CHAPTER ELEVEN

European Labor Markets: The Eastern Dimension

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THE END OF the cold war and the sweeping political and economic changes in central and eastern Europe have fundamentally changed the relationship of the European Community (EC) to its international neighbors.[1] One economic segment of the EC that has been sensitive to these events and is likely to remain so is the labor market.

The severe political and economic disturbances in the reforming central and eastern Europe countries are having immediate and profound effects on their domestic labor markets. These changes are likely to exert additional supply pressures on the European labor market, especially as the prospects of eventual enlargement of the European Community to include its eastern neighbors come closer to reality. The overall outlook for the EC need not be gloomy, however. It is possible that access to a new source of relatively well educated and highly skilled labor can lead to higher productivity and a higher GDP for EC member countries.

This chapter is organized as follows. The first section puts post-1989 east-west European integration into perspective. The next section begins the analysis of central and eastern European labor markets by concentrating on the effects of the economic reforms. The following section examines the consequences of changes in the labor markets in central and eastern Europe for EC labor markets.

East-West Integration

Europe has once again become a focus of intense economic and political reshuffling. Major developments in the region are characterized not only

1. The present analysis considers the formerly socialist economies of central and eastern Europe, exclusive of the former Soviet Union and its former republics.

by the formation of a new economic superpower, the European Community in western Europe, but also by profound economic reforms and increasing political instability in the eastern half of the continent.

The European Community cannot be indifferent to the intense economic and political turmoil in central and eastern Europe; not only are the regions economically interdependent, but political and security issues are also involved. Although the European Community itself is still undergoing consolidation (it would have been easier had the revolutions of 1989 happened after the integration of 1992), its main political challenge as regards the East is to take the lead in the construction of a greater democratic Europe. The EC and the United States have opportunities in and responsibilities for the liberalization of the central and eastern European countries. The EC in particular cannot isolate itself from the macroeconomic effects resulting from the changing trade patterns and industrial structure in central and eastern Europe.[2]

The EC must be concerned with two matters regarding the reforms of these economies. The first is to secure the irreversibility of the process of transformation into market-oriented economies and pluralistic democracies. The second is to sustain and nurture these reforms. As many observers have recognized, the transformation of central and eastern Europe cannot be accomplished painlessly. In fact, decreases in output and employment are occurring in higher proportions than expected. The sharply deteriorating living conditions have created considerable internal political pressures. These troubled economic conditions make it difficult to reach the necessary social consensus for successful reform. Perhaps the aspiration of the peoples of the central and eastern European countries to "return to Europe" is the ultimate force holding the reform process together.

Recently, the EC has entertained requests for accession from Austria, Sweden, Finland, and Switzerland. (It turned down Turkey in 1987, and the applications of Cyprus and Malta are still pending.) It seems clear that the next wave of enlargement, after accommodating the richer countries of the European Free Trade Association (EFTA), will be the accession of the successfully reformed central and eastern European economies. In fact, the EC has set up Association Agreements and has established the European Bank for Reconstruction and Development (EBRD) to foster the transfer of economic resources.

2. According to Portes (1991, p. 31) for example, the EC "cannot afford, politically or economically, to permit failure in the democratic transformation of Eastern Europe."

In 1991 Association agreements were reached with Hungary, Czechoslovakia, and Poland and in 1993 with Bulgaria and Romania. The purpose is to help the new democracies become stable and pluralistic, to assist with their transformation into market economies, and to increase their security. The goal is to prepare the associate member countries to become full EC members by meeting specific targets: achieving pluralistic democracy, meeting the standards of the European Convention on Human Rights, establishing functioning market economies, and acquiring the legislative and administrative capability to implement and enforce the rules and legislation of the European Community.

The Association Agreements are bilateral—they abolish tariffs on most manufactured goods produced and give the associate members full and immediate access to most of the EC markets. However, the sectors in which the central and eastern European countries have the greatest competitive advantage, such as agriculture, textiles, steel, and coal, will be granted full market access only gradually. Conversely, the three new associate members will open up their markets to EC manufactured goods in stages over a period of four to five years.

