

Chapter 9

European Enlargement and Transition from Plan to Market

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Eight new member states¹ (the “Eight”) of the European Union transformed their centrally planned economies into market economies during the last decade. They created the necessary basic infrastructure of a market economy. This creation was accompanied by destruction in different fields. The trade reorientation from Comecon to the EU disrupted established business contacts. Production and network capacities were scrapped. New capacities and business relations were required. These countries successfully and quickly reoriented their trade. The Eight used their resulting trade structure, which is similar to that of the old member states, as a first proxy for their readiness for economic and monetary integration.

State owned enterprises were privatized, and new private and foreign owned firms entered the corporate scene, shifting the share of output from state owned to private firms. This transition was accompanied by a major fall in output in all eight states—a phenomenon János Kornai has described as transformational recession.² These countries have recovered from this recession and their income level is now far above that of late 1980s and early 1990s.

Transformational recession and the subsequent recovery changed the structure of these economies considerably, with major consequences for each nation’s society. Labor markets underwent deep restructuring: professions, occupations and age cohorts were dramatically affected. Regional development was rather uneven, mostly determined by the location decisions of foreign investment enterprises. Technology changes followed the requirements of the

¹ Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

² See J. Kornai, “Transformational Recession: The Main Causes,” *Journal of Comparative Economics* 19(1) 39-63 (1994).

new market orientation and were influenced by the destruction of old capacities and the creation of new ones by foreign direct investments.

Two important questions arise. Are these structural changes temporary, that is, specific to the transformational recession and the following recovery, or are they likely to be sustained over the long term? Second, what impact will these structural changes have on the catching-up process? This paper seeks to answer these questions in order to understand how the Eight will participate in the Lisbon process.

Papers dealing with similar issues start with the presentation of the income gap. Assessments of the income gap's role on integration are rather mixed. Some say that it is a new engine for future integration as larger and more heterogeneous markets lead to more efficient allocation of resources. This view is based on the dominant role of access to new markets and resources, which may compensate for the marginal economic size of the Eight within the EU. Others claim that much poorer countries are not able to contribute to the enhancement of integration, because trade and capital transactions flow mainly between developed countries and the future weight of the Eight remains rather small. This view seems to underestimate the past and the expected speed of catching-up.

There is also a widely shared view that the Eight will divert EU funds and FDI from poorer countries of the EU15, and that rivalry between these two groups of countries could undermine the functioning of the EU. Other strong voices argue that the monetary integration of these countries is not even beneficial for themselves, because it will eliminate their most important shock absorbers—an independent monetary policy, the exchange rate and their own currency.

This paper does not try to answer these issues definitively, but rather to present a few special features of these countries that will affect their future development within the EU.

Catching Up

In 2003 the Economic Policy Committee of the European Commission published a report on the key structural challenges in the acceding countries.³ The main conclusion of this assessment was that the challenges facing acceding countries were not fundamentally different than those facing the old member states. Consequently, the major lines of reforms and the means by which to assess them should not be different for old or new member states.

There is a certain degree of optimism in these conclusions. It is obvious that this round of enlargement was significantly different than previous ones, as a large number of much poorer countries entered the EU. But even though some institutional changes have been introduced, this enlargement should not lead to the creation of specialized institutions dealing with the Eight within the European Commission or other EU institutions.

