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The Role Accorded to Trade and Migration in EU Enlargement: Impact on the Labour Market

Gudrun Biffl – Austrian Institute of Economic Research

Abstract

The fall of the Iron Curtain was the beginning of a new era of socio-economic and political interaction in Europe. The signing of the Europe agreements by the EU in 1991 gave precedence to increased trade rather than migration as a development tool. This has resulted in a marked rise in trade flows between the EU and CEECs in the 1990s. Increased trade was linked with substantial industry restructuring in the EU as well as in the CEECs, resulting in regional specialisation of production. Increased factor mobility largely took the form of investment capital flows from West to East rather than labour flows from East to West.

The process of industrial restructuring and reallocation of production had winners and losers in the West. Winners were the highly skilled workers and professionals; losers the un- and semiskilled and tradesmen, often migrants. As labour mobility within the EU (15) is comparatively low, industrial and trade specialisation resulted in a rise in unemployment and/or a decline in activity rates and/or a widening of wage differences by skill and occupation. In the new member states, labour market conditions have been improving in the last couple of years, but there remains a big gulf between the EU (15) and the new member states in terms of employment and activity rates and wages on the one hand, and the role of the informal sector for income creation on the other.

Given the strictures of EMU and the limited initiatives afforded to Member States on macro-economic policy, the burden of flexibility will largely fall on wage costs to meet competitive pressures if unemployment is to be prevented. However, the development of a system of continued learning and re/multi-skilling of the work force as an element of employment policy, to promote the adjustment of skills to the changing needs, could reduce some of the pressures on wage policy. The success of the implementation of a system of continued learning and up-skilling would show up in a slow-down of the widening wage scales, in the reduction of unemployment and in so doing it would promote social cohesion.

Introduction

Economic integration in Europe in the 1990s as well as globalisation at large, has been associated with increased international mobility of capital but less so of labour (*Biffl,* 2000, *Solimano,* 2001). This may be the result of a general view that commodity trade has in the main positive consequences, while migration gives rise to increased inequalities and results in winners and losers. This view is reflected in the fact that countries tend to impose restrictions on labour mobility while at the same time removing barriers to the free flow of goods and services across borders (GATS), thus discriminating against labour mobility in favour of international trade. This may be a contributory factor to the rising number of illegal migrants who endeavour to improve their economic situation by migrating even if it means working in the informal sector (*Ghosh,* 1998, 1999). The existence of informal sector production of goods and services and the creation of jobs and incomes in the non-observed economy, both in developing and developed countries (*OECD,* 2002A, *ILO,* 2002)[1], may thus harbour illegal migrants.

This view raises the following question: Which is valid – the policy assumption that trade and migration have different impacts on economic growth, the labour market, prices and income distribution; or, the theoretical proposition that they are in the main substitutes and thus can be expected to have similar impacts (*Markusen,* 1983, *Mundell,* 1957)? If the latter is true, a freer movement of people may be justified not only on economic grounds but also on humanitarian and social grounds. If, however, migration and trade are only substitutes under certain conditions, priority may be given to trade rather than migration in particular circumstances of socio-economic development.

The limited inter- and intra-member country labour mobility in the EU and the new member states (*Puga,* 1999, 2001) suggests that employment and wage policy may face a greater challenge with Eastern enlargement than Southern enlargement. This is all the more to be expected as the new member states tend not to have collective bargaining arrangements of Western EU countries (*Isaac,* 2003); social dialogue in the new member states will largely depend on the success of public administration to execute legislation which was brought in as a result of the requirements of the *acquis communautaire*. Competitive pressures in conjunction with the economic pressures arising from monetary union, may be expected to test the robustness of social cohesion in the old and new member states.

[1] The ILO claims that the bulk of new employment in recent years, especially in developing and transition countries, has been in the informal sector (*ILO,* 2002, 1).

Single Market and Single Currency did not boost intra-EU migration and trade

Free trade has, of course, been on the agenda of the European Community from its very beginning and free mobility of labour between the 6 founding countries (France, Germany, Italy, Belgium, Netherlands and Luxembourg) was phased in from 1958 onwards. Since 1968, free mobility of labour was in principle possible within the European Community in the private and public sector. But it was not until the Single Market came into effect in 1992 that many remaining impediments to labour mobility were removed (banking, insurance, transport, some free professions). Capital markets were, of course, fully integrated much earlier.

