Do capital market and trade liberalization trigger labor market deregulation? ☆

Hervé Boulhol *

University Paris I Panthéon-Sorbonne, 13 rue de Chabrol, 75010 Paris, France

A R T I C L E   I N F O

A B S T R A C T

Over the past decades, product market deregulation has typically preceded labor market reforms in OECD countries. This paper incorporates labor market rigidities in a model of footloose capital in order to study how globalization might affect the trade-offs generated by labor market regulation and put pressure on labor market institutions. In this two-sector model, globalization ultimately reduces labor market rigidities through either one of two channels: capital mobility triggers a re-allocation of resources, which trade integration amplifies, away from the high-rent / highly-unionized sector; the threat of costly relocations encourages labor market deregulation. The latter channel is more efficient because it avoids sub-optimal sectoral specialization.

1. Introduction

To date, the question of product-labor market interactions has mostly been viewed through the impact of competition on employment and wages. Yet, Brandt et al. (2005) highlight that product and labor market deregulations are correlated across countries, and that the countries which have undertaken the most labour market reforms recently are also those that had most deregulated their product markets beforehand, as illustrated in Fig. 1. Moreover, IMF (2004) provides evidence that trade and financial market reforms have generally preceded domestic product market reforms. Even if a liberal economic policy might seek to deregulate in all dimensions, which could explain this positive relationship, the sequence of events tells us more. The main purpose of this paper is to shed light on the mechanisms which could account for *this* interaction, from capital liberalization and increased competition in the product market to deregulation in the labor market.

In an influential paper, Blanchard and Giavazzi (2003) build an elegant setting combining monopolistic competition and wage bargaining to study the impact of product and labor market deregulation. The two are, however, analyzed separately, except for a short sub-section focused on their interaction, where it is argued that product market deregulation might lead to labor market deregulation. The intuition is the following: because rents are reduced, unions no longer fight as hard. However, this premise could be applied to shareholders as well. Going one step further, Ebell and Haefke (2006) develop a theoretical model and show how intensified product market competition induces a shift from collective to individual bargaining. They suggest that the strong decline in coverage and unionization in the USA and the UK might have been a direct consequence of product market reforms in the early eighties.

Our study reconsiders these interactions by focusing on the interplay between capital mobility, tradability and labor market regulation. The goal of the analysis is to provide insight into how international competition in capital and product markets in the presence of agglomeration externalities might combine to undermine the political support for labor market regulation. It therefore contributes to formalizing the idea of Gaston and Nelson (2004) that globalization is transformative, i.e. that its effects are not limited to its direct impacts on wages and employment but extend to transforming the structure of the labor market. The paper brings two novel elements into the debate. The first consists of modelling labor market imperfections in a framework where firms choose location. Specifically, this paper builds on the most tractable geography model, the footloose capital model developed by Martin and Rogers (1995) and further analyzed in Baldwin et al. (2003). Second, the level of labor market rigidities is endogenous, depending on

Labour market reform intensity, per cent

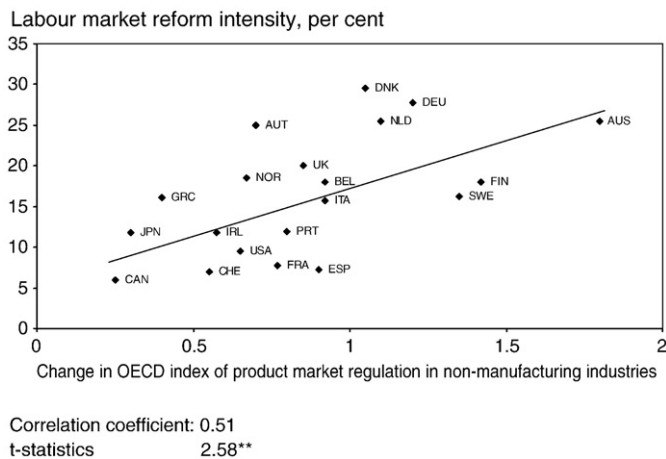Correlation coefficient: 0.51
t-statistics   2.58**

Fig. 1. Changes in product market regulation over 1993–1998 and intensity of labour market reforms over 2000–2004. Source: Fig. 34 in Brandt et al. (2005).

the country's social preferences or political support for labor market regulation, and the level of openness.

According to the conventional view (OECD, 2004, Chapter 2), one important objective of labor market regulation is to improve working conditions and the well-being of workers. It is generally believed however that this comes at a cost for employers and generates insider / outsider conflicts of interest. Therefore, regulation most likely raises labor costs and unemployment. Modelling regulation using a bargaining model inspired from McDonald and Solow (1985) enables us to include these trade-offs. As rent-sharing is mainly about distribution, the country's social preferences may shape labor market regulation. This link between social preferences and labor market institutions fits in well with Freeman (2006), who stresses that the stylized differences between the two systems organizing the economy of the EU and the USA lie in the strength of collective bargaining and social dialogue versus market-driven worker–employer relationship respectively.

