

Ansgar Belke und Martin Hebler*

EU Enlargement and Labour Markets in the CEECs

The implications for labour markets are central to any political and economic evaluation of EU Eastern enlargement. The resulting new levels of unemployment and of wages will have direct effects on social welfare in the acceding countries as well as in the present member states of the EU. Furthermore, employment and wages are substantial factors of political stability in the central and eastern European countries (CEECs). The following paper analyses the present situation on the labour markets in the CEECs and discusses the effects of their reintegration into the Western European system and the resulting implications for labour market and wage policy institutions.

It is often argued that the coming Eastern enlargement of the EU is unprecedented in terms of the increase in population and other indicators. However, this is not the case if the size of the countries that joined during previous enlargements is compared to the size of the EC they joined (see Table 1). Eastern enlargement is indeed significant in terms of population because all 10 central and eastern European candidate countries (CEEC-10) would increase the population of the EU by over a quarter (an increase equivalent to the increase in the German population due to unification). However, according to most economic indicators the size of the candidate countries is negligible, even if it is assumed that their economies will grow rapidly. Gros¹ shows that in terms of GDP, evaluated at current exchange rates, the 10 accession countries combined would be about 1/15th (7 per cent) of the Euro area. This corresponds roughly to the weight of the Netherlands.² Of course, the figures based on population and purchasing power standards (PPS) are much more imposing. After all, the CEEC-10 reached 40.1% of average per capita GDP in PPS of the Euro area in 1998.³

* Ruhr-Universität Bochum, Germany.

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Labour Market Performance

Any forecast presupposes a description of the status quo and an interpretation of the driving forces of past developments. For this reason, the performance since 1989 of major macroeconomic indicators relevant to the labour market situation is summarised briefly. We focus mainly on Poland, the Czech Republic and Hungary. Labour market developments in these countries are emphasised because they until recently belonged (together with Slovenia and Estonia) to the first wave of accession candidates from central and eastern Europe.⁴ Since

¹ D. Gros: EMU, the Euro and Enlargement, Centre for European Policy Studies, Brussels 2000, mimeo, Table 13.

² In terms of monetary indicators the story is not much different. Given that the candidate countries have rather small financial sectors their combined monetary supply generally amounts to less than 7 per cent of the corresponding Euro area aggregate. This implies that even serious problems with the banking sectors in the CEEC-10 could never materially affect monetary conditions in Euroland. Moreover, in the financial area most of the weight within the CEEC-10 is accounted for by the relatively advanced first wave of applicants. In summary, monetary policy induced labour market problems in the EU caused by Eastern enlargement are far from being a realistic scenario.

³ ECB: Monthly Bulletin, February 2000, p. 40; own calculation.

⁴ The second wave is Bulgaria, Romania, Latvia, Lithuania and Slovakia. This distinction is no longer formally correct in the sense that all candidates are formally at the same stage of their accession negotiations. However, in reality the (formerly) first wave countries are in general much further advanced in the negotiations. This does not necessarily imply, however, that actual accession will be in two waves. At present it seems that the first group to enter the EU might be as large as 7-8, with only Bulgaria and Romania as clear laggards. However, as this is not certain and the latter two constitute about two thirds of the "second wave" the distinction between two waves is maintained for expositional purposes.

Table 1

Size of the Next Enlargement Compared to the Previous Ones

	Population	GDP	Trade
UK+DK+IRL as per cent of EC-6	33.5	27.9	13.1
E+P as per cent of EC-10	17.5	8.3	4.7
CEEC-10 as per cent of EU-15	28.0 ⁵	4.1	10.9

Source: D. Gros: EMU, the Euro and Enlargement, Centre for European Policy Studies, mimeo, Brussels 2000.

these three countries have applied for accession to the EU with the greatest urgency it is often maintained that their increasingly improved macro performance in recent years is in part due to the perspective of EU membership.⁵ Moreover, their experiences might be helpful in further accession negotiations with less developed transformation economies. It is useful to recall that most candidates will have to eliminate their low remaining border protection against EU imports over the next years, so that their industries will at any rate have to compete in an open market with EU enterprises. All this implies that most of the adjustment in industry will have to come before accession. This should be compared to the case of Spain, which was given seven years to gradually eliminate rather higher tariff barriers and was then granted several years of exemption from many single market directives. Spain thus had to undergo the adjustment while inside the EC.

It is well-known that the CEECs had to undergo significant adjustment burdens – especially concerning their labour market performance (with the notable exception of the Czech Republic) – during their transition to decentralised and market-based economies. The liberalisation of prices led to serious price shocks. However, even more important for the initial development of employment figures in the CEECs was the significant and grave shock to output.⁶ In the first two or three years of transition, output fell dramatically. The losses increased to amounts from around 15 per cent (Czech Republic) to 37 per cent (Bulgaria) of GDP.⁷ Official unemployment rate figures increased within less than three years to

⁵ R. E. Baldwin, J. François, R. Portes: The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe, in: *Economic Policy* 24 (1997), pp. 169 f. Following this point of view, the delay or even failure of enlargement would have negative labour market impacts for the CEECs ("no enlargement and its own costs").

⁶ M. N. Jovanovic: What Are the Limits to the Enlargement of the European Union?, in: *Journal of Economic Integration* 14 (1999), p. 493.

two-digit values. They thus even partly exceeded the "slowly accumulated" high unemployment rates in continental Western Europe. The painfulness of the adjustment process expressed itself above all in a severe reallocation of resources.

Structural Change and Economic Growth

The employment structure in the CEEC economies has changed substantially during the course of transition. De-industrialisation and de-agricarisation as well as the establishment of the services sector are clearly identifiable trends which are, however, dependent on the respective initial situation and path of transformation and thus of different intensity. The planned economy distortions in favour of industrial employment have been abolished nearly everywhere. Nearly all CEECs were hit by a dramatic decrease in industrial employment. Seen on the whole, this sector is characterised by a labour shedding of about 3 million employees during recent years.⁸ Merely Hungary, where services already played a more important role at the beginning of transformation, experienced a more moderate decrease in employment. Seen over the whole sample from 1989 to 1997, the Czech Republic also represented an exception, with a share of industrial to total employment of nearly 40 per cent.⁹

At the same time, adjustment pressures also rose in agriculture (see Table 2). Some of the CEECs, above all the Czech Republic, Hungary, Slovenia and Slovakia, experienced a significant decrease in agricultural employment. However, the remaining accession candidates such as Poland and Estonia are still characterised by a very large share of employment in agriculture. Indeed, in some countries, for example Bulgaria and Romania, the reduction in employment in the industrial sector even led to a sharp increase in employment in the agricultural sector in both absolute and relative terms.¹⁰ As a consequence, the EU Commission did not classify

⁷ S. Fischer, R. Sahay: The Transition Economies After Ten Years, IMF Working Paper WP/00/30, February 2000, International Monetary Fund, Washington D.C., p. 34.

