

## TRANSCRIPTION

**HEADLINE:** Round Table on Creating a More Efficient Labour Market in Canada  
Hosted by the Centre for the Study of Living Standards: Luncheon  
Address

**PRINCIPAL:** Lars Osberg, Professor of Economics, Dalhousie University

**Moderator:** Before I introduce Lars Osberg I'd like to point out that the deputy, Claire Morris is in attendance now, sitting next to me. So we're very, very happy that she's had the time to attend this event so I'd really like to welcome her here. Our luncheon speaker today is Lars Osberg. He's the McCulloch Professor of Economics at Dalhousie University and he's a member of the Board of Directors of the Centre for the Study of Living Standards. But that's not why he's here today. He's here today because he's one of Canada's leading labour economists or just economists in general, Past-President of the Canadian Economics Association, his term just ended last year where he gave the presidential address on comparing poverty rates in Canada and the United States. He's worked in the labour market area for more than 20 years and is well known both in Canada and abroad for his many scholarly articles and books. So without further ado I'd like to turn it over to Lars who's going to talk to us about a framework, or the framework of an efficient labour market. Lars?

**Lars Osberg:** Thanks very much Andrew.

The title of my talk today is: The Framework of an Efficient Labour Market.

My objective is to try to be "obvious". So I'm going first of all to beat up a straw man (or straw person, whatever). Next I want to draw some unsurprising morals from that adventure and to discuss a few general issues. I will end by illustrating the discussion with two specific initiatives that are currently hot, one that I'll come out for and one that I'll come out against.

The straw person that I'd like to beat up on can be framed as: It is basically enough for labour market efficiency for government to supply training and to assist in labour market mobility.

I think there is a hypothesis out there, at least this straw person hypothesis, that if we want to maximize our GDP in a country like Canada, the name of the game is to put the square pegs in the square holes and put the round pegs in the round holes and then move them around when you have to. If so, then all government really has to do is forecast supply and demand, to enable it to provide a little better information to enable better labour market matching and to provide a little training and retraining. In this model, all government has to do is to forecast the demand for round pegs and turn the squares into the well rounded, as and when required.

I'm going to claim that it isn't quite as easy as that and there are a number of clear reasons in the way the labour market actually functions. And if we could have the handouts at this time perhaps maybe you can follow along with the slides.

First off, I think one of the things that characterizes the labour market is an incredible degree of heterogeneity. The labour market has markets for mortician services, for midwife services, for every stage of life in between and every conceivable thing that you'd want to do in your life. And all those areas of life are changing and they're changing pretty dramatically - which creates the problem of the instantly obsolete forecast.

The second reason is that if we're talking about an efficient labour market and labour market outcomes, it's really the macroeconomic context that's going to dominate the average outcome over the next four or five years. Hence, when we make a forecast about specific occupations, such forecasts are necessarily conditional on a macro economic context.

The third issue is that if you're talking about change, it actually mostly happens within firms. Actually, the best predictor of where somebody is and what they're going to be doing today is what they did and where they were yesterday. It's only a minority of people who change their jobs in any given year. Hence it's the reactions of infra marginal workers - the people that don't change their position in any given week or any given month or any given year - that are actually crucial to how technological change and market change is adapted to in a real life context. Certainly movements between firms are very important but let's not forget what's happening within firms because that's where most people stay. Hence, the efficiency of internal labour markets is absolutely crucial.

And finally, it's just clear in a lot of data that people care about a lot more than money income, and that the labour market affects a lot of areas of life. A huge number of issues from job satisfaction to the timing of work to the availability of work are really important to people's life satisfactions in a way that isn't actually captured in a dollar income number. Hence, because the desired outputs of the labour market are more than just GDP, one should not judge "efficiency" only in terms of increasing GDP per capita.

For these and other important reasons it's just not quite enough to maximize GDP by trying to put square pegs in square holes and round pegs in round holes.

