CENTRE FOR EUROPEAN REFORM essays

East versus West? The European economic and social model after enlargement

By Katinka Barysch

1. 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 skill 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. But 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 into the 'Anglo-Saxon' camp of liberal capitalists – 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 model 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 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 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.

2. 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 for 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 to 75 per cent of their exports to the EU. In other words, long before membership, they were trading more with the EU than many of the EU countries were trading with each other.

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.

The export boom has been closely related to large-scale inflows of foreign direct investment (FDI). Foreign investors did not wait until the accession date to buy up newly privatised companies in Eastern Europe and to take advantage of the region's growing markets and low-cost, skilled workers. The process of accession 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. As a result, foreign investors started to feel more at home in the accession countries. Second, as the EU opened up its markets for goods from Poland, Estonia or 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 the case of Germany, for example, FDI in the new accession countries has typically amounted to 1-2 per cent of total corporate investment in recent years. And in 2004, the old EU-15 invested eleven times more in each other's economies than in the new member-states. But for many of the East European countries, FDI inflows from the EU amounted to 20 per cent of total investment and 5 per cent or more of their GDP.

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 instrumental in 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. Even the faster growing Nordic countries could not match the East Europeans' economic growth rates (Sweden: 2.9 per cent, Denmark: 2.1 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 has created 114,000 jobs in the EU throughout the 1990s.[2]

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

Do you think your country has benefited from EU membership? % of those polled

	Spring 2004*	Autumn 2004	Spring 2005
Belgium	58	72	69
Spain	69	70	69
France	46	54	53
Germany	39	49	50
Austria	38	43	41
UK	30	39	40
Sweden	27	36	36
Hungary	58	48	47
Poland	50	55	62
Czech Republic	46	42	56
Estonia	41	56	58

**People in the candidates were asked whether they expected their country to benefit. Source: Eurobarometer.*

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 are in the eight Central and East European countries that joined the EU in 2004). Half of this investment was aimed at profiting from the 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] This is a sizeable number, but it only accounts for 1.5 per cent of Germany's total unemployment of 4.6 million. Other studies have come to similar conclusions about the limited impact of outward FDI on labour markets in the old EU. The European Commission, for example, estimates that only 5-10 per cent of all the jobs that were lost due to restructuring in Germany, France, Italy and the Netherlands in 2002-05 were related to the relocation of production or off-shoring of services (to anywhere in the world, not only the new members).[4]

[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.*

[4] *European Commission, 'European restructuring monitor', 2005 http://www.emcc.eurofound.eu.int/erm.*

Such estimates have to be interpreted with great caution, not least because they often ignore that outward investment also benefits the country where it originates. Much FDI has come from sectors that are under fierce global competition, for example 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.

The long-term impact

It appears safe to conclude that pre-accession economic integration has been highly beneficial for the Central and East European countries and marginally positive for much of the old EU. A trickier question is whether the actual accession has boosted growth or investment in the new members.[5] Average real GDP growth in the new members accelerated from 3.7 per cent in 2003 to 5 per cent in 2004. But the direct impact of membership was probably temporary: fearing EU-related tax and price rises, East Europeans went on a shopping spree in early 2004 while businesses stocked up on supplies. The result was a boost to consumption in the first half of 2004. At the same time, High export growth rates were helped by the dismantling of the remaining trade barriers between the old and new members, especially in farm goods, and by easier customs rules.[6] But other, non-accession related factors helped too. Many of the acceding countries were well into an economic upswing as the accession date approached. And many of them were reaping the economic rewards from difficult structural reforms in the preceding years (many of which were themselves related to EU accession preparations). The numbers for the first half of 2005 paint a more mixed picture. There were clear signs of slowdown in Poland and Hungary, while the Baltic economies continued to boom. Export growth fell sharply in the Czech and Slovak Republics and industrial output slumped in Poland and Slovenia.

[5] *Katinka Barysch, 'EU enlargement: one year on', Economies in Transition – Regional overview, The Economist Intelligence Unit, June 2005.*

[6] *World Bank, 'World Bank EU-8 quarterly economic report', April 2005.*

Real GDP growth in the old and new member-states, %

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
EU-15	3.8	1.8	1.1	1.0	2.2	1.3	1.8	2.0	2.1	2.0
NMS-10	4.1	2.4	2.4	3.8	5.1	4.1	4.4	4.4	4.1	4.0

Source: The Economist Intelligence Unit. 2005-2009 = forecasts.

