European Integration Consortium:
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The Impact of Eastern Enlargement on Employment and Labour Markets in the EU Member States

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This research is carried out on behalf of the Employment and Social Affairs Directorate General of the European Commission (contract SOC-97-102454). The views expressed are those of the researchers only and do not engage the Commission.

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Final Report

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Executive Summary

The purpose of this study is to analyse the impact of Eastern Enlargement on employment, wages and income distribution in the present EU member states and to evaluate policy options that could enhance both the potential for net job creation and mitigate any undesirable distributional effects of accession. The analysis is focused on three main dimensions of economic integration: (i) trade in goods and services; (ii) migration of labour; and (iii) capital movements.

Although the distinct gap in per capita income levels and factor endowments between the EU and the central and eastern European countries (CEECs) is bound to persist for decades, it is unlikely that the removal of the remaining barriers to trade and factor mobility will create severe tensions in the EU labour markets. In economic terms the CEECs are rather small, which means that trade and capital flows originating from these countries or directed to them are unlikely to affect prices, at the aggregate level in the EU, in the goods markets and hence for wages and employment. As the convergence of per-capita incomes in the CEECs to levels prevailing in the EU will be a fairly long process, migration will certainly increase once free movement will be introduced. The estimation results suggest a net immigration of some 335 000 residents following an assumed removal of barriers to migration in 2002. According to past experience, around 35 per cent of these will be employees. Concerns that EU labour markets will be swamped by migrants from the CEECs therefore seem to be ill-founded. Although Eastern Enlargement will not affect wages and employment at the aggregate level, trade and factor movements may well have a non-negligible impact on the regions immediately bordering the CEECs and on specific sectors that are more exposed to import penetration from the East. These distributional effects of accession can be magnified because western European social-welfare institutions are often not supportive of labour mobility across sectors and regions.

The report contains two parts: In the first part the likely impact is analysed of Eastern Enlargement on trade, migration and capital movements, as well as the implications for employment and wages amongst the present EU membership. The second part evaluates the set of policies that could reduce undesirable effects of enlargement and at the same time enhance its potential for job creation. The scope for a harmonisation of labour-market institutions in the candidate countries and in the EU member states is also discussed.
Executive Summary
Part A

The key findings of the first part of the report concern:

- the initial difference between the EU and the CEECs in terms of incomes and factor endowments and the prospects for convergence;
- the impact of the removal of trade barriers on wages, employment and income distribution in western Europe;
- the impact of integrating capital markets in the East and the West of Europe;
- the impact of opening EU labour markets to migration from the CEECs.

1. The income differential and prospects for convergence

The economic conditions at the outset of Eastern Enlargement are characterised by a distinct gap in per-capita incomes between the present EU members and the accession candidates, which can be traced back to differences in factor endowments and factor productivities. With per-capita incomes in the CEECs between 15 per cent, at current exchange rates, and 38 per cent, at purchasing power parities, of the respective levels of the present EU member states, the gap is considerably wider than in past accession rounds. However, the variance of income levels across individual CEECs is also large: per-capita GNP levels at current exchange rates vary between 7 per cent and 44 per cent, and at purchasing power parities between 22 per cent and 70 per cent, of respective figures in the present European Union.

The income gap corresponds to a distinct difference in endowments of physical and human capital. Physical-capital stock levels in the CEECs are, at around one-tenth, significantly below the EU average. Human-capital endowments, measured by formal indicators such as school enrolment rates and average years of schooling, are below those of most EU members. Moreover, there is evidence that the quality of education falls short of average standards in the EU. Nevertheless, human-capital endowments of the CEECs are largely relative to those of countries with comparable income levels. Moreover, although the CEECs are small in terms of output and capital stocks, their labour force amounts to around 30 per cent of that in the present EU. Average wage levels amount, at current exchange rates, to around one-tenth and, at purchasing power parities, to one-quarter of respective levels in the EU. The available information on factor endowments and factor prices indicates that the CEECs are richly endowed with labour relative to the European Union, while the EU is richly endowed with physical capital relative to the CEECs. Nevertheless, the large gap in per-capita incomes cannot be solely attributed to differences in factor endowments; total factor productivity is substantially lower in the CEECs than in the EU, and this can be traced back to technological differences, to the prevailing institutional framework, and to endowments available within the public infrastructure.