Looking at the first point, I think modern labour markets are characterized by incredible variety and constant change. I'm not actually very fond of the terminology that says that there's a "high tech sector". Because I think basically high tech is everywhere. High tech is pervasively affecting the structure of work and the type of things that people are doing and the products that they're producing in just every sector of society. So jobs in all sectors are not only just incredibly varied but also constantly changing. So if we want to think about this matching issue, it's not like putting square pegs in square holes, it's more like putting temporarily square pegs into holes that are continually morphing in shape.

Constant change is the norm of the Canadian labour market and it comes both from the job side and from the people side.

It's just characteristic of all of us that we're constantly changing in our capabilities and our skills. And we're doing so endogenously, in response to what's happening in the labour market. Two key truisms for the labour market are "Use it or lose it" and "Learn while doing". So skills that are not used atrophy, while people develop the attributes their job requires. [My favourite example here is calculus skills, which I imagine a number of you had at one point in your life. But if we were to have a surprise quiz, we would find that those who have not used calculus in their jobs recently are now pretty clueless. ] Basically, if you use a skill from day to day, you learn it and you develop it, and if you don't use it, you lose it - and you learn more while you're doing things. Hence, the changing characteristics of individuals are endogenous to the structure of the labour market and to developments in the labour market.

I think what that implies is that it's not really possible to have a lasting allocation of labour, or a lasting forecast. We never actually get to solve the labour market allocation or forecasting problem once and for all. What we have is contingent solutions which we have to continually revise over time. Hence, I'm kind of sceptical about grand plans and about the possibility mentioned this morning of a single labour market information system. That sort of filing scheme for the warehouse of characteristics in the labour market is unlikely to be feasible. I think the labour market is too varied and changing too fast for us to get this lasting central handle on the situation.

So I think really the fundamental issue is to design institutions that enable a continual and optimal readjustment. Since we never actually finish solving this labour market skills problem, and just get to redo it every period, what we want to design is a set of institutions that best enable us to cope with change. Furthermore, we want to cope in a way that doesn't just maximize a dollar GDP but in some sense maximizes human satisfactions.

When it comes to a concern with skills, Canada has actually been here before - several times. And as an example, let me cite a past grand design for the labour market. The formal title is "Labour Market Developments in the 1980s: A Report of the Task Force on Labour Market Development" but around Ottawa it was known as the Dodge Report and it came out 20 years ago. In 1981, like today, there was a lot of concern about future labour market shortages, and there were great big forecasts of huge skill shortages in the future. There was also a lot of concern then - as now - with the skills that were being developed and the adequacy of current training and educational institutions.

The Dodge Report made a great many good points and in fact it was a landmark report in a lot of respects. However, a central premise in the Dodge Report was the idea that the run-up in oil prices that we'd seen in the 1970s had ushered in an era of high oil prices and high energy prices in general. If that was going to be the case, and if Canada was going to face high energy prices off into the indefinite future, many oil, gas, coal and hydroelectricity projects would become viable. Of course, it wasn't just the federal government that was making this forecast, it was a general forecast in the private sector as well. A lot of energy mega projects across this country were forecast to pay off, in a major way. There were some very well developed plans for additional coal mines in Cape Breton as well as hydro developments in Labrador and tar sands and

frontier natural gas. Most of these were, in essence, huge construction projects in under populated areas of the country.

The labour market demand forecast that came from that macro economic scenario was that we would see a demand shift in Canada that was structural and long term. The occupational demand for labour in Canada would shift towards the skilled construction trades and to jobs in mining and manufacturing and the resource sector. Given the location of these mega projects and the small population base of these areas, the forecast was for a labour shortage in the outlying regions of the country (such as Cape Breton) of construction workers and miners.

Furthermore, a perceived problem emphasized by the Dodge Report was that Canada just had too many university graduates. The report argued that there had been an over investment in highly qualified person power in Canada, particularly university graduates, who would be in excess supply as the structure of the economy shifted away from the service sector.

