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From Bismarck to Maastricht:

The March to European Union and the Labor Compact

Alan B. Krueger
Princeton University and NBER

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ABSTRACT

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This paper considers the likely impact that European Union (EU) will have on the labor compact. It is argued that, despite increased economic integration in Europe, countries will still be able to maintain distinct labor practices if they are willing to bear the cost of those practices. The incidence of many social protections probably already falls on workers. In addition, it is argued that imperfect mobility of capital, labor, goods and services will limit the pressure that integration will place on the labor compact. Evidence is presented suggesting that labor mobility among EU countries has not increased after the elimination of remaining restrictions on intra-EU labor mobility in 1993. Moreover, immigration from non-EU countries, which is much larger than intra-EU migration, has declined since 1993. Evidence is also reviewed suggesting that the demand for social protection rises when countries are more open, and therefore subject to more severe external shocks. This finding suggests that increased economic integration and European Monetary Union could lead to greater demand for social protection. The U.S. experience with state workers' compensation insurance programs is offered as an example of enduring differences in labor market protections in highly integrated regional economies with a common currency.

Alan B. Krueger
Woodrow Wilson School
Princeton University
Princeton, NJ 08544

In the second half of the 19th Century Otto von Bismarck forcefully unified Germany and established the world's first modern social insurance system. In the second half of the 20th Century, Europe is being unified by diplomatic and political initiatives, best exemplified by the Treaty on European Union signed in Maastricht on February 7, 1992, but preceded by the Treaty of Rome (1957), European Monetary System (1979), European Parliament, Single European Act (1986), and Social Charter (1989). Labor, capital, goods and services can now flow freely across borders in the European Union (EU), and most EU countries share a common currency. From Bismarck to Maastricht, Europe is becoming economically and politically integrated, first as nation states, and now as a continent.

What impact will the integration of European economies have on the *labor compact*? From the outset I should be clear about what I mean by labor compact. This intentionally vague term is meant to capture the implicit bargain among labor, capital and government encompassing pay, work effort, social protection, and labor such market rules as union organization, safety standards, and termination laws. The idea of a labor compact has more currency in Europe than in the U.S., where employee-employer bargaining is diffuse and labor is not organized into a political party. Even in the U.S., however, are implicit arrangements that govern the employee-employer relationship, affect the distribution of compensation and output, and provide social insurance. In a speech to the Reichstag on May 9, 1884, Bismarck described his vision of the labor compact as follows:

Give the working man the right to work as long as he is healthy; assure him care when he is sick; assure him maintenance when he is old. ... [I]f the State will show a little more Christian solicitude for the working man, then I believe that the gentlemen of the Wyden [Socialist] programme will sound their bird-call in vain, and that the thronging to them will cease as soon as working men see the Government and legislative bodies are earnestly concerned for their welfare.¹

¹Quoted in Dawson (1890; pp. 34-35).

In short, Bismarck's labor compact was to provide social insurance and guaranteed employment in exchange for political stability and labor peace.²

In the decades following Bismarck's reign, European nations adopted an extensive set of labor policies and institutions, including generous Unemployment Insurance (UI), Workers' Compensation insurance (WC), pensions, disability insurance, national health insurance, firing restrictions, severance pay, health and safety regulation, job training, industry-wide bargaining, and works councils. Whether these practices cause labor market rigidities and unemployment is a subject of much research in labor economics, and a topic for another day. My interest here is in the effect of economic integration on the labor compact.

Many observers have argued that burgeoning European integration will fundamentally alter the labor compact. On the one hand, labor leaders fear that integration will provoke a "race to the bottom," weakening labor standards and worker bargaining power. On the other hand, business leaders voice optimism that European integration will spontaneously generate greater flexibility in the labor market, enhancing productivity growth, employment and living standards. In this lecture I try to provide an American perspective on the effect of European integration, and "globalization" more generally, on the labor compact. My thesis is that the likely impact of economic integration on the labor compact has been exaggerated, both by those who fear a deterioration of labor protections and pay, and by those who welcome it. I suspect that integration will cause some downward pressure on labor market protections, but the pressure will be modest, and European nations will continue to maintain their generous and distinct labor practices.

At a theoretical level, the main argument that integration will weaken the labor compact is

²Interestingly, Bismarck never followed up on his promise of guaranteed employment.

as follows. With free movement of factor inputs, goods, and services, noncompetitive cost differentials will be competed away. If government mandated benefits are particularly generous in one nation, for example, then that nation will face a large inflow of immigrants who will depress compensation, or an outflow of capital to nations with lower labor costs, which will also depress compensation and raise unemployment.³ Since comparative advantage and technology do not vary a great deal across Europe, all countries will be driven to a common low standard of labor practices in a "race to the bottom".

