LABOUR MARKETS IN THE EUROPEAN UNION

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A large portion of Europe is well on its way to becoming an economic entity comparable to the United States in terms of size, industry structure, and income levels. The employment performance of European economies compares unfavourably to recent U.S. experience, however, and their labour markets are much more heavily regulated than American ones.

The character of labour market regulation

Regulation aims at protecting workers from "unfair" labour market developments by means of two interrelated instruments. Employment-protection legislation (EPL) makes it costly or difficult for employers to terminate jobs without cause, i.e., for reasons related to the firm's overall business conditions rather than to the specific worker's performance and effort. Both theory and evidence indicate that more stringent EPL tends to smooth out employment fluctuations in the short and medium run and, for given wage behaviour, does not have important effects on average long-term employment.[1] Institutional features of rigid European labour markets, however, also limit the extent to which wages may fluctuate over time and differ across workers performing similar duties. Like employment protection, wage-compressing institutions take a variety of forms. Obviously, minimum-wage provisions tend to limit the range of wage rates; a little less obviously, unemployment benefits and other welfare payments also tend to truncate the lower end of wage distributions, since generous non-employment income flows reduce incentives for workers to accept low wage offers when searching for jobs. Most importantly, the terms of employment contracts are often negotiated between nationwide unions and employer confederations, and firm- and individual-level negotiations have a much less important role in Continental Europe than in the United States. Centralised bargaining of labour contracts quite naturally tends to compress wages.[2] Limits to the flexibility of employment levels and of wages reinforce each others' effects in "protecting" workers from labour market pressure, and overall wage inequality is typically lower in the same countries that tend to impose tighter restrictions to firms' freedom to reduce employment at will.[3]

Limited flexibility of employment levels and of wages protect workers

Regional aspects of labour market rigidity

The geographical configuration of labour markets within European nations and within the U.S. are most directly relevant to the possible consequences of fixed exchange rates and progressive erasure of national borders by economic integration.[4] European evidence on institutionally compressed regional wage differentials and limited labour mobility contrasts sharply with American labour markets dynamics. While the typical interregional pattern of labour market conditions has no persistence over a typical American business cycle, regional unemployment rankings are extremely persistent within the large Continental European nations. And earnings are more sharply dispersed in the U.S. than in

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[1] See Bertola (1999), "Microeconomic Perpsectives on Aggregate Labor Markets," O. Ashenfelter and D. Card (eds.), *Handbook of Labor Economics* Vol. 3, North-Holland, forthcoming; OECD (1999), "Employment Protection and Labour Market Performance," *Employment Outlook*, Paris: OECD, and references therein.

[2] See OECD (1997), "Economic Performance and the Structure of Collective Bargaining," *Employment Outlook*, Paris: OECD.

[3] Guiseppe Bertola and Richard Rogerson (1997), "Institutions and Labour Reallocation," *European Economic Review* 41:6, 1147–1171.

[4] Relevant references include: Olivier Blanchard and Lawrence F. Katz (1992), "Regional Evolutions" *Brooking Papers on Economic Activity* 1992:1, 1–74; Jorg Decressin and Antonio Fatas (1995), "Regional Labor Markets in Europe", *European Economic Review* 39, 1627–1655; Giuseppe Bertola and Andrea Ichino (1995), "Wage Inequality and Unemployment: U.S. vs, Europe", in: B. Bernanke, E.J. Rotemberg (eds.), *NBER Macroeconomics Annual 1995*, pp. 13–54; Maurice Obstfeld and Giovanni Peri (1998), "Regional Non-adjustment and Fiscal Policy", *Economic Policy* 26, 207–247; Juan F. Jimeno and Samuel Bentolila (1998), " Regional Unemployment Persistence (Spain, 1976–1994)" *Labour Economics* 5, 25–51.

European countries, where institutional wage compression has prevented earnings from becoming more dispersed over the 1980s and 1990s.

