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East versus West? The EU economy after enlargement

By Katinka Barysch

INTRODUCTION

The EU's enlargement to the East has been an economic success. Trade between the old and the new members is thriving. Foreign investment by West European companies has helped to create hundreds of thousands of jobs in Central and Eastern Europe, and it has generated multi-billion euro profits for the investing companies. Workers from Poland, Hungary and elsewhere have plugged skills gaps in those EU countries that have opened their labour markets. Money from the EU budget is flowing into the East's poorest areas. Even East European farmers – previously the region's most ardent eurosceptics – are much happier now that they can sell their goods to the whole EU, and have at least some access to EU farm subsidies.

Politically, however, the EU has not digested the accession of the ten new members. Voters and some politicians in Germany, Austria and elsewhere believe that enlargement has damaged their economies. Many people in the 'old' EU think that competition in the enlarged single market has somehow become 'unfair'. In March 2005, thousands marched in the streets of Brussels to protest against the erosion of the 'European social model' after enlargement. In France, opposition to enlargement was one of the reasons why so many people voted against the EU's constitutional treaty. Only a minority of people now support further enlargement – not only in France, but also in Austria, Denmark, Finland, Germany, the Netherlands and the UK.

Much of the resentment that has been building up in the old EU is fuelled by false perceptions about cheap Polish plumbers and Latvian builders 'stealing' West European jobs by undercutting local wages and disregarding social standards. Workers in slow-growing Germany and Italy may be jealous of the new members' apparent economic success. Many think that this success has been achieved by luring investment and jobs eastwards with the help of 'unfair' tax competition and 'social dumping'. Some West Europeans worry that enlargement has forced the EU into a 'race to the bottom' in wages, taxes and social standards. The East Europeans, it is said, are "unfamiliar with the solidarity of the European social model".[1] Most people in Germany, France and Italy would place the new members firmly in the 'Anglo-Saxon' camp of liberal capitalist economies – an impression that has been reinforced by Eastern Europe's close political ties with the UK and the US.

[1] *Marjorie Jouen and Catherine Papant, 'Social Europe in the throes of enlargement', Notre Europe policy papers, No 15, July 2005.*

The reality, however, is very different. There is no doubt that eastward enlargement is changing the European economy. But much of the impact has already taken place since economic integration has been going on for well over a decade. Undoubtedly, further changes will be required on both sides as single market integration deepens. And some eurozone countries would be well-advised to increase the flexibility of their labour markets before the East Europeans gain the right to apply for jobs across the whole EU in 2011 (and perhaps earlier in some countries).

But the widespread perception that the new members are ultra-liberal, low-tax economies that are damaging Western Europe's social systems is wrong. There are big differences between the individual East European countries. But generally, their levels of taxation and budget spending are only marginally lower than in most West European countries. They tend to have generous social security systems that are under severe strain from

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persistently high unemployment. Like many 'old' EU countries, the newcomers are struggling to stay competitive in the face of low-cost competition from fast-growing Asia. And they are looking for ways to produce more high-tech goods and services and fewer basic manufactured products. For the sake of European harmony, West European politicians should stop spreading stereotypes and instead start a more informed debate on how both old and new members can best benefit from EU enlargement.

THE IMPACT OF ACCESSION

Economically, eastward enlargement is yesterday's news. The EU and the Central and East European countries started to dismantle bilateral trade barriers in the early 1990s, even before they agreed timetables for full liberalisation through the 'Europe agreements'. By 2001 there were no more tariffs or quotas for trade in industrial goods, although some restrictions remained for trade in services and, of course, farm goods. The lowering of EU trade barriers – alongside rapid industrial restructuring – fuelled an export boom across Central and Eastern Europe that has been instrumental in the region's recovery. In the ten years before accession, Hungarian exports rose by 380 per cent (in dollar terms) and Czech ones by 280 per cent. By 2000, the big Central European countries were already sending 60-75 per cent of their exports to the EU. In other words, long before membership, they were trading more with the Union than many of the EU countries were trading with each other.

