

INCOMES POLICY AND THE RATE OF WAGE INCREASE: A COMPARISON
OF CANADA AND THE UNITED STATES, 1956-76

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Bachelor of Arts, Univeristy of Western Ontario, 1959
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A Dissertation

Submitted to the Graduate Faculty

of the

The University of Manitoba

in partial fulfillment of the requirements

for the degree of

Doctor of Philosophy

Winnipeg, Manitoba

May
1979

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A dissertation submitted to the Faculty of Graduate Studies of
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ACKNOWLEDGMENTS

I wish to thank Dr. Clarence Barber and Dr. Norman Cameron for their assistance and encouragement in the preparation of this dissertation. I also wish to thank the librarians at the University of Manitoba who were so helpful in searching out government documents and extending lending privileges.

While these people gave assistance and criticism, the responsibility for the interpretations and conclusions that follow are my own.

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ABSTRACT

The purpose of this dissertation is to present a comparative analysis of the rate of wage increase in Canada and the United States from 1956-76 and to assess the role that incomes policies played in the process of nominal wage determination.

Chapter One introduces the hypothesis that the effects of wage and price guidelines and wage and price controls over an extended period of time played a significant role in modifying wage behaviour in the United States vis-a-vis Canada. Proof of this hypothesis rests on two premises: (1) that the economies of Canada and the United States are sufficiently similar that it is not unreasonable to expect similar patterns of wage behaviour and (2) that the most significant changes in wage behaviour occurred during and after the interim of guidelines and controls.

Chapter Two presents evidence substantiating the thesis that the economies of Canada and the United States are very comparable; thus it offers a comparative study of economic aggregates such as the rate of change of aggregate demand, (including changes in consumption, investment and the rate of change of price indexes) and then focuses on key variables in the nominal wage determination process, particularly the rate of unemployment, the rate of change of prices, the level of profit and the growth in productivity. Chapter Three previews the incomes policies that were introduced in Canada and the United States and provides analytical support for the contention that the most

significant changes in wage behaviour occurred during and after the interims of guidelines and controls.

Chapter Four focuses on models of money wage determination in the manufacturing industry, excluding those studies that incorporate such factors as spill-over effects, union pressure or market concentration as important determinants of wage change. Those models of wage determination that are specified for the total private economy and for the manufacturing sector as simultaneous equations in wages and prices are included, although the focus of interest is on the wage equation. The most important variables examined are unemployment, prices, profit and productivity.

Finally it is proposed in Chapter Five that the hypothesis be tested by regression analysis using nominal wage equations based on manufacturing data from 1956-76, that these equations of nominal wage determination be specified to include a dummy variable for 'on-off' periods of control, and that the wage equations be tested over subperiods corresponding to periods of controls or guidelines to check for this effectiveness. But it is also proposed that coefficients on all the variables be tested as to their significance and more importantly that the changes occurring in Canada and in the United States be compared to determine whether they are significantly different from one another.

For Canada, for almost all specifications of the money wage equations, the impact of controls tended to be positive and significant. Since the analysis of the control period is confined to five quarters and it appears that, in the first year, controls had a more significant impact on prices than on wages, the results are not surprising; however, it is possible that the inception of a control program elicited higher wage demands from some sectors of the economy than might otherwise have

been the case.

For the United States, the impact of the guideline program remains ambiguous. Depending upon the specification of the variables, guidelines appear with both positive and negative coefficients, although the effect in either case is relatively small. On the other hand, the imposition of wage and price controls implies a decrease in the rate of inflation of one percent a year or more.

To the degree that results of subperiod analysis are significant it appears that the Canadian economy has moved away from a competitive framework while the U.S. economy has become more attuned to market forces; thus, it may be that controls have an important long range impact that has been underestimated.

CHAPTER I

INTRODUCTION

After World War II, growth and change in the Canadian economy closely paralleled that of the United States. Recession and recovery occurred in tandem and until 1966, economic growth, changes in economic indicators and increases in wage rates were virtually coincident. But divergent trends were evidenced thereafter as the United States furthered its war effort in Vietnam, while Canada enjoyed a rapid investment expansion. These differences became marked. Wages in Canada rose rapidly as aggregate demand grew, profits increased and productivity improved, but rather inexplicably, after 1970, wage increases accelerated sharply.

