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EMU and Labour Market Policy: Tensions and Solutions

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EMU and Labour Market Policy

Tensions and Solutions

Giuseppe Bertola

Abstract

Reforms observed in EMU do not conform to commonly expressed views that international economic integration comes with labour market deregulation, and that both are beneficial. This essay examines the country-specific policy reforms evidence generated by inception of Economic and Monetary Union and by its disruption during the Great Recession and the Eurozone crisis, outlines non-technically how a distributional perspective can explain key features of those experiences, and discusses how these empirical observations and theoretical insights may bear on the sources and consequences of more general tensions between Europe's policymaking framework and market integration process.

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1. INTRODUCTION

It might be natural for many economists to suppose that international economic integration triggers labour market deregulation, and some view both as beneficial developments. But labour reforms observed in the European Economic and Monetary Union integration and crisis cycle do not conform to that simple paradigm.

This essay outlines how allowing for distributional tensions can help theory interpret this experience. The resulting theoretical and empirical perspective offers more general insights into the implications of allowing policies to remain subsidiary within an integrated economic area, and into issues arising in international negotiation of policy harmonisation. Integration and deregulation do not always and everywhere come together, cannot generally improve the economic welfare of all individuals and all countries, and need to be supported clearly by political motives and constructive compromises.

The European Union pursues not only economic but also social and political integration of its member countries' citizens. Economic integration however interacts uneasily with the Welfare State policies and institutions that are essential building blocks of national histories and political identities. Labour policies are a key element of those policy frameworks in Continental Europe, and the international financial integration implied by monetary unification has particularly sharp implications for the first 12 members of the Eurozone. This makes it appropriate to focus on the interaction between labour policy reforms and the Eurozone boom and crisis, but the relevant insights are broadly applicable to other politically sensitive policies (that are more difficult to assess and measure precisely) and to settings where economic integration is difficult to disentangle from other policy-relevant developments (such as CEEC accession or the long-run OECD panel studied in Bertola 2016c).

The essay weaves three threads into its argument. The first examines graphically the country-specific labour policy reforms evidence generated by inception of Economic and Monetary Union and by its disruption during the Great Recession and the Eurozone crisis. The second outlines non-technically a modeling approach that applies a distributional perspective to explain key features of the EMU labour reforms and international imbalances experience. The third discusses the implications of these empirical observations and theoretical insights for the welfare effects and political implications of market integration under local policymaking. In so doing the essay develops and outlines in conclusion a more general perspective on the sources and consequences of tensions between Europe's policy reform and economic integration processes: not only in labour markets, but also in other policy areas, recognition of distributional tensions would arguably contribute to their constructive resolution through suitable political compromises and appropriately coordinated policies.

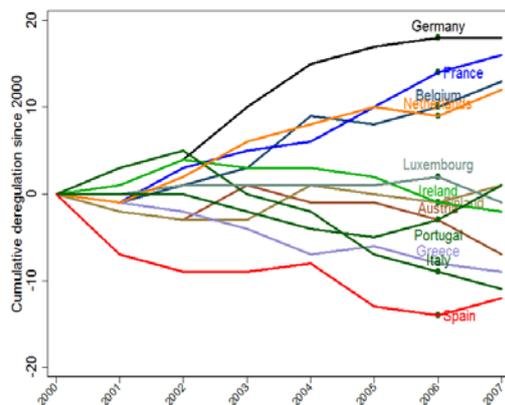
2. LABOUR REFORMS AFTER EMU AND IN CRISIS

A very useful and comprehensive source of information about country-specific labour policy reforms in the European Union is the LABREF database, developed at the European Commission's Directorate General for Economic and Financial Affairs upon initiative of the Labour Market Working Group attached to the Economic Policy Committee of the ECOFIN Council in 2005, and currently maintained by staff of Directorate General for Employment, Social Affairs, and Inclusion. Besides detailed legislative information the database contains a classification of measures in a variety of areas and an indicator of whether each increases,

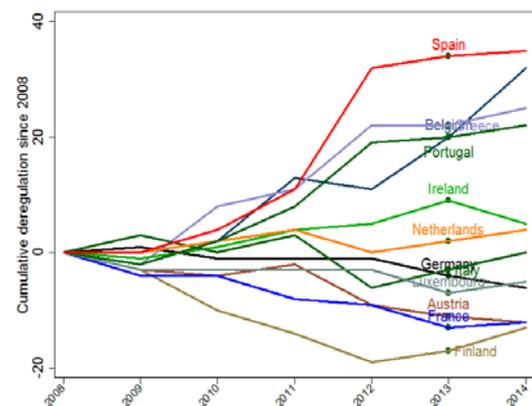
decreases, or leaves unchanged labour market flexibility. As in Turrini et al. (2015), a cumulative count of these indicators provides a time-varying measure of each country’s reform stance.

Graphs 1 and 2 plot against time for EA12 countries, respectively from 2000 until 2007 and from 2008 to the most recent 2014 available data, the cumulative “increasing flexibility” series that results from summing all measures in the policy areas “Early Withdrawal”, “Job Protection (EPL)”, “Labor Taxation”, “Other welfare-related benefits”, “Unemployment benefits”, “Wage Setting”, “Working Time”.

Graph 1. Labour reforms before the crisis, EA12



Graph 2. Labour reforms after the crisis, EA12



Source: LABREF database.

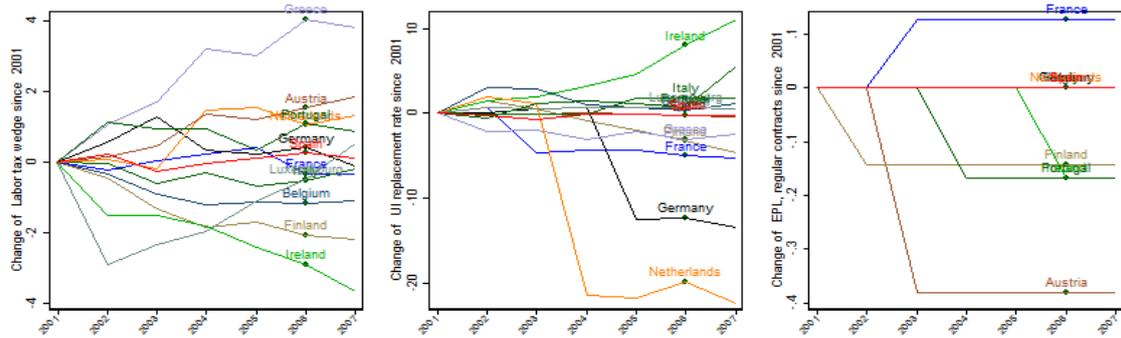
Among the 2031 measures tabulated by LABREF for the EA12, this indicator disregards the 111 measures labeled "Immigration/Mobility", also dropped by Turrini et al (2015) as not immediately relevant to labour markets.