Besides granting the new associate members concessions on market access, the Association Agreements also deal with such issues as the movement of workers and capital and economic, financial, and cultural cooperation. The extent to which the laws of the associated countries approximate EC law is recognized as a major precondition for their integration into the Community. More generally, establishing a set of legal and market institutions is considered crucial for the actual transition to a market economy. Once established, such institutions would provide for a degree of assurance that these countries' market orientation will become permanent.

The EBRD became operational in April 1991 as a new international institution of the post–cold war period. Conceived not simply as just another international governmental organization that finances development projects, its *raison d'être* is to actively support and oversee the transformation of the central and eastern European and the former Soviet Union economies to market-based democratic societies. Consequently, most EBRD loans are subject to explicit political conditions.

The forty governments involved in setting up the EBRD realized that developments in central and eastern Europe were promising but potentially dangerous; this left the West with some responsibility for security and stability throughout Europe. At the same time the western countries also realized that the central and eastern European labor force is literate

and skilled and that its industry is potentially competitive. Finally, it was understood that political changes could not be sustained if economic dislocations became permanent.

The main focus of EBRD activities is the private sector (only 40 percent of the bank's funds can be used to support the public sector). Thus "using a public sector organization . . . to pursue private sector development while maintaining a high credit rating when lending to risky ventures is the key challenge for the EBRD in the 1990s."[3] An additional task carried out by the EBRD in coordination with the World Bank and the International Monetary Fund (IMF) is to provide assistance in establishing new financial institutions (pension funds, mutual funds, stock exchanges, and so forth). This assistance and advice is an essential part of the aid program because of the limited capacity of the recipient countries to absorb capital. Another concern of the bank is environmental protection and restoration. This is of major importance not only to the central and eastern European countries, but because of industrial restructuring and migration, to their neighbors as well.

Economic Reforms and the Labor Markets

The implementation of economic reforms in central and eastern Europe has left virtually no segment of these economies unchanged. The changes were abrupt and monumental because eastern Europe had no experience with western-style factor markets and only slight experience with product markets (in a context of administratively distorted relative prices). The overview of labor markets that follows is, unfortunately, somewhat scanty because accurate and reliable labor statistics in the central and eastern European countries do not exist.

In the central and eastern European economies the very existence of labor markets was formerly negated on ideological grounds. In the traditional Marxist perspective, labor is not a commodity. Consequently it cannot be exchanged on the market. Everyone is free to work and has a right to do so. Firms (mostly large state-owned enterprises) cannot lay off workers except in disciplinary cases; as a result, there can be no official unemployment.

In practice, of course, there was considerable labor hoarding and hidden unemployment in state-owned enterprises. Before the introduction of economic reforms in Poland, labor hoarding was estimated at a minimum of 20 percent of total employment and possibly as much as one-third.[4] Most workers in central and eastern European countries were employed in the state sector, a typical characteristic of a command economy. In Poland at the end of 1989, for example, 63 percent of the workforce was employed in the state sector.[5]

Another distinctive feature of the labor markets before reforms was the relatively high participation rates of women. Figure 11-1 compares labor force participation rates by gender in central and eastern European countries in the late 1980s to those in selected OECD countries in 1988. The high female labor force participation rates typical of most of the central and eastern European countries were approached only by Sweden and to a lesser extent, the United Kingdom.[6] Particularly striking is Albania, where female labor participation rates actually surpassed male rates.[7]