Although economic theory provides no clear-cut answers as to whether incomes of rich and poor economies tend to converge, empirical measures of convergence indicate that per-capita incomes of the present EU members have actually converged throughout the period since the Second World War. However, convergence is a long-term process. On the basis of the convergence rates observed in the EU in the post-war period, the half-life of the CEEC–EU income gap would amount to more than 30 years. The growth record of the CEECs following the trough of the transitional recession does not suggest that convergence can be faster in this case. Thus, any realistic policy scenario has to acknowl-
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edge that large income differentials are likely to persist for decades rather than for years. Hence, it is all the more important that policies to promote growth in the CEECs should be given a high priority in order to mitigate pressures on EU labour markets as a result of economic integration.

2. The impact of trade

Trade in goods is the single dimension of economic integration that has proceeded farthest within Europe. With the notable exception of agriculture, tariffs and quantitative barriers to trade between the EU and the candidate countries have been almost abolished. An accession of the CEECs to the EU will change the conditions for trade, mainly by integrating the CEECs into the Common Agricultural Policy (CAP) and by harmonising product-quality standards and product-liability rules.

In the course of transition and integration, trade between the EU and the CEECs has boomed. Between 1988 and 1999, exports from EU countries to the CEECs grew by a factor of 6.5, and exports from the CEECs into the EU grew by a factor of 4.7. However, potential trade between the EU and CEECs is not yet exhausted; this applies in particular to countries that have been less involved so far in trade flows (i.e. Portugal, France and the United Kingdom). Actual exports from the EU to the CEECs in 1998 were at one-half of “normal” export volumes among EU countries of the same characteristics, and at 40 per cent of “normal” import volumes. Indeed, the trade surplus of the EU with the CEECs is expected to double in the wake of increasing EU investments in the CEECs. Although empirical evidence indicates that trade volumes of EU countries with other member states are between 20 per cent and 60 per cent higher than the levels prevailing with non-EU countries, it is worth noting that the conditions of trade with CEECs already resemble those applicable to other EU members. Thus, the further impact of accession on the trade potential is likely to be fairly moderate.

Trade theory predicts that the integration of economies with large differences in factor endowments yields large benefits in terms of income and consumer surplus at the aggregate level, but that the gains and losses are unevenly distributed among the individual factors of production. More specifically, the integration of the CEECs into the EU markets for goods and services could affect wages and employment through increasing imports of labour-intensive goods and through exports of physical-capital- and human-capital-intensive goods, which would in turn not only increase the relative price for physical capital and human capital but also decrease wages for unskilled labour. Indeed, actual trade flows between the EU and the CEECs clearly reflect differences in factor endowments and technological know-how. The European Union exports to the CEECs a range of goods that are produced with a high intensity of physical capital and highly skilled labour, and it imports goods with high labour intensity from there.

However, two arguments suggest that these trade flows have no economy-wide impact on relative wages and employment in the present EU, even in the most affected countries, as follows:

- Despite its notable dynamics, trade volumes are too small to affect prices in open economies. The shares of EU exports to, and EU imports from, the CEECs, as measured against gross domestic product (GDP), are comparatively modest, at around 1 per cent. Even in the most affected countries, exports and imports do not exceed 4 per cent of GDP. To have an effect on relative wages in open economies, the CEECs must become marginal suppliers for labour-intensive goods, and this is not likely in view of those dimensions. An analysis of the impact of
trade on wages, employment and labour mobility based on microeconomic data of individual labour-market performances in selected countries (i.e. Austria, Germany and Sweden) confirms this hypothesis.

- A huge gap in unit values between EU exports to, and EU imports from, the CEECs indicates that the CEECs are not specialised in the same quality segments of markets as are producers in the EU. But if the European Union and the CEECs are completely specialised in different kinds of goods, all factors of production would benefit from increased trade and relative wages would be unaffected.

