Chapter Seven
Wages and Employment in a Single Labour Market

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Learning Objectives

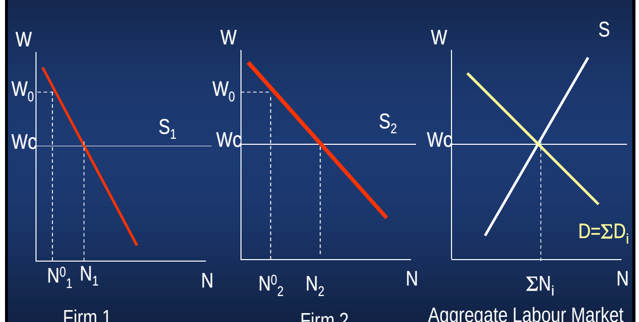
- Equilibrium in a Single Competitive Labour Market
- Imperfect Competition
- Payroll Taxes
- Monopsony
- Minimum Wage

Competitive Firm's Demand

Perfect competition in both the product and the labour markets

- Assumptions:
  - **homogeneous type of labour**
  - **price taker and wage taker**
- Supply of labour is perfectly elastic (horizontal) at the wage rate
- Firms can employ all the labour they need at the market wage rate
- Market wage rate is set by the aggregate labour market

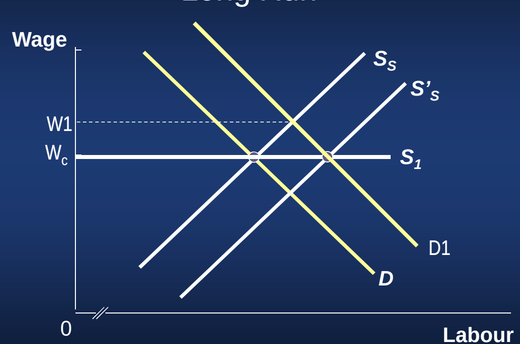
Competitive Product and Labour Markets



Short Run vs. Long Run

- In the short run a firm (firms) may raise its (their) demand for additional workers as demand for its (their) product increases.
- Given the upward sloping labour supply curve, the wage rate as well as employment will increase in short run.
- Short-run wage increases can be a market signal, resulting in increase in the labour force in long run (labour supply curve shifts to the right).

The Labour Market in the Short Run and Long Run



Equilibrium in a Competitive Market

- **Characteristics of the long run equilibrium and the market-clearing model (neoclassical)**
  - for markets with homogeneous workers and homogeneous jobs, wages will be equalized across workers
  - absences of “involuntary unemployment”
  - no queues for jobs or rationing of jobs

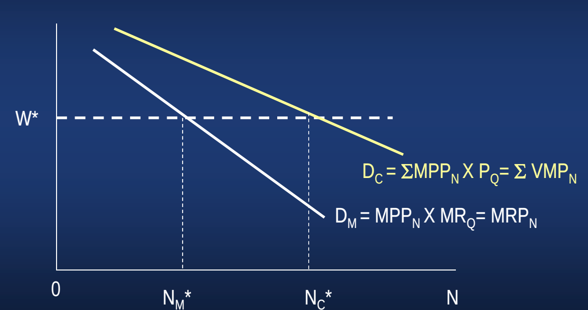
In Reality…

- The market-clearing model is not entirely true
  - **Wages do not adjust quickly to clear the market**
  - **Involuntary unemployment is frequent**
  - **Large wage differentials exist across homogeneous workers and jobs.**
- However, the neoclassical model still serves as a useful approximation of the market theory

Imperfect Competition

- Monopoly
- Effects of hiring more labour
  - marginal physical product of labour falls
  - marginal revenue falls
  - sells more output only by lowering the product price

Monopolist Versus Competitive Demand for Labour



Product Market Structure and Departure from Market Wages

- Monopolist:
  - earns higher profits and labour may be able to appropriate some of these profits
  - may be less cost conscious and may yield to wage demands
  - sensitive to public image and may pay higher wages to buy good image
  - large firms do tend to pay higher wages

