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The pros and cons of a common European employment policy

Richard Jackman*

Summary

■ This paper considers the advantages and disadvantages of having common employment policies within the EU. It argues that the adoption of common employment policies presupposes both shared objectives and the existence of inter-country spillovers. The paper suggests, however, that member states retain different political and social objectives, and these differences account for the very different labour market outcomes observed.

The main argument for harmonisation of policies is to avoid policy-induced distortions in competition. The paper suggests that where labour markets are flexible, the costs of labour market regulations are incident on labour and hence different regulatory regimes in different countries will not distort competition between them. The paper notes a movement towards greater labour market flexibility in some countries or towards wage policies giving greater weight to market forces in others.

The paper recognises a case for some harmonisation of labour market reforms, in that such reforms constitute nation-specific supply shocks which are difficult to accommodate in a single currency area. The final section of the paper looks at the case for policies encouraging greater nominal wage flexibility as a mechanism to replace exchange rate flexibility, but suggests that the magnitude of short-run exchange rate fluctuations observed over the recent past makes this an unrealistic aspiration.

The paper concludes that there is neither sufficient commonality of objectives nor sufficiently large inter-country spillover to justify a common employment policy for the EU. ■

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* *Richard Jackman is professor of economics at London School of Economics.*

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The average unemployment rate in the 15 countries of the European Union reached a peak of 11.1 per cent in 1994, and though by 2000 it had declined to 8 per cent, it has been double the US rate in every year from 1996 to 2000. The 11 countries of the Eurozone have an even worse record, with a year 2000 average unemployment rate of 8.9 per cent. By comparison the year 2000 unemployment rate in the US was 4 per cent and in Britain 5.5 per cent. The sustained high level of unemployment in much of Western Europe has been one of the most conspicuous failures of European economic policy, and it is natural to ask why this has occurred and what might be done about it. In particular, it is important to understand whether the institutions and policies of the EU itself may have contributed to raising unemployment, and whether there are gains from European, as against national, policy initiatives to reduce unemployment and to improve the workings of the labour market.

Employment policies may be defined as government measures whose prime objective is to influence labour market outcomes, in particular employment and unemployment, but including also wages, working conditions and employment security. While few in Europe would dispute that full employment, fair wages and good working conditions are appropriate concerns for governments, it is less clear that the European Union, as against national governments, has a role to play. While the EU has embarked upon a number of initiatives in this area, their impact in practice has been somewhat muted. The involvement of the EU (then European Community) in the establishment of various rights for working people has been most obviously manifest in the "Social Charter" (originally the Community Charter of Basic Social Rights for Workers, adopted in 1989) which is part of the

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Maastricht Treaty and the Single European Act. Equally, on the macroeconomic stage, the Delors White Paper (European Commission, 1993), entitled "Growth, Competitiveness and Employment" proposed the objective of halving the European unemployment rate, then standing at 10 per cent, by the year 2000 through a variety of macroeconomic initiatives.

From the standpoint of welfare economics, common employment policies can be justified only where there are externalities such that policies introduced in one country have an effect on the labour markets of others. In the terminology adopted by the Community, the principle of subsidiarity requires that intervention by the EU be limited to circumstances where policies undertaken by one nation have effects on other member states. But while externalities may be a sufficient reason for a "good neighbours" arrangement ensuring each country takes account of the effects of its policies on other member states, it does not constitute what would generally be described as a "Common Employment Policy". This last term would normally imply both shared objectives and an agreement as to the means appropriate for achieving these objectives.

The report of the Swedish *Government Commission on the EMU*, as reported in Calmfors et al. (1997), was fairly dismissive on this matter. It concluded its investigation of the labour market impact of Economic and Monetary Union with the statement "There is no strong case for coordinating employment and labour market policy at EU level. Institutional differences between countries and the high degree of uncertainty over what measures would best help to restore high employment argue in favour of allowing each EU country to formulate its own employment policy. But it is clearly useful to exchange experiences in this field." (ch. 8, p. 188).

This paper reaches a somewhat similar conclusion. I will in fact argue that the employment problem has different characteristics in the different member states of the EU, making a common approach to policy inappropriate in principle. It is necessary to start from an understanding of why unemployment is so high in many European countries, and why it differs across member states. These differences have their origins in the familiar differences in labour market institutions between countries, but it is now recognised that institutions, and the policies supporting them, have their roots in ideologies and social values which themselves affect the objectives of employment policy and perceptions of how labour markets work.

These issues are highlighted in Section 1 of the paper, which looks at employment and some other labour supply measures for the EU labour markets. The purpose of focusing on employment is because the fundamental concern of many people is with the failure of labour markets to provide jobs, rather than whether those without work are classified as unemployed or inactive. There is the linked concern that in some countries policies have successfully shaken unemployed people off the unemployment count while failing to create any new jobs. Of course, differences in employment rates may also be supply induced, but the disaggregated analysis in Section 1 suggests it is an absence of job opportunities, rather than individual choice, which is leading to low employment rates in many European countries.

Section 2 draws out some implications of these statistics for a common employment policy. It argues that the differences across countries have their roots in different national values, the contrast being between the "universalistic" welfare state approach of the larger continental economies, as against the "market liberal" approach of the UK and increasingly of some of the smaller European countries. The section goes on to describe the evolution of EU policy on structural labour market measures to raise employment and reduce unemployment. It may be noted that despite the institutional and political differences across countries, the stance of the EU Commission is currently in line with liberal market arguments concerning the need to deregulate the labour market and improve incentives if unemployment rates are to be reduced. The section goes on to consider the case for harmonisation of labour market reforms, on the grounds that uncoordinated reform may be disruptive in terms of the macroeconomic management of the European economy.

Section 3 considers some specific EU legislative policies. The section considers the provisions of the Social Charter, which, it is argued, have as their motivation the wish to protect working conditions of the workforce from the perceived threat of "unfair competition". However, it may be noted that the Social Charter is fairly limited in scope and its impact has correspondingly been fairly minimal. The section considers some economic arguments concerning the nature of the externalities involved.

It argues that there is not a strong case for superimposing European over national policy objectives where the people of different countries have different policy preferences. Consider, for example, the arguments over the increased availability of part-time work. On

the one hand, more part-time jobs offer improved employment opportunities for "secondary workers", particularly married women. On the other hand, part-time workers may undercut the wages of full-time workers. Evidently both may be true and which one regards as more important is a matter of one's overall perception of the role of the labour market in society. The section argues that the movement towards more market-orientated policies weakens the case for policy coordination, because deregulated labour markets are less affected by the precise nature of policy interventions. A system of deregulated labour markets is consequently more tolerant of different practices amongst member states.

