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# Europe's Labor Market Problem

Thomas F. Cooley, 03.31.10, 12:01 AM ET

Back in January Paul Krugman wrote a column about the surprising comeback of the European economy. He argued that Europe had overcome its lags in IT investment and addressed many of the labor market rigidities that had saddled it with very high rates of unemployment, particularly among younger workers.

He was quickly corrected by economist Greg Mankiw and others who pointed out that Europe still lags significantly in economic wellbeing measured by per-capita GDP adjusted for purchasing power parity. For the 15 original members of the European Union (the E.U. 15) per-capita GDP is about $34,900. For the U.S. it is about $47,500--more than one-third larger.

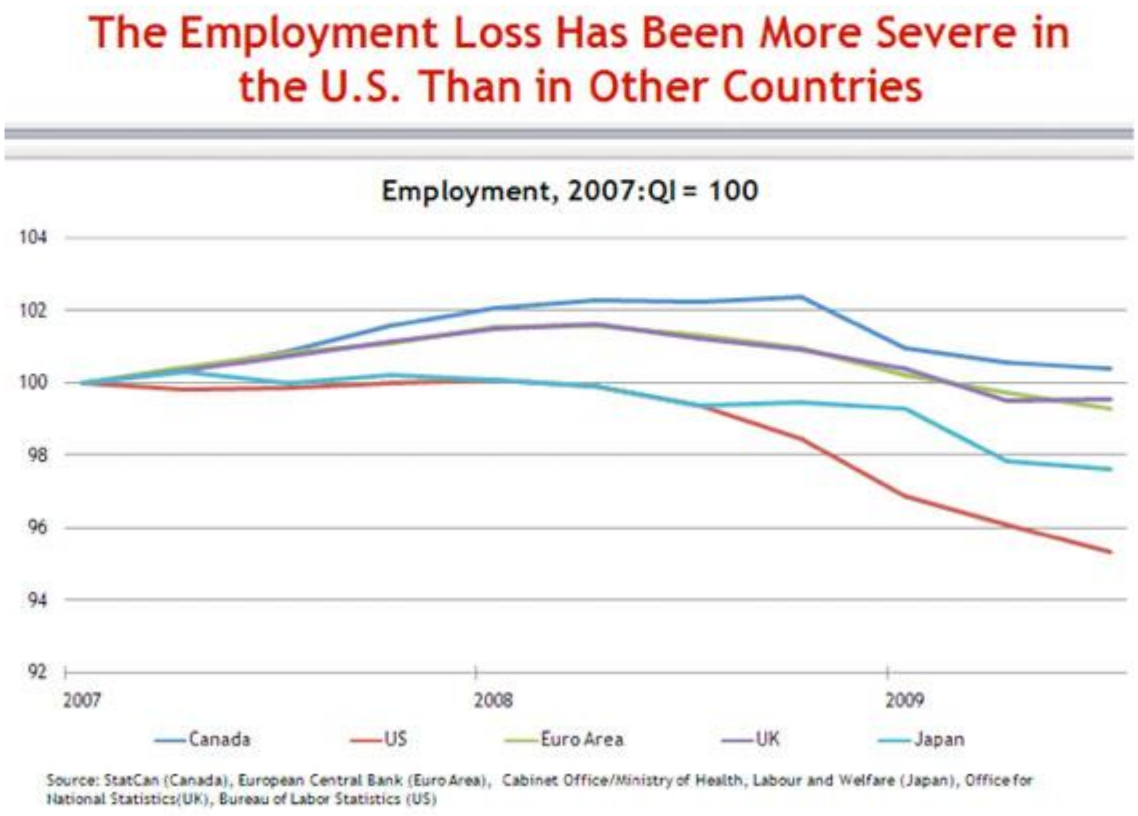
Since I am currently working in Italy for a few months it has been interesting to get more of a European perspective on these issues from my colleagues here. It is clear that Krugman was correct in one sense. Coming into the recent economic crisis Europeans did feel that their economies were more vibrant and flexible than they had been previously. And as the crisis took hold they expected to come out of it a lot better.

After all, with the exception of Spain and Ireland, most European countries had not had a housing market bubble as the U.S. did. Also, the financial sector problems were not as ubiquitous--although certainly the U.K., Switzerland and the Netherlands were big participants.

But many Europeans now express frustration that their experience has not been very good. GDP in the E.U. 15 economies declined by 4.1% in 2009 and is projected to increase by a very sluggish 0.7% in 2010, according to the latest statistics from Eurostat.

The unemployment rate in the E.U. 15 has increased to 9.9%, still not as high as in the U.S. Krugman's column observed, "In particular, in the prime working years, from 25 to 54, the big gap between European and U.S. employment rates that existed a decade ago has been largely eliminated." Apparently so, but this misses the deeper reality of European labor markets.

Consider the following data I took from David Altig's superb Macroblog site. The first chart shows the response of employment in the U.S., the E.U., Canada, the U.K. and Japan since 2007, the beginning of the financial crisis. The losses have been far more dramatic in the U.S.--something I have emphasized in previous columns. Bad for us, good for them, right? Not necessarily.

