# Are European Labor Markets as Awful as All That?

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"It's the job market, stupid."[1]

Few European institutions have had the bad press given to the labor market. The standard explanation of why advanced Europe has generated less work per adult than the United States is that something is seriously amiss with EU labor markets. Labor institutions are inflexible. Institutional wage interventions have reduced incentives. Social benefits are too high. Employment protection legislation is too strong. Mobility is too low. If only the EU could magically transform its labor market into ... the US market, it could do so much better.

**EU labor markets are bad, but better than their reputation**

Why the EU might be able to mimic the US record of ... three decades of declining real wages for average workers ... third world levels of inequality ... a jobless recovery in the early 2000s ... declining provision of health insurance for workers ... short vacations and increasing hours worked ... full-time employment by mothers with children less than one year old ...

Yes, EU labor markets suck compared to the perfect Invisible Hand market of economic theory. But so, too, does the US labor market. The EU labor market fails on the quantity side of the market in the volume of employment created for those who seek work. The US labor market fails on the price side of the market in the pay for those who work and economic security for those who do not.

Like virtually every other economic institution created by humankind, labor markets are imperfect. Whether labor markets are more or less imperfect than, say financial markets, with their excessive volatility of share prices, panics and manias etc; or than international trade and capital markets, with their sluggish response of prices to exchange rates, currency crises, wild flights of private capital, etc is debatable.

The theme of this piece is simple. Compared to an ideal competitive market, EU labor markets fall seriously short, but compared to labor markets in the United States and to other markets in advanced capitalist countries, EU labor markets do not live up to their awful press. EU labor markets can be improved, but so, too, can financial markets, corporate governance, business regulation, conditions for the formation of new businesses and bankruptcy laws, the efficiency of the EU Commission, and the operation of the EU Central Bank. The variety of labor market institutions among EU countries, moreover, reveals a much richer picture of performance and diversity than the blanket condemnation of inflexibility suggests.

I make my case in four propositions, with supporting evidence. My comparisons are with the actual labor market in the United States and with other real world markets, not with the economists' dream ideal competitive markets. I review briefly the evidence that labor markets in the EU have performed worse on the quantity side of the market but better on the price or wage side of the market than the US labor market, then consider the extent to which differences in outcomes are attributable to differences in the performance of labor markets .

### Differing labor market outcomes

Until the 1970s, EU countries had lower unemployment rates than the US and similar or higher hours of work. Productivity growth exceeded that in the United States as Europe recovered from World War II. EU countries managed this performance with a set of labor and social welfare state institutions that included significant reliance on

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[1] This paraphrases, "it's the economy, stupid" that Clinton used to focus his first campaign. The parallel phrase "it's the stupid economists" is associated with the Bush administration.

collective bargaining and administrative determination of labor market outcomes. One of my European friends used to say that during this period, he could never lecture on the virtue of competitive labor markets without feeling as if he was talking theology.

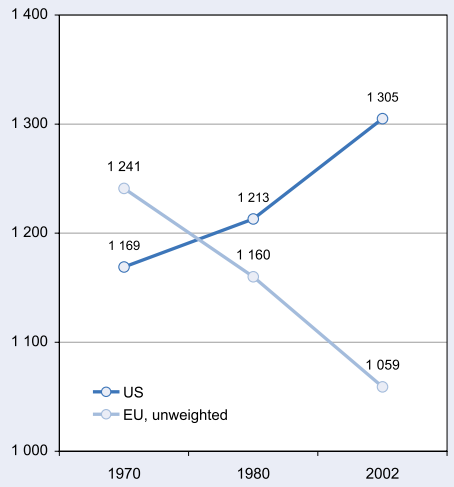
**Employment to Population rates, EU vs US, 2002, by education for persons aged 25 to 34 and for persons 15 to 24 and 55 to 64**

| | Men | | | Women | | |
|---|---|---|---|---|---|---|
| | EU | US | Gap | EU | US | Gap |
| **All, aged 15 to 64** | 72.9 | 78.0 | –5.1 | 55.7 | 66.1 | –10.7 |
| **15 to 24** | 43.7 | 57.1 | –13.4 | 37.2 | 54.3 | –17.1 |
| **25 to 54** | 86.7 | 86.6 | 0.1 | 67.3 | 72.3 | –5.0 |
| **55 to 64** | 50.5 | 66.3 | –15.8 | 31.0 | 53.2 | –22.2 |
| **Aged 25 to 64** | | | | | | |
| **Less than 2ndary** | 71.0 | 69.8 | 1.2 | 40.5 | 47.1 | –6.6 |
| **2ndary** | 81.7 | 82.1 | –0.4 | 66.8 | 70.6 | –3.8 |
| **Tertiary** | 88.3 | 89.9 | –1.6 | 79.8 | 79.1 | 0.7 |

Source: OECD, *Employment Outlook*, 2003, tables B, C and D.

