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Euro Adoption and the Labour Market

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1. Introduction

It is often argued that early EMU participation by the New Members States (NMS) should be discouraged on the grounds that they would loose the use of the exchange rate and interest rates as absorbers of asymmetric shocks, that the economies of the new Members are too "weak" to be subject to the supposed rigours of the single currency and the Stability and Growth Pact (SGP), and, finally, that *nominal* convergence within the EMU would delay *real* convergence.

Many of these concerns are ill-funded. Recent empirical research has shown that for NMS, possession of an independent currency can be more of a shock generator than a shock absorber, as a significant component of fluctuation of domestic interest rates seem to be linked to 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. Most economists also agree that, given a stable and low inflation macroeconomic environment, NMS can be expected to generate labour productivity improvements much faster than current EU members. EMU participation would provide such an environment. This makes it hard to understand claims that NMS economies are "too weak" too meet EMU or SGP requirements, or that the nominal convergence required for EMU participation would occur at the cost of the real convergence NMS need.

Yet, there is little doubt that Euro adoption will require some adjustments in the structure of output and quite radical changes in the conduct of macroeconomic policies in the NMS. Labour markets and social policy institutions will play a key role in this context. They should accommodate changes in the structure of output associated with trade creation with EMU countries, and some geographical reorientation of trade from non-EMU to EMU regions (although there is no evidence to date of significant trade diversion associated with EMU). Labour market institutions will also have to provide a favourable environment for FDIs fostered by early euro adoption, prove capable to resist wage pressures, notably in the sectors less exposed to foreign competition. Furthermore, preventing a further fall in employment

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rates and reducing the size of the informal sector is essential for the NMS to reduce their large structural budget deficits, as required by participation in EMU.

The purpose of this paper is twofold. First, in Section Two, it discusses the challenges to labour markets coming from early Euro adoption by the New Members, in the light of the (scant) evidence so far available on the effects of EMU. Second, in Section Three, it evaluates whether or not the labour market institutions which are already in place in these countries, are ill-suited to meet these challenges. The main policy recommendations are detailed in the fourth and final section of the paper.

2. The Challenges

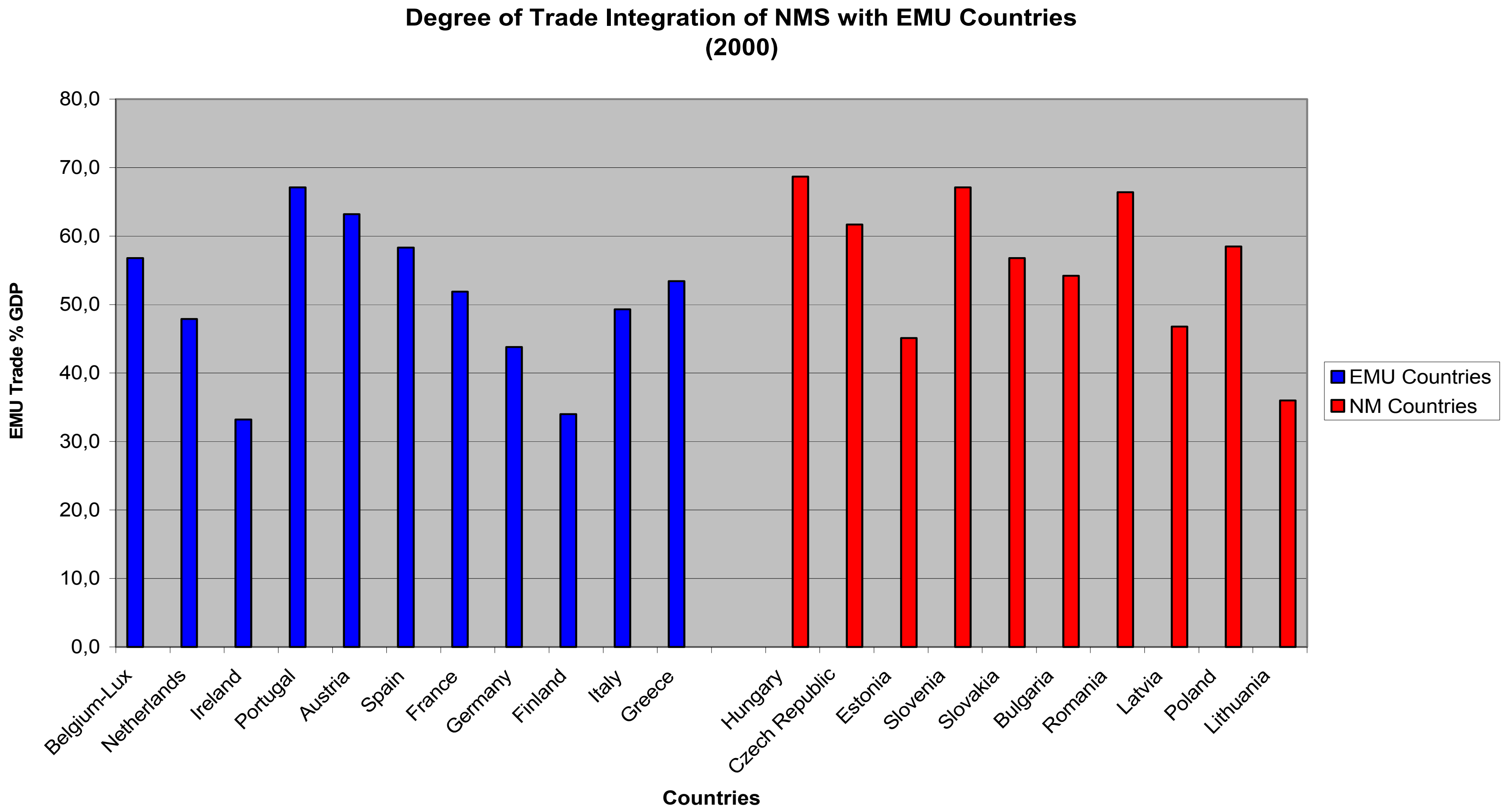
This section succinctly reviews the likely real effects of early euro adoption by the NMS. It also dwells on the potential consequences on growth of the fiscal consolidation required to qualify for EMU and on the implications on labour markets of having limited cyclical room for manoeuvre and, more broadly, less shock absorbers in place.

2.1. Trade effects

The NMS are already highly integrated in terms of trade and investment flows with the present EMU. Trade with other members of a proposed currency area as a share of GDP provides a good measure of the degree of a country's economic integration with the area, and of the extent to which it is protected by this integration from asymmetric shocks. As shown by Figure 1, all of the NMS in central and eastern Europe currently trade a higher share of their GDP with EMU countries than did six of the current 12 EMU members (including the four largest Germany, France, Italy and Spain) at the establishment of EMU.

This trade orientation will work also to reduce the likelihood of large asymmetric shocks originating from trade of the NMS with third parties outside the proposed currency area. All of the NMS traded a higher share of their total trade with EMU countries than two EMU members, and six of the NMS traded a higher share of total trade with EMU than ten current EMU members. Thus, NMS are no more likely to have to use monetary policy or the exchange rate to respond to asymmetric shocks than are current EMU participants.

Entry in the EMU is likely to further increase trade links with EMU countries. A common currency eliminates bilateral exchange rate volatility, and hence reduces significantly the uncertainty involved by trade transactions. It also phases-out the transaction costs associated with the fact of operating with multiple currencies. Empirical evidence on the trade impact of EMU is indeed supportive of significant trade creation effects associated with EMU. There is some uncertainty as to the magnitude of these effects, but all empirical studies to date found that these are positive and significant (Glick and Rose; Rose and van Wincoop, 2001; Rose, 2002; Micco, Stein, Ordonez, 2003). Moreover, there is also evidence that euro adoption fostered trade with non-euro nations. In other words, there seems to be no trade diversion associated with euro adoption. This may be explained by the fact that giving up national monies involves for many countries adopting a more liquid currency, providing a way to hedge exchange rate volatility also with respect to nations outside the monetary union.



