Revisiting the "Flexibility Hypothesis"

by Jim Stanford

A Premature Consensus

A significant unemployment rate differential first emerged between Canada and the U.S. following the recession of the early 1980s. For the rest of that decade, Canadian unemployment averaged about 2 percentage points higher than south of the border, despite the economic recovery in both countries. The gap widened further following the recession of the early 1990s, to more than 4 percentage points. This latter experience was especially painful in Canada, because it mostly reflected a sharp decline in employment rates among working-age Canadians. Employment rates in Canada and the U.S. had stayed closely similar during the 1980s (implying that the emergence of higher unemployment in Canada during that decade was driven mostly by higher labour force participation, and in particular by differences between the two countries in the labour force attachment of the non-employed). In the 1990s, however, the employment rate plummeted in Canada, falling more than 4 percentage points below U.S. levels by 1994. This deteriorating employment performance resulted in increased social hardship and a marked deterioration in Canadian living standards relative to U.S. levels – neither of which had been the case during the previous decade.

This relatively poorer labour market performance, especially the "second time around" (in the 1990s), sparked an important policy debate in Canada regarding the causes of persistent or "structural" unemployment, and potential policy cures. At the academic level, that discussion was rich and nuanced. Careful research (such as the work reported in Riddell and Sharpe, 1998a) identified a complex set of factors, including supply-side, demand-side, and statistical and definitional factors, which explained the higher unemployment rate reported in Canada. Consequently, no single overarching policy direction was indicated by this work.

At the level of policy and politics, however, the discourse demonstrated much less subtlety. A dominant consensus seemed to emerge that Canada's relatively poorer labour market performance was the result of a set of more interventionist labour market policies and structures. To solve this problem, policy should work to minimize the disruption of labour regulations and social policies with competitive market mechanisms, reduce the "disincentive" effect of income security measures, and take other measures to enhance the competitiveness and "flexibility"[1] of labour markets. For example, in an influential policy statement which set the tone for federal economic policy in the mid-1990s, the Department of Finance identified income security programs, labour market regulation, and payroll taxes as key causes of the increase in Canada's "core" unemployment rate, which they estimated as being at least 8 percent (Department of Finance Canada, 1994: 22-22). Policy conclusions stemming from this analysis included the "redesign of income support programs so as to reduce disincentives for individuals to seek work," a "reversal of the steady rise of payroll taxes," and reforms to "ensure that employers are not implicitly encouraged to maintain unstable employment patterns" (Department of Finance Canada, 1994: 26). The editors of the *Globe and Mail* put it more bluntly than this, arguing that the focus of labour market policy should be to "undo the rigidities that prevent labour markets from doing their job, which is to see that all available labour is employed in its best use" (*Globe and Mail*, 1994).

This broad approach, which we term here the "flexibility hypothesis," clearly emphasized the long-run impact of structural and institutional factors on unemployment, rather than shorter-run aggregate demand factors. It paralleled a similar policy consensus at the international level; in particular, the *OECD Jobs Study* (OECD, 1994) was important both in enunciating an agenda of flexibility-enhancing labour market reforms, and in promulgating that uniform agenda across the developed economies.[2] The analysis seemed to be supported by core principles of economic analysis. In a competitive market, supply and demand should autonomously adjust to reach a market-clearing equilibrium; there is no particular reason why this should not occur in the labour market, so long as well-meaning but counterproductive interventions (aimed at meeting social goals, but at the expense of the efficiency of the market itself) are minimized.

Canadian policy-makers, like those in several other countries, heeded the flexibility call. The conclusion that social programs and labour market regulations were causing more harm than good, contributing to unnecessary and harmful long-run unemployment, was used to justify a historic and far-reaching retrenchment in interventionist labour market policy. Canada's Employment Insurance (EI) system, in particular, was dramatically scaled back. Severe restrictions on eligibility for benefits, and more modest reductions in benefit levels, resulted in a roughly 40 percent reduction in the average generosity of the system. Figure 1 plots what is termed the average EI "replacement rate," equal to total regular EI benefits paid per unemployed person (including those unemployed who receive no EI benefits), as a share of average weekly earnings in the labour market. Successive rounds of EI "reform" in the early 1990s reduced this average replacement rate from about 40 percent of average employed earnings to 25 percent by 1997 – mostly by disqualifying an increasing share of unemployed persons from EI benefits.[3] Figure 1 indicates that the Canadian reforms produced some convergence in the average generosity of the Canadian and U.S. unemployment insurance systems (although, as will be discussed further below, the Canadian system is still significantly more generous than its U.S. counterpart).[4]

