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Globalisation challenges for Europe – labour market perspectives

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SUMMARY

Concerns over the effects of globalisation are mainly related to the labour market effects. How will jobs and wages be affected? Will there be enough jobs? What should we live on?

While globalisation creates aggregate gains, it is also a process which entails adjustment. Therefore, there will be both losers and winners. The main determinant of the relative net-gain is not necessarily closely related to the level of education, but rather to the extent to which economic activities can be relocated over borders. Increasing globalisation effectively creates increased job mobility, and the direction of job movements depends on comparative advantages relative to the scope for relocating production and jobs. Empirical evidence shows that export opportunities tend to improve labour market prospects, while the import threat does the opposite.

A key policy challenge is to support structural change and adjustment without leaving a disproportional amount of risk on individuals. This can be done in the short run in the form of income insurance, and in the medium to long run in terms of re-education and training. Increased investments in education is a popular remedy. While the return – private and social – in general is high, there is a danger for over-investment in education if it is perceived that all labour market problems can be solved by adopting an education policy based on the view “the longer, the better”.

1 INTRODUCTION

While economists persistently point to the gains from further international integration, the public debate leaves more scepticism and doubts. These concerns mainly derive from the labour market implications. How will jobs and wages be affected? Perhaps the debate in itself is sufficient to foster a general sense of uncertainty as to what the future will have to offer. Will there be enough jobs? What should we be living on? Questions of this sort abound in the debate.

The general tendency towards pessimism with respect to the future is not new, and can be traced back at least to the industrial revolution. Yet, it is striking given that the historical record on a consistent basis has proved it wrong. Material living standards have been improving significantly, which has also made room for improvement in health, social conditions etc. Likewise, employment has not been on a downward trend, and the employment share is in many countries at very high levels in a historical perspective.

However, pointing to historical records and aggregate gains does not seem very relevant to people when the issue turns to their job and wage prospects. The gains from globalisation and technological change do in general presuppose structural changes and thus adjustment. A process that inevitably will disrupt status quo and produce both winners and losers.

In the following, the labour market consequences of globalisation are approached by considering the implications product market changes have for labour markets. These effects arise from technological and political changes making market entry and production relocation across borders and distance much easier and less costly. Globalisation may also have direct labour market consequences via labour mobility - An important issue which is not discussed in the following.

The perspective taken here follows Baldwin in considering globalisation as a process allowing unbundling and thereby reducing the importance of geographical proximity between consumers and producers as well as between producers of intermediaries and final goods producers. The present note is thus complementary to Baldwin's paper in elaborating some of the labour market consequences of this process.

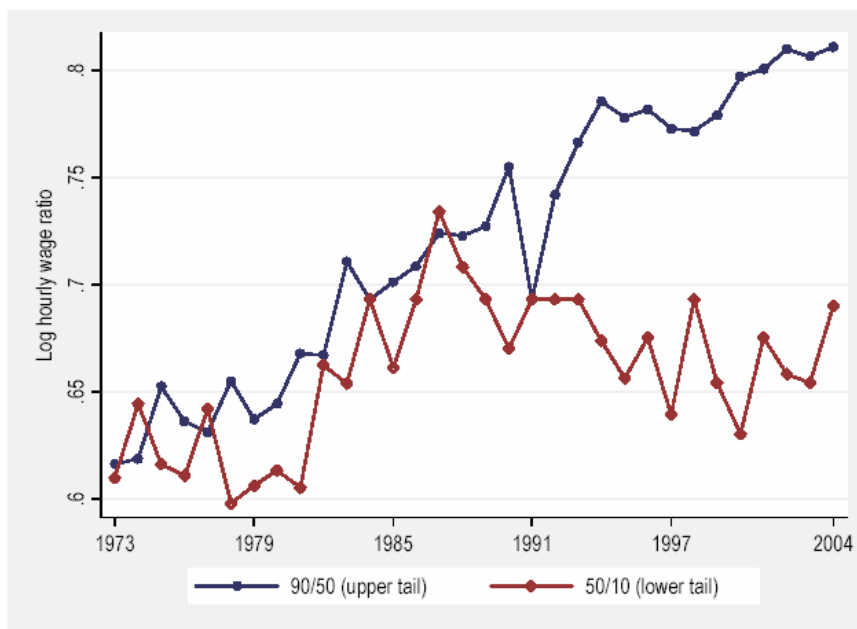
2 THE EVIDENCE

The relevant evidence is at the micro-level. Two issues are particularly important, namely the wage formation and job creation.

The debate on the labour market consequences has for some years focused on "skilled" vs "unskilled", based on the perception that globalisation would primarily affect unskilled since new economies in the global market tend to have a large and cheap supply of unskilled labour. This has been supported by increasing wage dispersion and weakening labour market positions for unskilled. In the US, in the form of widening wage inequality and even real wage decreases for some groups, and in Europe, we have seen excess unemployment rates for unskilled.

