U.S. Labor Market Outlook

November 2022

By Gad Levanon, Chief Economist, The Burning Glass Institute
Propped up by strong consumer spending on services, healthy business spending on R&D, and the continued recovery of key sectors adjusting to a new normal, the U.S. economy has managed to skirt recession thus far.

But recession isn’t far off. Continued tightness in the labor market will be a key driver of inflation, forcing the Fed to keep raising rates to lower demand for labor.

Even during a recession, labor shortages would linger, particularly in low- and middle-skill occupations where low rates of workforce participation, an aging workforce, and misalignment in the educational contours of the workforce will continue to challenge supply chains.

Labor shortages are not a temporary problem but a persistent challenge that will significantly limit economic growth for the rest of the decade.

Businesses can take reasonable steps to offset the impact of the ongoing labor shortage and to better weather the storm, while policymakers could return the economy to a growth footing through a series of reforms—but only if they can muster unwonted bipartisan resolve to address thorny issues.
This past spring and summer, as the war in Europe fueled a surge in inflation and interest rates were rising correspondingly, economists and the markets became pessimistic about the near-term U.S. economy. Many concluded that the United States was already in a recession in the first half of 2022. But the U.S. economy seems to be holding on better than many expected. In the third quarter of 2022, GDP grew at a 2.6% annual rate, indicating that the economy is still not in a recession.

To better understand what’s happening in the U.S. economy, it is useful to divide it into two parts: consumer spending on services, which is about 45 percent of the economy, and everything else. Consumer spending on services is surging, while the rest of the economy is shrinking.

Spending on consumer services is growing rapidly. That is not surprising, because consumer services (think hotels, passenger transportation, car rental companies, nursing homes, childcare services, and hair salons, for example) are still recovering from the pandemic, and therefore demand is rising far faster than normal. Consumer services are also more labor intensive, which is one reason that job openings are continuing to grow rapidly even as the economy slows down.

Just as some industries are growing because they are still catching up, others are experiencing high growth as they adjust to a new normal. Demand for data-processing and hosting services, semiconductor manufacturing, mental health services, testing laboratories, medical equipment, and pharmaceutical manufacturing is well higher than before the pandemic, and there’s reason to believe that these represent structural changes to buying patterns.

In addition, during the pandemic, corporate investments in software and in R&D reached unprecedented levels, which drove a rapid increase in new STEM jobs. Those jobs have borne a double bonus: Because these workers are especially well paid, they have had plenty of disposable income to spend on goods and services, yielding wider positive employment changes throughout the economy.
These factors are spurring positive momentum in job growth that will not disappear overnight. Over the past three months, job growth has increased at a 3 percent annual rate. It is lower than in the Great Recovery of 2021 but faster than in any three-month period in the 20 years before the pandemic.

In addition, employers are hording talent. After years of increasingly traumatic labor shortages, employers are not quick to reduce payrolls, even as their businesses are slowing. That’s because companies are worried that they will have trouble recruiting new workers when they start growing again. That also explains why layoffs are still historically low. Initial claims for unemployment insurance, an indicator highly correlated with layoffs, averaged 207,000 in the four weeks ending on October 1, one of the lowest readings in recent decades. The small increase in overall job cuts is mostly concentrated in the automotive, real estate, and technology sectors.

Also, given the historically high quits rate, companies can rapidly downsize without having to lay off workers and instead simply not fill some of their new job openings.

Employment growth is likely to slow down from its historically high rates but remain solid in the coming months. The Manpower Inc. Employment Outlook Survey shows that the hiring intentions for the fourth quarter are still quite elevated.
It is still unusually difficult to hire qualified workers. The average time to fill a position remains historically long. Meanwhile, despite a dip in hiring activity in recent months in reaction to the recession chatter, the quits rate remains very high.

As the labor market tightens and recruiting becomes more difficult, a growing number of jobs are being filled by workers who have no more than a high school diploma, when the positions have typically called for more. The conditions of the pandemic—which created a severe labor shortage and a disruption in post-high school education—accelerated this trend.
In such labor market conditions, and with the cost of living rapidly rising, it is not surprising that wage growth remains very high.

The wage growth for job switchers is almost always higher than that for job stayers. When a labor market is tight, the gap tends to be wider because annual raises fall behind market growth. The gap between the two is now the largest in recorded history. That’s a problem because the wage incentive to change jobs has never been greater. As a result, the quits rate is likely to remain historically high, and employers are facing even more pressure to increase raises.

