

**First Report on
Economic and Social Cohesion –
Study Area 3: The Impact on Cohesion
of EU Enlargement**

edited by

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1. INTRODUCTION

The following study comprises the Draft Final Report for Study Area 3 - the impact on cohesion of EU enlargement - of the Report on Economic and Social Cohesion. The Report has been drafted by the following institutes and researchers:

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The report comprises four main parts, sub-divided into eighteen chapters (each of which has its own set of bibliographical references). It is published in two volumes. In the first volume, *Part I* begins with a summary overview of the current state of transition in Central and Eastern Europe (CEE) and the progress with national reforms in the 10 acceding countries in the region. *Part II* comprises eight chapters, examining the current socio-economic situation in the CEE acceding countries: Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Bulgaria, Romania, Latvia, Lithuania and Estonia. The eight chapters examine, in turn: demography, labour market, economy, business, physical infrastructure, social infrastructure, environment and regional development. In each case, the chapters discuss three main issues: the principal trends identifiable across the accession countries; the main national commonalities and disparities; and, as far as comparable data allows, regional disparities and trends.

The second volume of the report begins with *Part III*, which provides a similar assessment of socio-economic conditions, based on the same structure, in the two island economies - Malta and Cyprus. *Part IV* is an analysis of the impact of EU enlargement on cohesion. It deals, first, with broad theoretical issues, and takes a more detailed look at the experience of the reunification of Germany and broader lessons which can be drawn for transition countries of Central and Eastern Europe and the Baltic states. It then analyses in more specific detail the effect on structural and regional development issues associated with an enlargement of the EU. The report concludes with a discussion of some of the policy issues to arise from the analysis, notably the financial and institutional issues facing EU structural policies.

PART I:

THE CURRENT STATE OF TRANSITION

2. THE STATUS OF REFORM IN CENTRAL AND EASTERN EUROPE

2.1 Introduction

In 1989, the creation of a new Solidarity government in Poland initiated a process of economic and political reform that quickly swept across the other countries of Central and Eastern Europe (CEE) and later the republics of the Soviet Union. The transition towards a market economy and democratic government was associated, first, with *macroeconomic stabilisation* involving tight monetary policy, reduction of budget deficits and exchange rate management. Systemic transformation was pursued through *microeconomic liberalisation* - abolition of restrictions on private enterprise, opening-up of foreign trade, currency convertibility, reform of property rights, deregulation, new legal frameworks; and through *institutional restructuring* - privatisation and restructuring of state enterprises, reorganisation of state administration, reform of banking and financial systems and the establishment of new institutions.

The consequences were immediately apparent in a sudden fall in output, rising inflation and hyper inflation, and (partly) a fall in living standards, particularly in those countries that followed a 'shock' programme such as Poland, Czechoslovakia, Bulgaria and Romania. Progressively the reforms also led to a realignment of export markets (away from the COMECON area, especially the Soviet Union, and towards Western Europe), and growth of the private sector.

Since 1992, stabilisation began to be evident in Poland, Hungary and the Czech Republic, and more recently for Bulgaria, Romania and the Baltic states where negative economic indicators are only beginning to be reversed. The political dimension of transition has been apparent in the break-up of countries - Yugoslavia, the Soviet Union and Czechoslovakia - and the emergence of new states, as well as political pluralism and greater assertiveness among ethnic minorities.

After five years of transition, what is the audit of progress to date? Overall, there is broad consensus that systemic transformation can now be considered to be permanent in all CEE countries. The extent and progress of economic and political reform make it extremely difficult, if not impossible, for the transition process to be halted or reversed. Specifically, the following conditions are evident.

2.2 Economic Performance

As described in more detail in Chapter 6 of this report, the most notable feature of the transition process is that the economic crisis associated with transformation appears to have been largely overcome. The latest comparative data indicates that the economy of much of the CEE region is growing at 3-4 percent per year, employment is rising (or falling more slowly), and with a more or less constant level of unemployment, currently falling in several countries.

The best economic performance is evident in Poland, Slovenia and the Czech Republic (tight monetary policy in Hungary is likely to restrict growth in the immediate future); Poland and Slovenia experienced GDP growth of at least five percent during 1994 with a prediction of 7 percent for Poland in 1995. Inflation is still high by Western European standards but has fallen significantly (with the exception of Bulgaria) from the hundreds/thousands of percent annual increases in the early 1990s. In the more advanced reform states, annual consumer price increases in 1994 were mainly in the range 10-20 percent. Budget deficits have been brought largely under control. Apart from the Baltic states (especially Latvia and Lithuania, where economic conditions are still extremely difficult), industrial production has begun to recover or grow strongly, accounting for much of the positive growth trend (WIIW, 1995).

2.3 Market Systems

A further important conclusion is that market economic systems are firmly embedded (as detailed in Chapter 7). Across much of the CEE region, especially in the early reform states, there has been comprehensive liberalisation of prices and reduction in budget subsidies, rising share of the private sector (and local replacement of the initial leading role of foreign capital in privatisation), reduction in customs tariffs and extensive market economic institution building and reform.

All the CEE countries have undertaken privatisation programmes, though at differing rates. Initially, significant parts of the public sector were privatised through the restitution of properties and enterprises seized by the former authorities. Most countries have also implemented 'small' privatisation, bringing numerous small-scale retail, construction, artisan and other commercial services into the private sectors. The 'large' privatisation, involving major state-owned enterprises, has been slower to proceed, in part delayed by practical problems, a shortage of buyers (especially foreign investors) and the political implications of the sale or break-up of major employers.

Consequently, the proportion of state-owned enterprises privatised by CEE governments ranged, in 1994, from two percent in Bulgaria and seven percent in Romania to 70 percent in Estonia and 75 percent in the Czech Republic (Table 5.1). Similarly, the private sector share of national GDP varied from 24 percent in Bulgaria to 75-80 percent in the Czech Republic (Table 5.3). Since 1994, there has been a narrowing of these national differences: the proportion of state-owned firms privatised in Romania, for example, had increased to 21 percent by mid-1995 (Podkaminer, 1995; UN ECE, 1995; CCET, 1994).

The revitalisation of foreign trade and investment, and its reorientation from COMECON to Western markets, has been a central feature of reform programmes. Measures have been taken progressively to remove many national trade restrictions by CEE countries, to introduce currency convertibility at international rates, to reduce foreign exchange controls, and to negotiate trade agreements with major partners.

Between 1990 and 1993, CEE exports (mainly of resource-based and labour-intensive goods) grew at an annual average of seven percent, while imports (characterised by

capital and high-tech intensity) increased at an annual average of 29 percent, accounting for the sizeable trade deficits of many CEE countries (Bulgaria being a notable exception). The Hungarian deficit, for instance, had risen to 40 percent of the value of exports by mid-1995. Foreign trade is dominated by the Visegrad states: in 1993, Poland, Hungary, the Czech Republic and Slovakia accounted for nearly three-quarters of all OECD trade with CEE countries. Since liberalisation, there has been a surge of foreign direct investment (FDI) into CEE; in one estimate, cumulative FDI has risen from US\$ 2.5 billion in 1989 to US\$ 21.9 billion by the end of 1995 (UN ECE, 1994; Artisien *et al*, 1993). The bulk of inward investment has been directed to Hungary (US\$ 8 billion) Poland (US\$ 5.4 billion) and the Czech Republic (US\$ 3.7 billion), particularly from the US and Germany, as described in more detail in Chapter 7 of this report.

2.4 Democratic Institutions

For the most part, democratic political institutions and systems have been established. Parliamentary and legal systems have been introduced with a separation of powers between the executive, legislature and judiciary. New constitutions are gradually being developed, although basic elements are still partially rooted in the old socialist system. Whereas in more advanced countries, like Poland and Hungary, the primary task is to consolidate institutions to ensure their effective operation and maintain the separation of powers, in other countries (eg. Bulgaria and Romania) there are still important institutional deficits to be filled. There is still considerable disagreement about the appropriate form of institutions, the allocation of responsibilities to parliamentary and government organisations and systems to ensure transparency and accountability. Three other features are worth noting.

- Although new private sector institutions and institutional structures have been created, in some cases accelerated through Western support, many are still operating imperfectly, lacking expertise or resources. In many cases, institutions such as banks operate in a highly centralised manner, concentrated in the capital cities. There is a need for the wider dissemination of good practice, use of advanced technologies and working methods
- New electoral systems have been introduced, generally operating proportional representation and/or party list systems with a five percent threshold (four percent in Lithuania, three percent in Romania) for representation in parliament. The political landscape is characterised by numerous political parties covering the entire political spectrum and fluctuating in form and composition. Such factors contribute to difficulties in forming and maintaining coalitions, causing political instability and inconsistency in the direction and commitment of policy. The most extreme case is Poland with more than 200 political parties, and eight prime ministers, seven governments and five parliamentary coalitions over the past six years.

- The enduring negative effects of transition have given rise to a certain ‘reform fatigue’ in terms of the popular commitment to reform, manifest in a political backlash against liberal, reform-oriented parties and the rise of anti-reform parties (eg. ‘reconstructed’ communists) and extremist groups. This emphasises the importance for continued efforts in all countries to reinforce political stability and increase popular awareness and understanding of democratic values and systems.

2.5 Social Conditions

The social situation for the majority of people has deteriorated. As described in Chapter 5, the employment effects of the recovery have so far been marginal, with persistently high levels of unemployment, averaging 13 percent over much of the region (the notable exception of the Czech Republic). The threat of job losses, especially where large enterprises are still to be privatised, and under-employment is widespread. Youth and long-term unemployment rates are rising.

Most CEE countries have seen a decline in average incomes and purchasing power, while the gains from transition (eg. opportunities for new firm formation) have been limited in extent. Differences in income between social groups have increased and the incidence of poverty has intensified dramatically, especially among ethnic minorities (eg. gypsies in Hungary). The combination of economic crisis and market liberalisation has been associated with major increases in crime, corruption and illegal economic activities, creating additional difficulties for the transition process, and adding to the social uncertainty/unrest about transition.

Hitherto, the official unemployment rates are not dissimilar to those in Western Europe, although considerable hidden unemployment is known to exist. Social tensions may be exacerbated further by major unemployment arising from the acceleration of large-scale privatisation as well as the reduction of social support or inefficient reforms (the privatised health insurance system in the Czech Republic is close to collapse).

2.6 Territorial Administration

The reform of the territorial administration is still to be undertaken across much of the CEE region. In most countries there are few intermediate state institutions - in some cases a political vacuum - between the central state and local government. Central governments have a high concentration of political power, while regional or provincial levels tend to be weak, having lost powers either to central government or to communes and municipalities since transition began.

A process of vertical and horizontal fragmentation has taken place in the relationships between different levels of government and among actors at local/regional levels. An extreme case is Hungary, where the number of local authorities doubled in one year (1990), each local community having the right to form self-government. As elsewhere, local authorities suffer from inappropriate size and expensive and unprofessional administration. Especially in the larger CEE countries, there is a

general recognition of the need for territorial reform, but consensus has proved difficult to establish.

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3. NATIONAL REFORMS

3.1 Introduction

Following the preceding overview of transition across Central and Eastern Europe (CEE), the following chapter provides a summary of the key developments within each of the ten acceding countries in the region. In each case, the country profiles start with a broad overview of recent economic developments, including trade and investment, together with a brief analysis of sectoral changes in both employment and production and a summary of labour market conditions.

3.2 Poland

Poland implemented a shock programme of economic reform from the start of 1990, which led to the rapid creation of the market system with the limited intervention of the state. After initial economic collapse (sudden drop in output, hyperinflation, steep fall in purchasing power), economic trends began to be reversed in 1992. Since then the economy has attained a high level of growth - reflected in indicators of GDP, industrial production, fixed capital formation, exports and foreign investment. The budget deficit has fallen considerably since 1994, due in part to the introduction of a new tax system. Inflation levels are still high (in excess of 28 percent in 1995), but have become 'acceptable' to some degree and do not appear to represent a major impediment to growth.

Despite frequent changes of government and prime minister over the past five years, and the difficulty of maintaining coalitions, Poland is a politically stable country. The fluctuating composition of parliament does not affect the development of a market economy or political institutions. It is anticipated that a new democratic constitution will be created and adopted in 1996. Institutional reform has been rapid since the end of the 1980s, and considerable progress has been made in the economic sphere. The process of privatisation has been the principal motor in the creation of market institutions, and democratic institutions such as the judiciary are also well-developed. However, institution-building needs to continue, particularly in the areas of the social security and personal insurance systems.

Foreign trade, and particularly imports, have increased rapidly in Poland. In 1995, the trade balance was negative, but was covered in part by the inflow of foreign currency through 'petty trade' along the western and eastern borders - it is estimated, for example, that German buyers spend DM4 billion annually in western Polish regions. The majority of trade is undertaken with EU countries, partly the inevitable result of the collapse of eastern markets. Foreign direct investment is considered one of the most important factors in economic recovery in Poland. There has been an accelerated inflow of foreign capital over recent years - the 1995 inflow alone (an estimated US\$ 3 billion) was half of the overall total up to that year and this level is expected to double in 1996. The main sources of investment are the USA, international capital institutions (such as the European Bank of Reconstruction and

Development), Germany and other major European countries, and the principal recipient sectors include industry and the financial sector.

Sectoral changes in the Polish economy have become apparent as a result of reform measures. The constant decline of agriculture, the growth then decline of industry and the rapid increase in the services sector share of GDP indicates the modernisation of the Polish economy. Industrial growth has provided the motor for the economic upturn, particularly in consumer-oriented sectors. The more technologically advanced and the more market-oriented the activity, the higher the rates of production growth. Traditional branches of heavy industry (mining, energy, basic metal production), however, are still in serious decline. Industrial restructuring produced an even greater concentration of industrial production in leading regions, with the top 13 *voivodships* producing 63 percent of industrial production in 1992.

Economic change has had substantial ramifications on the Polish labour market. Three particular dimensions can be identified: the decline of the working population and the emergence of unemployment; the shift from public to private sector employment; and changes in the sectoral structure of employment. The private sector created over 1.5 million jobs outside agriculture over the period 1990-94 (in comparison to 3.7 million shed by the public sector), the most important sectors being domestic trade and construction. Private sector employment in 1994 was 60 percent of the total. The shares of industry, construction and agriculture in overall employment have all declined, although agriculture acted for a short while as a reservoir for labour released from other sectors. Employment in services has grown consistently since the start of the transformation process, and represented 42 percent of total employment in 1994.

Unemployment is one of most serious effects of transformation in Poland, although it has been decreasing since the end of 1994. The unemployment rate at the start of 1996 was 14.9 percent, with higher levels among the non-agricultural workforce. Long-term unemployment is an issue of increasing concern, indicating the underlying structural nature of unemployment, and those with low qualifications are generally more at risk. Despite high levels of unemployment, excess employment levels, particularly in industry, are still evident in Poland. State enterprises remain reluctant to adjust the number of employees to production levels for fear of losing qualified personnel before an economic upturn. The perception of enterprises as institutions with a social function and responsibility towards maintaining employment also still persists.

Poland signed an Association Agreement with the European Union in 1991, and made a formal application for accession as early as April 1994. Since the start of the transition process, Poland's leading political forces have broadly supported the goal of accession, for both political and economic reasons.

3.3 Hungary

With a longer record of market reforms (beginning in 1968), the recent transition process has been more gradual in Hungary. Nevertheless, the first years were also characterised by declines in income and output, although the growth of the 'shadow' economy offset, to some extent, the decline in GDP. As in Poland, stabilisation started in 1992, with a resumption of output growth in mid-1993. The first recorded increase in GDP since 1989 was in 1994, and industrial production is now growing strongly.

The more recent course of economic reform has been shaped by the requirement to implement more thorough restructuring of the banking laws and enterprise sectors (stimulated in 1992 by the introduction of tough bankruptcy laws), but also the need to lower the perceived costs of transition due to the emergence of 'reform fatigue' in the population. These conflicting pressures have led to a degree of ambiguity and incoherence in the reform programme. The sustainability of economic growth also became questionable, particularly in the face of a large and growing current account and budget deficit, as well as increasing inflation. The danger of a debt trap developed as rising interest payments conflicted with pressures to maintain high levels of social expenditure. The principal objective of the 1995 government economic strategy was the reduction of the current account deficit by around half, using measures such as the lowering of public consumption and improved cost competitiveness through lower real wages. Other objectives include tightening the fiscal position to reduce the overall budget deficit, an ambitious privatisation target, and the reform of the social security system.

Hungary has enacted a constitution and a legal framework defining the role and powers of parliament, executive and judiciary. Administrative reform of government structures has been proposed by the current coalition government, including the reduction of the number of ministries, the establishment of integrated ministries rather than smaller scale ones with narrower scope, the dismantling of deconcentrated arms of the government which currently reduce the autonomy of local authorities and the speeding of the privatisation process. By comparison with Poland, Hungary has stable government: a conservative coalition lasted from 1990 to 1994, superseded by a socialist/liberal coalition in the 1994 elections.

Hungarian trade has been largely reoriented from former CMEA to western markets. Exports have remained concentrated in traditional sectors eg. agriculture, clothing, food and beverages, chemicals and basic metals, while import demand is principally for investment goods and industrial inputs.

Foreign investment levels in Hungary stood at over US\$ 8 billion in 1994, more than double the 1992 level. Manufacturing has been the major recipient of foreign investment, and foreign-owned firms are particularly important in engineering, the food industry and consumer goods. The initial determining role of foreign capital investors in the privatisation process has gradually decreased, although foreign owned firms still accounted for 50 percent of Hungarian exports in 1993. Foreign investment

in highly concentrated in Hungary, with Budapest alone having more joint ventures than the rest of the country put together.

The restructuring measures undertaken in Hungary have had important ramifications for the size and sectoral structure of industry. There has been a sharp reduction in the number of large enterprises (formerly dominant in Hungarian industry) and a notable increase in SMEs. However, there is still overall under-performance in the SME sector due partly to poor framework conditions for entrepreneurs - eg. unclear legislation, high taxation and lack of access to finance.