This logic makes some sense, and I think it will generate limited pressure for changes in the labor compact in some countries. But three reasons lead me to doubt that the pressure to adopt a uniform set of minimal labor standards across Europe will be very great. First, although it is common to treat the labor compact as a distortion that provides a drag on economic growth and employment, certain aspects of the labor compact probably enhance economic efficiency. For example, the private market fails to provide adequate insurance against job loss (e.g., because of adverse selection problems, correlated risks, and incentives for employers to provide misinformation); when structured properly, government mandated UI improves the efficiency of the labor market.⁴ To the extent that the labor compact enhances labor market efficiency (compared to the alternatives), economic integration will not cause an erosion of labor standards.

Second, even with a common currency, imperfect mobility of factor inputs and goods and

³Sinn (1998) provides a discussion of these issues, and proposes the "nationality principle" for taxing capital income.

⁴The possibility that government programs such as national health insurance could be efficient and desirable despite seeming distortions from insurance is one of the themes of Victor Fuchs's classic 1976 paper. Readers will also notice that I have unabashedly recycled part of Fuchs's title.

services will limit the pressure placed on uncompetitive labor practices. Europeans are famous for their national identities and low rates of labor migration. Eliminating restrictions on labor mobility has hardly changed this picture. Moreover, unrestricted migration of EU nationals coincided with a sharp reduction of non-EU immigration to Europe. Since differences in working conditions and compensation are much greater between EU and non-EU countries than among EU countries, this tendency has insulated the labor compact even more than when within-EU labor mobility was regulated. Research summarized in the next section also suggests that the flow of capital and finished goods is less than sufficient to arbitrage differences in labor market policies. Even in a unified Europe, geography will still matter, and provide a cushion against economic forces.

A third and related issue concerns the political economy of the labor compact. Fuchs (1976) and Stigler (1975) remind us that in well functioning democracies, it is fruitful to view legislation as a reflection of what a majority of the public desires. If the public desires protective labor legislation, they will have it -- but they will pay for it. For example, if workers in a jurisdiction desire generous workers' compensation benefits in the event of workplace injuries, then they can legislate generous benefits and the cost of providing those benefits will be shifted to workers in the form of lower pay.⁵ The federalist system in the U.S. illustrates the fact that large differences in social programs can exist in equilibrium. Greater economic integration in Europe will likely raise the cost of protective labor legislation, but I doubt the cost will be prohibitive; indeed, most of the costs already are borne by labor because labor supply is relatively inelastic. Another, perhaps overriding political consideration, is that economic integration raises the level of risk that workers

⁵If wages and other forms of compensation are inflexible, then the cost could be in the form of higher unemployment.

face, which in turn increases demand for social protection.

The remainder of this essay provides empirical evidence evaluating the likely impact of these three factors that will offset pressure for a race to the bottom. My conclusion is that the core of the labor compact will likely remain intact in the foreseeable future despite increased European union, although there will be some changes around the periphery of the labor-management-government relationship.

I. Mobility of Factor Inputs and Outputs

A. Labor Mobility

On January 1, 1993, remaining restrictions on intra-EU labor mobility were removed. If labor flows in response to generous social benefits or supra-competitive working conditions are to put pressure on the labor compact, one would expect to observe greater intra-Europe migration of EU nationals after 1993 than before. To analyze migration flows, I make use of the OECD's data on inflows of population by nationality.⁶ These data are far from perfect: different definitions of migrants are used in different countries; many countries lack data; some countries exclude EU nationals from their migration statistics; and data for some countries are available in some years and not others.

For six EU *destination* countries with available data, I calculated the migration rate as:

⁶The data sources are: *Trends in International Migration*, Annual Report, 1998 (OECD; SOPEMI); SOPEMI International Migration Statistics on Diskette, 1997 edition (OECD), Table 12; U.S. Bureau of the Census, International Database for population data; and *Statistisches Jahrbuch* 1998 for German population data.

$$\sum_i \sum_{j \neq i} M_{ij} / \sum_j P_j$$

where M_{ij} is the number of people who migrated from origin country i to destination country j , and P_j is the population of country j . Migration data for some of the destination countries are unavailable in some years (see the note to the Figure 1); these countries were excluded from the numerator and denominator of the migration rate in those years. A migration rate was calculated separately for migrants from all origin countries, and for migrants from EU origin countries.⁷ Results are displayed in Figure 1.

