Consumer Watch Canada

June 9, 2009

CIBC

Economics

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The Widening Canada–US Income Gap

by Benjamin Tal

For every dollar increase in Americans' real per capita disposable income during the past four years, Canadians have seen their income rise by two dollars. Since 2005, per capita real disposable income in the US has risen by just over $1,300 (US). In Canada, it has risen by $2,600 (Cdn). And the good news is that the post-recession economy will see this trend continue.

Personal Income in Canada is Rising Much Faster Than in the US

Chart 1 tells the tale. After keeping pace with the US over the early part of the decade, personal income in Canada took off at more than double the speed seen south of the border. Since late 2004, per capita Canadian real personal disposable income has risen by more than 11% vs. a less than 5% increase in the US. This trend is a complete reversal of the trajectory seen in the 1990s, where Canadian income stagnated alongside surging US income. So quick was the revival of Canadian income that in a short four-year span, per capita real income in Canada was able to wipe out no less than 15 years of income underperformance vs. the US (Chart 2, left). In fact, when measured in common currency, real per capita disposable income in Canada relative to the US is now back to the early 1990s level (Chart 2, right).

The Canadian performance is even more impressive if one considers that over the past decade, US households enjoyed a significant tax cut and increase in transfer payments. In fact, per capita real transfer to governments in the US was hardly changed over the past four years, while in Canada it has risen by almost $600 (Cdn). But the reality is that the widening Canada-US personal income gap is not really a tax story. One way of showing it is to compare pre-tax (gross) income and post-tax income in both countries. Since 2005, real gross income per capita in Canada has risen by more than 11% or $3,000 (Cdn) while in the US, it has risen by less than 5% or $1,400 (US). Give or take a few decimal points, this 6-percentage-point income gap (11%-5%) is identical to the gap seen in post-tax income—suggesting that

Chart 1

Real Personal Disposable Income Per Capita

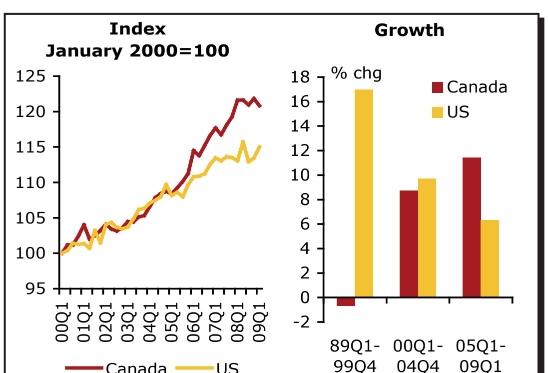
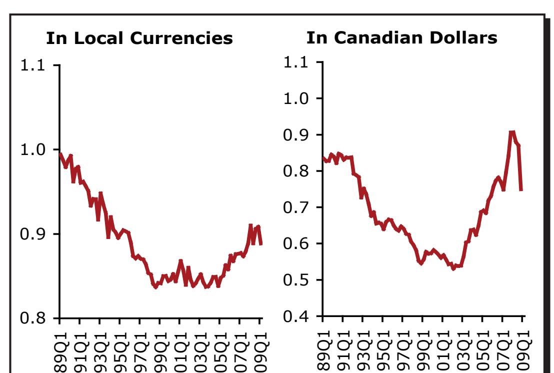


Chart 2

Personal Disposable Income Ratio—Canada vs. US

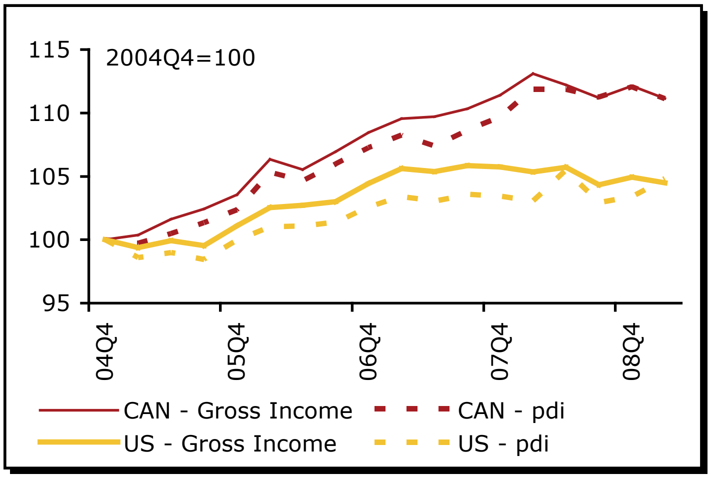


Inflation adjusted, per capita

http://research.cibcwm.com/res/Eco/EcoResearch.html the direct impact of taxes was minor at best in explaining the widening Canada-US income gap (Chart 3).

