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## Labour Market Institutions and Labour Market Performance in the European Union

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# LABOUR MARKET INSTITUTIONS AND LABOUR MARKET PERFORMANCE IN THE EUROPEAN UNION

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## ABSTRACT

The presented article deals with labour market institutions and labour market performance in the European Union. The first chapter is devoted to theoretical and methodological background of labour market performance. Theoretical literature has created a set of institutional aspects such as employment protection legislation, structure of wage bargaining, taxation of labour, active labour market policy, the system of unemployment and social benefits. All these aspects determine the institutional framework of labour market. Theoretical literature also has defined labour market flexibility as an instrument for adjustment process in case of asymmetric shock. Attention is also paid to influence of these institutional aspects on employment or unemployment. The second chapter is composed of the comparative analysis of selected criteria and corresponding economic indicators of the EU member states. The author has chosen the method of comparative analysis as the basic method for accomplishing the goal of the paper - to analyse the labour market institutions and their contribution to labour market performance in the EU member states. The evidence shows that the labour market flexibility in the Visegrad group countries is better than average of old EU-15 member states. However, this level of flexibility is much behind the level of USA or Anglo-Saxon countries. The main problem of Visegrad group is long-term unemployment and its composition and a lower level of employment. The author assumes that improving these indicators is one of the most important tasks for political-economic authorities.

## INTRODUCTION

New EU member states undertake to adopt single currency euro in Treaty of Accession. Every candidate for eurozone accession must fulfil Maastricht criteria. Most papers deal with the problem of nominal and real convergence. But there are more aspects which have to be analysed. The most important aspect is labour market, especially its flexibility, although this aspect is not a component of convergence criteria. Theoretical literature has defined labour market flexibility as an instrument which can be used for adjustment process in case of asymmetric shock after country's accession into eurozone. We accent that autonomous monetary policy will be no more available. The need for an analysis of labour market flexibility rises in the context of eurozone accession.

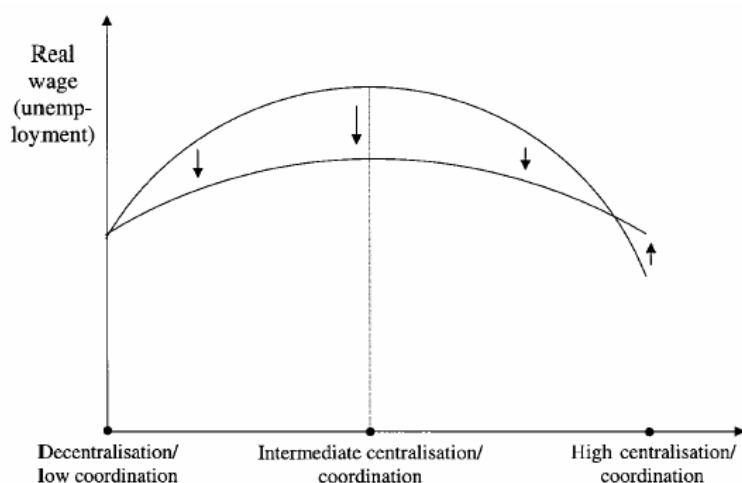
### 1. ECONOMIC INTEGRATION AND LABOUR MARKET

Andersen (2001:8) presumes, according to the factor price equalization theorem, "*if trade liberalization tends to imply equalization of relative product prices across countries then relative factor prices would also have to be the same*". In practise, if European firms compete at the same product market, use the same technologies, face the same capital market, then wages also have to be the same. However, this presumption is based on existence of perfect competition in product market and we can deduce specific impacts on European integration process. Empirical studies provide evidence that the process of wage convergence has occurred – closer cooperation and more linked business relations tend to imply tighter wage bindings, and has raised dependence of their stature in these integrated countries. This confirms the fact that ties between national labour markets have come closer. But Corneo (1994) disagrees and argues that product markets integration does not eliminate international differences in the wage levels, which are the result of existence of specific labour market institutions in these countries. Other authors who deal with this dilemma are Dantine – Hunt (1994). They mention a universal opinion that the European integration process has only imperceptible impact on labour mobility. Quod nota of fact in support of this idea that anywhere, where liberalisation measures were adopted, no recognizable effects were recorded. This is explained by the existence of significant cultural and language barriers which impede mobility of labour within member states of EU. But after all European labour markets (subsequently wages and employment) are impressed by the integration process. The authors use Calmfors-Driffill model and investigate integration effects on labour market.

