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EU Enlargement and Labour Demand in the New Member States

Research to date on labour market responses to EU integration has tended to concentrate on the labour markets of the “old” EU members. But what effect has the integration of trade had on wages in the new member states? The following article attempts to answer this question using an empirical model of conditional sectoral labour demand.

The previous two decades in Europe have been characterised by a dynamic process of East-West integration. Trade barriers between the EU15 and Central and Eastern European Countries (hereafter CEECs) were to a large extent already removed in the mid-1990s (Europe Agreements), which led to an intensification of links between the two groups of countries. Since the trade reorientation of the early 1990s, related to the collapse of the Soviet Union and the major political and economic changes in those European countries previously under its domination, the economic structures of countries that eventually joined the EU in 2004 and 20071 (New Member States – NMS) have become ever more integrated with EU15 markets.2 Increasing integration also resulted in an intensification of the mobility of production factors across Europe and the cross-border integration of different phases of production. Already in the 1990s, CEECs became important hosts for the outsourcing practices of the EU15, owing to substantial wage advantages.3 Outward processing trade in CEECs rose considerably throughout the 1990s.4 Nowadays, CEECs’ total exports to the EU15 are strongly linked to the fragmentation of production. The resulting similarity in export structures between the two groups of countries has been found to have had a positive impact on the catching up process.5 Integration also led to the intensification of migration flows, especially after the biggest EU enlargement in 2004 when some EU15 countries opened their labour markets to the new entrants.7

All of these changes accompanying the process of East-West integration in Europe must have affected labour markets in the NMS. However, with few exceptions, the literature on recent developments in European integration has primarily focused on the empirical analysis of its effects on EU15 economies. With regard to the labour market effects of integration, surprisingly little empirical research has been dedicated to the effects of integration on the new EU members’ labour force. Moreover, the general lack of comparable sector-level statistics over time for both “old” and “new” EU members has thus far prevented researchers from exploring the topic in a setting conducive to detecting the heterogeneous effects of integration on labour employed in different sector types.

We aim to contribute to the existing empirical literature on the labour market effects of EU integration by exploring the issue from the point of view of the newcomers. We make use of recently released detailed sector-level labour statistics concerning some of the NMS and EU15 countries. Due to data availability, we focus on the economies of the Czech Republic, Hungary, Poland, Slovenia and Slovakia (denoted as NMS) through the period 1995-

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1 Ten countries (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia and Slovakia) joined the EU in 2004; Bulgaria and Romania acceded in 2007.
2 For example in 2005, 61% of exports from NMS were directed to EU-15 countries, compared to 46% in 1990 (data from UN Comtrade).
7 For a recent survey on migration in the enlarged EU see M. Kahane, K. Zimmermann: Migration in an enlarged EU: a challenging solution, CEPR Discussion Paper No. 7200, 2008.
2005. In particular, we consider the response of NMS5-based labour to wage conditions in trade partners from both “old” (EU15) and “new” EU members. One important innovation is that in order to detect cross-border interdependence between European labour markets, the domestic demand for labour in the NMS5 is assumed to be affected not only by its own price but also by labour costs in partner countries. Ceteris paribus an increase in foreign wages either increases or decreases the demand for labour according to the degree of complementarity and substitution existing between domestic and foreign labour inputs. The key idea is that trade integration brings about the fragmentation of technology across countries; consequently, domestic employment levels also depend on labour market conditions in trading partners, thus making domestic and foreign labour interdependent. We test this hypothesis with regard to the specific case of our five CEECs. Moreover, given the rising importance of trade in services, we extend the traditional focus of the empirical analysis beyond manufacturing and also take into account the business services sector. Finally, we control for the heterogeneous responses of NMS5 labour to foreign wages across sectors with different skill intensities.

The rest of the paper is organised as follows. In the next section, we review the theory and the empirical literature on the labour market effects of trade integration. Next, we examine the data and present some descriptive statistics on trade and employment concerning the NMS5 (and in some cases NMS12) over the period 1995-2005. We then explore the response of domestic labour markets in the NMS5 to the evolution of wage conditions in “old” EU members and in other “new” EU countries. Finally, we draw our conclusions.

**Literature Review**

The main issue raised by our analysis is the interdependency of labour markets within the EU, as manifested by the impact of wage conditions in partner countries on the domestic demand for labour. Economic theory has addressed the nature of the relationship between domestic and foreign labour inputs (whether they are complements or substitutes) in several manners and, according to the approach followed, different outcomes have emerged. Continued globalisation, which results in more intense final and intermediate goods exchange, is reflected in the rapidly growing literature on the impact of international trade integration on domestic labour markets, in particular on wages. In early contributions, which focused on the effects of production disintegration and outsourcing on wages (the rising inequality between the wages of skilled and unskilled workers in developed countries has been a major concern), it was usually assumed that foreign labour was a substitute for domestic labour. In such a framework, the final effects of trade in intermediates on the wages of the unskilled very much depend on the initial hypothesis of the model. Contributions assuming a single final good show that trade in the low skill intensive parts of the production process leads to a reduction in the wages and the relative demand for unskilled workers in advanced countries, and these workers are replaced by workers in developing countries. On the other hand, in a framework assuming two final goods, more labour intensive parts of production may be sent to labour abundant countries, but wages and employment may also increase in advanced countries’ labour intensive sectors due to regained competitiveness. Consequently, the substitution of domestic labour by foreign labour is not the only plausible outcome, and an increase in employment abroad does not necessarily have to correspond to a reduction of labour demand at home.

Another view is presented in the outsourcing model where capital is a sector specific factor. When FDI is accompanied by outsourcing, labour always loses, and when arm’s length transactions are the only possibility, then the factor-intensity of the outsourced portion is relevant for the final outcome on wages. Consequently, when the outflow of capital is taken into account, an important degree of substitution can exist between the activities performed domestically and abroad.

Further work on the topic highlights the relevance of treating the issue in a general equilibrium setting, for example with endogenous outsourcing dependent on the level of

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