

THE REAL ECONOMY

VOLUME 47



LABOR SHORTAGES
POSE LONG-TERM
CHALLENGE FOR
MIDDLE MARKET

**POLICY RESPONSE CAN ADDRESS
SKILLS GAP,** HELP THOSE LEFT BEHIND

THE MYSTERY BEHIND **SLUGGISH
WAGE GAINS**

**PLANNING FOR MORE TRADE TENSION
AND TARIFFS:** WHAT NOW?

OPPORTUNITY ZONES:
WHO PROFITS, WHEN AND HOW?

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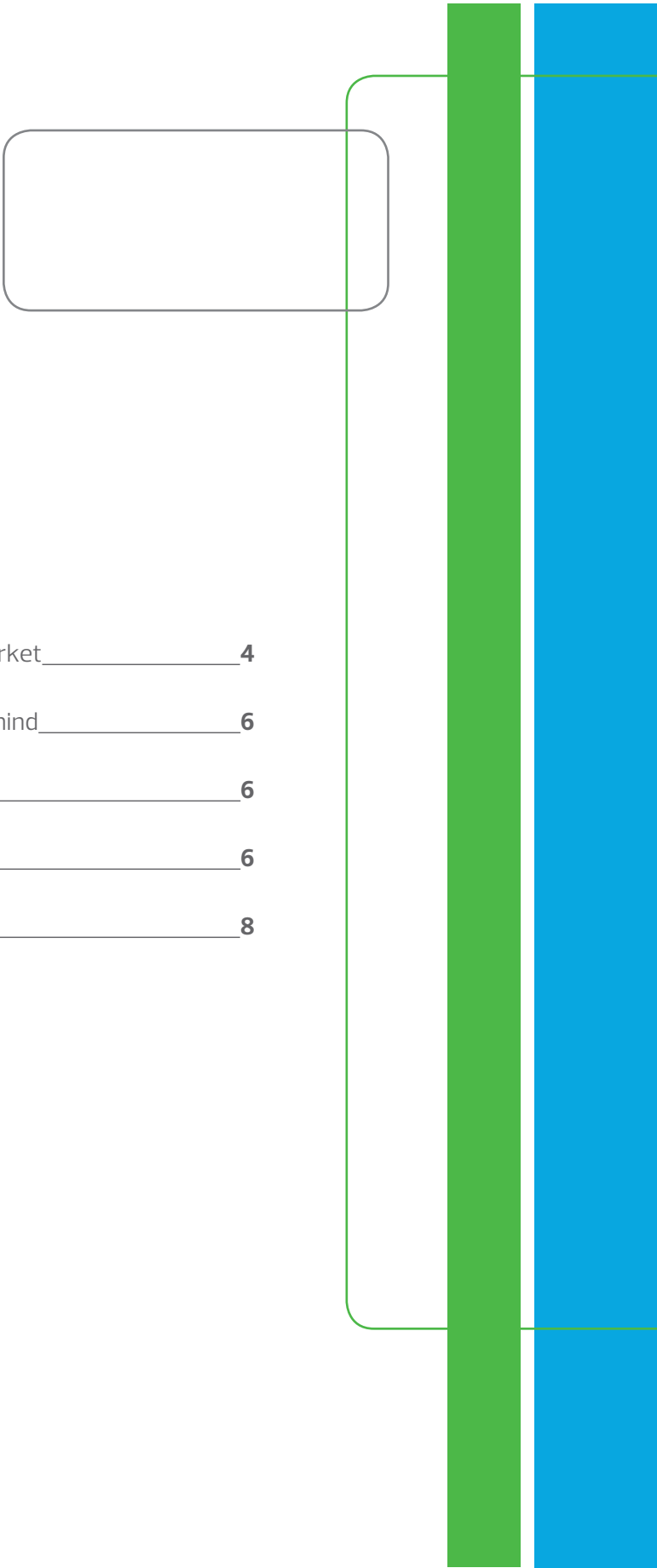


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LABOR SHORTAGES POSE LONG-TERM CHALLENGE FOR MIDDLE MARKET

How we got here and why hiring challenges won't go away soon

By Joseph Brusuelas, Chief Economist, RSM US LLP

At 3.7 percent, U.S. unemployment is at its lowest level in 30 years. Jobless claims are near a 50-year low, and the number of employed adults is at an all-time high. This should be good news, and for many households it is. But for the middle market, these historic numbers are creating significant growth challenges affecting everything from holiday hiring on the retail side, to commercial and residential housing construction, transportation, manufacturing and professional services—you get the picture.

