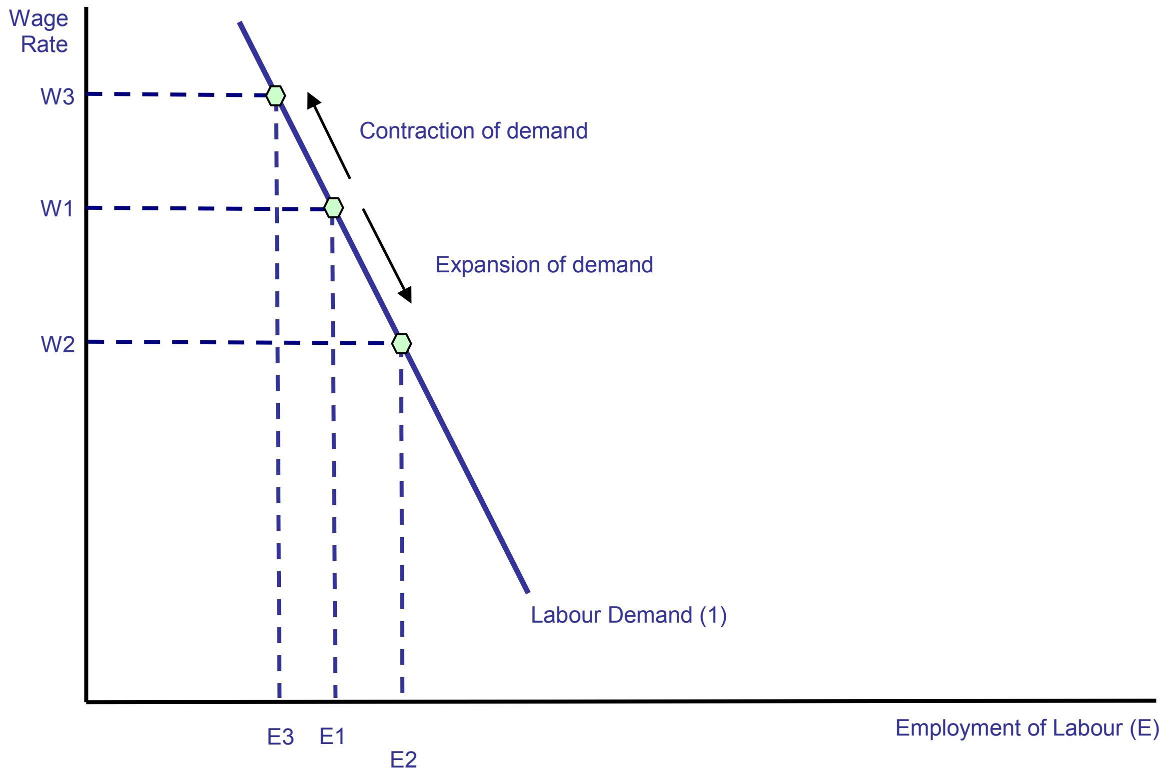
Markets in Action: The Labour Market

The labour market is a factor market – it provides a means by which employers find the labour they need, whilst millions of individuals offer their labour services in different jobs.

The Demand for Labour

Many factors influence how many people a business is willing and able to take on. But we start with the most obvious – the **wage rate or salary**. There is an inverse relationship between the demand for labour and the wage rate that a business needs to pay as they take on more workers. If the wage rate is high, it is more costly to hire extra employees. When wages are lower, labour becomes relatively cheaper than for example using capital inputs. A fall in the wage rate might thus create a substitution effect and lead to an expansion in labour demand.

