LICOS
Centre for Transition Economics

LICOS Discussion Paper

Discussion Paper 75/1998

The Integration of Central and Eastern Europe in the European Union: Trade and Labour Market Adjustment

Erik Faucompret
Jozef Konings
Hylke Vandenbussche

Katholieke Universiteit Leuven

LICOS Centre for Transition Economics
Huis De Dorlodot
Deberiotstraat 34
B-3000 Leuven
BELGIUM
TEL: +32-(0)16 32 65 98
FAX: +32-(0)16 32 65 99
http://www.econ.kuleuven.ac.be/licos

Abstract

This paper analyses the economics of EU enlargement from three perspectives. First, we provide an institutional background and point out the importance of *Agenda 2000*. Second, we then analyse the implications for EU trade with Central and Easter European Countries (CEEC's) and in particular we discuss the EU Antidumping legislation and its implications for trade integration between the EU and CEEC's. Third, we engage in an analysis of the implications of economic integration for the EU labour market. To this end, we use a unique firm level survey of 281 Belgian firms. Our findings suggest that: (i) the EU follows a too restrictive approach to trade integration; (ii) economic integration with CEEC's leads to a reduction in the demand for low-skilled labour in small firms, however, this effect is reversed for large firms.

Acknowledgements :

Konings acknowledges the financial support of the FWO, project number G.0193.96. Vandenbussche acknowledges support of the FWO as a post-doctoral researcher of the FWO. This paper is produced as a part of the research programme on "globalisation" at LICOS.

I. Introduction

In almost all post communist countries widespread economic reforms have taken place and an increasingly growing private sector has been established. Most of the transition countries are now starting to emerge from their deep recessions and show in fact high and positive growth rates of which many Western nations can only dream. Table 1 shows a number of key economic indicators for the Central and Eastern European countries (CEECs). From column (1) it can be seen that most countries have growth rates of more than 4% in 1996, while unemployment rates (column 2) vary a lot among different countries. Compared to the EU average of 1.6%, the growth rate in most CEEC's is much higher, so that some catching-up can be expected; the unemployment rate and the share of industry in GDP are comparable to the EU average; while the share of agriculture in GDP is much higher in CEECs.

Table 1: Key economic indicators for EU and CEECs

	GDP Growth	**Unemployment rate**	**Share of industry in GDP**	**Share of agriculture in GDP**
EU (15)	1.6	10.9	22.3	1.5
Bulgaria	-10.9	12.5	31.6	11.4
Croatia	4.3	16.4	20.3 (1)	9.2
Czech Republic	3.9	3.5	33.8	5.1
Estonia	4.0	5.6	18.9	6.4
Macedonia	1.1	24.9	n.a.	n.a.
Hungary	1.3	10.5	n.a.	n.a.
Latvia	2.8	7.2	27.8	9.1
Lithuania	5.1	7.1	28.3	11.4
Moldova	-8.0	1.8	25.0	n.a.
Poland	6.1	13.2	27.1	6.0
Romania	4.1	6.1	36.0	19.1
Slovakia	6.9	11.1	28.9	5.7
Slovenia	3.1	13.9	27.8	3.7

(1) At 1990 constant prices

Source: Transition report update (April 1998), European Bank for Reconstruction and Development

At the same time fear has grown in the industrialised countries that the globalisation of the economy and the increased competition from CEECs will harm domestic industry and welfare. Wood (1995) argues that the deteriorating situation of unskilled workers in developed countries is caused mainly by an expansion of trade with developing countries, while Krugman and Lawrence (1994) argue that the effects of trade have been relatively small. From a theoretical point of view a deeper integration of CEECs with the EU can occur through different channels (see also Abraham and Konings, 1997). Either CEEC workers in search of better paid jobs move to the EU or through the mobility of capital, integration can result in a rise of foreign direct investment (FDI). The other way is through an increase in trade between the EU and the CEECs.

In this paper we will deal with some aspects of the relations between the EU and the CEECs and their implications for economic integration. Our main argument in this paper is that the Europe Agreements are too conservative. This conservatism is the result of EU fear of losing jobs, capital and wealth. We show that in many respects this fear is ungrounded. Short run costly adjustments may occur, but long run gains from integration are eminent. In section II we provide an historical background in the form of a chronological outline of events that led to the Luxembourg Council which selected Cyprus, Estonia, Poland, Hungary, Slovenia and the Czech Republic for EU membership. In section III we will analyse the Europe Agreements and study their impact on trade flows. Section IV analyses the potential effect of CEEC integration on the EU labour market. Section V is a concluding one.

II. Institutional background

From Phare to Agenda 2000

The 1989 revolutionary changes in East and Central Europe took the European Community (EC) by surprise. Though it had fought communism relentlessly during the Cold War, its reaction was rather irresolute, to say the least. Emergency aid was granted to the Central and Eastern European Countries (CEECs) under the PHARE-programme. In 1991 and 1992 the Europe Agreements were signed. The aim was to set up an industrial free trade area, with a ten year transitional period starting from the entry into force of the Agreement. With the Europe Agreements the CEECs were no longer discriminated against by the EC (Nötzold, 1994). But they did not enjoy any major privileges either. About 80 % of EC imports from third countries entered duty-free anyway. The CEECs were less well off than the Mediterranean and the Associated Countries in Africa, the Caribbean and the Pacific that got more significant trade concessions from the EC. Therefore, one after another, the CEECs and the Baltic states applied for EC membership. The Copenhagen European Council (21-22 June 1993) agreed that the Associated Countries could join the EC provided they assumed the obligations of membership. But the conditions put forward in the European Council's final communiqué went much further than the ones mentioned in art. 237 of the Rome treaty (DN: DOC/93/3; 1993-06-22). As Inotai (1996) points out, the Copenhagen decision in fact constituted an act of discrimination against the CEECs. For the first time, specific conditions were being imposed on acceding countries, whereas art. 237 laid down only one condition, namely, that an entrant country must be European.