What about the future? Given that Central and Eastern Europe has already gained so much from integrating into the EU, actual membership will probably only bring limited further gains. 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. Already, there are signs that the East Europeans have reacted to sluggish eurozone growth by diversifying their sales away from Germany and Italy and towards each other, as well as fast-growing non-EU countries such as Russia and Ukraine. Provided that the new members keep up productivity growth rates (and thus remain competitive), export growth should stay at recent high levels. But since imports are growing equally strongly, the net contribution of trade to GDP growth will be small at best, and in some cases even negative.

FDI will continue to be crucial for the economic success of the new members. FDI inflows dropped sharply in the years leading up to accession but now seem to be recovering. Most of the larger West European companies

have been active in Central and Eastern Europe for many years, and for them EU accession makes little, if any, difference. On the contrary, some larger corporations fear that EU membership will push up wages and regulatory costs. 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.[7] Meanwhile, there is some controversy about whether EU membership has made the East European countries more attractive for smaller companies. Almost 60 per cent of German *Mittelstand* companies said that Eastern Europe was now their preferred location for outsourcing, according to a 2005 study from The Executive Committee (TEC). Only 38 per cent said they would rather shift production, logistics or marketing to Asia.

[7] Since data on off-shoring are sparce, it is difficult to assess in how far jobs in Western Europe have been affected by this kind of FDI. So far, West European countries such as Germany still run surpluses in their services trade with the new members.

Most analysts 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 Roedl & Partner, a consultancy, 80 per cent of German companies polled expected to increase their investments in the new member-states in the coming years. Even on the assumption that exports and FDI continue to expand, few economists expect the new members to grow faster than 3-4 per cent a year over the medium term. Under such assumptions, it will take most of the Central and East Europeans 20-40 years to catch up with average EU income levels.

3. UNFAIR COMPETITION IN THE EU?

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. Nevertheless, many West Europeans feared that enlargement would have a major – and negative – effect on their economies through trade, investment and, above all, migration.

The Polish plumber

In a poll conducted 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 East European immigrants.

Fears of a massive influx of East European workers into Western Europe have obviously not materialised, not least because most EU countries decided to keep their labour markets closed to jobseekers from the new members. Only three EU countries – Ireland, Sweden and the UK – removed (almost) all restrictions 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.

Even in those countries where all restrictions were dropped, the number of jobseekers from Eastern Europe has remained limited. In Sweden, only 22,000 people from the new members have applied for residency permits since May 2004, a rise in the workforce of only 0.07 per cent. Ireland has registered an increase of 85,000 – the largest relative to the its domestic workforce – and continues to actively recruit East Europeans to alleviate local skill shortages. The UK office of national statistics reports that 175,000 people from the new members registered for work between May 2004 and March 2005, of which perhaps 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.[8]

[8] 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 since accession around 30 per cent of emigrant Poles have gone to the UK and Ireland, while around the same share have moved to Germany despite continued restrictions (comparable figures for the other new members are not available).[9] Many of those going to Germany are thought to be working in the

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

burgeoning black economy. Others have set up small businesses under EU rules for the 'freedom of establishment' which, unlike the free movement of labour, is not subject to transition periods.

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.[10] 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 Poles or Czech willing to work for €5 an hour or less.

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

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 it will take a decade or two until most of those who want to move have actually done 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.[11]

11 Katinka Barysch, 'Does enlargement matter for the EU economy?', CER policy brief, May 2003.

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 their home country's qualifications. 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, only sectoral wage rules.[12]

12 Milosz Matuschek, 'Die geplante Richtlinie ist besser als ihr Ruf', Centrum für angewandte Politikforschung, April 2005.

'Old' Europe is forced to change

Enlargement-related fears 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. FDI is usually beneficial for the economies of both the target country and the country of origin. But the benefits are not easy to see. 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 in welfare entitlements.

In Germany, bosses have (successfully) demanded wage restraint in the face of low-cost competition from the East. Scores of companies, from DaimlerCrysler 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 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.

It is impossible to say in how far wage restraints and labour market reforms are 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 do not grasp globalisation or 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 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 new members 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 extend the Nordic countries. But unlike the latter countries, much of Eastern Europe suffers from very high unemployment rates, worse 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.

Unfair tax competition?