Chart 3

Taxes Played A Minor Role in the Widening Canadian-US Income Gap



Given that taxation did not play a significant role in accounting for the increase in the income gap since 2005, the focus should turn to the relative performance of gross (pre-tax) personal income.

And as illustrated in Chart 4, Canada did not outperform in all the components of personal income. For example, the performance of income from investment in both countries was roughly the same, and when it comes to transfer from governments to individuals, the US, in fact, saw a much more significant increase. Where Canada outperformed was in the "other income" category (which includes items such as self-employment income), but more importantly in the labour income category, which saw an 11% increase (inflation adjusted per capita) vs. a minimal 2% increase south of the border. In fact, the outperformance of labour income in Canada has accounted for the entire widening in the income gap between Canada and the US since 2005 (Chart 5).

Chart 4

Relative Performance of the Main Components of Personal Income

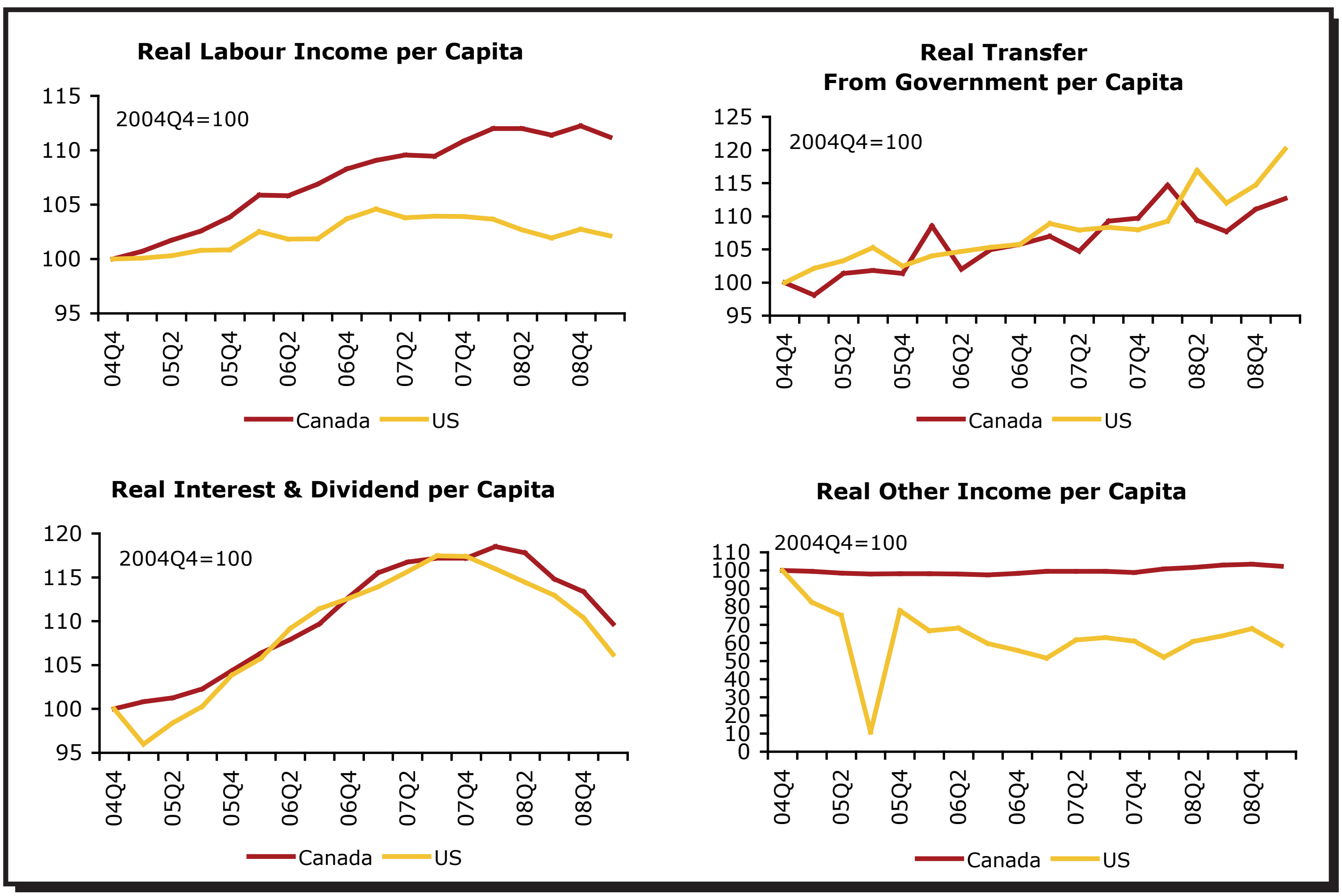
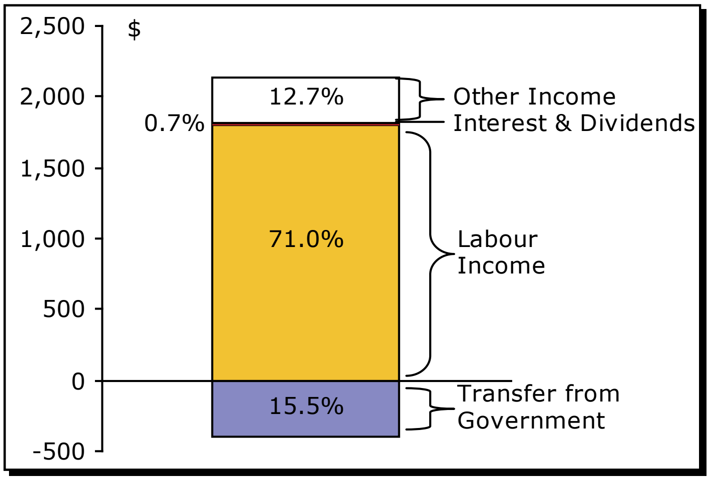