Meanwhile, wage gains have been tepid, to say the least, with workers at the lower end of the income scale only recently beginning to see increases in their paychecks. The lack of a more significant pickup in wages, as unemployment heads toward our forecast of 3.5 percent, and possibly lower, is one of the major dilemmas facing policymakers and economists. (More on that later, see: The mystery behind sluggish wage gains).

So what's behind this historically tight labor market? Why have wage gains been so stubbornly tepid? And will these hiring and wage challenges end soon? To get a sense of why we believe the tight labor market will persist for much longer than many expect, it helps to put how we arrived at this critical juncture in some perspective; the seeds for today's tight labor market were planted many, many years ago.

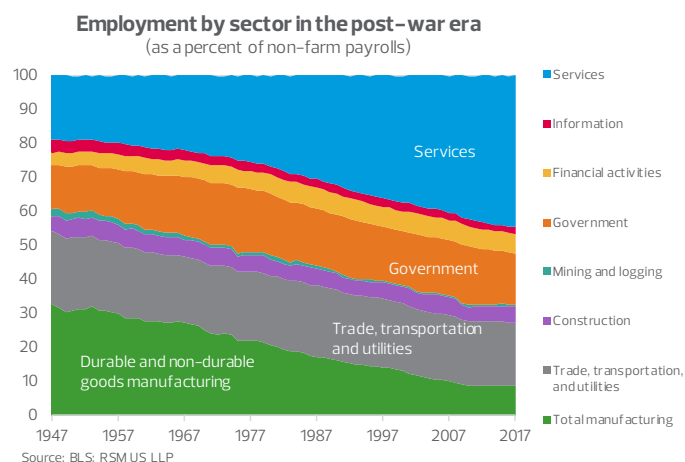
Since the advent of the consumer-driven economy at the end of World War II, the manufacturing sector has gone from

employing 32 percent of the labor force in 1947 to less than 9 percent of nonfarm workers in 2017 (see Figure 1). This shift occurred as consumer tastes changed and employment in local manufacturing was replaced by regional, and then global, supply chains.

During the same period, the service sector has more than doubled its share of the labor force from 19 percent of 1947 non-farm payrolls to 45 percent today. Government employment has averaged about 16 percent of the workforce, drifting slightly lower since 1975. The finance and construction sectors have also been relatively stable, each averaging about 5 percent of nonfarm payrolls.

The current U.S. political landscape is a reminder that for many American workers, the major story of the post-World War II era has not necessarily been the cultural shifts that society has undergone, but rather how sound investment decisions have resulted in a long-term hollowing out of the U.S. industrial base. So to the extent that employment opportunities are the basis for social discontent, we would have to look at the narrowing of employment opportunities in the manufacturing sector as a principal factor.

Figure 1



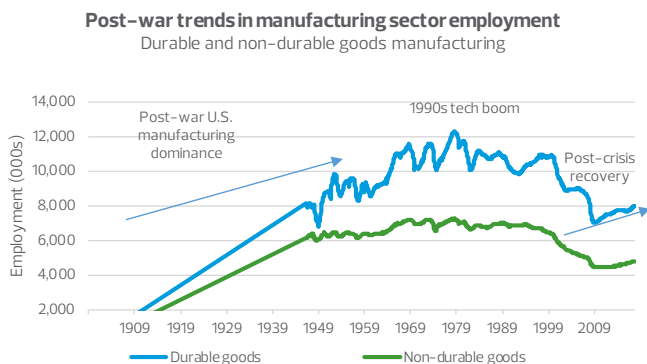
The share of employment in manufacturing declined on trend from 1947 until 2008, as increased consumer demand for high-end, cheaply produced foreign goods overwhelmed the demand for higher-cost and sometimes outdated, locally manufactured ones. Not only did production shift to offshore locations, but automation replaced domestic labor due to new technologies.

