

## **Why Is Canada's Unemployment Rate Persistently Higher than that in the US?**

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Canada's unemployment rate has been higher than its US counterpart since the early 1980s. What is the cause of the persistent differential in this key labour market indicator? This paper reviews what we know about this question. Part of the gap is due to differences in measurement concepts in the two countries. We now know much more about the sources of these measurement differences than we did when the gap emerged. However, even after adjusting for these factors the Canadian unemployment rate exceeds that of the US at all stages of the business cycle. Some progress has been made on understanding the sources of this "structural" differential, but a complete explanation has so far eluded researchers.

### **Historical perspective**

As documented in Card and Riddell (1993), the Canadian and US unemployment rates tracked each other very closely during the 1950s and 1960s. Some divergence occurred in the 1970s, with unemployment increasing more in the US than in Canada during the 1974-75 recession and declining more in the US during the latter part of that decade. These differences are generally attributed to the greater severity of the 1974-75 downturn in the US (due to that country's greater dependence on imported oil) and to the Canadian government's use of moderately restrictive monetary and fiscal policies during the 1975-78 Anti-Inflation Program. Nonetheless, despite these differences, as both countries struggled to restrain inflation at the beginning of the 1980s the unemployment rates in the two countries were identical -- at 7.6%.

The upper line in Figure 1 shows the Canada - US unemployment differential over the 1976-2002 period. The gap emerged during the recession of 1981-82. Initially many observers argued that the larger increase in Canadian unemployment reflected the greater severity of the economic downturn in Canada.<sup>1</sup> However, this "cyclical" explanation became more difficult to sustain as the gap persisted throughout the subsequent recovery and boom. Indeed, during the latter half of the 1980s Canada's

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<sup>1</sup> Relative to previous trends, real output fell 5.3% between 1981 and 1983 in the US, and 7.7% in Canada (Card and Riddell, 1993).

output and employment growth exceeded that of the US -- sufficiently so that by the peak of the cyclical expansion in 1989 Canada had approximately "caught up" in terms of cumulative output and employment growth over the 1980s. Yet at the cyclical peak an unemployment rate differential in excess of 2 percentage points remained. The persistence of the unemployment rate gap over a complete business cycle suggested a structural change in the nature of unemployment and labour supply in the two countries.

The experience of the 1990s in the two countries was in several respects a repeat of that of the 1980s, except amplified in magnitude. At the beginning of the decade Canada experienced a much deeper and lengthier recession than did the US -- aptly termed the "great Canadian slump" by Fortin (1996). The unemployment rate gap widened to over 4 percentage points during this period. However, during the latter half of the decade -- especially during 1997-2000 -- Canadian employment growth substantially exceeded that of the US. By the peak of the 1990s business cycle in 2000 the unemployment gap had again narrowed, although it remained above the level seen at the previous cyclical peak in 1989 (see Figure 1).

The story since 2000 is largely a cyclical one, with the pattern of the 1980s and 1990s reversed. The US experienced a mild recession whereas Canada's economy continued to expand, albeit at a slower rate. With weaker economic conditions in the US than in Canada, by 2002 the unemployment gap had fallen to about 2 percentage points -- its lowest level since the early 1980s.

### **Measurement issues**

Both Canada and the US measure employment, unemployment and labour force participation using concepts and surveys (the monthly Labour Force Survey (LFS) and Current Population Survey (CPS) respectively) that are very similar. Indeed, for many years analysts and statistical agencies in both countries treated any differences in recorded unemployment as reflecting behavioural differences rather than differences in the definitions of labour force status.<sup>2</sup> However, detailed comparisons of the LFS and CPS questionnaires and associated definitions revealed a number of differences in the way similar concepts are implemented in the two countries (Zagorsky, 1996; Statistics

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<sup>2</sup> For example, the US Bureau of Labor Statistics reports international measures of labour force activity "adjusted to US concepts". Traditionally the official Canadian data were reported without any adjustment.

Canada, 1998). Perhaps surprisingly, these apparently small differences are quantitatively important. As a consequence, Statistics Canada now reports on a regular basis the Canadian unemployment rate measured using US concepts.

The bottom line in Figure 1 shows the contribution of measurement differences to the unemployment rate gap over the 1976 - 2002 period. This "differences in concepts" component shows the effect of adjusting Canada's official unemployment rate so that it is measured in a comparable manner to the official US rate. The importance of this adjustment has evidently grown over time. In the late 1970s, the use of US concepts lowered Canada's unemployment rate by approximately 0.2 percentage points. In contrast, this adjustment lowered the Canadian rate by 0.4 to 0.5 points in the 1980s and 0.6 to 0.8 percentage points during the 1990s. At present one needs to reduce the official Canadian rate by 0.7 to 0.9 percentage points to make it comparable to the US measure.