Chart 5

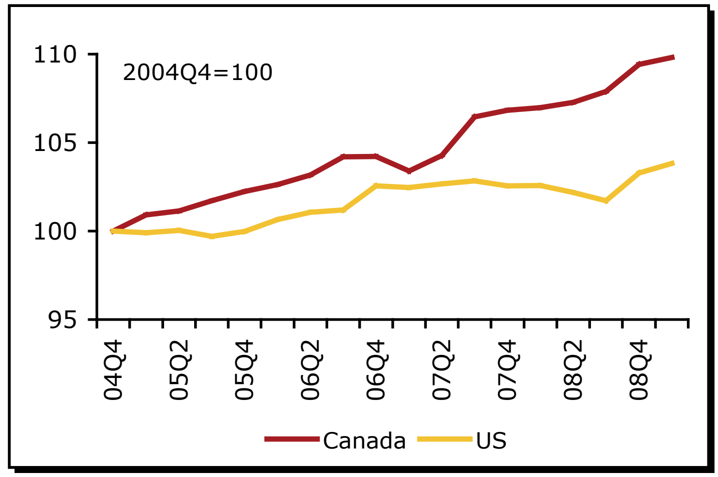
Relative Contribution to the Widening in the Canada-US Personal Income Gap (2005-2009)



Inflation adjusted, per capita

Chart 6

Real Average Wage



Digging Deeper

Given that labour income is by far the most important factor behind the widening in the Canada-US income gap, we now turn our attention to the factors that contributed to that labour income gap. In this context, the focus should be on the factors that determine labour income growth: wage increases; job creation; and the sectoral distribution of employment.

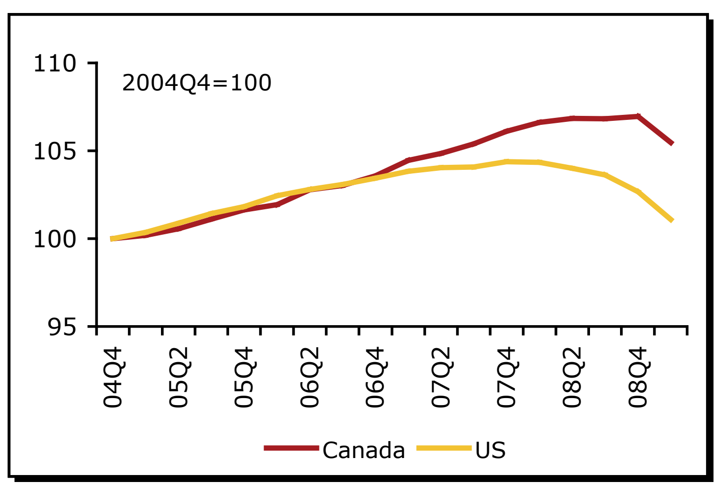
And the reality is that Canada has outperformed the US in all the above categories. Since 2005, real average wage in Canada have risen by 10%—that is more than double the pace seen in the US (Chart 6). In order to account for the relative importance of the wage component in the overall widening of the Canada-US income gap, we imposed the same wage growth observed in the US since 2005 on Canadian wages and recalculated the growth in Canada's labour income. We found that if Canadians had experienced the same wage growth as in the US, the labour income gap between the two countries would have been narrowed by roughly 25%. In other words, the wage increase factor accounted for one quarter of the increase in the labour income gap between the two countries.

Ditto for job creation. Since 2005, overall employment in Canada has risen by 5.5% while in the US it was hardly changed (Chart 7). Note that the outperformance here started in late 2006—with the gap reflecting, in part, the fact that the US labour market started to contract well ahead of the Canadian market. Again, by imposing the rate of employment growth observed in the US on Canadian employment data, we found that the stronger job creation in Canada accounted for 45% of the increase in the Canada-US labour income gap since 2005.