Although the more rapid rate of increase in Canadian wages after 1966 is justified to some extent by rapid economic growth and increasing productivity, there appears to be no set of economic factors to account for the rapid divergence in wage behaviour after 1970; that is economic behaviour in Canada and the United States showed no significant differences that would warrant such a dramatic difference in wage rate increases. Therefore, it would appear that another factor or combination of factors, played a key role in the differing patterns of behaviour. As a result, the basic hypothesis is presented that the effects of wage and price guidelines and wage and price controls over an extended period of time played a significant role in modifying wage behaviour in the United States vis-a-vis Canada. Evidence of this hypothesis rests on two premises:

(1) that the economies of Canada and the United States are sufficiently similar that, *ceteris paribus*, it is not unreasonable to expect similar patterns of wage behaviour and (2) that the most significant changes in wage behaviour occurred during and after the interim of guidelines and controls.

It is proposed that the basic hypothesis be tested by regression analysis using nominal wage equations based on manufacturing data from 1956-76, that these equations of nominal wage determination be specified to include a dummy variable for 'on-off' periods of control, and that the wage equations be tested over subperiods corresponding to periods of controls or guidelines to check for this effectiveness. But it is also proposed that coefficients of all the variables be tested as to their significance, and more importantly that the changes occurring in Canada and in the United States be compared to determine whether they are significantly different from one another. More precisely, it appears that wage rates have been determined more by price changes (\dot{P}) and profit levels (π) than to rates of unemployment (U), and accelerating wage rates in Canada after 1970 seem especially indicative of this trend. If so, the coefficients on \dot{P} and π should be much larger, that is play a much greater role in wage determination in Canada than in the United States.

In an attempt to assess those variables that play a key role in wage changes, models of money wage determination in the manufacturing industry, excluding those studies that incorporate such factors as spillover effects, union pressure or market concentration as important determinants of wage change, are examined. Those models of wage determination

that are specified for the total private economy and for the manufacturing sector as simultaneous equations in wages and prices are included, although the focus of interest is on the wage equation. The most important variables examined are unemployment, prices, profit and productivity.

Unemployment is viewed as a significant variable in the wage determination process, but because of its questionable status as an adequate measure of labour market tightness, it is subject to a variety of specifications. It appears in money wage equations as a weighted unemployment index, an index of dispersion, or as a function of such variables as labour reserves or hidden unemployment. Ultimately, deciding upon the specification of this variable for regression analysis requires an assessment of money wage equations. This assessment is based on the predictive strength of the equation and the feasibility of computing an appropriate variable.

The apparent failure of the rate of unemployment to accurately predict wage changes, particularly after 1970, led to an inquiry into inflationary expectations as an important determinant in the money wage equation. But the difficulty of specifying a variable to capture these expectations remains an elusive one. There is disagreement as to whether labour is 'backward looking', that is more concerned with past real income losses, or 'forward looking', and therefore more determined to stave off future income erosion.

In regression analysis, profit and productivity may serve as proxy variables for one another. Therefore, it is necessary to ascertain which variable is preferable in equations of nominal wage determination.

The decision to include profit rather than productivity as an important factor in nominal wage determination is based on theoretical debate and empirical evidence.

Since unemployment, prices, profit and productivity are key determinants of nominal wage rate change in Canada and the United States they are examined carefully. To the degree that an economy is functioning according to a competitive model, the rate of unemployment, a good proxy for excess demand, is an important gauge of wage pressure, i.e., the lower the level of unemployment, the greater the pressure on labour markets and the demand for labour and the greater the increase in wage rates. Conversely, the higher the rate of unemployment, the greater the decrease in wage rates. Since the rate of unemployment was generally higher in Canada than the United States, it is not unreasonable to assume that the rates of increase in wages would tend to be lower. The fact that they have not been implies either that the rates of unemployment are not comparable indicators of labour market tightness or that factors other than the rate of unemployment play a significant role in wage behaviour. Therefore, it is important to determine at the outset the comparability of unemployment in the two countries. Changes in the composition of the labour force resulting from the growing participation of women and the relative increase in the teenage population have tended to increase the level of unemployment in both countries, but what is relevant is whether given a comparable age-sex distribution of the population in Canada and the United States the rates of participation and rates of unemployment across the age-sex spectrum are sufficiently similar to ensure comparability of the rates of unemployment.