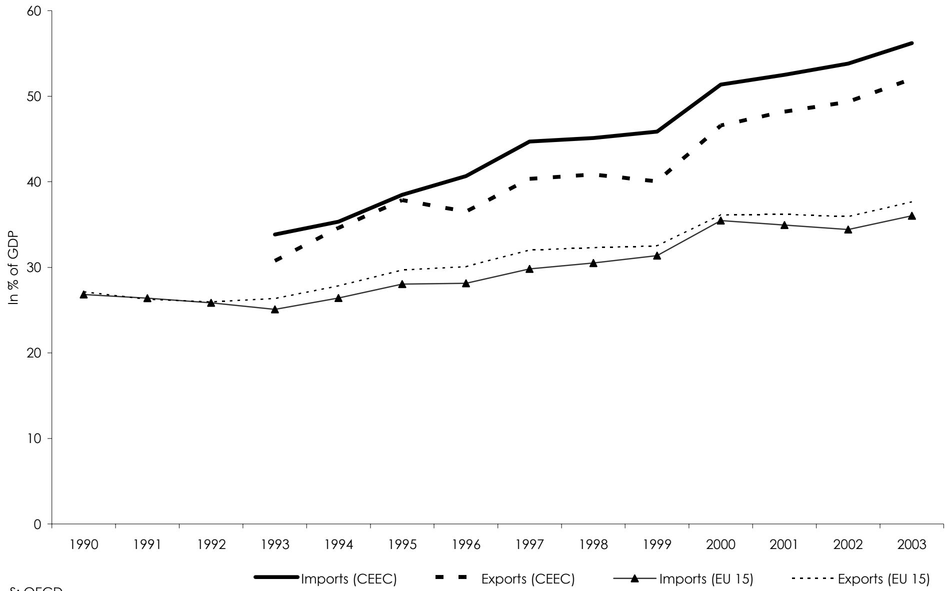
However, as will be seen, one of the important features of the increased socio-economic and political integration of and interdependence between EU member states as a consequence of the implementation of a Single Market and the Single Currency, is that it has neither given a significant boost to labour mobility of EU citizens within the EU nor to Intra-EU trade. The share of EU citizens living and working in another EU country has remained fairly stable at a very low level during the 1990s – on average 2 percent of the population/work force; while intra-EU (15) trade remained fairly stable at around 20 percent of GDP (2002). This comes as a surprise in view of the longstanding effort of the European Community to promote both free trade and free mobility of labour. But it suggests that specialisation of production has reached a free trade equilibrium within the EU (15) in the 1990s such that the Heckscher-Ohlin model no longer operates to extend trade and to increase migration *(Heckscher,* 1949, *Ohlin,* 1933/1967).

The story was somewhat different for South-North integration. In spite of institutional barriers to labour mobility in the 1950s and 1960s, substantial South-North migration of in the main low skilled workers occurred, as wage differentials and differences in the degree of unused labour resources generated labour movements. By the end of the 1970s and thus long before Southern EU enlargement, massive South-North migration had come to an end in the wake of a successful catching-up process of the Southern European Countries; as traditional trade theory suggests, the slow down in migration was accompanied by the relocation of low tech production from the North to the South and rising intra-European trade (*Biffl,* 1999, *Stalker,* 1994).

The limited mobility of EU citizens within the EU is a matter of concern to some policy makers as it is seen as a potential threat to economic and productivity growth and one reason for sustained large pockets of unemployment. This may be one reason why the EU has promoted the development of a common EU labour market through engaging in a complex process of policy harmonisation and co-ordination in areas as diverse as employment, education and – more recently – migration policy.

