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Working Paper

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IZA Discussion Papers, No. 1933

Provided in Cooperation with:

IZA – Institute of Labor Economics

Suggested Citation: Commander, Simon; Heitmüller, Axel; Tyson, Laura (2006) : Migrating workers and jobs: a challenge to the European social model?, IZA Discussion Papers, No. 1933, Institute for the Study of Labor (IZA), Bonn

This Version is available at:

<https://hdl.handle.net/10419/33162>

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IZA DP No. 1933

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A Challenge to the European Social Model?**

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January 2006

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ABSTRACT

Migrating Workers and Jobs: A Challenge to the European Social Model?*

This paper proceeds from two key assumptions. The first is that European countries are likely to face increased immigration of individuals. The second is that the emigration of jobs from Europe to other regions of the world through offshoring is also likely to increase. It has been widely argued that both factors are contributing to growing insecurity among European workers. This paper has two goals: first, to put the wider discussion of job displacement and wage changes resulting from immigration and offshoring on a firmer empirical foundation; and second, to explore changes in the European social model that will allow the European economies to adjust to the challenges and respond to the opportunities resulting from increased global competition from emerging market economies. Both immigration and offshoring confront European policy makers with trade-offs between efficiency and equity. These tradeoffs can be eased by active labour market and education policies to enhance the flexibility and skills of European workers so that they enjoy the productivity advantages necessary to support high wages and compete in the global economy. Such policies must combine an appropriate balance of incentives, obligations and benefits that focus on the overall employability of workers rather than on the number of jobs in a particular company or sector. A key challenge in designing such policies is how to combine generous income support for jobseekers while at the same time strengthening their incentives to find and accept available jobs.

JEL Classification: J3, J6, H2, L0

Keywords: offshoring, migration, social model, displacement

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* This paper has been written as a contribution to the Policy Network and London School of Economics project on the Future of the European Social Model. We would like to thank participants of the national debates and the LSE symposium for very helpful comments.

1. Introduction

In both North America and Western Europe there is mounting concern among the population that competition from low-wage emerging market economies is eroding job security and reducing wages. Both the immigration of low-skill workers from such economies and the growing offshoring of both manufacturing production and more recently production in IT and business services to such economies have aggravated this concern. The fear of the “Polish immigrant plumber” taking jobs and wages from his high-wage counterparts was a significant factor behind the no votes against the EU Constitution in France and the Netherlands. And German firms have used the threat of offshoring production to lower cost locations in central Europe and Asia to win significant compromises on wages and job flexibility from German workers. Overall, there is anxiety among both citizens and their political leaders in the US and throughout Europe that both the immigration of low-wage workers and the out-migration of jobs to low-wage locations will force a “race to the bottom” in terms of wages, job security and social welfare policy. But are such concerns warranted? And if so, how should the basic features of the European social model be adjusted to address the new challenges posed by increasing globalisation?

In order to answer these questions, it is important to move from perception to evidence because many of the fears about globalisation are not empirically grounded. For example, both the US and the UK have been and continue to be major recipients of jobs offshored from elsewhere in the world. And a recent report from the UK Office of National Statistics found that employment growth in occupations widely considered susceptible to offshoring has actually been very strong. While job turnover has also been high in those occupations, the rate of job loss has also tended to decline. The perception that job security has declined as a result of globalisation is also not consistent with the facts. For example, according to longitudinal data for individual workers in the UK – the British Household Panel Survey (BHPS) – average job security has actually improved since 1993. Interestingly, associate professionals – the category for which the largest number of work permits are issued to immigrants to come and work in the UK – do *not* feel more insecure than UK workers in other types of jobs. This result suggests that immigrants in the UK have largely been complements to rather than substitutes for native workers. In short, using this UK dataset, it appears that immigration has not eroded job security.² By contrast, using the same dataset, offshoring does appear to have a negative effect on the perception of job security of some UK workers.³ For example, the perception of job insecurity is clearly higher for machine operators – a category of work where offshoring has been quite prevalent – than for other categories of workers. Finally, the BHPS data also suggest that offshoring and work permit categories are broadly linked which, if anything, points to a possible two-way process with migrants coming in and jobs migrating out in the same broad job categories.

This paper attempts to link the dual challenges from continued immigration of people and emigration of jobs. While the two are not strictly linked – at least in a causal sense – they have a number of overlapping features in both policy and economic terms. In particular, the paper has two goals: first, to put the wider discussion of job displacement and wage changes resulting from immigration and offshoring on a firmer empirical foundation; and second, based on the evidence, to recommend changes in the European social model that will allow the European economies to adjust to the challenges – and respond to the opportunities – resulting from increasing globalisation. The basic conclusion is that globalisation, like technological change, requires active labour market and education policies to enhance the flexibility and skill levels of European workers – to provide them with what the ILO has termed “flexi-curity” – so that they have productivity advantages with which to compete effectively in the global economy. Policy adjustments are also warranted to help citizens who are dislocated or harmed by globalisation to cope with a variety of dislocation costs. The purpose of such adjustments is not to save particular jobs but to save individuals from bearing the cost of beneficial economy-wide changes triggered by immigration, offshoring, or other forms of global competition.