The fact that trade between the EU and the CEECs is too small to change relative wages and employment at the aggregate level does not rule out that specific sectors and regions are affected – provided that transport costs are high and factor mobility is limited. Geographical proximity plays a key role in trade between the European Union and the CEECs; three-quarters of all EU trade with the CEECs is carried out by countries immediately bordering them – i.e. by Austria, Germany, Greece, Italy and Finland. In these countries, the share of trade with the CEECs in total trade and GDP is markedly higher than in other EU countries. Moreover, some regional trade data from Austria and Germany indicate that, within these two countries, exporters to and importers from CEECs are concentrated in the border regions. If the impact of trade on wages and employment can be felt at all in the present EU member states, then it is in those border regions.

At the sectoral level, rather large trade shares of the CEECs in sectors such as clothing and footwear indicate that wages and employment of the unskilled might be negatively affected there, while the more capital-intensive textiles sector experiences a large trade surplus with the CEECs. Furthermore, construction workers in some German regions might be negatively affected by imports of the respective services from the CEECs. Conversely, large surpluses of exports can be observed on the EU side in physical-capital- and human-capital-intensive industries such as communications equipment, measuring instruments, computers and motor vehicles. It is worth noting that these surpluses are accompanied by rising shares of intra-industry trade. Large differences in unit values indicate that this intra-industry trade is of the vertical type, i.e. that physical-capital- and human-capital-intensive activities are located in the European Union and labour-intensive activities in the CEECs. Moreover, an increasing segmentation of production processes between the EU and the CEECs may affect wages and employment of the unskilled. Despite all this, trade volumes are too small to expect significant effects beyond some specific regions.

It is often supposed that the large surplus in EU trade with the CEECs is a job-generating machine. Indeed, a combined trade surplus of some US$15 billion was reached by the European Union in 1999 in relation to the CEECs. The trade surplus has increased since the opening-up of CEECs and their economic reform. Moreover, increasing capital transfers in the wake of accession to the EU will be mirrored by mounting surpluses of the trade balance. The deficit in the trade balance may double in the course of accession. Analyses of the labour services incorporated in traded goods indicate that, on a net basis, several tens of thousands of jobs are secured by trade with the CEECs. However, it has to be taken into account that the trade surplus is financed by a deficit in the capital balance, i.e. that income is transferred from the EU to the CEECs.

Another concern is raised by the southern EU countries, which fear that they may be indirectly affected by Eastern Enlargement because other EU countries could replace trade with them by trade with the CEECs. Three findings suggest that these concerns are ill-founded: first, no evidence has been found that exports of low-income EU mem-
bers to the major CEEC trading partners in the EU have fallen in the course of the trade surge with the CEECs; second, the pattern of EU imports from the CEECs and from the southern EU members is only slightly different from the pattern of EU imports from the CEECs and from other industrialised countries; third, distinct differences between unit values for EU imports from the CEECs and from the southern EU members indicate that producers from the accession countries do not compete in the same market segments with producers from the southern EU members. Overall, the impact of trade with the CEECs is likely to be confined to bordering countries, and within these countries, will be concentrated on bordering regions.

3. The impact of capital movements

The barriers to foreign direct investment and other capital movements have been largely removed. However, certain shortcomings in the regulation and supervision of capital markets and the banking systems are still present. From the perspective of the present EU members, capital flows to CEECs are negligible: an annual net capital flow of around US$15 billion corresponds to a share of 0.15 per cent of GDP and 0.8 per cent of gross fixed investment in the EU in 1999. This is too small to expect any impact on interest rates and factor incomes in economies with open capital markets such as the EU members. However, from the standpoint of the candidate countries, total annual capital inflows amount to 6 per cent of GDP and 24 per cent of gross fixed investment. Those inflows have thus contributed significantly to capital formation, relieving domestic capital markets in the CEECs and having a substantial impact on growth, interest rates and wages.

Foreign capital flows to the CEECs largely take the form of foreign direct investments. Cumulative net inflows of foreign direct investment (FDI) into the CEECs amounted in total to around US$70 billion between 1991 and 1999, while cumulative net inflows of portfolio capital were around US$40 billion during the same period. During the early stages of transition, portfolio capital inflows have been well below those into other countries of comparable income, but in due course they are expected to reach levels that are considered “normal” for such countries.