Source: Eurostat

Figure 1

As to the composition of trade induced by Euro adoption, this is likely to replicate the sectoral specialisation of current and projected post-accession trade flows between the NMS and the countries currently belonging to EMU. This means a specialisation of NMS in lower price and quality segments of markets, involving greater intra-industry trade flows but with a marked vertical differentiation of imports and exports.

It should also be stressed that NMS coming from central planning inherited from the previous regime a serious lack of varieties (Boeri and Oliveira-Martins, 2002), (Funke and Ruhwedel, 2003) á la Dixit-Stiglitz. Hence a favourable environment for new business startups would allow these countries to close domestically a significant portion of the variety gap prevailing after euro adoption, as a result of the reduction in trade transaction costs.

Overall trade creation and trade specialisation involved by euro adoption will increase competitive pressures in product markets and require a furthering of the ongoing job reallocation process in the NMS; an environment more favourable to business startups could magnify the benefit from trade creation.

2.2. FDIs

To the extent that early euro adoption reduces the risk of "emerging market contagion", it also encourages a higher level of capital inflow into the NMS. The experience of the EU Southern Enlargement round suggests that a stable macroeconomic framework is essential to attract substantial FDIs. In the aftermath of its entry in the EU, Greece attracted much less FDI than Spain and Portugal because of its greater macroeconomic instability (Boeri and Bruecker, 2001).

FDIs can, in turn, increase the long-term rate of growth of the NMS and accelerate real convergence. They can also lead to substantial job creation, reversing the trend to a jobless growth in the region. The effects of FDIs on employment are indeed likely to be positive, as there is evidence that – due to the obsolence of the capital stock inherited from the previous regime -- in formerly planned economies there is a strong capital/labour complementarity (Boeri, Burda and Kollo, 1997).

Welfare gains for FDI recipients are likely to exceed the value added and employment generated by foreign capital. There are indeed important spillover effects of FDIs on other firms. How large? Haskel et al. (2002) estimated that a 10% increase in foreign presence in the UK manufacturing sector in the previous decade increased total factor productivity of domestic firms by about 0,5%. The magnitude of these spillover effects in the accession countries will very much depend on the nature of FDIs originated after euro adoption and on the institutional environment in which they will take place. Spillovers are likely to be larger if FDIs are not only of the vertical type and promote spin-offs of capital, knowledge and skilled labour to other firms (Markusen and Venables, 1999).

Growth in the NMS will therefore critically depend on the capacity of these economies to attract capital. The sectoral composition of FDIs as well as surveys of foreign investors and further evidence summarised in Boeri and Bruecker (2001) does not lend support to the view that access to low labour costs has been the key factor in promoting foreign investment in the MNS. Market access and the speed of the privatisation would seem to have been more important than labour costs in the allocation of FDI, which was indeed so far complementary to trade.

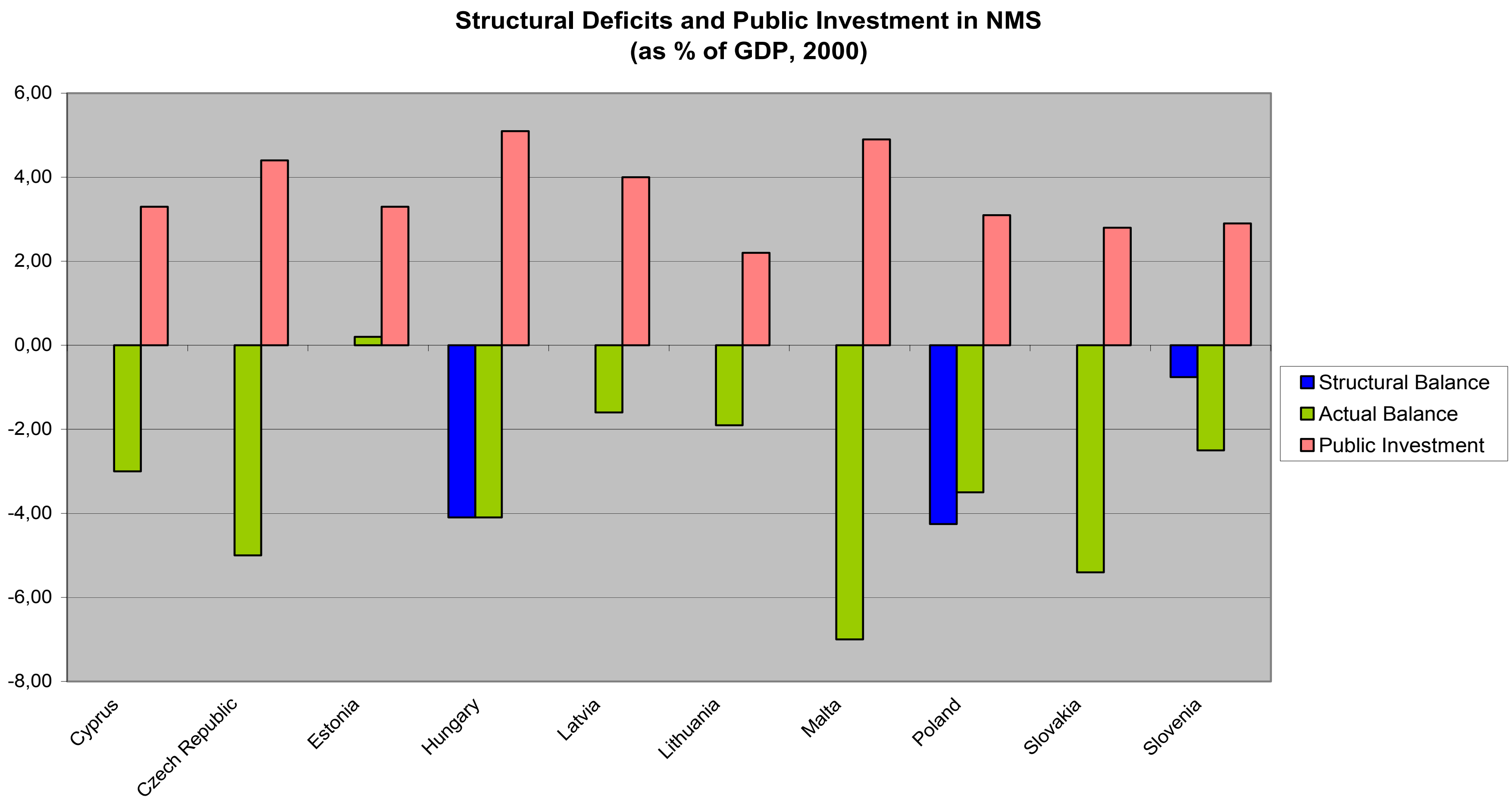
This clearly does not rule out the possibility that in future diverging developments in capital taxation and labour costs across the NMS may affect the distribution of FDIs in the new members. Governments will be pressed to reduce taxes on the mobile factor and keep as much as possible under control labour costs. As the exchange rate cannot compensate for differences in profitability conditions, competitive pressures will be stronger, potentially increasing the elasticity of labour demand in the new countries adopting the euro.

Thus, greater capital mobility induced by euro adoption will contribute both directly and indirectly to economic convergence of NMS to the EU, but also will put some strain on institutions creating a wedge between labour demand and supply, as labour demand is bound to become more elastic after euro adoption.

2.3. Fiscal consolidation and Growth

Better infrastructure would also contribute to attract more productive investment and enhance the export potential of these economies, allowing them to reap the benefits from Euro adoption. All the NMS would seem to badly need public investment in infrastructure, notably electricity generating capacity, railways and road infrastructure. FDIs do not provide these infrastructures and tend to be highly regionally concentrated. In the case of the Spanish accession, they indeed were almost entirely concentrated in Barcelona and Madrid (Boeri and Bruecker, 2001). This means that higher public investment, notably in poor regions, is warranted in the NMS with or without euro adoption.

