

Kemmerling, Achim et al.

**Working Paper**

**Regional Input : Labour Markets**

Ezoneplus Working Paper, No. 6A

**Provided in Cooperation with:**

Jean Monnet Centre of Excellence (JMC) - Ezoneplus Research Project, Free University Berlin

*Suggested Citation:* Kemmerling, Achim et al. (2002) : Regional Input : Labour Markets, Ezoneplus Working Paper, No. 6A, Free University Berlin, Jean Monnet Centre of Excellence, Berlin

This Version is available at:

<https://hdl.handle.net/10419/22121>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*



## REGIONAL INPUT: LABOUR MARKETS

Achim Kemmerling

Tiiu Paas

Raul Eamets

Marit Rõõm

Rena Selliov

Anne Jürgenson

Jaan Masso

Ezoneplus Working Paper No. 6A

September 2002



FIFTH FRAMEWORK PROGRAMME

**Ezoneplus**

The Eastward Enlargement of the Eurozone  
Research Project HPSE-CT-2001-00084  
Fifth Framework Programme 2001-2004  
European Commission  
[www.ezoneplus.org](http://www.ezoneplus.org)

**Jean Monnet Centre of Excellence**

Freie Universität Berlin  
Hnestr. 22, 14195 Berlin, Germany  
Phone: +49 (30) 838 – 54966  
Fax: +49 (30) 838 – 52357  
Email: [info@ezoneplus.org](mailto:info@ezoneplus.org)



The Eastward Enlargement of the Eurozone

---

Berlin Evora Helsinki Ljubljana Bologna Tartu Warsaw

## Regional Input: Labour Markets

Keywords : Statistics on Labour markets, Regional Input, Labour migration,  
Wage flexibility

### Corresponding authors:

Prof. Ph.D. Tiiu Paas. & Ass. Prof. Ph.D. Raul Eamets  
Institute of Economics  
University of Tartu  
Narva mnt. 4-A208  
EST-51009 Tartu  
tpaas@mtk.ut.ee. [eam@cie.ut.ee](mailto:eam@cie.ut.ee).

Achim Kemmerling  
Jean Monnet Centre of Excellence  
Freie Universität Berlin  
Hnestr. 22  
14195 Berlin, Germany  
Email: [achim\\_kemmerling@yahoo.de](mailto:achim_kemmerling@yahoo.de)

This paper has been prepared as a part of a broader Ezoneplus project that evaluates European Monetary Union (EMU) and its enlargement to prospective members in central and eastern Europe. The project is financially supported by European Commission (HPSE-CT-2001-00084).

## Table of Contents

### **Regional Input: Labour Markets in Benelux, France and Germany**

*Achim Kemmerling*

1. Overview	3
Part I: Western European Labour Markets – Structures and Trends	5
2 Migration, Mobility and the Composition of Labour Markets	5
3 Flexibility of Nominal and Real Wages	8
Part II: Western European Labour Markets – Policies and Institutions	12
4 Wage Bargaining Systems and Labour Market Regulation	12
5 The Social Security System, Taxes and Migration Policies	15
Conclusion	17
References	19

### **LABOUR MARKET FLEXIBILITY AND MIGRATION IN THE EU EASTWARD ENLARGEMENT CONTEXT: THE CASE OF THE BALTIC STATES**

*Tiiu Paas, Raul Eamets, Marit Rõõm, Rena Selliov, Anne Jürgenson, Jaan Masso*

1. Introduction	22
2. The main changes in the Baltic States' labour markets	24
3. The concept of labour market flexibility	27
4. Institutional flexibility	30
4.1. Labour market regulation	30
4.2. The role of trade unions	33
4.3. Labour market policy	36
5. Wage flexibility	38
6. International labour migration	41
Conclusion	45
References	46



## Regional Input: Labour Markets in Benelux, France and Germany

Achim Kemmerling

Ezoneplus Working Paper No. 6A

August 2002



FIFTH FRAMEWORK PROGRAMME

### **Ezoneplus**

The Eastward Enlargement of the Eurozone  
Research Project HPSE-CT-2001-00084  
Fifth Framework Programme 2001-2004  
European Commission  
[www.ezoneplus.org](http://www.ezoneplus.org)

### **Jean Monnet Centre of Excellence**

Freie Universität Berlin  
Hnestr. 22, 14195 Berlin, Germany  
Phone: +49 (30) 838 – 54966  
Fax: +49 (30) 838 – 52357  
Email: [info@ezoneplus.org](mailto:info@ezoneplus.org)



The Eastward Enlargement of the Eurozone

Berlin Evora Helsinki Ljubljana Bologna Tartu Warsaw



## **Regional Input: Labour Markets in Benelux, France and Germany**

Achim Kemmerling<sup>1</sup>

### **1 Overview**

Western European labour markets show a considerable lack of flexibility in terms of employment and wages (e.g. OECD 1994). In the beginning of the 21<sup>st</sup> century, two main events are expected to increase pressure for a more flexible job market in Western Europe: The European Monetary Union and the eastern enlargement of the European Union.

European Monetary Union enhances pressure on labour markets in three respects. First it tightens fiscal policy in accordance with the so-called stability pact and thus forces governments to cut spendings on social security systems. Labour market policies will have to find better ways to get unemployed people back to work more quickly. Second, since there is no room for devaluation of national currencies, opportunities for job creation by increasing exports are forgone, too (Bolle/Neugart 2000). Third, the integration of product and capital markets in a common currency area will lead to more transparency. This fosters competition between firms and thus, again, market forces are going to cut bargaining power of trade unions and put wages and employment protection under pressure (Burda 2001). If labour markets and institutions do not become more flexible, higher unemployment rates will be the consequence.

The same results become true for eastern enlargement of the European Union. Although economic integration is expected to have positive overall welfare effects for all countries involved (Baldwin 1994), gains may be strictly distributed between factors, sectors and

---

<sup>1</sup> I thank Sandra Pogodda and Andreas Spannbaauer for research assistance. All remaining errors are mine.

regions. Eastern enlargement will affect Western European labour markets through the channels of (1) trade, (2) foreign direct investments and (3) migration and, in fact, increase pressure on labour markets in western Europe in the following way (cf. Ezoneplus 2001): First, trade between regions with different factor endowment might lead to factor price convergence without factor mobility according to the Heckscher-Ohlin-Model. Thus, imports from low-wage CEECs may force competition in product markets in western Europe and thus lead to lower wages and higher unemployment in the sectors concerned. Second, the same result might become true as a consequence of foreign direct investment: Firms may have an incentive to move production to eastern Europe because of market access and/or lower wages and taxes. This might reduce labour demand and, again, lower wages and higher unemployment might be expected. Third, migration to western Europe due to freedom of movement within the European Union might increase labour supply and thus competition in Western European labour markets.

In sum, this development may pose severe political problems on the process of integration. In order to avoid these problems, Western European labour markets will have to become more flexible.

So far, labour markets in the incumbent countries do not seem to be prepared well to meet the challenge. Rigidities of western European labour markets are considered high in terms of factor prices (wages) and quantities. Other important features are labour market legislation (payroll taxes, minimum wages), passive and active labour market policies (OECD 1994), wage determination and union density and labour supply measures (reduced working time and early retirement). Notably, not all of these factors are considered to cause high unemployment (Nickell 1997).

The first round of enlargement will take place earliest in 2004. Theories about rational expectations, however, would predict that that markets might already have anticipated this event since the early 1990s, at least since the application process formally started in 1998. This assumption is moreover justified by empirical evidence about former enlargement rounds: The strongest impact on labour markets in accession countries was noticed shortly after their application, not after the date of membership (cf. Burda 1999: 94). So one might ask if the prospect of eastward enlargement has already reshaped Western European labour markets. This is what this paper intends to.

Section 2 starts with a glance on the current state of Western European labour markets. It describes the development of quantitative adaption of labour markets to economic changes

and discusses east west migration in more detail. A next step contains the question whether wages have already become more flexible in the wake of enlargement (Section 3). The second main part probes into the issue of so-called real rigidities. Section 4 deals with the current state of labour market policies and institutions. Section 5 discusses other relevant issues that condition the performance of labour markets such as social security systems, taxes and pensions.

## **Part I: Western European Labour Markets – Structures and Trends**

### **2 Migration, Mobility and the Composition of Labour Markets**

Are Western European labour markets prepared to absorb the shock of integrating Eastern economies into the EU? A short glance on aggregate data shows that the state of labour markets is everything but cosy at the moment (cf. Table 1). Unemployment, the politically most important indicator of labour markets, continues to be high in Belgium, France and Germany. Only the Netherlands have reduced (open) unemployment to levels even lower than the US rate. Long-term unemployment indicates that differences are due to structural problems as it is especially high in Belgium and Germany but has fallen significantly in the Netherlands. Another way of accounting for structural unemployment, the NAIRU, shows that in Western Europe equilibrium unemployment rose sharply in the 80s. Since then it stagnates on a high level – except for the Netherlands (Chart 2.1) that have witnessed a considerable down-turn of unemployment.

To round up the picture of aggregate levels, it is insightful to look at overall employment levels. Interestingly, those countries with high unemployment rates also show the lowest aggregate labour supply in terms of people employed. The contrast is particularly evident for low female labour force participation in Germany and Belgium. However, there are also high differences in the number and distribution of total hours worked in a national economy. Due to a high percentage of part-time workers, the overall amount of working hours in the Netherlands lacks significantly behind the number of employed people (Nickell/ Layard 1999: 3034). Another means of redistributing work is to reduce the average number of years worked. The level of early retirement is high in all sample countries with Belgium ranking on top position of core OECD countries. Germany is one of the countries with lowest participation rates for young people up to 25 years old (Schömann et al. 1998: 37).

Changing from stock to flow analysis of Western European labour markets it becomes evident that low employment, high unemployment and low levels of mobility and turnover go



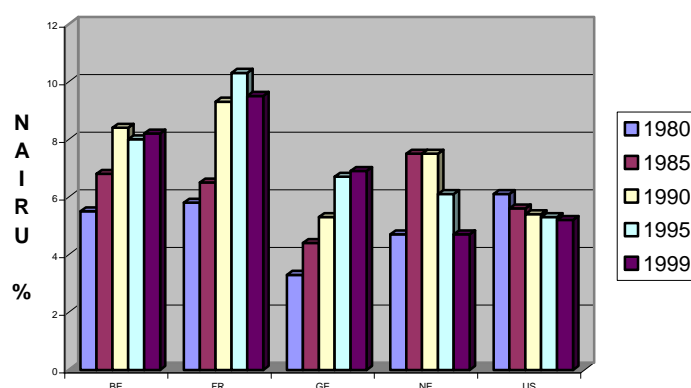
hand in hand. Regional mobility, for instance, is low in the sample countries, ranging from 1 to 1.5 per cent of total labour force per annum (OECD 2000; EU 2001). The mirror image of such low mobility rates is a high variation in regional unemployment rates in both big economies, France and Germany. Similar arguments hold for occupational mobility. Though it is difficult to compare changes of professions from one country to another, there is some evidence that overall levels are low compared to OECD standards (Schömann et al. 1998: 92). The general reaction of European labour markets to structural changes has been unemployment and early retirement rather than switching occupations. In general, turnover rates are low in Western Europe relative to other countries.

**Table 1: Standard Labour Market Indicators**

Time	Unemployment Rate					Employment/Pop ratio					Labour Force Participation Rate					Long-term Unemployment				
	BE	FR	GE	NE	US	BE	FR	GE	NE	US	BE	FR	GE	NE	US	BE	FR	GE	NE	US
1990	7,2	9,2	4,7	7,4	5,6	54,7	60,4	64,8	61,8	74,3	59	66,5	70	60,5	78,7	68,7	38	46,8	49,3	5,5
1991	7	9,1	5,6	6,9	6,8	56,1	60,4	67,6	62,9	73	60,3	66,5	71,6	62	78,4	62,9	37,2	31,6	46,1	6,3
1992	6,7	10,1	6,6	5,5	7,5	56,8	60	66,7	63,8	72,9	60,9	66,8	71,5	63,3	78,8	59	36,1	33,5	43,9	11,1
1993	8,1	11,1	7,9	6,1	6,9	56,3	59,5	65,7	63,8	73,2	61,2	67	71,3	62,7	78,7	52,9	34,2	40,3	52,3	11,5
1994	9,6	12,4	8,4	6,8	6,1	56	58,7	65,1	63,9	74,2	62	67	71,1	62,7	79	58,3	38,3	44,3	49,4	12,2
1995	9,3	11,6	8,1	7	5,6	56,6	59,4	65,2	65,6	74,7	62,4	67,2	71	60,6	79,2	62,4	42,3	48,7	46,8	9,7
1996	9,5	12,1	8,9	6,5	5,4	56,6	59,6	64,9	66,7	75	62,5	67,8	71,2	61,5	79,3	61,3	39,5	47,8	50	9,5
1997	9	12,3	9,8	5,5	4,9	57,3	59,2	64,5	68,7	75,7	62,9	67,5	71,5	61,9	79,6	60,5	41,2	50,1	49,1	8,7
1998	9,3	11,8	9,2	4,3	4,5	57,5	59,7	65,4	70,4	76	63,5	67,8	72	62,3	79,6	61,7	44,1	52,6	47,9	8
1999	8,6	11,8	8,6	3,5	4,2	59,4	60,1	66	71,8	76,2	65	68,1	72,3	63,3	79,5	60,5	40,3	51,7	43,5	6,8
2000	6,6	10	8,1	3,3	4	61,3	61,5	67	72,7	76,4	65,6	68,3	72,9	53,4	79,6	56,3	42,5	51,5	32,7	6

Source OECD Labour Force Statistics 2002

**Chart 1: Equilibrium Unemployment Rates 1980 – 1999**



Source: Van Poeck/ Borghijs 2001 based on OECD Ec. Outlook 2000

Besides regional and occupational mobility there is cross-boarder exchange between European countries. Free movement of labour is one of the central features of the EU acquis. Key empirical questions discussed in the literature so far are first, To what extent will an increase of labour supply from Eastern Europe affect labour markets in the selected countries? Second, Is there empirical evidence for increasing migration up to now? And, finally, How is migration distributed across sectors and regions/ countries? (e.g. Kunze 2000; Boeri/Brücker 2000; DIW 2000).