To interpret this evidence, consider the possible sources of geographic wage differentials in *laissez-faire* labour markets. On the labour demand side, workers may be compensated differently across regions because their productivity is heterogeneous. On the labour supply side, migration towards high-wage areas should proceed until earnings differentials compensate workers' mobility costs. Hence, wage differentiation and costly labour mobility are perhaps socially unpleasant, but certainly efficient features of an unregulated labour market. From this dynamic perspective, it is far from surprising that in Europe compressed wage distributions are associated with highly persistent unemployment differentials across regions. In an unregulated labour market, a negative shock to local labour productivity should result in lower equilibrium wages, a reduction of local labour supply via migration, and possibly some frictional unemployment. This is indeed what typically happens in the United States, where adjustment falls in roughly equal portions on wages and on unemployment (Blanchard and Katz, 1992). In European regions, conversely, wages respond very little to local labour market conditions, migration rates are extremely low, and all shocks are absorbed by labour-force participation and unemployment changes (Decressin and Fatas, 1995; Jimeno and Bentolila, 1998). European institutions prevent wages from adjusting to local labour market idiosyncrasies and subsidize low-employment equilibria in relatively depressed regions. European workers may have no incentives to move away from high-unemployment areas. Compressed wage differentials are too small to compensate migrants for mobility costs and cost-of-living differentials. Labour market rigidity further implies low job-finding rates (relative to the U.S.) in the low-unemployment regions, where firms' propensity to hire is reduced by forward-looking concerns as to the possibility of reducing employment in the future. In the resulting, quite stable politico-economic equilibrium, workers of better-developed regions are protected not only from wage competition by residents of poorer regions, but also from immigration.[5]

In European regions, wages respond very little to local labour market conditions

The aftermath of EMU

How will the institutionally rigid labour markets of Europe cope with Economic and Monetary Union? The economic size of the Northeastern, Midwestern, Western, and Southern groups of states within the U.S. is comparable to that of the large European Union nations. Hence, wage and employment dynamics across American macro regions offer a rough and necessarily vague picture of what a fully integrated European Union's labour markets might look like if they adopted U.S.-style institutions.

Historically, as Figure 1 illustrates, the dynamics of relative unemployment rates *across* the larger European countries have been quite volatile, in contrast to the very stable pattern of relative regional unemployment rates across regions *within* each of them.[6] And while regional wage inequality is remarkably stable or even decreasing within each European nation, European relative wages have been historically quite volatile across coun-

[5] For simple formal models of similar mechanisms see Antonio Spilimbergo (1999), "Labour Market Integration, Unemployment and Transfers," Review of International Economics (forthcoming).
[6] The line labeled "US macroregions" reports rank correlation statistics across four groups of US States, averaged across 11-year periods starting in 1980, 1981, 1982, 1983. The data and the regional classification of States are taken from the Bureau of Labor Statistics Web pages, at http://stats.bls.gov/blshome.htm. The line labeled "EU Nations" similarly reports rank correlation statistics across Germany, France, Italy, and the United Kingdom, averaged across 10-year periods starting in 1983, 1984, 1985. The data are OECD standardized unemployment rates; the series for Germany refers to West Germany through 1991, then to United Germany. The qualitative message of the data is similar for other sub-periods within the available data set.