It also excludes the 569 “Active labor market policies” measures that, while relevant, would need to be analysed separately and at a level of detail that exceeds this essay’s scope. The employment implications of more generous activation measures are to a first approximation like those of less generous UI benefits, or lower labor income taxation. However much depends on whether activation expenditures are financed by payroll contributions or general taxation. Over 96% of the relevant measures are coded as “aiming at increasing the availability, generosity, or effectiveness of ALMPs” in LABREF data. Countries that increase passive regulation also tend to implement somewhat fewer active policy reforms, however in 2000-2007 Spain and Germany record just about the same number of active policy reforms. Weighing such reforms the same as the less numerous and less monotonic measures in other areas would broadly preserve country and time rankings in the cumulative reforms indicator, but perhaps inappropriately suggest that flexibility increased in almost every year and country.

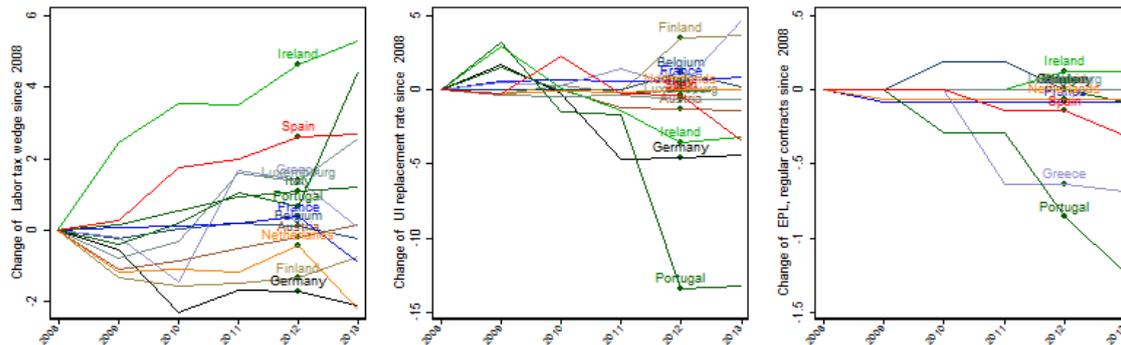
The LABREF count of reform assigns the same weight to more or less drastic changes of different policies. It is also possible to inspect narrower OECD quantitative indicators of labor tax rates, unemployment insurance replacement rates, and employment protection legislation indicators. The visual impression of their time paths, in Graphs 3 and 4, is much the same as that conveyed by LABREF count: for each country, policy indicators persistently move within each period in the same direction, which is often different before and after 2008. Their behavior differs in some details, which can be explained by their different roles and drivers: labor tax rates, for example, are instruments of both labour market and fiscal policy, and are influenced

by public finance needs as well as by labour policy objectives. To the extent that mixing a variety of indicators evens out such specificities, the simple LABREF count convey a more significant signal of labour policy time variation. The OECD indicators however do measure the levels of specific labour policies, rather than only their changes, and will be useful below to characterise the configuration and evolution of labour policies in country cross-sections.

Graph 3. Labour policy indicators before the crisis, EA12.



Graph 4. Labour policy indicators after the crisis, EA12.



Source: OECD.

Two features of these data motivate the discussion in the rest of this essay and the more technical derivations in Bertola (2016a, b, 2017).

- First, both before and after the crisis labour policies do not just drift apart: country-specific reforms appear to diverge explosively in different directions. (As discussed below, the visual explosion impression is qualified, especially in the after-crisis period, by considering the extent to which reforms may imply convergence of country-specific policy frameworks.)
- Second, the countries that display a persistent tendency to deregulate in the early EMU experience are largely the same that after the crisis move in the opposite direction.

3. WHAT DOES LABOUR POLICY DO, AND WHY

To understand why labour policies were reformed it is necessary to characterise what motivates their interference with laissez faire markets.

- On the one hand, collective action may aim at improving average welfare through better efficiency. Policy can correct labour market failures, remedying the informational and financial problems that make it difficult for the unemployed to fill vacancies, for workers to fund their own mobility and training, and for individual consumption to remain smooth in response to labour income shocks. This is the purview of “active” policies whereby governments exploit their superior observation and enforcement power to organise and fund training and job-seeking activities in ways that not only smooth incomes across individuals and within individual lifetimes, but also increase total and average productivity and welfare.
- On the other hand, politically determined policies may aim at redistributing resources across individuals who differ in terms of how heavily each relies on labour income, rather than other resources. “Passive” policies (such as minimum wages and legally protected collective contracts, payroll taxes that finance non-employment subsidies, limitations on working time) increase unit labour incomes and reduce employment: up to a point, this increases the aggregate surplus accruing to labour; but it decreases aggregate output and the surplus accruing to production factors that are complementary to labour. Employment protection legislation similarly trades job security, which is valuable for workers uninsured against labour income shocks, off the production efficiency afforded by labour reallocation, which is costly for workers (Bertola, 2004).

From the perspective of a hypothetical representative individual entitled to per capita aggregate welfare, labour policy is beneficial when it is meant to offset distortions. Economists who take that perspective are naturally inclined to advocate deregulation of policies that introduce distortions instead. That perspective, however, is appropriate only if it possible to address political tensions by transferring welfare across individuals and ensure that all benefit from aggregate efficiency. Because neither private contract nor government programs can apportion welfare on a lump-sum basis, realistic policies do not necessarily maximise an aggregate welfare objective. Distortions that appear inefficient from the aggregate point of view rationally aim at increasing the “slice” of a political majority so much as to offset the decline of the “pie” that a hypothetical representative individual would enjoy (Meltzer and Richards, 1981).

Laissez-faire markets do not necessarily optimise the trade-off between work effort and the level or stability of aggregate income and consumption. In markets with incomplete information active labour policy can improve matching of unemployed workers and vacant jobs and smooth uninsurable labour income shocks, increasing employment and aggregate production. This raises the income of factors that are complementary to labour: in a reality where labour is the most important resource of most individuals, however, democratic decision processes may well give lower weight to other factors’ income. This is especially relevant in societies with high wealth inequality, where active policies have less political support than passive policies (such as those tracked empirically in the Graphs above) which increase the scarcity and unit income of their labour at the expense of other factors of production, or trade higher and smoother labour income off lower employment, productivity, and aggregate and non-labour income.

The two motivations of labour policy coexist and interact in practice, so labour policies and their reforms are shaped by both technical and distributive factors. The relevance of the latter is shown not only by the very existence and indeed prevalence of passive policies, but also by the

tendency of policy to be uniform within countries even when its implications are different across heterogeneous regions. For simplicity and in the interest of national cohesion, policies are not fine-tuned to technically relevant characteristics of regions and individuals within Nations formed by wars and amalgamated by Welfare States as well as by cultural assimilation, market integration, and migration.