At least part of the resources required to finance public investment may come from the EU structural funds, notably regional funds. However, access to these funds is not a free lunch as it involves some co-financing by the recipient. In the presence of the tight budgetary constraints imposed by the Maastricht Treaty's fiscal criterion, the NMS may find it hard to support the required effort in enhancing their public infrastructure. Central and eastern European countries are experiencing budget deficits of the order of 4-6% of GDP per year, and it is highly likely that structural deficits of the new Members will be above the 3 per cent of GDP when euro adoption by the NMS could take place (Coricelli and Ercolani, 2003).



Source: Coricelli and Ercolani, 2002

Figure 2

The above does not imply that euro adoption should be postponed. Actually, delaying the convergence to EMU would not solve the problem. For at least three reasons. First, all Member States are obliged to avoid deficits in excess of 3% of GDP, whether or not they participate in EMU (an obligation which is not obviated by the fact that non-participating Member States are not subject to the financial penalties in the case of non-compliance). Second, the 3% limit leaves still ample room for borrowing to finance investment, notably if countries can obtain a return from euro adoption in terms of a reduction in interest rates on Government bonds. Although there has not been to date full convergence in eurozone Government bonds (Codogno, Favero and Missale, 2003), NMS could still enjoy a strong reduction in the costs of servicing the public debt with early euro adoption. Third, Galì and Perotti (2003) did not find that EMU participation significantly affected the decline in public capital investment within the current monetary union and there is no reason to believe that, outside EMU, New Members would find the right incentives to cut down their structural deficits.

It should be finally stressed that budgetary rules for EMU countries are not unmodifiable. They would have to be modified, after all, in order to restore their credibility after the November 2003 Ecofin meeting and the decision by the European Commission to take legal action against Finance Ministers for their violation of the Treaty. This opportunity could be seized to modify the 3% limit on deficits before euro adoption by the NMS. Among the various reforms of SGP being envisaged by the Commission and by a number of researchers (e.g., Fatas et al., 2003, Blanchard and Giavazzi, 2003, Wyplosz, 2003), those extending the time horizon of the fiscal rules are particularly important for the NMS. In particular, the introduction of a golden rule for public investment can be motivated by the enlargement. However, there are serious problems of enforceability of a golden rule. Perhaps more promising is the proposal developed by the Commission to allow for temporary breaks of the 3 % budget deficit rule in case of countries implementing reforms reducing their structural deficits. These reforms may involve, not lastly for political economy reasons, some short-term deterioration of fiscal deficits, but a significant improvement of public finance over the long-term. In particular, reforms of pension systems, involving a reduction of the pay-as-you-go pillar and an expansion of funded schemes, may temporarily increase the deficit of pension systems. In order to encourage the takeoff of private, funded, pension schemes in presence of a state monopoly in pension provision, it is indeed necessary to reduce compulsory contributions to the public system, while continuing to paying out pensions to current retirees. This means less yearly revenues for public pensions per given outlays. As part of the NMS structural deficit is related to inefficiencies of their welfare system, this provision can be quite valuable to them.

Rather than discouraging early euro adoption on the grounds that NMS have large structural deficits, it may preferable to use the convergence to EMU as a tool to enforce badly needed structural reforms in these countries. This circumstance was widely used by Government of EU countries that were trying to qualify for the Maastricht criteria. There is indeed evidence that EMU boosted structural reforms in the EU (Bertola and Boeri, 2003). The same conditionality can now apply to the new members, allowing them to improve the long-term sustainability of public finances and the quality of their spending. In order for the convergence to EMU to encourage politically difficult reforms, it is necessary that fiscal rules for EMU are credible. This provides an additional reason to give a better Pact to the euro-area. In particular rules combining short-term flexibility and long-term sustainability would be tailored to the specific conditions of the NMS. These countries should not be forced to bring structural deficit close to balance immediately, as they need to significantly invest in public infrastructure even acknowledging the significant contribution which will come to this process by the structural funds. Structural deficits of the order of 1-1,5 per cent are, after all, compatible with a progressive reduction of public debt in fast growing countries starting with a relatively low debt-to GDP position. This is the case of the Czech Republic, Estonia, Latvia, Lithuania, Poland and Slovenia which all have a stock of debt below 40% of GDP.

How about the implications of the fiscal consolidation required by euro adoption on growth and employment? As suggested by the discussion above, forced convergence to a zero structural deficit scenario in the short-term – involving the postponement of worthwhile public investment projects – is likely to imply a high cost in terms of foregone growth than under the convergence to Maastricht criteria by current EU members in the mid-1990s. The latter indeed gave up a very small fraction of public investment on their road to EMU (Sapir et al., 2003). NMS, under strict short-term budgetary targets would instead pay a much higher price than EU members rushing to qualify for EMU in the mid-1990s because they would be forced to cut more substantially public investment. If instead, it is possible to adopt the euro under fiscal rules combining short-term flexibility and long-term sustainability, the output costs of fiscal consolidation would be relatively modest and there would be longer term gains for these countries. These gains would be even larger if the NMS reform their institutions in order to increase job generation content of growth. This means cutting the wedge between labour demand and supply along the lines discussed in Part 3.

2.4. Implications of Having Less Shock Absorbers

Fiscal policy rules will also constrain the cyclical room for manoeuvre of the perspective new members of EMU. Coricelli and Ercolani (2003) estimated that the cyclical sensitivity of the budget in these countries is low (.35) compared with the average of the current EU Members. However, NMS are subject to relatively large output fluctuations, with a standard deviation of about 4-4.5. Thus, assuming away discretionary fiscal policy, the cyclical room for manoeuvre is of the order of 3 per cent of GDP. Coupled with a structural deficit of about of 1.5%, this implies that keeping the budget deficit within the 3% limit during downturns will be extremely hard for the NMS as realistic upper bound for the deficit during recessions can be located at about 4,5% of GDP during downturns (Sapir et al., 2003).

In the convergence to EMU, NMS will be as well prevented from using monetary policy as an absorber of asymmetric shocks. As argued in section 2.1 above, the strong degree of trade integration of these countries with EMU[1] reduces the likelihood that such asymmetric shocks may occur, but of course does not rule them out completely. It should be stressed that the countries which have to accommodate the largest adjustments to the new monetary policy regime because they have a floating exchange rate (Poland) or a crawling band (Hungary) or a managed float (Czech Republic, Slovakia and Slovenia) regime are just those that currently have the largest public deficits. In other words, the loss of degrees of freedom in the conduct

[1] Estonia and Malta are a partial exception in that they are quite heavily exposed to non-Euro trade, although not as much as Ireland.

of macroeconomic policy will be stronger just in the countries which would need room for manoeuvre.

Finally, early euro adoption prevents the NMS from using exchange rate devaluations to compensate for strong wage pressures associated to the entry in a Union with living standards and wages as much higher as 50 per cent. There is no indication as yet of real wage dynamics recently outpacing labour productivity developments in the region, except partly in the case of Hungary (see Figure 3 below). However, one cannot rule out a priori that a country more closely integrated in the EU could have wage setting institutions more responsive to wage levels and labour cost developments elsewhere.

In the convergence to EMU and even before, in the European Exchange Rate Mechanism (ERM), many current EU members resorted to Social Pacts implementing a tight income policy (Table 1). These involved broad agreements between unions and employer associations, setting guidelines for nominal wage growth. Sometimes such agreements involved the government as a third party. In other cases, they have been bipartite but concluded under pressure from governments. (Visser, 1997; Hassel, 1999; Fajertag and Pochet, 2000; Crouch, 2000a,b).

The most outstanding example of these Pacts is the Wassenaar Consensus in the Netherlands, forged in 1982. It resulted in nominal wage moderation on the part of private-sector unions and was followed by government-initiated labour tax cuts (mostly social-security contributions) and spending reductions. Another outstanding example of Social Pacts is Ireland, where the government has been a direct party, exchanging tax concessions for wage moderation. Unlike in Finland, Norway, Italy, Portugal, and Spain, in Belgium several attempts have failed, but have then been replaced by direct government intervention in wage setting through legislation. Less clear-cut cases are Denmark (Elvander, 1999). There have been also many failures in building up such Pacts, but the attempts to reach these agreements may still have affected bargaining behaviour.

