Edexcel Economics (A) A-level

Theme 3: Business Behaviour and the Labour Market

3.5 Labour Markets

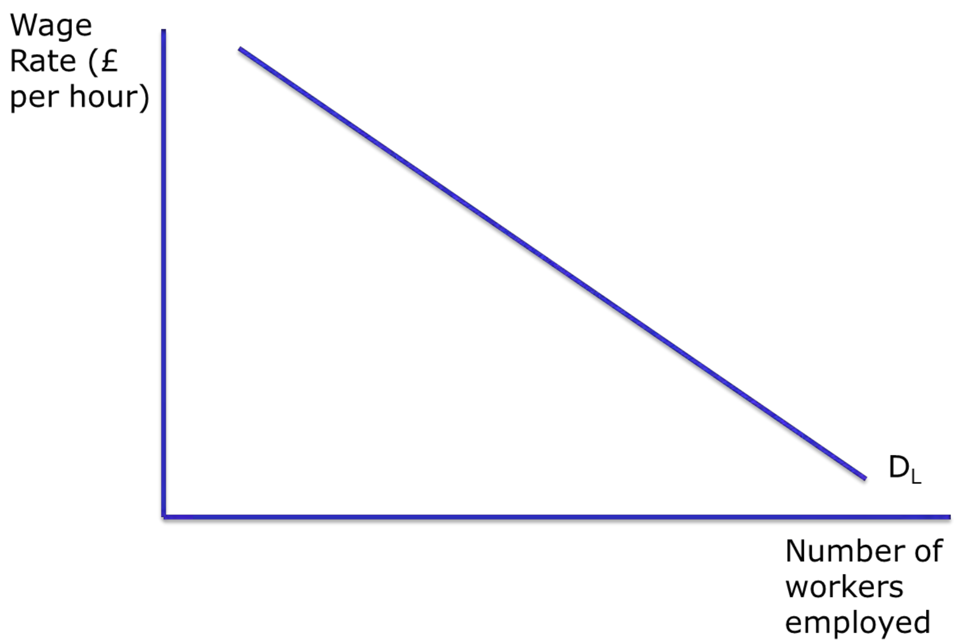
Summary Notes

3.5.1 Demand for 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.

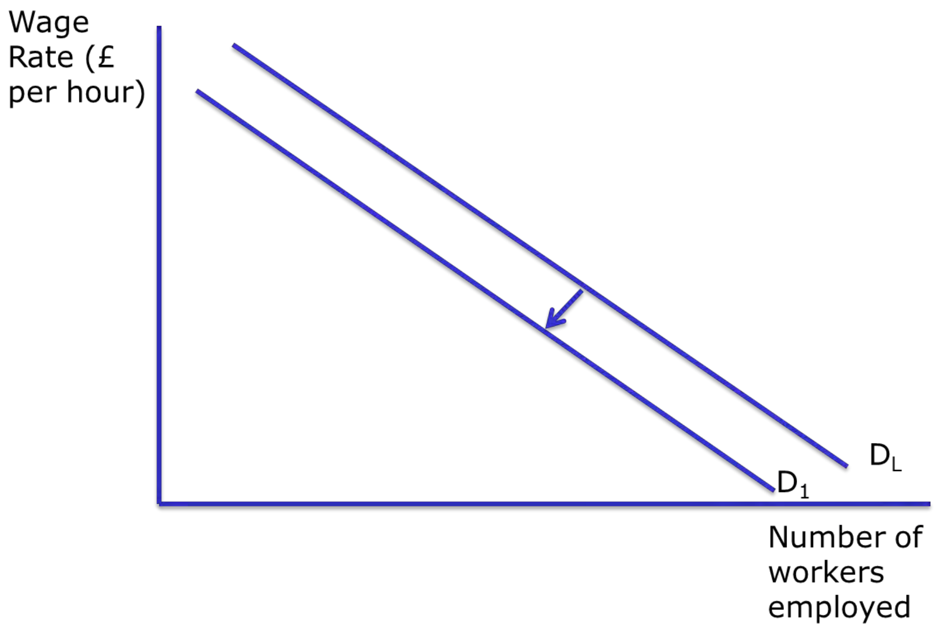
Demand for labour:

- 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:

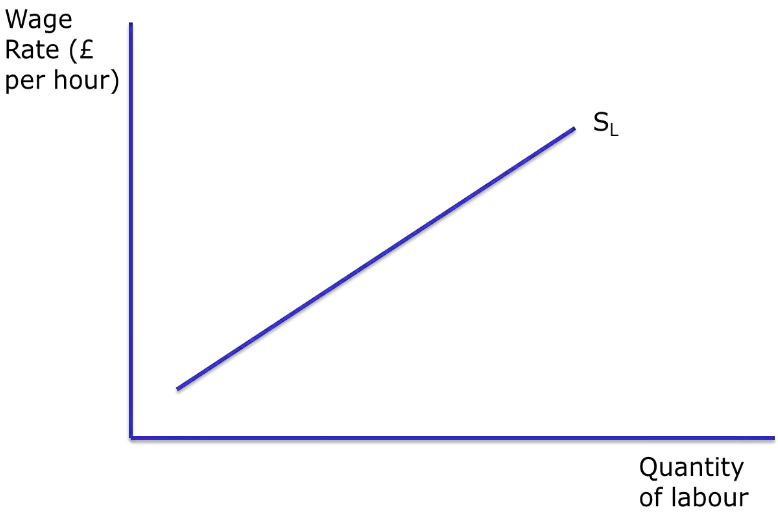


- **How profitable the firm is:**
    - The higher the profits of the firm, the more labour they can afford to employ.
- **The number of firms in the market:**
    - This determines how many buyers of labour there is. If there is only one employer, for example the NHS, the demand for labour is lower 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.

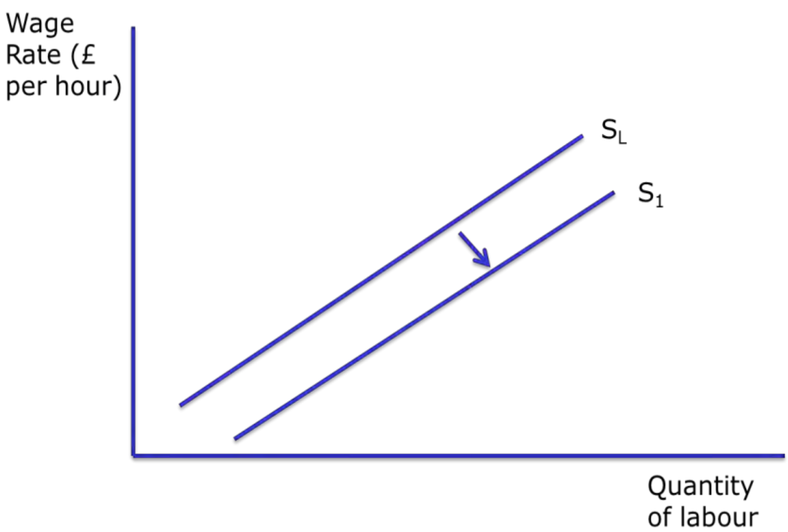
3.5.2 Supply of labour

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.
- **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.
- **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.

