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Wage is a Key Antidote

Higher Wages Would Help, Not to Hurt the Economy

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Summary

Increasing wages in a low-wage economy is vital for improving living standards, reducing income inequality, and stimulating overall economic growth. But a poorly structured wage policy may potentially result in unintended consequences, such as inflationary pressures, reduced business competitiveness, and potential job losses.

Currently, it is of utmost importance to prioritize wage enhancements for the middle-income group, especially semi-skilled workers, as their wage growth has lagged behind that of high-skilled and low-skilled workers.

Introducing a tailored progressive wage model for this specific group presents itself as a sustainable and impactful solution. By implementing such a model, we can foster fair wage growth, narrow income gaps, and cultivate long-term economic stability, ultimately paving the way towards a more prosperous and inclusive economy.

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Low-Wage Economy Limits Economic Opportunities

Wages has always been debated as a measure of how the “benefits of growth” are fairly distributed between labor and capital. The decent level and growth of wages represent the concept of economic justice or fairness for households as almost two-thirds of their income is sourced from the labour market. This implies that wage is uncertain, especially if someone loses a job, unlike property rights which have greater security in ensuring rents and other form of capital incomes perpetually.

The total income of a nation is distributed among two key components: labor and capital owners. Labor's income is primarily represented by wages, which encompass basic pay, allowances, and other in-kind payments, collectively referred to as compensation of employees (CE) in national accounts. For simplicity, we will use the term "wages" to represent CE in this context. Capital owners' income is typically represented by operating surplus (OS).

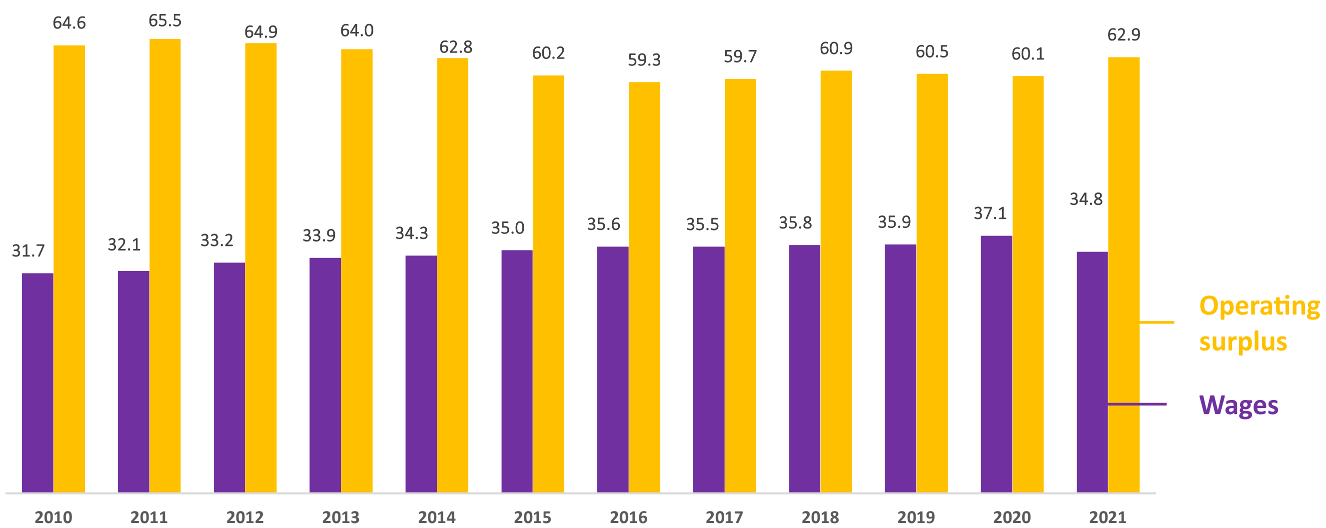
In the Malaysian context, the share of wages in relation to GDP has shown some improvement, increasing from 31.7% in 2010 to 35.9% in 2019, as depicted in Panel A of Figure 1. However, the proportion of wages remains significantly lower compared to other countries such as Germany (53.4%), the United Kingdom (48.7%), Australia (47.2%), Republic of Korea (47.5%), and Singapore (39.9%) in the year 2019.

