The impact of European integration on the development of national labour markets

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Foreword

In this paper Philip Raines of the European Policies Research Centre of the University of Strathclyde sets out to trace the effects of European integration on European labour markets. Integration has taken the form of increased intra-regional trade and to some extent increased flows of foreign investment. It has not taken the form of flows of labour migration, which may if anything have declined. But trade flows should still have some effect on convergence in wages and labour costs. However, although some poorer, later joining, members of the European Union have experienced a faster rate of per capita income growth than the average there has in general been remarkably little convergence in wage costs. Intra-industry trade has predominated (in products which are imperfect substitutes for each other) and a hierarchy of country productivity levels has been little changed over the years. However, there is a possibility that increased trade flows have widened regional differences within countries. Raines stresses that one reason why no European Union wide labour market has emerged is because so many practices, institutions and rules determining labour market functioning are set nationally. This has not inhibited a fast rate of trade growth but, of course, appropriately harmonized rules and practices might improve the process of labour reallocation and lead to even faster trade growth. This was an issue in the early days of the European Economic Community when it was feared that some institutional features of labour markets would give certain countries an unfair competitive advantage. This fear was effectively based on a theory of trade which placed excessive emphasis on labour costs and homogenous products. A more recent fear is that the single currency places greater strain on labour markets in dealing with “asymmetric shocks”. This may in turn lead to greater labour market harmonization among European Union members. In fact there will probably continue to be many different ways by which different labour markets achieve the necessary flexibility to cope with this issue.

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1. Introduction

The integration of economic activity within Western Europe over the last 40 years has been a steady but incomplete process. Indeed, European integration can be considered as a series of parallel but distinct processes, each moving along different - though often intersecting - time scales but contributing as a whole to common goals. At the heart of these processes has been the development of the European Community. The Community’s overall objective has been movement towards the creation of a common marketplace for economic activity, largely achieved through the amalgamation of different sets of markets operating at national level. While the emergence of these Europe-wide markets has often overlapped, with impacts which have reinforced each other, integration in certain markets has advanced more quickly than in others.

The Treaty of Rome, founding the Community, defined these markets as goods, services, capital and people (or product and production factor markets). The greatest progress has been made in the integration of the goods – and to a lesser extent, services – market. Beginning with the establishment of the Common Market – effectively a customs union with additional policy coordination in some sectors (such as agriculture, coal and steel) and controls over industrial competition – the creation of a single European market for goods and services has been a constant theme behind the drive towards greater integration in Europe. Marked by irregular bursts of deregulatory activity, the scale of success can be seen in the gradual increase in inter-regional trade, as the share of intra-Community trade in total Member States trade has increased steadily over the last four decades (as discussed in Chapter 3 below).

More variable progress has taken place in integrating the factor markets of capital and labour. With respect to capital, national markets have been successfully brought together to a large extent. Most capital controls have been eliminated at national level, allowing the relatively unrestricted movement of capital throughout the Community. Foreign investment flows have rapidly grown between Member States, and the attraction of operating within the Community has been a powerful impetus for investment by non-Community companies. The process towards capital market integration could be said to have culminated with the recent creation of the European Monetary Union.

By comparison, the integration of labour markets – and the scope for achieving full integration in the near-future – has proven more problematical. Member State labour markets continue to be characterized as largely fragmented and self-contained, governed by individual regulatory systems and bargaining structures with relatively little mobility of labour between countries. At the same time, the integration of national labour markets has been explicitly associated with the successive stages of wider European economic integration. Indeed, within the original Treaty of Rome, the importance of employment in the integration process was already underlined. Under Article 7, discrimination on the basis of nationality was forbidden, ensuring that the same treatment should be given to the nationals of all Member States working in any of the individual Member States labour markets. Articles 117 to 128 set out specific measures to support what was termed ‘social policy’, including commitments to improving working conditions, aspirations to pay equality between the genders for equal work and the establishment of the European Social Fund, which provided funding for training and employment programmes in the Member States. Although the specified actions involved ‘close cooperation’ between Member State governments rather than an imposed common policy, such measures demonstrated
the belief that efforts to integrate goods and services markets needed to be accompanied by harmonized labour market policies.

The recognition of the employment/social dimension to economic integration has derived from two constant themes in Community action. Efficiency considerations were reflected in initiatives to support rapid and smooth employment readjustments within Member States economies and ease labour mobility within the Community. At the same time, fears that increasing competition in products and service markets could lead to an erosion of working conditions and ‘social cohesion’ among the Member States have prompted actions along equity grounds, such as providing floors for the treatment of workers throughout the Community. This interaction between efficiency and equity goals has made labour market issues and European integration closely linked, occasionally resulting in policy initiatives whose effects have worked in opposing directions. The integration of national labour markets has consequently been shaped by a policy tension between support for such integration as a means of making other forms of market integration more efficient and a desire to ensure that the losses deriving from integration should not fall disproportionately on any one Member State or group of workers.

As a result, successive phases of European integration have been overtly connected to – and in some cases, conceived – with regards to both their positive and negative effects on national labour markets. These effects have taken place both indirectly – through trade-related measures in creating a Common Market and their effects on enterprise and worker behaviour - as well as directly – by affecting labour market conditions and regulations through direct Community activity.

The indirect impacts on employment have been acknowledged at different phases of integration. The attractions of Community membership to new Member States have often included the boost to trade and economic growth – and the subsequent impacts on national employment – resulting from membership of the Common Market. More prominently, job creation was an explicit goal in the Single Market programme that dominated Community integration efforts in the decade after 1985. In the initial report on the benefits of completing the Internal Market, Cecchini noted:

But, perhaps, most important of all, is the medium-term impact of market integration on employment… The European home market of the 1990s raises the prospect, for the first time since the 1970s, of very substantial job creation (Cecchini, 1988, xix).

The employment effects of the Single Market would result from widespread industrial restructuring, triggered by an extensive programme of deregulation. Gains to the Community as a whole were estimated at 1.8 million jobs with an overall reduction in unemployment of 1.5 percentage points. Similarly, European Monetary Union was defended in part because it would assist with Community job creation by providing substantial costs savings and reduce unemployment by removing exchange rate instability (CEC, 1990a).

The direct effects on Member State labour markets have derived from an emerging European social policy. As already seen in the Treaty of Rome, historically social cohesion has underlied much of Community policy activity. Over the decades, the European Social Fund evolved in terms of its aims and budgets into a substantial measure of Community policy for facilitating the adaptation of workers to industrial restructuring. Attempts at wider policy coordination were made with the Social Action Programme in 1974, which produced a list of
areas where Member State governments could act in cooperation. More active Community policy only developed in the wake of the Single Market programme, where concern at the impact of economic integration on social cohesion prompted first, the Social Charter in 1989, and later, the Social Chapter of the Maastricht Treaty in 1991. In spite of the United Kingdom’s initial refusal to participate, the creation of a more active social policy – acting through Directorate-General V of the European Commission – represented a significant direct extension of Community activity into Member State labour markets. At the same time, the promotion of social dialogue between ‘social partners’ at a European level – particularly through the Union of Industrial and Employers’ Confederations (UNICE) and the European Trade Union Confederation (ETUC) – has encouraged thinking about the possibility of increased transnational industrial relations and bargaining. More recently, the focus of Community activity has extended to coordinating Member State policies to reduce unemployment. Following the Commission’s explicit placing of a priority on tackling Community-wide unemployment in the 1993 White Paper on Growth, Competitiveness and Employment, a Jobs Strategy for the Community has been devised and Member State employment strategies have been increasingly scrutinized and linked together.

To understand how these different sets of effects have influenced the development of Member State labour markets, the paper will synthesize the large volume of existing theoretical and empirical research on European labour market integration. It will focus on how different types of integration - specifically successive enlargements of the Community’s membership (including the prospective expansion to Central and Eastern Europe), the Single Market project and European Monetary Union - have or are likely to affect developments in Member State labour markets. In particular, it will consider the respective roles of trade and factor flows in influencing convergence in employment/unemployment performance, labour costs and productivity.

The paper is structured as follows. Following this Introduction, the second chapter will review the theoretical trade-employment models and their predictions in the context of European economic integration. Chapter 3 will review the evidence for integration by considering changes in product and production factor flows as well as in comparative labour market indicators in the Community. An examination of the remaining main barriers to labour market integration is presented in Chapter 4. Chapter 5 looks ahead to the current and future phases of integration – specifically, monetary union and enlargement to the east – which is followed by a concluding discussion in the last chapter.

### 2. Theoretical aspects of labour market integration

#### 2.1 Introduction

Defining labour market integration is largely dependent on what constitutes a ‘labour market’. In abstract terms, a labour market could be said to be a relatively self-contained market where the factors determining the supply and demand of labour are common; again, in purely theoretical (and static) terms, a supply-demand equilibrium would result in a uniform wage level and employment rate across the labour market. Integration would then reflect the merger of two labour markets with distinct sets of supply-demand determinants and potentially differing labour market indicators (notably wages and employment rates), resulting in a new single market whose dynamics and features were constant across the whole.
In the real world, this never happens. First, ‘labour’ is not a homogenous production factor, but consists of a series of workforce groups – which can be classified in various ways (by skilled-unskilled, different skills groups, foreign-national, gender and age groups etc.) – which have broadly similar behavioural characteristics. Second, by the definition given above, labour markets can operate at different, overlapping levels, ranging from sub-enterprise to supra-national. Hence, even the United States, the country whose labour market tends to be contrasted most frequently with the Community, consists of several distinctive company, local, regional and national labour markets, resulting in little uniformity of employment indicators for the country as a whole. As a result, not only are the dynamics of these different markets – and their measurable outcomes – fragmented, but the web of interactions are sufficiently extensive to make it difficult to identify clearly-defined supply and demand determinants for any particular labour market.

Theoretical approaches to labour market behaviour (and integration) have recognized the methodological and definitional problems and concentrated on the processes of change in labour markets. Consequently, models of integration are used to examine the direction of change in labour markets – particularly whether convergence or divergence of key employment indicators takes place. With respect to national markets, they have also examined the determinants which separate these markets and the extent to which their removal – or standardization – results in the emergence of a single market. The principle differences in the main theoretical approaches to labour market integration lie in what national determinants and variations are used. The original model of labour market integration – the Heckscher-Ohlin-Samuelson theory and its antecedents – is based on industrial structure differences and their impacts on trade; while trade is fundamental to the main models, later approaches included other national differences, such as differing levels of technology and the capacity for enterprises to achieve economies in scale.

Trade has been regarded as the most important factor in most models. Indeed, theoretical analyses of the relationship of trade and labour markets have commonly emphasized how deeply connected they can be. First, they operate as strong influences on each other’s development: just as existing labour market structures can determine trade linkages between countries, when these linkages shift – for example, through the removal of trade barriers – they in turn shape the overall levels, distribution and price of labour in national markets. Second, theoretical models have shown how flows of traded products and factors such as labour can act as substitutes for each other.

The following chapter reviews theoretical models linking trade, employment and other national determinants together in the context of increasing economic integration. The first section reviews the main frameworks for models, particularly in the context of trade-employment linkages. The next two sections consider the dynamics of integration in the European context, notably the extent to which different types of integration – specifically increasing flows of products and production factors – can impact on national labour markets. Each form of integration is treated separately here, but are considered together in the last section, where the anticipated effects of integration are discussed in terms of employment and unemployment levels, wage rates and productivity at national levels.
2.2 Trade-employment linkage models

The defining model of labour market integration is the Heckscher-Ohlin-Samuelson (HOS) theory, linking trade and labour market effects together. The model emerged in the 1950s as a means of explaining inter-industry trade between developed northern-hemisphere countries and developing southern-hemisphere countries. In commenting on observed factor price differences and revealed comparative advantages between both sets of countries, the theory placed factor endowments and the role of increasing trade at the heart of their analysis of how labour markets integrate.

There are two key features of the model which have shaped subsequent theoretical discussions. First, the model offers static predictions about trade on the basis of factor endowments. In the simple version of the model, two countries have differing factor endowments, and consequently, industrial structures. Depending on the relative intensity of capital and labour (defined in the original version of the theory as homogenous) in each country, their mutual trade will reflect each country’s comparative cost advantage in one set of production factors. Hence, the relatively capital-intensive country will export capital-intensive products but import labour-intensive products from the other country.

Second, the model has a dynamic element, in that increasing trade integration between the two countries is likely to have the effect of equalizing factor prices across borders. Through increased trade, the differing factor intensity of comparative advantage sectors in each country will lead to a shift in factor prices: the less-used factor in each country will decline, resulting in a narrowing of the price differential across borders. With perfect integration, the overall effect of trade mobility would be to create single factor markets between the two countries. In the original HOS model, this was seen to occur without factor mobility, though modifications by Mundell (1957) showed how the same results could occur by allowing for cross-border labour and capital movements. Thus, capital would flow from the capital-rich country within the model to the labour-rich economy because of the price differential for capital, leading to the same factor price equalization which would have occurred had there been flows of capital-intensive products.

Two important implications of the model shaped subsequent consideration of labour market integration. First, increasing economic integration through freer trade should lead to the emergence of distinctive national comparative advantages as defined by relative factor endowments. Second, the mechanism for integration could either be through trade or factor flows. In this respect, the HOS model identified the key processes involved in labour market integration. However, its explanatory power has been weakened by the untenability of several of its significant assumptions. These include the following:

*there must be perfect competition in the integrating economies*: this would forestall the development of monopolistic or monopolistic influence over pricing in either product or production markets;

*the sectors should produce homogeneous goods*: this would allow for inter-industrial trade to occur, as had been observed in North-South trade when the model was originally set out;

*production technology should be the same across both countries*: this would ensure that it is the distribution of factors rather than how they are combined which sets factor prices; and
constant returns to scale existed: as with technology differences, this would ensure that the same production mix of factors would occur regardless of the enterprise size composition of industry in both countries.

Applying these assumptions, the HOS model has been less robust in explaining more recent trade patterns in Western Europe. In particular, while it has been valid in interpreting inter-industry trade patterns among countries with distinctive factor endowment variations, it is less useful with respect to the intra-industry trade that prevails within the Community. Numerous studies of how trade patterns have changed among the Member States have agreed that intra-industry trade has deepened over time as comparative advantage specialization has occurred within rather than between sectors (Balassa and Bauwens, 1988; CEC, 1990b; CEC, 1996).

Explaining intra-industry trade in Western Europe required a series of modifications to be made to the HOS model. The first set was to allow for different types of labour in the factor endowment, rather than the simple capital-labour division. For the purposes of modelling, this has traditionally involved a distinction between factor intensities involving skilled and unskilled labour. For example, Wood (1994) applied a modified HOS approach to examining recent patterns of North-South trade, concluding that while such trade did not reveal factor endowments with respect to capital and labour, it was broadly in line with the relative abundance of skilled labour in the North and unskilled labour in the south. In principle, the notion of different categories of labour can also include subdivisions within groups of skilled labour, given the tendency for some workforces to develop sector-specific skills which are not easily transferred between industries. Comparative advantage could then take place at a sub-industrial level and support the development of intra-industry trade.

The second addition that was made to the HOS model was the role of technology in affecting endowment ratios. Technological innovations can affect factor productivity in ways which can dampen the impact of trade and relative factor prices in other countries. This can occur in two ways. It can involve a more efficient production mix of labour (or different types of labour) and capital through new capital equipment or the introduction of new production systems and working arrangements. Alternatively, it can be felt by changing both the productivity of one factor – more advanced capital equipment, better trained workers - and the intensity of its use in production. Similar effects on relative factor prices are caused by allowing for economies of scale; as with technological developments, larger-scale production can influence both the absolute and the relative productivity (and hence, price) of production factors. Simply put, larger firms are more likely to be capable of developing, implementing and ultimately gaining the benefit of new production technologies (though the dependence of technology on enterprise size can vary between industries).

Productivity differentials are often the result of significantly different levels of research and technology development (RTD) and capacities for making use of new technologies. These technologies can be widely defined, including: capital-intensive technology, such as new production equipment; ‘technology’ relating to the capital-labour mix in production, such as new ways of organizing the workforce to maximize the productivity of capital equipment (e.g. shift systems); and measures to improve the productivity of individual workers, through training and upgrading their skill levels. Effectively, the introduction of technology and the resulting imperfect competition into the model partially decouples the price of production factors from their scarcity. It not only becomes linked more to the absolute productivity of different factors, but also to the capacity of enterprises to make productive use of the factors. For example, the productivity
potential of workers may increase with greater capital investment, not just through the use of equipment with larger output capacities, but often because the workers have had to acquire new skills in order to operate the equipment.

The result is that depending on the sector in which these technological advantages accrue, trade in labour- or capital-intensive products can take place irrespective of resource endowments. It also implies that trade can take place between countries with overall similar resource endowments. As a result, trade effects on the labour market are more likely to arise from the differentiation of skilled and unskilled labour and labour productivity in different industries.

The last set of modifications to the model are market-related. Intra-industry trade is characterized by trade in differentiated but similar products. Here, the product is distinguished from close substitutes by a series of features that may not be related to the factor intensity of production – for example, the product’s image as a result of marketing – with the result that inter-industrial comparative advantages – and the factor specializations that they imply within the HOS model – may not necessarily occur.

Other market factors that can overwhelm the processes identified by the HOS model include differential access to key markets by different countries, a reflection of factors such as trade regulations and transport costs. As a result, distance from ‘core’ markets – whether consumer markets (as defined by population centres and per capita income) or industrial ones (as determined by the concentration of other industries in certain countries) – will influence the costs of trade and factor flows between integrating economies.