Apart from the political conditions, membership of the CEECs required a functioning market economy, the capacity to cope with competitive pressure and market forces within the EC, and even adherence to the aims of the EMU. One and a half year later, the Essen European Council (9-10 December 1994) made a more concrete condition: the CEECs were expected to adopt the so-called Internal Market *acquis communautaire* (DN: DOC/94/4; 1994-12-10). Adoption of EC Internal Market Law was to benefit the reform of the CEEC economies and the strengthening of their competitive powers. At the Cannes European Council (26-27 June 1995) the Commission submitted a White Paper containing a detailed sector by sector presentation of relevant EC legislation in the Internal Market area (DN: DOC/95/6; 1995-06-27). It was intended to guide CEEC efforts towards integration into the Community. On 15 July 1997 - one month after the completion of the 1996 Intergovernmental Conference - the Commission put forward its *Agenda 2000*. This document dealt with both the enlargement and the necessary restructuring of the EU (COM (97) 2000 def.).

Agenda 2000

In *Agenda 2000* the Commission identifies three main bottlenecks for enlargement negotiations have to cope with: relocation of firms, migration of workers and the financial burden for the EC will have to bear. To start with the first bottleneck: the Commission apparently fears that EC firms with low costs of liquidation and relatively high labour and transport costs might want to relocate eastward in an enlarged Union, because of the low unit labour costs and the proximity to the main EU markets. This could result in substantial sectoral and regional adjustment pressure in the current Member States. It might be most marked in agriculture, coal and mining and traditional industries such as textiles. But at the same time the Commission vaguely admits that upstream sectors such as food processing and clothing could benefit from adjustment pressure. We will argue that empirical evidence refutes delocalization of EC companies (see section III).

With respect to labour the Commission does not expect mass emigration of CEEC workers to current Member States. Past enlargement experience learns that migration flows are affected by economic conditions and prospects, more than by the right of free movement. On the other hand, because of the rather substantial wage differential with the West and today's political and economic upheaval in the CEECs, migration pressures from Eastern Europe may be different from earlier enlargements. But as Faini (1995) points out, the anticipation of future economic growth in the CEECs themselves might act as a barrier to migration. The more so when migration costs are taken into account. Anyhow, labour market imbalances might increase, if lowly and highly skilled CEEC workers look for employment opportunities in the EC (especially Germany). The Commission is right when stating that more intense competition in the labour market, be it directly through migration or indirectly through FDI, will make necessary wage moderation in the current Member States. For the time being Member States are allowed to sign agreements with CEECs requiring strict controls on emigration. For the part of the CEECs, they will have to adopt EU social standards (e.g. with respect to safety and health at work) and this might hurt their competitive positions.

The CEECs are more populous, poorer, and more agricultural than the poorest four Member States put together (Baldwin, 1995). This will translate itself into an increase in the EC budget. First of all CEECs will become eligible for assistance under the Structural Funds and the Cohesion Fund. The Commission points out that many regions, both in current Member States and CEECs, will be exposed to strong competition and will remain very dependent on agriculture and sensitive industrial sectors. This implies that enlargement will lead to a sharp increase in the population eligible for assistance. Greece, Ireland, Portugal and Spain receive significant amounts of money out of the Funds because they have regions with a GDP per capita of less than 75 percent of the EC average. Some of these regions will loose aid in favor of CEECs, which have at the moment a per capita GDP of only about 40 to 50 percent of the EC average (Franke, 1997).

The extension of the Common Agricultural Policy (CAP) in its current form to the new Member States will create an additional financial burden (Nuti, 1996; Marks and Techen, 1997). CEEC prices are substantially lower than CAP ones, especially in heavily protected sectors (dairy products, sugar and certain vegetables and fruits). Introduction of CAP prices will stimulate CEEC production, thus add to projected surpluses. It will dampen domestic demand and raise raw material prices for the food industry. WTO constraints will prevent the EC from dumping its surpluses on third country markets. In order to prevent this, the Commission favors the further restructuring of European farming, both in current and new Member States. But it remains very vague about the way this is going to happen (Bos and Merrienboer, 1996; Fischler, 1997). Either way the CEECs will remain long-term net recipients of substantial EC transfer payments. Estimations vary widely but according to some recent literature they fluctuate between ECU 15 billion and ECU 18 billion a year (Inotai, 1996; Franke, 1997; Baldwin, FranHois and Portes, 1997). While the estimated cost seems small in relation to the total GDP of the EC, it represents nevertheless a significant amount of the EC budget. Half a year after the publication of *Agenda 2000* the Luxembourg European Council, while adopting the Commission’ s report (12-13 December 1997), officially launched the enlargement process. The Community declared itself ready to start enlargement negotiations with Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia (DN: DOC/97/24; 1997-12-13). This implies the liberalisation of trade, capital and labour. In the next section we will deal with trade issues.

III. Free movement of goods

Trading partners

International trade between the EU and the CEECs shows a huge potential for growth. Table 2 shows that in 1990 the EU traded only with a subset of CEECs. Moreover, the trade balance with these countries (Poland, Czechoslovakia and Hungary) was negative suggesting that the EU at that point was a net importer. Despite the trade deficit with CEECs, imports in 1990 accounted for no more than 2% of total EU world imports. Six years later in 1996, well beyond the early stages of transition the direction of trade flows has been reversed to the benefit of the EU. Although EU imports from existing trade partners in the East continue to rise and new partners enter the trade arena (Estonia and Slovenia), it is especially EU exports towards Eastern Europe which experience the most dramatic increase. Over the period 1990-1996 the trade deficit (column 3) of the EU with Eastern Europe has become a trade surplus which continues to rise. Or, in other words the EU has become a net exporter to the East.

Table 2: Trade between EU and CEECs (In 1000 ECU)

	IMPORTS		**EXPORTS**		**TRADE BALANCE**	
Partner	**1990**	**1996**	**1990**	**1996**	**1990**	**1996**
Poland	5156541	12252019	4393069	19856885	-763472	7604866
Czech Republic	0	9754836	0	13975408	0	4220572
Czechoslovakia*	2688731	0	2606242		-82489	
Slovakia	0	3420191	0	3997883	0	577692
Hungary	2934049	8826614	2876155	10000620	-57894	1174006
Slovenia	0	4270346	0	5377062	0	1106716
Estonia	0	1088772	0	1696732	0	607960
Total	10779321	39612778	9875466	54904590	-903855	15291812

* In 1993 former Czechoslovakia was split in the Czech Republic and the Slovak Republic (Slovakia).