Policy homogeneity is technically problematic, for example as a cause of poor labour market performance in underdeveloped regions of Southern Italy and East Germany. However, it is politically sensible not to fine-tune labour policies that aim at distributional objectives within politically defined countries. Labour policies are part of the Welfare States that in industrialised and urbanised economies replaced previous rural and extended-family risk-sharing arrangements, and developed a sense of national solidarity at times of actual or feared social unrest, such as Bismarck's industrialising Germany or Lord Beveridge's wartime United Kingdom. In Europe, a history of revolutions, dictatorships, and wars puts "cohesion" and "stability" at the same level as "growth" among the objectives of collective action. Within each country labour policy interacts with structural problems that certainly differ across regions and sectors, but its configuration and appeal also depend on its distributional implications across individuals and households that within each country differently rely on labour as a source of income.

The essay next brings this perspective to bear both on why labour policies remain subsidiary in the EU, and on why they changed in such different ways across EMU countries and before and after the crisis.

4. ECONOMIC INTEGRATION AND LABOUR POLICY

International economic integration challenges national labour policy frameworks in two contrasting ways.

- Its implications for income instability and inequality can make labour policy more necessary and appealing: international shocks can call for more active reallocation assistance, and the higher rate of return offered to wealthy individuals by investment in capital-poor countries can increase income inequality.
- However, labour policies chosen and enforced within portions of integrated economies can be less effective, because access to differently regulated markets makes it easier for private agents to escape supposedly mandatory policy prescriptions.

The latter need not be problematic for "active" policies which increase aggregate production and the income of mobile factors of production. For the more prevalent "passive" policies that trade high and stable labour income off production efficiency, conversely, there is race-to-bottom pressure in the absence of coordinated collective action throughout an integrated market area.

Such action is indeed largely absent in the European Union's policy framework (Sapir et al 2004). Article 149 TFEU states as objectives "the promotion of employment, improved living and working conditions, so as to make possible their harmonisation while the improvement is being maintained, proper social protection, dialogue between management and labour, the development of human resources with a view to lasting high employment and the combating of exclusion." In practice, however, there is very little supranational action in these policy areas (Bertola, 2015a). European structural and social funds are negligible next to National social expenditures which, despite co-financing requirements, may be adjusted so as to largely offset

within-country distributional implications. More importantly, supranational legislative competence is heavily restricted on labour policies, and envisioned only in fields that are more directly relevant to product market competitiveness. Article 151 TEU and Article 153 TFEU stipulate that Directives and minimum requirements can be introduced by the standard qualified majority co-decision procedure only for workers' health and safety, working conditions, information and consultation of workers, integration of persons excluded from the labour market, and equality between women and men. Unanimity of the Council is required instead for action on social security and social protection of workers, as well as employment contract termination, collective representation and defense of workers and employers, and employment of third-country nationals (a unanimous Council decision, rather than a Treaty revision, might however make the ordinary legislative procedure applicable to the latter areas). For social exclusion and social protection schemes “any harmonisation of the laws and regulations of the Member States” is explicitly ruled out, and only “measures aimed at cooperation, knowledge sharing, and exchanges of information and best practices” are allowed that in practice are only weakly implemented by requiring member states to report on jointly set, verifiable, regularly updated targets (Van Rie and Marx, 2012). Not even this “soft” supranational action may be taken for “pay, the right of association, the right to strike or the right to impose lockouts.”

The two conceptually different motivations of labour policy suggest two possible reasons for such severe limitations of EU legislative competence to “implement measures which take account of the diverse forms of national practices” for labour policy areas in which National histories and traditions resulted in very heterogeneous institutional configurations across member countries:

- To the extent that policy addresses structural problems, it can be appropriate to let it adapt to local conditions that undoubtedly differ extensively across Europe. Policy spillovers can be less problematic than coordination for “active” policies, that are not subject to race-to-the-bottom pressure and may converge spontaneously as integration tends to homogenise economic structures and lets policymakers learn from each other’s experiences.
- To the extent that more “passive” policies pursue distributional objectives, lack of supranational policy action reflects the difficulty of achieving political compromises between contrasting interests in the absence of suitable political processes outside the boundaries of member countries. Distributional issues cannot be addressed appropriately across Europe, because politics are still conducted at the national level.

Exposure to systems competition of politically crucial “passive” policies is a source of tensions and instability. Before Economic and Monetary Union uncoordinated macroeconomic policies, fixed exchange rate, and free capital mobility were mutually inconsistent (Padoa-Schioppa et al., 1987), and a single market with multiple currencies was disturbed by devaluations. To the extent that market integration and subsidiary policy are inconsistent with objectives that can only be achieved by collectively agreed and enforced actions (Sinn, 2003), the eurozone has been similarly disturbed by reforms of its multiple labour policies.

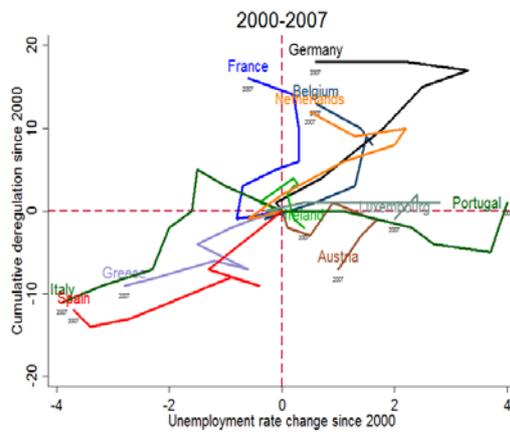
5. SUPPLY AND DEMAND OF LABOUR REFORMS

Graph 5 shows that in early EMU unemployment changes are positively correlated over time with country-specific labour market deregulation indicators, and Graph 6 that employment growth (in terms of hours worked) is negatively related with them. Recalling that the reform indicator singles out “passive” measures, it is interesting and may seem surprising to see that their deregulation is associated with worse labour market performance. Across the early EMU

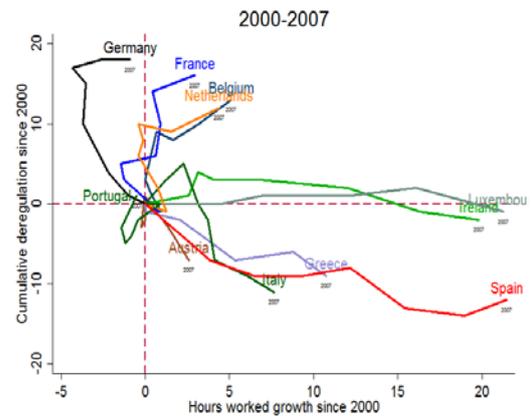
members, over the almost decade-long period shown, unemployment changes remained positively associated with deregulation, and employment growth negatively associated with it.