Beyond wage growth and job creation, labour income can be also influenced by the sectoral distribution of employment growth. Distinguishing between employment gain in high-paying industries (i.e. finance, utilities, transportation) and low-paying industries (i.e., retail trade, personal services) among paid employees in both countries reveals that since 2005, the number of jobs created in high-paying industries in the US has fallen by 4% while in Canada, this number has risen by more than 4.5%. As a result, the ratio of high-paying to low-paying jobs in the US has fallen by almost 10 percentage points

Chart 7

Employment



over the past four years, while in Canada it remained relatively stable (Chart 8). This fact is important as it adds another dimension to the increase in the Canada-US income gap. In fact, by imposing the same sectoral distribution of employment growth observed in the US on Canadian data, we found that the difference in the sectoral distribution of employment growth accounted for close to 18% of the increase in the labour income gap between the two countries since 2005.

Putting It All Together

Even putting aside the strengthening of the Canadian dollar, the Canada-US per capita disposable income gap has widened by 6 percentage points since 2005. The direct impact of taxes was marginal in explaining the increasing divergence. Rather, the chief factor here was the much stronger increases in Canadian labour income which in turn, were boosted by a cocktail of faster job creation, higher wage gains and a healthier sectoral distribution of new jobs in Canada (Chart 9).

While personal disposable income in Canada fell by more than 2% (annualized) during the first quarter of the year, the reality is that over the past four years, every Canadian saw his/her net income rising twice as fast as in the US. Not only does this outperformance suggest lower vulnerability to the current recession when compared to the situation south of the border, but this outperformance is, in fact, sustainable. There is little doubt that the reversal of fortune regarding growth in Canadian personal income vs. the US was largely linked to the recent surge in commodity prices in general, and energy prices in particular. The broadly based gains in labour income over the past four years (job creation, wage gains and favourable sectoral distribution) suggest that the economic multiplier of higher commodity prices on the labour markets, and thus personal income in Canada, is powerful. Our view that the recent retraction in commodity prices is just a correction within a context of rising commodity markets suggests that in the post-recession economy, Canadians will continue to collect more and larger pay-cheques than their neighbours to the south.

Chart 8

Ratio of High-Paying to Low-Paying Jobs

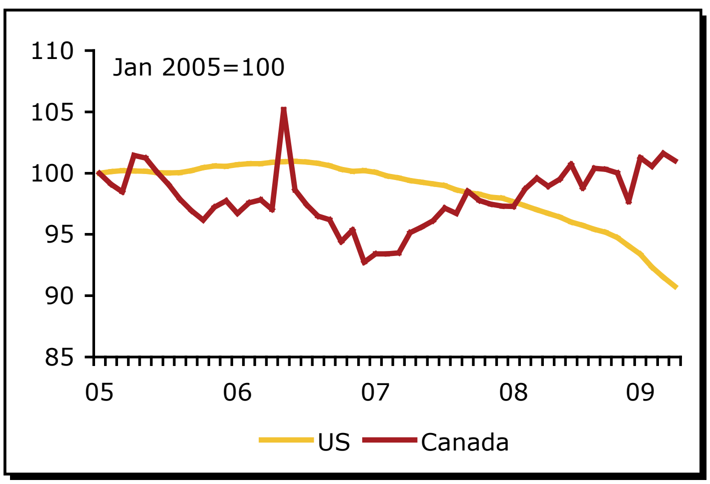
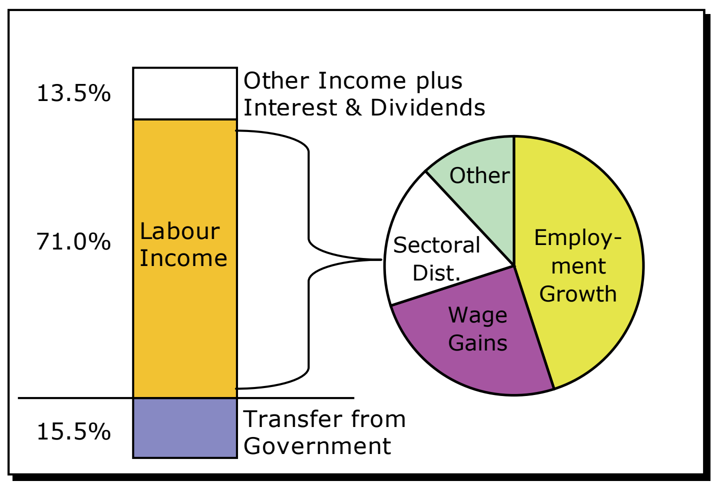


Chart 9

Accounting for the Canada-US Personal Income Gap (2005-2009)



Inflation adjusted, per capita