Recent evidence for the US (see Autor, Katz and Kearney (2006)) seems to indicate that this view was a correct description of the situation in the 1980s, but not for the subsequent period. Interestingly, widening wage dispersion has been driven by an increasing trend in the 90/50 earnings ratio, while the 50/10 ratio has been more steady. At the same time, net-job creation has been largest at the tails of the wage distribution. This suggests that we may see a tendency towards polarization in the labour market with a clear distinction between winners and losers, and where the net-gains are closely related to the level of education. The service sector is a case in point since activities, which just a few years back routinely were classified as non-tradables, suddenly found themselves in international competition with off-shoring of jobs.

Figure 1 US wage inequality – 50/10 and 90/50 decile ratios, 1973–2004.



Source: Autor, Katz and Kearney (2006).

There is only scant evidence for European countries on this issue. Goos and Manning (2003) find evidence of polarization of the UK labour market and a trend increase in both the D9/D5 and D5/D1 decile ratios, i.e. greater wage disparity between the top and the bottom. Izquierdo and Lacuesta (2006) find for Spain an increase in the D9/D5 ratio and a decrease in the D5/D1 ratio. For Germany, Gerhardt and Pfeiffer (2006) report increasing wage inequality, which in former West Germany is driven by an increase in the D5/D1 ratio, while for former East Germany, it is driven by an increase in the D9/D5 ratio.

A great number of studies have considered wage formation in greater detail. One interesting set of findings is that wage formation seems to be critically dependent on the trade position in the sense that import threats exert a downward pressure on wages, while export may be associated with higher wages. Bernard and Jensen (1999, 2001) and Bernard et al. (2003) find that exporting firms tend to have higher productivity and pay higher wages, with the causality running from productivity to exports. Interestingly, they also find that export tends to drive out less productive firms and induce a reallocation of production to more efficient firms. Schank, Schnabel and Wagner (2004) list 18 empirical studies using data from 20 countries, supporting that exporting firms tend to pay higher wages. Empirical studies have also found that import penetration tends to lower wages (see e.g. Boulhol et al. (2006), Revenga (1992), Nicoletti et al. (2001) and Jean and Nicoletti (2002)). This suggests that

the changes in the labour market and the possible polarization may be dependent on the extent to which activities are tradables or non-tradables, and in the former case, whether there is an import threat or an export possibility. In this way, further globalisation may affect wage formation, including the dispersion of wages.

It is worth pointing out that contrary to widespread perceptions, there is no evidence that the process of job creation and destruction is proceeding at a higher speed than in the past (see Economic Council (2003)). The overall turnover in labour markets is rather high (job creation and destruction of about 10 % of the total number of jobs within the year), but there is no upward trend. Hence, adjustments and structural changes induce substantial reallocation of labour at the same high level as in the past.

3 THE MECHANISMS

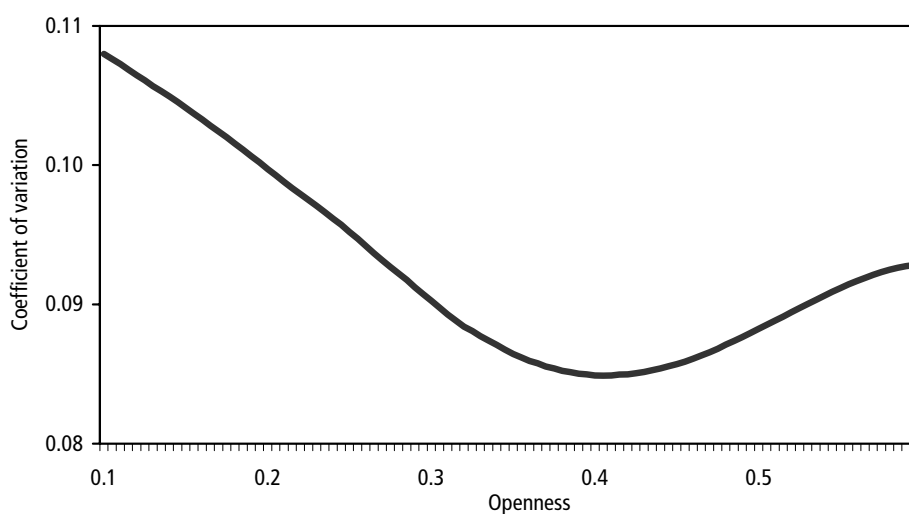
A useful approach in relation to the labour market consequences of product market integration is to focus on the scope for rent extracting between the firm and its employees. Basically, two factors can create rents to be shared in wage negotiations, namely, rents created by limited market entry (in the following termed protection rents) and rents created by having higher productivity than competitors (specialization rents). Globalisation will in a critical way change the balance between these two types of rents since it implies both easier market entry and further specialization. That is, the process of unbundling changes market power and therefore wage formation and employment creation.

Market integration causes some former non-tradables to become either importables or exportables, and this, in turn, affects the scope for appropriating the two types of rents outlined above. In a fairly closed economy, most activities are non-tradables since domestic markets are protected from penetration by foreign firms, and this improves the scope for rent-extraction (protection rents). In a more open economy, less efficient domestic production is driven out of business by more efficient foreign production, and vice versa, efficient domestic production drives out less efficient foreign production. The latter implies that production is better allocated across countries according to productivities (comparative advantages), which, in turn, implies specialization and the possibility of capturing specialization rents.