In the past three decades, there is no theology in arguing the virtue of competitive labor markets in generating employment. The facts are clear. Employment-population rates in the United States, with its less regulated and institutionalized labor market, rose compared to employment-population rates in the EU. The rate of unemployment in the EU has exceeded the rate in the United States for over a decade, while hours worked in the EU fell sharply relative to US levels. The figure below shows the rising divergence in hours worked per adult in the United States and the EU from 1970 to the present. In 2002, American adults averaged 20 percent more hours worked over the year than Europeans. About half of the divergence comes in the form of higher employment-population rates in the United States and about half in the form of greater hours worked per employee, with much of that associated with the smaller vacation time that Americans have compared to Europeans.

ANNUAL HOURS WORKED, US AND EU




Source: Freeman and Schettkat (2004), Table1.

Labor utilization differs among demographic groups. As the table shows, there are no differences between the EU and United States in employment rates for men aged 25 to 54. The differences are among younger and older men and among women. In part, the difference among younger persons reflects the greater tendency for US students to work part-time or over summers compared to European students, but in part it also reflects the lengthy time it takes to obtain a first job in the EU. Among older persons, the difference is associated with early retirement, which has grown more rapidly in the EU than in the United States. The sizable difference in employment rates among women is mirrored by a large difference in hours worked, as American women, including those with young children, tend to work full time compared to European women.

**Differences in labor utilization rates exist among younger and older men and among women**

Ronald Schettkat and I have shown that much of the difference in women working has to do with the differential marketization of household work in the United States and in the EU. US families rely on the market for the production of many traditional household activities, such as child care, preparation of food, and house-cleaning to a greater extent than Europeans. European women report many more hours of household work than American men. German women, in particular, work almost identical hours to American women, only they do more of their work in the household (Freeman and Schettkat 2001 and 2004).

Would the EU be better off if it had higher market employment? If one puts any stock in responses of not employed persons to questions about job search, the answer is yes. Would the EU be better off if it had longer working hours and limited vacations? If one

puts any stock in the responses of Europeans to questions about time worked[2], the answer is no.

On the price side, the situation looks quite different. Real wages in the EU have risen for virtually all workers in the past thirty years while they have stagnated or fallen for large numbers of American workers. The particulars of change for the Americans depends on the survey, the measure of earnings, the quality of the price deflator used to turn nominal pay into real earnings and the like, but there is no gainsaying that employed Americans have not enjoyed the fruits of economic growth to the extent that employed Europeans have.

Equally striking, EU labor markets have produced markedly lower dispersion of pay than the US labor market. The lower level of dispersion cannot, moreover, be attributed to the greater variation in skills among Americans than Europeans. This is most clearly seen in the 1998 International Adult Literacy Test (IALS) that the OECD organized across major OECD countries. The IALS gave adults in the countries the same exam in their native language. Americans had a wider dispersion in exam scores than did Europeans, in part because of a sizable number of immigrants, many of whom spoke Spanish rather than English. The surveys in some countries, including the United States, Sweden, the Netherlands, and Germany, also gave the earnings of workers. Consistent with other data sets, these data show that within narrowly defined skill groups, Americans have a much wider dispersion of earnings than the Europeans. Most amazing, however, is the fact that the dispersion of earnings among Americas with effectively the same level of measured skill exceeded the dispersion of earnings among **all** workers in the European countries.[3]

**Union density and collective bargaining coverage are major differences in labor market institutions**

Does the lower dispersion of earnings of persons with similar measured skills in the EU than in the United States imply that EU labor markets have excessively narrowed the wage distribution or is it a sign of a failure of the "law of one price" in the US labor market? In the United States there are large differences in the earnings of seemingly similar workers across firms or establishments. Workers earn more and gain larger increases in pay in more profitable firms or sectors. One interpretation of this is that there are huge differences in unobserved skills among workers that the US job market rewards but which EU job markets suppress. The other interpretation is that the EU job market comes closer to the competitive ideal of a single price whereas the US job market fails to reduce the effects of random luck, economic rents, discrimination, etc. to the levels of the Invisible Hand ideal. However one comes down on this (since the issue hinges on unobserved skills, it is difficult to get a scientific consensus) you can this to the bank: the dispersion of wages in the EU falls markedly below the dispersion of wages in the US.

