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Labor Markets in the European Union

GIUSEPPE BERTOLA

RSC No. 99/24

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Labor Markets in the European Union

GIUSEPPE BERTOLA

EUI and CEPR

EUI Working Paper **RSC** No. 99/24

BADIA FIESOLANA, SAN DOMENICO (FI)

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Abstract[*]

This paper addresses aspects of the interaction between labor market institutions and the process of Economic and Monetary Union in Europe. It reviews the nature and possible motivation of institutions which limit both wage and employment flexibility in Europe, with particular attention to the geographic dimensions of labor market rigidity. As a fully integrated economic area, the European Union is in many ways comparable to the United States. Institutionally compressed regional wage differentials and limited labor mobility within each European nation contrast sharply with U.S. labor market patterns, however. In the aftermath of EMU, European labor markets will need to be different from their own past selves, but may find it politically difficult to approach their American counterparts.

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1. Introduction

The Single European Act led to complete dismantling of trade and labor mobility barriers in 1992, and the Maastricht Treaty led to irrevocable fixing of exchange rate parities and adoption of the Euro currency by 11 of the 15 members of the European Union on January 1st, 1999. Thus, 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 poor employment performance of many European economies, however, contrasts sharply with U.S. experience. Institutional and structural characteristics may explain such divergent labor market outcomes, and much has indeed been written about the possible role of labor market rigidities in shaping the poor performance of European labor markets. It is natural to wonder how the institutionally rigid labor markets of Europe may cope with the extensive structural change to be expected in the process of irreversible economic integration, and with the more intense exposure to ongoing shocks they will likely experience within a large fully integrated economic area. Speculation about the future is difficult, because the scale and scope of European economic integration has no precedent, and is especially difficult for an economist because political interaction will certainly play an extremely important role in the process of reshaping European labor market institutions. Useful indications may however be gathered from an extrapolation of past experience: what we have learned about the performance and institutions of national European labor markets, in contrast to their American counterparts, is certainly relevant to the matter at hand.

This paper studies data and economic mechanisms relevant to the interaction of European labor market structure with the process of irreversible and complete economic integration envisioned in the context of EMU. Geographic aspects of labor markets within European nations are most directly relevant to the possible consequences of fixed exchange rates and progressive dismantling of national economic borders. Hence, the paper pays particular attention to regional dimensions of labor market institutions in the U.S. and within the larger E.U. countries, also studied from a similar perspective by Eichengreen (1993), Decressin and Fatas (1995), Bertola and Ichino (1995), Obstfeld and Peri (1998), Jimeno and Bentolila (1998), and Mauro et al. (1999).

Section 2 briefly reviews the nature and possible motivation of institutions which limit both wage and employment flexibility in Europe. Section 3 focuses on geographical dimensions of labor market rigidity. Simple empirical evidence on institutionally compressed regional wage differentials and limited labor mobility within each European nation contrasts sharply with American labor market dynamics. Section 4 characterizes the new challenges posed by EMU. Forecasts of labor market outcomes in the aftermath of EMU should be bracketed by the current U.S. configuration, and by the past experience of European countries (like Italy and post-unification Germany) whose regions feature very diverse levels of economic

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development. Italy is an economic and monetary union since 1870, and a collection of diverse local labor markets since the 1970s. Comparative evidence from Italy's regions, sketched in Section 5, gives some indication of what might happen if labor market regulation were to be extended to the whole European continent. Uniform regulation of very different labor markets prevents wage differentials from spurring labor mobility, condemns less developed regions to persistently high unemployment, and requires extensive fiscal transfers to be sustainable. A concluding section discusses interactions between institutional and fiscal aspects of regional labor market configurations, and outlines how the politically stable *status quo* of the larger Euro-area nations may conflict with increasingly necessary economic flexibility.

2. The Character of Labor Market Regulation

European labor markets are, of course, much more heavily regulated than American ones. Labor market regulation takes many different forms within and across European labor markets (see Blau and Kahn, 1999, and Bertola, 1999, for more detailed information, formal analyses, and further references). At a very general level, however, regulation aims at protecting workers from "unfair" labor market developments, and does so by means of two interrelated instruments.

On the one hand, 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.[1] Such legislation exists in all advanced countries, including the U.S. where, for example, the Worker Adjustment and Retraining Notification (WARN) Act of 1988 requires covered firms to provide employees with 60 days' advance notice of plant closures and large-scale layoffs. Employment reduction entails more stringent advance notice, severance pay, and/or administrative provisions in all European countries. The varying stringency and effects of such provisions across countries and over time has been extensively studied (see OECD, 1994 and 1999, Bertola, 1999, and references therein). 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 behavior, does not have important effects on average long-term employment.

On the other hand, institutional features of rigid European labor markets 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

[1] Legislation also typically protects workers from a different type of "unfair" dismissal, i.e., from job loss due to discriminatory behavior on the part of employers. The motives and implications of such provisions are somewhat similar to those of legislation aimed at shifting the impact of adverse market developments from (weaker) workers to their employers.

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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 typically negotiated between nationwide unions and employer confederations in European countries, where firm- and individual-level negotiations have a much less important role than in the United States. Union-negotiated contracts are often administratively extended to all workers in the covered sector, whether they are union members or not, and centralized bargaining of labor contracts quite naturally tends to compress wages (see OECD, 1997). Almost by definition, coordinated wage agreements across sectors have beneficial macroeconomic effects. The extent of centralization or "corporatism", however, does not feature a strong empirical association with employment creation and wage moderation. Rather, it does appear strongly to compress the dispersion of wage rates across workers in all geographic units and industries.[2]

The quantity and price dimensions of labor market rigidity are interrelated in obvious ways. The extent of job security granted to employees is often evaluated on the basis of simple qualitative rankings. In Table 1, countries are listed in order of increasing job market flexibility according to rankings developed by Grubb and Wells (1993) and others on the basis of institutional information for the period spanned by the Table's other data. Italy and the U.S. are unambiguously located at the opposite extreme ends of the employment-protection spectrum; France and Germany are somewhat more flexible than Italy; and the U.K. institutional structure is much closer to that of the United States. The other relevant aspect is the extent of institutional wage compression, reflecting centrally negotiated union contracts, minimum wages, and generous non-employment benefits. The simple statistics reported in Table 1 confirm that overall wage inequality is lower in the same countries that tend to restrict firms' freedom to reduce employment at will (Bertola and Rogerson, 1997).