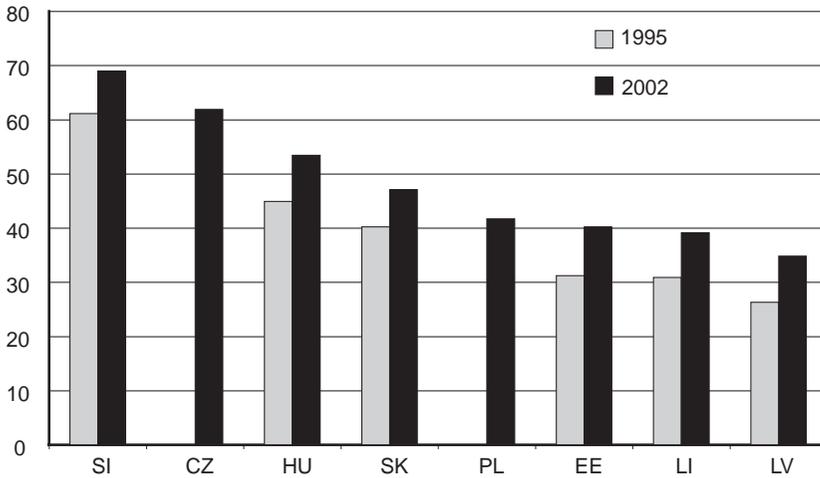
The income level of the Eight varied between 1/3 and 2/3 of the EU15 in 2002 (See **Figure 1**). It is worth noting that this level was achieved after a very quick catch-up process between 1995 and 2002, which closed the income gap by about 10 percentage points.

More or less the same relative development may be measured by looking at labor productivity (See **Figure 2**). The catch-up rate is the same as in the case of national income.

The catch-up rate depends on different factors. These are related to the nature of structural reforms, as well as how a country is able to introduce measures to ensure that the economy becomes more competitive and more capable of responding to present and future challenges from inside and outside the country. Competitiveness is to be understood in a wide sense; it is determined by the interaction between the corporate sector, labor markets, households supported by welfare, education and government administration systems.

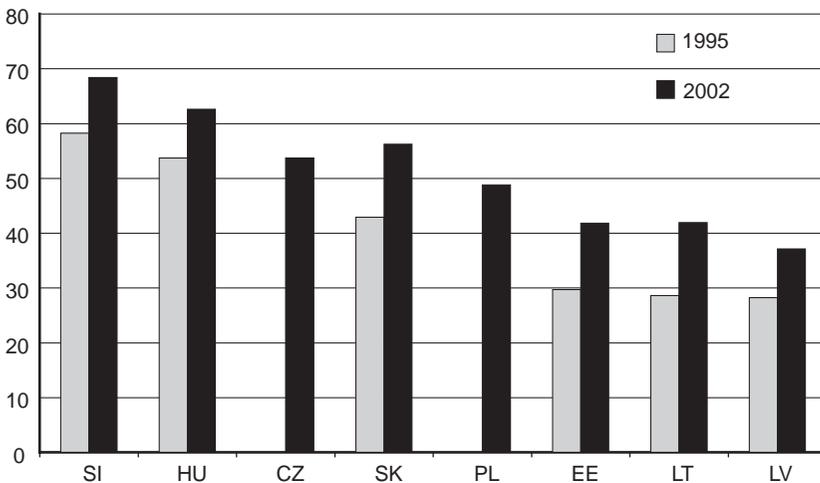
³ *Key structural challenges in the acceding countries: The integration of the acceding countries into the Community's economic policy co-ordination process*, European Commission, Economic Policy Committee, *European Economy*, Occasional Papers No. 4 (2003).

Figure 1. GDP per capita at PPP (EU=100)



Source: J. Gács, A. Havas and P. Valentiny, "A Lisszaboni Folyamatba történő magyar bekapcsolódás lehetőségei, különös hangsúllyal a versenyképesség javítása, az IT, az innováció és oktatás, a teljes foglalkoztatottság és társadalmi kohézió területén (The Lisbon Process and Hungary. Competitiveness, IT, innovation, education employment and social cohesion), IEHAS Budapest (in Hungarian, 2004).

Figure 2. Labour productivity (EU=100)



Source: Gács et al (2004).

Labor markets deserve special attention. Employment and its restructuring have short and long term effects on welfare and competitiveness. Different policies affect employment and their design should take into account its special features during the catch-up process.

Less developed countries may leapfrog their more developed partners if the replacement of old with new technologies implies huge social costs. The larger the stock of physical and human capital, the higher the replacement costs. This inherent non-linearity of the process is enhanced by the nature of the progress of technology. The analogy is the relative ease with which a building can be erected on a green field, compared to the hurdles involved in replacing an existing building with a new one in the heart of the capital. A more relevant example, perhaps, is the faster dissemination of mobile telephones were disseminated more quickly in the Eight than in some more developed countries, in part because the existing network of fixed telephone lines in the Eight was simply inadequate.