Ironically, a decline in the percentage of workers engaged in manufacturing durable and nondurable goods has moderated over the last decade and, in recent years, there appears to be a flattening out. Stabilization could very well be the result of demand for foreign-branded goods produced in domestic production facilities (e.g., German and Japanese autos manufactured in southern states) as well as renewed consumer preference for local products illustrated by farm-to-table and artisanal trends. All of this seems to have helped stop the bleeding, at least at the margins. From 2016 to 2017, durable goods manufacturing settled to house 5.3 percent of the workforce, while nondurable goods manufacturing has stabilized at 3.2 percent.

It is also worth noting that while U.S. manufacturers of durable goods have always employed more workers than those of nondurable goods, a bump up in durable-goods manufacturing employment coincided with increased demand for electronic products during the technology boom of the 1990s (see Figure 2). Employment in nondurable goods manufacturing has been trending lower since that time.

Ideally, rather than trying to stuff the toothpaste back in the tube, domestic manufacturers could further transition from producing base materials to higher-end goods, using the economies of Japan and Germany as a model for continued growth and the health of the manufacturing sector.

Figure 2



Wages, supply and demand for labor

From a macroeconomic perspective, access to a broader array of lower-cost goods has helped boost overall standards of living and the U.S. economy as a whole. On a human level, however, it has left many workers (formerly employed in the industry), and the regions and towns overly dependent on it, with reduced job prospects and

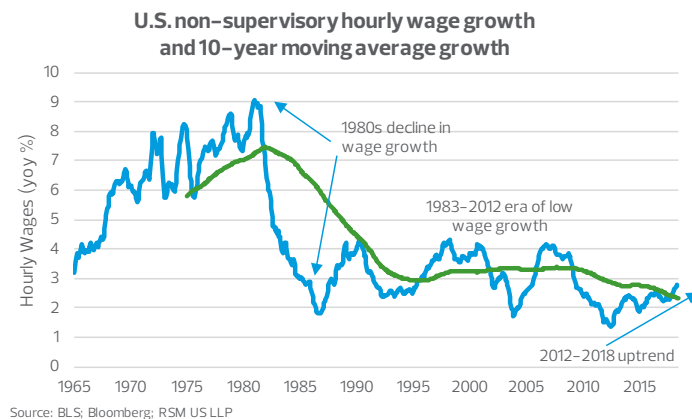
more challenging local economies. By the 1980s, instead of guaranteed pension plans and lifetime health care, workers were left to fend for themselves as the industry began to flee union-friendly regions for right-to-work states, in pursuit of cheaper labor.

Employers also began to outsource tasks not considered direct inputs to production (e.g., cafeteria services, janitorial tasks) that could be easily replicated by lower-cost service providers. Even direct inputs began to be outsourced to lower-cost providers, which not only limited demand for local labor, but also likely contributed to the reduction in research and development and the decline in production efficiencies that would eventually allow foreign manufacturers to overtake domestic production.

As Figure 3 illustrates, the period from 1981 to 1985 saw a sharp drop in hourly wages as the increased supply of low-cost labor led to “take-it-or-leave-it employment opportunities” and then to low-wage growth thereafter. The global labor market had indeed taken hold in the new political environment.

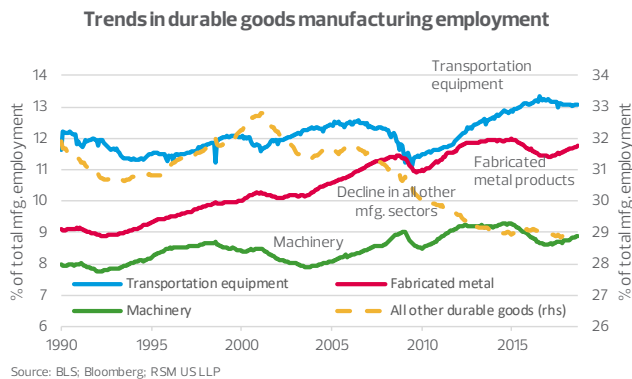
Note that in recent years, hourly wage growth is once again moving higher, but remains at historically low rates of less than 3 percent per year. This implies that household income gains will just barely be enough to cover rising prices if inflation were to remain at the Fed's current 2 percent inflation target. Furthermore, the discontent that has dominated the post-crisis recovery era seems likely to linger unless industry and policymakers come up with a solution.