This is unsurprising, because job security and wage compression (like a host of more explicit welfare-state policies) are similarly motivated by the desire to protect individual workers and groups of workers from "unfair" market pressure. Limits to the flexibility of employment levels and of wages reinforce each others' effects. Quantitative firing restrictions could hardly be binding if wages were completely unrestrained and could decrease so much as to make stable employment profitable, or to induce voluntary quits. And centrally negotiated (hence uniform and stable) wage rates would not offer much effective protection to workers if they resulted in more

[2] In the United States, a similar tendency to equalize wages may be a relevant factor within the unionized segments of the manufacturing sector, or within multi-establishment firms. Recent trends, however, indicate that "workers ... no longer insist on maintaining wage scales across a company's various operations, or even see the need to do so" (Alan Krueger, as reported in the *New York Times*, March 22 1999).

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frequent dismissal by employers unrestrained by employment-protection legislation. The combined policies may be motivated by a desire to amend market incompleteness, especially by financial market imperfections – which generally imply that contracting parties may not correctly evaluate the ultimate consequences of arrangements that might appear optimal at a particular moment. They may also, however, reflect organized labor's incentive to prevent underbidding by the unemployed, and ensure high-wage, low-employment outcomes in the labor market. This mechanism may rationalize the empirical association of compressed wage distributions and stringent employment-protection legislation not only with each other, but also with fast wage growth and persistently high unemployment rates (see Saint-Paul, 1996; and Bertola, 1999, for some simple evidence and further references).

3. Regional Aspects of Labor Market Rigidity

The Figures below display simple evidence drawn from the experience of the three largest countries of the Euro area (Germany, France, and Italy) and of the United Kingdom. After the Thatcher reforms of the 1980s, the U.K. labor market is not as heavily regulated as those of continental European countries; and, since the U.K. is not taking part in the EMU experiment, its empirical characteristics are a useful source of comparative evidence in both respects. Data from the United States, which is roughly comparable in overall size to the aggregate of European countries, offers a useful reference point for a study of the effects of labor market flexibility and economic integration. 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 an equally rough and necessarily vague picture of what a fully integrated European Union's labor markets might look like if they adopted U.S.-style institutions. Not all data are available for all countries and all time periods and, of course, even when data are in principle available they need not be fully comparable across countries and over time. This paper cannot offer a discussion of the many relevant data-definition issues; readers should be warned that the simple evidence displayed below is suggestive, though likely to be robust.

As is well known, the U.S. unemployment rate has recently been trending downwards, in sharp contrast to the increasing trend of its counterpart in most European countries. American unemployment rates are also historically more volatile than those of continental European countries. Figure 1 displays standardized unemployment rates for the four European countries mentioned above. Unemployment rates are higher, tend to increase, and are relatively stable in the three continental European countries, and appear to be converging (to 12% or so) as full Economic and Monetary Union approaches. The U.K. unemployment rate behaves very similarly to that of Italy, Germany, and France until the early 1980s and then

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with the Thatcher reforms, becomes roughly as volatile as the U.S. unemployment rates displayed in Figure 2.

The time pattern of unemployment rates in the four macro-regions within the U.S. is much more coherent, and not surprisingly so since economic integration across these economic entities is much tighter than across similarly sized European countries throughout the period considered. From this paper's perspective, it is interesting to focus on the dynamics of regional unemployment rates within the U.S., and compare them to those observed within each European country. Available regional data are not nearly as homogeneous as the OECD data considered in Figure 1. As Figure 3 illustrates, however, their national aggregates do display dynamics similar to those of the standardized data in the period when both are available. It is well known, though not as frequently discussed as the macroeconomic patterns illustrated in Figure 1, that unemployment is persistent at the regional level within European countries (see, e.g., Decressin and Fatas, 1995; Bertola and Ichino, 1995; Jimeno and Bentolila, 1998). Tables 2 and 3 display some relevant evidence. Within each European country, including the United Kingdom, the rank position of regional units in terms of unemployment is remarkably persistent over time. The statistics are computed and displayed for a specific starting year, but the message of the data is very similar for any other starting year. In each European nation, some regions consistently have low unemployment; others feature persistently high unemployment.

The four major regions within the U.S. are certainly as fully integrated as regions within each European nation. The time-series rankings of their unemployment rates in Table 3, however, are much more volatile than their European counterparts: within the U.S., it is not always the same region to display the higher unemployment rate. The regional rankings of unemployment rates appear to be strongly influenced by recent macroeconomic cyclical fluctuations. The Midwest was the hardest hit region in the cyclical unemployment peak of the early 1980s, while it suffered the least from the milder recession episode of the late 1980s. Interestingly, the relative rankings of the other regions were almost exactly specular in the two episodes. This indicates that the different source of macroeconomic shocks (roughly speaking, tight monetary policy in the first, reduction of military spending in the second) interacted in a systematic way with the four regions' different industrial structure. The last column of the Table shows how such systematic cyclical patterns may be smoothed over time, to find that the typical interregional pattern of labor market conditions has no persistence over a typical American business cycle.[3]

[3] Regions within European nations are comparable in size to small and medium States of the United States. A similar picture emerges when rank correlations are computed across States for the whole U.S. as in Bertola and Ichino (1995), or within each macro-region (with the exception of the Midwest, within which State unemployment rate rankings are remarkably stable). Within the U.S., it is not always the same region or the same State to display the highest unemployment rate; within each of the European nations, by contrast, unemployment is highly persistent.