The export boom has been closely related to large-scale inflows of foreign direct investment (FDI). The actual accession to the EU has done little to increase the attractiveness of the Central and East European countries for foreign companies. But the pre-accession process has been important for FDI, for several reasons. First, as the East European countries took over EU rules and policies, their business environments started to resemble those in Western Europe, so foreign investors felt more at home. Second, as the EU opened up its markets for goods from Poland, Estonia and Slovakia, these countries became more attractive locations for export-oriented production. And third, the prospect of EU membership acted as an 'external anchor' for economic reforms, guaranteeing a certain amount of stability and insuring investors against policy reversals.

As a result, EU companies have ploughed more than €150 billion into the ten Central and East European accession countries since the early 1990s. For Western Europe these sums were relatively small: in 2004, the old EU-15 invested 11 times more in each others' economies than in the new member-states. But for many of the East European countries, investment inflows from the EU frequently amount to 5-10 per cent of their GDP. This FDI has helped to build up massive new production capacities across Central and Eastern Europe, in particular in the automotive sector, but also in electronics, furniture, pharmaceuticals and other manufacturing sectors. And FDI has been instrumental in creating modern services sectors such as retail, banking, telecoms and transport.

In short, gradual economic integration with the EU has been the key to the new members' economic success. Since the mid-1990s, the Central and East Europeans countries have consistently outgrown most of the old EU. For example, Poland grew by an average of 4.4 per cent a year over the last decade, Hungary by 3.6 per cent and Estonia by 5.4 per cent. By comparison, Germany mustered an average growth rate of 1.3 per cent in 1995-2004 and France of 2.2 per cent. The accession countries also did considerably better than those countries that have not applied for (or been offered the prospect of) membership, for example Russia, Ukraine or Moldova (whose average growth rates in 1995-2004 were respectively 2.9 per cent, 1.5 per cent and 1.4 per cent).

Have you got my job?

Some West Europeans suspect that the East's economic success has come at their expense. Have cheap exports from Slovakia and Poland priced Dutch and French goods out of the market, they wonder. Have the large-scale FDI flows simply transferred jobs from West to East? For most of the EU member-states, trade and investment links with the candidate countries have been too small to have a measurable impact. The exceptions are Germany and Austria, which trade a lot with the region and, alongside France and the Netherlands, account for the bulk of foreign investment there. The net impact of economic integration with the East is fiendishly difficult to calculate. Economists at the *Osteuropa-Institut*, a Munich-based research outfit, have looked at the impact of trade and FDI and reached the following tentative conclusions: since Western Europe has traditionally run a trade surplus with Central and Eastern Europe, the impact of trade integration was almost certainly positive for the old EU. According to one study, the EU's trade surplus with the big four Central European candidate countries created 114,000 jobs in the EU during the 1990s.[2]

For FDI, the story is more complicated. Take the case of Germany: German companies have invested some €40 billion in the whole of Eastern Europe since the mid-1990s, and German-owned (or co-owned) companies now employ some 900,000 people across the region (80 per cent of whom work in the eight Central and East European countries that joined the EU in 2004). Half of this investment was aimed at profiting from the

[2] *Wolfgang Quaisser, 'Kosten und Nutzen der Osterweiterung unter besonderer Berücksichtigung verteilungspolitischer Probleme'. Osteuropa-Institut working paper, No 230, February 2001.*

accession countries' burgeoning consumer markets, for example through building supermarkets or buying local banks, so it has not replaced jobs in Germany. The other half sought to take advantage of low labour costs in the candidate countries, so may potentially have led to job losses in factories back home. To conclude, however, that 400,000 or so jobs have moved from Germany to the East would be wrong. Production in Eastern Europe is much more labour-intensive than in Germany. For each job lost in Germany (or France or Austria), there are usually several created in Poland, Slovakia or Latvia. So the *Osteuropa-Institut* calculates that at most 70,000 German jobs have moved eastward for cost reasons.[3]

3 Michael Knogler, 'Auswirkungen der EU-Osterweiterung auf die Arbeitsmärkte der neuen Mitgliedstaaten und der EU-15, insbesondere Deutschland', Osteuropa-Institut working paper, No 257, January 2005.