Figure 3



STEEL AND ALUMINUM
TARIFFS TO THE RESCUE...
WAIT, THIS ISN'T HELPING

Figure 4



While all other industries have employed fewer workers over the past 17 to 18 years, it is ironic that the industries that have increased their share of manufacturing employment are those that use steel or aluminum (see Figure 3), including transportation equipment, fabricated metal and machinery. The imposition of tariffs on the main inputs to production in those industries would threaten their ability to continue providing employment, further damaging the manufacturing sector of the economy.

THE LEFTOVERS

Policy response can address skills gap, help those left behind

By Joe Brusuelas, Chief Economist, RSM US LLP

Public and private policy

Capitalism's saving grace is its ability to adapt and to find the most efficient and least costly method of production, whether a durable good or a service. Historically, U.S. industry has relied on immigration to fill its demand for labor, and this continues today via the global supply of labor.

With 3.9 percent unemployment, it would be hard to argue that today's labor environment is as dire as that of the 1930s (or 2008, for that matter), or that immigrants are taking jobs away from citizens. As in all prior economic transitions, there are winners (i.e., those employees who have adapted to digitalization and the realities of automation and the global supply chain) and losers who are left behind. This time around, those left behind are disenfranchised and can take out their frustration on public policymakers.

Aside from allowing capitalism to work its course, what are some possible solutions to what is a perceived labor problem? Two issues need to be addressed: (1) how best to help those who are left behind, and (2) how to address the skills gap.

Safety net solutions for those left behind

Those workers who are left behind can't be expected to become computer engineers or other professionals overnight or accept low-paying service-sector jobs that would otherwise go to young people just entering

the workforce. And while capitalism might suggest that workers simply pack up and move to different regions where employment is available, low-wage employees have typically exhibited low mobility; it costs money to reinvent oneself.

Unfortunately, the public-policy, safety-net solutions ordinarily suggested—e.g., extended unemployment benefits, free tuition and income assistance—have run out, or are no longer politically acceptable or realistic given the current fiscal situation. These solutions require a societal shift similar to the 1930s New Deal or 1960s Great Society movements.

Society could very well decide to do nothing and simply allow those left behind to age out and hope that the upcoming generations have the time and education to adapt to a changing employment environment.

Addressing the skills gap by investing in human capital

Anecdotal evidence suggests the existence of a skills gap in which employers have difficulty filling "new-economy" positions because the current labor pool does not have the skills or knowledge to successfully complete the tasks. Government investment in new educational facilities seems logical, and would go a long way in propping up overall employment while also improving the future labor force.

Within the private sphere, companies could offer tuition subsidies and in-house training programs that would increase their human capital, while building good will throughout their firms. One could argue that these efforts would lead to greater efficiencies and promote a culture of in-house research and development. Simply put, companies need to decide if investment in their employees is important to their long-term viability.

THE PHILLIPS CURVE IS DEAD. LONG LIVE THE PHILLIPS CURVE. WHAT'S THE PHILLIPS CURVE?

The mystery behind sluggish wage gains

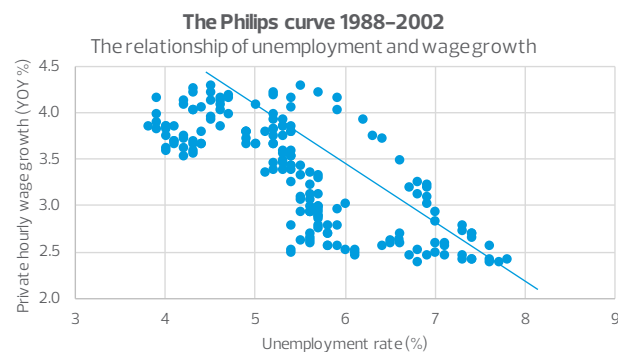
By Kevin Depew, Deputy Chief Economist, RSM US LLP

When the economy picks up, businesses look to hire more workers. As demand for workers increases, businesses begin offering higher wages to compete for a dwindling supply of labor. Pretty straightforward, right? This seemingly intuitive link between employment gains and an increase in wages is an economics observation known as the Phillips curve model.