The modifications to the HOS model have been sufficiently extensive to lead to the development of alternative models to explain the prevalence of intra-industry trade. These approaches have started from an assumption of imperfect competition, arising from the combination of the factors noted above (e.g. Krugman, 1991). Under these circumstances, agglomerations of economic activity can occur in individual countries, determined by absolute rather than comparative advantage. With respect to labour market effects, this can lead to an entrenched differential in factor prices between countries, arising from differing, and in some cases, widening productivity of production factors between countries.

The ‘agglomeration’ school consequently envisages increasing divergence in key labour market factors, with respect to unemployment rates, wage levels and productivity differences. The emergence of growth nodes could lead to self-reinforcing comparative advantages arising from a combination of economies of scale, better RTD and lower market costs. In this scenario, trade and factor flows do not act as substitutes: as higher rates of return will continue to accrue to both sets of factors in the country with absolute advantage, the latter will act as a magnet on both labour and capital. Where such flows are stymied by various barriers, economic growth prospects in the lagging countries are likely to worsen, potentially resulting in a ‘vicious’ spiral of economic decline which would have the perverse effect of reinforcing labour market stratification during a period of trade integration.

2.3 Trade integration

The impact of integration on labour markets takes place through the linkages described in these trade-employment models, affecting both the relative prices of production factors and national industrial structures. In this respect, equivalent effects can be generated by increasing product mobility or production factor mobility, but the processes by which different types of
integration cause these changes differ. The differences between integration by trade and by factor mobility are important with regards to the ease with, and the extent by, which national labour markets are integrated. As a result, and as noted above, trade and factor integration can have complementary, substituting or diverging impacts on labour markets, depending on the theoretical model being used.

Despite the ambiguity over how trade and factor integration interact, both share the means by which integration has been pursued. In the Community, as described in the Introduction, economic integration has been undertaken – though not necessarily achieved – by way of two parallel processes: increasing movement of goods and services and greater factor mobility. Both processes have involved similar mechanisms for achieving integration. The first has been by the removal of barriers to the free movement of goods, services, capital and labour within the European Union economic space, including:

- outright blocks on product and factor movements (such as trade and service prohibitions and immigration bans);
- various quantitative restrictions (such as import quotas, limited licenses and permits for foreign workers and limits to profit repatriation on multinational enterprises);
- discriminating levies (such as specific taxes on imports and foreign workers and companies); and
- preferential treatment to nationals in key demand markets (ranging from discrimination at enterprise level towards workers to government level in public procurement contracts).

Removing barriers has taken place through with the ‘widening’ of the Community - through its enlargement with new Member States complying with the acquis communautaire - as well as with its ‘deepening’ - through phased liberalisation among existing Member States (e.g. Single Market programme).

The second mechanism has been by standardizing (rather than removing) barriers and regulations to trade across the Community. While not necessarily increasing trade overall – unless the standardization led to a ‘levelling-down’ that is effectively a process of deregulation – it has altered relative national market access within the Community and as a consequence, influenced trade patterns. In practice, standardization has involved the incremental application of non-discrimination principles in specific fields, leading eventually to a harmonization of certain regulations and policies. An example of lack of discrimination in operation has been the mutual recognition of product standards as part of the Single Market programme, whereby (in principle) products certified for sale in one Member State market should not be barred from other Member State markets (apart from health and safety considerations). Harmonization can be shown by the emergence of common labour market policies at European Union level, exemplified by the Social Chapter (particularly since the United Kingdom has now acquiesced to measures introduced through the Chapter). Overall, the effects have been to create a common set of regulations which aim to encourage similar economic conditions and incentives in all Member States.

Both approaches to integration have influenced how trade and factor mobility has been achieved in the Community. Over the years, both types of integration have tended to be bundled together as part of the same sets of measures. For example, enlargement negotiations have often required Member States to adapt certain labour market policy commitments (such as non-
discrimination of treatment to non-national workers) as well as reducing trade barriers. Nevertheless, it is worthwhile distinguishing integration by different ‘markets’ – goods and services on the one hand, capital and labour on the other – as they have different implications for the integration of Member State labour markets.

In this section, the focus is on integration of goods trade in the Community. While integration has been occurring in services, it is not considered in detail here, mainly because until recently, many service markets remained fragmented and so international trade in services has been limited during much of the Community’s lifetime. In any case, many of the effects of integration in services market are reflected in the integration of goods markets.

Trade integration of goods markets has been the most consistent form of integration in the Community’s history. It can be presented in stylized form as a process of several interlocking stages, each with clear characteristics (as shown in Figure 2.1, based on Vickerman, 1992).

Originally established as a Customs Union, the Community represented an advance on a Free Trade Area by the introduction of a common external tariff. The tariff addresses the problem of placing a localized zone of free trade over differing national trade regulation systems. While the trade systems may be integrated with respect to each other, unless they present a common trade policy front to external countries, enterprises from outside the Free Trade Area are likely to exploit the ability to move goods freely within the zone by entering it at the point of easiest access (ie. lowest tariff). The case for a common external tariff displays in miniature the longer-term pressures on the Member States towards greater economic integration. Hence, the Customs Union evolved into a Single Market because of the continuing impact of non-tariff barriers on trade (such as quotas and the use of national product standards). Similarly, the shift towards monetary union reflected the continuing impact of uncoordinated macro-economic policies, currency rate uncertainty and the lack of a single monetary policy across the Free Trade Area. The commitment to promoting trade mobility has resulted in a process of incremental, progressive integration, where the deficiencies in one stage create the pressures for further integration.

**Figure 2.1: Stages of trade integration in the community**

- **Free trade area**
  - plus common external tariff equals

- **Customs union**
  - Minus non-tariff barriers equals

- **Common/single market**
  - plus macro-economic policy coordination
  - and single currency
  - and single central bank equals

- **Monetary union**

*Source: Based on Vickerman (1992)*
According to the trade-employment models outlined above, the impact of integration should be reflected in the development of comparative advantage (whether inter- or intra-industrial). The access to larger markets provided by the integration process should allow more price-competitive firms to expand output, and where possible, achieve unrealized economies of scale, leading to a Community-wide gain in micro-economic efficiency and macro-economic growth. The overall increase in efficiency can be demonstrated in Figure 2.2 (based on CEC, 1988). With the reduction of barriers, foreign producers are able to reduce their prices from $P_1$ to $P_2$, forcing domestic producers to follow by reducing costs (or exiting the market). With the increase in output from $Q_1$ to $Q_2$, a series of gains from economic efficiency result, consisting of: economic rents (gains to domestic producers from market protection); ‘X’-efficiency (internal efficiencies, such as reduced overhead costs); and restructuring economies (through economies of scale).

Such trade integration models for the Community do not predict the distribution of the gains from economic growth. While ‘creative destruction’ may take place for the Community as a whole, there has been little consensus over whether such integration would result in comparative advantages deepening in all countries or the emergence of a pattern of absolute advantage and disadvantage. In the debate over the Single Market programme, much of the discussion focussed on the future performance of lagging regions/countries, particularly Ireland and the Mediterranean periphery. Neven (1990) argued that the completion of the internal market would boost inter-industrial trade to the benefit of the more labour-intensive southern European economies, while Clement (1988) concluded that it was more likely to widen disparities between northern and southern countries. Others like Peschel (1992) expected a more complex, ‘mosaic’ pattern to emerge, in which integration resulted in a continuing process of shifting rankings of regional economies and inter-regional disparities, none of which could be easily deduced before integration had occurred.

### 2.4 Factor integration

In parallel with trade, European integration has also taken place in factor markets. They are closely linked in the case of services trade – a degree of capital and factor mobility is essential for trade in certain types of services (especially financial services). More widely, they have been part of the same integration policy efforts at Community level. Key developments in trade integration – such as the Single Market programme – have been accompanied by measures to support greater factor mobility as well, as it has been recognized that the efficiency gains to arise from integration are partly dependent on the capacity of production factors to shift and allow comparative advantages to be exploited. At the same time, equity issues have prompted efforts to ensure some common standards across the Community, notably in the legal status of workers and minimum working conditions. In the following sub-sections, the integration of different factor markets – capital and labour – are considered in turn.

#### 2.4.1 Capital

Increasing capital mobility is regarded as a key element of wider economic integration. It allows a greater supply of capital within the integrated market area by mobilizing additional savings and the capital to be allocated more efficiently in line with rates of returns in different markets. However, while capital mobility has been significantly affected by specifically European
integration, the impact should be seen as part of a wider trend towards the increasing global mobility of capital. While enterprises have increasingly distributed their production capital according to global strategies, individual measures within the Community have accelerated the trends within Europe, principally by removing barriers to capital flows - such as treatment of foreign enterprises investing in different Member States - and by standardizing regulations governing capital flows and transactions and financial services. Some of these measures have been taken independently of coordinated Community action, such as the general liberalization of capital controls by individual countries in the 1980s. Nevertheless, with the Single Market programme’s commitment to lifting the remaining barriers to the free movement of capital between the Member States and completing the liberalization of financial services, the conditions for a single capital market currently appear to exist in the European Union (Mayes, 1998).

All forms of capital flows are sensitive to differences in economic environments: savings will move towards countries offering higher interest rates, production capital will tend to be directed to locations with stronger economic backgrounds. The extent to which economies and labour markets are affected by capital flows though is largely dependent on the type of capital involved. Here, it is important to distinguish between different types of capital movements, as these can include capital flows (often as the transfer of credit rather than actual movements), portfolio investment between countries and physical investments through foreign direct investment. The latter has traditionally been most closely associated with changes in labour markets through the direct impacts of productive investments in employment. In this respect, changes within the Community have been particularly pronounced, reflected not just in the increasingly more liberal environment for foreign investors - notably through the removal of government regulations on FDI in Member States - but the rise in competitive foreign investment promotion at both national as well as regional level within the European Union (Brown and Raines, 1999). At Community, national and regional levels, governments have become more aware of the effects that such investment shifts can have on local employment rates, skills levels and productivity.

Greater competition for foreign investment in the Community indicates how much productive capital ‘markets’ have grown in recent years. While investment flows have been increasing worldwide, FDI growth in Western Europe has been seen as a complementary process to local trade integration. The trade creation effects of the Single Market programme were predicted to act as a powerful attraction to companies outside of the European Union (Bachtler and Clement, 1990; Cecchini, 1988). Not only would the benefits of an enlarged market be as apparent to non-Community as well as Community companies, but at the same time, they might be prompted to locate within the Community for fears of ‘Fortress Europe’ limiting their access at a later date. Such fears have also been present in the use of protectionist trade policies at Community level to restrict imports in certain goods by firms outside the European Union: anti-dumping rules and import quotas have been cited as major factors in investment surges from Far East multinationals in particular industries, adopting strategies of locating production within the Community to avoid the trade barriers (Raines and Wishlade, forthcoming 1999).

At the same time, foreign investment was anticipated to rise as a result of the restructuring of industries in response to the completion of the internal market. The traditional market-seeking motives of investors - in which access to individual national or specific industrial markets was the primary determinant of investment location - would give way to efficiency-seeking investment (Dunning, 1997). The shift in the type of investment involves greater priority placed on location
factors such as the cost and skills level of local workforces, access to local technological
advantages, the quality of local physical and business infrastructure, and government financial
incentives. As multinational enterprises underwent rationalization and reorganization of their
international structures, they would take advantage of economies of scale. Investment strategies
would change to promote greater product and activity specialization at individual sites, and with
the ability to serve several markets in the European Union from single locations, pressures would
rise to close some plants.

The labour market impacts of these investment shifts cannot be satisfactorily quantified,
though the direction of their combined effects have been predicted. Effectively, investment
relocations would reinforce the employment trends anticipated by the earlier trade and
employment models, leading to convergence or divergence depending on the assumptions used.
Overall, such foreign investment changes would not only have aggregate impacts on national
employment growth rates, but could also reinforce national competitive advantage (whether
comparative - as predicted by the HOS model - or absolute - as those supporting agglomeration
approaches would favour), as multinationals would tend to specialize their production sites in line
with local industrial advantages. At the same time, multinationals can also create limited internal
labour markets which are integrated across national boundaries, whether directly by promoting
labour mobility in certain skills groups or by standardizing training, working conditions and
remuneration practices across different plants.

At its most extreme, such investment changes could have a powerful influence on
workforce conditions and the regulatory environment as well as employment numbers. Fears of
FDI resulting in ‘social dumping’ were expressed by some commentators in the wake of
Hoover’s 1993 transfer of production between its French and United Kingdom sites because of
the willingness of its Scottish workforce to make greater concessions on pay and working
conditions (Raines, 1998). As long as European labour markets remain relatively unintegrated,
the scope exists for investors to pursue ‘regulatory arbitrage’ and exploit lower labour costs and
greater employment flexibility arising from reduced levels of employment protection. As a result,
integration of capital markets can create pressures to integrate labour markets by undermining
the regulatory frameworks which separate these markets at national the level.

2.4.2. Labour

The integration of labour markets can arise from two sets of pressures. The first, as noted,
is shifts in production factors within countries to readjust to trade integration, whether caused
by changes in trading patterns or by capital flows. The second is the movement of workforces
between different national labour markets. In policy terms, the two forms of integration have been
always considered in parallel with trade integration at Community level. A commitment to the
equal treatment of European Community workforces in all Member States was already expressed
in the Treaty of Rome; by 1968, the main legal restrictions on the movement of workers within
the Community were effectively removed with the elimination of the need for work permits.

Given this regulatory freedom, how far labour mobility would take place is determined
by the interaction of two forces: the incentive for worker migration; and the ability of workforces
to migrate between national labour markets. In theoretical models, the incentive for workers to
move between labour markets is usually dependent on a combination of wage differences and job
opportunities (Öberg, 1997). Where the wage differential is larger, the incentive for workers to
move is likely to be greater. Such factor movements would not necessarily have to lead to an
equalization of wages in line with HOS model predictions, but a narrowing of differences. The remaining gap in wage levels would largely consist of the costs of migration (such as the costs of moving residence) and levels of ‘hardship’ pay for migrants in the host countries. These effects could apply to workforces as a whole or be occupationally specific, particularly in certain higher-skilled professions.

Incentives for migration can also proceed from significant unemployment differences between labour markets. This would be measured less in terms of the actual unemployment rates between countries than the actual access of migrants to new jobs in other countries: ie. it does not matter to migrants if unemployment is lower in some countries if it is perceived that there is also limited access to jobs. Again, as with wage rate convergence as a result of labour mobility, it would not necessarily result in an equalization of unemployment levels, merely a reduction of the gap. Again, this could be sector-specific, as when occupational restructuring encourages workers with certain sets of skills to consider similar jobs outside of their own geographical labour markets, though if job opportunities in certain sectors are sufficiently large, it will influence the job search behaviour of workers in other sectors. It could also be a time-specific phenomenon, the result of a temporary, cyclical trends between different national labour markets (or just certain sectors within those markets) - in which unemployment rates briefly fall ‘out of synch’ between countries because of wider economic trends - rather than entrenched unemployment differences between two countries.

In addition to the incentives to migrate, the ability of workers to move is a critical factor. This capacity for movement is affected by a mix of ‘host’ and ‘donor’ country barriers, the actual level of migration depending on how these influence worker incentive to move to new labour markets and their access to new jobs. ‘Host’ country barriers include the following.

Legal discrimination against foreign workers. Legal limits on the ability of foreign workers to operate in national labour markets have been systematically removed at Community level, but they have continued to operate in Member States. Often, they have amounted to effective discrimination through the difficulties in obtaining and renewing work permits, acting not only as a disincentive to workers migrating - both in the ‘hassle’ factor as well as a result of lack of information on procedures - but for ‘host’ enterprises hiring such workers.

Restricted access to professions and certain activities. In certain professions, access to job opportunities can be limited for non-nationals. While this might not necessarily occur in terms of explicit discrimination, it can take place through the need for non-nationals to acquire necessary certification of their skills by ‘host’ authorities or by the difficulties in obtaining the relevant skills in the first place (e.g. the knowledge of national law in the legal profession). Difficulties in obtaining accommodation. For some workers, the difficulties in obtaining housing in foreign countries can be a strong disincentive, particularly where housing markets may be dominated by public housing for nationals. Concomitantly, this might also mean workers fear losing accommodation in their own country.

Restricted access to financial support. The risks of losing employment in foreign labour markets are often greater than in national ones, as foreign workers may have limited access to unemployment and other welfare benefits as well as less favourable longer-term financial considerations such as pension rights.

At the same time, foreign workers may also face other country barriers in migrating between labour markets. The most important of these are socio-cultural barriers. The attraction of remaining in a familiar social and cultural environment - and the desire to avoid discrimination
in foreign labour markets - has been a strong barrier between European countries. In addition, language differences have been an important disincentive: the need to acquire new languages effectively compels foreign workers to obtain new skills in order to compete with nationals in ‘host’ markets.

In theory, these different factors would have varied impacts on labour migration incentives occurring at different levels (Marsden, 1994a). As noted in the introduction to this chapter, these levels constitute different types of labour markets, often overlapping but responding to distinctive factors. They consist of enterprise, industry and economic levels. Mobility of workforces within enterprises through internal labour markets would be influenced least by these barriers: as these internal markets tend to form within multinationals, it might be expected that the enterprise would minimize the difficulties in host-country accommodation, financial support and in some cases, adjustment to linguistic and socio-cultural differences. In contrast, international migration of labour between enterprises within the same industry faces more barriers, as the costs of guaranteeing accommodation and financial support are more likely to be borne by individuals, reducing their incentive to migrate. Mobility between industries within different economies is perhaps the most problematical, as worker incentives are influenced by the barriers already noted, as well as those arising from general and profession-specific legal discrimination against foreign workers.