Many factors jointly drive labour market policies and outcomes, and not all countries display the counterintuitive association between deregulation and worse labour market performance: in Portugal, for example, unemployment rose before the crisis without any change in labour market policies, an experience that was very different from Germany's. It is also possible to detect in the data a sensible tendency for tax and benefit reforms to be followed, after a time lag, by improved activity rates and lower unemployment (Turrini et al, 2015), exemplified in the Graphs by the swings of the German trajectory.

Graph 5. Labour reforms and unemployment before the crisis, EA12.



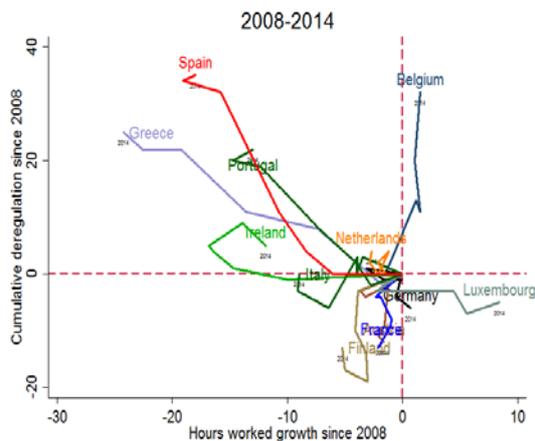
Graph 6. Labour reforms and hours worked before the crisis, EA12.



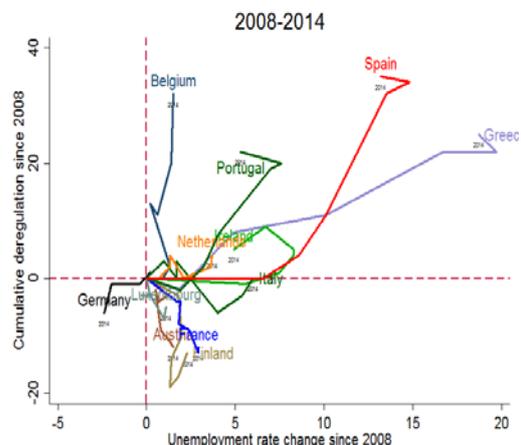
Sources: LABREF and AMECO databases.

Graphs 7 and 8 show that the overall correlation pattern remained similar as country-specific trajectories changed direction after 2008. It is certainly not what one would expect if reforms were exogenously driven by changes of political preferences or policy choice processes. It rather suggests that labour market deregulation is an endogenous reaction to factors that tend to increase unemployment and reduce employment growth, and that reforms symmetrically tend to strengthen passive labour market policies in reaction to factors that lower unemployment and speed up employment growth.

Graph 7. Labour reforms and unemployment after the crisis, EA12.



Graph 8. Labour reforms and hours worked after the crisis, EA12.



Sources: LABREF and AMECO databases.

The evidence cannot be interpreted in terms of a simple race-to-the-bottom in passive policies, and it is also hardly consistent with the idea that the common challenges implied by membership in a single market should lead country-specific policies to converge to a common implementation of efficiency-oriented active policies. It can instead be interpreted, and brought to bear on policy options for EMU, by a theoretical perspective that focuses on distributional tensions as the motivation of observed policies, and on international economic integration itself as the most interesting among the factors that drive the joint dynamics of labour policy reforms and labour market performances.

6. EMU, IMBALANCES, AND REFORMS

Policies that remain subsidiary within an integrated economic area are obviously subject to systems competition. But in EMU subsidiary labour policies in the absence of coordination do not just feature the deregulation that 15 years ago was expected, as a welcome or disturbing development, both by those who view labour policy as a source of inefficient distortions, and by those who view it as a technical instrument that needs to be enforced to remedy market failures.

The asymmetric reform patterns shown in the Graphs above are sharper and less obvious than the “race-to-the-bottom” labour policy dynamics predicted by Bertola and Boeri (2002) and empirically verified by Bertola (2010) comparing the average of EMU members to that of control groups of countries.¹ The contrast is particularly strong between Germany, which in the early stages of EMU introduced sweeping flexibility-oriented reforms, and Spain, Greece, Portugal, and (after 2002) Italy, which in the same period raced away from the bottom and tightened their labour market’s regulation. In these cases, and more generally, countries that deregulate before the crisis tend to be the same as those that accumulated international balances after EMU and before the crisis. Conversely, countries that defied race-to-the-bottom

¹ There is also some evidence of EMU-related changes in the structure, rather than the overall level, of labor market policies: the empirical results of both Bertola (2010) and Turrini et al. (2015) detect a tendency for monetary union to be associated with more generous unemployment benefits, which partly compensate higher flexibility in other policy areas.

predictions also accumulated international liabilities that appeared unsustainable when the crisis struck.

Economic integration has empirically very relevant implications for the intensity and direction of international capital flows, and the pattern of those flows' correlation with reform dynamics is consistent with the redistributive role of labour policy within each national politico-economic system. Suppose that country-specific policy maximises the welfare of an also country-specific decisive agent who earns the per capita labour income and on a non-average proportion of the country's national capital. Because higher capital intensity benefits individuals whose income disproportionately accrues from labour, "passive" labour policy boosts wages and reduces employment, and this is appealing to a political majority that is less wealthy than the country on average. Regardless of the extent to which structural issues might call for "active" policies from the aggregate point of view, in politico-economic equilibrium policy is more "passive" when wealth is distributed more unequally, and democratic decisive individuals rely on labour income more strongly than on capital income.

This mechanism, studied formally in Bertola (2016a, 2017), implies that policy is determined not only by each country's income distribution and political institutions, but also by capital mobility. Intuitively, the country's political majority earns only a portion of domestic capital income in a country that experiences capital inflows, and is less favorably inclined towards high employment when it increases productivity of capital owned by foreigners. In relatively capital-abundant countries the politico-economic equilibrium instead swings towards deregulation, because higher domestic capital productivity stems capital outflows and reduces their negative wage and employment implications for the country's relatively capital-poor political majority.²

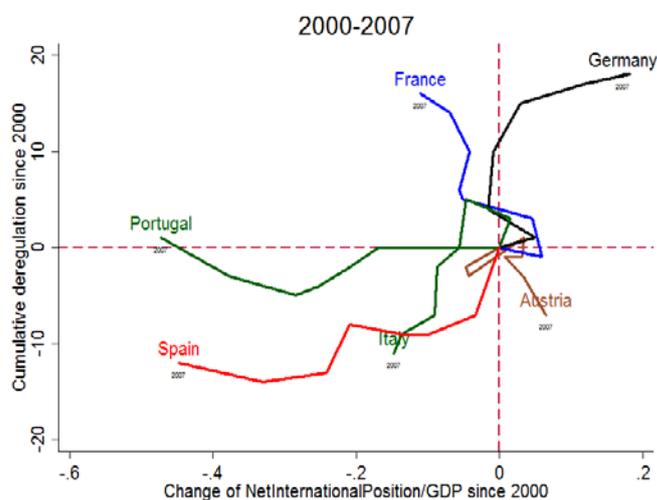
Covariation of labour policy reforms and international financial imbalances in the early stages of EMU corroborates the empirical relevance of that theory. Bertola (2016a) documents that in the early EMU period divergent labour reforms mirror similarly divergent international imbalances: between 1998 (the first year available in the LABREF database and the last before EMU) and 2007, an index of labour market deregulation similar to that plotted in Graph 1 above was positively and significantly related across countries to cumulated current accounts, serving as a proxy of the size and direction of capital flows.

