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Fifteen Years of Convergence: East-West Imbalance and What the EU Should Do About it

The year 2019 marks the 15th anniversary of the Eastern EU enlargement that incorporated the Visegrád Four, the Baltic Three and Slovenia into the EU. But it also marks the 30th anniversary of the fall of the Berlin Wall and the great political transformation that paved the way for the German as well as the pan-European reunification.

After the transformational recession of the early 1990s, the region demonstrated strong growth potential that has been consolidated by EU membership. However, the EU accession of East-Central European countries resulted in an imbalanced Single Market in which the positions and strategies of Eastern members have to be scrutinised from the perspective of economic as well as social sustainability.

In this article, I explore some key trends and point to some controversies. I argue that social convergence requires particular attention alongside economic convergence, and the decoupling of the two is a trend that should be a matter of concern. At the end, I highlight some ideas and initiatives in the context of East-West convergence policies.

End of boom and bust – almost

The 'Eastern enlargement' in May 2004 opened the EU's doors to ten countries. Eight of these (the four Visegrád states, the three Baltic countries and a former Yugoslav state) had at that time completed their 15-year transition towards a market economy. In the first half of the 1990s these countries' income, measured in terms of GDP, had fallen by 20 to 30 percent. Poland was the first country to return to the same income levels as before the transition, followed by Hungary in 2000, and the other countries followed later on.

Even if East-Central Europe did not experience the same type of disintegration as the Soviet Union, the global economic significance of this region diminished in the 1990s, while emerging economies, especially in Asia, were catching up fast. The transformational recession in the early 1990s was unexpected but also unprecedented due to simultaneous challenges in micro- and macroeconomics as well as international economic relations.[1] New markets had to be found to replace the collapsing Comecon system, while privatisation and repeated cycles of fiscal and monetary stabilisation dominated the domestic agenda.

The experience of the 'great transformation' which began in East-Central Europe 30 years ago played a key role in determining what citizens of the new Member States expected from their accession to the EU: stable and sustainable growth. If we look at the period since 2004, the region seems to have been catching up with Western Europe in terms of employment and economic performance.[2]

However, the financial and economic crisis, which started in 2008, disrupted the previous trend of convergence to some extent. Greater differences between individual countries'

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1 J. Kornai: Transformational Recession: The Main Causes, in: Journal of Comparative Economics, Vol. 19, No. 1, 1994, pp. 39-63.

2 M. Belka, E. Nowotny, P. Samecki, D. Ritzberger-Grünwald (eds.): Boosting European Competitiveness: The Role of CESEE Countries, Cheltenham 2016, Edward Elgar Publishing.

performances also emerged. Poland managed to escape the recession in 2009 while the Baltic Three experienced double digit contraction. Among the Visegrád Four, Slovakia, for example, continued to catch up, while Hungary fell behind on growth, employment and social indicators. More recently, Romania joined the club of fast-growing economies. EU membership has played a major part in consolidating strong economic performance in East-Central Europe, despite the fact that post-crisis growth rates were modest compared to the 2002-2008 period.[3]

The European Community (which in 1957 originally comprised six Member States) had already taken in nine additional countries prior to this enlargement. But the 2004 enlargement was different because the income disparity between new and old Member States was much more significant than in any previous round. As a result, great imbalances have developed: capital flowed largely from West to East, while workers went mainly from East to West.

Imbalanced Single Market: large labour outflows

Eastern enlargements doubled the volumes of intra-EU labour mobility. According to estimates, around five percent of the Polish labour force now resides in other EU Member States, while this number has exceeded 10% for Romania and Lithuania. Given the fact that young people are overrepresented among Eastern EU-migrants, these labour outflows tend to generate and sustain population decline, especially in regions with lower than average fertility and higher than average mortality.

At the same time, personal remittances paid by expatriates to their home countries have reached significant magnitudes – over three percent of GDP in Romania, Bulgaria and Lithuania. In the short term, these inflows are important for the prosperity and the balance of payments of the home countries. However, in the long-run, it is questionable whether remittances can be sustained at sufficiently high levels to actually offset the negative consequences of workers' outflow from East-Central Europe and the increasing dependency ratio between the employed and non-employed population in these countries. If labour mobility is a threat to social security systems, it is mainly in the sending countries.