There are other two key fields, however, where the ability of the society as a whole to keep up with the pace of international trends and integration has an impact on the economy's long term development: information-communication technologies (ICT) and innovation, research and development.

ICT introduces new ways and new methods, with far reaching effects for services and leisure as well as for production. Its effect on labor markets is already obvious; non-traditional forms of employment may help solve the highly praised gain in flexibility of employment. The explanation behind these processes is the restructuring of transaction (transportation) costs. In many fields these costs become significantly lower, while in other fields major investments are needed and substantial operating costs emerge.

Needless to say, the role of R&D and innovation is critical. Countries and companies are only likely to catch up in the long term if these activities are part of corporate strategies and policies to support them.

These themes play a central role in the Lisbon Agenda. **Table 1** compares the relative position of the United States and the EU15 according to the so-called Lisbon scores and try to assess the position of the Eight.

Table 1. Lisbon Scores

	U.S.	EU15	The Eight	Best of the Eight
Information society	5.94	5.42	-0.91	0.09
Innovation, R&D	5.99	5.15	-1.27	-0.64
Liberalization	5.06	4.78	-1.27	-0.56
Network industries	6.17	5.30	-0.81	-0.01
Financial services	5.75	5.13	-1.84	-0.44
Business environment	4.40	3.48	-0.44	0.22
Social segregation	4.75	4.85	-1.04	0.06
Sustainable growth	5.72	5.45	-1.28	-0.56

Source: Gács et al (2004).

According to seven criteria (information society; innovation, R&D; liberalization; network industries; financial services; business environment; sustainable growth) the U.S. is ahead of the EU15, while the EU15 is slightly better off than the U.S. in dealing with social segregation. The Eight lag behind the EU15; the closest they come is in the business environment. Neither the EU15 nor the Eight are a homogeneous group of countries, of course, but it is quite interesting that the average score of the best three of the Eight exceeds the EU15 average in three indicators (information society, business environment and coping with social segregation) and is almost the same for network industries.

Labor Markets

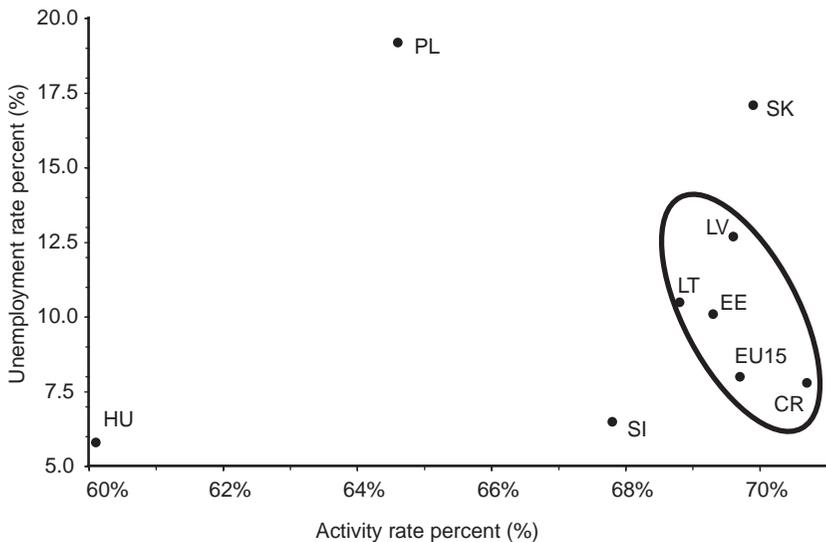
The most obvious impact of transformational recession was massive unemployment generated by the collapse of state-owned firms, mainly in heavy industries. New jobs were created in different industries, services and in different regions. Job creation and job destruction are normal phenomena of a market economy. The intensity of such phenomena, however, differs from country to country, affecting each nation's net position. Even similar intensities may refer to different outcomes. If competition is strong, for example, then high flows may reflect the intensive changes in the corporate sector. If high intensities are mainly due to other incentives (eg.: tax evasion), however, then job security may be quite low.