Graph 9 relates flexibility-oriented reforms (represented in cumulative terms on the vertical axis) to another indicator of international imbalances. In the period between adoption of the single currency and the crisis, reforms were associated with more positive changes of Net international investment position as percent of GDP. These include valuation effects, and are more sparsely available than current account data.³ They do however offer a spectacular illustration of an exploding empirical pattern along both the labour reforms and international balances dimensions, and they are very policy-relevant as one of the fourteen Macroeconomic Imbalances Procedure Scoreboard Indicators (with a level threshold of -35%, exceeded among the original EMU members by Spain).

² Capital mobility also influences the elasticity of labor demand: lower employment has less favorable implications for capital-poor individuals when the resulting decrease in capital unit income triggers capital outflows. The strength of this effect depends on the tightness of integration and on country size. See Bertola (2016a,b) for technical derivations, Bertola (2016c) for empirical assessment in a broader data set, and Bertola (2017) for extensions to partial integration and to "active" labor policies, which can explain some of the cross-country differences of policy configuration but leave unchanged the reform effects of integration.

³ The series available in the Eurostat Balance of Payments statistics aggregates Belgium and Luxembourg until the early 2000s. The MIP scoreboard GDP ratio series only starts later, and is available also on a quarterly basis for a somewhat longer period. The data are rather different when all three series are available, however the qualitative pattern of their changes' relationship to labor market reform is similar regardless of the exact definition, and of whether they are normalized by initial or current GDP.

Graph 7. Labour reforms and international imbalances paths before the crisis, EA12.



Sources: LABREF database, Eurostat balance of payments statistics.

Easier capital mobility shapes not only labour policies but also labour market outcomes (Bertola 2016c), in ways that can explain the counterintuitive correlation of reforms, unemployment, and unemployment shown by Graphs 5 and 6. In countries that experience capital inflows, and growth of complementary labour's marginal productivity, employment naturally increases along a labour supply curve. When labour policy is endogenously determined by distributional tensions, rather than by a country-level social plan aimed at offsetting distortions and equipped with lump-sum transfers, then higher employment is smoothed by policy reforms that shift some of the additional country-specific welfare towards labour, and away from the foreign investors whose interests are legitimately neglected by local policy makers. Symmetrically, in countries that experience capital outflows policymakers tend to deregulate labour markets, aiming to offset the negative effects of lower complementary capital on their constituents' labour income.

From this perspective labour market performance, labour policy reforms, and capital flows are all natural consequences of financial integration across countries with different capital intensities. The EMU empirical patterns in the graphs above illustrate both the implications and the sources of labour policy variation. The evidence is consistent with a sensible relationship between trade balances and reforms that let countries gain or lose competitiveness, but it can be explained by deeper politico-economic mechanisms, rooted in policy's distributional role.

Capital mobility across the boundaries of countries with independent labour policies changes the pros and cons of labour market regulation in ways that, like international financial flows, depend on countries' relative capital intensities. The politically decisive individual in a core country may be capital-poor relative to that country's average individual, but is less capital-poor relative to the average individual within an integrated market that includes countries with lower average capital/labour ratios. Hence, the politico-economic equilibrium in core countries should swing towards deregulation more strongly than in peripheral countries where the politically decisive individual becomes even more capital-poor, and more inclined to adopt passive labour market policies.

7. THE CRISIS

Current account deficits and surpluses were a natural implication of closer financial integration that made it easier for capital to flow “downhill” from rich to poor countries. From the theoretical perspective outlined above, relative labour market deregulation in surplus countries was an equally natural consequence of removing financial market barriers while leaving labour policymaking to the National level, and exercised a stabilising influence on international imbalances.

The insight is also relevant to the period after a crisis that saw asymmetric shocks reduce the effective capital intensity of peripheral countries and trigger incipient capital flows towards core countries. The pattern of labour reforms and capital flows in Graph 9’s early EMU data left some countries in a position of heavy indebtedness and relative labour market rigidity at the time of the crisis. It was natural for those countries to accept more labour market flexibility, and it is not surprising to see that in Graph 2’s post-crisis experience the LABREF cumulative reform indicator’s dynamics broadly mirror those seen in Graph 1’s early-EMU period, with e.g. Portugal, Greece, and Spain moving towards labour market flexibility, while core countries move in the opposite direction (Germany’s introduction of a minimum wage in 2015, not yet tallied in the data shown, also fits the predicted pattern).

History did not just reverse itself, however. This and the next section bring two types of additional considerations to bear on post-crisis labour reform trends.

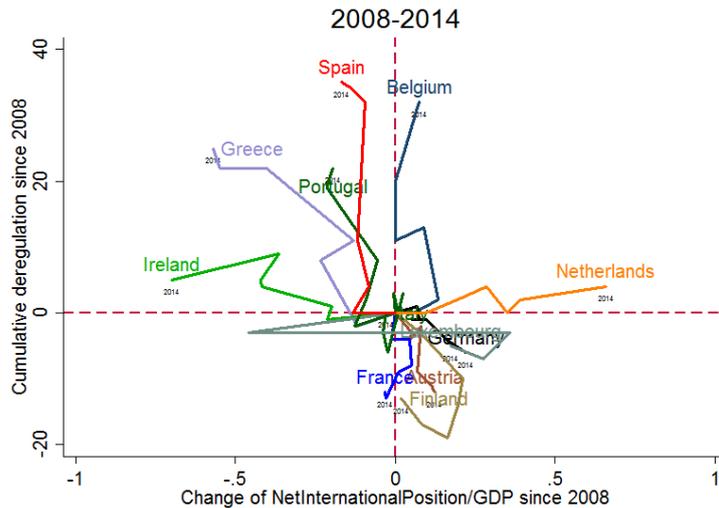
The first is that in the crisis international patterns did not simply reflect historically determined differences of capital intensity and diminishing returns to investment, with capital flowing from core countries towards better returns in capital-scarce peripheral countries. In crisis countries investment opportunities dried up for macroeconomic reasons: a “sudden-stop” of capital inflows required import reduction through a reduction of nontraded good production. This made capital abundant in crisis countries and triggered a pattern of labor reforms that, at least qualitatively, address in a monetary union the same competitiveness issues that would otherwise result in exchange rate movements.

