

# Cahiers Papers

BEI EIB

Employment in Europe



BANQUE EUROPEENNE D'INVESTISSEMENT  
EUROPEAN INVESTMENT BANK

# Contents

	<b>4</b>	Preface by Sir Brian Unwin, President
		<b>Employment in Europe</b>
Christopher Hurst	<b>7</b>	A discussion of the papers and an overview of the role of investment
Jørgen Elmeskov	<b>29</b>	The unemployment problem in Europe: Lessons for implementing the OECD Jobs Strategy
Gilles Saint-Paul	<b>55</b>	Does technical progress create unemployment?
Michael Burda	<b>65</b>	The consequences of EU enlargement for Central and Eastern European labour markets
José Viñals & Juan Jimeno	<b>83</b>	The impact of EMU on European unemployment
Jacques Drèze, Alain Durré & Henri Sneessens	<b>99</b>	Investment stimulation, with the example of housing
Ole Rummel & Thomas Schröder	<b>115</b>	The employment effects of investment projects
Pascale Viala	<b>127</b>	Financing young and innovative enterprises in Europe: Supporting the venture capital industry

# The consequences of EU enlargement for Central and Eastern European labour markets



Michael Burda

Professor,  
Humboldt Universität  
zu Berlin

## 1. Introduction

Two or three decades from now, economic historians will note that a hallmark of successful transformation in Central and Eastern Europe (CEE) was the speed in which it became a non-issue for the body politic. A corollary of this is the expectation that, as formerly centrally planned economies irrevocably transfer responsibility for resource allocation to markets, they will increasingly resemble and behave little differently from other less-developed OECD countries or advanced developing economies. The prospect of accession to the European Union has heightened an already exaggerated optimism that this transition will take little or no time at all. Since 1993, GDP in Poland has grown by more than 30 percent; in the Czech Republic by eleven percent; in Hungary by nine percent; and in Slovakia by more than 20 percent. But there is much work left to be done; these countries remain at per capita income levels well below those of the poorest EU members (1).

The principle that the same rules should apply to EU newcomers from the East is especially applicable to labour markets. It is generally observed that mechanisms which reallocate human resources in advanced economies have lost their cutting edge in Europe. While overall job turnover - measured as gross job creation and destruction - is comparable, worker turnover in Europe, especially employer initiated turnover, is dramatically lower (2). The attenuation of the churning or sifting function of labour markets has contributed to a low employment equilibrium in which outside hiring by firms has become an unusual, almost last-resort measure. As it stands, a large fraction of the CEE labour force has been reallocated, but more is needed to move skills and talents across alternative uses. Insofar as the CEE countries jump into the EU bed, to what extent are they giving up flexible labour markets - joining in effect the continental European camp - at a time when they might still need them?

Institutions of the "continental" sort will leave their traces in indicators such as the employment ratio, the participation rate, or labour force turnover. First, for most CEE countries, joining the European Union will imply additional structural shocks to agriculture, industry and services, after already been subject to the "transformation shock." Second and more significantly, EU membership may affect the labour markets' ability to

---

*This paper is based in part on Chapter 4 of the European Policy Initiative Report No. 4, "Mediating the Transition: The Labour Market in Central and Eastern Europe", written jointly with Tito Boeri (Universita Bocconi) and Janos Köllö (Hungarian Academy of Sciences). See Boeri et al. (1998).*

1) In 1995, the Czech Republic and Poland possessed a per capita GDP of USD 4,420 and USD 3,057, respectively, versus USD 22,631 for the EU-15 and USD 20,315 for OECD-Europe. When these numbers are corrected for purchasing power, the comparison remains striking; while the Czech Republic's per capita GNP is roughly 40 percent that of Germany's, Slovakia is only one-third, while Poland is 27 percent and Bulgaria is 21 percent! (Source: World Bank Atlas, 1996).

2) See Burda and Wyplosz (1994) and Boeri (1996).

cope with future shocks on the horizon. Could joining the EU lead to higher unemployment, if only by virtue of a much slower adjustment to the new steady state?

Boeri *et al.* (1998) provides a recent comprehensive overview of the progress made in transforming labour markets in CEE countries, including a discussion of what can be expected in the future. In this paper I have chosen to stress this latter issue, and in particular some of the risks and benefits associated with EU enlargement for CEE countries. Thus, despite Western Europe's fascination with the impact of the East on their own labour markets, I plan to spend more time asking - in the spirit of J.F. Kennedy, perhaps - not what can the CEE countries do for us, but what can or will we Western Europeans do for them?

The paper is organised as follows. Section 2 describes the state of affairs in the CEE economies and concludes that the transformation of labour markets, while well underway, is far from complete. Section 3 describes some of the labour market implications of EU entry, while Section 4 presents empirical evidence suggesting that EU entry may contribute to higher levels and persistence of unemployment rates. Section 5 concludes.

## **2. The current situation, end-1996: Transformation's scars on CEE labour markets**

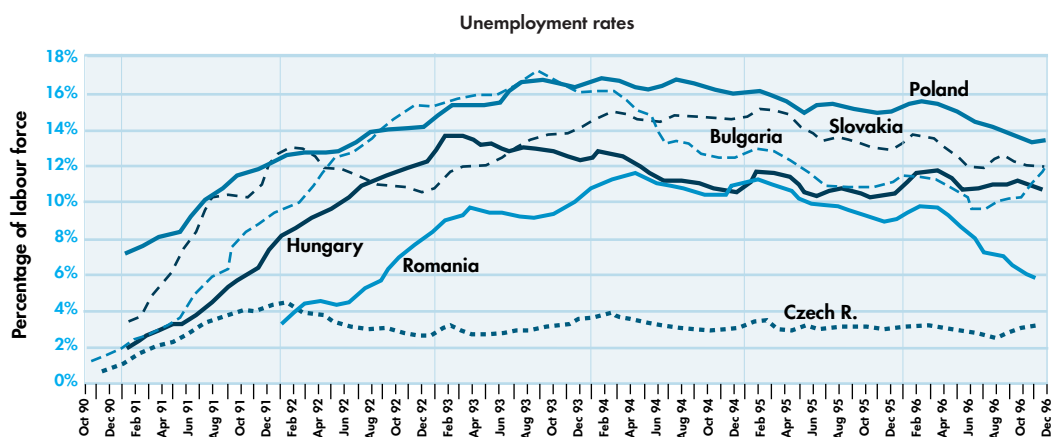
### **2.1 Growth returns but unemployment is still high**

It is well-known that the CEE countries took an economic nose dive in the course of transformation to a decentralised, market-based economy. The liberalisation of prices led to a price shock, but more importantly, output dropped dramatically in the first few two to three years, on the order of 20 to 30 percent of GDP and more if industrial output is considered. Explanations for the output shock have abounded: excessively tight fiscal and monetary policy, the collapse of COMECON trading arrangements, the destruction of network capital associated with the planned economy, lack of managerial incentives for restructuring, and so on. What is less well-known is that the CEE countries have made a dramatic recovery of economic output in the meantime.

