

Introduction

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This volume consists of a series of papers and discussions presented at the workshop entitled ‘What Explains the Pattern of Labour Supply in Europe?’ held at the European Central Bank (ECB) in Frankfurt am Main, Germany, on 23 and 24 June 2003. This was the first labour market workshop jointly organized by the ECB and the Centre for Economic Policy Research (CEPR).

The aim of the workshop was to analyse the developments of labour supply in Europe and to assess their link with economic policies and labour market institutions. Notably, differences in tax systems (labour income) and in social protection systems (non-labour income) are expected to strongly affect individuals’ decisions to supply hours in the labour market. In turn, labour supply developments have key implications for wages, prices, potential output and economic and social welfare in general. In the short run, the cyclical sensitivity of labour supply can affect labour market tightness and thereby influence the outlook for wages and prices. In the longer run, labour supply (together with other factors) is a key determinant of potential output. Policy decisions need to account for this interplay between institutions and market outcome.

The study of labour supply patterns in Europe was broken down into three main themes within the workshop. The first covered incentives to work. The second considered several economic and institutional factors affecting labour force participation. The third addressed the role played by the emergence of new forms of employment relationships in labour market developments. These themes were mainly addressed at the general European level or within individual European countries, and in some cases by comparing the European labour market experience to that of other OECD countries.

In view of the possible changes that the European labour market may face with the increase in the number of countries participating in the EU, a panel discussion on the topic ‘Labour supply in an enlarged Europe’ closed the workshop.

INCENTIVES TO WORK

It is frequently argued that in many European countries, labour market institutions – such as state pension benefits, unemployment benefits and disability benefits – reduce the incentives to work and participate in the labour market. At the same time active labour market policies (ALMPs) – consisting of public training programmes, job search assistance, subsidies to employment and direct job creation and designed to bring the unemployed back into work – have been put in place in these countries. Such policies may offer only piecemeal solutions since they do not address the underlying structural problems determining incentives to work. Moreover, such policies and benefits need to be funded via taxes, which may also influence the incentives to participate.

Issues surrounding incentives and disincentives to work and/or to participate in the labour market are at the forefront of the first two chapters in this volume. In Chapter 1 Andrew Brigden and Jonathan Thomas consider the role of inactive individuals in labour market outcomes in ‘A matching model of non-employment and wage pressure’. They develop a matching model with variable search intensity assuming two types of non-employed people: those with low levels of search effort and high values of leisure time and home production – defined as inactive – and those with higher search effort and a lower value of leisure time and home production – defined as unemployed. They calibrate the model for a range of different shocks, using the UK as a case study, and examine the behaviour of inactivity, unemployment and wages. Their results suggest an important role for unemployment benefits in the observed labour market outcomes.

Chapter 2 comprises Steven J. Davis’s and Magnus Henrekson’s study ‘Tax effects on work activity, industry mix and shadow economy size: evidence from rich country comparisons’. This chapter investigates the long-run total response of working time and other economic activity indicators to differences in tax rates on labour income, payrolls and consumption. To guide their investigation, the authors develop a theory of time allocation and task assignment between market and non-market production sectors. The theory, which is confirmed by empirical evidence from 19 rich countries in the 1990s, implies that higher tax rates reduce working time in the market sector, increase the size of the shadow economy, shift the industry mix of market activity and alter the composition of labour demand so as to amplify negative effects on hours of work and employment, particularly for the less skilled. Specifically, a unit standard deviation tax rate change of 12.8 percentage points is found to be associated with 122 fewer hours of market work per adult per year, a 4.9 percentage point reduction in the employment–population ratio, an increase

in the size of the shadow economy amounting to 3.8 per cent of GDP and a 10 to 30 per cent drop in employment shares in some sectors.

FACTORS AFFECTING LABOUR FORCE PARTICIPATION

Four chapters in this volume seek to shed some light on the factors affecting labour force participation. Chapters 3 and 4 illustrate the significant changes observed in women's participation, both in Europe and the USA, over the second half of the 1990s and relate these changes to cohort effects, personal characteristics and changes in the labour market institutional framework. Chapters 5 and 6 investigate how recent developments in labour market institutions may have affected participation trends for different demographic groups, using a macroeconomic and then a micro-economic perspective.

In Chapter 3, Shirley Dex, Siv Gustafsson, Andrew Jenkins, Heather Joshi, Eiko Kenjoh and Mark R. Killingsworth investigate changes in the labour supply of mothers in Britain, the USA and Sweden during the latter part of the twentieth century. They detect sizeable changes in labour supply from one cohort to the next, particularly among women with less than higher education and among women with children. The authors' purpose is to investigate whether these changes are explained by inter-cohort changes in measured characteristics, particularly education, or whether there are substantial cohort effects *per se*. For that purpose, they focus on two important margins of adjustment in female labour supply, that is, women's time to first birth and time to entry (or re-entry) into the labour market after the first birth. The fact that women with higher educational attainment tend to postpone motherhood is the only consistent finding, while the relationship between the level of education and the probability of re-entry and cohort effects are less clear-cut.

In Chapter 4, 'Women's hours of market work in Germany: the role of parental leave', Monika Merz documents empirical facts on women's involvement in the labour market in Germany, looking at both participation and hours worked, and the link between these empirical facts and some changes in the institutional framework. The evidence from the 1950s illustrates a trend increase in women's participation, which differs depending on their marital status and age, and which has been accompanied by a notable decline in hours worked, especially for those with young children. It is concluded that the decline in married women's weekly hours worked is to some extent related to institutional changes in the federal legislation governing parental leave.

