How Wage Growth Affects Employment and Prices in Both the Short and Long Term

Conrad Buckler, Senior Economist

Short-Term Effects:

Since the beginning of 2020, up to the second quarter of 2023, wage growth in Virginia has accelerated, increasing from an Average Weekly Wage of $1,136 to $1,378 respectively. That is a 21.3% increase in a little over three years, while the average yearly wage growth over the past ten years is 0.89%. Generally, wage growth is considered a good thing by most, but large increases in a relatively short amount of time can have both positive and negative impacts in both the short and long term. Let's consider a scenario where this rate of wage growth continues through 2024.

Wage growth can have immediate impacts on both employment levels and prices within an economy. In the short term, the effect of wage growth on employment can be mixed and depends on various factors such as the elasticity of labor demand, industry dynamics, and the state of the economy. Initially, firms facing higher labor costs due to increased wages may respond by reducing the quantity of labor demanded. Some firms might resort to cost-cutting measures such as layoffs, reduced hours, or automation to offset the increased wage bill.

Different industries may experience a variety of effects on employment. In sectors where labor costs constitute a significant portion of total costs, such as retail or hospitality, the immediate impact of wage growth on employment may be more pronounced due to the higher sensitivity of these industries to changes in labor costs.

In the short term, firms may also substitute labor with capital or technology to maintain production levels without significantly increasing labor costs. For example, a fast-food chain experiencing higher wage costs may invest in self-service kiosks or automation to reduce the need for human workers. They may even outsource the order taking process altogether, as in the case of some fast-food restaurants.

Wage growth can also influence prices in the short term through cost-push and demand-pull mechanisms. Firms facing higher wage costs may pass on these increased costs to consumers in the form of higher prices for goods and services. This can lead to cost-push inflation, where rising wages contribute to overall increases in the price level. For instance, a restaurant facing increased labor costs due to higher wages may raise menu prices to maintain profit margins.

On the other hand, if wage growth is accompanied by increased consumer spending and demand for goods and services, it can lead to demand-pull inflation. Workers with higher wages may increase their spending on discretionary items, leading to increased demand and upward pressure on prices.

Long-Term Effects:

In the long term, the effects of wage growth on employment and prices may evolve as the economy adjusts to the new wage environment. Over the long term, firms may invest in productivity-enhancing measures such as training, automation, and process improvements to offset higher labor costs associated with wage growth. These productivity gains can help firms maintain or increase employment levels despite higher wages.

Wage growth can also affect labor market dynamics by influencing workers' decisions when it comes to labor force participation, education, and acquiring new skills. Higher wages may incentivize more people to enter the labor force or invest in education and training to improve their skills, which can have positive effects on employment levels.

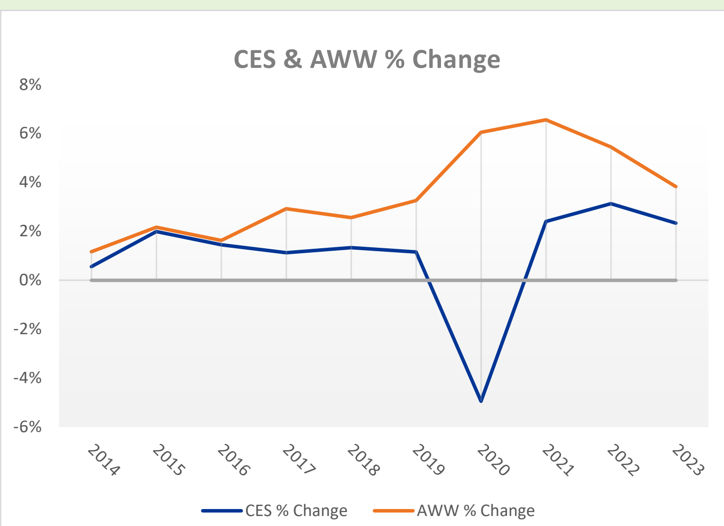
Higher wages can spur innovation and entrepreneurship as firms seek new ways to reduce costs or differentiate their products in response to increased competition. This innovation can lead to the creation of new methods, industries, and jobs, offsetting any short-term employment losses resulting from wage growth.

In the long term, sustained wage growth can influence inflation expectations among consumers and businesses. If workers come to expect continued wage increases in the future, they may adjust their spending habits and pricing behavior accordingly, which contributes to inflationary pressures.

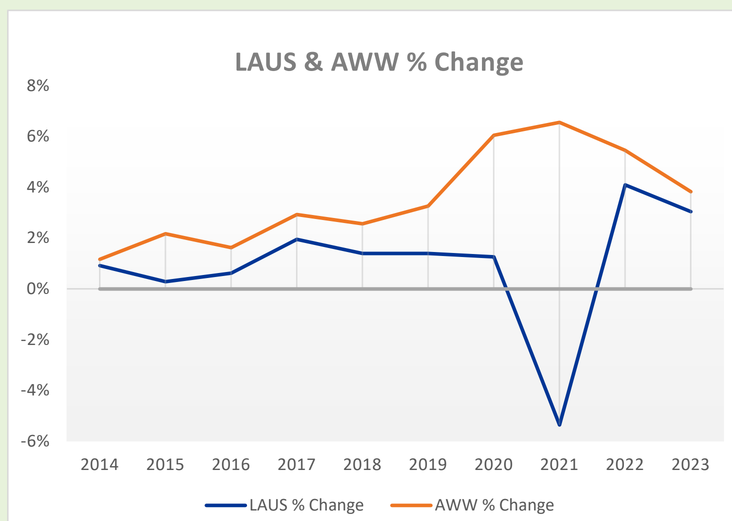
Persistent wage growth that leads to inflationary pressures may prompt central banks to respond by tightening monetary policy, such as raising interest rates, to cool down the economy and prevent excessive inflation. These monetary policy actions can influence long-term inflation and price stability.

Over time, firms may also adjust their production processes and supply chains in response to wage growth, which can affect the overall supply of goods and services in the economy. Changes in supply dynamics can influence long-term price levels and inflationary pressures.

Overall, the effects of wage growth on employment and prices in the short and long term are complex and multifaceted, shaped by various economic factors, institutional arrangements, and policy responses. While wage growth can initially lead to adjustments in employment levels and prices, its long-term effects depend on the ability of firms and the economy as a whole to adapt and innovate in response to changing wage dynamics.



The percent change in Current Employment Statistics (CES) employment growth, from an establishment survey, compared to the percent change in Average Weekly Wage (AWW) growth.



The percent change in Local Area Employment Statistics (LAUS) employment growth, from a household survey, compared to the percent change in Average Weekly Wage (AWW) growth.

The household survey only distinguishes between whether a person is employed or unemployed, whereas CES counts each employee that is on an employer's payroll. CES excludes business owners, self-employed persons, unpaid volunteers, private household workers, and those on unpaid leave or not working because of a labor dispute.

Sources: Wage Data - Unemployment Insurance Data, Employment & Training Administration (ETA) - U.S. Department of Labor (doleta.gov)

CES and LAUS data - https://virginiaworks.com/