**Unemployment rose in less than three years from virtually zero in 1990 to double digit, and decidedly West European levels.**

As Figure 1 shows, unemployment rose in less than three years from virtually zero in 1990 to double-digit, and decidedly West European levels. The interesting fact is that "Okun's law" seems to work, albeit in a limited fashion. Large one-off changes in labour force participation have wrecked havoc with the figures, but more so with the link between output and employment than between output and unemployment. In 1997 the long awaited declines in unemployment rates finally occurred in Poland (10.6 percent in October 1997 compared with 13.5 percent a year ago) and Hungary (10.5 percent in October 1997 compared with 11.1 percent a year ago). In contrast, joblessness in the Czech Republic stood at five percent, up from 3.3 percent in the previous year. Romania has also been a surprise to many, showing surprising resilience despite large political and economic setbacks. The curious pattern in Bulgaria can be attributed to a massive decline in participation coupled with a return to "subsistence" agriculture and an expansion of the underground economy.

**Figure 1.** Unemployment in the CEE economies, 1990-1996



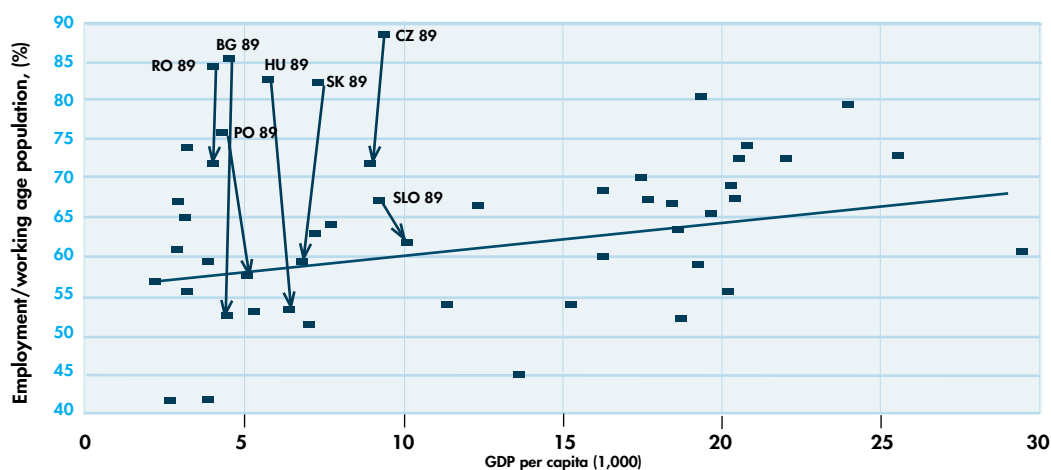
Source: Boeri *et al.* (1998)

### 2.2 Participation is down but not out

One of the most remarkable facts about labour markets under communism was the high rate of labour force participation by both men and women. Partly due to communist ideology, partly due to necessity, everyone worked, often long beyond established retirement ages. Explicit subsidies made this ideal affordable for the average family. The adoption of capitalist labour markets radically changed attitudes towards the benefits and costs of labour force participation, as well as the opportunities workers faced in the market. The socialist ideal of work for all at all costs was not only economically inefficient and unsustainable, but also conflicted with preferences for leisure, family, household production (especially the raising of children), as well as social alternatives to work. As Figure 2 shows, countries of Central and Eastern Europe have experienced dramatic declines in labour force participation rates in the years following transformation. Box 1 explains some of the data issues in arriving at employment figures.

**Central and Eastern European countries have experienced dramatic declines in labour force participation rates.**

**Figure 2.** Employment-population ratios (a) and GDP per capita (b) in international comparison, 1994



Notes: (a) Employment over population aged 15-64. (b) GDP per capita in USD at PPP. Regression line:  $y = 55.8 + 0.52x$ ,  $R^2=0.19$ .

Source: Boeri *et al.* (1998)

Seven years afterwards, labour participation rates in the CEE countries remain above those in OECD economies of similar levels of development or in advanced developing economies. When compared with EU neighbours, they are much more comparable, ranking roughly at the average for wealthier Central European countries. For males, participation declined below West European countries, while female participation - even after a sharp drop - remains considerably higher. Employment rates in CEE countries are now roughly comparable with OECD countries, so high unemployment rates can be attributed to above-average labour force participation, to a large extent (see Table 1).

**Table 1.** Labor force participation (percentage of population of working age), 1996 Q3

CEE Countries	Total	Male	Female	OECD Comparators	Total	Male	Female
Bulgaria	71.3	72.7	69.7	Belgium (1995)	65.0	73.1	56.8
Czech Republic	76.8	82.7	70.2	France (1995)	67.3	74.8	60.0
Hungary	65.6	70.8	60.0	Germany (1995)	71.0	80.3	61.3
Poland	69.5	73.8	64.9	Portugal (1995)	70.8	80.2	61.9
Romania	75.8	80.7	70.5	Sweden (1995)	77.0	79.0	74.9
Slovakia	76.2	80.9	71.2	Turkey (1995)	58.4	81.2	34.3
Slovenia	68.1	70.7	65.3	OECD Total (1995)	71.4	83.5	59.2

Source: Boeri *et al.* (1998).

### 2.3 The transformation was and remains painful

The transformation has been a painful process. An unprecedented rearrangement of economic activity has not only shifted individuals out of work and the workplace for good, but has also reallocated resources across uses. Table 2 displays the extent of these relative shifts since 1989. In almost all countries, a dramatic reduction in industrial employment could be observed; only in Hungary, where services had already assumed an important role at the outset, the shift was rather modest. In some countries, notably Poland and Hungary, there has been a marked shift out of agriculture as well; in Bulgaria and Romania, agricultural activity has increased in both relative and absolute terms. In all countries the relative and absolute size of the service sector has increased, in some dramatically so.

The transformation has had a significant regional element, leaving the landscape a patchwork of varying unemployment rates. Observers interpret this as reflecting a large deficit in labour mobility and in travel-related infrastructure (roads, highways, trains, buses etc.), as well as the nature of social insurance and the existence of family networks.