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Persistently different unemployment rates across European regions have two interrelated sources: European workers are not as geographically mobile as their American counterparts, and centrally-negotiated wages are not as sensitive to local market conditions in Europe. Available data on the regional dimension of wage inequality refer to compensation of employees and, like those on which the overall dispersion measures of Table 1 are based, fail to account for differential productivity and other determinants of wage inequality. The simple evidence displayed in Figures 4 and 5, however, indicates that regional dynamics have been quite different within and across European economies from what can be observed in the U.S.

The regional wage differentials plotted in Figure 4 decrease over time within Italy and (West) Germany. There is some indication that the more flexible U.K. labor market displays increasing wage differentiation across regions as well as across many other dimensions. In Figure 5, the pattern of wage inequality across U.S. macro regions is much more volatile than within each European nation where data are available. Interestingly, relative-wage dynamics across macro-regions in the U.S. are not nearly as synchronized as the unemployment rates illustrated in Figure 2. Fluctuations of economic conditions are far from fully synchronized across regions, but unemployment and wage fluctuations are such as to regularly alter the rankings of labor market tightness across States of the Union.

To interpret the picture emerging from the simple empirical evidence of the Figures, consider the possible sources of geographic wage differentials in *laissez-faire* labor markets. On the labor demand side, workers may be compensated differently across regions because their productivity is heterogeneous. A more highly skilled or better-educated labor force may populate certain regions, and the structure of their production may reflect their resulting comparative advantage in industrial sectors with high per-worker value added. The simple evidence reported in the Figures disregards such labor-force quality and industrial-structure issues. More refined evidence, however, indicates that even after accounting for observable worker characteristics earnings dispersion is more pronounced in the U.S. than in European countries, where institutional wage compression has prevented earnings from becoming more dispersed over the 1980s and 1990s (see Blau and Kahn, 1996, and Mauro et al. 1999 more specifically on regional wage compression in Italy and Spain).

On the labor supply side, if the cost of living were homogeneous across regions and geographic mobility were costless, then identical workers should earn identical wages when employed in different regions, because migration towards high-wage areas should otherwise proceed until earnings are equalized. Trade should equalize the price of many goods in an integrated economic area. Wage differentials may reflect the realistic role of non-traded goods, such as housing, in the determination of the cost of living in more or less congested regions, or in areas with more or less pleasant climates. In the short and medium run, however, labor mobility costs are

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certainly an important determinant of observed wage differentiation. In the face of ongoing fluctuations of labor market conditions, workers could not be induced to bear mobility costs if wages and job-finding prospects were fully equalized across areas.[4] Hence, wage differentiation and costly labor mobility are perhaps socially unpleasant, but certainly efficient features of an unregulated labor 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 labor market, simple theoretical arguments imply that a negative local labor demand shock should result in lower equilibrium wages, a reduction of local labor supply via migration, and possibly some frictional unemployment.[5] 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 labor market conditions, migration rates are extremely low, and all shocks are absorbed by labor-force participation and unemployment changes (Decressin and Fatas, 1995; Jimeno and Bentolila, 1998).

European institutions prevent wages from adjusting to local labor market idiosyncrasies, and subsidize low-employment equilibria in relatively depressed regions. Quite intuitively, 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.[6] Labor 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.

[4] What matters to workers contemplating the option to migrate, of course, is the relative real wage adjusted for job-finding probabilities. If anything, cost-of-living differentials should call for wages to be even lower in depressed regions, where housing and non-traded services should be cheaper than in more congested areas.

[5] See e.g. Topel (1986) for the theoretical argument, further references, and empirical tests of the theory on microeconomic data.

[6] In the long run, the extent to which regions remain less able to generate high levels of employment at a given, centrally negotiated wage depends on a variety of government policies, and on the very same labor market institutions of interest here. See Faini (1998) for a model where union policies prevent development of less-advantaged regions.

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4. The Aftermath of EMU

Regional wage inequality is remarkably stable or even decreasing within each European nation but, of course, European relative wages have been historically quite volatile *across* countries. Figures 6 and 7 display simple measures of wage dispersion. 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] Even though both aggregate and relative wages are quite stable within each country, the range of fluctuations in relative wages is larger across European nations than across U.S. macro regions, and the coefficient of variation of wages is comparable across European nations and U.S. States. Table 4 reports time-series rank correlations across the four European countries. As was the case in the similar statistics displayed in Table 3 for the four U.S. macro regions, rankings are quite volatile, and display a decreasing pattern over time when averaged across cyclically different starting years.

The European picture emerging from Figures 6-7 and Table 4 is not unlike its American counterpart in Figure 5 and Table 3, and contrasts sharply with the remarkable stability of relative wages and unemployment rankings within each European country. The mechanisms behind the broad similarity of European and American labor market outcomes are, however, quite different. In the U.S. interregional labor mobility and explicit variation of nominal and real wages achieve adjustment. 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, of course, 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 how national labor markets will cope with adjustment pressure, and whether labor market outcomes in an integrated European Union will more closely resemble the past experience of the United States or that of each European nation.

By renouncing its own currency and monetary policy, each European country loses the ability to conduct an independent monetary policy and thus to change the exchange rate. The evidence, however, indicates that economic shocks are increasingly less national and more regional in nature (see, e.g., Fatas, 1997) – with the obvious exception, of course, of the monetary and fiscal policy shocks that the Maastricht Treaty is meant to avoid in the future. Economic activity is still less

[7] The Figure's data are drawn from the harmonized 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.

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regionally specialized in Europe than a fully integrated economy like the U.S.,[8] but progressively less so, and as economic integration proceeds, specialized regions typically span national borders, blunting national monetary and fiscal policies as stabilization tools.

The credible irreversibility of EMU, however, will play an important role in speeding up integration across still very different European countries and labor markets. As the extent of economic integration approaches that of the United States, labor market institutions and labor market outcomes may also begin to resemble their American counterparts more closely than they did on the basis of the simple evidence reviewed above. Full and irreversible economic integration may call for harmonization of social and labor-market institutions within the European Union. More intense market competition, however, generally makes it difficult for local constituencies to adopt the "protective" institutions typical of European labor-market and social policies. Not surprisingly, social safety nets implemented at the State or local level in the U.S. tend to be quite shallow. Local constituencies are in danger of becoming "welfare magnets" if they offer generous benefits to their residents, and of losing business if they tax local production heavily in order to finance social spending (see Bean et al., 1998, for an extensive discussion). To the extent that social and labor market policies are subsidiary (chosen at the national level) in Europe, the "harmonized" labor markets of a fully integrated European Union would naturally tend to resemble the largely deregulated American model.

