Explain how the equilibrium wage rate in a labour market is determined both by th...

Demand for labour in the ‘ labour market’ is derived demand. Derived demand occurs when the demand for a factor of production arises from the demand for the output it produces. Therefore the price of labour is determined by the labour market and the forces of demand and supply play a key role in determining the relative wages. The equilibrium wage rate can therefore be defined as the point/price where demand for labour equals the supply of labour.

The theory of marginal productivity of labour states that demand for workers depends on their marginal revenue product (MRP – the value of the physical addition to output arising from hiring one extra unit of a factor of production. Where the MC of taking on an additional unit of labour equals its marginal revenue product, the equilibrium quantity of labour will be established. The MRP theory suggests that wage differentials result from differences in labour productivity.

Measuring MRP can be difficult in reality, with a lot of work carried out in teams, which makes it difficult to isolate the contribution to output made by an individual worker. Also those who work in the tertiary and service sector; the output of one worker is often dependent on other workers. The supply curve for labour slopes upwards – at higher wage rates more people will work.

How many more people make themselves available at higher wage rates is influenced by elasticity of demand for labour. Influences on the supply of labour can be categorised; with financial, which involve: Overtime (if overtime is available it helps to increase supply), wage rates in substitute jobs (if wage rates are higher than in substitute jobs more labour tends to be supplied) and barriers to entry (these can lead to a higher wage rate being paid).

The other category is non monetary influences: Increased mobility of labour (this could be occupational or geographical) and net labour migration (this is an increasing factor with more countries joining the EU and migrating to the UK to find jobs) The graph shows where S1 and D1 intersect the equilibrium wage rate is W1.

If there are changes to the factors that influence supply or demand of labour causing the curves to shift equilibrium moves and the wage rate changes and decreases in this model to W2. Therefore the equilibrium wage rate is determined by the interaction of supply and demand and additional workers are hired up to the point where the wages for that worker are equal to the extra revenue they generate