Table 3 shows that the CEECs have become very dependent on imports from the EU. Hungary is probably the most extreme example. Whereas in 1990 only 40% of total Hungarian imports came from the EU, in 1996 Hungary gets 80% of its imports from the EU. In contrast, when we consider total EU imports in 1996, the share of CEEC imports in total does not exceed 7%. When we look at the export structure we note from table 3 that CEECs have also become much more reliant on the EU in terms of their exports. In 1996 the majority of CEEC exports was shipped to the EU. While for the EU, exports towards CEECs compared to total exports was only 3% in 1990 and stayed just below 10% for 1996. Hence from these figures it appears that the power balance in the trade relationship is clearly in favor of the European Union.

Table 3: Relative Importance of trade partnership (in 1000 ECU)

	Imports from EU related to total imports	Imports from EU related to total imports	Exports to EU related to total exports	Exports to EU related to total exports
Partner	**1990**	**1996**	**1990**	**1996**
Poland	67%	68%	48%	64%
Czech Republic	0%	64%	0%	57%
Czechoslovakia	25%	0%	29%	0%
Slovakia	0%	46%	0%	49%
Hungary	42%	80%	39%	89%
Slovenia	0%	73%	0%	86%
Estonia	0%	67%	0%	67%

Source: Eurostat External Trade

Antidumping duties

Trade with CEECs will not grow unless it is encouraged by a commitment to open markets by the EU. For the time being this is not so. The Europe Agreements aim to abolish all tariffs and non-tariff barriers (NTBs) on EU-CEEC trade, but they maintain restricting clauses and, in critical sectors, offer only a gradual approach to free trade. (See e.g. text of the Agreement establishing an Association between the EC and its Member States with Hungary: *Official Journal* L347, 1993/12/31). For the time being, EC tariffs on sensitive products (some items of chemicals, steel products, furniture, leather goods, footwear, glass and vehicles) remain in existence. As Leipold (1995) points out: sensitive products make up roughly half of total EC imports from CEECs, so the later ones may have great difficulties further increasing their exports to the EC, if nothing changes. Broadly speaking, CEEC comparative advantages can be seen to correlate with the sensitive products where exceptions were made to the trade liberalization programme. (Leipold, 1995; van Brabant, 1996; Steinherr, 1995; Centre for Economic Policy Research, 1992). Agriculture is mainly left out of the Europe Agreements and trade concessions in this field are more symbolic than real. The Europe Agreements contain safeguard clauses in cases of *serious* injury to domestic producers of competitive products, *serious* disturbances in any sector of the economy or in the economic situation of a region, *serious* balance of payments difficulties.

There are further restrictions. The abolishment of customs duties and quotas only applies to products originating in the Partner Country. This means that the products have to be wholly manufactured in this country or they must have undergone sufficient working or processing. A processed product is not considered as originating in a Partner Country if its value does not represent the highest percentage of the value of the product obtained The simple assembly of parts imported from third countries to constitute a complete product is not covered by the Agreement. This precludes CEECs from many relatively light processing tasks applied to non-EU materials (CEPC, 1992). Evidence of origin has to be proven by certificates. The only exception to this rule is that the Europe Agreements signed by the Viségrad countries allow diagonal cumulation among Partner Countries. This means that these countries are considered as one trading partner as far as the local content rule of products is concerned. A local content requirement of about 60% can only serve to discourage the much needed direct foreign (non-EU) investment in CEECs (Centre for Economic Policy Research, 1992).

Another point which should be made is that the Agreements, as opposed to the one concluded with the EFTA countries (European Economic Area agreement), do not exclude the possibility of anti-dumping measures being taken by both parties (see e.g. art. 29 of the Agreement with Hungary). The EC made only minor concessions in this field. In anti-dumping investigations the CEECs are considered to be market economies. This means that the calculation of the *normal value* will be based on the actual prices in the CEEC concerned for the allegedly dumped products, thus not on the normal value for the goods in question in an analogue country. The Agreements also stipulate that the Association Council must be supplied with all relevant information in view of seeking a solution acceptable to the two parties. However this requirement seems to have had little impact on the practice of Community institutions (Lenaerts, 1997). At the Essen European Council (1994) the Commission committed itself to giving preference to price undertakings rather than duties in order to conclude antidumping cases where material injury was found (DN: DOC/94/4; 1994-12-10). This means that CEEC companies are requested to export at a minimum price and that in this case no duties will be imposed against them.

EU industries can apply for antidumping measures whenever they see fit. Because antidumping proceedings are very costly for the firms involved the mere existence of an antidumping procedure gives an incentive for exporters to revise their export prices upwards which reduces the probability of being involved in a dumping suit (see Staiger and Wolak, 1995; Pauwels, Vandenbussche and Weverbergh 1997). This implies that the number of antidumping suits actually observed is likely to underestimate the effects antidumping proceedings have on the trade flows. Even in the absence of antidumping petitions for protection being filed, the trade flows are bound to be smaller than in the case where antidumping laws would be abolished between the two trade partners. Table 4 gives an overview of the antidumping cases which were submitted to the European Commission against CEECs which are currently being considered for EU membership in the period 1990-1996.

It becomes clear that mainly EU sensitive sectors are filing for antidumping protection. More in particular the chemical sector (253) and the steel sector (222) are often triggering dumping investigations on imports coming from CEECs. These sectors are important employers in the EU (1.7 million jobs in the chemical sector) and are facing large overcapacity. Both the threat of antidumping action and the actual resort to measures are preventing prices in the EU market sliding down to levels, which are no longer viable for EU producers. The important question here is whether antidumping measures are really necessary to curb unfair pricing behavior by CEEC exporters or whether they are being used to compensate EU producers for the comparative disadvantage they have in these sectors. In case of the latter, antidumping measures are being used as a tool of industrial policy to overcome the lack of European competitiveness in these sectors. Recent empirical work seems to suggest that antidumping protection whatever the objective it is serving, leads to rent-seeking. This means that interested parties are trying to influence the outcome of antidumping procedures to their benefit. For example a study by Konings, Vandenbussche and Veugelers (1997) has indicated that the probability and level of antidumping protection are positively influenced by the strength of union bargaining power in a sector. A study by Vandenbussche (1996) has indicated that there are reasons to believe that European antidumping protection against Poland, Hungary and former Czechoslovakia in the period 1985-1990 was on average overestimated by 20 %. EU enlargement with these countries would eliminate antidumping proceedings which in any case is bound to have a further positive effect on trade flows. This also held true of Portugal and Spain the exports of which prior to their EU accession were heavily suffering from EU antidumping measures.