Central banks use the Phillips curve as an input when setting monetary policy. There have been periods when the Phillips curve appeared to be an appropriate framework for observing the relationship between employment and wage inflation. But recently, the lack of a more significant pickup in wages as unemployment heads toward our forecast of 3.5 percent has been one of the major dilemmas facing policymakers and economists. “The Phillips curve is dead,” some have said. After all, the risk around using the Phillips curve as a policymaking input amid sluggish wage gains is that the Federal Reserve may increase rates too quickly, thus stifling the economy.

The Phillips curve model is traditionally presented as a scattergram, with wage growth on the Y-axis and the unemployment rate on the X-axis. From 1988 to 2002, the period after the effects of the oil crisis and stagflation were wrung out of the economy (and before the housing bubble became a full-blown crisis), the intuitive relationship between monthly private-industry wage growth and the unemployment rate appeared to be largely intact over the course of a business cycle.

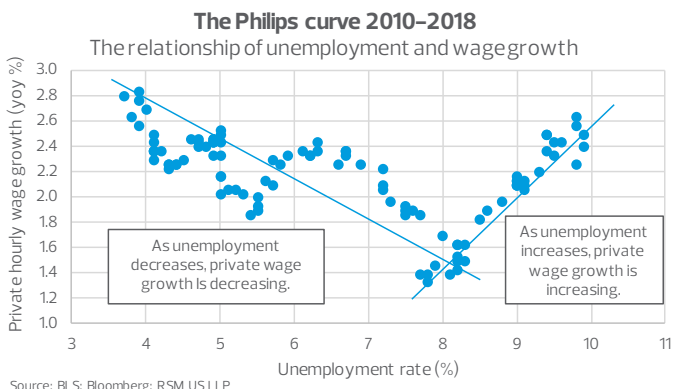
The Phillips curve in the post-oil crisis/stagflation era



But more recently, the relationship between monthly private wage growth and the unemployment rate has been somewhat unstable. Since 2010, the improvement in employment in the wake of the Great Recession has been constant, with unemployment dropping to 3.7 percent in October 2018 from 9.9 percent in April 2010. But wage growth over that eight-year period has been lagging (Figure 2b),

suggesting externalities (the development of the global supply chain and the infinite supply of labor) or structural shifts such as the impact of automation on the availability of low-wage manufacturing employment were at work.

Figure 2b: The Phillips curve in the post-financial crisis era



For middle market businesses, this is less about a policy choice and more about managing their labor costs. After all, if the Phillips curve relationship remains unstable, then businesses may be able to turn to alternative benefits packages or employment attraction strategies to increase their headcounts. But if the Phillips curve model is instead on the verge of describing a more traditional relationship between tight labor supply and wages, then their labor costs may be about to rise ... significantly.

October data says, “Not so fast”

The October U.S. jobs report showed a 3.1 percent gain in average hourly earnings on a year-ago basis—the strongest monthly showing since April 2009. Meanwhile, on a three-month average annualized pace, average hourly earnings increased 3.6 percent, a sign that wage pressures are starting to flow through the economy. This suggests a more stable relationship developing between labor supply and wages.

Meanwhile, the policy implications of the October jobs report are clear. The results reaffirm the growing hawkishness of the Fed, which will increase the federal funds rate by 25 basis points in December and is poised to increase the main policy rate by at least 75 basis points in 2019.

Given the Fed's use of the Phillips curve, it is likely going to interpret this most-recent data, if it's sustained, as modestly inflationary. The RSM view is that there is some risk the Fed increases the pace of its rate increases and hikes the policy rate by 100 basis points next year. Long live the Phillips curve.



PLANNING FOR MORE TRADE TENSION AND TARIFFS: WHAT NOW?

By Chris Shaker, Consumer Products Industry Partner, RSM US LLP

Escalating trade tensions between the United States and China became hot news over the summer. Many in the business community expected the imposition of tariffs by the United States to be a short-term negotiating tactic to right size a trade deficit with the largest U.S. trading partner. When it became clear trade tensions would escalate, fiscal conservatism by middle market businesses followed amid global uncertainty. [RSM research](#) shows that a majority of midsize businesses are unwilling to deploy excess cash on their balance sheets for growth investment, despite surpluses due to tax reform and a strong economic cycle. Tariffs, along with additional market volatility caused by unstable global trading partners such as Italy and Venezuela, among others, have left CEOs bracing for negative outcomes resulting from global trade issues.

