumer goods, and not in a way that fitted a theory of compensating differentials. This leads him to the conclusion that labor is rather immobile geographically; "it appears evidently from experience that a man is of all sorts of luggage the most difficult to be transported."

It is still probably true that geographical mobility is too small to establish a pattern of real wage differentials consistent with a theory of compensating differentials. Improvements in transportation have greatly lowered the monetary costs of moving long distances, but not the psychic costs. The net flows may be toward the places that combine high real wages and pleasant surroundings, but the flows are not large enough to create the equilibrium that would bring them to an end.12

This observation suggests that we should look at the dynamics of Smith's model. He speaks of the whole of the advantages and disadvantages of different employments being either perfectly equal or constantly tending to equality. The first case is one of equilibrium; the second is one in which equilibrium has been disturbed and is in the process of being restored. The disturbance was no doubt an event that caused a change in the demand for labor in an employment, since the model of Chapter 10 is

12 The mere existence of net flows in the right direction is insufficient to support the wage predictions of classical theory. The failure to realize this is a defect of Rottenberg's "On Choice in Labor Markets."
one of constant long-run supply prices. The distinction between this case and the case of geographical mobility may in fact not be that occupational mobility exceeds geographical mobility—it may lie in the nature of the forces that produce the disequilibrium. If a system that reacts in the right direction to a disequilibrating force is disturbed by a single shock, it will eventually attain a new equilibrium (not necessarily the same as the old one). However, if the disequilibrating force acts continuously, whether or not the system reaches a new equilibrium depends not only on the direction of the response but also on its strength. In the case of geographical wage differences, one of the causal factors is often a high rate of natural increase of population in the low-wage area. Substantial net outmigration may be needed merely to offset this, and can occur without making any contribution toward equalizing real wages.

H. Conclusion

The concept of compensating wage differentials has been a handy device for generating fruitful hypotheses about wage structure. Clearly, not all hypotheses growing out of the concept will be supported by the evidence, nor will all of them apply at all places and at all times. Yet it would be hard to imagine a theory of relative wages that did not make some use of this concept.

It has recently been fashionable to try to explain wages entirely on institutional grounds, to rest almost all of wage structure on differences in bargaining power, and to minimize the importance of labor markets. There is, of course, some basis for the recent view. Many of
the institutions now central to wage determination, such as the trade union, were unknown in Smith's time, and their growth has meant that the influence of market forces on wage structure is less direct and perhaps less sure than it was in his day. This does not mean that this influence is not present, or even important. A full understanding of wage structure involves both markets and nonmarket institutions, and to ignore either one will result in incomplete explanations.