Overall unemployment has fallen substantially since 1983, largely because unemployment rates for women and youth fell more than did rates for prime-age males. The unemployment rate for prime-age women now matches the rate for men for the first time. Nevertheless, the rate for men is not particularly low, and the 11 percent unemployment rate for youth is still well above any level considered indicative of a tight labor market.

Furthermore, although the recent strong growth in part-time, temporary, and low-wage employment reduces the overall unemployment rate, it may not shrink the pool of workers available for more lucrative jobs. Thus, growth of high-wage employment need not be associated with higher wages in that sector.

Nor should the expansion of service-sector employment necessarily tighten the labor market in other sectors; it may simply narrow the wage gap between service and manufacturing jobs. In short, the unusual number of unemployed prime-age workers and the large pool of part-time and temporary workers in the service sector are two important sources of slack in the labor market that are not reflected in simple unemployment rates.

Second, if the labor market tightens or if inflation accelerates, we will probably see a quick response in compensation levels, because rigidities are less likely to inhibit necessary labor-market adjustments. But, with flexible wages, wage-setting—even under such changing economic conditions—should be less prone to error, and thus much less likely to exacerbate inflation or business cycles.

Erica L. Groshen is an economist at the Federal Reserve Bank of Cleveland. The author thanks Linda Bell for illuminating discussion and for access to her related unpublished work. Comments from Randall Eberts, Janice Shack-Marquez, and Mark Sniderman are also gratefully acknowledged.

The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

■ Footnotes

1. See Audrey Freedman, "Human Resources Outlook 1988," Research Bulletin No. 217, The Conference Board, 1987.
2. By 1987, only 1 percent of all workers (and barely 40 percent of union workers) were covered by COLAS. In addition, key provisions of the remaining COLAS have been weakened substantially in many cases.
3. See Stephen A. Woodbury and Wei-Jang Huang, "The Slowing Growth of Fringe Benefits," unpublished paper, W.E. Upjohn Institute for Employment Research, March 1988.

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ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

What's Happening to Labor Compensation?

by Erica L. Groshen

Even into its fifth year, the current economic expansion appears to have plenty of steam. Real gross national product grew by 3.9 percent in 1987, and most analysts predict continued expansion this year.

Looming on the horizon, however, are early signs of tightening markets that could slow the expansion: historically high capacity-utilization rates and low unemployment rates. High capacity-utilization levels have raised concern about shortages that could fuel further price increases in the product market. Current low unemployment rates (see figure 1) have led to expectations that increased demand for labor will raise wages.

Although price increases in some industries have accelerated recently, labor costs as yet show few signs of following suit. One explanation for this wage stability is simply that rigidities in compensation practices have contained the mounting pressures in the labor market. Eventually, like the uncoiling of a spring, the pressures will be released and will lead to a generalized increase in labor costs.

This *Economic Commentary* argues against that explanation for the current stability of wages by presenting evidence that wage-setting in the United States is undergoing a fundamental shift toward flexibility. Enhanced flexibility originates both from a shift in the industrial composition of employment and from far-reaching changes in compensation practices in manufacturing and other rigid-wage sectors.

Wage growth has not accelerated because inflation has not accelerated and because the labor market is not tight. However, if and when these conditions change, the greater wage flexibility should make compensation adjustments more rapid and more accurate than they were in the past.

Despite recent low unemployment rates and high capacity-utilization levels, wages have remained stable. This stability is not a result of new wage rigidity. Wages have undergone a fundamental shift toward flexibility because of changes in the industrial composition of employment and in the structure of compensation.

■ Current Trends in Compensation Levels

What is happening to compensation levels, while employment is so high? Figure 2 charts the percent change in nominal compensation per hour and in the Consumer Price Index (a measure of inflation) since 1950. The rate of increase of compensation has fallen in almost every quarter since 1980. Nominal compensation rose by less than 3 percent in 1987. In this series, no sign of any impact of employment growth on wages is yet evident.

