A MICROFOUNDATION FOR SOCIAL INCREASING RETURNS IN HUMAN CAPITAL ACCUMULATION*

Daron Acemoglu

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Abstract

This paper proposes a microfoundation for social increasing returns in human capital accumulation. The underlying mechanism is a pecuniary externality due to the interaction of ex ante investments and costly bilateral search in the labor market. It is shown that the equilibrium rate of return on the human capital of a worker is increasing in the average human capital of the workforce even though all the production functions in the economy exhibit constant returns to scale, there are no technological externalities, and all workers are competing for the same jobs.

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I. Introduction

Human capital externalities arise when the investment of an individual in his skills creates benefits for other agents in the economy. Social increasing returns are a strong form of these externalities whereby the rate of return on human capital is increasing, at least in some region, in the stock of human capital of the economy. Despite much evidence indicating that such externalities and social increasing returns may be important, and their prominence in policy debates, little effort has been spent in investigating what underlies these phenomena. Quite often these externalities are simply built into an aggregate production function in the form of technological increasing returns. This paper shows that when the labor market is characterized by costly search social increasing returns arise naturally but they are pecuniary rather than technological: even though all the production functions of the economy exhibit constant returns to scale, the interaction of ex ante investments and bilateral search in the labor market will make the rate of return on human capital increasing in the average of human capital of the workforce. This result contrasts starkly with the standard conclusion; in the Walrasian (frictionless) analogue of the model the equilibrium rate of return on human capital would be a decreasing (or at least, non-increasing) function of other workers’ skills.

The basic idea is simple. Workers have to make a large part of their human capital investments (e.g. schooling, acquisition of general knowledge) before they know for whom they will work. The privately optimal amount of schooling depends on what type of jobs will be available, and what kind of equipment and machinery they expect to use. On the other hand, firms’ choices of jobs and physical capital depend on the education and skills of the workforce. If a group of workers increase their education, the firms who expect to employ these workers would want to invest more. And yet, in a non-Walrasian labor market, it is not known in advance who these firms will be or what exact characteristics they will possess. As a result, many firms hoping to match with the more skilled workers will invest more. Therefore, even some of the workers who have not increased their human capital -- and who are competing for the same jobs -- end up working with more physical capital and earning an increased rate of return on their human capital. In other words, as recently emphasized by Lucas [1988], the rate of return on human capital of a worker is increasing in the human capital stock of the workforce.
However, in contrast to Lucas' contribution, this feature is not assumed to be part of the aggregate technology; instead, it is derived from market interactions. Moreover, our argument immediately implies that there will also exist social increasing returns in physical capital accumulation; that is, if a group of firms invest more, the education decisions of workers will be affected and as a result, the rate of return for the other firms will increase.

Are social increasing returns in human capital accumulation empirically important? A wealth of evidence suggests that the answer is yes. Although each piece of evidence is potentially open to a different interpretation, together they paint a picture supportive of social increasing returns in human capital. For instance, Rauch [1993] finds that a one year increase in the average education in a metropolitan area is associated with a 3% increase in wages even in regressions that control for observed characteristics. Further high skilled workers tend to migrate to areas where such skills are abundant, which are also the areas with the higher skill premium (see for instance Borjas et al [1992]). Such emigration of high skilled workers, the brain drain, is often argued to be an important barrier to the development of many countries, e.g. Bhagwati and Rodriguez [1975]. Underlying this belief is the view that the low stock of human capital in many underdeveloped countries creates a vicious cycle -- through social increasing returns -- whereby the rates of return on both human and physical capital are low because the stock of human capital is limited. As Lucas [1990] notes, this view provides the natural explanation for the lack of physical capital flows to poor countries; physical capital wants to go, as skilled workers do, to areas where human capital is already abundant.

Cross-country regressions also reveal an important role for human capital variables in explaining international variations in investment and growth rates (see among others Barro [1991], Benhabib and Spiegel [1994]). These studies lend support to Lucas' [1990] hypothesis that differences in the stock of human capital restrict capital inflow and growth of poor countries. Finally, following Krugman [1991] many economists believe that most manufacturing industries are geographically concentrated, as would be suggested by the common examples of the Silicon Valley and Route 128, e.g. Ellison and Glaeser [1994]. Although such geographical concentration can be explained by other models of agglomeration, when combined with the migration flows and the willingness of skilled workers to also concentrate in
one area, they are supportive of increasing returns in human capital.

This discussion suggests that social increasing returns in human (and perhaps also in physical) capital accumulation process are important. But why do we need to look for the microfoundations of such increasing returns? Although part of the human capital externalities are undoubtedly technological, assuming that this is the only form of interaction is unsatisfactory. First, with a black box interpretation of these externalities, the policy recommendations and the testable economic hypotheses are limited. Where will these technological externalities apply? [For instance, according to Lucas, 1988, human capital externalities can apply within any unit consisting of different decision makers]. Should we expect to find them in industries, cities, countries or all over the world? Also, is it the total stock of human capital or the average human capital per worker that matters? [Suppose we add a high school graduate to an economy of university graduates so that average human capital falls but the total increases; what happens to returns?]. When the interactions arise from aggregate technological externalities, the answers are not very clear. In contrast, the approach taken in this paper, by providing microfoundations, makes predictions about where such externalities are expected to arise and what form they should take.

The second problem for the purely technological view is that excluding education and R&D, major human capital interactions happen among employees within a firm; for example, young workers learn from their more experienced colleagues. But these interactions should be internalized within the firm, and no economy-wide human capital externalities should be observed.

Are the proposed microfoundations that this paper proposing plausible? Unfortunately, there is no direct evidence for this (since these issues are so far unexplored). Nevertheless, empirical support for the three main foundations of this mechanism can be found: first, the allocation of workers to jobs is a costly activity; second, human and physical capital are complementary; and third, costs of changing partners in the labor market create a surplus (quasi-rent) which is shared between workers and firms. Considerable evidence suggests that job search is an important and costly activity. Sicherman [1991] and Topel and Ward [1992] show how workers are only slowly allocated to the jobs most suited to them. Barron et al [1989], for example, show that employers spend considerable resources in recruiting activities. Capital-skill complementarity also appears quite plausible, especially for technologies in use.
today [for instance, most truck drivers working in delivery need to use hand-computers]. Further, econometric studies find strong evidence in favor of such complementarities (see among others, Griliches [1969] and Bartel and Lichtenberg [1987]). Finally, the findings of high correlation between profitability of firms and wages both in union and non-union sectors (e.g. Dickens and Katz [1987], Estevao and Tevlin [1995] and Katz and Summers [1989]) support the view that there is rent-sharing.