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 2002, the ten accession countries collected the equivalent of 37 per cent of their GDP in taxes, compared with just over 40 per cent in the EU-15. Like in the EU, there are big differences between countries. Lithuania's tax level is on par with Ireland's (at 28 per cent of GDP) while Poland and Slovenia collect as much tax as Germany (around 40 per cent).

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 (38 per cent). Some of the country's largest companies enjoy so many tax breaks that their effective tax rate is zero.[13]

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

Other estimates come to a different conclusion. One widely cited study – by ZEW, a German research institute, and Ernst and Young – seeks to calculate the theoretical tax rate on specific projects on the basis of 2004 tax rules. It concludes 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.[14] However, some of the underlying assumptions, such as equal inflation rates across the whole EU, mean that the authors probably underestimate effective tax rates in the new members.[15]

14 Zentrum für Europäische Wirtschaftsforschung and Ernst and Young, 'Company taxation in the new EU member-states', 2005.

15 James Owen, 'Tax issues in the new EU members', Economies in transition – Regional overview, The Economist Intelligence Unit, 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 OECD, Germany collected corporate taxes worth only 1.3 per cent of its GDP in 2003, and France 2.5 per cent. Compare that with allegedly low-tax countries such as Ireland and the UK (3.8 per cent and 2.8 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.

Effective corporate tax rates, 2004, %

Germany	France	Italy	UK	Poland	Lithuania
36.1	33.1	32.8	28.9	18.0	12.8

Source: Zentrum fuer Europäische Wirtschaftsforschung and Ernst and Young.

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.[16] Estonia started the trend in 1994, and the other Baltic states and Slovakia have since followed. One of the parties in the new Polish centre-right government campaigned on the promise to bring the flat tax to Central Europe's largest country. Opposition parties in Hungary and the Czech Republic are equally calling for the introduction of flat taxes and even in more conservative Slovenia the government's economic expert group has called for such a move. The rates at which these flat taxes are levied are usually low, ranging from 19 per cent in Slovakia to 33 per cent in Lithuania, and some governments are planning to cut them further.

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

Such radical tax reforms have captured the imagination of many liberals in Western Europe. They compare Eastern Europe's light and simple income tax regimes to the complicated and cumbersome systems found in their own countries – and call on their governments to copy the East.[17] 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 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.

17 Among Western Europe's most prominent proponents are Paul Kirchhof in Germany, 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 (5.4 per cent of GDP in the EU-10 compared with 9.9 per cent in the eurozone in 2002). Instead, governments in the new member countries rely on other ways of taxing wages, namely social security contributions. In the classification of social welfare models, proposed by Gösta Esping-Andersen, they are closest to the 'continental' one: they finance their social expenditure predominantly through social security contributions levied on wages, not general income tax as in the 'Scandinavian' or 'Anglo-Saxon models'.[18] 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. On average, the ten new members collect 14.5 per cent of their GDP in the form of social security contributions to pay for their healthcare, pensions and social welfare systems. That is 1.5 percentage points more than the EU-15 average, according to 2002 figures from the European Commission.

18 Gösta Esping-Andersen, 'The three worlds of welfare capitalism', Polity books, 1990.

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. Most of the new members are working hard to reform their social security systems. They know they need to create social welfare and security systems that are better targeted, and offer better incentives for the unemployed to return to work. In other words, their reform challenges are not that different from those of most West European countries. Like in the West, such changes are politically controversial and often involve big upfront costs, which is tricky given that the new members are keen to join the euro and so need to reduce their budget deficits.[19] Also in some of the new members, the social challenges are

19 In 2004, the Czech Republic, Hungary, Poland and Slovakia all had budget deficit of 3 per cent or larger and spending pressures continue to rise, not least because of the costs associated with EU accession.

more daunting than in the old EU: in Hungary one-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.

