Labour market policy in Canada and the United States: Beyond "flexibility"

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In recent years, the paradigm of "labour market flexibility" has exerted a decisive influence on labour market policy making in developed industrial economies. This paradigm rests on the central notion that competitive labour market forces will generally attain the most efficient match between labour supply and labour demand, and hence a lower rate of long-run structural or "equilibrium" unemployment. Government interventions aimed at enforcing particular labour market outcomes, such as minimum wages, unemployment insurance programs, collective bargaining structures, and other employee protections, tended to disrupt these competitive market forces and produce a less flexible, adaptive, and efficient labour market.

THE "FLEXIBILITY LENS"

As a result of the intellectual and policy dominance of the labour market flexibility view, most recent international comparisons of labour markets have tended to be conducted through a "flexibility lens." In an international context, the typical depiction is to arrange countries on a one-dimensional scale of labour market flexibility. The United States is considered to have a highly "flexible" labour market and hence more efficient outcomes, including a lower rate of unemployment. Continental Europe is considered to have an "inflexible" labour market with, therefore, less efficient outcomes, including higher unemployment. Canada is typically placed somewhere between these two extremes—although generally in a position considered "too close" to the European end. The emergence of an unemployment gap between Canada and the United States in the last two decades is often ascribed to Canada's labour market inflexibility.

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A closer look at recent economic experience, however, suggests that in the common understanding of the word, Canada's labour market does not at all seem "inflexible." When flexibility is interpreted in the concrete, popular sense of being "able to change and to respond to change," Canada's labour market is highly flexible, by many measures, more so than that of the United States.

Empirical evidence suggests that sectoral employment patterns, measured in both relative and absolute terms, are more volatile in Canada than in the United States. This indicates that Canada's economy is, at least, as adept in moving workers from one industry into another. Employment levels also tended to be more closely and predictably tied to changes in GDP in Canada than in the United States. This implies that employers here do not face barriers to the quick hiring (and firing) of workers as demand conditions change.

Similarly, labour force participation decisions are more predictably linked to labour market conditions in Canada. Again it shows that Canadian workers more flexibly adjust their labour supply decisions in the face of macroeconomic circumstances. Rates of self-employment and part-time employment are significantly higher in Canada than south of the border, again indicating that the form of the employment relationship is also very flexible in Canada. And geographic labour mobility within Canada is also high. Contrary to the stereotype that income support programs provide a perverse incentive for unemployed workers to stay in depressed regions, the rate of out-migration from Newfoundland and other poor provinces was very high in the 1990s and higher than the out-migration from corresponding depressed states in the United States.

Canada's labour market has reflected a fast pace of change. Canadian workers have responded to the difficult circumstances they face with new forms of flexibility: working in different industries, under different forms of employment contracts, and in different parts of the country. All too often in the 1990s, Canadians have simply withdrawn from the world of work altogether. If "flexibility" is indeed interpreted as an ability to change and to adapt to change, it is hard to argue that Canada's labour market is inflexible.

Nevertheless, there is surely something to the one-dimensional labour market taxonomy described above. This taxonomy places the United States on one end, continental Europe on the other, and Canada somewhere in between. This continuum may indeed il-

lustrate some real pattern of structural variability in labour markets. It is just that this pattern has been misnamed with the deliberately inoffensive and seemingly neutral term "flexibility." What are the real differences that distinguish Canada's labour market from that of the United States, on one side, and from those of Europe on the other?

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"FEAR FACTOR"

In his famous 1997 testimony to the Senate Banking Committee, U.S. Federal Reserve Board Chairman Alan Greenspan listed what he believed to be the key structural features of the U.S. labour market that had contributed to the surprising coincidence of low unemployment with low inflation. Many of the features highlighted by Greenspan reflect precisely a *lack* of flexibility in the labour market: a lack of response of compensation to tight labour markets, a reluctance of workers to leave their jobs, and the prevalence of long-term labour contracts that lock in employment arrangements for six or more years at a time. All of this suggests that something other than flexibility is the key ingredient at work.

It seems, perhaps, that a high degree of labour market *discipline* is key to U.S. macroeconomic functioning. U.S. workers remain insecure despite a relatively low unemployment rate, and hence compensation gains—until 1998, anyway—remained muted as unemployment fell. In this environment, the monetary authority is willing to allow the unemployment rate to fall below previously acceptable levels, without fear of shrinking profit margins and accelerating inflation. Greenspan's story is more about *fear* than it is about flexibility and hence this famous quotation has come to be known as Greenspan's "fear factor" testimony, in which he concisely described the importance of labour market discipline.