Due to legal restrictions (Kunze 2000: 121), migration from eastern Europe has been quite moderate until now (Table 2). Moreover, a glance on the total stock of migrants shows that only border regions (Germany, Austria) are going to be affected by migration. In Germany, net migration flows from eastern Europe were estimated around 830.000 persons between 1988 and 1995 (Kunze 2000: 121). The number decreased until the end of the decade due to the tightening of legal restrictions introduced in 1993 (e.g. fewer working permits). The share of workers from eastern Europe to the total stock of working immigrants in western German labour markets increased until the mid of the 1990s from 6 per cent (1990) up to 10 per cent (1996) (Kunze 2000: 124). But these figures have to be treated cautiously because of illegal forms of migration. The number of illegal workers from CEEC-10 might be around half a million persons (Hönekopp 1997: 11).

**Table 2: Stock of total and CEEC-immigrants in Western Europe**

Member State	Total stock of CEEC-10 immigrants (1998)*	CEEC-10 Immigrants in percentage of population	Total Inflow non-EU Immigrants**	Total Inflow of non-EU Immigrants as per cent of working age population**
BEL	10773	0,1	68466	1
GER	554869	0,7	874023	1,6
FRA	22000	0	100014	0,3
NLD	9606	0,1	119151	1,1

Sources: \* DIW Wochenbericht 21/2000, \*\* Employment in Europe (2001: 42)

Skill-levels of immigrants play an important role for shaping the impact of migrants on labour markets in the host countries. Workers from eastern Europe are markedly higher qualified than immigrants in former rounds of EU-enlargement (Sinn 2000). However, since they are

employed in jobs with low wages that afford low qualification (Kunze 2000), rentability on human capital is not very high for most of them. In most cases, immigrants from CEEC-10 have been working in agriculture, construction and services in the past. Notably, employment of foreigners didn't have many negative effects on wages for German workers in total, although subcontracting Eastern European construction workers was considered to have an impact on unemployment of German construction workers (Kunze 2000: 125ff.) and their wages. This has led to political pressure from the sector specific trade unions and, finally, to legal protection of German workers (Kunze 2000).

Enlargement of the EU including free movement of labour should boost migration to Western Europe because of large income differentials. In the view of the Deutsche Institut für Wirtschaftsforschung (DIW) the number of foreign residents from the CEEC-10 in the EU-15 will increase by around 335.000 people p.a. immediately after the introduction of freedom of movement without delay. Germany is expected to receive 220.000 people p.a. – some 70 per cent of the total – immediately after full membership. Unskilled labour in the host countries, in particular, is feared to loose from migration in terms of wages and employment. The DIW concludes that an increase in the migrant share in a given branch by one percentage point decreases average wages there by 0.6 per cent in Germany and increases the individual risk of dismissal by 0.2 percentage points (Boeri/Brücker 2000). Sinn (2000) cites estimates of 250.000 to 300.000 immigrants p.a. from CEEC-10.

So far, these figures are much lower since the EU and the CEEC-10 agreed on restricting free movement of labour force for a limited period. To conclude, most observers (e.g. Puhani 1999) think that low cross-national mobility continues to be one of the main sources of real rigidities even after the accession of new countries to the EU.

### **3 Flexibility of Nominal and Real Wages**

Apart from increasing mobility of labour, wage flexibility is the second major process to be induced by Eastward enlargement. Intensified competition – due to more transparency in labour costs and prices in the wake of EMU – threatens labour-intensive firms, above all in regions next to Eastern Europe. Especially those enterprises with low productivity but without any possibility to source out parts of their business in countries with lower price levels are particularly sensitive to the growth of labour costs relative to other countries (Nicoletti 2001: 175).

According to Burda (2001) in an enlarged internal market the product market competition among companies will increase dramatically. Hence there will be a rising elasticity of product demand and of the demand for labour. Because of EWU, nominal price rigidity is expected to increase in an enlarging internal market (ibid.: 8ff.). On the other hand, nominal wages are likely to be less rigid than prices and should covary increasingly in accordance with macroeconomic factors such as unemployment and productivity increases.

Empirically speaking, a first source of flexibility is between nominal wages and nominal prices. Burda (2001: 12) reviewing some evidence finds that, indeed, nominal prices are increasingly 'more rigid' than nominal wages. Moreover, the basic law of social entropy informs the hypothesis that the cross-country correlation in nominal wages should be decreasing. Both Burda (2001) and Bolle/ Neugart (2000) found some empirical truth in these claims.

**Table 3: Nominal Manufacturing Wage Growth Correlations in National currency**

	Average Correlation Coefficient in Group Nominal Wage Growth in Local Currency		
	Total Sample	1961-79	1980-96
Core Europe* (BE, NE, GE, AT)	0.68	0.64	0.42
Core Europe+ FR, DK, IT*	0.66	0.59	0.22
Euro-11*	0.69	0.56	0.34
		1986.1-1992.4	1993.1-1998.2
(BE, AT, GE, FR, NE)**	-	0.34	0.00
<b>(BE, NE, FR, GE)**</b>	-	<b>0.42</b>	<b>0.04</b>
EU-11 + SW, DK**	-	0.20	0.07

Source: \* Burda (2001); \*\* Bolle/ Neugart (2000)

Table 3 displays the advanced divergence in the past decade. The nominal wage behaviour in EU member states has become increasingly uncorrelated over time - a tendency which will certainly increase with the enlargement. This is not only valid for larger samples, but also for those containing exclusively the countries analysed here.

Less nominal wage flexibility together with more nominal price rigidity is likely to coincide with increased real wage flexibility. Analyzing the development of real wages in France, Germany and in the Benelux-countries, one can notice a tendency to more responsiveness of wages with reference to the unemployment rate and productivity (Table 4).

**Table 4: The Correlates of Real Wage Growth in Manufacturing**

	Belgium			Netherlands			Luxembourg		
	1980-'89	1990-'95	1996-'01	1980-'89	1990-'95	1996-'01	1980-1989	1996-2001	1990-'95
Rw	0,6	2,7	0,7	-0,3	0,9	0,6	1	0,5	1,6
$\varpi$	2,2	1,7	1,8	1,5	1,5	1,1	3	1,4	2,0
rr	1,6	-1	1,1	1,8	0,6	0,5	2	0,9	0,4
ur	9,7	8,2	9	8,5	6,5	3,9	2,6	2,4	2,4

	Germany			France		
	1980-'89	1990-'95	1996-'01	1980-'89	1990-'95	1996-'01
Rw	1	2,2	0,5	1	0,9	1,2
$\varpi$	1,4	2,4	1,9	2,3	1,6	1,7
rr	0,4	0,2	1,4	1,3	0,7	0,5
ur	5,8	6,9	8,8	9	10,8	11,3

Rw= real wage growth,  $\varpi$ = productivity growth, rr= restraint rate regarded as the difference between real wage growth and productivity growth, ur= unemployment rate

Source: Eurostat pocketbook

Another aspect of wage developments in Western Europe is distributive in nature. How has wage restraint evolved in the course of EMU and enlargement? So far it seems that even during periods of high productivity growth the wage increases have been moderate. The wage bargaining in Germany and the Benelux-countries seems to take unemployment rates increasingly into consideration. France, on the contrary has witnessed a different development: While the unemployment rate has permanently risen, real wages also have increased in comparison with productivity growth.

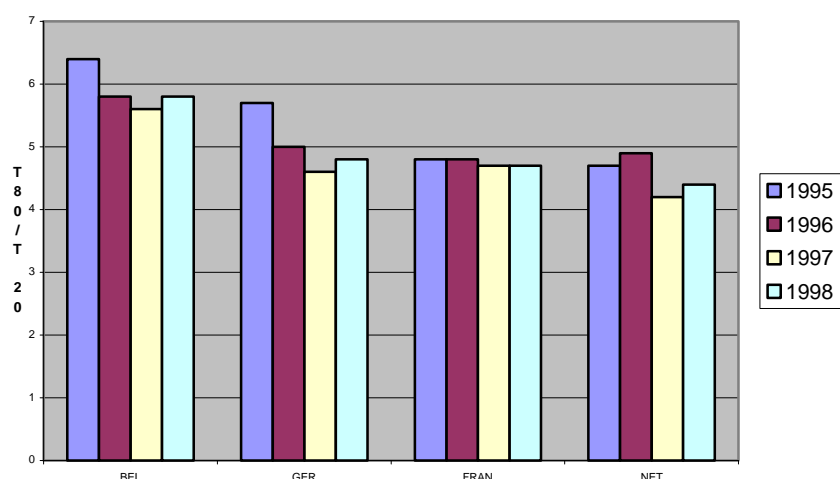
Hence the adaptability of wages to growth has increased, though to a very limited extent. How do we account for this phenomenon? For an explanation, two different approaches are suggested that both settle around the bargaining power of trade unions. Some economists believe the smaller nominal wage rigidity to be evidence for superior bargaining arrangements of corporatist countries (Teutlings 1998: 170). They assume that in these countries wage bargaining at a higher level allows wage contracts to be varied more easily than in decentralised countries where the two sides, antagonistic in most cases and suspicious of each other, fear „hold-up“ when a wage contract is varied (Siebert 2001).

A second explanation interprets the growing exit options for owners of capital as a clear bargaining disadvantage the unions face at present (Burda 2001). Finally, another source of pressure on the bargaining behavior of unions could originate from the changing mind within the society: The increasing extent of unemployment could have aggravated public discontent with the insider-outsider-policy of unions. Therefore they may be more and more forced to consider the requirements of unemployed people and exert more wage restraint.

The increased necessity to reduce wage rigidities may also lead to shorter durations of wage contracts (Bolle/ Neugart 2000). Long durations prevent wages from adjusting to shifts or demand for labour. Proponents of such a policy in Western Europe claim that shorter contracts will decrease inertia of wages relative to swings in productivity (Nicoletti et al. 2001; for alternative views see discussion in Bolle/ Neugart 2000). Though there is some anecdotal evidence at least for the German case, at present it is very difficult to substantiate these claims with empirical data.

A last dimension of wage flexibility is the adaptability of wage structure to differences in qualification. Empirically, this means larger spreads between average wages and high- or low-paid jobs. Earnings in Western European low-wages sectors appear to be high compared to other countries. This relates to evidence that manufacturers in Austria and Germany have started to outsource low-paid jobs to Eastern Europe (e.g. Dell'mour 2000).

**Chart 2: Wage Differentials in Manufacturing**



Source: Eurostat pocketbook

At present there is no evidence for increasing wage differentials induced by enlargement. To the contrary, the ratio between the 20% highest and lowest (Chart 2) has considerably declined for Germany and Belgium. This empirical coincidence between increasing flexibility in nominal wages and decreasing wage differentials seems to corroborate an old argument of (neo-)corporatist theory: Unions are likely to accept lower wages in a situation of increasing pressure on labour costs only on condition that they are able to prevent the relative heterogeneity of remuneration within the workforce (Siebert 2001). But clearly the bargaining system is not the only political institution that decreases wage inequality in an economy.

## **Part II: Western European Labour Markets – Policies and Institutions**

This part reviews some of the major issues and recent changes in institutions and policy areas that are relevant for developments in the labour market. It starts with briefly sketching the issues of wage bargaining systems and various forms of labour market policies and regulation. Thereafter, the social security system, tax policies and some other policies are discussed.

### **4 Wage Bargaining Systems and Labour Market Regulation**

How feasible is it to assume that the Eastward Enlargement of the Eurozone will dismantle real rigidities in the labour market? There are good reasons to believe that traditional wage bargaining systems are put under pressure. As the previous part has shown, there is some evidence that labour markets have become slightly more flexible.