Section 4 reverts to an earlier strand of argument over the causes of high unemployment in Europe which was based on the manner in which rigid institutions could make persistent unemployment resulting from macroeconomic shocks. In recent years, the inflation-targeting regime for monetary policy, adopted in the US and the UK and elsewhere, has proved rather more successful than any predecessor regime in stabilising the economy. A feature of this regime is that the exchange rate is left to float freely, and fluctuations of exchange rates between countries each pursuing inflation targets have been fairly large. The section briefly considers why exchange rates should fluctuate so much when prices themselves are so stable, but argues that, even so, the economic costs of exchange rate instability have not been overwhelming. The obvious concern that the Eurozone countries cannot deploy monetary policy in pursuit of domestic policy objectives has led to the suggestion that wage policies can to some extent fill the gap. This argument seems unconvincing at least if anything approaching the magnitude of relative price changes achieved by flexible exchange rates is required.

The last section offers a very brief conclusion.

1. EU labour markets in international perspective

The malaise in European labour markets runs very much deeper than the differences in unemployment rates. Not only are unemployment rates higher in EU countries than elsewhere, but also participation rates are lower, hours worked are lower, and the overall labour supply is a far smaller in relation to the working age population than say in the US or Japan. Nickell and Layard (1999) have calculated that whereas the labour supply in the US amounts to over 68 per cent of

maximum potential, the equivalent figure for most EU countries falls below 50 per cent and for Spain is only just over 40 per cent. This reflects differences both in the proportion of the working age population in employment and in average hours worked per year. Of course, more labour supply is not necessarily better than less, but I will argue the evidence suggests that the low European rates reflect discouragement and market failure rather than simply a preference for more leisure.

The first column of Table 1 sets out the employment-population ratio, i.e. those employed and self-employed as a proportion of the population of working age (15-64), in 1999, for the EU countries and for other major OECD economies. The EU average of 62.6 per cent is a full 10 percentage points lower than the equivalent figure for the US. In the US nearly three quarters of the population of working age are actually in work, whereas in Italy or Spain the equivalent figure is only just over half. There are also big differences in the employment-population ratio within the EU, with the ratio highest in Denmark (76.5 per cent), Sweden (72.9 per cent) and the UK (71.7 per cent), which happen, one must presume coincidentally, to be the three countries which have not signed up to the Euro.

As may be seen from Table 1, these very large differences in employment ratios are primarily attributable to differences in participation rates rather than to unemployment differentials. Within the EU participation rates range from 59.6 per cent (Italy) to 80.6 per cent (Denmark), which is about twice as large as the variation attributable to differences in unemployment rates, which range from 3.6 per cent (Netherlands) to 15.9 per cent (Spain). (The unemployment rates are measured in relation to a lower denominator—the labour force rather than working age population.) Column (2) reinforces the point that average EU unemployment rates are high by OECD standards. If OECD countries were ranked by unemployment rates the top 7 would all be EU member states, and the EU average is higher than the individual unemployment rate of any non-EU country.

The participation rate measures the economically active (employed, self-employed and unemployed) as a proportion of the total population of working age. Differences in participation rates may to some extent reflect differences in preferences across countries, but the magnitude of the differences seems improbably large across countries that in other respects are far from dissimilar. The magnitude of the differences and their correlation with unemployment rates suggest

there is an underlying problem of a lack of jobs in at least some of the EU economies.

Table 1. Labour market participation rates, 1999

	(1)	(2)	(3)	(4)	(5)	(6)
	Empl./ popul. ratio (%)	Stand. unempl. rate (%)	Partici-pation rate (%)	Participation rate (%)		
				Men	Women	Differ-ence
EU						
Austria	68.2	4.7	71.6	80.5	62.7	17.8
Belgium	58.9	8.7	64.6	73.0	56.0	17.0
Denmark	76.5	5.2	80.6	85.0	76.1	8.9
Finland	66.0	10.3	73.6	75.9	71.2	4.7
France	59.8	11.8	67.8	74.4	61.3	13.1
Germany	64.9	8.7	71.2	79.7	62.3	17.4
Greece[a]	55.6	11.0	62.5	77.1	48.5	28.6
Ireland	62.5	5.8	66.3	78.3	54.3	24.0
Italy	52.5	11.8	59.6	73.7	45.6	28.1
Netherlands	70.9	3.6	73.6	82.6	64.4	18.2
Portugal	67.3	4.6	70.6	78.7	62.8	15.9
Spain	53.8	15.9	63.9	78.3	49.9	28.4
Sweden	72.9	7.1	78.5	80.9	76.0	4.9
UK	71.7	6.1	76.3	84.1	68.4	15.7
EU average	62.6	9.3	69.0	78.4	59.5	18.9
Other OECD						
US	73.9	4.3	77.2	84.0	70.7	13.3
Japan	68.9	4.9	72.4	85.3	59.5	25.8
Australia	68.2	7.3	73.6	82.7	64.5	18.2
Canada	70.1	7.6	75.9	82.0	69.8	12.2
New Zea-land	70.0	6.9	75.2	83.2	67.4	15.8
Norway	78.0	3.2	80.6	85.0	76.1	8.9
Switzerland	79.7	3.1	82.2	89.6	74.5	15.1

Note: [a] 1998.
Sources: Columns (1)-(5): OECD Employment Outlook, 2000, Appendix C.

Causes of differences in participation rates across countries do not appear to have been very systematically explored, and in this section I offer a few inferences that can be drawn from the basic statistics. The EU average participation rate of 69 per cent is 8 percentage points lower than the comparable figure for the US, and as column 3 of Table 1 shows is also below the level attained in all non-EU advanced

OECD economies. Equally, within the EU there are also big differences. The Scandinavian countries have far higher participation rates (e.g. 78.5 per cent in Sweden and 80.6 per cent in Denmark) and the countries of central and southern Europe much lower (for example, Italy at 59.6 per cent has the lowest participation rate in the OECD and the participation rate in Spain is only 63.9 per cent).

One immediate cause of these differences, as might be expected, lies in the participation of women in the workforce. This reflects the fact, explored in more detail below, that male participation rates are relatively similar (at around 75-85 per cent) across EU countries, while female rates are more variable, ranging from 76 per cent in Sweden to only 45 per cent in Italy (Table 1, columns 4 and 5). The main single cause of low overall participation rates in many European countries is the low participation rate of women. The crude percentage point difference between male and female participation rates is high in countries where overall participation is low and *vice versa*. In Sweden and Finland, this gap is only 5 per cent, while in Italy and Spain it is over 28 per cent. While the origin of the participation gap is no doubt to be explained in terms of traditional social structures, it has to be said that these differences are very large and it is not clear that they have any coherent economic explanation.

Table 2 offers some further evidence on this matter. The first column records the employment rates of 25-54 year old ("prime age") men. There is a quite remarkable similarity across countries, with all in the EU within 3 or 4 percentage points of the EU average, and, in this group of workers, the employment rates of the EU countries are much the same as for other advanced OECD economies. The lower employment rates of prime age women in some of the EU countries follows the same pattern shown in Table 1.

The more remarkable evidence in Table 2 concerns the employment rate of young people. The variation in the employment rate of young people (age 15-24) across the OECD economies is enormous, ranging from 20.8 per cent in France up to 66 per cent in Denmark. These differences across neighbouring economies seem surprisingly large. One immediate explanation, that it reflects staying-on-rates in education, has some force, but the figures in column 6 of the Table suggest education is only part of the story. These figures, of the proportion of 21 year-olds in full-time education, are not exactly comparable with the employment ratios, which are for the whole age group. It may none the less be noted that some of the countries with the

highest educational enrolment rates, such as the Netherlands, have also very high employment ratios, and overall there is no close correlation in the data.