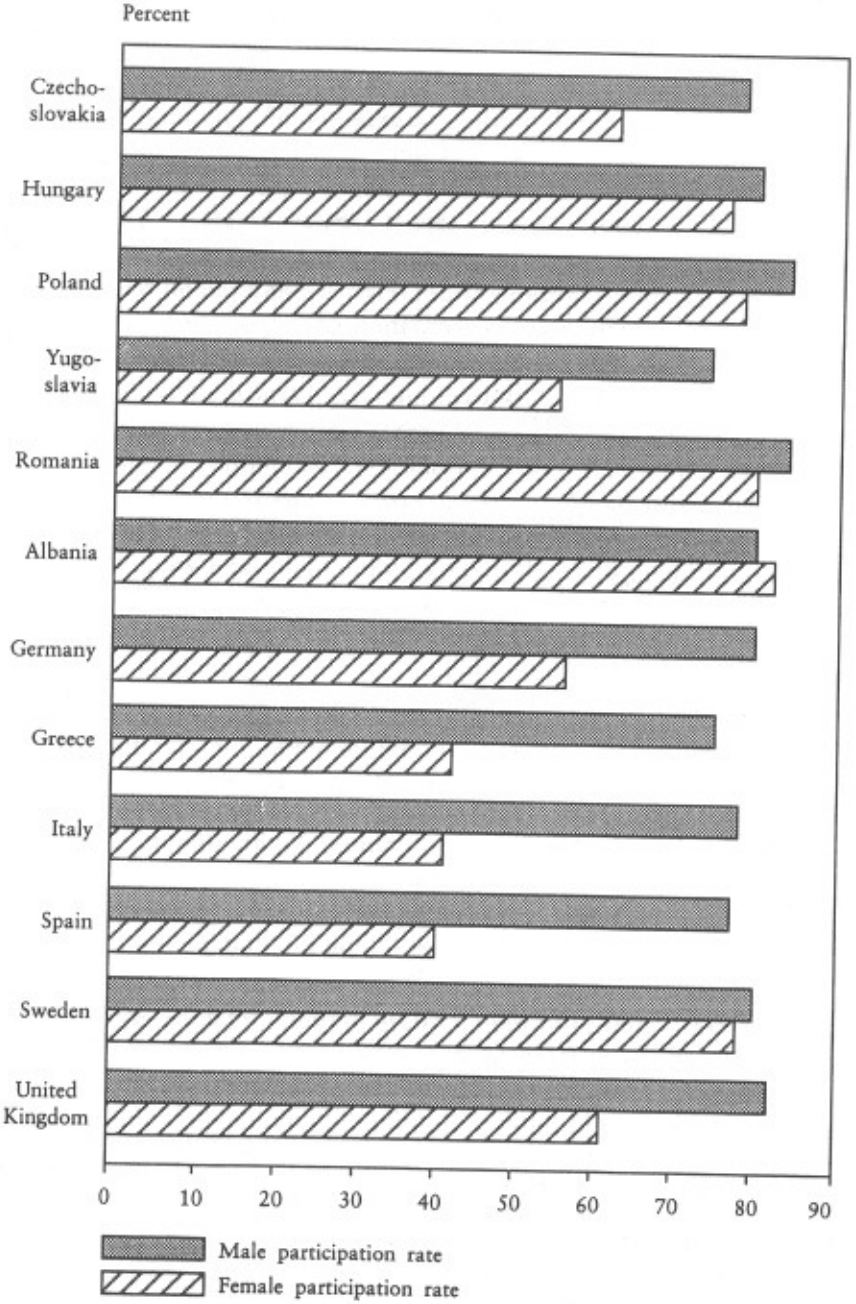
By contrast, female and male average earnings in the late 1980s and early 1990s show no distinctive pattern. Although relative female earnings (as a percentage of male earnings) were higher on average in the EC, there were exceptions to the rule (figure 11-2). In fact, the highest relative female earnings were in the former Yugoslavia, and the lowest in the United Kingdom.