## 3. The "Return to Europe" and the choice of labour market institutions

### 3.1 Efficiency versus solidarity

Jeffrey Sachs has stressed "the return to Europe" and the desire by CEE economies to regain their lost status in the process of European integration as soon as possible (3). This has become evident by their rush into EU association agreements as well as accelerated negotiations for outright entry,

3) See Sachs (1993).

**Table 2.** Changing structure of output and employment in CEE economies, 1989-1995

... originating in	Percentage point change in share of:		
	GDP	Employment	
<b>Agriculture</b>	Bulgaria	+2.0	+3.9
	Czech Republic	-0.7	-5.1
	Hungary	-3.7	-9.8
	Poland	-5.6	-7.0
	Romania	+6.2	+12.4
	Slovakia	+0.1	-4.6
	Slovenia	+0.2	na
<b>Industry</b>	Bulgaria	-28.0	-8.0
	Czech Republic	-14.9	-4.0
	Hungary	-2.7	-9.6
	Poland	-11.9	-3.4
	Romania	-20.5	-14.1
	Slovakia	-27.1	-7.4
	Slovenia	-9.2	na
<b>Services</b>	Bulgaria	+26.0	+4.0
	Czech Republic	+14.2	+9.1
	Hungary	+ 6.4	+22.4
	Poland	+17.5	+10.4
	Romania	+14.3	+1.7
	Slovakia	+27.0	+19.2
	Slovenia	+9.1	na

Source: Boeri *et al.* (1998).

**The "return to Europe" has the connotation of a "social market economy" which strives to avoid excessive inequality by state-managed solidarity.**

despite enormous problems associated with fast track admission (4). The "return to Europe" also has another connotation, namely the implementation of a "social market economy" which strives to avoid excessive inequality by state-managed solidarity with the less fortunate. In this context, it was only natural that strains placed on individuals during the course of the transformation would give rise to political demands for social insurance. In most CEE countries, programs of unemployment compensation, early retirement, social assistance, and severance pay were implemented soon after governments committed to market transformation, even before its most difficult consequences had occurred, and often without much consideration of potential future costs.

Interventions for reasons of equity and solidarity often collide, however, with efficiency-related objectives of a successful transition. One of the greatest challenges in the transformation has been to develop a system of social insurance that guarantees the basic needs of the population, yet at the same time does not impede labour mobility, a central element of transition. The transformation necessitates redeployment of talents and skills, and is often associated with human capital loss and reduction of expected lifetime income. Most attempts to protect unfortunate workers do so at the cost of postponing the necessary structural changes. This mobility is not restricted to the expansion of the service sector and shrinking of bloated manufacturing; within-industry mobility is also needed to allocate labour between shrinking and failing to new and growing enterprises, which are often in the same general area of activity. By reducing the cost of not acting, the social safety net can increase the option value of waiting, and thereby reduce the implicit cost of immobility.

4) See François *et al.* (1996).

### Box 1. Data issues

Some evidence on incentives to remain in the labour force despite unfavourable job market prospects, as well as the nature of unemployment itself, is available from comparisons of survey and registry unemployment. With the support of international organisations, labour force surveys using International Labour Office standards are now available in most CEE economies, and are now widely used for assessing joblessness there. It is agreed among labour economists that the labour force survey (LFS) provides the closest approximation to effective labour supply, as it measures the self-reported activity of employable individuals who are fit and available for work. Using this metric, worker discouragement reflects an assessment that work at current wages and job availability is not an economically viable strategy. Registry unemployment, in contrast, is based on actual count data generated by local labour offices and is related to advantages flowing from this status, including access to job information, counselling, and training programs; more importantly, registration is often a precondition for unemployment benefits, health insurance, housing subsidies, etc. The relationship of registry to survey unemployment can be viewed as an indicator of these net incentives. The Table shows that this ratio deviates widely from country to country. In countries where it is significantly less than one, job information services and social benefits linked to employment offices are probably unattractive. Values in excess of unity suggest either that many registered have ceased to search, or that continued registration is a requirement for other benefits administered by the employment offices. It may be important to ask whether the latter indicates an inefficient use of employment agency resources.

**Table.** Survey versus registry unemployment and benefit receipt in 1995 (in thousands)

Country	Registry count	Survey estimate	As a fraction of survey unemployment:		
			Registry unemployment	Unemployment benefit recipients	Registered unemployment social assistance recipients
Czech Republic	155.0	189.0	0.82	0.12	0.27
Hungary	507.7	416.5	1.22	0.38	0.47
Poland	2,694.6	2,276.8	1.18	0.54	na
Romania	1,111.3	967.9	1.15	0.21	0.77
Slovakia	348.2	324.5	1.07	0.27	0.49
Slovenia	121.5	70.0	1.74	0.40	0.08

Source: Boeri *et al.* (1998).



### 3.2 Taxation and regulation of the labour market (and the underground economy)

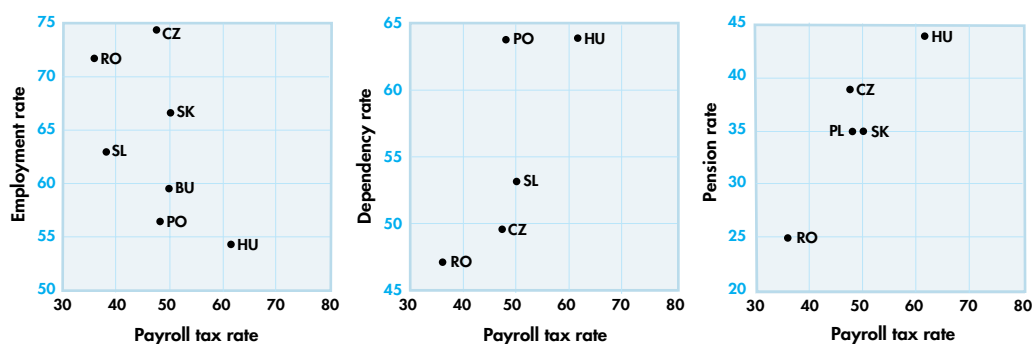
The abdication of central planning meant surrendering large parts of the economy to private owners and managers. Consequently, many government revenue sources disappeared, leading to increases in taxation of wages, either directly or via "contributions" to various social funds. These taxes and contributions were easier to collect than VAT or income taxes, so governments became increasingly dependent on their existence. So as the cost of passive measures (primarily unemployment insurance and assistance) soared and tax collections and contributions declined, labour taxes were increased, raising labour costs, dampening labour demand and making the system increasingly unsustainable (5).

