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INSIGHT

Labor Market Tightness and the Economic Recovery, Part 2

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Recently, many businesses have reportedly complained of labor market "tightness"—workforce shortages and difficulties in hiring to reduce them. This is surprising to many economists because employment is still low. If long-lasting, these shortages could hold back the economic recovery and potentially contribute to inflationary pressures. This Insight, which concludes a previous CRS Insight (Part 1) that analyzes evidence of potential labor market tightenness, discusses potential causes and the policy implications of those findings.

Potential Causes

Labor market tightness is likely being caused by a number of factors. As discussed in Part 1, the Coronavirus Disease 2019 (COVID-19) pandemic caused many people to initially leave the labor force, and for some, their reasons for leaving remain. Census Bureau data reveal that 3% of adults who were not working in early September 2021 did so because they were "concerned about getting or spreading the coronavirus." Workers who are unwilling to return to their jobs because of health fears are often concentrated in industries where social distancing is hardest, increasing tightness in those industries.

Another 4% of survey respondents were not working because they were "caring for someone or sick myself with coronavirus symptoms" (although someone on temporary leave is still part of the labor force). The unavailability of child or other dependent care or paid caregiving leave caused some parents of young children and others to be unable to continue working, and the Federal Reserve estimated that "nonparticipation in the labor force associated with caregiving has increased 0.7 percentage point."

Individuals who leave the labor force can re-enter at any time, but some types of exits, such as retirements, are more likely to be permanent. The pandemic led to a wave of extra retirements, which the Federal Reserve estimated "account for more than one-half of the 1.7 percentage point decline in the aggregate labor force participation rate (LFPR) over this period." The LFPR for workers ages 55 and over, which rose during the previous two recessions, is the lowest this year since 2007.

Unemployment insurance was temporarily enhanced during the pandemic in terms of eligibility, length, and size of benefits. Recipients received an additional $600 benefit weekly through July 2020, which resulted in roughly two-thirds of recipients receiving a larger benefit than their previous wages, and

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thereafter an additional $300 until September 2021 in some states. Some have posited that these policies created disincentives to return to work. A few recent studies used the fact that benefits ended at different times across states to measure the differences in employment outcomes, with mixed results. One study tracked individuals and found a modest increase in the probability of finding a job by the first week of August for unemployed individuals in states that withdrew benefits early. Other studies, performed at the state level, found no significant differences in outcome. As of September 5, 2021, all enhanced unemployment benefits expired, so their influence on the labor supply will fade.

Restrictions on immigration were implemented in response to the pandemic that may explain the temporary drop in the growth rate of the immigrant labor force. While net migration flows are small compared to the overall labor force, even small reductions in available workers can have a significant effect when markets are tight, especially for specific industries and regions that are heavily reliant on immigrant labor.

Labor shortages may be less of an overall phenomenon than one specific to certain industries. As discussed in Part 1, the pandemic caused changes in demand that necessitated job reallocation across industries. Inter-industry reallocation can be more time-consuming and costly than intra-industry reallocation, because retraining or relocation is more likely to be necessary. One study suggests inter-industry reallocation could contribute to elevated unemployment for about three years. Another study found that much of the reallocation was due to the disproportionate impact of the pandemic on the leisure and hospitality industry. Future reallocation will depend heavily on the speed of recovery in that industry. Outside the leisure and hospitality industry, there has not been a significant change in the overall rate of reallocation.

Hiring employees takes time. According to a LinkedIn study, the median hiring time was over a month across 15 industries. When a large decline in employment is followed by a large increase in hiring, this lag may simultaneously lengthen the time of unemployment for many individuals and temporarily maintain a relatively high level of job openings. With time, this lag will clear, which may lessen perceived labor shortages.

Policy Implications

Many of the underlying causes of labor market tightness are related to the decline in the LFPR, and policies that cannot address the specific reasons for the decline may be ineffective. There are a couple of timing considerations that may be important for policy. First, many of the potential causes of labor market tightness are pandemic-related and, therefore, are likely to dissipate once the pandemic ends. As such, policies aimed at ending the pandemic may also help the labor market. Second, the labor market, like other economic markets, has a theoretical equilibrium: There is an average wage at which labor supply will meet demand. Rising wages could be a sign that the labor market is moving toward this market-clearing equilibrium, at which point tightness would dissipate. However, as evidenced by hiring lag times, it could take time for the labor market to equilibrate on its own.

There are costs to inaction if the labor force remains permanently smaller. The combination of both a low labor force participation rate and labor market tightness points to challenges in regaining a level of full employment in line with its pre-pandemic path. If the labor force remained permanently smaller, potential output would be permanently lower as well, all things equal, perhaps justifying policies aimed at boosting employment and output (i.e., expansionary fiscal and monetary policy). However, given the current tightness in the labor market, these types of policies could cause offsetting effects, such as inflation, which is currently relatively high.

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