Though Western European bargaining institutions are similar in some respects, there are also crucial differences between them. In general, the level of centralisation of wage bargaining is assumed to be important for the macroeconomic performance (e.g. Calmfors/ Driffill 1988). Germany is a prototypical case of a system centred around industry-level negotiations that typically follow a sort of coordination practice dubbed as ‘patterned bargaining’: wage bargaining in the most influential sectors (metal industries, public employees) are serving as anchors for other industries. Bargaining is least coordinated in France (OECD 1997a; Kittel 2001a). Wage bargaining in Belgium and the Netherlands is also industry-specific, though the temporal evolution shows that in the 70s and 80s there were also peak-level talks frequently orchestrated by the government.<sup>2</sup>

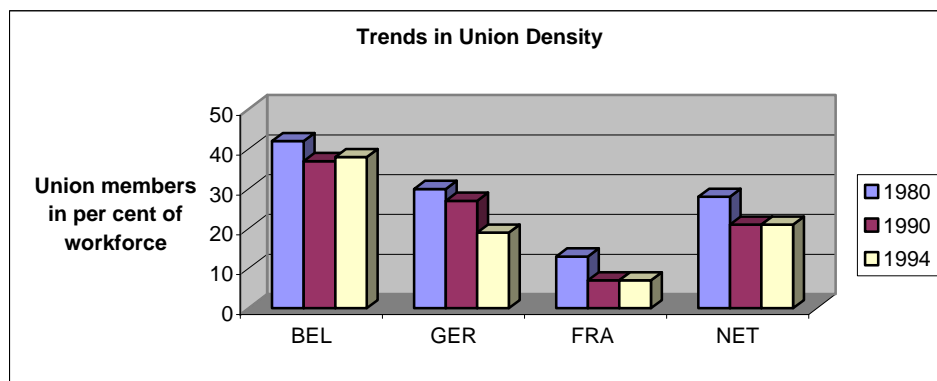
While the institutional features still show some inertia, changes in the organisation of unions are plainly visible. Union density (Chart 3) shrunk in Germany and France by half, whereas the decline was smoother in Belgium and the Netherlands. Some trade unions reacted to this trend with increasing concentration. The recent merger of major German service unions into the world’s largest union, VERDI, is a case in point. Interestingly, the coverage rate of wage contracts increased in all countries (Chart 4), implying that the number of employees affected by wage negotiation has not diminished till the mid-90s. There is, however, increasing regional and sectoral variety. The prime example is Eastern Germany (cf. Sinn 1999). After

---

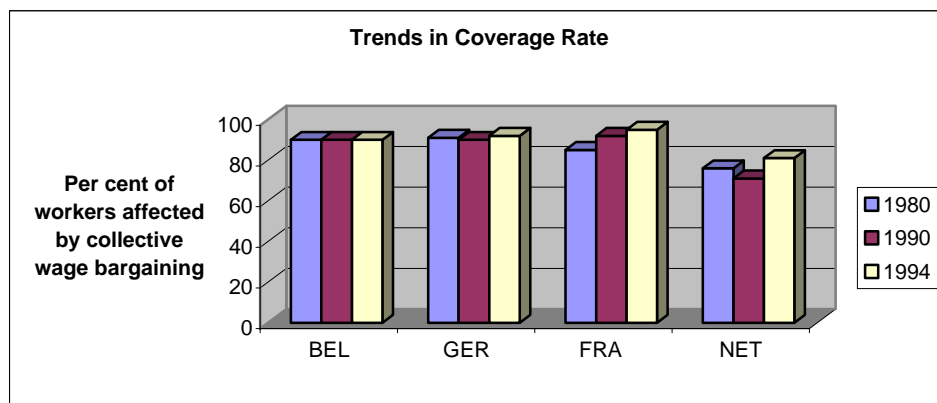
<sup>2</sup> Besides, this also implies that the idea of Calmfors and Driffills (1988) hardly fits the Western European case: although all countries show intermediate bargaining levels, the unemployment performance is very diverse.

the introduction of Western wage standards and levels the labour market was virtually annihilated. As a consequences employers' associations and even trade unions openly break with contracts set on the national level and relinquish their membership. In addition, there is also some anecdotal evidence that firms in Eastern Germany use their exit threat capacities, increased by the prospective of enlargement, to a considerable degree during wage negotiations (Kittel 2001).

**Chart 3: Trends in Union Membership**



**Chart 4: Recent Trends in the Coverage of Collective Bargaining**



Recent evidence suggests that strictness in employment protection causes lower turnover in the labour market as well as higher unemployment for some segments in the market. Synthetic indicators of employment protection (OECD 2000) show that strictness has – on the average – increased in the last years for all sample countries but the Netherlands. Overall levels are extraordinarily high for the German and French case benchmarked to ‘liberal’ protection schemes (cf. Table 5).



Increased pressure on labour market policies should also augment the necessity to implement the 'OECD job strategy' initiated in 1995. One of its major ingredients was to raise the expenditures for active labour market policies (ALMP) relative to passive ones. As a recent study (CESifo 2000) suggests this has not quite materialised so far. Although ALMP have risen relatively to GDP, at least in Germany passive transfers have clearly outpaced ALMP in the 90s. Moreover, as the scandal about the German Federal Office of Labour shows, the efficiency and governance of these transfers is clearly limited.<sup>3</sup> Another major form of 'clandestine' ALMP is public employment. Due to the general down-sizing of the public budget, public employment is also clearly on retreat.

Western European countries differ strongly in their attempts to redistribute work between the employed. The Netherlands are a prime example of a part-time economy that has been fostered by both the government and the industrial partners. Recently, France has passed several bills to reduce standard weekly working hours to 35. There are, however, important countervailing effects that reduce the total amount of employed people. The calamity of the old-age security systems has led to a hot debate about raising the average retirement age in Germany, France and Belgium. But, until now, all countries show a trend towards a decline in age and an increase in the expenditure for regular and disability pensions.

Minimum wages are another potential source of 'real labour market rigidities'. Although in terms of net replacement rates there are striking similarities (Nickell/ Layard 1999), minimum wages differ markedly in their relative importance across Western European labour markets. Specifically, raising 'SMIC' has always been a primordial point on the agenda of French governments, as the share of workers close to the minimum wage is much higher in France than anywhere else in core OECD countries (cf. Table 5). There is also some institutional variety as minimum wages are statutory in nature for both France and the Netherlands, whereas in Germany and Belgium they are reached by collective agreements between the industrial partners.

---

<sup>3</sup> In February and March this year, a federal control body revealed that the numbers of most of job services like placement and brokerage the Bundesanstalt für Arbeit (BfA) publishes are 'fake'. Up to 70 per cent of jobs allegedly mediated by the BfA have been 'spurious' in nature.

## 5 The Social Security System, Taxes and Migration Policies

Eastward enlargement, so the argument goes, increases the pressure on 'excessively' benevolent welfare states by the mechanisms of 'locational competition' for physical capital ('Standortwettbewerb'), trade and migration, as well as the erosion of tax systems and 'tourism' for social transfers (e.g. Burda 2001; Sinn 2000). While this question is open for speculation in future, it is interesting to scrutinize the recent past: Is there evidence for significant changes in major components of the social transfer system?

One of the focus points in the debate about real rigidities is the lack incentives for labour supply. In Western Europe social benefits are considered to be too high for many people to take up work. Table 5 shows replacement rates for unemployment benefits (usually with limited duration) and unemployment assistance (usually unlimited). Since some countries such as the Netherlands tax these benefits only net-of-tax ratios are shown. In 1997 unemployment assistance of the sample countries are significantly higher than in the US. This fact is closely related to the duration of these transfers which is much longer than in the US and, so far, there has been few changes. The picture for other forms of social transfers such as social assistance is very similar (OECD 1997). Hence, there is some variation between countries in terms of duration, whereas replacement levels were all in all in the same range and significantly higher than in the UK or US. But there is no evidence that there have been sizeable retrenchments so far. The OECD (1997), for example, shows that neither the benefit levels nor the duration has declined. There are, however, some qualitative changes that have arguably changed the responsiveness of labour supply predominantly in the Netherlands. The Dutch system makes increasingly use of conditionalising social benefits to active job search and take-up behaviour. In other words, social transfers are more and more granted on the basis of a however precariously defined willingness to work.<sup>4</sup>

---

<sup>4</sup> Two catch-words have been used in this context. The concomitance of high replacement levels with low levels of job protection has been dubbed 'flexicurity'. The increasing activation of people receiving benefits is known as 'workfare'.

**Table 5: Some Illustrative Indicators or Real Rigidities**

	Year	BE	FR	GE	NE	US	Source
Employment Protection	late 80s	1,5	2,3	2,7	3,1	0,2	OECD 1999
(overall strictness)	late 90s	1,5	2,3	2,8	3,1	0,2	
Employment Protection	late 80s	4,6	3,1	3,8	2,4	0,3	
(regulation of part-time)	late 90s	2,8	3,6	2,3	1,2	0,3	
Minimum Wages ( relative to average)	1991-1994	0,6	0,5	0,55	0,55	0,39	(Nickell/ Layard 1999)
Minimum Wages (% of workers at minimum)		4	11		3,2	4	
Unemployment Benefits (net replacement rates)	1997	64	71	60	75	60	OECD 2002
Unemployment Assistance (net replacement rates)		46	38	57	60	7	
Tax Wedge	1990	53,7		46,4	46,5		OECD 1998
(single average production worker)	1997	56,6	48,7	52,3	43,6		

Apart from the high number of unemployed people, pensioners are a second important source of financial distress for the welfare state. Here, too, cuts in replacement rates have been modest so far. As the previous sections showed the number of recipients in the old-age security system even increased in all countries due to early retirement. Nevertheless, there is a considerable degree of variation across countries concerning the dominance of public vs. occupational or private pension schemes. As is well known, public pensions are much less relevant in the Netherlands than in any other of the sample countries. On the contrary, the remaining countries had to increase the amount of social security contributions significantly in the last decades. Nowadays, in all countries but Belgium payroll taxes (including social security contributions) are the single most important form of public revenues (OECD 1999).

The last point prompts the question how the tax system has changed in recent times. The ratio of total taxation to GDP has increased in all four countries, though the rate of increase slowed down in comparison with the 70s (ibid.). Although all countries cut statutory income tax rates and reduced complexity, average effective tax rates on labour in total are still (slightly) increasing (Ganghof 2000; Daveri 2001). High marginal effective tax rates fire badly back for workers in low income brackets of the income distribution. Thus they can easily fall into the unemployment trap (OECD 1997a). None of the four countries has implemented a negative income tax or related instruments so far. But in some countries, such as Germany, model experiments have been launched though with limited success both political and economical.

There are numerous other policy areas with decisive influence on labour market outcomes: education and health policies, industrial policies etc. But their impact on labour markets is

commonly considered to be ambivalent in terms of efficiency. This has led us to exclude these topics. Nevertheless, one issue merits a brief discussion as it is closely related to geographical mobility: immigration law. In recent times, Germany has seen a couple of controversial debates about which immigrants may come and how many of them will do so. Last year, the government pushed through a German equivalent to the US Green Card. This allows IT-experts to receive a work permit in Germany. The bill was passed only after a hefty controversy about the allegedly harming effects for the labour market. A similar issue is in vogue these days, as government and opposition are rowing about the question whether to facilitate general immigration to Germany or not. It seems to be more a than a mere coincidence that other countries share similar problems<sup>5</sup> and that these issues have come to the fore at a time when the EU negotiated the freedom of settlements between current and future member countries.

## **Conclusion**

The aim of this paper has been to speculate about the past and future impacts the enlargement has on Western European labour markets. Whereas the adoption of EU standards is sometimes believed to be a hazardous game for accession candidates (Burda 1999; Sinn 2000), many observers assert that the enlargement will be a 'bargain' for the West (Baldwin et al. 1997). The overall impact on Western labour markets seems to be quite small – apart from the regions close to Eastern Europe: Eastern Germany and Austria – and increasing pressure on real rigidities may exert a 'healthy' influence on wage bargaining mechanisms and social systems.

Indeed, there is some evidence that labour markets have become slightly more flexible in Western Europe. Obviously, the enlargement has played a role in these trends, but it would be a Sissiphussian task to determine the size of its impact. To a limited extent, regional mobility will and has increased in Western Europe. Most of the migrants from the CEECs could be absorbed without raising overall unemployment. Nominal wages have become more flexible relative to prices, GDP growth and across countries.

It seems less clear, however, why this is the case. Most of the institutional features that are commonly assumed to be sources of real rigidities have remained remarkably stable.

---

<sup>5</sup> Immigration has become more severely restricted in all four countries.

Moreover, political attempts to reduce them have been moderate at best. This prompts the question where the 'institutional inertia' comes from. If there is some revealed preference logic at work in the political process of enlargement, the electorate does not tolerate massive changes in these institutions so far. Hence governments seem to be cautious not to cut the leash of the second 'Trojan Horse' after the Euro, enlargement that is, immediately. Most likely they do so, because they fear a political backlash from precipitous reforms. In a nutshell, it is the social dimension of the enlargement that seems to lack in a macroeconomic account of Western European labour markets.

Finally, an important topic deals with further research of Ezoneplus. How could we go on from here? A potential avenue for both academic and disseminative purposes would be to think about synthetic measures operationalising the degree to which labour markets have already been transformed. Of course, there are already related instruments available such as those from the OECD jobs strategy or the reform monitor of the Bertelsmann Foundation. But an indicator developed by Ezoneplus could and should be different in as much as it focusses on the reshaping of labour markets in an enlarging Europe. Hence both accession and member countries should be included. This could allow us to disentangle changes in markets, institutions and policies and their potential impact on performance of Ezoneplus labour markets.