For E.U. labor markets to ever mimic the U.S. ones, of course, labor mobility would need to become much more intense both within and across national boundaries. In the 1980s and 1990s, mobility rates across regional boundaries were below 1% per year in the U.K. and Italy (source: Eurostat, Regio databank), while roughly 3% of Americans move across the boundaries of their larger States in a typical year (source: Census Bureau). A superficial reading of the evidence of less intense labor mobility in Europe would invoke different preferences and technological conditions. Much more than their American counterparts, European workers like to live near their relatives and childhood friends, and to speak their own different languages.

The low level of labor mobility in Europe, however, results from the interaction of such preferences with institutional features and economic incentives. Several million European workers did migrate within and across national boundaries in the first few post-war decades. Migration subsided as income differential narrowed, and all but ceased when industrial relations and labor market institutions enforced a "rigid" labor market configuration in the 1970s (see Section 6 below for a

[8] For instance, two-thirds of U.S. automobile production is located in the Midwest and one-quarter in the South, whereas among the largest four E.U. economies, the corresponding shares range from 39% in Germany to 13% in the UK. See Bean et al (1998) for a fuller discussion of such issues and further references.

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discussion of fiscal subsidies' role in this context). Currently, only 1.5% of the E.U. labor force is from a different member country, and labor mobility is low (by U.S. standards) within as well as across the now vanishing national borders. Income differentials remain large in the EU15, however, and are slated to increase dramatically upon E.U. accession of Central and Eastern European countries. Thus, a more flexible configuration of employment relationships could quickly rekindle migration incentives now stifled by compressed wage distributions and long-term, as opposed to frictional, unemployment. In turn, more intense labor mobility might endogenously reduce the importance of family connections, and especially put pressure on national systems of redistributive taxation and social policies: local constituencies could no longer afford to tax high-earners heavily if they became more sensitive to after-tax wage differentials.

Even though such mechanisms would undoubtedly tend to bring European labor markets closer to the deregulated American status quo, automatic deregulation is unlikely to be politically acceptable. The tension between national safety nets and the new intensity of competition in a wider integrated economic area is well represented by the German "posted workers" case (see Davies, 1997, and Bean et al., 1998). As implementation of the Single Market procurement rules coincided with large public construction projects in former East Germany, wage competition by Portuguese, U.K., and Italian construction workers clashed with the generous safety net granted to their German counterparts by pre-Single Market social policies. The posted-workers case was resolved by a mix of labor market deregulation and limits to economic integration. German unemployment benefits were reduced. At the same time, a binding minimum wage was introduced for all construction work on German soil, effectively imposing a quota on German imports of construction services. After a long and politically complicated process, a Directive stated that, despite its obvious contrast with the European Union's Single Market ethos, such national legislation was allowed.

This small-scale example illustrates neatly the tension between labor market regulation and economic integration. Its outcome indicates that national deregulation is a natural response when increased market pressure makes national policies too expensive. It also indicates, however, that E.U.-level regulation will also play a role in the broader European politico-economic arena. It is safe to assume that competition among systems of welfare provision will not be allowed to proceed to the point where the social institutions of a united Europe would resemble those of the U.S. – a paradigm of dubious appeal for many European voters, who would perhaps favor higher employment but would certainly resent many other aspects of American society, especially its less than ideal degree of "social cohesion" as reflected in relatively high rates of single motherhood and crime.

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5. Labor Markets in the Italian Economic and Monetary Union

The outcome of politico-economic interactions triggered by full economic integration may tend to reproduce on a continental scale some features of the checkered economic landscape of current European nations. Thus, it is insightful to consider in some detail the historical experience of Italy – which, like Germany, was formed as an Economic and Monetary Union of pre-existing States in the 19th century and, again like Germany, adopted increasingly uniform labor market institutions in the 1960s and 1970s. Figure 8 displays relative wage and productivity indicators for the manufacturing sectors of Southern and Northern Italy: a convergent productivity pattern is broken around 1970, when national contracts began to impose stringent lower bounds on each sector's wages throughout Italy. Interregional migration all but ceased at roughly the same time (see, e.g., Brunello, Lupi, and Ordine, 1999, figure 5).[9] After some divergence, relative productivity remained flat from 1975 to the present. In the manufacturing sector, take-home pay is only 10% lower in the South than in the other regions, which is apparently not sufficient to induce outmigration, in light of cost-of-living differentials and of fairly small job-finding rates in the North. Productivity differentials are twice as large, at about 20%: only a smaller fiscal wedge, largely reflecting social-security contribution exemptions, makes it possible for employers' unit labor costs to be roughly equalized throughout Italy (as must be the case, of course, if firms are free to choose where to produce).

While employed Southerners earn almost as large a wage as their compatriots do, few are indeed employed. Since the 1970s, unemployment rates have been increasingly higher in the South than in the Center-North of Italy (Figure 9). And it is interesting to see how similar to its American counterpart is the unemployment time series in the more economically developed part of Italy, particularly in the richer regions within it (see Figure 10), while the overall unemployment rate is inflated by an essentially unbroken increasing trend in the Southern regions.[10]

The divergent pattern of unemployment rates is particularly striking in the recent past, i.e., in the aftermath of the aggregate shocks that hit Italy in the early 1990s. In the more dynamic and competitive regions, the contractionary effects of fiscal retrenchment required by the Maastricht Treaty were offset by the 1992 devaluation. In the South, conversely, the unemployment rate rose from 16% to over 23% in the first half of the 1990s, and employment and GDP both fell by over 10% as wages and productivity remained roughly unchanged. Loss of national monetary policy sovereignty is clearly not very consequential from this perspective. No amount

[9] In 1998, migration outflows from the South were sharply higher than in previous years (see SVIMEZ, 1999). It is too early, of course, to tell whether this is evidence of a permanently higher responsiveness to wage and unemployment rate differentials, as may be caused by reduced government expenditure overall and especially in the South.