Weaknesses of the migration data notwithstanding, Figure 1 shows that mobility rates are quite low between EU countries (from 0.1 to 0.2 percent of the destination countries' population), and that there is no tendency for migration to have increased after restrictions on labor mobility were relaxed in 1993. Another striking feature of Figure 1 is that the number of non-EU nationals migrating to the EU was sharply curtailed after 1993. Indeed, total migration is lower after 1993 than it was in 1988. The decline in non-EU migration was largely a result of stricter government policies and enforcement of the those policies vis-a-vis non-EU immigrants after 1993. Because living standards are much lower in non-EU countries than in the EU, this finding suggests there is less downward pressure on labor standards due to labor flows after the restrictions on EU labor mobility were relaxed than before.

The changing mix of countries over time could partially account for the trends in Figure 1. Consequently, Figure 2 provides estimates of migration rates just for Germany, where a longer time

⁷The EU was defined as 14 countries by some destination countries, and as 15 countries in other destination countries.

series of consistently-reported data is available. Figure 2 shows the same pattern as Figure 1: a sharp decline in migration from non-EU countries after 1993, and a very mild increase in migration from EU countries after 1993. Immigration from non-EU countries declined primarily because of more restrictive policies concerning refugees and asylum seekers beginning in 1993.⁸

There is probably little reason to expect that intra-EU migration rates will increase much in the future. A notable feature of European countries is the low rate of population migration within countries. Internal, region-to-region migration rates are more than twice as high in the U.S. as in many European countries. In 1987, for example, 2.8 percent of Americans moved between state boundaries, while 1.1 percent of Germans, 1.1 percent of Britons, and 0.5 percent of Italians moved across regions within their respective countries.⁹ Oswald (1999) offers the intriguing explanation that differences in home ownership rates and associated policies are the cause of the lower mobility in Europe, and this in turn raises the equilibrium rate of unemployment in Europe. A related finding by Decressin and Fatas (1995) is that regional economic shocks in EU nations are absorbed primarily by changes in labor force participation, whereas in the U.S. they tend to be absorbed by internal migration.

If it is difficult to entice Spaniards to move from Seville to Madrid, as the following cartoon suggests, it is unlikely they will move to Munich in search of better benefits. Language, cultural, and social barriers are likely to continue to provide roadblocks to perfect labor mobility -- to say

⁸On July 1, 1993, for example, the "Law on the Procedures of Asylum" was enacted, which denied asylum seekers from safe countries and safe "travel-through" countries entrance into Germany.

⁹These data are reported in Blanchflower and Oswald (1999), and are from the *OECD Jobs Study* Part II (1994), Table 6.1. The data for Britain are for 1986.

nothing of the imperfect harmonization of retirement, health and education systems across countries.

One familiar comment is that migration among current EU countries exerts little pressure on labor practices and compensation, but migration from Eastern Europe will pose a much greater threat once those nations join the EU. This is possible, but it should be noted that migration flows from non-EU countries still substantially exceed those from EU countries, so it is possible that non-EU flows could be restricted even further to offset a rise in immigration if eastern Europeans migrate to EU countries in large numbers.

In the U.S., seemingly uncompetitive wage differentials across regions, industries and small and large firms for workers in the same occupation and skill class have persisted for decades despite a relatively unregulated labor market (e.g., Brown and Medoff, 1989 and Krueger and Summers, 1988). Moreover, the U.S. experience has been that free geographic mobility has only very slowly led to convergence in income across regions (e.g., Barro and Sala-I-Martin, 1995), and studies have not found that migration rates are related to the generosity of welfare benefits (e.g., Blank, 1988). In view of this experience, it seems to me unlikely that the elimination of remaining restrictions on labor migration across EU countries will lead to convergence in the terms and condition of employment across Europe.

B. Investment and Goods Flows

Perfect mobility of labor is not necessary for competitive forces to eliminate uncompetitive labor practices across countries; capital or goods flows could prove sufficient. But again there are reasons to suspect that frictions will prevent markets from arbitraging differences in labor practices. A long-standing result in macroeconomics (e.g., Feldstein and Horioka, 1980) is that the investment

in a country almost exactly equals the country's domestic savings. Although sudden and large capital flows receive attention in the media and influence exchange rates, it is nonetheless the case that investment is significantly biased to one's home country. Language, informational, network, and social barriers probably play an important role in directing savings toward domestic projects, and this is unlikely to change dramatically with increased European union.

International Trade economists have also found a significant "home bias" in goods and service flows. A growing body of evidence summarized in Helliwell (1998) shows that international borders matter much more for trade flows than would be expected from distance and size alone. In the period after NAFTA was implemented, for example, Helliwell (1998) finds that the trade of goods between Canadian provinces was about 12 times greater than goods trade between Canadian provinces and American states of comparable size and distance apart. Interprovincial trade in services was 25 to 30 times as dense as Canada-U.S. trade in services. He also finds that national borders have a substantial, though smaller, effect on trade between EU countries: internal trade densities are about 6 times greater than international trade densities, and lower for countries that share a common language.

