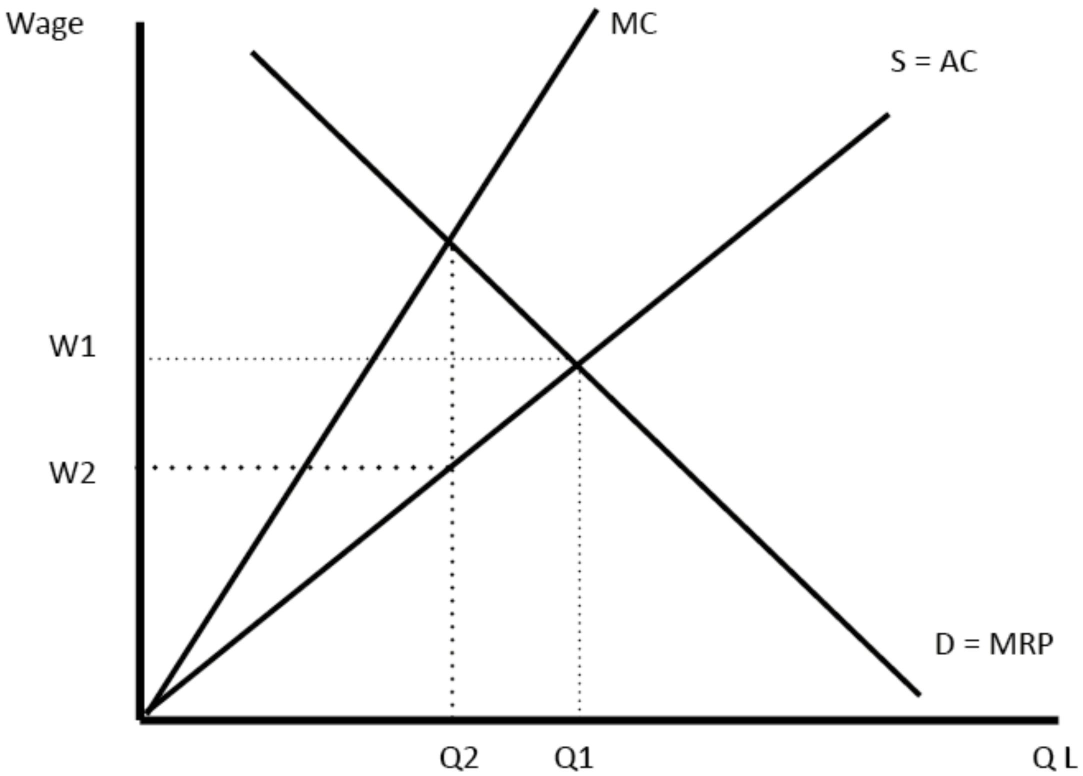
Market failure in labour markets

Monopsony

This occurs when there is just one buyer of labour in a market, or if the firm has substantial market power in employing workers.

Diagram of Monopsony



- The marginal cost of employing one more worker will be higher than the average cost. This is because, to employ one extra worker, the firm has to increase the wages of all workers.
- Therefore, MC is steeper than AC.
- To maximise the level of profit, the firm employs Q2 of workers where MC = D (MRP).
- Therefore, in a monopsony, the firm only has to pay a wage of W2. This is less than the competitive wage of W1.
- The monopsony also employs fewer workers than a competitive market.
- Lack of information, and difficulties in switching jobs, gives many firms a degree of monopsony power.

Geographical immobilities

Workers and firms can find it difficult to move, because of geographical immobilities. For example, because of high living costs, it may be difficult for workers to buy / rent a house in London. Therefore, there can be labour shortages in London, but high unemployment in depressed areas.

Government policies to deal with geographical immobilities

1. **Building new houses in popular areas.** However, this is difficult to do, because of limited space in places like the South East and London. It would also require huge house-building programmes to bring prices down.
2. **Subsidies to encourage firms to move to depressed areas**. However, firms may be reluctant to relocate to the north, even with subsidies, because of limited infrastructure, which makes business harder.
3. **Wage bonuses for expensive areas.** The government could pay a wage bonus for those living in London and other areas of high house prices. However, this would become a very expensive way of dealing with the problem.