It has been argued that the reaction of different types of labour markets to migration barriers would lead to differentiated migration within Western Europe, in which the barriers identified above would significantly affect the mobility of low- and unskilled workers, while the incentives for moving between different labour markets would remain strong for higher-skilled and occupational workers (Marsden, 1994b). The emergence of fragmented streams of labour migrants would be affected by a number of factors, including the role of different systems of occupational training as well as wider macro-economic cycles and the points on these cycles at which different countries found themselves.

2.5 Theoretical labour market effects

Depending on the theoretical approach advocated, the integration of trade and factor markets can have either reinforcing or diverging impacts on labour market structures. The combined processes of greater capital and labour movements and the removal of trade restrictions on trade have been predicted to lead to the development and sustaining of national competitive advantage. As a result, even if there is only selective industrial restructuring as a result of integration, there is likely to be a significant impact on both the demand for existing production factors and the supply of future factors. The anticipated effects on labour markets will be manifested in a number of different aspects: the overall levels and distribution of employment and unemployment; wage levels; and labour productivity.

2.5.1 Employment and unemployment

Theoretical models have discussed the integration of labour markets in the context of job creation (from increased macro-economic efficiency through emerging competitive advantages) and job distribution (between expanding and declining sectors, and between industry as a whole and joblessness, as a result of industrial adjustment). In the context of the Community, the overall employment effects of integration have been discussed most extensively in the context of the Single Market programme. According to the Commission, the emergence of competitive
advantage would result from a complex pattern of restructuring of individual enterprises and national sectors in the face of increased competition (Cecchini, 1988). Employment would decline in less-competitive industries, while increasing in more-competitive ones: overall, there should be net job creation and a reduction in unemployment as a result of increased macro- and micro-economic efficiency (CEC, 1988).

Relative unemployment rates may change with integration depending on the theoretical model that applies and a number of factors shaping national labour market structures. In the original HOS model, unemployment is depicted as a temporary phenomenon arising from restructuring, with full employment characterizing pre- and post-integration scenarios. Where residual unemployment is allowed in the integrating economies, if there is full trade and factor mobility, employment growth should result in a full clearing of labour markets through wage adjustments. However, while labour markets would not be able to clear completely and efficiently as a result of inter-market adjustments, no matter how integrated the markets have become, unemployment differentials should significantly narrow - not necessarily at first, depending on the length of the period of adjustment and the scale of restructuring in different labour markets during integration, but over time. By contrast, in agglomeration models, convergence is unlikely: either divergence of unemployment rates would result from the predicted widening of economic growth rates, or at least, no change in relative unemployment differentials. In both case, this variation or convergence of rates could be limited to particular sectors or skills groups rather than the labour market at a national level.

In the Community, the timing and pattern of such effects is difficult to determine, not just because of the impact of factors outside of the process of localized integration (such as global economic cycles) but also as a result of internal factors. The most important of these factors will be discussed in more detail in Chapter 4, but broad categories of determinants are mentioned here.

Demand factors. The extent to which employment and unemployment rates in the labour market change will depend largely on the demand functions of individual enterprises. These can be influenced by changes in factors such as worker productivity, access to new production technology and economies of scale.

Supply factors. Employment participation rates will be influenced by a variety of supply factors, such as the willingness of individuals to leave unemployment (partly the result of welfare entitlement considerations), access to new jobs, opportunities and incentives for re-training, and participation in education systems.

Structural factors. Differences in key features underlying labour market structures can determine whether unemployment rates can converge across integrating economies. These include the regulatory structure (as defined in employment protection legislation), collective bargaining systems, and welfare and tax arrangements. It also includes the extent to which each economy may be operating close to its ‘natural’ rate of unemployment: ie. that underlying structures in each economy may not only slow the adjustment to external shocks, but even once adjustment has taken place, full-employment may not be possible (OECD, 1994a). Moreover, these ‘natural’ rates can differ between countries.
2.5.2 **Wages**

Whether integration takes place by the full mobility of goods or factors or a combination of both, it is a central prediction of the HOS model of integration that there should be a tendency to the equalization of wages across countries. The process of integration would lead to wage rates increasing in low-wage countries and falling in high-wage countries: a narrowing of wage differentials across labour markets should be detectable, given the assumptions of the integration models.

A decline in wage disparities may not take place where there are significant barriers to wage equalization. This might occur where redistribution of employment is ‘sticky’, owing to structural deficiencies in the labour markets. It could also be affected by the differentiation in wages among skilled and unskilled workers in different sectors and the difficulties of individuals moving between groups. The existence of several groups within the labour force - either grouped at industry level or as skill groups within industries - does not invalidate the theoretical predictions of the model, but it means that wage levels as a whole may not equalize while they might do so for particular employee groups. At the same time, there are a series of institutional factors which will influence wage movements, notably the strength of unions, bargaining arrangements, legislation on minimum wages and national differences in taxes and benefits; again, these issues are discussed at greater length in Chapter 4.

At the same time, the abandonment of one of the assumptions of the HOS model - technological stasis and homogeneity - introduces new potential influences on the direction of wages. Within agglomeration models, it could result in an entrenchment of wage differences between labour markets, with little change in relative factor prices over time. As already noted, factor demand can lead to changes in production technology and factor productivity: if this results in an agglomeration economy which uses a relatively unchanged production factor mix, factor prices may not greatly alter overall (though if the productivity increases take place in one sector, it could lead to inter-sectoral changes in prices).

2.5.3 **Productivity**

Productivity and wage levels are closely linked together: within labour markets determined by the same overall regulatory and bargaining frameworks and supply-demand structures, higher productivity tends to be rewarded with higher wages. Wage differentials between different workforce groups - as defined by particular skills, sectors or countries - can be expected to be influenced positively by productivity variations. Moreover, where productivity alters in any of these groups, pressures would rise on wages to change in the same direction.

The relationship between wages and productivity is reflected in the trade-employment integration models. Productivity under these circumstances is influenced by the combination of workforce skills and capital intensities in different labour markets. Models tend to agree that the integration of these labour markets not only influences relative factor prices but it also changes the factors which govern relative productivities; but they differ over whether productivity differentials converge or widen, depending on the levels at which productivity is measured and the assumptions behind the workings of the labour market.

Within the HOS model productivity tends to be viewed as a function of capital intensity. As production techniques and technologies are held constant across different enterprises in the same industry, productivity in particular sectors is also constant; however, the equalization of productivity only takes place at *industry* rather than *country* level (Dollar and Wolff, 1993). As
some countries specialize in capital-intensive industries, their *aggregate* productivity levels will be higher for manufacturing as a whole than other countries. Even when introducing skilled labour into the model, productivity differentials are not affected across sectors, only *between* them: productivity differentials between countries are only influenced by the mix of industries and the emergence of comparative advantage. In theory, with inter-industrial trade prevailing, national productivity differences should diverge over time, depending on countries' endowment with factors which would raise overall productivity - such as capital and skilled labour - rather than with factors which would lower it - such as unskilled labour.

The HOS model is made more complex when integration creates incentives for enterprises to alter productivity by enhancing the value of their factors. In models where economies of scale or the possibility of enterprise-specific technological advances are allowed, productivity can be increased through new production arrangements which raise output without altering the factor mix (mainly through new equipment innovations, working practices or improving workforce skills). Under these circumstances, integration can lead to productivity differentials occurring between enterprises and sectors across labour markets, as well as between countries.

This makes it difficult for models to predict the distribution of productivity gains among integrating economies. Work by the European Commission on the Single Market programme has suggested that productivity gains would be experienced across those sectors which were most ‘sensitive’ to the removal of trade barriers (CEC, 1990b). If agglomeration economies developed during integration, self-sustaining clusters of productivity growth could reinforce existing disparities across the Community. This is particularly important where changes in production technologies and organization are not evenly distributed between countries, but remain in certain areas which have relatively substantial sources of innovation and capacities for adapting new technologies.

It has also been widely argued that the differences in labour costs are compensated by differences in productivity (EIRR, 1995; CEC, 1990b). The advantage possessed by countries with low wage costs diminishes, if not disappears, when unit labour costs (or the labour cost in producing one unit) are taken into consideration. Indeed, from a theoretical perspective, it might be expected that the cost of labour would converge within an economic union such as the Community due to labour mobility (moderate as it has been) and competitive pressures on high-cost countries. However, work on comparing international productivity differences has been difficult. Across the European Union, there has been little harmonization in the definitions of productivity and the economic activities being measured. Moreover, productivity comparisons are particularly sensitive to exchange rate fluctuations between European Union countries and differences between Member States in the stage their economies are in the business cycle (as discussed in more detail in the next chapter).

At the same time, if capital mobility is prevalent, new production methods and technologies can be quickly distributed between different economies, as foreign investors can often raise productivity in host sectors and supplier firms. They can act as a source of new production innovations and improve the skills of local workforces, potentially becoming an overall ‘leveller’ of productivity differentials between sectors located in different countries (Dunning, 1997).
3. Evidence of Labour Market Integration in the European Union

3.1 Introduction

While theoretical models can present stylized analyses of the integration of different types of markets, deciphering empirical evidence on labour market effects can be difficult. Attempts to identify the integration of Community labour markets have been made more complex by the difficulties of separating out different economic influences, particularly where they may be acting in opposing directions. For example, integration effects on national labour markets might be swamped by the wider effects of macro-economic developments, as when global growth trends have sector-specific influences on the changing composition of employment, unemployment levels and international wage differences (El-Agraa, 1998). Problems in determining counter-factuals – and the wider issue of linking particular labour market outcomes to certain economic causes – can diminish the value of empirical proof of theoretical models. Further difficulties arise in this context when defining integration processes in labour market terms: in the case of European integration, the processes have often been piecemeal over a long period of time, so that it can be impossible to relate changes in labour markets to specific sets of measures. Overall, it is not simple to identify what constitutes evidence of labour market integration.

However, integration has been empirically deduced by a series of simple principles, applying to both snapshot depictions of apparently separate labour markets at particular moments as well as to relative changes between those labour markets over time. If the features of integrating labour markets are sufficiently similar to each other and distinctive from other labour market sets, there can be a strong suspicion that they are operating as or becoming an enlarged single market. This suspicion can be further strengthened if the labour markets in question have demonstrated parallel if not simultaneous trends in key employment indicators which can be sufficiently distinguished from movements in these indicators with respect to other labour markets.

In the case of the Community, these principles can be tested in several ways. First, ‘family’ characteristics of integrating labour markets can be measured in terms of higher and lower levels of labour market behaviour. Higher level tests include comparing indicators of integrating labour markets not just with each other, but relative to other labour markets at a similar level of analysis (for example, in the case of Member States within the Community, a frequent comparator has been states within the United States). Tests can also be conducted at the level below Member State labour markets: if inter-regional disparities in certain indicators are broadly comparable to disparities at Community level, the barriers which separate labour markets at Member State level may not be significant.

Second, integration activity can be measured in terms of changes in Member State variation in employment indicators relative to the two levels of analysis identified above: hence, if the patterns of change in employment, unemployment, wages and productivity were more similar among Member States than at intra- or global levels, it might be argued that integration is creating common effects. This test can be used to assess the validity of the theoretical models discussed in the previous chapter. Where the patterns among key indicators may show convergence, it would vindicate the HOS model and its variants; if divergence, the agglomeration models.
As explained above, European integration has taken place through its impacts on different markets - trade, capital and labour – and each has had employment effects. These tests can be applied to the different processes and indicators of integration identified above. In order to assess the empirical evidence for labour market integration, it is useful to determine first whether – and how - these markets have changed at national level with Community integration efforts, particularly with respect to trade, capital and labour flows between Member States. Second, their collective impacts will be considered in terms of changes in a series of labour market indicators: employment and unemployment trends; wage levels; and productivity differences.

3.2 Trade

As an example of the problem of distinguishing the impact of integration from wider economic factors, trade demonstrates many of the key difficulties. Indeed, it can be necessary to identify which integration processes are under examination – not only have trade barriers been reduced within the Community, but over the same period, they have also been brought down globally through the activities of GATT. Similarly, the evidence for integration will be partially distorted by other global influences on the development of trade, notably world economic downturns such as the aftermath of the first oil crisis in the 1970s, and more recently, the ‘Asian crisis’. The combination of accounting for non-integration effects and counterfactuals have led some commentators to suggest that it may well be empirically futile to do more than assess the direction of trade effects as a result of European integration; estimating its scale is fraught with methodological pitfalls (El-Agraa, 1998).

Nevertheless, numerous studies have isolated integration effects within the Community and argued that they have produced distinctive and often measurable impacts. This can be seen in two trends: the emergence of the Community as a comparatively self-contained trading bloc, and the impact that the resulting rise in trade flows has had on the industrial structures of individual Member States. To measure these trends, empirical evidence has tended to focus on two issues: the level of intra-Community trade; and the extent of industrial specialization by Member States which can be attributed to integration.

3.2.1 Intra-Community trade

Certainly, the level and significance of trade flows in Member States has risen in parallel with Community integration. Trade as a share of GDP has become larger in all Member States between 1960 and 1995 (Molle, 1997). The EU-15 average grew for imports from 16 to 23 per cent, and for exports, from 15 to 24 per cent, during that period. The figures have been consistently higher for the member States than for the United States or Japan (particularly in terms of imports).

More direct links between economic integration and trade can be seen in the level of intra-European Union trade in the Member States (see Figure 3.1). Here, there has been clear evidence of growth. For the original EC-6, trade with fellow Member States between 1958 and 1972 grew three times faster than with the rest of the world (Molle, 1997). For EC-12 countries, between 1958 to 1988, average intra-Community exports increased from 37.2 of total exports to 58.7 per cent. Indeed, the importance of other Community countries as a trade source and destination has risen for every Member State since 1958, apart from Denmark and Ireland.
The trends have been particularly associated with enlargements and the completion of the Internal Market. With regards to the impact on new Member States, the impact has occasionally amounted to a rapid internationalization of the national economy and a catalyst for industrial restructuring - for example, this took place in the relatively-protected Greek economy (Giannitsis, 1994). It has also stimulated strong shifts to other Member States as trading partners, as witnessed in the case of Ireland following accession (O’Donnell, 1991). In the case of the Single Market, there is some evidence to suggest that intra-European Union trade was given a significant boost: the Commission’s Single Market Review pointed to an overall increase in the volume of trade, with intra-European Union trade alone increasing by between 19 and 30 per cent (CEC, 1998a).

Studies have also suggested that the trade creation effects of European integration have generally been larger than trade diversion. Mayes (1978) reviewed a series of studies estimating the trade impacts of integration and concluded that all the studies pointed to overall net gains for the Community as a whole. This has been reinforced by recent studies of the trade effects of completing the Single Market. An uneven distribution of trade effects were found between different sectors and Member States, but overall, trade creation appears to have been larger than trade diversion (CEC, 1997a). Studies of less-developed countries responding to the Single Market have also supported this conclusion, though the evidence is partially mixed; overall, a positive trade impact was measured in Ireland, Portugal and Spain, although it was less pronounced in Greece and southern Italy (CEC, 1998b).

### 3.2.2 Industrial specialization

The emergence of comparative advantage specialization as a result of economic integration according to traditional HOS models has been less apparent. Overall, little inter-industry specialization has been detected in the Community: for example, for the EC-6 countries between 1958 and 1977 (Balassa and Bauwens, 1988); for the EC-9, between 1970 and 1987 (Greenaway, 1987); and more recently, for the EC-12 during the period of completing the Single Market (CEC, 1996). Only in the case of Ireland have inter-industry effects become noticeable as a result of integration, though these have been attributed to deeper structural problems in the national economy (O’Donnell, 1991).

In contrast, the links between integration and *intra-industry* specialization have been considerably more evident. Greenaway (1987) noted that between 1959 and 1980, intra-industry trade between Member States grew more rapidly than total intra-Community trade. Similarly, the Commission’s Single Market Review concluded that similar growth had taken place between 1985 and 1993, as result of the economies of scale and FDI effects of completing the internal market (CEC, 1996). Indeed, intra-industrial trade appeared to increase among the ‘Cohesion’ countries – notably Greece, Portugal and Spain – as a result of the Single Market, in spite of expectations that their trade with the more prosperous Member States might follow inter-industrial specialization (CEC, 1998b); the extent to which this has contributed to a longer-term revealed comparative advantage is more difficult to prove though.

The suggestion is that trade flows have increased faster between similar industries within Member States than either inter-industrial trade or trade with non-Community partners. While this would tend to support the agglomeration model of trade specialization, there still remains considerable uncertainty over the links between trade flows and deeper structural changes within
Member State labour markets, though it might be argued that these represent longer-term changes yet to become apparent.

3.3 Capital mobility

Economic integration in Western Europe appears to have had an unambiguously positive impact on foreign investment flows into and within the Community, at least in recent years. This can be clearly measured in the growing importance of inward FDI stock relative to GDP (Table 3.1). The significance of FDI rose in all Community countries between 1980 and 1996, at least doubling in the case of six of the countries. Not only has the rate of increase been rapid, but it has left all but three Community countries with higher FDI ratios than the United States (and in the case of Japan, no Member States, owing to the infamously low levels of FDI in the Japanese economy).