The most important issue is whether working age unemployed still play a role in the labor market or have already left the labor pool. The most threatened groups are those with low skills, the elderly, minorities, and those living in distressed regions.

A common assumption is that labor mobility clears the market. It is supposed that whenever there is excess demand, wages rise and supply responds or—vice versa—excess supply is eliminated by lower wages. Extending basic models to account for wage rigidities and labor market institutions renders the adjustment mechanism a bit more realistic and plausible for policy design. The adjustment mechanism is costly: searching for new jobs or for new employees is expensive and mobility requires effort. Mobility costs consist of different components, such as transportation costs associated with periodic migration, as well as housing costs and other social costs associated with the concept of mobility itself.

The Eight differ from one another in their present level of unemployment and activity rates. There are two extreme cases: high activity rate with high unemployment associated with high intensity of job search; and low activity with low unemployment with relatively low job search (See **Figure 3**). Poland and Slovakia are rather close to the former, while Hungary seems to be better described by the latter.⁴ It is important to understand the reasons behind these differences in order to craft effective policies.

Figure 3. Activity and unemployment rates in 2002



⁴ For a review of the Hungarian situation, see K. Fazekas, J. Koltay and Z. Cseres-Gergely, "The Hungarian Labour Market. Review and Analysis," *IEHAS* Budapest (2004).

Countries differ in the composition of their unemployment pool. Analysts share the view that this is as important a feature of the labor market as the unemployment rate itself. If the inflow and the outflow are low then the unemployment tends to concentrate on the same group of people by lengthening their period of unemployment and increasing the probability that some will leave the labor market. Other features, such as age, skill, schooling and region, also determine the duration and frequency of unemployment.

In general, EU labor markets are characterized by rigidity. How do the Eight fare in this respect? The answer consists of two parts. Real wages seem to be more flexible in the Eight than in the EU15, due to much weaker unions and lack of efficient tripartite wage negotiation systems. On the other hand, mobility (commuting or migration) is much lower than in the EU15. The lower mobility can be explained by relatively high transportation costs and by the rather rigid housing market. This situation calls for targeted policies on different levels. The design of such policies, however, requires careful planning, since interventions may modify the markets and create fundamentally different arrangements and outcomes than the starting situation. There are different examples: housing subsidies affect real estate prices and, depending on the structure of these subsidies, may not affect overall mobility but instead modify income distribution in favor of those who can have access to those subsidies and enjoy the benefits of a housing boom.

It seems that fears of international migration are unfounded. High international mobility is characteristic of only a very narrow group of workers. The excess labor supply in the Eight is structurally different than the excess labor demand in the EU15. However, large wage gaps for the same kinds of jobs may modify the propensity to migrate within a particular country and may exert downward pressure on wages of those jobs in the EU15.

Labor should not be separated from other factors of production. It seems that it is much cheaper to move capital to those places where labor is available. International production cost differences (transport and transaction costs included), strategic interactions, proximity of markets and availability of input factors are all major factors in location and relocation decisions. They are very specific to industries and technologies, upstream and downstream connections. International

production, distribution and sales networks are constantly in flux, with continuing effects on labor markets.⁵