In sectoral terms, engineering, the metal industry, mining and building materials were particularly affected by the decline in industrial production. In relation to future development, the construction industry and telecommunications may play an important role, as well as the expansion of the services sector. The restructuring of traditional industrial regions, and the 'natural' process of industrialisation, is likely to be a long-term task, which can only be achieved gradually, in parallel with the transition of agriculture and the strengthening of the food processing industry. In the short to medium term at least, it is principally the local and Hungarian market, rather than the export market, which may play an important role in stabilising the economy.

The structure of employment in Hungary has broadly reflected general CEE trends ie. the decline of agriculture and the increase of the service sectors. Industrial employment fell sharply, although significant levels of over-employment had existed in Hungarian industry and labour productivity rose in 1993. More unexpected was the expansion of employment in the government sector (excluding state owned enterprises) which was strongest in 1993. Registered unemployment reached its peak in 1993 and declined to 10.5 percent in August 1995. Long-term and youth unemployment are particular problems.

An Association Agreement between Hungary and the European Union was signed in 1991, and an agreement regulating trade policy, including the establishment of free trade in industrial goods, entered into force in March 1992. The Association Agreement provides the basis for cooperation, particularly relating to the reduction of financial burdens. Economic, rather than political, factors are likely to determine the speed of Hungary's integration into the EU.

3.4 Czech Republic

Economic and political reform began in Czechoslovakia in 1989. However, disagreement over both the jurisdiction of federal and republic bodies and the economic and social policies led to the break-up of the country and the formation of two independent republics from 1 January 1993. The sudden implementation of the reform programme led to a rapid fall in macroeconomic indicators, although recovery became increasingly visible over the 1992-94 period, and economic growth in 1995 reached nearly five percent. The transition process was assisted by the sharp devaluation of the Czech currency and the rapid decline in real wages (partly through regulation), although the deteriorating balance of trade suggests that these artificial 'stimuli' to competitiveness may now be exhausted.

By comparison with other transition countries, Czech inflation (9.1 percent in 1995) and unemployment remain low, and the privatisation process is virtually complete. The ratio of GDP growth rates, real incomes, and real wages is an area of concern, with real wages growing more rapidly than GDP as the process of transition has continued. As elsewhere, the polarisation of population by income group is becoming apparent.

The new constitution of the Czech Republic defined legislative, executive and judicial powers as well as other key institutions such as the central bank and a system of territorial self-government. A new tax system was introduced in 1993 which is fully comparable with the EU system. The process of ownership change has been implemented through privatisation, restitution and the establishment of new private companies, and the non-state sector now accounts for more than half of GDP. Despite substantial realignment of party affiliation in parliament, there has been no change in the government since the formation of the Republic, and the next elections will take place in June 1996.

The Czech Republic currently has a negative trade balance, due principally to the rapid rise of imports, as economic growth has increased the demand for both capital and consumer goods. Exports have continued to increase throughout this period, although their competitiveness appears to be falling. In line with other CEE countries, the orientation of trade has shifted towards western markets, and Germany alone accounts for almost a third of total exports. The importance of geographic location is emphasised by the fact that nearly ten percent of Czech imports come from the relatively small, but neighbouring, Austria. The structure of export goods is not favourable, with an increasing share of raw materials and semi-finished goods, which have a low value-added but a high energy consumption, and a declining share of more sophisticated products eg. machinery. By 1995, the total amount of foreign investment in the Czech Republic was US\$ 3.7 billion, the main investor countries being Germany, the USA, France and Austria. In sectoral terms, transport machinery, consumer goods and tobacco, construction, financial institutions, foodstuffs and chemicals have been the principal recipients.

Economic reform has brought about considerable changes to the structure of employment. Strong falls have occurred in the primary sector and, to a lesser degree, in the secondary sector but, in line with other CEE countries, employment has risen in the tertiary sector. Agriculture and mining were particularly badly affected by employment decline, while the sectors increasing most rapidly included those where a relatively quick return could be made on invested capital eg. finance, hotels and trade. The restitution and privatisation of property led to an increase in demand for construction services and a corresponding growth in this sector.

The unemployment rate in the Czech Republic is considerably lower than most EU countries, standing at 2.9 percent in 1995. This is partly explained by the, as yet, incomplete process of privatisation and restructuring, but is also related to a decrease in the economically active population and people withdrawing from the labour force. Future declines in employment are likely to have a more direct impact on the unemployment rate. The areas which have been most badly affected by

unemployment (although rates in general still do not exceed five percent) are those dominated by heavy industry or mining.

An Association Agreement was signed between the EU and the Czech Republic in October 1993 and a Free Trade Agreement is also in force. The process of adapting Czech laws and regulations, as well as economic conditions, to come in line with those of the EU has already started. The Czech Republic has made considerable progress to meeting required economic conditions. The full international convertibility of the Czech crown was an important recent step, although higher degrees of fluctuation will probably be necessary in the future in relation to the fixed exchange rate with the DM and US\$. The further liberalisation of foreign trade, the abolition of all import restrictions and the reduction of customs duties will also be necessary in future, though some regulation on imports is likely to remain given the unstable balance of trade that persists. A potential future problem associated with accession may be the free movement of labour, and the possible emigration of workers seeking higher wages in western European countries.

3.5 Slovakia

Slovakia became independent at the start of 1993 against an unpromising economic background: the country had fewer financial and raw material resources than the Czech Republic and a greater dependence on military and heavy industry as well as trade with the former USSR. Nevertheless, Slovakia appears to have largely overcome the problems of separation, although it took until 1994 for the fall in GDP and rise in inflation to be halted. GDP is now growing strongly, by an estimated 7.4 percent, and the budget deficit is small by comparison with other CEE states. Slovakia is one of the least indebted post-socialist economies, with foreign debt per capita being less than in the other three Visegrad states. Economic growth has been achieved through a high level of exports and (increasing) trade barriers to protect the domestic market (in accordance with GATT trade agreements).

Hurdles to further economic development include the gradually developing banking sector, which has slowed the increase in market services, and the changes in the form of privatisation process. The second wave of voucher privatisation was canceled in mid-1995, and replaced by an issue of five-year bonds which can be used in payment in a number of areas (eg. housing purchase). The bond privatisation scheme, just like the voucher scheme, is unlikely to bring the necessary new finance into the economy.

Although the institutions characteristic of a democratic state with a market economy have been established (constitutions, elections, independent judiciary etc.), as in other transition countries, there is the need to stabilise the political structure further. The characteristic feature of this process is the diminishing number of political parties as the political situation begins to approximate Western European structures. Both coalition and opposition parties appear to be unable to co-operate in addressing major political and socio-economic problems, and there is an urgent need, for example, for social welfare reform and the implementation of adequate social policies. Despite this, social peace prevails, perhaps more so than in many other transition countries, although the polarisation of society in terms of wealth is becoming more obvious.

In terms of trade and investment, the balance of trade in 1995 was slightly negative and trade has been substantially reoriented to western markets (and Germany in particular), although the most important trading partner remains the Czech Republic, and Russia has also maintained an important trading position. Iron and steel are the most important exported commodities, while mineral fuels and oils the largest group of imported goods. Tourism is also an important earner. An additional problem facing Slovakia is the former centralisation of foreign trade, carried out principally by foreign trade enterprises based in Prague. New institutions must be established to take over this role in the future.

A total of US\$ 732.9 million had been invested in Slovakia by 1995, with levels of investment rising rapidly in 1995. The most important investor countries include Austria, Germany, the Czech Republic and the USA, with the principal recipient sectors being trade, financial and commercial services and industry. Transport and communications, construction and tourism still lag behind in terms of investment. Domestic investment continues to rise, and the volume of investment by the private sector account for 54 percent of the total volume in the first half of 1995. A key problem facing private businesses is insufficient finance for the purchase both of modern technology and of inputs to meet the orders placed, as well as for investment purposes.

The initial economic decline caused a considerable decline in the labour market, although the increasing number of small businesses led to a rise in the number of employees during the first half of 1995. The private sector share of employment is over two-thirds in the secondary and tertiary sectors. The sectoral structure of employment has followed the general CEE trend - falling levels in agriculture and industry, and rising employment in services. Future employment related issues are likely to include ensuring the correct balance in vocational training needs, the increase in the number of pensioners after the turn of the century, and the re-integration of the long-term unemployed into the labour market.

Unemployment currently stands at 14.8 percent in 1994, although regional unemployment rates varied between 4.5 and 26 percent, and in almost a third of Slovakia, unemployment was higher than 20 percent. Regions specialising in mechanical and electrical engineering, metallurgy and mining and agricultural production have found particular problems adapting to new world competition, and are more affected by unemployment. Long-term unemployment is a considerable concern, with nearly half of job-seekers having been unemployed for more than a year.

Slovakia signed an Association Agreement with the European Union in 1993, followed by its official application to the EU (with full political party support within the country). Although the country is committed to participation in European integration, there is a minority view, perhaps exaggerated in the media, in favour of political neutrality.

3.6 Slovenia

Slovenia achieved independence in October 1991. Reform has been hampered by the disintegration of Yugoslavia, notably the loss of the former Yugoslav market, problems of succession, and the consequences of continuous fighting in Croatia and Bosnia-Herzegovina. Nevertheless, Slovenia was able to benefit from earlier experience of a self-management system based on a quasi-market economy. In addition, from the mid-1960s, Yugoslavia was exposed to democratic and market economic influences through trade and free mobility of people. In the economic field, production levels fell sharply in the first years of transition, with recovery starting in 1993. Economic growth and industrial output have increased at a high rate over the past two years and per capita GDP in Slovenia is amongst the highest in the transition countries - although GDP is not expected to reach pre-transition levels until 1997. The budgetary situation is under control, inflation is falling (though still 12.6 percent in 1995) and the Slovenian tolar has appreciated over the last two years against currencies including the US dollar. Income disparities are growing, as in most CEE countries, although society is still considered to be cohesive.

The separation of powers between executive, legislature and judiciary has been completed. Institutional reform has allowed the emergence of more flexible arrangements necessary for a market economy, and the Ljubljana stock exchange, established in 1989, was the first in CEE. A privatisation law was passed in 1992, and privatisation is continuing steadily, although, as in all CEE countries, qualitative improvements are necessary for continued strong future growth. Slovenia has a relatively stable government comprising a coalition of three major (liberal/social democrat) political parties, despite the fact that the political structure has not yet stabilised, and there is considerable realignment and re-organisation of political parties. New elections are due to be held in 1996, and the continuation of a coalition based government is anticipated.

The fall in production and employment, growing unemployment and withdrawals from the labour market (eg. by long-term unemployed) led to a dramatic reduction in the labour force participation rate - formerly one of the highest in Europe. Private sector employment has increased, but not sufficiently to compensate for losses in the state sector. An estimated 26 percent of the active population are also involved in the shadow economy, thought to generate up to 21 percent of GDP. High labour costs, resulting partly from a very high ratio of contributors to pensioners, has been detrimental to the competitiveness of the Slovenian economy.

The structure of employment differs considerably from EU countries, with the share of the secondary sector virtually equal to that of the tertiary. However, the expected decrease in agricultural and industrial employment, and the increase in the tertiary sector, has been witnessed throughout the 1990s. Manufacturing (especially metal products, machinery, textiles, clothing, wood and chemicals) continues to be the main employment sector, although financial, technical and business services and public administration are the only sectors in which employment has grown consistently. The rate of registered unemployment in mid-1995 was 8.8 percent. This relatively low rate is due in part to early retirement schemes, increasing self-employment or employment

in the shadow economy, and retraining and other employment policy measures. Long-term unemployment is becoming a significant problem.

A Trade and Cooperation Agreement between Slovenia and the European Union was signed in September 1993, and a Europe Agreement was initialed in June 1995. Slovenia may be in a position to meet EMU convergence criteria within the next few years, and currently fulfills two of the fiscal criteria. The similarity in the structure of Slovenian and EU foreign trade means that the structural problems of accession may be lower. The sectors which could be threatened by integration include agriculture, where the disintegration of numerous small farms is feared. While the government is committed to full integration with the EU, there is an increasing political and social voice questioning the cost of such a move.

3.7 Bulgaria

Transition to political democracy and market economy in Bulgaria began in 1989, although political tensions and contradictory attitudes to reform delayed the introduction of a macroeconomic stabilisation programme until 1991. The later start of transition, combined with subsequent political instability and uncoordinated, *ad hoc* reform measures, meant that the unfavourable trends in GDP, inflation, unemployment, budget deficits and balance of payments persisted throughout the first half of the 1990s. Economic growth has only recently resumed, and GDP is expected to increase by 3-4 percent in 1996. Inflation fell from 90 percent in 1994 to 62.7 percent in 1995, but inflationary pressures still represent an important economic problem.

Bulgaria, therefore, faces a continued major challenge of macroeconomic stabilisation and structural reform, although the greater political stability of 1995 has provided a recent stronger basis. One positive aspect is the relatively stable social backing for the reform process, characterised by a sense of realism with regard to the inevitable difficulties and challenges of economic transformation.

With respect to microeconomic liberalisation and institutional reform, legislation has been enacted with respect to property rights, deregulation and price liberalisation. The institutional infrastructure remains incomplete or inefficient in areas such as the judiciary, police and economic affairs. The privatisation process has been slow, the financial sector (banking system, capital markets, stock exchange) remains underdeveloped and land restitution is still underway. Many of these delays to reform are attributable to period of political fluidity between 1992 and 1994. Since the December 1994 elections, however, political stabilisation has been maintained, based on a coalition of the democratic left, and considerable emphasis was placed during 1995 on increasing the efficiency of government ministries and institutions to facilitate a more coordinated, structured and efficient management of reform. There appears to be a recent trend to reduce political differences and focus more on the real economic needs of the country.

Considerable fluctuations in the volume of trade can be observed since 1990, reflecting the unstable nature of the economy. The foreign trade balance was positive

in 1991 and 1994, but negative in all other years. Trade has been reoriented to European Union countries, accounting for approximately 38.1 percent of exports in 1995, while the share of CEE countries fell from 88 percent in 1989 to less than 33.5 percent in 1995. There is an increasing body of opinion in Bulgaria that the import regime should be tightened to promote the revival of domestic production, and that the production of exports should become a key priority. At the end of 1995, total foreign investment was an estimated US\$ 532 million, the majority of which has entered the country since 1993, although this total is higher if indirect investment and privatisation revenues are taken into account. Key recipient sectors for investment include industry, transport and trade, while Germany, the Netherlands, Switzerland and Belgium are among the most important investor countries.

The macroeconomic reform programme has led to considerable sectoral restructuring in the Bulgarian economy in both production and employment. The structure of industry has changed as a result of three main factors: production decline resulting from the economic crisis; changing international conditions; and explicit restructuring measures, which have had only a weak effect on the economy. Industrial production is currently sectorally skewed towards the chemical, oil refining and food industries, which account for 45 percent of the total. The growth sectors in 1994 included the chemical and oil industries, ferrous metallurgy, glass and porcelain and paper production.

In relation to the labour market, employment levels have fallen, unemployment has risen sharply, and a mismatch has emerged between the supply and demand for labour. The unfavourable labour market situation is not expected to be overcome before the year 2000. The greatest decline in employment has occurred in the agricultural sector, while a slight rise was registered in the secondary, and a much steeper increase in the tertiary sectors. Within the overall high levels of unemployment, youth unemployment is a significant problem, with 40 percent of all registered unemployed being less than 25 years of age, and those with low qualifications are also particularly at risk. As is the case in CEE countries, the capital city had the lowest rate of unemployment.

Changes in the ownership structure are also clearly evident in the Bulgarian economy. The emergence of private property rights in the trade, services, agriculture and transport sectors provided the preconditions for private sector growth, which has occurred rapidly but to levels still lower than the Visegrad countries. The majority of established private companies are micro-enterprises (up to five employees), with self-employment comprising a significant part of this. The principal remaining obstacles to private sector development include the lack of adequate legal regulation or institutional support, the difficulty in accessing finance, the overall insecure economic environment and the shrinkage of domestic demand.

Bulgaria signed an Association Agreement with the European Union on 1 February 1995, establishing the basis for a free trade area. The opening of the domestic market and the full exploitation of export possibilities to the EU should aid the creation of competitive markets and the reduction of monopolistic prices and costs in Bulgaria. Certain commodities, including agricultural products and semi-manufactured goods, still have only limited access to EU markets but their trade, particularly during the

transition period, acts as a form of export buffer against the effects of deeper economic crisis. Greater market access is seen as particularly important for agricultural trade, as the impact of the Association Agreement on Bulgaria's agricultural exports to the EU has, to date, been relatively small.

The dynamic effects of the association with the EU are likely to become increasingly important as Bulgaria moves towards a stage of more positive adjustment and away from economic crisis. At this stage, the country will need to adopt more outward looking strategies for restructured or newly created internationally competitive production sectors. The opening of markets may provide the scope for the improved utilisation of resources, economies of scale, technological innovation and transfer, and greater factor of production mobility. The nature of the trade liberalisation between Bulgaria and the EU, particularly given the likely continued disparity in economic development between the two partners, will be of crucial importance in the coming years. The current effect of association with the EU is related more to the use of Bulgarian human resources in terms of skilled labour and low wage costs.

3.8 Romania

In comparison with the Visegrad countries, reform has had a difficult birth in Romania. Transition began, in 1989/1990, from one of the lowest points in CEE with respect to economic management and the organisation of social and political life. As elsewhere, a rapid fall in the national economy took place over the 1990-92 period, the decline being stopped in 1993 and a slight increase in economic growth resuming in 1994. Although growth prospects are positive, and GDP growth of 6.9 percent in 1995 exceeded expectations, inflation remains very high (33 percent in 1995) and the improved trade balance was achieved partly through import restrictions. There still appears to be a degree of political reluctance towards reform.

