CIE Economics A-level

Topic 3: Government Microeconomic Intervention

c) Labour market forces and government intervention

Notes

Demand for and supply of labour

- The labour market is a factor market. The supply of labour is determined by those who want to be employed (the **employees)**, whilst the demand for labour is from **employers.**

- Labour is a **derived demand.** This means that the demand for labour comes from the demand for what it produces. For example, the demand for people who make cars is derived from the demand for cars. With no demand for cars, there will be no demand for car manufacturers.

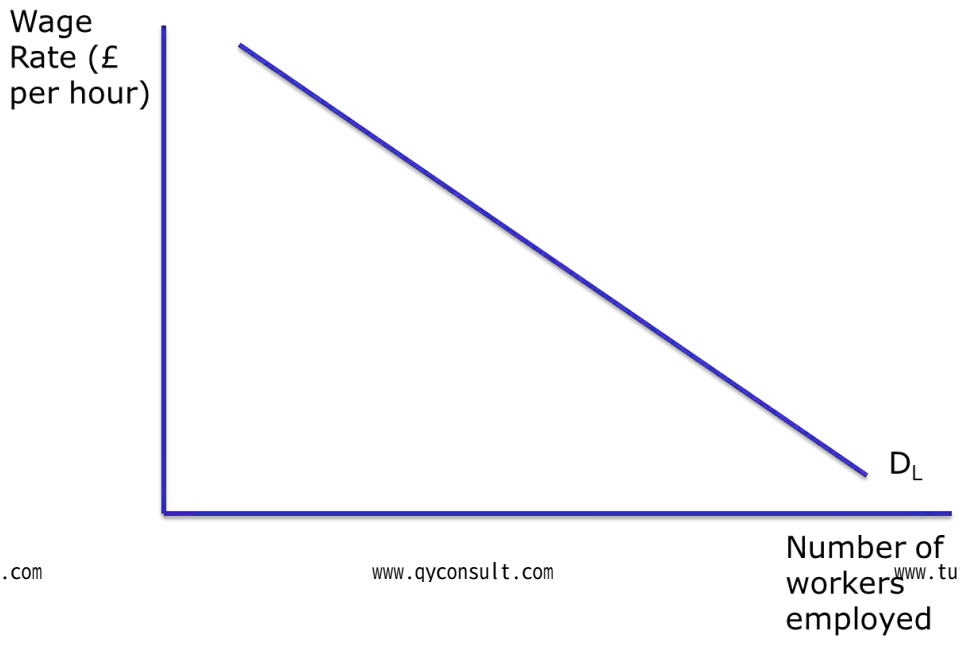
- Demand is related to how productive labour is and how much the product is demanded. The elasticity of demand for labour is linked to how price elastic the demand for the product is.

- The wage rate will lead to movements along the supply and demand curves for labour. All other factors will shift the curves.

Demand for labour:

- The demand for labour is affected by:

- **The wage rate:**
  - The downward sloping demand curve shows the inverse relationship between how much the worker is paid and the number of workers employed.

