Will There Really be a Labor Shortage?

Peter Cappelli

A number of recent studies warn that the U.S. economy will experience widespread job vacancies that cannot be filled because of a shortfall of workers. It is true that employers will face new and more difficult challenges in recruiting and hiring than previous generations faced, but the challenges have to do with changes in the employment relationship, not a shortfall of workers caused by demographic changes. These developments have important and positive implications for older workers. More generally, the solutions to these recruiting and hiring challenges focus back on employers and their own human resource strategies.

Recent Demographic Developments:

The dominant demographic event of the last century, the baby boom’s entry into the labor market, preceded what became a long period of economic stagnation and slow growth in the economy. It was hard for many workers, especially young workers, to find jobs in this period and unemployment rates remained relatively high. Chronic and long-term unemployment of young workers in particular was common as was widespread over-qualification of workers for jobs. Evidence suggests that the rapid expansion of the workforce associated with the entry of the baby boom workers depressed their wages and lifetime earning opportunities.

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It’s Time to Retire Retirement

Ken Dychtwald
Tamara Erickson
Bob Morison

The Concours Group in partnership with Age Wave recently conducted a yearlong research project “Demography Is Destiny,” in which we looked at the implications for businesses of an aging workforce. The study was sponsored by 30 major public and private organizations in North America and Europe (For a summary of our research findings, see http://www.concoursgroup.com/Demography/DD_MgmtSumm.pdf).

Broadly speaking, our findings suggest an urgent need to find ways to attract and retain employees of all ages. But of most concern is the potentially debilitating mass retirement that threatens to starve many businesses of key talent in the next ten to 15 years. On the basis of our research, we’ve concluded that the concept of retirement is outdated and should be put out to pasture in favor of a more flexible approach to ongoing work, one that serves both employer and employee.

In the past few years, companies have been so focused on downsizing to contain costs that they’ve largely neglected a looming threat to their competitiveness, the likes of which they have never before experienced: a severe shortage of talented workers. The general population is aging and, with it, the labor pool. People are living longer, healthier lives, and the
The years from 1998 to the recession year of 2001, in contrast, were a period of very tight labor markets when finding workers was a challenge and wages began to rise sharply. The studies that envision a future of labor shortage assert that this period represents the beginning of a fundamental shift in labor markets, in some ways the reverse of the 1970s slack labor markets. They foresee circumstances that will be even more difficult for employers than the tight labor markets of 1998-2001.

Behind the predictions of a coming labor shortage is a demographic event called the “baby bust” generation, the cohort just behind the baby boomers that is roughly 16 percent smaller than the baby boom. Those predicting a coming labor shortage assert that this smaller cohort will not be capable of staffing all the jobs currently filled by the much larger baby boom cohort. The assumption often is that this baby bust cohort is just entering the labor force now, but in fact, they entered about a decade ago and average 31 years of age in 2004.

Labor Supply Trends

Taking the labor shortage arguments seriously begins with an assessment of the role of the “baby bust” cohort in the overall supply of labor. Just behind it in the population is another, larger cohort that some refer to as the “echo” of the baby boom, the children of boomers, and this larger cohort is just now coming into the labor force. The “baby bust” cohort therefore did not cause the population or even the labor force of the U.S. to stop growing. The echo cohort and immigration saw the labor force grow at a rate of roughly one percent per year throughout the 1990s, and government projections suggest that the growth will actually increase at a rate slightly faster than the 1990s through 2014. The rate of increase will then begin to slow, although the labor force will still be growing over the following decades (Fullerton and Toossi, 2001).

But the biggest demographic development in the future will continue to be the baby boom and the increase in the number of older individuals as the baby boom ages. Those over age 65 account for roughly 13 percent of the population at present, a figure that will grow to 20 percent by 2050. The baby boomers are expected to live longer and be more active than any previous cohorts, which raises interesting and important questions for society, such as how we will pay for their retirements. It also raises important questions about the future supply of labor. Life expectancy is roughly 15 years higher now than when the retirement age of 65 was established in the U.S. through the Social Security program, and all indications are that it will continue to rise. Many of the studies that foresee labor shortages in the future assume that retirement patterns will be unchanged, and that people will retire at the same age even as life expectancy and the ability to work longer go up. Surely this is unrealistic if for no other reason than financial resources for retirement may not allow it. There are many indications that the baby boom generation expects to keep working longer, and even a small increase in the retirement age (to 67 by 2027) of baby boomers will increase labor supply substantially because this cohort is so large (Gustman and Steinmeier, 2003).

The first conclusion, therefore, is that the population and the potential labor force will still be growing at typical rates for the foreseeable future. If older workers decide or can be persuaded to work longer, the labor force may grow even faster, and since older workers are already experienced and trained, the average quality of the labor force may actually improve over time.