2.1 Migration of workers & job displacement

Immigration has been a contentious issue on both sides of the Atlantic for many decades. In the U.S. the steady - and often illegal - flow of Mexican immigrants has fuelled anxiety about the economic consequences for native Americans. In Europe, the extension of the European Union towards its Southern and Eastern perimeters has raised policy concerns about immigration. For example, around 23% of the British population see immigration and race relations as the most pressing political issue and hence immigration constitutes by far the single most important item of public concern.⁴

The pace and extent of immigration has varied across Europe over time. There have been substantial differences in net migration rates over time and the origin of immigrants across OECD and EU countries.⁵ While in several European countries the immigrant population has remained stable over time, by contrast, there has been a pronounced jump in the U.S. and Britain. In the latter, the fear that the accession of eastern countries would lead to a further jump in migration appears to have been exaggerated. Since 1 May 2004 only around 176,000 Eastern Europeans have registered under the new scheme of which up to a third might have already been in the UK before 1 May.⁶

There is a large gap between public opinion and academic evidence on the impact of immigration. Public opinion and the media have traditionally worried about the adverse effects of immigration. A commonly held perception is that foreigners take jobs away from native workers, claim benefits for which they do not pay taxes, and jeopardise social cohesion.⁷

By contrast, economic theory predicts that immigration like trade creates overall economic benefits for the host economy. These benefits are the result of greater efficiency resulting from enhanced specialization. According to this view, immigrants and natives are not interchangeable but rather complement one another. However, if immigrants are very similar to native workers in skill and experience, then native workers may experience job displacement as migrant workers compete for jobs and exercise downward pressure on wages. Yet, the increased competitiveness of sectors that employ immigrants may also lead to the creation of new higher-wage, higher-productivity jobs for native workers in other sectors. Furthermore, if the skill and experience of immigrants differ from those of natives, the wages of native workers may increase as they specialize in high-wage, high-productivity jobs and as skill gaps hindering growth in the host economy are closed.⁸

Immigration policy and hence immigration itself can be either demand or supply driven. Demand-driven immigration tends to be complementary because to obtain the necessary work permits for migrant workers employers are usually required to provide evidence that native workers are not available. In contrast, supply-driven immigration can bring both substitutes and complements to the native labour force. In reality, the relative magnitudes of different immigration types will depend on a variety of factors that include immigration policy but also economic performance in both sending and receiving countries. For example, in common economic markets such as the EU, supply-driven immigration may outweigh demand-driven immigration because of the relatively free movement of labour among union members. In short, the overall impact of migration on the labour market is less clear – not surprisingly – than the popular discussion suggests.

A growing number of empirical studies try to establish the impact of immigration on labour market outcomes in host countries. The majority of these studies examine the U.S. experience between 1980 and 2000, a period during which immigration increased the male labour supply in the US by about 11%⁹. There is also a smaller body of work focusing on European countries such as Germany¹⁰, France¹¹, Austria¹², and more recently the UK¹³. Most of these studies fail to find negative employment effects on the domestic workforce from immigration in either the U.S. or Europe. The majority of evidence provides no support for the view that immigrants displace

native workers from their jobs.¹⁴ By contrast, the evidence on the effects of immigration on the wages of native workers reaches more ambiguous conclusions but effects (both negative and positive) are generally rather small.¹⁵

According to some studies, even the substantial immigration of low-skill workers into the U.S. has had only minor effects on the wages of low-skilled American workers. But more recent work by Borjas documents a stronger effect.¹⁶ He concludes that a 10% increase in the number of migrants reduces earnings of comparable native workers by up to 4%. And in a yet more recent study¹⁷ he also finds that a 10% increase in the supply of doctorates in a particular field at a particular time as a result of immigration reduces the earnings of that cohort of doctorates by 3%. But such immigration also reduced the relative wages of unskilled workers — those with less than a high-school education — by about 3% or about one-third of the 10% decline in their relative wages that occurred during the 1980s. This result suggests that when supply-driven immigration of low-wage labour is large enough over a sustained period of time it can put downward pressure on the wages of native workers with similar skills levels.

Europeans also worry that because a comparatively large percentage of immigrants will draw heavily on the social welfare system, any gains from immigration will be more than offset by the costs imposed on native taxpayers. But the evidence on the fiscal consequences of immigration is far from unambiguous and varies across countries.¹⁸ As to the net positions of migrants with respect to the benefits system, much depends on the age, skill and family profile of migrants, the types of benefits available and the associated conditions of access. For example, research and government studies in the UK have shown that migrants make significant and often large fiscal contributions to the economy.¹⁹

Finally, inadequate attention has been paid to the consequences of different types of migration policy and to the important distinction between supply and demand driven immigration. It is possible that the mix of supply and demand driven immigration is responsible for the small effects of immigration on wages and employment of native workers found in existing empirical studies on the European economies. Clearly, this is an area that warrants further research.