Table 1. Social pacts and national agreements in Europe

Austria	Institutional Social Dialogue (*Paritätische Kommission*)	
Belgium	(Global Pact 1993)	Law
	(Future Pact 1996)	Law
	Central agreement 1998-99	within narrow legal limits
Denmark	Informal wage moderation norm (D-mark zone) 1987	
Finland	(Stability Pact 1991)	
	Social Pacts I 1996-97 and II 1998-99	
	(Social Contract 2000)	
France	(Attempt to establish national social dialogue in 1997)	law
Germany	(Alliance for Jobs 1995-96)	
	Alliance for Jobs, Training and Competitiveness 1999	
Greece	Pact of Confidence 1997	'stop-go social dialogue'
Ireland	PNR, National Recovery 1987-91	
	PESP, Economic and Social Progress 1991-94	
	PCW, Competitiveness and Work 1994-97	
	Partnership 2000 1997-2000	
Italy	National agreement to end *scala mobile* 1992	
	Ciampi Protocol 1993 (reform wage setting)	
	Pension reform 1995	govt. with unions
	Employment Pact 1996 (labour market reform)	
	Social Pact for Growth and Employment 1998 (Christmas Pact)	
Netherlands	Wassenaar (wage moderation) 1982	bipartite
	Convergence and Concertation (institutions) 1992	
	A New Course (decentralisation) 1993	bipartite
	Flexibility and Security ('flexicurity') 1996	bipartite
Norway	Incomes policy agreement 1987-88	bipartite
	Solidarity Alternative 1992-1997	
	(Basic Agreement 1998-99)	
Portugal	Economic and Social Agreement 1990	without largest union
	Short Term Social Concertation Agreement 1996	without largest union
	Strategic Concertation Agreement 1997-99	without largest union
	(Europact 2000)	
Spain	Toledo Pact on Future of Social Security 1996	govt. with unions
	Stability of Employment and Bargaining Pact (reforms) 1997	bipartite
Sweden	(Attempts at establishing 'Euro' wage norm 1995)	
	Industrial Agreement 1997	bipartite
	(Pact for Growth 1998)	bipartite

Note: The agreements are tripartite (*i.e.* involving unions, employers and government) unless indicated otherwise. Failed attempts are shown within parenthesis.
Source: Boeri, Brugiavini and Calmfors (2001)

The Irish experience is particularly relevant for the NMS as we are dealing with a country which experienced strong growth and diverging inflation rates in EMU (Onohan and Lane, 2003). Interestingly, inflation in Ireland had been persistently under 2% in the five years prior to EMU membership and rose to 4-5% (with peaks of 7 per cent) in the aftermath of EMU membership. Although generally considered as home grown, inflationary pressures were also associated with the devaluation of the euro vis-à-vis the USD. The fact of being a small open economy is indeed another feature in common between Ireland and many NMS. Another factor leading to the inflationary surge in Ireland was the low nominal and real interest rates in the EMU. The jury is still out as to the effectiveness of the Irish Social Pacts in repressing inflationary pressures. Wage restraint was strong before EMU membership and less afterwards, but it likely was the depreciation of the euro with respect to the USD to make room for wage increases in the industries exporting to the US. The issue is that after EMU membership it became increasingly difficult to define in wage negotiations an appropriate and affordable rate of wage increase and evaluate the exchange rate induced effects. The risk under these conditions is to have wage negotiations based on the expectation of continued above-EMU average inflation, which may be very damaging for competitiveness.

Overall, early euro adoption implies that shocks will have to be absorbed to a large extent by product and labour market adjustments. The countries with less room for cyclical manoeuvre are just those in which the regime change in monetary policy will have to be more radical.

3. Labour Market Institutions required for Successful Early Euro Adoption

The above suggests that product and labour markets in the NMS opting for early euro adoption will need to absorb asymmetric shocks, resist to wage pressures potentially arising from a cross-country co-ordination of unions and integration with countries with significantly higher living standards, accommodate stronger competitive pressures in product markets, create a favourable environment for FDIs maximising positive externalities from foreign direct investment, and, finally, adjust to a partial reorientation of trade. At the same time, social protection institutions will have to continue to perform their traditional functions – such as preventing extreme poverty and providing protection against uninsurable labour market risk -- without putting undue strain on the budgets of the NMS.

This section evaluates whether the institutions currently in place in these countries can cope with these multiple challenges. As the main issues concern formerly planned economies, reference is made to the institutions developed throughout the transition to a market economy. Particular attention is devoted to the design of wage setting institutions, non-employment benefit systems, and to the cost-effectiveness of the safety net.

3.1. The Scope for Income Policies

NMS coming from central planning have already experienced income policies. Fearing wage-push inflation at the beginning of transition, they all introduced at the beginnings of 1990s, in one way or another tax-based income policies (TIPs), providing penalties on firms granting wage increases above a given norm. A wide variety of schemes were adopted, which more or less linked wage norms to indicators of productivity at the enterprise level. Some of these schemes were grossly ill-designed and repeatedly revised. Thus, there were not only many national variants of TIPs, but also many different versions within the rather short history of these schemes in each country. Two key parameters, however, were common to all these TIP versions. The first was the warranted wage-price indexation admitted by the norm. The second was the progressivity of the tax rate scale used in defining penalties for firms violating the norms. Both parameters were subject to frequent revisions and negotiations, on the part of tripartite bodies and quite considerable energy and time was put into this process. Forgiveness measures and exemptions were also granted in many cases with the result of undermining the credibility of Governments' commitments to enforce penalties, and making the policies time-inconsistent.

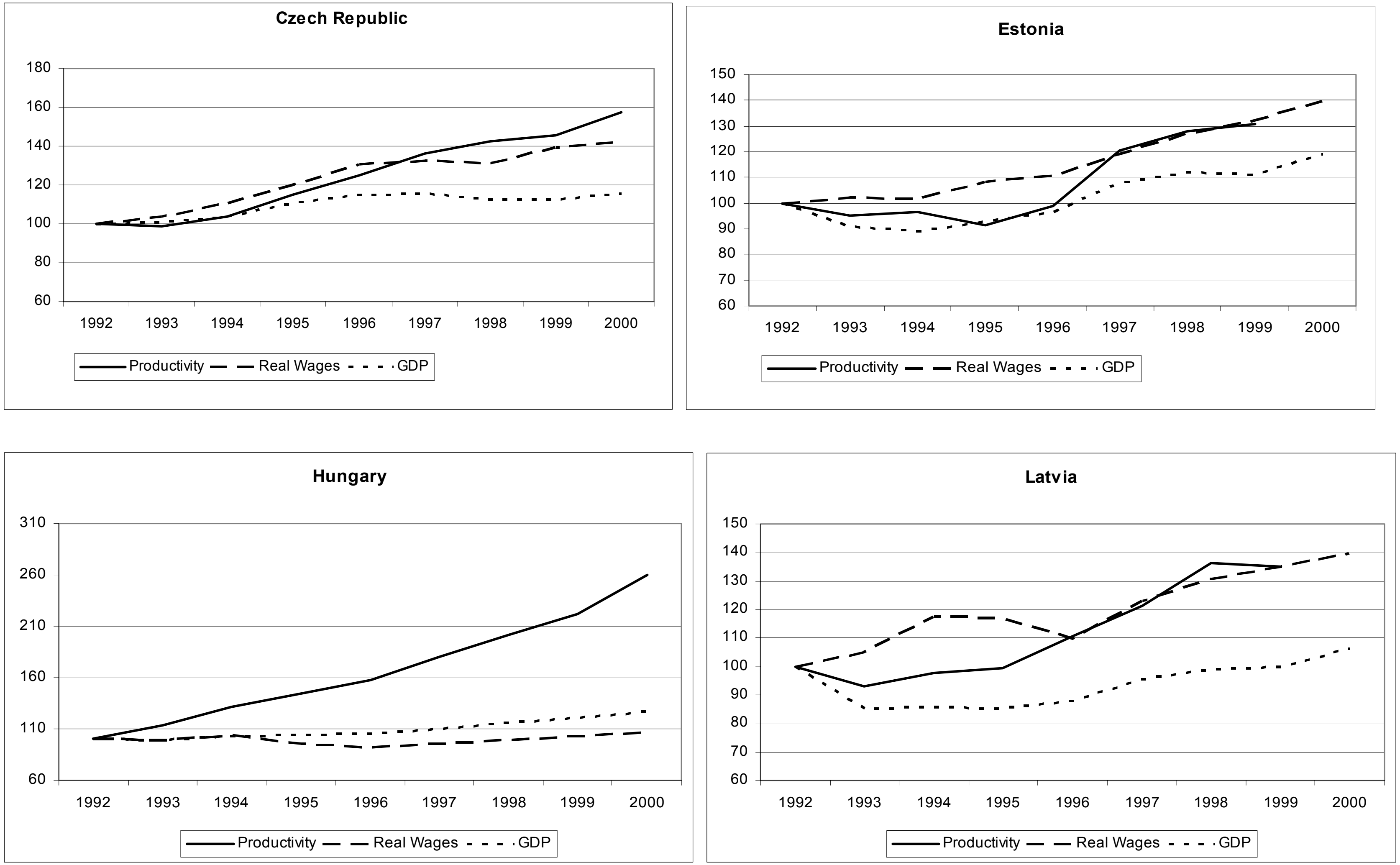
TIPs were either explicitly or de facto applicable only to state enterprises. Private units were exempted from the sphere of application of these regulations. In any event, enforcement of these regulations with private firms would have been dauntingly difficult, as proved by the experience of the countries and time-periods (e.g., the Czech Republic after 1993) in which TIPs were not confined to state enterprises. The fragility of tripartite structures was, in any event, a serious obstacle to the enforcement of tax-based income policies.

