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**Article**

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## Panel 3

## CREAKING LABOUR MARKETS: MIGRATING INTO UNEMPLOYMENT?"

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The title of this Panel expresses pessimism about European labor markets' ability to withstand new challenges, a very common angst among those who contemplate the persistently high level of many Continental countries' unemployment.

European labor markets, however, were not always creaking. In the post-War period, and until the 1970s, unemployment was lower in Europe than in the United States. Growth also used to be fast in Europe. Between 1950 and 1973 GDP grew at an almost 5 percent annual rate (almost 4 percent per capita) in the EU-15 countries. Growth slowed to about 2 percent in the 1974–85 period in both the US and the EU, but until the 1990s EU labor markets, while generating less employment, consistently experienced faster real-wage growth and smaller increases in wage inequality than their American counterparts. Most European unemployment rates increased above the US one in the early 1980s – but unemployment, concentrated as it was in secondary portions of the labor force, was not an important source of social tensions as long as primary earners enjoyed stable employment at high wages.

At the end of the 1990s, unemployment in the European Union was twice as high as in the United States and growth was also an elusive goal for European policymakers (Sapir et al, 2004). Not only in the 1990s, but also in the first few years of the new millennium, EU countries on average – and Germany in particular – grew significantly more slowly than the US. One may well be entitled to feel sorry about this state of affairs. But stagnation should not evolve into depression, and angst feelings are not constructive. Europeans need to devise forward-looking solutions

to the familiar problem of reconciling worker protection and economic efficiency in the current and future environments. Remembering past successes should not lead us to regret progress and justify defensive, backward-looking policy measures. Rather, a brilliant past can be a source of inspiration when devising such solutions.

### Cyclical factors and structural features

If growth and labor market problems are relatively new in Europe, policy concerns are even more recent and occasionally misguided. For a long time, policy responses to high unemployment included public jobs, “active” labor market policies, and early retirement programs. Little attention was paid to the structural mechanisms underlying Europe's steadily deteriorating employment performance. Institutional reforms were only prompted by the fiscal problems of the 1990s, and by the unsustainability of low employment levels in the face of population ageing and declining competitiveness. The European Union's “Lisbon” objective of achieving the status of “most competitive knowledge-based economy” in 2010 has not led to appropriate reforms and supporting instruments and, not surprisingly, little growth has materialized in the EU since its formal adoption.

Poor growth performance was and still is often blamed on cyclically depressed conditions, reflecting fiscal and monetary stabilization in the early 1990s, and international financial-market swings and security concerns at the turn of the century. Structural factors, however, are clearly more important in theory and practice. The Single Market, enlargement, and EMU have vastly improved Europe's market size and macroeconomic policy environment. To yield the better efficiency and faster growth that theory would predict, however, competitive conditions must be pervasively improved. The structure of production needs to be re-oriented towards sustained growth, and this is clearly not just a matter of reducing taxation – a strategy that may well foster a country's development if other countries' taxes remain

high, but hardly an option for a European economy where public expenditure and transfers pursue politically strong goals.

Competition and growth should be pervasive in all markets, not only in the labor market, whose institutional structure is often blamed for unsatisfactory employment performance. While such blame may be well-deserved in many respects and in many countries, it is easy to forget that labor market institutions serve potentially useful purposes in a world where labor income is difficult to trade in financial markets, and its stability is an important goal of collective action in general and public policy in particular. To understand why poor employment performance fails to trigger reforms in many European countries, consider that low employment is an unpleasant but not unintentional byproduct of many labor market institutions. Unemployment insurance, labor taxes and social transfers, employment protection, collective bargaining are all meant to prevent poverty and reduce inequality. Working is not a pleasure, and restricting employment to “good jobs” is attractive when unemployment is concentrated in secondary segments of the labor force. Hence, institutions that did support favorable wage level and dispersion developments in Europe relative to the US were and remain very popular among citizens and workers.

But high wages and labor income security do come at a price in terms of lower productive efficiency and lower employment, a price that depends on labor market characteristics. The performance of existing labor market institutions leaves much to be desired within existing national systems. Since unemployment benefits, which would have only minor effects in a highly productive economy, can dramatically reduce employment in a less developed one, larger and more diverse countries tend to display higher overall unemployment and much more dispersed regional unemployment. Nation-wide labor market institutions can be consistent with nearly full employment in North-eastern Spain, Northern Italy, and West Germany at the same time as they imply high unemployment in less developed regions, and for the whole country on average. And since the employment effects of a regulated labor market are more negative when product-market competition is more intense (Bertola and Boeri, 2002), cross-border integration also plays an important role: the same labor cost increase that would reduce employment only marginally in a closed economy with little product-market competition can dramatically worsen the

employment performance of an economy where production can be easily relocated abroad and product-market competition is very intense.

### **Economic integration and the labor market**

Since employment losses from labor market regulation are larger when competitiveness vis-à-vis trading partners is more important, economic integration – whether within the EU or on a global scale – threatens the sustainability of many European countries’ labor market institutions. The tradeoff between lower employment and better employment conditions is not as favorable for current institutions when higher wages can lead firms to substitute domestic with foreign labor as it would be in a closed economy where unemployed workers participate in the same social security scheme as protected primary workers.