⁸ R. Conquest: The Economic Prospects for Eastern Europe, 60th Kieler Konjunkturgespräch, 27.-28. September 1999, Institute of World Economics, Kiel, p. 4; EU Commission: Focus on Employment and the Labour Market in Central Europe, No. 1, Brussels 1999, p. 9; Z. Wisniewski: Effekte des EU-Beitritts auf den Arbeitsmarkt in Polen, paper for the conference "Herausforderung Europa: Konvergenz im Spannungsfeld zwischen Systemwettbewerb und Politik-Harmonisierung", Europa-Kolleg Hamburg, I.P.I. Wolfsburg und Südosteuropa-Gesellschaft München, Wolfsburg 30. 9.-1. 10. 1999.

⁹ EU Commission: Focus on Employment ... op. cit., p. 10.

¹⁰ EU Commission: Focus on Employment ... op. cit., p. 9.

Bulgaria and Romania as functioning market economies in one of its country reports on the applicants.¹¹

Finally, in all CEECs the relative and absolute magnitude of the services sector expanded markedly. The resulting employment impacts can be regarded as significant throughout. However, they are concentrated mainly on urban regions, leaving unemployment in countries such as Poland, Slovakia and Romania still a grave regional problem.¹²

Structural change in the CEECs has been accompanied by a marked recovery with respect to their overall macroeconomic performance as measured by the usual indicators of real GDP growth and – with some lag – of the unemployment rate as well.¹³ However, over the whole period from 1989 to 1998 employment growth displayed a less dynamic development than GDP growth.¹⁴ In spite of the strong GDP recovery in recent years, the levels of income in the accession candidate countries still continue to lag behind the EU average. Even the two leading CEECs in economic terms, Slovenia and the Czech Republic, are characterised by a per capita GDP which amounts to approximately 60 per cent of the EU average.¹⁵ The remaining CEECs are even much “poorer” (see Table 2). In the case of the Czech Republic and Slovenia, reaching the average EU income level by the year

2015 (under the assumption of an annual growth rate of 2 per cent in the EU) would necessitate an annual growth rate of 5 per cent. In Slovakia, Hungary and Poland this “threshold growth” amounts to 7 to 8 per cent and in Romania and Bulgaria even more than 10 per cent.

The employment impacts of EU Eastern enlargement are often derived from projections for the future development of foreign trade (as one component of GDP). This is often legitimised by the fact that the majority of the growth of exports by the CEECs to the EU countries can be classified as competitive gains of market shares. In the wake of the year 1992, during the period of active restructuring, the biggest growth rates of foreign trade were not gained in the area of the traditional, labour intensive industries but in the machinery and construction sector. These industries with obvious comparative advantages are – like the traditional industries – characterised by both an above average intensity in the use of labour and energy and a below average intensity of R&D, human capital and tangible assets. In all CEECs a continuously large scarcity of human capital in skill intensive industries can be observed: Some improvements in this respect can be established above all with respect to Hungary and Slovenia, and to a lesser extent also for the Czech Republic and Slovakia.¹⁶ These developments clearly correspond to the mainstream results of the research on the impacts of foreign direct investment (FDI) on efficiency and growth in the manufacturing industries of the CEECs. They underline the importance of the FDI flows for the economic catching up process and the labour market performance of these countries.¹⁷

Table 2
Indicators for Structural Change and Economic Growth

Country	Employment in the agricultural sector in selected CEECs (% of total employment)		Per capita GDP in purchasing power standards (% of Euro area per capita GDP)
	1990	1998	1998
Slovenia	n. a.	7	67.8
Czech Republic	12	5	60.1
Hungary	16	7,5	47.7
Slovakia	13	8	45.8
Estonia	n. a.	13	36.4
Poland	26	26	35.9
Lithuania	n. a.	n. a.	30.5
Latvia	n. a.	n. a.	27.2
Romania	29	36	27.0
Bulgaria	18	26	22.8
EU-15	n. a.	5	100

n. a.: not available.

Sources: ECB: Monthly Bulletin, February 2000, p. 40; F. Breuss, F. Schebeck: Kosten und Nutzen der EU-Osterweiterung für Österreich, in: WIFO Monatsberichte, 11/1998, p. 742; R. Conquest: The Economic Prospects for Eastern Europe, 60th Kieler Konjunkturgespräch, 27th - 28th September 1999, Institute of World Economics, Kiel, p. 4.

¹¹ B. Lippert: Erweiterung und Agenda 2000, in: W. Weidenfeld, W. Wessels (eds.): Jahrbuch der Europäischen Integration 1998/99, Bonn 1999, p. 44.

¹² E.g. Eastern Slovakia was not compensated for the massive reduction in the armaments industry. See R. Conquest op. cit., p. 5; EU Commission: Focus on Employment and the Labour Market in Central Europe ... op. cit., p. 10.

¹³ M. C. Burda: The Consequences of EU Enlargement for Central and East European Labour Markets, CEPR Discussion Paper, No. 1881, Centre for Economic Policy Research, London 1998, pp. 4 f.

¹⁴ EU Commission: Focus on Employment... op. cit., p. 8.

¹⁵ It is comparable to the per capita GDP of Greece and Portugal before their accession to the EU.

¹⁶ See Andersen Consulting: Reconnecting Europe, London 1999, p. 16; H. Gabrisch, K. Werner: Advantages and Drawbacks of EU Membership: The Structural Dimension, in: Comparative Economic Studies 40 (1998), p. 79; A. Inotai, K. Vida: Mittel- und Osteuropa, in: W. Weidenfeld, W. Wessels (eds.): Jahrbuch der Europäischen Integration 1998/99, Bonn 1999, pp. 255 f.; S. Richter, M. Landesmann, P. Havlik, op. cit., p. 21. Exceptions to this pattern of specialisation are Hungary and Slovenia.