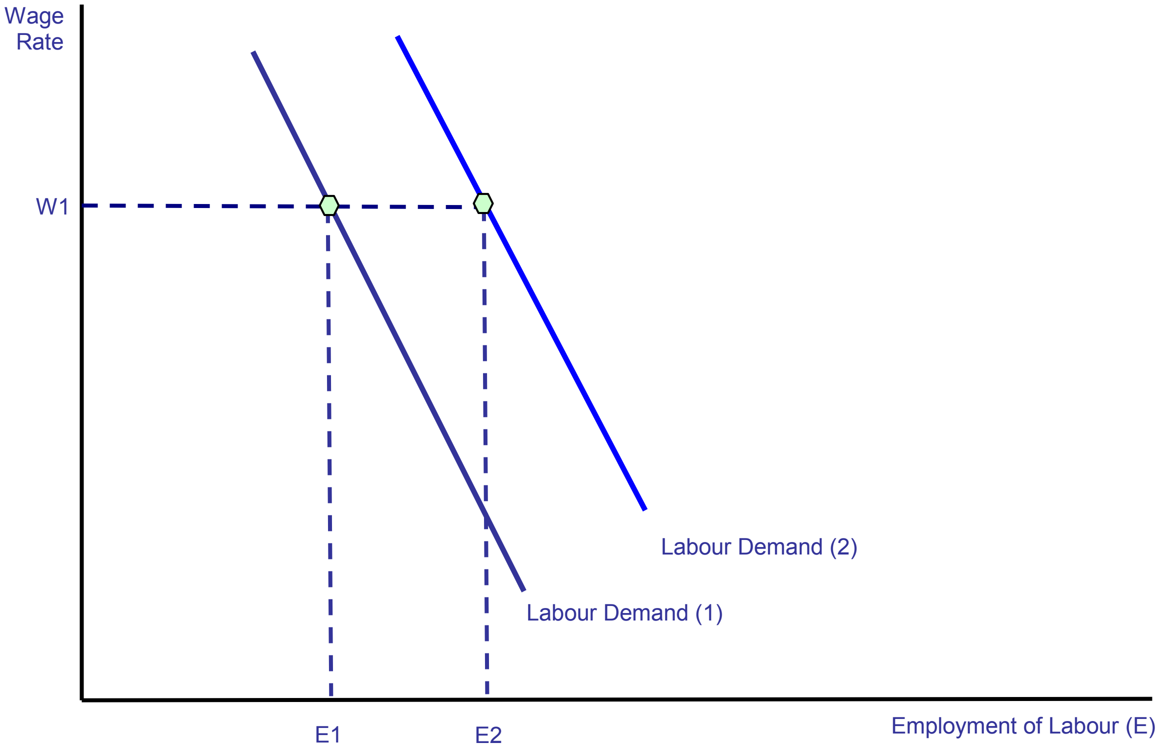


Shifts in the Demand for Labour

The number of people employed at each wage level can change and in the next diagram we see an outward shift of the labour demand curve. The curve shifts when there is a change in the conditions of demand in the jobs market. For example:

- A rise in the level of consumer demand for a product which means that a business needs to take on more workers (see below on the concept of derived demand)
- An increase in the productivity of labour which makes using labour more cost efficient than using capital equipment
- A government employment subsidy which allows a business to employ more workers

The labour demand curve would shift inwards during a recession when sales of goods and services are in decline, business profits are falling and many employers cannot afford to keep on their payrolls as many workers. The result is often labour redundancies and an overall decline in the demand for labour at each wage rate.



Labour as a Derived Demand

The demand for all factor inputs, including labour, is a **derived demand** i.e. the demand depends on the demand for the products they produce. When the economy is expanding, we see a rise in the **aggregate demand for labour** providing that the rise in output is greater than the increase in labour productivity. In contrast, during a recession or a slowdown, the aggregate demand for labour will decline as businesses look to cut their operations costs and scale back on production.

In a recession, business failures, plant shut-downs and short term redundancies lead to a reduction in the derived demand for labour. This has been a feature of the recession in the British economy from 2008 onwards.

Car-maker cuts jobs as sales fall

The biggest car-maker in the United States, General Motors, is shedding jobs from the assembly plant to the boardroom as it struggles to respond to falling demand for its vehicles. Soaring petrol prices and fears of recession have put motorists off buying its pick-up trucks and gas-guzzling 4x4s. Many Americans are switching to smaller, more fuel-efficient cars, which tend to be a speciality of Asian motor manufacturers. General Motors has announced a two-year pay freeze and a programme of voluntary redundancies as it looks to reduce labour costs. GM and its rivals - Ford and Chrysler - have already cut more than 100,000 jobs since 2006.