[10] See, e.g., Faini et al. (1999) and Brunello, Lupi, and Ordine (1999) for formal empirical evidence on Italian regional labor market dynamics.

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of national monetary policy flexibility could have helped Italy's South in the aftermath of the 1992 devaluation, when common macroeconomic shocks had sharply differentiated economic implications at the regional level.

Italian policymakers are keenly aware that some regional wage differentiation would help the South generate employment. Recently introduced policy instruments (*Contratti d'Area* and *Patti Territoriali*) aim at achieving this through a mix of after-tax wage concessions and fiscal incentives, but are not being implemented as widely as originally envisioned. National unions (which played a very important macroeconomic role by ensuring wage moderation throughout the 1990s adjustment period) are of course wary of losing bargaining power by agreeing to after-tax wage concessions. And, ironically, local tax incentives are challenged as illegal industrial policy subsidies at the European Union level.

6. The Future: Fiscal Aspects

Since the size and other economic characteristics of a united Europe are similar to those of the United States, it is natural to wonder whether the social and labor-market institutions of the European Union should become more similar to their American counterparts. Would it be advisable to homogenize labor standards, wage-setting institutions, and job security provisions throughout Europe? If so, should relatively rigid labor markets be made more flexible in a process of generalized deregulation, or should the original motivation of current institutions be kept in mind when redesigning them for the new economic environment? Most importantly, are the courses of action suggested by economic theory politically feasible?

The empirical evidence and theoretical perspectives of this paper do not offer simple answers to such questions. They do, however, identify likely lines of tension between conflicting mechanisms. As increased specialization and more intense product-market competition enhances opportunities for labor reallocation, and free mobility of capital more harshly penalizes relatively inefficient countries and regions, job security and wage-setting institutions meant to protect workers from exogenous market developments need to be reconsidered and redesigned.

To some extent, as mentioned above, deregulation may be more or less automatically induced by increased product- and labor-market competition. In general, social protection becomes more expensive when market pressure increases: competition among national labor market institutions tends to privilege cost-efficiency (for example, through higher reliance on targeted and means-tested benefits) 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

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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 (Sinn, 1998). Explicit coordination of the reform process is preferable on theoretical grounds, and may feature a mix of less-than-explicit limits to economic integration and of piecewise deregulation.

An explicitly coordinated re-design of European institutions, conversely, may dangerously tend to reproduce current nation-level rigidity on a continent-wide scale. Capital and goods markets are as integrated within Italy as they are likely to be among EMU participants, yet wage compression and mobility costs do effectively segment the Italian labor market, to an extent that was until recently and probably still is politically stable. Perhaps not surprisingly, in light of political and economic interactions within European nations, E.U.-wide coordinated wage setting was indeed advocated by Mr. Lafontaine and his advisors in the immediate aftermath of European monetary unification.

Alongside the labor-market regulation aspects emphasized in this paper, however, fiscal aspects also play an important role within each European nation, and will undoubtedly be relevant to Europe-wide developments as well. The low intensity of labor mobility was rationalized above in light of wage compression and employment-protection institutions – which, respectively, reduce the wage and job-finding advantages of migration to tighter labor markets. But subsidization of unemployment in low-productivity labor markets is an intimately related and perhaps equally important element of national European experiences. As already mentioned, non-employment income flows tend to reduce wage dispersion by reducing incentives for workers to accept low wage offers. And non-employment subsidies reduce migration incentives directly when they are generous enough to make continued unemployment or search in the local labor market preferable to mobility towards tighter labor markets.[11] Further, employment subsidies also support low-migration equilibria, and their role in the Italian case is illustrated by different tax wedges in the North and South between labor costs and take-home pay. Spilimbergo (1999) shows that it is generally in the interest of workers residing in the better developed regions of economically integrated areas to prevent wage competition by subsidizing depressed regions, and argues that such a mechanism can explain extensive interregional fiscal flows not only from Northern to Southern Italy, but also from the United States to Puerto Rico, from Western to Eastern Germany, and to the Southern regions from the rest of Spain.

Budgetary constraints and Europe-wide competition make it increasingly costly to subsidize high-unemployment equilibria in each nation's less developed

[11] In the Italian case, Brunello et al. (1999) document a statistically significant association between the steady increase in nationwide social expenditure per capita and reduction of migration flows from the South to the Center and North.

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regions, and should lead to lower labor market rigidity. Recent data, in fact, indicate that young workers may have begun to migrate again from Southern to Northern Italy. As to international labor mobility, the key ingredient of labor 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 subsidize high-unemployment outcomes across the borders of European nations. As long as the overall European Union budget is limited to 1.26 percentage points of GDP, it is safe to predict that the labor markets of the European Union will not resemble their own past selves or their American counterparts as closely as may be feared or advocated.

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APPENDIX

Table 1: Summary Indicators of Male Earnings Inequality (decile ratios).

1986	D5/D1	D9/D5	1994 (or...)	D5/D1	D9/D5
Italy	1.44	1.53	Italy (1993)	1.60	1.65
Germany	1.43	1.66	Germany (1993)	1.37	1.64
France	1.60	2.13	France	1.61	2.13
U.K.	1.66	1.73	U.K.	1.74	1.86
U.S.A.	2.07	1.87	U.S.A.	2.13	2.01

These columns report the ratio of the upper limit of the 5th decile to the upper limit of the 1st decile, and of upper limit of the 9th decile to the upper limit of the 5th decile. Larger figures indicate more inequality. Source: OECD (Employment Outlook, table 3.1).

Table 2: Time-series Rank Correlations of Unemployment Rates within European Nations.