Chapter 5, 'The determinants of labour force participation in the European Union', by Véronique Genre, Ramón Gómez-Salvador and Ana Lamo, illustrates recent trends in labour force participation in the EU and studies the role of economic factors and of several labour market institutions in shaping these trends during the past two decades. The chapter relates the participation rates of women and men of different age groups to economic and institutional factors using country-level panel data. The rich data set used by the authors contains sufficient time variation in measured labour market institutions, and allows them to identify the impact of institutions on participation after controlling for country fixed-effects. The main finding of the chapter is that the generosity of the unemployment benefit system, the strictness of employment protection, and union density tend to be associated with lower participation rates of groups with presumably lower labour market attachment such as women and older workers.

Chapter 6, 'Hiring incentives and labour force participation in Italy', by Piero Cipollone, Corrado Di Maria and Anita Guelfi, investigates how the quality composition of available jobs has recently affected labour force participation in Italy. In particular, the authors focus on the likely impact of a labour market programme introduced in Italy in 2000, which offered a substantial tax credit to firms hiring workers under open-ended contracts (as opposed to fixed-term contracts). This reform is supposed to improve participation incentives by increasing the share of permanent jobs in total job opportunities. The authors test this idea on micro-data from the Italian Labour Force survey, using a difference in difference approach. This is possible thanks to the cross-sectional variation in the applicability of the tax credit, which was only available for hires of workers aged 25 or more. The authors' estimates show that the introduction of the tax credit raised the participation of eligible groups by almost 2 percentage points above that of non-eligible groups.

NEW FORMS OF EMPLOYMENT RELATIONSHIPS

Until the mid-1970s the basic legal instrument regulating employment relationships in Europe was the full-time employment contract of indefinite duration. Increased economic integration, intensified competitive pressures and rapid technological progress on the demand side, along with the expansion of higher education, increased mobility and the effect of an ageing society on the supply side, have catalysed the need for new forms of employment relationships. Against this background, policy changes in EU countries over the last two decades have aimed to promote new forms of employment relationships, such as part-time and temporary employment.

Important issues surrounding these new forms of employment relationships are the topic of two chapters within this volume. Hielke Buddelmeyer, Gilles Mourre and Melanie Ward shed some light on the experiences of part-time work in Europe in Chapter 7, 'Recent developments in part-time work in EU countries: trends and policy'. They find that institutions and policy developments in Europe contribute to shaping both the time and cross-country development of part-time rates and have facilitated the growth of part-time employment. The authors argue that this supports economic performance in Europe, helping to raise the employment rate. In addition, part-time employment contributes to the achievement of higher levels of productivity by allowing workers to balance their professional life and private life and allowing employers to adjust working hours to business requirements. Nevertheless, policies designed to promote part-time work could have perverse effects for long-term productivity if part-time workers suffer lower hourly remuneration, insufficient access to training, lack of career development, and so on, with the consequent distortions in human capital investment. The authors argue that to be fully effective, employment policy should support voluntary part-time work.

In Chapter 8, 'Matching workers to jobs in the fast lane: the operation of fixed-term contracts', José M. Varejão and Pedro Portugal investigate the use of fixed-term contracts in Portugal. The Portuguese labour market is particularly interesting in this case due to the relative strictness of employment protection legislation on permanent positions and the recent increase in the use of fixed-term contracts, which currently account for nearly two-thirds of newly offered positions. Analysis of worker flows between labour market states reveals that temporary jobs are associated with a higher degree of job churning than permanent positions, but that a non-trivial share of all fixed-term contracts become permanent. Varejão and Portugal argue that there is significant evidence for the use of fixed-term contracts as screening devices by workers and firms. Interestingly however, for workers in more advanced stages of their careers, holding a fixed-term position following a job loss episode implies the loss of returns to experience, harming both wage and future employment prospects.

PANEL DISCUSSION – LABOUR SUPPLY IN AN ENLARGED EUROPE

In the panel discussion devoted to 'Labour supply in an enlarged Europe', several, if not all, aspects of labour market analysis are addressed: employment, wages, human capital, migration, labour market institutions and incentives to undertake reforms.

Francesco Paolo Mongelli investigates the evolution of employment and wages in a survey of various works on the effects of the European Monetary Union on labour markets. The bottom line of his discussion is that, although it is too early to fully assess the impact of monetary unification on labour markets, we can be confident that the most pessimistic forecasts have not materialized. Indeed, one can see some evidence of convergence to the Lisbon target of a 70 per cent employment to population ratio, although progress has been slower than expected. Mild optimism is shared by Dennis J. Snower, who dismisses the view that enlargement to the East should necessarily involve a 'race to the bottom' in making labour markets more flexible. For this to hold, factors of production and goods must be very mobile across countries. Snower stresses that capital flows between the former European Union and Central and Eastern European countries have remained low until recently and that migration flows will also remain at low levels in the near future. He agrees with Herbert Brücker in this, who distinguishes between static and dynamic estimates of migration flows in order to take account of transitional periods imposed in most countries during the enlargement process. His conclusion is that the East–West migration potential is moderate, that is, around 1 per cent of the EU-15 population. Etienne Wasmer also stresses the low mobility potential of enlargement, due to ageing populations both in the East and in the West. Wasmer expresses doubts about the neglect of transition costs in the enlargement process. Notably, the existence of specific skills in traditional sectors and the absence of ambitious redistribution schemes of the magnitude of past enlargements (Spain, Portugal, Greece and Ireland), combined with large GDP per capita differentials between the East and the West, will make the transition costly. Finally, most contributors, and notably Juan J. Dolado and Francesco Paolo Mongelli, insist on the necessity of labour market reforms given the slow progress made with these to date. Dolado makes a distinction between the demand for social protection from private agents (firms and workers) and the supply of protection from institutions and governments, indicating a possible mismatch between the former and the latter.