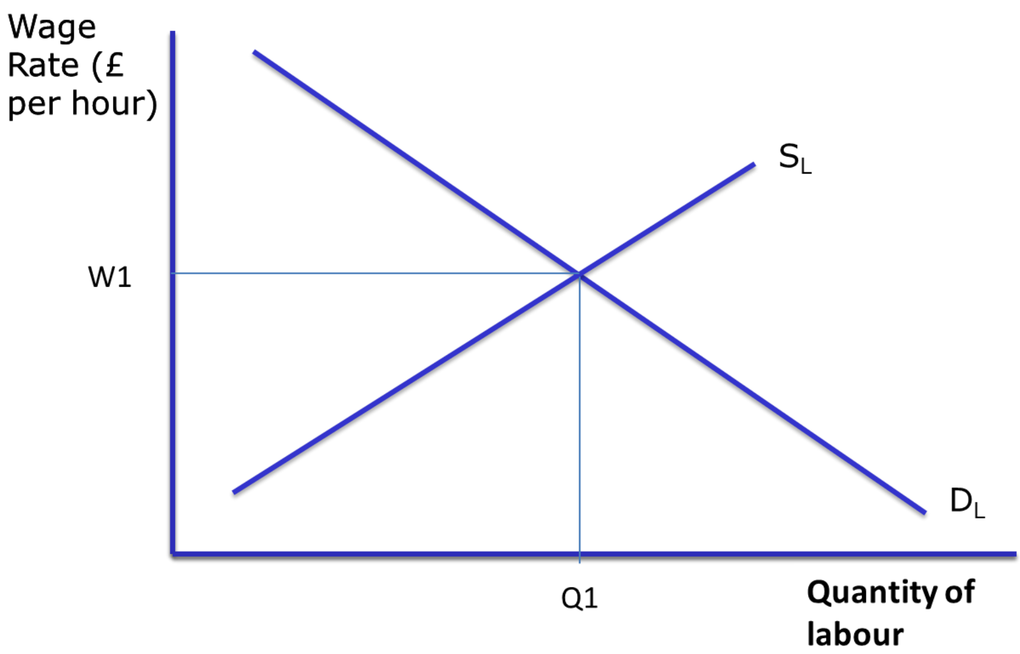
Market failure in labour markets- the geographical and occupational mobility of labour:

- The mobility of labour is the ability of workers to change between jobs.
  - The geographical immobility of the factors of production refers to the obstacles which prevent the factors of production moving between areas. For example, labour might find it hard to find work due to family and social ties, the financial costs involved with moving, imperfect market knowledge on work and the regional variations in house prices and living costs across the UK.
  - The occupational immobility of the factors of production refers to the obstacles which prevent the factors of production changing their use. For example, labour might find it difficult to change the occupation. This occurred in the UK with the collapse of the mining industry, when workers did not have transferable skills to find other work. The causes include insufficient education, training and skills.

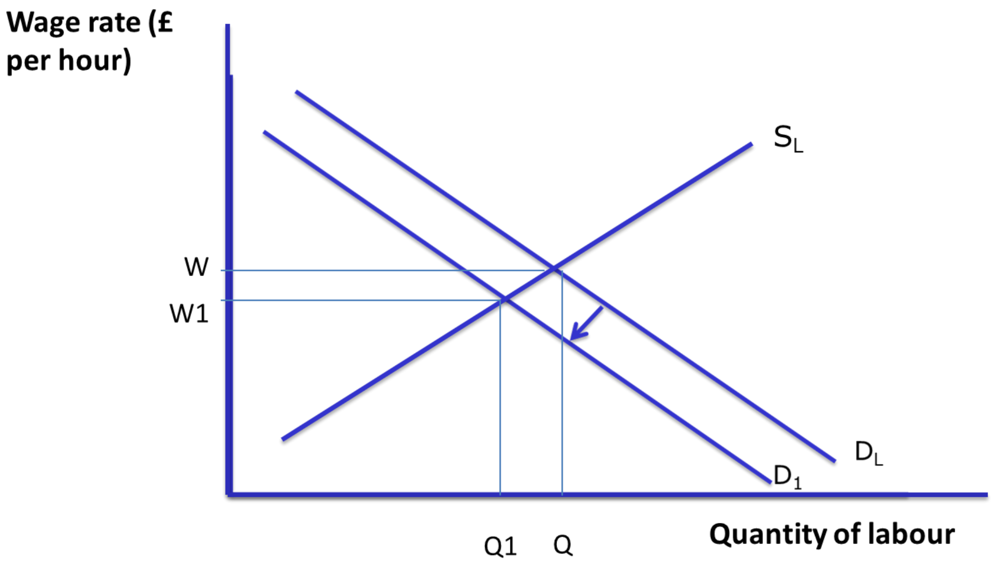
3.5.3 Wage determination in competitive and non-competitive markets

