

The Labour Market and the Euro

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Abstract

This paper investigates the reasons that the labour market is given so much prominence in discussions about the euro. It concludes that differences in labour market flexibility across countries can have the same impact as asymmetric shocks and so warrant different monetary policies. The paper further discusses the role of welfare policy and migration in European integration.

Keywords: Cyprus Euro, Labour Market Flexibility, Social Protection, Migration.

When the United Kingdom was considering whether to adopt the euro or not, the then Chancellor of the Exchequer, Gordon Brown, set down five criteria for UK entry. The most critical ones related to the labour market, and they were, in particular, about labour market flexibility (HM Treasury, 2003). When Sweden, which unlike Britain has not opted out from joining the euro, was contemplating entry it set up a Commission, headed by a labour economist, to report on the feasibility of entry. The report gave a lot of weight to the role of labour markets in the eurozone and Sweden (Calmfors et al, 1997; see also the special issue of Swedish Economic Policy Review, vol. 4, no. 2, Autumn 1997). According to the OECD (Nicoletti et al, 2000), the most flexible labour markets in Europe are in Denmark, Britain and Sweden, the three countries outside the eurozone. (Ireland also has flexible labour markets – the decision to adopt the euro was probably influenced more by politics than by economics.)

Why is the labour market so important for the euro? Adoption of the euro fixes the exchange rate between major trading partners and constrains monetary and fiscal policy. Why is so much influence given to labour in this scenario?

I want to highlight two reasons for the importance of labour markets. The first is that labour market rigidity – the inability of labour markets to

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respond quickly to new challenges – can be offset to some extent by monetary and fiscal policy. If the members of the eurozone have different degrees of labour market flexibility they will require different monetary policies, even if they are subject to the same shocks. This is not a good basis for a successful monetary union.

Compare for example Britain and continental Europe between the mid 1990s and the late 2000s. Britain had a bigger and longer boom than Europe had, supported by its more flexible economy. Because of it, its monetary policy was tighter than in the eurozone throughout this period. One might argue that the European Central Bank, because of the more rigid institutional structure and less flexible labour markets in the eurozone, was forced to keep interest rates lower and monetary policy more expansionary than it would ideally want to do in a period of global expansion. This policy would have been inappropriate for Britain. I suspect Ireland would have also been better off with a British-like policy than with a eurozone one. Closer to home, I also suspect that Cyprus would have increased its interest rates in 2006-07 had it not been for the euro.

This much, however, was well known when the euro was being planned, and I suspect it is the main reason that Britain and Denmark were unwilling to commit to the euro. But more recently, a new factor has emerged as potentially more important for the smooth functioning of European labour markets. At the core of this factor is the strong support that there is in Europe for welfare programmes and social protection. The challenge is how to ensure the co-existence of flexible labour markets with social protection; and how to accommodate internal migration in the face of different degrees of social protection across the eurozone.

European governments will provide welfare and social protection to their citizens, irrespective of the euro. How much social protection is provided is decided at the local level and it varies a lot across the European Union. But there is also a lot of regulation of labour relations in Europe. I believe that excessive regulation is bad for employment and does not help the smooth functioning of social protection measures. We can have good social protection with flexible labour markets and this should be the objective of European policy.

Let me briefly review current European experience (see, for example, Esping-Andersen, 1999, and Ngai and Pissarides, 2008). Scandinavian countries have extensive social protection systems with social services directly provided by the state. Yet, they also have flexible labour markets. Britain and Ireland also have flexible labour markets, but in contrast to the Scandinavians, they rely on the market to provide social services, with

some support given only to target groups. The state plays a less active role and taxes are lower.

France and Germany give lots of money away in the form of social transfers. They believe that the family should provide social protection and give away funds, in the form of social transfers, to support it. And finally, Italy and Greece provide very little social protection through the state, relying again on the family to provide it. But these countries, especially the southern European ones, also try to provide some of the social protection by regulating employment. This is not good for employment. With poorer employment outcomes, the tax base is reduced and so it becomes more difficult to raise the revenue required to support welfare measures. This encourages more regulation, which does not cost the government money. A vicious circle of regulation and low employment outcomes is set in motion, with low welfare support as the inevitable outcome.

