EUROPEAN INTEGRATION CONSORTIUM:
DIW[1], CEPR, FIEF, IAS, IGIER

THE IMPACT OF EASTERN ENLARGEMENT ON EMPLOYMENT AND LABOUR MARKETS IN THE EU MEMBER STATES

FINAL REPORT

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

Berlin and Milano 2000

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[1] Consortium leader.

Contents

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Introduction

The challenges and the opportunities arising from the Eastern Enlargement of the European Union (EU) have no historical precedent. The candidates for accession from Central and Eastern Europe are, due to transition and opening, still exposed to a severe process of structural change, which is not comparable in magnitude and speed to that of well-established market economies. The income differential is in case of the Central and Eastern European Countries (CEECs) markedly larger than those of past accession rounds. Moreover, European integration has gained momentum since the last enlargement rounds. The single marked principles are much less of a mirage than even just a decade ago, and there is now a common currency shared by a core group of EU Members. Thus, the scope of integration involved by accession and the pressures imposed by enlargement on both the present EU Members and the CEECs are unprecedented.

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

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

The report is structured in two parts: The first part analyses the likely impact of Eastern Enlargement on trade, migration and capital movements and their implications for employment and wages in the present EU member countries. The integration of the CEECs is understood to be an ongoing process, which has started with the step-wise removal of trade barriers in the course of the implementation of the Europe Agreements (EAs) and is proceeding with the adjustment of the institutional framework of the CEECs to EU standards. It is a process that will not be finalised at the date of accession. The analysis therefore focuses on the development of the patterns of trade, migration and capital movements before and after the accession as well as in the case where access does not matter. Since the size of trade, migration and capital movements between the EU and the CEECs is at present too small to make an economy-wide impact on relative wages and employment, even in the most severely-affected Member states, the possible effects of trade and factor movements are addressed mainly at branch and regional levels. Beyond a qualitative assessment of the implications of trade, migration and capital movements on employment and wages in specific branches and regions, a quantitative evaluation is provided, based on longitudinal data sets in selected countries (i.e. Austria, Germany and Sweden). An accession of the CEECs to the EU will not induce a substantial change of the conditions for trade and capital movements vis-à-vis the status quo. In contrast, the immigration of labour from the CEECs is largely restricted by the EU Member states. The conditions for the migration of labour is therefore that dimension of economic integration, which will most markedly change in case of accession. Special attention is therefore devoted to assessing the migration potential of the CEECs.

The second part of the report addresses the options for labour market policies in the course of Eastern Enlargement and assesses the scope for a harmonisation of labour market institutions in the candidate countries and the EU Members. Based on the findings of the first part the likely profile of winners and losers is discussed and the relevant trade-offs involved by Eastern Enlargement are outlined. Drawing on the historical experience of other integration episodes, i.e. Southern Enlargement of the EU, German unification and the North American Free Trade Area (NAFTA) agreement, inferences are made as to the proper set of institutions likely to minimise undesirable effects of accession on employment, income distribution and social cohesion. As the social costs of Eastern Enlargement are crucially related to the speed of convergence of the CEECs to EU income levels, the likely impediments to growth in the candidate countries and, hence, structural policies to accompany accession are discussed. Finally, on basis of this analysis, policies to foster worker mobility across industries and regions and to cope with the immigration of labour from the East are discussed.

Tito Boeri and Herbert Brücker

Executive Summary

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

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

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

Part A

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

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

1. The income differential and prospects for convergence

The economic conditions at the outset of Eastern Enlargement are characterised by a distinct gap in per capita incomes between the present EU Members and the accession candidates, which can be traced back to differences in factor endowments and factor productivities. With per capita incomes in the CEE countries between one-tenth, at current exchange rates, and one-third, at purchasing power parities, of the respective levels of the present EU member states, the gap is considerably wider than in past accession rounds. However, the variance of income levels across individual CEE countries is large: Per capita GNP levels at current exchange rates vary between 5 per cent and 40 per cent, and at purchasing power parities between 20 per cent and 60 per cent, of respective figures in the present EU.

