Introduction

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This volume contains a collection of papers and discussions presented at the workshop ‘What helps or hinders labour market adjustments in Europe?’ held at the European Central Bank (ECB) in Frankfurt am Main, Germany, on 28 and 29 June 2004. This was the fifth ECB Labour Market Workshop and the second jointly organized with the Centre for Economic Policy Research (CEPR) in London.

It is now widely accepted that expansionary fiscal or monetary policies alone are unlikely to help Europe’s ailing economies. Helping Europe to overcome its economic problems requires the reform of long-lasting economic institutions which influence long-run economic activity and the way the economy responds to macroeconomic shocks, such as changes in the rate of technological progress, the pattern of international trade and changes in oil prices. Examples of economic institutions influencing economic performance include trade unions, which affect real-wage flexibility and the provision of training to workers, employment protection legislation, which discourages firms from firing older workers and also from hiring new ones, the bureaucratic cost of starting up new businesses, which may hamper competition and technology adoption, and the structure of housing market imperfections, which can greatly affect regional mobility.

The volume consists of seven chapters which analyse the effects of institutions on economic performance, from both a theoretical and an empirical perspective. These chapters go beyond the standard approach of exploring the effects of institutions through a narrow focus on aggregate time series. Instead, they contain analyses using microeconomic data and case studies of changes in regulation in specific countries (Portugal, Italy and the Netherlands) to gauge the economic effects of institutions. This has the key advantage of clearly isolating the effects of institutions while other country-specific characteristics remain fixed. We would like to stress that a given institution can improve welfare through some channels and reduce it through others and that the net effect may change over time. Institutions

that in one time period may have had a net positive impact on economic performance may in another period, with a changed macroeconomic situation, have adverse effects. The view that emerges from the book is that institutional reforms should explicitly take into account their detailed functioning and the way they affect real activity.

UNIONS AND TRAINING

Chapter 1, 'New monopsony, institutions and training' by Alison L. Booth, Marco Francesconi and Gylfi Zoega, studies the role of trade unions in oligopsonistic labour markets. It argues that unions can help overcome market failures in the provision of training to workers. Firms' market power creates a wedge between wages and the marginal productivity of labour. Thus workers do not appropriate the whole return from their investment in general human capital and they invest too little in it. Firms are willing to pay for part of the investment, but they tend to provide too little training since workers may quit and employ the human capital provided by the current employer at other firms. The authors show that trade unions can help overcome this market failure, provided that trade unions bargain with firms over the provision of training. The chapter provides empirical evidence suggesting that a greater level of trade union coverage and coordination are typically associated with more firm-provided training, which supports the theory.

REAL WAGE CYCLICALITY IN EUROPE

Chapter 2, 'Cyclicalities of real wages in the euro area and OECD countries' by Julián Messina, Chiara Strozzi and Jarkko Turunen, analyses the cyclicalities of real wages in the euro area and in a group of OECD countries. The properties of real wages over the business cycle are still a matter of some controversy. Even less understood is the effect of institutions on the cyclical volatility of wages. This chapter uses comparable data for a large number of OECD countries and a common methodology to answer these questions. It finds that aggregate real wages have been largely acyclical since the 1970s in the group of countries forming the euro area. In most other OECD countries, in contrast, real wages have been moderately pro-cyclical over the same period. This reflects important differences across countries and in particular the fact that labour market institutions (such as the structure of wage-setting, unemployment benefits and employment protection) affect the cyclicalities of real wages.

OLD-AGE PENSION AND EARLY RETIREMENT

The utilization of labour, measured by the total number of hours worked per capita, has declined substantially in Europe over the last three decades, thus contributing negatively to growth in per capita income. Chapter 3, 'Pension systems, social transfer programmes and the retirement decision in OECD countries' by Romain Duval, analyses the impact of pension systems and other social transfer programmes in accounting for this trend. The chapter focuses on the impact of retirement incentives (such as unemployment and disability benefits, and early retirement subsidies) on the retirement decision of older males by using a panel dataset for the OECD countries. The chapter shows that variation in retirement incentives account for a substantial part of the observed decline in older males' labour force participation in OECD countries over the last three decades. A significant part, however, remains unexplained, which suggests that differences in preferences across countries could also play a role. The chapter describes how different institutions affect retirement decisions and proposes several economic policies that could increase labour utilization in Europe.