Trade economists are fond of reminding labor economists that free trade should impact the labor market via its effect on product prices; that is, price convergence, not goods traffic, is the engine of economic integration. Have goods prices converged among EU countries after the introduction of the Single Market in 1993? In recent work, Haffner, et al. (1999) find that price structures have been converging among EU countries in 1980s and 1990s, and that prices are more similar among EU countries than they are among other OECD countries. But they also find that price convergence in the EU has slowed down since the introduction of the Single Market. It is

possible that European Monetary Union (EMU) could improve the transparency of prices, enhance trade flows, and eradicate remaining price differentials in the EU.¹⁰ Personally, I am skeptical of this view. Deflating by an exchange rate is not a very high-order skill in an age of computers and electronic calculators; nor is exchanging currency very expensive (see Eichengreen, 1993). It seems unlikely to me that a common currency will have an appreciable impact on the volume or direction of trade. As a whole, these considerations suggest that increased integration in the future is unlikely to be dramatically different than the experience of the past two decades.

The U.S. Speaker of the House Tip O'Neill was famous for the axiom: "All politics is local." It is not too much of a stretch to argue that, "Almost all economics is local." In view of the frictions that restrain economic integration, I think Dani Rodrik (1998; p. 13) correctly observes that, "While the tradeoffs facing policy makers have been rendered steeper by the increased trade and capital flows, there exists plenty of room for nation-states to maintain their own distinctive domestic social arrangements."

II. The Political Economy of the Labor Compact

A consideration of political economy factors leads me to suspect that labor standards and labor programs are unlikely to be weakened in the foreseeable future as a result of European union, and may actually be strengthened.

A. Trade and Social Protection

In separate studies, Dani Rodrik (1997) and Jonas Agell (1999) find a positive relationship

¹⁰Other possible effects of EMU are discussed below.

between the openness of an economy (as measured by the ratio of imports plus exports to GDP) and the generosity of a variety of social welfare benefits and labor market characteristics. Across nations, they find that more open countries tend to have a higher union density rate, more centralized bargaining, higher minimum wages relative to average wages, more compressed wage distributions, more generous unemployment benefits, and a higher share of public expenditures in GDP. This type of phenomenon is illustrated in Figure 3, which presents a scatter diagram of labor market expenditures as a percent of GDP in the late 1990s against the share of trade in GDP in 1989.¹¹ The upward sloping Ordinary Least Squares regression line (t-ratio=2.52) shown on the graph indicates that more open countries tend to devote a higher proportion of resources to labor market programs including job training, youth measures, subsidized employment, unemployment compensation, disability benefits, and early retirement programs. Median regression, which is robust to outlying observations, also yields an upward sloping relationship with a t-ratio of 1.66.

I also explored the relationship between the OECD's summary measure of employment protection and openness. This bivariate correlation was positive but statistically insignificant. Agell also finds that the correlation between job protection and openness is statistically insignificant. Nonetheless, there is no evidence that job protection is weaker in more open economies.

The leading explanation for the positive association between social protection and openness to trade is that more government intervention and social insurance is demanded when countries open their borders to trade. Rodrik, for example, writes: "Societies that expose themselves to greater amounts of external risk demand (and receive) a larger government role as shelter from the

¹¹Data on expenditures on labor market programs relative to GDP are from OECD (1999; Table H) and pertain to 1996, 1997, or 1998. Data on openness are from the Penn World Tables Mark 5.6 (available from: <<http://cansim.epas.utoronto.ca:5680/pwt/pwt.html>>).

vicissitudes of global markets. ... Hence the conclusion that the social welfare state is the flip side of the open economy!" And Agell concludes that "increased openness may lead to increased institutional involvement in the labour market." If this is the case, then increased integration could possibly increase, rather than decrease, the demand for social protection, at the same time that it increases the costs of providing social protection.

Another, and related phenomenon, concerns the potential effect of EMU on economic volatility. Because countries that adopt a common currency are unable to utilize monetary policy to offset idiosyncratic country-specific macroeconomic shocks, business cycle swings could intensify. More frequent and intense boom and bust cycles, if they arise, are likely to increase the demand for greater risk sharing, social insurance, and labor market regulation. Although one might presume that a recession is not a likely time to increase regulation or taxation, recall that the main features of U.S. protective labor legislation and social insurance (including Social Security, the minimum wage, overtime restrictions, the National Labor Relations Act, and unemployment compensation) were established during the Great Depression.