Unemployment

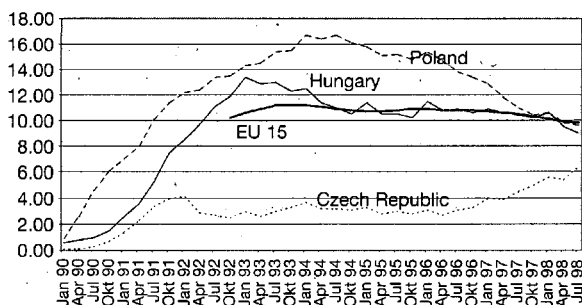
The adjustment processes induced by the shock of transformation in the countries under investigation differ significantly from one another. Following the market-oriented reforms of 1990, the official unemployment rates in Poland and Hungary rose from a level of zero to two-digit figures (see Figure 1). In Poland this happened in the third quarter of 1991; in Hungary the critical level was reached in the third quarter of 1992. In Hungary, a peak of 13 per cent was reached in 1993. In Poland, the unemployment rate peaked at 16.7 per cent in 1994. Since then unemployment has fallen continuously in these countries. In Poland the decrease even amounted to a considerable 6 percentage points.¹⁸ However, the development of the Czech unemployment rate represented a significant exception during the whole transition period, being admired even by the OECD countries until the currency crisis at the beginning of 1997.¹⁹ From the beginning of 1994 until the middle of 1997 the latter oscillated between 2 and 4 per cent, to increase in 1998 to a considerable 6.4 per cent. Finally, in the year 1998 the Hungarian and Polish unemployment rates were also below the EU average.

This phenomenon might be a first indication of the fact that differences between the labour market institutions of the CEECs analysed on the one hand and of the EU economies on the other should no longer be regarded as too large. In fact, the extent of the job destruction in the agricultural and industrial sectors should have led us to expect an even higher unemployment rate. Thus, a closer analysis of the trends observed in this section is clearly warranted (see Figure 2).

The high unemployment rates which could be observed in many CEECs in the wake of

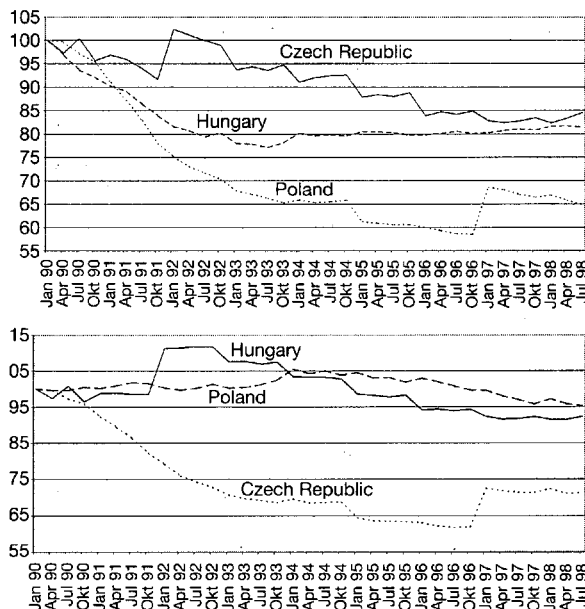
transformation can partly be traced back to the above average participation rate before 1989. The participation rates are now comparable with those observed in the EU countries.²⁰ The male participation rate fell in recent years below Western European levels. However, female participation stays significantly higher in spite of an initially high reduction. A closer inspection reveals that the developments of labour supply and labour demand

Figure 1
Unemployment Rates in Poland, the Czech Republic, Hungary and the EU



Source: P. Huber: Labour Market Adjustments in Central and Eastern Europe: How Different?, Paper presented at the Annual European Association of Labour Economists (EALE) Conference, Regensburg 23rd - 26th September 1999, p. 3.

Figure 2
Employment and the Labour Force in Poland, the Czech Republic and Hungary (January 1990 = 0)



Source: P. Huber: Labour Market Adjustments in Central and Eastern Europe: How Different?, Paper presented at the Annual European Association of Labour Economists (EALE) Conference, Regensburg 23rd - 26th September 1999, p. 3.

¹⁷ S. Richter, M. Landesmann, P. Havlik: Evaluation of the Consequences of Accession: Economic Effects on CEECs, Paper presented at the Conference "Shaping the New Europe: Challenges of Eastern Enlargement - East and West European Perspectives", Vienna Institute for International Economic Studies, Vienna 11.-13. 11. 1998, p. 21. FDI inflows are less volatile in comparison to other international capital flows because of their long-term character. Because they are an important source of economic and technological knowhow they have in general positive labour market impacts. See P. Brenton, F. Di Mauro, M. Lücke: Economic Integration & FDI: An Empirical Analysis of Foreign Investment in the EU and in Central and Eastern Europe, CEPS Working Document No. 124, Centre for European Policy Studies, Brussels 1998, p. 2; C. Buch: Capital Mobility and EU Enlargement, Kiel Working Papers, No. 908, Institute of World Economics, Kiel 1999, p. 27.

¹⁸ In most of the other CEECs the unemployment rates began to decrease as well in 1993 or 1994. See EU Commission: Focus on Employment ... op. cit., p. 10f.

¹⁹ M. Lavigne: Conditions for Accession to the EU, in: Comparative Economic Studies 40 (1998), pp. 50 f.

underlying these stylised facts are heterogeneous.²¹ In spite of rapid falls in employment, in the Czech Republic in the first years of transformation low unemployment rates could be registered since the employment potential decreased in a similar fashion. Factors contributing to this development were the growing employment in small private enterprises which was not statistically registered, the increasing flows of commuters to foreign countries and the reduction in participation rates, especially female ones. Especially in the Czech Republic (and to a certain extent in Slovakia as well) many employees are still hoarded in less productive enterprises. The official unemployment figures do not in fact mirror this hoarding. This could be very misleading because it is exactly this labour hoarding behaviour which in the medium term (i.e. within the next ten years) will lead to a further significant shedding of labour during transformation.²² In contrast, reactions to transformation were comparably less significant in Hungary because of the earlier beginning and the more gradual character of reforms. Both employment and the employment potential decreased by a moderate and relatively constant rate. Finally, Poland represents a middle case in the array of the CEECs examined here. With respect to the unemployment rate in this country, decreases in employment could not be compensated for by a fall in the employment potential.²³

The share of the long-term unemployed in the total number of unemployed persons amounts to a maximum of 57 per cent in Slovenia and Bulgaria and a minimum of 12 and 27 per cent in Lithuania and the Czech Republic respectively. In the majority of CEECs the labour market dynamic turns out to be relatively weak; the probability of becoming unemployed again after a period of employment is much larger than the probability of being employed after being unemployed. The long-term unemployed in the CEECs, i.e. the potential migrants for economic reasons, are characterised by a high share of the less educated and less qualified.²⁴

Seen on the whole, the interpretation of the stylised facts seems to support the view that the most extreme turbulences on labour markets were over by the year 1993. Consequently, an analysis of the "usual" labour market adjustments and the role of institutions for these adjustments should strictly speaking not start earlier than in the year 1993, when active restructuring actually started.²⁵ Therefore the sample period of quantitative measures of the labour market impacts of the "return to Europe" is very short.