Other labour-market-related programs were also targeted, by both federal and provincial policy-makers, as part of this drive to make Canada's labour market more "flexible" and efficient. Like EI benefits, provincially-administered welfare benefits (which provide a "last-chance" level of income support for individuals and families who do not qualify for other benefits) were scaled back in several provinces – especially in Ontario, where welfare benefits were cut by over 20 percent in nominal terms (and much more in real terms) following the election of a Conservative government in 1995. Laws and regulations governing labour standards and collective bargaining practices were scaled back in several provinces (again, notably including Ontario). Among other outcomes, this policy shift reinforced a gradual decline in trade union penetration in Canada's labour market. Minimum wages were frozen for long periods of time in some provinces (including Ontario and Alberta), and hence were eroded in real terms.

A desire for enhanced labour market "flexibility" was not the only motive for these policy changes. Especially with regard to income security programs, federal and provincial governments faced an important fiscal motive, as well. Governments at both levels were digging out from deficits that reached a combined 6.5 percent of GDP in 1992 and 1993, and large reductions in income security spending were a tempting and politically popular response to those deficits.[5] Nevertheless, the strong view of policy-makers that this belt-tightening would also produce lasting improvements in the efficiency of labour markets provided an important and over-arching intellectual rationale for the cutbacks.

Fast Forward: Ten Years Later

The impressive rebound of the Canadian labour market over the last five years, described in detail in Geoff Bowlby's article, might seem to ratify the general approach that was advocated according to the "flexibility hypothesis." Canada's labour market was made significantly more pro-competitive in the 1990s, thanks especially to deep cutbacks in EI benefits but also to other pro-market policy reforms. Today our labour market matches or (by some measures) exceeds U.S. labour market performance. Ergo, those reforms, modeled on the U.S. experience, must have been successful.

A more careful comparison of the structural and institutional features of the two national labour markets, however, casts considerable doubt on that quick conclusion. For notwithstanding the painful policy changes enacted in the 1990s, Canada's labour market remains distinctly more regulated than its U.S. counterpart, along a number of different axes. In fact, the "institutional gap" between Canada and the U.S., has been remarkably stable over the past decade. Table 1 summarizes these comparisons.

Canada's EI system, as noted above, was significantly clawed-back by the reforms of the 1990s. Yet by the measure introduced above (average wage replacement), the Canadian system remains approximately 50 percent more generous than its U.S. counterpart – a smaller "gap" than was the case in earlier decades, to be sure, but a substantial difference nonetheless. If unemployment insurance causes unemployment, as implied under the flexibility hypothesis, then it is hard to understand why Canada's unemployment could have converged so notably with the U.S. despite an unemployment insurance program that remains significantly more generous.

Unemployment insurance is the income support measure most singled-out for attention by advocates of flexibility-enhancing labour market reforms. But other interventions and programs are also identified as culprits in the flexibility hypothesis – including other income security programs (such as welfare), direct regulation (such as minimum wage or pay equity laws), unionization and collective bargaining, and payroll taxes. Along these other axes, as summarized in Table 1, the institutional gap between Canada and the U.S. has, if anything, widened since the early 1990s. Minimum wages retained more of their real purchasing power in Canada than the U.S. Trade union penetration declined in both countries, and collective bargaining arrangements still cover more than twice as large a share of Canadian workers as in the U.S. Canadian welfare benefit systems, despite restrictive reforms in the 1990s, remain more accessible and less punitive than in the U.S. – especially in the wake of U.S. reforms in the mid-1990s which disqualified many “repeat” welfare recipients for life. Total spending on welfare benefits (as a proportion of GDP) has been stable in both countries. Payroll taxes remained steady in Canada throughout the 1990s (at under 5 percent of GDP in total revenues – still one-third less than in the U.S.), with reductions in EI premiums being offset by increases in payroll deductions for public pensions and health care programs.

In summary, there was a partial harmonization of Canada’s EI system with its U.S. counterpart, yet the Canadian system remains significantly more generous. Along other indicators of labour market regulation, the “institutional gap” between the two countries has remained constant or even (by some indicators) widened. It is hard to point to any general convergence in overall labour market structures and policies between the two countries. Yet labour market performance in Canada has largely caught up to (and by some measures surpassed) that of the U.S. Credit for this positive development cannot rest with pro-competitive changes in Canadian labour market policy, since we are roughly as “different” from the U.S. in this regard as we have ever been.