This is a sizeable number, but it only accounts for 1.5 per cent of Germany's total unemployment of 4.6 million. Such estimates have to be interpreted with caution, not least because they often ignore that outward investment also benefits the country where it originates. Much FDI has come from companies that are under fierce global competition, in sectors such as cars, electronics and chemicals. By shifting parts of their lower value-added production to countries where workers are cheaper, these companies make sure that they stay competitive on a global scale. In other words, FDI in Eastern Europe has helped to preserve jobs in Germany and elsewhere in Western Europe. According to one survey cited by the *Osteuropa-Institut*, 20 per cent of the German companies with investments in Eastern Europe had shifted jobs eastward, while 60 per cent said their investments had helped to preserve or create jobs at home.

Basic indicators for the new members and the EU-15

	Population million	GDP € bn 2003	GDP per head at PPP, EU-25=100	Real GDP growth %, av 2000-04	Inflation %, av 2000-04	Current account, $ billion
Czech Republic	10.2	80.3	70	3.1	2.6	-5.6
Estonia	1.3	8.1	51	7.2	3.5	-1.4
Hungary	10.0	72.6	61	3.9	7.1	-8.8
Latvia	2.3	9.9	43	7.5	3.2	-1.7
Lithuania	3.4	16.3	48	6.7	0.5	-1.6
Poland	38.2	185.2	47	3.1	4.3	-3.6
Slovakia	5.4	29.0	52	4.1	7.7	-1.4
Slovenia	2.0	24.9	79	3.4	6.8	-0.3
NMS-10	73.7	442.1	-	3.6	4.6	-25.4
EU-15	383.5	9,373.5	109	2.0	2.0	21.8

Figures are for 2004 unless otherwise indicated.
Sources: The Economist Intelligence Unit, European Commission.

And the long term?

The direct impact of eastward enlargement on the old EU has been marginal. The new members' stronger economic performance may have added a degree of dynamism to the European economy. But since the ten new members account for only 5 per cent of EU GDP (or 10 per cent if measured at purchasing power parity), they are too small to act as Europe's economic engine. In economic terms, enlargement was the equivalent of adding an economy the size of the Netherlands to a single market with 380 million consumers and a GDP worth €10 trillion. But what about the future? Comparing existing trade flows with potential ones (based on factors such as geographical proximity and income levels), most economists assume that trade integration between the old and new members is pretty much complete. Any further trade growth will depend on demand in the big EU markets and developments within the new members. Provided that the new members keep up productivity growth rates (and thus remain competitive), their exports should continue to grow at the recent high rates.

Most analysts also expect FDI flows from the old to the new members to remain strong over the medium term. The need to cut costs has been reinforced by sluggish eurozone growth, a stronger euro and a ripple effect that is itself the result of outsourcing: as more and more companies transfer production to low-cost locations, the pressure grows on their competitors to follow suit. According to another survey by Rödl & Partner, a consultancy, 80 per cent of German companies polled in 2005 expected to increase their investments in the new member-states in the coming years. However, some larger corporations fear that EU membership will push up wages and regulatory costs in the Central and East European countries. As a result, they are moving their production facilities further east or to Asia, while using Prague, Tallinn or Budapest increasingly for the outsourcing of IT and other services. Such investment in services, especially in research and development (R&D), is important for the economic development of the new members. But it is generally less capital intensive so it may not show up in the form of higher FDI inflows.

UNFAIR COMPETITION IN THE EU?