Labour market equilibrium:

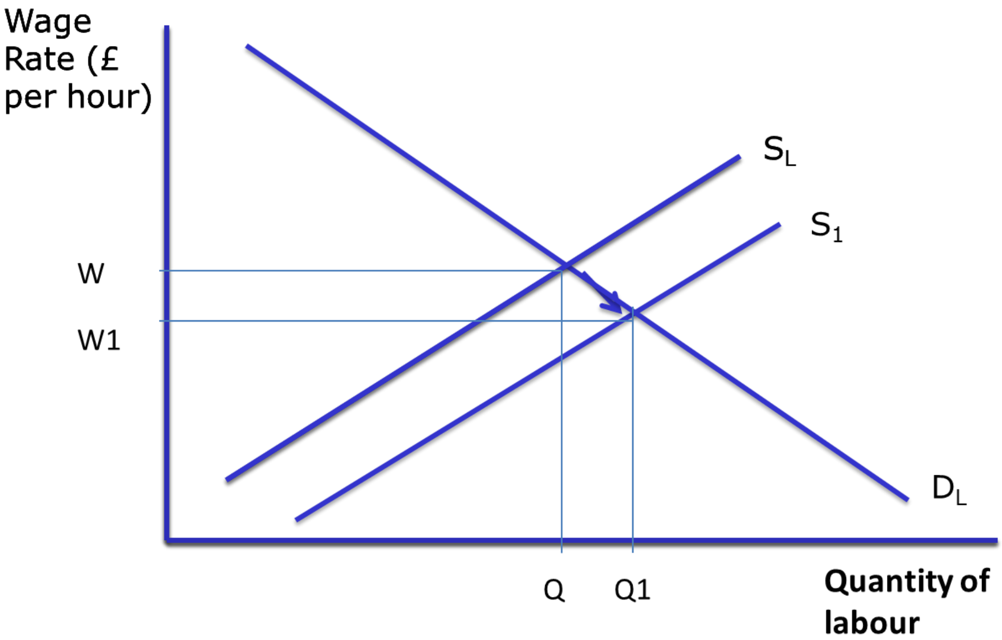
- The labour market is a factor market. The supply of labour is determined by those who want to be employed (the **employees)**, whilst the demand for labour is from **employers.**
- Labour market equilibrium is determined where the supply of labour and the demand for labour meet. This determines the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

Current labour market issues:

Wage differentials: Sometimes, even in the same job, workers can be paid different amounts. This is due to:

- **Formal education.** On average, those with a degree earn more over their lifetime than those who gain just A Levels.
- **Skills, qualifications and training.** Jobs which require more training and education offer higher wages. Training workers is expensive for firms, so they compensate for this by offering workers, who have already undergone education and training, higher wages.
- **Pay gaps.** The wage gap between skilled and unskilled workers has increased in the UK recently. This is due to technological change and globalisation, which has shifted production abroad.
- **Wages and skills.** Skilled workers produce higher outputs than unskilled workers because they are more productive, so the demand for their labour is higher. This means they can demand higher wages.
- **Gender.** Even with equal pay laws, women still earn less than men on average. This could be due to career breaks and fewer hours worked on average than men, or because women are crowded into low-paid or part-time jobs, which may only require low skill levels. Women could also be discriminated against when it comes to promotions, which effectively locks out higher paying jobs. Although a gap still exists, it is narrowing.
- **Discrimination.** Workers might be discriminated against due to age, disabilities, gender and race.

The impact of migration on labour markets

- There could be more competition to get a job due to the rise in the size of the working population. Migrants tend to be of working age, and many are looking for a job.
- Migrants tend to bring high quality skills to the domestic workforce, which can increase productivity and increase the skillset of the labour market. This could increase global competitiveness.
- Migrant labour affects the wages of the lowest paid in the domestic labour market, by bringing them down. However, this impact is only small. For the medium and higher income households, it is hard to find evidence of worker displacement or depressed wages.