The distribution of GDP growth between wages and operating surplus (OS) exhibits notable disparities. While both wages and OS demonstrate a positive correlation with GDP, the relationship with OS is substantially stronger, suggesting that capital owners benefit more than workers from economic growth (Panel B of Figure 1). For instance, a 1% increase in GDP growth contributes to a 1.05% growth in OS, whereas the growth of wages only sees a 0.63% increase. This indicates that the advantages of economic growth are predominantly attributed to capital owners.

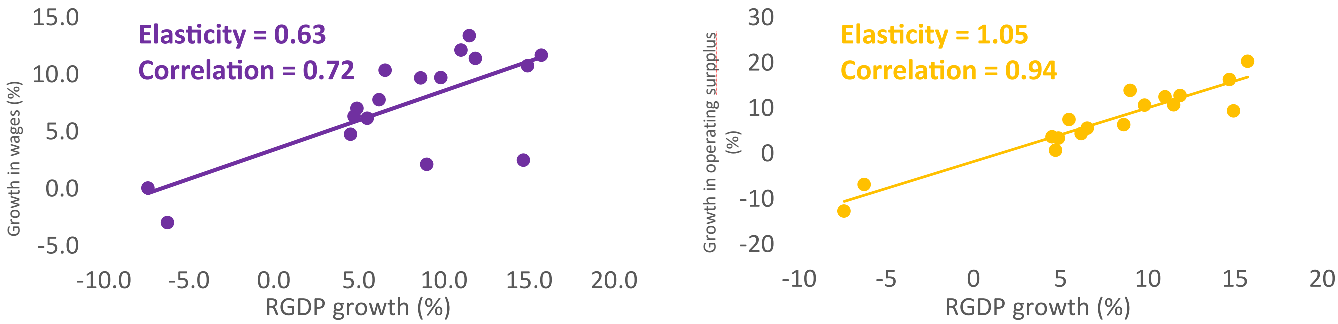
Figure 1

Trend and correlation of wages and operating surplus to GDP, Malaysia

Panel A: Share of wages and operating surplus to gross domestic product*



Panel B: Relationship between growth in wages and operating surplus relative to GDP**



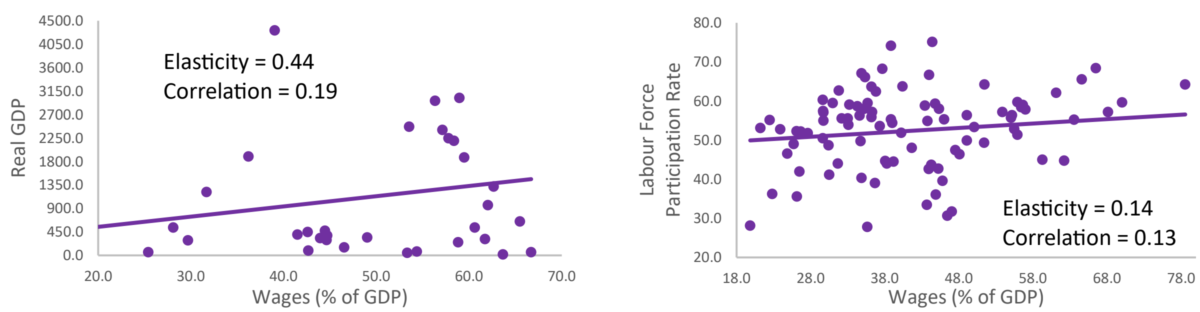
Notes: (*)The total summation of the shares would not equal to 100% because it excludes taxes less subsidies on production and imports, (**) All models throughout this study have been estimated using OLS with robust standard error due to Newey and West (1987) that correct for both autocorrelation and heteroscedasticity. RGDP denotes growth in Real Gross Domestik Product.