The White House continues to use wide-ranging tariffs to stimulate renegotiation of multilateral trade agreements and repatriate global supply chains back to the United States. This significant [policy shift](#) has both direct and indirect implications for many middle market businesses.

U.S. businesses haven't dealt with tariffs of this magnitude since the 1920s; few have a blueprint for how to handle them. Meanwhile, new trade agreements such as United States–Mexico–Canada Agreement inked in September to replace NAFTA, have made it even more difficult to discern facts from political posturing.

Impact to domestic companies, the role of big rivals

The negative impact of tariffs to middle market business is already apparent. In an interview with the [Middle](#)

[Market Transformative Radio Show](#), Cindi Bigelow, CEO of the Bigelow Tea Co., a U.S. maker of dried teas, estimated that an aluminum tariff imposed in March was poised to cost her company nearly \$2 million and has already changed the way the business buys and stores supplies from overseas.

"We have been significantly impacted," she says. "That aluminum tariff was crushing for our little tea company."

Bigelow is not alone. One middle market business executive whose company distributes to big box stores acknowledged that the business expects newly placed duties on a broad array of consumer products from China—which took effect in September—could reduce operating margins by as much as 13 percent. Even though retail customers are likely to accept price increases, the client wasn't as hopeful that big box retailers, which represent a significant portion of the company's customer base, will be on board. Either way, new border taxes are likely to have a significant impact on the company's bottom line.

An executive at another middle market business was also wary of the role big box stores may play in dictating the sector's response. The client, a family-owned chain of hardware stores, expects wholesale price increases at a level not seen before in the company's 100-year-plus history, and worried about passing them on to customers in his stores in a timely manner. If the market, driven by big box stores, won't allow for price hikes, the expected impact on the company's operating margins could be catastrophic. It would not only hurt earnings, but also curb planned capital expenditures for digital initiatives and information technology, leaving the business at a competitive disadvantage.

FREQUENTLY ASKED QUESTIONS

With the newly signed United States–Mexico–Canada Agreement replacing NAFTA, are the tariffs imposed earlier in 2018 going away?

No. While the agreement does include some significant wins for the middle market, the aluminum and steel tariffs put in place on both Canada and Mexico earlier in 2018 were not removed.

Who pays the tariff?

Typically, the importer pays the tariff to the taxing country. For example, when a U.S. manufacturer imports steel from China, the tariff is assessed at the U.S. border and paid by the importing company. The additional expense is meant to create an increased incentive to source materials elsewhere and decrease demand for the exporter.

If I have already paid for goods and those goods are still in transit when new tariffs come into effect, do the tariffs apply?

Yes, countries impose the tariffs at the port of entry.

How and where are the tariffs actually assessed and paid?

U.S. tariffs are included in the Customs and Border Patrol payment systems and are paid when goods arrive at the U.S. border. Similarly, tariffs on exported goods are paid when the goods pass through customs at their destination.

If I purchase a product from abroad, and that product is part of a value-added item such as a car that moves across the border multiple times, do I pay the tax just once or multiple times?

If the good falls under tranches of the steel or aluminum taxes that govern Canadian and Mexican borders, then you will pay the tax multiple times.

Can I apply for an exclusion or seek an exemption?

Yes, exclusions and exemptions are possible. However, the application appears to be a long and laborious process with a low probability of success, based on evidence to date.

Tariffs are temporary, right? Should I stock up on important tariff-affected goods before the next increase and then wait it out?

There is no clear answer. However, business leaders should expect a protracted trade dispute. There are numerous options to consider when planning around a global trade road map, including some of the steps we've outlined below.

What are my options for dealing with the increased costs?