Unlike in, say, Germany, the problem in Eastern Europe is not generous unemployment benefits. These tend to be quite low, and only a small fraction of those without jobs are actually receiving them. But the dearth of unemployment benefits has pushed laid-off workers to look for other kinds of state support – again a problem that the new members share with some of the old ones. The UK and the Netherlands both have large numbers of people on disability benefits, and Italy and Germany have too many people on early retirement schemes. But their problems look small compared with those of the East Europeans. In Poland and Hungary respectively 13 per cent and 10 per cent of the working-age population are living on disability pensions. Employment rates among older workers are only around 25 per cent in Slovenia and Slovakia (half the EU's target of 50 per cent), with millions benefiting from early retirement schemes. This matters because, unlike unemployment support, such benefits do not come packaged with job search assistance or retraining requirements. Also, these benefits tend to be poorly targeted and – if added up – can be quite generous, often way above the minimum wage, which means that low-skilled workers lack incentives to look for work. Since social benefits go a lot further in poor areas where rents and prices are lower, they also act as a disincentive for unemployed workers to move to more vibrant but more expensive areas.

4. THE TRUTH ABOUT EAST EUROPEAN LABOUR MARKETS

Reducing payroll taxes and reforming social security systems is a challenge that the new members share with Germany, Italy, France and other EU countries. Economists disagree about whether high payroll taxes harm job creation or not. But it appears plausible to assume that Eastern Europe's very high payroll taxes are harming their labour markets in a number of ways: first, high payroll taxes reduce the flexibility of wage bargaining (since a large part of the pay package is made up of levies that can only be changed by law). Second, they drive economic activity into the shadow economy, so further reducing the tax base. And third, they tend to disproportionately burden low-skilled (low-wage) workers, thus contributing to the very high unemployment rates among this group in Central and Eastern Europe.

Table 1: Labour market indicators

	Unemployment rate %, June 2005	Employment rate %, 2004	Hourly labour costs €, 2003	People with at least secondary education %, 2004	Workers who received training %, 2004
Czech Republic	7.8	64.2	5.5	91	6
Estonia	7.8	63.0	4.0	82	7
Hungary	6.3	56.8	5.1	83	5
Latvia	9.0	62.3	2.4	77	9
Lithuania	7.8	61.2	3.1	86	7
Poland	17.7	51.7	4.7	90	6
Slovakia	15.4	57.0	4.0	91	5
Slovenia	5.8	65.3	10.5	90	18
EU-15	7.9	64.7	24.3	74	10

Source: European Commission.

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.

★ High unemployment rates

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 more than 19 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, 10-12 per cent of the labour force appears virtually

unemployable. Perhaps even more worrying is the high rate of youth unemployment: almost one-third of the 15-24 year-olds in Central and Eastern Europe are jobless, again twice the rate of the EU-15. In Poland youth unemployment stands at more than 40 per cent. 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.

★ **Low employment rates**

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 get anywhere near the average EU employment rate of 64 per cent. In Poland, the region's biggest labour market, only around half of all people of working age actually have a job in the formal economy. At least the downward trend has now been reversed, and most of the new member countries record stable or rising employment rates. The chances of having a job depend a lot on an individual's qualifications. Like in the old EU, employment rates of the highly skilled tend to be 80 per cent or higher. They fall to 65-70 per cent for medium-skilled workers, and can be as low as 25 per cent for the low-skilled.

★ **Competitive wage levels**

Average wages and income levels in the new member-states are much lower than in the old EU. According to the European Commission, hourly labour costs in 2003 ranged from 12 per cent of the EU-15 average in Latvia to 53 per cent in Slovenia. In the larger countries – Poland, Hungary and the Czech and Slovak Republics – wage levels are 20-30 per cent of the West European level. Productivity levels also tend to be much lower. Most estimates put Eastern Europe's productivity at 35-40 per cent of the EU-15 level, although in export-oriented sectors with lots of foreign investment they are much closer to Western Europe.

That still leaves the newcomers with a sizeable advantage in unit labour costs. But the new members' dilemma is that to catch up with West European income levels, they need higher wages. High wage growth is only sustainable if backed by high productivity growth, otherwise it leads to a loss of competitiveness. But so far the East Europeans have achieved high productivity growth mainly at the expense of job cuts. In the future, they need to find a way of combining productivity gains with job creation, like Ireland and Spain have done in recent years. For this, they need GDP growth so high that it creates new jobs in services and high-value added industries while also soaking up fired workers in less competitive sectors. This, in turn, requires very high rates of investment, technological progress, and rapid skills upgrading.

★ **Rapid economic transformation**

Central and Eastern Europe does not have a future as a location for low-cost manufacturing. It simply cannot compete with China when it comes to producing low-value added, mass manufactured goods, such as textiles or simple consumer electronics. The car industry in Central Europe is still thriving and attracting fresh investments. But some Western investors in electronics and textiles are already packing up and moving their factories to China or Ukraine, where workers are cheaper.

