Labour market or laboured market: inefficiencies and unemployment in the European Union

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This article by Sean McGrath makes the case that European integration is very much a project which has yet to be accomplished – particularly from the point of view of the labour market. McGrath highlights the various factors which conspire to generate rigidities in the labour market and thus result in the unemployment levels which are well above target. He stresses that these rigidities are of particular concern for policymakers when it comes to addressing the worrying phenomenon of long-term unemployment which looks set to afflict Europe for some time to come.

Introduction

The recent spike in unemployment across Europe and much of the world has been a highly publicised and highly emotive issue. Similarly striking reductions in global trade and industrial output have not evoked the same fear and apprehension in the minds of millions. For many, anxiety regarding the future lies predominantly with the prospect of unemployment, rather than with the concern for the economy as a whole. Unsurprisingly then, given the sensitive nature of the issue, any analysis of the European labour market cannot be approached in a similar manner to that of other markets. Furthermore, the interplay of features such as collective wage negotiations, government regulation with regard to hiring and firing employees, minimum wage legislation and unemployment benefits all contribute to ensuring that the functioning of the labour market presents a unique set of challenges for policymakers to address when attempting to limit unemployment.

This essay will outline how such complexities have resulted in the failure of the European Union (EU) to maintain unemployment levels below even its own, self-imposed targets. It will also examine the manner in which EU policies, such as that of Europe-wide economic integration, facilitate the reduction in European labour market rigidity and ultimately, a likely reduction in initial levels of unemployment. Finally, this essay will analyse the highly controversial issue of migration and outline some reasons why the consternation which greets this phenomenon may be somewhat misplaced.

An underperforming Europe

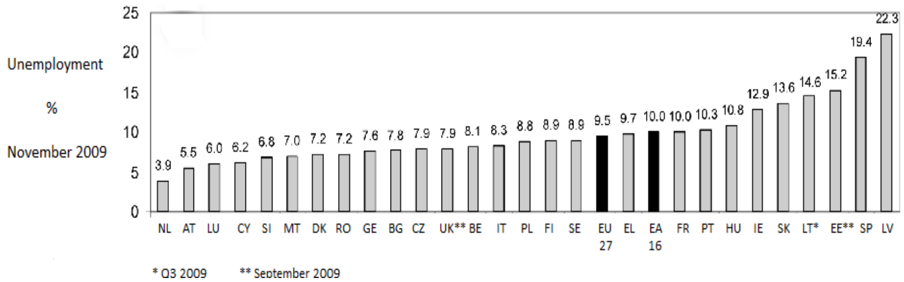
In attempting to characterise the European labour market and assess the success of its policies to limit unemployment, it is perhaps useful to identify a comparison against which the EU can be judged. The USA, as the world's principal economic actor, is appropriate for this purpose. Although, there are some issues which limit the extent to which this comparison is valid, such as disparities in measurement methods, the statistics highlight some points of significance. Ignoring the recent convergence in unemployment levels following the recent crisis, between the years 1992 and 2008, the USA consistently outperformed the EU in both maintaining a higher employment-to-population ratio and a lower unemployment rate.

Source: CEPR (2009)

Although this convergence indicates an improvement in the European position in relation to its American counterpart, the situation in Europe has continued to deteriorate in the ensuing period. According to the Eurostat website, as of November 2009, seasonally-adjusted figures show an unemployment rate of 9.5 per cent for the 27 EU member states, which indicates a 2.3 per cent increase since November 2008[1]. This figure also masks the extent of the disparity in unemployment figures

[1] http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-08012009-AP/EN/3-08012009-AP-EN.PDF

across member states, with the best positioned member, the Netherlands at 3.9 per cent and a particularly badly affected Spain with an unemployment rate of 19.4 per cent in November 2009.[2]



Source: Eurostat (2010)

The inability of certain EU member states to secure employment for its residents inevitably begs the question: how can the situation be improved and disparities addressed? In order for this to be undertaken, an understanding of the complexities involved in the functioning of the labour market is vital.

A not so perfect market

It is tempting to approach an analysis of the labour market in a similar manner to that of other markets, using demand and supply curve analysis and identifying an equilibrium level of employment, whereby the amount of labour that individuals' supply equals the quantity demanded by employers at a certain wage level. As previously mentioned however, to proceed in this manner would lead to a fundamentally flawed outcome. In reality, we do not see such fluctuating wage rates which correspond to changes in the demand or supply of labour. As this seems to counteract common economic intuition, it impels us to identify and examine some of the features unique to labour markets, and the consequences these have on wage and employment levels.

