Eastern enlargement, migration and Euro adoption

*Tito Boeri**

Western Europe has welcomed its new members by shutting the door in the face of the workers coming from the East and making their road to EMU more difficult. Two years down the road of enlargement, some countries are now liberalizing worker flows. Indeed, as shown in this paper, these restrictions are not justified by migration pressures and rely on ill-founded concerns that nominal convergence could delay real convergence. Moreover, they are mutually inconsistent: delaying EMU convergence would just worsen labour market conditions with respect to a scenario of relatively rapid Euro convergence, by increasing real interest rates and negatively affecting FDI directed to the new member states. This ultimately means that delaying EMU convergence may backfire in terms of stronger East-West migration pressures.

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* For this paper only the author is responsible.

1 Introduction

Europe is facing one of the most dramatic changes in its relatively short history. On May 1st 2004, 10 new countries formally joined the European Union (EU). The new member states are small in economic terms – they have significantly lower levels of income per capita than the EU-15 – but large in demographic terms: the two phases of eastern enlargement (including the planned admission of Bulgaria and Romania in 2007) involve more than 100 million people.

A common market also involves the free movement of people. In the presence of large differences in per capita income and wages across countries, this means migration. But for another 10 years migration flows between new and old member states will be restricted because the European Union has welcomed the citizens of the 10 new member countries (NMCs) de facto by shutting the door in their faces. Actually, it has done worse than that. As there is no agreement at EU level on a common set of rules to be applied to the new citizens during the seven-year transition period, each of the old member states has decided to establish its own rules without coordinating with the others. In general, these rules substantially tighten migration restrictions or other restrictions for the newcomers.

Supra-national authorities in the EU are also taking a rather negative stance vis-à-vis early Euro adoption by the new member states. The standard argument is that early EMU participation would prevent the new member states from using exchange rate and interest rates to absorb asymmetric shocks. Furthermore, it is stressed that the economies of the new member states are too "weak" to be subjected to the urigors of the single currency and the Stability and Growth Pact (SGP). All this means that *nominal* convergence with the EMU rules may delay *real* convergence, that is, the convergence of per capita incomes.

Many of these concerns are ill-founded. More importantly, they seem to ignore the interactions between macroeconomic stability, growth and migration. A stable macroeconomic framework for these countries is essential to foster growth and increase job creation, thereby reducing migration pressures, which will not be lower in 7 to 10 years' time, at the end of the transitional period. Euro adoption could provide such a stable macroeconomic framework, reducing the risk of contagion between emerging markets and bringing down interest rates on public debt in these countries. FDI, attracted by macro stability and the elimination of currency risk, would also promote stronger employment growth, increasing the job content of growth and hence moving the new member states away from the jobless recovery experienced there since the 1998 recession.

The remainder of this paper is organized as follows. Section 2 discusses restrictions on immigration from the new member states. Section 3 analyses the interactions between Euro adoption, employment growth and migration. Section 4 concludes.

2 Migration restrictions: a race to the top

Austria and Germany, the destination of four out of five migrants from Eastern Europe, announced in early 2003 that they would restrict migration from the new member countries for the full transitional period of seven years. France and Belgium decided to maintain their current restrictions on immigration for new EU citizens for at least the first two years. Finland, initially supposed to take a liberal stance, postponed the opening of its borders for at least two years and tightened immigrant access to welfare. The Swedish Prime Minister proposed to do the same, but his proposal was overruled by a parliamentary vote in Stockholm. Access to welfare for migrants has, however, been tightened up in Sweden as well as in the UK. Greece and Italy opted for quotas on workers from the new member states just as if they were migrants from countries outside the EU. On the whole, all the countries bordering the new member states introduced restrictions to migration for workers from the "New Europe".

Two years down the road some of these restrictions are being lifted. In particular, Spain, Finland, Portugal and Belgium announced their intention to remove restrictions to workers from NMCs.

From a political economy standpoint, this tightening of restrictions is a reaction to the mounting concerns of the public in the established EU members (the EU-15) about migration issues. According to a 2002 survey by Eurobarometer, one in two EU citizens believes that migrants, wherever they come from, are already abusing the welfare state, and two out of three consider that the EU should only open up to countries at comparable living standards. As discussed extensively by Brücker (2005) and Boeri/ Brücker (2005), closing the door to the new citizens will hurt EU growth and making the welfare issue even worse by inflating the ranks of shadow employment among workers from the NMCs.