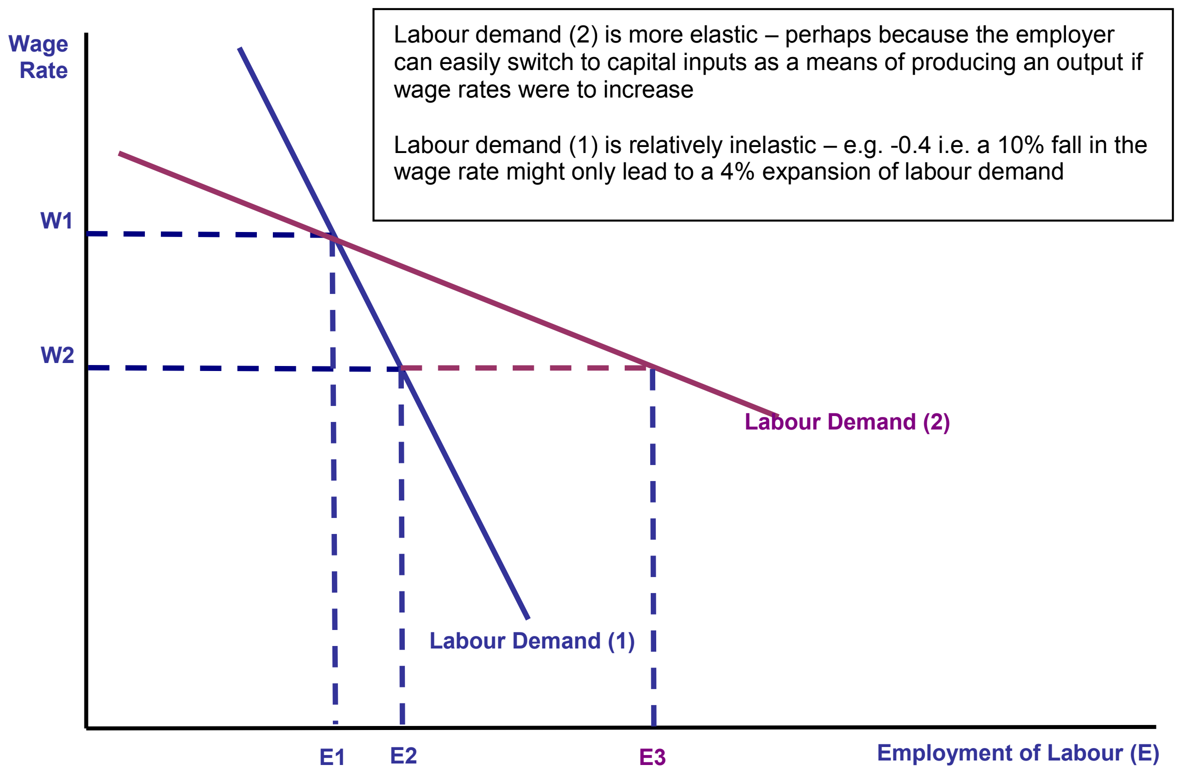
Source: Adapted from news reports, June 2008

The construction industry is another example of the derived demand for labour. The decade long property boom in the UK has led to rising prices, output and employment. But the turnaround in the housing market has led to thousands of job losses during 2008 and 2009 as the market demand for workers in housing construction has shifted inwards.

Elasticity of Demand for Labour

Elasticity of labour demand measures the responsiveness of demand for labour when there is a change in the ruling market wage rate. The elasticity of demand for labour depends on these factors:

1. **Labour costs as a % of total costs**: When labour expenses are a high proportion of total costs, then labour demand is more elastic than a business where fixed costs of capital are the dominant business expense. In many service jobs such as customer service centres or gas boiler repairs, labour costs are a high proportion of the total costs of a business.
2. **The ease and cost of factor substitution**: Labour demand will be more elastic when a firm can substitute quickly and easily between labour and capital inputs. When specialised labour or capital is needed, then the demand for labour will be more inelastic with respect to the wage rate. For example it might be fairly easy and cheap to replace security guards with cameras but a hotel would find it almost impossible to replace hotel cleaning staff with machinery!
3. **The price elasticity of demand for the final output produced by a business**: If a firm is operating in a highly competitive market where final demand for the product is price elastic, they may have little market power to pass on higher wage costs to consumers through a higher price. The demand for labour may therefore be more elastic as a consequence. In contrast, a firm that sells a product where final demand is inelastic will be better placed to pass on higher costs to consumers.