- The skills of migrant labour could substitute those of the domestic market, so workers could be replaced. If the skills complement the domestic labour market, there could be a welfare gain through higher productivities.

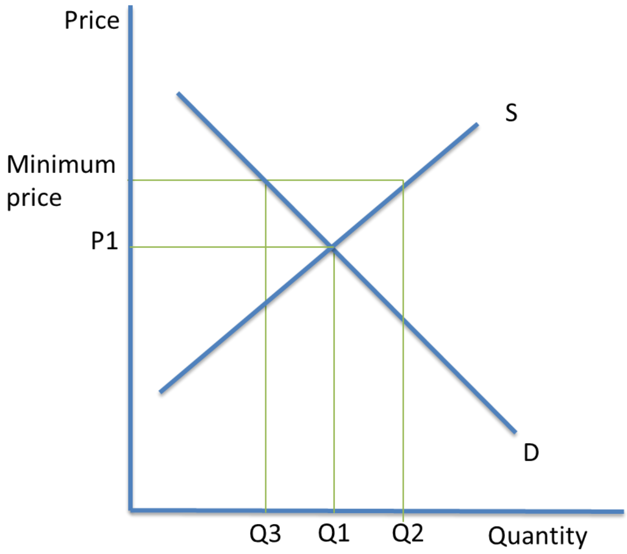
Unemployment:

- In the UK, the government aims to have as near to full employment as possible. They account for frictional unemployment by aiming for an unemployment rate of around 3%. The labour force should also be employed in productive work.
- In December 2014, the employment rate peaked at 73.2%. The employment rate fell during the period of the financial crisis to 70.1%. Currently the unemployment rate in the UK is 5.4% (as of February 2015). It fell to a seven year low in May 2015.
- Unemployment is a problem since, if consumers are unemployed, they have less disposable income and their standard of living may fall as a result. There are also psychological consequences of losing a job, which could affect the mental health of workers.
- If the unemployment rate increases, the government may have to spend more on JSA, which incurs an opportunity cost because the money could have been invested elsewhere. The government would also receive less revenue from income tax, and from indirect taxes on expenditure, since the unemployed have less disposable income to spend.
- Unemployment creates an opportunity cost to society, since workers could have produced goods and services if they were employed. There could also be negative externalities in the form of crime and vandalism.
- Youth unemployment is particularly damaging, because it could lead to **hysteresis.** This is a type of structural unemployment, where someone is out of work for a long time, so their skills deteriorate. This makes it harder to find a job, and it leads to long-term unemployment. If young people find it hard to get a job, then they might be discouraged from participating in the labour market as an adult.

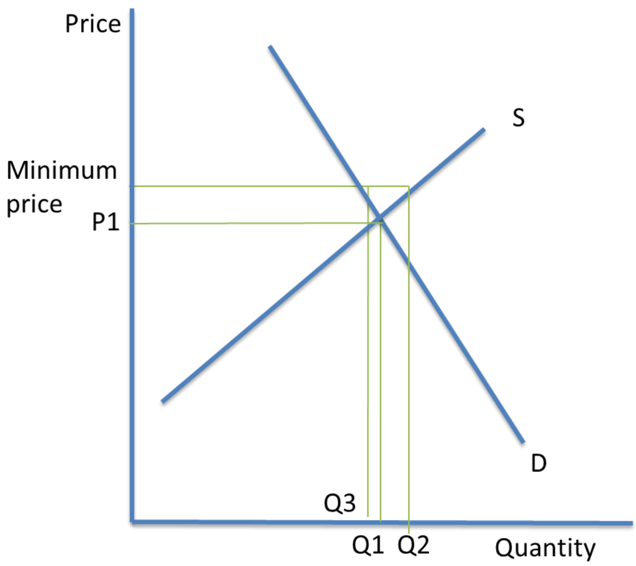
Government intervention in the labour market:

Maximum and minimum wages

- The **National Minimum Wage** is an example of a minimum price.
- The minimum wage **has to be set above the free market price,** just like other minimum prices, otherwise it would be ineffective.