In general, capital flows vary widely across countries and over time, so that future capital flows to the CEECs are hard to forecast. Experience from past enlargement episodes demonstrates that accession to the EU can considerably increase capital inflows, at least for a transitional period. Furthermore, our projections for the trade potentials imply that capital flows to the CEECs are significantly less than “normal”, since trade and current-account deficits are usually matched by capital inflows. Capital flows to the CEECs may double in the wake of accession, and the inflow of portfolio capital is likely to accelerate as the harmonisation of the regulation of financial markets gains momentum. Although such an increase in capital movements from the EU to the CEECs is still too small to affect interest rates and relative factor incomes in the EU, it may nevertheless contribute significantly to growth in the CEECs and income convergence.

It is often feared that labour-intensive production is relocated from the European Union to the CEECs through FDI. However, a detailed analysis of the structure of foreign direct investment does not confirm these concerns. Nearly one-half of the foreign direct investment from the EU to the CEECs is directed at non-tradable sectors (i.e. public utilities and communication, financial intermediation, and other services). The sectoral structure of investment, as well as enterprise polls, indicate that market access is the primary investment motive. Around one-fifth of foreign investment is allocated to industries where low labour costs play a significant role and the share of unskilled labour is relatively
high. This holds true for clothing and footwear, electrical machinery, and rubber and plastic products. In these sectors, a distinct gap in the capital intensity of production between the parent companies and their foreign affiliates can be observed. Furthermore, the respective FDI is highly correlated to increasing shares of intra-industry trade, which is an indication that production processes are increasingly segmented in human-capital-intensive activities on the EU side and labour-intensive activities in the CEECs.

Overall, only a minor part of FDI is driven by low wage costs in the CEECs such that home production is replaced; the major part of FDI is aimed at market access. These investments are either neutral for employment and wages in the home countries or they complement trade, thus having a positive impact on employment and wages in the affected enterprises and sectors. However, some FDI tend to foster the specialisation of production in human-capital-intensive processes in the EU and labour-intensive production in the CEECs, which may hurt the wages and employment of unskilled workers in specific enterprises and sectors. It is worth noting that large trade surpluses in relation to the CEECs can be observed in these sectors, so that undesirable effects of FDI on the wages and employment of unskilled workers could be compensated for by increasing exports.

4. **The impact of migration**

Ten years after the fall of the Berlin wall, the migration flows from the CEECs are still heavily restricted by the EU members. The Europe Agreements (EAs) do not impair the authority of individual EU members to regulate the immigration of labour and persons from the CEECs. The removal of the barriers to labour migration is therefore that dimension of economic integration that will see the most marked change as a consequence of the Eastern Enlargement of the European Union. Present numbers of employees and residents from the CEECs within the EU clearly reflect the restrictions to labour mobility and are, in view of the large gap in per-capita incomes, negligible. The number of foreign residents who have emigrated from the CEECs to the EU is estimated at some 870,000, while the number of foreign employees amounts to about 300,000. The latter figure includes the full-time equivalent of temporary and seasonal workers. Such figures account for 0.2 per cent of the EU population and of the EU workforce. Around 80 per cent of the migrants from the CEECs reside in Austria and Germany.

The majority of these migrants arrived in the EU before 1993; since then, net immigration from the CEECs to the EU has been negligible as a result of increasing restrictions in the countries of destination.

The findings presented above do not suggest that trade and capital movements can lead to an equalisation of factor prices; a large gap in wages is likely to persist and monetary incentives to migration remain high during the accession process. However, international migration is hindered by high transaction costs and by the absorption capacity of labour markets in the countries of destination. The estimation of migration potential in this study is based on a time-series model of immigration to Germany between 1967 and 1998, which explicitly takes into account the formation of expectations. This model allows estimation of the long-term potential of foreign inhabitants from the CEECs, as well as the speed at which adjustment to this potential takes place. The most important variables are

- the differences in per-capita income;
- the employment rate in the destination countries; and
- the employment rate in the countries of origin.

Beyond this, institutional restrictions on migration and the variables that reflect long-term differences in country characteristics such as common language and indicators for the
standard of living have proved to have a significant impact on migration. Indeed, the results of our own study show that the propensity to migrate decreases with the increasing proportion of the population that has already emigrated. Networking effects, which are created by a core group of migrants, influence the distribution of migrants between the countries but do not lead to a permanent increase in migration.