Information-Communication Technologies

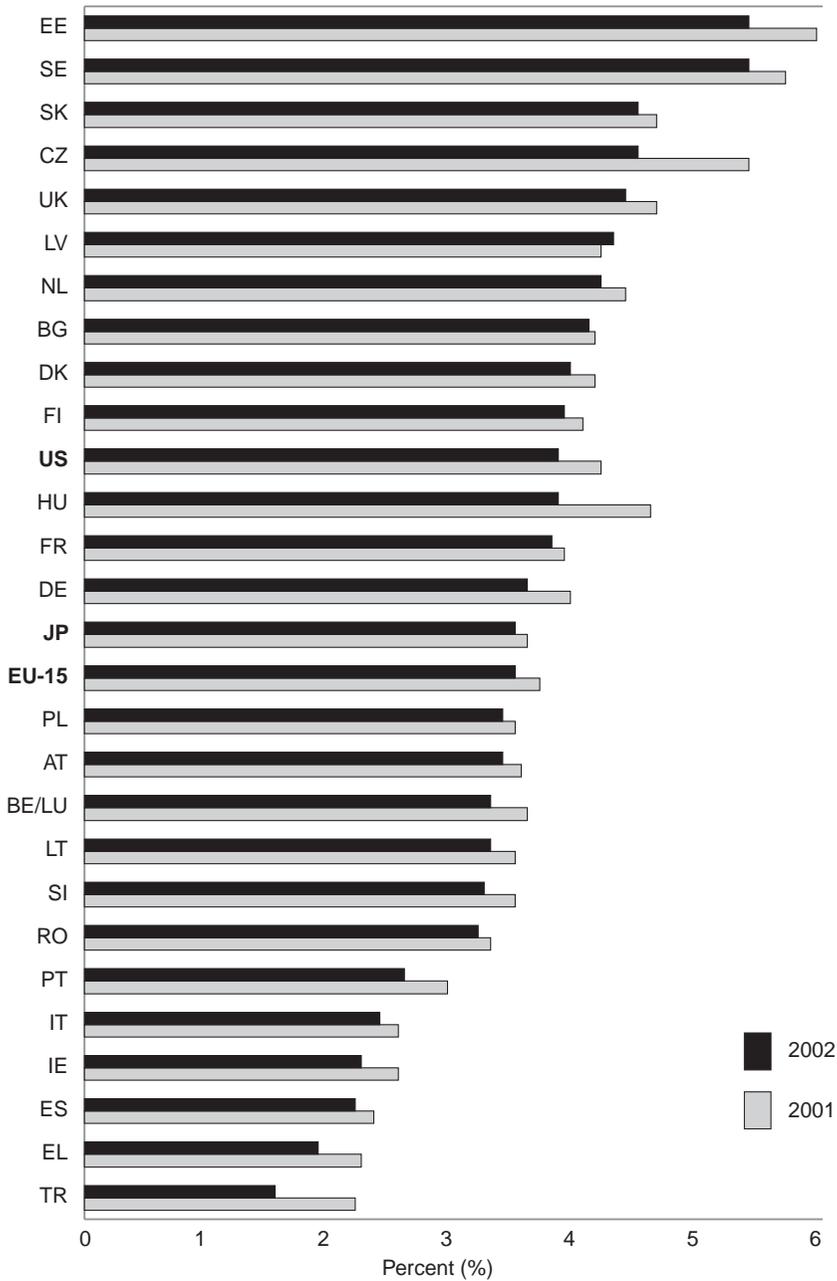
It is generally believed that the recent widening of the productivity gap between the U.S. and the EU is mainly due to ICT. ICT should be examined from two angles—its production and its use. The U.S. gain in producing ICT products is quite explicit and somewhat better than in disseminating ICT either in production or in household applications. **Figure 4** shows how the share of expenditures on ICT was higher in the U.S. than in the EU15 in 2001-2002, and that the gap has even widened further. The expenditure statistics, however, show that quite a few countries spent more on ICT per capita in 2002 than the U.S.: Estonia, Sweden, Slovakia, the Czech Republic, the United Kingdom, Latvia, the Netherlands and Hungary. Expenditure figures, of course, only tell one side of the story—efficient use of those funds is also required if all the benefits of ICT are to be realized.

The user side is illustrated by two measures. First, the index of digital access reveals that leading countries of the Eight are rather close to the EU15, and that the difference between the EU15 and the least developed countries of the Eight is not that big (see **Figure 5**).