In a context where real wages were experiencing declines of the order of 25 to 30 per cent, wage norms were rarely binding on the aggregate. Surprisingly enough, TIPs were abandoned just at the time when they could have been most useful. In more stable environments, with unions recovered from the transition shock and a workforce less exposed to the threat of dismissals typical of the early stages of transition, conditions of bilateral monopoly could materialise in some surviving state enterprises. There is indeed some evidence of significant insider power, that is workers capturing most of the productivity gains, in Polish state enterprises as soon as economic recovery begun (Grosfeld and Nivet, 1997). Micro data on Hungarian enterprises also point to state sector workers capturing almost 60 per cent of productivity increases against less than 10 per cent in private firms (Boeri, Burda and Köllö, 1997). Finally wage increases above productivity were reported in several large state enterprises surviving the initial phases of transition in Central and Eastern Europe notably in the Check Republic around the mid 1990s and in Hungary in 2001 (Pohl et al., 1997).

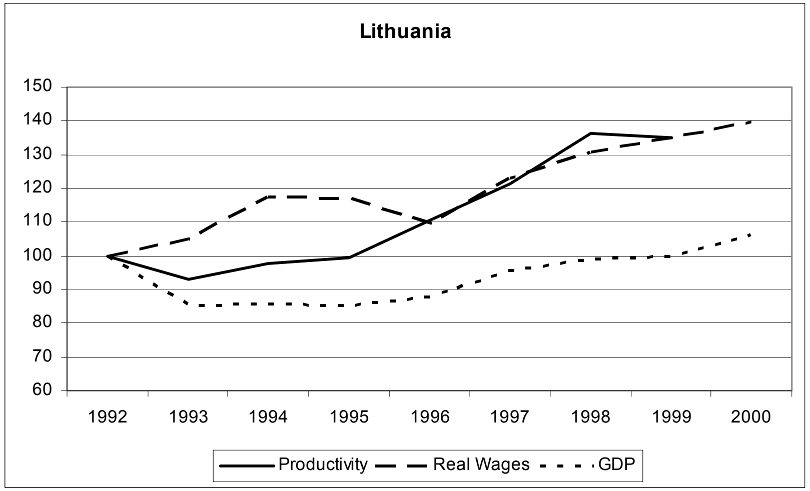
TIP or, more broadly, some milder form of income policy could be more useful today while preparing to EMU membership, in order to face conditions where bilateral monopoly prevails in wage bargaining. Figure 3 displays labour productivity and wage developments in the NMS since 1993. Although wages have still to recover the ground lost during the so-called "transitional recession", there are signs that wage growth is picking up, notably in the Baltics and in the Czech Republic. And these countries have still to absorb a sizeable non-employment pool if they wish to enhance their growth potential and reduce their structural deficits at the same time.

However, the type of bargaining structure which emerged from the transition is rather decentralised. Unions are relatively weak (union density rates collapsed throughout the region) and are concentrated in the state sector. As changes in industrial relations are time-consuming the risk is that, at the time of their entry in EMU, the NMS get caught into intermediate collective bargaining structures, which are typically those which offer the worse outcomes in terms of inflation and unemployment (Calmfors and Driffil, 1981). Neither it is clear that centralised wage setting would be good after EMU membership. The case of Ireland, discussed above, outlines the difficulties in defining national wage targets based on inflationary expectations, irrespective of the labour productivity conditions in specific firms. After EMU, nation-specific shocks are likely to have only a policy-based character, while other macro shocks will be more regional or sectoral in nature. Thus, national-union-based systems of industrial relations may not be adequate to address new demands for microeconomic adaptability.

Figure 3: Wages, Productivity and Unit Labour Costs in the NMS (1992 = 100)



Source, Galgoczi 2003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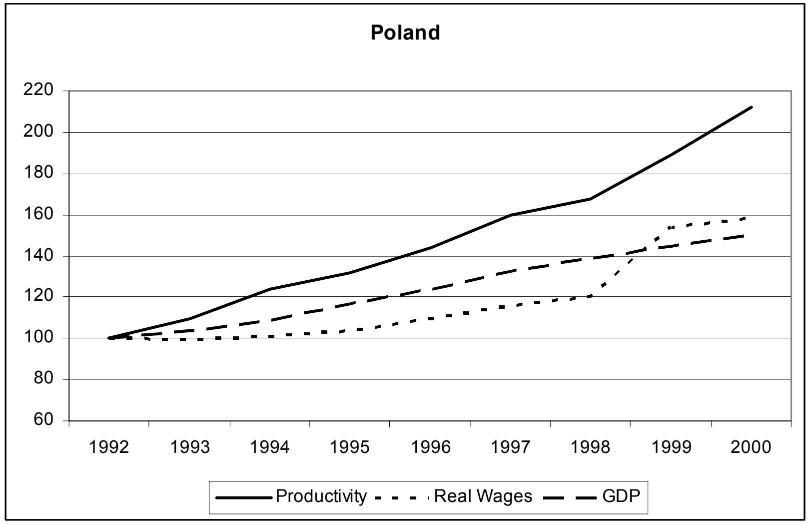
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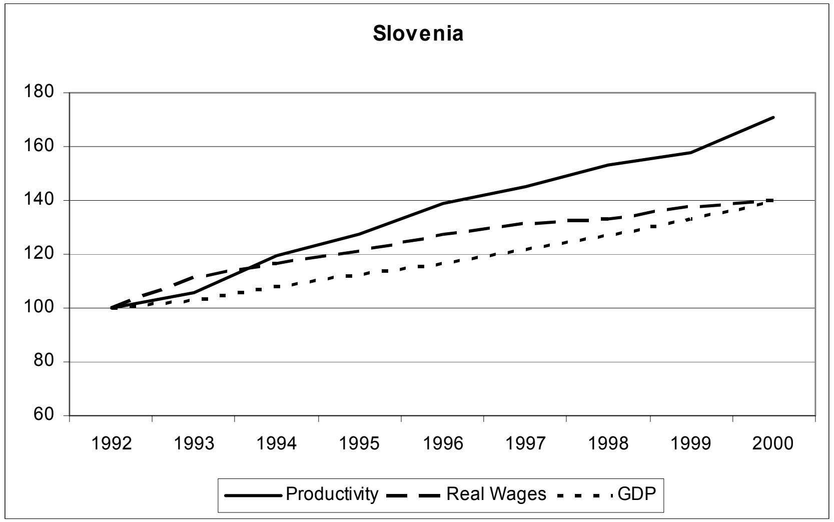
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3.2. Non-employment Benefits During the Return to Europe

Non-employment benefits (unemployment benefits, sickness pay, liberal access to disability pensions as well as social assistance and other schemes offered to jobless individuals in working age unconditional on job search) played a key role in the transition to a market economy of the four countries of Visegrad. Unlike the former Soviet Republics which allowed the real value of the transfers to non-employed individuals to fall dramatically throughout the transition, Czech Republic, Hungary, Poland and Slovakia have kept unemployment benefits at about 40% of the average wage. Although this replacement rate is lower than the one offered in many EU countries, during systemic transformations of the scale of those experienced in Central and Eastern Europe, it imposed binding floors to wage distributions. Indeed due to the weakness of unions and the decentralised patterns of collective bargaining which prevailed, non-employment benefits exerted a more important role on wage setting than minimum wages.