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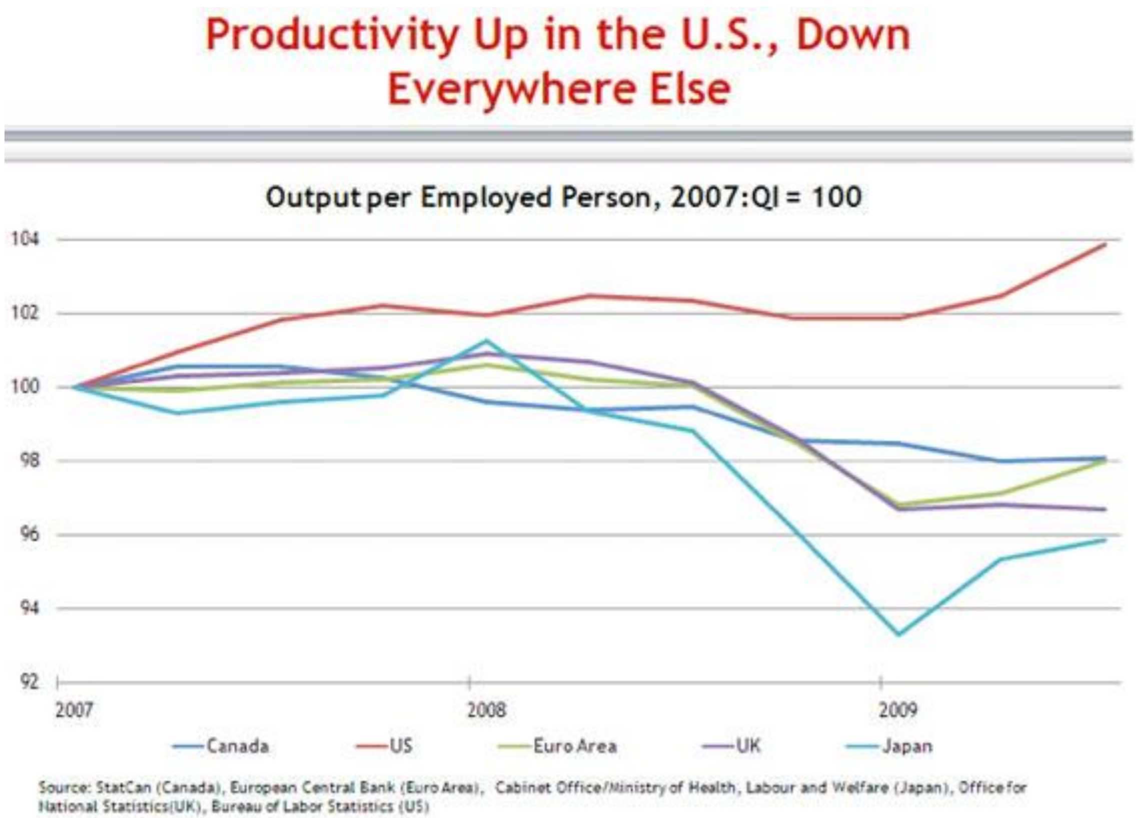
The next graph shows what has happened to productivity in these same countries. As you see productivity has increased sharply in the U.S. but has fallen everywhere else. One interpretation of this is that it is logical given that the U.S. has shed more workers--output per worker has increased faster. But that is probably not the correct interpretation.




It is true that European institutions act to protect employment and keep more workers on the job. To understand the data on productivity, however, one has to take account of how the Europeans managed to change their labor markets. In many European countries the costs of involuntary employment separations--either firing or laying off workers--is very high. It is exceptionally difficult and costly to terminate an employee. Because of this many countries--Spain and Italy are notable examples--developed dual labor markets.

A lot of recent employment is classified as temporary to avoid the separation costs. As a result most of the separations in the current recession have been of temporary workers. These tend to be younger and more productive workers who are treated as temporary simply by virtue of when they entered the labor market. In a more flexible labor market, like the U.S., it is more likely for the least productive workers to be separated first.

There is also more to the European problem. When countries experience shocks to their economies that are distributed differently across regions, they adjust in two important ways: through movements in capital and through movements in labor. Countries can also adjust by manipulating their exchange rates, but that is not a policy issue in most of the E.U. or the U.S. One of the features that accounts for the incredible dynamism of the U.S. labor market is the mobility of workers across firms and regions. The same is not true in Europe.

One of the founding principles of the European Union was to build a more dynamic economy by encouraging the free flow of trade, capital and labor across national borders. But this was not to be. In spite of the ideal, labor is very immobile--not just across national borders but within borders as well.

Peter Rupert and Etienne Wasmer showed using Census data that on average 15.5% of U.S. workers move annually for one reason or another. In the E.U. 15 less than one-third of that--4.95%--do.

Interestingly the reasons cited for moving suggest that the shocks to households are similar in the U.S. and Europe. It's just that the Europeans don't move.

Obviously there are choices being made that reflect differences in culture, language and institutions. Nevertheless it is clear that Europeans are again experiencing the costs of the inherent rigidities in their labor markets. Many of them expect the consequences of these differences will be a more robust economic recovery in the U.S. than in the E.U.

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