With respect to wage-setting in the centrally planned economies in general, rates were administratively regulated and were not determined in relation to the productivity levels. Wage differentials were relatively narrow, and the costs of labor were very low. Despite experiments with workers' participation in firms' management in the former Yugoslavia, Hungary, and Poland, no effective incentive scheme existed that actually prompted the workers to strive for higher productivity. The rigidities of the labor markets in the socialist economies resulted in tremendous inefficiencies because there was little worker incentive. A primary problem was the absence of a mechanism to close unprofitable firms or to encourage workers to move from relatively unprofitable firms to more profitable ones.[8]

3. Rollo (1991, p. 2).

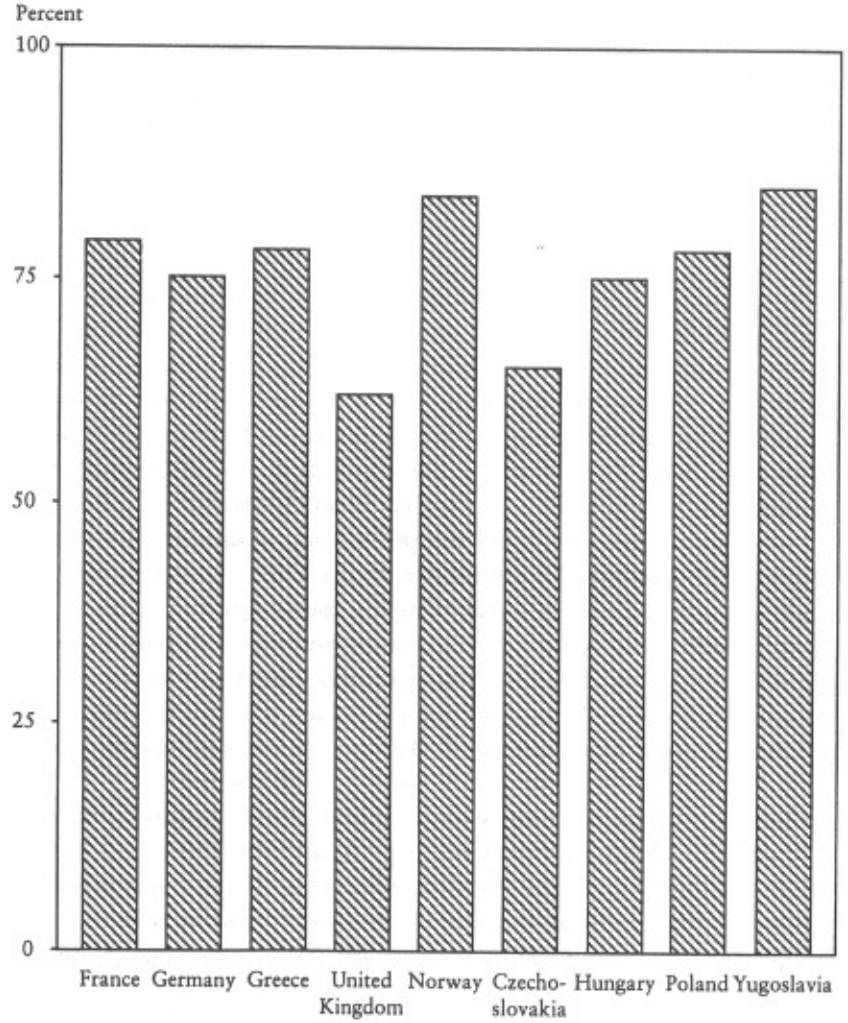
4. Gora (1991, p. 151).
5. Gora (1991, p. 154).
6. Norway and Finland had rates that were similar to Sweden.
7. This is also true of Bulgaria, not shown here.
8. According to Vodopivec (1990), the system led to inefficient labor allocation, suppressed work incentives, and inherent wage drift. At the root of this syndrome was the lack of appropriate mechanisms to enforce the exit of firms or workers, resulting in massive employment subsidization.

Figure 11-1. *Labor Force Participation Rates in Europe, by Gender, Late 1980s*



Source: Fong and Paul (1992, p. 2).

Figure 11-2. *Relative Female Average Earnings, Selected European Countries, Late 1980s*



Source: Fong and Paul (1992, figure 1).