**Yes, labor market institutions differ**

Anyone who works or employs workers in the EU and in the United States quickly realizes that there are great similarities and striking differences in the way labor market institutions operate in the two settings. The similarities are that the EU and the United States operate under the rule of law, with substantial regulations of employers, freedom of association, and so on. The differences are also substantial. Union density is higher in the EU, and even more important, collective bargaining coverage is far higher than density in the EU because many EU countries have mandated extension of collective contracts. Over 75 percent of workers were covered by collective contracts in EU countries compared to 14 percent in the United States.

Perhaps the greatest indication of the difference between EU and US markets is that the phrase "social partner", which the EU uses to describe the management and unions who deal regularly on economic issues, has no counterpart in the United States. Mention social partner to Americans and people think of square dancing in Texas, not business and labor. There are no regular forums in which business and labor meet to discuss national problems. When the two sides get together, it is more likely to push for protectionist legislation, as in steel, than to seek agreement about national problems.

The institutional differences between the United States and the EU countries can be measured in various ways. The World Economic Forum's *2002–2003 Global Competiveness Report* asked business persons four questions on labor practices in the US and

[2] European Foundation for the Improvement of Living and Work Conditions, *Working Time Preferences in Sixteen European Countries 2003*, www.eurofound.eu.int/publications/files/EF0207EN.pdf

[3] The average standard deviation of log earnings of Americans who scored within four points of each other was 0.79 compared to a standard deviation of log earnings of 0.68 for the EU countries. See Devroye and Freeman (2001), Figure 3.

EU countries that illustrate the differences. On the question of whether wages in your country are set by collective bargaining or were up to individual companies, the United States scored 3rd out of 80 countries in having wages set by companies compared to a 79th score for Germany, 78th for Finland, 76th for Ireland, with other EU countries save for the UK also scoring low on company and high on collective bargaining. On a question about regulation of hiring and firing, the United States scored 3rd in having decisions determined by employers compared to "impeded by regulations", Germany was 79th, France 76th and again most other EU countries save for the UK were rated as high in regulation. There was somewhat greater variability in responses on relation of pay and productivity, though again the United States was rated highly (2nd) compared to 44th for Germany. Thus, in all of these measures the United States was closer to the free market ideal. But many EU countries scored higher than the United States in cooperation in labor management relations. Here Germany was 20th in terms of cooperative, the United States 21st, and Denmark was 3rd, Austria 4th, Sweden 6th. Italy and France rated very low.

At the workplace, the EU has the Social Charter, which provides for works councils in which elected representatives of workers confer with management over workplace issues. This institution is largely outlawed in the United States as a company union. The EU also has stronger employment protection legislation than the United States, which gives European workers greater ownership of their jobs. In the United States, the employer owns the job to the extent that the employer can bring in permanent replacements for striking employees. The one area where US employment laws are more stringent than EU laws is in the option for court suits, which has led some US firms to insist that workers agree to forego their legal rights to going to court in favor of going to a company appointed arbitrator.

In short, the EU relies more on institutional wage setting and employment regulations than does the United States. Whether these institutions greatly affect the employment and wage differences noted above is by no means clear. Cantillon told the story of the rooster that cries cock-a-doodle-doo every morning before the sun rises and believes that its crying rouses the sun. Social partners may meet and talk and talk and meet but markets place great constraints on economic decisions. Much of what social partners do may be more rooster rhetoric and show than reality. The link between institutions and outcomes requires empirical analysis.

**So what is the effect of EU labor market institutions?**

It may seem obvious to critics of EU job markets that EU labor market institutions are the main cause of employment problems. The argument has two parts:

more institutionalized markets –> lower wage dispersion/higher costs of employment for low-skilled workers

wage/cost interventions –> lower employment rates.

The evidence that EU wage setting institutions are a major cause of lower wage dispersion seems fairly strong. Unions invariably seek to reduce wage differentials among similarly situated workers (outside of professional sports and entertainment) and reduce managerial discretion in pay-setting. Unions invariably seek to raise the pay of lower paid workers compared to higher paid workers. No one has come up with an alternative explanation for the lower dispersion of pay in the EU than in the United States.

