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My friend Stanley Fisher at the IMF likes to remark that from all the research he and his research department have made to explain *the growth performance of transition economies*, the one explanatory factor that stands out most clearly is the country's distance from the heart of Western Europe.

This in turn explains my own personal observation from years of extensive travel throughout CEECs that the idea which most vividly captures people's imagination is not anything I or the World Bank might say or do, it is the idea of reducing that very distance ...by joining the EU.

The potential social impact of EU enlargement is, I know, giving pause not only in candidate countries, which may be concerned about withstanding heightened competitive pressures, but also in member countries where fears about large scale labor migration have been blown out of proportion. I hope the session tomorrow will help deflate them.

Indeed, I would like to point out to you tonight how much, in my view, *the interests of member and candidate countries converge* in this area. Their common interests are to:

- 1 - create jobs at home; and
- 2 - struggle against social exclusion.

This convergence of interest should come as no surprise, if you consider how much both sides have already gained from integrating with each other.

Compare *GNP levels across Central and Eastern Europe and Central Asia* for 1991-1999 – they reveal a telling story:

Central Europe and the Baltics (CEB) saw a contraction in GNP 1991/2, but then experienced a sustained economic recovery, driven primarily by exports towards the EU. In contrast, the countries in the CIS (FSU minus Baltics) saw a continuous economic decline in 1991-98. The result in terms of relative economic strength is striking:

In 1991: GNP of CEB was 1/3 of GNP of CIS
In 1999: GNP of CEB was 1/3 greater than GNP of CIS

In 1991: GNP of Russia was 7 times that of Poland
In 1999: GNP of Russia was barely larger than that of Poland

In 1991: GNP of Poland was roughly the same as that of Ukraine
In 1999: GNP of Poland was 5 times that of Ukraine

By that year, over two-thirds of Poland's *exports* were going to the EU, while less than 20 percent of Ukraine's took the same direction.

Of course, nobody claims that EU integration on its own account for such different trajectories. Stabilization and structural reforms were key. But no one would deny either that integration with the EU provided the framework and the impetus for countries to forge ahead.

On the other side -- the EU side -- of the coin, the gains cannot be ignored either: the CEECs have become the *Union's second largest export market* (after the US)...and one where the EU enjoys a sizable trade surplus.

This is not to say that the integration process would be painless. To the contrary, countries are facing a number of *critical social challenges*:

- 1 - dealing with the ensuing economic restructuring;
- 2 - providing social protection without blunting incentives or compromising fiscal sustainability;
- 3 - activating labor markets;
- 4- enhancing human capital; and
- 5 - combating social exclusion.

Economic Restructuring

At the heart of the matter is the fact that the ongoing recovery in CEECs has created very few jobs on a net basis. To be sure, there has been a massive amount of "*labor churning*" as jobs shifted from dying industries to new, often smaller scale greenfield operations first in services, and more recently also in industry. Reflecting on the parallel experience of East Germany, Saxony officials reckon that three-quarters of the population now have different jobs than ten years ago.

But, even in a well performing country like Hungary, the level of *employment* remains more than 20 percent below the 1990 level. In Poland, it remained almost unchanged in the face of a 45 percent GDP expansion (cumulative) between 1993 and 1999, and *unemployment* remains high at 13 percent of the labor force.

Accordingly, Poland's *poverty* incidence was still higher in 1998 than in 1991. Indeed, across the CEECs, unemployment (and underemployment, particularly in rural areas) has been a leading cause of absolute poverty spreading to 15-20 percent of the population

across most of the region (and as much as two-fifths of the population in Romania), sparing only its most affluent members (Slovenia and Czech Republic).

The pressure is unlikely to let off. Across the board, continued *trade liberalization* will unlikely heighten competitive pressures, particularly as it extends to the often over-manned *agricultural sector*.

The implementation of EU policies (e.g., on state aids and internal market) will also speed up the restructuring of *declining industries* (e.g., steel and coal), and force other big employers in sectors such as services (banking, transport) and utilities (e.g., railways, telecom, power) to shape up. More jobs will be lost in the process.