There are five primary approaches, each with benefits and drawbacks, and not all will be available to every business. In general, however, a company may do the following:

- Source material from countries with a lower tariff
- Modify an item so that it falls under a code not impacted by tariffs. A pre-assembled product may fall into one category covered by tariffs while the subcomponents may not, or vice versa
- Legally challenge tariff codes for certain materials and components
- Request an exemption
- [Pass costs on to consumers through price increases](#)

Next steps

The impact of the tariffs goes beyond the direct cost increases from the import taxes. Retailers, for instance, must prepare for inventory price adjustments by having sufficient bin tickets and price tags. They must also ensure to budget enough payroll hours for employees in stores to update stock and change signage, steps that may seem trivial, but that can quickly drive up expenses. All consumer products firms, including retail, manufacturers and distributors, should also speak to vendors throughout their supply chain, attempt to quantify the impact rising prices might have and consider whether the additional costs can be passed on to customers. Financial performance and share valuation for both private and publicly traded firms could be significantly impacted if appropriate steps aren't taken to plan and prepare.

Consider the following:

- Impact assessment: Understand which components and materials are affected by tariff code.
- Cost impact assessment: Gain visibility into the impact of increased tariffs by analyzing actual costs to current or planned costs and their timing.
- Cost modelling: Develop a "what if?" scenario and analysis for increased material costs at the product level.
- Supply chain repatriation: Repatriating goods back to the United States may be an option. Moving to other countries outside the tariff zones could be a solution.
- A merger or acquisition: Some businesses with thin operating margins or lack of interest in continuing in lines of business may consider M&A a realistic option.
- Private equity financing: A cash infusion from PE may be an option for firms that cannot find bridge financing.

Tariffs and trade tension make finding the best path forward difficult, but not impossible. Visit RSM's [tariffs resource center](#) for continued coverage on how the middle market can both react confidently and plan decisively.



OPPORTUNITY ZONES: WHO PROFITS, WHEN AND HOW?

A Q&A with Troy Merkel,
RSM US LLP



The rollout of new specially designated tax-saving districts slated for development across the United States was unveiled as part of the federal government's post-recessionary \$1.5 trillion tax reform package – the Tax Cuts and Jobs Act – announced in late 2017.

These so-called “opportunity zones” were set up to attract investments and stimulate economic growth in urban, suburban and rural areas where development has been stagnant. The U.S. Treasury issued proposed regulations in October to provide guidance on how the zones would operate, the types of investors permitted to participate and the types of projects that may qualify.

In anticipation of the new rules, real estate investment firms, private equity firms, Silicon Valley and others have eagerly begun to raise capital for qualified opportunity zone investment funds designed to take advantage of investments in projects targeted for these tax-saving areas. Depending on the holding period, eligible capital gains from investments in a qualified OZ fund can avoid tax on up to 15 percent of the original gain and defer tax on the remaining original gain until the earlier of the sale of the fund or the end of 2026. Moreover, gains on appreciation of property inside the fund can escape taxation entirely if the investment in the fund is held for at least 10 years. Steve Mnuchin, U.S. Treasury secretary, said in early October that he expected OZs to pull in more than \$100 billion in fresh capital.

The Treasury's draft regulations are subject to a two-month public comment period; news media reported they would likely be completed by spring of 2019.

RSM's Troy Merkel, a real estate partner located in the firm's Boston office, provides a run-down on how OZs work and the investors and sectors that stand to benefit from their implementation.

**DEPENDING ON THE
HOLDING PERIOD,
ELIGIBLE CAPITAL GAINS
FROM INVESTMENTS IN A
QUALIFIED OZ FUND CAN
AVOID TAX ON UP TO 15
PERCENT OF THE ORIGINAL
GAIN AND DEFER TAX ON
THE REMAINING ORIGINAL
GAIN UNTIL THE EARLIER OF
THE SALE OF THE FUND OR
THE END OF 2026.**

Q: What qualifies as an OZ and who has the authority to designate an area?

Merkel: OZs are low-income census tracts, which are areas with a poverty rate of 20 percent or more and a median family income of 80 percent or less of the areas' median income. In addition, up to 5 percent of census tracts that are contiguous to an OZ may qualify, provided the median family income does not exceed 125 percent of the median family income in the nearby OZ. The governor of each state was allowed to designate up to 25 percent of these census tracts as OZs. The governors have made their selections and all the OZs have been declared.

Q: What type of investors qualify?