The heterogeneity of individual development paths since the beginning of transformation can be regarded as the result of different country-specific reform strategies. In those countries with a relatively high degree of fixed capital investment labour productivity and aggregate output have increased (although, at the same time, unemployment grew). For Poland and Hungary, for example, a significant improvement in their economic performance could be recorded. However, another country of this group, namely the Czech Republic, was to a certain extent limited by its inability to tackle the problems of companies suffering losses and the financing of these losses by state banks. In contrast, those CEECs which – like Bulgaria and Romania – have up to now nothing to show but rudimentary reforms and have neglected the privatisation of large state conglomerates come off more badly by far. While Poland and Hungary speeded up very actively the privatisation of state companies Bulgaria and Romania feared the consequences of a shock therapy and preferred a strategy of "gradualism".

Migration

East-west migration has taken place up to now within the narrow bands of bilateral provisions which have been agreed upon in the association conventions between the EU and the CEECs. From Poland, which in fact can be regarded as the CEEC with the largest migration potential, more than 70 per cent of migrants moved to Germany. With 276,753 inhabitants in 1996 (in relation to 81.8 million Germans), the Polish population in Germany represents the largest share of the foreign resident population with CEEC origin in Germany (see Table 3),

²⁰ M. C. Burda: *The Consequences ...* op. cit., p. 6, EU Commission: *Focus on Employment ...* op. cit., p. 9. Hungary corresponds to the EU average.

²¹ W. Franz: *Central and East European Labour Markets in Transition: Developments, Causes, and Cures*, CEPR Discussion Paper No. 1132, Centre for Economic Policy Research, London 1995.

²² E. Walterskirchen: *Auswirkungen der EU-Osterweiterung auf den österreichischen Arbeitsmarkt*, in: *WIFO-Monatsberichte*, 8/1998, p. 536.

²³ P. Huber: *Labour Market Adjustments in Central and Eastern Europe: How Different?*, Paper presented at the Annual European Association of Labour Economists (EALE) Conference, Regensburg 23.-26. 9. 1999, pp. 3 f.

²⁴ EU Commission: *Focus on Employment ...* op. cit., p. 12.

²⁵ S. Richter, M. Landesmann, P. Havlik, op. cit., p. 21; P. Huber, op. cit., p. 4.

Table 3
Population from the CEECs in EU Member States 1996

	BE	DE	DK1	ES	FI	GR	IT	NL	PO1	SE	UK
Estonia	n.a.	2509	129	11	8446	22	55	n.a.	1	938	n.a.
Former Czechoslovakia ²	706	59112	418	265	149	1013	3227	555	81	1448	5000
Poland	5371	276753	5216	1946	716	4875	12812	5910	186	15988	27000
Slovenia	n.a.	17328	12	37	6	20	1326	n.a.	3	418	n.a.
Hungary	895	55706	332	221	419	551	2153	1133	84	3046	2000
6 accession countries	6972	411408	6107	3480	9736	6481	19573	7598	355	21838	34000
Bulgaria	635	38847	270	931	309	5241	2882	550	269	1874	2000
Latvia	n.a.	4624	156	25	98	33	107	n.a.	n.a.	282	n.a.
Lithuania	n.a.	4800	161	30	83	71	127	n.a.	3	227	n.a.
Romania	1964	109256	1126	1208	374	5132	11801	1466	99	4186	3000
10 accession countries	9571	568935	7820	5674	10600	16958	34490	9614	726	28407	39000
Share of total population	0.09	0.70	0.15	0.01	0.21	0.16	0.06	0.06	0.01	0.32	0.07
Total population (in millions)	10.1	81.8	5.2	39.2	5.1	10.5	57.3	15.5	9.9	8.8	58.7

n.a.: not available.

¹ 1995.

² Czech Republic and Slovakia (not available separately for historical reasons).

Source: E. Hönekopp, H. Werner: Osterweiterung der Europäischen Union. Droht dem deutschen Arbeitsmarkt eine Zuwanderungswelle? in: IAB-Kurzbericht, No. 7/1999, p. 5.

followed at a significant distance by the former Czechoslovakia.²⁶

The number of legal employer-employee relationships develops proportionally to the share of the resident population. Therefore, at least in Germany the previous migrants are not hurt by unusually high unemployment and are not forced into the shadow economy to an above-average degree.²⁷ Some 150,000 seasonal workers have to be added to the figure for the resident population but their stay is limited to a few months by definition.²⁸

The future development of migration – especially if freedom of movement is granted from the start after accession – depends to a large extent on the difference between the real wage levels (and their growth rates) in the accession countries and the former EU countries.

Real Wages

All CEECs started their transformation in the post-communist era with strong devaluations of their currencies. This led to a very low level of real wages. In many cases monthly earnings were below 100 Ecu (Portugal's minimum wage at that time settled at values slightly above 200 Ecu). The cost of one hour

of work by a worker in the industrial sector in 1994 in Hungary amounted to only 10.5 per cent of the German level, in the Czech republic to 7 per cent and in Romania to merely 3 per cent.²⁹ Today, monthly salaries in the economically most advanced group within the CEECs (Estonia, Czech Republic, Poland, Slovakia) have recovered strongly. They correspond approximately to the Portuguese minimum wage. However, they still fall far below the Portuguese average wage. Only Slovenia already shows higher wages than Portugal. The average wages in Bulgaria

²⁶ H. Brücker, F. Franzmeyer: Europäische Union: Osterweiterung und Arbeitskräfteemigration, DIW Wochenbericht 5/1997, pp. 90 ff.; E. Hönekopp, H. Werner: Osterweiterung der Europäischen Union. Droht dem deutschen Arbeitsmarkt eine Zuwanderungswelle?, in: IAB-Kurzbericht, No. 7/1999, p. 5.