B. Monetary Union

European Monetary Union can have a number of other subtle and not-so-subtle effects on the labor compact as well. One obvious issue concerns the Growth and Stability Pact for nations that join the Maastricht Treaty, and the deficit-to-GDP restrictions for those that aspire to join. Maintaining low and stable debt is a condition for belonging to EMU. It is tempting to believe that binding debt and deficit restrictions will starve social welfare spending. But this does not necessarily follow. In 1995, when the U.S. budget deficit was \$150+ billion for as far as the eye could see, I

have a vivid memory of U.S. Treasury Secretary Lloyd Bentsen noting in a meeting of the National Economic Council in the Roosevelt Room of the White House that a salutary feature of a minimum wage hike was that it would not add one dime to the U.S. deficit. Instead of crimping the labor compact, deficit restrictions could result in more government mandates on business to provide benefits and services that the government would otherwise provide directly. Indeed, it is possible that policy makers in EMU member states will feel pressure to *do something* during a downturn, and with monetary policy off limits and constraints on fiscal policy, the most popular alternatives may be to support work sharing or raise future unemployment compensation, rather than weaken labor programs.

Bean (1998) and others argue that participation in EMU will enhance policy makers incentives to introduce labor market flexibility to lower structural unemployment. Calmfors (1998a) has dubbed this the *There is No Alternative* view. But, as Calmfors (1998a) notes, if monetary policy is neutral in the long run, there is little reason to suspect that political incentives to alter labor policies to reduce structural unemployment will be changed.

Monetary union can also have many other subtle and uncertain effects on labor market programs. Calmfors (1998a and b) analyzes several possible effects EMU could have on labor market programs. On the one hand, his 1998b paper provides a model in which policy makers in the EMU undertake labor market reforms such as reducing unemployment compensation as a precaution to lower equilibrium unemployment because country-specific monetary policy can no longer be used to offset asymmetric macro shocks. On the other hand, Calmfors (1998a) notes that pressure for labor market reform could be weakened among EMU members because a benefit of labor market reforms that reduce equilibrium unemployment is that the inflation-bias of a nation's monetary policy

is reduced; this channel is severed for EMU nations since monetary policy is not set on a country level. Calmfors (1998a) also argues that EMU could lengthen the time lag between when reforms are undertaken and when results are realized, which could further weaken the resolve to change the labor compact. In the end, I think Calmfors (1998a) sensibly concludes that, "It is quite likely that the EMU will not have any major impact on the extent of labour-market reform and structural unemployment."

C. Practical Politics

It is notable that 14 of the 15 EU countries currently have center-left governments (depending on who's counting). The popularity of more populist governments may, in part, result from anxiety that the general public feels about European union. Faced with much uncertainty about future economic developments, voters may feel more secure with left-leaning politicians at the helm, in the belief that they will maintain the labor compact and smooth the rough tides of economic integration. Worried about the erosion of labor protections and social benefits? Elect Gerhard Schroeder. Opposed to Prime Minister Alain Juppe's plan to cut the youth minimum wage? Take to the streets and elect Lionel Jospin. Labor protections continue to be very popular. Because, in the long run, democratic politicians usually deliver what the voters want, I suspect that the current support for center-left parties bodes well for the future of the labor compact; indeed, rather than erode, some features of the labor compact may in fact be upgraded.

But I would hasten to add one important caveat to this interpretation of political events: When a radical change in policy occurs, it is often the case that it is brought about by elected officials from the party that traditionally is opposed to the change. In the U.S. we call this

phenomenon, "Nixon goes to China," since it took Richard Nixon, a Cold War warrior, to embrace China. Other examples abound: President Clinton abolished welfare as we know it; socialist President Mitterand of France privatized some public sector functions in the 1980s; hawkish Israeli Prime Minister Menachem Begin returned the Sinai to Egypt. Indeed, even Bismarck provides a good example: The Iron Chancellor established social insurance despite his bona fides as a reliable conservative *junker* who previously had outlawed socialism.

Most relevant for present purposes, after months of wavering, Chancellor Schroeder of Germany embarked on an austerity course in the fall of 1998. Whether Schroeder will succeed -- and whether other EU leaders will follow his lead -- remains to be seen. But given Schroeder's Social Democratic party's resounding defeats in regional elections in Brandenburg, Saarland, Thuringia, Saxony and Berlin since his change of course, I suspect EU leaders will think twice before tinkering with the social compact.