However, our estimates cannot take into account all the factors that affect migration. Moreover, the future development of key variables, such as GDP growth and employment, are uncertain. The projections should therefore only be seen as a clue to the magnitudes of future migration from the CEECs, in particular not as a point forecast.

Results from this study indicate that, for the present EU as a whole, the number of foreign residents from the CEEC-10 into the EU-15 is likely to increase by around 335 000 people per year immediately after the introduction of freedom of movement, but within a decade this figure is expected to have fallen to below 150 000 people. The peak in the foreign population originating from the CEECs is expected to be reached 30 years later, with a 1.1 per cent share of the population in the EU-15. For Germany alone, that country is expected to receive 220 000 CEEC immigrants immediately after freedom of movement is introduced, and the peak in the foreign population originating from the CEEC-10 is expected to be reached 30 years later with a share of 3.5 per cent of the German population. These projections are based on the assumptions that per-capita incomes between the EU and the CEECs converge at a rate of 2 per cent annually and that the unemployment rates in Germany and the CEECs remain constant. Altogether, our estimates show that, in view of the large income gap, the foreign population will increase markedly in the most affected countries of the EU-15; however, this increase will be spread over a number of decades. This expectation can be traced back to the high transaction costs of migration and limited absorptive capacity of the labour markets in the destination countries. Of course, these projections rely on the proviso that the experiences of migratory movements in Europe after the Second World War can be applied to the CEECs and that the determinants of migration are adequately depicted. However, fears that the European Union will be swamped by immigrants from the CEECs as a result of free movement of labour seem to be ill-founded.

Economic theory predicts that migration enhances aggregate welfare in both the home and the host countries. However, the gains and losses are not distributed equally across the factors of production: while factors complementary to migrant labour are supposed to gain from migration, factors that can be substituted by immigrant labour may lose out. In particular, it is feared that unskilled labour may lose out from migration in terms of wages and employment in host countries. The findings of this report, as well as the findings of a number of other studies, suggest that undesirable effects of migration are concentrated on blue-collar workers in manufacturing industries and on unskilled labour in services. Nevertheless, the impact of migration on the labour-market performance of nationals is much smaller than widely believed. The reason is that migrants move into prosperous sectors and regions and that, furthermore, output and investment adjust according to the increase in the labour supply. Our study has found that, in any given sector, an increase in the migrant share by 1 percentage point decreases average wages there by 0.25 per cent in the Austrian and 0.6 per cent in the German regressions. At the same time, the individual risk of dismissal increases by 0.8 percentage points in the Austrian and by 0.2 percentage points in the German sample. The impact of migration on white-collar workers is slightly positive or neutral. Thus, since an increase to the share of foreign workers from the CEECs is expected to last for rather a long time, the impact...
Part A

of migration on wages and employment is likely to be rather moderate even in the two most affected countries, namely Austria and Germany.

Moreover, the impact of migration might be more dispersed across skills groups in the case of immigration from the CEECs than in case of traditional immigration. Formal education levels of migrants from the CEECs are surprisingly high. Nevertheless, the sectoral structure of employment shows that nationals from the CEECs are employed in the same branches as other foreigners and, most probably, at the same qualification levels. Furthermore, additional information on the labour-market performance of ethnic Germans who have emigrated from CEECs suggests that the returns on human capital attained are extremely low even when migrants possess good language skills. Although immigrants from the CEECs compete at present for jobs in manufacturing and construction sectors with blue-collar workers and unskilled workers, over time they may become more able to adapt to other skills profiles and demands within the EU labour markets, and hence increasingly compete with the more highly skilled indigenous workforce.

Part B

The main recommendations developed in the second part of the report concern the following four policy areas:

• policies to mitigate the impact of structural change;
• policies to foster worker mobility across regions;
• the political economy of regulating migration from the candidate countries;
• policies to promote the convergence of incomes.

5. Policies to mitigate the impact of structural adjustment

The first part of the report concludes that CEECs integration into the goods, capital and labour markets of the European Union will significantly affect only labour markets of the EU bordering regions. Eastern Enlargement, however, will deeply affect goods and factor prices in the CEECs, where a marked shift in production and employment away from resource-intensive to labour-intensive industries should be expected, accompanied by the furtherance of the ongoing shift of employment from primary and secondary sectors to services.