Macroeconomic stabilisation was hampered by an initial legislative vacuum (which also favoured the simultaneous development of underground economic phenomena), and it was not until a new constitution and new elections were organised that measures such as price liberalisation and currency convertibility could be introduced. A constitution was adopted in 1992 providing a clear distinction between the executive, legislative and decision-making powers. Elections, also in 1992, produced an unstable centre-left coalition which, with varying party combinations, has remained in office since. Political parties are in a state of flux, and present trends indicate a radicalisation of several parties with moves towards extremist nationalism (both left and right wing), capitalising on popular discontent with declining living standards. New institutions have been established - constitutional court, prosecutor's office, agencies for privatisation, economic development, and property - but their functioning has been hesitant and slow.

The volume of foreign investment had increased to a total of over US\$1.4 billion by the end of 1994, although investment has often involved low value projects. In terms of location, the principal recipient areas have been border regions and areas with large markets ie. the main urban areas and their hinterlands.

The structure of the Romanian economy is dominated by industry (despite dramatic decline since 1990) and agriculture to a considerably greater extent than in the European Union. The oil processing, metallurgy and machine building sectors are of particular importance to the Romanian economy. Industrial restructuring has proved problematic in Romania, with the need for change and modernisation in large industrial firms sometimes being ignored due to their perceived continued social function. This has, in some sectors, led to the growth of parallel private enterprises rather than the upgrading and restructuring of existing firms and infrastructure. The privatisation of large financial enterprises started as late as September 1995 and only nine percent of industry has been privatised. In the agricultural, construction and services sectors, privatisation is more advanced.

The dramatic fall in economic activity, particularly in the initial years of transition, had a corresponding effect on the labour market situation. The active population has declined as a result of falling production, and unemployment rose to over ten percent of the active population in mid-1995 and is expected to increase further. Very high unemployment rates are particularly evident in regions which were industrialised artificially eg. Moldavia, Oltenia, North Transylvania. The private sector currently accounts for nearly half of the working population, but many state industries still maintain oversized labour forces. The structure of the active population has also shifted, although in a slightly different pattern to the majority of other CEE countries. Employment in the primary sector, for example, has increased following land reform and a rise in the number of private producers. Agriculture has also acted as a form of reservoir for job losses in other sectors. Although considerable increases have been noted in certain sub-sectors eg. real estate, finance and insurance, there has been no significant shift of employment in favour of the tertiary sector - a clear trend in many of the other transition countries. It is, however, anticipated that Romania will move more in line with other CEECs as the reform process continues.

Romania has signed an Association Agreement with the European Union, and a National Strategy was drafted in mid-1995 as a preparation for accession. Accession implies for Romania the creation of certain specialised institutions and the elaboration of programmes for the restructuring of socio-economic and financial activities. The areas which are most likely to be affected by this restructuring include Moldovo and Baragan, and the coal mining regions and industries of the Oltenia Subcarpathians. It is anticipated that the lifting of the economic sanctions against the former Yugoslavia will stimulate activity related to the Danube river, and particularly the industrial city ports along the river. In sectoral terms, it is likely that wood processing, metallurgy and hydrocarbon extraction will be in a favourable future position following restructuring.

3.9 Estonia

The regaining of independence in Estonia in 1992 and the implementation of macroeconomic stabilisation policies followed a similar course to the other two Baltic states. Statistical trends suggest that the economic collapse was less severe than in either Latvia or Lithuania and the recovery was quicker. Significant growth of GDP started in 1994, based on strong upturn in construction and industrial production, and

preliminary statistics suggest a GDP increase in 1995 of 4.5 percent. Production in most industrial sectors stabilised after 1994 and only agricultural output continued to decline in 1995. Inflation was reduced from a peak of 1,069 percent in 1992 to 29 percent in 1995, although it is likely to stay relatively high by western standards over the next few years. The national budget is in balance, and foreign debt is comparatively small.

A new constitution was adopted in Estonia in 1992. The institutionalisation of private ownership has been an important task of government policy, and the process of privatisation has been one of the most successful of the CEE countries. However, the privatisation of land has been slowed by a complicated restitution procedure. The institutional and legal framework for entrepreneurial activity, a tax and banking system and capital market are established, although the process of change continues. Following the most recent (October 1995) elections, a centre-right coalition was formed.

Estonia has applied a very liberal trade policy since 1991, in which all trade barriers and tariffs have been abolished. The liberalisation of foreign trade has contributed to the stabilisation of the Estonian economy - the growth of exports has been promoted, the inflow of duty-free imports at world market prices have been exploited by manufacturers for production for domestic and foreign markets, and external competition has accelerated restructuring and helped to move the price level more towards that of the world market. The policy of undervaluing the Estonian kroon has also boosted exports. Over 60 percent of total trade is now undertaken with western countries, Finland, Sweden and Germany being of particular importance. Foodstuffs and textiles were the main export groups in 1995. The majority of foreign investment went into industry (51 percent), transport and trade, and the principal investor countries included Finland, Sweden and Russia.

Industry is still very important in the structure of the Estonian economy, its share of GDP in 1995 being 21 percent, although the contribution of mining and manufacturing has decreased considerably. In common with the other Baltic states, the difficulties facing the manufacturing sector include the requirement to move from a relatively inflexible production system integrated within the overall Soviet framework, to a more flexible arrangement which is responsive to market competition and consumer demand. The reorientation of production towards western markets has led to a decline in the share of light industry and an increase in the food industry.

Economic change has clearly affected the labour market situation in Estonia. The supply of labour has fallen, and the participation rate is the lowest of the three Baltic states. In part, this is related to withdrawals from the labour market, currently accounting for an estimated ten percent of the working age population. This problem has exacerbated the increase in the economic dependency rate, which represents a considerable burden to the economy. Although employment levels have fallen over the last four years, the time lag between production and employment indicates a continued hoarding of labour. As in other CEECs, the structure of employment has shifted, favouring the service sector and with falls in agriculture and industry.

The relatively low unemployment rate (five percent of the economically active population in mid-1995) is influenced by factors such as the decline in labour resources, the growth of the private sector, labour hoarding etc. The increase in dollar wages is likely to spur unemployment, particularly in sectors open to competition, and structural unemployment is also likely to rise. Long-term unemployment is becoming an increasing problem, and is concentrated in urban areas and counties with high unemployment or a concentration of industry. Low labour mobility and the poor housing market also affect the labour supply.

A Free Trade Agreement was signed between Estonia and the European Union in July 1994, an Association Agreement was completed in June 1995 and Estonia applied for full membership in November 1995. A Bureau for the Minister of European Affairs has been established in the Estonian government to deal with issues relating to integration. Estonia already has a liberal trade regime in place, and potential problems related to accession are more likely to stem from the adoption of EU market regulations, particularly in relation to agriculture.

3.10 Latvia

Latvia split from the USSR in 1990 and restored its independence in 1991. Beginning in 1990, the government gave priority to the development of a market economy with a comprehensive programme of land reform, privatisation and reform of ownership relations, and a re-organisation of banking, monetary, fiscal and judicial systems. As in Lithuania, a rapid decline in economic activity occurred between 1991 and 1993 and compared to 1990, GDP declined by half. The fall in GDP per capita, however, was less severe due to the significant reduction in population numbers over the period, related in part to emigration to the CIS. Although economic decline was halted and signs of GDP growth emerged in 1994, industrial production continued to fall, and the predicted 1995 growth in GDP did not occur. Inflation has been brought under control to some extent by tight monetary policy and was 26 percent in 1995.

Constitutional and institutional reforms have been carried out, although missing elements still exist with respect to the completion of the legal system, state administration, the large-scale privatisation, social reform and development of financial and property markets. Privatisation has progressed relatively rapidly in certain sectors - eg. retail trade, services and banking - but has been slower in industrial sectors, due in part to uncertainty about property rights and land ownership. The establishment of a Privatisation Agency in 1994 has improved the situation. Following the elections in autumn 1995, the previous centrist majority was replaced by a parliament split between left and right wing parties. Following some difficulty in forming a government, a politically neutral prime minister was appointed with a coalition government comprising representatives of six political groups.

The fall in GDP and the collapse of the Soviet market led to a considerable decline in Latvian exports and a negative foreign trade balance in 1994. A further factor hampering the entry of Latvian goods into new western markets is the inherited obsolete technological and economic structure. The role of Russia and the CIS in Latvian trade has declined considerably, and the EU now accounts for 44.1 percent of

exports. The most important types of export include wood, electrical machinery and equipment and iron and non-alloy steel. By the end of 1994, US\$ 309.5 million had been invested. Important investor countries include Denmark, the USA, Germany and the UK. Over 90 percent of investment is concentrated in Riga and the surrounding region.

The structure of the Latvian economy has changed, with a significant increase in the services sector over the period 1990-94 and a fall in agriculture, manufacturing and construction. Services development has been most rapid in the sub-sectors catering for international, as well as domestic, markets - eg. transport, communications, trade and financial mediation. The former position of Latvia (and the other Baltic states) within the overall Soviet system has resulted in a high level of industrial specialisation - in the Latvian case in the machine and equipment building sector. The disintegration of the former USSR has led both to the loss of markets and of suppliers of necessary parts. Reorientation of such specialised industrial is likely to be very difficult.

The Latvian labour market is characterised by declining labour demand as the state sector contracts without correspondingly large increases in the private sector. A decline in the supply of labour is also evident, due in part to emigration and increasing numbers of self-employed. In addition, it is estimated that up to 20 percent of the labour force is engaged in the so-called 'shadow' economy, with correspondingly negative effects on the economy due to loss of tax income. The structure of employment has not changed markedly, with only a small decrease in the secondary, and small increase in the tertiary, sectors. A significant number of people have remained employed in agriculture as the sector absorbs many of those who have lost jobs in other areas.

Official unemployment has stabilised at a relatively low level of 6.5 percent in 1995, although the problem of long-term unemployment is becoming more serious. The phenomenon of 'invisible underemployment' eg. the compulsory halting of production in enterprises, involuntary unpaid vocations, reduced working weeks etc, is thought to be pressing in Latvia. It is estimated that in 1994, losses from this type of underemployment amounted to more than 2,8 million man days, or the equivalent of 2.5 percent of the working population.

Latvia has signed both a Free Trade Agreement (July 1994) and a Europe Agreement (June 1995) with the European Union. The principal problems foreseen with further integration are in the area of agriculture, reflected in the imposition by Latvia of relatively high import tariffs on agricultural produce in December 1994. Agrarian reform has led to the creation of numerous small farms, which are likely to face considerably difficulties in competing in the European market. The technological backwardness of Latvian industry may also represent a potential future problem.

3.11 Lithuania

Lithuania declared independence in 1990, although Soviet influence was only lifted after the 1991 *coup d'état* in Moscow. In the interim, a wide range of economic reform legislation was passed relating to the liberalisation of prices and economic activity, agricultural reform, privatisation, restitution of property rights, social security, banking, foreign investment etc. The economy experienced a dramatic decline across all sectors in adapting to changes in prices of productive inputs, the disintegration of the economic area and loss of markets. Like its Baltic neighbours, the Lithuanian economy had been highly integrated with, and dependent upon, Russia through production relations, especially in the energy field. The rise in energy prices had a particularly devastating effect on the economy and it has been estimated that Lithuania's GDP declined to one-third of 1989 levels, the worst of all CEE transition countries. The trend in GDP was only reversed in 1994, and in 1995 GDP grew by 3.6 percent in the first half of the year. Although hyperinflation has been brought under control, inflation was still 37 percent in 1995.

In terms of institutional reform, considerable progress has been made although the functioning of political, market and social institutions is still inefficient by OECD standards. The banking crisis of late 1995, illustrated by the insolvency of the four largest banks, is of particular concern, both for national growth and for the attraction of foreign investment. In many areas, the credit and financial system still lacks a robust legal framework. Ownership reform has been rapid, with nearly half of industry and virtually all services now privatised, and over 60 percent of employment and production in the private sector. Lithuania has a constitution including separation of powers, and in the 1992 elections, a democratic left government was elected (currently in a minority) for a four-year term. The worsening economic and social situation has led to social discontent, lack of confidence in public institutions and the rise of nationalist pressure opposing liberal economic policies. Prospects of political stability after the 1996 elections seem uncertain.

The trade structure of the country has changed significantly, with the EU accounting in 1995 for nearly 30 percent of Lithuanian exports and imports. The CIS, and Russia in particular, still represent important trade partners, with Russia's share of imports being only marginally less than that of the EU. This situation is due in part to the requirement to import all energy resources and other raw materials, and the one-way technical design of terminals has made the ability to import oil and gas from non-CIS countries highly problematic. There has been relatively little foreign investment in Lithuania (amounting in 1995 to US\$ 397 million), although the lifting of sectoral restrictions by a new law passed in August 1995 may improve the situation. The largest current investor countries are Germany, the USA and the UK.

The changes to the economic structure of Lithuania reflect general patterns of CEE countries - a reduction in the share of agriculture and industry, and an increase in trade and services. The construction, transport and restaurants/hotels sectors have remained relatively stable, while the banking sector has increased faster than GDP. The increase in both the domestic consumption of, and the foreign demand for, electricity represents a positive development given the considerable importance of electricity

production in the overall industrial structure of the country. Sectors with good future potential include energy, transport and communications.

Labour market developments show a marked increase in unemployment during 1995, related in part to the post-privatisation accelerated process of restructuring. However, the unemployment rate, at 7.3 percent in December 1995, was still relatively low. Those sectors and social groups particularly affected include sectors requiring significant technological restructuring, the energy sector, and low-qualified young people. The non-employment level is quite high at 11.8 percent in the second half of 1995. In terms of employment structure, the share of industry has fallen, with the decline in absolute numbers being even more serious. Agricultural employment has increased, related to the rapid development of private farming and the difficulty of finding employment in urban areas, but is unlikely to be sustainable in the longer term.

Lithuania signed a Free Trade Agreement with the EU in January 1995 and an Association Agreement in June 1995. Under the former, Lithuania is bound to drop all import duties for EU countries within a six-year period with the essential elements comprising agricultural production in Lithuania and textile quotas in the EU. Attempts have also been made to develop closer relations with individual Member States, particularly Denmark.

In addition to economic advantages of closer links with the European Union, other perceived advantages include the integration of Lithuanian transport and energy system with European ones, given the economic importance of transit transport and the energy sector, and better prospects for foreign investment with the harmonisation of business and investment standards. The two principal concerns relate to agriculture and electronics. The efficiency of agricultural production is low, and although specialisation could provide niche markets for Lithuanian products, it is likely to prove very difficult to improve the productivity of the currently over-manned sector. The problems of the electronics sector are related to the obsolete nature of the goods formerly produced for the Soviet market, and the requirement to introduce new high-technology niche products.

PART II:

**REGIONAL SOCIO-ECONOMIC CONDITIONS
IN CENTRAL AND EASTERN EUROPE**

4. DEMOGRAPHIC SITUATION

4.1 Overview

Against the growing globalisation of all aspects of economic life, demographic processes are still very strongly influenced by national policies. “Although virtually all European countries belong to the group of demographically ‘advanced’ countries, demographic figures for fertility, mortality, age structure, migration, urbanisation, employment by sector, unemployment etc. still vary significantly from one country to another” (Blotevogel, 1996). With regard to Central and Eastern Europe (CEE), population data generally indicate that the populations are either growing slowly or declining, with *natural* positive increase only occurring in Poland. Infant mortality and the death rates of the elderly have changed very little during the transition period.

In terms of changes among *men*, only the middle-aged male category appears to have death rates which are disproportionately high, though as men in Slovakia, the Czech Republic and, more recently, Poland have come to grips with economic difficulties, the death rates for those over 40 have declined since 1989. Nevertheless, in most CEE countries (Bulgaria, Hungary, Romania, Slovenia, Estonia, Latvia and Lithuania), male life expectancy has fallen. There has been a notable rise in death rates, with the exception of the Czech Republic and Slovakia (*The Economist*, 1995). This upsurge in male mortality rates can be attributed to: the lowering of standard of living, poorer nutrition, and increased stress associated with the uncertainty of transition. In contrast, *women* seem to cope with the difficulties of transition better than men. In all CEE countries (with the exception of Bulgaria and Slovenia), female life expectancy has risen. Overall, throughout CEE, as a result of low birth rates, the populations are disproportionately old and middle-aged.

Immigration has been another important factor in the demographic process. Migration flows into Western Europe vary: fewer people migrate from the Czech Republic, Hungary and Poland than in previous decades, while the main long-term migratory flows come from Romania and Bulgaria. There has also been some short-term international migration within CEE (from Romania to Poland) as well as to the West (from Poland to Germany). In addition, two new phenomena are worth highlighting. First, there has been an increased migration between the Baltic states and CIS due to the withdrawal of Soviet troops. Second, extensive migration has resulted from the armed conflict in Yugoslavia, leading to a number of refugees entering Slovenia.

In regional terms, the picture has been more mixed. Inter-regional migration within CEE countries has declined, with the same pattern of out- and in-migration prevailing during the transition period as before. Similarly, ethnic homogeneity continues to vary between CEE countries (with native ethnic groups averaging 85 percent in some areas) and the Baltic states (where they account for approximately 60 percent of the population of Latvia and Estonia). However, at the same time, regional demographic patterns are being altered by changes in urbanisation processes, which have been greatly influenced by the economic restructuring programmes of the transition countries. In the past, the implementation of various settlement strategies and planning objectives dictated the pattern, structure and overall stability of urbanisation.

In combination, these different processes have meant that all CEE countries are now subject to both national and regional variations in the demographic terms. Consequently, this chapter provides an overview of the main demographic trends, with particular emphasis on migration, ethnic homogeneity and urbanisation at both national and regional levels.