## References

- Baldwin, R.E. 1994. *Towards an Integrated Europe*. London.
- Baldwin, R.E.; J.F. Francois, and R. Portes. 1997 "The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe" *Economic Policy*, **24**April. pp. 125-176.
- Boeri, T. and H. Brücker. 2000. "The impact of Eastern Enlargement on Employment And Labour Markets in the EU Member States", European Integration Consortium: Berlin and Milano.
- Bolle, M. and M. Neugart. 2000. "Will the Euro Shape European Economies?" Conference on the Effectiveness of the Economic Policy of the Republic of Estonia and the EU. University of Tartu.
- Burda, M. 1999. "Mehr Arbeitslose - Der Preis für die Osterweiterung? Zur Auswirkung der EU-Erweiterung auf die europäischen Arbeitsmärkte im Osten und Westen", in *Schriftenreihe zur Jahrestagung des VfS, V.f. Socialpolitik*, Editor. Duncker&Humblodt: Berlin. pp. 79-101.
- Burda, M. 2001. "European Labour Markets and the Euro: How Much Flexibility Do We Really Need?" *ENEPRI Working Paper*, **No. 3**, March.
- Calmfors, L. and J. Driffill. 1988. "Bargaining Structure, Corporatism and Macroeconomic Performance" *Economic Policy*, **6**: pp. 13-61.
- CESifo. 2000. "Active Labour Market Policies Running into Trouble". CESifo Forum, **3/2000**: pp. 33-32.
- Daveri, F. 2001. "Labor Taxes and Unemployment: A Survey of the Aggregate Evidence", 2nd Annual CERP Conference on Pension Policy Harmonization in an Integrating Europe. Moncalieri, Turin.
- Dell'mour, R.e.a. 2000. "Outsourcing of Austrian Manufacturing to Eastern Countries" in *Eastern Enlargement: The Sooner, the Better?* S. Arndt, ed. Vienna. pp. 249-295.
- DIW. 2000. *DIW Wochenbericht 21/2000*.
- EU. "DG for Employment and Social Affairs, Employment in Europe 2001. Recent Trends and Prospects" Manuscript completed in July 2001.
- Ganghof, S. 2000. "Adjusting National Tax Policy to Economic Internationalization. Strategies and Outcomes" in *Welfare and Work in the Open Economy*. F.W. Scharpf and V.A. Schmidt, eds. Oxford: Oxford University Press. pp. 597-645.
- Hall, P.A. 2001. "Organized Market Economies and Unemployment in Europe: Is it finally Time to accept Liberal Orthodoxy?" in *Unemployment in the New Europe*. N. Bermeo, ed. Cambridge. pp. 52-86.
- Hönekopp, E. 1997. "Labour Migration to Germany from Central and Eastern Europe - Old and New Trends" *IAB Labour Market Research Topics*, **Nr. 23**.

- Kittel, B. 2001. "EU Enlargement and the European Social Model: Trends, Challenges, and Questions. Keynote Lecture 3" in *The European Enlargement Process: Between 'Western Acculturation' and Regional Differences*. Vienna.
- Kittel, B. 2001a. "How Bargaining Mediates Wage Determination: An Exploration in a Pooled Time-Series Cross-Section Framework" *MPIfGF Discussion Paper*, **01/3**.
- Krugman, P. and M. Obstfeld. 1988. *International Economics*. London.
- Kunze, C. 2000. "Die Osterweiterung der Europäischen Union und ihre möglichen Folgen für den deutschen Arbeitsmarkt" *Transformation* **Nr. 9**. pp. 115-135.
- Nickell, S. 1997. "Unemployment and Labor Market Rigidities: Europe versus North America" *Perspectives* **11**: pp. 55-74.
- Nickell, S. and R. Layard. 1999. "Labor Market Institutions and Economic Performance", in *Handbook of Labor Economics* O. Ashenfelter and D. Card, eds. ? : ? pp. 3029-3083.
- Nicoletti, G.e.a. 2001. "European Integration, Liberalization and Labor-Market Performance" in *Welfare and Employment in a United Europe*. G.e.a. Bertola, ed. Cambridge.
- OECD. 1994. "The OECD Jobs Study: Evidence And Explanations, Part II: The Adjustment Potential of the Labour Market" Paris.
- OECD. 1997a. "Making Work Pay: Taxation, Benefits, Employment and Unemployment", Paris: OECD Publications.
- OECD. 1997. "Economic Performance and the Structure of Collective Bargaining. Employment Outlook 1997" pp. 63-92.
- OECD. 1999. "Employment Protection and Labour Market Performance. OECD Employment Outlook, 1999." pp. 50-59.
- OECD. 1999a. "Tax Revenue Trends, 1965 - 1998. Revenue Statistics 1965 - 1998" pp. 17 - 39.
- OECD. 1999b. "OECD Employment Outlook" Paris.
- OECD. 2000. "OECD Employment Outlook" Paris: OECD.
- OECD 2002. "Database - Labour Market Statistics" OECD.
- OECD. 2002. "About Benefit Systems and Work Incentives. A Selection of Net Replacement Rates" <http://www.oecd.org/pdf/M00009000/M00009888.pdf> Date of Access 29/03/02.
- Puhani, Paul. March 1999. "Labour Mobility – an Adjustment Mechanism in Euroland? Empirical Evidence for Western Germany, France, and Italy" *IZA Discussion Paper* No. 34.
- Schömann, K., T. Kruppe, and H. Oschmiansky. 1998. . "Beschäftigungsdynamik und Arbeitslosigkeit in der Europäischen Union" *WZB Discussion Papers*, FS I 98-203.

- Siebert, S.W. 2001. „Can Corporatism Partially Offset the Effects of Rigidities?” in *Beschäftigungspolitik in Europa*, D.F. Milleker, ed. Frankfurt. pp. 53-64.
- Sinn, H.-W. 1999. „EU Enlargement, Migration, and Lessons from German Unification” *CESifo Working Paper Series*, No. 182.
- Sinn, H.-W. 2000. “EU Enlargement and the Future of the Welfare State” *CESifo Working Paper*, 307.
- Sinn, H.-W.e. 2000. “ifo Beiträge zur Wirtschaftsforschung: EU-Erweiterung und Arbeitskräftemigration“, Institut für Wirtschaftsforschung: Munich.
- Teutling, C.a.J.H. 1998. *Corporatism or Competition*. Cambridge.
- Van Poeck A., Borghijs A. 2001. “EMU and Labour Market Reform: Needs, Incentives and Realisations” *Research paper / Faculty of Applied Economics UFSIA-RUCA ; 2001:22*, Antwerpen.
- Wallerstein, M., M. Golden, and P. Lange. 1997. “Unions, Employers' Associations, and Wage-Setting Institutions in Northern and Central Europe, 1950-1992.” *Ind Labor Relat Rev*, 50:3 pp. 379-401.





**Faculty of Economics and Business Administration**

**University of Tartu**

**LABOUR MARKET FLEXIBILITY AND MIGRATION IN THE EU EASTWARD  
ENLARGEMENT CONTEXT: THE CASE OF THE BALTIC STATES**

By

Tiiu Paas

Raul Eamets

Marit Rõõm

Rena Selliov

Anne Jürgenson

Jaan Masso

**Tartu**

**2002**

## Table of Contents

1. Introduction .....	22
2. The main changes in the Baltic States' labour markets.....	24
3. The concept of labour market flexibility .....	27
4. Institutional flexibility .....	30
4.1. Labour market regulation .....	30
4.2. The role of trade unions.....	33
4.3. Labour market policy .....	36
5. Wage flexibility .....	38
6. International labour migration.....	41
Conclusions .....	45
References .....	46

### 1. Introduction

The Eastern enlargement of the European Union and the requirements of the European Monetary Union (EMU) increase pressure for a flexibility of labour markets in both the current EU members (EU15) and candidate countries (CC)<sup>1</sup>. In order to follow the requirements of optimal currency area (OCA) the growth of labour market flexibility is unavoidable. If labour markets and institutions do not become more flexible, the growth of market disequilibrium is highly probable in both groups of countries.

The EU candidate countries have to combine transition processes with the requirements of the accession. Labour markets of the candidate countries deserve special attention because of their flexibility may be needed to offset asymmetric shocks, especially when other means such as monetary and fiscal policies are constrained. If labour markets of the accession countries fail to adapt to the challenges of monetary union, the convergence process will be hindered. This, in turn, may result in high unemployment and growth of labour migration. Social conflicts are possible in the accession countries as well the EU current member states.

The first round of EU eastward enlargement will take place earliest in 2003 or 2004. Of the former Soviet republics only the Baltic States are EU accession candidates. The Baltic States' favourable location between East and West, historical and cultural traditions of cooperation with the countries around the Baltic Sea, and market economy experience of the period

---

<sup>1</sup> Candidate countries (CC10) are Hungary; the Czech Republic, Slovenia, Poland, Slovakia Estonia, Latvia, Lithuania, Romania and Bulgaria.

between the two world wars are important initial conditions for transition. After regaining their independence in 1991, the Baltic States' have followed almost similar principles of economic policy that were directed to solving the following main tasks: 1) liberalization of prices and gradual elimination of all state subsidies; 2) privatization of state owned enterprises; 3) introducing a separate currency by means of a currency board system (Estonia and Lithuania) or regular pegs (Latvia); 4) maintaining conservative fiscal policy; 5) implementing a comparatively liberal foreign trade regime.

The Baltic States are providing an interesting case for generalizing transition and EU eastward enlargement processes and developing a new field of economics – economics of transition and integration. However the real influence of the Baltic economies on the EU eastward enlargement processes can not be significant due to very small size of the Baltic markets comparing to the markets of the EU current member states as well as the candidate countries. The share of the Baltic States' population is only 2% of the EU15 and 7.4% of CC10 population. The GDP of the Baltic States is forming about 0.3% of the EU15 and 6.3% of the CC10 total GDP (Straubhaar, 2001, p. 170).

The aim of the paper is to give an overview of the main changes in the Baltic States' labour market over the period (1990 – 2001) giving emphasis on the problems of labour market flexibility in the EU eastward enlargement context. The first section reviews the main changes in the Baltic States' labour markets. The next three sections analyse labour market flexibility issues paying attention to the macro level of this concept. Flexibility of labour market on the macro level can be divided into wage flexibility and institutional flexibility. Wage flexibility denotes how responsive wages are to market fluctuations. The institutional flexibility characterizes to what extent state institutions and trade unions are involved in the regulation of the labour market. These different aspects of labour market flexibility are interrelated. If institutional involvement is high, decrease of labour market flexibility could be the consequence. In case of trade unions weakness, wage flexibility is usually high.

Labour migration problems are discussed in the section five giving emphasis on pull and push factors of migration and on analysis of labour migration experience during the previous stages of EU enlargement. In the case of the Baltic States labour movement is mostly expected within the Baltic Sea region that has become one of the most competitive economic regions in Europe due to its favourable location between East and West and the dynamic

interdependence between transition and integration. The possibilities for cross-border movement of the Baltic States' labour force are also discussed in this part of the paper.

## **2. The main changes in the Baltic States' labour markets**

In this section the main trends in development of employment and unemployment are described. Unemployment, the politically most important indicator, which was relatively modest during the first years of transition, is continuing to be high now in all three Baltic States (Estonia 13.9%, Latvia 14.7 and Lithuania 15.9 in 2000). At the same time mobility of labour is declining comparing with the first period of transition, particularly in the case of Estonia, where transitions to and from employment, unemployment and non-participation have been relatively high in the beginning and middle of 90s.

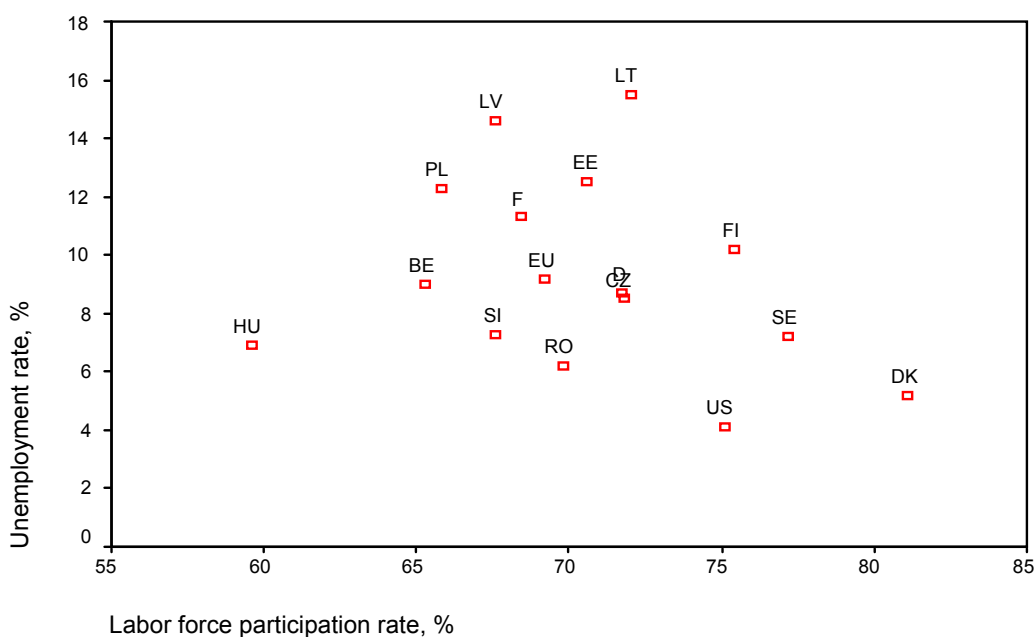
As in most other transition economies of Eastern Europe, the size of the population in Estonia and Latvia fell rather sharply in the early 1990s, and it continued to decline in the late 1990s, albeit more moderately. The decline reflects both negative natural increase and negative net migration. At the same time, the Estonian and Latvian populations also aged quite substantially. In Lithuania, by contrast, the population declined only negligibly: while the rate of natural increase was negative, the magnitude was much smaller than in Estonia and Latvia. Moreover, Lithuanian net migration has been close to zero, and in some years it was even positive. Like in Estonia and Latvia, however, the Lithuanian population has aged significantly.

Following the pattern in most other East European economies, the labour force participation rate declined sharply in all three Baltic countries. There are some differences in variation in labour force participation and employment rates across gender and age groups. The levels of the rates overall, by gender, and by age group are quite similar across countries, but some of the trends are markedly different. The declining participation in Estonia and Latvia over these four years, while in Lithuania a falling male participation rate was largely offset by a rising female rate. By age, the biggest changes in participation tend to take place for the youngest and oldest groups.