2.2 Offshoring and the Migration of Jobs

According to consultancy reports, millions of jobs are likely to be offshored from Europe and the US to the emerging market countries in the coming years. One widely quoted study suggested that the number of jobs offshored from the US will climb from 400,000 in 2004 to 3.3 million in 2015.²⁰ This translates into about 250,000 layoffs a year or 2% of all American job losses every year over the next decade. The same consultancy firm projects that up to one million jobs or 2% of the jobs in the EU15 are at risk from offshoring over the next ten years, with a high share of the total in the UK because of language.²¹ According to recent numbers, about 4% of total jobs lost in France between 2002 and 2004 can be attributed to offshoring. And a recent survey in Germany found that up to 130,000 jobs in the IT sector are at risk of being offshored in the coming three years.²²

Some observers believe that predictions about the number of jobs that will be lost to offshoring over the next decade in both the US and Europe are too low and that offshoring will increase in size and scope much more quickly than anticipated. According to IBM, less than 8% of the \$19 trillion spent each year on sales, general and administrative expenses has been outsourced, and many US and European companies project that they can outsource half or more of this work to foreign locations.²³ However, another survey among 500 top European firms shows that only about 40% have relocated services abroad in the past and that almost 50% are not planning to offshore services in the future. This survey also reveals that over 50% of service offshoring by European firms is occurring within Europe. And within Europe, some countries like Ireland are significant net importers of offshored jobs from other European countries.²⁴

The prospect of a large and rapid offshoring of jobs has caused considerable unease among workers and politicians in both Europe and the US. Some companies have undoubtedly aggravated this concern by using the threat of offshoring to win concessions from their domestic workers. In Germany, for example, Siemens, Daimler-Chrysler and Volkswagen have recently confronted their workforce with the choice of lower earnings or moving parts of their production offshore.

Yet offshoring is not a new phenomenon. The recent debate triggered by the growing offshoring of business services has many similarities with the debate sparked by the offshoring of manufacturing jobs in the 1980s. Today, there is broad agreement among economists that the offshoring of manufacturing jobs has created net benefits for both host and home countries. Nonetheless, there is also agreement that the offshoring of manufacturing production from the US and Europe to low-wage locations in emerging market economies has imposed dislocation costs on individual workers who have lost their jobs and wages.

Like other forms of skill-biased technological change in production processes triggered by the IT revolution, offshoring has reduced the demand for low-skilled workers while increasing the demand for high-skilled workers in high-wage economies. These effects have been most pronounced in the US because American multinationals have relied on offshoring in manufacturing to a greater extent than their European counterparts. It has also been argued that the US tax code has encouraged offshoring by US multinationals because the corporate tax system permits them to defer taxation on their foreign earnings²⁵. In the US, the offshoring of manufactured products has contributed to the decline in both the absolute and relative wages of low-skilled workers compared to the wages of workers with a college education as well as growing wage inequality. One view is that about a quarter of the wage inequality in the US over the last twenty-five years is the result of low-wage competition from immigration, imports of labour-intensive products, and the offshoring of manufacturing production by American companies, all of which have resulted in sustained downward pressure on the wages of unskilled American workers.²⁶

The current wave of offshoring is no longer confined to blue-collar manufacturing jobs.²⁷ Increasingly, relatively high-skill, high-wage, white-collar service jobs that have traditionally been “non-tradable” are being offshored to low-wage locations.²⁸ Several factors are behind these trends. First, recent advancements in digital technology have made it possible to store and share information more easily. Second, there has been a rapid increase in available infrastructure for sending digital information around the globe at very low (and declining) marginal cost. Third, developing countries such as India and China have growing skilled workforces with labour costs a fraction of those in the OECD countries. Finally, the business environment has improved considerably in the major emerging markets over the recent past making them far more attractive as investment and production locations.

In terms of motivation, cost considerations have been the single most important driver of offshoring. Labour costs in many countries that attract offshored activities are 70-90% lower than in the advanced market economies. For example, the wages of Indian software engineers are about 25% of the wages of comparably skilled American software engineers (as measured between the late 1990s and 2003).²⁹ Offshoring service production in the presence of such large wage differentials can create substantial costs savings for firms, allowing them to reduce their prices and strengthen their competitive positions in global markets. Overall, average cost savings achieved through service offshoring in recent years have generally been around 30%.³⁰


Although cost considerations are usually the most important factor behind offshoring, other considerations including the quality of services, the quality of infrastructure, language skills requirements, particularly for the growing number of call centres, higher education, staff turnover, time zones, and cultural affinity, affect offshoring decisions.³¹ However, some of these *soft* factors such as quality improvements may be *ex post* rationalisations for offshoring rather than its initial motive. Further, there has been significant variation in the types of service jobs susceptible to outsourcing. In particular, those services that require no face-to-face contact, have


low set-up barriers, low social networking requirements, high cross-border wage differentials, high digitization and high information content have been most exposed.³²