In order to mitigate any potentially adverse effects of Eastern Enlargement on employment and income distribution, economic policies should accommodate, rather than oppose, structural change both in the CEECs and in the current EU members. Sectoral shifts caused by changing specialisation patterns can be better accommodated by flexible labour-market institutions and income-support schemes. This is one of the main lessons that can be learned from other enlargement episodes. The striking contrast between post-accession unemployment dynamics in Portugal and Spain, for example, provides a particularly good illustration of the advantages of having a number of institutions in the acceding countries providing income support and employment protection without hindering labour mobility. High employment protection in Spain, in combination with rather generous unemployment benefits, made the re-absorption of the unemployed back into the workforce more difficult – although, significantly, strong obstacles to dismissals did not prevent mass labour-shedding. Flexibility in wage
determination in Portugal was a major factor behind the low post-accession unemployment rate experienced by this country (and such wage moderation did not translate into high outflows of workers). The NAFTA experience also points to the benefits of having flexible labour markets in the West. Free trade with countries such as Mexico, at GDP per-capita levels relative to the United States comparable to those of the CEECs relative to the EU, led to a significant reallocation of workers. Yet this did not involve net employment losses, because North American labour markets accommodated such shocks without large and persistent flows into inactivity.

Hence, it seems better to develop institutions coping with (rather than opposing) structural change. Non-statutory firing costs agreed in collective bargaining, the emphasis advanced notification of dismissals rather than on procedural obstacles to lay-offs, unemployment benefits of rather short duration and allowance for in-work benefits, and minimum wages differentiated by age are all good examples of the kind of institutional policies that could provide sufficient insurance to workers without precluding structural reforms and without yielding high unemployment rates. Many current labour-market institutional arrangements in the West have proved to be ill-suited to cope with structural reallocation and should not be imposed on the CEECs. The German unification episode is particularly revealing as to the adverse effects of exporting to countries undergoing major structural change: in these circumstances, collective bargaining institutions are unlikely to allow sufficient wage dispersion, notably precluding wage differentials from reflecting underlying differentials in labour productivity.

Greater investment in education will also pay off in the longer run in terms of reducing the social costs of sectoral change. In particular, the rather narrow base of qualifications attained by vocational training schemes in the CEECs hinders the transferability of human capital across jobs and occupations. Emphasis should therefore be placed on general skills mainly in the field of secondary education. Needless to say, these are long-term investments. EU conditionality can play an important role in extending the time horizon of decision makers in the accession countries.

6. Policies to cope with regional unemployment differentials

Candidate countries are characterised by marked regional disparities – to a large extent replicating the rural–urban divide – in the allocation of unemployment and job opportunities. Unemployment, notably long-term unemployment, has a marked regional dimension among current EU members, which might suggest that shocks associated with Eastern Enlargement may also be concentrated in specific regions.

The accession process will offer new opportunities to the Central and Eastern European countries to reduce regional imbalances, notably in terms of enhanced flows of foreign direct investment. However, the Southern Enlargement episode suggests that FDI tends to be concentrated in urban areas and, indeed, EU Structural Funds in that case played a very important role in contributing to capital accumulation, mainly in terms of large infrastructures in the poorest regions of Spain. Empirical evidence suggests that positive externalities arising from improvements in the stock of public capital are limited and can be felt only in the long run. Thus, capital inflows are in the short term quite unlikely to reduce labour-market imbalances, while they can even contribute to their widening at early stages of the enlargement process.

Against this background, regional labour mobility will initially play a very important role as a regional re-equilibrating factor. In particular, responsiveness of wages to interregional productivity differentials and some degree of
mobility of workers across regions will be required. This part of the report argues in favour of measures promoting the regional mobility of workers, such as mobility-enhancing wage subsidies to firms and workers (for instance, mobility loans and grants, or tax deductions offered to workers changing residence). It also suggests that improvements in the transportation network have the potential significantly to reduce unemployment differentials. Given the small scale of many countries in the region, inter-regional labour mobility can indeed be to a large extent accommodated via commuting flows rather than changes in residence. Finally, another key recommendation developed in the report is not to force in Eastern Europe the centralisation of the bargaining structures that have prevailed so far in decentralised form. This does not preclude the achievement of greater co-ordination in collective bargaining, which can be valuable in reducing the inflationary pressures associated with the accession and signs of overheating in some local (i.e. country-capital) labour markets.