	Germany	France	U.K.	Italy
1983	1.00	1.00	1.00	1.00
1984	0.97	0.95	0.95	0.85
1985	0.98	0.98	0.94	0.95
1986	0.97	0.95	0.94	0.96
1987	0.99	0.90	0.85	0.95
1988	0.99	0.92	0.88	0.91
1989	0.99	0.83	0.87	0.94
1990	0.99	0.85	0.86	0.91
1991	0.99	0.92	0.87	0.93
1992	0.98	0.90	0.92	0.86
1993	0.97	0.83	0.79	0.92
1994	0.96	0.81	0.88	0.92
1995	0.92	0.81	0.85	0.88

NOTE: Rank correlations with 1983 unemployment rates are computed across macro-regions defined at the NUTS-1 disaggregation level of the Eurostat REGIO database for each of the years listed.
Within Italy: Nord Ovest, Lombardia, Nord Est, Emilia-Romagna, Centro, Lazio, Abruzzo-Molise, Campania, Sud, Sicilia, Sardegna.
Within France: Ile De France, Bassin Parisien, Nord-Pas-De-Calais, Est, Ouest, Sud-Ouest, Centre-Est, Méditerranée.
Within Germany (West only): Baden-Wuerttemberg, Bayern, Hessen, Niedersachsen, Nordrhein-Westfalen, Rheinland-Pfalz, Saarland, Schleswig-Holstein.
Within the United Kingdom: North Yorkshire and Humberside, East Midlands, East-Anglia, South-East, South-West, West Midlands, North West,Wales, Scotland, Northern Ireland.

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Table 3: Rank Correlations of Regional Unemployment Rates within the United States.

	ρ_c with 1980		ρ_c with 1981		ρ_c with 1982		ρ_c with 1983	*Periods ahead*	**Average Rank Correlation**
1980	1	1981	1	1982	1	1983	1	*0*	1.000
1981	0.8	1982	1	1983	0.8	1984	1	*+1*	0.900
1982	0.8	1983	0.8	1984	0.8	1985	1	*+2*	0.850
1983	0.4	1984	0.8	1985	0.8	1986	0.4	*+3*	0.600
1984	0.4	1985	0.8	1986	-0.2	1987	0.4	*+4*	0.350
1985	0.4	1986	-0.2	1987	-0.2	1988	0.4	*+5*	0.100
1986	-0.4	1987	-0.2	1988	-0.2	1989	0.4	*+6*	-0.100
1987	-0.4	1988	-0.2	1989	-0.2	1990	0.4	*+7*	-0.100
1988	-0.4	1989	-0.2	1990	-0.2	1991	-0.8	*+8*	-0.400
1989	-0.4	1990	-0.2	1991	-0.4	1992	-0.4	*+9*	-0.350
1990	-0.4	1991	-0.4	1992	-0.2	1993	-0.4	*+10*	-0.350
1991	-0.2	1992	-0.2	1993	-0.2	1994	-0.4	*+11*	-0.250

NOTE: in each of the first four pairs of columns, rank correlations of unemployment rates with the initial year are computed across four macro-regions. 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 Northeastern region includes Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Vermont.
The Southern region includes Alabama, Arkansas, Delaware, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, N Carolina, Oklahoma, S Carolina, Tennessee, Texas, Virginia, W Virginia.
The Midwest includes Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, N Dakota, Nebraska, Ohio, S Dakota, Wisconsin.
The West includes Alaska, Arizona, California, Colorado, Idaho, Hawaii, Montana, Nevada, New Mexico, Oregon, Utah, Washington, and Wyoming.

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Table 4: Rank Correlations of National Unemployment Rates across Germany, France, Italy, and the United Kingdom.

	ρ_c with 1983		ρ_c with 1984		ρ_c with 1985	*Periods ahead*	**Average Rank Correlation**
1983	1	1984	1	1985	1	*0*	1.000
1984	1	1985	0.8	1986	0.8	*+1*	0.867
1985	0.8	1986	1	1987	1	*+2*	0.933
1986	1	1987	0.8	1988	0.2	*+3*	0.667
1987	0.8	1988	0.4	1989	0.2	*+4*	0.467
1988	0.4	1989	0.4	1990	0.2	*+5*	0.333
1989	0.4	1990	0.4	1991	0.4	*+6*	0.400
1990	0.4	1991	0.2	1992	0.8	*+7*	0.467
1991	0.2	1992	0.4	1993	0.8	*+8*	0.467
1992	0.4	1993	0.4	1994	0.4	*+9*	0.400
1993	0.4	1994	0.2	1995	0.2	*+10*	0.267

NOTE: in each of the first three pairs of columns, rank correlations of unemployment rates with the initial year are computed across the four countries. Source: as in Figure 1.

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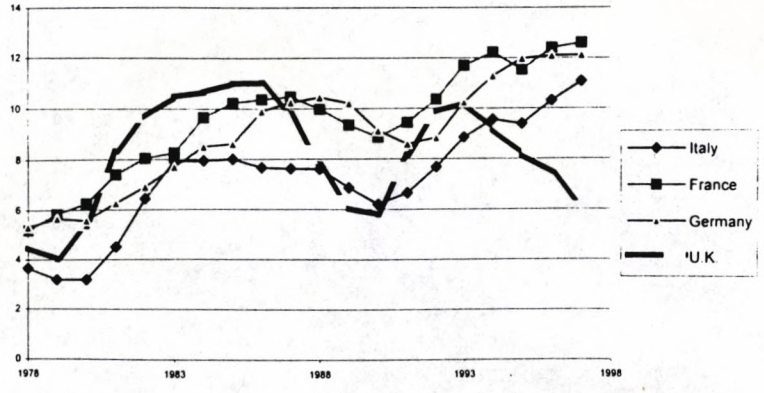
Figure 1: Standardized Unemployment Rates.



Data for Germany refer to West Germany through 1991, then to united Germany.
Source: OECD.