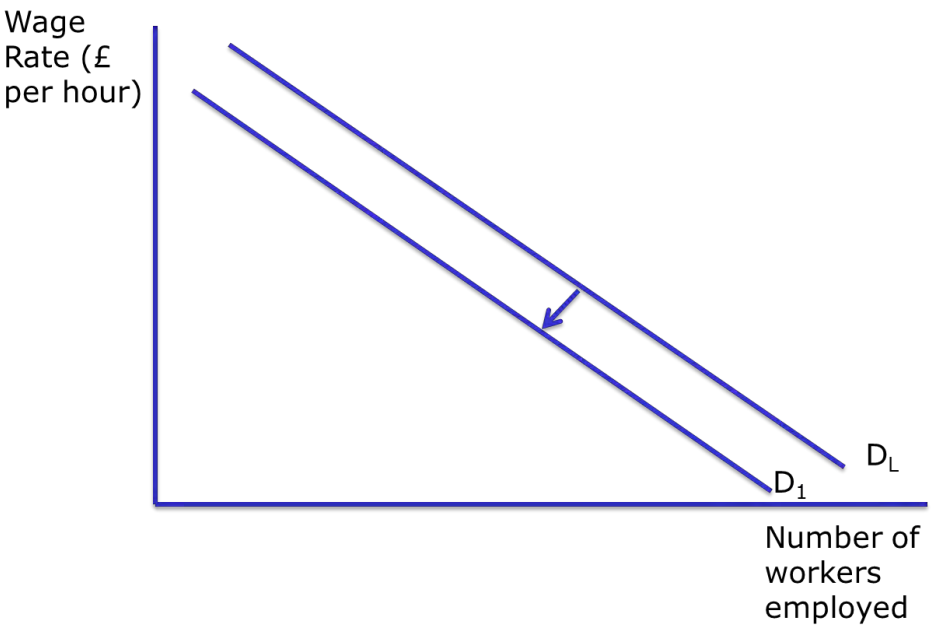


- When wages get higher, firms might consider switching production to capital, which might be cheaper and more productive than labour.

- **Demand for products:**
  - Since the demand for labour is derived from the demand for products, the higher the demand for the products, the higher the demand for labour.

- **Productivity of labour:**
  - The more productive workers are, the higher the demand for them.
  - This can be increased with education and training, and by using technology.

- **Substitutes for labour:**
  - If labour can be replaced for cheaper capital, then the demand for labour will fall. This will shift the demand curve for labour to the left:



- **How profitable the firm is:**
  - The higher the profits of the firm, the more labour they can afford to employ.

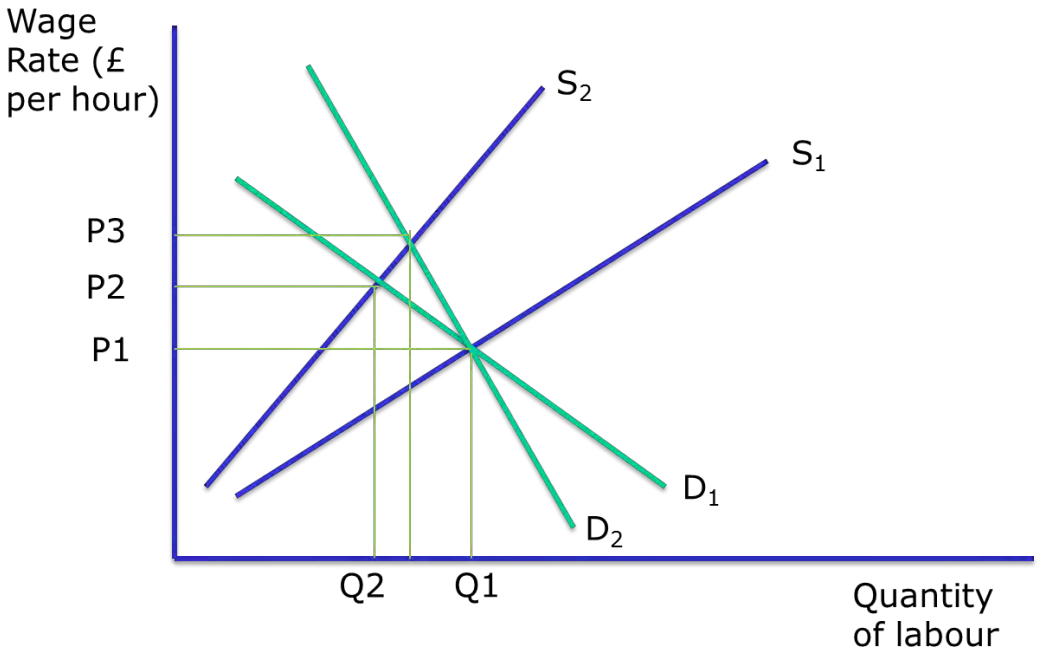
- **The number of firms in the market:**
  - This determines how many buyers of labour there is. If there is only one employer, for example the NHS, the demand for labour is lower than if there are many employers, such as in the supermarket industry.
  - The lower demand for labour can mean wages are lower, so trade unions try to encourage higher wages.

The marginal productivity theory of the demand for labour

- This theory states that the demand for labour is dependent on the marginal revenue product (MRP).
- MRP is calculated by marginal product multiplied by marginal revenue.
- MRP = MP x MR.
- The marginal product of labour is the additional output each unit of labour can produce.
- The marginal revenue of labour is the additional revenue derived per extra unit of labour.
- Equilibrium occurs where the marginal cost of one extra unit of labour is equal to the net benefit of one extra unit of labour.
- The demand curve shows the MRP.