EMPLOYMENT PROTECTION

Data on labour market institutions are available for just a few countries and exhibit little variation over time. This is why cross-country analyses have not been able to disentangle the effects of labour market institutions on real activity. Chapter 4, 'The effects of employment protection and product market regulations on the Italian labour market' by Adriana D. Kugler and Giovanni Pica, studies the ways in which product and labour market regulations jointly affect the functioning of the labour market. The authors exploit a regulatory change in Italy in the early 1990s, which made Italian firms with fewer than 15 employees experience a rise in firing costs relative to that of bigger firms. This regulatory change provides a natural experiment to identify the effects of firing restrictions and how they interact with product market regulations. The authors find that more stringent employment protection reduces workers turnover and employment. The effect is particularly pronounced for female workers. The rise in employment protection caused a reduction of around 1 per cent in the employment rate of female workers, while the effects on male employment were tiny. When comparing the effects of the reform across sectors, the authors find that the reform reduced accessions most sharply in sectors where the product market was relatively unregulated. This suggests that reforms that liberalize

both the labour and the product market are likely to be more effective than isolated reforms in just one of the markets.

Chapter 5, 'On the determinants of job flows in Europe: sectoral factors and institutions' by Ramón Gómez-Salvador, Julián Messina and Giovanna Vallanti, examines differences in job flows for a sample of 16 European countries in the 1990s. The chapter uses homogeneous data for continuing firms in different sectors of the economy. The authors find that sectoral characteristics are important determinants of labour market flows. Across countries, service industries typically exhibit more worker turnover. The authors also analyse the ways in which job flows vary for firms of different sizes, ages and capital intensity. They show that job reallocation tends to be higher among smaller and less capital intense firms. By exploiting cross-country variation, the chapter also documents the ways in which employment protection legislation, labour taxes and unemployment benefits are negatively associated with job reallocation. Interestingly employment protection legislation appears to have stronger negative effects in the industrial sector than in the service sectors. This may partly be the results of the introduction of atypical, more flexible employment contracts in the service sector.

HOUSING AND LABOUR MOBILITY

Chapter 6, 'The effect of home-ownership on labour mobility in the Netherlands' by Michiel van Leuvensteijn and Pierre Koning, investigates the relationship between home-ownership, labour mobility and unemployment in the Netherlands. Owning a house may discourage workers from moving despite a high and persistent unemployment rate. Previous studies based on macroeconomic data document that home-ownership rates tend to be higher in countries with high unemployment and little labour mobility, which may suggest that home-ownership may cause unemployment. The chapter provides new empirical evidence on the effects of home-ownership on labour market performance. It documents a negative relationship between home-ownership and labour mobility in the Netherlands and it examines whether the relationship is driven by unobserved factors that jointly affect home-ownership and job mobility decisions. The main conclusion of the analysis is that, after controlling for these unobserved factors, home-ownership does not appear to constrain job mobility in the Netherlands.

In Southern European countries young adults tend to live with their parents longer than in many Northern countries. For example in Spain, Portugal and Italy the fraction of young adults residing with their parents is around two-thirds. This may explain why in these countries young workers are relatively unwilling to move to another region to escape high

local unemployment. Chapter 7, 'The impact of credit constraints on household formation' by Nuno C. Martins and Ernesto Villanueva, proposes a possible explanation for this phenomenon. In particular the authors investigate whether it is partly the result of the fact that young adults are more credit constrained in Southern Europe than in other European countries. Credit constraints could prevent young adults from buying a house, forcing them to remain with their parents. To investigate the role of credit constraints the authors exploit a regulatory change in Portugal: the 1998 reforms of the Portuguese *Credito Bonificado* programme. The programme subsidizes mortgage borrowing of young individuals whose income is in the lower three quartiles of the income distribution. The '1998 reforms' put a ceiling on the price of a house that could be financed through the programme. This change affected mostly individuals living in areas with high house prices. The chapter shows that the effects of the reforms vary depending on the income of the individual. The effect is basically zero for low-income individuals, while for high-income individuals the reforms led to an increase in the probability of co-residence in the parental home of about 12 percentage points. This suggests that young adults do respond to housing subsidy incentives.

To sum up, the volume provides new evidence about the effects of institutions on an economy's dynamic response to adverse aggregate shocks and on long-run economic performance. The chapters analyse the effects of labour market institutions such as trade unions and employment protection legislation, as well as the effects of a broader set of institutions including product market regulations, housing market imperfections and welfare payments. A number of chapters in this volume exploit microeconomic data and natural experiments, an approach that appears quite promising in extending our knowledge of institutions and their importance for the economy.