But while before the crisis divergent reform patterns were largely physiological and helped decrease imbalances, after the crisis labour reforms are deployed in a pathological situation. Like devaluations, reforms not only have uneven distributional effects across each country’s population, but are ineffective or counterproductive when policy credibility is low (Bertola, 2015b). Flexibility can ease adjustment to structural shocks, but employers’ hiring and firing decisions and workers’ reallocation choices take into consideration future as well as current labour market conditions and policies, and are not easily influenced by tentative and easily reversible reforms. And if flexibility increases productivity it does not remedy aggregate demand shortfalls but deepens them, also because higher labour income uncertainty induces precautionary savings.

Empirically, post-crisis deregulation occurs in the same countries that experience a fall of labour demand, hence is again counterintuitively associated with increasing unemployment in Graph 7 and declining employment in Graph 8. Capital flows tend to depress labour incomes and non-tradable prices in surplus countries, and to inflate them in deficit countries, but other macroeconomic variables also respond to financial integration and disintegration, and labour market flexibility can do little to offset capital flight and demand-side, expectations-driven consumption and investment patterns. As a results reforms and international imbalances in 2008-14, shown in Graph 10, display an even more striking explosive pattern that is far from

being as symmetric as it was in the early EMU period, shown in Graph 9 and in the similar data analysed by Bertola (2016a).

Graph 8. Labour reforms and international imbalances paths after the crisis, EA12.



Sources: LABREF database, Eurostat Macroeconomic Imbalances Procedure statistics.

Core countries do engage in some re-regulation after the crisis, but their current accounts remain in surplus and drive continued accumulation of foreign assets. In the crisis environment, cross-country patterns are driven not only by the severance of international financial linkages (also evident in divergent interest rates, with or without default premia), but also by heterogeneous shocks which, from the theoretical perspective outlined above, need not trigger labour reforms unless they happen to be associated with changes of the distortions addressed by active policies, or of the political redistributive tensions that motivate passive policies.

Both demand and supply factors shaped the current accounts patterns observed before and after the crisis and, as in any dynamic macroeconomic situation, were in turn influenced by expectations. Before the crisis, expectations of productivity growth drove consumption booms and international imbalances alongside the investment patterns explained by downhill capital flows (Bertola, 2013). After the crisis, demand recovered relatively quickly in core countries, also because the competitiveness of their exports to the rest of the world was strengthened by euro depreciation. But expectations that gave positive probability to a break-up of monetary union steered investment, consumption, and employment towards a low-level equilibrium throughout the eurozone and especially in peripheral countries, where a looming possible devaluation made it rational for workers to resist wage cuts and for employers to refrain from creating jobs in the tradable sector.

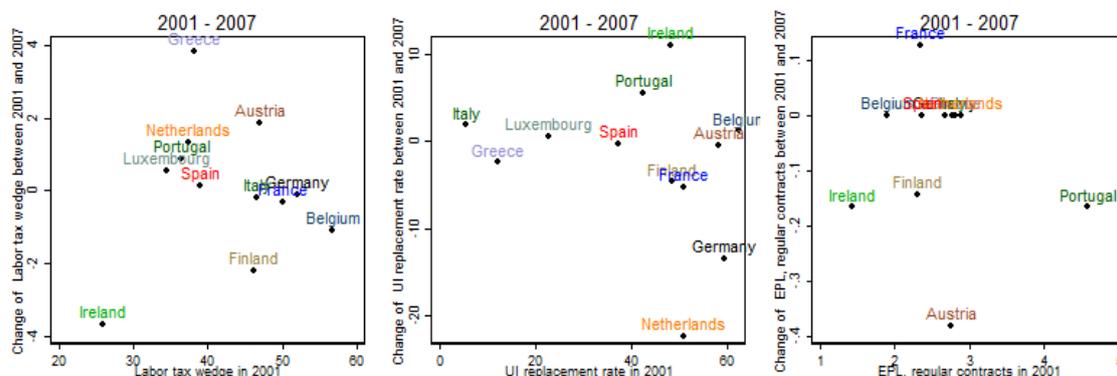
Rebalancing trade patterns takes time, and requires credibility: fears of redenomination or default explain why current account imbalances in EMU have been reduced only a little, and more by internal demand compression than by changes of competitiveness. While other policies may more quickly and reliably address these issues, the next section discusses how labour reforms may in theory and did in practice behave in the crisis aftermath.

8. LABOUR REFORMS AND CRISIS RESOLUTION

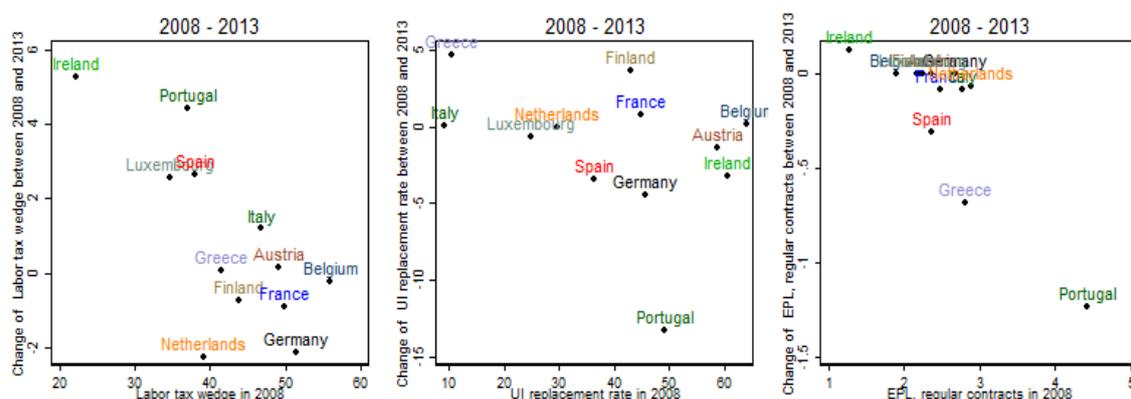
A second feature of recent experience is that in crisis countries reforms were triggered by imbalance overhangs and by financial assistance conditionality. Country-specific experiences during a crisis when outcomes were determined by shocks as much as by institutions might or might not call for labour policy reforms, because future shocks will likely be different. But labour market deregulation can ease repayment of asset imbalances. The relative competitiveness of indebted countries moves in the appropriate direction if their labour market becomes more flexible. Policy measures that increase labour market regulation in surplus countries may symmetrically contribute to reduce international financial imbalances also, and perhaps especially, by encouraging consumption by working households after an economic integration made workers suffer lower wages and more unstable employment.

Graphs 11 and 12 assess patterns of labour policy reforms by plotting changes of each of the three OECD policy indicators against its initial level.

Graph 9. Change and initial level of labour market policy indicators before the crisis, EA12.



Graph 10. Change and initial level of labour market policy indicators after the crisis, EA12.



Source: OECD.