It is difficult to explain to voters, and sometimes to social partners, that the regulation of employment is not good for employment and growth. This is why reform is so difficult to achieve. Take for example job security. Many countries have job security legislation, or if not legislation, agreements with unions about dismissals of employees. One may think that job security legislation is good for employment because it guarantees a job and reduces dismissals. In fact, there is no evidence that it is good for overall employment (see OECD, 1999). It is an obstacle for quick adaptation to new conditions, to structural change and to the economic growth that follows them.

When there is strict employment protection legislation, employers are more careful about whom and how many workers they hire. They prefer to keep the jobs within the family, keep the company small and not hire from outside, unless they know for sure that they will need the worker for a long period of time. Risky hiring in response to new challenges will not take place. But many new successes and “growth miracles” start off as small risky concerns.

Another implication of employment protection is that many employers will try to avoid the measures by going to the grey market. Jobs here are completely unprotected and workers are worse off than they would be in less regulated normal employment. In its attempts to provide job security to the workforce, policy throws some workers into a completely unprotected sector. It also loses out completely on tax revenue. It ends up protecting mainly public sector employees and employees of large companies.

Look at European countries. The countries with the least regulated labour markets (Britain, Netherlands, Scandinavia) are also the ones with the

biggest employment levels, especially for women, who find more part-time and other "atypical" jobs that accommodate the demands of family life. The ones with the most regulated labour markets (Italy, Greece, Spain) are also the ones with the biggest underground economy, the smallest protected sector and the lowest female employment levels.

The employee who benefits from job security legislation is the one who intends to get a job and stay there for the rest of his or her life. Usually such employees are men in their prime age. It works against women, young workers and immigrants. But these latter groups are the very groups that the European Union is now trying to help. It makes their integration into the economy a lot more difficult.

Labour market rigidity becomes even more costly in an integrated world like the one created by the euro. In an integrated world there is more competition in product markets. It is important in this world that labour markets are in a position to respond quickly to this competition. If a country has rigid labour-market institutions it is more likely to lose jobs to its partners when their output markets are integrated. The cost of poor labour market institutions is bigger in a more competitive world. Employers will move away from the regulated regions within the eurozone to the more flexible ones in order to gain a competitive advantage in the European or world export market.

It is not a coincidence that Ireland has been the main beneficiary from integration. It has a flexible labour market that attracts a lot of jobs, both from European companies and from foreign ones, especially American ones.

An issue that is attracting a lot of attention in the European Union and is closely linked to welfare programmes, is the issue of migration. Migration in an integrated world is potentially a big force driving reform. The European Union is struggling to find a good policy towards migration in view of the diverse welfare systems in place in Europe.

From a global welfare point of view migration is good. The European Union undoubtedly benefits from migration. Migrants move to regions where there are labour shortages or to where labour is more productive. This is good for European output as a whole. So why is there generally opposition against immigration, or if not opposition, why does migration arouse such strong sentiments?

In free labour markets it is inevitable that migrants will compete with domestic labour. This might adversely affect the wages of particular labour groups. It is good for the economy as a whole but not for the groups directly affected. Migrants do not "take jobs" from native labour. They also

create demand. There is no evidence that unemployment is higher in countries that accept more migrants. However, wage moderation might be an outcome.

Another factor that generates opposition to migration is that migrants do take advantage of the welfare systems of destination countries. Because welfare systems are administered nationally in the European Union, there are large differences in the generosity of national systems. Large-scale migration to countries that have generous systems may impose heavy burdens on taxpayers and render the systems unsustainable. The likely outcome is either restrictions on migration or reform of the welfare systems. Public demand is likely to be in favour of restrictions on migration because European nations have a long tradition of welfare systems which are not likely to change in response to migration.

There is no evidence that migrants move to parts of Europe with more generous welfare support just to take advantage of welfare. But there is evidence that once they move, migrants do take advantage of welfare support when available (see Zimmermann, 2005, especially the long introduction).