Labor market developments in central and eastern Europe have been influenced not only by the evolution of product and factor markets but by changes in macroeconomic policy. In fact, economic reforms started with macroeconomic stabilization measures, a prominent part of which was the anti-inflation program that produced significant labor market effects. In part because of this program and in part because of three other

Table 11-1. *Annual Percentage Change in GDP, Selected Eastern European Countries, 1989–91*

Country	1989–90	1990–91
Bulgaria	−13.6	−15.0
Czechoslovakia	−1.0	−16.0
Hungary	−4.0	−8.0
Poland	−11.6	−8.0
Romania	−7.9	−13.7

Sources: PlanEcon, Inc., *PlanEcon Report*, vol. 7 (October 10, 1991), p. 2; vol. 7 (November 8, 1991), p. 2; vol. 7 (December 30, 1991), p. 2; vol. 8 (February 28, 1992), p. 3; vol. 8 (November 13, 1992), p. 2.

external factors, all the reforming economies experienced severe decreases in GDP and substantial decreases in wages. The three other factors were the dissolution of CMEA (the Council for Mutual Economic Assistance—the eastern European bloc); the rise in oil prices following the Gulf War; and the changed position of the East German market after unification with West Germany. The dissolution of CMEA meant that trading had to occur with hard currency at world prices; it also led to an oil supply shock after the USSR stopped subsidized sales of oil to eastern Europe. The diminished supplies and higher prices of oil following the Gulf War affected eastern Europe's highly energy-intensive industry and contributed to the decrease in GDP. East Germany, for its part, had been the major exporter of high-technology engineering products and chemicals within the CMEA as well as a significant importer of central and eastern European consumer goods. Unification substantially reduced its high-technology exports to central and eastern Europe.

Table 11-1 provides some details of the recession in eastern Europe. The smallest decline in output was registered in Hungary—8 percent in 1990–91, following a 4 percent decline in 1989–90. (By contrast, the EC was enjoying growth of more than 2 percent during the same period.) The economic indicators in the second year of the "big bang" in Poland showed a decline in output of 8 to 10 percent following a decline of almost 12 percent in 1989–90. In Bulgaria the official figures reported a 15 percent drop in GDP in 1990–91, and in Czechoslovakia the decline accelerated from 1 percent in 1989–90 to 16 percent in 1990–91. The Romanian GDP decrease of 7.9 percent in 1990–91 intensified in 1991 to 13.7 percent. It is projected to decline another 15 percent in 1992.

In spite of the limited reliability of the data compiled for the central and eastern European economies there is ample evidence of large reductions in output. With the reductions these economies began to experience open unemployment, although some suggest that "unemployment did

Table 11-2. *Unemployment Rates in Four Eastern European Countries, by Month, 1990*

Percent

Month	Poland	Czechoslovakia	Hungary	Bulgaria
January	0.30	n.a.	0.60	n.a.
February	0.80	n.a.	n.a.	n.a.
March	1.50	0.07	n.a.	n.a.
April	1.90	0.08	n.a.	n.a.
May	2.40	0.10	n.a.	n.a.
June	3.10	0.14	n.a.	n.a.
July	3.80	0.21	n.a.	0.80
August	4.50	0.30	n.a.	0.80
September	5.00	0.42	n.a.	1.00
October	5.50	0.63	n.a.	1.20
November	5.90	0.74	1.70	1.50
December	6.10	0.85	n.a.	1.60

Sources: Gora (1991, p.157); Hars, Kovari, and Nagy (1991, p.169); Kapl, Sojka, and Tepper (1991, p. 203); Jones (1991, p. 217).
n.a. Not available.

not rise to anything like the levels that would surely have accompanied comparable falls in output in the West."[9] The unemployment rates for the same countries (with the exception of Romania for which no data were available) are shown in table 11-2.