It is also useful at this stage to relate the main mechanism of this paper to two strands of earlier research. The first is the search literature, such as Diamond [1982] and Mortensen [1982], which stresses that in environments characterized by search there will be important external effects. As more workers start looking for a job, it will be easier for firms to find the right worker, and their profits will increase. Although such externalities are theoretically appealing, their importance is limited. With a more crowded market, some other agents will also find it more difficult to find partners, and this second effect will tend to counteract the first. In fact, econometric studies have found that the matching technologies in the labor market exhibit constant returns to scale so that when the number of participants on both sides of the market double, the meeting probabilities are unchanged (e.g. Pissarides [1986] and Blanchard and Diamond [1989]). As a result, there appears to be no aggregate externalities on this front. The second literature follows Grout [1984] and discusses potential underinvestment in situations where investors cannot capture the whole of the surplus they create because of ex post hold-up problems. To derive these results, a strong form of incompleteness of contracts and credit market imperfections are assumed, and further because there are no general equilibrium interactions, no aggregate human capital externalities are generated. In contrast to these two literatures, this paper shows that in economies with ex ante investments and costly search, there exist external effects that work through changes in the value of future matches, and it demonstrates that these externalities take the form of social increasing returns because agents, even when they have increased their investments, will stop searching before finding the best possible partner.

The plan of the paper is as follows. Section II describes the basic environment and the Walrasian allocation. Section III derives the equilibrium with random matching, and demonstrates the presence of social increasing returns in human capital accumulation. Section IV analyzes the model with an
efficient matching technology. Section V considers some extensions, in particular, it shows how multiplicity of equilibria can easily arise in this setting. The Appendix includes the proofs, and provides a game-theoretic justification for the wage determination rule used in the text.

II. The Basic Environment and the Walrasian Allocation

The economy lasts for two periods, \( t = 0 \) and \( t = 1 \), and consists of two types of risk-neutral agents; firms (entrepreneurs) and workers. There is a continuum of equal measure of both types of agents, normalized to 1. At \( t = 0 \) workers choose their education level and firms choose their capital stock. At \( t = 1 \) productive relations are formed in one worker-one firm partnerships, production takes place, and output is divided between the firm and the worker. For the purposes of the analysis here whether firms are owned by the workers or are owned by entrepreneurs who consume the proceeds does not make a difference. The assumption that production takes place in a worker-firm pair is a simplifying one; it does not change the main conclusions, and since the measures of firms and workers are equal, issues related to unemployment are avoided until section V.3.

The production function for pair \((i,j)\) is

\[
\lambda_{ij} = \lambda h_i^s k_j^{1-s},
\]

where \( h_i \) is the human capital of the worker \( i \), \( k_j \) is the physical capital of firm \( j \), and \( 0 < s < 1 \). Firms maximize expected profits, and the cost of capital is constant and equal to \( \delta \).

Worker \( i \) maximizes his utility

\[
V_i(c, \lambda) = c_i - \frac{1}{\delta} \frac{\lambda_i^{1+\Gamma}}{1+\Gamma},
\]

with \( \gamma > 0 \). \( c_i \) is the consumption of worker \( i \), and since the economy comes to an end in period \( t = 1 \), it is equal to his total income, \( W_i \). In what follows, I will define \( \gamma = 1/\Gamma \) for notational convenience. The parameter \( 1/\Gamma_i \) measures the relative disutility of human capital acquisition for the worker. I assume that at the time of investment, the distribution of \( \Gamma \) across workers is common knowledge.

A complete description of behavior in this economy consists of (i) an investment decision for each worker and firm; (ii) given the distribution of investments of workers and firms, an allocation of
workers to firms; (iii) a wage level for each level of human capital (given the level of physical capital that the worker is matched with), \( w(h,k) \), and a rate of return for each level of physical capital (given the level of human capital it is matched with), \( r(h,k) \).

I start with the frictionless Walrasian system. At \( t = 0 \), the auctioneer calls out wage and rate of returns schedules, and trade stops when all markets clear\(^7\). The economy will be in Walrasian equilibrium, if and only if (a) given the distribution of investments, the allocation of workers to firms and the wage and rate of return functions are in equilibrium, and (b) given the final rewards, the ex ante investment decisions are privately optimal.

With Walrasian markets, a worker is allocated to the firm where his marginal product is highest, and since human and physical capital are complements, the most skilled worker will be working for the most productive firm [e.g. Sattinger, 1992]. In other words, imagine a ranking of all firms, and of all workers, in descending order. Worker \( i \) and firm \( j \) will be matched together when they have the same ranks in their respective orders (the Appendix gives a formal definition of this equilibrium allocation). This allocation is a Walrasian equilibrium if and only if all agents are paid their marginal products in their pairings. Therefore,

\[
\begin{align*}
\alpha \Delta \bar{b}_i^{\alpha -1} \bar{k}_j^{1 - \alpha} \\
(3a) \\
\alpha \Delta \bar{a}_j^{\alpha -1} \bar{k}_i^{1 - \alpha}
\end{align*}
\]

(3b)

for all equilibrium pairs \((h_i, k_j)\). The total equilibrium income of the worker will therefore be given as \( W_i = w(h_i, k_i) h_i \). The total income of the firm, \( R_j \), is similarly defined.

In the Walrasian allocation, it must be the case that \( r(h_i, k_i) = \frac{\bar{b}_i}{\bar{k}_i} \) [or equivalently \( R(h_i, k_i) = \frac{\bar{b}_i}{\bar{k}_i} \)] for all equilibrium pairs \((h_i, k_i)\) which, therefore, must have the same physical to human capital ratio:

\[
(4) \\
\frac{b_i}{k_j} = \left( \frac{\mu}{(1-\alpha)A} \right)^{\frac{1}{\alpha}}.
\]

The optimal human capital of worker \( i \) is given by maximizing (2);

\[
(5) \\
\alpha \Delta \bar{b}_i^{\alpha -1} \bar{k}_j^{1 - \alpha} = \frac{\bar{b}_i}{\bar{k}_i}.
\]

Substituting from (3) and (4), the optimal investment for worker \( i \) can be obtained as
Proposition 1. (i) There exists a unique Walrasian equilibrium where the human capital investments are described by (6), and all firms have a constant human to physical capital ratio given by (4).