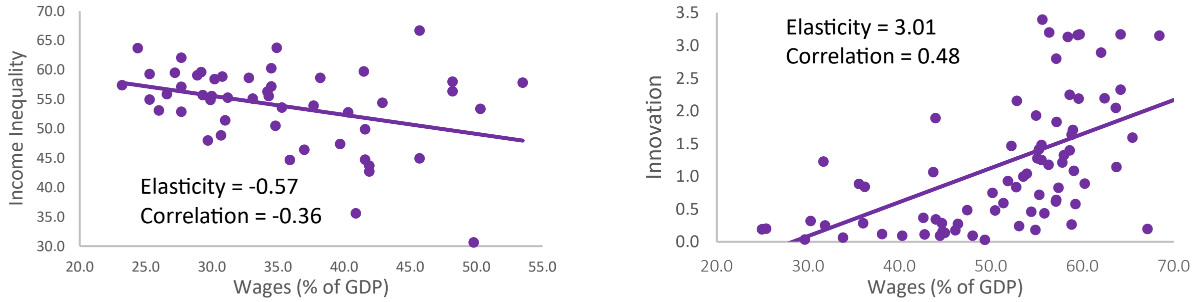
Source: Department of Statistics, Malaysia (various years).

Elevated wages have been identified as a viable solution to address certain structural challenges in Malaysia. These challenges include a low labor force participation rate (LFPR), income inequality, and a sluggish pace of technological innovation and adoption. Compelling cross-country evidence, as illustrated in Figure 2, demonstrates that higher wages can have positive effects, such as elevating LFPR, reducing income disparities, fostering technological advancements, and promoting overall economic growth. Conversely, a considerable deficiency in wage levels and growth may impede Malaysia's ability to fully unlock its genuine economic potential.

Figure 2

Wages and macroeconomic indicators, cross-countries data in 2019





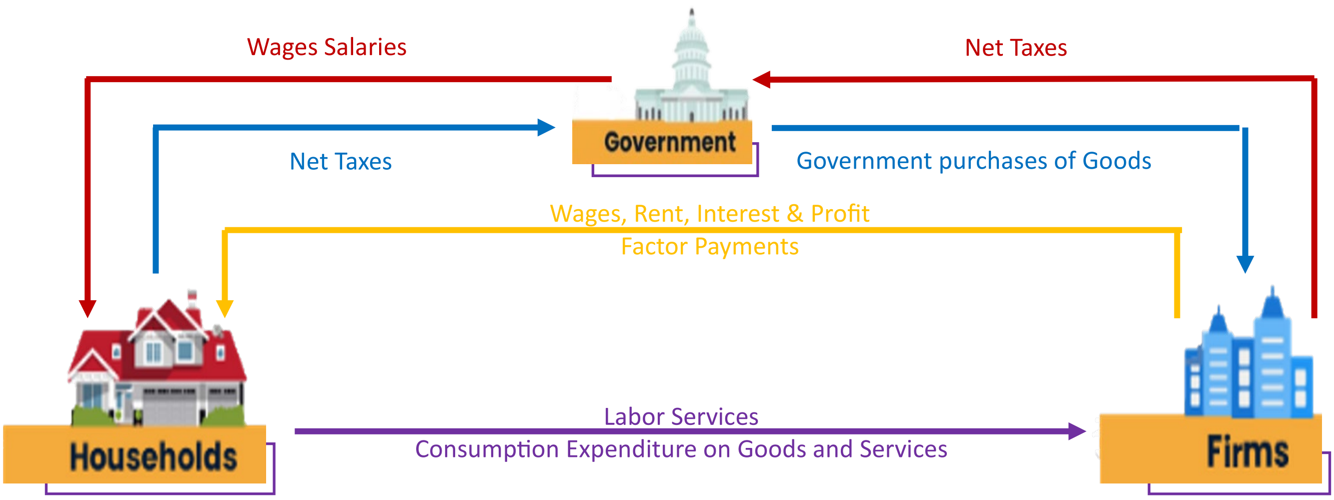
Notes: Income Inequality represented by the Gini index, innovation defined as Research and Development expenditure (% of GDP) and real GDP expressed in US$ million.
Source: World Development Indicator (2022) and Penn World Table (2022).