Other sources confirm the prevalence of wage moderation in the economy. For example, a recent salary survey by The Conference Board indicates that employers plan to raise salaries in 1988 by no more than they did in 1986 and 1987.[1]

The union sector also provides strong evidence of wage moderation. Union representation of U.S. workers has declined steadily (from 39 percent in 1955 to 16 percent in 1987) and is largely confined to five key sectors: manufacturing, transportation, communications, utilities, and construction. Nevertheless, unions strongly influence wage movements in the

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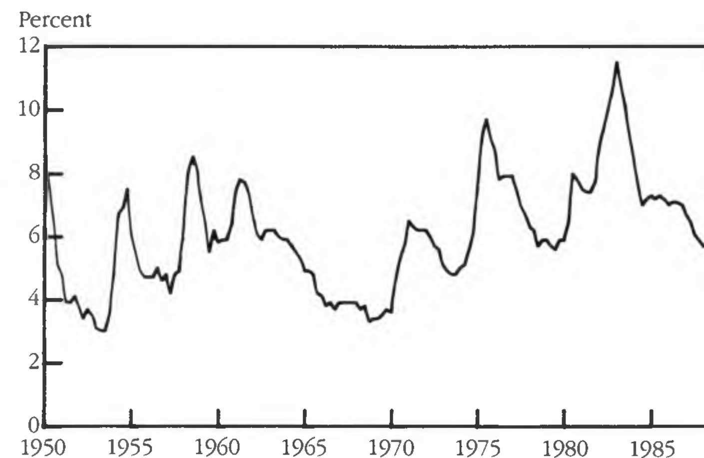
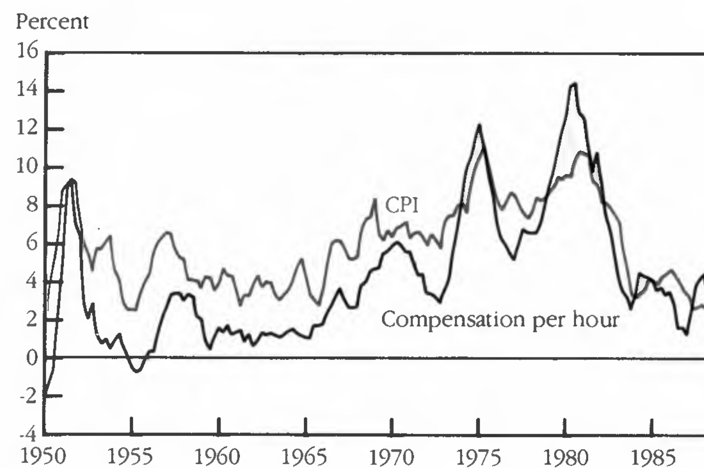
FIGURE 1 UNEMPLOYMENT RATE
(Nonagricultural, private, wage and salary workers)



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

FIGURE 2 PERCENT CHANGE IN NOMINAL COMPENSATION PER HOUR
(Nonfarm business sector)
AND IN CONSUMER PRICE INDEX
(Urban wage earners)



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

economy, even today and even outside the sectors they dominate. Union wage bargains typically spill over into the nonunion sector and affect average wage growth.

In 1987, 27 percent of unionized workers agreed to wage settlements that either offered no immediate wage increase or specified a wage reduction. The average wage increase in union agreements signed in 1987 was 2.1 percent per year over the life of the contract. This slight increase from the 1.8 percent rise in 1986 contracts is less likely to be affected by inflation than in the past, because cost-of-living adjustment (COLA) clause coverage has declined rapidly.[2]

■ Have Wages Become Inflexible?

What does the lack of response to employment growth indicate? One hypothesis is that wages have grown more rigid and unresponsive to demand-side pressures. Perhaps market forces are not being translated into wage increases because wages have been locked into low levels by institutional inertia.

The evidence is quite to the contrary. Compensation is undergoing a transformation toward more flexibility and quicker transmission of signals from the market to the worker's pocket. This enhanced flexibility is the result of two major changes in the labor market: the decreasing proportion of workers in rigid-wage (contract-type) labor markets, and institutional changes in the structure of compensation.

In five large sectors of the economy (manufacturing, transportation, communications, utilities, and construction), high unionization means that compensation is set in advance, for terms that typically last three years. Wages negotiated today are based on expectations of future conditions, particularly future inflation. The spillover effect ensures that even the nonunion workers in these industries have their wages determined to some degree by union contract provisions.

However, an increasing proportion of workers now hold jobs that are relatively insulated from the effects of unionization and that are subject to more short-term wage variability. In the majority of service industries, such as financial services, personal services, retail trade, and health services, most workers are not employed under fixed-wage terms, since most are not under contract. The labor market for these workers is much closer to a spot market than is the market composed of workers in manufacturing, transportation, communications, utilities, and construction.