Table 2. Employment ratios by age, 1999

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Employment/population ratios					Edu. enrol. (1995)	Birth rate
	Adult men	Adult women	Youths	Young men	Young women		
	%	%	%	%	%	%	per 1000
EU							
Austria	89.6	72.8	54.9	59.2	50.7	22	10.9
Belgium	86.2	66.4	25.5	27.5	23.4	49	11.4
Denmark	89.3	79.4	66.0	69.5	62.8	40	13.4
Finland	83.4	77.1	38.8	39.3	38.2	49	12.4
France	85.7	68.5	20.8	24.3	17.3	42	12.5
Germany	87.0	69.2	46.8	50.7	42.8	34	9.3
Greece[a]	89.0	51.6	28.1	34.2	22.2	29	9.8
Ireland	86.4	60.0	46.4	49.7	42.9	20	13.4
Italy	84.3	49.5	25.5	30.3	20.8	n/a	9.2
Nether-lands	91.5	69.4	62.7	62.9	62.5	48	12.3
Portugal	89.8	72.1	43.2	47.6	38.7	47	10.7
Spain	84.2	47.6	33.9	41.3	26.2	40	9.1
Sweden	84.5	80.6	43.8	44.8	42.8	31	11.7
UK	86.7	72.6	60.8	63.0	58.5	33	12.9
EU aver-age	86.3	64.7	39.5	43.4	35.5	n/a	--
Other OECD							
US	89.0	74.1	59.0	61.0	57.0	35	15.3
Japan	93.6	63.6	42.9	42.8	42.9	n/a	9.9
Australia	85.3	65.6	60.8	62.0	59.6	34	14.5
Canada	85.1	73.2	54.6	55.4	53.9	38	13.2
New Zea-land	86.0	69.6	54.6	57.2	52.0	51	16.3
Norway	89.4	81.4	57.8	60.2	55.2	41	13.8
Switzer-land	95.1	75.1	64.7	64.1	65.4	25	11.6

Note: [a] 1998.
Sources: Columns (1)-(5): OECD Employment Outlook, 2000, Appendix C. Column (6): OECD Education at a Glance, 1997, Table C3.1. Column (7): UN Demographic Yearbook, 1995, Table 4.

More clearly still, explanations based on traditional social structures and the role of women in society find no support from this table. While the employment rates of young women in nearly all coun-

tries are lower than those for young men, in most countries the differences are small and do not contribute much to the overall differences in youth employment rates. It may also be noted that the differential between men and women is biggest in countries with the lowest birth rates, suggesting that childcare responsibilities do not explain these differences. Spain, which has the lowest birth rate of all OECD countries, has the largest differential between male and female youth employment rates in the OECD. It appears hard to explain why only 17.3 per cent of women in France aged 15-24 should be in employment, when the equivalent figure for Denmark, which has about the same education participation rate and a higher birth rate, is 62.8 per cent. The proportion of the population of young people neither economically active nor enrolled in education seems worryingly large in many countries.

The very large differences in youth employment rates may more plausibly be explained by factors on the demand side. The fact that male and female employment rates are positively correlated also seems more consistent with a demand side explanation. As one example, it is often claimed that minimum wage legislation, which is generally believed to have particularly adverse consequences on youth employment, has more impact in France than in other countries, and this may well be a factor in the exceptionally low youth employment rates in France. The positive correlation between employment rates and birth rates may also be easier to explain from the demand side. Without jobs of their own, young people may remain living with their parents and delay setting up home. This, in conjunction with the lack of a secure income, may delay marriage and children, in turn accounting for the low birth rate.

It is well known that the participation rates of older people, particularly older men, have fallen markedly over the past 20 years. But the differences between countries are again very marked, with for example the participation rate of older men (55-64 years) about double in Norway or Sweden its level in Belgium (see Table 3). It is not in general possible to explain these differences in terms of health or preferences. In Europe it is generally the higher income countries, which have the higher participation rates of older people, although there is a discernible pattern of voluntary early retirement to take advantage of expanded travel and leisure opportunities amongst high-income groups in the US. In Europe, the main factor explaining the low participation rates of older men is the extent to which employers

have reacted to economic retrenchment through launching early retirement schemes motivated by the belief that, where jobs had to go, older workers were best able to adjust to non-employment.

Table 3. Employment rates of older workers, 1999

	(1)	(2)	(3)	(4)
	Employment/population ratios		Life expectancy	
	Men %	Women %	Men Years	Women Years
EU				
Austria	41.6	17.6	73.3	79.7
Belgium	35.1	14.8	72.4	79.1
Denmark	59.9	47.8	72.5	77.8
Finland	40.1	38.4	72.8	80.2
France	38.9	29.6	72.9	81.2
Germany	48.0	28.9	72.8	79.3
Greece	55.8	23.6	74.6	80.0
Ireland	61.7	25.7	72.3	77.9
Italy	40.8	15.0	73.8	80.4
Nether-lands	48.8	21.9	74.2	80.2
Portugal	62.1	41.1	71.2	78.2
Spain	52.4	19.1	73.4	80.5
Sweden	67.1	61.0	76.1	81.4
UK	59.4	39.8	74.2	79.4
EU average	48.3	27.8	--	--
Other OECD				
US	66.1	50.1	72.2	78.8
Japan	79.5	48.2	76.6	83.0
Australia	57.0	31.3	75.0	80.9
Canada	56.9	37.3	73.0	79.8
New Zea-land	67.7	46.3	72.9	78.7
Norway	73.6	61.1	74.2	80.3
Switzerland	78.9	62.2	75.1	81.6

Sources: Columns (1) and (2): OECD Employment Outlook, 2000, Appendix Table C. Columns (3) and (4): UN Demographic Yearbook, 1995, Table 4.

Turning from employment to hours, Table 4 sets out average hours worked per year in each country. The variation is very large, from close on 2,000 hours a year in the US to less than 1,400 in Nor-

way. It is obviously more difficult to measure hours worked than employment, and differences may to some extent reflect differences in national survey methods. Typically the "Anglo-Saxon" economies record the highest number of hours worked, with the EU countries supplying less. It is interesting however that the Nordic economies, which have, as noted above, very high employment and participation rates, have the lowest number of hours worked per employee. Evidently, a reduction in working hours is one possible response to a reduction in labour demand, but it has to be said that the Nordic countries have not been particularly active in using e.g. legislative means to lower permitted hours of work. It may well be that what is being observed is a standard supply side response to progressive rates of taxation.

Multiplying hours worked by the employment rate gives a measure of labour input relative to potential. This measure is also shown in Table 4. In the US, actual labour input is just over 70 per cent of potential, where the potential is calculated, following Nickell and Layard (1999), as the labour which would be supplied if everyone aged 15 to 64 worked 2080 hours a year. All countries outside Europe have total labour inputs of 60 per cent or more, whereas in Europe the highest are Switzerland (60.5 per cent) and the UK (59.3 per cent). Many European countries achieve less than 50 per cent, with Italy only managing just over 40 per cent.