Unemployment rose even more sharply after 1990. Poland's rate reached 10.4 percent in 1991 and more than 12 percent in 1992. In Czechoslovakia it rose from less than 1 percent in 1990 to 7.5 percent by the end of 1991. In Hungary the rate reached 10 percent in 1991. The rate of unemployment in Bulgaria was 8 percent in 1991.[10]

Although the absolute rates of unemployment do not seem very high by U.S. standards, they remain quite worrisome from a social perspective, especially because of continuing labor hoarding and hidden unemployment. Of primary concern is the lack of an adequate safety net or policy for adequately training workers. Labor compensation schemes, unemployment insurance, retraining programs, and so forth are only at the experimental stages, as are other macroeconomic policies that might ameliorate substantial unemployment.

Most of the restructuring and privatization efforts that followed macroeconomic stabilization were aimed at eliminating the inefficiencies in the vastly overgrown state-owned industries. The labor market effects of this economic restructuring have been serious; massive layoffs gener-

9. Standing and Sziracki (1991, p. 138).
10. *PlanEcon Reports* (1992).

ally occurred soon after the introduction of the reforms. Changes in the mix of jobs by skill level and by occupational sector are evident (due in part to new types of firms operating in the market).[11] The resulting high levels of structural unemployment are aggravated by the lack of labor market institutions to facilitate the quick transfer of workers from one employer to another.

The necessity for rapid adjustment poses several major problems related to the search for a feasible regulatory framework in health, workplace safety, and equal opportunity; an institutional structure to provide a social safety net; and a workable mode of wage determination. In all three the influence of the European Community's practices will be very significant. Thus, the Association Agreements provide a model regulatory framework for the central and eastern European countries. Regarding wage determination, the eastern European countries are also likely to emulate the EC model. Because wage rates are relatively low and not determined by the market, aggregate wages will have to increase as a share of all other sources of remuneration, and wage rates will have to be linked more closely to productivity. Wage differentials between sectors and skill levels can be expected to increase when these changes are made. This in turn raises the possibility that new gaps in income distribution will produce new social conflicts.

Specific problems emerge in connection with the institutional structure of labor markets. Labor market institutions and policies in western Europe developed over many years and are better suited to deal with such problems as frictional or cyclical unemployment, which occur in a near full-employment economy. In the central and eastern European countries the adjustments must, of necessity, be rapid. These adjustments are made especially difficult politically because of the possibility of ethnic segmentation if unemployment levels rise unevenly among different nationalities. Finally, the regional imbalances caused by the dismantling of heavy industry and the resulting massive layoffs create additional problems because they are often linked to increased ethnic and social tensions.[12] For example, the closings of obsolete factories in Czechoslovakia where the majority of workers happen to be Slovak is very likely to increase Slovak

11. For example, in Poland between 1980 and 1990, employment growth increased by 50.5 percent in health care and social welfare, by 15.4 percent in finance and insurance, and by 14.2 percent in public administration and justice. However, employment growth decreased by 12.1 percent in manufacturing and mining, by 18.3 percent in forestry, and by 20.6 percent in transport. See Gora (1991, table 1).

12. See Standing and Sziracki (1991).

antagonism toward the Czechs, and this will be amplified by social tensions that always accompany such measures.

One of the most important results of economic restructuring and privatization is the increasing number of small and medium-sized firms (at the expense of huge obsolete conglomerates). In addition, the number of workers in the private sector is increasing relative to those employed in the public sector, although the sharp decline in employment in the public sector so far has outweighed the growth of employment in the private sector.[13] This phenomenon is sometimes referred to as the sliding privatization of employment.

The most immediate consequence of both of these phenomena is the decrease in the overall rate of unionization. Under the old system, trade unions were organized at the national level and organized functionally as an extended form of Communist party rule. With the reforms, the role of trade unions is undergoing significant change, although it is not yet clear whether national general unions will be preserved in some form or whether the tendency toward industrial and crafts unions or company unions will prevail.

The number of trade unions that are independent of political parties is growing. This development has spawned pluralism—and conflict—among the rival union confederations.[14] On the national level, the trend in industrial relations seems to point toward collective bargaining as a new form of cooperative conflict management.