Will the offshoring of service jobs by firms in the US, Europe, and other high-wage countries create net economic benefits for them and enhance the overall economic well-being of their citizens, even if some of them suffer job losses and wage erosion in the process? Economic logic suggests an affirmative answer to this question. Offshoring the production of intermediate business services to low-cost locations should enhance the productivity and competitiveness of American and European companies, allowing them to reduce their prices and earn higher profits. Higher profits in turn can finance more investment to improve existing products or produce new ones. Lower prices can stimulate greater demand resulting in higher levels of production and employment. And more competition and increases in demand can spark innovation, resulting in new jobs to replace those that have been offshored. A recent influential study by the Institute for International Economics in the US documents this “virtuous cycle of benefits from offshoring” for the IT sector. This study finds that the significant offshoring of component parts by American computer and telecommunications companies in the 1990s reduced the prices of computers and communications equipment by between 10% and 30%. Lower prices in turn stimulated the investment boom in IT and boosted productivity in industries using IT hardware, adding 0.3 percentage points to US economic growth and fuelling the rapid expansion of IT jobs for American workers.³³

Economic logic also suggests that the offshoring of software products and business services will have similar beneficial effects on economic growth and job creation in the companies and in the countries from which jobs are offshored. And countries like India and China that attract offshored jobs will also benefit through more jobs, higher incomes, and faster growth, allowing them to increase their demand for exports from the offshoring nations. In short, offshoring like other forms of trade should be beneficial for both exporting and importing countries.

But this conclusion rests on a critically important condition – namely, that the workers whose jobs are offshored in high-wage exporting countries find new jobs at comparable wages. Whether this condition is satisfied depends on both the flexibility of labour markets in these countries and the level of aggregate demand for their products. Moreover, even in a flexible labour market environment, like that in the US, offshoring may foster economic benefits for the nation while imposing substantial “dislocation” costs on workers who lose their jobs to offshoring and are compelled to search for others.

Recent studies by McKinsey document both the importance of labour market flexibility to the potential benefits from offshoring and the uneven distribution of these benefits. In one study, McKinsey estimates that \$1 of offshoring of business services production by American companies creates \$1.14 of economic benefits for the US economy and \$.33 benefits for the Indian economy. The gains in the US are primarily the result of cost savings for customers and investors, and the cost savings come primarily from substituting cheaper labour abroad for more expensive labour at home. Although the overall economy benefits, there are significant distribution effects. Shareholders get up to 62 cents of the total benefits while displaced US workers who find other jobs get only 47 cents. And overall nominal labour income falls compared to what it have been in the absence of offshoring. 

A closer look at the McKinsey logic reveals that the aggregate benefits to the US depend on two critical assumptions: the redeployment assumption or what percentage of workers who lose their jobs to offshoring find new jobs; and the assumption of what percentage of the wages paid to workers in the jobs they lose to offshoring are recaptured by the wages they receive in their new jobs. Using the historical trends of the US economy between 1979 and 1999, McKinsey estimates that 69% of American workers who lose their jobs to offshoring to India find a new job within one year and that on average these workers earn 96% of their former wages. , even in the flexible US labour market, nearly one-third of workers displaced by offshoring will not find a job within a year and of those that do more than half will take a job with lower pay. Older, unskilled,

and less educated workers are most at risk of suffering long-term or even permanent job and wage loss as a result of offshoring.

In several continental European countries, where employment practices are more rigid than in the US, the redeployment rate for displaced workers is likely to be much lower. If low enough, offshoring could result in an increase in the overall unemployment rate and a decrease in overall income in the offshoring country. Some McKinsey studies conclude that the German economy may lose about €0.25 for every €1 of offshoring of business services by German firms³⁴ and the French economy may lose €0.15 for every €1 of offshoring of business services by French firms³⁵. These results reflect the low redeployment rates for German and French workers who lose their jobs to offshoring.³⁶

The UK is clearly the leader in offshoring in Europe with the great majority of deals occurring in financial services.³⁷ However, despite the higher level of service relocation compared to other European countries, a recent academic study has shown that the export of services by far exceeds the import of services in the UK.³⁸ Furthermore, around 50% of job growth in the UK over the past two decades has taken place in business services, a category that accounts for only £1 in £20 of imports and just over £1 in £6 of exports. Yet, there is still little empirical evidence on how offshoring will affect the type, number, regional distribution, and skill content of jobs in the UK in the future. One consultancy report estimates that offshoring activities in the UK will displace just 3% of employees over 10 to 15 years and that amounts to around 6% of all job losses in 2004.³⁹

Compared to both Germany and France, labour markets in the UK are more flexible, and offshoring is likely to generate both company-level and economy-wide gains as in the US. But even in the UK, as in the US, offshoring may generate economy-wide benefits while imposing significant dislocation costs – in the form of lost wages and lost jobs – on individual workers.

3. Implications for Policy

There is growing concern among European citizens that the immigration of labour from low-wage countries and the offshoring of production to such countries will mean fewer jobs, lower wages and lower living standards. Yet as the preceding discussion indicates, neither economic logic nor the available empirical evidence justifies this concern provided European labour markets are sufficiently flexible to take advantage of the efficiency-enhancing, competition-enhancing effects of immigration and offshoring while easing the dislocation costs they impose on individual workers. The remainder of this paper focuses on policies to realize this goal.