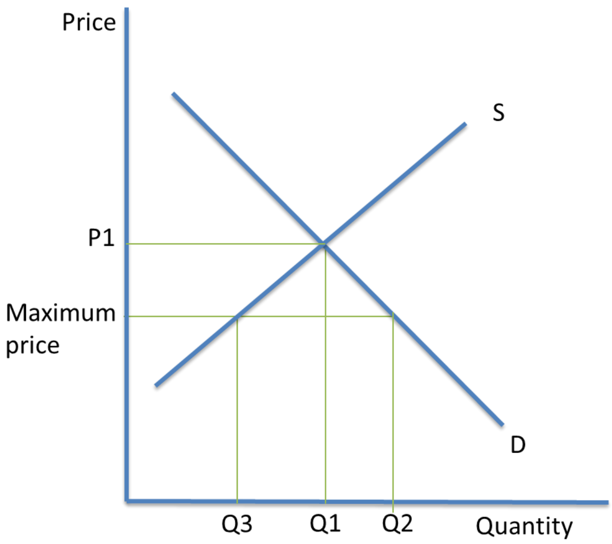


- The diagram above suggests that a minimum wage leads to a fall in the employment rate (Q1 – Q3). It depends on what level the wage is set at. An inelastic labour demand (diagram below) will mean there is only a small contraction in demand for labour (Q1 – Q3).

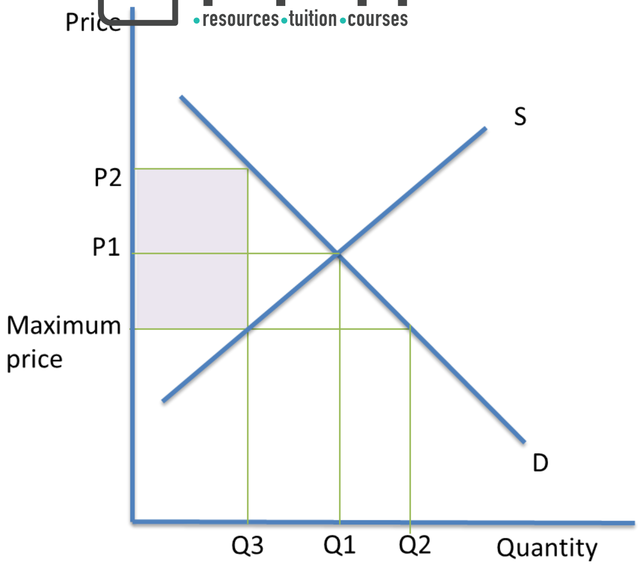


- There has been no evidence of a rise in unemployment with a rise in the NMW so far in the UK. Some firms say this is because the NMW is still relatively low.
- The NMW will yield the positive externalities of a decent wage, which will increase the standard of living of the poorest, and provide an incentive for people to work.
- It could make it harder for young people to find a job, because their lack of experience might not be valuable to firms who are paying more for their labour.
- The government might make more tax revenue, due to more people earning higher wages.
- A higher wage could make the country less competitive on a global scale, since they cannot compete with countries that have lower wages.

- A **maximum wage** is also known as a wage ceiling, and it limits how much income someone can earn. It can be used as a means to redistribute wealth more equitably in society.
- In theory, a maximum wage should limit inflation, since wages (and therefore consumer demand) is limited. Maximum wages must be set below the free market equilibrium wage to be effective.
- One criticism of a maximum wage is that it could be a disincentive to innovate, and workers might opt for less demanding work.



- The free market equilibrium is at P1, Q1.



- Maximum wages control the market wage, but this could lead to government failure if they misjudge where the optimum wage should be.
- It can lead to a more equal distribution of wealth in society.

- **Public sector wage setting**

- The public sector is the compilation of industries owned by the government.
- In the UK, public sector pay is higher than the private sector, in raw terms.
- Between 2008 and 2010, public sector pay grew (4.5%) relative to the private sector (1%). Women in the public sector were paid about 8% more than those in the private sector between 2013 and 2014. Across the country, public sector pay is more equal than private sector pay.
- About half of government spending goes towards public sector pay.