Effects depend on the level of wage coordination in economy (see Fig.1). According to hump-shape hypothesis, increased foreign competition makes this hump more flat. The reason is increasing wages and implicitly price level. This will have significant adverse impact on employment and firm profits in case of existence of foreign competition and industry level of wage bargaining (the incentives for wage restraint are weak because all domestic competitors are exposed to similar wage increases, this wage-raising effect is obviously of lesser importance, the larger is the risk to lose market shares to foreign competitors). In case of decentralisation or centralisation wage bargaining, this will be not affected by foreign competition (because of competition between domestic firms in the first case, and because of internalization of negative externalities of wage increases in the second case). It is important to distinguish between two different aspects: (i) the effect on the flexibility of wages in the case of macroeconomic shocks and thus on the cyclical sensitivity of employment and output; and (ii) the effect on the equilibrium real wage level and thus on equilibrium unemployment, or more loosely the effect on the average real wage level and average unemployment over the business cycle (see Calmfors, 2002).

In accordance with Haffner – Nickell – Nicoletti – Scarpetta – Zoega (2005) it stands to reason that an increase in product market competition will reduce the rewards that unions are able to extract from firms on behalf of their members. This could lead to a fall in membership which would be reinforced if the fall in entry barriers to traditionally unionised sectors led to an increase in the number of new non-union firms. On one hand if increased competition means that firms have to respond more rapidly to shocks, they will press for more flexibility in employment contracts. On the other hand workers will feel that their jobs are less secure and will press for more protection. Government could react by parallel reduction of employment protection legislation strictness and rise of generosity of unemployment benefits. As the result the costs of increased flexibility will be transferred to tax payers.

**Fig. 1: The impact of increased foreign competition**



Source: Calmfors (2002, p.332)

Bertola (2003) argues that institutional frameworks of labour market function in the EU countries are relatively stable and resistant to reforms. This could be a result or an effect of a fact that economic integration has not been completed yet and the advantages of specialisation and flexibility have not been taken in entirety yet. It is also a fact that removing barriers is associated with social and political pressures (mostly linked with elections), which strength the resistance to reforms. Individual labour market performances in EU countries are different and differences in integration reform pressures influence them. Member states implement various labour market policies. The different countries' levels of economic development explain much of Europe's heterogeneity. This argumentation is supported by Haffner – Nickell – Nicoletti – Scarpetta – Zoega (2005) who claim that movement to unification has failed (a presumption was significant contribution to main economic goal: a reduction of high and persistent unemployment). The authors ask also questions if market integration, economic policy and monetary integration provide satisfactory incentives for private subjects and member states to increased competition pressure.

Unsatisfactory labour market performance has been characteristic of Europe since 70<sup>th</sup>. Europe is facing up two problems (Bertola;16-17):

1. The need of social system reform (especially reduction in generosity of unemployment benefits and more strict conditions of qualifying);
2. Labour market legislation on European level is much less advanced than fiscal or monetary policy. The social and employment policy is almost completely subsidiary, left to intergovernmental negotiation and subject to explicit unanimity requirements.

Partial conclusions result from these problems. The first challenge is generated by increased international competition pressure (in and out of EU). This pressure will need re-configuration in terms of higher flexibility and lesser protection which is (and will) not easy because workers calls for labour protection will increase in case of international competition. Second challenge is generated by incompatibility in national policies, deregulation of international trade barriers and member states' concerns in social area. A consequence of these facts is unsatisfactory support of economic integration enhancement, different perception of questions by member states and the view of what role the EU institutions should play in co-ordination in this area.