The difference between the magnitude of the decline in activity and the employment decline is of course mirrored in the rise in unemployment. The Baltic States have experienced some of the highest levels of the unemployment rate in all East European economies, with maximum rates of 13.7 in Estonia (2000), 19.4 in Latvia (1996), and 17.1 in Lithuania (1995).

After peaking in the mid-1990s, the unemployment rate fell back in all three countries, but while the pattern in the late-1990s has been continually falling in Latvia, it has been U-shaped in Estonia and Lithuania. The rise in the latter two countries was particularly steep in 1999 and 2000, perhaps due to side-effects of the Russian crisis. By 2000, the rates were roughly equal in all three countries, in the 13-15 percent range.

Figure 1.1 allows comparing activity and unemployment rates in the Baltic States with other CEE countries, as well as established market economies. While activity level in the Baltic States is roughly equal to the EU average and similar to what is found in Slovenia, Romania, Czech republic and Slovenia, it is lower than in the Nordic countries and the US but higher than in Poland, Hungary and Bulgaria. Unemployment rates in Estonia, Latvia and Lithuania are significantly higher than in EU, Hungary, Romania, Slovenia and Czech Republic, but somewhat lower than in Bulgaria, Slovakia and Poland.



**Figure 1. Unemployment vs. participation rate of population aged 15-64 in selected Central European and OECD countries, 1999**

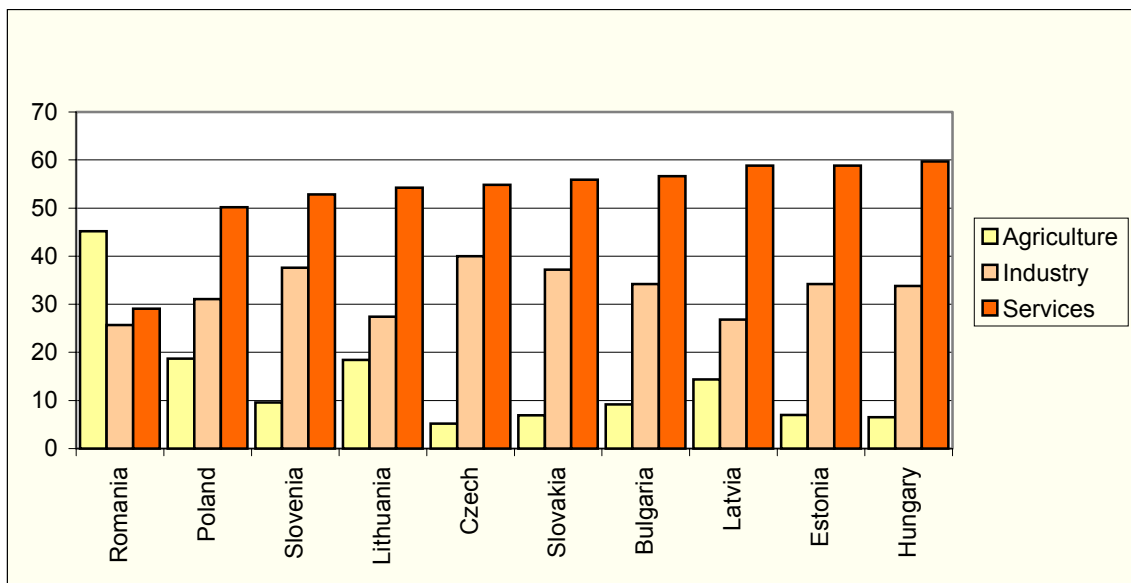
Political, economic and social reforms have completely reshaped the labour markets of all the transition countries. The immediate reaction to economic uncertainty was a sharp decline in demand for labour. External shocks such as the break-up of the USSR and the collapse of the common market of the former Eastern bloc occurred during the same period as internal shocks caused by economic reform and stabilization programs. This combination resulted in sharp production losses and pulled the national economies of these countries into a dragging

transition crisis. There was a certain delay before the effects on employment were felt, as enterprises were at first reluctant to dismiss redundant workers, assuming that the economic recession would be a short-term crisis.

The transition process brought fundamental changes to the composition of employment by sectors and by branches. If we analyze all CEE countries the serious employment losses were experienced by the industrial sector (Latvia, Romania and Lithuania) and in most countries in agriculture. Most dramatic decline of agricultural employment took place in Estonia where total employment dropped from 140 thousand (1989) to nearly 30 thousand (2001). Agricultural employment declined in other countries as well, except Romania and Lithuania. This is rather interesting phenomenon, because both countries are characterized by agriculture with small and medium-sized private farmers. One explanation for Lithuanian increasing agriculture sector might be high state subsidies and high tariffs to food import. Another reason for the increasing (or stable) employment in the agricultural sector in Lithuania was the fact that during the privatization process the land was distributed free of charge to those who were employed in the agriculture at that time, so that the people chose to stay in land and work in agriculture rather than be unemployed.

The share of employment in service sector is largest in Hungary, next are Estonia and Latvia. Also we see “industrialized” countries, like Czech Republic, Slovakia and Slovenia in our sample, where around 40 % of people are employed in industry. Finally we have “agricultural” countries like Romania, but also Bulgaria, Lithuania and Poland. If to look the dynamics of shares of different sectors and analyse how this distribution was achieved, we see that in agriculture we have clearly two groups of countries. One group represents countries where employment share of those who work in agriculture is around 20 % or higher and other group where the same share is 10 % or less. The low employment in agriculture in developed countries is based on high effectiveness, while in most of CEE countries we are simply dealing with decreases in production. We should also keep in mind that we are dealing here the overall decollectivization of agriculture and the re-establishment of small and medium-sized private farmers. The only exception was Poland where agriculture was based on small farms also before economic reforms.

The results of these sectoral shifts in employment shares are presented in the figure below.



**Figure 2. Employment by three economic sectors in CEE countries, 2000**

*Notes:* Agriculture (including Agriculture and hunting, Forestry, and Fishing), industry (Mining and quarrying, Manufacturing, Electricity, gas and water supply, Construction) and Services (all other activities). Employed aged 15-64 included.

The extent to which industry has been down-sized and services have grown is sometimes taken as a measure of progress in transition towards a market economy, and the service sector is well-developed in Latvia and Estonia, and slightly less so in Lithuania. Compared with some other transition economies (e.g., Romania and Russia), industrial employment has declined relatively little in the three Baltic States, especially in Estonia, where its share is still above 30 percent. The service sector has grown most strongly in Estonia, where the share increased from 43 to 59 percent.

### 3. The concept of labour market flexibility

The term labour market flexibility has been given many definitions. Wage and employment flexibility are intuitive enough concepts. But there are also numerical versus functional flexibility, internal versus external flexibility and, for the most exigent, the intensive and the extensive margin of flexibility. Indeed, the term labour market flexibility has been given so many definitions as to arouse the suspicion that one is grappling with a catchword devoid of any theoretical rigor.

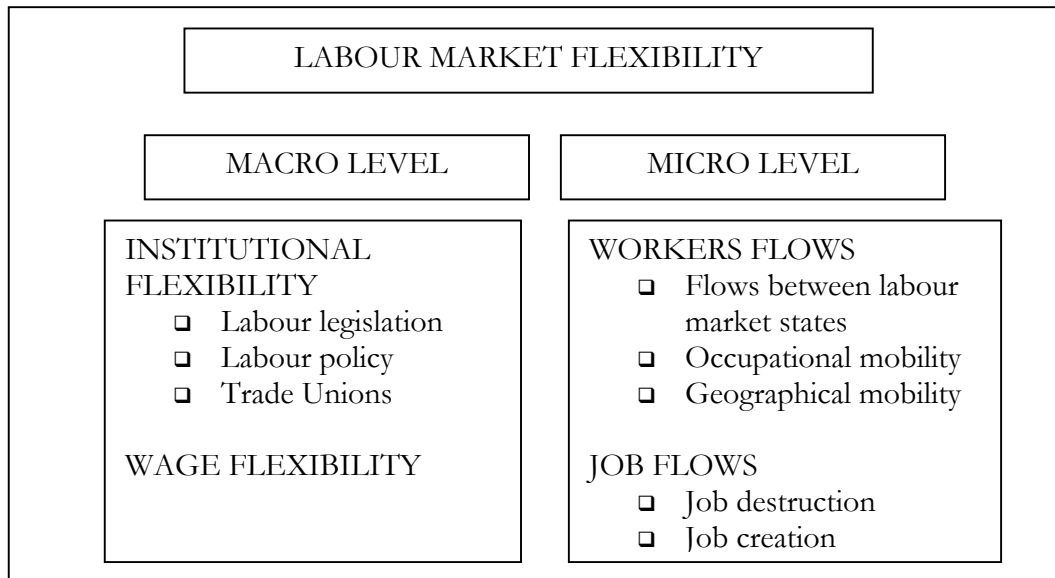
This is not entirely true. From the point of view of general equilibrium theory, perfect flexibility may be thought of as a situation where all resources on a given market are allocated in a Pareto efficient way (Hahn, 1998). But it could be also argued whether we treat this term as characterizing state or process. It seems to be more appropriate to describe with the term

of flexibility the process. For instance, one market is more flexible if it moves towards Pareto efficient resource allocation faster than the other. In principal it means that we use the framework of neoclassical equilibrium model and any kind of intervention to labour market will slow down adjustment speed. So, we can say that labour market flexibility shows adjustment speed to the external shocks and changing macroeconomic conditions.

If we consider the tightness of the country's employment protection legislation as a proxy for labour market flexibility, we can see that Western European countries have relatively inflexible labour markets (Bertola, 1990; Grubb, Wells, 1993). The group of experts with a background in business, labour, and government formed by OECD identified six categories of labour market flexibility and made recommendations for each (Flexibility in the labour..., 1996):

- labour costs: avoid mechanisms, whether institutional or automatic, that would lead to wage increases greater than productivity increases;
- conditions of employment: strike a balance between workers' desire for job security and the needs of economic efficiency;
- work practices and work patterns: modify the organization of work to enrich work content and raise levels of skill and to provide increased flexibility in the arrangement of working time;
- rules and regulations: apply rules and regulations in a reasonable manner and reassess their direct and indirect impact at regular intervals;
- mobility: remove obstacles to mobility such as non-transferrable pension arrangements and rigid housing markets;
- education and training: improve initial schooling, strengthen retraining programs, and publicize the importance of lifetime learning for a flexible society.





**Figure 3 The concept of labour market flexibility.**

We argue that labour market flexibility should be measured at two different levels: the macro level and the micro level (see figure above). The former can be further divided into institutional and wage flexibility. The institutional flexibility of labour market denotes to what extent state institutions and trade unions are involved in the regulation of the labour market. Wage flexibility denotes how responsive wages are to market fluctuations. Micro level flexibility relates to labour market flow analyses. The labour market can be characterized by various flows of transitions to and from employment, unemployment and non-participation, as well as flows of job creation and job destruction. This paper concentrates on the macro side of the labour market flexibility.

In practice different aspects of flexibility are interrelated, presumably in a hierarchical way. If institutional involvement is very high, workers transition rates are likely to be low. If trade unions are weak, then wages are more flexible. Thus, macro level flexibility can partly be measured via indicators of micro level flexibility. While it is generally difficult to measure quantitatively institutional involvement (although there are some indexes), it is much easier to measure workers flows, job creation and job destruction.

Next we try to present an idea how these different flexibility interpretations are interrelated and connected with general labour market behaviour. We do some simplifications. First, we will concentrate on transition economies labour market; secondly, we assume that restructuring and labour reallocation is dependent on labour market flexibility. More flexibility

means faster restructuring and reallocation<sup>2</sup> Thirdly, we will draw our theoretical framework from OST (Optimal speed of transformation) literature, first introduced by Aghion and Blanchard (1994).

Aghion and Blanchard found that countries, which had a large initial shock and thus a large increase in unemployment, are likely to restructure more slowly. From their model we can conclude that gradualism in implementing reforms is the better policy choice. According to them the transition was shaped by two main mechanisms: reallocation and restructuring. Reallocation means the changes in employment structure, how labour is allocated between sectors. Restructuring here means not only changes in the structure of ownership, but also changes in the structure and the organization of their production. Firms must redefine their product line, close some plants that are no longer needed and lay off workers in those plants. Also they must replace most of their equipment and train/replace the managers.

Both reallocation and restructuring are dependent on labour market flexibility. Via labour reallocation and restructuring economy reaches Pareto optimum resource allocation and this enables efficient use of resources and higher productivity. Comparing two economies, transition to higher productivity is faster in the economy with less rigid labour market. As far as most of transition economies are concerned on the convergence and catch up strategies, the issue of labour market flexibility becomes crucial for them. Secondly we believe, that higher flexibility means lower unemployment, because matching process is more successful and as result we have less long term unemployment than in rigid labour markets.

## **4. Institutional flexibility**

### **4.1. Labour market regulation**

This part of the paper reviews labour market legislation in Estonia, Latvia and Lithuania by its effect on labour market flexibility, discussing issues like the regulation of dismissals, regulation of work time and wages, the social protection of the unemployed. In general there are five sources of legal regulation of labour relations in the jurisdictional systems of Baltic States: 1) International conventions, 2) Constitution, 3) Laws 4) Decrees and regulations of administrative authorities, 5) collective agreements.