Geoff Bowlby's article summarizes the adjustments made by Statistics Canada to obtain measures of employment and unemployment based on US concepts. The most important adjustment arises from the fact that Canada treats as unemployed those who engaged in any job search during the previous month, whereas the US requires "active" search -- defined as an activity that could result in a job offer. Thus those who use only "passive" search methods are treated as unemployed in Canada but out-of-the-labour force in the US. The main "passive" search method is "Looked at job ads". Removing those who used only this search method reduces the unemployment rate by about 0.7 percentage points.<sup>3</sup> The importance of this factor has increased over time -- removing those who only "Looked at ads" resulted in a reduction in Canada's unemployment rate of 0.2 percentage points in the 1970s, 0.4 in the 1980s and 0.7 in the 1990s and early 2000s. Another difference is that since 1997 those not looking for work because they have a job to start within the next month -- a group referred to as "short term future starts" -- are no longer treated as unemployed in the US, whereas they continue to be classified as unemployed in Canada. Removing this group reduces the Canadian unemployment rate by about 0.2 percentage points. Offsetting this adjustment is the fact that full-time students looking for full-time employment are regarded as unemployed in the US but not

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<sup>3</sup> Most job seekers use multiple methods. The adjustment removes those who use no active methods.

in Canada. Adding this group to the unemployed raises Canada's rate by approximately 0.3 percentage points. Overall, the adjustments made by Statistics Canada reduce measured unemployment by 0.7 to 0.8 percentage points in recent years -- a significant portion of the Canada - US gap.

The top line in Figure 2 shows the Canada - US unemployment gap when Canadian unemployment is adjusted to US concepts using the adjustments made by Statistics Canada. The bottom line shows the magnitude of the adjustment. The upward trend in the size of the adjustment is mainly due to the rise in the relative importance of passive job search in Canada. The US decision to exclude "short term future starts" from the unemployed since 1997 also contributes to the upward trend.

As discussed in Riddell (1999), additional adjustments could be made to increase the comparability of unemployment measures in the two countries. Unlike the CPS, the LFS does not survey those living on Indian reserves. Because those living on reserves generally experience more unemployment, adjusting for this difference in coverage would raise Canada's unemployment rate by close to 0.1 percentage points. The second factor operates in the opposite direction. Both countries' surveys do not cover the institutionalized population. In the US a much larger fraction of the population is incarcerated. Since many inmates are young black males -- who typically have low attachment to jobs when not in prison -- the exclusion of this group artificially reduces measured US unemployment. Under reasonable assumptions about the labour force activities of inmates when not in prison, adjusting for the higher US incarceration rate narrows the gap by 0.15 to 0.2 percentage points.

If we sum these various measurement-related factors we obtain an adjustment of 0.8 to 0.9 percentage points in recent years. At a time when the official unemployment rate is 8.0%, the rate measured on a comparable basis with the US is approximately 7.2%.

### **Employment behaviour**

A striking feature of the 1980s was that while an unemployment gap opened up between the two countries, an employment differential did not. Figure 3 shows the differential in employment rates -- the fraction of the labour force employed -- over the 1976-2002 period. To make this graph comparable to that for unemployment, Canada's

employment rate is measured using US concepts.<sup>4</sup> Employment rates in the two countries were very similar in the 1970s and 1980s. Prior to the onset of the 1981-82 recession Canada's employment rate had climbed somewhat above that of the US. Because of the greater severity of the downturn here, employment declined more in Canada than in the US during 1982-83. By 1984 an employment rate differential of about 1% had opened up, but this gap gradually closed during the recovery and boom years 1984-89. By the peak of the business cycle the employment rate differential was negligible.

The emergence of a gap in unemployment without a corresponding differential in employment is unexpected. The significance of this development is discussed below.

The behaviour of employment in the two countries was very different during the 1990s. A large employment rate differential opened up during "the great Canadian slump" of 1990-92 and this gap widened during the "jobless recovery" that followed. The gap peaked at over 4 percentage points in 1997. However, since then it has narrowed substantially. At the peak of the US business cycle in 2000 the employment rate gap had declined to 2%, and by 2002 it was essentially zero -- back to its level in the late 1980s.

### **Accounting for cyclical conditions**

Adjusting the official statistics for differences in labour force concepts is important if comparisons are to be meaningful. If one is interested in structural differences between the two countries it is also important to control for cyclical conditions. One way to do so is to make comparisons when the countries are at similar stages of the cycle -- such as the cyclical peak years 1981, 1989 and 2000.<sup>5</sup> This relatively crude method of accounting for the business cycle is informative and often provides a good approximation to more elaborate methods.

The importance of accounting for cyclical conditions deserves emphasis. It is misleading to compare the countries during a period such as the mid-1990s -- when Canada was still recovering from the prolonged slump of 1990-92, whereas the US economy was operating at relatively normal levels of output and employment. Much of

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<sup>4</sup> The adjustment involves excluding 15 year olds, who are treated as being in the adult population in Canada but not in the US.

<sup>5</sup> Each of these years was preceded by a period of rapid expansion and falling unemployment and was followed by rising unemployment. It could be argued that 2000 was not a cyclical peak in Canada because Canada did not fall into recession in 2001 or 2002. Nonetheless the Canadian economy did slow down after 2000 and unemployment has subsequently increased by a significant amount.

the criticism of Canadian economic and social policy that was made during that period -- criticism that often pointed to the large unemployment rate gap as evidence of the failure of Canada's policies -- was misplaced. Similarly misplaced is the "back-patting" now going on because the employment rate gap has disappeared and the unemployment rate differential is the lowest in over two decades. Canada looks good at present because of temporarily depressed conditions in the US.