## 2. European monetary union and labour market

First, it is necessary to determine institutional framework of labour market in conditions of monetary integration. We will analyse impacts of supply and demand shocks on economy in these boundaries. Moreover, it is fundamental to distinguish between symmetric and asymmetric shock. De Grauwe (2003) offers detailed study of this problem. The study is based on existence of two countries (A and B).

First, we will discuss impacts of **asymmetric shock**. It is also important to know that two economic conditions can happen: i) negative asymmetric shock in country A, which means reduced output of economy and higher unemployment and ii) positive asymmetric shock in country B, which means a boom of economy and decline of unemployment which also leads to upward pressures on its price level.

If the countries had not been in a monetary union (they have national monetary policy tools to adjust to the asymmetric shocks). According to De Grauwe country A would have been able to devalue its currency against the country B's currency. The devaluation of the currency increases the competitiveness of the country A's products. This shifts the country A's aggregate demand curve upwards and in country B the opposite occurs. The result is that country A will solve the problem with higher unemployment and country B avoids having to accept inflationary pressures. If the countries had been in a monetary union, than they can not use national monetary policy and the Union's central monetary authority is paralysed because it has only one monetary tool to solve two different problems. If it lowers interest rate thereby stimulating aggregate demand in the country A, than it increases inflationary pressure in country B. If, on the other hand, it increases the interest rate so as to deal with the inflationary pressure in country B, it reduces aggregate demand in country A, and intensifies that country's problem.

**Symmetric shock:** in this case both economies will be hit in the same direction. If the countries had not been in a monetary union, according to De Grauwe, it leads to spiral devalue effect: countries try to raise competitiveness of their products. To avoid this problem cooperation of economy policies is necessary, which is difficult among independent nations. If the countries had been in a monetary union, this monetary cooperation is institutionalized and the central monetary authority can stimulate both economies. De Grauwe (2003;23) closes this dilemma with the argument: *"We conclude that a monetary union is a more attractive monetary regime than a regime of independent monetary authorities if shocks that hit the countries are symmetric. When shocks are asymmetric, however, this advantage of monetary union disappears."*

This statement has the key role in an analysis. If countries creating monetary union can not use autonomous monetary policy to solve impacts of asymmetric shock it is good to put a question: Does a mechanism exist, which would lead to automatic equalizing? De Grauwe mentions two relevant instruments:

- Wage flexibility (if wages are flexible both in country A and country B, than workers in country A who have become unemployed will reduce their wage claims. In country B the excess demand for labour will push the wage rate. This will have following effects: the aggregate supply curve will shift downwards in country A, whereas the aggregate supply curve will shift upwards in country B. These shifts tend to bring back equilibrium. In addition, the price level of products fall down in country A and this make more competitiveness against country B's products. This stimulates aggregate demand in country A, opposite happens in country B).
- Labour mobility (unemployed workers move to country B where there is excess demand for labour. This movement eliminates the need to let wages decline in country A and increase in country B. Thus,

the unemployment problem disappears in country A, whereas the inflationary wage pressures in country B vanish).

Substantial contribution of de Grauwe (2003;8) is following reflection: „*If wages are rigid and if labour mobility is limited, countries that form a monetary union will find it harder to adjust to asymmetric demand shifts than countries that have maintained their own national money and that can devalue (revalue) their currency.*“

Heterogeneity of European Union is one of the main characteristics of this integration group (compared with USA). In addition, many member countries show rigid labour markets – relatively high strictness of employment protection legislation, generous system of unemployment benefits and rigid wages. Moreover, structures of wage bargaining are also different – from centralisation form to decentralised (liberal) one. Then we can say that the present setting of labour market institutional aspects makes hard to operate two instruments of the labour market flexibility (wage flexibility and mobility of labour).