Instead, the new members are now attracting investments in high-tech manufacturing and increasingly also in high-value added services. Nokia and Ericsson are now running R&D centres in Hungary, and the Czech Republic is host to clusters of Japanese and Korean electronic producers. In these two countries, the share of people working in medium to high tech sectors (both manufacturing and services) is already slightly above the EU average, at around 12 per cent. But other East European countries are lagging badly behind. In Latvia and Lithuania, only 4 per cent of the workforce is employed in medium to high tech sectors. * Solid education systems

Economic upgrading requires countries to have highly developed education systems. Here, Eastern Europe fares well, at least at first glance. On some indicators, the new members outperform even the old EU countries: they boast very high enrolment rates in secondary education, and very few youngsters drop out of education without a qualification. Eastern Europeans also generally score well on basic educational indicators such as numeracy and literacy. Many of the new members spend a higher share of their GDP on education than the EU average (currently around 5 per cent). The good performance in secondary education and the heavy focus on technical and professional education appears adequate for Eastern Europe's current specialisation in producing cars, consumer electronics and basic manufactured goods.

But these skill levels may not be enough to build what the EU likes to refer to as the 'knowledge economy'. For this, the new members need to invest more in tertiary education, refocus curricula towards languages, IT or management, and encourage general skills such as creative thinking and problem solving. The number of graduates is rising rapidly in all the new member-states, but there is still much room for catch-up. In the US, more than 35 per cent of people of the relevant age group get tertiary (university) education. In the EU it is 24 per cent. In the accession countries it is only 16 per cent. Only 5-6 out of 1,000 people in Hungary and the Czech Republic obtained a degree in science or technology in 2003, and the figures are only somewhat higher for the other new members. By comparison, Sweden and Denmark produce more than twice as many scientists per 1,000 population and Ireland and France four times as many.

Even a top-class university degree is not enough in a fast-changing economic environment that requires continuous skills upgrading. That is why the EU has added 'a culture of lifelong learning' to its economic reform goals. While the typical Irish or French employee gets between 15 and 20 hours of vocational training a year, a Hungarian or Polish worker spends just four or five hours a year upgrading his or her skills. The European Commission estimates that the average East European worker would require six months worth of training to reach EU productivity levels. With only five hours of training a year, this kind of catch-up would take the new members around two centuries.

★ **Regional gaps**

Most of the new member-states suffer from 'dual' labour markets: they have dynamic and tight labour markets in fast-growing urban areas, and stale and stagnant ones in declining industrial heartlands and remote rural areas, where unemployment can reach 30 per cent or more. Inflexible housing markets and inadequate transport make it difficult for workers to move to where job opportunities are better. Regional gaps in skills and the quality of education exacerbate the problem. The OECD reports that one-quarter of Poland's rural population with only primary education is functionally illiterate, and only one in ten Polish university students comes from a farming area.

★ **Ageing populations**

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. In Hungary the size of the workforce is already shrinking. And for most of the others, the long-term outlook is not good. The UN predicts that the population of Estonia could halve by 2050. The number of Poles and Romanians will fall by 15-20 per cent over the same period. Even the richest among the new EU members – the Czech Republic, Hungary and Slovenia – will see their population decline by an average of 20 per cent.

Most of the new members have made more progress with pension reforms than the big eurozone countries: they have linked pension payouts more closely to lifetime earnings and encouraged additional voluntary savings through new, fully-funded pension funds. Many also have long-term plans to raise their retirement age from current low levels (typically 60 or below).[20] West Europeans are becoming aware that they will have to keep their labour markets open to immigrants to mitigate the economic impact of ageing. Given Eastern Europe's dire demographics, it is unlikely that many of these immigrants will come from Poland, the Czech Republic or Hungary. For example, in 20 years time, more than 30 per cent of Czechs will be over 60. As David Willets has put it: " These countries do not have a big future supply of young workers. Recruiting migrants from them is more a matter of 'hurry now while stocks last'".[21] Eastern Europe itself will need growing numbers of immigrants to 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 alone to make up for the fall in its indigenous labour force.

20 Incidentally, the introduction of such notional pension accounts has made it more difficult to cut payroll taxes: since ultimate pension payouts depend on a worker's lifetime contribution through payroll taxes, workers will be reluctant to see them cut.