It must be stressed again that more labour input is not necessarily better than less, but the differences are very large and do not correspond in any obvious way to demographic or other differences across countries. If one were to assume that the US labour market, being the least controlled or regulated comes closest to a free-market outcome, the shortfall in the other economies appears very large indeed. As a simple indicator of this, column 3 of Table 4 sets down the average tax wedge in each country. Plainly the proportion of income earned which is taken in tax varies greatly across countries, with again the EU countries at the top of the range, and this may well have an impact on labour supply behaviour.

Possibly the most interesting finding of the Nickell-Layard study concerns the impact of employment protection. They use a measure of employment protection constructed by the OECD (Table 4 column 4) which takes into account various aspects of the employment contract such as notice requirements and severance pay. They find that employment protection significantly reduces overall employment

rates, but has no effect on the employment rates of prime age males and a substantial but only marginally significant effect on total labour input. This is, of course, consistent with the use of such policies to exclude secondary workers.

Table 4. 4 factors affecting the labour supply

	(1)	(2)	(3)	(4)
	Hours worked	**Total Labour input**	**Average tax wedge**	**Employment protection**
	(per year)	**%**	**%**	**(ranking)**
EU				
Austria	n/a	n/a	43	12
Belgium	n/a	n/a	56	13
Denmark	n/a	n/a	42	8
Finland	1,765	56.0	46	9
France	1,604	46.1	47	17
Germany	1,556	48.6	51	16
Greece	n/a	n/a	35	20
Ireland	n/a	n/a	28	5
Italy	1,648	41.6	45	19
Netherlands	n/a	n/a	43	10
Portugal	n/a	n/a	33	21
Spain	1,827	47.3	37	18
Sweden	1,634	57.3	49	14
UK	1,720	59.3	30	2
EU average	n/a	n/a	n/a	n/a
Other OECD				
US	1,976	70.2	30	1
Japan	1,842	61.0	23	11
Australia	1,864	61.1	22	6
Canada	1,777	59.9	31	4
New Zealand	1,842	62.0	19	3
Norway	1,395	52.3	37	15
Switzerland	1,579	60.5	30	7

Sources: Column 1: OECD Employment Outlook 2000, Appendix Table. Column 2 is calculated as Column (1) divided by 2080 multiplied by the employment/population ratio. Column 3: OECD Economic Outlook, June 2001, Figure V.4. Column 4: OECD Employment Outlook 1999 Table 2.5.

These comparisons may suggest a difference between what might be termed "open" and "closed" labour markets. In "open" markets, such as that of the US, there are plenty of jobs available and labour participation decisions reflect individual preferences. By contrast, in "closed" labour markets, there are not enough jobs to go round, and employment and participation reflect the social mechanisms adopted in different societies to allocate the jobs that are available. Traditionally, these mechanisms have involved giving the work to adult men, and particularly heads of households, at the expense of secondary workers (youths and women).

Open labour markets can be the result of wage-setting processes, which are decentralised, and competitive, resulting in wages which clear the market. But centralised wage-setting processes can achieve a similar outcome where centralisation leads to wages being set at levels consistent with full employment. This is the traditional Scandinavian model, and similar practices now appear to have been adopted also in a number of smaller European countries such as the Netherlands (Nickell and van Ours, 2000) and Ireland (Walsh, 2000).

By contrast, closed labour markets arise where wages are set primarily in the interests of existing employees, through unions and collective bargaining. In such markets, the capacity of outsiders to undercut is prevented for example by extension agreements making it legally binding for all firms to pay wages at the union-determined rate. Such non-competitive behaviour is sanctioned by governments from a political tradition within which the employment contract is regarded as the bedrock of social security. Governments, and the "social partners" (employers and trade unions) take it on themselves to deliver the social objectives of decent wages and secure employment through setting wages and working conditions to reflect such aspirations.

The outcome is that in such economies labour costs tend to be high, and the demand for labour insufficient to provide jobs for everyone. Typically, in such economies, institutional arrangements are designed to ensure the jobs go to those who need them most (heads of households) so that every family has a wage earner and that wage earner has a relatively secure income. Those without jobs may be married women or those close to retirement age, who withdraw from the labour force rather than registering as unemployed, or young people who can be supported by their families.

2. Structural reform and employment policy

The conclusion of the last section was that high unemployment was simply the most visible symptom of a situation in many European countries where labour market institutions are set up primarily in the furtherance of objectives of social equality and security. These objectives are translated into the proximate goals of improving the wages and working conditions of primary workers. In other countries more weight is given to the attainment of full employment and high participation rates, though the means of achieving this differ between the Scandinavian and some other smaller countries, which rely on wage moderation achieved through centralised bargaining, as against the UK, which relies more on market mechanisms. It is not entirely clear whether these different political objectives represent different values on the part of the population, or simply the more important role allowed the "social partners" (unions and employers) in public life.

None the less, the consequence of the wage and employment protection policies adopted in most of the major EU countries is a diminution of employment opportunities in the economy as a whole. This in turn gives credence to policy diagnoses focussed on increasing the number of jobs through stimulating demand, or of reducing labour supply for example through the encouragement of early retirement. By contrast the liberal market model, now adopted by the "Anglo-Saxon" countries, takes as the objective of labour market policy the de-regulation of the labour market to facilitate the opening up of employment opportunities even while recognising that some of the jobs created may be low-paid or insecure.

Thus while there may be a "qualitative" consensus across Europe concerning the objectives of employment policy, in terms of wanting full employment, fair wages and good working conditions, the weight given to these objectives varies across countries in a manner which is of fundamental importance in relation to policy design. The structural reforms now routinely recommended (e.g. by international economic institutions such as the OECD) for reducing the persistent high levels of unemployment in Europe involve measures such as restricting the scope or generosity of unemployment benefits, eroding the effectiveness of minimum wage legislation, weakening employment protection and the like. All such measures undermine the capacity of existing workers to maintain current levels of wages and working conditions

and run counter to central economic policy objectives of many EU member states.

There has none the less over the past ten years been a major rethinking of EU policy with regard to employment and unemployment. This section describes the evolution of EU policy in this area, and contrasts the approach adopted in the early 1990s, in particular in the Delors Report of 1993, with the current stance of policy embodied in the Broad Economic Policy Guidelines. The final part of the section offers an economic assessment of the benefits of policy coordination on these issues.

