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Will the wage-hike trend spread?

— An overall increase in labor productivity and appropriate price pass-through are essential —

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<Summary>

- Amid historically high prices, momentum is building for wage increases. Ahead of this year's shunto spring wage negotiations, one large corporation after another has announced aggressive wage increases, but the question is whether this wage-hike trend will spread to encompass firms of all sizes in all industries.

- For the time being, rates of wage increases at small and medium enterprises (SMEs) are expected to lag behind those at large corporations. This is because the gap in earning power between large corporations and SMEs has widened further since the COVID pandemic, mainly due to the weak yen and high resource prices, as well as differences between them in terms of leeway to increase labor's share of income.

- By industry, the non-manufacturing sector is likely to see lower rates of wage increases than the manufacturing sector. This is down to many non-manufacturing industries being labor-intensive, so labor costs constitute a greater burden for them compared to the manufacturing sector, and also because the earnings of non-manufacturing companies hit hard by the COVID pandemic are still recovering.

- If wages at large corporations rise following this year's shunto, pressure to increase pay will gradually spread to SMEs, which are suffering even more serious labor shortages than large corporations. For SMEs to secure sufficient resources to raise wages, 1) they must work on digitalization to catch up with the labor productivity of large corporations, and 2) improvements must be made in the effectiveness of the "Declaration of Partnership Building" scheme, which commits participating companies to strive to make business transactions fairer, so that they can appropriately pass on higher costs, including personnel expenses.

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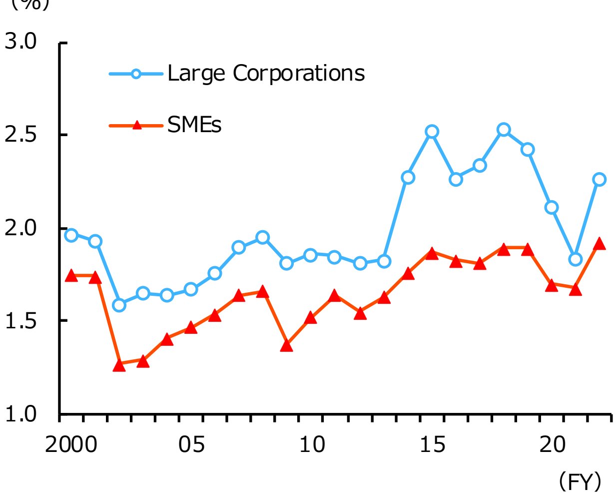
- **This is a English version of "賃上げの動きは広がるのか ― 労働生産性の全般的な向上と適切な価格転嫁が不可欠 ―" in JRI Research Focus (The original version is available at https://www.jri.co.jp/MediaLibrary/file/report/researchfocus/pdf/14027.pdf)**

1. Expectations for higher wages are rising

Amid historically high prices, momentum is building for wage increases. Prime Minister Fumio Kishida has asked the business community to raise wages above the inflation rate in this year's shunto spring wage negotiations. Rengo, the central organization of labor unions, has set a target for wage hikes of around 5% in its shunto policy. This should comprise a regular salary increase of 2% and a base pay increase of about 3%, the latter having the effect of leveling up the overall wage structure. In its own shunto guidelines, the Japan Business Federation (Keidanren) has positioned aggressive wage increases that reflect higher prices as a "corporate social responsibility," and urged its member companies to positively consider raising base pay. In response, one large corporation after another has announced aggressive wage increases.

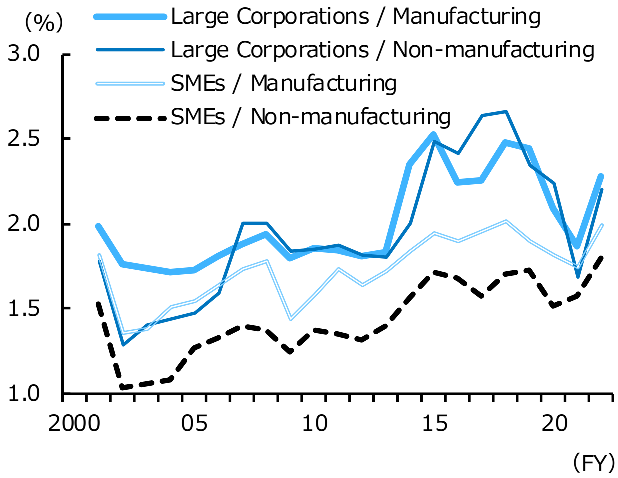
At this year's shunto, the question is whether wage hikes will spread to encompass firms of all sizes in all industries. According to historical data from Keidanren on shunto outcomes by industry for large corporations and SMEs, respectively, rates of wage increases at SMEs have remained below those of large corporations since the 2000s (Figure 1). Even since 2014, when the government started stepping up calls for pay hikes, rates of wage increases at SMEs have not kept pace with those at large corporations. Breaking things down by industry, there is no significant difference in rates of wage increases between the manufacturing and non-manufacturing sectors for large corporations, but for SMEs, rates of wage increases in the non-manufacturing sector are lower than in the manufacturing sector (Figure 2).