Two recent economics articles provide asymmetric-information-based models to explain the "Nixon goes to China" phenomenon (see Cukierman and Tommasi, 1998 and Cowen and Sutter, 1998). In essence, their theory is that incumbent politicians have superior information concerning the effects of certain policies than the public. Politicians value both improving policy outcomes and reelection. If new information is obtained supporting a right-wing shift in policy, a left-wing politician can more credibly signal that the policy is an appropriate course of action than a right-wing politician because voters will infer that the left-wing politician is motivated by objective facts, rather than his party's natural ideological tendencies. If this is an accurate explanation for policy reversals, then it is unclear whether left-leaning policy makers in the EU will reverse course and weaken social welfare programs because it is unclear what new information was revealed to them after taking

office. And as Professor Dumbledore notes in *Harry Potter and the Sorcerer's Stone*, there is a natural check on leaders who wish to desert their traditional base of support: "It takes a great deal of bravery to stand up to our enemies, but just as much to stand up to our friends."¹²

III. Lessons from Federalism

Ehrenberg (1994) and Freeman (1994) point out that in the U.S. federalist system, large differentials in state labor programs and standards have persisted across regions despite unrestricted labor, capital, and output mobility, and a common currency. It is unlikely that commerce across nation states in Europe will ever be more fluid or seamless than it is across states in the U.S., so a lesson from U.S. federalism is that diverse labor compacts can survive in a more integrated European Union.

The U.S. workers' compensation insurance system provides a good illustration of the wide range of program variability across jurisdictions that can persist in equilibrium despite a high-level of economic integration. Workers' compensation insurance is the oldest social insurance program in the United States; most states initiated programs in the early 1900s. The system still consists of 50 independently operated state programs. States are free to set their benefit generosity at whatever level the legislature chooses, and use whatever funding mechanism(s) they choose. In all but two states, employers are compelled to purchase insurance to cover claims by their employees in the event of a work-related injury or illness. Some states provide insurance directly to employers through a state-operated fund, some permit private carriers to sell insurance, and some allow employers to self insure; and varying combinations of these funding device are used by the states.

¹²J.K. Rowling (1998, p. 306).

Total WC costs to employers in 1995 were \$57 billion, more than 2.5 times as great as UI costs that same year.¹³

Most important for our purposes, employer costs and employee benefits vary considerably across states even for identical jobs. For example, for truck drivers in 1987, costs ranged from a low of 3 percent of payroll in Indiana to a high of 25 percent in Montana. Differences in employer costs across states are determined primarily by differences in benefit generosity (Krueger and Burton, 1990). Table 1 illustrates the range of benefit generosity across the states that arises for selected work injuries. The loss of the use of a leg qualifies for \$228,143 in Illinois, but only \$48,000 in neighboring Indiana. Benefit levels for less severe injuries also vary considerably across the states.

Interstate variability in WC costs and benefits has persisted since the inception of the program. There was never a race to the bottom; programs have not converged to a common, low level. Indeed, the only period of significant convergence of costs and benefits occurred in the 1970s and early 1980s, when the federal government threatened to take over the state programs. During this period benefits and costs increased more rapidly in the less generous states; a slow and unfinished race to the top took place, until the threat of federalization of the program receded.

It is also the case that, despite much rhetoric to the contrary, there is little support for the view that employers chose their plant locations based on workers' compensation insurance costs (see Burton, 1966).¹⁴ One reason why program generosity is unrelated to business location is that employees' value generous WC benefits, and are willing to take lower wage payments as a

¹³See Tables 618 and 619, *Statistical Abstract of the United States, 1999* (Washington, D.C.: Government Printing Office).

¹⁴More generally, Papke (1991) finds only weak evidence that the number of manufacturing start-ups in a state is related to the state's marginal effective tax rate.

consequence (Gruber and Krueger, 1991). More generally, even if nominal wages are rigid, society may be willing to pay a price for generous social welfare programs in the form of higher product prices or unemployment.

The limited experience from increased integration among a subset of EU nations is also consistent with that of U.S. federalism. Boeri (1999) points out that the DM-area countries (Austria, Belgium, Germany and the Netherlands) shared virtually the same currency for the last 20 years, yet exhibited no tendency to converge to a common, low set of labor standards and programs in the 1980s and 1990s. The effect of greater product market and monetary integration for the entire EU may not be terribly different.

Many observers consider the Maastricht Treaty on European Union to have far greater political than economic consequences. As an American, I must confess to being wholly confused about the domain, politics and power of the Council of Ministers, European Parliament, and Commission. But the charters and pronouncements of these bodies clearly carry some practical weight. And in this regard it seems possible to me that increased political integration could lead to a certain "levelling up" of labor standards, where lagging countries are encouraged to raise their standards to the highest existing level, just as the threat of federalization of state workers' compensation insurance in the 1970s led to a levelling up of benefits. Indeed, the 1989 Social Charter, which was ratified by 11 countries, sets forth minimum standards concerning freedom of association and collective bargaining, safety and health, work hours, and equal treatment of men and women that could strengthen labor protections in low-standard countries. Future charters could expand these rights.