(ii) The equilibrium allocation is Pareto Optimal.

(iii) The rate of return on human capital is independent of the distribution of $\mu$.

As with all the other results in the main text (unless otherwise stated), Proposition 1 is proved in Appendix 2. It establishes that the above wage and investment functions characterize the unique equilibrium allocation. The last part of the proposition states a result important for later comparison; a worker is indifferent about the human capital choices of other workers. This result is partly due to the exogenously given cost of capital. Suppose instead that $\gamma$, the required rate of return on capital, is an increasing function of the aggregate demand for capital, $K$. Then:

Corollary 1. Suppose $\gamma(K)$ is a strictly increasing function of $K$ and $\mu_i = \mu_i$. Now consider an increase in $\mu_i$ from $\mu_i$ to $\mu_i + \delta$ for a proportion $D$ of the workers, where $1 > D > 0$. Then the rate of return on human capital and the wage of $\mu_i$-workers fall.

This is the conventional story: an increase in the stock of human capital (or the average human capital of the workforce) reduces the rate of return on human capital --- or, in the limiting case of constant $\gamma$, leaves it unchanged. As the cost of education falls for a group of workers, the stock of human capital in the economy increases, and firms want to increase their physical capital. This pushes the cost of capital up, and the remaining workers end-up working with lower physical to human capital ratios and receive lower wages.

\[
\hat{h}_i = \left( \frac{1-a}{a} \frac{1}{A} \frac{1-a}{a} - \theta \right)^{\frac{1}{\gamma}}.
\]
III. Decentralized Equilibrium with Search and Random Matching

I now turn to the model of costly search and start with the case where \( i^* = i^* \) for all workers. As before, firms and workers make their investments at \( t = 0 \), and then they take part in the labor market at \( t = 1 \). I also assume that workers and firms are allocated to each other via a random matching technology; that is, at \( t = 1 \) each worker has an equal probability of meeting each firm, irrespective of his human and the firms' physical capital. Again there is no unemployment and matches are one-to-one. I also assume that once a partnership is formed, breaking up the match and finding a new partner is costly. As in the standard search models wages will be determined by bargaining (e.g. Pissarides [1990]). In the main text I make the simplifying assumption that the total wage bill of worker \( i \) (matched with firm \( j \)) is equal to \( W_i = y_{ij} \). This means that the worker receives a proportion \( \$ \) of the total surplus (output). All the qualitative results hold with other sharing rules as long as workers do not always receive their marginal product. Further, Appendix 1 derives this wage determination rule as the unique equilibrium of a general equilibrium wage bargaining game where switching partners has an arbitrary cost, \( \alpha > 0 \).

Two important features are introduced in this section, both as the result of the replacement of the Walrasian auctioneer by costly search: (i) wages are no longer equal to marginal product; thus the Walrasian mechanism can no longer be relied upon to provide the right contingent prices and to induce efficient investments; and (ii) anonymity; workers do not know who their employers will be when they acquire their education, and so, they cannot write contracts to improve investment incentives; hence, there is a natural incompleteness of contracts. With these features in place, the expected returns for workers and firms can be written as:

\[
\begin{align*}
W(k_j, \{k\}) & = \beta A b_j^e \left( \int k_j^{1-\alpha} \, dk \right), \\
R(k_j, \{k\}) & = (1-\beta) A \left( \int k_j^{1-\alpha} \, dk \right) k_j^{1-\alpha}.
\end{align*}
\]

Due to random matching, wages depend on the whole distribution of physical capital across firms, \( \{k\} \). Because each worker has an equal probability of being matched with each firm, his expected output is \( A b_j^e \left( \int k_j^{1-\alpha} \, dk \right) \), and his expected return is a proportion \( \$ \) of this. Similarly, the return to firms depends on the whole distribution of human capital in the economy, \( \{h\} \).
It can be seen that for all \( \{h_i\} \), the return to the firm is a strictly concave function of its own investment. Therefore, all firms will choose the same level of investment, \( k \). Similarly, given \( *_i = *_1 \), all workers will choose the same level of human capital, given by (8a) and (8b):

\[
\begin{align*}
(8a) & \quad (1-\beta)(1-\alpha)\lambda k^{-\alpha} \delta^\alpha = \mu, \\
(8b) & \quad \beta \alpha \lambda k^{-\alpha} \delta^\alpha - 1 = \frac{b^\beta}{\delta_1}.
\end{align*}
\]

Thus,

\[
\forall i, \quad h_i = h_k = \left( \alpha \beta \lambda [(1-\alpha)(1-\beta)]^{\frac{1-\alpha}{\alpha}} \lambda \mu \delta_1^{\frac{1-\alpha}{\alpha}} \delta_i \right)^{\frac{1}{\gamma}}.
\]

**Proposition 2.** Suppose matching is random, \( W_i = y_{ij} \) and \( *_i = *_1 \). Then:

(i) There exists a unique equilibrium in which \( h_i = h_k \) as given by (9).

(ii) A small increase in the investments of all agents would make everyone better off.

The first observation is that (9) differs from (6), and thus this economy is inefficient. Further, if all firms and workers simultaneously increased their physical and human capital investments, the welfare of all agents would rise. This is the first sense in which there exist social increasing returns. The terms \( \mu \) and \( (1-\mu) \) in (9), that were absent in (6), are responsible for these results, and these are the terms introduced by the incompleteness of contracts. Note that a similar result could be obtained in a reduced form model with the incompleteness of contracts exogenously imposed, but here this incompleteness is a direct consequence of search which creates anonymity and therefore prevents bilateral contracts between workers and firms at the investment stage.

It is also clear that no possible value of \( \mu \) can make the expressions (6) and (9) identical. Therefore, in contrast to Mortensen [1982] or Hosios [1990], there is no sharing rule that could restore efficiency in this economy. The externalities that the previous literature concentrated upon related to the changes in the matching probabilities, and with constant returns to scale in the matching technology [which is what the present model also has since the total number of matches is linear in the number of
firms and workers], an optimal sharing rule could balance these externalities exactly and restore constrained efficiency. However, in the current economy achieving constrained efficiency is impossible since externalities work through the value of future matches and are always positive. Consequently, as $\psi$ approaches 1, correct investment incentives are restored for the worker, but the firms' investment decisions are increasingly distorted. The converse applies when $\psi$ is reduced towards zero. Therefore (proof omitted):

**Corollary 2.** The decentralized equilibrium is always constrained Pareto inefficient and the level of aggregate output is too low. Aggregate output is maximized when $\beta = \frac{\gamma \alpha}{1 - \alpha + \gamma}$.

