

Accounting for a widening U.S.–Canada income gap

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As of 1999, close to 25 cents of each dollar earned in Canada went to the various governments. This compares with only 19 cents in the United States.

Despite recent improvements, real disposable income per capita in Canada is still Can.\$400 lower than its level in 1989. This is significantly different from the trend observed in the United States, where real per capita disposable income has risen by about U.S.\$2,400. This weak income performance in Canada requires a closer examination.

THE DIRECT IMPACT OF TAXATION

The high personal income tax rates in Canada, relative to the United States, are clearly an important factor to consider when analyzing the income gap between the two countries. Indeed, Canadians pay a larger percentage of their income in taxes and other transfers to governments. As of 1999, close to 25 cents of each dollar earned in Canada went to the various governments. This compares with only 19 cents in the United States. Over the decade, Canadians also saw the rate at which they transferred their income to governments rise faster than in the United States. Since 1989, transfers to governments, as a share of personal income, rose by close to 16 percent in Canada and by 13 percent in the United States.

However, the direct impact of taxes did not explain all, or even most, of the increase in the income gap between the United States and Canada over the decade. One way of showing this is to compare pre-tax (gross) income and post-tax (disposable) income in both countries. Since 1989, real gross income per capita in Canada rose by only 2.1 percent or Can.\$500, while in the United States it rose by 20.6 percent or U.S.\$2,850. This 18.5 percent performance gap is relatively close to the 20.0 percent performance gap observed for disposable (after-tax) income. Thus,

the direct impact of taxation in accounting for the increase in the income gap was comparatively minor.

THE ROLE OF LABOUR INCOME

Since the impact of taxation did not play a significant direct role in accounting for the increase in the income gap since 1989, the focus should turn to the relative performance of gross (pre-tax) personal income. As illustrated, since 1989, income growth in the United States has outperformed income growth in Canada in each and every category of income. The most important factor here is the significant gap in the performance of labour income, which in both countries accounts for about 60 percent of total personal income. On a per capita basis, and adjusted for inflation, this component of income rose in the United States by U.S.\$3,000 since 1989, accounting for over 60 percent of the total increase in

personal income. At the same time, in Canada, labour income per capita rose only \$350 since 1989.

In fact, the smaller increase in labour income in Canada accounts for close to three-quarters of the entire increase in the U.S.–Canada income gap since 1989. Lower growth in interest and dividend income in Canada along with slower growth in transfers from governments accounted for most of the rest.

Given that labour income is, by far, the most important factor that contributed to the widening in the U.S.–Canada personal income gap, it is important to determine what prevented labour income in Canada from growing as rapidly as it did in the United States. In this context the focus should be on the factors that determine labour income growth—wage increases and job creation.

THE ROLE OF WAGE INCREASES

Between 1989 and 1996, wages in Canada rose at a rate higher than or equal to that of the United States. However, over the past three years, reflecting the different realities in their respective labour markets, wage increases in the United States have risen much faster than in Canada. Annual wage increases in the United States averaged 2.1 percent (after inflation), between 1996 and 1999, compared with just 0.2 percent in Canada. In order to account for this factor, we imposed the same wage growth observed in the United States since 1989 on Canadian wages and found that if Canadians had experienced the same wage growth as in the United States, the labour income gap between the two countries would have been narrowed by 25 percent. In other words, the wage increase factor contributed about 25 percent to the in-

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crease in the labour income gap between the two countries.

THE ROLE OF JOB CREATION

Between 1989 and 1996, U.S. employment rose by an average of 1.6 percent per year, significantly stronger than the 0.6 percent in Canada. Since then, the pace of job creation accelerated in both countries, with annual employment growth averaging close to 2.5 percent in both countries. How much did this fac-

tor contribute to the increase in the labour income gap between the two countries? By imposing the rate of employment growth observed in the United States on Canadian employment data, we find that weaker job creation in Canada accounted for 41 percent of the increase in the U.S.–Canada labour income gap since 1989.

Accordingly, the combined role of wage increases and job creation accounted for about two-thirds of the in-