Table 4: Antidumping cases of the EU against CEECs

Initiation	Product	Sector (NACE)	Defendants
1990	Artificial Corund	253	Czechoslovakia
1991	ferro-silicon	224	Poland
1991	silicon carbide	253	Poland
1991	seamless steel tubes	222	Hungary, Poland
1993	Urea nitrate solution	253	Poland
1994	Portland cement	242	Poland, Czech and Slovak Republic
1994	Hermatite Iron	221	Czech Republic, Hungary
1995	zinc		Poland
1995	Pallets of wood		Poland
1995	profiles of non-alloy steel	222	Czech Republic, Hungary
1996	seamless pipes & tubes	222	Czech and Slovak Republic
1997	zinc		Poland
1997	ferro-silicon	224	Poland
1997	hardboard		Estonia, Poland

Source: Official Journal of the EC, 1990-97

Harmonisation of technical specifications and standards

Standards and specifications offer another loophole in the liberalisation process with CEECs. They act like not-tariff barriers (NTBs), protecting domestic markets and driving a wedge between domestic and border prices (Baldwin, François and Portes, 1997). In the Europe Agreements the CEECs commit themselves to ensuring that their future legislation will be compatible with EC specifications and standards as far as possible. But the Copenhagen European Council (1993) wanted the CEECs "to harmonise their laws in order to prevent distortion of competition and to offer protection to their workers, their consumers and their environment" before their accession to the EU. Apparently the EU feared for distortion of competition when CEEC companies were put on a lower level as to the protection of national health, national security, consumers, labour and environment. At the same time it wanted to prevent EU firms from relocating their plants to Member States with the lowest level of protection (levelling the playing field).

Without doubt, past experiences influenced EU behaviour. In the past, the free circulation of goods, services, labour and capital among the current Member States has often been hampered by the lack of harmonised technical regulations and standards. Eventually it took about thirty years to reach agreement on some one hundred thousand national regulations and standards and even today, in some areas the Internal Market is far from being completed. The two instruments to ensure free circulation within Community territory are either the mutual recognition of legally marketed goods and services, or the technical harmonisation of legislation. According to the European Court of Justice any product legally manufactured and sold in one Member State should in principle enjoy free access to the other Member States markets (Cassis de Dijon, 1979). Unfortunately some Member States (amongst them Germany) objected to this approach and invoked grounds for special protection of public morality, public security, health, industrial property, interests of workers or the environment. This left the Commission with no other option than to elaborate the legislation on technical harmonisation. This may explain why the EU wanted the preparation of the CEECs for the Internal Market to be at the heart of a Pre-Accession Strategy. It feared that lack of harmonisation of standards and specifications could undo 20 years of hard work. In case the CEECs acceded to the EC without their legislation being harmonised, current Member States might retaliate. In other words: adjustment strains in both the current and the new Member States would again segment the Internal Market, particularly in sectors where liberalization under the Europe Agreements had been rather limited. The CEECs clearly faced a trade off. If they did not adopt Community legislation, their products would be kept out of Member States markets. If they accepted Community specifications and standards, they might lose their comparative cost advantage vis-à-vis their major competitors in other markets. By applying for membership, the CEECs made it clear they were ready for harmonisation. But by requiring CEECs to adopt the same legal restrictions on economic activity as it has itself, the EU undermines many of the advantages of mutual trade (CEPR, 1992). Harmonisation should not precede free trade but it should follow it. Tariff removal will leave CEEC imports from the EU more vulnerable than EU imports from CEECs. CEEC standards and specifications are not sophisticated enough to keep EU products out of their markets, while CEEC exports to the EU are regulated by EU technical specifications and standards. When EU standards and specifications are harmonised, a high minimum level is always chosen. Less developed CEECs will find it difficult to meet these standards and specifications. CEEC vulnerability is compounded by the fact that by the year 2001, free trade is supposed to cover 96 percent of EU exports to the CEECs, but only about 70-80 percent of CEEC exports to the EU, since agricultural products are excluded (Inotai, 1996; Mayhew, 1998).

Alternative: free competition

It is generally believed that competition law could constitute a better alternative to cope with unfair trade practices (Lloyd, 1998). In the case of EU member states both competition and antidumping policy were used to regulate trade among the then Member States, but only during the transitional period. From 1970 on antidumping regulations were dropped so that companies could take advantage of the enlarged market provided they acted in a fair way. Unfortunately, in practice firms often take resort to various practices in order to offset the effects of losses in monopoly power as a result of the liberalisation of trade (e.g. common selling syndicates, which reserve their home markets for national producers, reciprocal exclusive dealing agreements, aggregate rebate systems, etc.). For this reason the Treaty of Rome contains a chapter on competition (articles 85-90). Thus article 85(1) prohibits agreements "... which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the Common Market ... ". Under the terms of art. 86, any actions by one or more companies which "take improper advantage of a dominant position and which affect trade between Member States" is prohibited. Since that time EC competition policy has developed as a result of a significant amount of case law promulgated by the Commission and the Court of Justice (Kemp, 1994; Bayliss and El-Agraa, 1990). The Commission is given strong executive powers and the Court can enforce its judgements upon the governments and firms without interference of national authorities. The companies are always entitled to take the Commission to the Court. The latter can uphold or strike down the Commission's decision.