Evidence-Based Assessment of Higher Wages

From the workers' perspective, an increase in wages is necessary to compensate for the higher prices of goods and services. Generally, employers claimed that wage increases could inflate prices, leading to market distortions that could pose a threat to the economy. However, cross-country studies (e.g., Lupu et al., 2022) show that an increment in wages will generate more income for businesses.

An economy functions as a system of interaction between expenditure and income flows as depicted in Figure 3. Households provide labor input to the economic sector and receive wages in return. The more wages earned, the higher consumption of goods and services, hence generating additional profits for the business sector. For example, a simulation of a 3% to 5% increment to the current wages of the semi- and low-skilled workers results in higher GDP growth and labor productivity. Meanwhile, another analysis using Gini Index shows that higher wages reduce income inequality as reaffirmed by Sotomayor (2021).

Figure 3
Economic impacts of higher wages



Note: Increase in wage rates induces additional consumption which in turn generates additional output and profit.

A projection of macroeconomic indicators for the periods 2021-2025 as a result of simulation 3%-5% of additional increases in total wage:

↑3%	↑4%	↑5%	
+5.6%	+6.0%	+6.5%	GDP (current price)
+4.2%	+4.8%	+5.4%	Labor Productivity
-2.2%	-2.4%	-2.5%	Income Inequality (Gini index)

Description of model.
The simulation results are derived based on a computable general equilibrium (CGE) model developed by EU-ERA. The CGE Model can produce projection of economic, social, and environmental indicators up to 2030.

Higher wages attract more women to the labor force. Labor is an important input in the production process. An increase in labor input will increase production, *vice versa*. In the event that labor shortages do occur, higher wages tend to attract more women outside of the labor force to the market. An empirical assessment as shown in Figure 4(a) suggests that a 1% increase in labor compensation tends to increase female labor force participation rate by 1.2%. These findings suggest that the policy approach to increase wages plays an important role in achieving the women LFPR target of the Twelfth Malaysia Plan 2021-2025 from 55.3% in 2020 to 57.0% in 2025.

Higher wages promote technological adoption. Adopting technology in the production process is a way to increase output by optimizing the use of production inputs such as labor and energy (Maneejuk and Yamaka, 2020). Technological adoption is found to complement the demand for skilled workers that help to increase wages. The empirical assessment as shown in Figure 4(b) indicates that adoption to technology leads to higher labor compensation and higher skilled workers. Thus, firms must be willing to share their wealth by increasing wages that are commensurate with higher skills.

Higher wages improve economic efficiency by reducing the size of shadow economy. Shadow economy includes all market-based legal production of goods and services that are deliberately concealed from public authorities to avoid payment of taxes and social security contributions as well as to avoid complying with labor market standards and administrative obligations (Schneider, 2011). The size of the shadow economy in Malaysia for the period of 2010-2019 is estimated at approximately 21.2% of GDP. Shadow economy creates economic inefficiencies as it could potentially reduce government tax revenue, cause a fragmented labor market and lower economic growth.

The shadow economy and the shadow labor market are closely connected. Any labor-related activities taking place as part of the shadow economy are considered involved in the shadow or informal labor market. People may be excluded from the formal labor market due to a lack of opportunities or choose to exit the formal sector voluntarily because of both monetary and non-monetary benefits of informality. If wages in the formal sector can be increased, this will encourage people to shift out of the shadow economy into the formal sector (Hohberg and Lay, 2015). The empirical assessment depicted in Figure 4(c) shows that the size of the shadow economy is likely to reduce by 0.5% for every 1% increase in labor compensation. In this regard, wage is considered as an indirect policy intervention to increase the formalization of the economy in addition to direct interventions in the forms of regulations and enforcements.