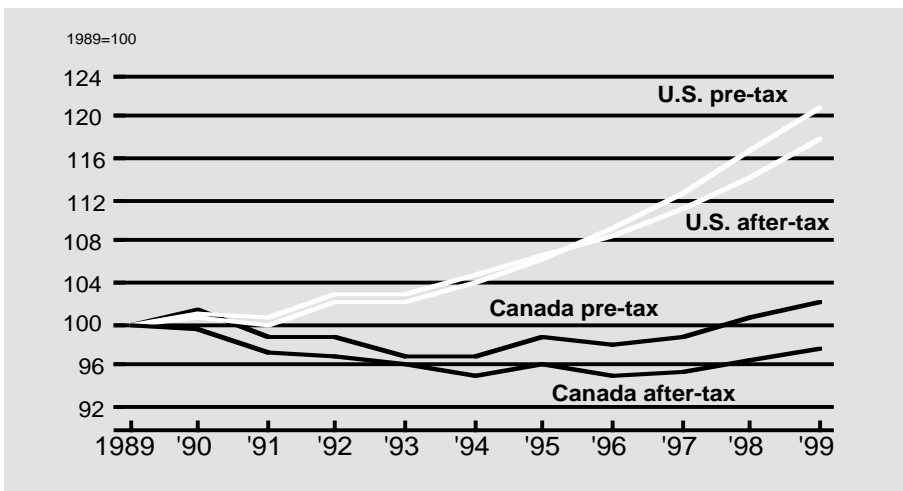
crease in the U.S.–Canada labour income gap since 1989 and, thus, for close to 50 percent of the entire increase in the personal income gap.

What accounts for the rest? An additional factor to be considered is the differences in the nature of the jobs created in both economies. In this context, of particular importance are the role that self-employment has played in overall job creation in Canada since 1989 and the different sectoral distribution of employment growth in the two countries.

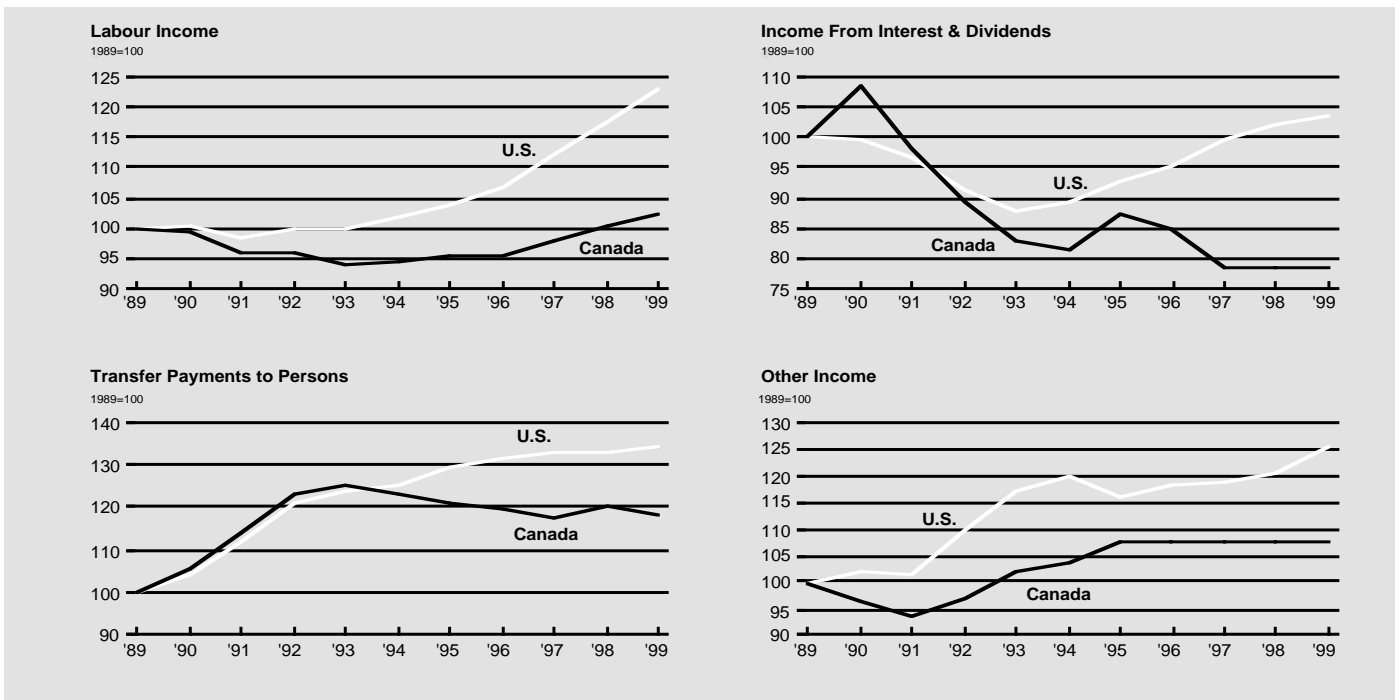
THE ROLE OF SELF-EMPLOYMENT

One of the most striking differences in labour market activity between the United States and Canada during the 1990s was the role played by self-employment. Since 1989, the number of self-employed in Canada rose by about 36 percent, while in the United States it rose by 10 percent. In fact, close to 45 percent of all jobs created in Canada over the past decade were in the form of self-employment. The self-employed in Canada now account for close to 17 percent of all workers—a significant increase from the 14 percent observed in

Income growth



Growth in real gross per capita personal income by source



1989. In the United States, the current share of self-employed is about 10 percent, unchanged from 1989.

Furthermore, almost of all the increase in self-employment in the United States was in the form of incorporated businesses, while the vast majority of the increase in Canada was in unincorporated entities. In fact, out of the 660,000 self-employment jobs created in Canada since 1989, 645,000 were in the form of one-person operations (self-employed with no paid help). This is significantly different from the trend observed in the 1980s, when one-person operations accounted for only one-third of the overall growth in self-employment in Canada.