Well this forecast came in 1981 and as we all know what actually happened was that around 1985 we had a collapse in energy prices. Until the last year, energy prices were extremely low in real terms. Energy mega projects were shelved and the demand for construction labour in places like Cape Breton basically disappeared.

What is the moral of this story ?

When I talk about these things in Halifax I always have a few students from Cape Breton in the audience and I think that they take the moral that it's better to give labour market advice than to receive it.

More generally the basic moral that I take is that the macro economic context is absolutely crucial to any labour market projection. We would like to know what specific skills are actually needed, but central forecasting has a poor record of prediction, partly because of the changing macro context of labour market change and partly because of the fluidity and rapidity of change on both the demand and supply sides of the market.

However, although forecasting models have problems, so does reliance on market signals. The problem with the market mechanism is that it signals *scarcity*. When workers are not scarce, the labour market is not very informative. In general, the labour market sends few signals when unemployment is high and skills are generally in surplus. Normally, in a market system, it is vacancies and wages that provide signals to guide individuals' choices of career. It is lost sales that signal firms that more training of their labour force is needed. And when firms cannot get the workers they need, it is the political pressure they exert that signals government and schools to redesign their curricula. But when there are few vacancies anywhere, there is little to guide individuals' choices. When firms have a queue of qualified workers available, they have no incentive to provide more training or to pressure training institutions to do a better job.

In my view, the single most important question for the operation of the labour market as a whole at any point in time is " Are Jobs Scarce or are Workers Scarce ?".

The general availability, or scarcity, of jobs conditions all other labour market processes. And for Canada, the Expert Panel on Skills (2000) was very clear in its findings. They concluded there was "No evidence of a generalized shortage of technical skills in Canada". There is evidence of scarcity in "specific sub-sectors of industry" - which should be a normal condition in an efficient labour market because in fact those shortages are signals for people to change their behavior and for training institutions or for firms to change their training behavior in future periods. And of course the Expert Panel did note a general shortage of what I'd call all-rounders, people who have both good technical skills and good soft skills, who are able to both manage both in the technical sense and in the human relations sense.

The Expert Panel did not emphasize a shortage of skills. Rather it talked about a shortage of opportunities in Canada and the emigration that has produced. And I have to agree totally. If you look at indicators that have been tracked over some time, such as the Help Wanted Index, and also at the occasional statistically representative surveys of vacancies that we've seen in Canada, the clear finding is that the current number of real vacancies is pretty small as a fraction of the labour force.

Now of course it's kind of easy to get firms to express dissatisfaction with the skill level of workers just as, and in about the same proportion, it's easy to get professors to express dissatisfaction about their students. But if you actually go ask a statistically representative sample of firms directly just how many vacancies do you have at this point in time - real jobs that are open right now - the answer is well under 1% of the labour force.

The basic lesson I take is that labour surplus creates inefficiencies.

The balance of supply and demand at any time in any particular labour market affects essentially all labour market institutions. If there is a queue of the already qualified, there are substantial tendencies in the labour market to see an atrophy of firm level training. There is a disincentive to firms to take the trouble to change, for example by making the effort to enhance job quality, or instituting things like family friendly work practices. I mean why bother changing work practices if there's a queue of replacements out there for any malcontents the firm now employs? And why spend the effort to demand curriculum reform from trainers when the firm already has a queue of people that can satisfy job needs right at this point in time?

So from the point of view of the demand side of the labour market, a surplus of labour creates a substantial degradation of the feedback mechanisms that we need to run an efficient labour market. And from the point of view of individuals, people who are anxious about the future have a big incentive to avoid specializing excessively and exposing themselves to the risk of future unemployment in thin labour markets.

But when we think about change in the labour market, we have to focus not just on the impact of labour surplus on the external labour market but also on what's happening in the internal labour market. Labour market change happens both internally and externally to organizations. One can define the "internal labour market" as being those decisions on wages, allocation of labour, training, vacancies, promotion and work practices that are made within firms. We can think about the "external labour market"

as those hiring, wages and mobility decisions that are made as people move between organizations.