This institutional setting generated more quantity than price adjustment in the NMS compared with the Former Soviet Union (Boeri and Terrell, 2002). It also generated more structural change and job reallocation: the floor imposed by non-employment benefits yielded a higher level of wages in the NMS which meant that old and inefficient firms were forced to shed labor or to close down the shop rather than being allowed to freely adjust wages downwards or even accumulate wage arrears, as occurred for instance in Russia. Unemployment benefits also imposed a wage floor in the private sector, which reduced job creation for the unskilled, but made jobs in the service sector more palatable to workers with higher qualifications.

There are clearly pros and cons in this institutional design. On the one hand, more redistribution in favor of non-employed individuals generated high unemployment and reduced the size of effective labour supply: most of this unemployment is long term, and goes hand-in-hand with declines in labour force participation. On the other hand, this institutional setting allowed for faster structural change to occur, contributing to growth later on in the transition. It also reduced inequalities as changes in the earning distribution drove changes in income distributions and non-employment benefits contributed significantly to contain the rise of inequalities (Milanovic, 1999; Garner and Terrell, 1998). Thus, this model worked relatively well as these countries covered considerable ground in the transition to a market economy without excessive hardship.

3.3. Is this model appropriate for EMU Membership?

Can this social policy model, assigning an important weight to subsidies to people in working age, cope also with the challenges associated with euro adoption? In order to answer this question, we need first to assess the possible alternatives to the current design of non-employment benefits, notably the trade-off between unemployment benefits and employment protection in the NMS.

EU countries provide protection against uninsurable labour market risk by using a varying combination of two instruments: unemployment benefits (UB) and employment protection legislation (EPL). At the aggregate level, it is possible to observe a trade-off between the two policy instruments: countries with a high coverage of UB and relatively generous replacement rates tend to have relatively liberal EPL rules (Figure 4). Vice versa, strict EPL goes hand in hand with less state-provided unemployment insurance. In other words, quantity (employment protection) and price (unemployment benefits) are substitutes as also confirmed by microeconometric evidence employment and unemployment insurance collected at Fondazione Rodolfo Debenedetti (www.frdb.org).

The fact that different countries resort to different combinations of UB and EPL suggests that there is a trade-off, with pros and cons of the two policy instruments.

Unemployment benefits induce upward shifts of labour supply and reservation wages of individuals. The extent to which such shifts bear on measured employment and unemployment depends on details of the policy: on whether payments are contingent on non-employment or employment elsewhere (active labour market programs), or on unemployment (degree of activation involved). These details are discussed in some depth in Section 3.4. below. The effects of unemployment benefits on wages of unemployment also depend on the interaction of cash transfer programs with wage setting institutions. If the opportunity cost marked up by wage setters is increased by the structure of subsidies, then wages will increase even further. But this needs not be the case, and depends importantly on the extent to which wage setters internalize this channel.

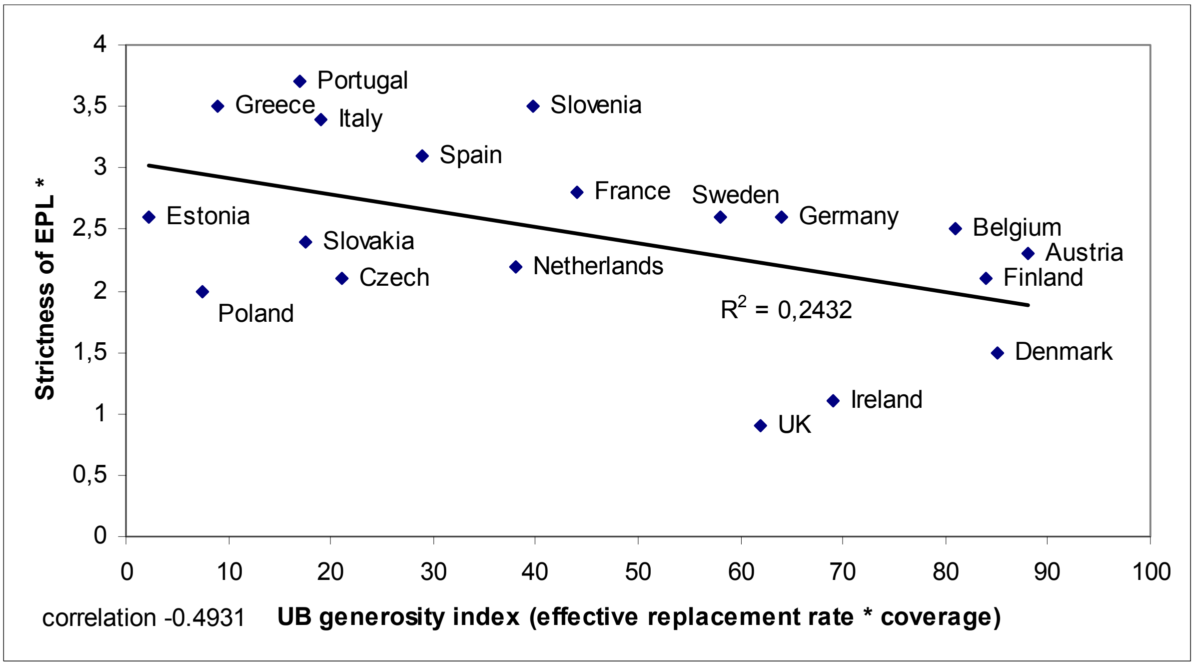
Employment protection legislation, instead, reduce productivity in the face of ongoing reallocation shocks. For given labour demand and wage dynamics, more stringent EPL reduces the incentives for firms to shed labour. EPL also reduces incentives to hire: if employers anticipate that layoffs will be difficult or costly, in fact, they should try and reduce the amount of labour shedding called for by future labour demand downturns or wage upturns. Hence, EPL should smooth adjustment dynamics, but aggregate employment and unemployment should depend on average wages and average labour demand. Its contrasting effects on employers' propensity to hire and fire imply that the impact of EPL on average employment for given wage, or on average wages for given employment, is in general ambiguous. In fact, “firing costs” are quite different from other labour costs, such as wages and social security contributions, that indeed tend to reduce labour demand. While employers must pay wages to employ labour, and reduce employment in the face of higher wages if labour demand is downward-sloping, they can avoid paying firing costs by choosing a stable employment path around a level that may be slightly lower or even higher on average than what would obtain, for the same wage and contributions level, in the absence of job security provisions. Of course, whenever firms fail to equate wages and labour's marginal revenue product they earn lower profits, and in this sense, it is quite sensible to think of employment security as imposing a “tax” on employers which is increasing at time of turbulence, when labour demand is more frequently hit by shocks. Still, EPL does not reduce profits through lower average employment levels, but rather through poor synchronization of productivity and wages around roughly unchanged average levels.

Under stronger competitive pressures as those associated with membership of a monetary union, and in an environment in which product and labour markets can no longer be insulated from shocks by exchange rate fluctuations, there is a strong case for adopting a configuration of the UB/EPL mix which gives more weight to unemployment benefits. Unemployment-insurance-based systems are indeed more mobility-friendly than job-security oriented labour market institutions, and are relatively less costly at times of turbulence in product and labour markets.

