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Economic integration and labor market institutions: Worker mobility, earnings risk, and contract structure

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Abstract

This paper investigates the effects of labor market integration, in the form of worker mobility, in a model with long-term labor contracts that lead to wage rigidities and unemployment. Reflecting the interdependence of regional labor markets, we develop a framework where the contract structure is *simultaneously* determined in all regions. It is shown that increased mobility leads to more flexible labor market institutions in which firms can more easily vary the level of employment in response to fluctuations in demand. Economic integration is potentially Pareto-improving but, in the absence of a system of compensation, workers are harmed by greater labor mobility while the owners of firms benefit from higher profits.

JEL classification: R0; J1; J6
Keywords: Labor mobility; Economic integration; Risk; Unemployment

1. Introduction

It has become commonplace for analysts (e.g., Burda and Mertens (1995) or Bertola and Ichino (1995)) to draw a sharp distinction between flexible "US-style" and rigid "European-style" labor market institutions, in which the former are characterized by relatively little regulatory control, high interregional and intersectoral mobility of labor, and wage flexibility, while the latter exhibit strong regulatory constraints, collective bargaining arrangements that limit the ability of firms to adjust employment and wages in the face of changing market conditions, and relatively

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limited intersectoral and interregional mobility of labor.[1] Some of these institutional features are determined as a matter of public policy while others are more "fundamental" in the sense that they depend on underlying "technological" determinants. In this paper, we focus on the cost of migration as a fundamental determinant of labor market institutions, including labor market policies.

Consider, in particular, the impact of imperfectly correlated "external shocks", such as terms of trade shocks (Rodrik, 1998), on the labor markets in a system of regions. If the fundamental costs of migration among regions are low, such as is true among regions within a highly-integrated economy like that of the US, then regions that experience positive shocks would tend to attract labor from those that experience negative shocks. One consequence of this spatial reallocation of labor is that it would tend to moderate regional wage fluctuations, even if public policies in this system are highly conducive to wage flexibility: the supply adjustment that results from workers leaving low-demand regions and moving to high-demand regions limits downward wage movements in the former and upward wage movements in the latter. Suppose, by contrast, that the fundamental costs of migration are high. External shocks would then give rise to large wage fluctuations, in the absence of public policies that constrain wage flexibility: smaller supply adjustments through migration would be associated with larger shocks to regional wage rates. Public policies and institutions that mitigate wage risk (i.e., that create or support wage rigidities) would potentially have much greater appeal in such an environment. If adopted by a system of regions such as the EU countries, imperfectly correlated external shocks would then be expected to produce variations among regions in rates of unemployment, a noteworthy feature of European labor market experience. In short, it may be useful to view some of the institutions that are believed to account for the varying experiences in US and European labor markets, such as the regulations that govern private-sector contracting and bargaining practices, as endogenously dependent upon underlying determinants of worker mobility.

The analysis below presents a model in which regional wage rigidities are endogenously determined in a way that depends upon the degree of labor market integration among regions, characterized as a migration cost parameter. As is typical of most labor-market models, the rigidities in our model generally result in unemployment when there are negative demand shocks. However, unlike models where there is only one regional labor market, our model allows for workers who lose their jobs in one regional economy to move to another region where labor demand is higher; the model thus incorporates not only "layoffs" due to adverse demand shocks but also "turnover", in the form of interregional migration.[2] The degree of wage rigidity, and thus the equilibrium levels of unemployment, migration, and other critical variables, all depend on the migration cost parameter. Comparative statics analysis with respect to this parameter shows how the equilibrium wage rigidities and other equilibrium properties of the entire system of regions depend on the degree of labor market integration.

The paper is organized as follows. Section 2 presents the basic model. Sections 2.1 and 2.2 examine equilibrium "contracts" in a single region, first in the special case where migration costs are prohibitive (the "autarky" case) and then more generally. This lays the foundation for the main

[1] See Nickell (1997, 2003) and Nickell (1999) for recent surveys of labor market institutions and their impact on unemployment.

[2] See, e.g., Gottfries (1992), Saint-Paul (1997) and the survey by Bertola (1999) who discuss the importance of turnover and hiring in modeling unemployment. Note that migrants in this model are like "outsiders" in an "insider–outsider" (Lindbeck and Snower, 1988; Leslie, 1992). See, e.g., Decressin and Fatas (1995), Coulombe (2006), and references therein for analyses of migration and unemployment relationships in the US, EU, and Canada.