7. Regulating migration flows from the candidate countries

As stressed above, convergence of the accession countries in central and eastern Europe to the income-per-capita levels prevailing in the EU will be a fairly long process. Thus, Eastern Enlargement will be associated with some East–West migration, particularly taking account of the fact that some East–West borders involve the richest regions of the European Union. Given the large differences in factor endowments, trade will exert only moderate pressures for East–West wage convergence in the interim period. Although relatively small in terms of western European populations and workforces, such migration flows, if regionally concentrated, may create problems of social cohesion in some local labour markets.

As documented in the full report, transitional restrictions to labour mobility were adopted in the case of the EU’s Southern Enlargement. In particular, in the case of the Portuguese and Spanish accession, restrictions to labour mobility from the acceding countries remained for several years until the completion of the Single Market in 1991. These restrictions turned out to have a rather small effect on migration flows, since during the transition period the acceding countries were experiencing economic expansion with booming labour markets. When the restrictions were lifted in 1991, migration flows did not increase significantly. However, income differentials were not as large as those existing between EU countries and the current candidates for accession.

8. Policies to promote income convergence

Differences in incomes per capita are the driving force behind potential labour-market tensions associated with Eastern Enlargement. Short-term policies to mitigate adverse implications of sectoral and regional adjustment should therefore be complemented by measures promoting a faster income convergence between the EU and the CEECs.

Post-war experience in Europe shows that the integration of the markets for goods, capital and labour enhances growth and the convergence of per-capita incomes across countries. Different measures of convergence have identified more significant trends for convergence and higher convergence rates within EU members than across the whole spectrum of European countries (including countries not belonging to the EU). Moreover, there is evidence that the density of trade links is positively correlated with income convergence. As discussed above, the potential for trade and capital mobility between the EU and the CEECs has
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not yet been fully exploited. Both, the EU and the CEECs should therefore pursue stronger market integration in order to promote the convergence of per-capita incomes.

A credible agenda for accession is indispensable to promote foreign and domestic investment, and hence convergence of per-capita incomes. If credibility is questioned, economic agents in both the CEECs and the EU may refrain from adjusting completely to the current state of integration, because the costs of investment in production and restructuring would not be recovered if integration failed to progress apace. In particular, foreign direct investment is affected by uncertainty on the timing and occurrence of accession.

National economic policies can also play an important role in the convergence process. Analyses of the growth experience across countries in this report (and in a number of studies reviewed in the report) point out that (i) the quality of institutions and the enforcement of the rule of law, (ii) macroeconomic stability in terms of inflation and fiscal balance, (iii) the structure of public expenditure, and (iv) the development of human capital are – beyond factor movements and an openness to trade – the main strategic elements affecting long-term growth. Indeed, the different growth record of the CEECs in the post-transition period can itself be attributed to a large extent to differences in institution building, law enforcement and macroeconomic stability. In particular, the size of the informal sector and corruption indicators negatively affect growth in the CEECs.

While the size of government consumption in general has a negative impact, public infrastructure investments as well as social expenditures foster growth rates significantly. The necessary control of budget balance in the CEECs should therefore not jeopardise investments in public infrastructure and social expenditure. Social expenditures can play an important role in easing structural adjustment, and hence in promoting growth and convergence. As compulsory contributions rates are already too high, a broader coverage of safety nets in these countries can only be achieved by increasing their efficiency in targeting low-income groups and in reducing inequality without discouraging labour-market attachment.

Although indicators of educational attainments of the workforce in the CEECs suggest that their human capital endowments are large relative to their income levels, too much emphasis has been placed in the past on narrowly-based vocational education. Thus, human-capital endowments developed under central planning have been significantly devalued in the course of transition and need to be adapted to the new economic environment in order to promote growth and convergence. The simulations produced in the second part of the report suggest that larger enrolments in general secondary education have the potential to significantly speed up the income-convergence process.
General introduction

The challenges and opportunities arising from the Eastern Enlargement of the European Union (EU) have no historical precedent. Because the candidates for accession from central and eastern Europe are currently in a transition period from being centrally-planned economies and are subject to a gradual opening-up to trade with the West, the candidate countries are still exposed to a severe process of structural change that is not comparable in magnitude and speed to previous examples involving any of the well-established market economies. Income differentials, in particular, are markedly greater for these central and eastern European countries (CEECs) than for those involved in past accession rounds. Moreover, European integration has gained momentum since the previous (southern) enlargement. Single-market principles are much more a reality than even a decade ago, and there is now a common currency shared by a core group of EU members. Thus, the scope of integration through accession to the EU, and the pressures imposed by enlargement on both the present EU members and the CEECs, are unprecedented.