3.1 Policies to Manage Migration

The empirical evidence suggests that immigration has not had a significant effect on job displacement among native workers. But this finding may reflect the fact that most OECD countries are already managing immigration flows. It is therefore conceivable that any further opening of borders may result in some negative transitional or even long-term employment effects on native workers, especially if future migrants are similar to them in skill and experience. Hence, the question arises as to whether there should be targeted policies to address displacement effects on native workers from immigration or whether existing general policies to help those who suffer job loss for any reason are sufficient. Given the strong preference across European countries to restrict immigration this is rather a theoretical question with little empirical evidence to direct policy makers. Whether there should be targeted and specific policies to help native workers displaced by immigration depends on whether they suffer disproportionately or are special in any other sense. It also seems plausible that any adverse employment effects that result from immigration will occur more slowly than similar effects caused by technological change or offshoring. On balance, it is hard to see a justification for policies specifically targeted to help native workers who suffer displacement or wage loss as a


result of immigration. Effective policies to assist all displaced workers regardless of the cause of their displacement should be adequate.

There is a strong preference in most developed countries for a managed immigration system to gain the benefits of demand-driven immigration while minimizing the downside risks – and foregoing any potential upside benefits – of supply-driven immigration. The main policy issue with such an approach is how best to design targeted demand-driven immigration schemes (e.g, the H1B visa programme in the USA and the High Skill Migrant programmes in the UK and Germany). The consensus seems to be around a ‘points’ based system (e.g, Canada or Australia as models) with points positively correlated with the skills, experience, and income potential of potential migrants and the sectoral needs of the economy.

However, economic consequences are only part of the controversy over immigration. In many European countries public opinion is often more concerned with the social implications of immigration. In response to concerns about the assimilation and integration of immigrants into broader society, a growing number of European countries now require immigrants to attend language and culture courses and civic education. Failure to comply with such requirements can trigger significant penalties such as lower unemployment benefits or reduced chances of obtaining resident permits.⁴⁰

3.2 Policies for Offshoring

Whether a country benefits from offshoring depends significantly on whether workers who lose their jobs to offshoring are willing and able to move to other jobs that pay equal or higher wages. And this in turn depends on the flexibility of that country’s labour market. To some, labour market flexibility means the absence of policies to help workers cope with job loss, and the US example comes quickly to mind. But as Denmark and the Scandinavian countries have demonstrated, labour market flexibility can be enhanced by “active” labour market policies that allow firms to dismiss workers at short notice while helping workers find new jobs through job relocation and training schemes. All of the countries in continental Europe that have employment ratios of over 70% have such active labour market policies. For example, in Denmark workers can be dismissed at short notice, and severance pay requirements are not high. Unemployment benefits, however, are generous and are available over four years with the most generous benefits available to lower-paid workers who are eligible to receive up to 90% of the wages they received in their previous job. Retraining is obligatory after a certain period of time, and unemployed workers are required to accept offers of employment or retraining in order to remain eligible for unemployment benefits. The Danish example suggests that successful active labour market policies combine an appropriate balance of incentives, obligations and benefits that focus on the “employability” of workers rather than on the number of jobs in a particular company or sector. A key challenge in the design of active labour market policies is how to provide income support for jobseekers while at the same time increasing their incentive to find and accept jobs. As a result, such policies usually involve both “activation measures” to encourage individuals to become more active in seeking new jobs and income support measures. The UK Jobseeker Allowance is an example of policy that has both features. Germany has also recently introduced some active labour market reforms—the so-called *Hartz* reforms.

Even though the British and German systems are very similar in some respects, they confront different problems both in terms of the numbers and characteristics of the unemployed. The UK has the lowest unemployment rate in Europe and Germany has the highest. The UK has been trying to improve the employability of specific groups such as the disabled and single parents, while Germany has been trying to reduce high unemployment rates across all categories with particularly high levels in the east. As such, the German experience may provide a test of whether the British scheme can be scaled up to work effectively during a recession. However, the fact that German and UK unemployment levels remain persistently different reinforces the broader point that differences in labour market institutions explain much of the difference in labour market outcomes.⁴¹  That extent, lower employment protection, fewer restrictions on the hiring and dismissal of workers, and until recently more restrictive and less generous benefits in

the UK compared to those in Germany and other continental European countries have contributed to the UK's superior performance in terms of employment levels and unemployment rates.

3.3 Distributional consequences of offshoring

While there is general agreement that offshoring can benefit the economy as a whole, the gains are likely to be spread unevenly across the population.⁴² In particular, displaced workers are at risk of losing out as discussed above. European governments offset some of the negative effects of job loss and unemployment by providing *income supplements* for unemployed workers, particularly low-income workers. However, it is important to design the tax and benefit system in such a way that accepting a new job makes economic sense for an individual worker. This is not the case in many European countries because such a worker may face a very high marginal effective tax rate – as much as 80% – if he accepts a new job at his previous wage level.⁴³ And the marginal tax rate can be even higher if the wage a worker receives in a new job is lower than the wage paid in his previous job.