In Graph 11 there is little evidence for 2001-07 of the negative relationships that would be implied by convergence across EMU countries.⁴ After the crisis, Graph 12 displays a much clearer convergence pattern.⁵ To the extent that this was driven by conditional-assistance interference with country-specific labour policy, it may be viewed as a tentative and asymmetric first step towards addressing the policy inconsistency engendered by the Treaty prohibition of supranational competences in that area.

It would be very optimistic, however, to think that the supranational policy action implemented in crisis conditions may prevent a reversal of previous European economic integration trends. Just like regulation was a natural response to capital inflows, so crisis countries should naturally tend to deregulate: higher employment reduces capital intensity and capital outflows, and is in the country's workers own interest. But reforms in crisis countries were not all spontaneously implemented by local policymakers. They were strongly influenced by supranational institutions

⁴ Bertola (2016a) documents that the convergence is actually stronger across non-EMU countries, where labor policy changes are not significantly associated with international financial imbalances.

⁵ The detailed statistical results of Turrini et al (2015, Table 7) corroborate this impression, in that "there are more reform measures reducing the tax burden on labor the higher the starting level of the tax wedge; there are more reform measures reducing the generosity of unemployment benefits if the net replacement rate is already high; and there are more reforms reducing employment protection legislation when the protection of regular workers is high".

as a condition of financial assistance, while no symmetric constraints reduced surpluses in core countries.

Asymmetric supranational constraints are not a politically sustainable foundation for the European integration process, because countries forced to reform beyond what is in its own politico-economic interest may justifiably suspect that reforms are inspired by other countries' interests. If a capital-rich country's political majority owns enough capital to be relatively rich in the integrated market, in fact, it benefits from labour market deregulation not only in its own country, but throughout the integrated capital market.

9. POLICY COMPETITION AND COORDINATION

International economic integration alters in observable ways the trade-offs facing country-level policy-makers. The reforms it triggers highlight empirically the motivation and effects of labour policies and do so more clearly in EMU than in broader experiences, where the empirical implications of heterogeneous and gradual financial integration are difficult to disentangle from those of country-specific structural or political trends.

In theory, and in EMU experience, labour policies are effectively akin to a tax on domestic non-labour income. Some of that income is paid to internationally mobile capital, and source-basis taxation of such cross-border income flows has well-known implications for public revenues, public goods provision, and cross-border investment patterns (Wilson, 1999). In the case of symmetric countries, tax competition unambiguously reduces public good provision, and the welfare of each country's average individual; when capital does flow across asymmetric countries, those that import capital will find it optimal to tax it more heavily, and oversupply public goods. Labour policies are similarly subject to uniform deregulation pressure when integration of symmetric countries does not generate capital flows. When integration implies active capital flow, conversely, it also implies divergent country-specific labour policy reforms (Bertola 2016a, 2017). This makes it wishful to suppose that labour policy may be left to national policy-making in an internationally integrated economy: if uncoordinated reforms naturally tend to diverge, they can be no less disruptive for politics in EMU than devaluations were for markets before EMU.

The analogy with capital income taxation, which in the EU is in principle imposed on a non-distortive personal basis, suggests that labour policy harmonisation is desirable. Should it be possible to aggregate each country's interests to those of a representative average citizen, the policy competition implied by integration would be unambiguously damaging as long as policymakers benevolently serve the interest of their country's representative individual. In that setting, coordination is indeed beneficial. From the point of view of all country-specific representative individuals, if subsidiary labour policies distort capital movements like a source-basis capital income tax then uncoordinated policymaking has same unpleasant implications as fiscal competition and other policies that, like state aid, the EU policy framework aims to control.

The implications of harmonisation for distribution-motivated policies are subtle, however, and can be politically awkward. When policymakers are not benevolent, "coordination is beneficial if and only if the elasticity of the tax base exceeds the policymaker's marginal propensity to waste tax revenue" (Edwards and Keen, 1996). If citizens have heterogeneous policy preferences, policy can be "wasteful" from their own perspective: policymakers who do not maximise a specific individual's welfare can very well look like a Leviathan to him or her. Like the policies themselves, so the policy implications of economic integration can be viewed

positively or negatively by country-specific politically decisive coalitions. Subsets of each country's population can very well welcome international competition as a check on the power of policy-makers who implement policies they dislike, and resent international policy competition.

While within-country distributional implications make coordination difficult, political sustainability of international integration is doubtful in its absence because the democratic majorities of heterogeneous countries can hardly all benefit from market integration and the resulting policy reforms (Bertola, 2017). Integration would be unanimously supported if in each country policy were aimed at maximising the average individual's welfare. But if decisive political coalitions everywhere rely more on labour than on other income sources, the same integration that in poor countries boosts labour incomes through capital inflows and regulatory reforms is not politically acceptable in rich countries, where workers suffer the consequences of capital outflows and deregulation.

In the absence of area-wide political decisions processes it is far from easy to establish legitimacy of supranational policy action that influences distribution. Explicit coordination of policies that compromise among conflicting interests in each country however can and should prevent integration and reforms from damaging those who wield political power in their own countries. This can in principle be achieved by smoothing out integration-related reforms and the cross-border implications of both deregulation and tighter regulation. To the extent that distributional effects can be gauged reliably it might also be possible to enhance the political sustainability of market integration with cross-border transfers, which would need to flow from the middle-class decisive agents of capital-poor countries to those of capital-rich countries in times of increasing integration, and in the opposite direction when integration becomes more difficult.

10. DISTRIBUTION, POLICY, AND INTEGRATION

Labour market analysis offers an opportunity to reflect more generally on the flanking measures needed to ensure economic integration's political sustainability. In the European Union competition, workplace safety, state aid, and many other policy fields are subject to binding supranational legislation. Policies with strong and visible distributional implications have so far been assigned to the National level where most political interactions still take place in Europe. Yet it is dangerous to disregard the effects that economic integration exerts on labour and other distributive policies, and not surprising to see that country-specific reforms of these policies are a source of political and economic tensions.

Policies that influence distribution (as most will, in the absence of lump-sum instruments) are controversial and so is economic integration itself, because its impact on market outcomes is uneven across individuals. Like labour policy, so international integration can improve efficiency. It may do so without impacting on distribution if it exploits economies of scale and product variety, which might have been the most relevant mechanism when European market integration involved just a few industrialised countries. The average income implications of integration when countries have widely different factor endowments and institutional infrastructure, however, are easily outweighed by its distributional and policy implications in the eyes of country-specific political majorities.

If integration evens out relative prices and factor income, it can easily be damaging for the owners of factors that are less scarce in the integrated economy than in autarky. And while its income and welfare implications are positive for the average individual in an undistorted market

economy, they can plausibly be negative for decisive individuals who choose policy to address distributional and structural issues (Bertola, 2017). Lump-sum redistribution would in principle make it possible to let all individuals benefit from economic integration, but the necessary information about counterfactual gains and losses is not available in practice.