²⁷ In contrast, H. Brücker, F. Franzmeyer, op. cit., p. 90, rate the number of legal employer-employee relationships as low. We cannot follow this interpretation because from the figures of Brücker and Franzmeyer a quota of approximately 40 per cent can be calculated which is nearly the same as for the share of employed people of the resident population in Germany as a whole (41.5 per cent 1998, see Institut der deutschen Wirtschaft: Zahlen zur wirtschaftlichen Entwicklung der Bundesrepublik Deutschland 1999, Cologne 1999, Table 2).

²⁸ H. Brücker, F. Franzmeyer, op. cit., p. 90.

²⁹ E. U. Cichy: EU-Osterweiterung: Chance, Risiken, Konvergenzkriterien, in: Wirtschaftsdienst 75 (1995), p. 663.

and Romania, economies of the "second wave" with relatively large populations, still fall far below even the Portuguese minimum wage.

Comparisons of wage labour costs between the CEECs and the EU are still quite difficult since at least up to now huge differences with respect to data availability (minimum wages, average wages for a specific sector or total economy wages) exist. However, it is obvious that real wages in Poland, in the Baltic states, in the Czech Republic and in Slovakia have risen steeply (by 10 to 20 per cent) from 1995 to 1997. These trends are extrapolated by Emerson and Gros.³⁰ According to their forecast, Polish wages will reach the Portuguese level approximately in the year 2005. Later on, growth will slow down somewhat and real wages in the CEECs will converge asymptotically to their new equilibrium values (see Table 4).

It clearly seems to be too early at this stage for efforts to quantify these equilibrium values more accurately. However, the latter will most probably exceed Portuguese wages in the (nearer) future. This may be explained preponderantly by two factors, which taken by themselves enhance inward FDI flows and productivity: geographical proximity to the high wage economy Germany and the relatively high level of education of the potentially employed. This is especially valid for sectors in which technology and working methods have been completely overhauled and a high general education level is available. In fact, the latter is higher in the "first wave" of the CEEC accession candidates than in Portugal. In view of their continually low per capita income levels the CEECs as emerging markets promise high growth potentials. Apparently, the CEECs strive to catch up with the highly developed EU economies as rapidly as possible.³¹ In summary, the growth of real wage labour costs (in Ecu) is currently much larger than in Portugal. Since at the same time Portugal's trends in wage development seems to have stabilised relative to Euroland, real wage costs in the CEECs will converge to the EU average level as well.

Unit Labour Costs

With respect to the attractiveness of the CEECs for inward FDI flows and their competitiveness in the EU common market the performance of unit labour costs represents a decisive factor. Although average labour productivity in the CEECs is at the same time much lower than in the EU, the (wage related) unit labour costs in the CEECs continue to amount to only a fraction of the latter in the EU. Estimates for 1997 quote figures of between 17 per cent of the Austrian

Table 4
Wage Dynamics in the Czech Republic, Hungary, Poland and Portugal
(in ECU)

	Czech Republic	Hungary	Poland	Portugal minimum	Portugal average
1992	127	218	164	222	536
1993	170	252	184	237	569
1994	201	267	195	246	604
1995	235	237	218	260	644
1996	281	242	255	273	680
1997	294	274	311	286	710
1998	332	296	358	300	745
1999	375	320	411	315	783
2000	424	345	473	331	822
2001	479	373	544	348	863
2002	542	403	626	365	906
2003	612	435	719	383	951
2004	692	470	827	402	999
2005	782	507	951	422	1049

Note: annual growth rates between 1997 and 2005: Poland: 15 per cent, Czech Republic: 13 per cent, Hungary: 8 per cent, Portugal average: 6 per cent, Portugal minimum: 5 per cent.

Source: M. Emerson, D. Gros: Impact of Enlargement, Agenda 2000 and EMU on Poorer Regions – The Case of Portugal, CEPS Working Document, No. 125, Centre for European Policy Studies, Brussels 1998, Annex 20. Monthly average industry wages.

level in Bulgaria, 25 per cent in Romania, 27 per cent in Slovakia, 31 per cent in the Czech Republic, 37 per cent in Hungary, 45 per cent in Poland and 72 per cent in Slovenia. If non-wage labour costs are included the difference becomes even more pronounced.³² However, as already noted with respect to absolute wage cost differentials, the international competitiveness of the CEECs as measured by unit labour costs has gradually worsened. This is especially the case in the Czech Republic and Hungary (the latter only until 1995 however) where wage growth has by far exceeded productivity growth. These country-specific developments mirror *inter alia* different progress in restructuring, country-specific institutional factors (privatisation) and above all different degrees of activity by foreign investors. The cost advantages of EU companies with FDI activities in the CEECs are comparatively large since they pay only marginally higher wages than on average in the CEECs but profit from high EU productivity. Moreover, they absorb the

³⁰ M. Emerson, D. Gros: Impact of Enlargement, Agenda 2000 and EMU on Poorer Regions – The Case of Portugal, CEPS Working Document, No. 125, Centre for European Policy Studies, Brussels 1998, p. 29 f.

³¹ F. Breuss, F. Schebeck: Kosten und Nutzen der EU-Osterweiterung für Österreich, in: WIFO Monatsberichte, 11/1998, p. 749.

³² S. Richter, M. Landesmann, P. Havlik, op. cit., p. 20.

“cheap” labour force and thus lower the incentives for a significant migration from the East to the West.³³

Labour Market Institutions

During the eleven years since the start of the market oriented reforms in the CEECs, the assessment by economists of the functioning of labour markets in these countries has changed quite strongly. In the early phase of transformation, a rather pessimistic view was dominant, i.e. that on the one hand inflexibilities were necessarily induced by a population which – as an initial condition – was not familiar with the functioning of a “capitalist” labour market and by an inadequate institutional framework. On the other hand, the latter caused high and persistent unemployment due to the enormous necessities of adjustment during transformation. While this interpretation that labour markets in transformation economies are characterised by substantial rigidities is mainly shared by academic analysis,³⁴ Layard and Richter³⁵ recently rated the Russian labour market as flexible. Moreover, Burda³⁶ implicitly assumes that the labour markets in the CEECs are more flexible than their counterparts in the Continental EU, when warning not to hamper the functioning of the flexible CEEC economies by forcing on them the relatively inflexible institutional set-up of the EU countries at the time of EU entry.