One approach currently being implemented in the US, Canada and Switzerland and to some degree also in Germany (only to workers aged 50 or older) and France (only to workers who lose their jobs in “mass layoffs”) is that of wage insurance. The basic features of the approach are illustrated by the US scheme. The programme was introduced in 2002 and provides wage insurance for manufacturing workers fifty years or older who can prove that trade is a “major cause” of their job loss. The scheme pays eligible workers half the earnings that have been lost if they take a new job with a ceiling of \$10,000.⁴⁴ The goal of the programme is to encourage displaced workers to accept new jobs quickly to avoid the depreciation of their skills and experience. As noted earlier, older workers are much more likely to face long-term or even permanent job loss as a result of import competition or offshoring unless they are willing to accept new jobs at lower wages than what they earned in their previous jobs. Implementation of the wage insurance programme in the US has been very limited so far, and only a small number of people have actually been beneficiaries. Recently, it has been argued that service workers displaced by offshoring should have wage insurance extended to them. The proposed extension would include permanently displaced full-time workers with at least two years of tenure in their previous job.

The evidence on whether wage insurance has significant benefits is very limited. A controlled experiment in Canada provides evidence of modest employment effects from wage insurance but also finds no impact on the amount or duration of unemployment benefits.⁴⁵ Although wage insurance may be helpful in addressing the political fallout from offshoring, such an approach amounts to a wage subsidy programme that like any other wage subsidy scheme will distort prices in the labour market. For example, a firm may offer a lower wage to a worker eligible for wage insurance or a firm may specifically hire displaced workers who qualify for wage insurance because they are less expensive than workers who are not eligible. Such possible incentive effects have not yet been analysed in detail. Equally, the fiscal implications of an broad-based wage insurance programme are not fully understood. For example, a recent US study estimated that the proposed extension of wage insurance discussed above would cost up to \$4 billion a year.⁴⁶

3.4 Role of Education, Training and R&D

Improving skills and training has long been a major tool to enable displaced workers to find new jobs and shorten their time out of work. There are many challenges confronting European policy makers in the education arena. These include developing effective job-retraining programmes for such workers and designing educational systems that promote the acquisition of general skills rather than occupation-specific training, which has been the traditional focus for workers in Germany, France and Italy. Recent reforms in the UK have been designed to achieve the latter objective. Wage insurance may also serve as a training subsidy if it encourages displaced workers

to take up entry-level jobs providing training on the job while also saving them the opportunity costs of foregone wages during the training period. Policy makers tend to underestimate the ability of workers to acquire substantially more human capital on the job than in the classroom.

Improving human capital in general may help to reduce potential losses from offshoring. Education and training can have a significant impact on economic growth, particularly through the influence of human capital on the introduction and absorption of new technologies.⁴⁷ Furthermore, successful R&D policies can mitigate the effects of offshoring. Although most developed countries distribute only a fraction of their overall expenditure on physical equipment and structure to R&D, evidence suggests that the potential positive externalities to R&D investment are substantial and a major source of long-term economic growth.⁴⁸

Flexible labour markets are important, but their success hinges critically on the ability of an economy to create new jobs. Whether the offshoring of jobs will lead to net employment losses will very much depend on the job creation rate of an economy, and that in turn is closely linked to its productivity performance.

3.5 Interplay with immigration policy

Immigration and offshoring are not necessarily distinct phenomena and can happen at the same time and may even depend on one another. For example, immigrants are often prepared to work for significantly lower wages compared to natives for a given skill level and may therefore ease the cost pressures that encourage a business to offshore parts of its production to an emerging market location. Hence, policy solutions may benefit from a joint approach given the significant overlap outlined above.

Possible approaches could include selective changes to migration policy (e.g., skill quotas). For example, if offshoring leads to a loss of unskilled jobs in the advanced economies, channels for unskilled migration could be closed off. At a minimum, migration quotas could be used to mitigate job losses in a particular sector as a result of offshoring. In this respect, managed migration schemes can be used (either directly or indirectly) to address the employment effects of offshoring. If offshoring is primarily driven by wage differentials, more open borders could be expected to have an impact on wage levels in advanced economies. However, wage differentials between advanced and developing countries are very large, while a wage floor – often through a legally mandated minimum wage – will obviously limit the degree of wage flexibility.

4. Looking ahead – concluding remarks

Although there is some evidence from North America that significant immigration at the lower skill end of the labour market can lead to downward pressure on the relative wages of natives, so far the evidence from Europe has been that immigration has had little or no effect on either the wages or the employment levels of native workers. Based on the evidence, it is reasonable to conclude that while immigration may potentially have an impact on the distribution of wages across skill categories, it is unlikely to have a significant impact on the overall wage level.

Although the out-migration or offshoring of jobs is clearly increasing, the evidence about its long-term effects on wages and employment in the advanced industrial countries is still very limited and long-run predictions are fraught with uncertainty. On the one hand, as technological change raises the share of activities that are tradable, and hence shifts the size and composition of the global labour markets in which firms can feasibly operate, it is conceivable that these trends could unleash major and permanent relocations of work across borders, with associated shifts in relative wages. If this is indeed a plausible conjecture, then the obvious challenge for policy will be to address the consequences for the employment and wage prospects of those skill groups for whom the out-migration of jobs may have a significant adverse impact.