4.2 Data Issues

Before considering population trends, it is important to consider the peculiar data problems associated with demographic research in CEE. For this chapter, three types of data have been used: international sources, national sources (at national, regional and local levels) and data from various articles. For international comparisons three sources are cited: the WIIW-Handbook of Statistics (based on research by the Vienna Institute for Comparative Economics), data provided by the World Bank and research undertaken by Venesaar and Hachey.

- *WIIW*. The first source contains demographic data provided by the national statistical offices and national banks of the respective countries. As CEE countries move toward market economies their statistical offices replace old classifications and methodologies with internationally-accepted standards. However, progress made by each country in this respect varies and this may impact upon the comparability of statistics across countries, over time, and between transition and market economies.
- *World Bank*. Data from the World Bank is used in Table 4.1 (among others) to indicate the natural increase in population in the Baltic states, calculated by combining the declining crude birth rates and rising crude death rates
- *Venesaar and Hachey*. As Latvia has the highest negative rate of natural increase, caution should be exercised when comparing it with other countries as data comes from different sources. Venesaar and Hachey (1995), based on national sources, is used to provide a degree of comparability.

At national and regional levels, if data is not specifically sourced, it originates from national reports compiled by local experts. Most of the data is based on appropriate population censuses (eg. 1989 for Estonia; 1991 for the constituent regions of Czechoslovakia; 1992 for Poland). It is at the regional level that data is least comparable due to the differing sizes of regional units and lack of information concerning the methodology used for its collection. The nature of data quoted from various articles may also raise the question of its suitability for cross-country comparisons.

4.3 Demographic Indicators

In 1994, the *total population* of the seven CEE (ie. not including the Baltic states) countries was 97.6 million - a fall of 0.5 million people from the 1990 total of 98.1 million - and 7.8 million in the three Baltic states. The most populous countries were Poland and Romania, although the Czech Republic had the highest population density. Conversely, the smallest populations were found in Slovenia and Estonia; the latter also had the lowest population density (Table 4.1).

	Total Population ('000)		Population Density (per km ²)	Natural increase (per '000 pop'n)	Infant mortality (per '000 live births)
	1994	1990	1994	1994	1994
Bulgaria	8,427	8,669	76.3	-3.8	16
Czech Republic	10,336	10,363	131.0	-1.1	8
Hungary	10,245	10,355	110.3	-3.1	12
Poland	38,581	38,183	123.0	2.6	16
Romania	22,712	23,207	95.5	-0.8	24
Slovakia	5,356	5,311	109.1	3.9 ¹	11 ¹
Slovenia	1,989	2,000	98.2	-0.1 ¹	7 ¹
Estonia	1,506	1,573 ²	34.5	-5.3	15
Latvia	2,565	2,680 ²	39.7	-7.5	16
Lithuania	3,724	3,690 ²	57.1	-3.6	15

¹ - 1993 figures,

² - 1989 figures

Source: WIIW, 1995; Venesaar and Hachey, 1995; Heleniak, 1995; national sources.

The majority of the transition countries populations are either growing very slowly or declining; the rate of natural increase in 1994 was positive only in Poland and Slovakia. The three Baltic states have experienced a negative natural increase combined with out-migration, mainly of Russians. Furthermore, two of them - Estonia and Latvia - have experienced negative rates of natural increase since 1989. However, Lithuania, due to its rural population and a smaller number of Russians than the other two republics, has only recently registered a negative natural increase. As Heleniak (1995) noted: "These demographic trends, which include steep declines in marriage rates, are tangible evidence of societies' responses to the great uncertainty brought about by the break-up of the Soviet Union and the difficult transition to market economies."

Amongst the natural reasons for population change, increasing mortality rates and decreasing fertility rates play an important role in many of the countries. (*The Economist*, 1995) The decline in fertility has to be highlighted: "By the early 1990's nearly all European countries (including most of those east of the former Iron Curtain) had witnessed a slipping of their net reproduction rate below 1.0 and thus confronted a negative natural balance: more deaths than births" (Blotevogel, 1996). More revealing

is the data on the total fertility rate (TFR), which is the overall number of children born to a women during her reproductive life. TFR of 2.1 is regarded as crucial for population stability - of all the CEE countries only Hungary had fertility well below that figure (1.8).

Similarly, only two of the transition economies have seen decreases in their death rates: the Czech Republic and Slovakia, while figures for Poland did not change between 1989 and 1993 (*The Economist*, 1995). Death rates have increased in most of the other transition economies (in Latvia, by as much as 45 percent in the last five years). The increase in mortality rates can be attributed to increased poverty, deterioration of the health care, and social stress. Infant mortality rates are relatively high, particularly in Romania. Most economically-developed countries have infant mortality rates of less than ten, according to World Health Organisation classifications - only the Czech Republic and Slovenia are included in this category of the ten transition countries.

Table 4.2: Age and sex structure of CEE population					
	Percentage of total population				
	<i>Male</i>	<i>Female</i>	<i>Pre-working age</i>	<i>Working age¹</i>	<i>Post-working age</i>
Bulgaria	49.1	50.9	19.6	56.2	24.2
Czech Republic	48.5	51.5	21.0	58.5	20.5
Hungary	47.9	52.1	18.6	62.1	19.3
Poland	47.5	52.5	28.1	58.4	13.5
Romania	49.1	50.9	22.7	60.6	16.4
Slovakia	48.8	51.2	24.9	57.8	17.3
Slovenia	48.5	51.5	19.3	69.1	11.6
Estonia	46.7	53.3	23.0	55.7	21.3
Latvia	46.4	53.6	21.0	56.9	22.2
Lithuania	47.3	52.7	23.6	56.5	19.9

Source: national sources; Venesaar and Hachey, 1995.

As has been noted elsewhere: “Ongoing fertility decline, combined with the continuing trend of increasing longevity in all European countries, leads to the fundamental reshaping of the age structure known as *ageing*” (Blotevogel, 1996). This trend can be observed in the majority of transition countries. In Romania, for example, the percentage of people over 60 rose from 12.3 percent in 1966 to 16.4 percent in 1992. In some countries - notably Slovenia, Latvia and Romania - this trend has been particularly marked in rural areas, whereas in other countries - especially Bulgaria - the active-age population has declined both absolutely and relatively, with a parallel increase of people above active age in all regions of that country.

¹ Definitions of age groups as follows:

Bulgaria: pre-working - up to 15; post-working - above 55 for women and 60 for men

Poland: pre-working - up to 18; post-working - above 60 for women and 65 for men

Romania: pre-working - up to 14; post-working - above 60

Slovenia: pre-working - up to 14; post-working - above 65

Czech Republic: pre-working - up to 14; post-working - above 54 for women and 59 for men

4.4 Migration

Migration flows are an important factor in CEE demographic patterns. The transition economies as a whole continue to be an area of emigration. Some countries have experienced emigration towards western Europe, principally as a result of people seeking better economic opportunities. In the past, “the principal source for these flows was Poland, while more recently flows from Romania and Bulgaria have become more significant... the great majority of these flows has been absorbed in Germany and Austria, in many cases due to historical or ethnic associations” (Koser,1996). Furthermore, in the 1990s, there has been no propensity to emigrate to western Europe from former Czechoslovakia and Hungary while the number of emigrants from Poland has declined. In contrast, in Romania, over half a million people left during the early 1990s, two-thirds of whom went to Germany during 1991-1993 - although over 180,000 subsequently left Germany, many returning to Romania (UN ECE, 1995).

There also has also been some migration *between* the CEE countries. A considerable percentage of it is medium- and short-term labour migration, particularly to Poland, Hungary and the Czech Republic. CEE countries are also serving as a transit migration route for irregular and illegal migrants from other east European countries not directly bordering on the West. These migrants come with the intention of moving further to the West rather than settling down in CEE. Armed conflict, especially in the former Yugoslavia, has also led to flows of refugees entering certain CEE countries, particularly Slovenia. Over 30,000 registered and 10,000 unregistered refugees entered Slovenia during the last three years in addition to around 130,000 immigrants who fulfilled the requirements for and obtained Slovenian citizenship. From the European perspective, it is worth noting that many western countries have modified their migration laws and enforcement procedures in the early 1990s, leading a considerable decrease in the number of refugees and asylum seekers from 700,000 in 1992 to 300,000 in 1994.

Special circumstances prevail in the Baltic states, following both the withdrawal of Soviet troops and emigration of (principally) Russian nationals back to other countries of the former Soviet Union. These movements have led to significant levels of emigration from the Baltic states, mainly of people of working age. In Estonia, for example, between the end of 1989 and mid-1995 there was a net negative migration balance of 71,894. In Latvia, the same phenomenon can be observed over the period 1991-1994, with a net negative migration balance of 104,000. Most new arrivals are ethnic Latvians and their offspring, and their numbers are likely to increase as a law on repatriation (which seeks to facilitate the immigration of Latvians currently residing in Russia and elsewhere in the former Soviet Union) was adopted by Parliament on 10 October 1995.

Inter-regional migration within the individual CEE countries has generally decreased during the 1990s, as can be seen using the following select examples.

- In *Romania*, both intra- and inter-county migration was dependent on the degree of economic development and existence of larger cities. In 1990, a vast number of

people began moving from small towns or the countryside to the large cities due to the lifting of migration restrictions. At the same time, townspeople started moving into the countryside - mainly elderly people who had decided to resettle after obtaining rights to land ownership (though this process has slowed down by 50 percent over the last 2-3 years). The migratory flux stabilised in Romania in 1995 due to job restructuring, macroeconomic and organisational changes, and resettlement based on changes in the Land Law.

- In *Bulgaria*, around four percent of the population migrated within the country over the period 1985-1992, compared with eight percent during 1976-85. This decline is related in part to falling real income, as a result of the recession, as well as a shortage of new houses and stagnant housing markets.
- In *Poland*, there were no major changes between the 1990s and 1980s when a fall in internal migration occurred. While overall flows are declining, the same pattern of out- and in-migration regions has generally been maintained, with some exceptions. Out-migration is a serious impediment to development in some backward, more peripheral regions of Poland which lose the most dynamic and well-educated young people as they leave for universities and rarely return to their native regions because these offer fewer job opportunities. In consequence, new migratory patterns have emerged in some Polish regions. One of the most obvious examples is Upper Silesia, where the positive migration balance has dropped from 27,000 in 1980 to 2,000 in 1992.
- In line with other transition economies, *Slovenia* also experienced a significant decrease in internal migration (by nearly 15 percent between 1989 and 1994). Although the net immigration balance is positive in some regions, there exists large depopulated areas which are mainly the consequence of large migratory flows in the past and mortality in the aged population in less attractive and remote rural areas.
- The latest available data (1992) on internal migration in the *Czech Republic* shows the net balance of 4957 people in favour of the Czech Republic. There was a net excess of Slovak immigrants in all regions of the Czech Republic and both South and North Moravia had a higher surplus than Prague. The same two regions had the highest excess of migrants to other regions in the Czech Republic.

4.5 Ethnic Homogeneity

The degree of ethnic homogeneity differs among the seven CEE countries and the three Baltic states. In relative terms, the CEE countries are all ethnically homogenous, with native ethnic groups accounting generally for over 85 percent of the population. However, there are situations where a minority is seeking to participate fully in the democratic process and obtain clear guarantees from the state of which it is a consenting part politically.

- In *Poland*, a sizeable German minority is concentrated mainly in Upper Silesia (85 percent), Mazury and in Gdansk, Wroclaw, Torun and Katowice. Since 1989,

numerous German organisations have been created and the number of schools teaching German has risen from four in 1970 to 170 in 1991. Other minorities living in Poland include; Ukrainians (300,000), Belarussians (200,000) and Lithuanians.

- In *Slovakia* and *Romania* most of the minority grouping is comprised of ethnic Hungarians. The Magyar speaking Hungarians in Slovakia constitute 12 percent of its population and in some districts between Bratislava and Komarno they represent more than 75 percent of the population. There are ethnic tensions linked to the use of the Magyar language in official functions in Slovakia. In 1990, the Slovak authorities set up poly-ethnic regions (13 districts with Slovak-Magyar population) which have their own education policy. In Romania, 23 distinct minority groups represent 10.6 percent of the total population. The biggest minority are the Hungarians. The Szekely Hungarians, Calvinist by religion, are the majority population in Hargita and Covasna. The other Magyar-speaking community, which are Catholic, lives in the towns and in the interior of Transylvania.
- *Bulgaria*, has a large Turkish minority, 10.8 percent of the population. They are mainly concentrated in the mountainous area of Rhodope, in Dobrudja and along the Danube. The Gypsies, who number between 600,000 and 800,000 live in urban areas and do not constitute a homogeneous minority since they are highly dispersed and speak various dialects.
- The *Baltic states*, conversely, have a much lower proportion of native populations, due to the 'Russification' of the states within the former Soviet Union. Lithuanians account for 80 percent of the population in Lithuania and constitute an explicit majority, with territorial distribution of various ethnic minorities following a certain pattern (Lakis, 1995). Russians, who migrated to Lithuania in large numbers, live in cities while Poles live mainly in and around Vilnius (42 percent). In Latvia, during the past four years, the population has undergone substantial changes. "Since the 1989 census, the overall population has diminished from 2,666,567 to about 2,576,000, while the Latvian share of the population has increased from 52 percent to 53,5 percent" (Bungs, 1993). This is due to a steady emigration of Slaves and a low birthrate in an ageing society. Ethnic Estonians comprise 62 percent of the total population in Estonia. "Compared with many other post-communist states, the minorities and citizenship policy in Estonia in 1991-93 appeared to be quite successful: the visible signs of the ethnic tensions diminished; violence or active separatism on ethnic ground was avoided" (Park, 1994).

4.6 Urbanisation

The urban-rural division of the population varies widely across the ten transition countries. The urban population represents over 50 percent of total population in all ten countries, although the national figures range between 51 percent in Slovenia to 69 and 70 percent in Latvia and Estonia respectively. The nature of the urban structure differs widely between countries. Poland has one of the most spatially balanced urban hierarchies - Warsaw has a population of 1.7 million, followed by Lodz with over 0.8 million and a further four cities have populations in excess of half a million. Conversely, in Hungary, although the percentage of urban population is very similar to Poland (around 62 percent), Budapest overwhelmingly dominates the remainder of the country. Similarly in Latvia, Riga is the most important city, accounting for over 33 percent of the population. In the majority of the countries, since the early 1990s, there has been a reversal of the rural-urban shift, and an increase in the rural population. The main exception to this is in Poland, where the urban population is still gradually increasing.

There is also a growing trend of urban-rural migration, either in terms of suburbanisation (very evident in the Slovenian case), or movement out of towns into rural areas or smaller villages. The latter is clearly evident in Bulgaria, where the migration from towns to villages has increased from 13.3 percent over the period 1976-85 to 19.7 percent during 1986-92 whereas the corresponding village-town movements have fallen from 34.3 percent to 22.6 percent over the two periods. The same process can be observed in Latvia and Estonia. In Lithuania, internal migration from rural to urban areas was quite intense for many years but slowed down recently, reaching a positive balance of 6,300. The rural population of Estonia began to increase at the expense of the urban population in the mid-1980s. Migrants were young people seeking better living conditions and higher wages. Due to domestic migration in recent years, the population of Latvia's cities has decreased while rural areas benefited. Slovakia provides a different example with "major centres of development expanding rapidly and attracting migrants, with relatively few people returning or making countermoves" (Podolak, 1995).

Capital or large cities are commonly important recipient regions for internal migration, while less attractive or peripheral rural areas are often 'losers'. For example, in the inter-census years, 1980-1991, the population of Prague in the Czech Republic increased by 70,592 and Bratislava in Slovakia experienced an increase of 16 percent. Similarly, spectacular migratory flows to large cities occurred in Romania in 1990. The average population of Constanta grew by 13.7 percent, Timisoara by eight percent and Bucharest by more than two percent. Due to an influx of migrants as well as privatisation and the reintroduction of the property market, many cities have undergone important changes. "In all these countries a process of revitalisation of old historical centres can be observed and in combination with growing tourism, this process will continue" (Musil, 1993).

As a result, the socio-spatial structure of large cities is changing, leading to intra-city migration and the emergence of new patterns of social segregation. Predictably, low-income families and the elderly have left the inner cities due to rising cost of housing.

Some of the Central and East European capitals have every chance of becoming centres of European importance:

“At the beginning of the century, the status of Prague was weak, that of Warsaw only a little better, and Budapest was not much stronger. Although, the number of foreigners living in Prague has reached 35,000 in 1993, Prague’s role cannot be increased; on the contrary, the new relationship between the Czech and Slovak republics will most likely diminish Prague’s regional position. In contrast, Budapest is gaining the status of a commercial and financial centre with 50-80 percent of the national scientific potential located there.” (Bartha,1993).

In particular, Warsaw, located on route from Paris and Berlin to Moscow and further East, has a great potential to become an important European city.

Similarities between CEE and West European urbanisation are very significant, in that they were common products of similar processes of industrialisation. However, urbanisation in these countries has some *specific features*.

- Capital and large cities in the CEE countries are proportionally less populous than in the market economies, which indicates lesser ‘metropolisation’, while the opposite is true for medium-sized cities.
- There are further differences at the regional (meso) level, where the polarisation effect of large cities on smaller settlements around them is less pronounced in transition than in market economies.
- The implementation, in the past, of the so-called settlement strategies of the command economies contributed to significant differences.
- Most cities located on the main transport routes and in the west of the countries will grow faster than those in the eastern regions.
- Cities built adjacent to large, industrial plants (ie. Nowa Huta in Poland) during the socialist industrialisation will experience difficulties as many of these plants collapse during economic restructuring.

4.7 Regional Trends

In all ten transition economies, considerable regional variation is apparent in demographic terms. In addition to the general points made above, the following specific features should be highlighted as well for the six countries with a significant regional dimension.

- In *Slovenia*, the settlement structure is dispersed, with only two towns having a population greater than 100,000 inhabitants. There is a historic tradition of concentration of population and working places in towns with a parallel depopulation of rural areas.