The Conference Board's U.S. Salary Increase Budget Survey suggests that employers are already being forced to rapidly increase annual raises. In 2022, employers' total budget for salary increases, a proxy for average raises, rose to 4.1 percent when they expected the bump to be 3.6 percent. The increase for 2023 is projected to go up even more, to 4.3 percent. That would be the highest since 2001— and approximately 40 percent above the typical increase of around 3 percent, which was the case through most of the decade prior to the pandemic.
While we have thus far averted a recession, the U.S. economy is likely to slow down and enter a recession in 2023. Next year, many of the industries that are still recovering from the pandemic will have reached pre-pandemic employment levels. With demand saturated, those industries may revert to typical, less dramatic growth patterns. That by itself is unlikely to push job growth into negative territory, however. What will do that is monetary policy reacting to the high inflation.

Inflation is becoming more entrenched, in large part because of the very tight labor market and the rapid wage growth it has triggered. In a new study from Brookings, the authors find that the labor market tightness “can explain three-quarters of the rise in monthly core CPI inflation.” According to another recent study by the New York Fed, researchers have found that the pandemic-era rise in labor costs has significantly contributed to higher prices. The implication is that lowering inflation without cooling down the labor market will be difficult, if not impossible.

As of September 2022, measures of underlying inflation show no sign of moderating and remain above a rate of 6 percent. The Fed is raising interest rates at the fastest pace in 40 years. Industries sensitive to these increases are suffering and will continue to feel the impact. The housing market is a prime example. Housing starts and sales, already in deep contraction, will continue to decline as mortgage rates remain elevated. In addition, stock prices tend to decline when interest rates rise, reducing the net worth and spending of households.

Some economists argue that the unemployment rate will have to move much higher for inflation to come back to its 2 percent target. According to American economist Larry Summers: “We need five years of unemployment above 5 percent to contain inflation—in other words, we need two years of 7.5 percent unemployment or five years of 6 percent unemployment or one year of 10 percent unemployment.” A recession is likely to start in 2023.
U.S. labor market conditions will significantly limit economic growth not just over the next year, but for the rest of the decade. Low labor supply relative to demand isn’t a temporary problem, but rather the result of several long-term demographic and labor market trends that converged with the pandemic in a “perfect storm.”

**FIRST,** and most important, as baby boomers age out of the workforce, working-age population growth is slowing to a halt for the first time in U.S. history. And that will continue through the rest of the decade.

**SECOND,** relative to recent decades, men in the 25 to 54 age group are more likely to be out of the labor force. The drop is especially pronounced for younger men without a four-year college degree. They are much more likely to be single and living with their parents. As they have less of a need to earn income, they are less likely to be in the labor force.

**SHARE OF NEVER MARRIED, 40-44 AGE GROUP, BY GENDER AND EDUCATION**

Source: Current Population Survey
THIRD, for decades people younger than 25 have been withdrawing from the labor force to enroll in higher education.

FOURTH, in recent decades, there has been a large increase in the share of people not in the labor force due to disability.
The pandemic further reduced labor force participation, especially among older people and those who fear getting infected or those suffering from long COVID.

In addition, the flow of new immigrants to the U.S. was significantly restricted from 2018 to 2021 due to tighter government regulations, tougher enforcement, and the pandemic, further slowing the supply of available talent.

In recent months though, the U.S. experienced a remarkable recovery in the share of workers who are foreign born. Some of it is because of people apprehended at the border and then released into the US. The Economist estimates that so far during the Biden administration, 1.5 million people who have crossed the border have been released into the U.S., though it is unclear how many of them are working, either legally or illegally. It is possible that these numbers are large enough to significantly reduce labor shortages in industries like construction and food services.

Increasing labor productivity could offset stagnation in the size of the workforce, but the past decade saw the slowest productivity gains in recorded history, and the pandemic brought no improvement. Labor productivity tends to grow rapidly during and after recessions. Not this time. Why?

For one thing, the pandemic may not have been long enough to force businesses to reevaluate their core business processes and to consider automation-driven reductions in operating cost. For another, many of the most obvious ways of replacing lower productivity U.S. workers with technology or workers in other countries, were already put into place before 2010. Since 2010, additional automation investment seems to be progressing more slowly. What is more, the pandemic may have unleashed economic forces that are slowing productivity growth further. The shift to remote work, quiet quitting, the drop in labor force participation, and declining college enrollments may all be part of an “ambition recession” or deprioritization of one’s career. That in turn may have something to do with the disappointing productivity growth since the pandemic.
The trends described above have led to an environment where the demand for labor is unprecedently high compared with supply, when labor demand is measured as employment plus job openings, and supply is measured as the labor force plus people not in the labor force who want a job.

These trends are maintaining a very tight labor market. “The labor market is particularly strong, but it is clearly out of balance, with demand for workers substantially exceeding the supply of available workers,” Federal Reserve Chairman Jerome Powell remarked in a recent speech.