The importance of rising prices, for wage determination, particularly those reflected in the consumer price index, cannot be underestimated. Because in the initial stages of an inflationary spiral, increasing prices were unanticipated, wages tended to lag behind prices and cause a slow down or even a decrease in the rate of growth of real wage rates. The growing concern of labour to offset price increases and, at a minimum, maintain a given real income position, was reflected in changing attitudes towards cost-of-living adjustment clauses in both Canada and the United States; thus, the concern to protect real income and prevent real income loss or erosion resulted in a substantial change in kinds of contract clauses.

The inclusion of a profit variable in money wage equations provides tacit acknowledgment of non-competitive forces in the labour market. There is an underlying assumption that high or rising profits encourage the demand for greater wage increases on the part of labour, and because the opportunity cost of a strike is high, management is more willing to accommodate these wage demands. The converse is equally true as management is more resistant to high rates of wage increase when profits are at low levels and labour has less incentive to press for these increases. Because profit is a key variable in the process of money wage determination, the levels of profit both before and after taxes in Canada and the United States are compared. To provide a more meaningful assessment and give some accounting of changes in employment, the ratio of profits before taxes to the total manufacturing wage bill is presented for each country. It is anticipated that important differences in profit levels will provide some insight into the differing pattern of wage be-

haviour and that the profit ratio will give some indication of changes in income shares.

Since productivity is an important long run determinant of wages and an important variable in the cost structure of a firm, changes in productivity, worker compensation and per unit labour costs in commercial industries, commercial, non-agricultural industries and manufacturing are assessed. Because the manufacturing industry provides the data base for an empirical test of nominal wage determination, a more detailed analysis of compensation and costs in this sector is provided.

That the economies of Canada and the United States are similar can be illustrated effectively despite the considerable differences in economic capacity that exist between them. These similarities are evidenced by a comparison of economic aggregates such as the rate of change of aggregate demand, including changes in consumption, investment and government spending; by labour market indicators such as the rate of growth of the labour force and employment, and by the level of unemployment, and the rate of change of price indexes, particularly the consumer price index (CPI).

To show that the most significant changes in wage behaviour occurred during and after the interim of guidelines and wage and price controls requires a study of wage changes in the non-farm economy and the manufacturing industry in Canada and the United States during the periods prior to, during, and after controls. The economic conditions prior to the institution of restraints are discussed, the logistics of the programs are reviewed and wage and price changes during and after the period of restraint are scrutinized. Observations are tempered by the rapid rise in the rate of

inflation after 1972 when a world-wide commodity shortage and the oil crisis precipitated an unprecedented post-war acceleration of prices. Rising prices were reflected in the CPI which provides the cornerstone for cost-of-living adjustments in a majority of the manufacturing industries in both countries. The importance of the CPI is evidenced by the growing number of escalator clauses in contract negotiations, by the removal of 'caps' on ceilings of adjustment clauses and by changes in the length of many contracts. Similarities and differences in contract negotiations in Canada and the United States are noted; the intent, again, is to determine whether differences in contractual agreements may have accentuated differences in wage behaviour. Since a deceleration in the rate of wage increase may also be a result of a slow down of economic growth, some assessment of market pressure is in order. This is provided by additional labour market indicators such as the help-wanted index, and by a measure of capital demand implicit in the capacity utilization ratio in manufacturing. A partial explanation for the generally higher rates of unemployment in Canada relative to the United States is sought in a comparative analysis of unemployment benefits paid. In a work-leisure trade-off, increased unemployment benefits will enhance leisure, and therefore unemployment; thus, it is expected that higher benefits per unemployed person will increase unemployment, irrespective of labour market conditions. In this way a differing schedule of benefits can create differences in the rates of unemployment of two countries even if the level of economic activity is relatively comparable.