- The highest rates of population increase in *Slovakia* are evident in the northern and eastern regions, with an inter-census increase of 10-12 percent, while the southern border regions showed the lowest rate of growth, with an increase of less than one percent. Not surprisingly, the most attractive cities as immigration destinations, Bratislava and Kosice, have the highest long-term population increases, though the birth rate is highest in the Catholic-dominated north-western regions, and lowest in the capital. In contrast, the mortality rates show the opposite pattern: the highest rates are found in the southern, and lowest in the northern regions.
- All the regions in the *Czech Republic*, apart from Prague and South Bohemia, experienced a positive natural growth over the period 1980-91. However, these regions were the only two to have a positive balance in terms of migration. The age composition of the population is the most unbalanced in the capital, with the lowest percentage of pre-productive age groups and the highest proportion of elderly people. More optimal age structures are found in North Moravia, and North and South Bohemia.
- The population of *Poland* is spread relatively evenly across the territory, with the exception of Upper Silesia where the Katowice *voivodship* accounts for ten percent of the total population. As noted above, the urban structure is also even. The highest demographic growth occurs in two groups of regions: south-eastern, with a high rural population; and northern and western regions, with a younger population. Lodz and Walbrzych have witnessed a population decline, related partly to the severe restructuring problems. The sex structure of the population is unbalanced in several regions, particularly in the north-east. The regional distribution of the Polish population has remained stable for a number of decades.
- Regions with the highest population density in *Romania* comprise the hilly areas in the Subcarpathians, and urban areas, while the lowest densities are found in mountainous areas and the Danube waterplain. The majority of towns are located in the south of the country, in the centre of Transylvania and Moldavia. The age structure is relatively well balanced in urban areas, but favours the elderly population in rural regions.
- There is a strong trend in *Hungary* towards the concentration of population in larger towns. As noted above, Budapest dominates the urban structure and, apart from the capital, the regions of Csongrád and Hajdú-Bihar are also heavily urbanised. The highest percentage of population in the economically active age group is found in Central Transdanubia, Northern Transdanubia and the hinterland of Budapest.
- In *Bulgaria*, 40 percent of the population live in the three districts of Plovdiv, Sofia-City and Lovech, while the region with the smallest population is Montana. Lovech and Montana have witnessed a consistent decline in population over the past quarter of a century; the ageing trend, noted above, is also most apparent in these two regions.

4.8 Summary and Outlook

In terms of future developments, the following population trends can be predicted in various CEE countries.

- In *Poland*, the regional structures of population and settlement systems will not change to any significant extent but some rural, north-eastern areas may face demographic problems due to a distorted gender balance (shortage of young women who migrated to towns). Poland may also experience a new urbanisation wave based on two processes: an accelerated growth of the urban population and an 'urbanisation of the country side'.
- In *Hungary*, based on the optimistic scenario, the vital demographic processes are not expected to change substantially; the total fertility rate may remain the same but a modest improvement in mortality might be expected.
- The latest population projection for the *Czech Republic* assumes two alternatives: small and large changes. Both alternatives forecast a further decline in birth rates and an increase in death rates as a result of an ageing population. These developments, coupled with a net increase in migration, may mean that the population in rural areas will increase more rapidly than in towns leaving some areas depopulated.
- Projections for *Slovakia* envisage a 8.3 percent increase in population between 1991 and 2015. The decisive factor will be the change in population growth with no substantial effect from emigration or immigration. Two more phenomena are worth noting, the declining birth rate and an increase in the number of retired people.
- *Slovenia's* population is not expected to exceed two million in the next decade. Based on the prognosis for the period 1992-2020.
- *Bulgaria's* population will continue to diminish with the same tendency occurring at the regional level, with Montana and Lovech experiencing particularly high rates of decrease.
- A similar trend can be observed in *Romania*. Due to low fertility, high mortality and negative migration, estimates put the population of Romania at 20.6 million by the year 2020, that is 2.2million less than in 1993.
- The *Lithuanian* population will decrease slightly by the year 2015 with male-female ratio remaining almost constant. Contrary to the situation in other CEE countries, the percentage of the working age population will increase from 56.5 percent to 62.9 percent.
- The *Latvian* population is also likely to decline, due to a negative natural increase and international migration.
- A similar population decrease can be observed in *Estonia*. This is coupled with an ageing of both the working-age and total population. The situation may become

critical after 2010 when the younger generation, born in the early 1990s, reaches working age.

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5. LABOUR MARKET SITUATION

5.1 Introduction

The process of economic transformation being undertaken in the CEE and Baltic acceding countries has necessitated the introduction of a new labour market model. Under the former centrally-planned systems, the labour market in the majority of these countries was characterised by the (contradictory) features of, first, the commitment to full employment and central government protection of employment and, second, the often inefficient use of manpower resulting in low labour costs. With the onset of political, ideological and economic reform, this model has become obsolete and a new model has evolved characterised by a liberalisation of the labour market, increasing private sector employment (including self-employment), the extension of the deregulatory functions of the state in the use of manpower, and the introduction of new systems of labour relations and negotiation.

Labour market change in the transition economies is clearly significantly influenced by macro-economic developments, including the dramatic falls in production and output at the start of the 1990s. The number of employed in the potential Member States of Central and Eastern Europe (excluding Slovenia) has fallen over the period 1989-95 (Q1) by nearly 6.4 million, a fall of 14 percent (Employment Observatory, 1995). The figures for the Baltic states, similarly, are a decline of 515,700 in the number of employed, or a fall of 12.6 percent. In terms of unemployment, in 1995 all the CEE countries under study, except the Czech Republic and the Baltic states, had double digit unemployment rates (DIW *et al*, 1995).

This chapter addresses the issues of both employment and unemployment trends and developments in the CEE and Baltic acceding countries, noting initially a number of difficulties associated with labour market statistics. Employment is analysed first, including the sectoral distribution of employment, private sector employment and issues of excess and 'shadow economy' employment. Second, the problem of unemployment is examined, its emergence, nature and the most vulnerable groups. Finally, the regional dimension of the labour market situation is considered, including a brief analysis of the principal spatial disparities in labour market trends in each of the ten acceding countries.

5.2 Data Issues

There are considerable difficulties associated with the comparability of labour market statistics in the acceding countries of Central and Eastern Europe and the Baltic states. This is related in part to the more general problems of data collection in the transition phase and the differing stages of development of individual countries. Definitional issues are clearly apparent - the age range categorised as 'working', for example, varies in national statistics from 15-54 (women) and 15-59 (men) in a number of countries (Czech Republic, Hungary, Slovakia) to 15-57 (women) and 15-62 (men) in Romania and 18-59 (women) and 18-64 (men) in Poland. Equally, the classification and inclusion of groups such as women on paid maternity leave, apprentices,

professionals in the military service, and seasonal workers vary between countries. In relation to unemployment, these problems include the differing eligibility criteria for unemployment benefit across countries, and the fact that these criteria have not necessarily remained constant since the start of the transition period (Ingham and Grime, 1994).

Specific problems of employment statistics in the transition countries are also linked to the changing labour market conditions and the shift towards a more market-driven system. The extent to which the statistics currently reflect these changes is partly related to the level of sophistication of the administrative and data collection systems in the individual countries. The growth of the private sector, for example, has presented a new area of employment which must be incorporated into overall employment statistics but can currently generally only be estimated. Perhaps a more serious problem is the estimation of employment in the 'shadow' or 'hidden' economy. This is estimated at up to 20-25 percent of employment in some countries. Clearly, because of its nature, an accurate calculation of employment within the shadow economy is extremely difficult, although it is thought to be significant in most of the transition economies.

Two of the main sources of employment statistics in the countries themselves are population census data and Labour Force Surveys. All the CEE acceding states now have regular Labour Force Surveys (Employment Observatory, No. 7, May 1995). The introduction of these Surveys (LFS) has considerably improved the standard of employment data, but this recent data can be compared only with great caution with data from earlier transition years when the LFS were not in practice. The Employment Observatory (No. 6, October 1994) points to differences in the definitions of employment and unemployment between Census and LFS (un)employment data. In the LFS, both concepts are defined in all countries in terms of internationally agreed criteria (ie. a person is employed if they worked at least one hour during the reference week, and are unemployed if they were available for work and actively seeking work). In the Census, definitions differ slightly and vary between countries. However, it is pointed out that the two sources should give similar results, particularly for rates of participation, employment and unemployment in each age group.

The internationally comparable datasets from which much of the data in the tables of this chapter is derived include the UN ECE (1995) *Economic Survey of Europe in 1994-95*, Employment Observatory (1995) *Central and Eastern Europe - Employment Trends and Developments*, DIW *et al* (1995) *Wirtschaftslage und Reformprozesse in Mittel- und Osteuropa*, and WIIW (1995) *Handbook of Statistics: Countries in Transition 1995*. The UN ECE data covers both the CEE and Baltic acceding countries, and generally comprises UN ECE Secretariat estimates based on national statistics. The Employment Observatory dataset does not include the Baltic states or Slovenia, but its coverage of the remaining six countries includes all the principal labour market related indicators. The sources of the data are listed (as well as notes on definitions and inclusions), and generally comprise the National Statistical Institutes of the individual countries as well as Labour Force Surveys where they exist. Important distinctions in data eg. between registered unemployment and unemployment as measured through the Labour Force Survey are made in the dataset,

as well as indications of where data for individual countries may not be strictly comparable.

The DIW text covers all the acceding countries, and sources listed include the national Statistical Offices and statistical publications of the transition economies, international organisations such as UN ECE and the EBRD, other research institutes active in this field including the WIIW (Wiener Institut für Wirtschaftsvergleich, Vienna), and the German *Statistisches Bundesamt*. This text has been compiled by six of the main German institutes working in the transition economies, with individual institutes taking responsibility for particular countries. It is noted at the start that, particularly in the statistical tables, no comprehensive comparative system could be adopted, and therefore individual sources are cited under each Table. Therefore, while the Tables cover the same indicators, there may be some doubt as to their strict comparability. Finally, the WIIW Handbook covers the CEE acceding countries only for the period 1990-95, and the statistics are largely drawn from published statistical sources in the countries themselves. Definitional issues of relevance to cross-comparison are generally listed in footnote form.

The other principal source of statistics on the labour market situation used in this chapter are taken from the individual reports of the national consultants. In general, the reports utilise national statistics from the National Statistical Offices or domestic publications. This data is used here to expand the regional dimension of the labour market situation in particular, as they provide considerably more detail on the spatial dimension of (un)employment than can be found in international sources. They are also used, where necessary, to supplement the comparative analysis at national level.

5.3 Employment Trends

The labour market changes in individual CEE and Baltic countries clearly vary in relation to a range of factors such as the nature of the reform process, the existing sectoral structure of employment, the degree of sectoral specialisation and so on. However, broad trends have been distinguished and, at national level, Blanchard, Commander and Coricelli (1995) identify three forms of labour market development in CEE countries.

- First, in Poland, Hungary and the Czech Republic, the state sector is declining and restructuring and the private sector is expanding, compensating to a degree for the loss of state employment.
- Second, in Bulgaria and, to a lesser extent, Slovakia, the decline of the state sector has been dramatic, the growth of the private sector weak, and unemployment has risen sharply. In Bulgaria, employment fell by nine percent annually between 1991-94.

- Third, in Romania, state firms are being allowed to maintain employment at the cost of potential hyperinflation. Unemployment is relatively low, but much restructuring is still to come, and the costs associated with an inability to stabilise the economy are significant.

The reduction in overall employment has been a development common to all CEE and Baltic acceding countries (Table 5.1). The most obvious cause for employment decline, especially at the start of the reform process in the early 1990s, was the poor macro-economic situation of the transition countries and the dramatic falls in production and output (although the decline of production and employment was not always parallel). This was particularly prevalent in the industrial sector, although agricultural employment has also fallen considerably in a number of countries.

Sziráczki and Windell (1992) identify three stages of employment restructuring, with differing effects on groups of workers and overall employment levels. The first stage is the cutting of workforces through 'soft' measures eg. halting recruitment or raising disciplinary standards. Second, certain workers are made redundant and programmes leading to a reduction in the workforce are implemented eg. early retirement schemes. The final stage is the most drastic, involving widespread employment cuts and the possible complete closure of factories or plants. The harsher the economic reform, the more likely that the third stage of employment restructuring will be reached, and as reform progresses, this stage is generally reached. As market conditions and competitive pressures become a reality, excess labour shedding is likely to become more brutal.

Employment decline, particularly through methods which would be included in the second phase above, has meant that there has not only been rising unemployment but also a reduction in the economically active population (Timár, 1995). Labour force participation has generally fallen, due also to a reduction in the previous labour surplus, generated as a result of the political commitment to full employment. Retirement schemes comprise an important method of labour shedding. It is estimated, for example, that early retirement accounted for 70 percent of the cutback in employment levels in 1990 in Slovenia, while in the Czech Republic similar measures had affected 70,000 people by the end of 1992 (Koltay, 1995). Differing employment policies and registration systems for unemployment, as well as factors such as increased student numbers and international labour migration, will also affect this area.

The process of privatisation has had ramifications on the labour market situation. Privatisation has led to employment growth in the private sector, which has offset (to some extent), the loss of employment in state companies and declining sectors. However, privatisation has also contributed to employment decline. Employment created through privatisation is determined to a much greater extent by market and competitive conditions, and thus privatisation can reduce the demand of firms for labour in that efficiency and rationalisation may necessitate a reduction in the existing workforce. In Hungary, for example, it is estimated that labour demand following privatisation declined by 30-35 percent in the medium term, and the longer-term effect could be more pronounced as factors which maintained excess employment in the

economy are gradually dismantled eg. soft budget constraint and inefficient management (Viszt and Ványai, 1994).

5.3.1 Sectoral Distribution of Employment

The sectoral distribution of employment has changed significantly during the transition period, reflecting changes in the pattern of production (Table 5.2). The overall patterns shown in this data are very similar, despite some discrepancies between the actual figures (although these, in reality, are relatively minor). The clear trends are that industrial employment has declined and services employment has increased in all the CEE and Baltic acceding countries. The extent of the change differs between individual countries, but the overall trends hold true across the ten countries. Agriculture provides a more mixed picture, although in general, employment has also declined in this sector.

(i) Agriculture

While agricultural employment has fallen in the majority of acceding countries, there are important exceptions to this trend. In Poland and Romania in particular, this sector plays a particularly key role and accounted, in 1990, for over 25 percent of total employment in both countries. In Poland, the significance of agriculture is related to the fact that full collectivisation was never achieved in the country. The importance of these sectors have not decreased with the progress of economic reform, and indeed the share of agriculture in total employment in Romania has significantly increased over the period 1990-94. This increase in agricultural employment is also noted in Bulgaria (according to the national statistics), and two of the Baltic states (Lithuania and Latvia), while in Poland, the share has remained relatively static.

An important part of the reason for this trend is that agriculture has acted as a reservoir for job losses in other sectors, and agricultural small-holdings are viewed as a necessary source of income and a form of insurance against the prospect of future unemployment. Land reform and privatisation have rapidly increased the number of private farms, and this has encouraged and facilitated the move of labour into agriculture as a form of safeguard. However, in many cases, the farms or agricultural units being created are too small to be economically efficient, and, certainly in Romania, agricultural productivity has not risen in line with the employment increase. It is anticipated that, as reform continues, currently small farms are likely to be amalgamated into more optimally sized units, and the demand for labour will fall. In Poland, where private land ownership was already high prior to 1990, it is also anticipated that the continued high share of agricultural employment is a temporary feature, again related to the slower decline of this sector in comparison to the national economy because of the 'safety valve' role of agricultural activity.

(ii) Industry and construction

Industrial employment has fallen, in some cases dramatically, in all the CEE and Baltic potential Member States. This reflects, to a great extent, the changes of production patterns and the collapse, or significant decline, of formerly important industrial sectors. Sectors such as mining have suffered particularly severe employment decline, although employment in the manufacturing sector in CEE countries is also estimated to be twice as high as market economies, and firms in this sector can be expected to shed up to 50 percent of their workforce during transition (Barr, 1994). In spatial terms, certain areas such as the Upper Silesia region, contain significant concentrations of heavy industry which have not yet undergone comprehensive restructuring, often for political reasons. A severe process of employment decline is anticipated in these regions once restructuring is initiated in earnest, although a rise in tertiary sector activity may mitigate this to some degree.

An interesting exception to the decline in construction employment can be noted in the Czech Republic. The share of construction employment increased over the period 1990-94 from 7.5 to 9.1 percent, reflecting increasing demand for construction work related to restituted or privatised property. This trend is not evident in Slovakia, where construction employment declined from 11.2 to 6.1 percent over the same period (WIIW, 1995).

More recent data indicate that, in some countries, there has been a slight increase in manufacturing employment. Data from the Employment Observatory (No. 8, November 1995) indicate that this was the case in Poland and Slovakia, with manufacturing employment in the latter country two percent higher in the first half of 1995 than a year earlier. In Poland, the employment level in this sector was around one percent higher, although it is noted that caution should be taken in considering this a continuous trend given the data fluctuations between quarters.

(iii) Services

In contrast to industrial employment, service sector employment has increased in all the CEE and Baltic potential Member States. This is a marked development from the situation at the start of the 1990s when the underdeveloped service sector was considered a substantial bottleneck to the efficient functioning of the economy and the growth of the private sector (Bachtler, 1992). Within the overall services sector, certain sub-sectors have experienced particularly rapid growth in most countries, including finance, retail, hotels, and trade. Even in countries less advanced on the path of reform, there has been a notable growth in services. In Bulgaria, for example, the percentage of total employment in the tertiary sector rose from around 36 percent in 1990 to 41 percent in 1994 (Employment Observatory).