Figure 1. Rates of Wage Increases at Large Corporations and SMEs



Source: Prepared by JRI based on data from Keidanren
Note: Rates of wage increases include regular salary increases.

Figure 2. Rates of Wage Increases by Company Size and Industry



Source: Prepared by JRI based on data from Keidanren
Note: Rates of wage increases include regular salary increases.

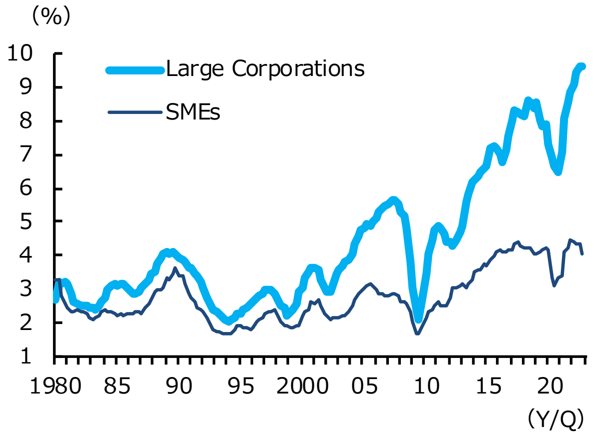
2. Disparities exist in room to raise wages depending on company size and industry

At this year's shunto, it is expected that disparities in rates of wage increases depending on company size and industry will continue to exist. This is because there are differences in the leeway of companies to hike wages.

In terms of company size, SMEs seem to have less room to raise wages than large corporations do. First, since the COVID pandemic, the gap in earning power between large corporations and SMEs has widened further. According to the Ministry of Finance's quarterly Financial Statements Statistics of Corporations, the ratio of ordinary profit to sales (trailing four-quarter moving average) for large corporations was around 9.6%, close to the record high, in the October-December quarter of 2022, while that for SMEs remained at 4.0%, the same level as before the COVID pandemic (Figure 3). As a background factor, it can be pointed out that while earnings of large corporations, for which overseas operations account for a relatively large share of their business, have been boosted by the substantial depreciation of the yen in 2022, SMEs have been slow to pass on rising import costs stemming from the weaker yen and higher resource prices by raising prices, and this has put pressure on their earnings. According to the Bank of Japan’s December 2022 Tankan survey, the DI for input prices, which is the percentage of firms that answered that input prices are “rising” minus the percentage that answered that they are “falling,” was 67 for small enterprises, higher than the 60 for large enterprises. On the other hand, the DI for output prices was 31 for small enterprises, lower than the 35 for large ones. This suggests that while input prices for SMEs have risen more than they have for large corporations, SMEs have not been able to raise their output prices sufficiently.

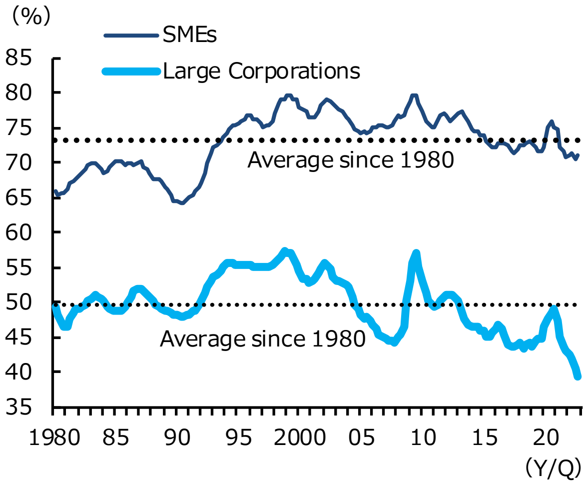
Second, there are differences in terms of scope to increase labor’s share of income. According to the Ministry of Finance's quarterly Financial Statements Statistics of Corporations, labor’s share of income (trailing four-quarter moving average) for the October-December 2022 quarter declined to a record low for large corporations, while it remained high for SMEs (Figure 4). In the background to this, it can be pointed out that even as their value-added has increased steadily, large corporations have kept personnel expenses down in favor of Western-style management styles that emphasize shareholder returns, while SMEs have found it difficult to lower the burden of personnel expenses as their value-added has remained flat.