Fortunately, mobile workers also occasionally return. They bring valuable new skills and experience that benefit the economies of their countries. The example of Poland in 2011-2012 shows that returning workers can contribute to a country's above-average growth performance. Generally, most people entering East-Central European Member States are actually returning nationals.

Although the destination countries in Western Europe benefit a great deal from mobile East-Central European workers in economic terms, these countries are also witnessing a kind of 'welfare chauvinism', turning public opinion against EU migrants. Some people find it hard to accept that the EU's enlargement to the East has brought with it not only countries and markets but also people and these people have the same rights. In fact, the 2004 and 2007 enlargements brought more instead of less welfare to the receiving countries: a higher proportion of mobile citizens from East-Central Europe are of working age, in good health and more often employed, compared with nationals of the destination countries; therefore, they are actually net contributors to their social security systems.

The real risks of labour mobility from East to West are not in the recipient countries but in the sending countries. A large percentage of workers who migrate from East-Central Europe to the West are overqualified for the jobs in which they find themselves. In 2012 this was the case for about half of East-Central European migrants who had completed higher education. This rate of over-qualification is more than twice as high as for the nationals of the receiving countries. In certain sectors of employment, particularly health care, we can speak of a 'brain drain' which leads to serious problems in the sending countries.

Behind mobility: an inner periphery

The eastward enlargements, which took place in 2004 and 2007, doubled the mobility of labour within the EU. This mobility is likely to be sustained as long as income disparities between Member States persist. However, this should not be seen as an automatic link that is independent of all other factors. For example, there is a large income disparity between the Czech Republic and its neighbour Germany, and yet relatively few Czechs migrate. This is obviously partly due to the fact that in the Czech Republic, the at-risk-of-poverty rate (10%) is even below that of Germany (16%), despite a much lower per capita GDP.

In several new Member States the issue of finding a way out of poverty is linked to the situation of the Roma population. While there is a sizeable Roma minority in some of the older Member States, for example Spain, Roma integration has really become an issue in the EU only since the 2004 enlargement. Not all Roma are poor, but in Romania, Bulgaria, Hungary, the Czech Republic and Slovakia, the Roma

3 Strong and convergent income growth in the East has been particularly striking in comparison with divergent growth and unemployment trends between North and South (or Eurozone core and periphery), which is not subject of this study. For more on income growth in the East see C. Alcidi et al.: Income Convergence in the EU: A tale of two speeds, CEPS Commentary, 9 January 2018, available at https://www.ceps.eu/system/files/ConvergencePDF.pdf.

minority and the rest of the population are worlds apart in terms of education, employment, health and housing. As a result of constant prejudice and open racism (in many cases with political support), it is difficult to overcome this disparity and often even to determine its extent.

Other features also distinguish East-Central Europe from older EU Member States, for example, working conditions. There are major differences between East and West with regard to the degree of organisation of employers and employees. According to the OECD, less than one-fifth of wage and salary earners in Poland or the Czech Republic are actually members of trade unions – compared with a share of almost 70% in the Scandinavian Member States. This means that in terms of economic policy there is a constant temptation to improve competitiveness at the workers' expense. Recent changes in Hungarian labour law provide examples that would not be acceptable in Western or especially Nordic countries. In the area of vocational education and innovation capacity, substantial progress has only been made in East-Central Europe in relation to individual foreign investments.

It can therefore be said that most of the newer Member States, irrespective of the varying speeds of convergence (in terms of GDP), have developed as an 'inner periphery' within the EU. The region's booming capital cities are an exception, which only reinforce the challenge in terms of economic, social and territorial cohesion.

Wage dynamics and competitiveness

East-Central European wage dynamics deserve attention for economic and social reasons. Wages are not only low compared to Western Europe but, as demonstrated by a number of variables, also tend to be lower than what the economic potential of these countries would allow.[4] After the initial and turbulent phase of the transformation process, wages in all East-Central European economies started to grow dynamically from the mid-1990s up until the 2009 recession.[5] In the wake of the crisis, however, wage convergence either experienced a sudden halt or slowed down substantially.

Wage trends are not simply by-products of the macroeconomic processes. Maintaining wage cost competitiveness has been part of a reindustrialisation and broader economic development strategy in many cases. In Poland, for example, the early 2000s saw an aggressive reduction of wage share in the manufacturing industry. And even in the past five years of strong GDP growth, wage convergence has been sluggish, which is a trend increasingly frustrated by sectoral or more general labour shortages.