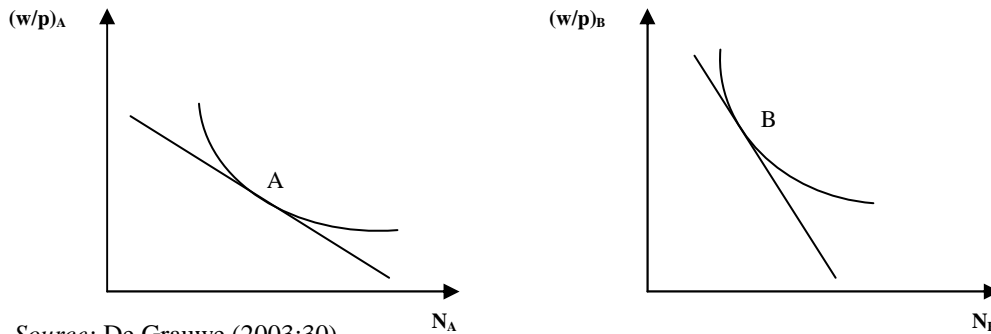
Another theory which deals with impacts of supply shock on labour market institutions is called Bruno-Sachs model. Its main invention according to de Grauwe (2003;15) is: “*Supply shocks, such as an oil price increase, have very different macroeconomic effects depending upon the degree of centralization of wage bargaining.*”

Haffner et al. (2005) ask a question, if an economic and monetary integration is able to improve unsatisfactory labour market performance in the EU. Some empirical evidence exists to prove that both product market competition and labour market flexibility have been fostered by integration. Though, space for increasing competitive pressure still exists in the EU. Market competition could be effectively promoted via coordination, simplifying and reforming product market regulations. Authors claim that benefits are twofold: higher market competition creates a space for reduction of labour market rigidities and more flexible product markets could improve significantly the EU employment prospects. The authors agree with general feeling that while private agents, unions and employers have adjusted their behaviour to meet the challenge of economic and monetary integration, national governments implement structural reforms at much slower pace. In addition, they suppose that the Single Market and EMU will be not sufficient conditions to bolster the reform effort from their point of view.

Borghijs – van Poeck (2001) argue that higher degree of integration in the product market results in lower wages. This increases the pressure on unions to restore the original wage level, which can be achieved by an increase in bargaining power. Therefore, increasing economic integration bolster the incentives for unions to negotiate at the European level. At the same time EMU lowers the barriers for European co-operation among labour unions through increased transparency, reduced uncertainty and convergence of the institutional environment. Solow – McDonald model investigates if labour unions change or by contrast do not change their behaviour in principle. De Grauwe (2003) offers a smooth analysis of this model.

Fig.2 presents labour markets of two countries that are candidates for a monetary union. On the vertical axis is the real wage level and on the horizontal axis is the level of employment. The convex curves are the indifference curves of the labour union. It is assumed that there is only one labour union in each country. The union maximizes its utility which depends on both the real wage level and the employment of its members. The negatively sloped line is the economy-wide demand for labour curve. For the union, which maximizes its utility, the demand for labour curve is a constraint: thus, the union will select a point on which it maximizes its utility. This is represented in Figure by the points A and B. The interesting feature of this model is that the employment line takes into account the reaction of the authorities to what the labour unions are doing. De Grauwe assumes that the authorities give a higher weight to employment in their utility function than the labour unions do. Then when the labour unions set a wage that reduces the employment level below the level that the authorities find optimal, they will react by changing their policies (e.g. more expansionary monetary and fiscal policies to absorb unemployed, creation public jobs, etc.). To the extent that labour unions take this reaction of the authorities into account, the constraint the unions face will change (the employment line becomes steeper because an increase in the real wage reduces private employment and, thus, induces the authorities to intensify their job-creating policies. As a result, an increase in the real wage level has a less pronounced effect on the total level of employment.