In view of the ambiguous situation at the outset with respect to this question, we shall analyse here in more depth the extent to which labour markets in the CEECs are in fact flexible in reality. For this purpose, we present an overview of the evidence on micro and macroeconomic labour market flexibility in these countries to be found in the literature so far. Relevant criteria are the incentive effects of the social security systems, the flexibility of dismissal protection, the organisation of active labour market policies and the degree of regional mobility of the labour force.

Wage Compensation Schemes

Up to now, the focus of the literature on institutional barriers to labour market flexibility in transformation economies has mainly concentrated on the incentive effects created by the systems of social security. On the one hand, the specific kind and organisation of wage compensation schemes is decisive for the magnitude of incentives to search for a new job (the so-called search incentives). On the other hand, the importance of non-wage labour costs has been emphasised, which possibly conflict with the process of creating new jobs. In this respect it is often stressed

that the magnitude of the non-wage labour costs depends on the design of the systems of social security.

During transformation, political demands for social security grew quickly since individuals were confronted by the hardship of adjustment. For this reason, programmes of unemployment benefits, early retirement, social security income support and severance pay were quickly put on the agenda in most of the CEECs after governments had committed themselves to market transformation. This happened before the consequences of these decisions became obvious and in most of the cases without an evaluation of the costs which would be connected with it in the future.³⁷

According to recent calculations for 1998 by the EU Commission the systems of social security most probably lead to negative employment impacts in Slovakia, Poland, Hungary and above all Slovenia (in contrast to the Baltic countries). This conclusion is reached by a comparison of registered unemployment and the unemployment figures according to the labour force survey (see Table 5). Figures greater than one might imply that many registered unemployed have stopped searching or are engaged in the shadow economy, or that a protracted registration is a precondition for receiving other additional transfers from the state (unemployment benefits, housing subsidies and health insurance). In those countries where the rate of registered unemployed exceeds the rate which is calculated based on the labour force survey, the preconditions for these claims are probably interpreted rather generously. However, this clearly represents an incentive to register as unemployed³⁸ with implications for total employment as derived above. A more active search by the unemployed and more restrictive preconditions for the

³³ E. U. Cichy, *op. cit.*, p. 664; H. P. Lankes: *Obstacles on the Way to Accession: The Investment Challenge*, Vortrag anlässlich der Jahrestagung des Vereins für Socialpolitik, Mainz, 24.09.-01.10.1999; M. Lavigne, *op. cit.*, p. 51. Typically enough, the transport sector was the only branch in the Czech Republic in which unit labour costs decreased in 1996 because of Skoda-Volkswagen. See Andersen Consulting, *op. cit.*, p. 28.

³⁴ See, e.g., T. Boeri, M. C. Burda, J. Köllö: *Mediating the Transition: Labor Markets in Central and Eastern Europe*, Forum Report of the Economic Policy Initiative No. 4, Centre for Economic Policy Research, London 1998.

³⁵ R. Layard, A. Richter: *How Much Unemployment is Needed for Restructuring? The Russian Experience*, in: *Economics of Transition* 3 (1995), pp. 39-58.

³⁶ M. C. Burda: *The Consequences ... op. cit.*

³⁷ M. C. Burda: *The Consequences ... op. cit.*, p. 9.

³⁸ For this interpretation see EU Commission: *Focus on Employment ... op. cit.*, p. 11.

Table 5

Ratio of Registered Unemployment to Unemployment according to the Labour Force Survey

Country	1997	1998
Slovenia	1.8	1.6
Romania	1.2	1.4
Slovakia	1.2	1.4
Hungary	1.3	1.3
Czech Republic	1.1	1.2
Poland	0.9	1.0
Bulgaria	1.0	0.8
Lithuania	0.5	0.6
Latavia	0.5	0.5
Estonia	0.4	0.5

Source: EU Commission: Focus on Employment and the Labour Market in Central Europe, No. 1, Brussels 1999, p. 15.

payment of benefits would lead to a decrease in non-wage labour costs.

However, additional institutional barriers to more labour market flexibility in the CEECs can be identified, which resemble those at work until recently in the continental EU economies.³⁹ Wage compensation payments, which at the beginning of transformation were granted very generously, were quickly diminished when the unemployment rates increased and the financing of existing claims became increasingly difficult. Insofar, parallels to continental Europe become obvious again. In the literature, there is still no consensus with respect to the incentive effects of unemployment benefits in transformation economies. Micklewright and Nagy,⁴⁰ for example, find that unemployment in Hungary behaved relatively inelastically with respect to changes in the entitlements. However, Wolf⁴¹ for Hungary and Puhani⁴² for Poland reach the conclusion that the duration of unemployment is affected significantly positively by higher unemployment benefit transfers. Social security transfers represent a further important impact on the search intensity of the unemployed. According to Micklewright and Nagy, in Hungary the cessation of unemployment insurance benefit transfers after a certain time and their substitution by the (on average lower in absolute terms) social security income support, as in many continental European countries, does not lead to an increase in the probability of exit from the unemployment pool.

Non-wage Labour Costs

The importance of non-wage labour costs has increased steadily throughout the transformation period. Whereas in (continental) Western Europe legal regulations represent a large part of these costs, non-wage labour costs in the CEECs tend to take the form

of fringe benefits which are agreed upon voluntarily in order to attract highly qualified and well-motivated staff.

A special feature of the CEECs as compared to the EU economies consists of the fact that the state lost a major share of its sources of revenue due to the transformation and the take-over of large parts of the economy by private owners and managers. For political and economic reasons, this led either directly, or indirectly via contributions to different social funds, to an increase in the taxation of labour. Since this kind of duty can in principle be collected more easily than the usual value-added or income tax, the governments of the CEECs have become increasingly dependent on these revenues in the recent past. When the financial burdens of unemployment insurance and the benefits became pressingly high in the course of transformation and, as a consequence, tax revenues decreased (above all in Hungary and Poland), the taxation of labour increased again as a reaction. As a consequence, demand for labour decreased further. This finally led to the dynamic instability of the whole system. Since, in contrast to investigations for the OECD,⁴³ for the CEECs a significant and negative impact of the taxation of labour on employee-employer relationships throughout cannot be rejected empirically, employment in these countries often fell into the so-called fiscal trap, i.e. into an equilibrium with excessive taxation and tax evasion. In this connection, the emergence of a comprehensive shadow economy as an evasive action with respect to the increasing taxation of labour can be regarded as typical of the CEECs.⁴⁴

Employee Protection Regulations

Based on a more comprehensive research project,⁴⁵ Burda⁴⁶ compares institutional labour market conditions in the CEECs and in continental Europe.