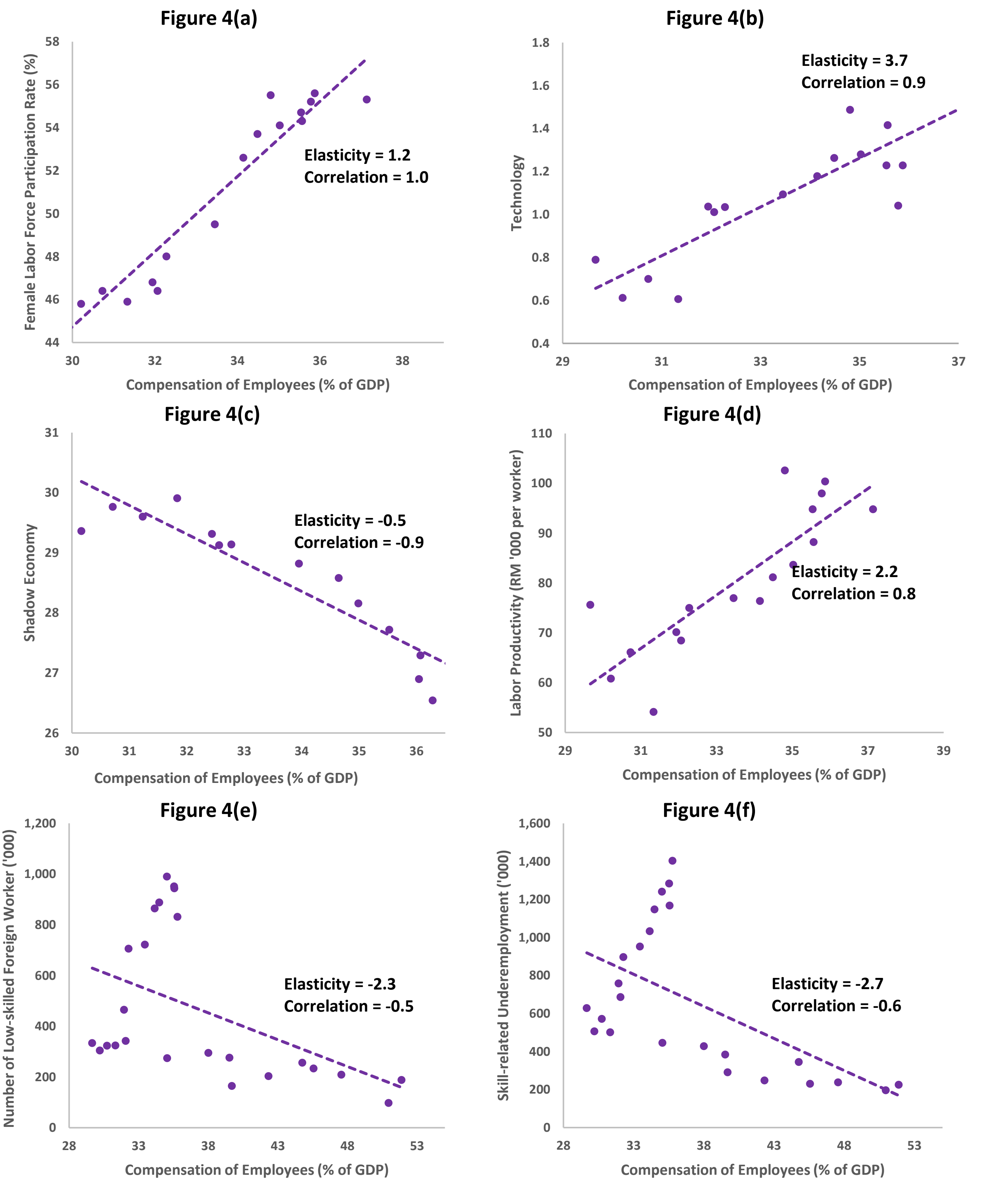
Higher wages promote labor productivity growth. Productivity growth is the primary determinant of an economy's long-term growth and higher wages. If an employer is willing to share the wealth by raising wages, employees will consistently exert extra efforts in response to higher wages, in line with the so-called "efficiency wage" theory (Riley and Bondibene, 2017). Workers, therefore, may be more motivated to work with higher pay that subsequently contribute to higher productivity. The analysis in Figure 4(d) confirms this expectation, showing that productivity tends to expand by 2.2% for every percentage increase in wage.