There was a marked convergence between Canada and the U.S. during the late 1990s, however, in the vibrancy of aggregate demand conditions and the direction of macroeconomic policy levers. During the early 1990s, when the Canada-U.S. unemployment rate gap doubled (and the Canada-U.S. *employment* rate gap first emerged), Canadian aggregate demand conditions were far more negative than in the U.S. The contractionary impact of uniquely high interest rates, an overvalued currency, the one-time adjustment to continental free trade, and later a historic retrenchment in fiscal policy, together served to knock the winds out of Canada’s macroeconomic sails for several years. U.S. macroeconomic conditions, on the other hand, were not nearly as weak during the recession of 1991-92, and U.S. macroeconomic policy remained oriented in a far more expansionary direction throughout this period. As summarized in Table 2, economic growth rates and macroeconomic policy were far more strongly conducive to employment creation than in Canada.

This “demand gap” between the two countries was largely eliminated later in the 1990s. Canadian monetary policy became much more accommodative. And by 1997, the main fiscal retrenchment in Canada was completed. An undervalued currency contributed further to a vibrant macroeconomic environment. Not surprisingly, in this context, Canada matched or exceeded U.S. real GDP growth rates for 6 years in a row beginning in 1997. And by the end of that period, the gap in labour market performance that had so preoccupied Canadian policy-makers in the mid-1990s had mostly disappeared.

In retrospect, the relative deterioration of Canadian labour market performance in the early 1990s was clearly mostly a result of uniquely negative macroeconomic conditions – not Canada’s more interventionist and egalitarian labour market structures and policies. Similarly, the rebound in our performance since then is mostly if not entirely due to a rebound in macroeconomic conditions and policies. The pro-competitive labour market reforms which dominated social policy in Canada in the mid-1990s were, at most, a sideshow to both the emergence of the Canada-U.S. labour market gap, and its subsequent disappearance.

Ominously, macroeconomic policy in the two countries has more recently diverged again. As indicated in Table 2, during 2003 Canadian monetary policy has once again become significantly more restrictive than in the U.S., akin to the period of the late 1980s and early 1990s. One consequence of this more restrictive monetary policy has been the unprecedented appreciation in the Canadian currency, which rose by 20 percent versus its U.S. counterpart in the first 10 months of 2003. On the fiscal side, while Canadian finance ministers have been more generous with new spending than at any time in the past two decades, Canadian fiscal policy still remains significantly more restrictive than in the U.S. (where government spending, and deficits, are growing significantly). To some extent, the more restrictive stance of macroeconomic policy in Canada reflects the fact that Canada's economy was relatively stronger than in the U.S. (at least until the second half of 2003), and hence was not in need of the same degree of policy stimulus. Yet based on the demonstrated macroeconomic sensitivity of the Canadian labour market over the past two decades, that policy stance will have consequences for the relative strength of Canada's labour market. If this renewed differential in macroeconomic policy between Canada and the U.S. is sustained, it is very likely that much of the progress made by Canada's labour market since 1997 relative to U.S. employment conditions will soon begin to be reversed.

Conclusion: Time for a Rethink

Canada's labour market performance over the last five years has been very strong – better than comparable U.S. performance according to several key indicators, despite being "hampered" by labour market regulations and social programs that are still relatively more interventionist. Yet the flexibility paradigm dies hard. Even today, for example, the OECD offers regular advice that Canada's labour market needs to become still more "flexible." For example, a recent OECD country survey of the Canadian economy reminds Canadian policy-makers of the importance of labour market reforms; it listed a dozen proposed flexibility-enhancing measures aimed at more fully attaining the goals of the *Jobs Study* (OECD, 2001: 146-148), including heightened restrictions on unemployment insurance eligibility, more rigorous control of active labour market programming, and measures to reduce the extent to which educational credentials limit labour mobility within Canada. One wonders how the OECD would explain Canada's strong employment performance relative to the U.S. in recent years, if these "rigidities" were really so important to overall labour market functioning.

In fact, the "flexibility" consensus was never justified by a close reading of the academic literature. For example, Riddell and Sharpe concluded their survey of research on the Canada-U.S. unemployment rate gap with a pointed warning to those enunciating a more unidimensional pro-flexibility approach:

> "The emergence and persistence of the Canada-U.S. unemployment differential has led certain observers to conclude that Canada's labour market is less dynamic than its U.S. counterpart and that Canadian policies

> and institutions result in a labour market that is more rigid and less able to adjust to change. The findings in this volume suggest that one should be cautious in drawing such a conclusion. Indeed, much of the evidence does not support this position" (Riddell and Sharpe, 1998b: 30).