**Fig. 2: The Solow-McDonald Model in two countries**



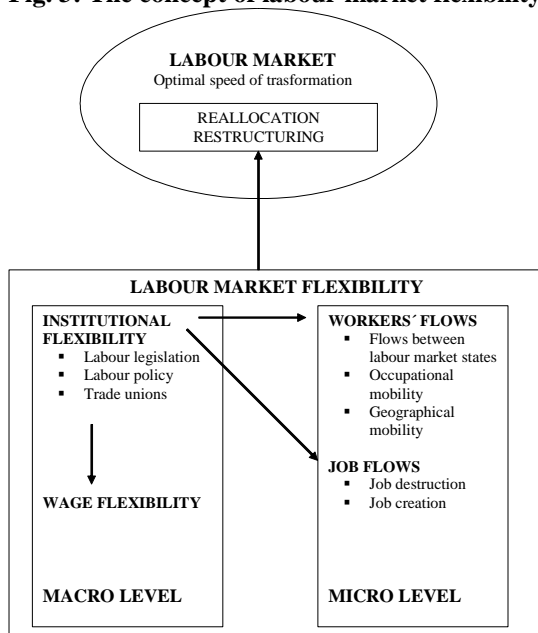
Source: De Grauwe (2003;30)

De Grauwe (2003;23) mentions that the level of coordination is different in contrast to this model and is not entirely clear how monetary policy will influence institutional differences. „We conclude that the institutional differences in the national labour markets will continue to exist for quite some time after introduction of a common currency. This may lead to divergent wage and employment tendencies and severe adjustment problems when the exchange rate instrument has disappeared”.

An argument about labour market reform inside EMU is called TINA (*There Is No Alternative*) appears in works of several authors - Duval, Elmeskov (2005); Borghijs – van Poeck (2001); Bentollina - Gilles (2000) and Boeri – Nicoletti – Scarpeta (1999). Under EMU it means that monetary policy on national level is no longer available to offset negative shocks. The only alternative is to make sure that labour markets are sufficiently flexible to absorb the impacts of these shocks. On the assumption that labour markets in most EU countries do not provide good performance, the only way how to achieve flexible labour market is the reform.

Hallet – Jensen (2003;3) suppose that rigid labour markets may represent costs both for new member states of eurozone and current members. This applies to a case when does not exist enough reform effort. The authors make reference to Groucho Marx theorem: “countries already reformed, or with considerable market flexibility, would not want to join a union of less flexibility or with fewer structural reforms. But that union would want them. Conversely, a union that has reformed will be reluctant to admit new members that have not yet reformed, even if they want to join. That clearly makes the process of enlargement much more difficult”.

**Fig. 3: The concept of labour market flexibility**



Source: Eamets – Masso (2003;9)

Hence, the reform of labour market is a main aspect of discussion which concerns eurozone enlargement. Moreover, labour market reform is considered as the most important component of national economic policy for countries which make effort to fulfil Maastricht 's criteria, though labour market criterion is not their component. Bentolila – Gilles (2000;3-4) ask the question if a change of monetary authority will foster or put back the labour market reform within EMU. They refuse often mentioned idea: “the more rigidity, the higher costs associated with EMU enlargement”. If labour market flexibility may be an instrument of adjustment process in case of hitting economy by the asymmetric shock the author matters to define labour market flexibility and its aspects. We can find out the most sophisticated definition of labour market flexibility in Eamets – Masso (2003;4): “*We can say that labour market flexibility shows how quickly markets adjust to the external shocks and changing macroeconomic conditions.*”

Klau – Mittelstadt (1987) distinguish four broad aspects of labour market flexibility: (i) real labour cost flexibility at the economy-wide level; (ii) Adaptability of relative labour costs across occupations and enterprises; (iii) Labour mobility and (iv) Flexibility of working time and work schedules. The first two are macro- and microeconomic aspects of labour-cost flexibility, while the latter two relate to the quantitative and qualitative adaptability of the supply and the use of labour. Some of these elements interact. For example, rigid wages for full-time employment may lead to increased openings for part-time work raising the flexibility of working time and work schedules. Similarly, market-clearing wage differentials partly depend upon the degree of labour mobility.

Back to Eamets – Masso (2003): authors also subdivide flexibility into microeconomic and macroeconomic level (see Fig. 3). Macroeconomic level can be further divided into institutional flexibility and wage flexibility. The first one represents to what degree the institutions and labour unions are involved in regulation of labour market. The latter one indicates how the wages are sensitive to market fluctuations. Microeconomic flexibility is associated with the labour market flows analysis. The labour market can be characterized by various flows of workers (transitions between labour market states, occupational mobility and geographical mobility) and by jobs flows (job creation and job destruction.)