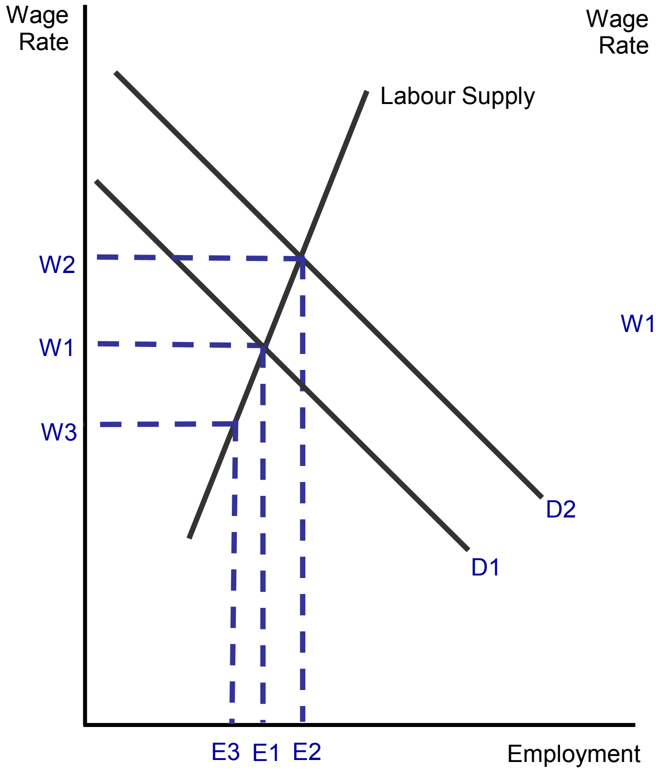


Labour Supply

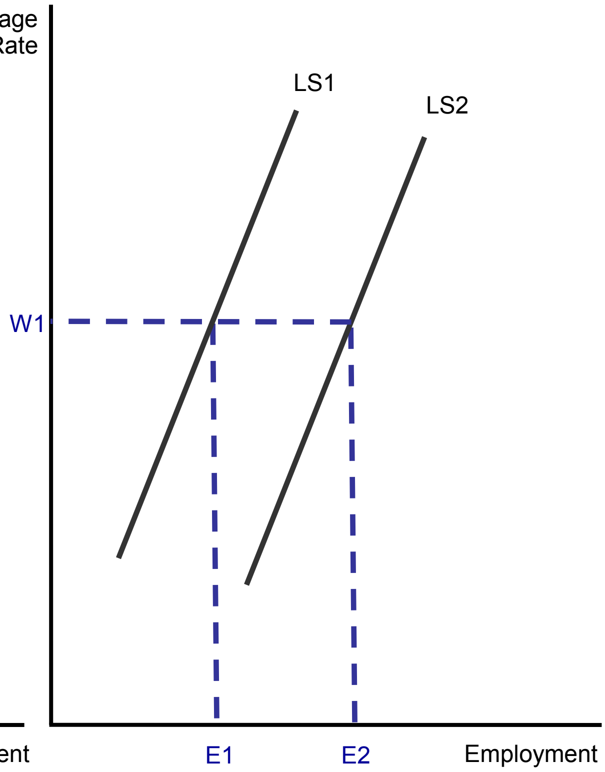
The **labour supply** refers to the total number of hours that labour is willing and able to supply at a given wage rate. It can also be defined as the number of workers willing and able to work in a particular job or industry for a given wage.

The labour supply curve for any industry or occupation will be upward sloping. This is because, as wages rise, other workers enter this industry attracted by the incentive of higher rewards. They may have moved from other industries or they may not have previously held a job, such as housewives or the unemployed. The extent to which a rise in the prevailing wage or salary in an occupation leads to an expansion in the supply of labour depends on the elasticity of labour supply.

The Labour Supply Curve
The supply curve for labour shows the number of workers willing and able to enter an industry or occupation different wage levels



Shifts in the Labour Supply Curve



Key factors affecting labour supply

The supply of labour to a particular occupation is influenced by a range of factors:

1. **The real wage rate on offer in the industry itself** – higher wages raise the prospect of increased factor rewards and should boost the number of people willing and able to work
2. **Overtime:** Opportunities to boost earnings come through overtime payments, productivity-related pay schemes, and share option schemes.
3. **Substitute occupations:** The real wage rate on offer in competing jobs is another factor because this affects the wage and earnings differential that exists between two or more occupations. So for example an increase in the relative earnings available to trained plumbers and electricians may cause some people to switch their jobs.

4. **Barriers to entry:** Artificial limits to an industry's labour supply (e.g. through the introduction of minimum entry requirements or other legal barriers to entry) can restrict labour supply and force average pay and salary levels higher – this is particularly the case in professions such as legal services and medicine where there are strict "entry criteria" to the professions.