Fig. 1

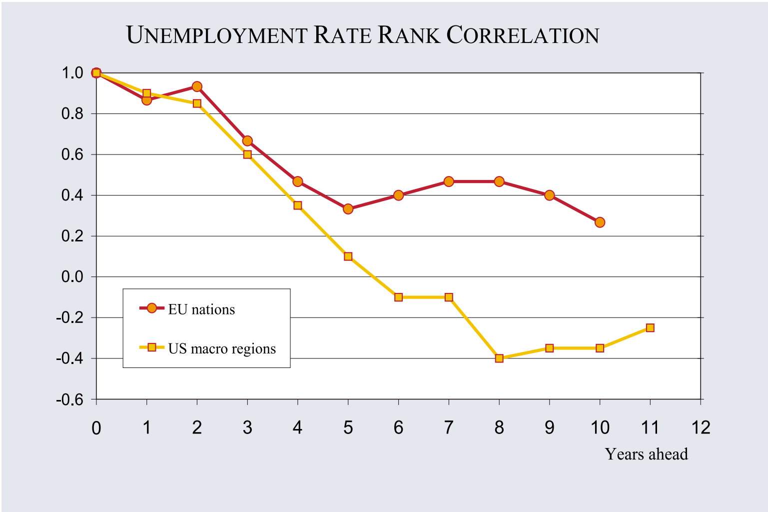
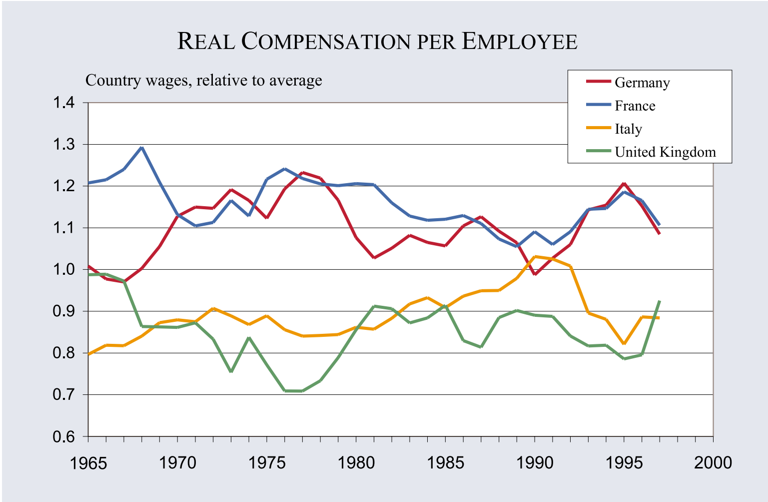


Fig. 2



privilege cost-efficiency and to decrease their generosity when politically feasible. Flexibility-oriented reforms, however, need not be easy to implement in the new environment of increasingly uncertain and turbulent economic interactions, which may actually generate new calls for protection. And in the absence of federal safety nets and fiscal mechanisms that even remotely approach the size of those implemented in the United States, unfettered competition among subsidiary social policies could well result in race-to-the-bottom dynamics and make it impossible for government intervention to correct market failures.[8]

tries, as Figure 2 illustrates: a convergent pattern of decreasing inequality in compensation per employee is broken by sharp divergent episodes in the late 1970s and the early 1990s.[7]

The mechanisms behind the broad similarity of European and American labour market outcomes are, however, quite different. In the U.S., adjustment is achieved by interregional labour mobility and explicit variation of nominal and real wages. Across European countries, conversely, inflation differentials and infrequent exchange rate realignments used to generate relative-wage and unemployment patterns. Absorption of exogenous shocks by such monetary instruments generates smaller within-country redistributive tensions than explicit wage differentiation would. As a single monetary policy and irrevocably fixed exchange rate parities remove both sources of past wage flexibility, it is natural to wonder whether labour market outcomes in an integrated European Union will more closely resemble the past experience of the United States or that of each European nation.

As the extent of economic integration approaches that of the United States, labour market institutions and labour market outcomes may also begin to resemble their American counterparts. In general, "protective" institutions become more cumbersome when market pressure increases: competition among national labour market institutions tends to

Fiscal aspects

Explicit coordination of the reform process, while preferable on theoretical grounds, may dangerously tend to reproduce current nation-level rigidity on a continent-wide scale. Alongside the labour-market regulation aspects emphasised above, however, fiscal instruments also play an important role within each European nation. Subsidisation of low-productivity labour markets is an important element of national European experiences. Budgetary constraints and Europe-wide competition make it increasingly costly to subsidise high-unemployment equilibria in each nation's less developed regions, and should lead to lower labour market rigidity. As to international labour mobility, the key ingredient of labour market configurations within the larger European nations is absent in the wider continental context, where international transfers are strictly limited. Thus, the very same lack of fiscal integration that makes American deregulation unfeasible in Europe also makes it impossible to subsidise high-unemployment outcomes across the borders of European nations. As long as the overall European Union budget is limited to 1.26% of GDP, it is safe to predict that the labour markets of the European Union will not resemble their own past selves or their American counterparts as closely as may be feared or advocated.

With EMU, the sources of past wage flexibility have been revomed

[7] The Figure's data are drawn from the harmonised OECD database, and measures of dispersion are not weighted by the size of the four nations. The overall picture is very similar, however, if weighted data or data from the Eurostat database are used over the more limited period where either or both are available.

[8] Hans-Werner Sinn (1998), "European Integration and the Future of the Welfare State," CEPR D.P. 1871.