The other measure is the share of households with internet. It is obvious that this measure is skewed by income level, since households tend to acquire internet connections if they can afford them; hence it is not obvious how this measure differs from any indicator of income. Anyway it shows much larger difference between the EU15 and most of the Eight, the only exception being Slovenia with a share comparable to the EU15 (see **Figure 6**).

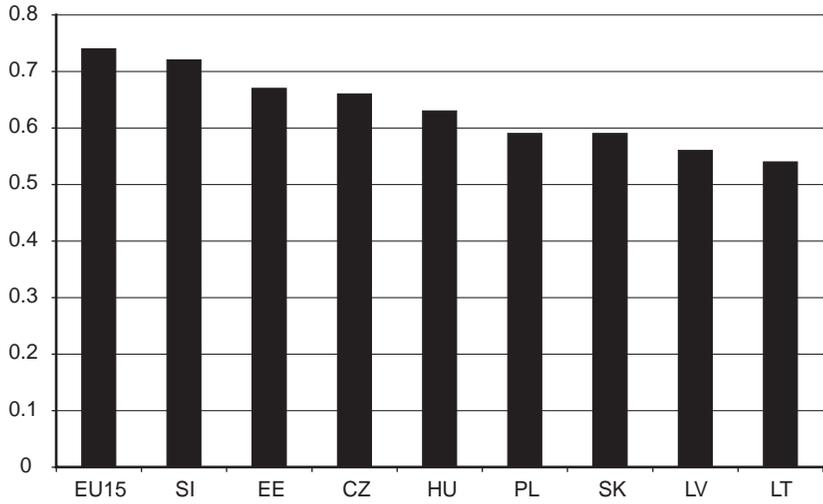
⁵ Other factors may also explain the slow opening-up of labor markets in the EU25, such as the expected pressure on the welfare system in richer countries, which in turn is linked in many ways to labor markets; this paper does not cover these issues.

Figure 4. Expenditures on ICT (% of GDP)



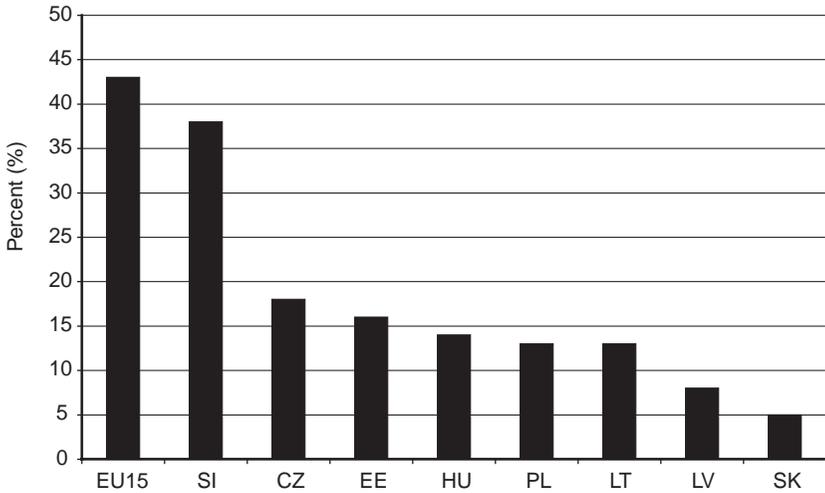
Source: Gács et al (2004).

Figure 5. Index of digital access



Source: *Revue elargissement* No. 58, January 26, 2004.