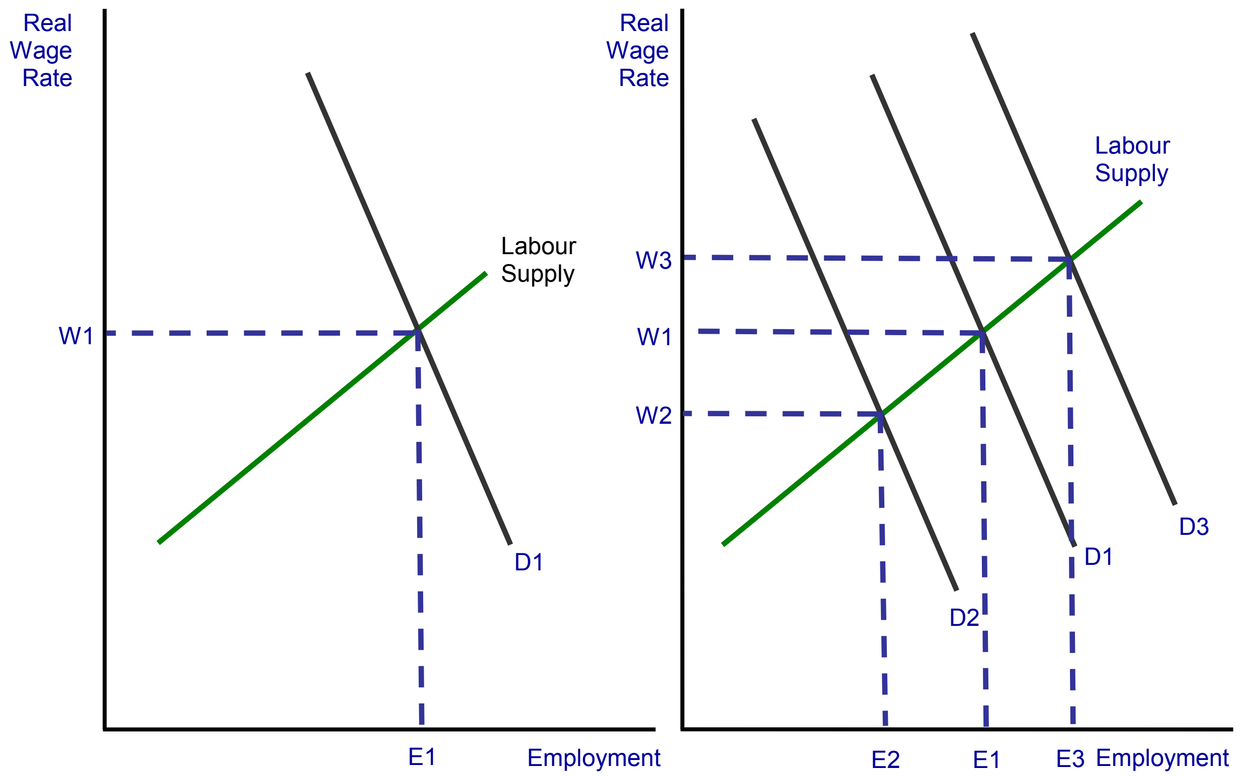
5. **Improvements in the occupational mobility of labour:** For example if more people are trained with the necessary skills required to work in a particular occupation.

6. **Non-monetary characteristics of specific jobs** – include factors such as the level of risk associated with different jobs, the requirement to work anti-social hours or the **non-pecuniary benefits** that certain jobs provide including **job security**, opportunities for promotion and the chance to live and work overseas, employer-provided in-work training, employer-provided or subsidised health and leisure facilities and other in-work benefits including occupational pension schemes.

7. **Net migration of labour** – the UK is a member of the European Union single market that enshrines free movement of labour as one of its guiding principles. A rising flow of people seeking work in the UK is making labour migration an important factor in determining the supply of labour available to many industries – be it to relieve shortages of skilled labour in the NHS or education, or to meet the seasonal demand for workers in agriculture and the construction industry.