In the past the Court ruled that action could be taken against companies wholly outside the EC and without affiliates, branches or subsidiaries in Member States, when they pursue a commercial policy which has detrimental effects upon the EC. Such action might imply the use of commercial power, e.g. the banning or limiting of imports into the EC from these companies (Commercial Solvents Case, 1974; Continental Can Case, 1971). The EC competition policy thus encompasses firms in third countries in a manner that is not found in the national legislation of any Member State. This means that the Commission does not necessarily have to use protection instruments in case of alleged third countries (e.g. CEEC) unfair trade practices. The Europe Agreements explicitly refer to articles 85-90 of the Rome treaty. The CEECs received a three-year moratorium in order to apply EC competition policy. For the first five-year period the CEECs will be regarded as an area identical to those areas described in article 92.3(a) of the Treaty of Rome, i.e. backward areas where some relaxation of competition rules is allowed. The Association Council can prolong this period for a further five years. But if in the mean time the EC thinks that a particular practice is incompatible with its laws on competition, it can take the appropriate measures. This could mean taking antidumping measures. Although it has been shown that these measures are biased in favour of EC producers and their application is subject to discretionary powers (Lenaerts, 1997).

As said before CEECs are obliged to adopt within three years nearly the full arsenal of EU competition law. The only exception is for state aid, which may be deemed acceptable on some grounds. State aids could also act as a NTB. As a general rule state aids which favour certain enterprises or products and which distort trade between Member States is, under the terms of art. 92 incompatible with the Common Market. However there are certain exceptions. Aid may be deemed compatible if it is intended to aid the development of underdeveloped regions, the promotion of certain important projects of European interest or the development of certain activities or certain economic regions. It is for the Commission to decide whether aid is acceptable but the Member States can appeal to Court. In 1973 the Council reached an agreement on the principles for regional and sectoral aid. These principles aimed both at regulating competition between Member States (that tried to woo foreign investors to underdeveloped areas) and at assisting the Commission in its task of evaluation (Bayliss and El-Agraa, 1990). On several occasions the CEECs - who dismantled state controls in recent years - declared themselves ready to control state aids, to adopt the 1973 criteria put forward by the Council and to accept the Commission's authority to sanction unjustified aid. CEEC producers suffer a double-jeopardy: if competition and state aids law does not get them, antidumping will (CEPR, 1992). We firmly believe that both competition and state aids policies would be more first best ways of safeguarding EC interests. Moreover these policies are more transparent for third countries, more predictable and provide more legal certainty than Antidumping Regulations.

IV. Adjustment of the Labour Market

Contrary to what the CEECs had hoped for, the Europe Agreements do not accord free movement to CEEC workers. They just stipulate that, taking into account the labour market situation in each Member State, the existing facilities for access to employment accorded under bilateral agreements are to be improved, if possible. Moreover the treatment given to CEEC workers has to be free from discrimination. On the other hand, the Europe Agreements do provide a stimulus for FDI. Companies are granted freedom of establishment provided they comply with the respective national legislation. During the ten year transitional period the CEECs are allowed to introduce measures which derogate from the freedom of establishment if certain national industries are undergoing restructuring or are facing serious difficulties, particularly when this entails serious social problems or when they face the drastic reduction of their market shares or when they are newly emerging industries. These measures shall cease to apply upon the expiration of the transitional period and shall be reasonable and necessary in order to remedy the situation. While applying such measures, the CEECs shall grant whenever possible a preferential treatment to EC companies. Freedom of establishment is also limited by the restriction on the EU side placed on the free movement of labour. A CEEC firm can be established in the EU but must employ, with only a few exceptions (key personnel like managers, supervisors, highly qualified workers and professionals) staff recruited within the EC.

Competitive pressure

The restrictive clauses in the Europe Agreements show that the opening of Central and Eastern Europe has led to concern about the job generating potential of the economies in the EU. With an unemployment rate of 10% in the EU, the EU fears trade with the CEECs as well as free mobility of CEEC capital and labour. CEEC residents might move westwards or EU firms might decide to open up production facilities in CEECs so as to benefit from low wage costs and to avoid the bargaining strength of strong EU labour unions (e.g. Wes, 1997). In this section we will first analyse the potential effects of the EU opening towards CEECs on the labour market by making use of a firm level postal survey that was sent out to 1580 Belgian firms in the Summer of 1996. Following a pilot study with a Belgian multinational active in CEECs, we conducted a postal survey for which we selected companies at random regardless of firm size or sector; 312 companies replied (i.e. 20%), 281 of which could be used for our analysis. We subsequently merged our survey data with company accounts data from the Central Bank of Belgium. We were able to match 262 companies, the remainder being typically small companies employing no people.

We report the answers to a number of questions that are relevant for EU enlargement and adjustment of the labour market. In the survey we inquired after the extent of changing competitive pressure and its reasons. Table 5 shows the responses to the question whether firms experienced an increase, no change or a decrease in domestic or foreign competition (missing cases are excluded from the calculations).

Table 5: Changes in competition

	1986-1989			1990-1995		
	Increase	no change	decrease	increase	no change	decrease
Domestic	39 %	55 %	6 %	54 %	37 %	9 %
Foreign	51 %	45 %	3 %	81 %	16 %	3 %

In table 6 the origin of the increased competition for the two periods is reported. We asked to rank the most important regions where increased international competition came from.

Table 6: Source of foreign competition

Region (period 1986-89)	Rank 1	Rank 2	Rank 3	Rank 4	No Rank
Western Countries (*)	79 %	8 %	6 %	1 %	7 %
Central- and Eastern Europe	6 %	18 %	20 %	12 %	43 %
Southeast Asia	15 %	20 %	19 %	9 %	38 %
Others (**)	9 %	9 %	7 %	12 %	63 %
Region (period 1990-95)	**Rank 1**	**Rank 2**	**Rank 3**	**Rank 4**	**No Rank**
Western Countries (*)	66 %	11 %	9 %	2 %	12 %
Central- and Eastern Europe	17 %	26 %	15 %	11 %	31 %
Southeast Asia	20 %	19 %	18 %	9 %	33 %
Others (**)	9 %	7 %	9 %	14 %	61 %

(*) Western Europe, USA, Canada, Australia
(**) e.g. Latin-America, Turkey, Middle-East, Africa

It is interesting to note that the increase in foreign competition for both periods originated especially from Western countries. Only 6% of the companies experienced as top rank an increase of foreign competition from Central and Eastern Europe in the period 1986-89, while this increased to 17% in the second period. This confirms some of the points raised before. There has been an increase in foreign competition, yet one should not overemphasise the impact of increased CEEC competition. While the region did become more important, growing competition from other Western countries is still the most important one for most companies.