Figure 6 Share of households with internet

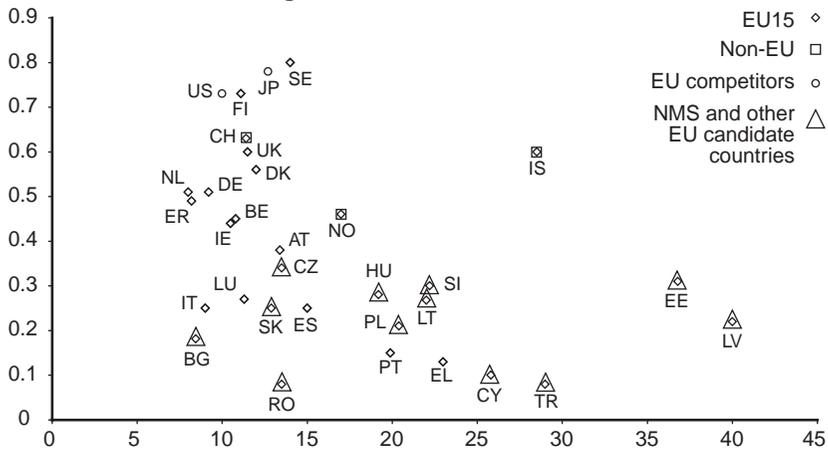


Source: *Revue elargissement* No. 58, January 26, 2004.

R&D and Innovation

The aggregate indicator of innovation indicates that while developed countries perform better, there are exceptions, such as Austria, Italy, Spain, Portugal and Greece (see **Figure 7**). The dynamics reveal that six of the Eight registered dramatic improvements in this indicator—Estonia, Latvia, Slovenia, Lithuania, Poland, and Hungary. Only two EU15 countries—Portugal and Greece—kept pace with this group. If those innovations translate into economic performance through increased competitiveness, then one of the conditions for long term catching-up is met.

Figure 7. Aggregate indicator of innovation (SII2) in 2003 and its change

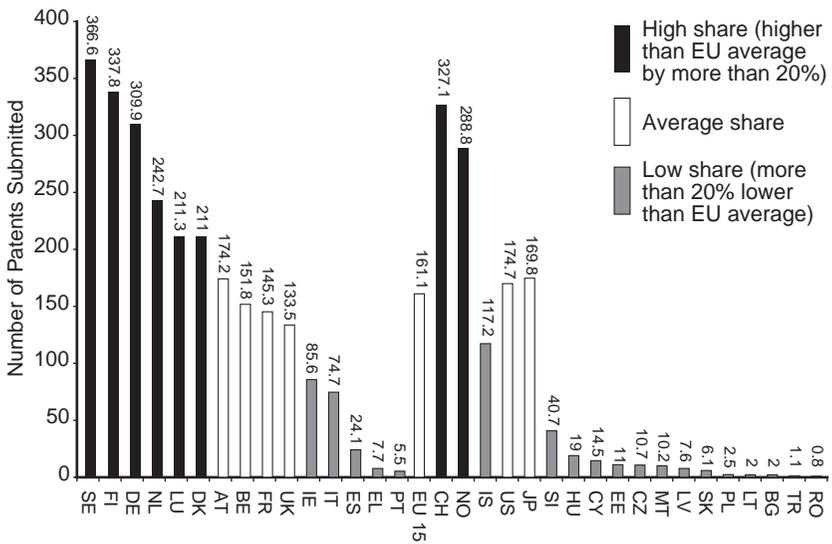


Source: Gács et al (2004).

One output indicator of innovation and R&D is the number of patents. In this respect the gap is quite substantial between the EU15 and the Eight (see **Figure 8**), although Slovenia is ahead of Spain; Hungary Estonia and the Czech Republic are better off than Greece; and Latvia and Slovakia outperform Portugal.

