Key Findings

- The current cost structure of firms is heavily tilted toward labor costs, despite massive layoffs.
- This could spell danger for the jobs recovery as firms try to manage through the pandemic.

Despite the massive job cuts, it appears that companies’ costs are disproportionately “labor-heavy.” That is, firms appear to be hanging onto workers in hopes of a timely recovery. A disproportionately high share of corporate expenses remain tied up in labor; this bodes ill for a continued upward trajectory in the labor market.

Labor Costs in Past Recessions Preceded Peak Unemployment

In past recessions, the labor share of costs and unemployment have followed a predictable pattern. Immediately before a recession, competition and compensation for workers increased while firms become more cautious with other expenses (capital expenditures, rent or utility payments). Labor share of expenses peaks. When the recession finally hits, the labor share starts to fall as companies start to lay off workers. That is, the labor share of costs tends to be a leading indicator of peak unemployment.
This pattern has been borne out in most recessions since World War II – the most recent examples are in Figure 1. The run up to the current recession is a distinct outlier to this pattern.

**Figure 1 | The Historical Relationship Between Unemployment and Labor Costs Around Recessions**

![Graph showing the historical relationship between unemployment and labor costs around recessions](source: BLS, NBER, MIMS)

**This Labor Market May be Different**

In a conventional recession, we would wait for the share of labor costs to start decelerating before looking for a peak in unemployment. In the current recession, the unemployment rate has very likely already hit its maximum, if only because of the spring lockdown.

However, a still-unanswered question is whether there could be a second wave of unemployment as part of a second, more modest, downturn. The peak would likely be lower than in April, but it is possible for unemployment to worsen before it gets better. As a base case we find that scenario unlikely; the recovery appears to have some
momentum, consumers in aggregate are in a strong financial position, and there will likely be additional stimulus after the election if not earlier. However, risks remain and job gains have continued to slow.

There are several reasons, grounded in the outsized labor cost share, that the unemployment rate could stall out or worsen going forward.

First, most firms have in mind optimal labor-capital proportions. For example, a fast food restaurant may know that to sell 100 burgers it needs X employees and Y amount of working capital. All of those levels are out of whack right now, and until these firms have certainty about how much they will be able to sell, they will struggle to get back to their optimal cost structure. They may not want to commit to righting any imbalances until they have more clarity.

Second, firms may need to rethink those labor-capital proportions for the long run. From the above example, the proportion of X employees to Y working capital may no longer hold in the “new normal.” Restaurants may need more outside seating and a lower density of workers in the kitchen. Office workers may need more space per employee, and/or more technology per employee. We may expect more capital per employee, but the quality (and therefore cost) of employees may need to be higher as well. What the ultimate optimal labor-capital proportions should be is currently unclear.

Finally, with labor cost shares so high, firms aren’t likely to hire too many people right now. If anything, they may start by adding capital if the recovery goes well. More pessimistically, they may start laying off people if the economy starts to head south again. In either case, a big jump in employment doesn’t appear very likely in the near term.

The (Uncertain) Way Forward

Substantial and rapid improvements in the job market cannot be ruled out. They could come from unexpectedly good news on the COVID-19 virus front. A well-structured stimulus plan could provide some assurance to firms. But more likely scenarios involve the extreme uncertainty and structural headwinds noted above. The path forward is likely to be long and gradual.

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