I now show that there is a stronger form of social increasing returns in this economy. Let us repeat the thought experiment of the last section and increase $*\alpha$ from $*\alpha_1$ to $*\alpha_2$ for a proportion $D\alpha$ of the workers and assume that wages are still determined by $W_i = \psi y_{ij}$; thus (7) applies\(^1\). Evaluating the integral in (7):

\[
R(k_j) = (1 - \beta) \lambda \beta_1^{1 - \alpha} (1 - \rho) \beta_1^{\alpha} + \rho \beta^2 - \lambda \beta_1^{1 - \alpha} \beta_2^{\alpha - 1},
\]

where $h_1$ is the investment of workers with $*\alpha = *\alpha_1$, and $h_2$ corresponds to workers with $*\alpha = *\alpha_2$. Once again, $R(k_j, \alpha)$ is strictly concave in $k_j$, and all firms will choose the same level of investment, $k_j = k$.

Therefore, the optimal human capital investments are given by:

\[
\begin{align*}
(11a) & \quad \beta \alpha \lambda \beta_1^{1 - \alpha} \beta_2^{\alpha - 1} = \frac{\Gamma_1}{\beta_1} \\
(11b) & \quad \beta \alpha \lambda \beta_1^{1 - \alpha} \beta_2^{\alpha - 1} = \frac{\Gamma_2}{\beta_2} 
\end{align*}
\]

Let us divide (11a) by (11b) and substitute into the first order condition derived from (10), then

\[
\frac{\delta k}{\delta \beta_2} = \left(1 - \alpha \right)(1 - \beta) \lambda \beta_2^{\alpha - 1} \left[ (1 - \rho) (1 - \rho) \frac{\delta_2}{\delta_1} \right] \mu \right)^{1/\alpha},
\]

where I have defined $\theta = \frac{\psi \gamma}{\gamma (1 - \alpha) + 1} = \frac{1}{\Gamma + (1 - \alpha)}$. Therefore, the physical to human capital ratio for workers who have not experienced a change in their cost of education is increasing in $D$.

**Proposition 3.** Suppose matching is random, $W_i = \psi y_{ij}$, and that there is an increase in $*\alpha$ from
\[11 \text{ to } 12\text{ for a proportion } D\text{ of workers. Then the equilibrium rate of return on the human capital of all other workers increases.}

Intuitively, all firms will try to take advantage of the increased level of human capital by investing more in their physical capital, but not all of those firms will match with the high human capital workers. Therefore, the workers who did not increase their human capital investments will benefit by being able to also work with more physical capital. In the real world, this can be thought of as a firm who invested in a new technology hiring workers who require more training rather than waiting for other workers who would need less training, or employers giving the benefit of the doubt to interviewees at the screening stage. As a consequence, the rate of return on human capital is increasing in the average skill of the workforce, even though in the absence of matching frictions, workers would be pure substitutes. Interestingly, this result also implies that if the education of one group of workers were subsidized, other workers could also benefit.

It is worth emphasizing that the presence of two different types of social increasing returns have been demonstrated, and that these two forms of increasing returns are conceptually different [and do not always hold together - see next section]. The first is established in Proposition 2; when all agents increase their investments by a small amount, everyone is made better off, and this was shown to be driven by the incompleteness of contracts [which was due to anonymity]. The second is in Proposition 3; when a group of workers increase their investments and firms respond to it, the rate of return on the human capital of remaining workers increases. This second aspect is directly related to imperfect matching; even with the terms $a$ and $(1-a)$ removed from equation (12), exactly the same result would be obtained. This second type of increasing returns is entirely driven by the fact that in the absence of the Walrasian auctioneer, all workers have a positive probability of working with firms that have invested more.

A number of additional features have to be noted. First, this model implies not only social increasing returns in human capital but also in physical capital accumulation. When a group of firms increase their investment, the workers will choose more education in response, and the rate of return
to firms that have not invested more will increase as a result. Second, if the increase in * had happened after the physical capital investments of the firms, or if it had been unknown to them, there would have been no change in the physical capital investments and thus no change in the wages of the other workers; this is due to the constant returns property of the production function. In this economy, increasing returns are derived not from the production function but from pecuniary interactions, and they always work through the investment response of the other side of the market. Third, what matters is not the total human capital in the economy, but the average human capital of workers because firms make their investment based on the expected human capital (or more generally, quality) of the workers they will meet. For instance, a doubling of the number of workers and firms would not change the equilibrium rates of return because the matching technology is constant returns, and so, the matching probabilities will remain unaltered.

Finally, as an application consider two separate geographical locations A and B such that A has a higher ratio of *₂-workers. Now because the rate of return on physical capital is higher in A than B, more capital will go to A, and as a result there will be a large wedge between the returns on human capital in these two labor markets. Next, provided that costs of migration are less than proportional to human capital [e.g. fixed costs of migration per person], *₂-workers from area B will be the ones to migrate, thus creating a high degree of (often inefficient) concentration of economic activity as it is often observed in practice.

IV. Decentralized Equilibrium with "Efficient" Matching

The assumption of completely random matching is extreme. In this section I look at the polar case: efficient matching. By this I mean a matching technology that replicates the allocation of the Walrasian economy [the most talented worker is allocated to the firms with the highest physical capital - see the appendix for a formal definition]. However, this is not the same as a Walrasian labor market, because after the initial matching, there is still the cost of breaking up the match, , . I first characterize the equilibrium with *₁ = *₁, ¹/₄A.
**Proposition 4.** Suppose the matching technology is efficient, $W_i = y_{ij}$, and $\forall i \ *_i = *$, then the allocation characterized in Proposition 2 is the unique equilibrium.

