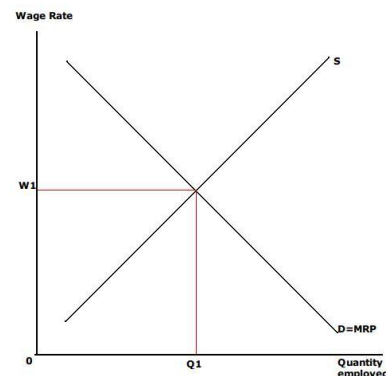


Labour Market

Demand for labour

A firm is an organisation that brings together factors of production in order to produce output. The aim of a firm is to produce output to sell in order to generate revenue and make profits. Labour is one of the key factors of production used by firms as part of this process. This means that firms do not demand labour for its own sake but for the revenue that is obtained, this is an example of derived demand. If the price of labour is relatively low, then firms will tend to demand more of it than when the price is high, in order to maximise profits.



There are a number of factors that determine the position of a labour firm's labour demand curve. For instance if the productivity of the labour is increased by new technology, the demand for labour will increase although the wage rate will stay the same so it will only impact the quantity of labour demanded. Also if the equilibrium price of a product falls the quantity of labour demanded will decrease at the same wage rate as the supply is decreased and the firm's profits decreases.

The elasticity of demand for labour is dependent on the availability of substitutes. One significant effect on the elasticity of demand for labour is the extent to which other factors of production such as capital can be substituted for labour in the production process. If capital or some other factor can be readily substituted for labour, then an increase in the wage rate (ceteris paribus) will induce the firm to reduce its demand for labour by relatively more than if there were no substitute for labour. The extent to which labour and capital are substitutable varies between economic activities, depending on the technology of production, as there may be some sectors in which it is relatively easy for labour and capital to be substituted and others in which it is quite difficult. However, this only works in the long run as in the short run the availability of capital is very inflexible. So labour demand will tend to be more elastic in the long run than in the short run, as the firm needs time to adjust its production process following a change in market conditions. As the demand for labour is a derived demand, the elasticity of labour demand will also depend on the price elasticity of demand of the firm's product.

Labour supply

The labour supply curve is upwards sloping as more people will want to work if the wage rate is higher. Wages act as a signal to workers about which industries are offering the best returns to work. This is another example of how the price mechanism operates to allocate resources within a society. An increase in the rate of unemployment benefits would decrease the supply of labour as less people would offer their services. Largely what effects the supply of labour is the decisions of

individuals over whether to participate in the workforce. The participation rate measures the proportion of people of working age who are employed or looking for work. This excludes those who have taken early retirement and students as well as discouraged workers who were seeking employment but have given up. In summary the factors that influence the supply of labour are:

- Population migration
- Income tax and benefits
- Government regulation (minimum wage)
- Trade unions

Labour market equilibrium

The labour market equilibrium is the point at which the labour demand and supply curves meet. On the diagram on the previous page, if the wage is lower than W_1 employers will not be able to fill all their vacancies and will have to offer a higher wage rate to attract more workers. If the wage rate is higher than W_1 there will be an excess supply of labour and the wage rate will drift down until it reaches the equilibrium point. Suppose there is an increase in the demand for a firm's product, this will lead to a rightward shift in the demand for labour and therefore the wage rate will rise. This will eventually return to the equilibrium as the supply increase will be followed by a rightward shift in the supply curve until the wage rate has not increased sufficiently to encourage workers to transfer.

Effects of government intervention

Unemployment benefits: an important influence on labour supply, particularly for low-income workers, is the level of unemployment benefit. If unemployment benefit is provided at too high a level, it may inhibit labour force participation, in that some workers may opt to live on unemployment benefit rather than take up low-skilled (and low paid) employment. In such a situation a reduction in unemployment benefit may induce an increase in labour supply. However, such a policy needs to be balanced against the need to provide protection for those who are unable to find employment. It is also important that unemployment benefit is not reduced to such a level that workers are unable to leave their jobs to search for better ones, as this may effect the flexibility of the labour market.

Incentive effects: similarly, there are dangers in making the taxation system too progressive. Most people accept that income tax should be progressive (that those on relatively high incomes should pay a higher rate of tax than those on low incomes) as a way of redistributing income within society and preventing inequality from becoming extreme. However, there may come a point at which marginal tax rates are so high that a large proportion of additional income is taxed away, reducing incentives for individuals to supply additional effort or labour. Again, however, it is important to balance these incentive effects against the distortion caused by having too much inequality in society.

are questions over whether taxes should be made on an individual level or as just a flat rate.

Another approach is to use pollution permits under which the government issues or sells permits to firms allowing them to pollute up to a certain limit. These permits are then tradable, so that firms that are relatively 'clean' in their production methods do not need to use their full allocation of permits can sell their polluting rights to other firms, whose production methods produce greater levels of pollution. This scheme's advantage is it provides firms with an incentive to invest in more efficient technology that means they do not need as many permits as they face a higher cost by having to pay for them. In this sense, the government uses the market for permits to address the externality problem – in contrast to direct regulation of environmental standards, which tries to solve the pollution by overriding the market. A second advantage is that the overall level of pollution can be controlled by this system as the authorities have control over the total number of permits.

However, the permit system does have its faults in that it is hard to enforce with sanctions needing to be harsh in order to disincentivise firms from going over their allowed limit. There also needs to be a cost efficient way for authorities to be able to check the level of emissions. There are also questions over the number of permits that should be provided initially. There is also an argument that is both in favour and against using the permit system. It does mean that some firms are able to pollute as much as they want if they purchase enough permits but these firms will not want a reputation as heavy polluters and therefore may strengthen incentives to reduce pollution levels. However, there is also an issue over it being hard to compare different types of pollution.

Property rights

One of the reasons underlying the existence of some externalities is that there is a failing in the system of property rights. For example, think about the situation in which a factory is emitting toxic fumes into a residential district. One way of viewing this is that the firm is interfering with local residents' clean air. If those residents could be given property rights over clean air, they could require the firm to compensate them for the costs it was inflicting. However, the problem is that, with such a wide range of people being affected to varying degrees (according to prevailing winds and how far away they live from the factory), it is impossible in practical terms to use the assignment of property rights to internalise the pollution externality. This is because the problem of coordination requires high transaction costs in order for property rights to be individually enforced. It may also be difficult to introduce property rights into a situation where they previously had not existed before. Therefore the government effectively takes over property rights from residents and acts as an enforcer.