Although the literature is agnostic about the role of labour taxation and employment in the OECD (see Nickell and Bell, 1997, or Layard *et al.*, 1991), the first panel of Figure 3 shows a clear negative association in a cross-section of CEE countries between statutory payroll tax rates on the one hand, and employment ratios on the other. The second and third panels show that payroll tax rates are positively correlated with both the incidence of dependent individuals (unemployed plus those out of the labour force) as well as pensioners. It is difficult not to infer the existence of an unemployment/fiscal trap. Under such conditions, a given regime could be consistent with an equilibrium of high job creation, high employment rates, low taxes and low dependency ratios; or with an equilibrium of low employment, with high dependency ratios and high labour taxes necessary to finance them.

**The early transitional experiences of Hungary and Poland confirm that a "vicious circle" of labour taxation and job destruction can arise.**

The elasticity of labour demand, while thought to be relatively low in the short run with given capital stock, is effectively increased by the emergence of the underground economy. It is commonplace for small and medium-sized firms to take on a core of officially reported workers and use a second group "off the books" to reduce tax and social charge liabilities, as well as to respond more flexibly to demand fluctuations. A number of studies, many originating in the CEE countries, confirm a large role for the underground economy (6).

**Figure 3.** Payroll taxes, employment rates and contribution rates (in percent)



Source: Boeri *et al.* (1998).

5) A widely-cited case is Hungary. From 1991 to 1993, Hungarian social security contributions rose from 42.3 percent of wages and salaries to 50.2 percent. This was a direct result of increasing social insurance burdens and increases in the social security tax contribution rates. See EBRD (1994, 1995, 1996).

6) See Lacko (1995), who estimates the sizes of the underground economies of Poland, Hungary and the Czech Republic as well as more advanced OECD economies on the basis of household electricity use. For a recent review, see EBRD (1995).

There is a danger that social systems could kill the goose even before the golden egg has been laid. The early transitional experiences of Hungary and Poland confirm that a "vicious circle" of labour taxation and job destruction can arise, in which initially inexpensive but potentially costly programs put in place at the outset of the transition became problematic when unemployment rose rapidly.

### 3.3 Active labour market policies

Another sign that the CEE economies have adopted the "return to Europe" is their aggressive implementation of active labour market policies (ALMPs), which are intended to help reintegrate long-term unemployed. ALMPs are usually discussed in terms of three types (7). *Job intermediation* measures aim at improving information about vacancy availability, employee qualifications currently in demand, and future prospects; they provide guidance to the unemployed and monitor their search behaviour. *Labour market training measures* are intended to improve worker skills, and are justified to the extent that workers lack access to capital markets to finance human capital investments themselves. *Job creation* schemes - either direct make-work or employment subsidies - usually comprise the largest component of ALMPs and are designed to increase the demand for labour, particularly for those individuals in long term unemployment. Such interventions make sense if workers are "scarred" by unemployment (loss of skills or industry specific human capital) or discriminated against ("ranked" by duration of their current spell of joblessness). Another interpretation of job creation schemes is a direct test of the unemployed's willingness to work, as they are usually used to generate offers for long-term unemployed (Jackman, 1995).

**During transformation when firms are shedding their least productive employees, being unemployed is a particularly negative signal in the labour market.**

In a transformation context in which all firms are shedding excess labour and selecting their least desirable productive employees for culling, unemployment is a particularly negative signal in the labour market. At the same time it is a noisy signal, so a strategy of preventing long-term unemployment could presumably be justified. In general, targeted job creation for problem groups can increase outflows out of unemployment and reduce the power of insiders hindering downward adjustment of real wages. While active labour market policy commands considerable political support among both the employed and the unemployed, a strong case can be made that ALMPs have *negative* effects on the functioning of labour markets (8). Most importantly, dead-weight loss and substitution effects can be large, and under such conditions, they are a questionable use of scarce public resources.

In recent years, this scepticism concerning the efficacy of active labour market policies has mounted. Most European commentary can be traced to the disastrous response of Swedish and Finnish labour markets to shocks in the early 1990s. This stands in stark contrast to the 1970s and 1980s, when the outstanding labour market performance of the Nordic economies was linked to high spending on ALMPs. In the aftermath of the serious recessions of the early 1990s, both countries now have open unemployment several times higher than levels in previous decades which shows

---

7) See Calmfors (1994).

8) The most important negative effects cited by Calmfors (1994) are (i) reduction in search intensity of program participants; (ii) a labelling or lock-in effect which stigmatises participants (see Burtless, 1985); (iii) dead-weight loss effects (some of those receiving subsidies would have found a job anyway); (iv) substitution effects of the favoured at the expense of others (naturally, what one would hope for!) (v) fiscal displacement effects (local governments undertake projects that would have occurred anyway), and (vi) "crowding out" effects in local labour markets, in which wages rise due to labour market tightness, leading to unemployment elsewhere.

no sign of returning to previous low levels. That labour market policies have done nothing to stem this tide has cast doubt on their ability to cope with stressful conditions (9).

The Czech Republic now appears in line to provide confirmation of this hypothesis. The aftermath of the currency crisis in the spring of 1997 has been a slowdown in industrial activity. Until then, the Czech Republic was the positive outlier in the labour market experience of the transition economies. With an unemployment rate of under four percent, it was the envy of the OECD as well as the transforming economies. It was tempting to link the extraordinary success of the Czech Republic to its use of ALMPs, and a number of successful aspects of Czech active labour market policy have been isolated by researchers (10).

While a judgement at this stage may still be premature, evidence is mounting that other circumstances peculiar to the Czech Republic may have been responsible for the "unemployment miracle" (OECD, 1995). These include favourable initial conditions with respect to industrial specialisation, a well-educated labour force, a large potential for service employment (tourism especially), a tradition of entrepreneurship, a small agricultural sector, and proximity to high-wage Germany with its demand for low wage labour and low-cost production sites. Less optimistic observers have criticised the slow restructuring pace in privatised state enterprises as a sign that the storms lurk on the horizon; recent bank failures and growing internal and external macroeconomic imbalances certainly do not belie this impression.

**The extensive use of active labour market policies can be interpreted as accepting some inefficiency as the price of "churning up" stagnant pools of unemployed.**

In fact, econometric evidence adduced by Burda and Lubyova (1995) conveyed the impression that ALMPs alone cannot explain the difference between Czech and the Slovak unemployment rates, though other evidence does point to a significant, albeit small, effect of ALMPs on flows from unemployment to jobs in the CEE economies (11).

Viewed in this light, the extensive use of ALMPs to increase turnover can be interpreted as accepting some inefficiency (in the form of displacement effects) as the price of "churning up" stagnant pools of unemployed. However, the recent experience in some Nordic economies suggests that the resulting supervision of the unemployed can be an Achilles heel in the face of large negative macroeconomic shocks.