The proof of this proposition follows from Lemma A.2 and Proposition A.1 in Appendix 1. Intuitively, all workers have the same cost of education, they will all choose the same level of investment. Whether matching is efficient or random does not make a difference to the investment incentives. As in the case of random matching technology, there are inefficiently low physical and human capital investments, and an increase in these investments will make everyone better off. Therefore, the incompleteness of contracts and the social increasing returns of the first type are still present. However:

**Proposition 5.** Suppose the matching technology is efficient. Consider a change in $*$ from $*_1$ to $*_2$ for a proportion $D$ of workers. Then in equilibrium, a proportion $D$ of the firms increase their physical investment from $k_1$ to $k_2$, the rest leave it unaltered at $k_1$, and the rate of return on the human capital of workers with $*_1$ remains unchanged.

Although the equilibrium with homogenous workers is exactly the same with efficient matching as it was with random matching, when the costs of education for a group of workers change, the wages for the remaining workers are not affected. Thus, the first form of social increasing returns remain, but the second one disappears. The intuition is simple: with the efficient matching technology, a firm who has increased its investment never meets a worker who has not invested more in his skills. Therefore, in this economy the employers never face problems in contacting the right workers and the second type of increasing returns is absent.

Nevertheless, because an efficient matching technology is an extreme case, the result of Proposition 5 is only useful as a benchmark. The real world matching technology should be thought of as a combination of random and efficient matching\(^1\), and as a result, social increasing returns will be present in general [though their importance will be limited if we are close to an efficient technology].
A number of empirical observations indeed suggest a limited degree of efficiency in the matching technology. First, recall that workers eventually finding the "right" employer by matching and then breaking up with unsuitable firms is not efficient matching. The efficient technology refers to an "invisible hand" creating the right matches within the pool of unmatched firms and workers, and thus ensuring that workers who are less skilled do not benefit at all from the increase in the physical capital of firms. Although certain labor market institutions, such as job advertising and interviewing, play this role, there is still a high degree of randomness. In practice, workers spend a long time in unemployment and in jobs that are not right for them. Topel and Ward [1992] document the loss of earnings in the process of workers finding the jobs that are best suited for them. Heckman [1993, p.108] reports that even in Germany, where firms have better internal labor markets, there is a high degree of reallocation at some point in workers' career. A large literature [e.g. Rumberger, 1981] suggests that there can be substantial "mismatch" at any given point in time between the education level of workers and the required human capital of the jobs they perform. Although the concept of "required human capital" is somehow difficult to interpret, Sicherman [1991] shows, using PSID data, that this "mismatch" has a significant impact on wages, and that a substantial part of such "mismatch" is transitory because over time workers move to more appropriate jobs. But he also finds this process of transition to be long. Overall, the evidence suggests a process of search far from the fully efficient scenario.

V. Extensions

V.1. Multiplicity of Equilibria and Social Increasing Returns in Physical Capital

The analysis so far has provided a microfoundation for social increasing returns to scale. However the equilibrium has been unique despite these "increasing returns". This feature is driven by the linearity of the production technology. With some degree of non-convexity, the social increasing returns proposed in this paper will lead to multiple Pareto ranked equilibria. To illustrate the main ideas I maintain the wage determination rule\(^{12}\) as \(W_i = y_i\). But instead of continuous choices, I suppose that each firm has a choice between two levels of physical capital, \(k_1\) and \(k_2 > k_1\) [e.g. two different technologies]. The rest of the model is unchanged; in particular, I assume \(*_i = *\) for all workers.
Proposition 6. Suppose \( (1-\beta)\Delta k_2^{1-a}(\alpha\beta\delta.\Delta k_2^{1-a-\theta}-\mu.\Delta k_2) > (1-\beta)\Delta k_1^{1-a}(\alpha\beta\delta.\Delta k_1^{1-a-\theta}-\mu.\Delta k_1) \) and \( (1-\beta)\Delta k_2^{1-a}(\alpha\beta\delta.\Delta k_1^{1-a-\theta}-\mu.\Delta k_2) < (1-\beta)\Delta k_1^{1-a}(\alpha\beta\delta.\Delta k_1^{1-a-\theta}-\mu.\Delta k_1) \) where \( \Delta \) was defined in section III. Then there exist two symmetric pure strategy equilibria; in one, firms choose \( k_2 \) and workers choose \( \hat{h}_2 \) and in the other firms choose \( k_1 \) and workers have \( \hat{h}_1 = (\alpha\beta\delta.\Delta k_2^{1-a-\theta}) \) The first Pareto dominates the second.

When all firms choose \( k_2 \), the rate of return on human capital increases and workers are willing to invest more (\( h_2 \) instead of \( h_1 \)). But since human capital is not paid its marginal product, this raises the rate of return on physical capital; thus in the terminology of Cooper and John [1988], there are strategic complementarities. However, in contrast to Section III, where the same forces were also present, the indivisibilities imply that the social increasing returns can lead to multiple equilibria.

Expressing this intuition differently is also useful: by investing more, a firm is creating a positive externality on other firms because it encourages workers to accumulate more human capital. Therefore, as well as the social increasing returns in human capital, social increasing returns in physical capital accumulation are present. Such increasing returns are often used in recent work [e.g. Romer, 1986], but again they are assumed to be technological, whereas in this economy they have been derived as pecuniary externalities resulting from interactions in the labor market.

V.2. Directed Search and Wage Posting by Firms

Random matching implies that search is undirected, and therefore there is no point for firms in announcing wages or wage contracts associated with their vacancies. This is a strong assumption. A previous version of the paper showed that if firms can post and fully commit to wage contracts that map from the general and firm-specific human capital of workers to a wage level, the Pareto optimum can be achieved. However, full commitment to wage contracts requires that a sufficient number of agents who are capable of punishing a deviant firm should be able to observe the exact characteristics of the worker and his wage -- also an extreme assumption. As soon as full observability is abandoned, the
optimality result collapses, and we are back to social increasing returns. The intuition is similar to Diamond [1971]. Suppose all workers have chosen the surplus maximizing level of human capital, and all firms are offering wage contracts that reward workers appropriately. With full observability, firms will not be able to deviate to cut their workers' wage because they will fear punishment by other agents in the economy. However, if observability is imperfect, a firm will be able to reduce its worker's payment by a small amount without getting detected. And if one firm can do this, all other firms can too, and this will reduce the "outside option" of the worker, and therefore increase the power of the firm over the worker. By applying this argument recursively, it can be seen that without full observability, investment incentives will be distorted, and the economy will not be able to get close to a Pareto efficient outcome.