How are the NMS located along the UB/EPL trade-off? Should they change configuration with an eye to EMU membership? As stressed above, the return to Europe of formerly planned economies has been associated with an important role of unemployment benefits. At the same time, Labour Codes were reformed in these countries to allow firms to layoff workers for economic reasons, and adopting rather liberal (by EU standards) statutory severance pay and notice periods. However, the Visegrad countries did not significantly liberalise temporary contracts (Temporary Work Agency and fixed-term contracts) except Poland very recently which elsewhere have been a very powerful tool to introduce flexibility "at the margin" in European labour markets.

Thus the overall trade-off (highlighted in Figure 4) put the NMS still at the North-West end of the spectrum: one combining still rather strict EPL and relatively low coverage of UBs. The key factor, it should be stressed, is here the relatively low coverage of UBs rather than particularly low nominal replacement rates offered by UBs in these countries. Judging from the chart, NMS can still cover considerable grounds by adopting more mobility friendly configurations, e.g., moving to the South-East of the diagram. And this can be done, at least in part, by liberalising temporary work at the margin, a reform which is not too politically sensitive as it does not affect the rights of the insiders.

Figure 4: The Trade-off between UB and EPL (late 1990s)



* OECD Index of the Strictness of Employment Protection (0-6, increasing in the costs of dismissals)

3.4. The Scope for Activation Measures

Thus, unemployment benefits should continue to play a key role in the social policy mix offered by these countries. If anything, the coverage of unemployment insurance should be increased, jointly with a reduction in the strictness of employment protection, in order to better accommodate the demand for protection and the competitive pressures arising from early euro adoption.

This does not mean that the whole set of non-employment benefits should not be reformed: adjustments in the design of these instruments could significantly reduce their employment bias. In particular, two strategies could be devised, which are being increasingly applied in Europe to reduce disincentives associated with the provision of non-employment benefits: i) activation strategies enforcing work-tests and sanctioning with benefit reductions those who do not actively seek employment, and ii) financial incentives to work at relatively low wages. Financial incentives, unlike activation strategies, not only reduce disincentives to participation of low-skilled individuals, but also reduce the potentially large windfall effects on workers of non-employment benefits. However, they require significant administrative capacity, good tax records and wage structures not too compressed at their low-end. As these countries are still building from scratch their labour market infrastructure, have a large informal sector and wages are highly concentrated above the levels of unemployment benefits, activation measures seems to be a better option at this juncture.

Important lessons as to the effectiveness of activation strategies come from the experience of some European countries (Walsh, Atkinsons and Barry, 2000). In particular, Anglo-Saxon countries have moved increasingly towards a "shortest route to re-employment" approach that, rather than placing the unemployed individuals on hold in large scale training or work-experience programs, tries to reintegrate them into a job as quickly as possible. This strategy relies heavily on job search assistance and tests. In Switzerland and the United Kingdom individuals must now achieve a minimum frequency (usually determined by the PES based on each individual case) of job applications. Empirical evidence supports the role of job search assistance and tests for women and non-long-term unemployment benefit recipients with relatively short spells of joblessness.

Experimental evidence (available mainly for the US) is supportive of significant effects of job counselling efforts on outflows from unemployment to jobs. Insufficient action to prevent the loss of a job and refusal to take-up a "suitable"[2] job or to be involved in training schemes is also increasingly be sanctioned across the EU with a reduction in benefit amounts. These sanctions (ranging between 5 and 35 per cent of the benefit amount) proved rather effective in The Netherlands and Switzerland (Abbring, Van den Berg and Van Ours, 1999; Engelen et al., 1999) and in Switzerland (Lalive, Van Ours and Zweimüller, 2000): transition rates to employment were in these countries significantly enhanced by the imposition of sanctions.

Activation policies have been more successful from some groups of beneficiaries than for others (Martin, 2000). In particular, policies for women returning to the labour market have empirically been the most successful. For this group, job search assistance, counselling and training directed at the immediate return to work have been found successful in several experimental evaluations. Much more difficult is the case of unemployed youths with limited or no labour market experience. There is increasing evidence that training per se has very little effects on this group and that constant monitoring and testing of their activity is crucial. The British New Deal (Boeri, Layard and Nickell, 2000) is perhaps the most articulated effort to deal with this problem to date. Key features of the New Deal are: (i) the combination of lump-sum wage employment subsidies with job search assistance and on the job training; (ii) the initial 4 months Gateway period, to screen out individuals who are more easily unemployed and minimize deadweight costs; (iii) a separation of young unemployed into two types, according to age and duration of the unemployment spell. To date, there is virtually no empirical evidence on the New Deal, except for some - encouraging – evidence on outflows from unemployment in the Gateway period: Blundell et al. (2001) and van Reenen (2001) estimate that the New Deal is responsible for an increase in the probability of exiting unemployment by about 20 percent, of which one fifth can be attributed to the stricter job search requirements.

As suggested by the above, these activation policies require an effective Public Employment Service (PES), separate from the administration of social assistance benefits but interacting with social welfare centres, and an effective systems of sanctions. The whole approach of activation policies is indeed based on a "help and hassle" or "back to work" approach that cannot work without a clear legal framework and effective sanctions. Responsibilities and prerogatives of the various agencies should be clearly spelled out; in particular, the PES

[2] Among the most relevant issues to be addressed by the definition of a “suitable” job offer, there is the amount of travel time required to get to the workplace. In the UK and the Netherlands, no more than two hours travel daily are contemplated. In Belgium and Switzerland, the upper limit is four hours, although it is rarely enforced. Occupational protection (allowing unemployed people to refuse job offers involving a change in occupation) is typically provided only at the beginning of an unemployment spell (OECD, 2000).

should be able to sanction violations of the "suitable work" criteria and "job search" requirements quickly and terminally, without endless administrative litigation.

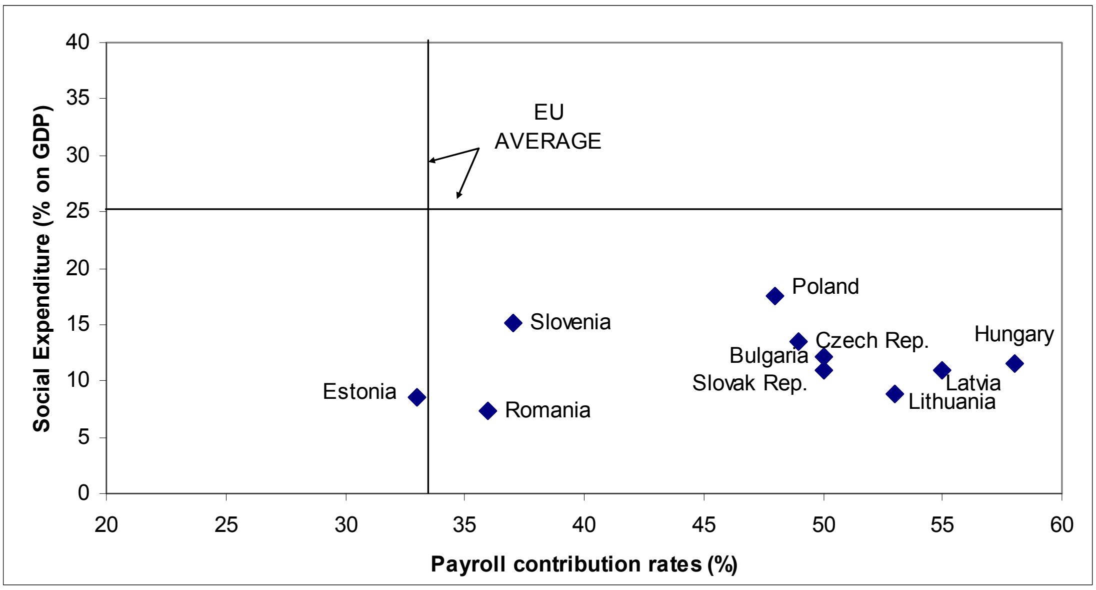
In Hungary, Poland and Slovakia, continuing eligibility to unemployment benefits in principle requires claimants to be actively seeking, capable of, and available for work. In Poland, claimants are also supposed to attend vocational training courses or be involved in public work programmes. However, these provisions are rarely enforced. Thus, the NMS will still have to build some administrative capacity and an effective system to set legal disputes if they aim at combining a higher coverage of unemployment benefits with effective activation measures bringing jobless people quickly back to work. If done properly, this system could contribute to *reduce* the structural deficits of these countries, and endow them with powerful automatic stabilizers.