Merkel: The range of investors is quite broad. It may include individuals, C corporations, real estate investment trusts, partnerships and other pass-through entities, including common trust funds. It is important to note that in order to benefit from a qualified opportunity zone investment, these investors need to have recognized recent capital gains.

Q: How does the tax-savings work? Have you assessed what hold time is the best?

Merkel: The overall concept is one of deferral and partial forgiveness of capital gains tax. In addition, there are potential benefits upon the exit of the qualified opportunity zone investment. Let's take an investor who recently sold some stock with a basis of \$50,000 for \$150,000, resulting in a capital gain of \$100,000, which would normally be taxed that year. That investor has 180 days to decide to invest a portion or all of the \$100,000 gain in an OZ investment, either directly or through an investment vehicle like a fund. At that point, any taxes on the gain are deferred until the OZ investment is sold or until 2026. Let's assume our investor elects to invest all of the \$100,000 gain. Now if the investor were to hold onto the OZ investment for five years, the gain would be reduced by 10 percent (\$90,000). If the investor holds the OZ investment for seven years, the gain is reduced an additional 5 percent (\$85,000). If the investor holds the investment for 10 years, the basis of the OZ investment would be automatically adjusted to the sales prices, resulting in no taxes paid on the sale of the OZ investment. As such, the best hold time for the investment to fully realize the tax benefits is 10 years. For a real estate investor, five-, seven- and 10-year hold periods are the norm and an easy sell to investors.

Q: What type of risk is associated with these OZ districts and are there strategies to mitigate it?

Merkel: The need for a 90 percent tangible asset and the 50 percent income to come from the OZ will be easy for real estate investors to meet. The initial risk is being able to make a qualified investment and required improvements, which means a dollar-for-dollar improvement in the tangible property, in time. Fortunately, the IRS recently released guidance that will make it easier for real estate companies to meet this requirement. The IRS has stated that land is not included when calculating the basis of the tangible asset needed to be improved, thereby reducing the total cost of

improvements. Furthermore, there is a safe harbor that allows for the initial investment and substantial improvement to occur over a 31-month period.

Once you have made the investment and substantial improvements required to qualify for the OZ investment benefits, the next biggest risk is helping investors with tax planning. If investments are held past 2026, there will be a tax due on the original gain (as adjusted for any reductions). There is a high likelihood that this tax payment may not be aligned when the investors receive cash from the investments. It is important that anyone investing in OZs understands that this tax is coming and has a clear plan in place to handle this tax payment, likely through a financing or operating distribution.

Q: Which industries besides real estate and construction are likely to benefit from OZs?

Merkel: Any industry that can operate with 90 percent of its tangible assets and 50 percent of its income from an OZ. Many of the OZs are located in emerging urban markets. These types of markets tend to attract startups in the technology and life sciences space, as well as service companies. It is important to note as well that your tangible assets do not need to be a building. The tangible assets could be leasehold improvements to spaces that companies often lease for five, seven or 10 years.

Q: Does investment in a designated OZ preclude taking advantage of other real estate tax incentives such as historic rehabilitation credits?

Merkel: No. There is nothing precluding an investor of taking advantage of historic, new market or low-income housing tax credits. In many cases, investors were already looking to take advantage of these traditional redevelopment-driven tax incentives, and the OZ benefits make these types of investments even more attractive. In addition to these federal tax incentives, OZ investors can look to take advantage of state and local tax credits or funding, which are often designated for the same census tracts as the OZs.

Q: How do you think investment in OZ funds compares to other asset classes such as private equity?

Merkel: A typical private equity fund has a lifespan of approximately 10 years, which will likely match the typical lifespan of an OZ fund. In addition, both funds have the benefit of liquidating and reinvesting within the fund. We are still waiting on clarity regarding how long an OZ fund has to reinvest proceeds from a sale, but the ability to recycle capital exists with both types of funds. It also should be mentioned that nothing precludes the investor from only taking the five-year deferral and 10 percent reduction of the initial gain benefit.

Ultimately, any tax benefit won't make a bad investment good, but it can make a good investment great. If a fund, PE or other, has the opportunity to invest in a OZ, it can provide a significant increase in the returns, whether the investment is held for five or 10 years.

For more information on RSM, please visit www.rsmus.com.

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