Figure 3. Ratio of Ordinary Profit to Sales



Source: Prepared by JRI based on data from the Ministry of Finance
Note: Trailing four-quarter moving average. SMEs are companies with capital of 10-100 million yen, while large corporations are companies with capital of over one billion yen.

Figure 4. Labor's Share of Income

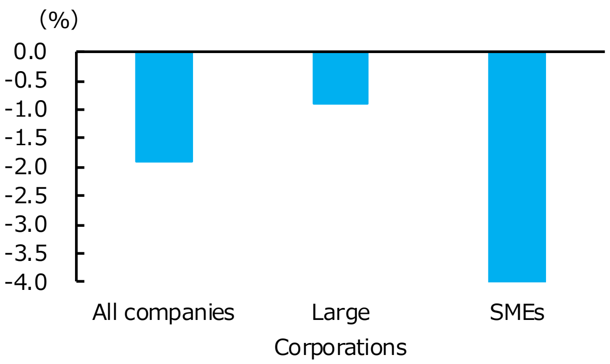


Source: Prepared by JRI based on data from the Ministry of Finance
Note: Trailing four-quarter moving average of personnel expenses / value-added

Reflecting these differences in profit margins and shares of income, wage increases have a greater impact on corporate performance at SMEs than they do at large corporations. Based on data for the April-December period of 2022 from the Ministry of Finance's quarterly Financial Statements Statistics of Corporations, the impact (percentage change) on ordinary profit of a 1% increase in personnel expenses is estimated to be -0.9% for large corporations and -4.5% for SMEs (Figure 5).

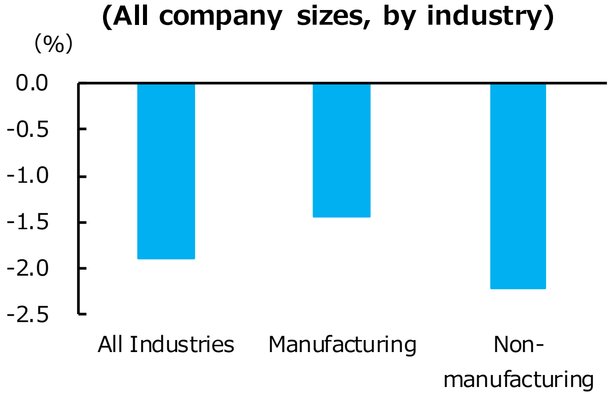
By industry, the impact of wage increases on corporate performance is greater in the non-manufacturing sector than in the manufacturing sector. The impact on ordinary profit of a 1% increase in personnel expenses is estimated at -1.4% for the manufacturing sector and -2.2% for the non-manufacturing sector (Figure 6). As a backdrop to these differences, non-manufacturing industries are more labor-intensive than manufacturing industries, so personnel expenses constitute a greater burden for them. In addition, the earnings of non-manufacturing companies in sectors such as lodging and food/beverage service and lifestyle-related/entertainment services, which were hit hard by the COVID pandemic, are still recovering.

Figure 5. Impact (Percentage Change) on Ordinary Profit of 1% Increase in Personnel Expenses (All industries, by company size)



Source: Prepared by JRI based on data from the Ministry of Finance
Note: Estimates based on data for the April-December 2022 period

Figure 6. Impact (Percentage Change) on Ordinary Profit of 1% Increase in Personnel Expenses (All company sizes, by industry)