Presciently, they predicted that up to three-quarters of the unemployment rate differential would disappear following a period of stronger economic growth in Canada.

In the world of sound-bites, however, this more careful and nuanced interpretation was lost. The "flexibility" hypothesis was invoked to justify a painful and unprecedented retrenchment in income security programs and labour market regulations that, in retrospect, had little if any impact on Canada's aggregate labour market performance. The hypothesis was broadly justified with an appeal to a simple-minded economics in which private markets always function best when government stays out of the picture.

More recent comparative labour market developments should cause considerable second thought on the part of those who argued (and continue to argue) that pro-competitive structural reforms are the most promising means of reducing long-run unemployment. The once-booming U.S. labour market, which served as a strong piece of evidence for a more flexible labour market vision, has cooled dramatically since 1999.[6] Several European countries, meanwhile, demonstrated that very strong aggregate employment performance can be quite compatible with interventionist labour market policy-making and generous social welfare systems. For example, employment outcomes in Denmark, the Netherlands, Ireland, and Austria have all exceeded U.S. performance in recent years, yet within a context that features a strong network of social security programs and strong levers of centralized labour market regulation (Auer, 2004). In terms of the bilateral comparison that is most important for Canada, the relative strengthening of Canadian labour market performance despite a persistently more interventionist approach to labour and social policy, should spark further reconsideration of the earlier consensus that unemployment mostly reflects structures and institutions, not aggregate demand.

In short, the mid-1990s policy consensus that Canada's labour market was "inflexible" and needed to be rejuvenated with pro-market reforms was premature at best. This view contributed strongly to a set of policy changes that, for many Canadians, resulted in reduced incomes and social hardship, yet which had little if anything to do with the subsequent improvement in our labour market fortunes. Many, but not all, economists contributed to this mistaken policy consensus with their predisposition to assume that markets, including labour markets, automatically work better when left to their own devices. The recent relative labour market success of Canada, and other OECD countries with even more strongly interventionist labour market structures, gives us a happy reason to fundamentally rethink the "flexibility" consensus. In terms of future research, hopefully we can now enter a period of more open-minded and balanced consideration of the complex relationships between labour market regulation, aggregate demand, and labour market performance.

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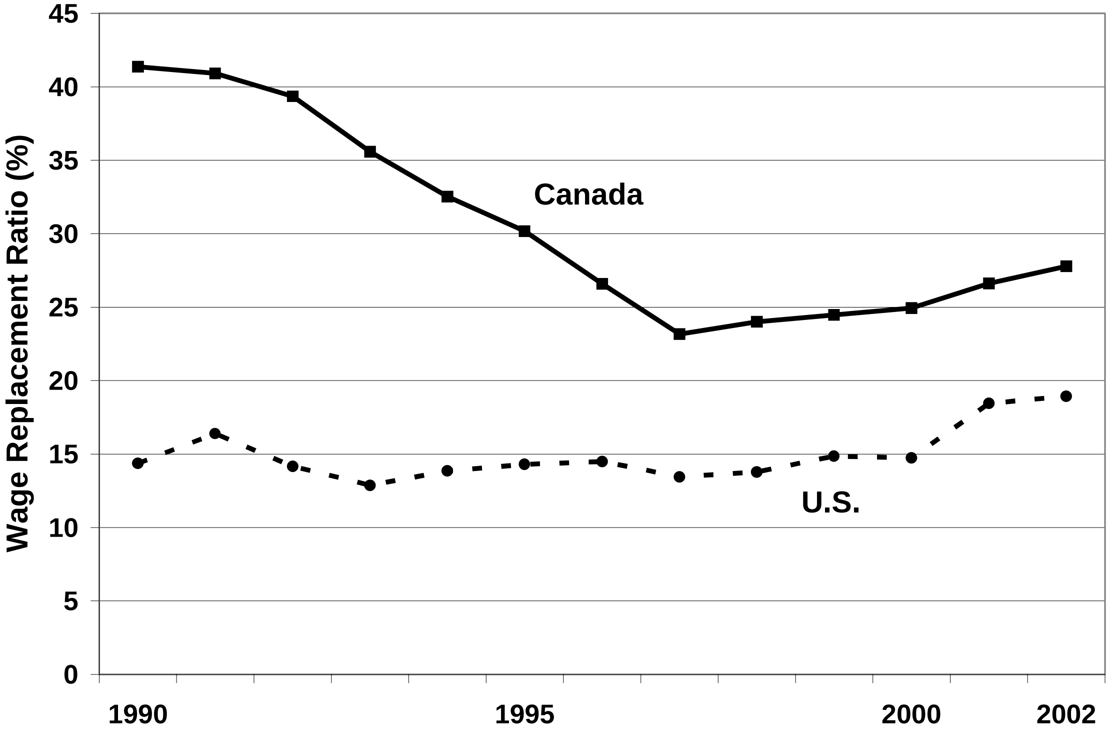
Figure 1
Average EI Generosity in Canada and the U.S.

