The Economics Lowdown – The Labor Market

Audio/Video version available at: https://www.stlouisfed.org/education/economic-lowdown-video-series/episode-4-the-labor-market

Have you looked for a job recently? If so, you've been an active participant in the labor market.

The labor market works much like other markets. There are buyers and sellers, and they interact to determine a price. In this case, the "good" being bought and sold is labor and the "price" for that good is a wage.

In many of the markets we encounter, individuals such as you and I demand goods and services, and firms supply those goods and services. Although the labor market works in a similar way, the roles reverse. In the labor market, firms demand labor, and individuals such as you and I supply that labor.

Employers demand labor because workers are an important part of the production process. Workers use tools and equipment to turn inputs into output. Without workers, employers couldn't produce goods and services and earn profits.

When graphed, the demand for labor looks much like the demand for other goods and services—it has a downward slope. This indicates that a greater quantity of labor is demanded at lower prices than at higher prices. That is, in the labor market, employers are willing to buy more hours of labor at lower wages than at higher wages.

Although the employers who demand labor prefer lower wages, the workers who supply that labor prefer higher wages. Workers are willing to supply labor because the wages they earn enable them to buy the goods and services they want.

When graphed, the supply of labor looks much like the supply of other goods and services—it has an upward slope. This indicates that workers are willing to supply a greater quantity of labor hours—that is, they are willing to work more—at higher wages than at lower wages.

Here's an example: Acme Company is hiring a new employee to help with the production of widgets. I'm interviewing these potential employees to find out what motivates them.

How many hours would you be willing to work for $2 an hour? Probably not many. When you think of other ways you could spend your time, a $2 wage probably isn't enough to lure you away from the other alternatives, such as an afternoon at the beach. Or, put differently, the opportunity cost is too high.

But what if you were offered $10 an hour? Now, you'd probably be willing to give up other opportunities and work a few, or more than a few, hours.

But what if you were offered $50 an hour? Now, you'd probably be willing to forgo other alternatives and work as many hours as you could.

Like most people, you are far more likely to work more hours at a higher wage than at the lower wage. This is called the substitution effect and explains why the labor supply curve is upward sloping: workers are willing to work a greater quantity of hours at higher wages than at lower wages.

Again, like other markets, the demand for labor and the supply of labor interact and result in an equilibrium price. In this case, the price is called a wage. And, like other markets, the demand for labor and the supply of labor shift, which can cause wages to increase and decrease.

What causes the demand for labor to shift? The demand for labor is derived from or determined by the demand for goods and services produced.

For example, the demand for nurses is determined by the demand for healthcare services. If the demand for healthcare services increased dramatically, the demand for nurses to provide those services would also increase. In such a case, the demand curve would shift to the right and wages for nurses would increase.

On the other hand, if the demand for healthcare services were to decrease, the demand for nurses would decrease as well. The demand curve would shift to the left, and wages for nurses would stagnate—or even decline—over time.

The supply of labor in the labor market is determined by the number of workers who are willing to provide that labor. One factor that affects the number of workers in given professions is the comparative attractiveness of jobs.

For example, if higher wages or better working conditions make nursing more attractive than other jobs, more people may be willing to work in nursing, which would shift the supply curve for nursing to the right. This rightward shift would decrease wages for nurses.

Likewise, if nursing were to become a less attractive occupation, some nurses would leave for other professions. This decrease in supply would result in higher wages for the nurses who remain.

So, do you want to earn higher wages? If so, find a profession with high demand but a relatively small supply of qualified providers. Obtain the appropriate education and training for that profession. Then, continue your education and training so that you increase your productivity and, as a result, also increase the demand for your services.

Reference

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