In table 7 we report the rankings of the reasons of this increased competition. The percentages refer to 209 companies that experienced an increase in foreign competition during the period 1990-1995.

Table 7: Reasons for increased competition

Increase in foreign competition due to…	Rank 1	Rank 2	Rank 3	Rank 4	Rank 5	No Rank
Technological developments	16 %	12 %	18 %	16 %	1 %	37 %
Product innovation	16 %	14 %	19 %	13 %	1 %	37 %
Labour Costs	49 %	16 %	6 %	9 %	3 %	18 %
Globalisation	18 %	15 %	11 %	16 %	0 %	40 %
Other Reasons	21 %	6 %	4 %	2 %	2 %	66 %

Note: rank 1 is the most important, rank 5 is the least important. Columns do not sum to a 100% since the same rank to multiple options was allowed.

Almost half of the respondents consider the lower labour costs abroad to be the most important factor contributing to the increase in foreign competition during the 1990-1995 period. It is well-known that, due to a number of institutional restrictions, labour costs in Belgium are very high, the gross labour cost for an employer being on average twice the net take home pay. Especially for companies operating in international sectors the regulatory nature of the Belgian labour market seems to be a plausible explanation for the importance of labour costs in table 7. This is also consistent with recent micro econometric evidence estimating a long run labour elasticity of well above 1 in absolute value for Belgium (Konings and Roodhooft, 1997). It seems to be the case that *labour costs* are important in explaining increased competition in *international trade*. In contrast, as we will show later, labour costs do not seem to be the dominant factor for multinational firms to decide whether or not to invest in the region.

In response of this increased international competition it is likely that companies took some restructuring measures. Indeed, in our sample 52% of the companies did so. Table 8 gives an overview of the most important actions that companies took. Modernising the production process and reducing employment are some of the most frequent actions taken (respectively 32% and 29%). However, also 13% of the firms actually increased their labour force, so a priori it is not clear which effect will dominate. It is striking that only 12% of the firms moved their production facilities abroad in response of increased foreign competition. Thus integration with CEECs has only a minor impact on transfer of EU production. Moreover, employment adjustment did occur, but both in the negative and in the positive sense. The fact that some firms expanded their workforce while others contracted it, could be related to the type of workers in the firms, highly vs. lowly skilled. (At this stage, however, we do not have further information available.

Table 8: The response of companies to increased competition

Action	
Modernising the Production Process	32 %
Cutting the workforce	29 %
Outsourcing some part of the production process	16 %
Increasing the workforce	13 %
Moving abroad the production process	12 %
Retraining employees	12 %
Other measures taken	13 %

Only a small number of firms, 16 %, have its own production, service or sales facilities in CEECs. Most of them are situated in the more advanced and politically stable countries of Central Europe and in Russia. Of the 46 companies with production facilities in CEECs only 18 have transferred production lines from Belgium to CEECs and only 2 firms admitted that this coincided with a decrease in the domestic workforce. When we asked for the reasons why companies moved their activities to CEECs, the most important reasons they gave were labour costs and expansion plans, while general restructuring and social legislation were not important.

Productivity

While labour costs seem to matter, it is important to relate them to productivity. Lower labour costs reflect lower productivity. Indeed, as shown in table 9, 73% or 35 companies with production facilities in CEECs, find that productivity is lower or much lower than it is in the home country. 21 of them indicate cultural background and work ethics as the principal cause. Aged technology and a less qualified workforce also play a role. Trade unions, although politically important in many of the CEECs, do not seem to influence productivity in an adverse way.

Table 9: Productivity of CEEC production facility compared to its Belgian counterpart

Relative Productivity in CEE	Percentage
Much Lower	23 %
Lower	50 %
Equal	19 %
Higher	6 %
Much Higher	2 %

We finally asked a series of questions related to risk factors for investment in CEECs. We asked to rank the five most important risk factors for investing in CEECs, out of a list of 12 possible risk factors, leaving the option of adding one more risk factor to the list. We asked this question to the companies that invested in CEECs, as well as to those who did not invest or plan to invest. The results are summarised in table 10.

Table 10: Risk factors for investing in CEE

Risk Factors.	Rank 1	Rank 2	Rank 3
Lack of clear legislation	25 %	12 %	9 %
Political instability	19 %	14 %	7 %
Uncertainty about the currency value	18 %	11 %	7 %
Insufficiently developed market economy	15 %	8 %	10 %
Difficulties in obtaining management control	13 %	7 %	10 %

Insufficiently developed capital market	11 %	7 %	8 %
Deficient infrastructure	11 %	8 %	13 %
Lack of market information	9 %	6 %	5 %
Aged production technology	8 %	4 %	7 %
Other Risk Factors	8 %	2 %	1 %
Lack of protection of property rights	7 %	7 %	7 %
Uncertainty about price fluctuations	7 %	5 %	5 %
Lack of protection of intellectual rights	6 %	2 %	4 %

Table 10 shows that many companies still consider the CEEC market economies to be underdeveloped, with a lack of clear legislation. Furthermore political instability and the unstable currencies are important risk factors. This is consistent with the findings of Genco, Taurelli and Viezolli (1993) covering 83 companies. They found that the main risk factors relate to the weakness of the legislative framework, with the strictly economic problems only coming second.