### 3. Empirical part

Before our own labour market flexibility analysis we submit some conclusions, which are taken from OECD Economic Outlook 2006. First, we discuss data which are contained in Tab. 1. The table was set up by simple statistics methods in order to identify empirical patterns between different conceptions of an institutional framework of labour market. Though, the data do not imply causal relationships, we can find some parallels, which enable to divide OECD countries into four basic groups:

- Report mentions that relatively low tax wedge and low generosity of unemployment benefit system are associated with good labour market performance. This is mainly typical for Anglo-Saxon countries. In addition, this group of countries prefers less strictness of employment protection legislation which is accompanied by lower active labour market policy expenditures. Union coverage and density tend to be found under OECD average.
- Second finding is the paradox, which means that some countries reach as good labour market performance as the previous ones. Indeed, this group prefers different conception of institutional framework of labour market (and setting of all its aspects). We can characterize these countries as the countries with high wage bargaining centralization, its high coordination and density or coverage. These high valuables are a result of traditionally intense social feelings. Relatively generous unemployment benefits are another signs. On the other hand the countries have higher tax wedge. This is mainly typical for Scandinavian countries.
- The third group shows analogous data as previous one but labour market performance is not as good. The main problem of this group is system of generous unemployment benefits. This group is represented by Continental Europe.
- The last group achieves in many aspects the values which are typical for Anglo-Saxon countries but these low values of institutional aspects do not contribute to lower rate of unemployment or high rate of employment. These countries have lower rate of employment and simultaneously they have higher rate of unemployment (especially the long term unemployment). This is typical for Visegrad countries.

Whether we look at right part of left part of the table, it stands to reason that achievement of the same labour market performance is possible by different conceptions of labour market policy. It is also a question, if we can implicitly determine general framework of economic-political recommendations for optimal labour market performance. We argue that it is good to follow recommendations made by OECD. Therefore it is

necessary to implement other measures which should take into account different cultural and historical progress and, of course, current setting of the institutional framework of labour market (e.g. lowering tax wedge should be accompanied with parallel reform of social and health system with a view of keeping a balance between government revenues and expenditures). In other words, it is not maintainable, in long run view, to practice Anglo-Saxon taxation of labour and parallel exercitation of Scandinavian unemployment benefits.

**Tab. 1: Four different regimes of labour market function**

	OECD unweighted average	High employment outcome and institutional aspects		Low employment outcome and institutional aspects	
		Anglo-Saxon countries <sup>a</sup>	Scandinavian countries <sup>b</sup>	Countries of continental and southern Europe <sup>c</sup>	Countries Visegrád 4 <sup>d</sup>
Employment protection legislation	2,01	1,38	2,13	2,71	1,83
Generosity of unemployment benefit system <sup>e</sup>	27,81	18,23	39,86	36,17	9,69
Active labour market programmes <sup>f</sup>	29,25	15,76	64,14	25,84	3,46
Tax wedge <sup>g</sup>	27,1	18,54	27,42	34,33	32,43
Union coverage	59,96	30,75	83,33	82,57	38,33
Union coordination	2,88	1,88	3,92	3,79	1,33
Employment rate	67,11	70,92	71,92	62,54	58,00
Unemployment rate	7,47	5,3	4,79	8,97	15,12

Note:

a) This group of countries includes Australia, Canada, Japan, Korea, New Zealand, Switzerland, the United Kingdom and the United States.

b) This group of countries includes Austria, Denmark, Ireland, the Netherlands, Norway and Sweden.

c) This group of countries includes Belgium, Finland, France, Germany, Italy, Portugal and Spain.

d) This group of countries includes the Czech Republic, Poland and the Slovak Republic.

e) Average unemployment benefit replacement rate across two income situations (100% and 67% of APW earnings), three family situations (single, with dependent spouse, with spouse in work), over a five-year period of unemployment.

f) ALMP expenditures per unemployed workers as a percentage of GDP per capita.

g) Tax wedge between the labour cost to the employer and the corresponding net take-home pay of the employee for a couple with a dependent spouse and two children earning 100% of APW earnings.