There has been a clear need in central and eastern Europe for a new model of industrial democracy and an institutional structure for settling industrial disputes. New tripartite structures involving government, employers, and trade unions representing employees have emerged in response. For example, in Bulgaria the National Council for the Coordination of Interests was established in 1990 as an independent agent of social change. These new institutions, which are actively involving unions in broader policymaking, are influenced by the European model, and there are strong tendencies to approximate it in the long run.

Successful reform of central and eastern European labor markets will mean increased labor mobility. Before reform, labor mobility was limited, in part because of the employment policies of state-owned enterprises and the shortage of capital and the regional concentrations of required infrastructure relating to housing, health care, education, and

13. Standing and Sziracki (1991, p. 142).

14. For the example of Bulgaria, see Jones (1991, p. 225).

Table 11-3. *Economic Growth, Employment Growth, and Unemployment Rates in the EC, 1985–89*

Percent

Indicator	*1985*	*1986*	*1987*	*1988*	*1989*
GDP growth	2.5	2.6	2.9	3.4	2.8
Employment growth	0.6	0.8	0.9	1.1	0.9
Unemployment rate	11.8	11.9	11.6	11.3	11.0

Source: Belous, Hartley, and McClenahan (1992, p. 118).

training. Voluntary labor mobility, a prerequisite of large-scale labor relocation, requires government policies for social protection and an adequate social safety net.

It is clear that the patterns of labor mobility within central and eastern European countries will involve movement from obsolete state enterprises to newer small and medium-sized private firms. Internationally, however, given the economic and political difficulties at home, these patterns will also entail increasing migratory pressures on the EC labor market.

Can Fortress Europe Isolate Itself?

Although economic activity has been on the rise in the EC, unemployment has not ceased to be a problem. Thus, as table 11-3 shows, GDP growth ranged from 2.5 to 3.4 percent in the latter half of the 1980s, while unemployment rates never fell below 11 percent. Not only are unemployment rates higher than the norm in the EC, there has been a comparatively low rate of employment growth.

It is worth noting that throughout the 1980s, EC labor force participation rates have been relatively low in comparison to both the United States and most of the central and eastern European countries. For example, the labor force participation rate was 65.8 percent in France, 54.7 percent in Spain, 67.2 percent in Germany, and 72.0 percent in the United Kingdom. By comparison, the comparable rate was 76 percent in the United States and Japan, 78.9 percent in Czechoslovakia, 78 percent in Poland, and 79.6 percent in Romania.[15]

Both the regional component and the gender characteristics of the European labor markets are very pronounced (table 11-4). The unemployment rate varied from 8.1 percent in West Germany to 20.5 percent in Spain. The female employment rate also showed considerable regional differences. In Spain only one-third of the female population was employed; in West Germany 62 percent were. Comparing these figures with central and eastern Europe, where female labor participation has traditionally been high, it is reasonable to assume that any significant labor market interaction between the two would lead to increased female participation in the west European labor market as well.

15. For the United States and Japan, see Belous, Hartley, and McClenahan (1992, p. 117). For the EC and central and eastern European countries, see Gelb and Grey (1991, p. 5).

Table 11-4. *Unemployment Rates and Female Employment Rates in the EC, by Country, Second Quarter, 1988*

Country	*Unemployment rate as percentage of labor force*	*Female employment rate*
Belgium	12.3	51.3
West Germany	8.1	51.8
Spain	20.5	37.5
France	10.8	55.8
Ireland	19.2	51.8
Italy	14.0	43.2
Netherlands	11.5	41.1
United Kingdom	10.6	62.0

Source: Belous, Hartley, and McClenahan (1992, p. 118).