The differences between the two markets can be seen not only in the extent of unionization, but also in the size of establishments and firms. Service employers are typically much smaller. The average length of service is shorter for service workers, while the proportion of part-time workers is higher. Also, the most inflexible part of compensation, fringe benefits, is a much smaller share of total compensation in the service industries.

Although service employment has grown fairly steadily over the past 40 years, it is only in the past decade that it has overtaken manufacturing as a share of employment. Compared to previous expansions, a much larger portion of the U.S. work force is receiving compensation that is very responsive to supply and demand conditions. This shift in the industrial composition of employment—and thus in the balance between rigid and spot-market wage-setting—raises the average flexibility of wages in the country as a whole.

Compounding the trend from the industrial shift is a striking set of institutional changes that have increased wage flexibility in the more rigid wage sector. The first development is the decline of unionization, that is, in the prevalence of explicit contracts. No matter how strong spillover effects may be, they can be no stronger than a legal contract in determining a path of wages. Thus, the decline of union contract coverage must have some effect on wage flexibility.

Second, in both the union and nonunion sectors, more compensation packages include significant lump-sum payments. Sixty-nine percent of union contracts negotiated in 1986 contained provisions for lump-sum disbursements. Lump sums can vary with the financial health of the employer and with economic conditions and are not part of base pay on which future wage increases will be calculated.

Fringe benefits (both voluntary and legally required) were not a growing part of the average compensation package in the 1980s. The growth in fringes as a share of compensation slowed dramatically in the late 1970s; from 1980 to 1985, the share declined slowly in each year.[3]

Finally, reopener clauses now appear in many union contracts. These clauses allow or mandate renegotiation of the terms and conditions of employment in the event of certain specified circumstances, generally related to the financial health of the employer. Thus, in the event of unforeseen inflation changes, compensation can be changed accordingly.

In short, the 1980s have brought dramatic changes in the nature of compensation, all of which are likely to improve the speed with which wages respond to changes in sectoral or national economic conditions.

■ Implications of Changes in Compensation

To understand the impact of these changes on the path of inflation, it is helpful to put them in the following context. When future wage changes are planned or negotiated, the following equation must be true if a company is to maintain its current profit margin:

Planned change in nominal wages = expected change in price level + expected change in productivity.

That is, the company cannot simultaneously maintain its profits and raise wages above what is warranted by increases in productivity, plus any increase in the price received for its output. The problem is that in long-term contracts, labor and management can under- or overestimate future inflation or future productivity.

In a single firm, if the expectations on which wage-setting were based prove wrong, one of two things will happen: either nominal wages must be adjusted to reflect the actual price level or productivity, or profits and real wages will suffer or gain in equal and opposite amounts. As the term of a contract grows, the possibility that labor and management may systematically under- or overpredict inflation or productivity grows. Likewise, increasing the rigidity of the compensation contract raises the likelihood that expectation errors will have real effects on wages or profits.

To generalize to the whole economy, a predominance of long and rigid compensation contracts creates the possibility that errors in expectations can have real effects (that is, affect production). If expectations overshoot price levels or productivity, real wages rise temporarily; undershooting reduces real wages temporarily. The effect on profits will be exactly opposite.

It is possible that the errors will have no immediate real effect, but this is at the cost of translating the expectational errors directly into price changes. For instance, contracts that result in too-high real wages raise production costs and thus drive up prices as producers try to maintain their profit margins. This is the path of causality postulated in discussions of "cost-push" inflation.

Business cycles and inflation are both unpleasant prospects, so the best alternative may be the one apparently being taken in the labor market today: increased flexibility of wages.

■ Conclusions

Two conclusions may be drawn from the preceding discussion. First, the lack of recent wage growth, despite a low unemployment rate, is not the result of rigidity in compensation. Compensation rigidity has been reduced by the shift toward services and by changes in compensation practices in the past few years. Thus, the lack of upward pressure on wage rates probably reflects slack in the labor market. But where is the slack, if the unemployment rate is so low?

The slack is probably masked in the aggregate figures. In particular, from 1983 through 1987, the unemployment rate of prime-age workers (ages 25-54) remained above 5 percent. The May 1988 rate of 4.4 percent represents only a slight drop in the rate, and is still high by historical standards. (The average rate for men from 1969 through 1979 was 3.4 percent.)