### **3.4 Continental labour market regulations**

An important component of the "return to Europe" was the adoption by CEE countries of Western European style labour market regulation and the rejection of Anglo-Saxon "hire at will" industrial relations. As an example, the annex provides an overview of severance regulations currently in force. While not as strictly enforced as in Western Europe, these laws have the general flavour of

---

9) For a discussion of the early apparent successes of active labour market policies in the Nordic countries see Jackman et al. (1990); for a critical discussion see Calmfors and Nymoer (1990).

10) See OECD (1995).

11) See, for example, OECD (1995), Munich et al. (1994), and Boeri and Burda (1996). Recent evidence relating to experiences of other transforming economies make it clear that conditioning on the country is important for predicting success and may cast doubt on earlier optimism. In particular, the country understudy seems to have a systematic effect on the findings. In Poland, the evidence is almost uniformly negative (Lehmann, 1995, Kwiatkowski, 1996, and Puhani and Steiner, 1996) which is often rationalised by poor targeting of programs (Puhani and Steiner, 1996).

continental severance rules. As will be shown below, the accession of these countries to the European Union is likely to mean that these laws will be enforced more rigorously or perhaps even tightened in the future.

It is useful to distinguish between severance benefits paid by the employer directly to the employee, and severance costs imposed from the outside on firms for dismissals (formal approval from ministries, adjudication procedures, costs related to "social plan" regulations, the need for specialised legal staff, etc.). In the former case, wage adjustments or side payments - as long as they are feasible - can generally offset the economic effects of mandated severance bonuses. In the latter case, however, severance regulation acts like a tax on job creation, and creates a wedge between the wage and the (marginal) productivity of workers which accrues to third parties or is pure loss (12). Despite rather compelling evidence from employers' surveys (e.g. Emerson, 1986), there is little academic agreement that severance regulation adversely affects employment. It is nonetheless important to stress one prominent effect seldom considered in the context of the CEE countries and systemic transformation: the impact of such regulations on small firms and new business formation. In a situation of systemic structural change, such regulations might have an important effect on the emergence of new firms (Hopenhayn and Rogerson, 1993). This is because firm formation and dissolution is not only a precondition for production, but serves the important purpose of processing information, which is still scarce in these countries. Matching of resources, capital, and talents inherently entails a certain amount of experimentation. Concretely, the creation of firms is a highly risky undertaking, many of which do not succeed (13). Imposing red tape costs can be equated to a direct tax on this activity, which curtails (gross) employment growth at this level.

**Strict enforcement (of severance rules) will either push small enterprises out of business or into the underground economy.**

It follows that the enforcement of severance rules will either push small enterprises out of business or into the underground economy with the consequent impact on tax collection and the aggravation of the fiscal trap discussed above. By this logic it would seem important to offer generous exemptions for small firms from these rules, and that "small" should be liberally defined. This is especially true in light of the high fixed cost of compliance, for which a separate department and personnel is often required. In fact, the present regime has achieved de facto precisely this outcome; only large state enterprises have been subject to such rules, with smaller and foreign firms evading them in one way or another.

#### **4. Accession to the European Union and implications for labour market policy in CEE**

Despite current preoccupation with the single currency project, recent EU pronouncements have only strengthened accession aspirations of the first wave candidates (Czech Republic, Hungary, Poland, Slovenia and Estonia) before 2005. At first sight, admission to the EU seems to have few official implications with respect to labour markets and labour market policy, besides the direct impact of trade creation and diversion as these countries are more intensively integrated into the EU pattern of specialisation.

---

12) See, for example, Lazear (1990) or Burda (1992).

13) It is for this reason that even in advanced, developed western economies the amount of churning - that is, the excess of gross labour and job turnover over net changes, or even the excess of labour turnover over job turnover - is significant. See Burgess et al. (1995).

**Raising wages and introducing more regulations will vitiate the attractiveness of Central and Eastern Europe for direct investment.**

One important quasi-legislative document with implications for the CEE is the Social Charter of the European Union (ESC), the provisions of which enumerate a number of rights of workers and responsibilities of employers.

A benign interpretation of the ESC is an expression of "European" concern for solidarity and an effort to enshrine this idea in a common doctrine, which is especially valid with respect to newcomers to the club. The "return to Europe" necessitates, in this view, a common stance on what constitutes "European" labour market and social policy. The ESC is not a precondition for accession to the European Union, although it is difficult to believe that ratification is irrelevant. The ESC embodies a number of provisions which, taken individually and legalistically, are not specific enough to cause alarm; yet in their entirety they commit member countries to provide minimal work conditions. Since its original enacting, it has been accepted with little derogation by all countries except the UK, and accession implies an expectation of implementation of the terms of this agreement.

A second, less favourable interpretation of the ESC is an attempt to preclude "wage and social dumping," meaning preventing some EU member countries who, because of low labour costs and lower standards of living, offer a cost competitive production environment. This interpretation would imply that joining the EU implies loss of export competitiveness, and of a chance to develop and raise standards of living rapidly.

It is significant that most of the provisions are currently hardly enforced in the CEE economies. Cynically, because the newcomers produce at significantly lower labour costs, it might be in the interests of other EU countries to adopt measures which inhibit direct wage competition with existing EU members. Specifically, raising wages, increasing the cost of the hiring decision, and introducing more regulations and standards will vitiate the attractiveness of Central and Eastern Europe for direct investment as well as diminish its ability to compete in the internal market.

I see a number of potential mechanisms at work here. First, the enforcement of the Social Charter will certainly take on a less elastic quality as accession draws near. For example, the European Commission has recently found new energy in extending social Europe (14). Second, another problem is the underground economy, which has assumed mammoth proportions in these countries. Insistence on tracking down lost VAT income that this forgotten segment of the economy brings in will be equivalent to increasing its production costs. Finally as foreign firms invest increasingly larger stakes in these countries they will come under pressure to adhere to the same rules at home, especially as labour unions begin to break out of their national boundaries.

In any case, EU accession could have a deleterious impact on labour market performance. To examine this issue in a more quantitative fashion, Boeri *et al.* (1998) studied the behaviour of unemployment rates and employment growth for newcomer EU-members (those joining after 1970), and it is these results that I would like to summarise here. The behaviour of these variables were studied around the dates of (i) first application to the EU, and (ii) EU accession.

---

14) According to the *Financial Times* of December 16, 1997, the European Commission will launch a number of proposals in March 1998 to extend the 1993 law on working hours, rest, and paid holidays to previously exempted workers. In addition, directives have extended holidays, pension rights and dismissal rights to a number of previously exempted industries. Ostensibly, these measures are designed to counter what Social Affairs Commissioner Flynn considers a trend towards excessive exemptions.