Partly because external market changes are easiest to observe, they have been the most studied and economists talk about the external labour market all the time. But actually most decisions that are made at any point in time are made within firms. The reason is fairly clear, because most workers now, as in the past, are in and will remain in, long term jobs. The predominant pattern, now as in previous decades, is for people to have a period of initial mobility in the labour market followed by relatively infrequent job changes. Statistics about averages, such as the average duration of a job, can therefore be quite misleading because it's a highly skewed distribution.

Long terms jobs imply substantial sunk costs by both firms and workers in the nature of that job match. Although both internal and external change are important and both matter a lot to the labour market, it's change within firms that dominates aggregate productivity statistics. For this reason, it's the motivation of the infra marginal worker - the man or the woman that's not just right at the margin but who has some protection from seniority - that dominates the average level of productivity change within an organization. And one can note that the Expert Panel did emphasize the shortage in Canada of management skills and the ability of management to develop that sort of motivation on the part of the infra marginal worker.

The fourth point is that well-being is not equal to dollar GDP. There's a large literature in fact on what makes people happy - or at least on what makes people say they are happy. There are a lot of surveys where people are asked are you happy, are you miserable, are you very happy or not happy? And the results of these surveys are consistent with other questions that ask people to express their opinions about their jobs, and their life satisfactions. The whole literature on subjective well being has been evaluated in a lot of different ways.

A common finding in this literature is that money income plays a role in personal satisfaction or self-reported happiness, but it's not a major variable. The things that really matter are being in a satisfying, long term personal relationship or not being unemployed or having adequate leisure time or having some degree of job security, or having an interesting job. Those are things that really drive self-reported satisfaction. If you actually ask people, it's quite clear from the empirical evidence that in their own lives people care about a lot more than simply dollar income.

Now a common aspect of all of those characteristics that drive personal satisfaction and life satisfaction is that they're heavily influenced by the labour market. Sometimes the labour market works directly, as in whether or not a person works long hours or has an interesting job. Sometimes the impact is more indirect, as the higher probability of divorce of couples who experience the stress of unemployment. But since paid work occupies so much of the time of adults, and is so significant to their social standing and relationships, the labour market casts a long shadow.

I would argue that the implication is that if we're going to talk about an efficient labour market, we'd better not just talk about a labour market that's efficient in the narrow sense of maximizing money income. Because if we think about what it is that actually

creates more satisfied human persons, it's partly about money, certainly, but that's only a small part of it. All these other characteristics which really do matter to individuals in their personal lives are heavily influenced, I would argue, by the availability of choice in the labour market. There is an enormous variety of emphasis and differences among people in how important each of these different dimensions of jobs actually are to them as individuals. No one is actually "average" -- hence, it's just not the case that one size will fit all. But one thing that is clear is that if there are a number of available jobs, individuals get to choose which dimension of job satisfaction is more important in their own lives.

To sum up, if we want to specify the necessary conditions for labour market efficiency, I think one imperative for government is the idea of decentralization of decision-making. We've got a complex diversity of local changes, so we're going to have to deal with some sort of decentralization.

A second necessary condition for efficiency is that if we're going to talk about an efficient labour market we'd better have something happening on the demand side. Since the demand for labour is a derived demand from the demand for commodities, strong aggregate macro economic demand is absolutely crucial to labour market outcomes. In a small open economy with a flexible exchange rate, monetary policy is just absolutely key to whether you're going to have strong aggregate demand or not. So a monetary policy that recognizes the importance of full employment is just an absolutely necessary condition for an efficient labour market.

I also think it's important to have an understanding of the full incentive structure that faces both workers and firms, and in particular the role that social security sometimes plays as a risk sharing device in what's inherently an uncertain and unknowable and risky future.