Job killers

We next want to investigate whether economic integration potentially kills jobs in the West. We therefore estimate a labour demand function that we augment with indicators of increased foreign competition. To focus our attention, the equation we seek to estimate is an augmented labour demand function as follows,

$$\ln n_{it} = \alpha_0 + \alpha_1 \ln y_{it} + \alpha_2 \ln w_{it} + \beta globalization + \varepsilon_{it} \qquad (1)$$

where y stands for output, n stands for employment, w for the wage cost of the firm, subscript i and t stands for firm i at time t, globalization represents the controls for increased foreign competition. We constructed three dummy variables, a dummy equal to 1 if there was an increase in foreign competition originating from CEECs, *fcco*, a dummy equal to 1 if the increase in foreign competition came from South East Asia, *fczoa*, and a dummy equal to 1 if increased foreign competition came from other Western Countries, *fcw*. We also included a proxy for market structure, measured by a dummy equal to 1, *comp*, if the manager responded that his firm faced more than 5 competitors in its main product market. Finally ε stands for the error term. Since we are using panel data it is possible to take into account firm heterogeneity. The error term in equation (1) is therefore assumed to satisfy the following assumptions,

$$\varepsilon_{it} = \mu_i + \vartheta_{it} \tag{2}$$

with

$$E(\vartheta^2_{it}) = \sigma^2_{\vartheta}$$
$$E(\mu_i^2) = \sigma^2_{\mu}$$
$$E(\mu_{it}\mu_{sj}) = 0$$
$$E(\mu_i v_j) = 0$$

Thus we model firm heterogeneity by an unobservable firm specific random effect, μ, and equation (1) can be estimated using general least squares (Greene, 1990, pp.470-71).

Table 11 shows the results. First, in all specifications it can be seen that the labor demand elasticity with respect to wages is high and statistically significant, as we would expect in a labor demand equation.

Table 11: GLS Results, dependent variable: ln(L)

	(1)	**(2)**	**(3) lowly skilled**	**(4) highly skilled**
ln(w)	-0.63*	-0.55*	-0.40*	-0.36*
	(0.041)	(0.049)	(0.07)	(0.07)
ln(Q)	0.48*	0.25*	0.52*	0.44*
	(0.019)	(0.03)	(0.07)	(0.06)
Comp	0.09	0.14	-0.07	-0.16
	(0.16)	(0.18)	(0.27)	(0.23)
Fcco	0.56*	-6.38*	-4.78*	-2.16*
	(0.26)	(0.96)	(1.57)	(1.50)
Fczoa	0.55*	-2.47*	1.53	-0.52
	(0.23)	(0.90)	(1.42)	(1.45)
Fcw	0.29*	-3.35*	0.41	-1.22
	(0.17)	(0.54)	(1.08)	(1.09)
Technology	0.57*	0.022	0.33	0.21
	(0.15)	(0.42)	(0.58)	(0.51)

FccoXln(Q)		0.52*	0.38*	0.21*
		(0.066)	(0.11)	(0.10)
FczoaXln(Q)		0.23*	-0.055	0.08
		(0.064)	(0.10)	(0.10)
FcwXln(Q)		0.27*	-0.03	0.09
		(0.039)	(0.08)	(0.07)
University	-	-0.005	-0.022*	0.15*
		(0.04)	(0.007)	(0.006)
UnivXtechnology	-	0.029*	0.010	0.035*
		(0.012)	(0.016)	(0.014)
FccoXtechnology	-	-0.64	-0.63	-1.10**
		(0.58)	(0.78)	(0.67)
FczoaXtechnology	-	0.15	-0.10	-0.85
		(0.54)	(0.73)	(0.64)
FcwXtechnology	-	0.21	0.14	-0.17
		(0.44)	(0.61)	(0.54)
Year dummies	yes	yes	yes	yes
Number of Observations	916	916	583	651
Global R2	0.7	0.7	0.62	0.68

Note: standard errors between brackets, * means statistical significant on the 5% reslevel.

In the first column it can be noted that the effect of increased foreign competition on the demand for labor is positive, irrespective from where the increased competition has originated. We also included a variable to control for technological innovations the firm had undertaken. From the cross-tabulations it was clear that many firms responded to increased foreign competition by modernizing their production process. We therefore included a dummy equal to 1 if the firm introduced new technology (*technology*). The effect in column (1) shows that technological innovations generate a positive effect on labor. In the second column we tested whether small firms experience globalization differently than large firms. This is not unreasonable since large firms typically have more market power and hence increased foreign competition might erode this market power of the firms without causing exit or layoffs. In contrast small firms often operate at the margin and so increased foreign competition might force them out of the market. We had our indicators of globalization interacted with the log output of the firm. A number of interesting results emerge. First, the direct effect of foreign competition is negative and strongest for foreign competition from CEECs. However, this negative effect disappears for larger firms, which can be seen from the interaction terms (fccoXln(Q); fczoaXln(Q); fcwXln(Q)). We further tested whether technological innovations were especially beneficial for firms with more highly skilled people. We therefore had technological innovations interacted with the percentage of workers holding a university degree in the firm (*university*). It can be seen that the direct effect of technological innovations disappears, but the interaction effect is positive and significant. In other words, only firms with highly skilled labor benefit from technological innovations. At the same time this result throws into doubt the commonly held argument that technological progress is bad for lowly skilled people. We also tested whether the effect of foreign competition was different in firms that introduced new technology. This was done by relating the technology variable to the indicators of foreign competition. None of these interactions were statistically significant. Finally, we tested in columns (3) and (4) whether foreign competition affects lowly skilled people in a way different from the way it affects highly skilled people. This is important because the unemployment problem in Europe refers especially to the lowly skilled workers and the integration with CEECs could threaten especially this category of workers. In the first two columns we did not make this distinction and we just used as a dependent variable the log number of employees. We measure in column (3) lowly skilled workers by the number of blue collar workers in the firm, highly skilled workers are proxied by the number of white collar workers.

We find that only the effect of increased foreign competition that stems from CEECs has an effect on the demand for blue and white collar workers. Moreover, the direct effect is negative and almost twice as large with blue collar workers compared to white collar workers. The effect vanishes however the larger the firm is. Nevertheless, this result suggests that the effects of increased foreign competition are larger for lowly skilled workers than for highly skilled. They are negative for workers in small firms, but positive for workers in big firms.

V. Conclusion

In section I we learned that the European Council, though accepting the principle of enlargement, made CEEC accession dependent on their preliminary adoption of the Internal Market law. The Europe Agreements were a missed opportunity to create strong trade links with the CEECs because fear dominated EU strategy vis-à-vis the CEECs. Fear for a significant growth in imports, fear for loss of jobs, fear for firms moving abroad , fear for the financial burden, fear for pressure groups, fear for Member States protectionism, fear for not being ready to welcome new Member States. This is the more amazing as we found out in section II that although in the nineties imports from CEECs have increased, the EU has become a net exporter to these countries and almost the entire CEEC imports and exports are of EU origin. Therefore they are much more dependent on the EU than vice versa. Abolition of antidumping and other trade restricting measures like rules of origin and mandatory standards and specifications would positively influence trade. In case of unfair trade practices the EU should extend its own competition and state aids legislation to CEECs.

