Current Economic Conditions

Robert C. Fry, Jr., Ph.D. June 19, 2017

LABOR MARKETS ARE TIGHT: WHY AREN'T WAGES ACCELERATING?

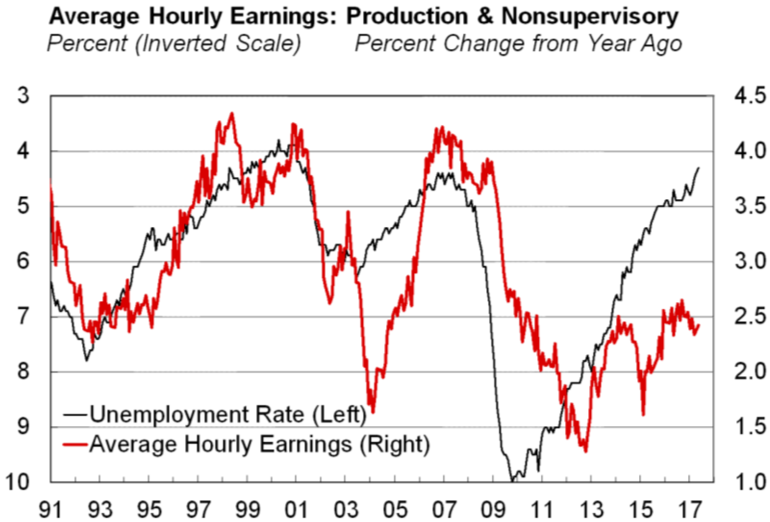
The U.S. Civilian Unemployment Rate fell to 4.3% in May, the lowest since 2001 and well below the Congressional Budget Office's 4.7% estimate of the Natural Rate of Unemployment. Many economists, myself included, have argued that the headline unemployment rate has overstated the tightness of the labor market and have focused on the U-6 employment rate, which includes as unemployed those who are working part-time but would prefer full-time employment and those who have not looked for a job within the last month because they are discouraged. That case is harder to make than it was a few months ago; the U-6 unemployment rate fell to 8.4% in May, down from 9.4% in January and 9.7% last September.

Other measures of labor market conditions also point to a tight labor market. The total number of Americans receiving unemployment insurance ("Continued Claims") fell in May to its lowest level since 1973. Relative to the size of the labor force, it fell to a record low. The Job Openings and Labor Turnover (JOLTS) Survey showed a record 6.044 million job openings in April. Of the small business owners who responded to the National Federation of Independent Business's survey in May, 59% said they hired or tried to hire workers in May. Of those, 86% said they found few or no qualified workers. Nineteen percent of respondents said that "finding qualified workers was their top concern, making it the second-biggest problem for small business." (Taxes were first.)

The only measure of labor market conditions that suggests there may be a reserve of potential workers who could reenter the labor force and fill unfilled positions is the Labor Force Participation Rate, which has declined from a peak of 84.6% in 1999 to 81.5% this May. But the decline in the LFPR largely reflects the ongoing retirement of baby boomers and trends that have been underway for two decades. There may be some potential workers who have left the labor force and haven't looked for a job in the last year (and thus aren't counted in U-6), but it is unlikely that there are enough people who retired early, went on disability, or got discouraged to reverse the conclusion that the U.S. labor market is very tight. Growth in payroll employment has slowed sharply in recent months. This has happened even as unemployment rates have fallen, suggesting that it reflects a dearth of workers to hire, not a slowing economy.

Despite the tight labor market, U.S. wages and salaries are not accelerating. Average hourly earnings of production and nonsupervisory employees on private payrolls were up just 2.4% year-over-year in May. This is up from the cyclical low of 1.3% hit in 2012, but down from the cyclical peak (so far) of 2.7% hit last September, which was no higher than the year-over-year growth rate at the trough of the 2008-2009 recession. Average hourly earnings can be affected by the amount of overtime worked and by shifts in employment from one industry to another, but the Employment Cost Index, which is not so affected **and which includes benefits** as well as wages and salaries, shows similarly slow growth. The

ECI was up 2.4% year-over-year in the first quarter. Compensation per hour in the nonfarm business sector was up 2.3%. Slow growth in wages and salaries has held back growth in disposable income. After a big downward revision to data from the fourth quarter of 2016, real (inflation-adjusted) disposable personal income was up just 1.5% year-over-year in December. Despite a recent increase, income was up just 1.9% year-over-year in April.



Consumers have dipped into savings to keep consumer spending growing at a moderate rate despite the slow growth in disposable income; real personal consumption expenditures were up 2.6% year-over-year in April. But this growth is not sustainable unless income growth accelerates. Retail sales fell 0.3% in May. Housing starts fell to an eight-month low in May and building permits to a 13-month low, but that has more to do with tight supplies of building lots and construction labor than with slow income growth or mortgage availability.

Why is growth in wages and salaries so slow if labor markets are so tight? One explanation is purely demographic. When baby boomers retire, voluntarily or involuntarily, they are replaced by younger workers earning lower wages or salaries. Even if individual workers get healthy raises – according to the Federal Reserve Bank of Atlanta, respondents to the household employment survey report median raises of 3.5% over the last year – growth in aggregate wages will be held down by the retirement of well-paid baby boomers. This will persist until the last of the boomers reach retirement age in the early 2030s.

There are other possible reasons for slow wage growth. Many economists believe rising benefit costs have "crowded out" wage increases, but slow growth in the ECI weakens this argument. Some blame the declining unionization of the U.S. labor force. It seems that CEOs now fear the reaction of equity analysts to rising labor costs more than they fear the reaction of unions to slow wage growth. Increased industry concentration could be restraining the compensation of those with specialized skills that are useful to relatively few employers. Antitrust authorities focus on the upward pressure mergers exert on prices, but may neglect the downward pressure they exert on wages and salaries. But the most important reason for slow wage growth is the global abundance of labor following the fall of the Iron Curtain and the opening of the Chinese and Indian economies to global trade and investment. Without tight restrictions on both trade and immigration, wages are set in a global market and – adjusted for differences in productivity – will converge across countries. As a result, wages are growing slowly in all developed countries. Wage growth is even slower in Western Europe, Japan, Australia, and Canada than in the United States.

While many of the factors restraining wage growth are likely to persist, one word argues strongly for an acceleration. Many employers complain about a "shortage" of workers. But as Ohio University Professor John Peterson drummed into my head in college, shortages persist only if prices are not allowed to rise to equilibrate supply and demand. Higher wages and salaries will eliminate a shortage of workers by reducing demand, perhaps through increased automation, and by increasing supply, by pulling potential workers into the labor force and by attracting immigrants to the United States (if immigration policies allow). Employers who claim there is a shortage of workers are implicitly admitting they aren't paying workers enough. When they say there's a shortage, what they really mean is there's a shortage **at the wage or salary they are offering to pay**. If wages and salaries rise to eliminate the shortage of workers, disposable income will rise, boosting growth from the demand side, and workers will move to higher-productivity jobs, boosting growth from the supply side. Future economic growth will have to come mostly from productivity growth, not from growth in employment. Low oil prices and reversion to historical trends are likely to boost productivity growth, which is the underlying source of growth in real wages.