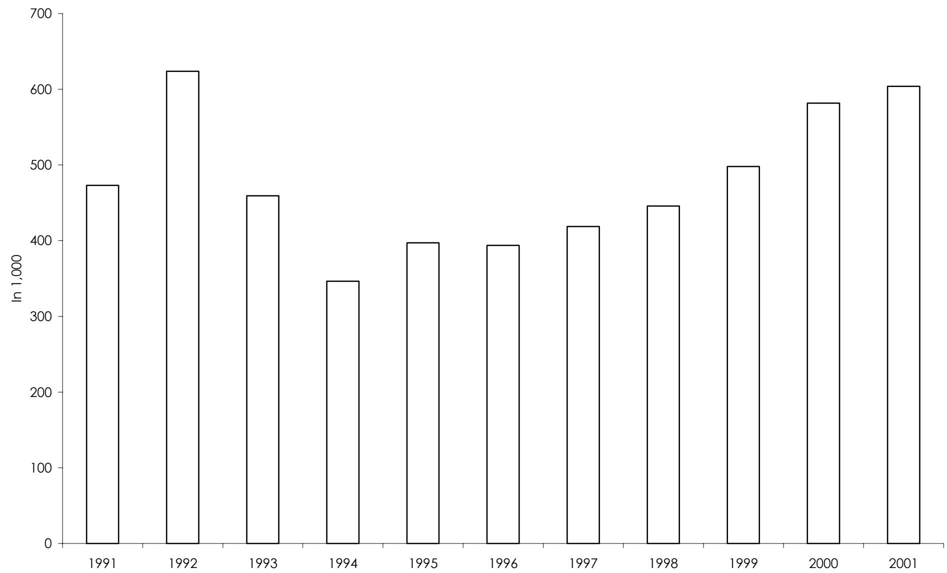
On the other hand, what stands out during the 1990s, is that the international trade of the EU (15) became increasingly dynamic. Between 1990 and 2003, imports and exports in percent of GDP rose by some 10 percentage points in the EU (15), i.e., the share of imports/exports of goods and services in percent of GDP increased from 28 percent in 1989 to almost 40 percent of GDP today. The rise was in the main attributable to increased trade with Central and Eastern European Countries (CEECs), raising the contribution of trade with CEECs from about 7 percent of GDP in the early 1990s to some 14 percent of GDP in 2003 (Graph 1).

Graph 1: Imports and Exports in percent of GDP in the EU (15) and CEECs in the 1990s



S: OECD.

Graph 2: Inflow of workers into the EU(15) in the 1990s



S: OECD SOPEMI, excluding Finland, Italy, Portugal.

In contrast, the inflow of migrants into the EU(15) lost momentum after a transitory boost following the fall of the Iron Curtain in 1989. As the economic, political and social environment stabilized in the CEECs, the rate of out-migration fell, partly as a result of legal barriers to migration, partly as a result of the economic recovery of CEECs after the transition recession (Graph 2). However, there has been a rising number of illegal migrants who try to improve their economic situation by migrating even if it means working in the informal sector. The existence of informal sector production of goods and services and the creation of jobs and incomes in the non-observed economy in Western Europe may thus encourage illegal migration.

Empirical evidence suggests that the forces at work appear to have promoted trade rather than labour mobility to facilitate economic integration between Western and Central and Eastern European countries since the 1990s. Research into trade and industry specialization in the enlarged European trading zone suggests a gradual process of specialization, which is responsive to factor endowments, in particular to the relative supply of highly skilled workers (for R&D intensive industry clusters) and skilled tradesmen (for labour intensive industries). (*Traistaru et al.,* 2002*, Midelfart-Knarvik et al., 2000, Aiginger et al.,* 1999*, Fidrmuc et al.,* 1998) This seems to support *Brülhart* (2001) who argues that exogenous endowment, as emphasized in the traditional trade theories, and industry-specific economies of scale which are at the centre of the new economic geography theory, become more important causes for inter- and intra-industry trade.

Thus, in the current period of socio-economic integration of Europe, economic as well as political forces are behind the promotion of international trade rather than migration. Thus, technological innovations, for example, computer programming, have tended to promote mobility of services rather than labour, while relatively small transport costs due to the geographical proximity of the new trading partners, promote trade in goods rather than labour mobility. This is not difficult to understand – the cost of migration to individuals is high because of language and cultural barriers, problems of skill recognition across countries as well as housing costs (*Decressin & Fatas,* 1995*, Biffl,* 1997). At the same time, increased mobility of capital, technology and managerial skills boosted inter- and intra-industry trade, constituting the main driving force behind productivity increases in the EU and in CEECs (*Landesmann & Stehrer,* 2000).

To appreciate the new paradigm, it is important to note that Eastern Enlargement is being accompanied by different industrial specialisation patterns compared to the earlier Southern Enlargement. In particular, the re-location of production from the EU to CEECs goes beyond low-skilled and low-tech production. There is ample empirical evidence suggesting that this is the result of the better average skill endowment in the new member states. Some of the new EU countries outstrip the EU South in terms of human skills and are much closer to the EU core than Southern regions of the EU (*Boeri & Brücker,* 1999). With membership, remaining trade barriers are dismantled between the old and new member states, free mobility of labour is, however, not granted to the new EU citizens for at least two years to come, with the exception of Ireland. This may encourage trade within the enlarged EU also in the years to come. Increased migration may be expected to take place mainly of highly skilled workers who tend to be complementary to particular production modes (*OECD*, 2002B), as exemplified by the 'new geography' trade model[2].