V.3. Unemployment and Human Capital Accumulation

Finally, it is straightforward to endogenize job creation and unemployment in this setting. The main result of this exercise is that in a high unemployment environment, workers often expect their human capital not to be used and thus may end-up investing less in their education (a similar point is made by Robinson [1995] in the context of a model with technological externalities). However, with a low human capital workforce, the profitability of jobs is also reduced, and this depresses job creation. These interactions open the way for an additional multiplicity of equilibria: one equilibrium with high unemployment and low human capital, and another with high investments in human capital and low unemployment. In the Pareto dominated equilibrium (the former), workers do not invest because they expect that, even with high education, they will not be able to get jobs. This finding may be part of an explanation for high drop-out rates from high school in ghettos and poor neighborhoods. Also, note that in contrast to Diamond [1982], the multiplicity here does not rely on increasing returns in the matching technology, but on the social increasing returns introduced by ex ante investments and search.

VI. Concluding Remarks

This paper has demonstrated how matching imperfections in the labor market together with investment decisions on the part of firms and workers lead to social increasing returns in human (and
physical) capital accumulation. This result explains quite naturally the importance of human capital externalities in the development context, geographical concentration of skill-intensive industries, higher rates of return on human capital in high average education urban areas, the lack of capital flow to low-skill areas, and other similar findings without resorting to technological externalities.
Appendix 1: Wage Determination

1. Wage Determination with Random Matching and Homogeneity

I now analyze wage determination explicitly rather than assume $W_i = y_{ij}$. Suppose that once a pair is formed, both parties must incur a cost $c$ to change partners. This can be interpreted as a monetary or non-monetary mobility cost, or a flow loss because finding a new partner takes time. I also assume that a randomly drawn proportion $\epsilon$ of the agents looking for a match remain unmatched at the end of every round. I will analyze this economy as $\epsilon \leq 60$. This modelling assumption enables me to avoid the problem that when an agent wants to switch partners, there may be no one to match with. It is also a convenient substitute for the more rigorous strategy of characterizing the steady state of a bargaining market with entry and exit [e.g. Gale, 1987, Osborne and Rubinstein, 1990].

Bargaining after a match takes the form of the firm, $F$ [she], and the worker, $W$ [he], playing a continuation game $^1(y)$ (Figure I) where $y$ is the total output produced if there is agreement in this round. First, the firm makes a wage demand (node A) which can be refused by the worker (node B). If the worker refuses, he can at no cost make a counter offer (node C) or decide to leave and find a new partner at cost $c$, (to both parties). If he makes an offer, the firm can refuse this (node D), and quit at cost $c$. If she decides to continue with bargaining, Nature decides whether the firm or the worker will make the last offer (node E), and at this stage quitting is no longer permitted. The probability that the worker will make the offer is denoted by $\psi$. If $\psi$ is high, the worker has a strong bargaining position. In the case where one of the parties terminates bargaining, both find new partners (incurring the cost $c$), and play a similar continuation game $^1(y')$ [where $y'$ is not necessarily the same as $y$ if there is heterogeneity among the agents]. Note that as $\epsilon$ becomes smaller, the amount of frictions are diminished.

FIGURE I ABOUT HERE

At any point in time, this game will have a complicated history which describes the way agents have matched and bargained up to that point. I am only interested in equilibria that do not depend on this history in a complicated way. Since I also want the equilibrium to be subgame perfect, I am only interested in Markov Perfect Equilibria where all agents will play the same strategies in each completely identical continuation game $^1(y)$ [see for instance Fudenberg and Tirole, 1991, or Osborne and
Lemma A.1: With homogenous agents, random matching and the game \( y \) as described above, \( W_i = \$y \) is the unique equilibrium for all \( \beta > 0 \).

Proof: Consider the extensive form in Figure I and let us denote the supremum expected return of the firm by \( V^* \). If the game reaches node E, the expected return of the worker is \( \$y \) and that for the firm is \( (1-\$)y \). Next consider node D; since all pairs are playing the same continuation game, in a Markovian equilibrium the maximum the firm can expect from changing partners is \( V^*_F \). On the other hand, she can choose to go to node E and obtain \( (1-\$)y \). The supremum of her equilibrium pay-off is therefore \( \max\{V^*_F , (1-\$)y\} \). Now at node B, the worker can obtain \( y - \max\{V^*_F , (1-\$)y\} \) by proceeding to node C. Alternatively, he can leave and obtain his outside option. Since \( V^*_F \) is the supremum pay-off for the firm, the worker needs to expect his infimum, denoted by \( V^*_W \). Then at node A, the supremum of the payoff set of the firm is

\[
(A1) \quad V^*_F = y - \max\{V^*_W - e , y - \max\{V^*_F - e , (1-\$)y\}\}.
\]

Now noting that \( V^*_F + V^*_W = y \), this equation has a unique solution which is \( V^*_F = (1-\$)y \).

Repeating the above argument with the infimum of the payoff gives \( V^*_W = (1-\$)y \). Thus \( W_i = \$y \), \( V^*_W \) is the unique Markov Perfect Equilibrium. Q.E.D.

This Lemma establishes that even with very small search frictions, there may be a large wedge between the marginal product of factors of production and their rates of return. The intuition is simple; when the worker leaves, he will meet another firm and enter a very similar bargaining situation. In fact, if the firm he meets is exactly the same as the one he is bargaining with, he cannot expect anything better, and hence his outside option will not be binding (i.e. the threat to quit is not credible), and bargaining will take place over the whole of the pie [see Diamond, 1971, or Shaked and Sutton, 1984, for a similar intuition]. It follows immediately from this result that if the model of the text is augmented with the wage determination game outlined here, the allocation of Proposition 2 would be the unique symmetric equilibrium.

The limitations of this result should also be noted. First, it does not always hold in the presence of heterogenous agents because the worker (or the firm) may be moving to a better partner [but see ...
Lemma A.3]. Second, I am not allowing Bertrand type competition so that a worker is never able to bargain with two firms simultaneously. If a firm were allowed to meet two workers (or vice-versa) with a certain probability [e.g. Burdett and Judd, 1983], then there would be a closer relationship between the rates of return and the marginal products, but the Walrasian outcome will not be achieved unless the mobility costs were completely removed\(^{14}\). Third, it should be noted that if Nature decides when bargaining will end and when parties will be forced to take their outside options, bargaining markets converge to the Walrasian equilibrium as \(\rho\). This is not surprising since we know from Binmore, Rubinstein and Wolinsky [1986] that in these cases, the Nash solution to bargaining applies, and with this solution, as the frictions disappear, the allocation must converge to the Walrasian one.