So let's consider the issue of risk and reward. One of the issues that I think is important in the Canadian labour market is that as an economy we need a diversified portfolio of specialized skills and we need a high level of skills. But individuals have the problem that they cannot both diversify their personal portfolio of labour market skills and attain a high level of proficiency in each. There are not enough hours in the day for me to get to be both a brain surgeon and a world class magician and an economics professor all at the same time. I can be "Jack of all trades, master of none" or I can take the risk of putting all my eggs in one basket and specialize in my occupational choice.

Although the economy as a whole needs a huge variety of specialized skills, individuals face the problem of undiversifiable risk – each person has to specialize in a particular occupation and bear the risk that in an unknowable future that occupation may be in surplus in the future. If so individuals can actually reduce risk by choosing general training.

In recent years we have observed a trend in Canada to make individuals bear more and more of the cost of their human capital investment and to acquire a higher debt load for any given investment in aggregate human capital, either generalized or specialized. As a consequence, I think we're in a situation where we run the risk that risk averse individuals will under-specialize in training. Although the country needs a diversified

portfolio of specialized and highly trained workers, individuals face increasing incentives to being generalists and as we shift more and more of the burden of human capital financing towards the individual, the training opportunities that are chosen become less diversified and less specialized.

A second issue that we face for the future is who's going to pay the bill for the base funding for higher education?

I think a lot of people in Canada kind of forget just how dramatically and how quickly the Canadian post-secondary system expanded in the period after 1960. If you go back to the 1950s there were essentially two institutions in English Canada that did PhD studies, McGill and the U of T. Since the 1960s we've built this incredible world class system across the country. However, the building period only ran up to about 1975 to '80 and then stopped. Perhaps because there was a perception of an over-supply of university graduates in about 1981 (as articulated in the Dodge Report), we've seen a period of very substantial decline in funding over the last twenty years. As well, federal/provincial turf wars and deficit fighting have been filtering down to the trenches in very substantial budget cuts. In terms of what will happen to post-secondary education, the basic fact of the matter is that both physical and human capital in the post-secondary education system is wearing out. And so the question we want to worry about is who's going to pay for renewing it.

The base funding issue is kind of unglamorous and it's an old hat kind of thing. There's now money around for the sexy marginal expenditure - for the ribbon-cutting ceremony and the new initiative. However, providing an adequate level of base funding for the general skills that will be used from a large variety of contexts over the entire course of a person's life, is seen as kind of unglamorous and "old". So, when it comes to the Canadian post-secondary education system as a whole, I kind of wonder whether we are going to see a rise and fall in two generations.

And a third issue of course I'd like to focus on is the issue of building institutions to manage continuous social change.

One of the institutions that will influence labour market change of course is the internet and the whole telecommunications revolution. I think this is going to have fantastic implications for labour market information. We're only just sort of scratching the surface - as this technology develops and becomes more generally appreciated and more generally available to a whole new generation of really internet savvy kids. Kids who get on Napster and all its replacements are developing an incredible degree of expertise in internet use and the medium itself is developing incredibly fast.

However, that's already happening in some sense. I think what's more difficult to arrange are the social institutions. Let's take as an example the sector council initiative, which I think is kind of a good idea basically. I think it's a useful innovation and it's something that's actually more difficult than the Internet to get going in the longer term. It is useful because it provides a mechanism for "voice", which pools the interests of different firms who have both competitive interests in the marketplace and common interests in affecting the curriculum of educational institutions and of training institutions. It's also important because it has this social dimension of providing some



sort of forum for labour management consultation. Informal contact between firms and unions can help them to speak from at least somewhat the same framework of reference in discussing future change. And those benefits are over and above the role of sectoral councils as an agency for direct service delivery and accreditation.

And so I think that the sectoral councils are a very useful innovation because they're a mid-level type institution. They're not the central forecasting model where one agency tries to comprehend the whole of the labour market. Rather they're mid-level between the central planning kind of model and the complete decentralization to the individual model. A mid-level institution can acquire a really specialized bunch of expertise about its own little corner of the economy. Each council tries, in an effectively competitive way, to maximize the interests of their particular corner of the economy and to develop the information base about the labour market realities of that particular corner of the economy. So society as a whole ends up with a diversified portfolio of real expertise. Hence, I think the central councils are a very useful innovation.

