

Edexcel Economics AS-level

Unit 1: Markets in Action


Topic 5: Wage Determination in Labour Markets

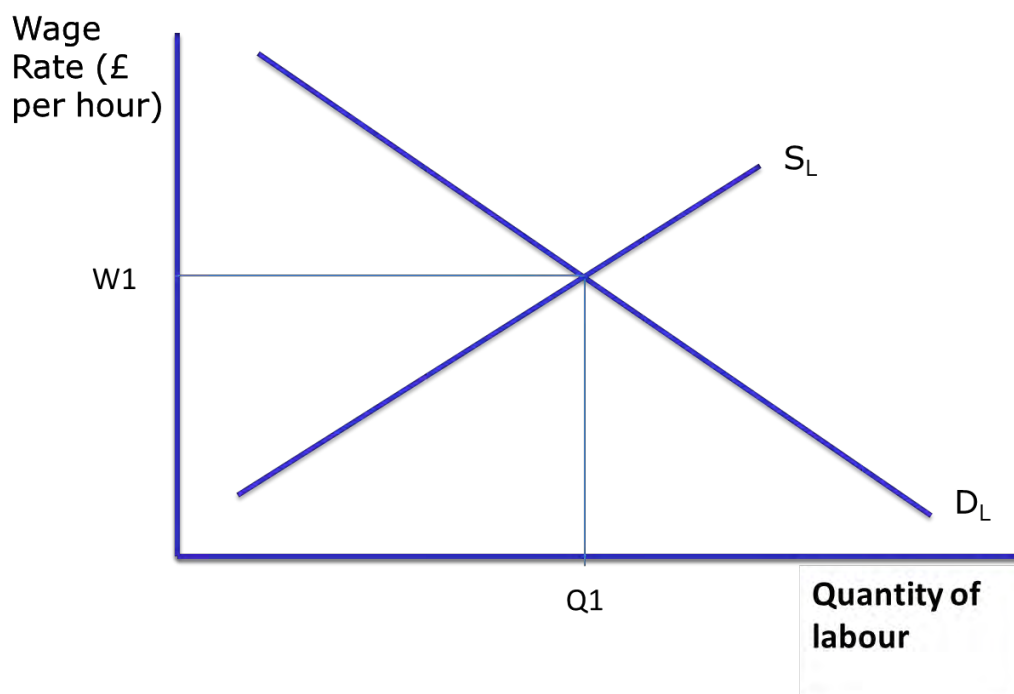
5.3 Determination of wage rates


Notes

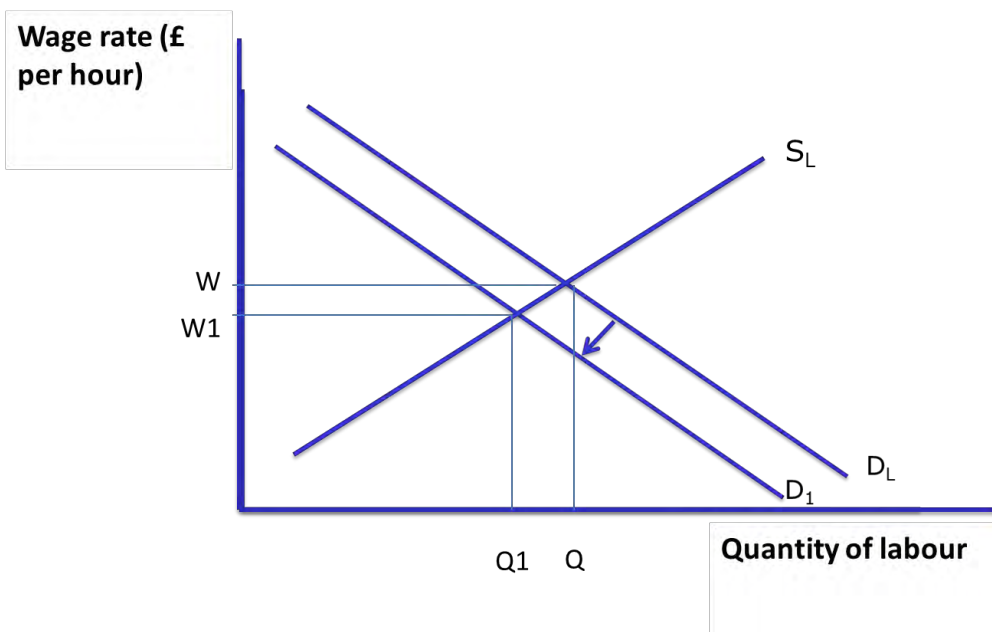



 **How wages are determined in a highly competitive market**

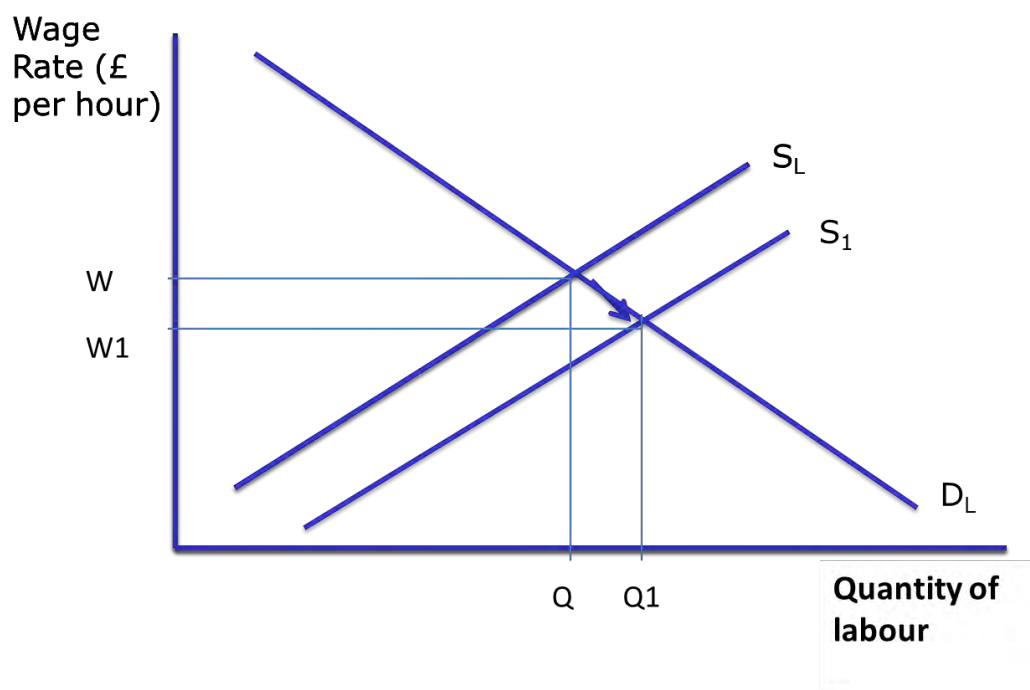
 Labour market equilibrium is determined where the supply of labour and the demand for labour meet. This determines the equilibrium price of labour, i.e. the wage rate.




 When the demand for labour falls, such as during a recession, in a free market the wage rate would fall from W to W_1 .