In a poll conducted for *Der Spiegel* in early 2004, 73 per cent of Germans said they expected enlargement would threaten their jobs. Germans are particularly sensitive to the issue of migration, not least because some 60 per cent of the million-odd East Europeans that moved to the EU before accession settled in Germany – and that at a time when unemployment continued to rise steadily. Austria has been the second most popular destination, taking perhaps another 5-10 per cent of the East Europeans coming to the EU-15 before 2004. This is why Germany and Austria led the campaign for the EU to impose long 'transition periods' on the free movement of workers from the Central and East European countries. Only three EU countries – Ireland, Sweden and the UK – removed restrictions for East European jobseekers in May 2004. In the other 12 old member-states Poles, Hungarians and others still require work permits until at least May 2006, and probably until 2011.

The Polish plumber

Even in those countries where all restrictions were dropped, the number of job-seekers from Eastern Europe has remained limited. In Sweden, only 22,000 people from the new members have applied for residency permits between May and December 2004, a rise in the workforce of only 0.07 per cent. Ireland registered an increase of 85,000 in the 12 months following enlargement – the largest relative to its domestic workforce. And Ireland continues to actively recruit East Europeans to alleviate local skill shortages.[4] The UK reported in November 2005 that 290,000 people from the new member-states had registered for work after May 2004. Since around 40 per cent had already been in the country before EU accession, this suggests worker immigration of around 10,000 people a month – hardly an uncontrollable flood in a country of 60 million.

[4] *Julianna Traser, 'Who's afraid of EU enlargement? Report on the movement of workers in EU-25', European Citizen Action Service, September 2005.*

Although the absence of restrictions has turned the UK, Ireland and Sweden into popular destinations, many East Europeans still prefer to join the much larger immigrant communities in Germany and Austria. The Polish foreign ministry reports that after accession around 30 per cent of emigrant Poles went to the UK and Ireland in 2004, while around the same share moved to Germany despite continued restrictions (comparable figures for the other new members are not available).[5] Many of those going to Germany are thought to be working in the burgeoning black economy. Others have set up small businesses under EU rules for the 'freedom of establishment' which, unlike those for the free movement of labour, are not subject to transition periods.

[5] *Katinka Barysch, 'Storm in a teacup', E!sharp, November 2004.*

A number of East Europeans work in the old EU on the basis of temporary contracts, hired out by service companies from their home countries (under the EU's 'posted workers directive'). The number of East Europeans working on such contracts is small, but they have caused a disproportionate amount of political upheaval in France, Germany, Sweden and elsewhere. The alleged job competition from cheap Polish plumbers fuelled anti-EU sentiment during France's referendum on the EU constitution.[6] In December 2004, 14 Latvian builders were forced to stop working in Sweden for what a local trade union had claimed were 'unfairly' low wages. Similarly, in March 2005 the Danish authorities fined a Polish construction company (owned by a Dane) for undercutting local wages. And Germans were outraged in the autumn of 2004 when about 25,000 abattoir workers lost their jobs to Polish or Czech immigrants willing to work for €5 an hour or less.

[6] *According to Newsweek, October 17th 2005, only 150 Polish plumbers worked in France in 2005, while the French plumbers association reported 6,000 vacancies. British government statistics show that 75 East European plumbers registered for work in the UK between May 2004 and March 2005.*

Fears of the mythical 'Polish plumber' have also fuelled opposition to the Commission's proposal for a further opening of EU services markets through its 'services directive'. The services directive would make it easier for Polish architects or Slovenian consultants to work across the EU because all member-states would have to accept qualifications gained in their home country. But it would not allow East Europeans to generally undercut West European wages. Local minimum wages and sectoral wage rules would continue to apply for all workers, irrespective of their origin. The reason why German abattoir workers lost their jobs to cheaper competitors is that, unlike the UK, Germany does not have a country-wide minimum wage, and there was no sectoral minimum wage for slaughter houses.[7]

[7] *Milosz Matuschek, 'Die geplante Richtlinie ist besser als ihr Ruf', Centrum für angewandte Politikforschung, April 2005.*