The low labour mobility within the CEECs, within the EU (15) and between them, signifies (*Biffl,* 2000) that, especially under the restrictions of Monetary Union, the brunt of labour market adjustments resulting from increased trade (specialization) will show up in quantity adjustments such as changes in unemployment/activity rates (Decressin & Fatas, 1995) and/or in increased flexibility of the wage system. This is a different pattern of development from that in the USA, which is marked by substantially higher mobility of labour within the country and a higher labour inflow from abroad. Higher labour mobility reduces the labour market adjustment costs of specialization in production and trade (*Blanchard & Katz,* 1992).

The limited inter- and intra-member country labour mobility in the EU and CEECs (*Puga*, 1999, 2001) suggests that education and labour market institutions face a greater challenge with Eastern Enlargement than they did during the Southern Enlargement of the EU. If unemployment and/or increased wage dispersion are to be avoided, they will have to ensure that the skills of the respective resident populations, including migrants, will be adapted to the new needs arising from flexible specialization of production and the relative decline of Fordist mass production systems.

More informal work as the EU is enlarged?

Increasing flexibility in the western style formal economy, together with the legacy of a second economy in the transition countries provide strong incentives for a large informal sector production in the new member states (*Kurkchyian,* 2000, *Thomas,* 1992, *Sik,* 1992). The large proportion of informal work in GDP and in total employment is not only the result of a legacy of informal work practices and a lack of experience with a whole set of new institutions typical for market economies (for example, managerial capacity), but also of the massive impoverishment of large segments of the population in the wake of transition to a

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[2] The 'new economic geography' models (*Krugman,* 1991/1993, *Puga,* 1999, *Ottaviano & Thisse,* 2003) introduce a new feature into trade theory, namely that trade and migration may, under certain circumstances, not promote factor price equalisation across regions and countries. An initial shock, e.g. the reduction of trade costs below a certain critical value or the prospect of increasing returns to scale in an industry, may generate flows of mobile workers and firms into core locations (increasing returns industry) while other regions preserve their traditional production and immobile work force. Thus a core-periphery industrial structure develops endogenously. In such a case, factor movements may promote a divergence in factor prices between the core and periphery.

market economy. Transition from a command to a market economy went hand in hand with substantial output declines in manufacturing, mining and agriculture and with an increase in services. The reallocation of labour was associated with a rise in unemployment and a corresponding loss of benefits traditionally provided by enterprises. A feature of the communist system of full and life-time employment was to top up wages by generous universal benefits, e.g., family allowance, pensions, subsidised food, housing and heating. The welfare system was thus linked to employment in the formal sector. The loss of formal sector jobs and the slow implementation of western style welfare institutions, like unemployment benefit systems, retirement pay, health provision, often made work in the informal sector a survival strategy.

Currently some 10 percent to 20 percent of GDP is produced (and employment created) in the informal sector in EU member countries (*Schneider – Enste,* 2000, *SAMLEG,* 2002, *Biffl,* 2002), and some 30 to 50 percent in the transition countries (*Musiolek,* 2002), which have joined the EU in May 2004 (*EC,* 2002A). Thus, informal sector production plays a significant role in employment creation, income generation and poverty reduction.