IV. Conclusion

Bismarck appreciated that the labor compact requires a constant balancing of societal goals within the shifting boundaries of economic constraints. "Where is the limit," he once asked while discussing Sunday labor restrictions, "up to which industry can be burdened without killing the hen that lays the labourer's golden egg? When requirements are imposed upon industry for the fulfillment of State purposes -- and the giving to all employees of a higher measure of contentment, as to which industry may itself be indifferent, *is* a State purpose -- it is necessary very accurately to know the limit up to which this industry may be burdened. If we proceed to work without considering this limit, and it may be without seeking it, we run the risk of loading industry with burdens which it may be unable to bear."¹⁵

Every country's labor market operates with some rules and institutions. Despite popular opinion in Europe, even the U.S. is a long way from unbridled cowboy capitalism. The labor compact in many European countries is extraordinarily generous to workers, probably reflecting national values and norms. "When in doubt," writes Josef Joffe (1999), "the English speakers will go for liberty and the market while the Europeans will opt for equality and paternalism." I suspect that the economic forces being unleashed by economic integration in the European Union will tilt the constraints that led to the existing labor compacts in member states. But I also suspect that policy-makers will nonetheless have a great deal of leeway to maintain distinctive labor compacts in their countries, and that their constituents' desires for protection from economic volatility will increase because of economic and monetary union. Although Bismarck warned that "No political question can be brought to a perfect mathematical conclusion, so that book balances can be drawn

¹⁵Quoted in Dawson (1890), p. 105.

up," when the dust settles I suspect that the competing forces of integration and demand for social protection will roughly balance out, and that the broad outlines of today's labor compact in European nations will still be recognizable in the future.

One final prediction I would make is that future pressure to relax product market restrictions as a result of economic integration will likely be greater than pressure to relax labor market standards. Relaxing product market restrictions (e.g., limits on entrepreneurship) will probably be more politically popular than cutting labor standards and social benefits. Steve Pischke and I have previously argued that product market restrictions are a more important source of Europe's employment problems than labor market restrictions, although both factors probably contribute (see Krueger and Pischke, 1998). Combining these two conjectures leads me to be something of a Euro-optimist (Eurooptimist?) going forward.

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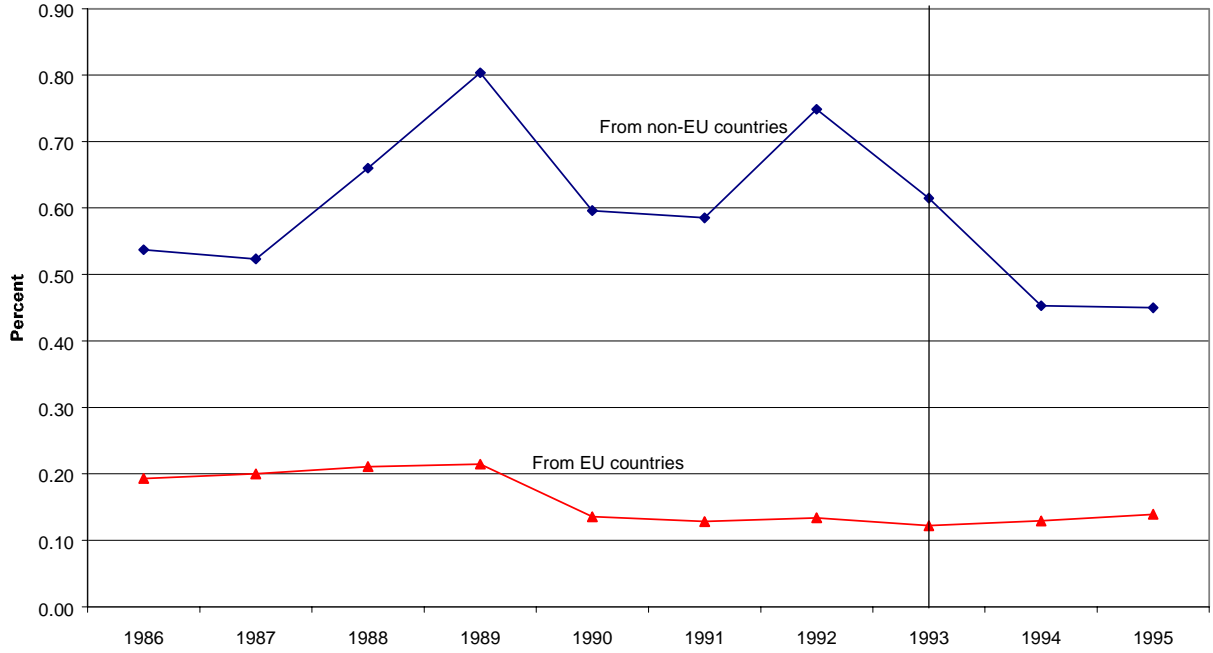
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Table 1: Maximum Workers' Compensation Benefit Payments for Selected Disabilities, 12 States in 1996