21 David Willets, 'Old Europe? Demographic change and pension reform', CER, September 2003.

★ **Relatively flexible employment rules**

The EU's standard cure for labour market problems is twofold: deregulation and active labour market policies. But the East Europeans lack the money for more make-work programmes (which tend to be of dubious value anyway); and red tape does not seem to be the main problem in the region. Indicators for the strictness of labour market regulation, such as those published by the World Bank and the OECD, usually show that East European labour markets tend to be more heavily regulated than the UK or

Ireland, but much less so than Germany, France or the EU's Mediterranean members. Hiring and firing rules in the new member-states are not particularly onerous, although they tend to be stricter for mass dismissals related to restructuring. The new members do, of course, follow EU standards for health and safety at work, non-discrimination, annual paid holiday and maximum working time. But on the whole, investor surveys indicate that over-regulation is not the main problem in these countries.

There is an added degree of flexibility because existing rules are not always enforced, especially in the small enterprise sector where the costs of red tape tend to be highest. Inspections carried out in Hungary in 2000 revealed that up to 30 per cent of all workers did not have an employment contract at all. In Poland new recruits frequently negotiate their employment conditions directly with their boss, who may make it clear that notice periods or severance pay will not be available. Curiously, although the rules governing non-standard employment contracts in the new member-states are not particularly strict, there are much fewer people working part-time or on temporary contracts than in most of the old EU countries.

★ **Shrinking trade union power**

Although reliable figures on trade union membership in Eastern Europe are hard to come by, the trend is clearly downwards. Trade union membership was usually compulsory under communism. Today membership has fallen to 20-30 per cent or less in Central and East European countries, not least since many of the 'old' unions have been discredited (Poland's *Solidarnosc* was one of the few trade unions in the former eastern bloc that was not an appendage of the communist party) and the new ones have struggled to attract members and resources. Trade unions are still stronger in the public sector, where most strike action takes place (more often than not in protest against privatisation or other policy decisions, rather than wages or working conditions). Strikes in the private sector are extremely rare.

Of course, membership is not the only or even the best measure of trade union power. In Germany, union membership is now below 30 per cent. But German unions remain powerful because they and the employer federations negotiate binding wage and working condition agreements for entire sectors. In Central and Eastern Europe, only Slovenia and, to a lesser degree, Slovakia have binding sector-wide agreements. All other countries are closer to the UK approach in that wage bargaining takes place at the company level (or even the individual level).

In its various reform programmes, the EU likes to emphasise co-operation between the 'social partners'. So it has encouraged the East Europeans to set up tripartite forums to negotiate minimum conditions for work and pay. In practice, the impact of such agreements has been limited. Since both trade unions and employer federations tend to be weak and badly organised, the government is usually the strongest party in these talks. But if the agreed guidelines on say, wage increases do not meet the needs of the private sector, the unions and employers are usually free to ignore them.

5. 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 share the newcomers' objective of rapid income growth. So far, income 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. In 2004, French and German politicians started calling for the introduction of minimum rates of corporate taxation in the EU to end 'unfair' tax competition from the East. Thankfully, such calls have died down; perhaps because more people have realised that the EU would have to start by harmonising tax bases (which may even exacerbate the competitive effect of different rates); or because the politicians realised that tax harmonisation would simply not be politically feasible: taxation is one of the areas where each EU government retains a veto. And the East Europeans, as well as the UK, Ireland and others, would surely use theirs to forestall any move towards an EU-wide tax system.

An EU cure for the new members?

Similarly, the old member-states should give up any ideas about exporting a – however defined – European social model to the East. The new members' welfare states are already quite extensive, especially given their low levels of incomes and development. The challenges they struggle with – from ageing workforces to badly targeted welfare systems and underfunded universities – are not that different from those faced by West European countries. Like the old member-states, the new ones can benefit from the EU's benchmarking processes. But for these processes 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".[22] At the same time, the East European countries suffer from severe budget constraints and weak public bureaucracies. So in a way, the Central and East European countries face a dilemma: they are simultaneously more ambitious in their social objectives than many old EU countries, and less capable of fulfilling them.

22 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.

Reforms are perhaps easier in the new member-states because vested interests are not that deeply entrenched; because trade unions and industrial lobbies are weak; and because many people have little to lose. But that does not mean that reforms are painless. 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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