# °243

# Higher Wages May Help Overcome the Shortage of Skilled Workers!

There is currently intense debate in many countries about a shortage of skilled workers. For instance in Germany, despite record employment figures, according to surveys by the ifo Institute, close to 50 percent of companies say they are constrained by a shortage of skilled workers ¬– also an all-time high. From an economic perspective, there is a simple answer to shortages: higher prices.

In a labor market context, this suggests shortages could be overcome by raising wages. What would the consequences be? Some companies would withdraw from the market. Some unpleasant jobs would be eliminated or automated. Employees would switch to jobs with higher wages and higher productivity. This would be bitter for individual companies that cannot keep up with the competition. But for the economy as a whole, the result would be a gain. In addition, people are more willing to accept a job or work longer hours when wages are higher.

## Is the Labor Market a Fully Functioning Market?

One objection to this would be that the labor market is not a fully functioning market and that the conclusion drawn is therefore misleading. From the perspective of evidence-based labor market research, this is both correct and incorrect.

It is true that the labor market is not a market with perfect competition. Frictions are the rule, not the exception. Many employees have specific skills and are not easily interchangeable. At the same time, employees often cannot move effortlessly from one employer to another. This results in market power for employers and also for some employees who, unlike in perfect competition, are not price takers but themselves influence wages. This perspective helps us better understand many surprising findings: for example, that there are vacancies and unemployment at the same time. Or that minimum wages often do not seem to strongly reduce employment.

Now to the crucial question: Does the fact that the labor market is not a perfect market mean that more competition for workers and wage increases in the current situation are merely redistributive or even harmful? From the perspective of labor market research, there is much to suggest that the opposite is true. Accordingly, labor shortages are an expression of the fact that – unlike in perfect competition – the wages offered are lower than productivity, i.e., than what the employee could generate for the company. Due to these frictions in the labor market, workers are not deployed where they are most productive. A productive e-mobility startup cannot grow sufficiently if the engineers it needs stay with an older auto supplier because of frictions. More competition could thus lead to a double dividend: workers are increasingly deployed where they are more productive, and wages and working conditions improve, especially where they were too low from a market perspective. Insofar as employees with low incomes benefit disproportionately, this reduces inequality.

## More Competition Can Reduce Inequality and Misallocation

This is precisely the conclusion suggested by a recent study from the United States, where, despite a more favorable demographic structure, there are also complaints about a shortage of skilled workers. During the pandemic, many employees there had reoriented themselves professionally or geographically. This greater mobility increased competition for labor, leading to migration from relatively low-paying jobs and to wage increases, especially in the low-wage sector. Inequality declined.

But what are the costs associated with stronger competition for labor? One concern is that higher wages lead to higher prices, so that real wages stagnate. Price increases are to be expected, but the US study, for example, suggests that stronger competition for labor has led to rising real wages for a large share of the workforce. This is not surprising, because wages represent only a part of aggregate income.

In some European countries including Germany, this is compounded by the fact that the low-wage sector is subsidized by transfers such as top-ups. As a result, the food delivered by the app driver is already more expensive for society as a whole than its price on the invoice. Consequently, wage increases in this area reduce subsidies that make sense from a social policy perspective, but also distort the labor market – higher wages and prices would better reflect the costs to society as a whole.

## Policymakers Should Endow Regulated Sectors Appropriately

Another concern is that more competition for labor could lead to an exodus of employees from socially important but regulated areas, such as kindergartens or care. Here, however, it is political decisions rather than markets that determine how services are valued. Accordingly, policymakers have a duty here to shape pay and working conditions in a way that ensures sufficient workers are available. For the care sector, for example, a study suggests that many workers would actually work more if wages and working conditions were improved. Keeping wages low elsewhere just to retain workers in these areas would be wrong.

All in all, this means that more competition for workers, and the associated improvements in wages and working conditions, can currently play an important role in dealing with the shortage of skilled workers. This does not mean that measures to encourage labor supply like reforms of the immigration system, childcare, or family taxation should be put on the back burner. But precisely because a demographically induced shortage of labor is brewing, it is crucial to come up with a competitive response to the shortage. To this end, legislators could remove barriers to competition and review measures such as short-time work that may counteract job changes. Above all, however, it is up to the collective bargaining parties themselves to counteract the shortage by raising wages in areas where there is a shortage of labor.

**Clemens Fuest**
**Professor of Public Economics and Finance**
**President of the ifo Institute**

**Simon Jäger**
**CEO of the Institute of Labor Economics (IZA), Bonn**
**Associate Professor of Economics, Massachusetts Institute of Technology (MIT)**

*Published under the title "Mehr Lohn",*
*Frankfurter Allgemeine Sonntagszeitung, March 5, 2023*