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Tight Labor Markets and Wage Growth in the Current Economy

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Abstract

Labor markets in the US are currently tight and are generating substantial growth in nominal wages – i.e., those measured in current dollars (not adjusted for inflation). On the other hand, wage growth does not appear to be keeping up with inflation right now, regardless of how the latter is measured. Whether market tightness will last, and whether workers can expect to enjoy some real (or inflation-adjusted) wage growth anytime soon, is very hard to predict. Still, some facts about our currently tight labor markets, and the wage growth they have or have not generated, can give us insights into how economic policymakers should respond to current circumstances, including high inflation. This review examines real wage growth for workers – especially for those in low-wage jobs and industries, whose real wages have been mostly stagnant for decades in the US.

Keywords: *Labor market, Jobs, Wage growth, Economy*

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Background to the Study

Facts on the Currently Tight Job Market and Recent Wage Growth

Certain factors determine real wage growth for workers – especially those in low-wage jobs and industries, whose real wages have been mostly stagnant for decades in the US. The study highlights some important facts on the current tight job market and recent wage growth in the US. According to (Groshen and Holzer, 2021), the facts are,

1. *Until recently, nominal wages have more than kept pace with inflation, allowing real wages to grow since the start of the pandemic. W*orkers enjoyed over 2 percent real wage growth in 2020-21, even after adjusting for the fact that the composition of the workforce changed in that period. Unfortunately, inflation has been higher than wage growth since mid-2021; but, if supply-side price shocks soon diminish, real wage growth could return (as long as such growth itself doesn't generate too much inflation).

2. *Nominal and real wage growth have been highest in the lowest-wage sectors of the economy*. Nominal wages increased the most among leisure/hospitality and retail workers – the two lowest-wage sectors of the US economy – and especially among non-supervisory workers. Using virtually any price index to adjust for inflation over these two years, workers in these sectors experienced real wage growth.

3. *High job vacancy and quit rates in leisure/hospitality and retail have generated the stronger wage growth we observe in these sectors. W*hile overall job vacancy rates in the US economy are 7%, those in retail and leisure/hospitality are 8-10%. Alex Domash and Larry Summers (2022) recently show that vacancy and quit rates are the strongest predictors of wage growth, and comparisons across sectors support that view. It is also clear that the rise in quit rates, overall and within these sectors, can account for some, though not all, of the rise in job vacancy rates between 2020 and 2022; this indicates that vacancies are more frequent but also last longer than before, as workers appear less likely to accept the wage offers that they receive.

4. *Declining labor force participation now accounts for almost all of the "missing employment" (relative to the pre-pandemic labor market) in the US today.* Using monthly BLS employment data, the decline in labor force participation between February 2020 and 2022 accounts for about 85 percent of the decline in the employment/population ratio in that period; the rest is accounted for by unemployment, which can reflect both labor demand-side (employer) and supply-side (worker) factors. This reinforces the view that it is aggregate labor supply that mostly constrains employment growth now, more than absent labor demand, and the supply constraints raise job vacancy rates as well.

5. *Productivity growth has likely helped generate some of the real wage growth we have observed and might play an even greater role going forward.* Productivity growth appears to be a major source of real wage growth over time, even though the relationship between the two has weakened somewhat over time (Stansbury and Summers, 2017). And measured productivity growth has averaged over 2 percent per year since the pandemic, which – if everyone's share of output had remained stable, might have generated 4 percent real wage growth. Unfortunately, supply-side

price shocks have likely diminished labor's share of output. On the other hand, if such shocks diminish; and if we are at what some economists call a "Solow moment" – when the economic benefits of automation, in terms of higher productivity, are soon likely to become clearer- real wage growth might reappear.

6. *Education and training could also help ensure that workers benefit from productivity growth, in the form of real wage growth, going forward.* Vacancy rates and wage growth in professional services and health care have also been substantial, and indicate strong demand in these sectors for workers with postsecondary education and training. In addition, the new infrastructure bill (and Baby Boomer retirements) will likely create more labor demand in construction and manufacturing, which could be filled by well-targeted training programs for these sectors. Of course, broad-based growth in educational attainment among workers can also enhance productivity growth over time.

Discussion

If supply-shock price inflation diminishes soon – despite the Ukraine War, and even if prices level off at a high level – there might still be sufficient labor market tightness to generate real wage growth. Of course, this also assumes that the Fed's new policy of interest rate growth can succeed without causing a "hard landing," in the form of a (potentially serious) recession. And wage growth itself must not be a major cause of inflation. Large nominal wage increases currently reflect tight labor markets (plus productivity growth), generated by the following:

1. Declining labor force participation, primarily among older workers (ages 55+) who had left the workforce (though many are now returning) and women who have provided the care needed for other family members;
2. Increases in quits – especially in low-wage jobs – as workers are more dissatisfied with conditions in their earlier jobs; and
3. Increases in what economists call workers' reservation wages – the lowest wages they will accept on new jobs – extend their job searches and add to job vacancy rates.

The greater dissatisfaction that workers now seem to feel in low-wage jobs is not a bad way to pressure employers to improve wages and working conditions – especially if it lasts. And some falling labor force participation among older workers, even if temporary, was perhaps inevitable – given the rise in their asset values in recent years. But falling participation among prime-age workers and especially women could be counteracted with family-friendly policies, like more child-care and paid leave. And, though declining labor force participation likely adds to the market tightness that raises wages, it comes with significant costs. First, nonparticipation impedes employment and earnings that these potential workers would otherwise enjoy; second, it likely contributes to price inflation, especially by generating worker bottlenecks in key industries (like those in transportation and logistics); and third, it also reduces tax revenues that could finance needed services.

Conclusion

From the highlight above, our best hope of achieving higher real wages while reducing inflation and encouraging employment would be to increase labor force participation (with family-friendly policies) and education/training to improve worker productivity and wages over time. To train workers in the short term for new jobs in sectors like construction, manufacturing, or health care, we should expand *sector-based training* programs for those sectors. Indeed, recent evidence (Holzer, 2022) suggests that such training can be very effective in raising worker earnings. And providing workers with better information about job openings and wages, to help them move to high-demand/high-wage sectors, can be very useful in increasing their wages as well.

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