---

<sup>2</sup> This phenomenon characterises labour markets in transition economies. The dependence has also opposite direction, if market situation has stabilised, also institutional stability is achieved, then reallocation and restructuring will slow down and finally we can see fewer flows in labour market and less flexibility. In a way we can say that less flexibility shows that restructuring and reallocation (needed for transformation) will soon be over.

The regulation of employment relations mainly corresponds to international standards: the most important ILO conventions are ratified and the legislation assures the protection of employees' rights in terms of work time, work remuneration, holidays, and termination of contracts. There are several measures to protect employees in less favourable conditions like old-aged employees, pregnant women and women with children, disabled persons etc.

The work relations are governed in all countries by employment contract (except people working in civil service)<sup>3</sup>. On the one hand there are several similarities across Baltic States: laws prohibit differential treatment, there exist upper limits for regular work time, overtime and work during night-time, workers are granted regular vacations and other holidays, termination of employment contracts is subject to restrictions like the obligation to give advance notice, pay compensation etc. On the other hand, there are some differences in regulation measures between the Baltic States. For instance, in Lithuania the legal regulation has more adverse impact on labour market flexibility than in Latvia: higher minimum wage, longer advance notice period and bigger compensations when employment contract is terminated on the initiative of the employer.

The notification period varies in Latvia from 10 days (misconducts of employee) up to 1 month (lay-offs). In Lithuania the period is 2 month (4 month for minors, parents of children etc.). In Estonia the notification period varies from 2 weeks (long-term incapacity for work) to 4 month (lay-off of workers who have continuously worked for the employer more than 10 years). The compensation for the termination varies in Latvia from 1 to 4 month average wage depending on the employee's work experience with the present employer (according to the Labour Code valid till 1 June 2002 the compensations was no less than 1 month average pay and the notification period was 1 month<sup>4</sup>). In Lithuania the compensation varies from 1 to 12 average monthly wages depending on the reason of termination and the length of work experience with the present employer. In Estonia the compensation for the termination varies form 1 to 4-month average wage.

---

<sup>3</sup> <sup>3</sup> The Republic of Latvia Labour Law (comes into force 01.06.2002). Translation and Terminology Centre [<http://www.ttc.lv/en/default-translations-lr.htm>]  
Republic of Lithuania Law on the Employment Contract (12.06.2001). Seimas of the Republic of Lithuania. [<http://www3.lrs.lt/c-bin/eng/preps2?Condition1=151151&Condition2=>]  
Eesti Vabariigi Töölepingu seadus. (01.07.1992)  
[[http://lex.andmevara.ee/estlex/kehtivad/AktDisplay.jsp?id=6668&akt\\_id=6668](http://lex.andmevara.ee/estlex/kehtivad/AktDisplay.jsp?id=6668&akt_id=6668)]

<sup>4</sup> Republic of Latvia Labour Code (with amendments to 25 October 1994). Latvian National Labour legislation. International Labour Organization Central and Eastern European Team. [<http://natlex.ilo.org/txt/E94LVA01.htm>]

In order to generalize the information concerning legal regulation of employment relations and to compare how strict is the regulation of labour relations across Baltic States and European countries summary indicators were calculated according to the methodology of Nicoletti *et al.* (2000). The value of index depends on the procedural inconveniences, notice period and severance pay, penalties on unfair dismissals, regulation of the usage of probation period. The index measuring the legal restrictions for individual dismissals shows that in Latvia the dismissals are less regulated than in Estonia and Lithuania. The value of index for the Baltic States is higher than the average of the European Union. On the other hand the usage of fixed term contracts is less restricted in the Baltic States and in Lithuania their usage is less restricted than in Latvia and Estonia.

**Table 1 The index measuring the restrictions of dismissals for regular contracts and the usage of fixed term contracts**

Index	Country									
	Latvia	Lithuania	Estonia	Average of the Baltic's	Average of EU (1998) <sup>c</sup>	Germany	United Kingdom	France	Italy	
<b>Regular contracts</b>	2.76	3.21	3.31	3.09	2.4	3.0	0.1	2.5	3.0	
<b>Fixed term contracts</b>	2.29	1.85	2.13	2.09	2.3	2.5	0.3	3.7	3.6	
<b>Average<sup>b</sup></b>	2.52	2.53	2.72	2.59	2.4	2.8	0.2	3.1	3.3	

In the Baltic countries the status of civil servants is regulated by separate laws and employment contracts shall not be concluded with civil servants<sup>5</sup>. So civil servants have some advantages, but are also subject to additional duties. The positions of the civil servants are grouped into categories and civil servants are given grades (Lithuania, Estonia) or qualification categories (Latvia). There are several restrictions for who can be on the civil service position. These restrictions are similar across the countries and concern citizenship, possession of the official language, education and age.

Civil servants are paid wages for the grade of the servant and for the qualification category and level of position. They are granted annual leave and other vacations and leaves. Civil servants receive special benefits in case of death and work accident; have rights on training

<sup>c</sup> See Nicoletti 2000 (pp. 87). The average of the European Union is the simple average of 14 member countries.

<sup>b</sup> The average is here a simple average of the indexes for regular contracts and fixed term contracts.

<sup>5</sup> <sup>5</sup> The Republic of Latvia State Civil Service Law (01.01.2001) Translation and Terminology Centre [<http://www.ttc.lv/en/default-translations-lr.htm>]

The Republic of Lithuania Law on Public Service (08.06. 1999). [<http://www3.lrs.lt/c-bin/eng/preps2?Condition1=94580&Condition2=>]

Avaliku teenistuse seadus (01.01.1996).[

[http://lex.andmevara.ee/estlex/kehtivad/AktDisplay.jsp?id=13738&akt\\_id=13738](http://lex.andmevara.ee/estlex/kehtivad/AktDisplay.jsp?id=13738&akt_id=13738)]

and improvement of professional qualification financed from the state, municipal etc. budgets. For public servants there are special restrictions and duties, that limit the possibilities to work elsewhere, membership in political parties (Estonia), responsibility for lawfulness of ones' actions or failure to act (Latvia) etc.

As the last issue the legal regulation of the unemployed needs to be discussed. In all three Baltic Sates the status of the unemployed people is legally regulated and they are subject to several rights<sup>6</sup>. But there are certain conditions that need to be fulfilled before acquiring the status of the unemployed (registration at the state employment agency, presence of employment record in Estonia etc.). After acquiring the status they are entitled to the receipt of unemployment benefits, the vocational training (in Lithuania and Estonia with training allowance), right to participate in paid public works, free labour exchange services in looking for job. In Lithuania the unemployed people enjoy higher unemployment benefits and the conditions for getting these are less stringent than in Latvia and Estonia. In Latvia these are determined according to the length of service and of unemployment. In Lithuania unemployment benefit is calculated from formula that considers along with state supported income and minimum livings standard also the length of the individuals insurance. In Estonia state unemployment benefit is fixed – 400 EEK per month but in addition the unemployment insurance was introduced in 2001. According to that both employer and employee make contributions to the fund; the payment period of benefit depends on insurance tenure and the size of insurance payment depends on previous average salary. For instance, if national average before tax salary is 5500 EEK, then maximum unemployment benefit will be  $50\% \cdot (3 \cdot 5500) = 8250$  EEK. So the replacement rates are expected to increase.

## **4.2. The role of trade unions**

The role of trade unions in Central and East European countries (CEE) is discussed in this part. The aim is to give the overview of trade unions in CEE countries concentrating especially on trade union developments in the Baltic States. The union membership, collective bargaining levels and coverage of collective agreements is discussed.

---

<sup>6</sup> Republic of Lithuania Law on Support of the Unemployed (15.01.1998) Seimas of the Republic of Lithuania. [<http://www3.lrs.lt/c-bin/eng/preps2?Condition1=56458&Condition2=>]  
Republic of Lithuania Law on Vocational Education and Training (07.07.1999). Seimas of the Republic of Lithuania. [<http://www3.lrs.lt/c-bin/eng/preps2?Condition1=123796&Condition2=>]  
Töötu sotsiaalse kaitse seadus (01.01.1995 ).  
[[http://lex.andmevara.ee/estlex/kehtivad/AktDisplay.jsp?id=36821&akt\\_id=36821](http://lex.andmevara.ee/estlex/kehtivad/AktDisplay.jsp?id=36821&akt_id=36821)]

## Union density

In most western and northern European countries trade unions have a great role in wage determination. Trade unions in the Baltic States like also in all other Central and East European countries are rather small in both the union density and collective agreements coverage. The importance of trade unions has been decreasing in CEE and Baltic countries since the beginning of 90s. In the end of 90s trade union density was less than 35% in all the transition countries except Slovenia. In the Baltic States trade union density is even smaller compared with the Central and East European countries' average. The largest union density rate in the Baltic States is in Latvia (one fourth of employees). The importance of unions varies across sectors, industries, types of enterprise etc. For instance, there are more trade unions in the public sector, there is larger share of women in the unions, and trade unions do not exist in the small enterprises. In Latvia the main sectors with union membership are health care, education, transport, communication, public services, agriculture, food and fishery, industry, energy and construction. In Lithuania the industries are healthcare, transportation, construction, railway, agriculture, trade, education and civil service and in Estonia food industry, public sector, other industry, energetics and transportation (there are sectors where unions are missing, e.g. banking, construction and services). In Estonia there are older workers in the unions, the average union member is 40 years old.

**Table 2 Union density**

Country	Union density	
	1995 (1)	1996-2001
Slovenia	60.0	63.5 (2)
Slovakia	61.7	35 (3)
Czech Republic	42.8	30 (4)
Latvia	30	25 (5)
Lithuania	40	15 (5)
Estonia	36.1	12 (5)

Source: (1) – Riboud *et al.* 2002; (2) – Vodovnik 1999; (3) – Joint Assessment of Employment Policy Priorities in the Slovak Republic 2001; (4) Vaughan, Whitehead 1998; (5) Antila, Ylostalo 1999.

Even more important than the number of unionised workers is the coverage of collective agreements as these are usually enlarged to the whole workforce. Somewhat surprisingly, collective agreements' coverage in the Baltic States is not much higher than the union density. The result is partly due to the missing data of collective agreements: in most transition countries collective agreements are not registered. The other reason is the small number of sectoral level agreements.

Collective wage bargaining in the Baltic States (as well as in CEE general) takes place mainly at the enterprise level or national level. At sectoral or regional level the bargaining process is less developed (Casale 1997). Due to the low coverage of collective agreements, it can be concluded that more employees in the Baltic States rely on individual employment contracts. The popularity of the national level wage bargaining is probably caused by the traditional coordinative role of government. The larger scale of enterprise level bargaining compared to sectoral level is due to the less organised employers.

### **The state or national level bargaining**

Transition countries introduced the national level bargaining already in the beginning of transition process and it takes place in tripartite bodies (members from government, employers and unions). One of the main tasks of national level bargaining is to decide the level of minimum wage; other questions in the bargaining have been reforms of labour market legislation, social reforms and pensions. Still the importance of unions even in national level bargaining is rather low and the main function of tripartite bodies is consultative.

#### *The regional level bargaining*

Regional level bargaining is not developed in most of the transition economies including the Baltic States (one exceptions is Poland). Social partners in the Baltic States have weak regional structure. One of the main reasons for the lack of regional level bargaining in the Baltic States is the small geographical unit (much smaller than e.g. Poland).

#### *The sectoral or branch level bargaining*

Sectoral level bargaining is rather rare in transition economies, it is estimated to cover about 10-17% of the workers in the Baltic States (from 6 to 30 percent in all the CEE countries). The idea of the sectoral level agreements is usually to provide minimum standards. In some cases they are only agreements about fixing the minimum wage in the sector. The main problem is the weak employer associations. It has been noted that trade unions have been helping to establish employer federations in branch level to have the social partner in the negotiations. It is expected that sectoral level bargaining will develop more when the employers will organise themselves. Most of the sectoral level bargaining takes place in the public sector. In Lithuania the sectoral level agreements are least developed in the Baltic States with only a few examples of sectoral agreements in Lithuania (compared to 26 agreements in Latvia and 13 in Estonia in 2000) for example the agreement in telecommunication industry (Due, Mailand 2001).

### *The enterprise level bargaining*

Besides the national level agreements, enterprise level agreements are the most common in CEE countries. In all the CEE countries employers are not interested in concluding the collective agreements. The initiative to bargain is usually taken by the trade unions. Employers are under legal obligation to conclude the agreement if the employees wish to do so, but in practice employers attempt to avoid signing agreements. Enterprise level bargaining is more developed in the public sector and in privatised enterprises, and remarkably less developed in foreign companies (Due, Mailand 2001). The estimates of enterprise level agreements' coverage in the Baltic States vary: according to Due and Mailand (2001) 6-14 % in Estonia, 10-30 % in Latvia and in Lithuania. Antila and Ylöstalo (1999) report that in Latvia is the rate of unionisation 25 % and in Lithuania 15 %.

It can be concluded that most employees in CEE countries rely on individual employment contracts. The reasons for the small importance of unions in the transition economies have usually been found in the following.

- Trade unions are not well organised, which could lead to a situation where several unions with different aims enter the bargaining process.
- Weak position of unions.
- Weak employer associations.
- Large share of small enterprises.
- Employers' preference to bargain only at the company level.
- No enforcement of sectoral level agreements.

### **4.3. Labour market policy**

Public spending on labour market programmes absorbs significant shares of national resources in most EU member and candidate countries. For analytical purposes, the spending is split into active measures (policies aimed at improving the access of the unemployed to the labour market and jobs, job-related skills and the functioning of the labour market) and passive measures (spending on income transfers).