The determinants of the elasticity of demand for labour

- The wage rate and level of employment is affected by shifting the demand or supply curve differently, depending on how elastic the other curve is.
- If labour demand is inelastic, because there are few or no substitutes, strikes will increase the wage rate but not affect the employment rate significantly.
- Where there is an inelastic demand for labour, a lower supply will lead to a higher increase in the wage rate (P1 → P3), than where there is a more elastic demand (P1 → P2).



- The elasticity of demand for labour measures how responsive the demand for labour is when the market wage rate changes. This is affected by:
    - How much labour costs as a proportion of total costs. The higher the cost of labour as a proportion of total costs, the more elastic the demand. Labour costs are high as a proportion of total costs in the services.
    - The easier it is to substitute factors, the more elastic the demand for labour, because firms can easily to switch to cheaper forms of production, such as capital.
    - The PED of the product also affects labour. The more price elastic the product, the more price elastic the demand for labour.

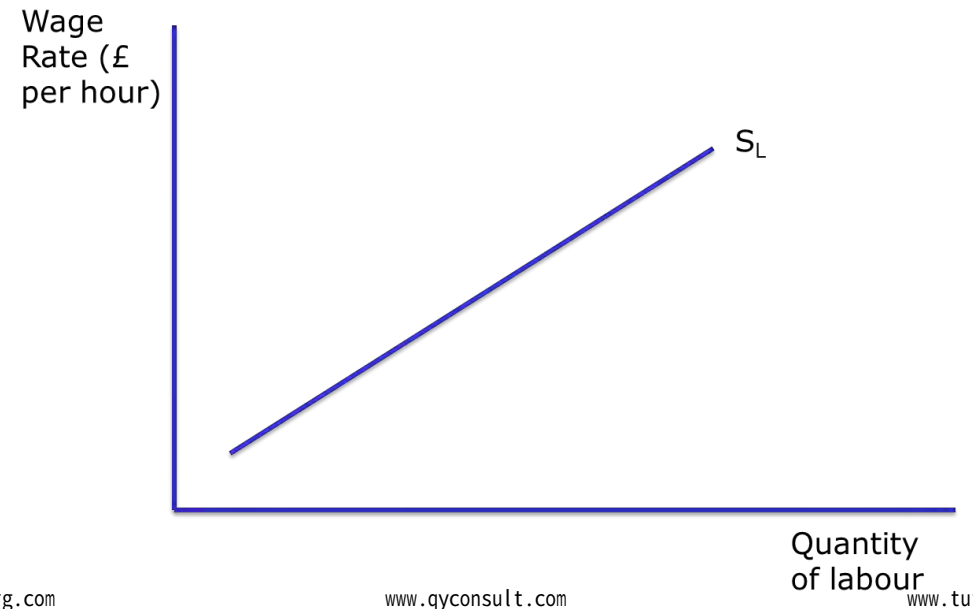
Factors that influence the supply of labour to a particular occupation:

- The supply of labour is calculated by the number of workers willing and able to work at the current wage rate, multiplied by the number of hours they can work. It is influenced by monetary and non-monetary considerations.

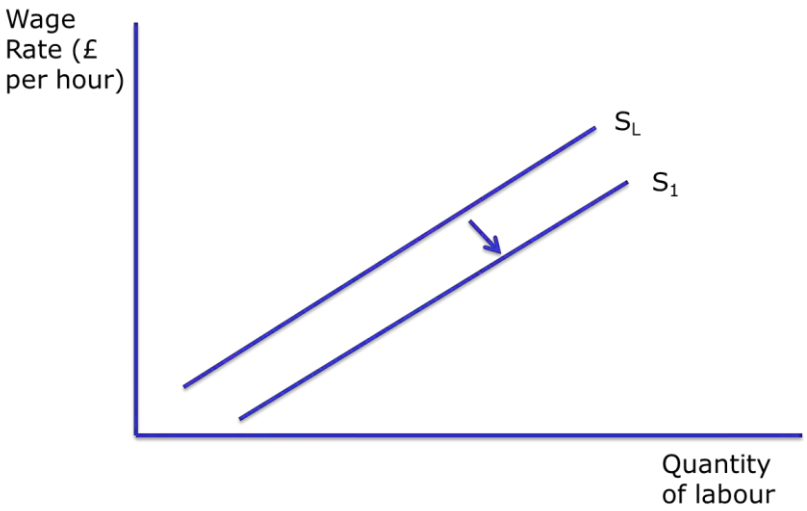
- Non-monetary considerations include how satisfied workers are with their job and their working conditions.