Higher wages reduce the dependency on low-skilled foreign labor. According to the Department of Statistic Malaysia (DOSM), low-skilled foreign workers in Malaysia in 2021 made up about 8.0% or 1.2 million persons of the total employments, of which almost 91% of them occupied the low-skilled and semi-skilled employments. The economic costs of extensively relying on low-skilled foreign workers in Malaysia are well documented in the literature, which highlighted the high reliance of low-skilled foreign workers would suppress the domestic wage growth and adversely affect productivity growth (Bank Negara Malaysia, 2018). The empirical analysis as explained in Figure 4(e) indicates that the size of low-skilled foreign workers can be reduced by 2.3% for every percentage increase in labor compensation. The results suggest that wage adjustment is the most effective market-based price mechanism to be used as a policy tool to reduce the dependency on low-skilled foreign workers.

Higher wages reduce the size of skills-related underemployment. Skills-related underemployment is a condition where workers hold skills or qualifications higher than that required to perform their jobs. Indirectly the skill-related underemployment can be portrayed as the indicator for the skill underutilization which measures those workers with tertiary education and working in the semi- and low-skilled occupations. In 2021, the skill-related underemployment increased by 6.3% to record 1.9 million workers compared to 1.8 million in 2020 (DOSM, 2022).

The incidences of skills-related underemployment are still significant in Malaysia and have been persistent, depicting a structural issue similar to unemployment (Zakariya, 2014). If underemployment continues to remain, the true potential of workers will not be maximized. Furthermore, those who have higher skills but working in lower-skilled jobs normally earn lower labor compensation or wages. Based on the empirical assessment shown in Figure 4(f), the size of skills-related underemployment can be reduced by 2.7% for every percentage increase in labor compensation. This finding suggests that policy intervention to increase wages could lead to higher adoption of automation and technological upgrading, which in turn stimulate the demand for skilled occupations. As more demand for skilled occupations is generated within the economy, it should be able to reduce the skills-related underemployment (Lee and Wie, 2015).

Figure 4
Impact of higher wages on macroeconomic indicators, Malaysia



Notes: Technology denotes research and development expenditure (% to GDP). Shadow economy measures were estimated using Computable General Equilibrium approach (Elgin et al., 2021).
Source: World Development Indicator (2022), Department of Statistics Malaysia (2022).

New Wage Model that Sustainable for Workers and Businesses

Raising wages in a low-wage economy is undeniably crucial to uplift living standards, reduce income inequality, and boost overall economic growth. However, it is essential to recognize that implementing wage increases without a carefully designed and well-balanced wage policy could lead to adverse effects. A poorly structured wage policy may potentially result in unintended consequences, such as inflationary pressures, reduced business competitiveness, and potential job losses. To achieve the desired positive outcomes, it is imperative for policymakers to adopt a comprehensive approach that considers various factors, including productivity levels, industry-specific dynamics, skills development and the capacity of businesses to absorb higher labor costs.