- **Policies to tackle labour market immobility**

- The flexibility of the labour market is how willing and able labour is to respond to changes in the conditions of the market. It is important for labour to be able to adjust to changes in demand, and it is vital for the supply-side of the economy.

- **Trade union power:** If trade unions are pushing for higher wages, the labour market is likely to be more flexible. Trade unions can also increase job security. If trade unions limit the rights of a worker to strike, there could be a decline in flexibility.

- **Regulation:** The more freedom firms have to hire and fire workers and the more freedom workers have in terms of their rights, the more flexible the labour market. Excessive regulation will limit flexibility.

- **Welfare payments and income tax rates:** The reward for working should be high. If welfare payments are generous and income tax rates are high, labour market flexibility is likely to be lower.

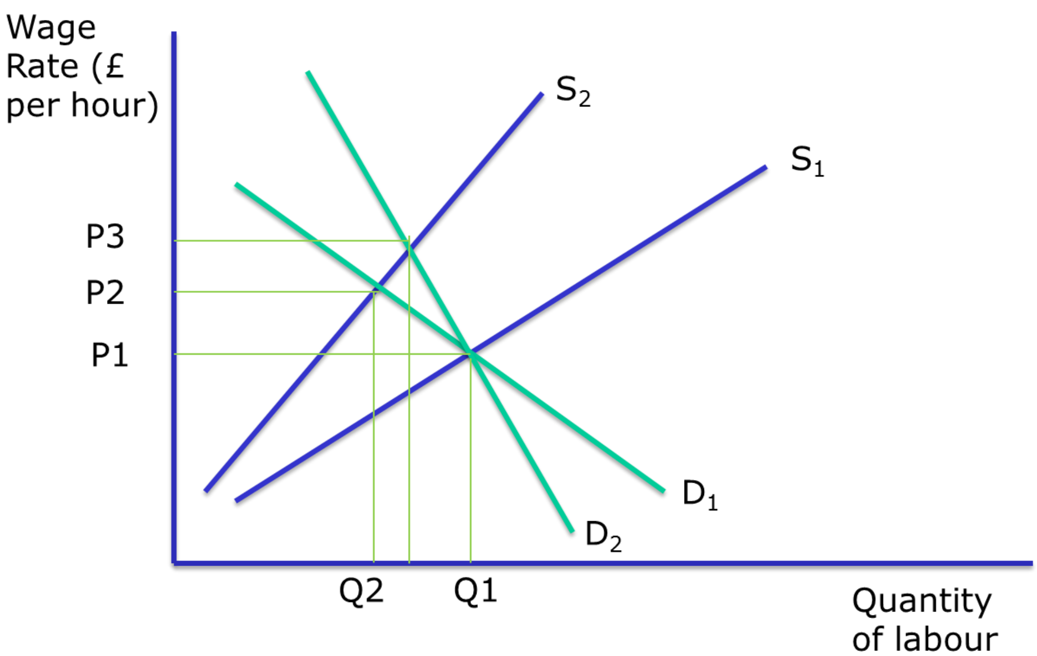
- **Training:** More widely available training opportunities and a more skilled workforce makes the labour market more flexible. The quality and price of education should be improved, so more people can afford a good education.

- **Infrastructure:** Improving infrastructure might help the geographical immobility of labour, since it becomes easier to move around the country.

- **Housing:** If housing became more affordable, then people might be more able to move around the country for work, which improves the geographical mobility of labour.

The significance of the elasticity of demand and supply of 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.

- The elasticity of supply of labour is the responsiveness of the quantity of labour supplied to a change in the wage rate.
- This is affected by:
    - The skills of the workforce. Skilled jobs have lower elasticities than unskilled jobs, because it is more difficult to attract workers, since only a few have the necessary skills.
    - Length of training. The longer the training period for a job, the lower elasticity of labour supply.
    - Sense of vocation. Some jobs have rewards which are not financial, such as teaching. These will have inelastic supplies.
    - Time period. In the short run, the supply of labour is more inelastic than in the long run.