A second point is that the size of the entry-level cohort of workers may be less relevant now. In the 1960s, large employers especially hired mainly from the population of school-leavers and then promoted from within. Now, they increasingly hire laterally, filling positions at all levels from the outside. Further, even though the entry-level cohorts may be smaller in the future than they were in the baby boom, the overall number of college graduates in the period since the baby bust cohort left high school has actually risen, and U.S. Department of Education projections suggest slow but steady growth in all degrees through the foreseeable future. If any group within the baby bust cohort is noticeably smaller, therefore, it is likely to be those with high school or less education, a group that is not particularly in demand.

Labor Supply and Economic Growth

Does the labor force have to grow in order for the economy to grow? No, because productivity growth can allow each individual worker to contribute more to the economy. Productivity rises when employers invest in equipment and systems that help workers do their job or when workers receive more training and skills that improve their performance. If one compares the U.S. economy now to where it was at the end of WWII, we see that it is roughly eight times larger, but the workforce is only twice as large. Each employee is roughly four times as productive now as compared to the late 1940s.
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If there had been no productivity growth, the U.S. economy would need four times as many workers as we currently have to sustain its current level. Productivity growth has been fastest when labor markets are tight, because wages are rising then. So if the labor market should tighten for a sustained period of time, efforts to increase labor productivity should help offset that tightness.

The more sophisticated of the labor shortage arguments agree that the growth rate of the economy as a whole depends on productivity growth—output per worker—but they argue that it also depends on growth in the number of workers: Output per worker multiplied by the number of workers equals total output in the economy. And so, the argument goes, if the growth rate of the labor force is falling, other things equal, then the growth rate of the economy has to fall as well. But this argument applies only if the economy is operating at absolutely full employment, and it almost never is.

If labor markets become tight and wages rise, employers have an increasingly simple alternative to increasing productivity in the U.S., and that is to “off-shore” the work by sending it to contractors or even their own operations in countries where labor is less expensive. Indeed, many observers believe that the opportunities to off-shore work have essentially expanded the available labor force for U.S. employers to such an extent that the logical consequences are a sharply declining labor market for workers. Off-shoring is a far easier option than expanding immigration as the former can be done unilaterally while the latter requires government intervention.

Some proponents of a coming labor shortage argument use evidence from the 2001 recession and the fact that the number of unemployed and available workers following 2001 was at the lowest level among modern recessions, contending that this should indicate that a labor shortage is imminent when the economy rebounds and that we have moved into a new era of tight labor markets. But all recessions are not the same. Recessions are defined by relative rather than absolute measures of economic activity—a decline in the economy not an absolute level of activity. And the 2001 recession, which followed the longest economic expansion in modern times, was among the shortest and weakest.

Finally, there is an argument that increasing the labor supply would help the economy by holding down wage growth, which would encourage hiring. The complication is that stagnant real wages also hold back consumer demand. While adding workers faster than productivity growth might help expand Gross National Product, standards of living will fall, and it is not obvious that such a goal is desirable.

Surveys indicating that employers have job openings that they have not filled are sometimes used to suggest that there is a labor shortage. These surveys do not indicate what wages and benefits the employers are offering, however. From the perspective of an individual employer, it is a real problem for them if they cannot find workers with the skills they feel they need at the wage they can afford to pay, even if that wage is below the market level. But it is not a labor shortage or even necessarily a problem for public policy if employers cannot pay the market price for what they need.

An Overall Assessment of the Labor Situation

For the economy as a whole, there will be no decline in labor supply. Indeed, it will continue to grow, and the growth will likely increase (e.g., through delayed retirements) if labor markets tighten and wages and job opportunities improve. There is absolutely nothing about the changing demographics of the U.S. labor market that guarantees tight labor markets. As long as there is unemployment, it is next to impossible to argue that the labor force is holding back economic growth or that expanding the labor force would help to create new jobs. To see that demographics are not destiny and that labor supply does not dictate the state of the economy, it is useful to look at the experience of Europe where many countries have sharply falling birth rates and true declines in labor supply. Yet virtually all of these countries still suffer from high unemployment.

What causes tight labor markets is sustained periods of economic growth that exceed productivity increases. That growth then begins to draw down the additional pool of workers who will be added to the labor force every year. (It is worth remembering that the 1999-2001 tight labor markets resulted from the longest sustained period of economic growth in U.S. history.)

Does it matter if the arguments about long-term shortages of labor are wrong, especially for individual employers? If there is a long-term shortage of workers, then most any policies designed to get work done—off-shoring, substituting capital for labor to automate lower-skill jobs, raising wages and other terms and conditions of employment to attract more applicants, etc., all become attractive. If there is no long-term shortage, then these options are not necessarily optimal, and other options make more sense.
**What Is Different Now**

Many employers have a gut feeling that the labor market situation they experienced in the late 1990s was a sea change. Part of the explanation may be just that few employers now have memories long enough to recall that tight markets were the norm in the 1950s and especially the 1960s. The period 1998-2001 offered up new challenges in addition to tight labor markets, however, and I believe that it is these new challenges to which employers are reacting. The first is increased employee turnover, which forces employers to be in a continuous hiring mode. The second is the pressure to hire new skills and expertise from the outside for jobs at all levels of the organization in order to restructure quickly. This is in contrast to previous generations where recruiting was almost entirely limited to entry-level positions that were filled by newly minted college grads.