Occupational immobilities – lack of skills

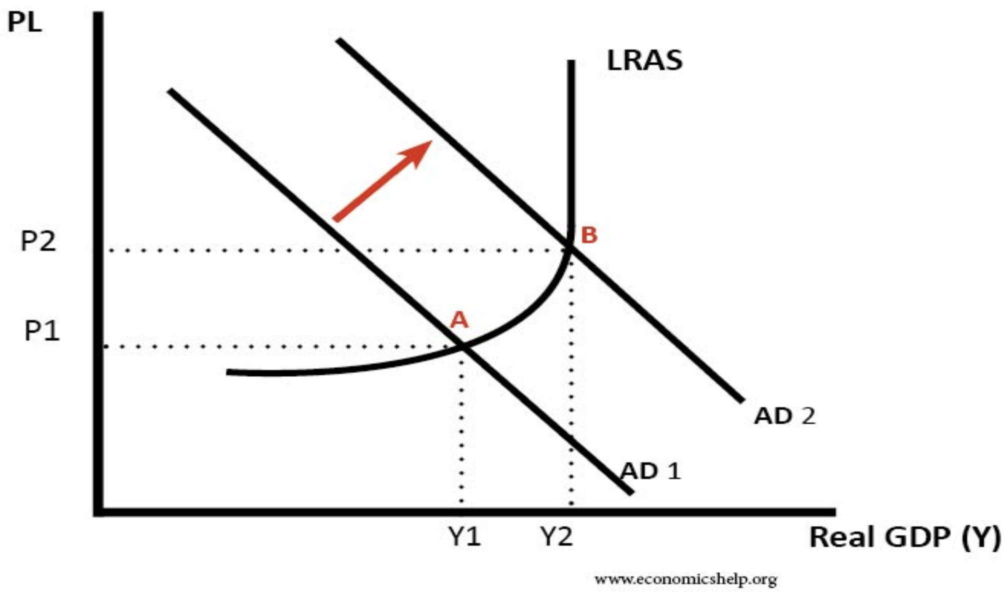
- Often, vacancies remain unfilled because unemployed workers have inadequate skills to take on the jobs. This leads to occupational immobilities and structural unemployment.
- The UK has many vacancies in jobs, such as HGV drivers. This is partly due to the UK not valuing practical vocational jobs as much as 'academic qualifications'.
- A shortage of skills may be more common in an economy facing rapid technological and social change.

Government policies to deal with skills shortages

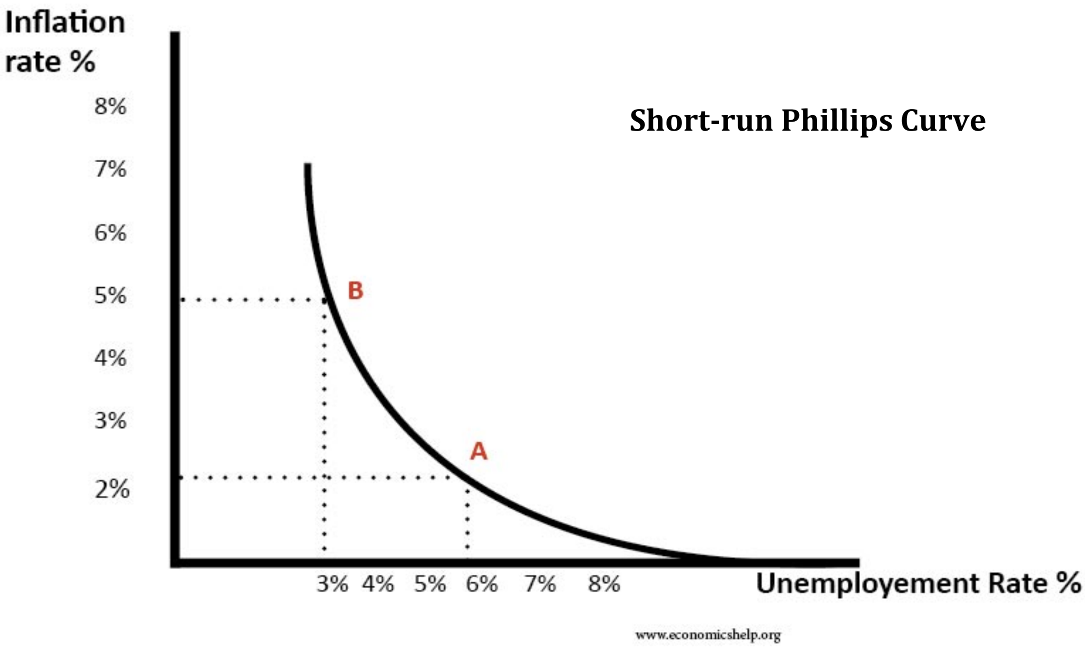
1. **Government provision of education and training.** This is important with the greater focus on vocational skills needed by the economy.
    - However, it is expensive and there is a concern that people may not want to undertake government training schemes, though the government could make training schemes a requirement of receiving benefits.
2. **Government subsidies to firms who provide training schemes.** This helps to overcome government failure, as the firm is likely to have better knowledge of the skills that industry really needs.
    - But the government still needs to evaluate which firms would be good to support.