In applied practice, most proposals for flexibility-enhancing policy reforms have tended to promote models of a more disciplined labour market: less social insurance and income supports, available to fewer workers, less ability for unions and wage regulations to influence incomes, and a reduced degree of upward wage pressure corresponding to any given level of unemployment. With more reliance on private market forces as the dominant determinants of employment and compensation, this is a highly *deregulated* labour market. In other words, the paradigm of labour market flexibility can in practice be considered a model of labour market deregulation.

With the focus placed more appropriately on the varying intensity of labour market regulation, rather than on the revealed degree of flexibility, a comparison of labour market structures and institutions in different OECD economies can be conducted as follows. Table 1 (on page 92) summarizes 7 dimensions of labour market regulation for a sample of 17 OECD countries, as of the mid-1990s. A numerical index of labour market regulation is then constructed from data on each of these series.* This index of regulation does indeed roughly correspond to the commonly expressed scale of "flexibility." The United States places far at one extreme of the scale, with what is by far the most deregulated (or "disciplined") labour market in the OECD. Several European countries (particularly in Scandinavia) rank at the other extreme, with tightly regulated labour markets. The continental European countries demonstrate more moderate degrees of regulation. Canada scores somewhere between the United States and Europe but by international standards, Canada's labour market is relatively *deregulated*. In other words, while Canada's labour market is more regulated than that of the United States (characterized by more generous social programs, stronger unions, and less poverty), by the standards of the industrialized world as a whole, Canada's labour market is relatively freewheeling.

LABOUR MARKET PERFORMANCE

While this taxonomy summarizes international differences in the intensity of interventionist labour market *regulations*, it does not shed much light on international differences in labour market *performance* during the 1990s. Some countries with deregulated labour markets enjoyed relatively strong employment outcomes in the 1990s, including the United States and Japan, but so did several countries with relatively regulated labour markets, including Ireland, the Netherlands, and Norway. Similarly, some countries with deregulated labour markets experienced declining employment rates in the 1990s, including Canada, Australia, and the United Kingdom, as did other countries with regulated labour markets, such as Italy and Germany. There is no significant correlation whatsoever between the intensity of labour market regulation in OECD countries, in the 1990s, and their corresponding employment performance.

The one-dimensional model of comparative labour market performance which informs the argument for deregulation needs to be supplemented, therefore, with additional information. The uniquely difficult aggregate demand circumstances that were experienced during most of the 1990s were surely important in explaining Canada's poor employment performance during that dec-

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Table 1 Indices of labour market regulation, by selected OECD countries, 1995

	UI coverage (% unemployed)	TU penetration (% employed)	Labour market programs (% GDP)	Payroll taxes (% average wages)	Dismissal protection (OECD index)[1]	Poverty (% population below minimum)	Government program spending (% GDP)	Index of labour market regulation[2]
Canada	67	37	1.9	11	0.9	11.7	40.9	–6.9
OECD[3]	89	40	2.9	23	1.9	9.3	37.5	—
U.S.	36	14	0.5	14	0.2	19.1	30.8	–16.6
Japan	39	24	0.5	14	2.7	11.8	35.0	–7.7
Germany	87	29	3.8	34	2.8	5.9	46.6	2.2
France	76	9	3.1	42	2.3	7.5	50.8	4.5
Italy	na[4]	44	2.0	39	2.8	6.5	41.8	3.7
U.K.	94	33	1.8	17	0.8	13.5	41.4	–6.2
Australia	101	35	2.1	2	1.0	12.9	33.9	–7.9
Belgium	138	52	4.2	36	1.5	5.5	45.1	6.4
Denmark	100	80	6.6	10	1.6	7.5	55.8	6.7
Finland	108	79	5.5	26	2.1	6.2	56.8	9.5
Ireland	149	49	4.3	16	1.6	11.1	33.8	0.4
Netherlands	125	26	4.8	37	3.1	6.7	46.4	7.4
N.Z.	127	24	1.9	0	1.7	9.2	37.2	–4.5
Norway	94	58	2.1	18	2.4	6.6	48.3	2.6
Spain	40	19	2.8	29	2.6	10.4	40.2	–2.9
Sweden	109	91	4.5	29	2.8	6.7	62.9	11.8

1 Index calculated for "late 1990s."
2 A positive number indicates a relatively regulated labour market, a negative number a relatively deregulated one.
3 Unweighted averages.
4 Data unavailable; regulation index calculated on basis of 5 componenets for Italy.

Source: Author's calculations from *OECD Economic Outlook*; OECD, *Tax and Benefit Position of Workers*; OECD, *Country Survey: Ireland*; United Nations Development Program, *Human Development Report*.