Table 3.1 FDI in Western Europe

<table>
<thead>
<tr>
<th>Host region/country</th>
<th>1980</th>
<th>1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium/Luxembourg</td>
<td>6.0</td>
<td>45.8</td>
</tr>
<tr>
<td>Denmark</td>
<td>6.3</td>
<td>13.4</td>
</tr>
<tr>
<td>France</td>
<td>3.4</td>
<td>10.1</td>
</tr>
<tr>
<td>Germany</td>
<td>4.5</td>
<td>5.9</td>
</tr>
<tr>
<td>Greece</td>
<td>11.3</td>
<td>16.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>19.5</td>
<td>21.0</td>
</tr>
<tr>
<td>Italy</td>
<td>2.0</td>
<td>7.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>11.3</td>
<td>30.4</td>
</tr>
<tr>
<td>Portugal</td>
<td>4.4</td>
<td>6.4</td>
</tr>
<tr>
<td>Spain</td>
<td>2.4</td>
<td>18.1</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>11.7</td>
<td>20.5</td>
</tr>
<tr>
<td>European Union-15</td>
<td>5.4</td>
<td>13.0</td>
</tr>
<tr>
<td>US</td>
<td>3.1</td>
<td>8.3</td>
</tr>
<tr>
<td>Japan</td>
<td>0.3</td>
<td>0.7</td>
</tr>
</tbody>
</table>


As a whole, the Community is the largest recipient of foreign investment in the world, now outstripping the United States. FDI inflows into the Community rose from 28 per cent of total global inward investment to 44 per cent between the periods, 1982-87 and 1991-93 (UNCTAD, 1996). By 1995, Community countries accounted for 37 per cent of the worldwide stock of FDI, larger than the United States or any other country/trading bloc.

Much of the recent surge in foreign investment has been directly attributable to the Single Market programme. The Commission’s Single Market Review concluded that the completion of the internal market had not only attracted new FDI into the Community but catalysed restructuring FDI (CEC, 1998c). In other analyses of FDI flows during the Single Market period, there is widespread agreement that there was a strong correlation between market integration and
FDI growth in the Member States (e.g. Dunning, 1997; Balasubramanyam and Greenaway, 1992). At a micro-economic level, this is reinforced by business surveys of multinational enterprises which have highlighted the role of the Single Market in encouraging new firms to locate within the Community as well as existing firms to reconsider their investment and location strategies as a result of the internal market programme (e.g. for the United Kingdom, Bachtler and Clement, 1990; for Norway, Bachtler, Clement and Raines, 1993; and for the Community as a whole, CEC, 1997b).

The increase in investment has been from both inside and outside the Community, but the stronger growth has been by intra-European Union FDI since 1985 (Cross, 1999). In 1984, intra-Community FDI only accounted for some 41 per cent of total inward investment flows, but by 1991-93, had risen to an average of 60 per cent (CEC, 1996). In suggesting that capital flows between Member States have been affected more strongly than those between Member States and non-Community countries, it seems that Community economies have become increasingly integrated in FDI terms (though there is evidence that the ‘integration’ effect may be tapering off and FDI from other countries – notably the United States – has become more significant again in recent years) (UNCTAD, 1998). This can also be seen in the changing destination of outward investment by individual countries: in 1985, Italy located 49 per cent of its FDI in Western Europe, but this had increased to 73 per cent by 1994; for Germany, the comparable figures are 44 and 61 per cent of total outward FDI, and similar increases can be seen for other Member States (Dicken, 1998).

In a fully integrated capital market, there should be little difference between international and inter-regional investment. However, whether the increase in intra-Community investment flows has removed the distinction between shifts of investment between Member States or regions has been difficult to assess. Measuring international against inter-regional investment flows is complicated by problems of data comparability and interpretation. One measure is to view changes in the significance of FDI with respect to all national capital investment over a period. In terms of gross capital formation, inward FDI flows still account for small shares in the Community as a whole and this has not greatly changed during periods of extensive economic integration: the European Union-15 average for 1986-91 of 5.7 per cent is almost identical to the most recent figure, for 1996, of 5.8 per cent (though the figures do include both intra- as well as extra-Community investment) (UNCTAD, 1998). The Community averages do conceal some variation between Member States, but the pattern at national level does not appear consistent: hence, while FDI as a share of gross capital formation increased dramatically for Ireland during the same period (5.9 to 20.4 per cent), it declined slightly for Spain.

Another approach is to examine figures for investment projects. These are not easily available, but can be partly deduced from the statistics on Regional Selective Assistance (RSA) in the case of Britain: RSA is a discretionary financial incentives that can be given to foreign or domestic investment projects within regions designated as having particular development problems. While not capturing all investment activity in the country (or indeed, within the designated regions), it can be used as a relatively unskewed indication of investment activity. The figures for the total investment of these projects between 1984 and 1995 are presented in Table 3.2, averaged for four time periods to reduce the distorting effects of individual investments in any one year.
If integration effects were very strong in the case of the United Kingdom, it might be expected that a clear trend on the value of FDI to domestic projects might be detected, particularly during a period of strong economic integration within the Community. However, the figures do not indicate any clear trends: while the value of FDI in the country’s lagging regions appears larger than domestic investment across the period as a whole, there is no steady clear trend. Indeed, it could be argued that the balance between FDI and domestic investment has converged during the period of the Single Market’s completion, although FDI flows have increased more generally. While these figures are affected by a wide range of economic factors, they do demonstrate that while international FDI flows have increased in the Community with integration, it is not clear that their importance relative to domestic capital flows has altered significantly.

Lastly, while FDI flows have clearly increased within the Community, it is not clear to what extent this strengthens the claim of one model or the other in terms of labour market integration. Hence, from an agglomeration perspective, it might be expected that integration would lead to a concentration of investment in particular countries, while the HOS model might see concentrations of investment in different sectors for different countries. The data have proven ambiguous on both counts. The national concentration of FDI has not changed significantly during the period of its rapid growth. Indeed, it is difficult to find a clear pattern in FDI destinations: for example, the United Kingdom’s success in attracting FDI contrasts sharply with the low levels going to Germany in recent years, although both have broadly similar industrial structures and GDP. Yet just as intra-industry trade patterns have been dominant in the Community, FDI has also tended to cluster in similar sectors in different countries, playing little part in industrial specialization processes. The evidence suggests instead that the sensitivity of FDI to a wide range of location factors has led to an aggregate impact on trade-employment structures at Member State level which is both diffuse and difficult to link to integration activity.

3.4 Labour mobility

Labour mobility has been seen as one of the clearest indications of the operation of a single labour market. In theory, where labour markets are increasingly integrated, labour flows should increase from regions of high unemployment and low GDP per capita to regions of low unemployment and high per capita income. By measuring the extent of migration within the Community – and its change over the years – it should be possible to determine whether national labour markets have become more integrated as trade markets have. This can be accomplished using several tests: changes in intra-Community migration during a period of economic

---

Table 3.2 Investment associated with RSA awards in Great Britain

<table>
<thead>
<tr>
<th></th>
<th>FDI projects (£mn)</th>
<th>Domestic projects (£mn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984-86</td>
<td>2,884.0</td>
<td>1,831.5</td>
</tr>
<tr>
<td>1987-89</td>
<td>3,371.4</td>
<td>3,270.9</td>
</tr>
<tr>
<td>1990-92</td>
<td>2,820.9</td>
<td>3,811.9</td>
</tr>
<tr>
<td>1993-95</td>
<td>3,542.3</td>
<td>3,082.4</td>
</tr>
</tbody>
</table>

Source: Industrial Development Act 1982 annual report (various years).
integration; intra-Community migration relative to other labour migration between Member States; and inter-regional relative to intra-Community labour mobility.

Applying the first test, overall, the evidence for labour mobility within the Community as a sign of increasing labour market integration has been weak. Over the period of the Community’s history, migration between Member States has historically been low (Table 3.3). While there is some evidence that, as the Community got larger, the share of foreign workers in the Member States increased, the scale of growth has been relatively modest.

Table 3.3. Foreign workers in Member State workforces, 1960-73 (per cent)

<table>
<thead>
<tr>
<th></th>
<th>1960</th>
<th>1970</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>EC-6</td>
<td>3</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>EC-9</td>
<td>3</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>EU-15</td>
<td>3</td>
<td>5</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: Molle (1997); Gros and Hefeker (1999).

With the original EC-6, in the period immediately after the formation of the Community in 1958, national labour markets were generally tight, providing few incentives for workers to migrate, though the legal conditions had been established in the Treaty of Rome (as noted in the Introduction). Only Italians were involved in migration to other Member States in any significant numbers (Molle, 1997). Only Luxembourg had any substantial foreign worker presence initially (16 per cent in 1960, as opposed to the EC-6 average of 3 per cent). During the 1960s and early 1970s, worker migration remained relatively strong among the Member States, largely in response to labour shortages in the northern European countries. Nevertheless, migration trends appeared to be moving in different directions: rising in countries such as Belgium and the Netherlands, while falling in France and Germany (Mayes, 1998).

In the 1970s, labour needs were increasingly met by non-Community labour, notably the influx of Turks and Yugoslavs (as gastarbeiter) in Germany. By this second test of integration, the composition of worker migration has not been determined by the integration of European economies. Hence, across the decade, the share of intra-EC labour flows of total international migration within the Community declined from over 60 to only 20 per cent, suggesting that non-Community migration has overtaken intra-Community flows (Tsoukalis, 1997). By 1995, foreign workers of other-Community origin only accounted for two per cent of the total European Union-15 labour force, while non-European Union workers were responsible for three per cent (Molle, 1997). Belgium and Luxembourg are currently the only Member States where there are more European Union than non-European Union nationals in the migrant workforce (Mayes, 1998).

More recently, in spite of increasing trade and capital integration, labour migration flows have declined, in part as a result of increasing unemployment and fewer labour shortages among the traditional host countries of Community labour flows. By 1990, the only national workforces where the share of other European Union citizens of the working-age population was higher than...
three per cent was Belgium and Luxembourg (Adnett, 1996). At the same time, not only have absolute numbers of migrants declined, but the decrease has been particularly marked with respect to economically-active migrants (Gros and Hefeker, 1999). Until 1980, between 80 and 90 per cent of migrants were economically-active, but since then, the shift has been towards dependants of existing immigrants. This has left the level of inter-Community migration far below mobility within Member States - for example, in the early 1980s, 1.2 million workers migrated within Italy, but only 50,000 emigrated abroad (Tsoukalis, 1997). Indeed, the numbers have fallen to the point that between 1980 and 1994, it is difficult to establish a link between changes in migration and in employment within Member States.

The evidence of declining mobility is reinforced by recent analysis of the Single Market impacts. The Single Market programme was explicitly focussed on the barriers to trade and capital flows – with some direct measures influencing particular professional groups – but by employment-trade theory, it may have increased incentives for workers to migrate. However, the Single Market Review showed that labour migration flows remained small with the completion of the internal market. The only exception was Ireland, as the longer-term local lack of employment opportunities has prompted extensive migration (though much of it to countries outside the Community) (CEC, 1998b). As a whole, it suggests that labour mobility within the Community may have reached a peak, unless there is a more dramatic change in the barriers to migration and the incentives to move. Moreover, the decline in migration has taken place alongside the rise in trade integration, reinforcing the conclusion that either trade flows have been acting as substitutes for production factor flows, or that integration has not had significant employment effects. Hence, while trade flows have responded rapidly between Member States such as Greece, Spain and Portugal on their accession, there have been few clear changes in labour flows in spite of the lifting of migration restrictions and high unemployment in these countries (Mayes, 1998).

This contrasts substantially with the United States: intra-European Union migration accounts for less than 0.2 per cent of the total Community population, whereas migration between the nine Census regions in the United States was 1.5 per cent of the population (CEC, 1997c). Eichengreen (1993a) compared the internal migration rates of the United Kingdom and Italy with the United States and found the last to be three times greater than the others. Such labour flows have characterized the United States labour market, where significant migration between different regions has long been a feature; indeed, contrasts have been regularly drawn between the United States and the Community: for example, in 1987, a higher share of the United States population (2.7 per cent ) changed their place of residence than in individual Member States or the Community as a whole (Ehrenberg, 1994).

The lack of response of labour mobility to market integration seems to be related to deeper structural problems within individual Member State labour markets. This can be seen by applying the third test: comparing migration between countries and between regions within the Community. In theory, if labour markets were fully integrated, there should be little difference between both. To an extent, this seems to be supported by the evidence, but only because inter-regional migration within the Community is limited as well. Inter-regional migration within Member States is also relatively minor when compared to similar-sized states in the United States (Gros and Hefeker, 1999). Moreover, as with international migration in the Community, the scale of labour mobility between European regions appears to have contracted significantly between the 1960s and 1980s (Champion and Vandermotten, 1997).
The differences with the United States labour market underlines the distinctive barriers to the movement of production factors within the Community. Although the legal restrictions to Member State nationals working elsewhere in the Community have been steadily reduced over the years, labour market mobility continues to be hindered by a number of factors. Some of these are discussed in greater detail in Chapter 4, but others specific to labour mobility are noted here below.

Culture and language. Significant cultural and linguistic differences among Member States make it difficult for workers to follow job opportunities across the Community, particularly from the newer Member States such as Greece, Spain and Portugal, in spite of what might appear economic and employment incentives to do so (Kontis, 1994). As noted in the previous chapter, language differences between the Member States increase the ‘costs’ to workers of migrating between labour markets. Even where such differences are minimized in Western Europe, labour migration can still be relatively small, as in the case of Scandinavian countries, where in spite of the fact that languages are relatively similar and there is a high degree of cultural familiarity, a single Nordic labour market has not yet emerged (Karppi, 1998). As well as providing strong disincentives to move, socio-cultural factors can also influence the choice of destination: for example, according to which countries have existing immigrant communities, rather than simply, or indeed principally, on economic grounds; in the United States, where mobility is considerably larger, migration among certain ethnic groups is still dictated to a large extent by the location of similar ethnic communities.

Welfare and housing rigidities. Problems in being able to obtain welfare and housing rights in new Member States can provide huge disincentives to worker movements between national regulatory systems, particularly if they involve losing such rights within their home countries. To an extent, this has been partly redressed by Community legislation, as guidelines have been laid down to prevent discrimination in terms of certain benefits (e.g. sickness) and to avoid double collection of social security premiums. In the case of housing, rigidities in the accommodation market within countries have also acted as dampeners on inter-regional migration, as some jobs require formal proof of long-term accommodation in the host country.

Regulatory barriers. In some professions, until recently, it has been difficult for qualified personnel in one Member State to establish their qualifications for employment in other Member States without special certification. While in some cases this is because Member State job differences require different skills – e.g. as a lawyer – in other cases, the capacity to undertake jobs is related more to national authorization and professional controls than a recognition separate skills may be required.

### 3.5 Employment and unemployment

From the previous sections, it is clear that integration within the Community has taken place mainly in terms of trade and capital rather than labour flows. However, the links between economic integration, employment change and unemployment have proven difficult to assess empirically. While the processes underlying the linkages are understood theoretically, it is not clear how data can test the veracity of different models. A number of problems hinder the extent to which the integration of labour markets can be measured in employment and unemployment terms. First, as noted above more generally but worthwhile emphasizing in the case of employment changes, factors external to European integration can have a considerably stronger impact. Global economic shocks - such as the first oil crisis in the early 1970s - have often had
stronger effects on employment and unemployment than economic integration. Indeed, trade exposure to non-Community countries (and for that matter, capital flows as well) has remained extensive throughout the period of integration, even if trade and capital linkages among Member States have increased. In other words, it is difficult to separate the effects of Member State integration with each other with their partial, but significant integration with other countries.

Second, care needs to be taken in determining the direction of effects. For example, if economic integration does result in revealed industrial specialization, it is not certain how this might manifest itself in employment terms. An expected contraction of less competitive industries might not necessarily be compensated by growth in competitive sectors, as the latter will be muted by productivity growth, elasticity of demand for labour and economy of scale effects. Hence, it is possible that expanding enterprises might not take on more workers - particularly if growth is achieved by higher productivity - while contracting firms might be able to maintain employment levels, particularly if there was an incentive to keep workers (e.g. company investment in skills) and costs savings can be made in non-labour aspects of production.

Nevertheless, repeated attempts have been made to estimate the employment effects of successive integrations, especially as many integration movements in the Community have been so clearly linked to employment growth. First, in terms of the direction of employment growth, there has been little evidence for revealed competitive advantage, as already noted in the earlier section on trade. In that section, it was shown that estimates had concluded that trade creation effects were greater than trade diversion, but it is more difficult to relate these findings to employment creation and diversion. The Single Market Review estimated overall employment gains at between 320,000 and 620,000 jobs, though these have been muffled by the poor global economic conditions prevailing at the time; the wide range in the estimate only serves to underlie the problems in estimation (CEC, 1998d). Moreover, such studies have found considerable difficulties in commenting on the distribution of net employment growth at Member State level. For example, the Single Market Review’s study of the less-developed regions could not come to any firm conclusions about the employment effects in Ireland, Greece, Portugal and Spain (CEC, 1998b).

The impact of European integration on unemployment is in many respects a more problematical issue than job creation. As noted earlier, the high levels of unemployment in the Community have emerged as one of the main problems collectively facing European policymakers, leading to specific initiatives at Community level to tackle the problem and becoming a consideration in other policy areas (Symes, 1995). To examine the effect of economic integration on unemployment in the Community, it is useful to test its impact from several perspectives: as before, overall differences among Member States and with non-Community countries; evidence of convergence or divergence over time; and disparities at inter-regional as well as intra-Community levels.