When we compare the countries at similar stages of the cycle, three conclusions emerge. First, a persistent or "structural" gap has been present since the early 1980s. After controlling for measurement differences, the unemployment rate differential was essentially zero in 1981 and almost 2 percentage points in 1989. At the next cyclical peak in 2000 the gap had widened slightly -- to just over 2 percent. Second, most of "the action" took place in the 1980s. This is the period when a persistent unemployment gap emerged. Despite much concern expressed in Canada throughout the 1990s, there appears to have been little change in the structural gap during that decade.<sup>6</sup> Virtually all of the widening of the gap that occurred in the 1990s was cyclical in nature. Third, the current unemployment rate differential understates the gap in unemployment that exists in the two countries when they are at similar stages of the business cycle.

### **Sources of the structural gap**

Following Card and Riddell (1993), we can decompose the unemployment rate into three components: (i) the non-employment rate (this is simply 1 - the employment rate); (ii) the labour force participation rate; and (iii) the fraction of the non-employed that is classified as unemployed. This last component is the least familiar. Because it represents the probability that a non-employed individual is searching for work, I call it the "labour force attachment of the non-employed".

Using this decomposition, Table 1 shows the amount of the rise in unemployment in Canada relative to the US that is associated with each of these factors. To make the decomposition meaningful the countries are compared at the cyclical peak years 1981, 1989 and 2000 -- points in time when cyclical conditions were most similar.

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<sup>6</sup> One possible explanation is that the significant revisions made to Canada's unemployment insurance program during the 1990s reduced Canadian unemployment and offset any tendency for the gap to widen.

Several points are evident from this decomposition. First, most of the rise in unemployment in Canada relative to the US took place during the 1981-89 period. Only a small further increase occurred between 1989 and 2000. Second, changes in employment and labour force participation account for very little of the unemployment rate gap that emerged during the 1981-89 period. Over 80% of the gap is associated with the rise in the "attachment of the non-employed" in Canada relative to the US. Third, the key factor contributing to the (much smaller) increase in the unemployment gap during the 1989-2000 period was the weaker growth in employment in Canada compared to the US.

Over the entire 1981-2000 period, the increase in the labour force attachment of non-employed Canadians contributed about two-thirds of the growth in the unemployment differential. Most of the remainder is associated with Canada's somewhat slower employment growth.

### **Remaining puzzles**

The decomposition tells us that the unemployment gap arose not because of an inter-country change on the margin between employment and non-employment, but because of a change on the margin between participation and non-participation among the non-employed. Relative to Americans, non-employed Canadians became more likely (or Americans less likely) to search for work -- and thus to be classified as unemployed. What caused this change in labour force attachment? A definitive answer to this question is not yet available. Two explanations have been proposed.<sup>7</sup>

Perhaps the leading explanation relates to differences between the two countries unemployment (employment) insurance programs. Although there are some differences between Canada and the US in both the coverage and "generosity" of the respective EI/UI programs, the most striking difference is in the likelihood that an unemployed worker receives EI/UI benefits. During the 1980s this inter-country difference widened substantially. Because EI/UI programs encourage beneficiaries to search for work, this increase in the "inclusiveness" of Canada's EI/UI program relative to the US may have resulted in a greater propensity of non-employed Canadians to search for work than comparable Americans.

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<sup>7</sup> See Riddell (1999) for further detail.

Another explanation points to the rapid growth of temporary help agency employment in the US. Such intermediaries may reduce the need for costly job search activities, allowing employees of such agencies to move directly from employment to out-of-the-labour force without an intervening period of unemployment. The sketchy available evidence suggests that the temporary help services industry grew more rapidly during the 1980s and 1990s in the US than in Canada.

Although both hypotheses may have some validity, we do not yet have a definitive explanation for the change in the labour force attachment of non-employed Canadians relative to Americans. As a consequence we cannot confidently assess the significance of the structural unemployment gap. One view is that Canada's higher unemployment reflects greater unutilized labour supply, and a serious waste of human potential. At the other extreme, an alternative view is that the division between unemployment and non-participation is murky, and America's lower measured unemployment may largely reflect different "labeling" of otherwise similar behaviour. Either position can be defended. Nonetheless, we can probably all agree that a rise in unemployment that is not associated with a decline in employment is preferable to one that is so associated.



## References

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**Table 1: Decomposition of the relative change in unemployment using US concepts for employment and unemployment**

Time period	Relative change in unemployment	Amount contributed by the relative change of:		
		Non-employment rate	Attachment of non-employed	Participation rate
1981-1989	33.3	5.3	26.9	1.2
	100%	16%	81%	4%
1989-2000	13.0	5.5	3.5	3.0
	100%	43%	27%	23%
1981-2000	46.2	10.8	30.4	4.2
	100%	23%	66%	9%