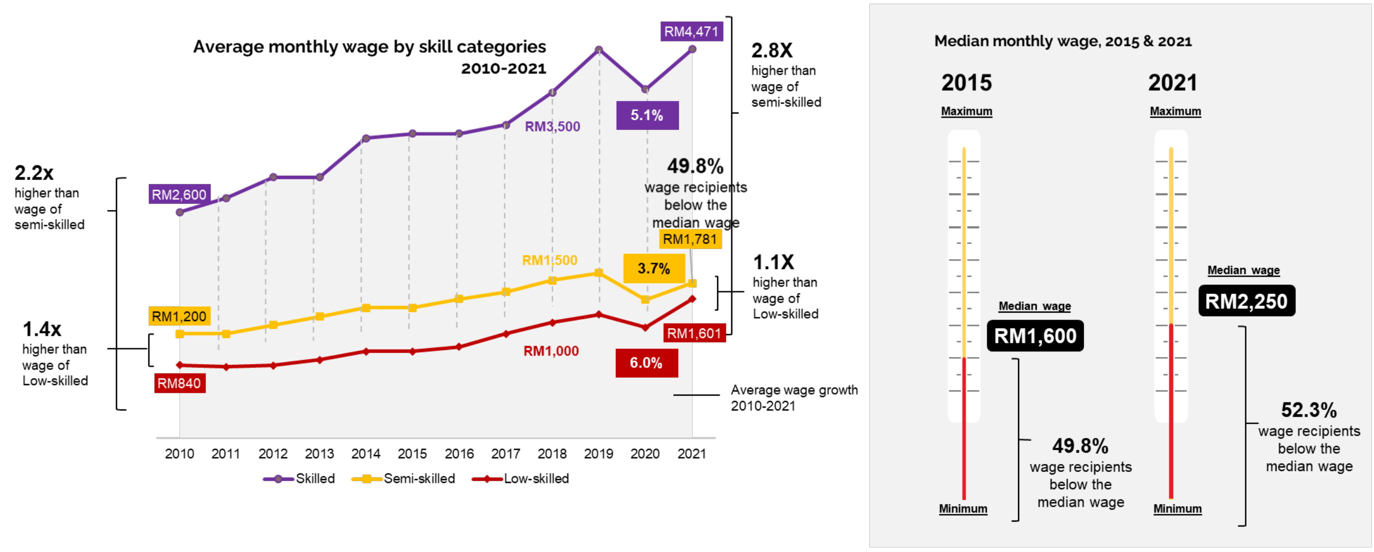
Uplifting middle-wage workers. Careful consideration must be given to wage intervention policies to avoid unintended consequences on the economy. At present, a critical priority is to bolster wages for the middle-income group, particularly semi-skilled workers, as their wage growth has been the slowest compared to high-skilled and low-skilled counterparts. Alarming data reveals a rising percentage of wage earners below the median wage from 2015 to 2021. In light of these challenges, the implementation of a progressive wage model tailored to this group emerges as a sustainable and effective solution. Such a model can foster equitable wage growth, bridge income disparities, and promote long-term economic stability, ultimately leading to a more prosperous and inclusive economy.

Figure 5

Slower wage growth among middle-income workers

The sluggish growth in the overall wages mainly attributed to the slower wages among the middle-income earners, particularly those in the semi-skilled workers

We need an appropriate intervention beyond the minimum wage @ floor wage.



Source: Computed by EU-ERA based on salaries and wages survey, Department of Statistics Malaysia.

Potential application of a progressive wage model. The term "progressive" in this context refers to the idea of moving forward or advancing. Under the progressive wage model (PWM), wages are not solely determined by the minimum wage level but also take into account factors such as skills, experience, and productivity. As workers acquire more skills, gain experience, and demonstrate improved job performance, they become eligible for higher wages, progressing along a wage scale.

PWM provides a structured framework for career advancement and income growth. By linking wage increases to skills development and productivity improvements, workers have the opportunity to enhance their skills, increase their earning potential, and enjoy improved job security. Firms benefit from a more motivated and skilled workforce. The model encourages investment in employee training and development, leading to higher productivity and efficiency. It also helps attract and retain talent, as employees are more likely to stay with companies that offer a clear path for advancement and fair compensation.

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EU-ERA Policy Brief

EU-ERA Policy Brief offers a short note with combined analysis and policy recommendations in addressing developmental issues that are directly and indirectly affect the labor market in Malaysia. This policy brief aims to generate a forward-looking and proactive discussion among policymakers, researchers and stakeholders in identifying emerging trends, challenges, and opportunities in the economy. The orientation is toward the real-world policy challenges and opportunities, with an emphasis on providing practical recommendations that can help guide decision-making.

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Centre for Future Labour Market Studies (EU-ERA) is a state-of-the-art research centre in Malaysia that focuses on the labour market research and analytics. EU-ERA operates as a nucleus hub within the Centre for Future Studies Berhad (THE FUTURE). We are dedicated to conducting cutting-edge research and analysis on the rapidly changing economic and labour market landscapes, with the goal of informing policymakers, businesses, and the public about the implications of these changes.

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