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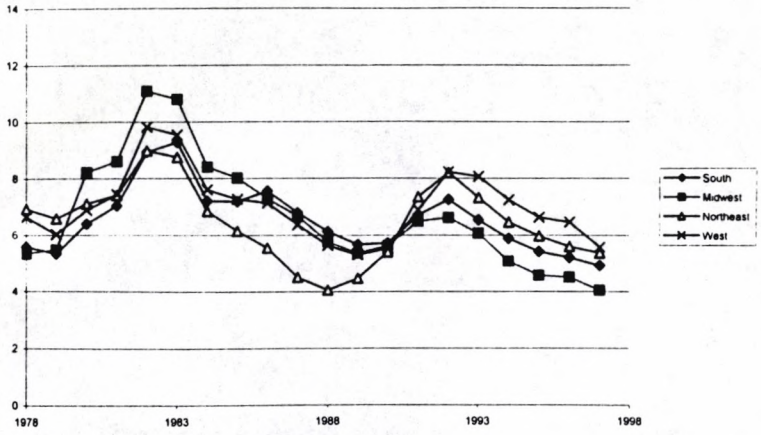
Figure 2: Unemployment Rates in U.S. Macro Regions.



See the note to Table 3 for a list of States included in each region. Source: aggregates of Bureau of Labor Statistics state-level data.

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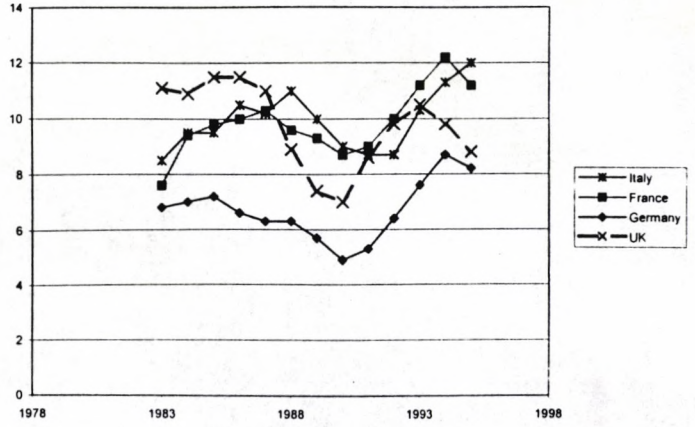
Figure 3: Unemployment Rates, Eurostat/National Definition.



Germany is West Germany only. Source: Eurostat, REGIO database.

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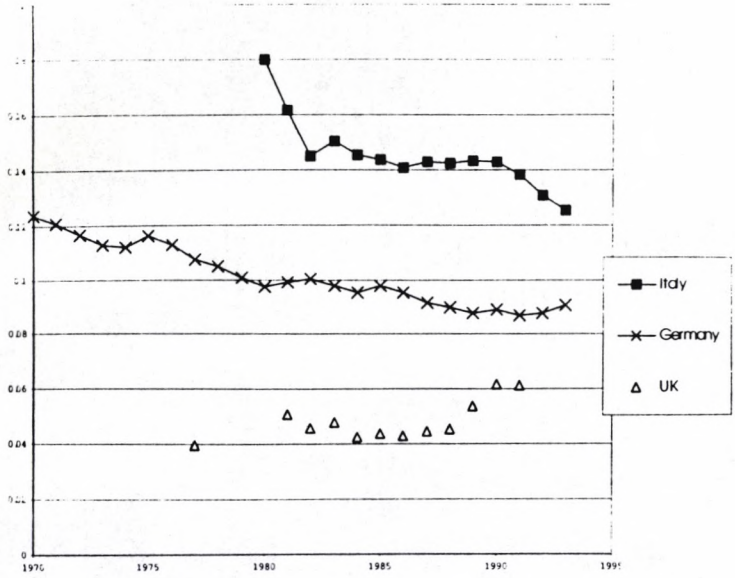
Figure 4: Regional Wage Inequality within European Nations.



NOTE: Coefficient of variation of compensation per employee data, weighted by employment, across the macro regions defined in the note to Table 2. Source: REGIO database, Eurostat. French data are not available.

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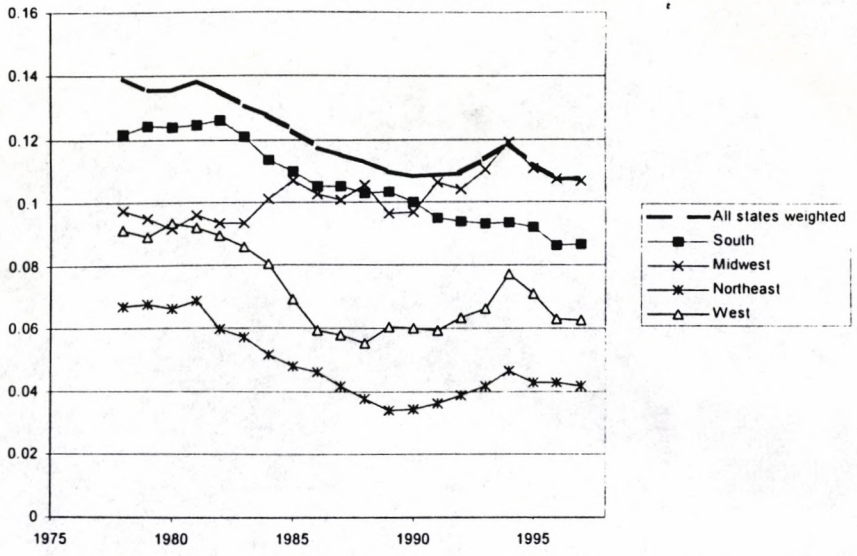
Figure 5: Regional Wage Inequality within the United States.



NOTE: Employment-weighted coefficient of variation within each of the four U.S. macro regions defined in the note to Table 3, and across the whole distribution of State-level data. Source: Bureau of Labor Statistics.