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ing in Canada due to government cutbacks. Employment growth in the manufacturing sector was very similar in both countries, as was the trend in business services.

Distinguishing between employment gains in high-paying industries (that is, finance, transportation) and low-paying industries (that is, retail trade, personal services) among paid employees in both countries reveals that, since 1989, the share of jobs created in low-paying industries in Canada was about 65 percent of all new jobs created. This is higher than the 55 percent observed in the United States. This fact is important because it adds another dimension to the increase in the U.S.–Canada income gap. In fact, by imposing the same sectoral distribution of employment growth observed in the United States on Canadian data, we find that differences in the sectoral distribution of employment growth accounted for 13 percent of the increase in the labour income gap between the two countries since 1989.

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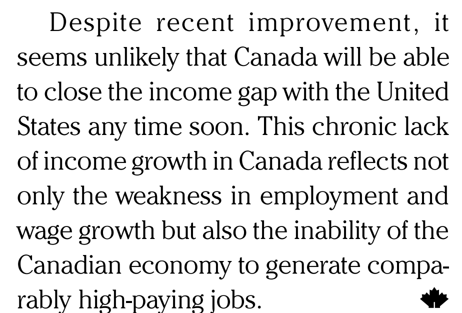
PUTTING IT ALL TOGETHER

Even putting aside the weakening of the Canadian dollar, the U.S.–Canada income gap widened by 18.5 percent since 1989. One-quarter of this gap was due to lower interest and dividend income and transfers from governments in Canada. The rest was due to lower growth in labour income in Canada—of which two-thirds is attributed to the combination of slower wage growth and weaker job creation in Canada and one-third to the different nature of jobs created in both countries since 1989.



Despite recent improvement, it seems unlikely that Canada will be able to close the income gap with the United States any time soon. This chronic lack of income growth in Canada reflects not only the weakness in employment and wage growth but also the inability of the Canadian economy to generate comparably high-paying jobs.

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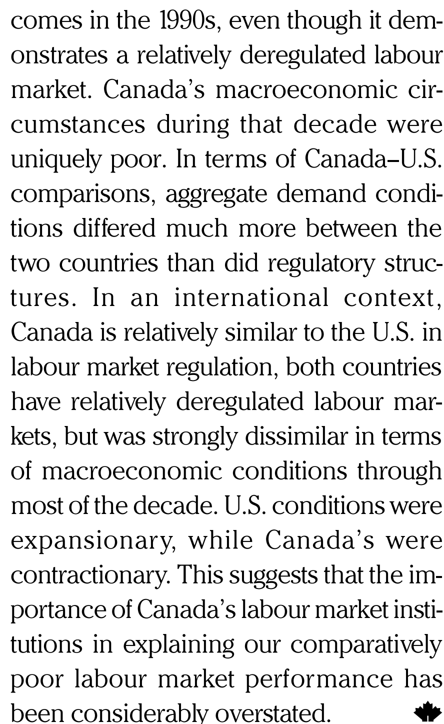
ade. On two key performance indicators, Canada ranks second worst among the OECD countries: Canada's average output gap (the difference between actual output and potential output) during the decade was exceeded only by Finland's, and Canada's rate of real per capita GDP growth was faster only than Switzerland's. According to numerous macroeconomic policy indicators, Canada's macroeconomic policy stance was significantly more contractionary than that experienced in the OECD as a whole. In particular, the decline in government program spending was the fourth largest in the OECD, and Canadian short-run real interest rates averaged more than twice as high as those in the United States.

In summary, Canada experienced relatively negative labour market outcomes in the 1990s, even though it demonstrates a relatively deregulated labour market. Canada's macroeconomic circumstances during that decade were uniquely poor. In terms of Canada–U.S. comparisons, aggregate demand conditions differed much more between the two countries than did regulatory structures. In an international context, Canada is relatively similar to the U.S. in labour market regulation, both countries have relatively deregulated labour markets, but was strongly dissimilar in terms of macroeconomic conditions through most of the decade. U.S. conditions were expansionary, while Canada's were contractionary. This suggests that the importance of Canada's labour market institutions in explaining our comparatively poor labour market performance has been considerably overstated.



* Consistent data on each of these 7 dimensions of the degree of labour market regulation are gathered for each of the 17 OECD countries. Each data series is oriented so that a higher score reflects a higher degree of regulation. Each variable is normalized such that the unweighted mean score for the sample equals zero (and hence a positive score implies a relatively intense form of regulation, and a negative score a relatively passive one). Each variable is further normalized such that the standard deviation of each series is a constant. Finally, an index of labour market regulation is calculated by averaging each country's scores over the seven indices considered.