Nevertheless, most workers in the old EU countries are not looking forward to the day when restrictions on the free movement of labour are lifted. Migration flows are notoriously difficult to predict but many researchers think that between 100,000 and 400,000 East Europeans will head West every year once they gain the right to apply for jobs in the old EU. Assuming that most of those who want to move will do so within a decade or so, they predict that maybe 2-3 million people from the new member-states will be living in the old EU by say, 2020. That sounds a lot, but it only amounts to 0.5-0.8 per cent of the EU's current population.[8]

[8] *Katinka Barysch, 'Does enlargement matter for the EU economy?', CER policy brief, May 2003.*

In the medium to long term, however, the new members will not be a source of large-scale labour migration. In most Central and East European countries the demographic trends are even more worrying than in Western Europe. While life expectancy is rising, birth rates tend to be extremely low, so societies are ageing even faster than those in the old EU. The UN predicts that the populations of Latvia and Lithuania will shrink by one-third by 2050, while the number of Hungarians and Czechs will fall by more than one fifth. So the new members will themselves have to admit larger number of immigrants to help sustain economic growth and patch up national pension systems. But many of these countries are not used to dealing with large numbers of foreign workers. Hungary is currently host to only 50,000-80,000 foreign workers, mostly from neighbouring Romania. But the country may need as many as two million immigrants over the next five years to make up for the fall in its indigenous labour force.

'Old' Europe is forced to change

Enlargement-related fears in the old EU go well beyond the impact on slaughterhouses and building sites. West Europeans know they can keep cheap East European workers out of their labour markets, but they cannot prevent their companies going to where labour is cheaper. In Germany, company bosses have successfully demanded wage restraint in the face of low-cost competition from the East. Scores of companies, from DaimlerChrysler to Siemens, threatened to shift more production eastward unless their workers agreed to work longer hours for the same money or less. Real wages in Germany have been stagnating for years, and unit labour costs are now back where they were in the mid-1990s. Germany's belt-tightening, in turn, has increased the pressure on its big West European trading partners. Italy, France and others are now struggling to restore their competitiveness vis-à-vis Germany. As a result, unit labour costs in the entire eurozone have fallen by an average of 0.5 per cent a year since 2001.

Moreover, eastward enlargement took place at time when many West European countries were (and are) undergoing painful structural reforms, such as the loosening of job protection rules and the reduction of welfare entitlements. It is impossible to say how far wage restraint and labour market reforms have been the direct result of eastward enlargement. It appears that the availability of millions of cheap workers on their doorstep has strengthened the hands of West European company bosses vis-à-vis their workers. But, as pointed out above, the relocation of some production processes or backroom services may also have saved jobs in the face of heightened global competition. Even if Eastern Europe disappeared from the face of the earth tomorrow, social and demographic trends (ageing, the erosion of traditional family structures), European integration (the single market, monetary union) and global competition (from China, India, the US and others) would still force the old EU countries to adjust. However, many people in these countries fail to grasp globalisation and deny the changing nature of their own societies. When they fear losing their jobs, they quickly point their fingers at Eastern Europe. France's frantic debate about delocalisation is mainly aimed at the new member-states (and the countries still queuing for membership, such as Bulgaria, Romania and Turkey). Some Germans fear that eastward enlargement is turning their country into a 'bazaar economy' where only a limited number of finished products is assembled while most of the work is outsourced across the eastern border.

Such fears have gone hand in hand with perceptions that the new members are using 'unfair' means to lure companies eastward, namely low levels of social protection, low taxes and a lack of workers' rights. In short, many people in Western Europe think of the East Europeans as ruthless 'Anglo-Saxon' capitalists whose addition to the EU is undermining the cherished 'European social model'.

The real situation across the new members is of course much more complex. The new members boast relatively flexible labour markets, a feature that they share with the UK, Ireland and to a certain extent the Nordic countries. But unlike these countries, much of Eastern Europe suffers from very high unemployment rates, higher even than those found in Germany, France or Italy. The new members also resemble the large eurozone countries in that they have generous social security systems that are funded out of payroll taxes.

Tax dumping?