1990-2002



Source: Author's calculations from Statistics Canada, *Canadian Economic Observer*, and U.S. Bureau of Labor Statistics.

Table 1
Labour Market Policy Indicators

Canada and U.S., 1990 – 2002, percent

Labour Market Policy	1990		2002		Direction Of Change in Canada-U.S. "Gap"
	Canada	**U.S.**	**Canada**	**U.S.**	
Unemployment insurance (weighted average wage replacement rate)	41.4	14.4	27.8	18.9	Partial convergence
Minimum wage (as proportion average hourly wage)[1]	40.7	38.0	40.4	34.9	Divergence
Unionization (as proportion of non-agricultural employment)	34.7	16.0	30.3	13.2	Stability
Welfare benefits (as proportion of GDP)[2]	2.8	2.2	2.8[3]	2.6[3]	Stability
Payroll taxes (social insurance deductions as proportion of GDP)	4.3	7.1	5.0	7.2	Stability

Sources: Statistics Canada; U.S. Department of Labor Employment and Training Administration; *Monthly Labor Review; Economic Report of the President*.

1. For Canada, weighted average of provincial minimum wages; for U.S., federal minimum wage.
2. For Canada, measures all provincial transfer payments to persons.
3. Data for 1999 (latest comparable U.S. data).

Table 2
Macroeconomic Indicators

Canada and U.S., 1990 – 2003

	Real GDP Growth (% p.a.)		Nominal Interest Rate (%)[1]		Real Interest Rate (%)[2]		Canada-U.S. Exchange Rate	Change Gov't Program Spending (% GDP)[3]	
	Canada	**U.S.**	**Canada**	**U.S.**	**Canada**	**U.S.**		**Canada**	**U.S.**
1990-1996	1.5	2.5	7.4	5.1	4.8	1.7	78.9	-4.0	-1.5
1997-2002	4.1	3.2	4.4	4.6	2.4	2.3	67.1	-1.5	+2.1
2003[4]	2	2.75	3.2	1.1	0.1	-1.3	71.0	0	+0.6

1. Central bank rate.
2. Central bank rate less annual growth in CPI.
3. Cumulative change in all government expenditures less debt service payments.
4. Bank of Canada forecast (October 2003) for GDP growth; 9-month actual average for interest rates and exchange rate; OECD forecast for government program spending.

Notes

[1] Stanford (2000) argues that the use of the term "flexibility" to describe this concept is a deliberate misnomer. By conventional understandings of this word (meaning "ability to respond to change"), Canada's labour market was not inflexible relative to the U.S. And some aspects of the "flexibility" policy agenda (such as a greater reliance on private employment-related insurance and benefit programs in the areas of health care and pensions) could actually make employment patterns *less* flexible.

[2] For this reason, Kuhn (1997) labels this broad pro-flexibility approach the "OECD hypothesis."

[3] By 1996, less than half of unemployed persons in Canada qualified for any regular EI benefits at all, compared to an average of 75 percent during the 1980s.

[4] The data in Figure 1 actually understate the relative generosity of the Canadian EI system: Canadian benefits are measured relative to average weekly earnings for all employed workers, while the U.S. series is based on average weekly earnings of production and non-supervisory workers. If equivalent wage series were utilized, the U.S. EI wage replacement rate would appear relatively less generous.

[5] Reductions in transfer payments to individuals accounted for one-third of the improvement in the all-government fiscal balance (measured relative to GDP) in the ten years following 1992. Since transfers to retired persons increased during this period, reduced transfer payments to working-age Canadians (through cutbacks in EI and provincial welfare benefits) accounted for an even larger share of the fiscal improvement.

[6] By several measures, the U.S. clearly possesses what is by far the most deregulated labour market in the OECD. See Stanford (2000) and Buchele and Christiansen (1999) for attempts to quantify this aspect.