Labour policies are rather insufficiently funded in the Baltic States compared to the EU. The expenditures on labour market measure policies account for 0,22 % of GDP in Estonia, 0,64 % in Latvia and 0,27% in Lithuania in 2001<sup>7</sup>. This is a very small fraction compared to the respective average rate of 3, 4% in the EU. In Latvia, the expenditures on labour market

---

<sup>7</sup> Source: Estonian Labour Market Board; Republic of Lithuania Ministry of Social Security and Labour



policies accounted for 0,76 % of GDP in 2000. The share of active measures is relatively low both either to consider the expenditures or participation rates. In Lithuania 34,1%, in Latvia 22% and in Estonia 28% of the overall employment policy budget is allocated on active measures while the EU average is almost 40%. The participation of registered job-seekers in active labour market measures is low too. In accordance with the European Union employment guidelines the goal is to achieve the involvement rate of 20% unemployed. At the moment the respective number is highest in Estonia - 10%, followed by 4% in Latvia and 3% in Lithuania. It is not clear, if recruitment to programmes is appropriately targeted. The groups covered are not necessarily those to which greatest priority should be given in the light of changing labour market circumstances.

At the same time, the overall coverage of the unemployed by the system of income maintenance is low in all three states, too. In Estonia the rate of unemployment benefit is currently so small that a person who has lost a job has to apply for subsistence benefit as well, thus the unemployment benefit fails to fulfil its function as a mean of smoothing consumption during the unemployment period. In Latvia only a minority of the registered unemployed receives benefit. In the year 2000, the average number of benefit recipients was approximately  $\frac{1}{4}$  of the unemployed<sup>8</sup>. While initially high replacement rates fall relatively sharply as the duration of unemployment increases, these initial rates appear sufficiently high to create disincentives for persons in the early stages of unemployment to consider job-offers offering wages even marginally lower than their previous earnings level. In Lithuania, in general, the rates of payment are low relative to net earnings when in employment. There are, however, some instances where people on social assistance could face disincentives to moving into employment.

Replacement rates are low in comparison with the 60% in the EU member states. Slight differences among the Baltic States could be pointed out: the replacement rate is lower in Estonia and Latvia and higher in Lithuania where it amounts to the EU average in certain cases. Still, it could be noted that in all of the three states the income maintenance system has to a certain extent dampened the incentives to look for a job. The influence is still minor if to compare with the well-developed European countries where the replacement rates are sufficiently large to have significant effects on work incentives and consequently on labour market flexibility. However, given the political conditions, only marginal cuts have been made

---

<sup>8</sup> Source: State Employment Service; Social Report 2001, Ministry of Welfare of Republic of Latvia.

in the generosity of benefit entitlements. Rather the eligibility conditions for receipt of benefits are tightening up and activation strategies for the unemployed are developed. The Baltic States have the same path ahead of them.

**Table 3. Spending on labour market programmes in the EU and selected candidate countries**

	<b>Total spending (as % GDP)</b>	<b>Active spending (as % of GDP)</b>	<b>Active spending (as % of total spending)</b>
<b>Estonia</b>	0,22	0,06	28,0
<b>Latvia</b>	0,76	0,15	22,0
<b>Lithuania</b>	0,27	0,12	34,1
<b>Czech Republic</b>	0,52	0,22	42,9
<b>Hungary</b>	0,87	0,39	45,3
<b>Poland</b>	2,25	0,54	24,0
<b>EU</b>	2,48	1,12	39,8

Sources: Martin et al. (2001); Estonian Labour Market Board; Ministry of Social Security and Labour of the Republic of Lithuania; Joint Assessment of Employment Priorities in Latvia (2002).

It could be concluded that because of the undercapitalization of the labour market policy, the unemployment benefits are low and in this way do not decrease remarkably the labour market flexibility. On the other hand, through placing stronger emphasis on active labour market programmes, the positive impact of labour policy on labour market flexibility could be increased. In this context, more attention should be paid on education and training, including development of lifelong learning which is now an established priority throughout the EU. At the moment, for example in Lithuania the balance within active programmes is over-concentrated on the provision of temporary jobs but short periods of temporary employment are unlikely to contribute to the longer-term employability of participants.

## **5. Wage flexibility**

Wage flexibility shows how the wages react to the recessions and growth in economy. It shows if wages are rigid only downwards or if the long-term wage agreements also slow down the wage rise. The more quickly the wages react to the changes in economy, the more flexible the labour market is. Here we try to measure the flexibility of nominal wages. Usually the flexibility of real wages is treated in literature. In our opinion the fluctuation of nominal wages during business cycle is even better evidence of wage flexibility than the changes in real wage.

We analysed the wage flexibility in Baltic States by investigating how wages behaved during the recession caused by the Russian crises. In 1999 a remarkable fall in GDP growth has taken place in the case of all three countries because of the crisis in Russia at the end of 1998.

The fall was largest in the case of Lithuania and the smallest in the case of Latvia because Lithuanian economy is more tied to Russian economy than the other two countries' economies – Estonian export to Russia was in 1998 13,4% of GDP, Lithuanian export to Russia was 16,5% of GDP. In 1999 the shares were in Estonia 9,2%, in Lithuania 7%. In Latvia these numbers were smaller (Source: Statistical Offices of the three Baltic States). As the growth rate of GDP has fallen, too, it should be the consequence of changes in different sectors.

Highest wages in Baltic States are in financial intermediation and public administration sector, at the same time the lowest wages are in all three countries in agriculture and hotels-restaurants sector<sup>9</sup>. It seems that the wage level structure is quite similar in all three countries, although some small differences remain. Estonian and Latvian wage level structure is quite similar, Lithuanian case differs more.

Over the time period 1994 – 2000 the highest minimum wage has been in Lithuania, the lowest in Estonia although in last years it has been almost at the level of Latvian minimum wage<sup>10</sup>. In Latvia the minimum wage is since 1<sup>st</sup> of July 2001 EUR 104 and in Lithuania from 1<sup>st</sup> of January 2001 125 EUR) (in Estonia – 90 EUR). Still it is argued that in Lithuania the enforcement of minimum wage is almost nonexistent. Speaking about the level of minimum wage in European Union countries as a comparison, the lowest minimum wage in 1999 was in Portugal (359 USD) and the highest was in Luxembourg (1168 USD). The first one is about three times and the second one is about ten times as high as in Baltic States.

At the same time the highest average wages have been in Estonia. The Latvian and Lithuanian wages seem to be quite similar. As in the last years the growth of Estonian average wages has slowed down, Latvian and Lithuanian average wages have had the possibility to converge with

---

<sup>9</sup> Average gross and net monthly wages and salaries by kind of activity, 2002. Monthly Bulletin of Latvian Statistics 1(92)/2002, Central Statistical Bureau of Latvia, Riga, p. 61

Average gross and net monthly wages and salaries by kind of activity. Statistical Yearbook of Latvia 1997, 1998, 1999, 2000. Riga, Statistical Office of Latvia.

Average monthly gross earnings in the whole economy by economic activity, 2001. Statistical Yearbook of Lithuania, Statistics Lithuania, Vilnius, p. 238

Average monthly gross wages (salaries) by economic activity indicator and year, [http://gatekeeper.stat.ec:8000/px-web.2001/Dialog/Saveshow.asp] 28.05.2002

<sup>10</sup> Minimum monthly earnings, LTL, [http://www.std.lt/STATISTIKA/Socialine/Darbo\\_uzm\\_e.htm](http://www.std.lt/STATISTIKA/Socialine/Darbo_uzm_e.htm), 30.05.2002

Minimum wages in Latvia, <http://www.mac.doc.gov/eebic/cables/1997/dec/rig179.htm> 06.06.2002

Minimum wages in Latvia,

[http://www.balticdata.info/latvia/macro\\_economics/latvia\\_macro\\_economics\\_employment\\_basic\\_information.htm](http://www.balticdata.info/latvia/macro_economics/latvia_macro_economics_employment_basic_information.htm) 06.06.2002

Estonian wage level. But the difference between average wages in Baltic States and in European Union is still very large – in 1999 the lowest average wage was in Portugal (653 USD) that is more than two times as high as in Estonia and the highest was in Luxembourg (2866 USD). This is about ten times as high as in Estonia. Such huge differences between wages (especially between minimum wages) in Baltic States and in European Union may indicate also that the wages in Baltic States are more flexible than in European Union.

The easiest way to say whether the wages in Baltic States are flexible or not is to find out if there has a fall taken place in wages of those sectors that were tightly connected to Russian market. It is possible to summarize that wages are rather flexible, but there are also differences between countries and economic sectors. The nominal wages are most rigid in Lithuania and most flexible in Estonia. The most flexible wages are in construction sector in all three countries. In Estonia and Latvia the wages are also flexible in fishing, agriculture, hotels and restaurants sectors. The wages in public sector and in financial sector are mostly rigid. The data also show that if the wages are low they are more flexible.

Lithuanian nominal wage dynamics is different compared to the other Baltic States. While in other countries the Russian shock has bigger influence on agricultural sector and smaller influence on sectors of non-tradables like services and public goods, the opposite dynamics can be seen from Lithuanian figures. The only sector which suffered similarly in all three countries after Russian crisis is industry and even here we have to add smoother exception — Latvia does not suffer that much. It can be guessed that the crucial point here is the share of the particular sector's export to Russia, but we can not dismiss the fact that in some countries and some industries wages react in a more sensitive way than in others. In this respect Lithuania seems to have more rigid wages than Estonia and Latvia and the rigidity seems to be the highest especially in agricultural sector. This may be a reason why Lithuania suffered longer after Russian crisis than other Baltic States.

In the context of EU enlargement it is possible that the wages in these sectors where they are most flexible will converge faster with the EU wage level if EU labour market policies will be liberalized. It may also happen that if the labour markets of the Baltic States will be regulated as highly as in EU, the wage flexibility will decrease in all three countries, especially in Estonia. The last option is more realistic one.

## 6. International labour migration

Theoretically labour migration is a result of rational choice oriented at certain system of values. One of the conditions of migration movements is an existence of more or less stable social context composed of people which needs are satisfied at least in minimum. If those minimal needs within one social context are not fulfilled some people emigrate to a new social context, where they will find better conditions to fulfil their needs or expect relatively smaller deprivation and better possibilities for development (see also Mangalam and Morgan, 1968). That is one possible explanation of the labour migration phenomenon, which certainly does not completely explain all factors and consequences of the labour movement during the EU eastward enlargement processes. Actually, there is no single, coherent theory of migration, only a fragmented set of theories that have often developed in isolation from one another<sup>11</sup>.

Reasons for migration are divided into pull and push factor, which promote or restrain migration. The factors are nominated as pull or push factors depending on whether these factors emanate from the source (home) or destination (host) country. The pull factors include high potential income in the potential country of destination and good employment opportunities. The push factors are high unemployment and low earnings in the home country. The factors could be divided into economic (income cap, labour market situation, fiscal conditions, social security), legislative (legislation that regulate labour movement between the countries, labour legislation), demographic (number and structure of population), social, political, psychological, cultural, historical factors.

Numerous studies have been made on the prospects of labour migration after EU eastward enlargement, when the current regime will be replaced with the right of free movement of labour. The forecasts of possible labour movements between the countries in absence of administrative restriction vary considerably depending on methodology and assumptions used within the studies (Brücker and Boeri, 2000; Sinn, et al, 2001, Walterkirchen and Dietz, 1998, Bauer and Zimmermann, 1999, Hille and Straubhaar, 2000). The main methodological distinction is between surveys and quantitative models.

According to the Eurostat data, the stock of labour force in EU15 from non-EU countries was about 5.3 millions (or 3.1% of EU total labour force) in 1999, and the number of

---

<sup>11</sup> The set of theories trying to explain migration processes includes neoclassical theory of migration, segmented labour market theory, world system theories, human capital theory, new economics of labour migration, dual labour market theory, the gravity model based approach etc.

residents was about 12 millions (3,2% of total EU residents). The number of official labour force from the candidate countries was only 290 000 (0.2%), but some estimates show that there were also 600 000 “working tourists” from the candidate countries. The number of residents from the Baltic States were respectively about 15 000 from Estonia, about 7500 from Latvia and about 8500 from Lithuania (Eurostat, 2000 a and b).

Estimates that base on various research studies put the long-run migration potential from the candidate countries roughly 1% of the EU15 population (hence, about 3.8 millions). Surveys suggest a strong preference of candidate country nationals for temporary work, which implies also important flows of return migration towards the candidate countries. Based on some predictions in the absence of administrative restriction for labour movement, the initial immigration from the CC8 countries (the European candidate countries excluding Bulgaria and Romania) into EU15 would be around 70 000 workers annually (that means totally 200 000 people including also family members) or 0.05% of the EU15 population (The Free Movement... 2001, pp.7-8).

According to the study of Brücker and Boeri (2000), labour migration would be concentrated in only a few member states and enlargement will not significantly affect wages and employment in the EU. It is expected that two-thirds of the labour migration flows from the candidate countries will be absorbed by Germany (hence, around 45 000 – 50 000 workers per year from the CC8 in the first few years). Austria will absorb about 20% of the labour flows coming from the CC8. The forecasts show that the share of the CC10 people in the population of the present EU member states would rise from 0.2% in 1998 to 1.1% in 2030 (Ibid. p.9). Hence, according to predictions, the movement of labour between the EU countries after eastward enlargement will not be significant.