Oligopoly in the Product Market

- Few firms
- Similar products
- Action of one firm affects the others
- May depart from market wages because:
  - **Firms earn above normal profits, some of which may be captured by workers since larger firms may pay above-market wages**

Monopolistic Competition in the Product Market

- Many small firms with differentiated products giving the firm some discretion in price setting
- Short-Run
  - **Earn Economic Profit**
    - **Able to pay higher than the market wage**
- Long-Run
  - **No Economic Profit**
    - **Has to pay the market wage**

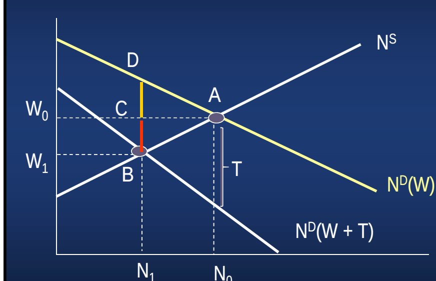
Working with Supply and Demand

- Simulating the effects of a policy change on equilibrium
- Incidence of a unit payroll tax

Unit Payroll Tax

- Tax levied on employers
- Proportional to the firm's payroll
  - CPP/QPP
  - Workers' compensation
  - Unemployment insurance
  - Health insurance
- Often considered "job killers"

The Effect of a Payroll Tax on Employment and Wages



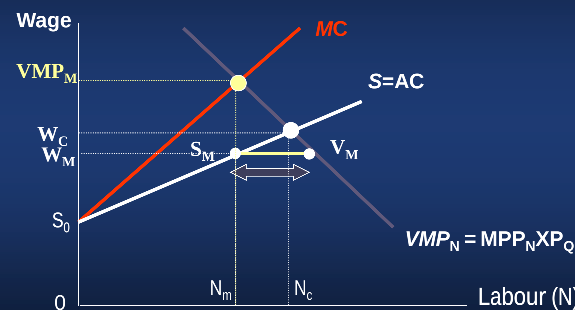
Monopsony

- A monopsony is a large firm relative to the size of the labour market
- It influences the wage rate
- It must raise wages to attract labour (since S curve not perfectly elastic)
- Will not lose all of its work force if wages are decreased
- Upward-sloping labour supply schedule

Monopsony

- Average cost is the wage rate
- Marginal cost is the new wage plus the cost of paying the higher wage to existing workers
- Marginal cost is higher than average cost
- Profit maximization when MC = VMP

Monopsony



Implications of a Monopsony

- Employment is lower than a competitive situation
- Restricts employment because hiring additional labour is costly
- Higher wages must be paid to intra-marginal workers (i.e., those hired first)

Characteristics of Monopsonistic Market

- Some inelasticity of supply of labour
- Most firms have an element of monopsony power in short run
- Long run costly problems of recruitment, turnover and morale issues
- Examples of monopsony in long run:
  - **would be a one industry town in an isolated region**
  - **if workers have specialized skills that are useful mainly in a specific firm (lesson here is avoid firm-specific human capital)**

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Perfect Monopsonistic Wage Differentiation

- Existing workers receive higher wages when a monopsony raises the wage rate
  - seller's surplus or economic rent
- Monopsonist may try to retain some of this seller's surplus by differentiating it's work force

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Perfect Monopsonistic Wage Differentiation

- Supply schedule equals to the average cost and marginal cost
- Does not have to pay existing workers any more than their reservation wage
- Monopsonists may try to conceal higher wages or use nonwage mechanisms to attract additional labour

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Minimum Wage Legislation: Impact on Competitive Labour Market

- Adverse employment effect
- Firms employ less labour at a higher cost
- Higher wage encourages more people to seek work
- Magnitude of adverse employment effect depends on the elasticity of the demand for labour as well as the elasticity of supply

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Minimum Wage: Offsetting Factors

- Labour could increase…
  - if there is an exogenous increase in demand for output
  - if there is an increase in the demand for labour substitutes (and hence the labour that produce these)

Summary

- The determinants of employment and wage rate in a single market under perfect competition
- The impact of imperfectly competitive product market on the labour market
- The impact and the incidence of payroll taxes on the labour market
- Monopsonistic labour market
- Minimum wage

End of Chapter Seven