**EU accession could have a deleterious impact on labour market performance.**

Some elaboration on the analysis is appropriate. Because candidate countries usually have to "get their house in order" in order to qualify to join, it is important to distinguish between accession (formal membership) and first application (the lodging of the formal petition for membership). Both dates of application preceding accession as well as accession itself were taken as indicators of regime change and as benchmarks for analysing labour market performance. The time between application and entry into the EU is variable, ranging from 33 months (Finland) to almost nine years (Portugal); this turns out to provide useful variation in the data for econometric estimation.

In a first pass at the data, I present the average behaviour of unemployment rates and employment growth around dates of first application and EU entry. In order to control for business cycle factors, a cyclical component was removed from these data using conventional regression methods (15). The unweighted average of the results centred around application and accession dates can be seen in the panels of Figure 4. The evidence does suggest that countries experience the strongest increases in structural or equilibrium unemployment upon application, and that this rise continues after accession. The most likely explanation is the structural change that joining brings, possibly also combined

**Box 2. Testing the impact of EU membership**

To test the hypothesis that EU membership could have negative implications for employment, a fixed-effects regression model was estimated pooling all nine countries into one sample, while allowing an individual trend for each country's relative unemployment rate. The specification was

$$\eta_{it}^{(k)} = \mu_i + \tau_{i1}t + \tau_{i2}t^2 + \tau_{i3}t^3 + \sum_{j=0}^2 \alpha_j g_{it-j} + \beta_1 ap_{it} + \beta_2 ac_{it} + \varepsilon_{it}$$

where  $\mu_i$  is a fixed effect for the  $i$ th country,  $\tau$  are country-specific time trends coefficients,  $t$  is a time trend, and  $g_{it}$  is the current growth rate of real GDP. The dependent variable is either  $\eta_{it}^{(1)} = u_{it}/u_{it}^{core}$  or  $\eta_{it}^{(2)} = e_{it} - e_{it}^{core}$ , where  $u_{it}$  is the unemployment rate and  $e_{it}$  is the employment growth rate for the  $i$ th country in period  $t$ , respectively. "Core" refers to an unweighted average of France, Germany and Italy. The different specifications of the two dependent variables are chosen because  $e_{it}$  can take negative values.  $ap_{it}$  ( $ac_{it}$ ) is a dummy variable which takes the value one after application (accession) to the EU, zero otherwise; so  $\beta_1$  and  $\beta_2$  are the coefficients of primary interest.

15) Specifically, we ran the regression for each country

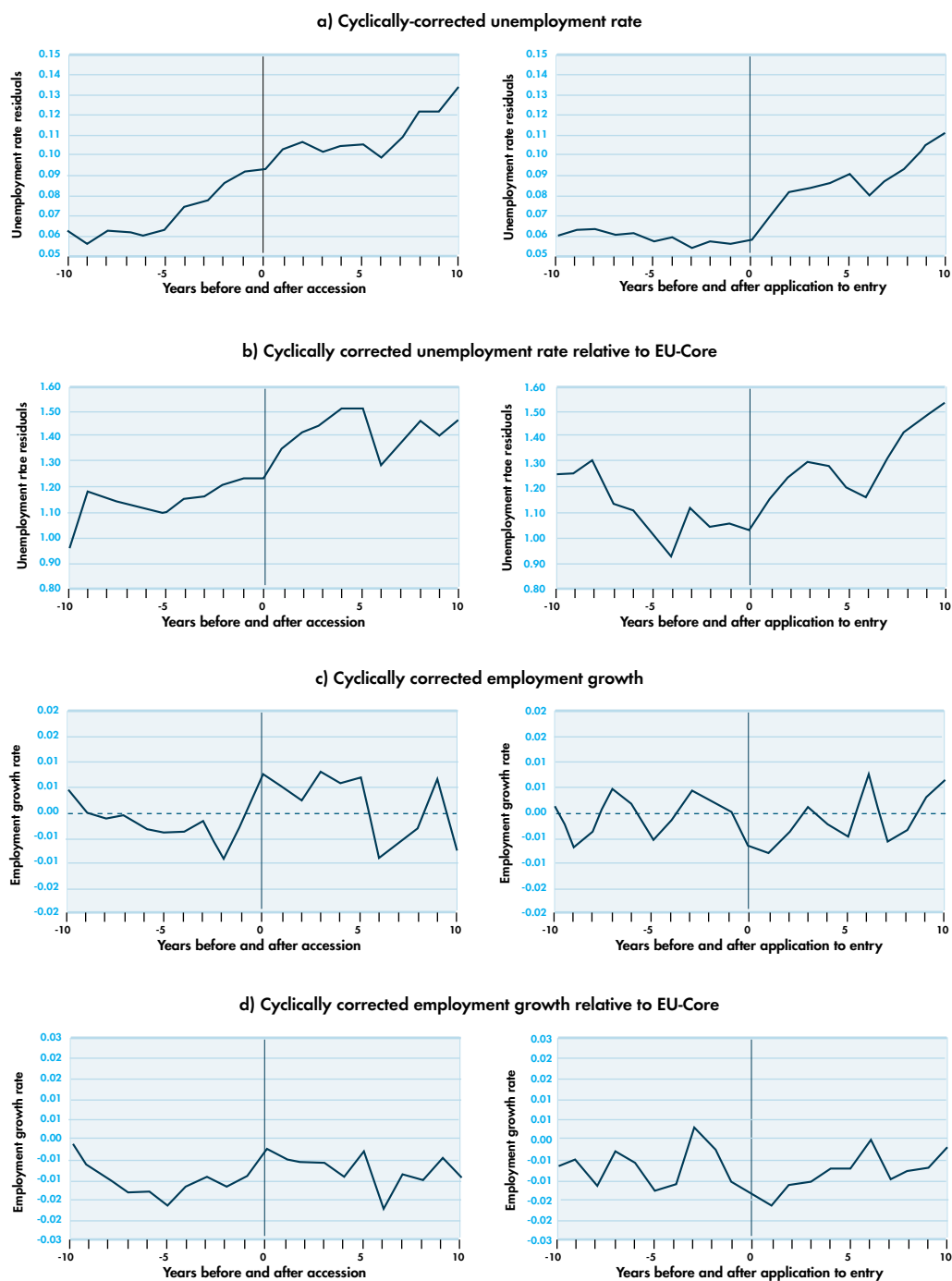
$$x_t = \alpha + \sum_{i=0,1,2} \beta_i \Delta y_{t-i} + \gamma_1 t + \gamma_2 t^2 + \gamma_3 t^3$$

where  $x$  is either the OECD standardised unemployment rate or the growth rate of employment,  $y$  is the log of GDP, and  $t$  is a time trend. From the estimates we then constructed and studied the series  $x_t - \sum_{i=0,1,2} b_i \Delta y_{t-i}$ , where the  $b_i$  are estimates of the  $\beta_i$ .

with an increasingly "European" safety net which slows the transition process. An optimistic view suggesting accelerated integration, however, is buttressed by results for employment growth.