Source: OECD Employment Outlook 2006, p.191

This analysis provides following considerations:

- Positive labour market indicators development (employment and unemployment rate) could be associated with different levels of interventionism.
- It depends on a mix between supply and demand side economic policy.

**Tab. 2: Data for creation the pentagon of labour market flexibility**

	Employment insurance benefit duration (2005, in months)	Tax wedge (2005, in %)	Strictness of employment protection legislation of regular employment (2003, Coefficient 0-6)	Coefficient of union density and union coverage	Coefficient of wage bargaining co-ordination (1995 – 2000, values 0-5)
Belgium	No limit	55,4	1,7	1,6	4,5
Austria	9	47,4	2,4	2,56	4
Denmark	48	41,4	1,5	1,08	4
Finland	23	44,6	2,2	1,18	5
France	23	50,1	2,5	9,0	2
Germany	12	51,8	2,7	2,72	4



Italy	6	45,4	1,8	2,28	4
Netherlands	24	38,6	3,1	3,43	4
Portugal	24	36,2	4,3	3,33	4
Spain	21	39,0	2,6	5,33	3
Sweden	28	47,9	2,9	1,13	3
United Kingdom	6	33,5	1,1	0,96	1
Czech Republic	5	43,8	3,3	0,92	1
Hungary	9	50,5	1,9	1,5	1
Poland	12	43,6	2,2	2,67	1
Slovakia	8	38,3	3,5	1,39	2
USA	6	29,1	0,2	1,08	1

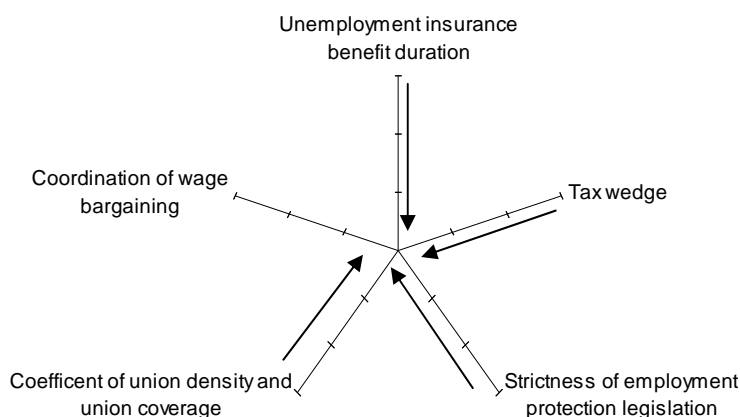
Source: OECD Employment Outlook 2006; OECD Employment Outlook 2004; OECD Taxing Wages 2004-2005; own calculation.

In term of these considerations we can divide countries into two groups: i) according to level of interventionism (horizontal axes) and ii) according to labour market indicators and economic policy mix. It holds generally: *the higher is coordination on both axes the more institutional framework of labour market conforms to labour market performance.*

We created a specific pentagon for comparative analysis of labour market flexibility. Each axis represents one institutional aspect of labour market. Arrows represent the direction to the centre of the pentagon. It means that the closer the valuable is to the centre the more institutional aspect contributes to flexible labour market. The direction of the wage bargaining coordination axis could be toward the centre as well as from the centre. This indicator depends on union density.