- The supply of labour is affected by:

- **The wage rate:**
    - The upward sloping supply curve shows the proportional relationship between how much the worker is paid and the number of workers willing and able to work.



- **Demographics of the population:**
  - The more people there who are able and willing to work, the higher the supply of labour. This changes with retirement and school leaving ages, the number of university students and immigration.
  - It can be illustrated with a shift to the right of the supply curve.



- **Migration:**
  - Migrants are usually of working age, so the supply of labour at all wage rates tends to increase. Migration particularly affects the supply of labour at the lower wage rates, because migrants are usually from economies with average wages lower than the UK minimum wage.

- **Advantages of work:**
  - This can influence how much people prefer to work, and is linked to non-monetary advantages. If the cost of working is lower, so families can afford childcare, people are more likely to work. If the benefits of working are high, such as holiday entitlements and the potential to be promoted, the supply of labour is likely to increase. It also considers job satisfaction and how good the working conditions are.

- **Leisure time:**
  - Leisure is a substitute for work, which is why part-time work and early retirements are attractive options for some people.
  - People have to choose whether to spend their time on work or leisure. This is influence by age, the amount of taxes paid, how many dependents the worker has and income from not working.

- **Trade unions:**

- These could attract workers to the labour market, because they know their employment rights will be defended. However, the limits on workers, such as limiting their ability to strike, might cause some people to withdraw from the labour market.

- **Taxes and benefits:**
  - If taxes are too high and benefits are too generous, people might be more inclined to withdraw from the labour market.

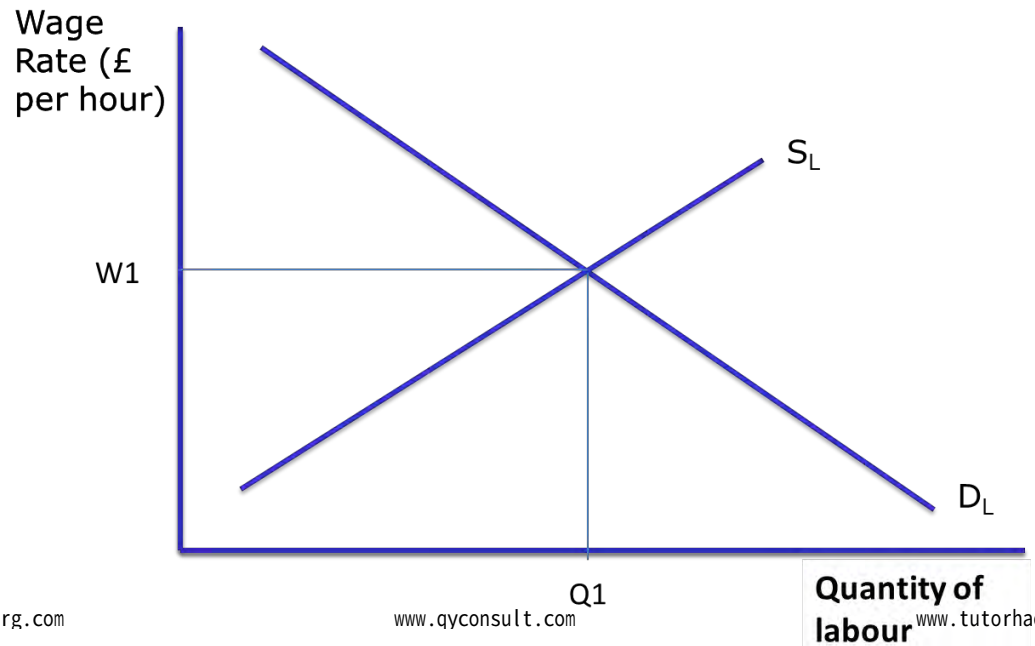
- **Training:**
  - If a lot of training or high qualifications are required for a job, then the supply of labour may fall. However, if the government subsidise training, it is easier for workers to gain the necessary skills for a job, so the supply of labour could increase.