Individual countries began from different starting points, and have subsequently experienced divergent levels of growth. Hungary, the Czech Republic and Slovakia all had service sectors which accounted for over 40 percent of employment in 1990, and tertiary employment now comprises over half of total employment in these countries. At the other end of the scale, Romania began the transition period in 1990

with a very low share of tertiary employment (ca. 27 percent of total employment), and remains one of the very few acceding countries which has not yet experienced a significant shift to this sector. Growth in service employment has tended to be concentrated in Romania on certain sub-sectors eg. real estate, finance and insurance, although a more general shift of employment towards the tertiary sector is anticipated as reform continues.

5.3.2 Ownership Structure of Employment

Private sector employment statistics are difficult to obtain, and much of the literature comments on the estimated nature of these figures. Despite the uncertainty of the data, however, private sector employment appears to have proliferated in all the CEE and Baltic potential Member States. This growth has been focused, in most countries, on the services sector and helps to explain in the universal increase in importance of the tertiary sector in the sectoral structure of employment. Private sector employment has also increased in certain countries in the agricultural sector (see above). Within services, new private units are particularly prevalent in distribution and retail trade, as well as financial services.

The strength of the growth of the private sector, and the degree to which it has been able to compensate for employment decline in the state sector, has varied between countries. Koltay (1995) identifies several groupings for the CEE acceding countries:

- *Hungary, Poland and Slovenia*: sharp decline in employment in the state sector but parallel dynamic private sector employment growth;
- *Czech Republic*: rapid rise in private sector growth (from a very low base) but delay, and to some degree, more limited shrinkage of public sector employment;
- *Slovakia*: more far-reaching reduction of public sector employment and a weaker development of the private sector, resulting in a less favourable employment situation than the Czech Republic; and,
- *Romania*: despite a dramatic fall in production, economic restructuring was delayed, affecting both the reduction of public sector employment and also the stimulation of the private sector.

The national reports back up this evidence to some extent. In Poland, for example, over the period 1990-94, the public sector shed over 3.7 million jobs, but over 1.5 million new jobs were created in the private sector. Within the private sector, 200,000 people moved from agricultural to non-agricultural occupations, with the effect that the private sector created 1.7 million new jobs outside the agricultural sector. The low starting base and rapid expansion of the Czech private sector is also noticeable from the national statistics, with the sector accounting in 1990 for only seven percent of total employment but rising to over 60 percent by 1994. Romanian national figures seem to go against the above analysis to some degree. National figures indicate that 91 percent of agricultural employment is in the private sector, however, and, given the

importance of this sector within the overall economy, this could be one explanatory factor of the relatively high figure for private sector employment.

Much of the private sector employment is being generated through the creation of new jobs, rather than through the privatisation of state companies. The private sector has responded more rapidly to changing market conditions, creating employment and a wider diversity of potential employers (Koltay, 1995; Barr, 1994). However, in OECD countries, net employment change stems mainly from net expansions of existing firms rather than new entries (Franz, 1995). The low survival rate of new firms means that many jobs created through new start-ups are often subsequently lost. There is also some evidence for this in the transition economies, and a certain percentage of new private sector jobs are uncertain, of a low standard and poorly paid (Koltay, 1995). This clearly has ramifications for the nature of future employment development, although the continued process of privatisation and market reform is likely to reinforce the position of the private sector in employment terms.

5.3.3 Other Employment Related Factors

Despite clear falls in employment levels, the rate of decline has generally been lower than the rate of decline in output between 1990-1993, suggesting the existence of *excess employment* or 'internal labour reserves' (UN ECE, 1994; Koltay, 1995; Timár, 1995). This problem appears to be particularly acute in the Baltic states. According to UN ECE figures, the cumulative percentage point difference between the change in employment and the change in GDP over the period 1990-93 was 55.9 percentage points in Lithuania and 38.9 in Latvia. The problem was less significant in Estonia, with the corresponding figure of 14.6 percentage points, close to the Romania figure of 16.9 percentage points. Interestingly, the Czech Republic was also in a similar range (10.0) while Slovakia and Bulgaria were lower at 6.2 and 1.0 respectively and in Slovenia, Poland and Hungary, the cumulative change was negative.

There is a degree of correlation between the levels of excess employment and the stage of economic transition - as restructuring and privatisation measures continue, excess employment usually declines. Moreover, there are also social reasons for the maintenance of a certain level of excess employment. Many governments have been, or continue to be, unwilling to implement severe restructuring or bankruptcy proceedings, as this would lead to sharp rises in unemployment, often with inadequate social security provisions in place. There is also a continuing perception in many of the former socialist countries that enterprises should perform a social function, and therefore maintain a high level of employment.

The existence of a *shadow* or *hidden economy* in the CEE and Baltic acceding countries is virtually undisputed but, because of its nature, is highly problematic to measure, either in terms of output or of employment. It is thought in some countries to account for a considerable degree of GDP eg. up to 20-25 percent in Poland. Substantial unregistered employment is clearly involved in this unofficial economy; in individual countries, estimates range between around 400,000 people in Romania, approximately 20 percent of the Latvian labour force, and 26 percent of the Slovenian active population (9.6 percent of the labour force). A recent paper published by the

Polish Central Statistical Office on the subject of unregistered employment (summarised by Grime, 1996) estimates the total in Poland at around 2.2 million people, with a concentration in Warsaw of 338,000 but the eastern and northern regions, where unemployment is particularly acute, having the highest proportion of the workforce in the hidden economy.

Employment in the hidden economy can either be full-time or a secondary job to supplement income from the principal source of employment. In many cases, such work is of a temporary nature and relatively insecure in terms of employee rights etc. Secondary employment in the hidden economy can encompass both highly skilled workers whose services are in great demand (eg. computer analysts) and also worker in low-skill occupations eg. agricultural or construction workers, repairs and maintenance etc. (Grime, 1996).

5.4 Unemployment Trends

Unemployment is one of the principal social and economic costs of transformation in CEE countries and the Baltic states. The market rigidities and imperfections, some a result of the stage of transition, have led to unemployment levels which are politically damaging and can be economically inefficient. Although unemployment levels peaked in most of the CEE countries in 1994, and have continued to rise in only a small number of countries - eg. in Romania, the overall rates remain very high (Table 5.3). The unemployment rates in the Baltic states are generally lower than the CEE countries, although the national rate hides significant levels of unemployment in certain regions. Several factors account in part for the lower rates including labour hoarding by state enterprises, a fall in the participation rate, unrecorded unemployment and outmigration of population following independence to other states of the former Soviet Union.

Within the CEE region, the Czech Republic represents the principal exception to the overall rise in unemployment rates. This is related to a number of factors including an active labour market policy, favourable economic starting conditions for the transformation process, and the rapid growth of new firms in the private sector. Other factors such as the often enforced retirement of older workers, cuts in unemployment benefit and the introduction of stricter eligibility criteria are also thought to have played a role.

The social and economic cost of unemployment in the CEE and Baltic acceding countries has fallen more heavily on certain groups eg. young people, females, low-skilled, and those who have been unemployed extended periods of time (Table 5.4).

	<i>Long-term unemployed</i> *	<i>Youth unemployed</i> *	<i>Female unemployed</i> *
Poland	32.3	20.9	54.8
Hungary	41.3	22.0	41.3
Czech Rep.	40.0	38.2	61.8
Slovakia	51.9	29.8	50.4
Slovenia	57.2	24.0	44.0
Bulgaria	91.0	40.2	54.0
Romania	37.0	34.5	55.6
Estonia		15.0	65.0
Latvia	25.0	20.0	52.3
Lithuania		35.0	54.7

* as percentage of registered unemployed.

Source: Employment Observatory, 1995; national sources (Slovenia and Baltic states)

The most serious problem is the increase in *long-term* unemployment, and the low turnover in the unemployment pool. In all the CEE countries, except the Czech Republic, at least 40 percent of the unemployed in the third quarter of 1994 had been unemployed for more than a year. Even in the Baltic states, where unemployment rates are lower, long-term unemployment is still recognised as a problem. By mid-1995, the proportion of unemployed who had been out of work for more than a year was one-fifth in Estonia, and in Latvia had increased by a factor of 5.7 as compared with the start of 1994.

The problem of long-term unemployment is well documented in the output of the *EU Employment Observatory - Central and Eastern Europe* and the UN ECE. The problem is identified as particularly intractable, and one which will not automatically find its resolution with economic growth and the creation of more jobs - evidenced by the fact that the decline in employment rates over the last year in most CEECs has not significantly affected the number of those out of work for more than 12 months. High unemployment rates are generally associated with higher shares of long-term unemployed, and countries with relatively high long-term unemployment also have relatively high rates of very long-term unemployment. The longer a person is unemployed, the more difficult it is to find a job, creating serious problems for the market-clearing mechanism. In some countries, eg. Slovenia and Estonia, long-term unemployment is driving many people out of the official labour force into work in the hidden economy.

Youth unemployment rates are high in the majority of CEE countries, and some sources suggest the young people under 25 are affected disproportionately by unemployment. In September 1994, young people (under 25 years old) accounted for 30 percent of total unemployment in the Czech Republic, Hungary and Slovakia and 45 percent in Romania. The reform of the educational system may increase the incidence of youth unemployment - eg. in Latvia - and the increase in students of working age also contributes to a reduction in the labour supply (Timar, 1995). Long-

term unemployment among young people is also increasing in many countries, although, once a person becomes unemployed, the likelihood of their experiencing long-term unemployment increases markedly with age (UNECE, 1995).

There is a relatively large share of *female* unemployment as a percentage of the total - women accounted for at least 50 percent of total unemployment everywhere except Hungary, Slovakia and Slovenia. However, this problem is less severe than in Western Europe, and is declining in some countries eg. Romania. Female unemployment is lower in some countries as many women drop out of the labour force altogether. Other reasons for lower levels of female unemployment include the decline - eg. in Slovenia - of old industries with a prevalence of male workers while sectors with a higher female workforce - eg. SMEs - have been less badly affected (Koltay, 1995).

At regional level, assuming a similar demographic structure (by sex and age) of the population across regions, some statistics suggest that when unemployment is low, a large share of the pool is accounted for by the most vulnerable groups ie. women and young people. Conversely, as labour market conditions deteriorate, the risk of becoming unemployed spreads across all socio-economic groups. The higher than average shares of women and young people in more dynamic labour markets may suggest the utilisation of selective layoff and hiring strategies (Scarpetti, 1994).

It should also be noted that, as might be suggested by western experience, the *low-skilled* within the workforce is a further group which is particularly vulnerable to unemployment (Ingham and Grime, 1994; Koltay, 1995; Viszt and Ványai, 1994). In the restructuring of enterprises, it is also often this group which is first to be affected by labour cutback measures. The likelihood of low-skilled labour being affected by unemployment, and the under-representation in unemployment figures of people with the highest academic qualifications, appears to be common across the CEE and Baltic acceding countries. The socialist system of vocational training also led to the training of certain groups of the workforce (often regionally concentrated) in rather narrow specialisations. In Poland, for example, the Katowice region, one of the largest industrial concentrations in CEE, is the national leader in the share of semi-secondary level education - but in a narrow range of skills which now presents considerable problems in terms of re-training.

5.5 Regional Disparities: Comparative Overview

There are significant regional disparities in unemployment in virtually all CEE countries and the Baltic states (Table 5.5 and map). These patterns are partly a result of regional disparities which emerged during the pre-transformation period, and partly new regional differences resulting from the process of transition. The former are particularly evident in the distribution of industrial employment, concentrated, in several countries, in a small number of regions - eg. Poland and Romania. These regions were often not natural locations for industry, and the industrialisation process resulted in mono-industry regions or towns in areas otherwise characterised by backward agriculture. The recent process of restructuring has led to new patterns although still reflecting their predominant industrial structures (Scarpetti, 1994). In

general, it also appears that those regions which suffered the sharpest rise in unemployment at the start of the transition process are also those with the largest labour market imbalances two or three years later.

Spatial variations are also evident in terms of occupational structure and the nature of the labour force. Highly educated employees tend to be concentrated in urban areas, while agricultural and mono-functional industrial regions and centres have a higher proportion of lower skilled and educated employees. This has clear ramifications for job creation and diversification, and for the attractiveness of regions for foreign investment and private sector growth.

The extent of regional disparities within individual CEECs varies by country. The data sets used in the current discussion are taken primarily from the Employment Observatory figures but are supplemented with national statistics. As can be seen from Table 5.5, at regional level Poland has the widest range of unemployment rates, with a difference between the regional maximum and minimum of 18.2 percent. The Czech Republic, with a very low overall unemployment rate, also has the smallest regional disparity, with a difference of only 5.3 percent. At sub-regional levels, the disparities increase considerably in some cases, although Poland and the Czech Republic retain their ranking positions.

In relation to the occurrence and scale of unemployment, three distinct types of region can be identified: capital cities and western regions; industrial regions; and agricultural regions.

(i) *Capital cities and western regions.*

The capital cities and western regions of CEE countries tend to have lower rates of unemployment. The existing advantages of these regions in terms of location, infrastructure, access to R&D facilities, proximity to western markets etc. stimulates the generation of new employment and the growth of the private sector. This, in turn, has positive ramifications for the labour market situation and unemployment rates through a process of positive cumulative causation. In general, a diversified regional economy appears to play an important role in the ability to generate new employment: even amongst specialised regions, those with a relatively better economic structure face lower labour market pressures (Boeri and Scarpetti, 1994).

Table 5.5 shows that in the six countries broken down by region, the regional unemployment rates are smallest in the capital cities, falling as low as 0.3 percent in Prague. The unemployment rate was below six percent in all the capital cities of the ten CEE countries. Diversified urban centres tend, in general, to have lower rates of unemployment - eg. Ventspils in Latvia and Klaipeda in Lithuania which had the lowest rates of unemployment in the country at the start of 1996.

(ii) Industrial regions

Regions dominated by heavy industry have suffered particularly high levels of unemployment due to the effects of restructuring. This situation is most serious in regions where industrialisation was forced, and few other related employment opportunities exist. In Romania, for example, several counties where unemployment is considerably in excess of the national average comprise part of the Moldovo region, one of the main targets of the socialist industrialisation drive. Similarly in the Czech Republic, at the end of 1995, of the ten districts with unemployment rates higher than five percent, five were in North Bohemia in or near the largest coal mining centre, and a further four were in North Moravia, with a concentration of heavy industry and mining. Central Slovakia and north-eastern regions of Hungary are likewise affected by high unemployment related to industrial restructuring.

Converse to the situation in diversified regions, the problems of industrialised regions are further compounded by their apparent difficulty in creating new employment opportunities and/or attracting new private business. The link between high unemployment and long-term unemployment (which is stronger in some countries than others) does pose a further threat to industrialised regions with consistently high unemployment levels.

One of the largest areas of industrial concentration in Central and Eastern Europe, the Upper Silesia region of Poland, has not yet undergone extensive restructuring, and therefore the unemployment rate is lower than would be expected. Once this process is initiated, considerably higher levels of unemployment can be anticipated.

(iii) Agricultural regions

Agricultural regions are not homogenous with regard to the unemployment situation. In certain countries, some of the highest unemployment rates are found in underdeveloped agricultural regions eg. Poland (northern and north-western regions), Hungary (eastern regions), Estonia and Slovenia. Conversely, in other countries, developed agriculture has acted as a reservoir for the unemployed, able to absorb a considerable part of the unemployed population. This is particularly the case in Romania (eg. the Calarasi, Ialomita, Giurgiu and Teleorman regions) and Poland, where the unemployment situation of the rural labour force is generally better - although the collapse of state agricultural farms has seriously affected areas mentioned above which have very few alternative employment opportunities.

5.6 Regional Labour Market Trends: National Patterns

This section provides a more detailed, country-by-country overview of the regional labour market situation in the ten CEE and Baltic acceding countries, focusing principally on the six larger states. The data and analysis is taken principally from the individual reports provided by national experts.

5.6.1 Poland

A considerable degree of regional variation is evident in the labour market trends in Poland. The following broad regional sectoral employment structures have emerged in the country:

Eastern, and to some degree central, regions are dominated by primary sector employment, where the share of total employment exceeds 50 percent in certain regions (in 1994: Lomza, 60.3 percent; Biala Podlaska, 56.1 percent; Siedlce, 55.6 percent), while in large urban centres, this sector often accounts for less than ten percent. The maintenance of a high level of agricultural employment in these areas is related to its role in providing a source of income in the absence of alternative employment opportunities. This activity is also reflected in the overall participation rates of these regions, which are amongst the highest in the country. Service sector development has tended to stagnate in these regions (Radom, 29.1 percent, Biala Podlaska, 31.5 percent, and Chelm, 35.1 percent).

Northern and western regions have higher unemployment rates and lower participation rates. This is related in part to the collapse of state farms, which has resulted in sharp falls in agricultural employment. Some western regions also have relatively high rates of industrial employment (Zielona Gora, 34.0 percent, Jelenia Gora, 38.1 percent and Legnica 39.8 percent). The pattern of industrial employment is generally less clear. The Upper Silesia basin is clearly the key concentration of industry (Katowice 51.4 percent and Bielsko Biala, 36.1 percent), but other foci for industrial activity include urban centres such as Lodz (41.6 percent) and Wroclaw (32.6 percent).

Urban centres and western regions, generally with more diversified economic and social structures, are the principal beneficiaries of tertiary sector growth. The share of tertiary sector employment in Warsaw, for example, is 61.5 percent, while in other urban centres it ranges from 54.7 percent in Gdansk to 52.3 percent in Lodz. The influence of western Europe, and Germany in particular, has also been a contributory factor for regions in western Poland (eg. Szczecin, 57.7 percent).

Future regional trends in terms of employment structure are likely to encompass a number of directions. Service sector employment is likely to increase in central and eastern areas of the country, as a future process of industrialisation in these areas is unlikely and agricultural restructuring will release a considerable proportion of the current agricultural labour force. This process, however, is not likely to start before the year 2000. The more advanced regions are likely to witness a continued rapid movement of employment from industry into services, which will strengthen the role of large urban centres as the foci of financial, educational and research activities. Finally, western regions may experience slower changes, as agricultural employment is already low, industrial employment moderate and the demand for services has already been satisfied to a great extent.