**Institutional pay setting is a major reason for lower wage dispersion**

It is less clear that EU institutions raise the cost of hiring workers relative to the cost in the United States, though this is certainly plausible. On the one side, because the United States lacks national health insurance, employers pay health insurance for permanent workers, which creates an incentive to outsource work or favor additional hours to additional workers. By contrast, health costs are covered by national taxes in EU countries. But EU employment protection legislation increases the cost of hiring workers by raising the cost of firing. It is more expensive to hire and to fire, with uncertain effects on overall employment, though with a definite impact on the distribution of employment between those initially holding jobs (the 25 to 54 year old men in the table above) versus other groups. On net, the effect on employment may be negative, but neither the economic arguments nor the evidence are definitive.

The argument that has not fared well is that lower wage dispersion/higher costs of employment of low-skilled workers leads to lower employment rates.

The 1994 OECD Jobs Study made an evidentiary case that wage interventions and inflexible institutions were at the heart of EU employment problems. The evidence on which the OECD relied was largely time series or cross country comparisons based on limited observations and imperfect measures. In ensuing years the evidence has proven to be non-robust. Add a few years, change the definition or model specification modestly and poof! it vanishes in a cloud of a large standard error.[4]

If you have strong priors, you can still hold to the Jobs Study view of the world, but your belief is just that – a belief based on priors rather than evidence. American economists, aware that growth of employment and hours in the United States has been concentrated among highly educated workers and among women workers, whose wages rose relative to others, have always found it hard to believe that wage compression at the bottom of the income distribution lay at the heart of EU jobs problems. The barely discernible impact that US minimum wages has had on employment reinforces this suspicion.

When the United States produced relatively more college graduates per young person than EU countries, it was plausible to argue that the EU labor market was not giving young people enough inentive to invest in higher education, with adverse effects on human capital investment. This in turn could have contributed to the lower employment rate in the EU due to the historically higher rates of employment among the more educated. But without US levels of earnings dispersion and college/high school wage differentials, EU countries have greatly increased the proportion of young persons going to university. Perhaps most important as an indicator of the future, in 1999 the EU produced more PhDs in science and engineering that did the United States – for the first time since before World War II.

**There is no good evidence that wage interventions and inflexible institutions cause the EU employment problems**

If a badly functioning EU labor market is not the prime cause of the EU-US employment gap, what is? If I knew for certain I would rush to Frankfurt or Brussels or Berlin or Paris, or wherever the key decisions are made and shout the answer at officialdom until they cured matters. My surmise is that a series of major institutional changes and policy errors – ranging from the unification of Germany at economically indefensible wage and currency valuations, to the currency union without accompanying institutional changes to conservative monetary policy lies at the heart of the problem. Imagine if the United States and the EU had traded central bankers and central banking policies over the past decade or so. Whose employment record would have looked better, at least over the 1990s?

**EU institutions and outcomes can be improved**

The claim that EU labor institutions are not as awful as many critics of EU-style institutional arrangements make them out to be does not of course mean that the instititutions and outcomes cannot be improved. They can. On the one side, policies that make it easier for women, particularly those with considerable education, to work full- time will go a long way to increasing the EU employment rate for a group with a very large gap compared to the United States. These policies may include greater social support of child care, stronger equal opportunity laws, changes in school leaving hours, as well as changes in taxes, and in immigration laws. Given its aging population and the improved health of the elderly, Europe needs to change pension policies and to consider new policies on immigration. Perhaps more EU countries should adopt policies to encourage more child-bearing, as some countries such as France and Sweden have done. Experiments with unemployment insurance countries suggest that greater pressure/assistance to the unemployed to find jobs can reduce the length of time people spend unemployed. The Nordic policy of tying social benefits to work has clear advantages over forms of social welfare that make non-work more attractive.

There is one area in which the EU job market performs so differently than the US job market as to seem from another world. Americans think nothing of moving from Atlanta to San Francisco, or from St. Louis to Boston for a job. Despite the absence of any institutional rigidities, Europeans tend to cluster in their own countries, in some cases in their native cities, for work. Greater geographic mobility would ease European employment problems, particularly among countries with the common currency. Politicians who lose jobs in London, Paris, Berlin, seem to find full employment by migrating to Brussels. Workers could surely reduce spells of unemployment if they showed similar mobility. But low mobility cannot be readily blamed on labor insti-

[4] Howell (2004) provides the most recent evidence, but the OECD Employment Outlooks in ensuing years told a more complex story than the Jobs Study as well.

tutions, which have become increasingly friendly to migration within the EU.

In sum, EU labor markets are imperfect institutions. They are imperfect in different ways than US labor markets and are imperfect in different ways than other economic institutions. But they are not the monster at the end of the book, the villain in the movie, the prime cause of EU employment problems. Not as awful as all that.

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