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Breaking Down the Labor Shortage

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Inflation has become the focus of conversation. But in its shadow — and partially pulling the strings — is tightness in the labor market. Employers continue to struggle to bring in new workers and keep existing ones. Job openings far outnumber individuals looking for work. Absenteeism is elevated due to COVID-19. Jobs are still down by nearly three million. Immigration remains far below its pre-COVID-19 trend. As a result of this tightness, wages are up 4.5 percent, the highest year-over-year growth in over 20 years.[1]

Discussion about this labor shortage has focused on demographics. We have written about the surge in retirees and how child care challenges have pushed mothers out of the labor force. But it is also useful to look at the dynamics by sector. I hear very different stories in three distinct segments of the economy: low-paying personal services, in-demand skilled trades and remote-friendly professionals.

The low-paying personal services segment was heavily disrupted by the pandemic. In accommodation and food services, for example, employment fell by nearly 50 percent between February and April 2020, and the workforce is still 1.5 million short of pre-pandemic levels. This segment has seen the fastest wage growth and highest quits rates. Wages for accommodation and food services, for example, grew 9.3 percent year-over-year. Their quits rate hit record highs.

This pressure doesn't seem to be a demand issue, as revenue for many of these services remains short of pre-pandemic levels. The story here is labor supply. Workers have left the segment — perhaps because it now seems less stable, perhaps because of concern about COVID-19, perhaps because of working conditions (including the need to wear masks), or perhaps because of child care responsibilities.

Importantly, these workers see better alternatives. Many have entered industries that grew during the pandemic, such as transportation and warehousing (up more than 500,000 jobs). Others have taken advantage of a hot labor market to take entry-level positions now offering much higher pay. Others are leveraging their excess savings to be choosier about when they rejoin the workforce.

As demand returns in this segment, employers are investing in higher wages, enhanced search efforts, and productivity and automation initiatives to bring supply and demand back into balance. I suspect they will also need to think about working conditions that match the needs of those labor market segments who could be attracted from the sidelines, like students, parents and retirees. Topics like scheduling, child care, job design and screening criteria are being considered by innovative employers.

The issues in skilled trades (think nursing, trucking and manufacturing, for example) are different. These sectors typically require credentials or licenses and were already facing tight labor markets prior to the pandemic. Labor supply is quite inelastic in the short run, and these sectors have been unable to keep up with pandemic levels of demand.

Wages and quits in these industries aren't as elevated as in low-paying services, but they too have escalated against their historic norms. Wages in manufacturing, for example, grew 4.1 percent year-over-year in the fourth quarter of 2021, nearly a percentage point higher than the fastest growth the industry had seen in any quarter since the Great Recession. Its quits rate remains near the industry's record high hit in September.

The story in many skilled trades is increased demand. Trucking and construction are booming. And, despite supply chain challenges, industrial production in manufacturing has already surpassed where it was pre-pandemic. Perhaps the growth in manufacturing and trucking isn't too surprising given that — at its recent peak — consumer spending on goods was 20 percent higher than pre-pandemic. Labor demand reflects that recovery. If manufacturers could fill every open position, they'd be 200,000 jobs above where they would have been had they done the same in February 2020.

Skilled trades have a pipeline problem, and it may be getting worse. Community colleges, which play a central role in preparing workers for these jobs, have seen enrollment decline over the past two years. The decline may well be explained by increased wages raising the opportunity cost of education, but it puts the economy further away from building the necessary pipeline of workers for these sectors.

Employers and localities will need to take ownership of their education, training and credentialing pipelines. Employers can provide their own training, or can partner with community colleges to provide equipment, instructors and apprenticeship opportunities. States can simplify their licensing requirements and debottleneck their credentialing processes. They can also work to expand the pipeline by providing more holistic funding to students pursuing noncredit programs.

The remote-friendly professional segment has seen less trauma. Layoffs were rarer in the pandemic. Demand stayed robust. Work got done. Financial activities, information, and professional and technical services have all seen employment recover since February 2020, with the latter adding more than half a million jobs.

This segment has also been tight, though perhaps somewhat less than its late '90s peak. For example, the most elevated quits rates for information and financial activities during the pandemic were still more than half a percentage point below their record high rates in 2001.

The story here is what may be to come. Now that we are nearing the end of the pandemic, we hear widespread stories of professionals reassessing their careers. Many are suffering from burnout: workers experiencing "loyalty punishment" as their workloads increased when colleagues left. Employers will also need to navigate emerging mismatches, especially on work preferences. During COVID-19, employee preferences evolved, on remote work and even on where they chose to live. As I've written, it's not yet clear which model of work will optimize business performance and talent retention. But, regardless, it is likely a number of workers will find themselves mismatched against their employer's intended operating model and emboldened to explore alternatives by the strong labor market. So, we may well see further pressure in this segment, requiring employers to change the narrative to meet the needs of a workforce that has become more demanding.

Whether it be a lack of supply, an abundance of demand, or a new set of worker demands, employers feel the pressure and are now innovating to try to address the unique workforce issues that affect their particular industry. We are monitoring their efforts closely, in hopes that a return to balance will in turn reduce pressure on inflation.