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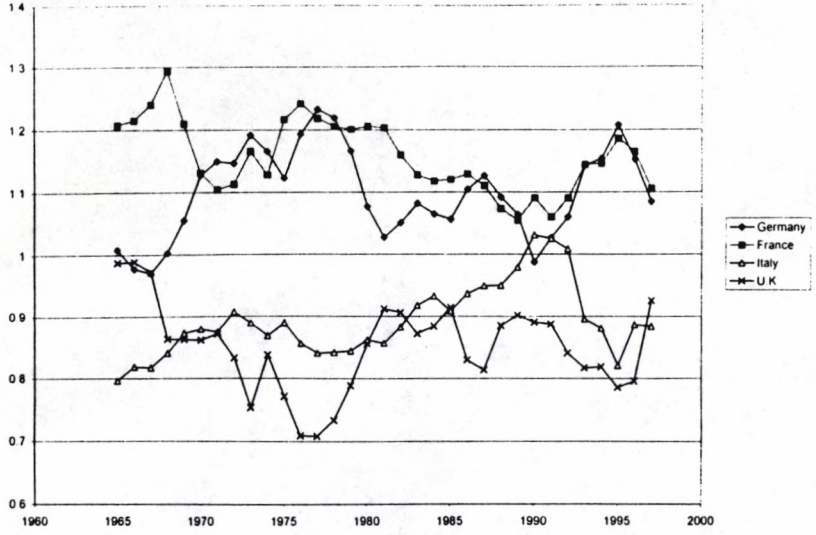
Figure 6: Wage Indicators in a Common Currency, for the Largest European Nations.



NOTE: Real compensation per employee indices, converted in a common currency, as a fraction of the unweighted average. Source: OECD.

Figure 7 : Unweighted Coefficient of Variation for the Data in Figure 6.

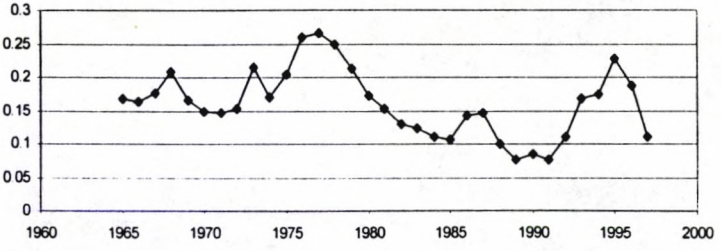


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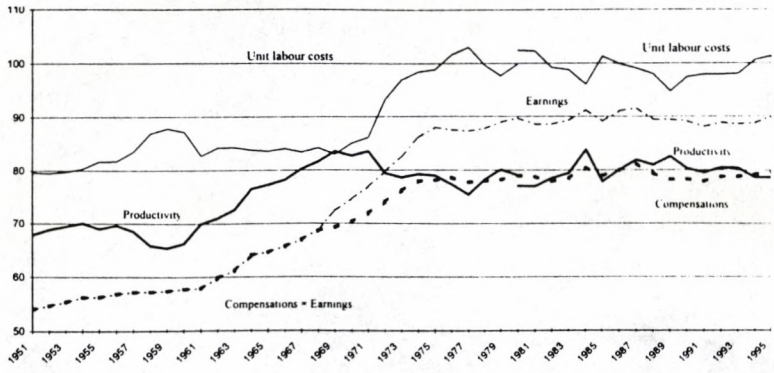
Figure 8 : Earnings, Compensations, Productivity and Unit Labour Costs in Southern Italy, Manufacturing Sector (North=100).



Source: Chiri and Gobbi (1999). NOTES: Earnings are gross-of-taxes wages; Compensations include pay-roll taxes; Productivity is value added at current prices per unit of labour and refers to total labour force (employees and self-employed); Unit labour costs are the ratio between compensations and productivity.

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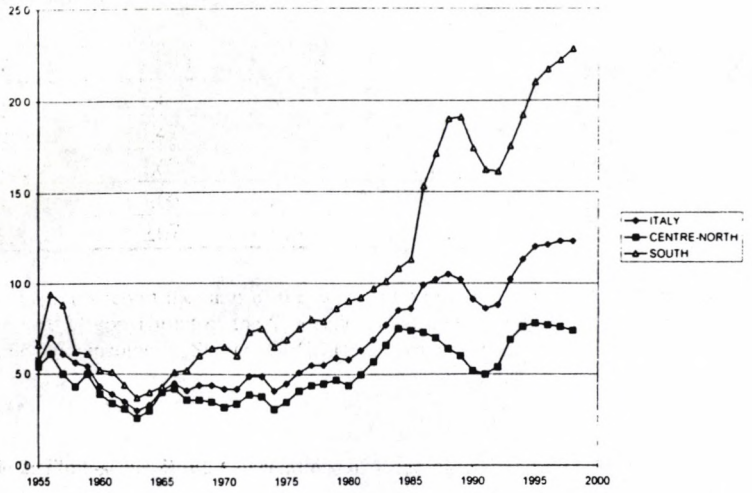
Figure 9 : Unemployment Rates in Italy.



NOTE: Reconstructed according to the current definition and kindly made available by Paola Casavola, Bank of Italy / Ministero del Tesoro.

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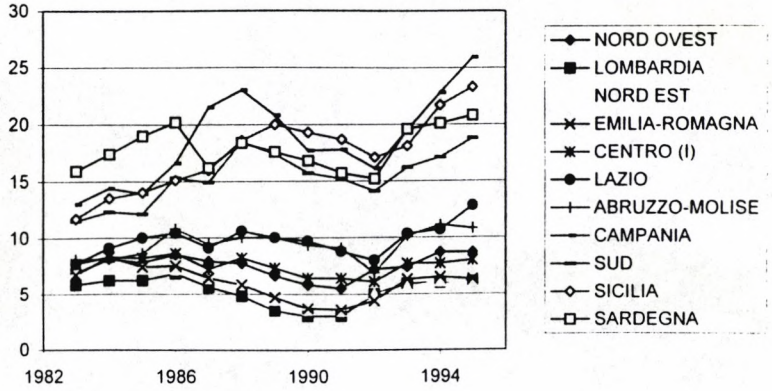
Figure 10 : Unemployment Rates in the NUTS-1 Regions of Italy.



Source: Eurostat, REGIO databank.

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