Can the EU do anything about East-Central European wages, and should we think about this at all? Wages and wage setting represent an area where the EU has no direct competences but in various ways the issue has gradually come under EU influence. Most importantly, the EU crisis response brought pressure towards a decentralisation of wage-setting mechanisms, a disruption of pre-crisis collective agreements, and a downward adjustment of the minimum wage in programme countries in particular. This came in addition to a longer-term trend of a declining wage share in a number of countries. In order to counter such negative trends, a campaign for a European Wage Alliance was launched to focus on the central question of East-West upward wage convergence.

Some concrete proposals have already been outlined for a prospective wage coordination policy. For example, agreement could be sought on a guaranteed wage floor in each country, based upon a coordinated approach towards minimum wages at the EU level that ensure that the levels are set above the poverty threshold and represent decent pay for the work undertaken. Guaranteed national minimum wages would help sustain internal demand while also improving the situation of posted workers and helping to fight social dumping.

Further, a guaranteed minimum income (at different levels per country) could be an effective way of ensuring adequate income support and fighting poverty while providing for activation incentives where relevant. Such a 'national social floor' would also indirectly define the minimum performance expected from national automatic fiscal stabilisers in times of economic crisis.

East-West imbalance and the social question

Beyond wages, the more general state of social security and social protection had an influence on East-West relations in the EU. In certain periods (e.g. 2011-2013) certain segments of Western media and politics were obsessed with poor migrants from the East and their access to social benefits in receiving countries. The purpose of that discourse was not so much to develop a common strategy to improve the well-being of those citizens, but to exclude them somehow from the richer countries and their welfare systems.

The never ending debate on social dumping supports the feeling in the East, and especially in the Visegrád countries

4 B. Galgóczi: Why central and eastern Europe needs a pay rise, ETUI Working Paper No. 2017.01, european trade union institute, 2017, available at http://www.fesbp.hu/common/pdf/2017_Galgoczi_Why_central_and_eastern_Europe_needs_a_pay_rise_EN.pdf.

5 Wage convergence in the pre-crisis period was spectacular, particularly when expressed in euro terms. Czech wages, for example, more than quadrupled between 1993 and 2010 in comparison to Germany, and most CEE countries showed a similar pattern. See B. Galgóczi, op. cit.

that the West does not want to see economic competition from the East and that arbitrary rules in the area of the mobility of services were introduced to push back Eastern companies in the very few sectors where they might be competitive: namely construction and road transport.[6]

Such controversies reflect the general fear that the enlargement of the EU to the East puts the feasibility of a 'Social Europe' into question. Rounds of enlargements created a geographical divide in Europe in terms of productivity and wage levels and made the EU much more imbalanced and heterogeneous as compared to its predecessor, the European Economic Community, which in itself can be seen as an obstacle to a deep social dimension whether it requires more common legislation or common funds.[7]

It is of course good news that there is economic convergence between East and West. However, those who believe that all problems in the East will be slowly resolved by experiencing higher than average GDP growth need to look beyond the GDP growth figures and see the gaps in health conditions, life expectancy and, in particular, the extraordinary population decline in Eastern Member States.

Economic convergence seems to be happening simultaneously with divergence regarding political values and social models. Therefore, the EU has to make efforts to ensure that economic growth in the East is sustained and is coupled with convergence in terms of political and social policy standards. In the long run, this is the real solution to the problem of social dumping, which has been the focus of legislative activity in the past decade. This is the reason for the significance of the 2017 European Pillar of Social Rights and the insistence of the Commission on the participation of non-Eurozone countries.

The East-West divide is often observed through the lens of controversies around labour mobility. Upholding the right to free movement and to ensure equal treatment for mobile workers remains a pivotal issue. But today a key question is how the peripheral regions (mainly the Eastern ones) can rebuild human capital, which is being lost through constant migration towards the West and disinvestment in health and education sectors. Besides, the EU must remain active in addressing the situation of Roma and promote integration, which is arguably Europe's biggest social challenge today.

6 Concerns about social dumping generated legal and political debates in the context of posting workers from one country to another by using the free movement of services. The legislative outcomes were the 2014 Enforcement Directive and the 2018 revised Posted Workers Directive.

7 M. Matzaganis: Snakes and ladders on the road to ESU, EUVisions, 3 December 2018, available at http://www.euvisions.eu/snakes-and-ladders-on-the-road-to-esu-matsaganis/.