The "EU is bad news" hypothesis can be tested more formally using econometric methods. This is explained in more detail in Box 2.

**Figure 4.** Labour market performance and EU accession



**Application as well as accession of a country to the EU is associated with a statistically significant higher unemployment rate, where application appears to be more important than accession.**

The regression results are presented in the columns of Table 3. As expected, cyclical factors are significant with the expected sign, i.e. that higher GDP growth is associated with lower relative unemployment and higher employment growth. As in the figures, both application as well as accession of a country to the EU is associated with a statistically significantly higher unemployment rate, relative to the core. Interestingly, application appears to be more important than accession, although all coefficients are estimated positive. In columns (b) and (d), in which the cubic time trend is omitted, EU accession is also accompanied by significantly higher employment growth.

**Table 3.** Unemployment and employment growth rate regressions, 1964-1996 (unemployment) and 1966-1997 (employment growth)

Trend	$\eta_{it}^{(1)} = u_{it}/u_{it}^{core}$				$\eta_{it}^{(2)} = e_{it} - e_{it}^{core}$			
	(1) linear, square, cubic time trends	(2) linear, square time trends	(3) linear, square, cubic time trends	(4) linear, square time trends	(a) linear, square, cubic time trends	(b) linear, square time trends	(c) linear, square, cubic time trends	(d) linear, square time trends
Constant	1.926** (0.362)	1.224** (0.206)	1.847** (0.363)	1.333** (0.206)	0.015 (0.038)	0.006 (0.016)	0.014 (0.038)	0.007 (0.017)
$g_{it}$	-1.764** (0.536)	-2.082** (0.606)	-1.760** (0.533)	-2.013** (0.596)	0.162** (0.040)	0.172** (0.040)	0.162** (0.040)	0.172** (0.040)
$g_{it-1}$	-2.796** (0.526)	-2.921** (0.600)	-2.807** (0.523)	-2.880** (0.590)	0.117** (0.041)	0.122** (0.041)	0.116** (0.041)	0.122** (0.041)
$g_{it-2}$	-2.827** (0.537)	-3.048** (0.600)	-2.797** (0.535)	-2.897** (0.592)	0.080* (0.041)	0.084** (0.040)	0.080* (0.041)	0.083** (0.040)
$ap_{it}$	0.141* (0.073)	0.204** (0.065)	0.140* (0.073)	0.227** (0.064)	-0.004 (0.005)	-0.002 (0.005)	-0.004 (0.005)	-0.003 (0.005)
$ac_{it}$	0.092 (0.069)	0.225** (0.065)	0.101 (0.068)	0.241** (0.064)	0.010* (0.005)	0.009** (0.004)	0.010* (0.005)	0.009** (0.004)
$ems_{it}$			0.115* (0.059)	0.166** (0.052)			0.002 (0.004)	-0.0003 (0.004)
adj. $R^2$	0.873	0.838	0.875	0.839	0.222	0.215	0.222	0.212
# of obs.	296	296	296	296	288	288	288	288

Notes: A \* (\*\*) denotes significance at the 10 percent (5 percent) level. Standard errors are reported in parentheses. Estimated coefficients on time trends are not reported.

Source: Boeri *et al.* (1998).

While it is theoretically possible that a few isolated countries affected our results, we obtained similar results when excluding Austria, Sweden and Finland (not reported). This is a particularly interesting result, since the typical ratchet adjustment in the EU to the oil shocks was absent for these countries during that period - a period during which they were not EU members. Since most analysts describe the recent, obviously very persistent 1990 shock to Sweden and Finland as a "demand" shock, it seems that the "side" (supply or demand) from which the shock originates is less important than the fact that a negative shock occurred.



*While entry in the EU will carry enormous advantages, it will also imply additional structural adjustment. This process may be attenuated by excessively rapid entry.*

Finally, we wanted to investigate the possibility that the result was simply an artefact of the introduction of the EMS, which coincided with the second great ratchet upwards in unemployment rates. The results in columns (3) and (4) report the same specification as columns (1) and (2), but include an "EMS dummy" with a value of zero before 1978, and one afterwards. The results show that relative unemployment rates of EU entrants were indeed significantly higher in the EMS period. But controlling for the EMS period does not change the result that accessions and applications have a significant positive coefficient in the relative unemployment rate regressions. In the employment growth rate regressions the EMS dummy is insignificant.

## **5. Conclusions**

The message of this paper is straightforward and disturbing. The CEE countries have already experienced a great deal of stress in the adjustment process. At the risk of speaking in platitudes, it is important to emphasise just how much adjustment still needs to occur in these countries. The "return to Europe" is a desideratum, yet the price is negotiable; it is currently too high. While entry in the EU will carry enormous advantages, it will also imply additional structural adjustment, as inefficient producers in agriculture, high tech manufacturing and services are squeezed. More importantly, the evidence reviewed in this paper suggests that the adjustment process itself may be attenuated by excessively rapid entry into the rich man's club which is the European Union. It would be a mistake, therefore, to adopt continental-style labour market rigidities at such an early point in the process.