Most of the Central and East European countries lowered their corporate tax rates in the run-up to accession to compensate for the abolition of discriminatory tax breaks, which was required by EU state aid rules. Many countries also introduced 'flat' rates of personal income tax. Slovakia went furthest in its tax reforms by standardising taxes on profits, income, capital and value added at a low rate of 19 per cent. Tax cuts have spread throughout Central and Eastern Europe and now appear to be extending into the old EU, fuelling fears that there is a 'race to the bottom' in tax rates. Austria cut its corporate tax rate from 34 per cent to 25 per cent in January 2005. Three months later, the German government announced a cut in the federal profit tax rate from 25 per cent to 19 per cent (although the plan subsequently ran into opposition in the upper house of parliament).

It is not clear whether such reforms are the direct consequence of EU enlargement or part of a broader international trend towards lower direct taxation (income and profits) and higher indirect taxes (VAT, property). But it is important to quash the myth that Eastern Europe is a low-tax paradise that flourishes at the expense of its high-tax neighbours. Generally, taxation levels in the new member-states are lower than in the EU-15, but not much. In 2003, the ten accession countries collected the equivalent of 36 per cent of their GDP in taxes, compared with just over 40 per cent in the EU-15. There are big differences among the newcomers. Lithuania's tax level is below that of Ireland's (at 29 per cent of GDP) while Hungary and Slovenia collect as much tax as Germany (around 40 per cent).[9]

9 European Commission, 'Structures of the taxation systems in the European Union', 2005 edition.

It is true that headline corporate tax rates in the new members are now much lower than in the EU, typically 15-20 per cent compared with 34-38 per cent in Germany, Italy and France. But this does not automatically mean that East European governments are shy to tax local companies. Tax revenue consists of two components: the tax rate and the tax base (on which the tax is levied). West European tax systems tend to be riddled with exemptions, and many offer generous depreciation rules to encourage certain investments. So the 'effective' tax rate on corporate profits is often much lower than the headline rate. Estimates of the effective tax rates vary widely. According to some calculations, the effective rate of corporate taxation in Germany is only half the headline rate of 38 per cent. Some of the country's largest companies enjoy so many tax breaks that their effective tax rate is zero.[10] Other estimates show that the effective tax rate in the East European members is now a lot lower than in the old EU, for example, around 18 per cent in Poland and Hungary, compared with 35-36 per cent in Germany and France.[11]

10 Katinka Barysch, 'Is tax competition bad?' CER Bulletin, No 37, August/September 2004.

11 Zentrum für Europäische Wirtschaftsforschung and Ernst & Young, 'Company taxation in the new EU member-states', July 2004. However, these estimates probably under estimate effective tax rates in the new members. See James Owen, 'Tax issues in the new EU members', EIU Economies in Transition, December 2004.

Another (albeit similarly flawed) way of gauging the real tax burden is to look at how much money national treasuries actually obtain from companies. According to the European Commission, Germany collected corporate taxes worth only 0.8 per cent of its GDP in 2003, and France 2.2 per cent. Compare that with allegedly low-tax countries such as Ireland and the UK (3.8 per cent and 2.7 per cent of their GDP, respectively) or Slovakia and Hungary (2.8 per cent and 2.2 per cent of GDP respectively). Even Estonia, which does not tax reinvested profits at all, still managed to collect more than Germany in corporate taxes as a share of its GDP.

But even if one assumes that effective corporate tax rates in Central and Eastern Europe are significantly lower than those found in the old EU, it does not necessarily follow that tax policy is behind Eastern Europe's investment boom. Investor surveys show that tax levels are just one factor among many that companies take into account when they decide where to set up shop. Others, such as economic and political stability, the quality of the labour force, wage and productivity levels, market size or proximity to major markets, usually rank higher.