One issue which cannot be ignored here is the role of so-called labour market institutions. These "form a complex web of incentives and disincentives on

[2]http://epp.eurostat.ec.europa.eu/tgm/graph.do?tab=graph&plugin=1&language=en &pcode=tsisc070&toolbox=type

both sides of the market" and enshrine in law features such as "specific regulations relating to work time, layoffs, or other matters" (Siebert, 1997: 39). This ensures that demand is not simply determined through "conventional market elements like output prices and the productivity of labour" (Siebert, 1997: 39). Adding to this complexity is the imposition of a minimum wage and social security measures that influence the individual's reserve wage price, creating a further distortion in the supply of labour, particularly at low wage levels. As a result, conventional demand and supply analysis cannot be applied to labour markets. Labour markets, therefore, cannot be expected to clear in the short or medium term and involuntary unemployment will ensue.

A Union for whom?

In the previous analysis of labour markets and unemployment, one crucial feature has been neglected, namely, the collective nature of labour negotiations. Employees come together in the form of trade unions in an attempt to strengthen bargaining positions and improve the outcomes they can achieve in negotiations with employers. In this sense, "the main incentive to join the union lies in the appropriation of employer rents… and in their distribution to members" (Checchi & Lucifora, 2002: 364). However, as labour demand is sensitive to the wage rate, an increase in this rate (due to increased bargaining power on the part of trade unions, for example) can be assumed to have some negative effect on employment levels.

Of further concern is the question of who exactly is represented by trade unions. A trade union represents its members (that is, those who are currently in employment), whereas those who are unemployed receive no representation. If union members were to collectively agree to reduce wages, then presumably some of the unemployed, non-members would have the chance of finding employment through greater demand for the now cheaper labour. However, as there is little incentive for union members to accept such a reduction in pay, it is logical to expect higher wages to be maintained and unemployment to persist. The Irish example provides a useful illustration of the potential outcomes of collective negotiation. In 2006, the pay differential between the highly unionised public sector and the private sector, where unionisation is sparser, was estimated to be 23.5 per cent, with no obvious productivity premium in the public sector, indicating a significant imbalance (Kelly, McGuinness & O'Connell, 2008).

Compounding the above is the broader effects that trade unions can have on labour market flexibility. The influence of trade unions extends into areas such as labour market legislation, with more employment protection for employees resulting in increased labour market rigidity and, thus acting as a further disincentive for employers to hire new staff.

Of course, one must be cautious when discrediting the activities of trade unions. In certain circumstances, the protection that union membership offers vulnerable workers is invaluable, but this must be scrutinised in light of the need to reduce unemployment across the economy as a whole. Furthermore, there are undoubtedly some anomilies which seem to run counter to the theory outlined, notably in the Nordic countries, where union membership is high and unemployment is generally relatively low. This can perhaps be attributed to specific features of the Nordic economies, such as the use of the Ghent System[3] for unemployment insurance and also to specific labour market policies adopted in the Nordic countries that are not reflected elsewhere in Europe. Nevertheless, the Nordic system attests to the fact that trade union membership need not necessarily lead to high unemployment.

Long-term unemployment: a pressing concern

Incorporating the differences between the types of unemployment can help to highlight further issues afflicting the European economy. Short-term, cyclical unemployment is not nearly as detrimental as peristent, long-term unemployment. Several issues present themselves here:

> "First, long-term unemployment is felt to have disastrous effects on the individuals who suffer it both in terms of their labour market opportunities and their more general physical and mental well-being… Secondly, it has been argued that the long-term unemployed become detached from the labour market and play little role in competing for jobs."

(Machin & Manning, 1998: 7)

These individuals therefore, do not exert downward influence on the wage rate resulting in the further possibility of increased unemployment. In addition, the financial burden placed upon states with generous social protection schemes can be quite large if the number of long-term unemployed people remains persistently high. Finally, a hysteresis effect may occur, whereby high unemployment in the past essentially leads to higher unemployment in the future. The logical conclusion here is that long-term unemployment should be avoided wherever possible. Certainly, the past experiences of Germany, Italy and France in fighting consistent unemployment

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[3] Under this system welfare payments are the responsibility of the trade unions instead of Government. The Ghent system takes its name from the Belgian town where it was first implemented.

attest to the damaging effects long-term unemployment can have. It also provides justification for the desire to avoid a similar scenario again, in which regard European nations are succeeding to different extents.

Given that long-term unemployment poses such a threat, governments must consider the optimal way to deal with it or, ideally, how to prevent it from occurring. The primary concern is to identify some of the reasons why people who become temporarily unemployed do not find employment again and are consequently consigned to long-term unemployment. Although there may be many reasons, one which deserves particular attention is the level, duration and conditionality of unemployment payments. Certainly there is merit to the argument that recently unemployed individuals should receive some sort of financial compensation. A problem arises, however, if these unemployment payments are large enough to act as a disincentive for the individual to find employment again. In this case, a so called ‘welfare trap’ develops whereby some unemployed people deem themselves to be better off by remaining unemployed and availing of unemployment benefits rather than accepting low-paid employment.