# Annex

## Employment protection regulation in CEE economies

Country	Law	Definition of mass redundancy	Required consultation with employment representatives	Advance notice	Statutory severance pay
Bulgaria	Labour Code 1994 (Ch. 16,1)	Total or partial closing down of enterprise or staff cuts	Yes	30-90 days	Up to one month, more if stipulated in collective agreements or labour contracts
Czech Republic	Labour Code 1993	Redundancies resulting from changing firm objective, new technical equipment, increasing work efficiency, other organizational changes	Yes	3 months	Two months' wages unless collective agreements state otherwise
Hungary	Labour Code 1992	Dismissals of 25 percent of employees or at least 50 people	Yes	30-90 days depending on seniority	One months' pay if job tenure was less than three years, up to six months' pay if job tenure exceeds 25 years
Poland	Act concerning termination of employment relationships for reasons connected with establishments (1989)	Dismissals of at least ten percent of the staff in establishments up to 100 workers or at least 100 workers in establishments employing more than 1000 workers	Yes	45 days	One month's pay for seniority up to ten years, two months' pay for seniority of 10-20 years, three months' pay for seniority of more than 20 years and compulsory allowance for lower income workers in new job, up to six months
Romania	Labour Code 1994	Dismissal due to organizational changes, insolvency or reallocation	Yes	15 days	At least three months' average wages, possibly extended depending on seniority and sector of employment
Slovakia	<ul style="list-style-type: none"> <li>• Act No. 195/1991, Col. on severance pay after termination of labour contract,</li> <li>• Labour Code (Act No. 451/1992 Col.)</li> <li>• Act. No. 387/1996 on employment</li> </ul>	At least ten employees in a firm with 20-99 employees, at least ten percent of employees in a firm with 100-299 employees, at least 30 employees in a firm with more than 299 employees	Yes	3 months	Two months' wages, possibly extended up to five months' wages on the basis of collective agreement or an internal instruction of the employer
Slovenia	Labour Code	Following temporary redundancy of up to six months (at reduced pay), no numerical limits	Yes	6 months	For employees with least two years' tenure: at least one half of the wage during the last three months, for each year of previous employment

Sources: Boeri *et al.* (1998).

## References

- Baldwin, R., François, J., and Portes, R. (1997). "The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe". *Economic Policy*, 24, pp. 125-176.
- Blanchard, O. and Diamond, P. (1994). "Ranking, Unemployment Duration and Wages". *Review of Economic Studies*, 61(3), pp. 417-434.
- Boeri, T. (1996). "Is Job Turnover Countercyclical?". *Journal of Labour Economics*, 14, pp. 603-625.
- Boeri, T. (1997). "What Can we Learn from the Experience of Transitional Economies with Labour Market Policies". *Oxford Bulletin of Statistics*, forthcoming.
- Boeri, T. (1997). "Labour Market Flows in the Midst of Structural Change". In Commander, S. (ed.), *Enterprise Restructuring and Unemployment in Models of Transition*. Cambridge: Cambridge University Press, forthcoming.
- Boeri, T. and Burda, M. (1996). "Active Labour Market Policies, Job Matching and the Czech Miracle". *European Economic Review*, 40(3-5), pp. 805-817.
- Boeri, T., Burda, M., and Köllö, J. (1998). "Mediating the Transition: Labour Markets in Central and Eastern Europe". EPI Report Number 4. London: CEPR, forthcoming.
- Boeri, T. and Scarpetta, S. (1994). "Convergence and Divergence of Regional Labour Market Dynamics in Central and Eastern Europe". OECD Technical Workshop on Regional Unemployment in Central and Eastern Europe, IAS, Vienna, November.
- Burda, M. (1992). "A Note on Firing Costs and Severance Benefits in Equilibrium Unemployment". *Scandinavian Journal of Economics*, 94(3), pp. 479-489.
- Burda, M. and Wyplosz, C. (1994). "Gross Worker and Job Flows in Europe". *European Economic Review*, 38(6), pp. 1287-1315.
- Burda, M. and Lubyova, M. (1995). "The Impact of Active Labour Market Policies: A Closer Look at the Czech and Slovak Republics". In Newbery, D. (ed.), *Tax and Benefit Reform in Central and Eastern Europe*. London: CEPR, pp. 173-205.
- Calmfors, L. (1994). "Active Labour Market Policy and Unemployment: A Framework For the Analysis of Crucial Design Features". OECD Economic Studies No. 2, pp. 7-47.
- Calmfors, L. and Nymoén, R. (1990). "Active Labour Market Policies in the Nordic Countries". *Economic Policy*, 11, pp. 397-438.
- EBRD (1994, 1995, 1996). "Transition Report". London, EBRD.
- EU Commission (1995). "Employment Observatory". No 8., Brussels.
- Hopenhayn, H. and Rogerson, R. (1993). "Job Turnover and Policy Evaluation: A General Equilibrium Analysis". *Journal of Political Economy*, 101(5), pp. 915-938.
- Jackman, R. (1995). "What Can Active Labour Market Policy Do?". Centre for Economic Performance Discussion Paper No. 226.

- Jackman, R., Pissarides, C., and Savouri, S. (1990). "Labour Market Policies and Unemployment in the OECD". *Economic Policy*, 10, pp. 450-483.
- Kwiatkowski, E. (1996). "Remarks on the Role of Active Labour Market Policies in Poland". Institute of Economics, University of Lodz.
- Lacko, M. (1995). "Hungarian Hidden Economy in International. Comparison: Estimation Based on Household Electricity Consumption and Currency Ratio". Institute of Economics, Hungarian Academy of Sciences, mimeo.
- Layard, R., Nickell, S., and Jackman, R. (1991). *Unemployment*. Oxford: Oxford University Press.
- Lazear, E. (1990). "Job Security Provisions and Unemployment". *Quarterly Journal of Economics*, 105(3), pp. 99-126.
- Lehmann, H. (1995). "Active Labour Market Policies in the OECD and in Selected Transition Economies". World Bank Policy Research Working Paper No. 1502.
- Lindbeck, A. and Snower, D. (1985). "Wage Setting, Unemployment and Insider-Outsider Relations". *American Economic Review*, 76(2), pp. 235-239.
- Ljungqvist, L. and Sargent, T.J. (1995). "The Swedish Unemployment Experience". *European Economic Review*, 39(5), pp. 1043-1070.
- Lubyova, M. and van Ours, J. (1996). "Work Incentives and Other Effects of the Transition to Social Assistance: Evidence from the Slovak Republic". Mimeo, November 1996.
- Munich, D., Svejnar, J. and Terrell, K. (1994). "Regional Unemployment Dynamics and Mismatch in the Czech and Slovak Republics". Paper presented at technical workshop "Regional Unemployment in Central and Eastern Europe", Vienna, 3-5 November 1994.
- Nickell, S. and Bell, B. (1997). "Would Cutting Payroll Taxes on the Unskilled have a Significant Impact on Unemployment?". In Snower, D. and De la Dehesa, G. (eds.), *Unemployment Policy: Government Options for the Labour Market*. London: CEPR.
- OECD (1993). "Employment Outlook". Paris: OECD.
- OECD (1995). "Review of the Labour Market in the Czech Republic". Paris: OECD.
- OECD (1997). "Labour Market Policies in Slovenia". Directorate for Education Employment Labour and Social Affairs, Employment, Labour and Social Affairs Committee, Paris: OECD.
- Puhani, P. and Steiner, V. (1996). "Public Works for Poland? Active Labour Market Policies during Transition". ZEW Discussion Paper No. 96-01.
- Sachs, J. (1993). *Poland's Jump to the Market Economy*. Cambridge: MIT Press.