More integration or openness thus cause a shift from rents primarily being generated by protection to being generated by specialization. The very process through which globalisation causes structural changes, specialization, changing trade patterns etc. has, in this way, a fundamental impact on wage setting. This has several interesting implications (Andersen and Sørensen (2006)): (i) Wage

inequality may depend on openness/integration in an U-shaped way: Integration first diminishes wage dispersion by reducing the importance of “protection rents”, and later increases wage inequality by increasing the importance of “specialization rents”, cf. figure 2. are driven out of business or forced to accept lower prices/wages to stay in business/jobs. The winners are a) exporting firms and their employees benefiting from that fact that smaller frictions improve the scope for exploiting their comparative advantage (ii) The losers tend to be former non-tradable activities and their employees who, and b) non-tradable service sectors benefiting from higher income and thus demand generated by the gains from further integration. (iii) This process is necessarily associated with substantial reallocation of labour. However, the direct effect of globalisation on job turnovers is diminishing in the sense that a given drop in market frictions causes more relocation in an economy that is initially relatively closed compared to a more open economy. The reason is simply that the amount of reallocation is related to the relative size of the non-tradable sector. This also points out that market entry caused by globalisation cannot be a permanent cause of job reallocation (structural changes vs. fluctuations).

Figure 2 Openness and inequality.



Note: Based on model simulation. Inequality measured by the coefficient of variation for wages, and openness by the trade share.

Source: Andersen and Sørensen (2006).

The mechanisms outlined above provide a basic sketch of why the process of wage formation is affected when the scope for relocation of production and thus jobs across countries and labour markets increase as a result of further globalisation. It can be phrased in different ways – the elasticity of labour demand increases, the scope for rent extracting is affected – but it essentially

comes down to the point that underlying the aggregate gains is a process having distributional consequences with both winners and losers.

There is one important lesson which is often overlooked when considering these issues in a partial context. Aggregate gains from international integration will in general show up in terms of aggregate increases in wages and employment, implying that there is a non-trivial distinction to be made between absolute and relative winners and losers. Moreover, inherently, non-tradable sectors such as certain forms of services would gain (provided the income elasticity is sufficiently large) since the aggregate gains will increase demand for these services. Hence, the winning groups are not uniquely given by the groups at the cutting edge of international competition.

The above mentioned changes may also cause important institutional changes. Basically, the process forces wages to be more closely aligned to productivity; something which can be difficult to ensure in centralized wage bargains. Many European countries have seen a tendency towards more decentralized wage formation, and it can be interpreted as in part reflecting the changes induced by globalisation. Decentralization of wage formation may imply more flexibility in wage setting and therefore improve the ability of labour markets to adjust to changes in market conditions. However, a virtue of the centralized wage setting system was that it could internalize interdependencies in wage determination and thereby enable wage setting to be in accordance with macroeconomic objectives.

4 POLICY RESPONSES

A key policy challenge is to support structural change and adjustment without leaving a disproportional amount of risk on individuals. Since the risk carried by individuals is associated with gains for society, it is reasonable to have some collective diversification of shocks (social insurance). This should not solely be considered as a passive question of compensating the losers, but as an active question of establishing risk sharing arrangements conducive to adjustment and flexibility.

This can be done in the short run in the form of income insurance, and in the medium to long run in terms of (re-) education and training. In the design of such schemes, it is important to clarify the implications for incentives and insurance. While there is a case for social insurance, it is important that it is combined with an incentive structure ensuring that the schemes have a clear employment focus, i.e. temporary vs permanent support. Otherwise the financial burden of financing such scheme will become large. This can be accomplished by limiting the duration of risk sharing arrangements (e.g. unemployment

benefits) or combining them with workfare elements. The lessons from the 1970s and 1980s are quite clear on this point. Many countries adopted a passive orientation in labour and social policies which turned out to cause increasing and unsustainable transfer burdens on the public sector. These policies were based on the faulty perception that “too many hands are chasing too few jobs”. Historical records have proven this view wrong, and it is therefore important to maintain an active focus in policies, also in the short run where it may seem less obvious.

An often aired mantra is to invest more in education on a general basis. This is an evergreen in policy debates since it is difficult to find opponents to more education. While there in general are high – both social and private – returns to education, two important points should be emphasized. First, the return to education (beyond basic education) is often appropriated by well-defined agents (workers and firms), and it is not generally clear that there are strong arguments for large public subsidies to these activities. For these groups, it is important to signal that they assume responsibility for development and maintenance of their human capital. Second, public intervention is in particular called for in the case of groups at risk of being marginalised in the process. This applies particularly in cases where a lock-in effect arises when human capital suddenly becomes obsolete. In these cases, educational and social programmes are called for. Finally, while uncertainties are large, it does not seem that the trend in future labour demand is monotonously increasing in education. Various service activities must be expected to expand partly due to high income elasticities (e.g. health care) and partly due to the shifting age composition of the population. Hence, if more education is taken to imply “the longer, the better”, there is a risk of overinvestment in education.

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