At the same level of labor market tightness, then, contemporary employers face considerably greater recruiting and hiring challenges compared to earlier periods. The underlying problem for most employers was in not recognizing this change in the underlying employment relationship. Hiring could not meet their labor force challenges, hence the conclusion that the problem was beyond their control and must be due to an overall shortage of workers. But the problem was that many employers relied solely on recruiting to respond to these developments, when in fact, retention management should have been at least as important a mechanism for addressing this new environment. Performance management also became crucial, and recruiting and selection to find the best workers became a potential source of competitive advantage, although few employers adjusted fast enough to do anything strategic in this area.

By the time many employers began to develop more sophisticated recruiting and selection systems, retention management programs, and performance management competencies, the economy had turned down. By the middle of 2001, retention problems virtually evaporated for most employers as new jobs dried up. Hiring demands fell drastically when voluntary turnover declined and even faster once company growth slowed. (Note that the demographic picture was basically the same in 1999, a boom year, as in 2001, a bust year.)

When the economy rebounds, problems will resurface, and they will be the same problems that employers faced before. And if employers rely solely on hiring to address them, they will have the same sense that there are not enough workers to go around.

Instead, employers need to invest in a range of responses beginning with performance management to identify which workers are crucial to retain. Even in the height of the 1999 boom, most employers conceded that their problem was retaining their best workers, not workers per se.

Most companies have to get better at recruiting as well, but simply attracting more applicants per se is unlikely to be cost-effective because of the effort required to sort through to find the best ones. Employers need to invest in programs that help them target appropriate recruits and identify where their recruiting investments are most effective.

**Implications for Older Workers**

Overall, then, what can we conclude about the future from this quick summary of the past? From the 1970s through to the late 1990s, most employers experienced an abundant supply of labor that made it possible to offset and overlook the gradual decay of their human resource competencies and practices. Employers did not have to be good at recruiting or selection when overqualified applicants were queuing up at their door. They did not have to worry about retention policies when no one was quitting. They did not have to develop employees when corporate hierarchies were shrinking and what talent was needed could easily be hired from outside. And when companies were downsizing and restructuring, human resource capabilities were the first thing cut. When labor markets tightened, in contrast, surplus labor was no longer available to camouflage the problems caused by not having these competencies. The recruiting function, which had eroded into the role of simply taking and filling job orders, could not by itself solve all the problems caused by the breakdown of these other systems.

It would be as much a mistake to believe that the slack labor markets of the 2001 recession have eliminated the challenges facing employers as it would be to believe that we are facing an inevitable shortage of workers. No one knows whether future labor markets will be tight or slack—it depends almost entirely on growth and productivity prospects for the economy—but it is also fair to say that the persistent worker surpluses associated with the baby boom that made it possible for employers to ignore virtually all human resource challenges through the mid-1990s may not be back any time soon. Employers will have to develop competencies in recruiting and selection, performance management, retention policies and other practices that support the ability to find and keep good workers.

An important part of those competencies are skills needed to identify the best talent and find the best candidates.
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in managing older workers. In many organizations, the human capital “pipeline” began with inexpensive, inexperienced workers, who then advanced through the ranks with seniority-based pay to become experienced and expensive workers. Efforts to restructure costs, therefore, often meant—at least implicitly—getting rid of older workers and replacing them with younger ones. When employers thought about having older workers, they saw problems because the pay for those workers—tied to seniority—was high.

The days of lifetime employment and seniority-based systems are largely over now as companies move toward models of contingent work, independent contracting, and more free-market arrangements. At the same time, a very large group of experienced, often highly-skilled workers are leaving their current employers, and increasing numbers of them would like to be doing something in the labor market even if it does not look like what they did before. There is a tremendous “fit” possible between this enormous pool of re-entrants and these more flexible work systems. Employers can tap into it with policies and practices that accommodate older workers. It requires going somewhat further down the path to flexibility than many employers may be comfortable going: Older workers do not necessarily want to work the long schedules of their younger counterparts, and they may not be as willing to manifest the “commitment” and “rah-rah” spirit that some organizations require even of their contractors. But these workers also offer skills and competence and are often willing to work for much less money than their younger, career-minded counterparts. Employers who cannot adapt to embrace them will miss a significant source of competitive advantage.

Peter Cappelli, PhD, is George W. Taylor Professor of Management and Director, Center for Human Resources, The Wharton School, University of Pennsylvania.

References