Wage determination in perfect markets

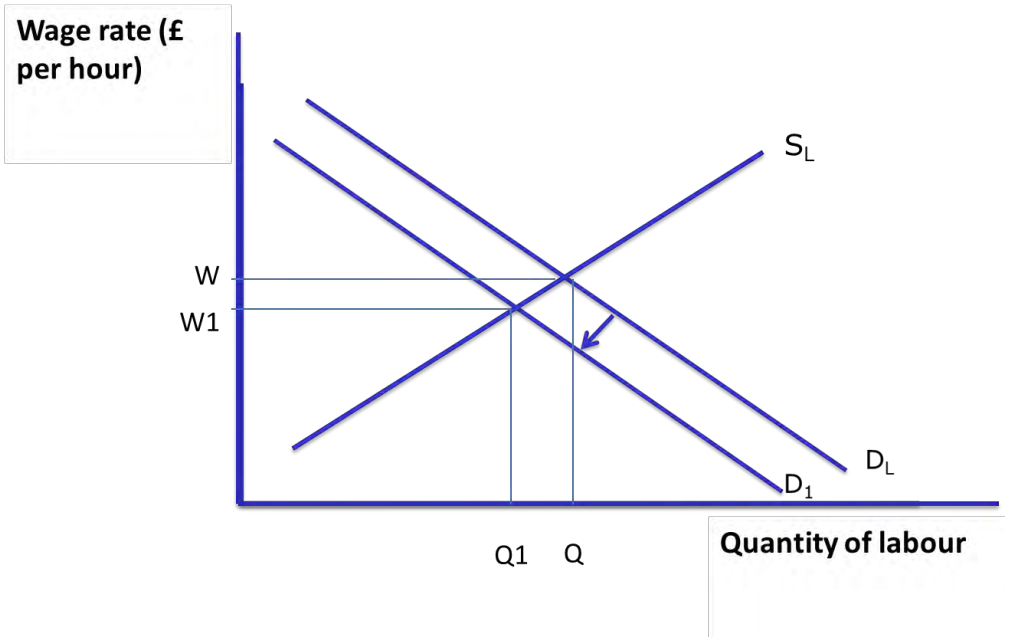
- **Labour market equilibrium:**

- The labour market is a factor market. The supply of labour is determined by those who want to be employed (the **employees)**, whilst the demand for labour is from **employers.**

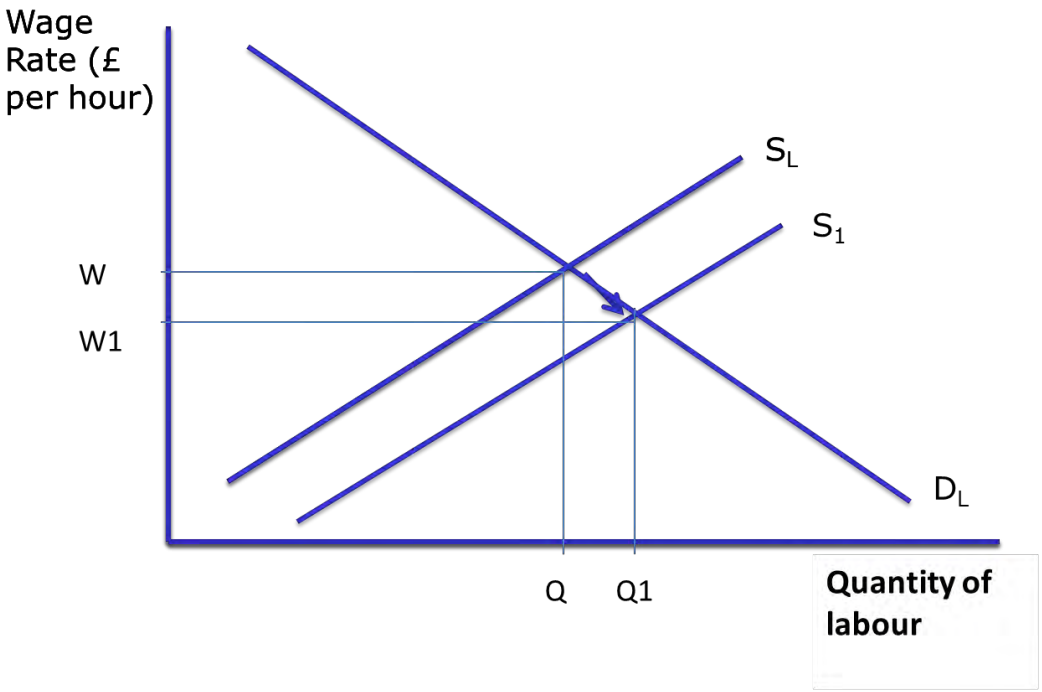
- Labour market equilibrium is determined where the supply of labour and the demand for labour meet. This determines the equilibrium price of labour, i.e. the wage rate.