2.1. The Delors Report

The European Commission has for many years been concerned with the high levels of unemployment prevailing in member states, and this concern reached its height in the early 1990s as unemployment rates peaked in many countries. To address these concerns, the Commission published in December 1993 a White Paper, produced under the aegis of the then President, Jacques Delors, entitled "Growth, Competitiveness, Employment: the Challenges and Ways forward into the 21st Century (European Commission, 1993). In line with the continental perception of the problem of unemployment as one of a shortage of jobs, but aware of the limitations of Keynesian style demand management policies, the White Paper focussed on the alleged "competitive weakness" of the EU economies. While many of its proposals attracted broad support (e.g. reducing taxation of lower-paid workers) others were more contentious. For example one major set of proposals involved increased public investment, in particular in infrastructure such as improved transport links. Such policies were seen to hark back to outdated concerns over inadequate aggregate demand, and were felt to be out of line with the general climate of fiscal retrenchment being at that time forced on member states as part of the prerequisites for monetary union.

The Meeting of the European Council at Essen in December 1994, convened to determine what measures to take in response to the White Paper, thus effectively abandoned the public investment recommendation, and instead focussed on five areas on which member states were urged to take action. These were:

- investment in vocational education
- increasing the employment intensity of growth

- reducing non-wage labour costs
- improving the effectiveness of labour market policy
- more help for groups particularly hard hit by unemployment.

The specific administrative measure taken following the Essen Meeting was to arrange a series of studies and meetings where member state governments were invited to outline their progress in tackling unemployment with specific reference to the five areas set out above.

From an Anglo-Saxon perspective, the notable feature of the five areas is their focus on inclusiveness in the sense of increasing opportunities rather than sharpening incentives. The search as it were is for means of reducing unemployment without cutting wages, by improving the skills and employability of the unemployed (areas 1 and 4) and by increasing the availability of jobs (2 and 3). The fundamental ideological difference is that the approach embodied in the Essen proposals supposes that the general level of wages can be taken as exogenous and historically determined, or at least not affected by the proposed policies or their effects. By contrast, the approach adopted in the Anglo-Saxon countries assumes that the structural determinants of unemployment are fundamental, and wages adjust until unemployment is at its equilibrium. Hence, policies can have an impact only if they impinge on these determinants.

The particular proposals agreed at Essen are to some extent successful in squaring this circle. Even the most free-market economist would hardly deny that enabling unskilled workers to improve their skills and hence earn higher wages in work relative to benefits out of work would be likely to increase their labour supply and reduce unemployment. The concern is that if politicians believe they are addressing a problem of an absolute shortage of jobs, rather than the need to improve the incentive to work, they may accompany these reforms with an improvement in the unemployment benefit regime, which would undo its effects.

2.2. Broad economic policy guidelines

More recently, EU structural policy in the labour market has become absorbed into the "Broad Economic Policy Guidelines" which were introduced in 1993, and are reviewed annually. The introduction of the Euro in 1999 was accompanied by greater emphasis on the impor-

tance of these guidelines in terms both of their scope and of the mechanisms adopted to encourage compliance. In the present context the key section is that devoted to "Better functioning labour markets" (European Commission, 2000). The guidelines are organised under four headings:

- active labour market programmes
- the tax burden on labour
- benefit systems
- work organisation and flexibility

While the first two of these are carried over from Essen, the third and fourth headings evidently represent some movement towards a more market-orientated approach. This impression is strengthened by more detailed analysis of the structural measures which have been proposed. For example, the general assessment of structural reforms in the labour market in the "Report on the Implementation of the 1999 Broad Economic Policy Guidelines" (European Commission, 2000), stresses the case for linking active labour market policies with the reform of benefit systems to improve incentives. It cites with approval the policy measures introduced in Denmark, the Netherlands and the UK. These countries are judged to have addressed the "combined incentive effects of the tax and benefit system, tightening eligibility criteria and job availability requirements while linking receipt of benefits more closely to active labour market programmes to improve employability, and introducing employment-contingent benefits and tax credits." (p.57). By contrast, there have been "no substantial reforms as of yet in Germany or in Belgium".

In a similar vein, on the topic of work organisation and flexibility, the Commission complains that "Very little has been done to address the problems of rigid employment protection legislation (EPL) and excessive dismissal costs in some Member States" (p. 59). It goes on to point out that "There have been no substantial reforms of EPL in Belgium, Germany or Italy and, in France, it has tightened slightly, if anything." In one of the few references to the minimum wage, Ireland is advised to "Avoid potential negative impacts from setting the minimum wage too high" (p. 105). What is remarkable is not the observations themselves, but rather the recognition by the Commission of the arguments for market-orientated structural reforms if unemployment is to be brought down.

But what force, if any, do these guidelines have? The EU offers each member state "country-specific recommendations" with regard to structural reform of its labour market. These recommendations very often take the form of asking member states to "review" or "evaluate" or "reconsider" various policies or arrangements, with the fairly clear implication that the policy in the particular country requires reform. Thus for example, Belgium is asked to review benefit durations and the availability requirements, Denmark to reconsider leave schemes, Germany to assess employment protection legislation, France to monitor the introduction of the 35-hour working week and so on. Other recommendations are more direct, for example Finland is recommended to reduce the overall tax burden on labour, Spain to shift from passive to active labour market policies, and Sweden to reduce the number of participants on active labour market programmes. While these recommendations lack any means of enforcement, they do at least offer a clear direction in which the Commission believes policy should be moving. This in turn permits an *ex post* appraisal of whether any progress has been made in terms of implementing the recommendation.

The Report on the 1999 guidelines (European Commission, 2000) was commendably blunt in recording instances where no reviews are being undertaken or no progress being made. The Commission makes clear that it is relying on "peer pressure" and "public debate" as its means of encouraging governments to adopt its recommendations. Evidently however there is a limit to the impact of such mechanisms where they do not accord with the perceptions of member state governments. For example, the Commission has recommended that Germany "assess employment protection legislation for SMEs" (small and medium sized enterprises). It notes however that "the German government does not see any negative impact from the stricter employment protection in SMEs", and without any pressure from within Germany to change matters, there is nothing much the Commission can do about it.

2.3. Economic assessment

The different member states of the EU have different labour market characteristics, and give different weights to the various labour market policy objectives. Evidently therefore each will have different priorities in terms of the design of policies to reduce structural unemployment. This is clearly recognised in the Broad Economic Policy Guide-

lines, which make country-specific rather than general recommendations. But it leads to the question whether the EU has any legitimate interest, or role to play, in such structural policies.

With regard to the first, it has to be recognised that there are not, as yet, that many countries in the EU and the behaviour of each has an effect on the reputation of the EU as a whole. This issue has been made more acute since the introduction of the single currency. The perception of Europe as an economic area characterised by rigid labour markets and high unemployment has created a poor image but which may spill over from one country to another. The low return on capital associated with highly protected labour markets will deter investment, and particularly foreign investment. If a country is perceived to have labour market institutions unfriendly to capital, it will experience a net capital outflow. Such perceptions may affect investment in the EU area as a whole. If that country is a large country, like Germany, the capital outflow will have the further impact of weakening the exchange rate not simply of Germany but, with the single currency, of all the countries of the Eurozone. This currency weakness not only creates difficulties for monetary management, but also requires offsetting macro policy adjustments from other member states.