The main contribution of this analysis is to provide a stylized framework highlighting a key mechanism through which globalization might alter these trade-offs. Capital mobility improves the bargaining position of shareholders by expanding their range of outside options. A fall in trade costs amplifies this phenomenon by increasing effective capital mobility, since this makes it more profitable for firms to relocate abroad and supply also the domestic market from that location. In this model, while unemployment increases with the level of labor market regulation and with the endogenous size of the high-rent sector, globalization ultimately promotes high employment by *de facto* reducing labor market rigidities. It does so by inducing specialization in the low-rent sector if the labor market remains highly regulated, due to the relocation abroad of firms in the high-rent sectors. However, since such developments bear dissuasive economic costs, the rational outcome is that the threat of relocations be a sufficient disciplining device to trigger fundamental changes in labor market institutions, thereby directly reducing rigidities. When trade costs are sufficiently low, the new effect, introduced in this analysis, of regulation on the firms' choice of location dominates the usual interplay of agglomeration/dispersion forces in geography models. In other words, increase in capital mobility creates political incentives to dismantle labor market regulations, and trade liberalization magnifies these incentives. With full trade liberalization, the optimal choice is to fully deregulate whatever the social preferences.

The mechanism through which opening the economy could put pressure on labor market institutions analyzed in this paper is as follows. As workers capture some share of the rents, capital return is negatively affected. Thus, when barriers to capital mobility are removed, economies which have a fully deregulated labor market

(because of their own preferences) tend to attract economic activities – firms relocate where profits are higher. Regulation differences drive capital flows in addition to differences in productivity levels and factor endowments. As domestic rents are transferred abroad, the positive effect of regulation on average real wages is reduced or even reversed, especially when importing the delocalized good is costly. When trade costs fall, the costs of regulation in terms of geographical attractiveness gain in intensity. Labor market institutions being endogenized, it is the threat of relocations that drives labor market deregulation, which in turn neutralizes the actual relocations.[1]

The analysis of this paper is related to a number of empirical studies. Along the lines of Rodrik (1997), Kramarz (2003) finds some support for the idea that the combination of capital mobility and cheaper trade may weaken the bargaining position of workers through offshoring by limiting the availability of alternative jobs. Studying the UK in the eighties and nineties, Pencavel (2004) documents how the changes in the legal and political framework were detrimental to unions, but he also stressed that it is the context of fiercer product market competition which determined the impact of the new laws. Moreover, Hornstein et al. (2005) suggests that, as union density did not fall in the public sector, competitive pressure seems to be a reasonable cause of deunionization in the UK. Dreher and Gaston (2007) find that globalization has contributed to deunionization in OECD countries, while Dumont et al. (2006) and Boulhol et al. (2006) provide evidence that international trade has weakened workers' bargaining power. Finally, Bertrand (2004) shows that import competition exerts increased financial pressures on managers, which alters the employment relationship and leads to increased wage flexibility.

The remainder of the paper is organized as follows. Section 2 presents the model and Section 3 focuses on the impact of regulation on firms location. Section 4 shows how capital mobility and trade liberalization induce changes in labor market regulation. Finally, Section 5 concludes.

2. A model of footloose capital with labor market regulation

The model builds on the footloose capital model proposed by Martin and Rogers (1995) in order to take labor market regulation into account. In the following two sections, the level of labor market regulation is considered as a given, whereas, in Section 4, it is treated as endogenous.

The utility function of a typical consumer is a Cobb–Douglas CES (constant elasticity of substitution) nest of the consumption of two goods. A is the numeraire good and R a composite Dixit–Stiglitz good made up of a mass N of differentiated products:

$$V = \alpha^{-\alpha}(1-\alpha)^{-(1-\alpha)}C_R^{\alpha}C_A^{1-\alpha}, \quad C_R = \left[\int_0^N c(i)^{(\sigma-1)/\sigma}di\right]^{\sigma/(\sigma-1)} \quad , \sigma > 1 \,(1)$$

This mass is supposed to be fixed by initial endowments of capital, but the location of firms is determined in equilibrium based on whether capital is mobile or immobile internationally. Consumptions $c(i)$ and C_A of an agent with income E are chosen to maximize utility subject to the budget constraint $\int p(i)c(i)di + C_A = E$, which yields the following consumer demands:

$$C_A = (1-\alpha)E, \quad c(i) = \frac{p(i)^{-\sigma}}{\int p(i)^{1-\sigma}}\alpha E \tag{2a}$$

---

[1] This way of formalizing labor market regulation bears some resemblance to tax competition models. One difference is that there is no pubic good to be financed by tax receipts, which are the target of tax competition. Here, the benefits of the regulation simply accrue to workers in the rent / unionized sector. Moreover, the link between regulation and social preferences highlights that the questions at stake are deeply rooted in the history of social relationships and collective choice. Observe that this "social competition" can arise between identical countries in terms of size and factor endowments.