Recent research has shown that the elimination of legal barriers to migration among EC countries has yet to produce substantial migratory flows.[16] In fact, the principal pattern of migration has always been from nonmember states to the more affluent EC countries. In fact, it has been estimated that by mid-1992 there were 8 million foreign nationals in the EC member states, 3.5 million of whom were in the labor force, a figure not including illegal immigrants or those seeking political asylum.[17] However, the most significant impact for European labor markets is yet to come, to arise either as the EC is enlarged or if serious, prolonged political and economic trouble persists in the central and eastern European countries.

The most urgent problems for the European labor market started with the fall of the Berlin Wall in 1989 and the economic crisis and transition in central and eastern Europe. The EC's failure to respond adequately and quickly to its first serious foreign policy challenge—in the former Yugoslavia—has greatly aggravated the preexisting problem of a con-

16. Molle and van Mourik (1988); Straubhaar (1988).

17. "Standing Committee on Employment Discusses Migrant Workers," *European Industrial Relations Review*, 221 (June 1992), p. 3.

siderable influx of migrants from central and eastern Europe across its borders. The political instability within the former Yugoslavia escalated into outright war, creating the worst European refugee crisis since World War II.

Given the geographical proximity as well as the historical and cultural ties with all the central and eastern European countries, such shocks are bound to have considerable effects throughout Europe, in particular on the European labor markets. The United Nations High Commission for Refugees has estimated that in July 1992 there were more than 2 million persons displaced because of the fighting in Croatia and Bosnia-Herzegovina. Most had stayed in Croatia, but 425,000 refugees (with the number still increasing) had crossed the borders into western Europe.

Some European countries have shown greater concern for the refugees. Germany has accepted more than 200,000, Austria and Hungary have taken in more than 50,000 each, Sweden nearly 45,000, and Switzerland about 17,500. Public pressure has moved the Luxembourg government to express its willingness to accept more refugees, and Denmark is ready to accept 1,000 more in addition to the 1,600 already there. However, according to the UN commission's list of July 29, 1992, France and Britain had accepted fewer than 1,200 refugees each, Belgium and Finland fewer than 1,000, Spain only 120, and Greece only 7.[18] Substantial burdens have continued to befall Croatia, which is coping with a large and still increasing number of refugees from Bosnia, despite its having suffered widespread destruction during the war on its territory.

With no stable political settlement in sight and with no homes to return to, many temporary political refugees will seek asylum and try to find jobs. Experience has shown that not all rejected asylum-seekers leave western Europe, even if they are not granted asylum. Some are officially tolerated for humanitarian reasons. Between 1983 and 1990, out of the 1.6 million asylum-seekers registered in western Europe, 640,000, or 40 percent, fell into this combined category of recognized or tolerated refugees.[19]

These statistics (as well as the data on unemployment rates and the slow growth of employment in the EC) suggest that the costs of the false belief in a Fortress Europe are likely to be very high. The all-permeating labor markets on the continent of Europe, which are very sensitive and are the first to register major shocks in an economy, will act as a conductor transmitting shocks from one area into another. The awareness of such delicate interdependence places even greater responsibility on future policymaking in the EC.

18. Kinzer (1992, p. A4).
19. Bohning (1991, p. 447).

Conclusion

The implementation of economic reforms in central and eastern Europe led initially to declines in real GDP and rapid increases in unemployment. Fortunately, labor market restructuring and privatization efforts aimed at eliminating inefficiencies and encouraging growth are well under way. A number of needs must be met if these adjustments are to be successful. Foremost among them are coherent health and workplace safety regulations, a regulatory structure that guarantees equal opportunity, and an institutional structure that offers a social safety net.

The reforms in central and eastern Europe pose important questions for the European Community. The EC has, to this point, failed to respond to the challenge resulting from the refugee problem created by the war in the former Yugoslavia. It is essential that the EC develop a coherent plan to deal with this and related labor migration issues in the future. There are risks for the EC if the additional labor supply exerts downward pressure on an unsteady economy, but there is a prospect of benefits as well given the numbers of relatively well educated and highly skilled workers in the labor pools of the central and eastern European countries.

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