Social investment imperative

To sustain economic growth in East-Central Europe, but also to reproduce the growth potential in the region for the long term, a first necessary step for the governments would be to rethink their role in the development of human capital and invest in it. As the coming decades must combine better living conditions for all with higher productivity growth, new investments are necessary in education, health and social inclusion, where the emphasis – until now – has tended to be on cutbacks.

Greater social investment is not only a responsibility of the public sector but is also in the best interest of companies. However, survey data confirm that businesses in East-Central Europe tend to attribute lower priority to human capital issues than their Western European peers. This is especially true for businesses in Romania and Bulgaria. Poland also stands out: on the one hand, Polish business seems to be more optimistic than in Western countries when it comes to the availability of skilled, educated, competent and experienced human resources. On the other hand, investments in human capital formation (apprenticeships, attracting talents, training, workers' motivation) tend to be seen as a lower priority in Poland compared to the EU average. Such an attitude may be explained by the strength of the cohorts entering the Polish labour market in recent years, but cannot be sustained when the workforce begins to age and shrink as in the rest of Europe.

The great human capital challenge in East-Central Europe is well illustrated by data on workers' participation in lifelong learning. With the exceptions of Slovenia and Estonia, East-Central Member States tend to have a far lower percentage of workers or unemployed people who participate in training and education compared to 'older' Member States. According to the Labour Force Survey, in Romania, Slovakia and Bulgaria the share is only around five percent.

The necessity to step up investment in human capital should be reflected by the way East-Central European countries make use of resources available from EU Structural and Investment Funds (ESIF). The European Social Fund, for example, could play a much greater role than before in helping to promote the employment of women, young professionals starting their career (by introducing the Youth Guarantee), Roma integration, labour market integration for people with disabilities and active ageing. It can also make a major contribution to improving the quality of education systems. The EU has established a rule for 2014-2020 that a certain minimum share of each country's allocation from the Structural Funds has to be dedicated to human capital investment through the European Social Fund. However, more effective financing of these programmes depends primarily on the political will in the individual countries.

Reformed Cohesion Policy needed

While the contribution of Cohesion Policy,[8] including ESIF, has been obvious in regions that lag behind, the effectiveness of these old budgetary tools in a new environment of East-Central Europe and the Balkans have been questioned in both qualitative and quantitative aspects. With support from academic researchers,[9] new conditionalities have been proposed, with particular reference to countries that tend to violate EU values and norms (namely Hungary and Poland).

Cohesion policy and EU funds are certainly not 'gifts' to Member States, but rather indispensable parts of a balanced and fair functioning economic governance and single market in Europe. However, we have seen that systemic corruption can lead to a situation in which EU funds simply do not fulfill their original goal of improving competitiveness, developing infrastructure and investing in human capital or better governance. In some countries the situation is indeed grave and include examples of state-level fraud organised by political actors. That results in a waste of EU resources that inevitably undermines democracy, the public interest and the rule of law. Because of the lack of ability to exert control, some even accuse the EU of funding a cleptocratic and autocratic regime in Hungary.

Beyond the already functioning procedures of interruptions and suspensions, sanctions can play a stronger role in stamping out irregularities, abuse and systemic fraud. However, the triggering of sanctions needs to be objective and transparent which requires a solid set of indicators and benchmarks as opposed to political considerations. Besides, sanctions must be well-targeted to punish the perpetrator of the fund abuse rather than the innocent bystanders.

The EU could take funds into its own hands and distribute them in the Member States according to the original goals. In other words, the Commission should suspend shared management in cases of repeated abuse or systemic fraud. This way the EU's actions cannot be regarded as blackmail; it could avoid the corrupted allocation channels and financing of oligarchs with close government ties.

Direct management solutions could be introduced in a gradual and proportional manner: first, only the funding that has already been refused due to significant irregularities or detected fraud would come under direct control of the Commission. Next, in case of systemic problems in operative programmes or the failure of management systems and democratic control mechanisms in a Member State, a more comprehensive direct management by the Commission could be established. Alternatively, a third type – assisted management – could be invented by placing EU experts in national agencies.[10] Assisted management could be either requested by the Member State or, above a certain threshold launched by the Commission.

