Economics

IN FOCUS

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Elevated low-wage vacancies not triggering proportional wage response

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It happens often in economics. You start with a well-articulated thesis, you think long and hard about the potential implications, then you run the numbers... and they do not support your brilliant theory. That's what happened in the process of writing this piece. Economics 101 and common sense suggest that if the labour market is experiencing a significant shortage of low-skilled workers, wages in those occupations should rise notably faster than occupations that do not suffer from the same shortage. But that's not happening. That might have important implications for the future trajectory of inflation and the Bank of Canada's response.

Share of low-paying jobs in overall employment still very low

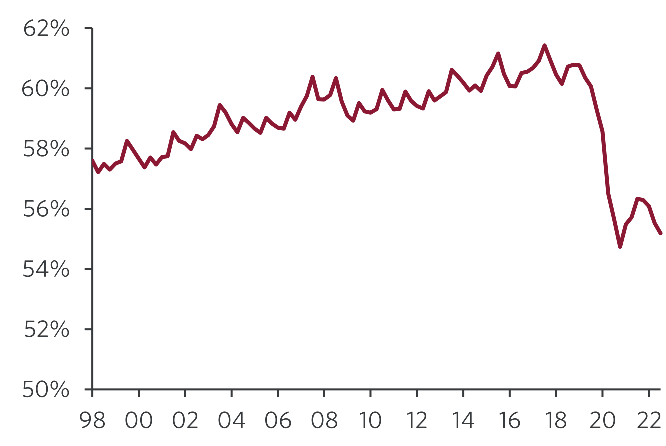
On the first Friday of every month at 8:30 am, we get the labour force data from Statistics Canada. We glance at the headline numbers and then quickly update Chart 1 – the share of low paying jobs in overall employment (defined as occupations with a wage at least one standard deviation below average). For obvious reasons, that share plunged early in the pandemic as the vast majority of the job losses were in low-paying occupations. But since then, the labour market seems largely back to normal: the unemployment rate is lower than it was in 2019 and participation rates are largely in line with pre-pandemic trends. But the share of low paying jobs is still at a record-low level. So the headline employment numbers mask a dramatic shift in the composition of workers in jobs across the wage distribution.

Help wanted

And those missing low-wage workers are in high demand. The latest data shows that vacancies remain extremely elevated at just under one million, only slightly off their all-time peak. And while the vacancy rate is higher in all industries relative to the pre-pandemic period, it is particularly so in low-wage sectors (Chart 2).

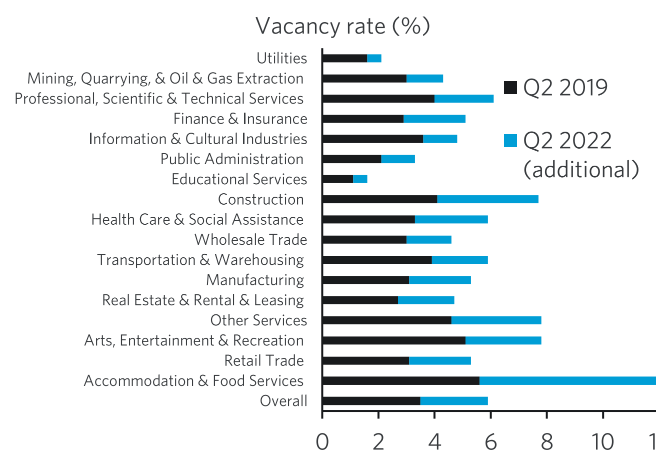
Accommodation and food services, the sector with the lowest average offered wage, serves as a prime example, as its vacancy

Chart 1: Share of low-paying occupations in employment



Source: StatCan, CIBC

Chart 2: The job vacancy rate has increased for all industries



Source: StatCan, CIBC

Chart 3: Lower-wage occupations seeing larger increase in vacancy rates

Source: StatCan, CIBC

rate has more than doubled since mid-2019. While that sector might be somewhat of an outlier given how badly it was affected by the pandemic, the negative correlation between offered wages and the change in vacancy rate holds more generally (Chart 3).