The problem is in a sense the mirror image of the "re-unification problem" which caused the break-up of the ERM in 1992. Then the strength of demand in Germany drove up German, and hence European, interest rates, creating a recession across Europe. Now the weakness of investment, particularly in Germany, is pulling down interest rates and the value of the Euro, and threatens to generate inflation in the Eurozone member states. Of course, the asymmetries are not as severe. Re-unification affected demand in Germany to a far greater extent than other countries, while many European countries suffer labour market rigidities and low investment demand. Further, the country which is most out of line, the UK, is not at present part of the Euro arrangement. None the less, the contrast between countries like Germany, which are seen as unreformed, and say Ireland, which offers a more receptive home for new investment, is clearly leading to imbalances in the strength of demand across European countries. Obviously the monetary policies of the European Central Bank cannot address such imbalances.

Countries with reformed labour markets, or more generally with higher investment demand, are thus faced with a policy dilemma. Either they must try to contain demand through fiscal policy or else

they have to accept the likely consequences of excess demand in the form of higher inflation. The former entails raising taxes or cutting public spending, neither of which may be attractive to a government or its electorate. The second means allowing one's exports to be priced out of the market, which may itself create structural problems as well as possibly being difficult to reverse. The unattractiveness of these options may well deter countries from undertaking structural reforms. Thus if reforms can be to some extent coordinated the disruptive effects of different policies in different countries can be reduced.

The same point can be put in a different way: structural reforms undertaken in one country are a type of asymmetric shock. With a common currency the most effective instrument for dealing with such shocks, monetary policy, is no longer available. This justifies measures of coordination to reduce the amplitude of such shocks. One argument sometimes put against the introduction of the single currency was that it would discourage structural reforms, precisely because of the difficulty of balancing the demand and supply side effects when one was a responsibility of the European Central Bank and the other of national governments (Calmfors et al.., 1997; Bean, 1998; Calmfors, 1998). It is evidently consistent with this concern that the Commission should seek to harmonise supply reforms.

More fundamental than the case for harmonising the pace, or at least the direction, of reform is the question whether labour market institutions should themselves be made uniform across countries. This concern moves away from issues of macroeconomic stability to issues of externality or spillover effects, of whether different institutions in a single market may have adverse economic effects. Such concerns have been manifest for some years and first emerged in specific policies with the introduction of the Social Charter, which is discussed below.

3. The Social Charter and "unfair competition"

The member states of the (then) European Community adopted the "Community Charter of Basic Social Rights for Workers" in 1989. This Charter was subsequently incorporated into the Single European Act, and forms the basis of a European Commission "Action Programme", which provides legislative mechanisms for realising its objectives.

The Social Charter covers many issues, including employment and pay, working conditions and working time, social protection, freedom of associations and collective bargaining and consultation rights, health and safety, freedom from discrimination and the protection of children, the elderly and the disabled. The Social Charter contains only general aspirations, but some of these have been given substance in the Action Programme, which consists of various Regulations or Directives, which will ultimately have legal force within the member states. These Regulations and Directives can enter EU law only with the agreement of the member governments so that in some areas implementation has been a fairly protracted process. Furthermore, employment law remains a responsibility of member states, so that EU Regulations are not intended to displace national laws in these areas; rather the objective is that national laws conform to the EU requirements.

Thus to take a well-known example, the Social Charter supports the imposition of a national minimum wage. However, the Action Programme avoids any Regulations on this matter offering only an "opinion" that, while there should in each member state be legislative provision for a minimum wage, the level of that wage should be set in each state according to criteria defined at the national level. At first sight it may seem odd to insist on the existence of a minimum wage while taking no interest in the level at which that wage is set. There are obvious economic and political pitfalls for the Commission if it were to try to set minimum wage levels in the member states. But the legislative reason is also important—the Commission simply cannot involve itself in detailed legislation on these matters and its effective powers are limited to ensuring that national legislation confirms to clearly enunciated principles.

3.1. Competition and wage harmonisation

The Social Charter came into being as a governmental response to the fears of the European trade union movement that the wages and working conditions of their members in high-wage countries would, in the single European market, be undercut by competition from lower-wage countries. The perceived solution was to harmonise wages and working conditions across Europe so that producers in low-wage (or low-labour cost) countries would not have an "unfair" advantage. For example, the Commission's report on *Employment in Europe* states that "if differences in working conditions (wages, social protection,

social benefits, etc.) are not to lead to distortions of competition, these standards may need to be brought closer in line across the Community" (1989, p. 67).

In the long run it would be inefficient, as well as inequitable, for workers of given skills and work characteristics to be paid different amounts in different countries. But the reality of differences in capital stock, infrastructure, economic organisation and product mix across economies, combined with the very low mobility of labour between them, means that there is no single European labour market, but rather a set of nationally segregated markets. In these circumstances, uniform wages across economies would inevitably create high unemployment in the currently low-wage countries. Given the immobility of labour, wage differentials across countries lead not to distortions of competition but rather to an efficient allocation of resources, e.g. by encouraging the investment of capital in economies where it is scarce. The inflow of capital to low-wage economies may be the most effective way of achieving the objective of wage harmonisation. Average wage levels differ considerably between European countries, and recommendations concerning wage determination under the Broad Economic Policy Guidelines recognise the need to retain these large differences

Thus, for example, the 1999 Guidelines recommended that wage policy within each member state be based on four principles:

- nominal wage increases must be consistent with price stability
- real wage increases in relation to labour productivity should take into account the need to strengthen, where necessary, and subsequently maintain the profitability of investment
- wage agreements should better take into account differentials according to qualifications, skills and geographical areas
- wage imitation should be avoided and labour cost differences between member states should continue to reflect discrepancies in labour productivity.

These principles are very much in line with the operation of centralised wage policy in a number of the smaller European countries, such as the Netherlands. But they are also consistent with the likely pattern of wage determination under competitive labour markets. Most importantly there is no continuing aspiration to the harmonisation of wage levels; rather the countries with lower wages can only

catch up with the others if they can achieve more rapid productivity growth.

If it is now accepted that labour cost differences across countries should reflect differences in productivity and hence continue to exist as long as productivity differences remain, is there any argument based on competition for the involvement of the EU in other aspects of the employment contract? There have been a large number of specific regulations to harmonise working conditions, guided by the principles laid down in the Social Charter. These have concerned working time, minimum wages, the treatment of "atypical" workers, freedom of movement, health and safety at the workplace, workers' participation and collective bargaining, vocational training, and the protection of children, the elderly and the disabled. These are clearly issues on which it might be thought the individual member states might be allowed to determine their own policies, and one may ask why the EU should concern itself with such matters.

3.2. Competition and harmonisation

While these various measures raise different issues of detail, a broad framework for considering their effects is provided by the standard theory of public finance. The arguments derive from the principles of tax harmonisation to avoid the excess burden of distortionary taxation. We may consider all these requirements as placing a burden of higher costs on the employer, matched by the provision of benefits in kind to the worker. In terms of Marshall's (1920) distinction between beneficial and onerous taxation, a substantial element of these regulations might be regarded as beneficial in the sense that the value of the benefits enjoyed by the employees is approximately equal to the cost falling on the employer. However, there may also be an onerous element, for example where a particular policy has a strongly redistributive character.