³⁹ P. Huber, *op. cit.*, pp. 6 ff.

⁴⁰ J. Micklewright, G. Nagy: Living Standards and Incentives in Transition: The Implications of Employment Insurance Exhaustion in Hungary, CEPR Discussion Paper, No. 2061, Centre for Economic Policy Research, London 1999.

⁴¹ J. Wolf: Unemployment Benefits and Incentives in Hungary: New Evidence, Paper presented at the Conference "Labour Markets in Transition", University of Michigan 17.-19. 10. 1997.

⁴² P. Puhani: Poland on the Dole - Unemployment Benefits, Training and Long-Term Unemployment During Transition, ZEW Discussion Paper 96-30, Zentrum für Europäische Wirtschaftsforschung, Mannheim 1996.

⁴³ S. Nickell, B. Bell: Would Cutting Payroll Taxes on the Unskilled Have a Significant Impact on Unemployment?, in: D. Snower, G. de la Dehesa (eds.): Unemployment Policy: Government Options for the Labour Market, Centre for Economic Policy Research, London 1997.

He draws the unambiguous conclusion that most of the CEECs have adapted labour market regulations of the continental European style. Especially the rules and regulations concerning severance pay and employee protection against unlawful dismissal follow, with some exceptions for small and medium-sized firms, the continental European pattern. However, they are not yet applied as strictly as in continental Europe. As shown below, accession to the EU by the CEECs will probably lead to a stricter application, or even an aggravation, of these regulations.

It is well-known that it cannot be derived definitively and unambiguously from economic theory that the strict regulation of employee protection against unlawful dismissal has a negative impact on employment. However, it is common sense that the impacts of such regulations cannot be neglected during the phase of transformation (as a systemic structural change) for small enterprises and start-ups.⁴⁷ Since firm start-ups can be regarded as a risky and often unsuccessful venture, regulations on employee protection against unlawful dismissal impact on these activities like a direct tax. These regulations have negative employment impacts since they tend to prevent the innovation and structural change resulting from firm start-ups.

It follows directly that the instalment of regulations on employee protection against unlawful dismissal either tends to move small firms out of business or forces them into the shadow economy. In both cases, significant negative consequences for tax revenues and tendencies to aggravate the fiscal trap described

above have to be expected. Moreover, the firms have to bear significantly large fixed costs for a separate department for the organisational handling of these rules. From a labour market policy perspective it would make sense to grant small firms some exemptions from these rules. In fact, exactly this happened in the CEECs. Only large enterprises have to conform to these regulations; small and foreign enterprises actually manage to evade these rules in one way or an other.⁴⁸

Active Labour Market Policies

During the transition process, active labour market policies (ALMPs) became an integral part of the labour market policies of the CEECs, as they have been in Western Europe since the first oil price shock in the mid-seventies. The aim of "job intermediation measures", "labour market training measures" and "job creation schemes" is to enhance the flexibility of workers and therefore reduce long-term unemployment.⁴⁹ From a theoretical point of view ALMPs seem to make sense even in times of transformation when the majority of enterprises release redundant labour, which is usually manifest in the least productive workers. Being unemployed is therefore an indication of a low level of productivity, which could perhaps be increased by ALMPs. In contrast, the effectiveness of such measures is regarded critically in the empirical literature, especially in view of the fact that the labour markets of Sweden and Finland performed poorly using ALMPs as a reaction to the shocks of the early nineties.⁵⁰

Are these results robust regarding the experiences of the CEECs, especially regarding the "employment miracle" in the Czech Republic up to 1997? It seems that the answer is "yes". ALMPs in the CEECs can be characterised as measures that on the one hand actuate stagnating "unemployment pools" and on the

⁴⁴ T. Boeri, M. C. Burda, J. Köllö, op. cit., pp. 86 ff.; M. C. Burda: *The Consequences ...* op. cit., p. 10; P. J. J. Welfens: *Systemstrategische und strukturelle Anpassungsprobleme in post-sozialistischen Ländern Osteuropas, Teil II: Strukturelle Anpassungs-erfordernisse und Perspektiven der EU-Osterweiterung, Berichte des Bundesinstituts für ostwissenschaftliche Studien, Cologne 1998*, pp. 10 f. Further differences can be established above all with respect to the institutions of wage determination both between the CEECs and the EU economies and within the CEECs as such. See extensively W. Franz, op. cit., pp. 33 ff., and J. Bell, T. Mickiewicz: *EU Accession and Labour Markets in the Visegrad Countries*, in: K. Henderson (ed.): *Back to Europe: Central and Eastern Europe and the European Union*. London 1999, pp. 130 ff.

⁴⁵ T. Boeri, M. C. Burda, J. Köllö, op. cit.

⁴⁶ M. C. Burda: *The Consequences ...* op. cit.

⁴⁷ M. C. Burda: *The Consequences ...* op. cit., p. 16; W. Franz, op. cit., p. 43; H. Hopenhayn, R. Rogerson: *Job Turnover and Policy Evaluation: A General Equilibrium Analysis*, in: *Journal of Political Economy* 101 (1993), pp. 915-938; Z. Wisniewski, op. cit. On the one hand, the formation and the abandonment of companies are preconditions for productive activity in a rapidly changing world. On the other hand, both formations and abandonments of companies produce valuable information which was rather scarce in transformation economies up to now.

⁴⁸ M. C. Burda: *The Consequences ...* op. cit., p. 16.

⁴⁹ T. Boeri, M. C. Burda, J. Köllö, op. cit., pp. 78 f.; M. C. Burda: *The Consequences ...* op. cit., pp. 11 f.; Z. Wisniewski, op. cit.