The East European social model

The perception that Eastern Europe loves low taxes has been reinforced by the fact that four of the new members have introduced 'flat' income tax rates.[12] Estonia started the trend in 1994, and the other Baltic states and Slovakia have since followed. Opposition parties in Hungary, Poland and the Czech Republic are now calling for the introduction of flat taxes as are some politicians and economic experts in the old EU.[13] There are specific reasons why flat taxes were a good idea in Eastern Europe, most notably the weakness of the local tax administration and the pervasiveness of tax evasion. And there are good reasons why West European countries may prefer to stick with their more sophisticated and progressive tax systems, for example social fairness (higher tax rates for big earners) and the use of the tax system for specific policy objectives (encouraging pension savings or home ownership). But even if the large EU countries are unlikely to follow the flat tax trend, some of them may go part of the way by simplifying their tax systems and reducing the top rate of income tax rates.

12 Flat income taxes have also been introduced by Romania, Ukraine, Russia, Serbia and Georgia.

13 Among Western Europe's most prominent proponents are Paul Kirchhof, Angela Merkel's economic advisor during her election campaign; the Conservative Party shadow chancellor, George Osborne, in the UK; the Dutch government's Council of Economic Advisors; and the Greek finance minister, Giorgios Alogoskoufis.

With their low income tax rates and widespread tax evasion, Eastern European countries collect much less money from personal income taxes than West European ones (5 per cent of GDP compared with 10 per cent in the eurozone in 2003). Instead, governments in the new member countries rely on other ways of taxing wages, namely social security contributions. As a result, payroll taxes in the new members are usually above those found in most of the 'old' member-states. In Poland, Hungary and Slovakia, for example, social security contributions add almost 40 per cent to labour costs, more than in Italy or Germany, and twice as much as the UK. According to the European Commission, the ten new members in 2003 collected on average 13.3 per cent of their GDP in the form of social security contributions to pay for their healthcare, pensions and social welfare systems – almost exactly the same share as in the old EU-15.

Rather than being 'ultra-liberal' and socially minimalist, the Central and East Europeans spend too much on social security, given their rather low level of income and economic development. In Hungary a quarter of the working age population relies on some kind of social transfers as their main source of income. In Poland, one in five people of working age obtains state benefits and less than 2 per cent of all benefits are means-tested. So the new members are working hard to create social welfare and security systems that are better targeted and less costly. Like in the West, such changes are politically controversial and often involve big upfront costs. This is tricky given that the new members are keen to join the euro and so need to reduce their budget deficits.[14] At the same time, they need to find ways of getting millions of unemployed people back into work.

14 *In 2005, the Czech Republic, Hungary, Poland and Slovakia all had budget deficits of over 3 per cent of GDP.*

THE TRUTH ABOUT EAST EUROPEAN LABOUR MARKETS

Most people in Western Europe are wholly unaware of the daunting labour market problems that the new members are struggling with. Perhaps if they knew more, they would be a little less critical of the East Europeans' desperate attempts to boost growth and attract investment. The average unemployment rate in the new members stands at around 15 per cent, compared with 8.5 per cent in the old EU-15. The East European average is pushed up by Poland, where 18 per cent of workers are looking for a job. Long-term unemployment is also much higher than in the old EU. In countries such as Poland and Slovakia, 10 per cent of the labour force appears virtually unemployable. Perhaps even more worrying is the high rate of youth unemployment: almost one-third of 15-24 year-olds in Central and Eastern Europe are jobless, again twice the rate of the EU-15. That means that millions of young people in Eastern Europe are neither in education nor picking up skills on the job, which does not bode well for their future.

Unemployment rates in Central and Eastern Europe would be even higher if it was not for the fact that millions of workers dropped out of the labour force altogether during the 1990s. As a result, employment rates in the new members are generally below those found in the old EU, and much below the EU target of 70 per cent by 2010. Currently only the Czech Republic and Slovenia match the EU-15 average of 64 per cent. In Poland only around half of all people of working age have a job in the formal economy. At least the downward trend has now been reversed, and most of the new members record stable or rising employment rates. Job creation is driven by foreign investment and small enterprises. Both tend to cluster around fast-growing urban areas in the western parts of these countries. Meanwhile, in rural areas and declining industrial heartlands unemployment remains stuck at 30 per cent or higher. Inflexible housing markets and inadequate transport make it difficult for workers to move to where job opportunities are better. And foreign investors rarely venture into the eastern parts of the new member-states, where infrastructure and education levels are often poor.