Enlargement of the EU to relatively poor Central and Eastern European countries adds new challenges of this type to the complex politico-economic reform problem facing European countries. Immigrants may of course be sensitive to the availability of welfare benefits in the destination country – in fact, more sensitive than current residents. Even small differences across possible destinations can determine the trajectory of individuals who have chosen to bear the largely fixed cost of migration, and empirical evidence does indicate that migrants are more likely than natives to take advantage of generous welfare provision (see Borjas, 1999 for US evidence, and Sapir, 2001, for a discussion of European data). Will many Central and Eastern Europeans “migrate into unemployment” – either feeding into such stagnant pools as may be found in regions of Germany and Italy, or putting such unsustainable pressure on existing welfare arrangements as to kill the planned creation of an area of economic freedom (after lengthy transition periods)? Or may CEEC accession instead bring the long 1970–90s phase of labor market rigidity to an end, and recreate the vibrant growth performance and labor market conditions of the 1950s and 1960s?

The answer to these crucial questions depends in part on cultural factors. It is often argued that European labor mobility is hindered by cultural and linguistic barriers. This is unlikely to shape future developments, because attitudes towards migration are not invariant to economic and institutional fac-

tors. Some 10 million European workers in search of better employment opportunities did move across the borders of countries in the European golden age of the 1950s and 1960s, and many more migrated from the countryside towards cities within each country. Cultural and political factors are unlikely to prevent efficiency-oriented migration if European labor markets return to their ancient dynamism, but such factors may well play an important role in shaping the Western European policy framework's reaction to migration pressure. Incipient and actual immigration is extremely unlikely to result in the demise of Western European welfare systems. Labor market regulation and collective welfare schemes are strongly supported by many Europeans' social and political attitudes, and public opinion would surely prefer barriers to personal mobility should "race to the bottom" tendencies initiate a transformation of Continental Europe's institutional landscape into, say, Texas's.

Hence, the interaction of *status quo* welfare schemes and economic integration endangers the latter much more than the former. Whether incipient opportunities for labor mobility will result in anti-integration resentment, or renew growth in Western Europe, will chiefly depend on whether policymakers will rise to the new challenges and find new ways to achieve social cohesion and economic progress in a new environment, without forsaking the social and labor market policy goals that are so politically strong in Continental Europe.

The challenges facing current social and labor market arrangements do arise from economic integration. But the labor market and social security arrangements that Europe inherits from its past are made obsolete by demographic trends and technological innovation, not just by economic integration. Economic integration offers important efficiency gains, and changes the balance of current institutions' pros and cons through many channels, not just through migration. Personal mobility is perhaps the most visible aspect of economic integration, but neither migration, nor the availability of benefits for non-nationals in the destination country are crucial. Trade and capital mobility can put much the same competitive pressure on workers as migration, which is all but impossible to stop (whether from within the EU, or from neighboring regions), and is much more likely to displace local workers from their traditional employment into subsidized unemployment than to draw on social transfers directly.

### Reform directions

It would be wrong to regret economic integration because it undermines a tradition of low-employment, high-regulation labor markets. Integration of markets across the boundaries of families, villages, and kingdoms has fostered economic progress throughout history. Our willingness and ability to engage in economic interactions with counterparts that are geographically and culturally distant from ourselves is the main reason why we can afford a better standard of living than primitive men (Seabright, 2004). There is no reason to advocate stopping that progress at the borders of nation states as currently defined.

A reevaluation is in order of how labor market regulation is implemented, rather than of its objectives. Reforms should be motivated by new cost-benefit trade-offs. Economic integration opens new opportunities, but can have adverse welfare implications if markets' institutional structure is ill-equipped to accommodate new opportunities to trade and specialize. The EU's labor market and growth performances suffer from lack of appropriate reorganization under new competitive pressure. Hence, flexibility-oriented reforms are essential for both longstanding and new members of the EU to take advantage of new opportunities. If workers and other resources that can no longer be profitably employed in traditional industries are left idle in subsidized unemployment, and not reallocated to new tasks, then loss of industrial production is not compensated by new (service) production, and welfare is reduced.

Integration and deregulation are far from painless, of course, and it would be dangerous to neglect the politico-economic tensions generated by dismantling the current system of worker protection in Continental European countries. At the same time as protecting workers becomes increasingly difficult in light of more intense competition, demands for such protection can become more urgent. Hence reform should not simply deregulate, nor should defensive measures be put in place to stem the tide of progress. Policymakers should not, like cavalry generals in the 20th century wars, fight old battles with obsolete policy instruments. The German construction workers' unemployment benefits should not remain unchanged when their employability is threatened by competition from Central and Southern European workers, rather than by the weather and business-

cycle conditions on the minds of Bismarckian scheme designers.

Rather, institutions should be reformed and modernized, at both the national and EU levels, so as to facilitate change and mobility, encourage work, and better deliver old objectives in a new environment. As economic interactions reach the scale and intensity of those experienced in the United States, the challenge facing individual countries and the EU as a whole is that of preserving a European tradition of attention to working conditions by means of an appropriately redesigned institutional framework.