In early EMU experience the capital flows and labour policy reforms triggered by financial integration and country-specific policy reforms did have significant distributional implications. In theory, integration and the reforms it triggers should benefit workers in poor countries, where capital inflows raise wages and employment, and capitalists in rich countries, who benefit from the higher yield of investment in capital-poor countries. In the data, income inequality was positively and significantly associated with current account surpluses (Bertola 2013, 2016a), as it should if capital income is a larger proportion of income for richer individuals. In capital-rich countries labour incomes should in theory and were in fact relatively reduced by capital outflows and labour policy deregulation. To the extent that this damages the country's political majority, non-economic motives (such as a desire to achieve consensus on German reunification) had to play a significant role in triggering democratic acceptance of monetary and financial integration with capital-poor countries.

Because economic integration does not benefit all countries' political majorities and compensatory transfers are even more difficult to arrange internationally than within countries, in history dissolution of economic borders has been slow, problematic, and most often implemented by wars of conquest (Findlay and O'Rourke, 2009). Consensual European integration was exceptionally supported by a mutual interest in preserving peace through convergence of institutions, cultures, and policies. It has not so far extended to the design and implementation of labour and social policies, which entail technical and political issues more formidable than even adoption of a single currency. Harmonisation or joint administration of policies with "active" motivation, such as retraining and search-conditioned unemployment benefits, would be extremely complex. And while payroll contributions may arguably be closer to value added than to income or wealth taxes, the European Union has no competence on them. Because much of labour policy plays a distributional role, it would be politically as well as technically difficult to design a supranational scheme that could replace or be added to the historically determined payroll tax and benefit schemes of the member countries, and to control its implementation in countries with very different administrative capacities and heterogeneous political interests.

Still, just like a single money was the logical consequence of product market integration (that needs stable exchange rates) and capital market integration (that equalises rates of return), so a common employment and social policy framework should logically be enforced in an integrated area throughout which goods, capital, services, and people are free to move. Steps in that direction should be possible if policymakers and the public recognise that European integration is first and foremost a political project, meant to prevent further wars, to ensure commitment to democracy in countries that (like Spain, Portugal, and Greece) had experienced dictatorship, to ease the post-Communist transition of Central and Eastern European countries, and to provide protection from external threats. The project has so far used market unification as a tool to achieve the ultimate "growth, stability, and cohesion" objectives of European societies. The crisis has triggered different political sentiments and shown the limits of that approach. Economic integration does not automatically deliver peace and prosperity in the absence of accompanying measures, which need to be motivated and implemented by political rather than technocratic methods.

11. A PERSPECTIVE ON EU POLICY DEBATES

Labour policy issues are neglected and sometimes misrepresented in the EU policy framework and debates, but it is myopic and dangerous to sweep difficult issues under the rug. Distributional issues are pervasive, and there is little theoretical and empirical support for a policymaking perspective that lets each country be represented by a benevolent social planner in international relationships – an aggregation of policy preferences that presumes an ability to enact lump-sum transfers inside its borders, and would counterfactually imply that economic integration and policy coordination are unambiguously beneficial.

This essay's interpretation of labour reform evidence admits that distributional tensions are unavoidable and detects their theoretical implications in the data. This perspective may help understand how more clearly structured policy negotiation could address and perhaps resolve the inconsistency of subsidiary decision-making, unfettered integration of product and factor markets, and politico-economically sustainable policies in this and other areas of National welfare states. The insights reviewed in this essay do in fact bear more generally on the sustainability of an economic and policy integration process that in Europe is now endangered by political tensions and unproductive debates that see opposing sides adopt oversimplified and inflexible viewpoints, and are not informed by a clear assessment of the pros and cons of a common economic and policy framework across individuals who, within as well as across nations, have heterogeneous interests as well as shared goals.

It is incorrect and counterproductive to argue that economic integration is good for everybody, or that a specific set of structural reforms is right for everybody. A more constructive approach should admit that each integration step and policy action triggers heterogeneous gains and losses, and seek broad and long-lasting compromises between conflicting interests. Economic research can help if it analyses how and why reality deviates from the perfect and complete markets that in theory would justify a representative agent approach to policy problems, recognises that markets and policies not only maximise production but also resolve conflicting interests in its distribution, and characterises policy tradeoffs clearly to build consensus around sound macro policies and structural reforms.

Because available information is too scarce to ensure that everybody gains, reforms unavoidably create economic losers. Much as one might have hoped that EMU would uniformly improve labour market performance in all member countries, this is not what happened. For sensible theoretical reasons, adoption of the euro triggered capital inflows, higher employment, and labour-friendly reforms in some countries, but capital outflows, lower employment, and unpopular reforms in other countries. The purely economic implications of these patterns are not everywhere positive for country-specific decisive individuals, and they are unlikely to be so large as to trump plausible non-economic motives that played a crucial role in ensuring support for EMU inception, and after the crisis are playing the opposite role.

Countries that did not make their labour market more flexible before the crisis should not necessarily adopt later the labour policies of countries that did and, for that and other reasons, experienced less serious crises. The pros and cons of policies differ across countries and across individuals. This is obvious for labour policies: working more at lower wages may increase aggregate production and capital productivity, but is not a generally attractive option for individuals or countries that predominantly rely on labour income and appreciate leisure. A clearer debate of other policies' diverse pros and cons would also contribute to the single currency's politico-economic stability. For those who represent the interests of a capital-exporting creditor country it is as natural to advocate labour market deregulation as to favor

high interest rates and fear domestic inflation (German Council of Economic Experts, 2016). However, neither all citizens of such a country, nor the average or representative individuals of indebted countries benefit from such policies.

These insights would need to be fed to a less dysfunctional political process than the myopic and rigid ones that currently shape most countries' policy positions, and dominate the intergovernmental negotiations that have largely replaced the slow but comprehensive Community co-decision method. Reforms implemented without a clear understanding of their pros and cons can be a source of instability, as they may only too easily be reversed by future equally myopic decisions. Sensible policymaking is also not well served by equally simplistic technocratic arguments that support specific policy paradigms without admitting that disagreement is both natural and legitimate.

Politics should be the art of reasoned compromise, and policy decisions should rely on well-informed and long-lasting political support. It is poorly supported in doing so by populist attitudes that focus on short-term one-sided issues, disregarding tradeoffs across policies and over time (Andersen et al, 2017). Policy positions in a constructive debate should not package self-interested arguments as a matter of general principle. They should instead recognise that conflicts of interests are unavoidable but can be addressed and composed over time within a stable framework, where labor reforms (and inflation and financial imbalances) can be stabilising, and symmetric across such periods as those that preceded and followed the crisis. Only addressing the distributional implications of economic integration and of policies may protect EMU from the political and economic risk of a permanent reversal of previous European economic integration trends.

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