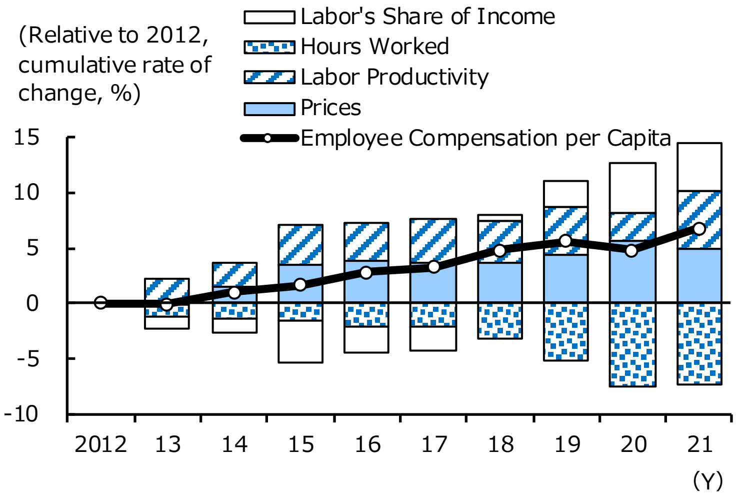
Source: Prepared by JRI based on data from the Ministry of Finance
Note: Estimates based on data for the April-December 2022 period

3. An overall increase in labor productivity and appropriate price pass-through are essential for wage increases to spread

For wage increases to encompass firms of all sizes in all industries, it is essential to reduce disparities in labor productivity, and ensure that all companies can pass on increased costs in the form of higher prices.

What can be expected to drive sustainable wage increases in the macroeconomy as a whole are increases in labor productivity and output prices. Using estimates from the Cabinet Office's Annual Report on National Accounts, it is possible to break down nominal wages (employee compensation per capita) into 1) labor productivity (real GDP per hour), 2) prices (GDP deflator), 3) hours worked (hours worked per capita), and 4) labor's share of income (ratio of employee compensation to nominal GDP). Looking at the period since 2012, when nominal wages turned upward, the main factors behind wage growth have been labor productivity gains and price increases (Figure 7). On the other hand, a decline in hours worked has been a factor behind wage decreases. This is due to an increase in the proportion of part-time workers and progress with workstyle reform. Note that although an increase in labor's share of income has been a factor in pushing up nominal wages since 2018, the potential for further increases in labor's share of income is limited and cannot be expected to be the driver for sustained wage increases.

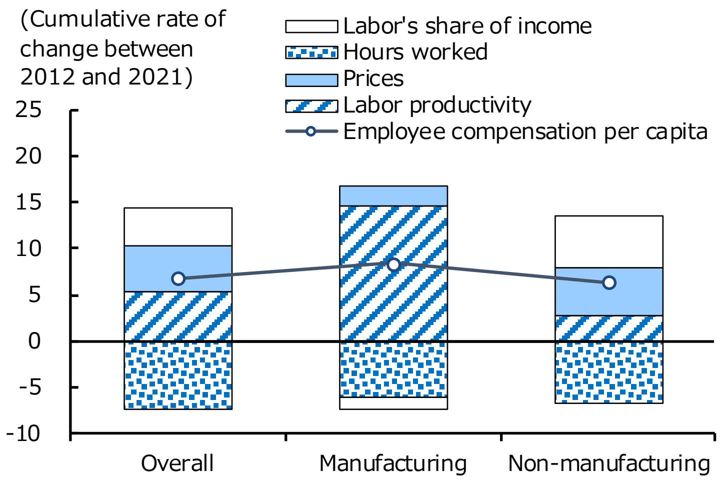
Figure 7. Factor Breakdown of Employee Compensation per Capita



Source: Prepared by JRI based on data from the Cabinet Office

By industry, the pace of labor productivity growth is slower in the labor-intensive non-manufacturing sector than in the manufacturing sector, suggesting a greater need in the non-manufacturing sector to secure resources for wage increases by raising output prices. Since 2012, labor productivity growth has been the main factor behind higher wages in the manufacturing sector, while in the non-manufacturing sector, increases in prices and labor's share of income have played a greater role than labor productivity in pushing up wages (Figure 8). Although it is not possible to break down the factors that contribute to changes in wages by company size, it is probably important for SMEs, whose labor productivity growth is weaker than that of large corporations, to secure resources to raise wages by increasing prices appropriately.

Figure 8: Factor Breakdown of Employee Compensation per Capita



Source: Prepared by JRI based on data from the Cabinet Office

If wages at large corporations rise as a result of the shunto, pressure to raise wages is likely to rise even at SMEs, which are suffering more severe labor shortages than large corporations. For SMEs to secure sufficient resources to raise wages, 1) they must work on digitalization to catch up with the labor productivity of large corporations, and 2) improvements must be made in the effectiveness of the "Declaration of Partnership Building" scheme, which commits participating companies to strive to make business transactions fairer, so that they can appropriately pass on higher costs, including personnel expenses.