### **Cross-market aspects**

The U.S. differs from the EU in many respects, not just in its labor market structure. Not only labor markets, but all markets need to be reconfigured. Workers cannot be expected to accept labor market risk if other aspects remain unreformed that are relevant to their welfare. In some countries, but not in most European countries, redundant white-collar workers can easily find employment as taxi drivers: ease of entry in product markets and self employment can play a crucial role in making a deregulated labor market acceptable. The relevant processes can be fostered by economic integration and EU competition authorities, and make labor market deregulation more acceptable than it currently is. Even more importantly, competitive and efficiently regulated financial markets are needed to reduce workers' need of protection against market pressure – offering, for example, the same affordable consumer credit that allows American workers to protect their consumption from income shocks. Patterns of covariation are quite apparent across aspects of labor, product, and financial market regulation and development (Nicoletti, Scarpetta, and Boylaud, 1999; Bertola and Koeniger, 2004). Each market-specific regulation framework may well need to be reformed in each country, but evidence and theory both suggest strongly that reform processes should be coordinated across all markets.

### **Transnational aspects**

The U.S. also differs from the EU in featuring a robust layer of federal policies, funded by a budget that dwarfs its European supranational counterpart.

Not only in the monetary policy and competition policy areas, but also in the social and labor market area policies need to be coordinated to ensure that the relevant trade-offs are addressed at the relevant level (Bertola et al, 2001). Collectively administered schemes meant to replicate markets that the private sector cannot develop, such as old-age and unemployment insurance systems, need not be coordinated if they adhere to actuarial fairness standards. Appropriate design of the relationship between individual contributions and benefits can in principle ensure that such systems are robust to economic integration pressures, and competition among systems of the type analyzed by Sinn (2003) can foster efficiency in their implementation. Policies meant to prevent social exclusion of individuals who could not participate in insurance markets even if they existed, however, need to be designed and implemented at the level where benefit-shopping and race-to-the-bottom tendencies may materialize, namely at the EU-wide level where economic interactions take place.

Failing to recognize and face explicitly the policy spillovers introduced by an enlarged, diverse, and ever closer Union can only lead to calls for retrenchment in national or sub-national economic and perhaps ethnic entities, and to the elimination of welfare gains from economic integration. A minimal standard for welfare benefits, and for taxation of mobile capital and corporations, should have higher priority than intrusive schemes such as the Common Agricultural Policy. In an integrated economic area, addressing welfare-policy spillovers should have a priority at least as high as that of common monetary and competition policy, similarly meant to prevent uncoordinated policy reactions resulting in uniformly undesirable outcomes. A suitable welfare floor does not need to be implemented as part of a full-fledged “Social Union:” homogenization of minimal standards would be impossible without politically unrealistic cross-border fiscal transfers, and would be economically dangerous on a continent where uniform national standards (and large fiscal transfers) prevent the development of less-developed regions within large countries. Harmonization, however, does not imply homogeneity. Minimal standards specified in terms of local wages and price levels would prevent cross-border tensions and, since this is in the interest of richer members of the integrated economic area as much as in that of poorer members, might well be cofinanced by supranational funds.

### Comprehensiveness and coherence

Europe's policy landscape is not everywhere as stagnant as in some of the larger member countries. Reforms of pension and unemployment benefit schemes, prodded by status-quo unsustainability, are often directed towards the actuarially fair configuration that, as mentioned, can be consistent with efficient systems competition. Labor market performance success stories do exist, ranging from the Netherlands' early experiences, to Ireland's and Finland's more recent booms. In all cases, and even more clearly in Mrs Thatcher's UK reforms, a crucial feature of successful reform processes was their comprehensiveness, ranging from labor market to financial and product market aspects. Many success stories took place in relatively small countries, where a comprehensive approach is easier to design and implement. Progress is lacking in larger countries, and at the European Union level. The draft constitution envisioned qualified majority voting on a number of shared-competence social and labor market policy aspects, where European framework laws may establish minimum requirements. While the relevant provisions have not survived intergovernmental negotiations, one may hope that better arrangements among a subset of more closely integrated countries may emerge if the current draft fails to be ratified, despite its weak contents, in some or all of the countries opposing coordination of the relevant policies.

Progress is difficult, but necessary. In order to let economic interactions at both the level of regions and of the whole European Union achieve the desired balance of competitive efficiency and individual welfare protection, all reforms, and not just labor market reforms, will need to be undertaken on a suitably comprehensive and coherent basis. Of course economic integration (free mobility of goods and factors), effective social protection, and policy decisions at the local level are an inconsistent trio, just like independent macroeconomic policies, fixed exchange rates, and capital mobility before Economic and Monetary Union: pursuing two of the three necessarily implies forsaking the third (Bertola, 2004). Forsaking integration, however, would be tantamount to forsaking economic progress. In a reality that sees large nations unable to cope with their own regions' economic heterogeneity, and all European policymakers concerned with possible cross-border spillover effects of local welfare policies, it is both theoretically and empirically difficult to see why national competence on labor

market and social policies should be preserved by limits to personal mobility and other channels of economic integration.

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