The educational level of the regional labour force is important both for the ability of a region to diversify and restructure, and for the dynamics of unemployment. In Poland, three groups can be identified in terms of regional labour market qualifications. First, the large urban centres (Warsaw, Krakow, Poznan, Wroclaw, Lodz) are characterised

by high shares of the labour force with university of secondary level education, and relatively low levels of workers with semi-secondary vocational training. Second, the labour force in rural areas tends to be dominated by very low qualified people, often only with primary school level education. Third, industrial centres (eg. the Katowice area) often have labour forces characterised by a narrow range of skills suitable for the industrial activity of the region, presenting problems for diversification and re-training.

Finally, the regional disparities in unemployment in Poland are very marked. At NUTS I level (see map at the end of the chapter), unemployment is shown to be highest in western and northern regions, lower in eastern regions and the lowest in the southern region. However, although the overall pattern is similar, this level of aggregation hides a great deal of variation, particularly the much lower rates of unemployment in the urban pockets of Warsaw, Poznan and Krakow (5.3, 7.7 and 8.1 respectively at the end of 1995). The only *voivodships* at the end of 1995 to have single digit unemployment rates were the urban centres mentioned above and Katowice (9.2 percent). Given the concentration of industry in Katowice, this lower rate is interesting, although it is thought to be linked to the fact that far-reaching restructuring has not yet been initiated in this region. Once this process begins, the unemployment rate is likely to rise dramatically, although the currently low level of tertiary activity could act as a reservoir for employees released from the secondary sector. Further variation not identified at NUTS I level is the relatively lower rates of a number of western regions eg. Szczecin in the north-west (13.5 percent).

The extent of regional disparities is not fully portrayed even at the level of *voivodship*. There are areas in Poland where the share of unemployed exceeds 50 percent of total employment in the area. Several localities have been left with virtually no economic base following the collapse of a dominant state farm or industrial enterprise. This situation is particularly serious in the remote, underdeveloped rural areas where alternative employment opportunities are virtually non-existent.

Regional disparities in unemployment are likely to continue in the future, although at a lower level. Certain regions and localities have succeeded in reducing their unemployment rates in the face of considerable difficulties. Lodz, for example, formerly dominated by the now collapsing textile industry, has initiated a successful transformation process and, although unemployment is high (17.5 percent at the end of 1995), the rate is declining. Diversified urban centres may even experience a labour shortage due to the influence on employment of the 'shadow' economy.

5.6.2 Hungary

A characteristic feature of regional disparities in Hungary is the divide between the eastern and western regions of the country, and the dominant position of Budapest. This pattern is also clear in terms of the labour market. The North-East region of Hungary shows the poorest labour market indicators. The counties in this region have the highest rates of unemployment in the country, concentrated on the two regions of Szabolcs-Szatmar-Bereg (18.9 percent in 1994) and Borsod-Abauj-Zemplen (16.3 percent) which are dominated by heavy industry. Conversely, in unemployment

terms, the western regions of Hungary bordering western European countries have considerably better indicators eg. Győr-Ménfőcsanak (6.8 percent) and Vas (7.1 percent).

Budapest is the clear centre of service sector activity, with over 70 percent of its total employment in the tertiary sector and accounting for 36.8 percent of all service sector employment in the country. In addition, Budapest accounts for over half of Hungary's employees in financial and administration services, as well as in research and development.

5.6.3 Czech Republic

Total employment has declined in all regions in the Czech Republic since 1989, with the exception of Prague. The regions worst affected both by employment decline and rising unemployment include North Moravia, the location of much of the country's heavy industry and electricity production, and the Bohemian regions. North Moravia had the highest rate of unemployment of the Czech regions (4.8 percent at the end of 1995) - although a rate still remarkably low in comparison to other CEE acceding countries. North Bohemia has also witnessed a very negative pattern of development since 1991, and had an unemployment rate of 4.8 at the end of 1995. While Prague was the only region not to experience employment decline, the fall in employment in the surrounding region of Mid-Bohemia has been one of the worst in the country. Commuter flows into Prague from the Mid-Bohemian region are now considerable.

Agricultural employment as a percentage of total regional employment was concentrated in the South and East Bohemian regions, where it accounted in 1995 for 10.9 and 9.5 percent respectively. This share had fallen slightly since 1993 in the case of South Bohemia, but had remained the same in East Bohemia. The share of industrial employment in total regional employment was, not surprisingly, highest in North Moravia (46.7 percent in spring 1995), although the share had fallen from 51.3 percent in 1993. All the regions in the Czech Republic had shares in secondary employment of over 40 percent in 1995 with the exception Prague, where the figure was only 25 percent. The opposite was true in the case of tertiary employment, which comprised 74.5 percent of total employment in Prague but less than 51 percent in all other Czech regions. The lowest share of tertiary employment was found in East Bohemia (44.2 percent).

Prague displays a quite different labour market situation to that of the rest of the country, and has witnessed the most positive development in this area. Employment has not fallen since 1991, and, as noted above, tertiary employment has increased and accounted for nearly three quarters of the region's employment in spring 1995. The surrounding region of Mid-Bohemia was the region with the next highest share of services employment as the percentage of the total (51.2 percent). Unemployment in Prague was also very low, at only 0.29 percent at the end of 1995.

As is the case in most countries, the disparities at sub-regional level are greater than those revealed at the higher level of aggregation. In the Czech Republic, at the end of 1995, 10 of 76 districts had unemployment levels higher than five percent (average for

the country was 2.93 percent). Five of these districts were in North Bohemia (Most, 7.3 percent, Louny, 7.1 percent, Teplice, 6.3 percent, Chomutov, 6.4 percent and Decin, 5.8 percent) and were, without exception, located on or near a coal basin. Four of the remainder were in North Moravia, two in coal or non-ferrous ore mining areas (Karvina, 6.6 percent and Bruntal, 5.8 percent) and two dependent on large machinery factories which are undergoing restructuring (Novy Jicin, 5.9 percent and Prerov, 5.4 percent). The final district is Znojmo in South Moravia which is an agricultural area.

The regional labour market situation is unlikely to change markedly in the near future, with poor labour market conditions continuing to be focused on areas of coal mining, intensive agriculture and mountain districts. The areas which are most vulnerable in terms of future developments are mono-company towns dependent on one or several large plants eg. Novy Jicin, Vsetin, Zlin, Plzen, Kladno and Mlada Boleslav.

5.6.4 Slovakia

The regional disparities in Slovakia, in terms of both employment and unemployment, are linked to a great degree to the sectoral structure of the regions. Particularly problematic situations have emerged in regions where the production base is dominated by industries severely affected by the exposure to world competition eg. mechanical, electronic and textile industries, mining, as well as regions with a high percentage of agricultural production. The regional variation in terms of unemployment is extremely high, with unemployment rates ranging (at the end of 1994) from 3.9 percent in Bratislava to 29.4 percent in the Rimavska Sobota district. Over one third of districts in the country has unemployment rates exceeding 20 percent.

High employment levels are focused on urban areas, particularly Bratislava and Kosice, but also other centres such as Banská Bystrica and Poprad. Equally, these are the areas suffering from the lowest unemployment. The capital, Bratislava, has the lowest unemployment rate, but the other districts with unemployment under ten percent also contain important urban areas eg. Kosice city (9.3 percent) and Banská Bystrica (9.7 percent). The other district with a relatively low unemployment rate (7.6 percent) is Trenčín, on the western border between Slovakia and the Czech Republic. The low unemployment rates in cities are not always continued into the surrounding hinterland. The Bratislava hinterland district had an unemployment rate of 11.3 percent at the end of 1994, and the corresponding figure for the Kosice hinterland district was 25.4 percent, one of the highest rates in the country.

The majority of the districts in the Central and Eastern Slovakian regions which border Hungary have unemployment rates in excess of 22 percent and, at regional level, Eastern Slovakia has the highest number of districts with unemployment rates of over 20 percent (7 out of 12). These regions, together with the neighbouring eastern Hungarian regions, comprise a pocket of very high unemployment, rooted principally in the sectoral structure of heavy industry and mining.

5.6.5 Bulgaria

The regions in Bulgaria which are experiencing the most positive labour market developments include Sofia, Plovdiv and Lovetch. In terms of the total number of employed people, Sofia has the highest share in both the public and the private sectors, accounting in 1994 for 21.4 percent of total private sector employment in the country. Plovdiv had the next highest share of private sector employment (17.1 percent) and the Lovetch (13 percent). The foci for tertiary sector growth have been the urban centres with clear higher order service functions eg. Sofia, Plovdiv and Varna. Indeed, service sector employment accounts for 71 percent of total employment in Sofia. The unemployment level in Sofia city was very low, at only 4.3 percent in 1995, the only region with an unemployment rate lower than ten percent. Although Plovdiv had a relatively high unemployment of 13.7 percent in 1995, the rate had fallen significantly from a peak of 17.5 percent in 1992 as a result of private sector development and the initial results of economic restructuring.

Montana and Rousse, both in northern Bulgaria, are among the poorest regions in terms of the labour market situation. Rousse has one of the highest shares of agriculture in total employment in Bulgaria (15.8 percent in 1994), while 42 percent of the Montanan population is employed in the secondary sector. This region with the highest proportion of industrial employment is the Sofia region surrounding the capital (49.9 percent). Private sector growth has been very slow in Montana, and accounted in 1994 for only 6.2 percent of total employment. In both these regions, unemployment has risen over the period 1991-1995, from 11.0 to 16.3 in Rousse and from 13.0 to 19.6 in Montana. Other regions where unemployment has risen include the other northern regions of Varna (from 10.4 to 11.6 percent) and Lovetch (from 8.9 to 11.1 percent). Montana and Lovetch also have the poorest indicators in terms of the total number of vacant jobs, accounting in 1994 for only six and seven percent respectively. In addition, while in most regions, the number of unemployed per vacant job fell during 1995, this has not occurred in Rousse or Haskovo (in southern Bulgaria), indicating a potential mismatch between available vacancies and the unemployed pool.

5.6.6 Romania

The average number of employees fell throughout Romania over the period 1990-94, although to a more significant extent in the counties with low economic potential, such as Giurgiu, Tulcea, Calarasi and Mehedinti, where employment fell by over a third. Many of these regions had received substantial subsidies under the centrally planned system which were withdrawn or reduced with economic reform.

In terms of unemployment, the economic activity of the former regime also affects the current pattern of regional disparities. The most severely affected region is Moldova. The worst affected county is Vaslui, with an unemployment rate of 24.7 percent at the end of 1994. With the exception of Vaslui, located in the South Moldova region, the counties of North Moldova had, at the end of 1994, the highest rates of unemployment in the country (Botosani, 18.1 percent; Iasi, 17.3 percent; Neamt, 17.3 percent; and, Suceava, 14.1 percent). The Moldova region was one of the key targets of forced industrialisation in Romania. Some of the unemployment is also linked to the return of now unemployed workers who had migrated to other counties.

The counties with a stronger economic base and which have experienced a degree of economic development - eg. Gorj, Brasov, Timis, Arad and Bucharest city - are better able to absorb the unemployed population. Counties with a developed agricultural system - eg. Calarasi, Ialomita, Giurgiu and Teleorman - have also witnessed lower unemployment rates, with agriculture acting as a reservoir for industrial layoffs (see section 5.3.1). Industrialised counties - eg. Buzau, Iasi, Cluj, Galati, Olt, Salaj and Neamt - are at the most risk from rising unemployment.

5.6.7 Slovenia

A wide range of factors, including historical, geographical and economic, have contributed to the emergence of significant regional disparities in Slovenia. There is a marked difference in the structure of the economically active population. Three regions could be classed as agrarian - Pomurska, where the share of economically active population in agriculture is 37.1 percent, and Posavska (24.2 percent), and Dolenjska (20.3 percent). Central Slovenia, including the capital Ljubljana, and the Obalno-krasko region, a focus of tourism activity, could be called service regions, where the proportion of tertiary sector employment of the total is 59.2 and 64.2 percent respectively. In the remaining regions, industrial activity is dominant, with the highest share evident in the Zasavska region (61.2 percent). The differing economic structures of the various regions have influenced their ability to adapt under restructuring, and cope with problems such as unemployment.

Regional unemployment disparities are evident in Slovenia, although not to the same degree as in some other CEE acceding countries. The lowest rate of unemployment in mid-1995 was in the Goriska region (6.4 percent) while the highest was in the agricultural region of Podravska (13.7 percent). In general, the regions with more service sector oriented economies eg. Central Slovenia and Obalno-kraska had lower rates of unemployment (7.5 and 7.6 percent respectively). The unemployment levels have been mitigated to some degree by international migration of workers in search of employment abroad. The 1991 population census showed that Slovenian people employed outside the country represented 3.1 percent of the total working age population, with regional shares rising as high as 7.7 percent (Pomurska). Emigration was particularly prevalent in regions which had experienced labour market problems in the past.

5.6.8 Estonia

In terms of regional unemployment, the greatest regional disparities are evident between urban and rural areas. The lowest unemployment rate was registered in 1995 was in the Pärnu county (1.9 percent) and in the capital of Tallinn (2.4 percent). However, in the previously agricultural region of South Estonia, the unemployment rate rose to 12.6 percent and in North-East Estonia, a region dominated by energy, chemical and light industry, the rate of 8.9 percent. The rate of regional variation has, however, slowed in 1995, with the rate of increase in unemployment increasing in

high unemployment regions but rising at a faster rate in regions with currently lower rates.

Some of the regional disparities are inherited from the past, while others have developed since the process of transformation began. Certain industrial regions in particular (eg. Ida-Virumaa) have persistently experienced relatively high unemployment. Long-term unemployment is concentrated in urban areas and in counties with a high unemployment rate and where there was formerly a high concentration of industry. The very low labour mobility, linked to a housing shortage, as well as a skills mismatch between labour supply and demand are both factors in the continuation of regional labour market disparities.

5.6.9 Latvia

There are considerable regional disparities in the Latvian labour market situation. In terms of unemployment, the two industrially developed port cities had the lowest registered unemployment at the end of January 1996 - Riga (2.9 percent) and Ventspils (2.2 percent). The western and central districts of the country also had relatively low unemployment - eg. 2.4 percent in the Saldus district, 4.0 percent in Ogre and 4.4 percent in Valka. At the other end of the scale, Latgale in eastern Latvia faces some of the worst conditions, with almost a fifth of the economically active population having no employment and the majority of districts having unemployment rates 3-4 times the national average. Unemployment was, for example, 27.2 percent in the Rezekne district and 22.6 percent in Preili district.

The problem of low labour mobility (see Estonia) is also true in Latvia, with unemployed people often living a considerable geographical distance from suitable available jobs. The underdeveloped housing market is again a significant contributory factor to this situation.

5.6.10 Lithuania

As in the other Baltic states, regional disparities do exist in the labour market situation in Lithuania. Unemployment is least significant in the urban centres of the country, with the port city of Klaipeda having the lowest rate at the start of 1996 (4.8 percent), and other urban centres eg. Kaunas (5.5 percent) and Vilnius (5.9 percent) also relatively little affected. The unemployment rates at province level are not that wide, ranging from 6.2 percent in the Kaunas and Panevezys provinces to 12.8 percent in the Taurage province, neighbouring the Russian region of Kaliningrad. The highest sub-province rate of unemployment is also in the Taurage region (18.8 percent).

As in other CEE and Baltic acceding countries, the regions most affected by poor labour market conditions are generally those which formerly specialised in sectors or industries now facing restructuring or costly technological upgrading. In the Lithuanian case, these industries include energy, construction materials, electronics and the production of metal processing machines. In addition, those regions located

relatively far from an administrative or economic centre often face considerable difficulties in developing tertiary sector employment.

5.7 Summary and Outlook

Labour markets in CEE are currently in a state of considerable flux. CEE is currently undergoing a painful adjustment process resulting in the devastation of traditional industries areas coupled with a search for new sources of employment and wealth creation. This is partly attributable to the shaking out of the former state sector, resulting in major employment cuts in most of CEE. Looking at the dynamics underlying this process is complicated by the lack of good comparable labour market data. Substantial hidden unemployment in the shadow economy together with concealed unemployment within state enterprises further complicates this matter. Clearly, caution must also be taken when comparing cross-country figures collated using different methodological frameworks.

A number of discernible sectoral, demographic and geographic labour markets trends are apparent. One of the key changes to CEE labour markets caused by the restructuring process is reduced employment in manufacturing (and extractive industries) coupled with a concomitant increase in service sector employment. Although the latter has not fully compensated for the former, it has alleviated unemployment in some of the more developed countries in CEE (eg. the Czech Republic and Poland). The impact of the restructuring process also falls unevenly on different parts of the labour market, with poorly skilled young people worst affected. This is resulting in a rapid increase in the levels of long-term unemployment with all the deleterious social consequences this brings. Female employment service sector employment has, however, benefited from the restructuring process throughout CEE.

Unemployment disparities are evident throughout CEE at various spatial scales. The regions with worst unemployment problems tend to be those with a concentrated industrial structures and narrow skills profiles. Often these areas are heavily dependent upon traditional heavy industries and mining (eg. Upper Silesia). On the other hand, capital cities and more westerly located regions within CEE have managed to escape the worst excesses of unemployment owing to their more varied labour markets and new firm (often service sector) formation levels. Intra-regional unemployment disparities in CEE are often caused by similar factors with regional population nodes displaying lower unemployment levels than older industrial towns and remote agricultural areas.

A wide range of factors are likely to determine the future development and shape of labour market conditions in the CEE and Baltic acceding countries. Koltay (1995) identifies a number of influences which may fragment future labour markets, including large territorial differences, the uneven spread of unemployment risk, discriminatory recruitment and dismissal policies, the marginalisation of certain groups of employees, the transformation of economic governance and organisation into market structures, and the effect of continued economic restructuring. Timár (1995) points to the likelihood of continued employment decline in many of the potential Member States in the near future, as well as to the fact that employment

cannot be expected to increase significantly in any country, even given economic upswing.