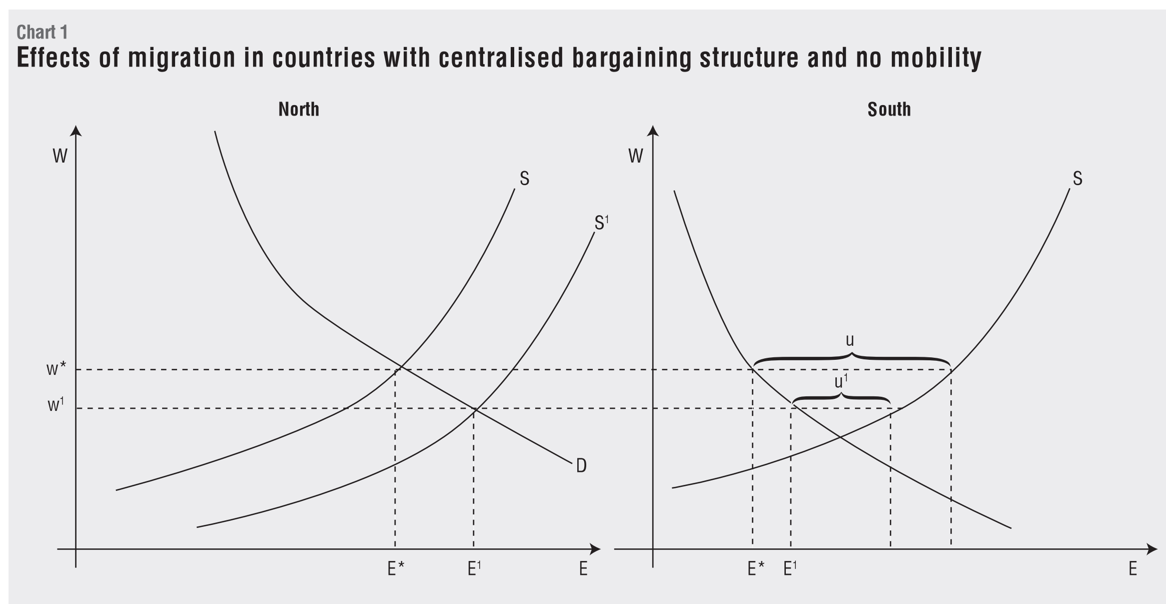


Chart 1
Effects of migration in countries with centralised bargaining structure and no mobility

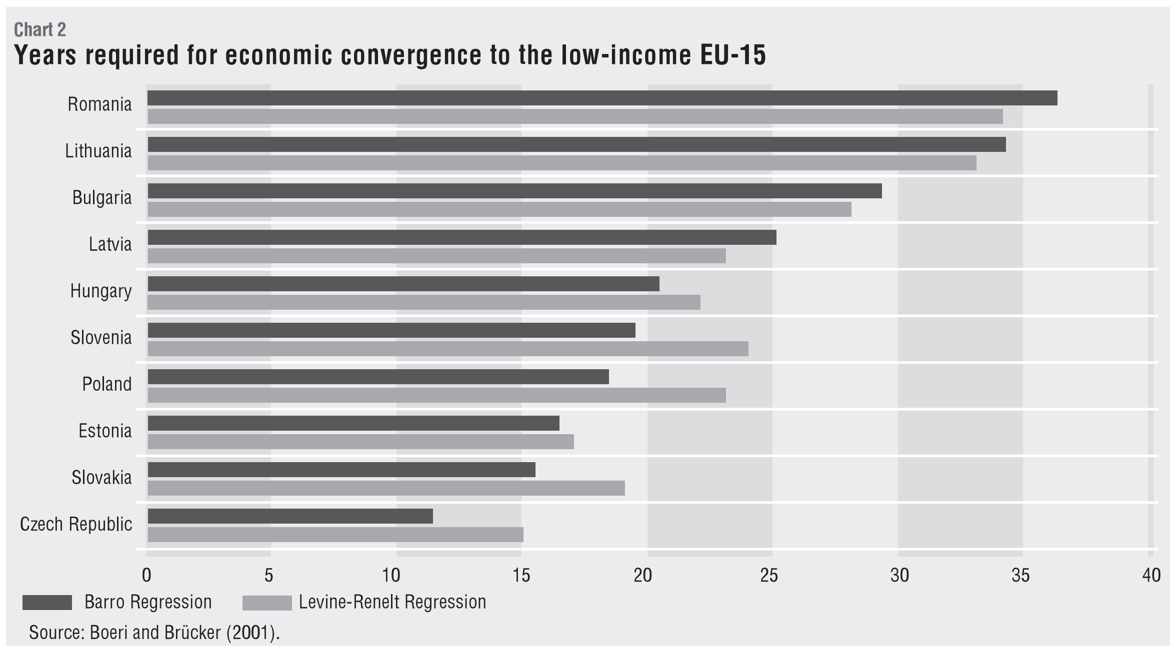
From the allocative standpoint, the new restrictions will alter the geographical orientation of migration, preventing migrants from the new member countries going to the countries where they can be most productive. In Central and Southern Europe, where the labour markets have low mobility levels, migrants play an important role by increasing average productivity, contributing not only to stronger growth but also to higher per capita incomes. Due to distortions in wage patterns (wages are often set irrespective of local labour productivity conditions) migrants can even reduce unemployment by lowering wages in the regions where the pool of jobseekers is larger.