⁵⁰ Representative L. Calmfors: *Active Labour Market Policy and Unemployment: A Framework for the Analysis of Crucial Design Features*, in: *OECD Economic Studies* 2 (1994), pp. 7-47. For a conclusion and evaluation of Western European experiences with ALMPs see OECD: *What Works Among Active Labour Market Policies: Evidence from OECD Countries' Experiences, Labour Market and Social Policy, Occasional Papers No. 35, Paris 1998*. For first estimations of the efficiency in the CEECs see M. Lubyova, J. van Ours: *Jobs from Active Labour Market Policies and their Effects on Slovak Unemployment*, Paper presented at the Conference "Labour Markets in Transition", University of Michigan, October 17-19, 1997; C. J. O'Leary: *Preliminary Evidence on Active Labour Market Programs - Impacts in Hungary and Poland*, Upjohn Institute for Employment Research, Staff Working Paper 1998-50.

other hand create inefficiencies manifested above all in displacement effects.⁵¹ The latter means that ALMPs often displace existing jobs instead of creating new ones. Even though the budgets for this policy differ between the CEECs the spectrum covers the same band-width as in Western Europe. Several econometric studies cannot reject the hypothesis that for the Czech Republic the specific conditions at the beginning of the transformation were exceptionally good (the structure of industrial specialization, a well-educated labour force, a large share of services and a small agricultural sector, a tradition of entrepreneurship and the closeness to Germany and Austria) and therefore responsible for the good performance of the labour market, rather than the application of ALMPs.⁵² However, a closer inspection of ALMPs once again supports the thesis that CEEC labour markets resemble EU labour markets in many respects.⁵³

Regional Mobility

In addition to the items referred to above, the development of labour markets in the CEECs is characterised by the increase of regional disparities: "the transformation has a significant regional element".⁵⁴ First, there is strong evidence in favour of the hypothesis that Hungary, Poland and the Czech Republic from 1989 on quickly built up regional disparities in unemployment rates. These increased until 1993 and since then they have persisted at a high level.⁵⁵ Once again, there is a striking similarity to the labour markets of Western Europe.⁵⁶ Second, similar regional differences with respect to the development of wages are found.⁵⁷ It is generally expected that accession to the EU will strengthen these disparities at least in the short run.⁵⁸

These results underline the extraordinary importance of capital mobility for supporting regions in overcoming disparities and imbalances as well

as compensating for an insufficient degree of regional mobility of workers. The latter seems to depend on the dimension of social security systems, regional family circles, infrastructure and "regional chauvinism".⁵⁹ The experiences of Western European economies demonstrate that a reduction in regional disparities regarding unemployment presumes a considerable elasticity of wages related to differences in productivity as well as an increase in the regional mobility of workers. Since the mid-eighties some of the EU countries (e.g. the UK and Sweden) decentralised wage bargaining as a means of encouraging the flexibility of wages. For this reason, the differences in unit labour costs decreased. It seems that this could also be an adequate way for the CEECs to fight regional disparities.⁶⁰ As stated above, the CEEC and EU labour markets resemble one another in many respects and so do the recommendations to politicians.

Conclusion

Two important conclusions can be drawn. First, the future dynamics of labour market performance in the CEECs will be different from the EU, predominantly for the following three reasons. First, the transformation recession determined by special factors such as the collapse of the former Soviet Union and connected with fiscal and balance of payments problems, wars in the Gulf and above all in the Balkans region, still impedes the recovery of labour demand (problems of hysteresis). Second, job elimination and job creation in the CEECs are connected by endogenous feedback because of fiscal policy. The structural changes necessary to compete on the Single Market enforce bankruptcy. However, too great a speed of job elimination will aggravate the fiscal trap. There clearly

⁵¹ T. Boeri, M. C. Burda, J. Köllö, *op. cit.*, pp. 78 ff.; M. C. Burda: *The Consequences ... op. cit.*, p. 14.

⁵² T. Boeri, M. C. Burda: *Active Labour Market Policies, Job Matching and the Czech Miracle*, in: *European Economic Review* 40 (1996), pp. 805-817; T. Boeri, M. C. Burda, J. Köllö, *op. cit.*, pp. 78 ff.; M. C. Burda, M. Lubyova: *The Impact of Active Labour Market Policies: A Closer Look at the Czech and Slovak Republics*, in: D. Newbery (ed.): *Tax and Benefit Reform in Central and Eastern Europe*, Centre for Economic Policy Research, London 1995, pp. 173-205. On the other hand it seems that restructuring was slowed down in privatised state enterprises as the EU Commission in their report on the success of the candidates in November 1998 pointed out an alarming deceleration of the speed of reforms (except in Slovenia) especially in the Czech Republic. See M. C. Burda: *The Consequences ... op. cit.*, pp. 13 f.; EU Commission: *Focus on Employment ... op. cit.*, p. 21; A. Inotai, K. Vida, *op. cit.*; B. Lippert, *op. cit.*, p. 44.

⁵³ P. Huber, *op. cit.*, p. 7; Z. Wisniewski, *op. cit.*

⁵⁴ M. C. Burda: *The Consequences ... op. cit.*, p. 7; also T. Boeri: *Labour Markets and EU Enlargement*, Paper presented at the Conference "Shaping the New Europe: Challenges of Eastern Enlargement - East and West European Perspectives", Vienna Institute for International Economic Studies, Vienna 11.-13. 11. 1998, p. 3; Z. Wisniewski, *op. cit.*

⁵⁵ P. Huber, A. Wörgötter: *Local Unemployment Dynamics in Transition: A Comparison of Three Countries*, forthcoming, in: G. R. Crampton (ed.): *European Research in Social Science*, Pion, London 1999.

⁵⁶ A. Belke, D. Gros: *Asymmetric Shocks and EMU: Is There a Need for a Stability Fund?*, in: *INTERECONOMICS*, Vol. 33 (1998), pp. 274-288; T. Boeri, *op. cit.*; S. Bradley, J. Taylor: *Unemployment in Europe: A Comparative Analysis of Regional Disparities in Germany, Italy and the UK*, in: *Kyklos*, Vol. 50 (1997), pp. 221-245.

⁵⁷ P. Huber, *op. cit.*, p. 5.

⁵⁸ T. Boeri, *op. cit.*

⁵⁹ T. Boeri, M. C. Burda, J. Köllö, *op. cit.*; M. C. Burda: *The Consequences ... op. cit.*, p. 8.

⁶⁰ T. Boeri, *op. cit.*

