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Globalization and labor market institutions: International empirical evidence

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ABSTRACT

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A widespread concern is that labor market institutions erode in the course of globalization, which, in turn, decreases employment and wages. By using panel data and cross-sectional data, I investigate the influence of globalization on labor market regulation. I use the indicators of labor market institutions by Gwartney et al. (2012) and the KOF indices of globalization. To deal with potential reverse causality, I employ a system GMM panel estimator and use a constructed trade share as proposed by Frankel and Romer (1999) as an instrumental variable for globalization in cross-sectional models. The results do not show that globalization induced labor market deregulation. *Journal of Comparative Economics* **41** (3) (2013) 829–842. Universtiy of Munich, Center for Economic Studies, Schackstr. 4/I, 80539 Munich, Germany; Ifo Institute, Department Public Finance, Poschingerstr. 5, 81679 Munich, Germany.

1. Introduction

It is often claimed that working conditions of unskilled workers deteriorate in the course of globalization and that jobs of unskilled workers even disappear (e.g., Heine and Thakur, 2011; Stiglitz, 2002; Wood, 1995, 1998).[1] This skeptical view on globalization is held for two reasons: first, internationalization is supposed to increase competitive pressure. Firms, as a consequence, decrease wages, rationalize production processes, and demand more from their workers. Second, globalization is also believed to induce governments to deregulate labor markets to provide advantages to national and foreign investors. Governments may do so, for example, by reducing employment protection, unemployment benefits and minimum wages. More competition between firms and increasing trade liberalization is believed to induce a race to the bottom at the expense of workers, and labor market deregulation, in particular, is often held responsible for deteriorating working conditions and well-being of workers (e.g., OECD, 2004, Chapter 2; Häberli et al., 2012).

While a widespread concern is that globalization adversely influences labor market performance (employment and wages) and labor market institutions, there are gains from specialization according to comparative advantage and benefits from trade.[2] The influence of globalization on labor markets has been investigated using theoretical models and using firm or

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[1] Stiglitz (2002: 84) argues: "We have seen how trade liberalization *accompanied by high interest rates* is an almost certain recipe for job destruction and unemployment creation – at the expense of the poor."

[2] See Gaston and Nelson (2004) on the dissonance between the worries of the average citizen in the course of globalization and economists' point of view.

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plant level data and macro-data. Evidence is mixed and depends on the aspect of globalization investigated (trade openness, foreign direct investment, or outsourcing) and labor market indicators. Globalization influences labor markets in many ways: it directly influences employment and wages as well as labor market institutions, which, in turn, affect employment and wages.[3] Research designs therefore vary with respect to the aspect of globalization investigated and also with respect to labor market indicators (employment, wages, wage equality, unemployment benefits, minimum wage legislation, union density, etc.). Studies that investigate the influence of an individual component of globalization such as trade openness on labor market performance and institutions conclude that globalization affects labor market performance and institutions.

The term globalization has many aspects. Many studies defined globalization as either trade openness or flows of foreign investments. An empirical study examining the influence of globalization on labor market institutions should encompass all dimensions that reflect the multi-faceted face of globalization. There is a need for precision about what is meant by globalization and how the identified elements of globalization can be measured.

Empirical evidence on the influence of globalization on labor market institutions is mixed because labor market institutions vary significantly across countries (e.g. Freeman, 2010; Feldmann, 2003). Labor markets are, for example, less regulated in Anglo-Saxon countries such as the United States, Canada, the United Kingdom, Australia and New Zealand, and are more regulated in countries such as Finland or Norway. Labor market institutions vary across low-income countries but less so than across industrialized countries (Freeman, 2010). In particular, in low-income countries, government regulations are nominally as important as in industrialized countries, whereas unions and collective bargaining are less important. To find out how globalization influences labor market institutions around the world, empirical studies need to exploit the institutional variation across countries.

Globalization-induced labor market effects receive attention in the scientific and public debate because of the broad consequences for perceived social justice as well as efficiency (Hillman, 2008). If globalization erodes labor market institutions that protect jobs and wages, government intervention might be regarded as justified when the focus is on social justice. This might be particularly so if the purpose of international trade policies is to protect labor.[4]

I investigate the influence of globalization on labor market institutions by employing the indicators on labor market institutions of the Economic Freedom of the World (Gwartney et al., 2012), which I use in a panel data analysis and a cross-sectional analysis. Globalization is measured by the KOF indices of globalization by Dreher (2006a) and Dreher et al. (2008a).[5] I use the overall labor market institutions indicator and sub indicators on, for example, minimum wage legislation, and the KOF sub indices on economic, social and political globalization. While globalization is expected to influence labor market institutions, causality between globalization and labor market institutions may be reverse: it is conceivable that flexible labor markets, for example, attract foreign investment. Governments may thus compete in deregulating labor markets in order to attract foreign direct investment. I deal with potential reverse causality by using a system GMM panel estimator and using a constructed trade share as proposed by Frankel and Romer (1999) as an instrumental variable for globalization in cross-sectional models. The results do not show that globalization induced labor market deregulation.

2. Background

2.1. Theoretical background

Globalization is ''transformative'' and influences labor market outcomes such as employment and wages and labor market institutions (Gaston and Nelson, 2004). System competition may induce a ''race to the bottom'' with regard to labor market institutions and regulation of product markets (e.g. Sinn, 1997). Some theoretical models predict how aspects of globalization influence labor market institutions. The model by Boulhol (2009) shows that globalization puts pressure on labor market institutions via two channels: first, ''capital mobility triggers a re-allocation of resources, which trade integration amplifies, away from the high-rent/highly unionized sector. Second, the threat of costly relocations encourages labor market deregulation'' (p. 223). The main mechanism why labor market institutions erode in the course of globalization is that shareholders decide where to invest and where to locate firms. Because capital is mobile, shareholders have many options to invest and, thus, strong bargaining power. Trade liberalization amplifies the firms' bargaining power. Political support for labor market regulation is endogenous. Governments deregulate labor markets because they fear that firms invest in other countries.

The model by Dimitrova and Tchipev (2004) examines how international capital mobility influences labor market regulation and predicts that labor market institutions are not necessarily scaled down in the course of globalization. In fact, the relative strength of the politically active groups determines the direction of the globalization-induced policy response.

[3] Labor market institutions have been shown to significantly influence unemployment: labor market freedom increases employment (e.g., Botero et al., 2004; Feldmann, 2009; Freeman, 2010). Mandated benefits appear to increase labor costs and reduce employment. Minimum wages appear to reduce employment. Weakened employment protection legislation has been associated with lower unemployment. Empirical studies examining the influence of labor market institutions on economic growth provide however mixed evidence. Freeman (2010) concludes that labor market institutions do not influence economic growth.

[4] On the political economy of protection, which studies how interests of different groups are reflected in international trade policy, see Hillman (1982, 1989/2001, 2005), Grossman and Helpman (1994), and subsequent studies.

[5] The KOF index is used to measure globalization in empirical research on the influence of globalization on human development and economic policy-making (see, for example, Dreher, 2006b; Dreher and Gaston, 2008; Bergh and Nilsson, 2010a, 2010b; Bjørnskov, 2010; De Soysa and Vadlamannati, 2011; Bezemer and Jong-A-Pin, 2013; Gaston and Rajaguru, 2013).