This additional role of migration – flows of workers "greasing the wheels" of labour markets in presence of wage compressing institutions – is visually characterised in Chart 1. The left-hand side diagram shows the market-clearing wage prevailing in the dynamic regions (the north) which is also used – due to the imposition of the same contractual minima throughout the country – in the south. At the initial equilibrium, the south experiences unemployment as the northern wage acts as a binding minimum wage. Migration flows to the northern region, in this context, play two useful functions. On the one hand, they increase employment and reduce wages in the north by shifting to the right labour supply (as shown by the bold line, S'). On the other hand, migration, by acting on northern wages, reduces labour costs also in the south (from W^* to W^1) allowing to partially absorb its unemployment pool (which shrinks from u to u^1).

Moving now to the effects of restricting immigrants' access to welfare services, the problem here is that restrictions on legal migration only encourage higher illegal flows of workers, which is much worse from a fiscal standpoint. Unlike legal migrants, illegal workers do not raise revenues for the welfare state. Foregone revenues are sizeable because migrants are young and work most of the time. Furthermore, illegal migrants tend to be less skilled than legal migrants. When they are regularized, illegal migrants are more likely to receive social transfers than if migration restrictions had not been there in the first place. Regular migrants from the new member countries are generally better educated than the average EU worker, let alone migrants from other nations.

A better way to deal with concerns of citizens would have been to adopt a common transitional quota set by the EU as a whole – enabling the realization of at least part of the potential welfare gains in the form of higher growth while providing information on migration pressures. The quota could have been established at a level based on past migration episodes, perhaps accommodating an annual inflow of some 400,000 people, in line with the "consensus forecasts" on the migration potential associated with the enlargement (Boeri/Brücker 2001).

While transitional restrictions are in place, reforms that tackle concerns about the future viability of the welfare system need to be carried out. In seven to ten years time, when the "transitional period" is over, differences in incomes between the old and



new members will still exist, and will still be sizeable. If new member countries are set to grow at an optimistic 5 percent for the next two decades, they will still not reach the average income of the EU, and will only barely converge with the income of the poorest countries. At 5 % growth rates in the NMCs and 2 % in the EU, it will take more than three decades to halve the income gap with the current EU members. Thus, economic convergence is a long-term business.

This slow convergence is documented in Chart 2. Using traditional specifications for long-term growth equations (as in Barro/Sala-i-Martin 1991, and Levine/Renelt 1992) and applying the coefficients estimated on Postwar Europe growth patterns, we can predict a long-term yearly average growth rate for the NMCs of around 5 %. This implies a rather slow process of convergence not only to the average income of the EU as a whole, but even to that of low income members like Greece, Spain and Portugal (Fischer et al. 1998). These estimates are broadly consistent with the rate of 'conditional convergence' of 2 % found by Barro and Sala-i-Martin (1991, 1995). Conditional convergence is the rate of convergence towards the steady-state level of income of the benchmark countries, taking account of the effects of a set of variables that influence economic growth.

As income disparities within the new borders of the EU are likely to be large for some decades, the critical challenge facing EU policymakers will be to reconcile policies that promote mobility with the needs of its immobile citizens. One solution would be to coordinate at EU level the programs – such as social assistance – that are financed out of general government revenues. In principle, common standards could be defined in terms of minimum guaranteed income schemes, protecting the countries from fiscal competition across jurisdictions and preventing a potential "race-to-the-bottom" in welfare provision. All EU countries, including the new members, could be encouraged to gradually adapt their social assistance programs (which also exist in the new member states) in order to meet some basic income requirements. EU coordination at the level of these minimum guaranteed income schemes could then be pursued gradually, with the long-term intention of building up a pan-European safety net as one of the pillar institutions of the European Union.

Another problem which needs to be tackled as soon as possible relates to the enforcement of border controls in a Union of 27 states, where illegal immigrants have thousands of kilometres of border to access. The continuous patrolling of such a wide and diverse piece of land would be very difficult for a number of reasons:

- First, border controls would need to be coordinated across EU member states, which would inevitably require coordination of police activity.
- Second, and most importantly, it is quite likely that most illegal immigrants would try to enter the

EU at its eastern border, with the intention of going west. It is likely that illegal immigrants will ultimately want to settle in the wealthy countries of Western Europe, such as France and Germany, with east-east migration being a temporary step in that direction.