Analyzing labour migration problems of the Baltic States, the emphasis should be first of all given to possible labour movement within the Baltic Sea region. The integration of border regions appears to be relevant in the EU forthcoming enlargement. The countries, which mainly attract the Baltic States' labour force, are the current EU member states that belong to the Baltic Sea region: Denmark, Finland, Sweden and Germany. According to the Eurostat data (2000), 96% of the Baltic States citizens that were living in the EU15 countries lived in the Baltic the Baltic Sea region countries, which are the current members of EU (98.2% of Estonian citizens, 91.8% of Latvian and 92.6 of Lithuanian).

The main pull and push factors that influence labour movement within the Baltic Sea region countries are presented in table below.

**Table 4. Factors influencing the Baltic Sea region countries' labour migration, 2000**

Factor	The Baltic States	The Baltic region countries – the current members of EU
<b>GDP (PPP) per capita, int.\$</b>	Estonia – 10068; Latvia – 6893; Lithuania – 7094	Denmark. – 27404; Finland – 25154; Germany – 25290; Sweden – 24288
<b>GDP (MER) per capita, USD</b>	Estonia – 3577; Latvia – 2938; Lithuania – 3044	Denmark – 30400; Finland – 23418; Germany – 22829; Sweden – 25627
<b>Number of population (Mil.)</b>	Estonia – 1.4; Latvia – 2.6; Lithuania – 3.7	Denmark – 5.3; Finland – 5.2; Germany – 82; Sweden – 8.9
<b>Unemployment rate (%)</b>	Estonia – 13.9%; Latvia – 14.7%; Lithuania 15.9%	Denmark – 4,6 %; Finland – 9,7 %; Germany – 10%; Sweden – 4,7 %.
<b>Distance (km, between the capitals)</b>	Est-Den.: 482; Est-Ger.: 1045; Est-Swe.: 383; Est-Fin.: 84	Den.-Est.: 842; Den.-Lat.: 733; Den.-Lit.: 826
	Lat.-Den.: 733; Lat.-Fin.: 361; Lat.-Ger.: 850; Lat.-Swe.: 450	Fin.-Est.: 84; Fin.-Lat.:361; Fin.-Lit.: 611
	Lit.-Den.:826; Lit.-Fin.:611; Lit.-Ger.:828; Lit.-Swe.: 686	Ger.-Est: 1045; Ger.-Lat.: 850; Ger.-Lit.:828
		Swe.-Est.:383; Swe-Lat: 450; Swe-Lit: 686

*Sources:* Financial Statistic Yearbook, IMF, 2001; World Bank, 2001 ([www.worldbank.org](http://www.worldbank.org)); Statistical Office of Estonia, 2001; The Baltic and the Nordic Countries. Central Statistical Bureau of Latvia, 2000; International Labour Organization 2002 ([www.ilo.org](http://www.ilo.org))

According to the survey information of the Ministry for Social Affairs and Labour of Lithuania (2001), Lithuanians have worked in the following countries in the recent years: Russia – 20.3%, Germany – 18.6%, Great Britain – 9.9%, US – 8.1%, Denmark – 7.6%, Italy – 6.4%, Sweden – 4.1%. Hence, more than 50% of Lithuanians that temporarily worked outside of the home country made that in the Baltic Sea region countries.

The conditions of present labour market access in the Baltic Sea region countries – the members of the EU15 are presented in the table below.

**Table 5. The conditions of the labour market access in the Baltic Sea region countries, the current members of EU in 2000**

Country	Access of third country nationals to the labour market	Special regime for candidate countries	The long-term residence permits
<b>Denmark</b>	Very limited access. Work permit needs to be obtained prior to entering the country. Labour market need has to	No special regime	In general, if a work permits granted a residence permit would also be

Country	Access of third country nationals to the labour market	Special regime for candidate countries	The long-term residence permits granted.
<b>Finland</b>	Work permit needs to be obtained prior to entering Finland. Labour market has to exist. Privileged regimes for qualified workforce.	No special regime	Usually for 1 year, after 2 years a permanent residence permit may be granted
<b>Germany</b>	Residence permits (granted up to 5 years) and work authorization needed. Work permit normally requires existence of need in labour market. Total number of permits in 1999: 1 083 268	Quota-based agreements on trainee workers with Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia.	–
<b>Sweden</b>	Different countries decide together with the national authorities on the issuance of temporary work permits. Work permits are only issued in case of labour shortage. Total number of foreign workers about 220 000.	Bilateral agreements on trainees.	After 2 years of residence a permanent residence permit may be applied for.

*Source:* The Free Movement, 2001.

It is highly probable that cross-border movement in border regions of the Baltic States will significantly increase after free movement of labour will be achieved. Cross-border workers keep their house and family in their home countries and thus avoid the high transaction cost of moving to another country. The cross-border workers ordinarily take their wage back to the home country, and hence, the wage gap should be assessed taking into account the higher purchasing power of their wage at home. It is predictable, that cross-border work can be first of all costly to the country of residence, which may not receive income tax revenue from the worker but has to finance social expenditure and local infrastructure for the benefit of the worker's family. The employing country even enjoys corresponding financial advantages.

In summary labour migration from the Baltic States into the EU15 countries will not be significant in the near future. Based on experience of the previous stages of the EU enlargement and the predictions that labour migration will not exceed 0.2% of population, it is possible to estimate that in the first years of free movement of labour, migration from Estonia could be about 2500-2800 people per year or about 10000 - 14000 during the first four-five years; 5000-6000 people per year from Latvia (about 15000-23000 during the four-five years period); and 7000-8000 per year from Lithuania (about 27000-37000 during four-five years). Over long-term period (10 years period) the labour migration is declining.



Previous experience and research studies also show that labour migration processes have had little effect on host country unemployment and wages (Sinn, 2001). Migration of labour from a home country to a country of destination can even provide gain for the host country, since migrants generally receive a wage below the gain in value added to the economy. Income earned by immigrants does not usually create a burden for the domestic population. There are also possibilities of additional investment income, rents and increased consumer spending. As regards public finances, immigration impacts on government expenditure and revenues, but the net impact at the national level is negligible. In a long-term perspective, immigration can limit the adverse impact on living standards and government budgetary positions due to declining and ageing of populations. Of course, labour migration cannot on its own solve the ageing problem of the European population. In order to maintain a sufficient labour force, additionally to import of labour through migration, the European countries have significantly reduce unemployment rate and to increase the participation rate in their labour markets.

Free movement of labour will have rather serious pressure on the labour markets of the Baltic States due to possible movement of better-qualified and flexible labour force. Movers will be mainly people with good qualification, also young people with secondary school (gymnasium) education, who do not find qualified job at home. They are ready to work abroad as blue colour workers getting salaries which are relatively higher that their expected to get in their home countries. Also possible cross-border movement of workers in the Baltic Sea region will have a pressure on the Baltic States' labour markets.

## **Conclusions**

The findings concerning the labour market flexibility can be summarized as follows:

- ❑ Labour market flexibility is relatively high in all three Baltic States.
- ❑ Wages have been flexible due to the low minimum wages and small importance of trade unions.
- ❑ Only the rather long advance notice periods and large compensations when employer terminates employment contract decrease labour market flexibility.
- ❑ The unemployment benefits are also low and do not decrease remarkably labour market flexibility.
- ❑ On the other hand, labour market flexibility could be increased through active labour market programmes.

- ❑ More attention should be paid especially on education and training. At the moment, for example in Lithuania the balance within active programmes is over-concentrated on the provision of temporary jobs.

Analysis of labour migration experience of the previous stages of EU enlargement allows us to reach the following conclusions.

- ❑ Free movement of labour will not have a significant pressure on the labour markets (first of all on the level of unemployment and wages) of the EU current member states. The main absorbers of the labour flows from CC10 will be Germany and Austria.
- ❑ Due to the very small size of the Baltic labour markets comparing to the rest of EU, labour migration from the Baltic States into the EU15 countries will be insignificant and will not have any remarkable pressure on the EU labour market
- ❑ Due to historical and cultural conditions and close neighbourhood, the migration of the Baltic States labour force will be mainly to the Baltic Sea region countries. The growth of the cross-border movement is expected with significant cost to the country of residence.
- ❑ Free movement of labour will have a certain burden on the home countries' economy. It is predictable that movers are first of all qualified and flexible labour force.
- ❑ The European countries have to reduce the unemployment rate and to increase the participation rate in their labour markets in order to maintain a sufficient labour force for sustainable development.

## References

- Aghion, P., Blanchard, O. (1994). On the speed of transition in Central Europe. National Bureau for Economic Research Macroeconomic Annual, pp. 283-320.
- Antila, J. Ylöstalo, P, 1999. Working Life Parameter in the Baltic Countries 1999. Labour Policy Studies No. 214, Ministry of Labour, Helsinki, pp. 50-188.
- Arro, R., Eamets, R., Järve, J., Kallaste, E., Philips, K, 2001. Country Report on Labour Market Flexibility and Employment and Social Security: Estonia. Tartu, 96 pp.
- Bauer, T., Zimmermann, K.F., 1999 Assessment of Possible Migration pressure and Its Labour Market Impact Following EU Enlargement to Central and Eastern Europe, *IZA*, Bonn, CEPR, London.
- Bertola, G., 1990. Job security, employment and wages. *European Economic Review*, Vol. 34,

pp. 851-879.

Brücker, H., Boeri, T., 2000. The Impact of Eastern Enlargement on Employment. Berlin, Milano, European Integration Consortium.

Casale, G. 1997 Collective Bargaining and the Law in Central and Eastern Europe: Some Comparative Issues. – ILO-CEET Working Paper, No 20, Hungary, 34 p.

Due, J., Mailand, M., 2001. Social Dialogue in the Baltic Sea region – the state of the art. University of Copenhagen, 16 p.

Eamets, R., 2002. Eesti tööturu paindlikkus Euroopa Liiduga liitumise kontekstis – Effect of Accession to the European Union on the Economic Policy of Estonia, Värskä, pp. 54-64

Eamets, R.; Philips, K.; Annus, T., 1999. Background Study on Labour Market and Employment in Estonia. ETF National Observatory.

Employment Action Plan 2002, 2001. Republic of Estonia. Tallinn.

Estonia Latvia Lithuania in Figures 2000/2001/2002. Statistical Office of Estonia, 2000/2001/2002.

Estonian Statistics Monthly, 2001. Statistical Office of Estonia, Tallinn

Europäische Sozialstatistik, 2000. EUROSTAT, Wanderung, Ausgabe, Brüssel.

Flexibility in the labour market: The current debate. A technical report, 1996. OECD, Paris

Grubb, D, Wells, W., 1993. Employment Regulation and Patterns of Work in EC Countries, OECD Economic Studies, no. 21, pp. 7-58

Hahn, F., 1998. Labour market flexibility and welfare, Quaderni del Dipartimento di Economia Politica, No. 223, Università degli Studi di Siena.

Hille, H., Strabhaar, T. (2000) The Impact of the EU Enlargement on Migration Movements and Economic Integration: Results of Recent Studies. OECD Discussion Paper

Joint Assessment of Employment Policy Priorities in the Slovak Republic, 2001. European Commission for Employment and Social Affairs/Ministry for Labour, Social Affairs and Family, 41p.

Joint Assessment of Employment Priorities in Estonia. 2001.

Joint Assessment of Employment Priorities in Latvia. Draft, 2002.

Joint Assessment of Employment Priorities in Lithuania. 2002.

Labor Market Flexibility, 1986. Report by a high-level group of experts to the Secretary-General, OECD, Paris

Mangalam, J., Morgan C., 1968. A Guide to Migration. Lexington

- Martin, J. P., Grubb, D., 2001. What works and for whom: a review of OECD countries' experiences with active labour market policies. Office of Labour Market Policy Evaluation, Working Paper 2001:14, 53 p.
- Nicoletti, G., Scarpetta, S., Boylaud, O., 2000. Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation. OECD ECO/WKP No. 220, 86 p.
- Patterns and Trends in International Migration in Western Europe, 2000. Eurostat Studies and Research, Luxembourg, 2000.
- Riboud, M., Sanchez-Paramo, C., Silva-Jauregui, C., 2002. Does Eurosclerosis Matter? Institutional Reform and Labour Market Performance in Central and Eastern European Countries. – in eds. by Bernard Funck and Lodovico Pizzati, Labour, Employment and Social Policies in the EU Enlargement Process. World Bank, Washington, pp 243–311.
- Sinn, H.W., 2001. Social Dumping in the Transformation Process. NBER Working Paper, No 8346
- Sinn, H:W. et al., 2001. EU – Erweiterung und Arbeitskräftemigration. Wege zu einer schrittweisen Annäherung der Arbeitsmarkets. IFO Beiträge zur Wirtschaftsforschung, 2, München
- Social Report 2001. Ministry of Welafræe of Republic of Latvia, Riga, 110 pp.
- Straubhaar, T., 2001. East-West Migration: Will It Be a Problem? INTERECONOMICS; July/August.
- The Baltic and the Nordic Countries. A Collection of Statistical Data. Central Statistical Bureau of Latvia, Riga, 2000
- The Free Movement of Workers in the Context of Enlargement, 2001. Information Note, European Commission.
- Vaughan-Whitehead, D., 1998. Paying the price: the wage crisis in Central and Eastern Europe. ILO, 418 p.
- Vodovnik, Z., 1999. Tripartism and industrial relations in Slovenia. – in Ed by G. Casale, Social Dialogue in Central and Eastern Europe. ILO, pp 305-318.
- Walterkirchen, E., Dietz, R, 1998. Auswirkungen der EU-Ost-Erweiterung auf den Österreichischen Arbeitsmarkt. Österreichisches Institut für Wirtschaftsforschung. Wien