By the first and second tests, economic integration seems to have had little impact on unemployment within the Community. Unemployment in Western Europe has been persistently higher than in other OECD countries (Table 3.4). Indeed, it has been rising steadily in most years since the 1970s, and remains significantly above the United States and Japan. At the same time, disparities between Member States have been increasing over time as well: the differential between the Member State with the highest and the Member State with the lowest rate, the gap has increased from a factor of 4.7 in 1979 to a factor of 6.1 in 1998 (OECD, Employment Outlook, various years).
Table 3.4. Unemployment in the Community, United States and Japan

<table>
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<tbody>
<tr>
<td>EU-15</td>
<td>4.8</td>
<td>9.4</td>
<td>10.8</td>
<td>10.5</td>
</tr>
<tr>
<td>US</td>
<td>6.7</td>
<td>7.2</td>
<td>6.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Japan</td>
<td>1.9</td>
<td>2.5</td>
<td>2.7</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Source: OECD, Employment Outlook (various years).

The principal problem has been the overall rise of the long-term unemployed among the total unemployed. The rates have been considerably higher in Community countries than the United States; indeed, it declined in the latter during the 1980s from 13.3 per cent of total unemployed in 1983 to 5.7 per cent in 1990, while rising in Community countries so that by 1990, France, Germany, the Netherlands, Spain and the United Kingdom all had long-term unemployment accounting for over a third of total unemployment (Symes, 1995). As Adnett (1996, p.207) noted: “While the probability of an employed worker becoming unemployed is not particularly high in the European Union, once unemployed a person in the European Union has relatively little chance of quickly finding another job.”

The performance of the Community as a single labour market in unemployment terms is marred also when comparing inter-regional and international disparities (CEC, 1991a, 1991b). The impression of a continuing fragmentation of Community labour markets is reinforced by the lack – and during some periods of economic integration, the reversal - of significant convergence of unemployment rates and per capita income at the regional level; disparities appear to be more sensitive to cyclical economic growth trends than any longer-term economic convergence within Western Europe (Dunford, 1996, 1993). Inter-regional unemployment disparities increased between 1983 and 1993 in all Member States apart from the United Kingdom; currently, unemployment rates often differ more across regions in individual Member States than at national level across the Community (Gros and Hefeker, 1999). For example, by the end of the 1980s, they ranged from a factor of 2.8 in France to 19.1 in Italy (OECD, 1995).

Again, this contrasts with the United States labour market. Not only has the United States a better job creation performance overall - an average of 1.5 per cent annually between 1986 and 1996, as against the Community average of 0.4 per cent (OECD, 1999) - but its labour market has shown a stronger tendency to return to ‘full employment’ following periods of rising unemployment. Much of this can be attributed to factors already discussed: for example, Blanchard and Katz (1992) found that inter-state migration in the United States had assisted in moderating unemployment differentials. Given the low level of mobility in the Community, disparities have proven more resistant to change. Consequently, the evidence of the emergence of a single labour market in the Community is weak with respect to unemployment effects. It points more to common institutional structures underlying the national labour markets, which have contributed to maintaining persistent unemployment.

In particular, commentators have drawn attention to the problem of the slow adjustment of European labour markets to economic shocks (OECD, 1994a). The initial shock to labour markets came in the early 1970s with the oil crisis, but labour markets have been unable to adjust fully since then because of a mixture of the effects of the anti-inflation policies adopted by many Member States during the 1980s - with severe consequences in terms of unemployment - and the structural and regulatory inflexibilities of their labour markets. The latter - and other institutional
barriers to labour market integration in the Community - are discussed more fully in the next chapter.

3.6 Wages

If integration of labour markets has operated in accordance with the HOS model, a convergence of wage levels at industry level between different Member States would be expected over time. However, the measurement of wage convergence is complicated by the interaction of wage levels with other factors. On the one hand, it is influenced critically by productivity differences, as discussed in the next section. On the other, wage costs cannot easily be compared because of differing levels of social security charges on enterprises, as considered more fully in the next chapter.

In any case, existing evidence suggests that wage convergence has not taken place within the Community. Using separately United States Bureau of Labor and Swedish Employers Confederation time series data on hourly labour costs, Flanagan (1993) examined wage dispersion in the EC-6 and EC-9 countries between 1957 and 1989. As shown in Figure 3.2, wage differences did not appear to have altered greatly across the period, nor do they seem to have responded significantly to key integration milestones, such as the abolition of the last legal barriers to intra-Community workforce mobility in 1968 nor the first major wave of enlargement in 1973.

Similar conclusions have been found for more recent phases of integration. In its study for the Single Market Review, Cambridge Econometrics concluded that the effect of the Single Market programme on labour costs had not encouraged convergence significantly (CEC, 1998a). Convergence of labour costs was also not detected in the study of the impact on less-developed regions (CEC, 1998b). This can be seen in more recent United States Bureau of Labour statistics on hourly compensation costs for manufacturing workers in the European Union-15 countries (Table 3.5). Taking the United Kingdom as a base for selected years between 1975 and 1996, variation has remained relatively entrenched across the Community. Convergence for new members only appears to have occurred in the case of Spain, as Greece and Portugal have not shown consistent patterns in terms of labour costs (either before or after their accession).
Table 3.5. Variations in labour costs in EU-15 countries, 1975-96 (UK=100)

<table>
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<td>186</td>
<td>172</td>
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<td>166</td>
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<td>142</td>
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<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

1 - 1980 data for Finland, Greece, Ireland, Luxembourg and Portugal
2 - 1985 data for Finland, Greece, Ireland, Luxembourg and Portugal

Wages have also been less responsive to economic changes in Western Europe than the United States. Although income differences widened considerably during the period of the geographical expansion of the United States westwards, there has been a steady decline in inter-regional wage differentials in the United States over time (Flanagan, 1993). In spite of the impact of unsynchronized business cycles in different United States regions, wage dispersion appears to have narrowed over a long period, largely as a result of the impact of labour mobility. In the Community though, it not only varies greatly between Member States - at regional level, variance is high in France and Portugal, low in Germany and the United Kingdom - but has not changed greatly in response to new market conditions over the last two decades (Lindley, 1997; CEC, 1993). United States aggregate wages appear to be more responsive than the Community as a whole, though it is comparable to some Member States (such as the United Kingdom and Spain) (OECD, 1994a).

3.7 Productivity

The problems of comparing productivity between different countries are well known (Mayes, 1996). Productivity varies between sectors: hence, differences in industrial structure mean that the appropriate level of study should be the industry level, making international comparisons difficult because of variations in how sectors are defined in output statistics. In some cases, comparisons may not be appropriate because of the differences between equivalent products in each country (Mason and Wagner, 1994). The impact of exchange-rate variations on value-added and output can also distort international comparisons, though they can be minimized as far as possible with the use of purchasing power parity deflators. Moreover, problems can arise with how employment is measured: the use of employment figures without taking into account the average length of working weeks can also make comparisons misleading.
Most commentators have used two sets of statistical shorthand: simple figures for GDP/output per worker and their growth rates. With this approach, among OECD countries as a whole, there is considerable evidence of a convergence in productivity, but only at the industry level (Dollar and Wolff, 1993). Over the post-war period, Western European countries and Japan have been catching up with United States in each sector. As noted in the theoretical chapter, aggregate productivity growth has differed depending on the mix of industries within each country.

Examining growth rates in labour productivity (as measured by output per worker) for several European countries, the trends between 1960 and 1988 only ambiguously suggest labour market convergence (Table 3.6). Growth rates have been within a common band among these countries (in contrast to low growth in the United States and high in Japan) and have largely moved in the same direction (apart from the United Kingdom, whose growth rates increased in the 1980s while continental countries’ went down).

Table 3.6  Labour productivity growth in selected countries (output per worker)

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>France</td>
<td>5.4</td>
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<td>2.4</td>
</tr>
<tr>
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<td>4.6</td>
<td>3.4</td>
<td>1.9</td>
</tr>
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<td>6.3</td>
<td>3.0</td>
<td>1.6</td>
</tr>
<tr>
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<td>3.5</td>
<td>1.5</td>
<td>2.6</td>
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<tr>
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<tr>
<td>Japan</td>
<td>9.4</td>
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<td>3.1</td>
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</table>


However, when looking at different standardized measures of productivity, the range between Community countries remains substantial (Table 3.7). Using the analysis by Oulton (1994) of productivity differences, significant variation remains whether considering GDP per worker (a factor of 2.4 between the highest and lowest countries) or restricting to manufacturing output per worker (a factor of 5.6). Further, when unit labour cost figures are used, the disparities are not removed (there is still a factor difference of 2.6), although in theory, productivity and wage costs should more or less offset each other.
### Table 3.7  Comparative hourly productivity estimates, 1990 (UK=100)

<table>
<thead>
<tr>
<th>(UK=100)</th>
<th>GDP per worker (PPP)</th>
<th>Manufacturing output per worker</th>
<th>Unit labour costs (PPP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>126.2</td>
<td>141.1</td>
<td>97.8</td>
</tr>
<tr>
<td>France</td>
<td>130.4</td>
<td>131.6</td>
<td>101.3</td>
</tr>
<tr>
<td>Germany</td>
<td>120.1</td>
<td>128.3</td>
<td>107.9</td>
</tr>
<tr>
<td>Greece</td>
<td>59.6</td>
<td>48.3</td>
<td>115.0</td>
</tr>
<tr>
<td>Italy</td>
<td>125.3</td>
<td>130.8</td>
<td>92.5</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>110.9</td>
<td>141.9</td>
<td>93.1</td>
</tr>
<tr>
<td>Portugal</td>
<td>53.4</td>
<td>25.5</td>
<td>236.6</td>
</tr>
<tr>
<td>Spain</td>
<td>105.0</td>
<td>72.7</td>
<td>124.3</td>
</tr>
<tr>
<td>UK</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>US</td>
<td>138.7</td>
<td>180.0</td>
<td>79.0</td>
</tr>
<tr>
<td>Japan</td>
<td>102.8</td>
<td>145.3</td>
<td>81.8</td>
</tr>
</tbody>
</table>

Source: Oulton (1994).

### 3.8  Concluding summary

Economic integration in the Community has led to observable changes in trade and factor flows which - at least in theory - can result in labour market integration. Incremental integration over the last four decades - through enlargement and increasing trade liberalization - has resulted in increasing trade links throughout the Community, as trade - especially trade with other Community countries - has become more important to Member States. Similarly, international direct investment flows have risen in response to integration, though they have not yet matched investment flows within Member States.

However, labour mobility has not been greatly affected by increasing economic integration. Separated by strong socio-cultural differences and worker support frameworks (such as benefits systems), in spite of significant wage and unemployment differences within the Community, labour migration has been notably weak when compared with the United States. This may well be a critical factor in the more clear evidence that the United States operates as an integrated labour market.

In spite of (at least partial) trade and capital integration, key labour market indicators do not show systematic convergence (or divergence, as predicted in agglomeration models). Wage differentials between Member States have not shown any clear response to economic integration, and as a whole aggregate wages have been less responsive in the Community to external shocks than in the United States. No clear pattern of convergence/divergence can be gleaned from labour cost data for EU countries, either before or after their accession. Similarly, gaps in productivity - insofar as it can be accurately compared across the Community - between Member States appear entrenched.

The only common behaviour in Community labour markets has been the rise and persistence of unemployment, oddly at odds with the theoretical expectations of the main trade-employment models. It suggests that while some of the barriers separating national labour
markets have changed over the last four decades, several powerful ones remain; these are discussed in the next chapter.

4. Determinants of Labour Market Integration in the European Union

4.1 Introduction

From the previous chapters, it is clear that in spite of extensive efforts to encourage trade integration, national labour markets in the Community have remained largely unintegrated. In spite of evident employment creation through integration, unemployment has remained high in the Community, wage disparities have not narrowed significantly, productivity does not appear to have been greatly affected and labour mobility has been minimal. The explanations for the lack of labour market integration lie in the continuing barriers to convergence at national level rather than shortcomings in the theoretical models for integration. The structures of national labour markets not only reinforce the fragmentation of workforces within the Community but have proven impervious to change. These structures have set up powerful internal forces within Member State labour markets that have played a large role in counteracting integration impacts.

Aspects of these structures have been considered in earlier chapters, including socio-cultural and language differences and housing provision, both of which have discouraged worker migration between Member States. In this chapter, the operation of a selection of structural barriers are considered: bargaining systems; employment protection and social security arrangements; and training policies. They have been chosen as – unlike cultural factors – they are part of the regulatory, legal systems which define labour market behaviour in Member States. As such, they not only create a distinctively-national environment for changes in employment, unemployment, labour costs and productivity, but they also directly interact with integration. While they have not hindered trade integration in the Community – and indeed, have developed independently of it - they have influenced the extent to which increased trade flows have caused labour market integration. In this, they can act both as facilitators of, as well as barriers to, integration.

The importance of these determinants of labour market integration can be seen in a comparison with the United States. As already noted, the United States has more of the characteristics of an integrated labour market than the Community. However, despite the existence of separate state laws on many labour market issues – such as occupational licensing (as occurs within Member States in the Community) – the United States regulatory structures governing the main processes of the labour market are relatively uniform. These include common contractual arrangements, common approaches to collective bargaining (with the existence of nationwide unions), a basic social security and welfare system applying across the country, and centralized employment protection (notably the minimum wage). These structures provide the conditions to support labour mobility – the key factor in the more integrated United States labour market (Ehrenberg, 1994).

In the sections below, the impact of the three structural determinants of European labour market integration are considered in detail. In each section, the theoretical impacts of the factor
as a determinant on labour market convergence are considered first, before examining the empirical evidence for changes within the Community.

4.2 Trade unions and wage-setting systems

4.2.1 Theoretical impacts

In the HOS and related models of integration, factor price equalization is mainly the result of the interaction between unmediated supply and demand forces in factor markets, effectively acting at the enterprise level. Factor prices are set in response to changes in the industrial structure through an amalgam of micro-economic actions, with little ‘stickiness’ in cost shifts. However, where wage-setting systems influence factor prices, integration effects can be muted. Not only can the operation of collective bargaining and wage-fixing regulations slow down the process of wage determination, but the existence of separate bargaining systems for different parts of the economy can delay industrial adjustments following integration. Where separate and autonomous bargaining systems exist in different countries, the impact of integration on national labour markets becomes more difficult to predict.

In this context, wage setting is determined principally by trade union structures, collective bargaining and minimum wage legislation; the first two are treated in the next subsection, the last in the one following.

(i) Industrial relations

Industrial relations institutions differ in both the extent of unionization in the national labour force as well as the degree of centralization and coordination in negotiations over pay and employment conditions. Such differences can have the effect of maintaining separate sets of pressures on national labour markets which can ‘drown out’ integration forces. Trade unions tend to respond principally to national factors in pay negotiations, such as the historical trend in wage levels within particular industries or enterprises as well as wage claims made in other industries and enterprises. Depending on the structure of collective bargaining, some commentators have argued that these responses can have a significant impact on overall economic and employment performance. With regards to Western Europe, Calmfors and Driffill (1988) observed that the strongest sets of performance occurred in countries with either highly centralized or decentralized systems of wage bargaining; where wage-fixing systems were ‘in-between’ – for example, taking place at the level of the sector or region rather than the enterprise or country – unemployment rates tended to be higher. Moreover, the differences in the systems can lead to differences in adapting to integration: during periods of integration, factor and product markets are likely to adjust quickly in more decentralized systems – leading, according to theory, to a more rapid revelation of comparative advantage – whereas countries dominated by centralized bargaining systems could experience difficulties in adapting to the new competitive environment (Danthine and Hunt, 1994).

Such differences can produce ‘anti-convergence’ effects arising from labour market segmentation, particularly with regards to unemployment and wage levels. It has been argued that highly-unionized systems can generate a higher rate of unemployment than the ‘market-clearing’ rate (for a summary of the debate, see OECD, 1994a). The operation of unions can not only segment international labour markets, but divide national labour markets according to
an ‘insider-outsider’ model. In this model, unions act to defend their members’ interest, leading to wage increases and resistance to enterprise restructuring that can lead to reduced efficiency and less employment creation in the wider economy.

Similarly, as part of the same process, unions can act to maintain higher wage levels that the ‘market-clearing’ rate. Over time, the risk of a ratcheting-up of wages increases, particularly where large industrial awards become benchmarks to other unions within the economy. Depending on the extent to which the labour market is dominated by oligopolies (stronger employers) or oligopsonies (stronger unions), wage fixing can become detached from the integrating effects of increased foreign trade. Indeed, in some cases, unions may become anti-integration by campaigning against increased competition from cheaper foreign imports (leading to job losses in particular industries) or the migration of cheaper workers into the national labour market.

However, it has also been argued that trade unions can facilitate the adjustment processes required by integration. In some countries, companies favour a stable, consensual industrial relations environment in which certain employment decisions are taken collectively (e.g. sector-wide payment agreements), as it removes issues of potential conflict at enterprise level. Where systems of collective bargaining foster better industrial relations, this not only supports adjustment at the national level – for example, through pay restraint – but can also lead to a more consensus-based approach to promoting workforce flexibility at the enterprise level (effectively, a variation on the argument put forward by Calmfors and Driffill). Unions and collective bargaining systems can provide stable frameworks for negotiating changes in different forms of flexibility with the introduction of new training systems, new work patterns and greater employment flexibility. In supporting higher productivity among their workforces, unions can encourage the transfer of best practice systems from enterprises in other countries. They can also respond to changes in the employment conditions and labour markets of other countries: unions can have an internationalist perspective and work in cooperation with other unions towards convergence in certain labour market features, notably labour standards.