2. Robustness of Wage Determination: Heterogeneity and Efficient Matching

As in the text, if the matching technology is efficient, initial matches are organized so that the highest skilled worker is matched to the firm with the highest capital. In other words, the initial match will be the same as the Walrasian allocation of section III. Formally, let us define for every worker \(i\), \(\Omega_{ji}(t) = \int_{x \in S_j, \mu_i > x} ds\) and similarly for each firm \(j\), \(\Omega_{ij}(t) = \int_{x \in S_i, \mu_j > x} ds\) where \(S_j\) and \(S_i\) are the sets of firms and workers who are looking for a match. Then \(\Omega_{ji}(t)\) and \(\Omega_{ij}(t)\) are the ranks of firm \(j\) and worker \(i\) in the set of firms and workers looking for a match. With the efficient matching technology, \(i\) and \(j\) will be matched if and only if \(\Omega_{ji}(t) = \Omega_{ij}(t)\); or (ii) \(\Omega_{ji}(t) < \Omega_{ij}(t)\), but all \(j^*\) that have \(\Omega_{ji}(j^*) < \Omega_{ij}(j)\) are matched with \(i^*\) such that \(\Omega_{ji}(i^*) < \Omega_{ij}(j)\); or (iii) \(\Omega_{ji}(t) > \Omega_{ij}(t)\) but all \(i^*\) that have \(\Omega_{ji}(i^*) > \Omega_{ij}(j)\) are matched with \(j^*\) such that \(\Omega_{ji}(j^*) > \Omega_{ij}(j)\). Lemma 2 in Acemoglu [1995] establishes that with ex ante investments, out of these three possibilities, the economy must always be in (i). That is, \(\Omega_{ji}(t) = \Omega_{ij}(t)\). The intuition for this result is quite simple: if this were not the case, an agent could improve his or her payoff by investing more by an infinitesimal amount. (I refer the reader to Acemoglu [1995] for a formal proof). Then:

**Lemma A.2.** Let us assume that matching is efficient and agents are potentially heterogenous at the wage determination stage. Then in the unique equilibrium we have \(W_i = y_{ij}\) where \(\Omega_{ji}(t) = \Omega_{ij}(t)\).
Proof: Suppose worker i leaves firm j. Matching at the second stage is efficient and \( \Omega_{\mathbf{w}}(t) = \Omega_{\mathbf{r}}(t) \), thus he will meet a firm exactly of the same physical capital as firm j. Hence the proof of Lemma A.1 applies. Q.E.D.

Thus this Lemma demonstrates that the divergence between rates of returns and marginal products is not due to the random matching assumption, but is driven by the presence of transaction costs of decentralized trading [which combined with anonymity introduces the incompleteness of contracts]. Next a similar result for random matching with heterogenous agents can be stated, but only when \( \rho \) is arbitrarily small.15

Lemma A.3. Let us assume that matching is random and agents are potentially heterogenous at the wage determination stage. Then as \( \rho \to 0 \), the unique equilibrium is \( \omega_i = \pi y_{ij} \) where \( \Omega_{\mathbf{w}}(t) = \Omega_{\mathbf{r}}(t) \).

Proof (sketch): Take an allocation where worker i who has the lowest (best) rank is matched with firm j who does not \([ \Omega_{\mathbf{w}}(t) = 0, \Omega_{\mathbf{r}}(t) > 0 ]\). Then for \( \rho \) small enough, either i or j will want to switch partners; therefore, for \( \rho \) small enough we cannot have an allocation which is not "efficient" so that we must have \( \Omega_{\mathbf{w}}(t) = \Omega_{\mathbf{r}}(t) \).

Now suppose that worker i prefers to separate and matches with firm j*. By definition it cannot match with a better partner. Thus, \( k_i \neq k_j \). But since i prefers to match with j*, \( b_{ij} < b_{j*} \). Then for \( \rho \) small enough, either i or j will want to switch partners; therefore, for \( \rho \) small enough we cannot have an allocation which is not "efficient" so that we must have \( \Omega_{\mathbf{w}}(t) = \Omega_{\mathbf{r}}(t) \).

Proposition A.1. With efficient matching or with random matching and as \( \rho \to 0 \), the unique equilibrium of Proposition 2 is the unique equilibrium of the fully specified economy even when agents are allowed to use non-symmetric strategies.

Proof (sketch): Consider two workers of human capital \( h_1 \) and \( h_2 \) who have different utility levels \( u_1 > u_2 \). Suppose \( h_1 > h_2 \). Then the second worker can increase his investment to slightly above \( h_1 \), get a
better rank and thus obtain the job of worker 2, and the same utility, $u_2$, (or arbitrarily close to it) since $h_1 < h_2$. If $h_1 < h_2$, this time he can reduce his investment to slightly above $h_1$ and the same argument applies. Hence a contradiction, and all workers must obtain the same level of utility. The same argument applies to firms. Since the problem is strictly convex, this can only be possible if they all choose the same level of ex ante investment, and this is the allocation of Proposition 2.

Q.E.D.

Appendix 2: Proofs of Propositions

Proof of Proposition 1: (i) All competitive equilibria have to satisfy (4), thus all competitive equilibria have constant human to physical capital ratios. Then (6) defines the optimal human capital decision of workers. Since (6) has a unique solution, there is a unique competitive equilibrium. (ii) As all markets are complete, the equilibrium is Pareto efficient. (iii) follows from the fact that human to physical capital ratio is given by (4). Q.E.D.

Proof of Proposition 2: (i) In the case of $W_i = y_i$ and $*_i = *_i$, (9) uniquely describes equilibrium. (ii) Take the return of the firm given by (7) and evaluate these small changes at the equilibrium values $(h_R, k_R)$. This gives the change in the return of the firm:

$$\alpha (1-\beta) A k_R^{1-\sigma} b_R^{-\sigma-1} db + \{(1-\alpha)(1-\beta) A k_R^{1-\sigma} b_R^{-\sigma-1} - \mu\} dk_R$$

(B1)

The second term that multiplies $dk$ is zero by the first-order condition (8), and the first term is positive, thus (B1)$>0$. A similar reasoning applies to workers. Q.E.D.