Conclusions as to the effectiveness of guidelines and controls are

not easily derived, primarily because of impossibility of conducting a controlled experiment that will yield unambiguous results. It is only if differing testing techniques and varying equations of nominal wage determination provide similar results that an assessment of market intervention can be made. In this study, it is anticipated that through a variety of approaches, ranging from a survey of economic aggregates to regression analysis, that some measure of the effectiveness of wage and price controls and guidelines can be ascertained.

Chapter Two presents evidence substantiating the thesis that the economies of Canada and the United States are very comparable; thus it offers a comparative study of economic aggregates such as the rate of change of aggregate demand, (including changes in consumption, investment and the rate of change of price indexes) and then focuses on key variables in the nominal wage determination process, particularly the rate of unemployment, the rate of change of prices, the level of profit and the growth in productivity. Chapter Three previews the incomes policies that were introduced in Canada and the United States and provides analytical support for the contention that the most significant changes in wage behaviour occurred during and after the interims of guidelines and controls.

Chapter Four focuses on models of wage determination in manufacturing industries. The evolution of wage equations is traced primarily through key variables such as unemployment, prices, profit and productivity. It is this comparison that provides the rationale for the specification of variables for regression analysis in Chapter Five. The basic hypothesis is tested, 1) by measuring the impact of controls through

a dummy variable; 2) by assessing the impact of inflationary expectations on wage behaviour; 3) by introducing a variable that functions as an expectations generator, such that its value is zero when controls are not in force and the value it acquires during controls may be construed as a measure of the success of the control program; 4) by examining wage equations over sub periods, 1956-66 and 1966-76. The results of the study and its limitations are presented in Chapter VI.

CHAPTER II

NOMINAL WAGE DETERMINATION AND THE ECONOMIES OF CANADA AND THE UNITED STATES

After 1966 wage rates in Canada began rising much more rapidly than those in the United States and the growing differential in their rate of increase accelerated dramatically after 1970. Some difference in the rate of wage increase appeared justified by the greater economic growth and investment opportunities prevailing in Canada, but the generally higher rates of unemployment, relative to the United States provided a countervailing force; thus in view of the strong economic ties between the countries, the excess labour supply in Canada and the relatively moderate wage behaviour in the United States, the much higher rate of Canadian wage increase is not easily explained.

If nominal wages in Canada and the United States are a function of comparable factors and if the behaviour of these factors over time is similar, this change in wage rates in the two countries should also be similar.¹ Since empirical work affirms the role of key variables in the process of money wage determination and this role is supported by theoretical analysis as well, the problem appears to be one of confirming that these key determinants, the rate of unemployment, the rate of change of consumer prices and the level of profit have been relatively similar.

¹The close cultural, political and sociological ties that exist between Canada and the United States relative to other countries lend support to this approach. It would be more difficult to compare wage rates in Italy and Japan in this way, for example.

But the underlying assumptions relating to the choice of these variables must also be considered. Recognition of market forces is incorporated in the unemployment variable, acknowledgment of labour's perception of income erosion is accounted for in the price variable and the prevalence of oligopolistic forces is reflected in the level of profit.

In a perfectly competitive wage model it is assumed that the economy is static; thus, national income, the distribution of national income, productivity, investment, government spending and consumer preferences are assumed to remain constant. Since they do not, their changing behaviour becomes relevant to wage determination; thus, the greater the similarity in all of these indicators, the stronger the case for comparable wage behaviour. To confirm strong parallels and to sort out important differences in economic behaviour in Canada and the United States changes in such economic indicators as Gross National Product (GNP) and aggregate demand are examined.

The labour market is examined initially through the rate of unemployment; however, weaknesses in this proxy for excess demand have arisen as a result of dramatic shifts in the composition of the labour force. Although criticisms of the rate of unemployment as an inadequate measure of labour market tightness appear to be justified, what is of interest is the comparability of this indicator between Canada and the United States; that is, have the changes that have occurred in the labour force of both countries been sufficiently similar that a given level of unemployment represents a comparable measure of labour market tightness? This question is explored by examining trends in the growth and composition of the labour force and of employment.

To complete the comparison, prices, productivity and profit are examined. The growing tendency of tying wages to the consumer price index supports the inclusion of prices, and while productivity does not appear as a decisive variable in wage determination in the short run, it is important over the long run. Profits, which provide a strong incentive to unions for greater wage increases are examined within the context of national income shares.