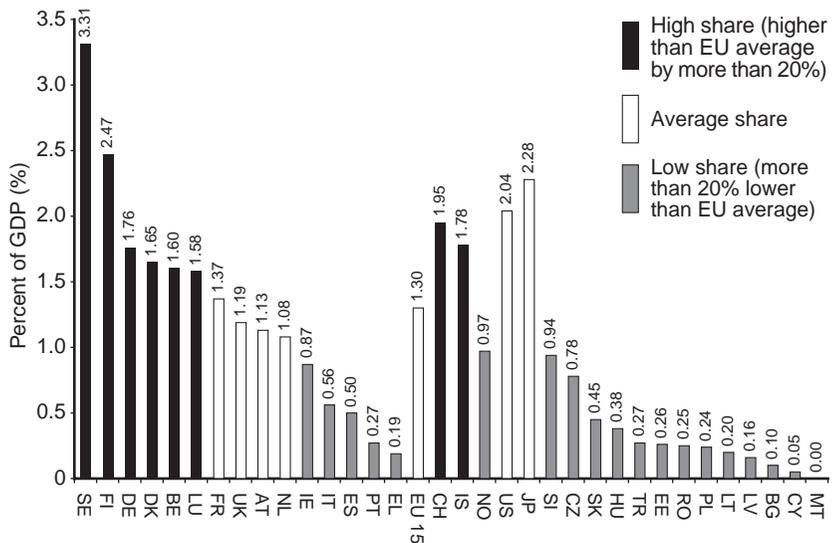
One of the major weaknesses of European R&D is the low share of corporate R&D expenditures; it is only 1.3% for the EU15 to be compared with 2.04% for the U.S. and 2.28% for Japan (see **Figure 9**). Few of the Eight fare very well: Slovenia and the Czech Republic are comparable to Ireland; Slovakia is at par with Italy and Spain; and figures for Hungary, Estonia, Poland, Latvia and Lithuania are quite close to that of Portugal and Greece.

Figure 8. Patents submitted to European Patent Office in 2001 (per million inhabitants)



Source: European Innovation Scoreboard 2003, Technical Paper No 1, Indicators and Definitions, p. 21 (Gács et al, 2004).

Figure 9. Corporate R&D (in percent of GDP)



Source: European Innovation Scoreboard 2003, Technical Paper No 1, Indicators and Definitions, p. 15 (Gács et al, 2004).

R&D and innovation activities are closely related to the strategic decisions of multinational firms, particularly where to locate such activities outside the country of the parent company. These activities require superior human and capital resources. Their composition varies substantially across activities and sectors. The location decisions take account of these features.

The nature of these activities offers a large number of niches for catch-up countries. There are obvious examples of start-ups, where the initial capital was a concept or an excellent idea. An appropriate environment is necessary to ensure that such visions result in corporate success. This environment is still in short supply in many EU countries and in most of the Eight.

Conclusions

The leading countries of the Eight are quite close or even ahead of lower-tier EU15 countries. This analysis indicates that there is considerable potential for the Eight to catch up further, given that they are recording higher growth in many indicators crucial elements of the Lisbon Agenda, such as labor (education), innovation and ICT.

The ambitious targets of the Lisbon Agenda can only be met if policies support them. Policies should ensure a more flexible labor market with due respect to the overall welfare system. A few of the Eight have already progressed in their efforts to reform their welfare systems by increasing the role of the fully funded pillar of the pension system, or by introducing some elements of co-financing into health care.

Among the Eight the business environment needs further support, the financial fragility of small and medium-sized enterprises requires serious attention, and there is a need for private venture capital. It is widely misunderstood that this capital should be provided by government agencies or the EU. Governments and EU institutions can help to regulate such capital; make the early phase of start-ups easier; reduce entry costs and remove entry barriers erected by incumbent firms sometimes in monopolistic position—but the private economy must drive the process.

The Eight are lagging behind in their infrastructure and social capital. They appeal for help from different sources. Here again EU

funds will help, but learning from the experience of other catch-up countries is indispensable. It is important that elites within the Eight familiarize themselves with best practices and learn how to avoid traps common to this phase of economic and social development. Corruption is the number one public enemy in the Eight, because the petty corruption of communism—which was sometimes the survival technique—has rendered the public less sensitive to large scale corruption. Different forms of corruption have even survived. Taxes and public expenditures are not associated with each other, for example, and consequently tax evasion is perceived differently than other types of economic crimes.

The Eight tend to reveal a dual character. While some regions and social classes are enjoying the benefits of EU integration and economic growth, others are somehow not able to grasp these opportunities. The welfare system may ease the resulting tensions, but this is not a long term solution. Targeted education programs and regional development policies may offer a way to tackle the dangers of social exclusion and segregation. They are easy to write about, but much more difficult to implement.