Equilibrium Wages

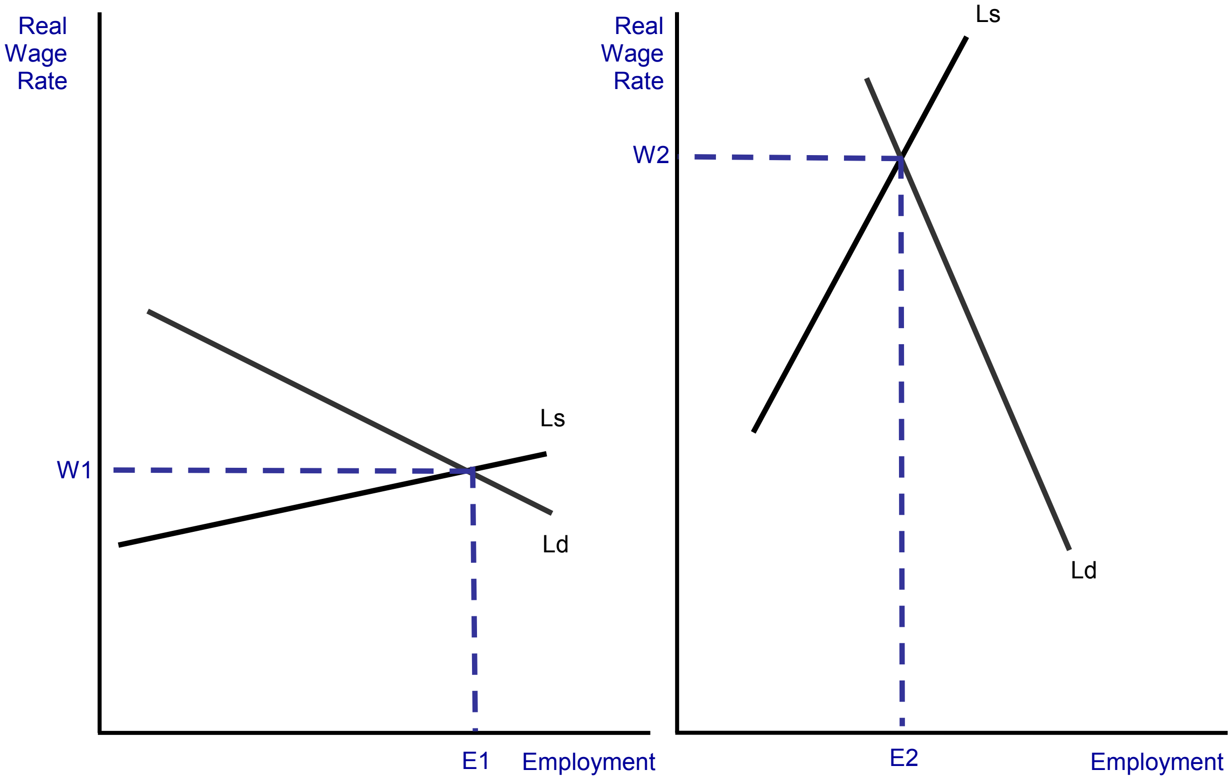
The equilibrium price of labour (market wage rate) in a given market is determined by the interaction of the supply and demand for labour. Employees are hired up to the point where the extra cost of hiring an employee (their wage) is equal to the addition to sales revenue from hiring them, their MRP.



Wage Differentials

There is a wide gulf in pay and earnings rates between different occupations in the UK labour market. No one factor explains the gulf in pay that exists and persists between occupations and within each sector of the economy. Some of the relevant factors are listed below

1. **Compensating wage differentials** - higher pay can often be some reward for **risk-taking** in certain jobs, working in poor conditions and having to work **unsocial hours.**
2. **Equalising difference and human capital** - in a competitive labour market equilibrium, wage differentials compensate workers for (opportunity and direct) costs of human capital acquisition. There is an opportunity cost in acquiring qualifications - measured by the current earnings foregone by staying in full or part-time education.
3. **Different skill levels** - the gap between poorly skilled and highly skilled workers gets wider each year. One reason is that the market demand for skilled labour grows more quickly than the demand for semi-skilled workers. This pushes up pay levels. Highly skilled workers are often in inelastic supply and rising demand forces up the "**going wage rate**" in an industry.
4. **Differences in labour productivity and revenue creation** - workers whose efficiency is highest and ability to generate revenue for a firm should be rewarded with higher pay. City economists and analysts are often highly paid not least because they can claim annual bonuses based on performance. Top sports stars can command top wages because of their potential to generate extra revenue from ticket sales and merchandising.
5. **Trade unions and their collective bargaining power** - unions might exercise their bargaining power to offset the power of an employer in a particular occupation and in doing so achieve a **mark-up** on wages compared to those on offer to non-union members
6. **Employer discrimination** is a factor that cannot be ignored despite over twenty years of equal pay legislation in place



Trade Unions

Trade unions are organisations of workers that seek through **collective bargaining** with employers to protect and improve the real incomes of their members, provide job security, protect workers against unfair dismissal and provide a range of other work-related services including support for people claiming compensation for injuries sustained in a job.