With regard to the "beneficial" element in employment regulations, if wages are flexible they will simply adjust to compensate. A fall in wages both compensates the employers for the extra costs falling on them and likewise matches the value to the employees of the additional benefits they gain. Total labour costs to the employer are unchanged and so is the total return to the employee. Hence to a first approximation such regulations have no resource allocation effects and there is therefore no reason they need be harmonised across

countries (or even for that matter across sectors, regions or firms within a country).

On the other hand, if we consider a situation in which wages are rigidly fixed, then the imposition of some employment regulation will raise total labour costs to the employer, while leaving the worker better off. It is in this context that the principle that uniform taxes minimise distortions is relevant. If the incremental cost is everywhere the same, while the overall demand for labour will fall, the allocation of labour between sectors will be unaffected and thus, in accordance with standard public finance principles, the excess burden of the intervention will be minimised.

While absolute wage levels are obviously not rigidly fixed, it may be more plausible to think that there could be some long-run rigidities in the structure of relative wages. For example, minimum wage laws may effectively index the minimum wage to the average wage. Another example is the provision in the Social Charter requiring firms to pay the same (hourly) wage to part-time as to full-time workers. In many countries, unions have resisted wage differentials in response to market conditions, for example regional wage differentials.

In general, the imposition of the relative wage rigidity will raise the wage of some groups of workers above the market-clearing rate and hence be associated with some unemployment in such groups. This will create market pressures to lower labour costs of these groups. If employers cannot circumvent the wage rigidity, they may instead attempt to reduce their labour costs by evading the various employment regulations. At best, employers will be subject to competitive pressures to provide no more than the minimum legally required or collectively agreed. Employers subject to less stringent requirements will evidently be at a competitive advantage, and it is in this context that a case can be made for harmonisation of employment regulations across the countries of a single market.

An elemental model giving a feel for these issues could be constructed as follows. Imagine a world of two countries initially identical, each with two types of labour, termed "skilled" and "unskilled". In each economy the market clearing relative wage of the unskilled is 50 per cent of the equilibrium skilled wage, but in each country minimum wage laws set the relative wage at 60 per cent. Thus, in both countries, the market for skilled labour clears but there is some unemployment of unskilled workers. Let us imagine that in one country, employment regulations are introduced which are aimed particularly

at the lower paid and which have the effect of raising labour costs of the unskilled relative to the skilled. Country two, however, introduces regulations which affect all labour costs in equal proportion, with the effect that wages in the skilled, and hence also the unskilled, sectors fall. Overall labour costs in both sectors, and relative wages, in country two thus remain unchanged. The upshot will be that unskilled labour costs, previously the same in the two countries, will now be higher in the first country, and this will in principle lead to the relocation of industries intensive in their use of unskilled labour to country two.

Country one's policy will reduce the demand for its unskilled labour, but the magnitude of this effect will be greater if its trading partner, country two, adopts different policies. There is therefore a policy interaction in the sense that had country two chosen to introduce the same employment policies as country one, labour costs would have increased by the same amount in the two countries and the inefficient relocation of industry would have been averted. The point of the argument is that it is the interaction of the relative wage rigidity and the differential employment policies which leads to this outcome. This argument echoes the recent work of Daveri and Tabellini (2000) who argue, and provide extensive empirical support, for the proposition that higher rates of taxation create unemployment only in countries with rigidities in their labour markets.

The argument has thus far considered only the impact of measures on the demand side. There is also the potential for resource allocation effects working through labour supply. If wages are fully flexible, and some part of the cost of employment measures is "onerous" rather than "beneficial", then that part will be incident on the workers in each sector. Unless the labour supply is perfectly inelastic, this will lead to labour supply response. Similarly, with rigid wages, measures which benefit workers will have labour supply effects unless the elasticity is zero.

The assumption that the labour supply is fairly inelastic in each sector in current circumstances is not unreasonable. It is though worth noting that were labour mobile between countries, there would be a tendency for it to flow towards the countries offering the highest expected return. If labour were highly mobile between countries, member states would face the same constraints on policy as do local governments within a country, and the standard result of fiscal federalism, that local governments cannot pursue independent income re-

distribution policies because of perverse migration effects, would apply.

It therefore follows that, provided wages are flexible but labour immobile between countries, each country may pursue its own policies and there will be minimal spillover effects. However, wage rigidities could lead to such effects, but as argued earlier, the direction of movement across Europe is away from rigid towards more flexible wages setting arrangements.

Perhaps a more fundamental concern is that permitting competition from part-time and other "atypical" workers will, in the long run, weaken the position of full-time unionised workers, and thus weaken the power of the trade union within the firm. Indeed, one might regard the Social Charter Action Programme as a set of elaborate mechanisms to protect unionised labour from competition from outsiders. This then raises the more interesting question of whether the power of unions in one country is affected by the degree of unionisation in its trading partners.

To make this question more precise, one might imagine a world of many industries, with one firm in each country in each industry, and one (rent-maximising monopoly) union in each firm. Each industry operates under conditions of imperfect competition, because of transport costs and other costs of trading across national frontiers. With the development of the single market, such costs diminish and product market competition increases, thus increasing the elasticity of demand for labour. Optimising unions will therefore cut their wage demands. The greater degree of product market competition means that jobs in one country are more sensitive to wages in another. While naturally unions will resist such developments, and it will be to their advantage if the supply of labour to competitor firms in other countries can be restricted, this does not constitute an externality in the normal sense of the word. The possibly more attractive option of international linkages amongst unions to allow them to jointly exploit their combined product market power (Driffill and van der Ploeg, 1993) does not appear to be feasible, possibly due to difficulties in accepting existing wage differential across countries.

At its limit, the single European market approximates the economic ideal of a perfect market with perfect competition in the product market and perfect mobility of capital. In such circumstances, under constant returns to scale, the "product exhaustion condition" holds, which states that each factor gets paid its marginal product and

there is no surplus left over. In these circumstances, how can unions or governments do anything to improve the wages or working conditions of workers? There are only two possibilities, either the taxation of capital, or to reduce the labour supply to raise the capital-labour ratio. While these mechanisms might work in a single Europe, sheltered behind barricades from the rest of the world, the scope for benefiting labour by redistributing the return on capital is clearly limited in conditions where international capital mobility is global and not just European.

The conclusion of this section is therefore that global economic changes have undermined the capacity of trade unions to raise the wages and living standards of their members, and have by the same token weakened the capacity of corporatist countries to pursue policies defiant of the market. As policies become more market orientated and wages approximate more closely market-clearing levels, it has been argued that the importance of similar terms and conditions in the employment contract becomes less.