(ii) Minimum wages

Operating in a similar fashion are statutory minimum wages. As with collective bargaining systems, they can act to raise wages above the clearing rate in the standard neo-classical model, potentially resulting in loss of employment and reduced economic efficiency. They differ from collective bargaining systems in that on the one hand, they can provide more stability for business planning – minimum wage levels tend to be less volatile and more predictable than wage rates emerging from union negotiation – but on the other, they are less flexible as minimum wages tend to be set at a common level across all sectors and enterprises. Where minimum wages differ between countries, factor price equalization can be hindered because of the ‘floors’ underlying any shifts in relative factor prices.

Similarly, the counter-argument to the damaging impact of minimum wage legislation has application to collective bargaining. Under conditions of oligopsony, minimum wages can give businesses incentives to achieve efficiencies in their operation and activities that they might not otherwise have contemplated, compelled by the need to make savings elsewhere in the enterprise (Dickens, Machin and Manning, 1994). It can also influence the factor mix in production by enterprises, either by encouraging the use of more capital (leading to higher
productivity but potentially reduced employment) or by raising human capital by increasing the
skills levels of unskilled workers (Boyer, 1993).

4.2.2 Evidence in Western Europe

(i) Industrial relations

Before considering how far collective bargaining systems have influenced labour market separation within the Community, it is important to recognize the considerable differences that exist between Member States. Bargaining generally occurs at three different levels: nationally, where bargaining is coordinated across the economy as a whole; at the sector and regional level, by industry-wide unions or binding collective agreements; or within individual enterprises, either through firm-specific workforce representation or in the absence of any union activity. Although bargaining can take place at these different levels within the same system, countries tend to be characterized by predominance at one level (Adnett, 1996).

National level bargaining has been notable in Belgium, the Netherlands, Portugal, Spain and the Nordic countries. Sector- and regional-level bargaining is a strong feature of France, Italy and Germany, although in the last mentioned within nationally-determined legal frameworks underpinning a consensual industrial relations system. Distinctive from the rest of the Community, the United Kingdom has become more similar to the United States with enterprise-level wage determination, in large part the outcome of the Conservative Government’s policy of diminishing union power during the 1980s. The United Kingdom trend has been partly reflected elsewhere in the Community with movement towards more decentralized bargaining in recent years, though substantial structural differences have persisted.

Similarly, there are significant differences in both unionization and collective bargaining coverage rates (Table 4.1). The two figures do not necessarily correspond: for example, low rates of unionization in France and Spain do not preclude the relatively wider coverage of their collective agreements. The highest shares of both unionization and collective bargaining coverage have traditionally been in Nordic countries such as Finland and Sweden while low rates mark countries with decentralized systems, particularly the United Kingdom.

The activity of trade unions also differs between countries, when examining labour disputes. Looking at the annual average for 1989-93, the most working days lost per 1,000 employees was in Greece (4,470 days), Spain (430 days) and Italy (250), while the least was in Austria (10 days), Germany and the Netherlands (20 each) (Bird, 1994). The figures do not relate simply to the levels of unionization/collective coverage among the Member States, suggesting that the differences are more likely to proceed from other factors influencing the existence of consensual or adversarial relations. Moreover, there is no clear evidence of the trends in disputes either: while the number of days lost fell during the 1980s in most countries, they rose in the Netherlands and Greece.
Table 4.1. Coverage by collective bargaining and trade unions

<table>
<thead>
<tr>
<th>Shares of total employees</th>
<th>Unionization rate</th>
<th>Collective bargaining coverage rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>46</td>
<td>98</td>
</tr>
<tr>
<td>Belgium</td>
<td>51</td>
<td>90</td>
</tr>
<tr>
<td>Denmark</td>
<td>71</td>
<td>n.a.</td>
</tr>
<tr>
<td>Finland</td>
<td>72</td>
<td>95</td>
</tr>
<tr>
<td>France</td>
<td>10</td>
<td>92</td>
</tr>
<tr>
<td>Germany</td>
<td>33</td>
<td>90</td>
</tr>
<tr>
<td>Greece</td>
<td>34</td>
<td>n.a.</td>
</tr>
<tr>
<td>Ireland</td>
<td>49</td>
<td>n.a.</td>
</tr>
<tr>
<td>Italy</td>
<td>38</td>
<td>n.a.</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>49</td>
<td>n.a.</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>26</td>
<td>71</td>
</tr>
<tr>
<td>Portugal</td>
<td>32</td>
<td>79</td>
</tr>
<tr>
<td>Spain</td>
<td>11</td>
<td>68</td>
</tr>
<tr>
<td>Sweden</td>
<td>83</td>
<td>83</td>
</tr>
<tr>
<td>UK</td>
<td>39</td>
<td>47</td>
</tr>
</tbody>
</table>

Source: Taken from Adnett (1996).

Differences also exist on the extent to which collective agreements constrain businesses in different countries. For example, European Union labour force surveys have shown that companies were more concerned by the restrictions of collective agreements on weekly operating hours in Germany and Portugal than in other Member States, whereas enterprises in the United Kingdom noted the fewest restrictions (CEC, 1995a). The differences were particularly telling in the negotiations for the transfer of production between France and the United Kingdom by Hoover Europe in 1993. Collective agreement restrictions prevented French workers in Dijon from negotiating employment concessions with the company that might have prevented the shift in production to its Scottish plant (EIRR, 1993). Clearly, there is an interaction between the benefits of centralized and decentralized systems of industrial relations, where the scope for negotiating manoeuvrability tends to be influenced more by the specific circumstances of individual cases.

The difficulties in relating industrial relations systems to individual enterprise outcomes illustrated above apply also to the link between wage fixing, wage inflation and unemployment. In an econometric study, Flanagan (1989) did not find a significant relationship between differences in wage determination structures and unemployment changes. In contrast, Marsden and Silvestre (1992) in reviewing a series of studies confirmed the work of Calmfors and Driffill that better performances in unemployment and inflation were strongly related to highly centralized or decentralized industrial relations systems. The relevant issue here may be not just centralization, but coordination as well: Nickell (1997) found that higher levels of unemployment tended to occur in systems which were not just highly centralized, but in which there was relatively little coordination between employers and workers. Similarly, the OECD
(1997a) concluded that statistical relationship between economic performance and the centralization of the bargaining structure was ambiguous, but a case could made with respect to the extent to which wage-setting coordination took place across the economy.

This does not fully outline the flexibility of wage setting in each country, so use should be made of comparative data on wage flexibility. Beatson (1995) cites several methods of measuring such flexibility. Inter-industrial wage dispersion demonstrates the extent to which wage levels are allowed to vary between industries - a limited study covering the period between 1975 and 1986 showed that there was high dispersion in Belgium, Ireland, Italy and the United Kingdom, but there was little variation in Denmark, France, Germany and the Netherlands. In addition, average real wage flexibility can be measured by the trends in wage levels and unemployment over a period of several decades. Recent studies (also cited by Beatson, 1995) have produced mixed results, concluding that wages may have responded to macro-economic changes more flexibly in France, Germany and the United Kingdom but notably less so in Denmark, Ireland, Italy and Portugal. Comparing the statistical measures demonstrates the difficulties in determining pay flexibility, as one set of indicators point to flexible systems in Ireland and Italy whereas the other suggests the opposite.

At present, the existence of different wage fixing systems is likely to continue in the European Union. The Community has encouraged the development of trans-European industrial relations groups with the ‘social dialogue’ between European employer and trade unions representatives (UNICE and ETUC respectively). However, their influence on Community policy currently remains limited and cannot be taken as a serious presage of cross-national unions, employer federations and bargaining systems (Teague and Grahl, 1993). Indeed, evidence seems to suggest that unions are tending to identify more with their own enterprises rather than with workforces in other enterprises, particularly in multinationals where plant survival is becoming increasingly critical as a result of corporate restructuring in the wake of greater trade integration (Raines et al, 1999; Mueller and Purcell, 1992).

(ii) Minimum wages

Evidence for the impact of minimum wage legislation is more mixed. As with industrial relations, there is significant diversity within the European Union. Three types of minimum wage agreements have been identified in the Community (Income Data Services, 1993):

- statutory minimum wage systems: France, Luxembourg, the Netherlands, Portugal and Spain (as well as Belgium and Greece, where it is set through collective agreements that become generally binding);
- collective agreements within industries: Denmark, Germany and Italy (as well as Ireland, though binding rates are set for sectors with low union density by statute); and
- no minimum wage restrictions: until recently, the United Kingdom.

However, there appears to be little evidence that differences in the regulation of minimum wages have greatly affected employment levels and inter-industrial adjustment. Cross-national research has not been undertaken on the issue, but individual national studies have tried to relate the existence of minimum wages to unemployment and wage movements. Hence, studies by Fitoussi (1994) for France, Koutsogeorgopoulou (1994) for Greece and Dickens, Machin and Manning...
(1994) for the United Kingdom did not find significant links between such legislation and unemployment. However, van Soest (1989) concluded that just over a tenth of the Dutch workforce were made unemployed because their ‘shadow’ wages fell below the minimum wage level; other studies conducted on United States data found similar research ambiguities (OECD, 1994a). In its most recent study of the issue, the OECD (1998) decided that minimum wages only had conclusive effects in lowering employment when set at relatively ‘high’ levels (or close to the average level in an economy).

4.3 Employment regulations and benefits

4.3.1 Theoretical impacts

The regulatory framework surrounding national labour markets are a second set of factors influencing the extent to which integration can take place. Member States have distinctive employment protection frameworks, consisting of legislation governing worker rights, guaranteeing financial security during periods of unemployment through welfare support, and requiring employers to contribute to social security payments. The impact of these different issues are considered in turn below.

(i) Employment regulations

Employment protection and differences in national labour market flexibility can also influence the degree to which employment adjustments can take place following integration and the convergence of key indicators between different national labour markets. The process of influence works two ways. First, it has been argued that economic integration can lead to changes in labour standards. Some commentators have noted that greater trade integration worldwide has led to improvements in working conditions and hence, labour standards over time (Fields, 1990). Among others, fears have been expressed that integration can undermine higher levels of labour standards through a process of ‘levelling-down’. The higher direct cost of maintaining such standards can make enterprises less competitive than firms in lower-standard countries, and in some cases, result in the transfer of production investment to the latter. Such concerns have been expressed in efforts to strengthen international labour standards to prevent multinationals undertaking regulatory arbitrage or higher-standard countries eroding employment protection in order to maintain their competitiveness (Sengenberger, 1994).

At the same time, labour standards can influence the direction and extent of economic integration, particularly with respect to readjustment between industries and within enterprises. In recent years, the debate over the appropriate levels of employment regulation in an economy has been linked to the issue of labour market flexibility. Workforce flexibility can be viewed as the ability of firms to adapt the organization of employment (collectively and individually) to existing and anticipated changes in markets, products and production processes. Against a background of mounting pressure on companies to maximize flexibility to increase plant productivity, companies have been experimenting with altering workforce compensation arrangements, the working conditions of their workforce and the quality of individual workers in order to reduce costs and raise productivity. In particular, companies have been affected by two types of workforce flexibility which are subject to regulation: ‘numerical’ and ‘temporal’.
Numerical flexibility can be defined as the employers’ ability to modify the overall size and composition of the workforce. Its influence on production flexibility relates to the costs of companies of changing the size and composition of their workforce in line with changing market conditions. It can also influence the cost of maintaining a ‘peripheral’ labour force, which includes the use of part-time and temporary employment on non-core business activities in which there are relatively low transaction costs involved in a high level of personnel turnover.

Temporal flexibility refers to the ability of companies to change production working time. Working time has become a more important aspect in strategies for raising plant productivity in response to the increasing need for firms either to maximize production output through continuous plant operation (resulting in a higher utilization of the existing capital stock) or to reduce and expand output in markets characterized by significant variation of demand (usually as a result of seasonality).

While each company’s approach to flexibility will differ depending on a range of factors including company, sector, size and location, several determinants are common to all efforts to increase flexibility. Employment regulation by governments is one of the major determinants in setting the type and extent of workforce flexibility. For example, with respect to numerical flexibility, restrictions exist on the freedom, timing and scale of dismissals, the levels of redundancy payments and the mechanisms for ruling on unfair dismissals. Non-standard employment contracts are becoming popular in certain countries and for certain types of work: regulation can determine not only the extent to which employers can use these different contractual forms (e.g. in avoiding claims of unfair dismissals), but also the costs of their use, mainly through employer liability for social security contributions. Similarly, working time issues consist of several areas where national regulation has been influential: ceilings on the length of working week, holiday and leave entitlements, and night shifts.

The absence of certain types of flexibility can create problems in labour market adjustments as a result of integration. Indeed, a set of regulations in one aspect of labour market flexibility can have unwanted consequences in another. The severe restrictions in Spain on employment dismissal have led to the extensive use of temporary employment, so that Spain has the highest share of fixed-term contract workers in its labour force of all European Union countries (Blyton and Martinez Lucio, 1995). Indeed, the restrictions have been linked to the relatively high and persistent levels of unemployment in Spain, as temporary workers are more likely to be made redundant quickly during a recession (OECD, 1994a).

(ii) Employee benefits

In addition to employment protection legislation, differing systems of social security contributions can hinder full market integration. High labour taxes can have a substantial impact on overall wage levels and wage disparities across the Community. Moreover, such contribution levels can result in ‘sticky’ wage adjustments, as they can prove resistant to change because they are normally entrenched at a centralized policy level. Labour costs become less responsive to changes in wage levels, making factor price equalization and labour market integration more difficult to achieve.
However, it has also been argued that differences in social security costs do not affect the overall level of labour costs to employers over time (Adnett, 1996). Where a relatively high share of total labour costs are made up of employers’ contributions for social protection expenditure, this may mean that employees seek a compensatingly lower wage for any given level of productivity and labour demand. Where indirect labour costs are low, it can be anticipated that social protection costs will have to be met privately by employees, who will consequently demand a sufficient wage to meet their fiscal responsibilities. Effectively, the theory implies that wage growth takes into account the costs to workers of social protection expenditure, so that employers should be indifferent to whether this expenditure is met by their own social security contributions or higher wages for workers.

Similarly, unemployment and welfare benefits alter the extent to which labour markets can adjust to integration effects. Relatively ‘generous’ systems arguably create disincentives to job searching, resulting in higher levels of unemployment and slower industrial readjustments through their effects on job search behaviour (Buti, Franco and Pench, 1998). However, it could be argued that the absence of unemployment benefits can result in greater efforts by existing workers to maintain their employment, potentially through the use of union influence on enterprise hiring behaviour, resulting in the unemployment effects already noted.

### 4.3.2 Evidence in Western Europe

(i) **Employment regulations**

National variation in labour flexibility is extensive in the European Union, and as a result, has often been cited as a key factor in persistent labour market differences within Western Europe (Raines, 1998). With some exceptions, numerical and temporal flexibility in its different forms is more broadly apparent in some countries than others. Ireland and the United Kingdom have the most flexible labour environments in these terms, whereas Belgium and Spain may be characterized by having the regulations that make this kind of flexibility more difficult to achieve. At the same time, the link between labour market flexibility and the ‘severity’ of employment regulation has been strongly supported by several studies (Nickell, 1997; Grubb and Wells, 1993).

However, it is not clear to what extent more ‘rigid’ labour market regulatory systems influence the wider processes of industrial adjustment within a national economy. Although it has been linked in specific circumstances (notably Spain, as outlined above), more general studies have not found statistically significant links between employment regulation and levels of unemployment (Nickell, 1997). Similarly, the OECD noted little connection between the performance of different labour markets (and economies) within the OECD area and the ‘severity’ of their labour market regulations (OECD, 1994b).

Moreover, the extent to which such regulation actually constrains enterprise behaviour is open to question as well. Lindley (1997) concluded that it was difficult at a macro-economic level to link the level of regulatory restrictions to specific types of flexibility, as these tend to result from a complex interaction of enterprise behaviour, bargaining structures and the overall regulatory system. Micro-economic evidence suggests that different types of flexibility may be more common than supposed. In a study of the investment behaviour of German and United Kingdom multinationals with subsidiaries in each country, Raines et al (1999) found that different types of flexibility could be generated in both countries, depending on a combination of individual company culture, industrial relations, the needs of the particular production process and workforce capabilities. Where flexibility improvements have been made, they have occurred
in both plants based in Germany as well as the United Kingdom, normally where the need to make productivity improvements is more pressing and local plant circumstances permit change. In this respect, the research echoes findings in other recent studies: a study of employment flexibility in different companies operating across Europe by the consultancy, Towers Perrin (1997), found that there were few substantive differences between countries, in spite of the higher levels of deregulation in the United Kingdom.

(ii) Employee benefits

The impact of social security contributions on labour costs can be considerable. When examining a table of labour costs for 1992, the ranking by total labour costs among Member States is changed when indirect wage costs are removed (Table 4.2). As a result, some countries which have a limited comparative advantage on wage levels improve their cost ranking because of the relatively low share of additional indirect costs - particularly Denmark, Ireland and the United Kingdom.