These labor supply constraints have created an economy where significant job growth and low inflation cannot coexist. It is either one or the other, because significant expansion of employment in a supertight labor market will accelerate wages and therefore prices. This means that we should expect slow economic and job growth in the years ahead.
The overall labor supply and demand trends mask two opposite trends related to education. While employment of workers in low-education occupations has remained roughly flat over time, the supply of workers without a bachelor’s degree has been rapidly declining. At the same time, the supply of workers with a BA is growing faster than employment of workers in high-education occupations.

This is one of the reasons that the labor market for blue-collar and manual services has been tighter and their wage growth faster than for white-collar workers.

**NOTES:** The two groups of occupations consist of the same occupations throughout the entire period. The share of BA by occupation was based on 2011 and 2021 averages.

People with a bachelor’s degree are unlikely to end up working in blue-collar and services occupations (such as transportation, production, construction, repair, personal care, food services, and cleaning), especially in a tight labor market. As a result, the supply of available blue-collar and manual services workers is dwindling and is likely to continue to shrink in the next decade. Therefore, these occupations have a higher risk of labor shortages than white-collar occupations, which is the exact opposite of prevailing trends in recent decades.
The tighter labor market for blue-collar and manual services led to a much faster wage growth for people in these occupations in recent years than for those in management and professional roles.

In fact, a positive outcome of all of this is an unprecedented level of wage compression. Over the past two years, according to the Atlanta Fed Wage Tracker, wages at the bottom quartile (typically for low-wage service occupations) are growing twice as fast as those in the top quartile of the market.
The faster wage growth among workers without a college degree is perhaps one of the reasons for the recent decline in the share of the 18-to-20-year-old population that is enrolled in college full time. The decline has been stronger for men than for women. The rapid wage growth in blue-collar and manual services occupations, combined with the declining college degree wage premium have reduced the incentive to pursue a degree.

Other factors may be at play as well: First, the pandemic may have disrupted high school to such a degree that fewer graduates were adequately prepared. Second, in recent years there has been an increase in the willingness of employers to hire workers without a college degree. According to a recent study by The Burning Glass Institute, the share of jobs requiring a college degree dropped from 51 percent in 2017 to 44 percent in 2021, with some 46 percent of middle-skill and 31 percent of high-skill occupations experiencing material reductions in degree requirements. Third, in the past decade there has been a general decline in the perceived importance of higher education. According to Gallup, the number of Americans who consider higher education “very important” has fallen nearly 20 points since 2013.
As discussed above, labor shortages are not a temporary problem but a challenge that will continue to impact the U.S. economy for the rest of the decade. What could be done to reduce the impact of labor shortages?

Companies have two fundamental options for addressing this shortage: Either find ways to grow the supply of labor or boost the productivity of the staff they have. Both can and should be leveraged. Here are some concrete ways of doing so:

**GROW THE SUPPLY OF LABOR**

- **Expand** the pool of potential recruits by lowering requirements for prior experience, reducing or removing degree requirements, eliminating background checks, and considering alternative credentials for establishing readiness;

- **Offer** training to new hires who lack experience in a given field;

- **Leverage** models of skill adjacency to seek out hidden talent pools with many—even if not all—of the required skills;

- **Review** hiring processes and replace prevalent exclusive, filter-out systems with inclusive practice;

- **Expand** usage of remote work to access talent across a wider geography and accommodate worker preference;

- **Cultivate** connections with local education providers and develop internship and apprenticeship programs;

- **Provide** incentives to retain older workers;

- **Redistribute** operations to areas less impacted by shortage.

**BOOST STAFF PRODUCTIVITY**

- **Invest** in training to enable workers to acquire the skills that will make them more productive;

- **Consider** investing in automation to augment staff in fields faced with persistent shortages.
Some common but avoidable firm behaviors can also make the task of navigating both labor shortage and recession harder than it needs to be. Hoarding talent is only a rational strategy if economic slowdown is short-term. However, given the likelihood that slow growth is here to stay, the widespread current practice of hiring into a recession makes little sense and will only increase the scope, cost, and disruption – both financial and human—of eventual layoffs. Similarly, even those companies who are continuing to be pressured by labor scarcity would be well advised to avoid oversteering. For example, on its most recent earnings call, American Airlines described how it is pressing forward with its plans to hire 2,000 new pilots, the most pilot recruitment it has done in its history. Given how famously cyclical travel demand has been historically, there are important questions here about whether this is a prudent strategy or will drive a whipsawing in staffing.

While a protracted slowdown is likely, it need not be inevitable. Righting the ship, however, will take a willingness to implement policies that grow the effective size of the U.S. labor pool. The most obvious means of growing the labor supply would be to encourage greater immigration. There is a range of policy options for boosting labor force participation, from improving healthcare to reducing incarceration to shifting incentives to make work more attractive. However, thus far, politicians have shown little interest in tackling these “third rail” issues. Until then, batten down the hatches.