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

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

2. The impact of trade

Trade in goods is the single dimension of economic integration which has proceeded farthest. With the notable exception of agriculture, tariffs and quantitative barriers to trade between the EU and the candidate countries have been almost abolished. An accession of the CEE countries to the EU will change the conditions for trade vis-à-vis the status quo, mainly by integrating the CEE countries into the Common Agricultural Policy (CAP), by harmonising product quality standards and liability rules. In the course of transition and integration, trade between the EU and the CEE countries has boomed: between 1988 and 1998, exports from EU countries to the CEE countries have grown by a factor of 6.5, and imports from CEE countries into the EU by a factor of 4.5. However, potential trade between the EU and CEE countries is not yet exhausted; this applies in particular to countries which have been less involved so far in trade flows (i.e. Portugal, France, UK). Actual exports of the EU to the CEE countries in 1998 have been at 50 per cent of ‘normal’ export volumes among EU countries of the same characteristics, and at 40 per cent of ‘normal’ import volumes. The trade surplus of the EU vis-à-vis the CEE countries is expected to double in the wake of increasing EU investments in the CEE countries. Although empirical evidence indicates that trade volumes of EU countries with other Member States are between 20 and 60 per cent higher than those with non-EU countries, it is worth noting that the conditions of trade with CEE countries already resemble those of trade with other EU Members. Thus, the further impact of accession on the trade potential is likely to be fairly moderate. Trade theory predicts that the integration of economies with large differences in factor endowments yield large benefits in terms of income and consumer surplus at the aggregate level, but that the gains and losses are unevenly distributed among the individual factors of production. More specifically, the integration of the CEE countries into the EU markets for goods and services could affect wages and employment through increasing imports of labour-intensive goods and exports of physical capital and human capital intensive goods, which would in turn increase the relative price for physical capital and human capital, and decrease wages for unskilled labour. Indeed, actual trade flows between the EU and the CEE countries clearly reflect differences in factor endowments and technological know-how. The EU exports goods produced with a high intensity of physical capital and high-skilled labour to the CEE countries, and imports goods with high labour intensity from there.

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

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

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

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

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

It is often supposed that the large surplus in EU-trade with the CEE countries is a job-generating machine. Indeed, a combined trade-surplus of some US-$ 25 billions vis-à-vis the CEE countries has been reached in 1998. The trade surplus has continually increased since opening and economic reform. Moreover, increasing capital transfers in the wake of accession to the EU will be mirrored by mounting surpluses of the trade balance. The deficit in the trade balance may double in the course of accession. Analyses of the labour services incorporated in traded goods indicate that, on a net basis, several ten-thousand jobs are secured by trade with the CEE countries. However, it has to be taken into account that the trade surplus is financed by a deficit in the capital balance, i.e. that income is transferred from the EU to the CEE countries.

Another concern is raised by the Southern EU countries, who fear that they may be indirectly affected by enlargement, since other EU countries could replace trade with them by trade with CEE countries. Three findings suggest that these concerns are ill-founded: first, no evidence has been found that exports of low-income EU Members to the major CEE trading partners in the EU have fallen in the course of the trade surge with the CEE countries. Second, the pattern of EU-imports from CEE countries and EU-imports from Southern EU Members is only slightly more similar than at EU-imports from the CEE countries and from other industrialised countries. Third, distinct differences between unit-values of EU-imports from CEE countries and EU-imports from Southern EU Members indicate that producers from the accession countries do not compete with producers from the Southern EU members in the same market segments. Overall, the impact of trade with the CEE Countries is likely to be confined to bordering countries, and within these countries, will be concentrated on bordering regions.

3. The impact of capital movements

The barriers to foreign direct investment and other capital movements have been largely removed. However, certain shortcomings in the regulation and supervision of capital markets and the banking systems are still present. From the perspective of the present EU Members, capital flows to CEE countries are negligible: an annual net capital flow of around USD 15 billion corresponds to a share of 0.15 per cent of GDP and 0.8 per cent of gross fixed investment in the EU in 1998. This is too small to expect any impact on interest rates and factor incomes in economies with open capital markets such as the EU Members. However, from the standpoint of the candidate countries, those annual capital inflows amount to 5 per cent of GDP and more than 20 per cent of gross fixed investment and thus have contributed significantly to capital formation, relieving domestic capital markets in the CEE countries and having a substantial impact on growth, interest rates and wages.

Foreign capital flows to CEE largely take the form of foreign direct investments. Cumulative net inflows of foreign direct investment (FDI) into the CEE countries amount to around USD 50 billion between 1991 and 1997, while cumulative net inflows of portfolio capital were at around USD 16 billion during the same time period. Portfolio capital inflows in particular are well below those into other countries with comparable income. This suggests that equity and security markets of the CEE countries are still in their infancy.