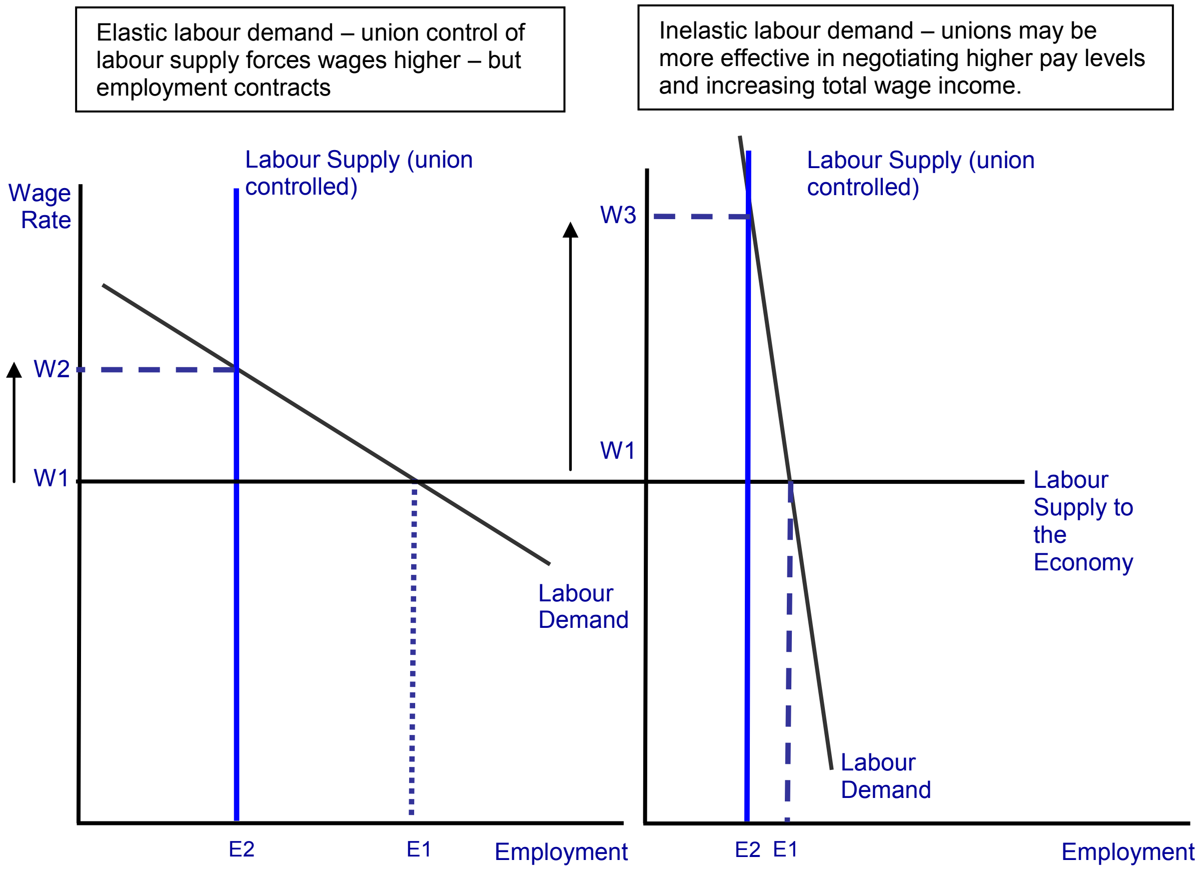
Most trade unions in the UK belong to the Trades Union Congress (TUC). Examples include Amicus, Unison, the Rail and Maritime Union and the National Union of Teachers.

Main roles of trade unions

- Protecting and improving the real living standards of their members
- Protecting workers against unfair dismissal (employment rights)
- Promoting improvements in working conditions, workload & health and safety issues
- Workplace training and education, accumulation of human capital
- Protection of pension rights for union members
- A counter-balance to possible power of employers in the labour market

Trade Union membership

There has been a large decline in union membership over the last twenty-five years
In 2006 an estimated 6.39 million employees in the UK were members of a trade union- less than half the figure when union membership peaked in 1979.



Unions might seek to exercise their **collective bargaining power** with employers to achieve a mark-up on wages compared to those on offer to non-union members. For this to happen, a union must have some **control over the total labour supply** available to an industry. In the past this was possible if a union operated a **closed shop agreement** with an employer – i.e. where the employer and union agreed that all workers would be a member of a particular union. However in most sectors, the closed shop is now history.

More frequently, a union may simply bid through **bi-lateral negotiations** with employers to achieve an increase in wages ahead of the rate of inflation so that real wages rise, and other improvements to working hours and conditions.