The Phillips curve

The Phillips curve suggests that we can often see a trade-off between unemployment and inflation.



- If the government increased spending (G), we would see an increase in AD. This leads to a rise in real GDP (Y1 to Y2).
- As output rises, firms will hire more workers, and unemployment falls.
- But as the economy gets closer to full capacity (positive output gap), we start to see inflationary pressures (P1 to P2).

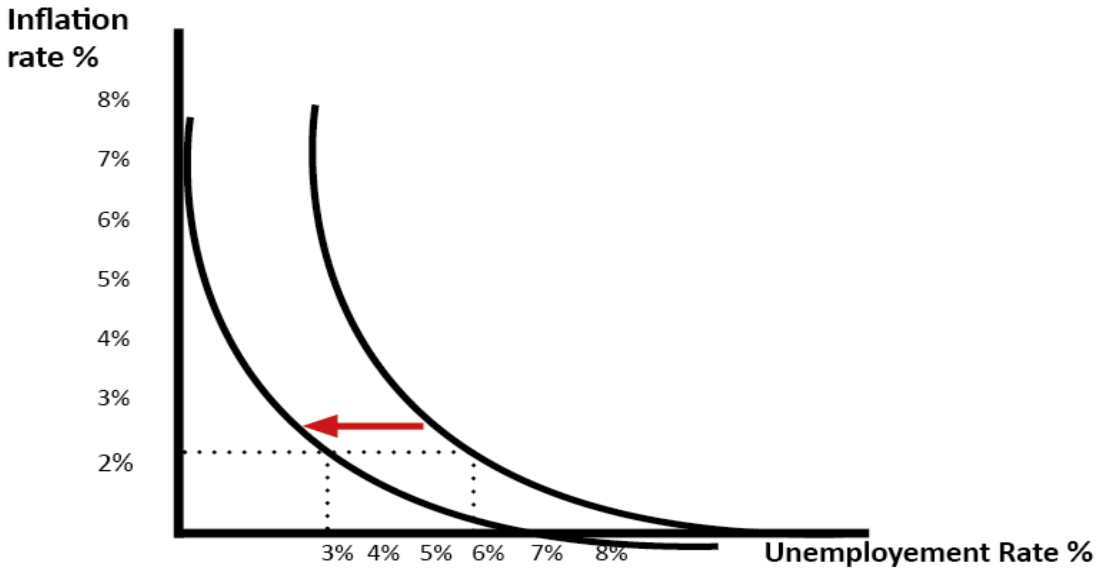


Therefore, after a rise in AD we go from **(A)** - unemployment (6%) and low inflation (2%), and move to point **(B)** - unemployment (3%) and higher inflation (5%).

Avoiding conflict between inflation and unemployment

1. Supply-side policies to reduce structural unemployment.

If the government introduced successful supply-side policies, we could see a fall in structural and frictional unemployment. This would reduce the natural rate of unemployment and shift the Phillips curve to the left.



There is still a trade-off between unemployment and inflation, but after the fall in the natural rate of unemployment there is a better trade-off.

2. Economic growth close to long-run trend rate of growth.

If the economic growth is kept close to the long-run trend rate (e.g. 2.5%), then the growth is sustainable. In this case there will not be a positive output gap, but we will reach full employment with minimal inflationary pressure.