Where China really matters

On the whole, however, the new members boast very solid education systems. On some indicators, such as secondary school enrolment or drop-out rates, the new EU countries outperform the old ones. Eastern Europeans also generally score well on basic educational indicators such as numeracy and literacy. The heavy focus on technical and professional education appears adequate for Eastern Europe's current specialisations in cars, consumer electronics and basic manufactured goods. However, in these areas the new members are coming under heavy competitive pressure from China and other low-cost emerging economies. So Eastern Europe does not have a future as a location for low-cost, labour intensive manufacturing.

Wages in the East appear very low if compared to the EU: hourly labour costs in 2003 (the latest date for which comparable data are available) ranged from 12 per cent of the EU-15 average in Latvia to 53 per cent in Slovenia. But wages in countries such as China and India are much lower still. So if the new members want to catch up with the old EU, they need to move swiftly into high-tech manufacturing and high-value added services. For this, they need very high rates of investment, technological progress, and rapid skills upgrading.

Labour market indicators

	Unemployment rate %, 2005	Employment rate %, 2004	Hourly labour costs €, 2003	People with at least secondary education %, 2004	Workers who received training %, 2004
Czech Republic	8.0	64.2	5.5	91	6
Estonia	7.5	63.0	4.0	82	7
Hungary	7.1	56.8	5.1	83	5
Latvia	9.0	62.3	2.4	77	9
Lithuania	8.2	61.2	3.1	86	7
Poland	17.9	51.7	4.7	90	6
Slovakia	16.4	57.0	4.0	91	5
Slovenia	5.8	65.3	10.5	90	18
EU-15	7.8	64.7	24.3	74	10

Source: European Commission.

CONCLUSION

West European concerns about enlargement – from labour migration to low-cost competition – are mostly related to the big income gap that persists between the old and the new members. In principle, therefore, the old member-states should support the newcomers' wish to catch up with EU-15 income levels. So far, catch-up has been rather slow, despite rapid productivity growth, because too many people from Estonia to Slovenia are not productively employed. To speed up income convergence, Eastern Europe needs to sort out its labour markets. What could the EU do to help? It is clear what the EU should not do, namely seek to harmonise tax rates and welfare standards across the Union. French and German politicians are calling for the introduction of minimum rates of corporate taxation in the EU to end 'unfair' tax competition from the East. And they accuse the new members of 'stealing' jobs through undercutting West European social standards. As this essay shows, such accusations are unfounded. The new members' welfare states are already quite extensive, especially given their low levels of incomes and development. And the challenges that the new members struggle with – from ageing workforces to badly targeted welfare systems and under-funded universities – are not that different from those faced by West European countries.

EU benchmarking and peer pressure, such as that guided by the 'Lisbon process', can help the newcomers with their reform efforts. But for these methods to be constructive, West European politicians need to stop painting the new members into an ultra-liberal corner. The Central and East European countries are not instinctively liberal. Most of the people in the region grew up with a feeling of entitlement when it comes to jobs and social security, and a strong sense of social fairness and equity. Some researchers think that the East European preference for equality is an "attitudinal legacy inherited from socialist times".[15]

15 Marc Suhrcke, 'Preferences for inequality: east vs west', HWWA discussion paper, No 150, 2001. Jan Delhey, 'Inequality and attitudes – post-communism, western capitalism and beyond', Wissenschaftszentrums Berlin für Sozialforschung, 1999.

The East Europeans have gone through more than a decade of turbulent change to get ready for EU membership. The 'old' EU owes them a welcome. In practical terms, this means that West European politicians should stop exploiting populist resentment of low-wage competition. They should explain to their voters that economic reforms would be necessary even in the absence of enlargement and that, on the whole, the addition of ten new members has been good for the EU economy.

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