Nominal Wage Determination

In a perfectly competitive model, wage rates are determined by the interplay of supply and demand in the labour market², in an economy wherein income distribution, the level of national income, production techniques, capital investment and consumer preferences remain unchanged. Prevailing in utopia is an assumption of omniscience and complete mobility on the part of labour and capital. Since reality often departs rather significantly from theoretical postulates, it is necessary

²In perfect competition the wage rate equals the value of marginal productivity of the last worker. To test this theory empirically is a complex process yielding dubious results. Apart from data problems there are serious definitional problems to overcome. The term 'wages' may be defined to cover average hourly earnings, but more accurately should include some accounting of fringe benefits which currently constitute approximately 25 percent of wage increases. Other factors such as differences in occupation, industry region or sex which could account for wage differentials should also be separated out. Although there appears to be little relationship between productivity changes and wages in the short run, over the long run the wage rate does tend to follow the average rate of productivity on a nation wide basis. See Richard Perlman ed., Wage Determination: Market or Power Forces? (Boston:D.C. Heath & Company, 1964) p. 2.

to expand the model of wage determination³; however, to the extent that wage rates do respond to market forces the previous assumptions require examination. Although it is necessary to reject the proposition of a static economy, particularly as change, and especially rapid change, appears endemic in an industrialized society, it is relevant in this comparative wage study to determine the extent to which economic behaviour is comparable in Canada and the United States.

Although the economy operates at full employment in a perfectly competitive model, market rigidities and imperfections have interfered with the smooth adjustment process to such an extent that unemployment beyond an accepted frictional level has become commonplace. As a result the rate of unemployment serves as a good proxy for excess demand in the market; at low levels it implies tight labour markets and the expectation of rapidly rising wage rates. Conversely, high levels of unemployment are indicative of low aggregate demand and decelerating wage rates.⁴

In empirical work on money wage determination in the United States, wage rates are generally expressed as a function of the level of unemployment, the rate of price change and the level of profit, or more specific-

³ If Galbraith's thesis is correct that the economy may be divided into two sectors--a market or competitive sector and a planned or corporate sector--then classical assumptions on the determination of wage rates in the labour market give way to the realities of union pressure and the dominance of economic power in determining wage rates. John Kenneth Galbraith, Economics and the Public Purpose (Boston:Houghton Mifflin Company, 1973).

⁴ Problems with the unemployment rate as a good indicator of labour market tightness are discussed later and alternative measures in empirical estimation are explored in Chapter 4.

ally as the ratio of profit to equity. In Canada, a similar equation to which a lagged rate of change of the United States wage rate has been added as a vital explanatory variable tends to give improved results.⁵ It has been stated that 85 percent of the variation in Canadian wage changes can be attributed to 1) the rate of unemployment, 2) the rate of change in consumer prices, 3) the rate of wage change in the previous year, 4) the rate of wage change in the United States in the previous year and 5) the level of profit per unit of output in manufacturing.⁶ Because unions are concerned with maintaining their members' relative income position there is a tendency for a settlement in one union to form the basis of contract negotiations for another union. In the process, a wage increase for one union becomes the basis of a price rise that is included in the wage demands of another union a short time later. This particular pattern is noted in contracts such as those negotiated in the automobile industry and has played a significant role among public servants, particularly in Canada. As noted earlier this wage-wage reaction has been confirmed by empirical work as well. Although Canadian wages tend to show a significant dependence on previous wage changes, this relationship is less marked in money wage equations for the United States.

⁵The empirical aspects of money wage determination are not pursued since Chapter 4 is concerned with this facet of wages. In many Canadian wage equations a lagged wage rate is also added (an acknowledgment of the wage-wage reaction), but is generally excluded in American wage equations. See George L. Perry, "Determinants of Wage Inflation Around the World" Brookings Papers on Economic Activity 2 (1975):403-47.

⁶See Grant L. Reuber, "Stable Prices, High Employment, and Economic Growth: Must Canada Choose?" in Wages, Prices, Profits and Economic Policy, ed. by John H. G. Crispo (Toronto:University of Toronto Press, 1967):27.