This trend is significant. The fact that almost all of the increase in self-employment in the 1990s was in the form of one-person operations helps to explain the weak employment growth in Canada in the 1990s versus the 1980s (one-person operations do not hire paid help). This trend also helps to account for some of the weakness in the overall personal income growth in Canada during the 1990s as, on average, the reported income of a self-employed who runs his or her one-person operation is about 75 percent of the income earned by a paid employee.

In fact, controlling for this factor by imposing on Canada the same growth rate for self-employment and paid employment observed in the United States shows that the self-employment factor accounted for an additional 15 percent of the increase in the labour income gap between the two countries since 1989. In other words, the fact that most of the jobs created in Canada in the 1990s were in the form of self-employment and not paid employment, as was the case in the United States, added to the overall increase in the income gap between the two countries.

THE ROLE OF SECTORAL DISTRIBUTION

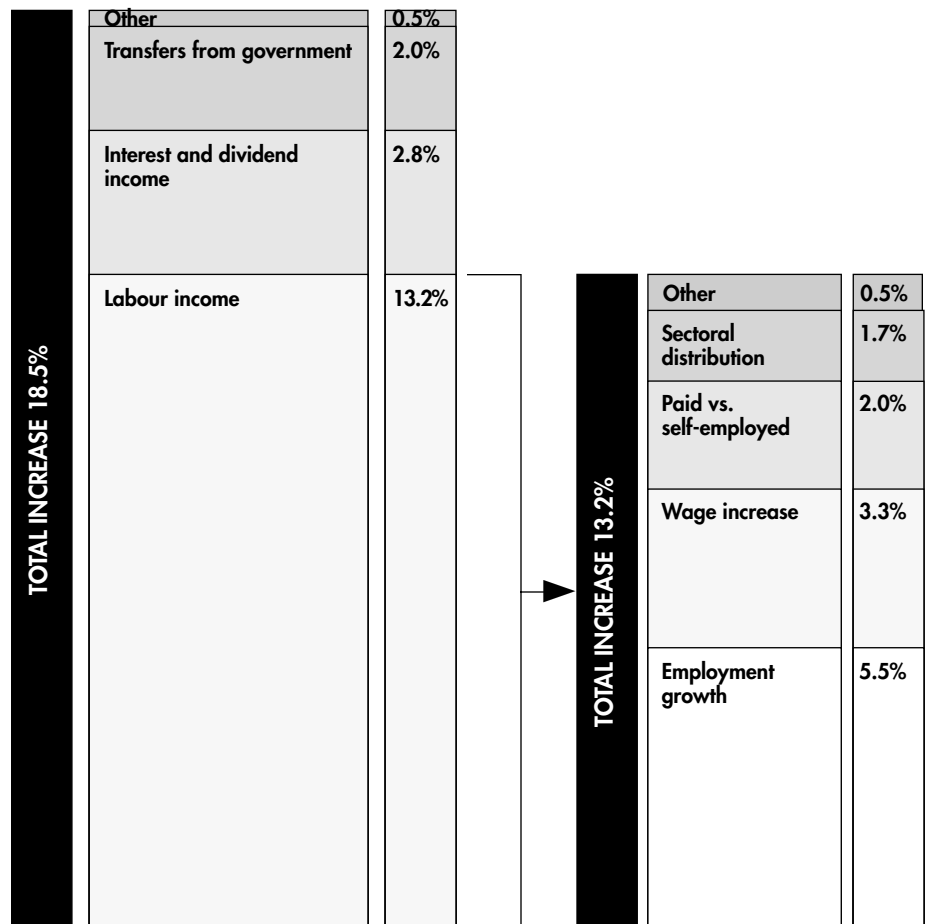
It is well known that in both the United States and Canada growth in service-oriented jobs during the 1990s was

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much stronger than in the goods-producing sectors. However, a closer look at the sectoral distribution of employment growth in both countries reveals some important differences. Reflecting stronger retail and wholesale activity in the United States, since the 1991 recession, employment growth in these sectors was stronger in the United States

than in Canada over the decade. As well, employment growth in the construction, transportation, and financial industries was much stronger in the United States. Another important difference was in the public sector, where employment has risen modestly in the United States since 1989, while declining in Canada. **Accounting for a widening gap, page 96**

Accounting for the increase in the U.S.–Canada personal income gap (1989-99)



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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.

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.

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 out-

comes 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.