Higher job vacancy rate should lead to higher relative wage pressures.... Right?

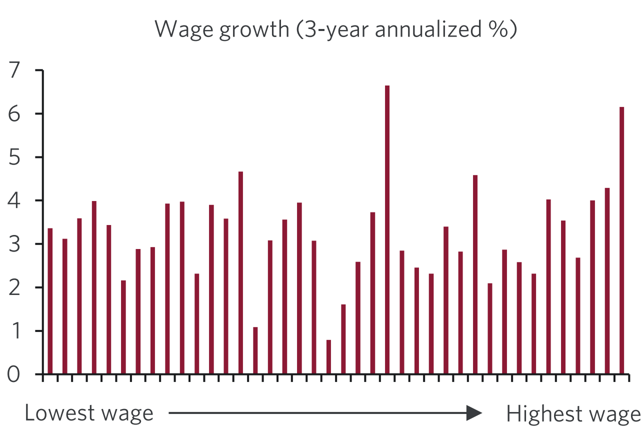
Now go back to your economics 101 course. The first thing you learn is that when demand is too strong for supply, the price goes up. This implies that the labour market should clear via a higher relative wage in low-paying jobs. But that's not really happening.

Chart 4 provides a disaggregated look at wage growth by occupation (ranked from low to high paying occupations), and suggests no clear evidence of wage growth outperforming in low-paying occupations. While wage growth has varied greatly depending on the occupation, we find no pattern at all with respect to wage level. At 3.4% per year, wage growth over the past 3 years has been solid for sales support occupations, the occupation with the lowest average wage, but at 6.2%, it has been much higher for senior management occupations, the top ranked one. And at 6.6%, professional occupations in arts and culture win the prize of strongest wage growth, but stand firmly in the middle of the wage distribution overall.

Just to be sure, we also looked at a more direct measure – average weekly wage by wage quintile – and we found that that weekly wage growth has been slightly stronger in the bottom quintiles, but not markedly so given the magnitude of the shortage of low-wage workers (Chart 5).

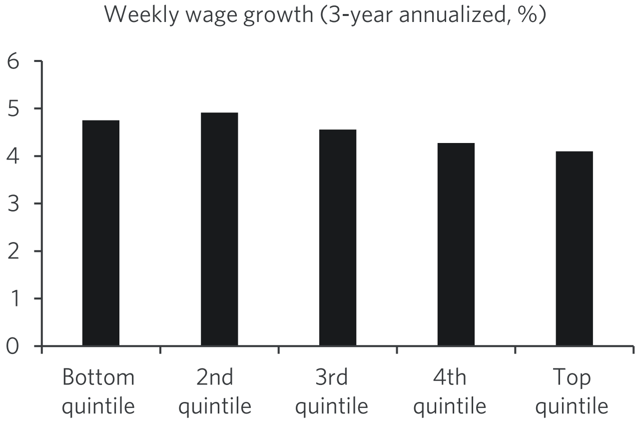
To get a better sense of the trajectory of that relative wage performance since the beginning of the pandemic, we also produced Chart 6, which illustrates the ratio of the bottom 40% to the top 40% of the wage distribution. This ratio is slightly higher than before the pandemic but again, not significantly so. It increased noticeably at the onset of the pandemic, partially as a result of layoffs of low-wage, lower-tenure workers in sectors affected by restrictions, but also because the wage of many low-paid frontline jobs had to be increased to keep people

Chart 4: Wage growth by occupation–do you see a pattern?