- When the demand for labour falls, such as during a recession, in a free market the wage rate would fall from W to W1.



- If the supply of labour increases, such as if the retirement age was raised, the wage rate would fall from W to W1.

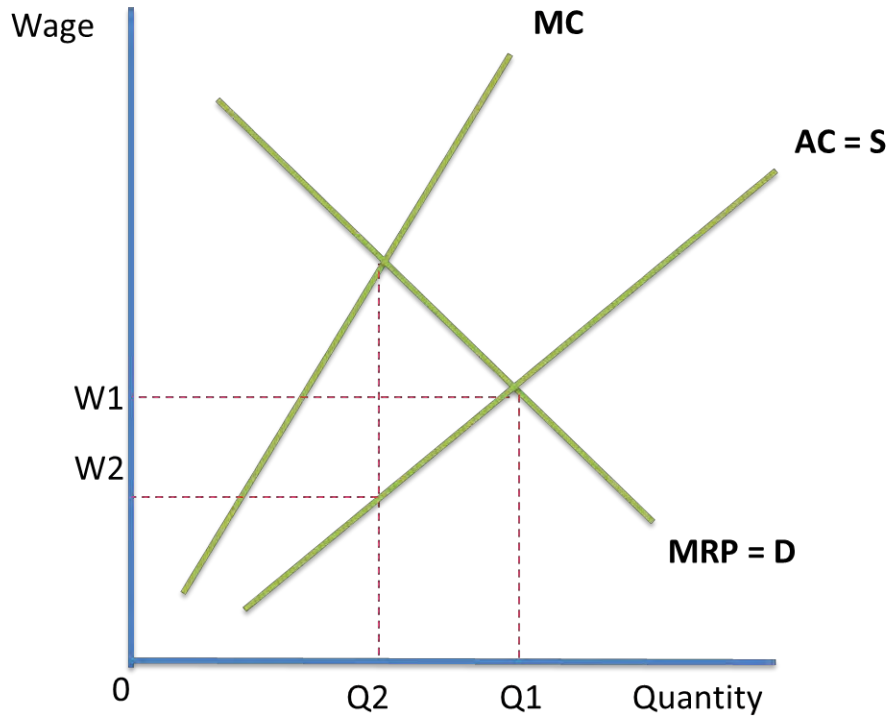


- However, in the real labour market, wages are not this flexible. Keynes coined the phrase 'sticky wages'. Wages in an economy do not adjust to changes in demand. The minimum wage makes wages sticky and means that during a recession, rather than lowering wages of several workers, a few workers might be sacked instead.

Wage determination in imperfect markets

How various factors, such as monopsony power, trade unions and imperfect information contribute to imperfections in a labour market

- **Monopsony power:** When there is only one buyer of labour in the market, there is said to be monopsony power. It means the firm has the ability to set wages.



- The marginal cost of adding an extra worker is more than the average cost. This is because in order to employ another employee the firm has to pay all of their workers more.
- At MC = MRP, the firm profit maximises. This means they employ Q2 workers. This makes the wage W2, lower than the market equilibrium competitive wage. The employment rate and the wage rate are below those that would exist in a perfectly competitive labour market.

- **Trade union power:** If trade unions are pushing for higher wages above the market equlibrium, the labour market is likely to be more flexible. Trade unions can also increase job security. Higher wages can be demanded by limiting the supply of labour, by closing firms, or by threatening strike action. Higher wages could cause unemployment, however. Trade unions can counter-balance exploitative monopsony power.

- **Imperfect information:** Some qualified workers might not be aware of higher paying jobs in other industries or with other firms. Some workers might not understand the long term benefits of investing in improving their skills and education. This can limit the productivity and potential progression of workers. It makes the market inefficient.