7.2 Lecture 16: Input Markets II: Labor and Capital

7.2.1 Labor market equilibrium

- Firms demand for labor is driven by the additional revenue generated by hiring an extra unit of labor, which is the value of marginal product.
- The supply of labor reflects the trade-off between income and leisure for workers.
- Equilibrium wage and employment is where aggregate labor demand equals aggregate labor supply.

7.2.2 Minimum wage effect

- A legally imposed wage floor (minimum wage) above the equilibrium wage creates a gap between the quantity of labor supplied and demanded.
- Employers reduce hiring when faced with a higher mandated wage, while more workers are willing to work at that wage, resulting in a surplus of labor (unemployment).

7.2.3 Monopsony

- A monopsonistic employer faces an upward-sloping labor supply curve, meaning that hiring additional workers requires raising wages for all employees.
- The marginal cost of labor exceeds the wage paid, leading the monopsonist to hire fewer workers and pay a lower wage compared to a competitive market.
- Introducing a moderate minimum wage can counteract monopsony power by setting a wage that aligns with a competitive market.

7.2.4 Capital supply

- Capital is all the machines, land, and other physical inputs
- Price of capital is the interest rate. The interest rate functions as the cost of borrowing and the reward for saving.
- Firms demand for capital depends on the expected return from investing in productive assets relative to the interest rate.
- Households decide how much to save based on **intertemporal preferences** – tastes for consumption today vs. consumption in the future
- Wage rate is the price of forgoing productive work to take leisure, the interest rate provides the price of forgoing productive savings to take consumption.

- Interest rate on savings operate in exactly the same way as changes in the wage rate on labor.

7.2.5 TO KNOW – Conceptual Understanding

- A wage floor set above the market equilibrium reduces the quantity of labor demanded and increases the quantity supplied, thus creating unemployment
- A monopsonistic employer faces an upward-sloping labor supply curve, so hiring additional workers requires raising wages for all, making the marginal cost of labor exceed the wage
- Households allocate consumption across periods by weighing the benefits of consuming now against consuming later, constrained by the interest rate which determines the trade-off