In other words, the solution shouldn't be to punish citizens of the affected Member States but to repair the management system in a way that is able to efficiently prevent systemic misuse of funds by national political or management systems. Choosing the best way forward is by no means easy, especially with such a highly politicised instrument. However, a greater effort in defense of EU values and resources is necessary. This should not only translate into taking a strong stand against populism, but also defend the rights and opportunities of the victims of misbehaving governments.

Eurozone enlargement: unfinished business

Finally, it is also worth mentioning that economic and social development programmes (where they exist) should be tailored not only to the use of EU funds but also to plans for monetary reform. The euro was successfully introduced over the past decade in five East-Central European countries. Significantly, these were all among the smaller countries in the region. However, there was a price to be paid for this monetary success: for example, greater social inequality in Latvia and greater geographical inequality in Slovakia.

Eastern countries with an impressive adjustment record have earned international acclaim and Riga, the capital of Latvia, became a kind of Mecca of internal devaluation. However, while pursuing an aggressive strategy of internal devaluation (i.e. the reduction of wages, pensions and government expenditure) government policy pushes up unemployment, poverty and out-migration and this can undermine the potential for economic growth in the longer run.

For example, from 2008 to 2013, Poland, Hungary and the Czech Republic have all seen their unemployment rates increase by two to three percentage points. That said, these shifts in unemployment were below EU average (+3.8 percentage points) and certainly more modest than under the 'Baltic model' where priority was given to maintaining the

8 Cohesion Policy invests about one-third of the EU budget in the service of economic, social and territorial cohesion, through three funds: Cohesion Fund, European Regional Development Fund and European Social Fund (the latter two are currently also called European Structural and Investment Funds or ESIF). The allocations of all these funds reflect the income level of the beneficiary country or region.

9 See F. Heinemann: Going for the Wallet? Rule-of-Law Conditionality in the Next EU Multiannual Financial Framework, in: Intereconomics, Vol. 53, No. 6, 2018, pp. 297-301.

10 For more details on the limits of conditionality and the concept of assisted management see L. Andor: Resources for a Prosperous Europe: Redesigning the EU Budget in a Progressive Way, WISO DISKURS No. 18/2018, Friedrich-Ebert-Stiftung, 2018, available at https://library.fes.de/pdf-files/wiso/14700.pdf.

currencies' peg with the euro. In addition, over the same period in countries that kept their own currencies, pressure on wages had led to a noticeable decline in the real compensation per employee only in Hungary. External devaluation through the exchange rate has reduced the pressure on these countries to pursue internal devaluation. The crisis may have led to more detrimental labour market outcomes if these countries had attempted to maintain the pre-crisis exchange rate of their currencies.

However, while currency devaluations reduce the pressure on labour markets during a downturn, they can hardly be seen as sustainable compensation for lacking competitiveness in the long run. Likewise, internal devaluation at the expense of the economy's human capital is socially unacceptable and represents an equally poor substitute for reforms and investments that genuinely strengthen productivity and competitiveness. The point is again that East-Central European countries need to invest in human capital in order to be able to reap the benefits of joining the Eurozone. The problem of economic adjustment within the monetary union is European by nature, so that satisfactory answers must be found at the European level: Member States confronted with economic shocks should not be left alone and condemned to internal devaluation in an effort to restore growth.

Conclusions

The last 15 years of economic transition in East-Central Europe can be characterised by a more convincing convergence process as compared to the pre-EU phase. However, economic convergence in these countries was not necessarily coupled with social convergence, which may undermine the continuation of strong economic performance for the next 15 years. The EU has to pay attention to the East-West imbalances and consider new strategies for cohesion and convergence.

The major question for the next stage is whether the EU's eastern region can continue to catch up without the internal socio-economic polarisation observed thus far, and how exactly the latter process could in fact be reversed. Whether EU membership has been positive for the new Member States is something that cannot be measured only in terms of GDP. The quality of economic development and the changes in society are at least as important, if not more important. That makes the overall picture somewhat uneven.

If the 'new' Member States wish to create a new development path for themselves that has the qualities of being smart, sustainable and inclusive, and allows for convergence towards Western social models and not only the EU income average, they must promote stronger (and genuine) social dialogue and social investment. If Europe moves towards a more successful, globally competitive 'balance of interests' model of economy and society, this may bring significant benefits for East-Central Europe. The question remains whether the necessary social and political will exists on the ground and if the East and West can work together in partnership for such a purpose.