

Wage Effects of Clusters

Location	Wage	Switch Cost	Probability of Switch	Expected Net Income
Isolated Site	\$20	\$8	50%	$\$16 = (1/2) * 20 + (1/2) * (20-8)$
Industry Cluster	\$16	\$0	50%	$\$16 = (1/2) * 16 + (1/2) * (16-0)$

For a worker to be indifferent between the Isolated Site and the Industry Cluster, the worker would have to be paid a higher wage in the Isolated Site to compensate for the risks of being laid off and having to pay high search and moving costs.

Since firms can hire workers at \$16 in the Industry Cluster and \$20 in the Isolated Site, all firms will locate in the Industry Cluster to minimize labor costs.