4. Employment policy and asymmetric shocks

The demand for labour across sectors is continually changing, and in a frictionless world, such shifts of demand would be met by the mobility of labour from declining to growing sectors. In reality, there are of course frictions and adjustment costs and labour is far from perfectly mobile. Thus we observe in many economies persistent structural unemployment, as jobs are lost in some sectors but workers do not move to sectors where prospects are better. In particular, we observe regions of persistently high unemployment, and to some extent also skill groups with continuing above average unemployment rates. Many studies of European countries have shown that geographical mobility is the main mechanism of adjustment in the medium term, but that it works very much more slowly than in the US, as a result of which regional unemployment differentials persist for much longer (Decressin and Fatas, 1995; Jackman and Savouri, 1998; Obstfeld and Peri, 1998).

It is noteworthy that while we observe persistent regional unemployment differentials within the countries of the EU, relative unemployment rates across countries display much less persistence. This is the more remarkable as labour mobility, which is the one of main adjustment mechanisms within countries, is almost wholly absent across

countries. The greater ability of nations, as against regions, to tackle unemployment may reflect in part the capacity of countries to offset structural shocks with a range of policy initiatives. But to some extent it must also reflect the capacity to adjust relative wages in accordance with changes in relative competitiveness. It may be easier to change relative wages across national than across regional boundaries in part due to the absence of internationally coordinated wage bargaining, but part may also be attributable in some countries and in some historical periods to the use of exchange rate flexibility. The coming of the Euro, and the resulting loss of exchange rate flexibility within the Eurozone, has affected the capacity of its member states to offset macroeconomic disturbances, and thus thrown a greater weight on labour market institutions.

The only direct substitute for exchange rate flexibility, of course, is greater wage flexibility, either through greater responsiveness of wages to market conditions, or through some sort of formula linking wage changes to what is required to maintain international competitiveness. The Broad Economic Policy Guidelines, summarised in Section 3 above, have the objectives of ensuring not only that nominal wage increases are consistent with the targets of monetary policy, but also of promoting flexibility of relative wages (European Commission, 1998). But the magnitude of the changes in relative competitiveness which have historically been achieved by exchange rate changes seem enormous as compared with the size of adjustments that can be realistically brought about through changes in relative wages. In 1992, the countries which left the Exchange Rate Mechanism (ERM) experienced nominal exchange rate depreciations averaging around 30 per cent relative to those countries which remained members. These depreciations were not offset by differential inflation, and allowed a real improvement in competitiveness of the same order of magnitude, which persisted at least until the introduction of the Euro in 1999. As a result, the countries which left the ERM experienced faster growth and lower unemployment than those which stayed in (Gordon, 1996).

Nor was this an isolated episode. While many European economists tend to that assume nominal exchange rate depreciations are rapidly eroded by domestic price inflation, more comprehensive work (Obstfeld, 1999) shows that nominal exchange rate changes are typically correlated with real exchange rate changes which are not only commensurate in magnitude but highly persistent. According to Obstfeld, this correlation very often breaks down in periods of high

inflation, such as in Europe during the 1970s, but reasserts itself once prices are more stable.

By contrast, nominal wage adjustments are likely to be least effective in achieving improvements in international competitiveness in times of price stability. This is because it is difficult to cut money wages even at times of stable, or even falling, prices (Akerlof et al., 1996, provide an assessment of the evidence). Quite clearly, the maximum likely adjustment of relative costs made possible by differential wage movements will be of the order of a few percentage points a year, as against the 20 or 30 per cent made possible by exchange rate flexibility.

It is, however, conspicuous that the large changes in relative prices arising from exchange rate movements have not led to comparably large changes in trade flows. On the contrary, the impact on real activity often seems remarkably small. The evidence seems consistent with the idea that elasticities may be quite low, both in the long, and in particular in the short, run. Obstfeld and Rogoff (2000) suggest that this may be attributable primarily to the existence of substantial costs of international trade, which create thresholds which have to be surmounted before trade patterns change in response to changes in relative prices. Calmfors et al. (1997, chapter 8, appendix) quote evidence for the Swedish economy that a relative wage depreciation of 20 per cent would be required to raise GDP by 3.6 per cent. More recent work by Gottfries (forthcoming) has confirmed the orders of magnitude implied by this estimate.

These estimates suggest that the Mundell-Flemming model of adjustment under flexible exchange rates needs to be stood on its head. In the standard model, if the economy suffers an adverse (real) demand shock, the prospective weakness of the interest rate leads to a sharp exchange rate depreciation, which restores demand. In the end income rises sufficiently that there is no change in the interest rate, which remains at the world level. It seems more realistic to consider the opposite extreme where the exchange rate has no impact on trade flows in the short run, but some impact in the long run. A fall in demand would then lead to a fall in interest rates which would only partially restore the level of activity. The depressed interest rate causes the exchange rate to depreciate, which will over time generate a recovery through affecting trade volumes. However, the recovery will take time and during this period the interest rate will remain below the world level. The initial exchange rate depreciation will thus over-

shoot, to compensate those holding the currency for an extended period of low interest rates.

While this mechanism of adjustment may seem far from ideal, it is at least speedier than in the absence of exchange rate flexibility. There are the short-run benefits of lower interest rates, which are now regarded as the most efficient tool of short-run stabilisation policy. And in the longer run, the effects of relative price changes are at least likely to come through more quickly with exchange rate flexibility than without. All this suggests that countries in a monetary union may be unlikely to achieve competitiveness at full employment through wage adjustments and may therefore instead, like regions within a country, allow the impact of shocks to fall primarily on output and employment.

To the extent that asymmetric shocks are short term or transitory in nature, it is well understood that it is unlikely that any employment policies undertaken at national level are likely to be as quick to introduce, or to take effect, as monetary policy. But where asymmetric shocks are longer term in their impact, and therefore likely to lead to persistent structural unemployment in a particular sector, employment policies may have more of a role. Most nation states have operated various forms of regional policy, even though migration remains the most powerful equilibrating force in the long run. Within the EU, the Structural Funds have at least in part this purpose, and unemployment remains a criterion applied in determining the distribution of the Funds. The above analysis suggests that there are likely to be increased calls on the Funds in the future as a result of the single currency.

5. Conclusion

The adoption of a common employment policy presupposes both shared objectives and the existence of spillovers which make collective action more effective than policies undertaken at the national level. In this paper, I suggest that neither of these assumptions prevails at the present time. The labour markets of the different European countries have very different characteristics reflecting in part differences in political and social values. These in turn lead to different objectives, or at least to different weights being given both to the objectives of policy and to the importance of different constraints.

Likewise it is argued that policy spillovers are of limited importance. The traditional corporatist model of the major Continental European countries appears giving way to a more market-orientated approach, which, it is argued, is more tolerant of different national arrangements. Essentially, in a deregulated market, labour market policies are incident on labour, and while labour is immobile internationally, this is a matter that can be delegated to individual member states. Matters would of course be very different were labour to become more mobile across national boundaries, but this appears to be some way into the future.

Finally the paper considers whether it is necessary to encourage more wage flexibility to counteract asymmetric shocks, given the absence of exchange rate flexibility. It is argued that trade flows are relatively insensitive to relative prices, and hence the large movements in exchange rates that have been observed are neither as powerful nor as disruptive as might have been expected. Given the likely relative inflexibility of wages, it seems that the effects of shocks are likely to be more persistent in the single currency zone.

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