In Europe, the migration of jobs through offshoring is in its relative infancy and as yet has had no significant impact on the wages or employment rates of European workers. While the evidence from North America suggests that it will in the future, there are also reasons for being quite cautious about the size of these effects. For a start, offshoring has mostly been for functions – back office and the like – that are not generally deemed core to companies. Yet many functions within firms remain ill suited to offshoring for organisational and technical reasons, as well as because of coordination and other costs.⁴⁹ There is, of course, a large literature on firm organisation – stretching from the managerial to transactions costs – that provides reasons for why this has been and, in many cases, is likely to remain the case. Further, with plausible assumptions concerning labour supply elasticities, the cost advantage of offshore locations will steadily decline over time as labour and capital costs rise in such locations. Indeed, there is already evidence of labour supply constraints beginning to operate⁵⁰ in both India and China for certain kinds of skills and in certain locations. Hence, neither the demand nor supply side arguments necessarily support the notion that offshoring must accelerate radically in the years ahead. According to a recent analysis by McKinsey, only about 11% of the world's service-sector jobs can be performed at remote locations. Most services, including those associated with homes and with health must by their very nature be provided by workers in the same location as consumers.

What is clear, however, is that the impact of offshoring on European labour markets and the distribution of skills and income will depend mainly on the institutional context. In this regard, there are already important differences within Europe. The balance between job protection and benefits like unemployment insurance varies among European countries as does the extent to which active labour market policies are used to strengthen employability. Nonetheless, despite these differences, there is widespread agreement across Europe that policies to provide better incentives for job creation—including reducing the tax rate on labour—and to provide greater skill acquisition will be important to mitigating any adverse effects on the employment and wages of European workers from the out-migration of jobs to lower-cost locations in emerging markets.

Fears among European and American workers about the effects of immigration and offshoring for their jobs and wages are usually dismissed by economists and business leaders. And the evidence reviewed in this paper shows that at least to date these effects have been insignificant and the fears unwarranted. But such fears have a sound analytical foundation. As Richard Freeman⁵¹, a respected labour economist at Harvard University has recently pointed out, the global labour force has more than doubled over the last fifteen years as a result of the entrance of China, India and the former Soviet Union into the global system of production and trade. These new workers have brought little physical capital with them. As a result, their arrival has cut the global capital/labour ratio in half and this ratio is the primary determinant of worker productivity and pay. A lower capital/labour ratio also means that the distribution of income—the balance of negotiating power—has shifted in favour of the owners of capital and against labour. Overall, the doubling of the global labour force will mean that over the next several years average real wages are likely to grow more slowly in the advanced industrial countries and that many workers, especially those at the lower end of the skill distribution, are likely to face painful job dislocation and stagnant or falling real wages. So the challenges confronting European governments will be how to adjust their policies to take advantage of the efficiency gains from globalization—the lower prices, greater competition and growing markets—associated with the rise of China, India and other emerging markets while at the same time making sure that these gains are shared among their populations in accordance with their notions of equity and fairness.