It is critical that issues such as this be addressed on a European-wide scale and there are numerous initiatives which have and could be further advanced to better address these concerns. One such programme is to make unemployment payments conditional on the individual’s acceptance of work or training whenever it becomes available, and withholding payments if this training or work is rejected, as in the so-called Nordic model. Indeed, this point has been stressed by the OECD (2010). Other methods include the gradual reduction in payments as the duration of unemployment increases, therefore increasing the incentive to find employment. In many cases however, these initiatives may not be enough to entice the long-term unemployed back to work. As a result, active labour market policies such as training, ‘up-skilling’, job-search assistance and public recruitment have been adopted throughout Europe. Although long-term unemployment remains a topic of constant concern, the levels in Europe are currently far lower than those which prevailed in the 1980s and 1990s, indicating some success in the policies implemented in the intervening period.

Economic integration and migration: employment stimulus or sacrifice?

In any discussion relating to EU labour market, it is almost impossible to ignore concerns about further economic integration and migration. Regardless of the facts, it can be argued that increased competition from economic integration and migration has had a negative impact on employment levels, particularly in the more prosperous European states. Certainly the reduction in trade barriers, the adoption of a single currency and the formation of a single market within the EU have led to increased competition for firms operating within its borders. Whereas once a firm may have had an almost monopolistic position in its domestic market, the introduction of potential competitors with lower prices for similar products or services, exerts downward pressure on wage levels in the originally uncompetitive market. As this has occurred on a large scale throughout the EU, it has resulted in an adjustment of the entire European labour market. Whereas once a firm in an uncompetitive domestic market could shift the burden of higher wages onto the customer through higher prices, the introduction of new lower-priced alternatives eliminates this possibility.

Further intensifying this adjustment are the effects of the monetary union. Prior to its introduction, complications such as a lack of price transparency and the risk of exchange rate fluctuations limited intra-European trade. With the removal of such obstacles, the possibility of increased trade was realised. The result was a reduction in the ability of firms to pass on increases in wage costs to consumers, as well as an increased possibility for growth offered by the opening up of the entire European market.

The cumulative effect from increased economic integration, therefore, would be an expected increase in overall employment levels. This is not to say that everyone benefits equally. Certainly some people will gain more, in some cases at the expense of others, and relocations of multinational corporations from higher-cost economies to lower-cost ones within Europe have highlighted this issue but the overall employment gain from economic integration would be expected to outweigh the employment loss.

Another somewhat more controversial topic is that of migration. Once again, public opinion on this matter focuses largely on negative and sometimes unfounded claims about the adverse impact of migration on the host country. Indeed, immigrants are often held "responsible for high unemployment, abuse of social welfare programmes, street crime and deterioration of neighbourhoods" (Baldwin & Wyplosz, 2009: 252). Whilst a comprehensive study of migration is beyond the scope of this article, some key issues are worth examining. The critical point here, similar to that of economic integration, is that there are asymmetrical outcomes from migration. Undoubtedly, some people gain quite a lot from this phenomenon, such as the opportunity to find more highly-remunerated employment abroad, or the ability to establish a firm in a lower-cost environment, whereas others may find themselves in competition with immigrants who are willing to supply labour at a lower cost. In summation, however, migration can be viewed as beneficial in the sense that it improves the efficiency of the labour market. As labour demand is related to the marginal productivity of labour, migration from lower-wage economies to higher ones is equivalent to the reallocation of labour to where it is valued most highly. In the sense of the European labour market as a whole, this improved efficiency can be assumed to be beneficial, even though it may lead to resentment amongst indigenous workers faced with unemployment or a reduction in wages due to the increased supply of labour.

Perhaps the critical question to be addressed here is in relation to the overall effect of migration on unemployment in the EU. Unfortunately, empirical evidence on this issue is rather ambiguous. The clearest outcome that can be reached is that "the empirical evidence we have does not support the notion that immigration has large, negative effects on European labour markets" (Baldwin & Wyplosz, 2009: 255). This seems to indicate that the widespread dismay, throughout Europe in relation to immigration, is at least somewhat overstated. The consistent upward trend in the employment rate across the 27 EU members seems to reflect the success of economic and labour market integration[4].

Conclusion

This article has attempted to outline some issues which hinder the efficient functioning of the European labour market, such as collective wage negotiations, as well as those which have seemingly improved its functioning. It has also examined the potentially damaging effects of long-term unemployment and identified why policies to limit its occurrence across Europe need to be maintained and, if possible, extended further.

The transformation of the European labour market in recent decades and the advancement of policies to foster economic and labour market integration, which are fundamental to the entire European project, have undoubtedly led to an improvement in the lives of millions of European citizens. Although this is the case, the sheer complexity of the labour market and the psychological and economic consequences of issues such as unemployment and migration, ensure that it will remain a controversial topic.

[4]Employment has risen by over four per cent in the ten years up 2008 (Eurostat, 2009).

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