-  If the supply of labour increases, such as if the retirement age was raised, the wage rate would fall from W to W_1 .



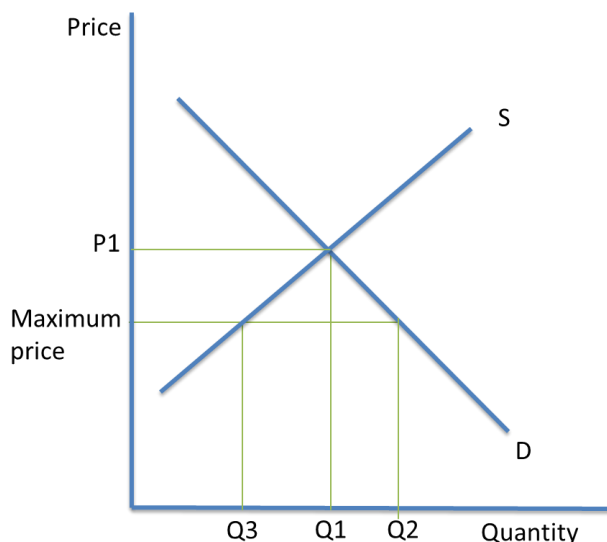
-  However, in the real labour market, wages are not this flexible. Keynes coined the phrase 'sticky wages'. Wages in an economy do not adjust to changes in demand. The minimum wage makes wages sticky and means that during a recession, rather than lowering wages of several workers, a few workers might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