In section III we learned that increased foreign competition for EU firms came predominantly from other Western countries. High labor costs seemed to be an important factor explaining increased foreign competition. Only in a limited number of cases EU firms moved their production facilities abroad. We also found out that CEEC competition did kill EU lowly skilled jobs but only in a limited number of (small) firms. Technological progress, which was a typical response in firms subject to increased foreign competition, was of benefit to the highly skilled workers only.

In order to appease current Member States and pressure groups arguing the need for protectionism against so-called unfair CEEC competition, the EU has opted for a conservative strategy. It tries to keep CEEC products out of its markets when they are thought to injure Community industries and it does not want to accord CEEC workers free access to its labour market. Based on the findings in this paper we firmly believe that a better strategy for the future would be for the EU to brace itself for its enlargement with CEECs. This would entail encouraging the modernization process, especially in its small enterprises and by offering more educational opportunities to its lowly skilled workers. Rather than to protect its large industries against what it calls unfair competition from CEECs. A better remedy would be to strengthen the competitive basis in current Member States so as to enable them sustaining the competition from CEECs in case of full free trade. There is no doubt that in the short run EU consumers would benefit from this new approach while in the long run a deeper integration between the EU and the CEECs will turn out to be mutually beneficial for all the social partners in both countries.

References

Baldwin, R.E. (1995) ‘The Eastern Enlargement of the European Union’. *European Economic Review*, vol. 39, pp. 474-481.

Baldwin, R.E., François J.F. and Portes, R. (1997) ‘The Costs and Benefits of Eastern Enlargement: the Impact on the EU and Central Europe’. *Economic Policy*, April, pp. 127-177.

Bayliss, B.T. and El-Agraa, A.M. (1990) ‘Competition and Industrial Policies with Emphasis on Competition Policy’. In A.M. El-Agraa (ed.), *Economics of the European Community* (New York: Philip Allan), pp. 137-155.

Bos, M. and van Merrienboer, E. (1996) ‘De Uitbreiding van de EU in Oostelijke Richting: een Dynamisch Perspectief’. *Tijdschrift voor Politieke Economie*, vol. 19, nr. 1, pp. 87-107.

Commission of the European Communities (1997) *Agenda 2000* (Luxemburg: Office for Official Publications of the European Communities).

Center for Economic Policy Research (1992) *The Association Process: making it work. Central Europe and the European Community* (London: CEPR).

Faini, R. (1995) ‘Migration in the integrated EU’. In R.E. Baldwin, P. Haaparanta and J. Kiander (eds.), *Expanding Membership of the European Union* (Cambridge: Cambridge University Press).

Fischler, F. (1997) ‘Ein Neues Konzept für die Zukunft der Europäischen Landwirtschaft’. *Wirtschaftsdienst*, vol. 77, nr. 9, pp. 495-504.

Franke, S.F. (1997) 'Europa vom Atlantik bis zum Ural: Vision, Illusion oder Absehbare Realität?'. W*irtschaftsdienst*, vol. 77, nr. 10, pp. 573-579.

Gleske, L. (1994) 'The Integration of Former Eastern Bloc Countries into Europe'. In A. Bakker e.a. (eds.), *Monetary Stability through International Corporation. Essays in Honour of André Szasz* (Dordrecht: Kluwer), pp. 201-212.

Henderson, K. and Robinson, N. (1997) *Post-Communist Policies. An introduction* (London: Prentice Hall).

Inotai, A. (1996) 'From Association Agreements to Full Membership? The dynamics of Relations between the Central and East European Countries and the European Union'. *Russian and East European Finance and Trade*, vol. 32, nr. 6, pp. 6-29.

Inotai, A. (1997) 'Warum ist die EU-Osterweiterung Neuartig?'. *Europäische Rundschau*, vol. 25, nr. 3, pp. 37-49.

Kemp, J. (1994) 'The Competition Policy of the European Union'. In F. McDonald and S. Dearden (eds.) *European Economic Integration* (London and New York: Longman), pp. 90-115.

Konings, J. and Vandenbussche, H. (1998) 'Globalization, the Effects of National vs International Competition on the Labour Market. Theory and Evidence Belgian Firm Level Data' in *Conference on Competition Policy and International Trade* (Brussels: European Institute for Advanced Studies in Management).

Leipold, H. (1995) 'The Eastward Enlargement of the European Union: Opportunities and Obstacles'. *Aussenpolitik*, nr. 2, pp. 126-133.

Lenaerts, K. (1997) *EC anti-dumping measures with respect to goods originating in Central and Eastern European countries: legal framework/rights of defence/role of the courts* (Brussels: Seminar on Trade Defence Instruments).

Lloyd, P. (1998). ‘Trade and Competition Policy’, in *Conference on Competition Policy and International Trade* (Brussels: European Institute for Advanced Studies in Management).

Mayhew, A. (1998) *Recreating Europe. The European Union’s Policy towards Central and Eastern Europe* (Cambridge: Cambridge University Press).

Marks, A. and Techen, S. (1997) ‘EU-Osterweiterung: Agrarmarkt als Hindernis’. *Blätter für Deutsche und Internationale Politik*, nr. 9, sept., pp. 1134-1138.

Nötzold, J. (1994) ‘Wann werden die Staaten Ostmitteleuropas Mitglieder der EU?’. *Europäische Rundschau*, vol. 22, nr. 4, pp. 53-65.

Nuti, D.M. (1996) ‘European Community Response to the Transition: Aid, Trade Access, Enlargement’. *Economics of Transition*, vol. 4, nr. 2, pp. 503-511.

Steinherr, A. (1995) ‘The Pivotal Role of the European Union for Central and Eastern Europe’. *Swiss Journal of Economics and Statistics*, vol. 131, nr. 3, pp. 303-327.

van Brabant, J.M. (1996) ‘Bonding the EU and the Transition Economies’. *MOCT-MOST: Economic Policy in Transitional Economies*, vol. 6, nr. 4, pp. 31-53.