Table 1: The share of the informal sector in terms of GDP and employment

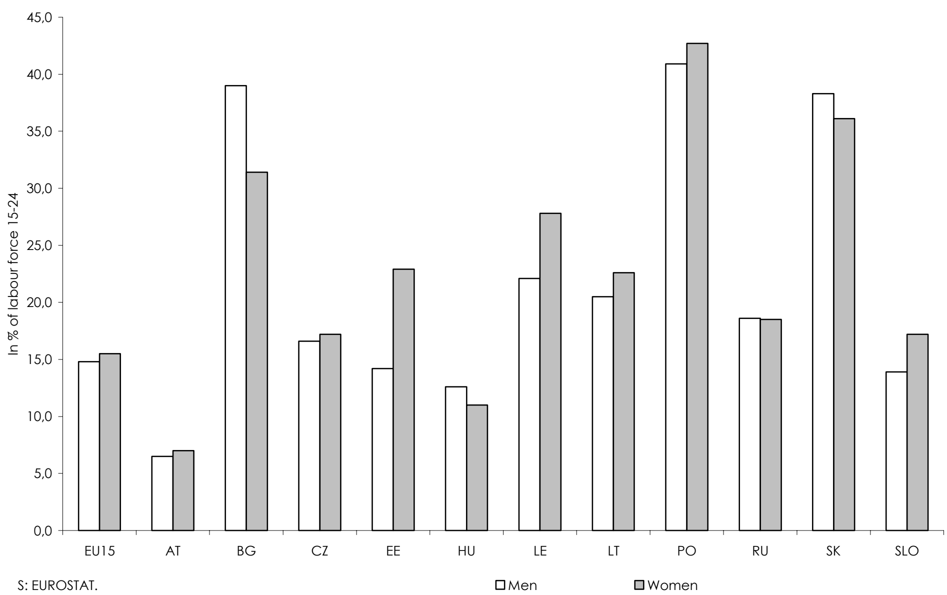
	Informal sector in percent of GDP				Informal sector in percent of employment
	Ø 1989-1990	Ø 1990-1993	Ø 1994-1995	Ø 1999	Ø 1999
Austria*)		4.5		8.5	10.0
Bulgaria	24.2	26.3	32.7	33-35	33.1
Czech Republic	6.2	13.4	14.5		
Estonia	20.2	23.9	18.5		
Germany			15.0	18.0	
Hungary	28.2	30.7	28.4		
Latvia	13.2	24.3	34.8		
Lithuania	11.2	26.0	25.2		
Poland	18.2	20.3	13.9		
Romania	16.2	16.0	18.3		
Slovakia	7.2	14.2	10.2		

Source: *Schneider – Enste* (2000). *Musiolek* (2002). – *) Statistics Austria.

By drawing the CEECs into the EU, the expansion of informal sector activities in the EU 15, especially those bordering the CEECs, will be reinforced – at least for the period of time in which free labour movement is not allowed between the EU 15 and the new member countries. Labour movement will be restricted to regulated cross-border labour movement and labour migration. In that situation it can be expected that migrants and cross-border workers from CEECs will be pulled into the formal-informal continuum of labour markets as we know it today. EU countries bordering on accession states may expect an increased supply of informal sector labour as a result of migration on the one hand and through petty trade with informal sector products from CEECs, given the large differences in wages and consumption opportunities.

Informal sector work may be a rational coping strategy in a world of scarce formal sector jobs. However, there is a risk of a permanent de-skilling of those workers who are effectively excluded from formal employment. This may seriously impair the productive potential of a country. Therefore, in order to devise effective employment policies, it is important to learn about the structure of informal work – the demand side, – and about the characteristics of the workers in the informal sector – the supply side. The inadequate statistics currently available makes possible outcomes difficult to forecast. However, given the current state of statistics, high youth unemployment could serve as an indicator of barriers to formal sector jobs of newcomers. We do not know, if and to what extent young people are working in the informal sector; nor do we have systematic and comparable information on the type of jobs in the informal sector. Graph 3 shows that youth unemployment rates are substantially higher in most CEECs than in the EU 15. The danger of persistent skill-deficient youth due to their low participation in the formal labour market, is particularly pronounced in Slovakia, Poland, Bulgaria, and the Baltic States.

Graph 3: Youth unemployment rates (15 to 24) in the EU 15, Austria and CEECs (2002)



S: EUROSTAT.

In the long run, i.e., when free mobility of labour will be extended to the Eastern EU member countries, integration into the formal sector will be facilitated thus reducing the incentives for and the extent of informal work.

Only the development of a system of continued learning and re/multi-skilling of the work force as an element of employment policy, to promote the adjustment of skills to the changing needs, could take off some of the pressures on wages as instrument of flexibility. A system of continued learning and re-skilling of the work force, which promotes the adjustment of skills to the changing needs of the market. The success rate of such a system, will show up in less pressure to widen wage scales or to increase unemployment resulting from the workings of market forces, with less risk of undermining social cohesion.

Conclusion

The new European paradigm in trade and migration is reflected in the characteristics of economic integration of CEECs with the EU. Unlike earlier experience of substantial South-North migration in the 1950s, 1960s and 1970s, it has so far largely taken the form of increased trade in goods and services. Migration may play an important role in economic integration but as a facilitator of specialised production processes and trade rather than as a substitute for trade. The availability of skilled labour in the CEECs, together with the likely inflow of investment capital and managerial skills, distinguishes the present integration process from the earlier South-North story.

If immigration continues to take place along the traditional un- and semiskilled lines into the old EU member states, and is thus not in harmony with the specialisation processes of industrial production and economic integration, increased unemployment of the less skilled will take place in the formal and informal economy. These circumstances will not only hamper the potential for economic growth but will contribute to rising income inequality and endanger social cohesion.

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