Because of the uncertainties related to Eastern Enlargement, there are mounting concerns within the present EU members that accession may have a number of undesirable effects on labour markets and on income distribution. In particular, a deterioration of living standards of the unskilled is feared, associated with job displacement and wage losses triggered by the accession of low-income countries. Moreover, it is suspected that mass migration from the CEECs will create further pressures on labour markets and social cohesion. Indeed, although economic theory predicts that the integration of economies that differ in incomes will provide gains for all countries involved, it also states that the benefits and losses will be distributed unevenly within each country. Of course, many qualifications apply to this general result, and a detailed analysis is needed for an evaluation of the distributional implications of integration.

The purpose of this report is to analyse the likely impact of Eastern Enlargement on employment and wages and to evaluate the policy options that could enhance net job creation and mitigate any undesirable distributional effects of CEEC accession to the EU. The analysis in this report focuses on three main dimensions of economic integration: trade in goods and services; migration of labour; and movement of capital. We are aware that accession to the EU has numerous other political, institutional and fiscal implications that may, in one way or another, affect wages and employment in both the present EU members and the candidate countries. This is true in particular of the Common Agricultural Policy (CAP) and the reform of structural and
regional policies in the EU. However, an assessment of these issues would require much more attention than could be possibly offered in this report, which is devoted to the implications of integrating the CEECs into the EU markets for wages and income distribution and the evaluation of labour-market policy options.

The report is structured in two parts. Part A analyses the likely impact of Eastern Enlargement on trade, migration and capital movements and their implications for employment and wages in the present EU member countries. The integration of the CEECs is understood to be an ongoing process, which has started with the step-wise removal of trade barriers in the course of the implementation of the Europe Agreements and is proceeding with the adjustment of the institutional framework of the CEECs to EU standards. This process will not be finalised at the date of accession. Part A’s analysis therefore focuses on the development of the patterns of trade, migration and capital movements before and after accession. Since the size of trade, migration and capital movements between the EU and the CEECs is at present too small to make an economy-wide impact on relative wages and employment, even in the most severely affected member states, the possible effects of trade and factor movements are addressed mainly at sector and regional levels. Beyond a qualitative assessment of the implications of trade, migration and capital movements on employment and wages in specific sectors and geographical regions, a quantitative evaluation is provided that is based on longitudinal datasets in selected countries (namely Austria, Germany and Sweden). We judge on the evidence available that CEEC accession to the EU will not induce a substantial change in the conditions for trade and capital movements. In contrast, with the immigration of labour from the CEECs largely restricted at present by EU member states, the conditions for the migration of labour are the dimension of economic integration that will most markedly change with accession. Special attention is therefore devoted to assessing the migration potential from the CEECs.

Part B of the report addresses the options for labour-market policies in the course of Eastern Enlargement and assesses the scope for a harmonisation of labour-market institutions both in the candidate countries and the existing EU member states. Based on the findings of Part A, the likely profile of winners and losers is discussed and the relevant trade-offs from Eastern Enlargement are outlined. Drawing on the historical experience of other integration episodes – the Southern Enlargement of the EU (involving Spain, Portugal and Greece), German unification, and the North American Free Trade Agreement, inferences are made as to the proper set of institutions likely to minimise any undesirable effects of accession on employment, income distribution and social cohesion. As the social costs of Eastern Enlargement are crucially related to the speed of convergence of the CEECs to EU income levels, the likely impediments to growth in the candidate countries and, hence, structural policies to accompany accession are discussed. Finally, on the basis of this analysis, policies are discussed that are aimed at fostering worker mobility across sectors and regions and at coping with the immigration of labour from the CEECs.