3.5. Dealing with the Informal Sector

Another factor reducing incentives to job search in these countries is the possibility for many individuals to cumulate unemployment benefits and earnings from the informal sector (or self-employment). While this circumstance allowed unemployment benefits throughout the transition to operate de-facto as a subsidy to self-employment, it is currently a major factor reducing the cost effectiveness of the social safety net in the region.

Figure 5 documents the poor cost-effectiveness of social policies in the NMS. As we would expect given their relatively low income per capita levels, NMS spend *less* on social policy than an average EU country. However, they impose on employers and employees *higher* social security contributions than a typical EU country.

Figure 5: Social expenditure and social security contributions in the NMS

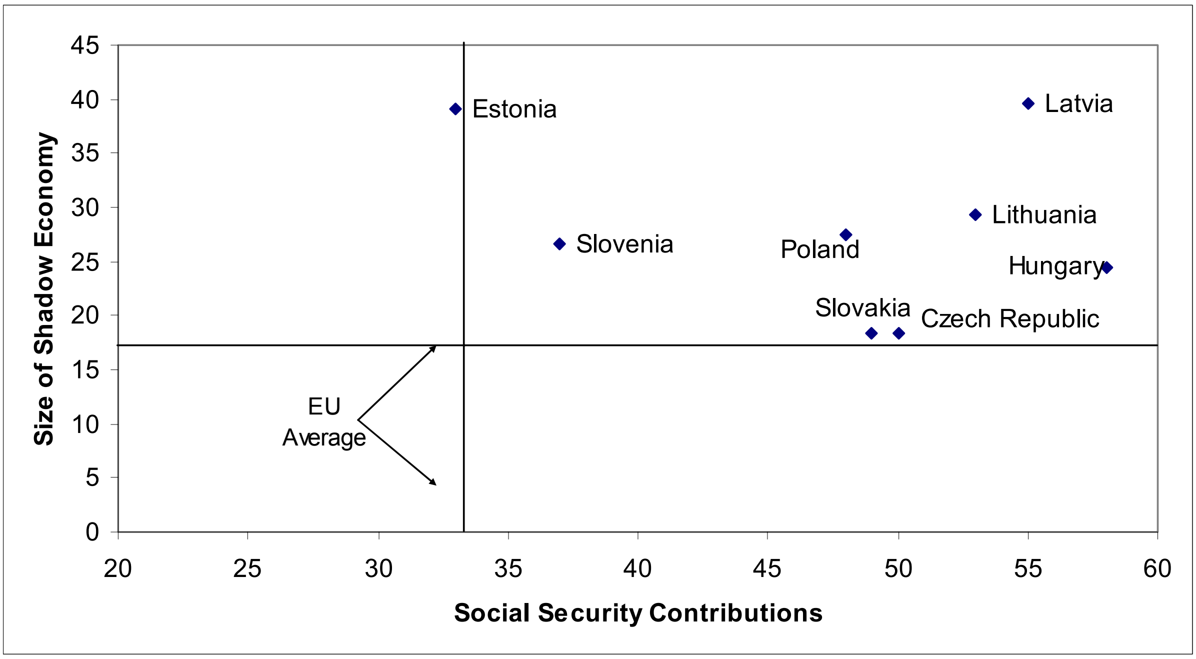


While the figure suggests that frequent claims about the risk of "social dumping" by the NMS are ill-funded, it also points to poor tax collection.

All available measures of the informal sector in these countries (Lacko, 1999; Earle and Sakova, 2000; Friedman et al., 2000) are displayed in Figure 6 against indicators of tax incidence. Unsurprisingly, the informal sector tends to be larger in the countries with the highest compulsory contributions and/or tax wedges. A vicious circle would therefore seem to be in motion in the NMS thereby a small tax base induces Governments to increase taxes on labour which further reduces the tax base.

How is it possible to break this vicious circle? Surprisingly enough the literature on the informal sector is mostly focused on incentives for employers to underreport sales or wages, while it devotes little, if any, attention to incentives coming from the supply-side. However, the decision not to hide or under-report economic activities should be backed by the workers. Otherwise it is bound to fail even when account is made of the inefficiency and corruption of state administrations in some of these countries.

Figure 6: Informal sector and social security contributions



Properly designed non-employment benefits can also contribute to reduce the informal sector. The key design feature enabling cash transfers to jobless people to play such a role is that non-employment benefits should be truly unemployment benefits, that is, cash transfers provided only to those who are actively searching rather than to all inactive, able-bodied individuals. It is important to combine large (ex-ante) coverage with tough (ex-post) activation measures, as those outlined in the previous sector. If benefits are low and eligibility is strict ex-ante, then workers will have no incentives to pay social security contributions. Moreover, unemployment benefits should be strictly earning-related above benefit minima at least up to a given wage-educational attainment level.

Other design features of unemployment benefits which can play an important role in inducing larger compliance to compulsory insurance against the risk of job loss have to do with the access to unemployment benefits. If eligibility criteria require that workers have a relatively long contribution-work record, then evasion from payment of social security contributions may be encouraged for those with low educational attainments as the expected tenure the youngsters and may appear too short to be sufficient to gain access to unemployment compensation. In general, eligibility criteria linking the maximum duration of benefits to the length of the contribution period without requiring long minimum employment records should be preferred on the ground that many new jobs offer relatively short tenures, and this will be even more the case if temporary work is further liberalized in the NMS.

4. Final Remarks

Euro adoption opens up new opportunities for growth in a stable macroeconomic environment for the NMS, but also imposes new challenges to the young labour markets institutions developed after central planning.

Wage bargaining institutions, although often considered as crucial for successful euro adoption, may not need major reforms in the NMS. Introducing social pacts, and more broadly centralising wage setting, may backfire as these countries have de facto decentralised wage bargaining and this flexibility in wage setting will turn out to be very valuable after EMU membership. However, NMS can find it useful to adopt wage norms for the public sector and, more broadly, for the (generally highly unionised) sectors which are still sheltered from competition. This does not require centralization of wage setting in the competitive segment.

Employment protection should be further liberalised, above all extending the scope of temporary contracts, at the margin. Under the new environment, it will be very important to have in place labour market institutions which are more mobility-friendly, and protect individuals against uninsurable labour market risk without preventing the restructuring of firms. This is just what unemployment benefits are supposed to do. A general conclusion of this paper is indeed that challenges coming from early euro adoption can be better faced by reforming the whole battery of non-employment benefit systems. Better designed cash transfers to people in working age for countries adhering to EMU should satisfy three key conditions.

The *first* condition is that different policy instruments should be used to achieve different objectives. In particular, it is preferable to have an unemployment insurance scheme tailored to job losers (as job search can be effectively carried out also on-the-job) allowing them to search efficiently and not discouraging outsiders from accepting jobs offering low employment security, and an income support scheme of the last resort for those with skills are no longer marketable. This social assistance scheme should be administered *separately* from unemployment insurance. Social assistance benefits should also possibly be differentiated between urban and rural areas in order to take into account of differentials in the cost of living.

The *second* condition is that rather than having overgenerous benefits, it is important to increase the coverage of unemployment benefits. This would also contribute to reducing the size of the informal sector by discouraging collusive behaviour by employers and employees in tax and social security evasion.

The *third* condition is that there ought to be strong activation policies for the beneficiaries of unemployment benefits and an effective system of sanctions for those not co-operating with the labour administration in seeking new jobs. Strict enforcement of work-test and welfare-to-work policies are essential already at low durations of joblessness and could substantially reduce the risk that individuals with marketable skills fall into long-term unemployment.

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