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

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

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

4. The impact of migration

Ten years after the fall of the Berlin wall, the migration flows from CEE countries are still heavily restricted by the EU Members. The Europe Agreements (EAs) do not impair the authority of individual EU Members to regulate the immigration of labour and persons from CEE. The removal of the barriers to labour migration is therefore that dimension of economic integration, which will see the most marked change as a consequence of the Eastern enlargement of the EU. Present stocks of employees and residents from CEE in the EU clearly reflect the restrictions to labour mobility and are, in view of the large gap in per capita incomes, rather negligible. The stock of foreign residents immigrated from CEE to the EU is estimated at some 850,000, while the stock of foreign employees amounts to about 300,000. The latter figure includes the full-time equivalent of temporary and seasonal workers. Such figures accounts for 0.2 per cent of the EU population and 0.3 per cent of the EU workforce, respectively. Around 80 per cent of the migrants from CEE reside in Austria and Germany. The majority of these migrants immigrated before 1993. Since 1993 net immigration from CEE to the EU has been negligible as a result of increasing restrictions in the countries of destination.

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

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

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

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

In view of the results of the study, the number of foreign residents from the CEE-10 in the EU-15 increases by around 335,000 people p.a., immediately after the introduction of freedom of movement. Within a decade this figure will have fallen to below 150,000 people. The peak in the foreign population originating from the CEECs is expected to be reached 30 years later, with a 1.1% share of the population in the EU-15. Germany is expected to receive 220,000 people immediately after freedom of movement is introduced. The peak in the foreign population originating from the CEE-10 is expected to be reached 30 years later with a share of 3.5% of the population. These projections are based on the assumptions that per capita incomes between the EU and the CEECs converge at a rate of 2% annually and that the unemployment rates in Germany and the CEECs remain constant. Altogether, our estimates show that, in view of the large income gap, the foreign population will increase markedly in the most affected countries of the EU-15. However this increase will be spread over a number of decades. This can be traced back to the high transaction costs of migration and limited absorptive capacity of the labour markets in the destination countries. Of course, these projections rely on the proviso that the experiences of migratory movements in post-war Europe can be applied to the CEECs and that the determinants of migration are adequately depicted. However, fears that the EU will be swamped by immigrants from the CEECs as a result of free movement of labour seem to be ill-founded.

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

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

Part B

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

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

5. Policies to mitigate the impact of structural adjustment

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

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

Hence, it seems better to develop institutions coping with (rather than opposing) structural change. Non-statutory firing costs agreed in collective bargaining and putting more emphasis on the advance notification of dismissals rather than on procedural obstacles to layoffs, unemployment benefits of rather short duration and allowing for in-work benefits, minimum wages differentiated by age, are good examples of the kind of institutions which could provide sufficient insurance to workers without precluding structural reforms and without yielding high unemployment rates. Many current labour market institutional arrangements in the West have proven to be ill-suited to cope with structural reallocation and should not be imposed on the Central and Eastern European countries. The German unification episodes is particularly revealing as to the adverse effects of exporting to countries undergoing major structural change collective bargaining institutions which do not allow sufficient wage dispersion, notably precluding wage differentials from reflecting underlying differentials in labour productivity.

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

6. Policies coping with regional unemployment differentials

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

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

Against this background, regional labour mobility will initially play a very important role as a regional re-equilibrating factor. In particular, responsiveness of wages to interregional productivity differentials and some degree of mobility of workers across regions will be required.

This part of the report argues in favour of measures promoting the regional mobility of workers, such as mobility-enhancing wage subsidies to firms and workers (e.g., mobility loans and grants or tax deductions offered to workers changing residence). It also suggests that improvements in the transportation network have the potential to reduce significantly unemployment differentials. Given the small scale of many countries in the region, inter-regional labour mobility can indeed be to a large extent accommodated via commuting flows, rather than changes in residence. Finally, another key recommendation developed in the report is not to force the centralisation in the East of the de-centralised bargaining structures which have prevailed so far. This does not preclude the achievement of greater co-ordination in collective bargaining, which can be valuable in reducing the inflationary pressures associated with the accession and signs of over-heating in some local (e.g., some of the country capitals) labour markets.

7. Regulating migration flows from the candidate countries

As stressed above, convergence of Central and Eastern Europe to the income per capita levels prevailing in the EU will be a fairly long process. Thus, the enlargement process will be associated with some East-West migration, particularly taking account of the fact that some

East-West borders involve the richest regions of the EU. Given the large differences in factor endowments, trade will exert only moderate pressures for East-West wage convergence in the interim period. Albeit relatively small in terms of the Western populations and workforces, such migration flows, if regionally concentrated, may create problems of social cohesion in some local labour markets.

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

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