There have been calls in the European Union for restricting the access of migrants to the host nation's welfare system for a short period of time. In particular, if migrants become unemployed soon after moving, their home nation should support them. But if this is accepted, the logical next step is that since most migrants move into jobs, the home nation should also receive the taxes they pay. This would obviously be unacceptable to the host nation as shifting the burden of unemployment to the home nation, is a policy that cannot work in an integrated world.

Despite the increase in migration in European countries, it is still the case that labour is much less mobile than capital and European labour markets operate more like closed national markets than like regions in an integrated European market. The adoption of the single currency makes comparisons across member-countries easier and is more likely to increase cooperation and exchange of ideas between the social partners. It is imperative in this case that trade unions and policy-makers bear in mind that although they are partners within the eurozone, they are also competitors for job creation. Welfare systems and wage scales cannot be exported from one partner to another. Wages and welfare support should reflect local productivity, not wages in the most productive region of the eurozone. Otherwise employment in the least productive regions will suffer. This is the hard lesson learned from German unification, when Western German wage systems and welfare support were transferred to

the much less productive East. Nearly twenty years later the problems are still present and they still influence policy in the eurozone as a whole.

Another factor that labour leaders should bear in mind is that joining a large union like the eurozone brings some changes to relative prices. In the case of countries like Cyprus, the prices of traded goods are likely to come down but the prices of goods that are not traded, especially land, should go up. The prices of traded goods come down because in an integrated world countries buy from the cheapest producer in the union. Less efficient firms go out of business in the face of competition from the more efficient ones and each country is producing only the traded goods in which it has the comparative advantage.

But with non-traded goods, like most services and land, the opposite is true. The price of services is expected to go up, because wages increase from the gains in productivity achieved through economic union. Services do not usually benefit from these productivity gains, so those engaged in them need to put up their prices, to be able to reward themselves and their workers at the higher levels that workers are rewarded in the traded sectors. If labour is internationally mobile, the push on wages, and by extension on the price of services, will be even stronger. If Cypriot workers are attracted by higher wages elsewhere in the eurozone, Cypriot employers will have to pay more to attract and retain labour.

The price of land is also likely to go up after joining a union characterised by higher wages and prices. Land is in fixed supply and non-traded. In a growing economy its demand rises and any increase in demand is passed on to higher prices. So the productivity gains from economic union eventually filter through to higher land prices, as those who benefit from the gains buy more land. Once foreign investors realise that land prices in a member of the union are way below those elsewhere, they add to the land inflation by buying land as an investment.

It follows that the adjustments that are currently taking place in Cyprus in the relative prices of land and services are inevitable. These should not be followed by demands for wage rises, or by automatic anti-inflation wage rises, to offset any erosion to the purchasing power of wages. This is not inflation caused by monetary factors. It is an adjustment in relative prices necessitated by economic integration, and wages should be allowed to adjust to the new system of relative prices on the basis of labour productivity and mobility potential, not automatically through indexation.

Strong support for welfare and social protection is not incompatible with a well-functioning labour market, as countries like Denmark and the Netherlands have shown. But there are also failures. Flexibility with respect to the setting up companies, preparing accounts and reports,

taking on and dismissing employees is compatible with social protection. In fact, it helps social protection, because it attracts into employment workers who would otherwise rely on the state.

Social protection also requires taxation. When employment is more flexible more workers will come into the legal economy and add to the tax base. But high taxation itself can discourage employment and growth. This is especially true of low wage jobs, which are more responsive to taxation. In an integrated economy with migration growth it is important to deregulate and not tax low-wage jobs, to encourage job creation. How much taxation is paid for by higher earning workers and by consumers is a choice that society should make, bearing in mind that the more demand there is for social protection, the more tax revenue is needed to finance it. But the main message is clear. Social protection should not be used as an excuse to regulate labour markets, because it will set in motion a vicious circle that will eventually lead to less employment, more reliance on the state and eventually less social protection. The costs of this vicious circle are much higher within the eurozone than without, and although they fall mainly on the “guilty” countries, they also hurt the rest of the eurozone.

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