Notes

- ¹ Ordered logit with base year of 1993 with age, tenure, time and regional dummies and occupational classification.
- ² C. Dustmann and I. Preston, "Is immigration good or bad for the economy? Analysis of attitudinal responses". CReAM Discussion Paper No.06/04 (London: University College, Centre for Research and Analysis of Migration, 2004) argue that the fiscal implications of immigration are more important.
- ³ Significant when using a Spearman test.
- ⁴ MORI, *MORI Political Monitor February: Topline Results* MORI 2005, www.mori.com/polls/2005/mpm050221.shtml
- ⁵ For a comprehensive review of statistics see OECD, "Trends in International Migration" (Paris: OECD, 2005)
- ⁶ Home Office, "Accession Monitoring Report" May 2005
http://www.ind.homeoffice.gov.uk/ind/en/home/0/reports/accession_monitoring.Maincontent.0012.file.tmp/AM.pdf
- ⁷ See e.g. Dustmann and Preston (2004)
- ⁸ For a comprehensive discussion on the economic effects of migration see e.g. Borjas, "The economic analysis of immigration", in O. Ashenfelter and D. Card (eds), *Handbook of Labor Economics*, Volume 3A, North-Holland, (1999), pp. 1697-1760 for a review of the most important studies.
- ⁹ See Borjas, G. (1999)
- ¹⁰ Pischke and Velling, "Employment effects of immigration to Germany: an analysis based on local labor markets", *Review of Economics and Statistics*, 79, 4, (1997), pp. 594-604. DeNew and Zimmermann, "Native Wage Impacts of Foreign Labour: A Random Effects Panel Analysis" *Journal of Population Economics* 7, (1994), pp. 177-192.
- ¹¹ Hunt, J., "The impact of the 1962 repatriates from Algeria on the French labor market." *Industrial and Labor Relations Review*, 45, 3, (1992), pp. 556-572.
- ¹² Winter_Ebmer, R. and J. Zweimueller, "Do Immigrants Displace Young Native Workers? The Austrian Experience" *Journal of Population Economics* 12, 2, (1999), pp. 327-340.
- ¹³ Dustmann, C., F. Fabbri and I. Preston, "The local market effects of immigration in the UK" (Department of Economics, University College of London Working Paper, 2003); Glover, S., C. Gott, A. Loizillon, J. Portes, R. Price, S. Spencer, V. Srinivasan and C. Willis, "Migration: an economic and social analysis", (RDS Occasional Paper No.67, Home Office, HMSO London 2001); Portes and French "The impact of freer movement of workers from central and eastern Europe on the UK labour market: early evidence", (Working Paper No.18, Department for Work and Pensions, HMSO London, 2005).
- ¹⁴ An exception are Angrist and Kugler, "Protective or Counter-productive? Labour Market Institutions and the Effect of Immigration on EU Natives." *Economic Journal*, 113, (2002), pp. 302-328, who find negative but mostly insignificant effects for some European countries.
- ¹⁵ For a summary of studies see Bruecker, H., Frick, J. R. and Wagner, G. G., "Economic Consequences of Immigration in Europe." (Mimeo 2004 <http://www.lisproject.org/immigration/papers/wagner.pdf>)
- ¹⁶ Borjas, G., "The labour demand curve is downward sloping: re-examining the impact of immigration on the labor market", *Quarterly Journal of Economics*, 118, 4, (2003), pp. 1335-74.
- ¹⁷ Borjas, G., "The Labour Market Impact of High-Skill Immigration" (NBER Working Paper 11217, 2005)
- ¹⁸ For example in Austria, Belgium, France and Holland the dependence on immigrants on welfare has generally been higher than that of locals, while the contrary has obtained in other European states, such as Germany, Greece, Portugal, Spain and the UK
- ¹⁹ Home Office, "The Migrant Population in the UK: Fiscal Effects" Development and Statistics Directorate Occasional Paper No. 77, www.homeoffice.gov.uk/rds/pdfs/occ77migrant.pdf (2002); IPPR, "Paying their way in: The fiscal contribution of immigrants in the UK" <http://www.ippr.org/econom/files/Paying%20Their%20Way.pdf> (2005)
- ²⁰ Forrester Research, "3.3 million US services jobs to go offshore," J.C. McCarthy, with A. Dash, H. Liddell, C. Ferrusi Ross and B.D. Temkin (11 November, 2002), at <http://www.forrester.com>.
- ²¹ Forrester Research, "Two-speed Europe: why 1 million jobs will move offshore," A. Parker, with D. Metcalfe and S. Takahashi, *Trends* (18 August 2004), at <http://www.forrester.com>; J.F. Kirkegaard, *Outsourcing and offshoring: pushing the European model over the hill, rather than off the cliff!*, Working Paper Series, WP 05-1 (Washington, DC.: Institute for International Economics, 2005).
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- ²³ The Economist, "Germany's Surprising Economy," *The Economist* (August 20th 2005).
- ²⁴ UNCTAD and Roland Berger Strategy Consultants, *Service Offshoring* (June 2004). United Nations, Geneva
- ²⁵ L. Brainard and R.E. Litan, "Offshoring" service jobs: bane or boon - and what to do?, Policy Brief No.132, (Washington DC: The Brookings Institution, 2004).
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- ²⁷ Tyson, L. A'D, "Outsourcing: who's safe anymore?", Economic Viewpoint, *Business Week*, 23 February 2004.
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- ³⁰ UNCTAD and Roland Berger Strategy Consultants. *Service Offshoring*, 2004

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- ³¹ UNCTAD, *World Investment Report 2004: The Shift Towards Services* (New York and Geneva: United Nations, 2004).
- ³² A. D. Bardhan and C. Kroll, “*The New Wave of Outsourcing*”, Fisher Center Research Reports No.1103 (Berkeley: Fisher Center for Real Estate & Urban Economics, University of California, 2003).
- ³³ C.L. Mann, *Globalisation of IT services and white-collar jobs: the next wave of productivity growth*, Policy Brief 03-11 (Washington, DC: Institute for International Economics Policy Briefs, 2003).
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- ³⁵ McKinsey & Company, *How offshoring of services could benefit France*, McKinsey Global Institute (June 2005).
- ³⁶ See also D. Farrell, “Offshoring: value creation through economic change,” *Journal of Management Studies*, 42, 3, (2005), pp. 675-683.
- ³⁷ See UNCTAD, *Investment Report 2004*, and European Monitoring Centre on Change, *European Restructuring Monitor Statistics* (2005), at <http://emcc.eurofound.eu.int/erm>.
- ³⁸ L. Abramovsky, R. Griffin and M. Sako, “*Offshoring of business services and its impact on the UK economy*”, Research Briefing Note (London: Advanced Institute of Management, November 2004).
- ³⁹ Forrester Research, *Two-Speed Europe*.
- ⁴⁰ For an overview see OECD, *Trends in Immigration* (Paris: OECD, 2004).
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- ⁴⁸ Dowrick, S., “*Investing in the Knowledge Economy: Implications for Australian Economic Growth*”. (Working paper, Australian National University for a summary 2002).
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