A Labor Drought?

Following the economic pain of the pandemic, the economy has bounced back, supported by historic levels of fiscal and monetary stimulus. Unemployment has dropped and is now basically at pre-pandemic levels. Yet labor force participation has been slow to return.

At first, that seemed to be due to sickness and quarantining, child care responsibilities, and enhanced unemployment benefits. But even once the economy and schools reopened, vaccines rolled out, benefits ceased, and wages went up, participation has remained stubbornly below pre-pandemic levels.

More recently, even as the Fed has raised the fed funds rate steeply to bring inflation under control, labor demand has continued to run ahead of supply. The result has been unprecedented labor-market tightness. Job openings have hit record highs. Businesses have struggled to hold on to or find enough workers, especially in industries with lower pay or tougher work environments. This issue has been particularly pronounced in skilled trades, like nursing or welding or truck driving. In March 2022, we reached two open jobs for every unemployed person; we are not far from that high today. Labor force participation in January stood at 62.4 percent, well short of the 63.3 percent of February 2020.

A NEW WORLD

All of this leads me to ask: Are we seeing a shift in the supply of labor?

To be sure, the labor market will continue to ebb and flow with the business cycle. Yet it's time to consider whether our economy is entering a period of — on average — unaccustomed labor scarcity.

Our economy has operated with a growing labor force for decades. We benefited from a number of trends

boosting the labor supply: the post-World War II baby boom, women more fully entering the workforce, increased educational attainment making more people ready for more jobs, better health allowing workers to work longer, and high levels of immigration. Companies could also tap into ever-growing pools of low-cost offshore labor.

Businesses adapted accordingly. They often chose to hire from outside rather than develop their own people; for example, the huge and attractive bank training programs of my era were largely eliminated in the '90s when banks realized the market had surplus bankers. Firms got more comfortable with higher-attrition staffing models, reoriented toward part-time work and outsourcing, and became more willing to do layoffs rather than commit to job security. They reduced retirement and health care benefits.

This excess-labor world kept wages and benefits, and effectively inflation, down. Labor's share of income dropped. (See "Workers' Shrinking Share of the Pie," *Econ Focus*, Second/Third Quarter 2019.) This was good for businesses and good for investors. It was less good for the existing workforce.

Now, there have been many predictions over the last 10 years that as baby boomers aged, participation would reverse its positive trend. But in the long economic upturn before the pandemic, participation declined far less than expected. Perhaps the sheer duration of that upturn brought hesitant people on the margin back to work. Or maybe the Great Recession forced near-retirees to work longer. Or perhaps the rise of certificate programs and the gig economy better connected workers to the workforce. Regardless, the net outcome was that — despite some complaints by companies — labor was fully available. Wage growth was relatively modest.

That's certainly not the world we find ourselves in now.

It's possible that labor force participation will rebound — over time — to our pre-pandemic normal. But what if it doesn't? What if the aberration isn't today but instead the above-trend participation at the end of the last upturn? There are many reasons to think that might be the case.

The growth of the working-age population is relatively straightforward to forecast, and the outlook isn't good. Fertility rates are down, and that trend would take a generation to reverse. My generation, the baby boomers, are aging out of the workforce, and the many workers who retired during the pandemic are unlikely to come back. As of January, we were still down about 1.6 million older workers. Immigration policy also looks unlikely to materially change any time soon. As of January, we were missing over 800,000 prime-age immigrants versus our 10-year pre-pandemic trend. Offshoring has been complicated by increasing wages in developing countries and heightened awareness of the risk of being dependent on foreign labor sources.

And participation is clearly challenged too. COVID-19 had an impact, especially given the added pressure of child care and elder care. This seems most pronounced for working-class women, who may no longer be able to make the math work to stay in the labor force, and for the many recent retirees taking care of their parents, spouses, or grandkids.

So, labor supply looks like it will remain constrained for some time.

THE ECONOMY IN A SHORT-LABOR WORLD

A shortage of workers would limit our growth and pressure inflation — until businesses, nonprofits, and governments can deliver productivity enhancements, structure incentives to bring more workers into the workforce, or both.

As I travel my district, I hear about many initiatives already underway to bring people off the sidelines. I've talked to a steel company that invested in full-time recruiters and to a tool distributor that started its own soft-skills training program. I've talked to a poultry processor that has widened the profile of whom they are open to hiring — dropping drug tests and background checks. Employers are reconsidering working conditions, revising schedules, and redesigning jobs to better match worker preferences. Remote work is a visible example of this. They are investing in partnerships with community colleges to better attract and develop skilled tradespeople. Particularly intriguing have been initiatives to provide child care or housing support for employees, taking a more active role in tackling barriers to work. I'm reminded of what happened the last time labor was this short — in the early '50s. Employers in company towns attracted workers by investing in the broader environment, including housing and amenities.

But not all responses will be good for workers. I talked to a fast-food brand that described how automation and robotics could reduce store staffing by half. Employers who pay more will demand higher productivity or raise prices, thereby lessening demand and eventually jobs. You are seeing lower service standards already, such as hotels cutting back on housekeeping or restaurants taking orders via QR code. Offshoring could increase, focused on markets with fewer geopolitical pressures. All of these are particularly threatening to the last people into the workforce who might find entry is more of a mountain to climb with entry-level jobs increasingly scarce.

Governments and nonprofits will want to think through how they can promote more labor supply as well. Constrained longer-term economic growth isn't good for our tax base, our competitiveness, or, in the longer run, our workers. They should be exploring policies that work the supply side by encouraging workforce participation and preparation.

Canada's prime-age women's participation grew over five points in the 20 years before the pandemic, while the U.S. rate dropped nearly a full point. Research from the San Francisco Fed points to parental leave policies in the two countries as a key differentiator. The same research highlights flexible work arrangements as a driver of increased women's participation in other industrialized countries. And the two countries tax second earners much differently as well.

Similarly, between 2000 and 2019, the employment-to-population ratio for Japanese adults ages 60 to 64 increased 19.3 percentage points to 70.3 percent — seven in 10 Japanese in that age bracket are working. For context, the U.S. ratio in 2019 was 56 percent. Japan (where the population is, to be fair, healthier) has pursued several policies to increase employment of older workers, including subsidies, pushback against mandatory retirement ages, and training for employers on how to make jobs friendlier for older workers.

These ideas are worth exploring in this country. Additionally, it is worth exploring increased legal immigration, bringing those with skills, work ethic, and entrepreneurship into our workforce. On participation, there could be significant leverage in further investment in education, job training, and drug rehabilitation, as well as in reimagining the child and elder care industries and in exploring benefit and tax policy changes that could bring about further workforce participation.

To sum it up, COVID-19 has caused businesses, governments, and — yes — even economists to reassess their assumptions about the labor market. Increasingly, I fear we are moving to an environment where, over the medium term, labor is considerably scarcer than we are used to. That situation can be managed, as other countries have proven, but it will require innovations by companies and by our public institutions.

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