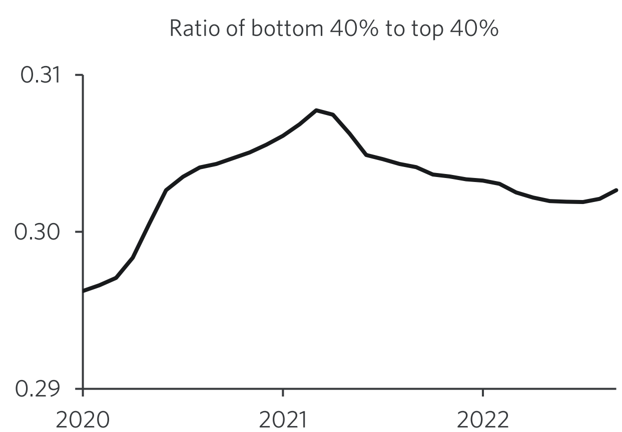
Source: StatCan, CIBC

Chart 5: Growth in average weekly wage by quintile



Source: StatCan, CIBC

Chart 6: Average weekly wage ratio of bottom 40% to top 40%



Source: StatCan, CIBC

working despite increased health risks. Economics 101 therefore seems to have worked at least a little initially. But that ratio has since declined.

Why?

Why are we not seeing higher wage growth in low-paid jobs despite high demand? On this, we may only speculate, though there are a number of possible reasons.

First is the data itself. Wage data comes from surveys and is therefore prone to measurement issues. This is particularly true when looking at wage data from the Labour Force Survey, which can be very volatile. Wages as reported also don't capture compensation fully. The pandemic has induced a change in what workers demand from their employer, with the importance of wages falling in many sectors. For instance, workers now demand more flexibility in work location and better working conditions and are willing to forego wage increases to get them. In some industries, such as accommodation and food, there is also anecdotal evidence that businesses are providing other benefits (e.g. health benefits), a relative novelty for workers in this sector. Moreover, survey evidence suggests that tips are also higher than pre-pandemic, which may help to compensate for lack of wage growth in some sectors. But while this means that "compensation" could have increased by more than the wage data shows, it has clearly not increased enough to clear the market.

In addition, this could reflect the inability of employers to raise wages sufficiently as they face pressure on their margins – particularly following the 2017-2018 notable increase in minimum wages in many provinces. Most of the sectors at the bottom of the wage distribution are very labour intensive, which means that the wage bill represents the majority of costs. They also tend to have lower productivity. Though also imperfect, labour productivity measures for accommodation and food suggest that output per hour is only slightly above $20. And the pandemic, with its added health safety measures, has put downward pressure on productivity in this and many other sectors. While we expect productivity to recover somewhat, it will be harder for sectors where technology cannot easily help provide a boost. That leaves many with very little room to increase wages.

Finally, as they emerge from turbulent times, employers may fear the extent of the slowdown to come. While service industries overall are generally less sensitive to "traditional" downturns than goods-producing sectors, some services tied to discretionary spending, such as restaurants, travel, and retail trade will feel the pressure of a slowing economy. And because wages don't typically fall on a nominal basis (what economists call downward nominal rigidity), employers in those sectors may be reluctant to raise wages further as they face yet another uncertain future.

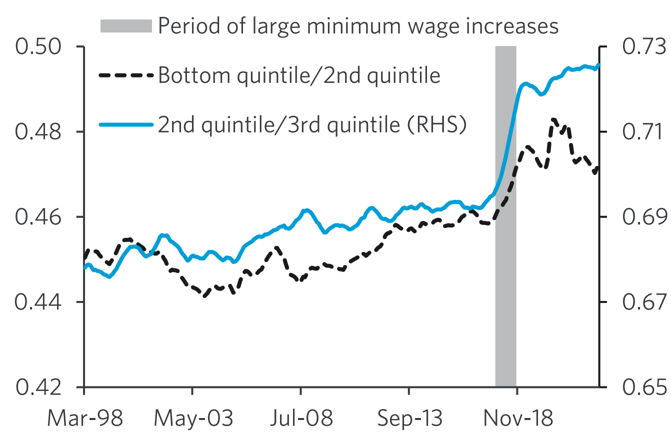
What does it mean for inflation?