However, just to retain my popularity at HRDC, I should be sure to mention that there's some things I think you shouldn't do. I think you should avoid gimmicks in the labour market and among those I would classify the Registered Individual Learning Account idea.

And why would I put it like that? Well I know it's trendy to devolve to individuals entirely the risks and rewards of decision-making on training - and of course individuals do have the ultimate responsibility for what happens in their own lives.

It's also kind of trendy to try to do all social policy through the tax system. And in some sense, putting something like Individual Learning Accounts into the tax system is a policy reaction to the central forecasting model. Instead of Ottawa having a view about where occupational demand and supply is going to go in the future, Ottawa has no view. It just sets up a tax incentive and people choose whatever they want.

The question is whether that will produce better choices. I suppose the implicit economic theory that underlies it is the idea that we rely on the market mechanism for lots of things, so why not training? Implicitly the idea is that training is a bit like breakfast cereal, and that we devolve to individuals the purchase of their own breakfast cereal so we're going to devolve to individuals the purchase of their own training.

But if you think about that example, actually in the breakfast cereal case we have clear product labelling. Each box of cereal is labelled as to its nutritional content and we have a science about what that nutrition implies for individuals later on in their lives. There's some actual, pretty uncontroversial, pretty unambiguous information about what a decision taken today means for tomorrow. And you also have a lot of regulation as to the conditions of production of breakfast cereals so we know that they're produced under certain types of situations- for example, clean factories. So we regulate stringently the food production industry and we force labelling on breakfast cereals.

But a comparable level of information is just not available in the training market. Actually, given the problems of forecasting already discussed, it's hard to see how it could be provided.

And it actually is the case that 19-year-olds are kind of poorly informed. [In fact, 49 year olds who are laid off are also often poorly informed, since they usually spent their working years learning how to do their old jobs, and not prospecting in the labour market for new jobs. And we actually do not want everyone to spend a lot of their time always looking for new jobs – we actually want to keep their attention focussed on doing their current jobs better.]

More generally, it's inherent in the issue of education and training that there is an asymmetry of information out there. That's what gives professors job, the fact that there is actually an asymmetry of information between student and professor.

And the thing that I'd like to focus on particularly is that this problem of asymmetry of information is particularly severe for disadvantaged groups. There is the real problem when you get into the training area of vulnerability and of what I'll call dream merchants. The disadvantaged are at particular risk of exploitation. Already we do see out in the labour market some problems in devolution of training decisions strictly to individuals. Although it is neither desirable nor politically possible to exclude for-profit trainers from the ILA, there's also currently a segment of the for-profit training industry which has decided that all that really matters is the ability to market your services to successive generations of gullible incoming students. Whatever happens to the students after you've relieved them of their money, well that might feed back to the future crop of students but the information flow is very imperfect out there and some groups in the population are quite susceptible to promises of indefinitely bright futures. We have already a problem in Canada of recovering the student loans made to the people who've attended for-profit training institutions. We would just be pumping more money into this aspect of the training market if we go for something like registered individual learning accounts, which I guess we are.

So if we come back to sort of the bottom line, what do we need for efficiency?

It's clear that we need a strong, aggregate macro economic demand. We've got to have something happening on the demand side if the market is to generate signals that are going to guide people to reasonable choices and if they're to have those choices in the first place.

We have to work harder at developing our institutions which will both identify needs and articulate solutions at the industrial level - so I'm kind of a fan of this sectoral council initiative.

And we need a policy design that matches incentives to social needs. Policy design needs to reflect the full range of incentives across each individual situation - and particularly the incentives that affect not just individuals but also which affect firms. Policy design also needs to recognize that there's a lot of, politely put, asymmetry in information as to what is really going on.

And finally we are going to actually need some bucks in the end because we're going to have to pay at some point for the base of general skills which people are going to use in a variety of contexts throughout their working lives.