From the perspective of policy-makers, awareness of the potential impact of employer contribution levels has prompted several Member States to make temporary and limited suspensions of charges wherever possible (CEC, 1995b). The Belgian government has reduced indirect labour costs on sectors with high exposure to international competition. Similar targeted reductions have been introduced in France, Ireland, Italy, the Netherlands and Spain in order to encourage the hiring of more unemployed people by firms (Sysdem, 1995). Nickell (1997) concluded that high labour taxes appeared to be closely related to higher levels of unemployment.

Table 4.2. Wage-only and total labour costs in EC-12 countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Wage-only labour costs (UK=100)</th>
<th>Ranking (highest=1)</th>
<th>Total labour costs (UK=100)</th>
<th>Ranking (highest=1)</th>
<th>Indirect costs as % of total costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany (1992)</td>
<td>153.1</td>
<td>1</td>
<td>169.0</td>
<td>1</td>
<td>22.5</td>
</tr>
<tr>
<td>Belgium (1991)</td>
<td>138.3</td>
<td>4</td>
<td>151.6</td>
<td>2</td>
<td>22.0</td>
</tr>
<tr>
<td>The Netherlands (1992)</td>
<td>141.5</td>
<td>3</td>
<td>141.6</td>
<td>3</td>
<td>14.5</td>
</tr>
<tr>
<td>Denmark (1991)</td>
<td>112.4</td>
<td>5</td>
<td>113.1</td>
<td>5</td>
<td>15.0</td>
</tr>
<tr>
<td>Luxembourg (1990)</td>
<td>94.9</td>
<td>8</td>
<td>112.8</td>
<td>6</td>
<td>28.0</td>
</tr>
<tr>
<td>France (1988)</td>
<td>87.2</td>
<td>9</td>
<td>105.2</td>
<td>7</td>
<td>29.0</td>
</tr>
<tr>
<td>Italy (1988)</td>
<td>100.0</td>
<td>7</td>
<td>100.0</td>
<td>8</td>
<td>14.5</td>
</tr>
<tr>
<td>UK (1992)</td>
<td>100.9</td>
<td>6</td>
<td>95.9</td>
<td>9</td>
<td>10.0</td>
</tr>
<tr>
<td>Ireland (1992)</td>
<td>84.5</td>
<td>10</td>
<td>95.7</td>
<td>10</td>
<td>24.5</td>
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<td>Spain (1988)</td>
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<td>26.0</td>
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<td>36.2</td>
<td>11</td>
<td>35.8</td>
<td>12</td>
<td>13.6</td>
</tr>
<tr>
<td>Portugal (1992)</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: Taken from Raines (1996).
Differences in welfare systems have also been directly linked to differences in unemployment performance. Reviewing numerous studies on the issue, the OECD (1994a) concluded that there is significant research supporting the hypothesis that relatively high levels of benefits tend to be associated with slow adjustments in labour markets, notably through significant time lags in unemployment declining following external shocks to an economy. High benefit entitlements seem to not only affect long-term unemployment, but can encourage shorter employment periods, with higher levels of part-time employment, early retirement and voluntary job-leaving.

4.4 Training systems

4.4.1 Theoretical impacts

Trade and labour market integration can lead to a shift in the skills requirements of workers during the period of industrial readjustment. This can either occur because of the need for workers to adapt to new industrial activities which require a different set of skills or because of shifting factor mixes in production as a result of increased competition (for example, if there is a shift to more capital investment, workers may have to learn new skills to operate new equipment). The economic cost of workers taking on new skills can be borne by either enterprises or individuals, and under some circumstances, training market failures can take place. Enterprises may be reluctant to invest in training workers where the benefits of their investment reside with individuals who can take up new jobs elsewhere before the full economic benefit of their training has been recovered. Individuals may not have the resources to undertake the necessary training or be unwilling to sacrifice current earning streams for future benefits where the nature of those benefits are uncertain.

The role of government in addressing these market failures is well understood and forms the basis for public training and education policies. Government action in this field can provide several ‘public-good’ benefits. First, it can address bottlenecks in the supply of workers with particular sets of skills in sectors that may be expanding as a result of industrial restructuring. Existing firms in these sectors may lack the resources to provide the training (particularly where there is a high risk of poaching where demand is in excess) and firms considering entering these expanding markets may be dissuaded by the slow response of factor markets. Second, government training policies can both reduce unemployment and shorten its duration by easing the movement of workers between sectors through re-training. Enterprises would have little incentive to support such unemployment reductions while the individuals concerned would not be able to fund their acquisition of new skills.

The last set of benefits arising from publicly-funded training programmes is the contribution to the overall economy of increasing productivity through raising overall skills levels. Here, it is important to distinguish between training that provides specific skills for particular sectors and jobs and more general trans-sectoral skills, often imparted through the wider education system. Both contribute to another aspect of labour market flexibility which can be critical to the process of industrial restructuring. Functional flexibility is set by the work capacity of the employees, as determined by their skills levels, task definition and overall productivity performance. It reflects the ability of workers to perform a wider range of tasks, adapt to changing job definitions and undertake responsibilities quickly and efficiently.

Differences in national training and education systems can influence the extent of
integration. More effective systems can support more rapid and less economically difficult industrial readjustment; where systems differ within an integration process, they can contribute not just to a reinforcement of productivity differences, but to a widening of productivity and unemployment differentials. At the same time, differences in training systems can also hinder trade integration by restricting mobility between labour markets. As noted already, differences in skills training, their certification and transferability between Member States can create significant disincentives for workers to migrate. Moreover, there is a potential incentive for workers to remain in certain countries if training opportunities are perceived to be more widespread and the quality of the training (and its eventual earning potential) better.

4.4.2 Evidence in Western Europe

Differences in training and education outcomes are significant in the Community. For example, in a survey for the European Commission (CEC, 1995b), a higher share of employees over the age of 25 had undertaken training over the course of the previous month in the Netherlands and Denmark (15 per cent) than workers in France and the Member States along the Mediterranean periphery (3 per cent or less). Similarly, the number of new entrants into tertiary education in the starting age group varied between 29.3 (per 100 persons) in Greece to 52.8 in Denmark while the percentage of the population in tertiary education ranged from 7 per cent in Italy to 24 per cent in Sweden (Adnett, 1996).

The statistical variations reflect substantial differences in training and education systems. For example, the success of the highly-developed vocational, apprenticeship-based system in Germany - and its coordination with the academic system - is reflected in the high proportion of young people who receive a national qualification. The system contrasts with the less nationally-integrated, mixed system in the United Kingdom, where there is less coordination between the academic and vocational systems and the apprenticeship approach has - until recently - been in decline. The impact of these training systems on functional flexibility is difficult to establish because of the absence of cross-national comparative data. Several studies have examined the proportion of skilled workers and the definition of job boundaries as indicators of the level of rigidity in this type of flexibility (Beatson, 1995). The evidence from these and other studies suggests that there is a spectrum of varying functional flexibility, placing countries like Germany, the Netherlands and Italy (specifically the more industrialized northern regions) at the more flexible end of the range and France, Spain and the United Kingdom at the other. As functional flexibility requires significant and long-term investment in human resources in order to maximize the adaptability of the workforce, one indicator of functional flexibility could be the level of training investment by firms. Tüselmann (1995) noted that two-thirds of the West German workforce were qualified to crafts level or higher, as compared to one-third in the United Kingdom.

The differences in the systems appears to be related to the pattern of skills shortages in different Member States. During the 1980s, an average of 14 per cent of surveyed United Kingdom firms reported problems for recruiting key skills as compared to 5 per cent or less of German and French firms (Adnett, 1996). A series of studies by the National Institute for Economic and Social Research suggests that these skill deficiencies may result in lower productivity levels. O’Mahony (1998) found that the relationship between skills and productivity differences in the case of Germany and the United Kingdom was strong while Mason and Wagner (1994) concluded that variations in skills have common impacts at different levels of production across several industries. For example, in cross-sectoral studies, it was found that German machine operators were able to perform a wider
range of tasks than their British counterparts, often resulting in a greater transfer of managerial responsibilities to the shop-floor. German firms were also more likely than United Kingdom companies to possess specialist technical expertise which would allow them to take advantage of new technological developments, arising from their higher share of specially-trained graduates.

5. Future impacts

5.1 Introduction

Economic integration remains an incomplete process in the European Union. Integration has never been a carefully-planned process proceeding through a series of milestones: no fixed end-date for economic integration has been specifically defined within Community policy and legislation, and although the Community has seemed to proceed through a sequence of distinct phases - both in terms of the depth of integration (from trade to currency union) and its breadth (from the original six to its current fifteen members) - it has not been articulated as a consistent programme. Nevertheless, in economic terms, integration has been part of a continuing dynamic. Indeed, as described earlier, one stage of integration in the Community has often created both the preconditions and the rationale for the next stage. In recent years, this has become very apparent in the immediate stages of further integration now facing the European Union: monetary union and enlargement into Central and Eastern Europe.

Although its achievement appears to be the result of a relatively recent and short-term campaign, monetary union has a long tradition within the Community. Attempts to set up a monetary union date back to the 1970s, reaching a then peak with the establishment of the European Monetary System. The recent impetus for monetary union is linked to the Single Market project, and EMU has been cast by its supporters as the essential complement to full trade integration. The Single Market was predicted to create new problems as well as opportunities which would require the existence of a single currency and European monetary policy, not least as a result of the increasingly integrated capital markets of the European Union. The plans for EMU are consequently almost coterminous with those for completing the internal market.

At the same time, but independently, enlargement of the Community to include former Communist countries in Central and Eastern Europe has become an integration priority in the wake of the collapse of the former Comecon and trade liberalization within these countries. The pressure for integration has arisen on both sides. For the candidate countries, the benefits are perceived as greater access to European Union markets (which has been selective up until the present), the opportunity to introduce what their governments may view as essential economic reforms as part of the acquis communitaire, and increased financial resources through eligibility for European Union regional policy funding. From the European Union perspective, enlargement allows the creation of a wider economic union as the basis for greater political stability in Western Europe.

While both integration processes have separate origins, the two have come to dominate the agenda of the Community - representing more pressing issues than other potential integration measures in other policy areas - and have largely been locked together. This is not just in terms of their parallel timetables, but the two processes have strong implications. On the one hand, candidate countries have to consider their ability to join monetary union as well on their accession. On the
other, questions can be raised about the capacity of a single currency union to accommodate countries with such disparate economies.

Both integration processes are widely anticipated to have strong labour market impacts, though the scale and novelty of both economic events are such that predictions have varied. While firm conclusions cannot be drawn, particularly with respect to how the two processes will interact with each other as well as the continuing completion of the internal market, different theoretical considerations can be analyzed. In the following chapter, the effects of each process on labour market integration within the Community will be reviewed separately and in detail.

5.2 European Monetary Union

At present, monetary integration is a project involving only a subset of Community countries: the EU-15 with the exceptions of Denmark, Greece, Sweden and the United Kingdom. No explicit plans or dates have been set for other countries to join the ‘Euro-zone’ eleven, though enlargement is widely expected within the next decade. As long as candidate countries fulfil the criteria for monetary union and have the political will, membership of monetary union can be secured. Its expansion may tend to hang more on the latter issue rather than the former, and in this, the progress of monetary union and its economic effects on the member countries will feature strongly. Such effects cannot be accurately been gauged at this point.

Although there is significant uncertainty over what will occur with monetary union, it is still seen in large part as an extension of previous trade integration. In many respects, it is anticipated to act as a complement to the Single Market programme. Its overall impact has been envisaged as a means of concentrating and possibly accelerating the trade effects, economic restructuring and labour market changes of existing integration.

The theoretical effects of monetary union are expected to be felt most directly on trade. A single currency will create price transparency across the single trading union; by reducing information uncertainty about the price of goods, services and factors of production, it should allow easier international comparisons to be made and encourage greater price competition across borders. A single, fixed currency should also reduce export uncertainty by removing exchange rate fluctuations - and consequently, the need to discount future transactions in different currencies - as well as commission costs.

Monetary union will also have wider effects on economic convergence by affecting government as well as individual enterprise behaviour. Indeed, the process of becoming eligible for monetary union has already induced convergence. As a result of the Maastricht Treaty’s commitment to monetary union, candidates countries were required to fulfil a set of criteria for EMU entry. These included convergence of inflation rates to the lowest average within the Community, a levelling-down of interest rates to another low average, and low ceilings on the share of government debt of GDP and the annual public sector deficit. The criteria were intended to ensure that the members of monetary union had economies whose main indicators were broadly similar; achieving these criteria has demanded similar policy approaches by each country.

The implications for macro-economic policy have been common across the different Member States, and in some cases, drastic. In combination, the criteria have compelled an anti-inflation strategy by governments, involving reductions in spending and occasionally an increase in taxes. As a result, fiscal policy and government spending strategies will be constrained by monetary union, just as governments will also be losing the use of monetary and currency policies as an instrument of
economic intervention. At the same time, monetary union is expected to provide an overall boost to economic growth, amounting to 0.4 per cent according to Commission predictions (CEC, 1990a).

Through its combined effects on the activities of enterprises, governments and other economic agents, a monetary union can have a range of potentially substantial impacts on labour market integration. From one perspective, as already noted, monetary union can be envisaged as producing no new effects or set up any new processes within labour markets which have not already been dealt with earlier: rather it would intensify previous trade and labour market effects by encouraging comparative advantage specialization, economies of scale and industrial restructuring.

However, monetary union is widely regarded as likely to result in a series of specific, potential labour market effects. In the same way that price transparency will reduce information costs in product markets, it will also make the comparison of labour costs easier internationally. This transparency can have several effects on different economic agents. First, businesses with internationally-mobile production will be able to assess labour costs in different locations with less uncertainty arising from exchange rate fluctuations. Second, wage negotiations could be affected by the greater ease in comparing labour costs and wage settlements in other countries. It may have the effect of making both employers and workers more sensitive to bargaining outcomes throughout the monetary union, providing a wider set of benchmarks for both parties. While this may reduce the nationally-distinctive factors influencing wage determination, it could have the impact of promoting faster wage growth, depending on the strength of labour bargaining in different countries. At the same time, it could reduce wage inflation because of the greater price stability and consequently increased certainty in predicting wage claims for the following year. In either case, the forces determining wage levels will become more common across the monetary union, potentially with the result of greater wage level convergence.

Labour mobility may also be encouraged in a monetary union. While the effect may be marginal, the removal of currency uncertainty could influence the willingness of individuals as well as businesses to migrate through reducing information costs. However, such labour mobility is unlikely to minimize the impact of monetary union on regional disparities in unemployment. Eichengreen (1993b) found that greater labour mobility had not insulated regions within the United States from the impact of real exchange rate shocks any more than in the United Kingdom or Italy. Increasing labour mobility within the monetary union will still leave the wider problem that regional and national labour markets are likely to bear the brunt of real economic adjustments.

Commentators view such adjustments to be inevitable because of the ‘one-size-fits-all’ dilemma of a single monetary policy covering disparate economies (Peters, 1995). The problem arises when demand shifts between countries producing common goods. The country facing increased demand will experience inflationary pressures, while the country experiencing reduced demand will be subject to higher unemployment. A common monetary policy cannot accommodate both countries’ problems: a contractionary monetary policy will lower inflation in one country and raise unemployment in the other by stifling demand, while an expansionary one will lower unemployment in one country and boost inflation in the other. Adjustments can only take place in the real economy through higher unemployment, labour migration and changes in wage levels and flexibility. In the short term, this would exacerbate regional disparities as the resolution of inflationary pressures have to be made by national labour market institutions.

Governments will lose much of their ability to muffle these impacts on the real economy. First, they will no longer have the opportunity to influence trade competitiveness through currency devaluations. This will remove the capacity of governments to make short-term adjustments in order
to ease longer-term restructuring (Marsden and Silvestre, 1992). Second, policy will be less able to respond to asymmetric economic shocks in the economy (or indeed, the restructuring effects of economic integration). The budget deficit limits set for participation in EMU could prove particularly restrictive during a recession: a reduced tax base would occur at a time of increased need for unemployment benefits and active labour market policies. Declining capacity for expenditure will determine the extent to which governments can address skills shortages and minimize short-term unemployment.

Overall, an erosion of employment protection and trade union strength might occur as a result of these effects in combination. The pressure for increasing the flexibility of wages and employment levels to respond to changes in the real economy are likely to lead to a gradual attrition of such national-level labour market institutions. Trade union behaviour in a single currency area could determine how far convergence may take place between labour markets. If unions set their wage claim on the benchmarks set by the highest increases or levels in the currency area, this could exacerbate economic adjustments if productivity rates continue to rise at differing levels (Peters, 1995). However, a consensual approach to aligning wage demands with productivity growth on a Europe-wide basis could support the development of the centralized and coordinated industrial relations system which Calmfors and Driffill (1988) argued would favour economic growth.

5.3 Accession of Central and Eastern European countries

It is widely anticipated that the next wave of European Union enlargement will take place within the first decade of the new century. Because of their progress towards reforming their economies and political systems and their adoption of key European Union legislation, five Central and Eastern European (CEE) countries have been designated candidates for accession: the Czech Republic, Estonia, Hungary, Poland and Slovenia. These countries have already benefited from an extensive degree of trade integration with the European Union through earlier initiatives which have played a major role in catalyzing industrial restructuring and policy reform within these countries. However, full integration is expected to have wider-ranging and more intensive effects, not just for the CEE candidates, but potentially for existing European Union Member States.