The lack of a proportional wage response at the lower end of the wage distribution has obvious implications for the ability of the market to clear as well as for inequality. But it can also matter for inflationary pressures. Strong wage growth at the bottom of the distribution can be more inflationary than pressure coming from the top for a few reasons.

First, the literature dedicated to the impact of minimum wage changes on the wage distribution found some evidence that significant wage pressure at the bottom of the distribution can trickle up. We also see it in Canadian data. Over 2017-2018, the large minimum wage increases that were almost simultaneously implemented in the most populous provinces impacted not only the wage of the bottom quintile relative to the 2nd quintile, but also the ratio of the 2nd quintile to the third (Chart 7). That means that the whole bottom 40% was lifted relative to the rest, and speaks to the potentially large impacts of those increases on wages that were originally far from the minimum wage.

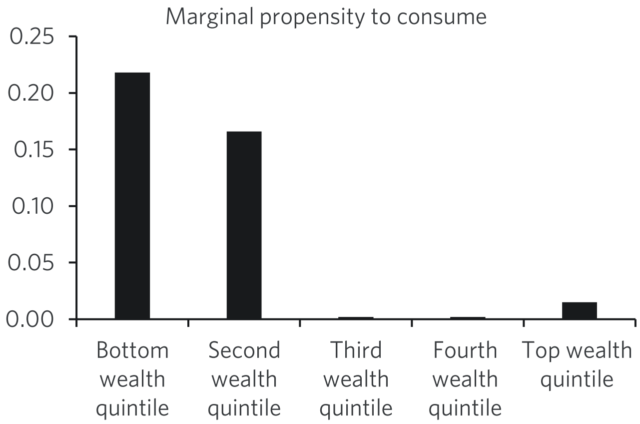
Second, the impact on consumption can be very different. People at different points of the income distribution react differently to changes in income. Those at the low end of the distribution, who are often cash constrained, tend to have a much higher marginal propensity to consume. For that reason, income gains in the bottom 40% of the distribution translate into a larger boost to consumption than gains concentrated in the top 40%, even if the latter have a much higher consumption level. According to researchers at the Boston Fed, the marginal propensity to consume is more than 20 times higher for the bottom two wealth quintiles relative to the top two (Chart 8).

Chart 7: Minimum wage increase in 2018 trickled up to 2nd quintile



Source: StatCan, CIBC

Chart 8: Higher propensity to consume among low-income households



Source: Fisher et al. (2019), Federal Reserve of Boston working paper, CIBC

Finally, while evidence of meaningful direct pass-through of higher wages to higher prices is mixed, it is generally much stronger for service industries such as accommodation and food. In its recent World Economic Outlook, the IMF found evidence of about 10 percent pass-through of wage increases to prices for the US service sector. They also found evidence that this pass-through is stronger when wages are rising faster. Specifically, it can increase to 20 percent when wages are growing very fast (about 4% or faster), but remains almost nil in periods of low wage growth. Since many sectors at the bottom of the wage distribution are services, prices may rise more if wages in those sectors pick up further.

Low-wage workers are enjoying their best bargaining position on record, but it appears that so far businesses are unwilling/unable to lift wages at a rate needed to clear the market. From a pure monetary policy perspective, that's good news for the Bank of Canada. The potential disproportionate inflationary pressure resulting from wage inflation that is originated from the bottom of the wage distribution could have resulted in even stronger wage-induced inflation.

Looking ahead, the most likely scenario is that the ongoing softening in economic activity will lead to a situation in which the labour market will start bleeding vacancies as opposed to jobs, and in the process reduce the bargaining power of labour in general, and low-wage labour in particular. However, at this critical point of the cycle, it's advisable to pay close attention not only to overall wage pressure, but also to its composition.

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