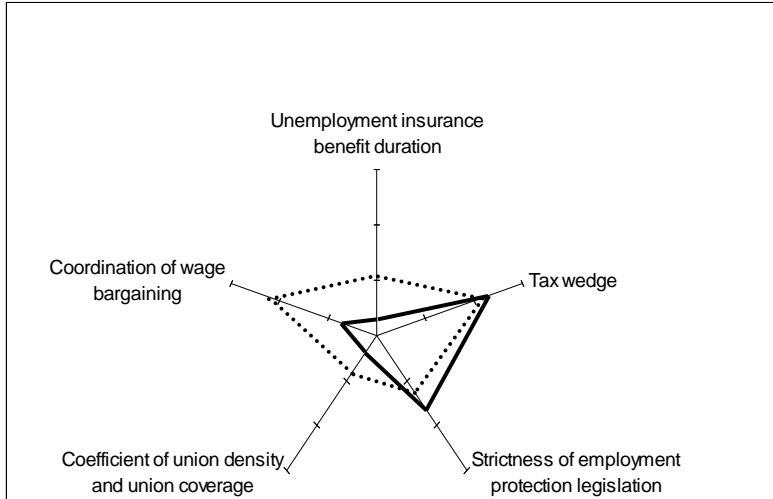
The closer individual sides are to the centre the more flexible is labour market. Scindum est, in case of high valuables it is necessary to take into account the level of wage bargaining centralisation or decentralisation. The high value could not mean rigidity of labour market a priori.

**Fig. 4: Construction of labour market flexibility pentagon**



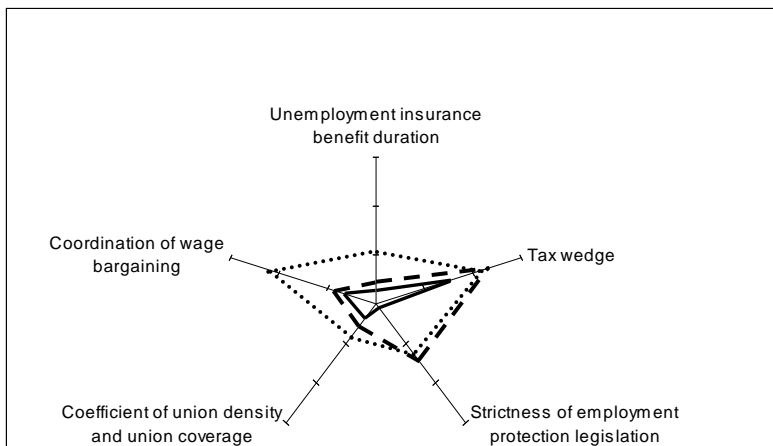
Note: unemployment insurance benefit duration is measured in months; tax wedge is measured in %; strictness of employment protection legislation of regular employment is based on OECD index (valuable 0-6); Coefficient of density end union coverage is counted as a rate of density and coverage; coordination of wage bargaining is measured accordance with OECD index (valuable 1-5).

**Fig. 5: Labour market flexibility: Czech Republic vs. EU-14**



The conception of comparative analysis is following. Dotted line represents valuables of EU-14 average. Solid line represents valuables of individual state. Fig. 5 illustrates the situation for Czech Republic (other V-4 countries pentagons are in an annex). Fig. 6 illustrates main aspects of labour market flexibility among countries of V-4, EU-14 (except Luxembourg) and USA. These pentagons confirm detected data from partial analysis of institutional aspects.

**Fig. 6: Labour market flexibility: V-4 vs. EU-14 vs. USA**



Note: .....EU-14, - - - V4, —USA

## CONCLUSIONS

This paper deals with labour market in the context of monetary union. If the autonomous monetary policy is no more available, economic theory defined the labour market flexibility as an instrument for adjustment process in case of asymmetric shock. Another need of the labour market flexibility is resulting from maintenance or increase of competitive strength. The comparative analysis provides these conclusions:

- Most V-4 countries had slightly higher tax wedge compared to EU-14.
- Strictness of employment protection legislation among V-4 countries was reaching the higher valuables (except Hungary), whereas these valuables were higher for regular employment than temporary employment.
- Coefficients of union density and union coverage of V-4 countries were close to valuable of 1 (except Poland) which means that bargaining power is corresponding to union membership.
- Wage bargaining coordination is among V-4 countries significant lower. This is given in that wage bargaining takes place on firm level.
- Duration of providing unemployment replacement rates was shorter in V-4 countries than EU-14.
- The most flexible labour market was in the USA. Labour markets in V-4 countries appear to be more flexible than in EU-14 but level of flexibility was much lower compared to the USA.

Finally we can say that labour markets in Visegrád countries reached, in comparison with EU-14, at least the similar even better values of labour market flexibility.

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