Will the police in the NMCs have sufficient incentives to stop illegal immigrants from temporarily entering their countries when their final destination will probably be elsewhere? Probably not. This 'free-rider' problem is potentially very serious. Indeed, the United States had a potentially similar problem across states, and accordingly chose to delegate its border controls to a federal authority (Boeri/Hanson/McCormick 2001). But in Europe, there is no federal police authority, and there will not be one in the foreseeable future.

A more efficient way to deal with illegal migration – as most of the east-east migration is likely to be – is to enforce internal controls on firm compliance with immigration law. However, such controls may not be politically viable options given the tolerance of employment in Europe's shadow economy. This implies that supranational authorities may be called also to play an important role in strengthening worksite inspection and restricting illegal employment of foreign workers.

Another way to proceed is to establish close cooperation with the likely countries of origin of future illegal immigration. In an EU of 27 members, these will probably be the traditional Arab countries of North Africa and Albania, plus the lowest-income members of the Commonwealth of Independent States, countries like Azerbaijan, Tajikistan and the Ukraine. Unfortunately, the latter group of countries currently has limited ties with the EU, suggesting the need to establish a long-term policy of close cooperation with such countries. One way or another, it will be necessary to influence the incentives for these countries to increase their border controls and stem the flow of illegal immigrants. Such incentives will involve favourable trade agreements as well as specific aid policies, all of which represent a major challenge for European policy-makers.

3 The EMU track

While Western Europe is temporarily closing borders to workers from the new member countries, current members of the EMU are making increasingly difficult the nominal convergence of the new members to the monetary union. Tight requirements are imposed on this track. In particular, the requirement of spending two years in Exchange Rate M II has been kept in place in spite of the fact that some countries come from currency unions and have a longstanding experience of fixed parities with the Euro. Moreover, the text elaborated by the Convention was amended by the ICG introducing new procedural obstacles to nominal convergence.

These additional hurdles being put on the path to EMU of the NMCs are inspired by the view that nominal convergence (convergence to EMU) would delay real convergence (convergence in GDP per capita). But this view is wrong for a number of reasons.

First, possession of an independent currency for the NMCs can be more of a shock generator than a shock absorber for middle-income countries, exposed to turbulence in emerging markets. Indeed, the main reason for exchange rate and real interest rate movements in the region would seem to have been changes in the risk premium. These changes were due to world capital market increases in the premium required of emerging markets, an effect which would very largely disappear after EMU accession.

Second, under a stable and low inflation macroeconomic environment, NMCs can be expected to generate labour productivity improvements much faster than current EU members and EMU participation would provide such an environment.

Third, Euro adoption would promote FDIs, contributing significantly to reducing capital shortages in the region and exerting positive knowledge spillovers on firms in the NMCs, which badly need better human capital.

All of this means that labour market conditions, too, are bound to improve in the course of Euro convergence. There is, indeed, evidence that in the new member states there is a strong complementarity between capital and labour. Moreover, employment growth in the region has been found to be negatively affected by high real interest rates (Boeri/Garibaldi 2004), and real interest rates in the Euro area are much lower than those experienced by most CEE economies. Hence, adopting a common currency would provide an environment of low interest rates in the years to come, and would probably help these countries to increase the job content of growth. If growth were to continue, low real interest rates would also lead to a reduction in unemployment. Keynesian arguments are often used to argue that the fiscal consolidation required to accommodate

Euro adoption could hamper growth and job creation in the new member countries. However, evidence of the recessionary effects of fiscal consolidation packages is far from uncontroversial: in a number of cases fiscal consolidation packages involving public expenditure cum tax cuts did indeed strengthen macroeconomic performance even in the short-run. As far as employment growth is concerned, if fiscal consolidation involves a reduction in wages paid to civil servants, it may avoid the crowding out of private employment in many low-productivity jobs (e.g. in the retail trade). Thus, the adjustment required for Euro adoption is far from negative from the employment standpoint, too.

4 Conclusions

Western Europe has welcomed its new members by shutting the door in the face of the workers coming from the East and making their road to EMU more difficult. Two years down the road of enlargement, some countries are now liberalizing worker flows. Indeed, as shown in this paper, these restrictions are not justified by migration pressures and rely on ill-founded concerns that nominal convergence could delay real convergence. Moreover, they are mutually inconsistent: delaying EMU convergence would just worsen labour market conditions with respect to a scenario of relatively rapid Euro convergence, by increasing real interest rates and negatively affecting FDI directed to the new member states. This ultimately means that delaying EMU convergence may backfire in terms of stronger East-West migration pressures.

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