Proof of Proposition 3: In equilibrium, the physical to human capital ratio for the low human capital workers is given by (12) which is strictly increasing in $D$. Q.E.D.

Proof of Proposition 5: With efficient matching technology, (8) defines the human to physical capital ratio for all pairs irrespective of the value of $*$. Therefore, the distribution of $*$ does not matter, and the rate of return on human capital is independent of this distribution.

Q.E.D.

Proof of Proposition 6: When all firms choose $k_2$, workers will choose $h_2$ as defined in the proposition. Then, firm profit when $k_2$ is chosen is given as;
In contrast, if a firm deviates and chooses \( k_1 \), I have;

\[
\Pi_2(k_2) = (1-\beta)\Delta k_2^{1-a}(\alpha \beta \delta \Delta k_2^{1-k})\alpha \phi - \mu k_2.
\]

From the first condition in Proposition 6, (B3) is greater than (B4), and thus, when all other firms choose \( k_2 \), it is more profitable to do so.

Repeating this exercise for the case where all firms choose \( k_1 \), we get the profit for choosing \( k_2 \) as;

\[
\Pi_1(k_2) = (1-\beta)\Delta k_2^{1-a}(\alpha \beta \delta \Delta k_2^{1-k})\alpha \phi - \mu k_2.
\]

And in contrast with \( k_1 \), the profit is;

\[
\Pi_1(k_1) = (1-\beta)\Delta k_1^{1-a}(\alpha \beta \delta \Delta k_1^{1-k})\alpha \phi - \mu k_1.
\]

Provided that (B6) is larger than (B5), it is too costly to deviate to \( k_2 \), when other firms choose \( k_1 \). Thus with both conditions in Proposition 6 satisfied, there is a multiplicity of equilibria. Also in the equilibrium with \( k_2 \), firms are making higher profits and workers have higher utility, hence the Pareto ranking. Q.E.D.

Massachusetts Institute of Technology
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Notes

1. To refer to the case in which the increasing returns are built into the aggregate production function I use the term technological increasing returns or technological externalities. The analysis will establish that an economy with a constant returns to scale production function can have the equilibrium rate of return of an individual increasing in the average human capital of the workforce. I refer to this feature as (pecuniary) social increasing returns. The assumption of constant returns is a simplifying one, and a decreasing returns aggregate production function would lead to the same results as long as the degree of decreasing returns is not too strong. However, note that the pecuniary externalities derived in this paper will never introduce ‘endogenous’ growth as long as the returns to all variable factors are decreasing.

2. More precisely, the mechanism proposed here suggests a link between the rate of return on human capital and the human capital investments of other agents. However, this link arises because firms, expecting more skilled workers --i.e. a higher "stock"--, invest more. It is straightforward to generalize the model to a dynamic setting whereby the past stock of human capital contributes to the skills of the current generation, and thus increases the current rate of return.

3. Mare’ [1994] finds that much of this premium disappears once one controls for metropolitan area fixed effects.

4. Note that this last piece of evidence can also be interpreted as supportive of social increasing returns in physical capital; that is, higher return on investment in areas with high investment. Interestingly, the mechanism here leads to social increasing returns not only in human capital but also in physical capital and therefore, it accords with this different interpretation of some of the evidence [see section V.1].

5. For instance Caballero and Hammour [1996] and Davis [1994] discuss the implications of Grout’s hold-up problem for job creation and destruction dynamics and composition of jobs respectively.

6. The investment decisions of firms are irreversible. These can be thought as decisions regarding the type jobs they open (e.g. a secretary or an administrator) or the quality of the fixed equipment they purchase.

7. Note that with the Walrasian auctioneer all trades are taking place at time t = 0. An alternative scenario would be one where agents choose their investments at t = 0, and then trade in a competitive
labor market at $t = 1$. With this scenario, the Walrasian allocation is still an equilibrium, but in the absence of some heterogeneous agents who choose different levels of human capital, there may also exist other equilibria. This is because with sequential competitive trading, it matters whether all markets are open: when all workers choose the same level of human capital, the markets that correspond to the other levels of education would be closed. However, even when these other equilibria exist, they do not satisfy some appropriate game-theoretic refinement such as stability or trembling hand perfection. Trading through the Walrasian auctioneer at $t = 0$ avoids this problem and enables me to establish uniqueness without additional technical details.

8. Proof is straightforward and thus omitted. This corollary also holds for an arbitrary right-ward shift of the distribution of $\ast$. Details available from the author upon request.

9. Incompleteness of contracts means that employers and workers do not write contracts conditional on the education level of the worker and the type of job before the worker finishes his education process.

10. If instead of assuming that wages are a proportion $\$ of total output, I use the wage bargaining formulation in the Appendix, I need to impose that $\ast_2/\ast_1$ and $D$ are small relative to the mobility cost, in order to ensure that a firm that meets with a worker of lower skill does not turn him down, and thus the wage rule $W_i = \$y_{ij}$ can be derived as part of the equilibrium. This reasoning also suggests that the results here would not hold when $\ast_2/\ast_1$ is large and thus less skilled workers will not benefit from having more skilled competitors around when the gap between these two groups is large (details available upon request, also see Acemoglu [1995] where this case is analyzed).

11. See Acemoglu [1995] for a matching technology that is a hybrid of random and efficient. Social increasing returns in human capital are present in this more general case as long as the gap between high and low skill workers is not too large.

12. In this case, for this wage determination rule to be derived from microfoundations as in Appendix 1, a lower bound for the mobility cost, is once again required.

13. I chose Nature to move at node E to simplify the game tree. The alternative game is one in which the worker and the entrepreneur asymmetrically alternate in making offers.

14. It is natural in this context that two firms would never simultaneously meet a worker and vice versa. If a worker is bargaining simultaneously with two firms, both firms will get zero surplus. Thus ex ante a firm will have no incentive to contact a worker who is already in negotiation with, or
employed by, another firm.

15. Note that \( \Omega_\nu(\theta) = \Omega_{\theta}(\theta) \) is important for this result. To see this suppose the case in which there is one type of firm and two types of workers. Then even as \( 60 \), the wage determination rule \( W_i = \$y_i \) would not be an equilibrium.