Government economic policies and the labour supply

The main policies designed to increase the supply of labour available to the economy are as follows:

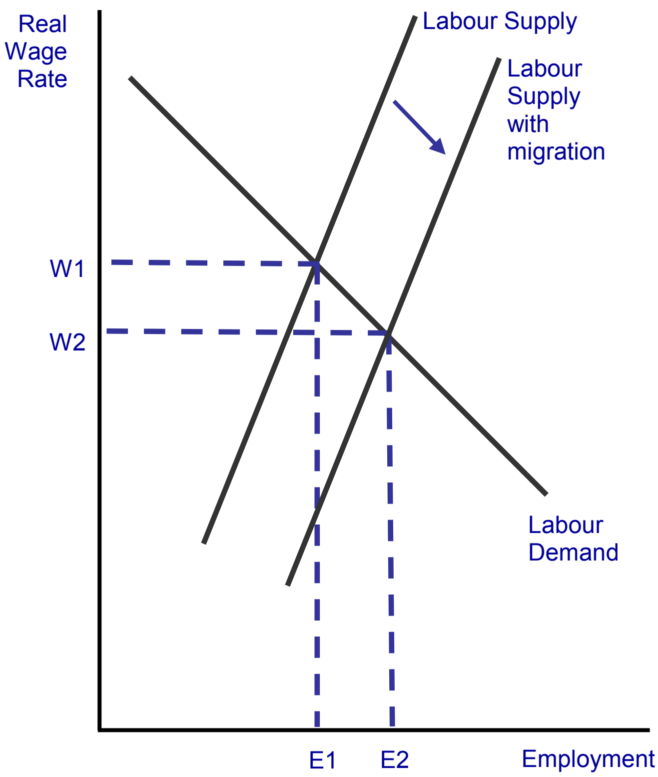
1. **Reforms to the system of direct taxation:** In the 1980s, Thatcher's economic policies focused on cutting income tax rates particularly at the top end and switching away from direct towards indirect taxation. More recently, successive governments have tended to focus more on reductions in the lower rates of income tax and tax allowances for lower-paid workers. The theoretical idea remains broadly the same, that lower direct taxes increase the post-tax reward to working and act as an incentive for more people to join the labour supply. In 2007 the government announced that the 10% starting rate of income tax would be withdrawn in 2008 and that the basic rate of tax would be cut from 22% to 20%.

2. **Reforms to the benefits system:** The emphasis here has changed away from the rather crude idea of cutting the real and relative value of welfare benefits towards encourage people into searching for work, towards a reliance on tax credits (for example the Working

Families Tax Credit) to give parents with children a greater financial incentives to work. The aim is to reduce the disincentive problems created by the unemployment and poverty trap.

3. **Increased investment in education and training**: This is designed to boost the **human capital** of the labour force and improve the **occupational mobility** of the labour force to meet the changing demands of employers across different industries.

4. **A more relaxed approach to labour immigration**: Particularly where there are shortages of workers with skills such as consultants and fully trained nurses in the NHS, or shortages of teachers in certain subjects. The effect of net inward migration on the labour supply is shown in the diagram below.



Strong inflows of labour into the economy can have the effect of increasing the labour supply

This puts downward pressure on real wages (for a given level of labour demand) e.g. through helping to relieve labour shortages in particular industries and occupations

If migration provides a boost to the labour supply and to labour productivity, there is the prospect of an outward shift in a country's long run aggregate supply

The importance of incentives

Incentives are important in affecting the labour supply. Most of us rely on income from our work to pay for the things we need and higher pay and better conditions should be an incentive perhaps to work some extra hours or search for work in the first place. But for many workers there are disincentives to supply their labour – and these problems often affect people in lowly paid jobs. This is known as the problem of the poverty trap.

The Poverty Trap Worsens in Scotland

The soaring cost of child care is worsening the poverty trap according to a new report commissioned for the save the Children Fund in Scotland. More than one quarter of Scots parents on low incomes cannot work full time because of the cost of registered childcare which has risen by more than 10 per cent this year across most of the country. Joanne Brady, a single mother of two children from Glasgow, is unable to work because she loses more in means-tested child tax credits than she gains in income. "They take 20 per cent off for each child when you go to work. You still have to pay your housing, travel and lunches and it's just not adequate." Ms Brady, 27, is among the 28 per cent of parents with children under 18 and an income of less than £15,000. *Source: The Times, July 2008*