Government intervention in the labour market e.g. maximum and minimum wages

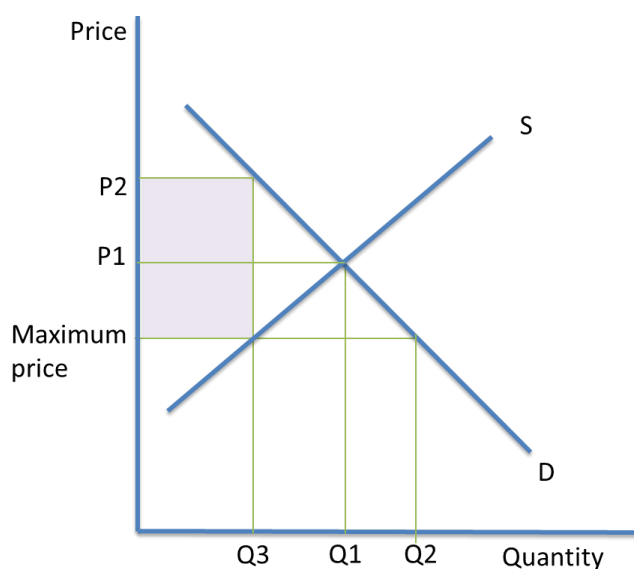
Maximum price





-  The government might set a **maximum price** where the consumption or production of a good is to be encouraged. This is so the good does not become too expensive to produce or consume.
-  Maximum prices **have to be set below the free market price**, otherwise they would be ineffective.







 The free market equilibrium is at P1, Q1.








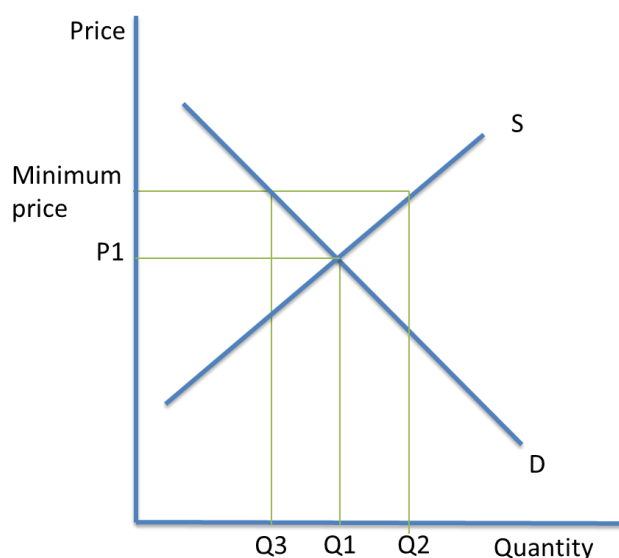
-  If suppliers only produced at Q3, some consumers would be willing to pay P2. The shaded area shows the consumer surplus producers can take with the higher price.
-  A quantity of Q3 would require rationing or auctioning, since quantity demanded is Q2.
-  They prevent monopolies exploiting consumers. For example, in the EU, price caps on roaming charges are in place to make sure it is not too expensive for consumers to use their mobile phones abroad.
-  Maximum prices control the market price, but this could lead to government failure if they misjudge where the optimum market price should be.




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 Maximum prices could lead to welfare gains for consumers by keeping prices low, and they could increase efficiency in firms, since they have an incentive to keep their costs low to maintain their profit level.
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 However, it could reduce a firm's profits, which could lead to less investment in the long run. Moreover, firms might raise the prices of other goods, so consumers might have no net gain.

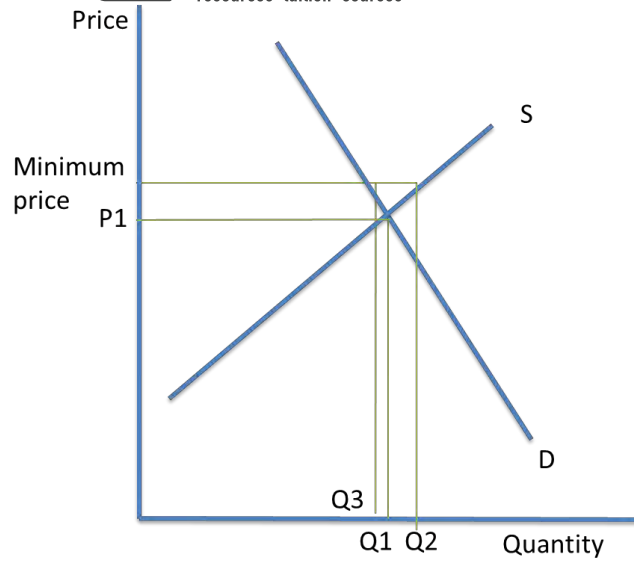
Minimum price


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 The government might set a **minimum price** where the consumption or production of a good is to be discouraged. This ensures the good never falls below a certain price.
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 For example, the government might impose a minimum price on alcohol, so it is less affordable to buy it. The **National Minimum Wage** is an example of a minimum price.
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 Minimum prices would reduce the negative externalities from consuming a demerit good, such as alcohol.
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 Minimum prices **have to be set above the free market price**, otherwise they would be ineffective.
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 The minimum wage could be used as an example.



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





-  This minimum price 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.