Labor Market Policies

To facilitate a shift in jobs from declining to growth activities, candidate countries may need to maintain a perhaps-greater degree of *labor market flexibility* than is commonly the case within current members of the Union. The 25 percent ratio between minimum and average wage observed in the Czech Republic is likely, for instance, to do more for job creation than the France-like 50 percent ratio which Poland experiences.

Of course, bringing down unemployment will require measures that go beyond labor market policies. More active *housing markets*, for instance, would also help prevent that workers be trapped in “rustbelts” after their jobs have moved elsewhere.

Social Protection

Appropriate social safety nets are also needed. The fact however is that accession countries are already spending heavily on *social security*. They actually spend as much as a percentage of GDP as member countries, although their levels of income per capita is one to two third lower than the EU average.

To finance those systems, labor is sometimes heavily taxed: labor tax wedges in a number of accession countries exceed those observed in cohesion countries (above 50 percent in Czech Republic vs. about 35 percent in Ireland).

Left unattended, the situation could easily get worse. In Romania, for instance, the rate of contribution to the public pension scheme, which has already jumped (from 14 percent of wages in 1990 to 37.5 percent now) would need to escalate further to 62 percent over the next fifty years to keep the current system afloat. The alternative of subsidizing social security systems out of general taxes is not fiscally sustainable.

Unsurprisingly, a growing number of candidate countries (including the likes of Poland, Hungary, and Bulgaria) are looking for innovative ways to ensure social protection while invigorating labor markets. Witness the movement towards multi-pillar pension systems, or the focus on targeting of cash benefits.

Human Capital Development

Whether or not good jobs become available over the medium term will depend fundamentally on the extent to which countries succeed in redirecting their human capital and the social programs that help build it towards the need of a globally integrated market economy. A number of candidate countries have taken good strides towards reforming their *education* (e.g., Latvia) and *health* (e.g., Czech Republic) sectors. Sustained efforts will be needed for them to bear fruit and benefit all members of society.

Social Inclusion

In the meantime, one needs to recognize that economic restructuring of the magnitude experienced can strain the social fabric and raise the spectrum of social exclusion, in member and candidate countries alike. Within candidate countries, two groups among the weakest are particularly vulnerable: *children* (18 to 59 percent of the poor in CEECs) and *ethnic minorities* (85 percent of the gypsies live in poverty in Bulgaria). We were glad to see the European Union take up their causes in the context of accession.

Similarly, the enlarged Europe will want to keep the door open to its new neighbors (e.g., Belorussian workers in Poland), as they contribute to the prosperity of all.

Clearly, the candidate countries are confronted with unprecedented social challenges. What is heartening is to see the *innovative spirit* with which candidate countries are dealing with them.

Dealing with these challenges remains at present very much a national responsibility. But as the *acquis* develops in the social areas, it will benefit from taking into account not only the needs of candidate countries, but also from bringing on board the lessons of their innovations. It is my personal belief that the impact of these innovations will reverberate beyond the candidate countries themselves, and will help all of Europe move forward.

Indeed, they will form part of the new members' dowry to the enlarged Union.

We at the *World Bank* are doing our bit for those innovations to flourish and spread, with interventions in each of the five areas I just mentioned.

1 - Enterprise restructuring in coal mining, railways (Poland, Romania) and rural sector (Poland)

2 - Social Protection (e.g., Social Protection Adjustment Loan in Bulgaria),

3- Labor Markets (e.g., Employment Services in Poland),

4 – Human Capital Development: (e.g., Bulgaria, Hungary and Latvia Education projects, Latvia Health project)

5 – Social Inclusion at the community level (e.g., Community Services in Lithuania) and of target groups (e.g., Child Welfare project in Romania).

In concluding, let me say that we look forward, and offer our services, to support the EU and candidate countries in their respective efforts to tackle successfully the social agenda of EU enlargement.