State	Arm	Hand	Leg	Foot	Eye
Arkansas	\$53,130	\$39,974	\$46,552	\$33,143	\$26,565
Illinois	228,153	144,496	209,140	117,879	121,681
Indiana	48,000	34,000	41,000	27,000	27,000
Massachusetts	25,973	20,537	23,557	17,517	23,557
Michigan	140,956	112,660	112,660	84,888	84,888
Mississippi	52,910	39,683	46,296	33,069	26,455
New Jersey	116,160	70,560	110,880	58,880	44,800
New York	124,800	97,600	115,200	82,000	64,000
North Carolina	118,080	98,400	98,000	70,848	59,040
Pennsylvania	216,070	187,085	216,070	131,750	144,925
South Carolina	96,314	80,991	85,369	61,291	61,291
Texas	67,200	50,400	67,200	42,000	33,600

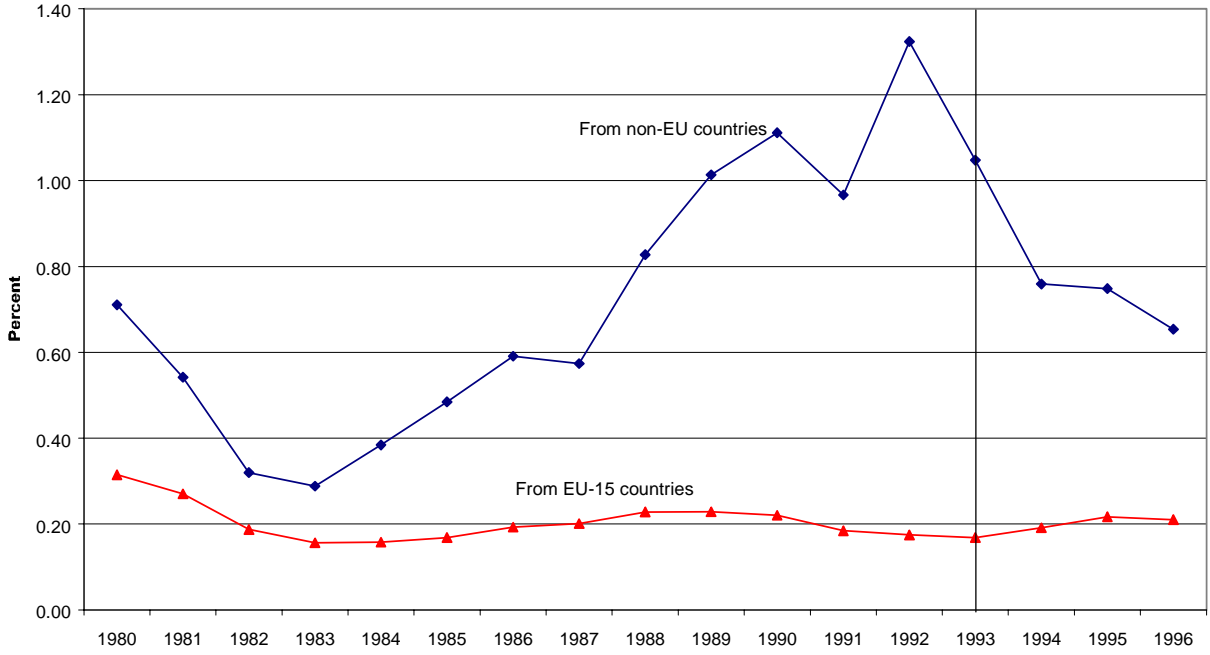
Source: *State Workers' Compensation Laws*, U.S. Department of Labor, Washington, D.C., 1996, Table 9a.

Figure 1: Migration to Six EU Countries as a Percent of Combined Population of Destination Countries



Notes: Six EU destination countries included are Belgium, Denmark, France, Germany, Luxembourg, and the Netherlands. Data are missing for Denmark and France (1986-89) and Luxembourg and the Netherlands (1986-87).

Figure 2: EU and Non-EU Migration to Germany as a Percent of German Population, 1980-96



Sources: Author's calculations based on OECD *Trends in International Migration 1998*, OECD International Migration Statistics on Diskette, and *Statistisches Jahrbuch*, 1998, p. 41. Migration and population data exclude East Germany prior to 1991.

I don't care about the health benefits, I won't move to Germany if I have to change careers and learn German.



ABK '99

Figure 3: Labor Programs as Percent of GDP versus Openness