The current enlargement activity is distinguished from previous integrations by one critical factors: its scale. In population terms, it is similar in overall size to the 1973 enlargement of the United Kingdom, Denmark and Ireland, and will increase Community population by nearly a seventh. However, the most important impact of the current enlargement will be its widening of existing economic disparities within the European Union. Although their unemployment rates are broadly similar to many Member States – indeed, only Poland had an unemployment rate higher than the European Union average, and none had rates as high as Spain - per capita incomes are considerably lower (Table 5.1). All the candidate countries have national figures below the lowest national levels within the Community. In most cases, the figures are also lower than averages of the less-developed Member States at their time of accession. While economic growth in these countries has been higher than the European Union average – suggesting a continuing narrowing of income differentials – enlargement will represent the largest widening of European Union disparities in its history. Moreover, as Table 3.5 has shown, wage differentials for these countries have not narrowed consistently over the period of their membership of the Community, in spite of changes in per capita income variation.
Table 5.1 CEE candidate countries and the European Union (1996)

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP per capita (EU=100, PPP)</th>
<th>Unemployment rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>57.0</td>
<td>3.6</td>
</tr>
<tr>
<td>Estonia</td>
<td>22.0</td>
<td>9.6</td>
</tr>
<tr>
<td>Hungary</td>
<td>37.0</td>
<td>10.8</td>
</tr>
<tr>
<td>Poland</td>
<td>31.0</td>
<td>12.7</td>
</tr>
<tr>
<td>Slovenia</td>
<td>59.0</td>
<td>9.7</td>
</tr>
<tr>
<td><strong>European Union</strong></td>
<td><strong>100.0</strong></td>
<td><strong>10.9</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Accession (date in brackets)</th>
<th>1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>54.2 (1981)</td>
<td>65.9</td>
</tr>
<tr>
<td>Ireland</td>
<td>60.8 (1973)</td>
<td>97.7</td>
</tr>
<tr>
<td>Portugal</td>
<td>58.5 (1986)</td>
<td>68.3</td>
</tr>
<tr>
<td>Spain</td>
<td>69.6 (1986)</td>
<td>77.0</td>
</tr>
</tbody>
</table>


To a large extent, economic integration – beginning with the initial trade integration of the Europe Agreements and culminating in full membership in the near-future – will result in similar sets of effects to those described in earlier sections on integration within the Community. Estimates of the growth in trade between CEE countries and the European Union have varied, usually depending on the assumptions behind growth in the reforming economies, but have concurred in their significance. Hence, by 2010, Landesmann (1995) predicted that CEE countries would account for 4.2 per cent of all European Union-15 manufacturing imports (as opposed to 2.4 per cent in 1993), while Baldwin (1994) estimated imports from European Union-15 countries would grow over the same period by a factor of four in Poland, six in Hungary and eight for the Czech Republic. As with other integrations, trade creation effects have been estimated to be larger than trade diversion (e.g. CEC, 1995c). In terms of the distribution of gains, while these will largely depend on the distribution of import-competing and export-growth sectors within the Community, it is likely that strong effects would be felt in the main trading partners of the accession countries: Germany, and to a lesser extent, Austria.

As with previous enlargement processes, the employment effects of accession can be discussed theoretically but remain difficult to predict empirically. Impacts are anticipated to be largely restricted to sectors sensitive to CEE competition, and further limited by the small share of European Union trade for which the candidate countries account. Indeed, the evidence of previous accessions of relatively less-developed countries – notably Ireland, Greece, Portugal and Spain – suggests that the benefits – as well as the scale of industrial restructuring and employment change – will be larger among the joining countries than in the rest of the Community (Waniek, 1999). The earlier experience also points to the difficulties in assessing which countries will gain and which will lose from accession, given the sensitivity of outcomes to national macro-economic policy orientations (Bean et al, 1998). Within the Community, as with these other accessions, integration should
encourage a short-term inter-industrial specialization, as the revealed comparative advantage of the candidate countries is in agricultural products, textiles, clothing, steel and less sophisticated plastic manufactures, generally sectors where primary resource and labour intensity is strong (Döhrn, 1999).

Inter-industrial trade impacts have been predicted to rise because of the substantial labour cost differentials between the existing Member States and the accession countries. As seen in Table 5.2, labour costs in the candidate countries are considerably lower than both the European Union average and the average costs of the less-developed Member States. According to the HOS model, factor price equalization could be expected to take place through trade integration and industrial restructuring. In terms of labour markets, it would be expected that the greatest impacts would be felt in the labour-intensive industries within the Community: most keenly in those in the more prosperous (and higher labour cost) Member States, but perhaps most extensively in the Member States with relatively larger shares of labour-intensive industries (such as Greece, Ireland, Portugal and Spain).

However, previous experience of the impact of wage differentials in the Community does not suggest major industrial restructuring, followed by labour costs convergence. For example, European Commission research did not identify the scope for such trade competition between new Member States and the ‘Social Cohesion’ countries, in part because of the low volume of trade (CEC, 1995c). Moreover, competition is likely to be complicated given the high share of skilled and educated labour within the accession countries. Statistical research by the OECD (1997b) found that the link between changing trade composition between the accession countries and the Community, and European Union wage levels was highly ambiguous. While current levels of capital investment and skills training are relatively deficient, over the longer-term, the accession countries could begin to develop intra-industrial comparative advantages with the older Member States, with a consequent rise in labour costs. At this stage, it is difficult to estimate the composition of trade sufficiently accurately to assess its competitive effects on Member States labour markets.
Table 5.2 Hourly labour costs in CEE candidate countries and the European Union, 1994 (European Union=100)

<table>
<thead>
<tr>
<th>Country</th>
<th>EU=100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>31.3</td>
</tr>
<tr>
<td>Estonia</td>
<td>24.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>17.3</td>
</tr>
<tr>
<td>Poland</td>
<td>12.7</td>
</tr>
<tr>
<td>Slovenia</td>
<td>16.0</td>
</tr>
<tr>
<td>European Union</td>
<td>100.0</td>
</tr>
<tr>
<td>Greece</td>
<td>38.7</td>
</tr>
<tr>
<td>Ireland</td>
<td>86.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>40.7</td>
</tr>
<tr>
<td>Spain</td>
<td>85.3</td>
</tr>
</tbody>
</table>


The labour cost differential has also led to speculation about the transfer of labour-intensive aspects of Western Europe production to these countries. Foreign investment by Western European companies has been a major part of the industrial restructuring undergone by the CEE countries, in some cases, resulting in significant productivity gains, new industrial practices and a degree of technology transfer. Whether this has resulted in investment diversion from existing European Union locations has been extensively debated, and the evidence for widespread shifts has not been found. For example, in the case of Spain, Gual and Martín (1995) concluded that full market integration would not affect investment inflows, in spite of the potential competition on labour cost grounds. Most investment in the CEE region appears to be based on developing and serving CEE markets rather than as a production base for supplying western Europe (Helinska-Hughes and Hughes, 1999).

At the same time, while there have been only a handful of clearly-identifiable transfers of production from Western European locations to CEE sites, fears of a 'hollowing out' of production in some Member States have been expressed. In Germany – as a result of the extensive, trans-border investment by German companies - it became part of a national debate about threats to its national economic competitiveness (Tüselmann, 1995). Nevertheless, the current level of FDI in CEE does not suggest production transfers on a scale to influence labour market integration and convergence (European Parliament, 1996). Its overall volume has been relatively small and on balance, appears to have had positive employment impacts on the investors’ host countries (for the case of Germany, see Döhrn, 1996).

Labour cost differentials might act as an incentive for migration from the accession countries into other Community countries. However, while the scale of such migration is difficult to estimate, there is little evidence to suggest that it would have a major influence on the labour markets of existing Member States. As shown above, wage differences in the existing Community have not led to widespread population movements, and in addition, in the candidate CEE countries, the unemployment incentive is likely to be absent, given how close their unemployment rates are to the European Union average. CEE migrants would face the same barriers to moving within the Community as other European Union workforces (Werner, 1994). Indeed, Baldwin (1994) estimated
labour migration of less than ten per cent of the accession countries’ populations. Such shifts would only have significant impacts if they were to concentrate in certain parts of the Community, though to an extent, this may take place in the regions bordering the accession countries (Germany, Austria). At this local level, a degree of labour market integration may take place with a convergence of unemployment and wage indicators.

6. Concluding discussion

It was noted at the outset of this paper that economic integration within Western Europe has been an incomplete process (or indeed, set of processes). Consisting of a series of overlapping short-term objectives guided by a long-term ‘vision’, integration has occurred through parallel streams of activities. Before one group of objectives has been fulfilled (such as integrating markets in goods, services, capital and labour among existing Member States), another set has been introduced (such as monetary union, or expanding the Community’s membership). In part, this reflects the difficulties in defining a set of objectives that will not create the conditions – and often, the need - for further integration, and in part, it is a measure of the scale of the project. Overall, it makes it awkward to assess a single element of this integration process – with respect to labour markets – because it is part and parcel of the whole.

Consequently, labour market integration in the Community is a goal without precedent. The closest analogy is the evolution of a single labour market in the United States, but they only compare in terms of the size of the labour market, not the process by which it has formed. The United States has been characterized by incremental expansion, in which common frameworks have been carried forward during geographical expansion of the state and the economy, linking together regional, sectoral and even internal enterprise labour markets. These frameworks are a complex web of inter-connected structures, including nationwide regulations on employment protection and wage-fixing and common bargaining structures. While aspects of the development of the United States labour market are apparent in the Community – notably in its own geographical expansion – integration is different in the Community. Rather than expansion of common frameworks, it is proceeding through the merging of distinct, national labour market systems into a single structure.

To understand labour market integration in the Community, it is worthwhile comparing developments in the Community with the United States in greater detail. Their differences are readily apparent when considering a series of labour market indicators. Over the past two decades, unemployment performance has been much worse in the Community than in the United States, with long-term unemployment becoming persistently high. Labour markets appear to ‘clear’ more quickly in the United States, and short-term inter-regional disparities in unemployment have diminished quicker in the United States than in the Community. Wage differentials between Member States have not changed much in the Community with integration, whereas in the United States, there has been a steady decline in inter-regional differences. Similarly productivity differentials - and perhaps more importantly, unit labour costs – have not narrowed significantly in the Community.

The differences between the United States and the Community seem to be largely attributable to differences in the mechanisms of convergence. In the Community, integration has led to trade flows increasing and to a deepening of trade links between Member States. Capital flows have been affected to an extent (notably FDI), but it has been difficult to assess the labour market
impacts of greater capital market integration. In contrast though, labour migration has been very limited, with flows remaining at low (if not actually diminishing) levels during the whole integration period. In the United States, inter-state labour migration has been strong; indeed, labour mobility has been viewed as the main source of convergence pressures on wages and unemployment in the United States (Blanchard and Katz, 1992).

The conclusion seems to be that increased trade flows do not necessarily create the same pressures for changes in industrial structures and employment at the national level that labour flows might do. Within the Community, in spite of the theoretical predictions of different trade-employment models, there has been little unambiguous evidence of whether the HOS or agglomeration models have applied. Trade integration has occurred without significant labour market integration. Indeed, cross-national labour market indicators show few trends of systematic convergence or divergence. For some indicators, the pattern appears to be cyclical: for example, unemployment and per capita income differentials at the regional and national level have been more closely linked to global economic cycles than to Community integration phases (Dunford, 1996, 1993). Other indicators have not altered greatly over the period, such as wage differentials. In other words, it appears that changes in trade flows have not been sufficiently large - or perhaps sufficiently different - to produce deeper changes in labour market behaviour at national level in the Community.

Several possible explanations can be put forward to explain the resistance of European labour markets to more substantial change. At an aggregate national level, it could be that labour demand may not be shifting significantly, so that there are few pressures operating on the price of labour. This could be the result of the combination of a number of factors: for example, expanding firms may be achieving economies of scale which can allow them to Use the same quantity of labour, while contracting enterprises may be able to increase internal efficiencies and be less willing to shed labour because of earlier investment in their workforce. For all firms, competitive pressures have been leading to improvements in overall productivity through training, technological improvements and new production and supply arrangements (such as just-in-time). Overall, experience suggests that enterprises have significant leeway in adapting to industrial restructuring without necessarily having to alter employment levels.

A second explanation is that labour demand may be shifting as a result of integration, but it could be highly localized, with impacts muffled at the national level. Changes in trade flows often result in self-contained and varying effects on regions within a country. Patterns of long-term unemployment blackspots and zones of strong growth in Member States have been remarked upon by a number of commentators in the context of European integration (e.g. Begg, 1991; Clement, 1988). There is some evidence that while agglomeration models may not necessarily characterize relative differences between national labour markets, they may describe inter-regional economic activity. They can be seen in the persistence of substantial economic differentials within nearly all Member States (e.g. CEC, 1994, 1991b). Linked to the earlier point about the mechanism of integration, this often reflects the absence of significant labour migration within Member States as well as across the Community as a whole.

Lastly, the absence of integration could proceed from deeper structural differences between Member States that affect the capacity of their labour markets to respond to integration forces. In particular, such differences can influence the supply of labour within Member States. As described in Chapter 4, there are a variety of determinants of labour market behaviour which appear to continue to separate national labour markets in the Community. Determinants with a strong influence include trade unions and bargaining structures, unemployment benefits administration and differences
in training systems. Other determinants include regulations governing employment conditions and minimum wages, though the evidence is more mixed on their collective impact.

Examining these different explanations in the context of the United States, it is clear that these structural differences in the Community may be the strongest influence. The first two explanations also apply to the United States, but as noted in Chapter 4, there is considerable variation between the United States and the Community with respect to employment regulations, bargaining structures and a common unemployment benefits system. In addition, there is a common government policy touching on different aspects of labour market behaviour across the United States labour market. The common welfare system is particularly important in this regard, as it has been a significant factor in supporting labour migration by reducing worker financial uncertainty. Interestingly, the awareness that a common policy approach to employment issues could support wider economic integration within the Community has been increasing in fits and starts over the last few decades. As described in the Introduction, this has included the introduction of financial support to Member States for employment change - through the European Social Fund - as well as steps to produce common regulations – notably in the Social Chapter. However, to date, a common labour market policy has had little integration impact in the Community (Raines, 1996). Further, in the foreseeable future, it is unlikely to duplicate the policies operating nationwide in the United States, because of a lack of both a similar scale of resources (through inter-regional financial transfers across the United States) and the political will among Member States. In connection with the latter point, the sharp dispute between the United Kingdom and other Member States over placing a Community-wide ceiling of 48 hours on the working week illustrates the difficulties (Adnett, 1996).

The slow progress towards labour market integration within the Community may ultimately demonstrate the size of the challenge in bringing together labour markets which have been defined by differing social, political/legal and economic factors. It has not just been an issue of integrating trade frameworks, but finding ways of harmonizing a range of nationally-entrenched frameworks. Given the difficulties in achieving the task to date, it raises the wider question as to whether it matters whether labour markets are integrated within the Community.

The main argument supporting the integration of labour markets is that it allows a more efficient - and from a social perspective, arguably a less damaging - adjustment to both short- and long-term shifts in competitiveness. A single labour market supposedly can do this better than a collection of separate labour markets responding to individual factors. The inability of an industrial structure to adapt to either external shocks or changes in international demand for that country’s products can lead to entrenched unemployment and an erosion of the sources of national competitiveness. At the same time, the persistence of different labour markets can potentially cause problems with respect to future economic integration. In the Community, the threat derives less from enlargement into Central and Eastern Europe than from the pressures arising from monetary union. As argued in Chapter 5, a single monetary policy can create differentiated effects in different economies. Governments lose the ability to intervene to support industrial adjustments at national level, and there is no centralized government policy of support at Community level (as there is in the United States). Hence, industrial adjustments must be in the real economy within national labour markets, but with less scope to ‘smooth’ adjustments across a wider labour market as can take place in the United States (e.g. in terms of locations for unemployed workers to migrate). The danger increases of the current inter-regional agglomerations within Member States increasingly beginning to characterize countries as a whole.
The exposure of the Community to these pressures is only likely to arise if Member States’ economies are sufficiently different that a single currency would produce specific changes. The extent to which Member States are individually vulnerable to external shocks or the Community as a whole cannot be assessed easily at present. However, this consideration has been publicly cited by United Kingdom authorities as a reason for holding back from membership - indeed, the Bank of England has argued that greater convergence of unemployment rates should take place before joining EMU.

It can also be argued that this is less a Community problem than a Member State one. Policy changes at Member State level could support increasing flexibility in labour markets, particularly with respect to increasing flexibility in employment regulations, unemployment benefits system and bargaining structures and increasing support for training systems that facilitate more rapid adjustments within the labour market. Introducing such policy reforms could lead to the emergence of common approaches to employment policy in the different Member States, effectively harmonizing policy without replacing the different policies with an imposed, centralized one. Such steps could allow the Community to begin to approach the conditions in the United States that allow an integrated labour market to exist.
Bibliography


CEC (1990a) ‘One market, one money’, European Economy, 44, Commission of the European Communities, Brussels.


Figure 2.2: Impact of removing trade barriers

Situation of domestic producers

Price

\[ P_1 \rightarrow D_1 \rightarrow Q_1 \rightarrow D_2 \rightarrow Q_2 \rightarrow P_2 \]

Economics rents

X-inefficiency

Economies from restructuring

Situation of foreign

Costs of market barriers

Demand

Figure 3.1: Growth of trade among member States

Figure 3.2: Dispersion of manufacturing labour costs in the Community
Coefficient of variation