The national reports back these conclusions to some extent. In many of the CEE and Baltic acceding countries, a fall in the working age population is likely to occur (excepting certain countries - eg. Slovakia and Estonia) although this will not necessarily mean a decline in overall labour supply. The labour market situation in countries such as Bulgaria and Romania, which still face a considerable restructuring task, is likely to remain negative at least until the end of the century. In virtually all countries, however, a continued shift to service and private sector employment is anticipated. The regulation of the informal economy is also likely to be a universal task among the potential Member States. Future labour market policy measures will need to take into account issues such as vocational training and re-training and assistance for disadvantaged or marginalised groups within the labour force - eg. long-term unemployment, young people and the disabled.

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Table 5.1: Change in total employment in CEE and Baltic acceding countries

Country	UN ECE				WIIW				DIW <i>et al</i>				Employment Obs.				National figures			
	1990	1991	1992	1993	1990	1991	1992	1993	1990	1991	1992	1993	1990	1991	1992	1993	1990	1991	1992	1993
Poland	-4.0	-5.9	-4.2	-0.6	-4.2	-5.9	-4.2	-2.4	-22.5	-6.3	-2.2		-4.2	-5.9	-4.2	1.4	-5.7	-4.4	-2.8	-1.7
	(1992:1993 data not strictly comparable)																			
Hungary	-3.1	-9.6	-9.3	-5.0	-1.9	-6.3	-9.4	-7.2	-2.1	-10.6	-7.1		-2.1	-4.7	-16.3	-6.5				
	(1991:1992 data not strictly comparable)																			
Czech R.	-0.9	-5.5	-2.6	-2.6	-1.0	-5.5	-2.6	-1.6	-5.4	-2.6	-1.6		-1.0	-5.5	-2.6	-2.4	-1.0	-5.5	-2.6	-1.6
	(1992:1993 data not strictly comparable)																			
Slovakia	-2.6	-7.0	-7.5	-0.4			-7.3	-0.2	-12.6	-7.0	-0.5		-0.8	-7.9	-5.2	-2.8				-2.6
	(1992:1993 data not strictly comparable)																			
Bulgaria	-6.1	-13.0	-8.1	-1.6	-6.1	-13.0	-8.1	-1.6	-16.9	-16.9	-13.5		-6.1	-13.0	-8.1	-1.6				
Romania	-8.1	-1.0	-0.5	-3.0	0.2	-0.7	-1.8	-3.4	-8.6	-12.2	0.0		-1.0	-0.5	-3.0	-3.8				
Slovenia	-3.9	-7.8	-6.6	-3.0	-3.9	-7.8	-6.6	-1.9	-3.9	-7.8	-6.6	-3.0								
Estonia	-2.1	0.4	-11.1	-8.5							-6.4	-8.9					0.4	-9.9	-3.1	
Latvia	0.1	-0.8	-3.7	-5.9					-0.9	-3.7	-7.4						2.4	-2.2	-4.2	
Lithuania	-2.6	2.4	-2.2	-4.2					2.3	-2.2	-4.2									-8.0

Sources:

UN ECE (1995) *Economic Survey of Europe in 1994-95*, United Nations Economic Commission for Europe, New York

WIIW (1995) *Handbook of Statistics: Countries in Transition 1995*, Vienna Institute for Comparative Economic Studies, Vienna

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**Table 5.2 : Percentage share of total employment by sector in the CEE and Baltic acceding countries
(unless otherwise stated, top line figure for 1990 and bottom line for 1994)**

Country	Agriculture (includes forestry and fishing)				Industry (includes construction)				Services (residual figure)			
	WIIW	UN ECE 1989 1993	Emp. Obs.	National figures	WIIW	UN ECE 1989 1993	Emp. Obs.	National figures	WIIW	UN ECE 1989 1993	Emp. Obs.	National figures
Poland	26.6 1993 26.2	26.8 25.8	26.3 24.0	26.8 26.8	36.0 1993 31.3	36.8 31.6	36.2 32.6	36.0 30.8	37.4 1993 42.5	36.4 42.6	37.3 43.4	37.2 42.4
Hungary	15/8 1992 9.9	15.5 9.1	15.0 8.7	7.6	36.1 1992 34.9	38.2 33.8	38.2 33.0	27.6	48.1 55.2	46.7 57.1	46.8 58.3	64.8
Czech R.	11.8 7.0	10.6 6.9	12.1 7.0	11.8 7.0	45.3 42.8	49.2 44.6	45.3 43.0	45.4 42.2	42.9 50.2	40.2 48.6	42.6 50.0	42.8 50.8
Slovakia	12.6 ¹⁹⁹¹ 1993 12.0	13.8 12.1	13.5 10.2	11.8 ¹⁹⁹² 8.9	44.1 ¹⁹⁹¹ 1993 35.7	46.3 39.8	44.6 39.6	39.3 ¹⁹⁹² 37.2	43.3 52.3	39.9 48.1	41.9 50.2	48.9 53.9
Bulgaria	18.5 22.1	18.6 22.1	19.8 23.2	17.8 ¹⁹⁹¹ 9.3	44.8 35.5	45.3 36.6	44.2 35.3	37.3 39.9	36.7 42.4	36.0 41.3	36.0 41.5	44.9 50.8
Romania	29.0 1993 35.9	27.9 35.9	29.0 36.4		43.4 35.8	45.1 35.8	43.5 34.4		27.6 1993 28.3	27.0 28.3	27.5 29.2	
Slovenia	2.4 2.0			15.0 ¹⁹⁹¹ 1993 10.7	52.6 46.6			45.1 ¹⁹⁹¹ 1993 44.2	45.2 51.4			39.9 ¹⁹⁹¹ 1993 45.1
Estonia				19.0 ¹⁹⁹² 11.0				40.0 ¹⁹⁹² 39.0				41.0 ¹⁹⁹² 50.0
Latvia		17.4 19.5		17.4 19.3		37.4 28.5		37.4 26.1		45.2 52.0		45.2 54.6
Lithuania		17.9 19.6		19.6 ¹⁹⁹² 23.4		42.1 38.0		37.9 ¹⁹⁹² 29.0		40.0 42.4		42.5 ¹⁹⁹² 47.6

Sources: UN ECE (1995); WIIW (1995); Employment Observatory (1995).

Table 5.3: Unemployment rates in the CEE and Baltic acceding countries, 1991-1995

Country	UN ECE					WIIW					DIW <i>et al</i>					National figures				
	1991	1992	1993	1994	1995	1991	1992	1993	1994	1995	1991	1992	1993	1994	1995	1991	1992	1993	1994	1995
Poland	11.8	13.6	16.4	16.0		11.8	13.6	16.4	16.0		11.8	13.6	16.4	16.0		11.4	13.6	16.4	16.0	14.9
Hungary	7.4	12.7	12.6	10.4		7.8	13.2	12.6	10.9		7.8	13.2	12.1	10.1	11.0	2.1	8.2	13.3	12.8	10.5
Czech R.	4.1	2.6	3.5	3.2		4.1	2.6	3.5	3.2		4.1	2.6	3.5	3.2		4.1	2.6	3.5	3.2	2.9
Slovakia	11.8	10.4	14.4	14.8		11.8	10.4	14.4	14.8		11.8	10.4	4.4	14.8		11.8	10.4	14.4	14.8	13.1
Bulgaria	11.5	15.6	16.4	12.8		11.1	15.2	16.4	12.8		11.0	15.2	16.4	12.5		11.3	12.0		12.4	12.0
Romania	3.1	8.2	10.4	10.9		3.0	8.4	10.4	10.9		3.0	8.4	10.2	10.9	14.0	4.0			12.9	
Slovenia	10.1	13.4	15.5	14.3		10.1	13.4	15.4	14.2		10.1	13.4	15.5	14.3	13.0	5.7	7.8	9.8	9.4	8.8
Estonia	0.1	1.9	2.6	2.2							0.1	1.9	2.1	1.8				4.7	5.1	5.0
Latvia		2.1	5.8	6.5								1.1	4.7	6.4			0.9	4.6	6.4	6.5
Lithuania	0.3	1.0	3.4	4.5							0.2	1.3	4.4	3.8		0.2	1.3	4.4	3.8	

Country	Employment Obs. (unemployment rate - LFS)				Employment Obs. (registered unemployment rate)				
	1992	1993	1994	1995	1991	1992	1993	1994	1995 (QII)
Poland		14.0	14.4	12.9	9.7	13.6	14.9	16.5	15.2
Hungary	9.9	11.9	10.7	10.1	4.1	10.3	12.9	11.3	10.1
Czech R.		4.1	4.0	3.7	2.6	3.1	3.0	3.3	2.8
Slovakia		12.5	13.7	12.5	6.6	11.4	12.7	14.4	13.3
Bulgaria		21.4	20.5	15.7	6.7	13.2	15.7	14.1	10.7
Romania			8.2	8.0	3.0	8.4	10.4	10.9	9.9

Table 5.5 : Regional Disparities in Unemployment Rates, 1994

	Region	Unemployment Rate
Poland		16.0
	Warsaw	14.2
	North-Eastern	23.5
	Northern	20.6
	Central-Western	18.0
	South-Western	19.8
	Southern	11.7
	Central	18.9
	South-Eastern	15.0
Central-Eastern	14.7	
Hungary		12.8
	Trans-Danubian	11.0
	Great-Plain	13.2
	North-East	16.5
	North-West & Budapest	7.3
Czech Republic		3.2
	Mid-Bohemia	1.4
	South & West Bohemia	2.1
	North Bohemia	4.0
	East Bohemia	2.4
	South Moravia	3.2
	North Moravia	5.6
Slovakia		14.8
	Bratislava	5.2
	West Slovakia	13.8
	Mid Slovakia	14.1
	East Slovakia	17.4
Bulgaria		12.4
	Sofia Town	7.0
	Burgas	11.4
	Varna	11.1
	Lovtech	11.3
	Montana	21.2
	Plovdiv	15.8
	Russe	15.7
	Sofia District	13.6
Haskovo	16.8	

	Region	Unemployment Rate
Romania		10.9
	Bucharest	7.0
	Constanta	10.0
	N. Muntenia	10.4
	Oltenia	11.3
	Banat	9.1
	Central	10.0
	Cluj	10.3
	N. Moldova	16.2
S. Moldova	13.9	
Slovenia		9.4
Latvia		6.4
Lithuania		9.0
Estonia		5.5
Malta		4.0
Cyprus		2.7

6. ECONOMIC PERFORMANCE

6.1 Overview

The Central and Eastern European region as a whole experienced a steep decline in economic output during the 1990-1993 period as aggregate GDP fell in the four successive years. This general contraction of the transition economies can be attributed to two sets of factors: the pursuit of economic stabilisation policies and the shrinkage of foreign export markets (UN ECE, 1995). First, the policies of the transition governments have been governed by the overriding objective of achieving stabilisation of the economy while initiating widespread industrial restructuring. As a result, there was a gradual but effective decline in the level of support to state-controlled enterprises, and as many of these enterprises were uncompetitive in the newly-liberalised commercial environment, industrial output in a wide range of sectors fell sharply. Second, the impact of internal restructuring was exacerbated by global recession. With Western countries undergoing their own economic difficulties, many firms in the transition economies found key export markets - on which they were increasingly becoming dependent - shrinking.

All of the countries discussed here undertook a combination of reform measures to achieve macroeconomic stabilisation, though the course and success of the programmes differed by country, depending on the nature of its existing administrative machinery, the political situation and the wider social consensus for reform. In spite of a variety of approaches and outcomes, the economic reforms had common elements.

- *Price liberalisation.* This aimed at establishing market mechanisms for setting prices and encouraging greater commercial freedoms while at the same time making the maintenance of price stability a priority. For most Central and Eastern European countries, the latter has often been difficult to achieve because of great inflationary pressures within their economies, notably arising from 'monetary overhang' (as a result of the excess of household savings from the previous regime and the scarcity of goods currently available) and the extensive use of subsidies and credits by state-owned enterprises.
- *Monetary and expenditure policy.* As a consequence of these problems, governments adopted a range of measures to control inflation: restrictive monetary policy, efforts to balance government budgets (usually by improving revenue collection and cutting down government subsidies to industry) and incomes policy (frequently through taxes on wage increases).
- *Foreign trade.* Price reform also required opening access to foreign trade, allowing domestic prices to approach world price levels, which in turn highlighted the importance of achieving full current account convertibility (at least as a longer-term goal) and in many cases, maintaining a fixed exchange rate system.
- *Legal and financial reforms.* In addition to macroeconomic stabilisation, reform governments prepared for the process of industrial restructuring by providing its

key legal foundations in property rights and commercial law as well as by initiating banking and financial market reforms in order to support the development of efficient domestic capital markets.

As well as common measures for pursuing macroeconomic stabilisation, the new governments also faced similar problems in designing reform programmes. First, given the scope of activities involved, the *sequencing* of reforms became a crucial issue (Lavigne, 1995). As different measures were often linked together, reform programmes would have to advance in several areas at the same time. For example, for price liberalisation to be successful, property rights would have to be clarified and reformed financial market institutions should be in place to give new and restructuring enterprises access to investment capital. Consequently, there were political debates as to whether comprehensive reform programmes should be adopted - as in the 'big bang' approach of Poland and Czechoslovakia - or the gradual introduction of reforms over time - as characterised the reform process in Hungary, Romania and Slovenia. Arguments cited in favour of 'shock therapy' were based on the belief that a permanent and immediate change to the business environment was required if genuine reform was to be achieved, otherwise the process could be rendered ineffective by longer-term political wrangling over measures by affected interest groups. In contrast, 'gradualists' feared that a sudden lurch in economic policy and performance would risk jeopardising political support for reforms as well as allowing parts of the economy to slip into foreign control (notably through rapid privatisation).

Sequencing was tied in with a second problem faced by the new governments - how to maintain *credibility* in the reform process. In many ways, it was not the speed of reform (whether 'big bang' or gradual) that mattered but the consistency with which reforms were pursued over a longer period. In order to form, markets required both stable conditions and clear indications of future development. Where policy consistency was maintained - as in the Central European economies of Czechoslovakia, Hungary and Poland - economic progress was marked, often in spite of the precise sequencing of reforms. Where consistency was frequently lacking - as in Bulgaria and Romania - the economic collapse has been both deeper and longer-lasting.

In consequence, macroeconomic stabilisation was regarded as an objective that was essential to achieve before wider economic transformation was possible, though it was tempered by political and social considerations. Governments were often vulnerable to the political shifts of opinion caused by unpopularity at the initially (and in some cases, protracted) painful measures undertaken, particularly when it was connected to cuts in government support to industry (frequently leading to job losses) and social welfare (Kirkpatrick, 1994). Policy decisions were ultimately based on the strength and duration of political support for reform and the country's administrative capacity for implementing reforms.

In spite of the difficulties of implementing reform, a combination of the achievement of macroeconomic stabilisation in several transition economies and recovery in the main Western markets has led to the renewed expansion of economic activity (Podkaminer, 1995). At the same time, there has been a shift among the contributions made by different parts of the overall economy. Within manufacturing, the reduced

support to loss-making enterprises and the implementation of privatisation programmes have altered the sectoral composition of GDP as more internationally-competitive sectors have begun to emerge. Services have increased rapidly in the transition economies and account for a significantly higher share of GDP throughout the region than at the start of transition. The agricultural sector has also undergone extensive restructuring (and in some cases, contraction) in a few CEE countries following the liberalisation of agricultural markets, the collapse of collectivisation and the re-establishment of property rights.

In terms of facing future challenges, the incremental ‘muddling-through’ approach that has marked the majority of CEE reform programmes is likely to be continued (Podkaminer, 1995). Although economic stabilisation has been achieved in most transition economies (though some still experience economic decline or slow growth, as detailed in the following section), a common set of difficult tasks remains, including the establishment of secure and well-functioning banking and financial systems, property rights and environmental liabilities legislation, reform of the social welfare system, transport and telecommunications infrastructure development, and restructuring of the agricultural sector. In addition, specific issues need to be addressed by individual countries, notably privatisation programmes (eg. Bulgaria, Poland and Slovenia), foreign trade deficits (eg. the Czech Republic, Hungary and Romania) and rising inflation (eg. Bulgaria, Hungary and Poland). Given the pace of development already demonstrated, it is likely that economic restructuring will be completed earliest and most successfully in the Central European economies - especially the Czech Republic, Hungary and Poland - and Slovenia.

Economic restructuring remains a complex process, likely to produce a range of impacts in different regions and countries. In order to understand these better, a number of specific issues raised in this general overview can be pursued in greater detail. As a result, in the following sub-sections, different aspects of economic performance are examined at both national and regional levels. The starting point is the problem of data sources, both those provided on an international comparative basis as well as national statistics, as there are serious questions about the reliability and comparability of the different datasets. Once this ‘information’ context has been set for the subsequent comparative analysis, a range of economic indicators are then considered: macroeconomic indicators, such as GDP and GDP per capita; industrial output and productivity indicators; and measurements of regional disparities both across the CEE region as a whole and within individual countries as well as in comparison with the EU. The chapter finishes with a summary and future outlook for the potential Member State countries of the CEE.

6.2 Data Issues

Obtaining and using comparative economic data for the transition economies is beset with several problems, as also described in Chapter 16. Such data are available from international datasets - where efforts have been made to standardise information for the purposes of comparability - as well as from the statistical offices of the acceding countries. In all cases, measuring economic activity within the transition countries is complicated by the different bases used in the key indicators. In particular, distortions

in the statistical databases for the transition countries often make it difficult to compare figures for GDP and GDP per capita.

The basis for all the datasets on the transition economies is the national statistical sources. In nearly all the acceding countries, GDP statistics suffer from under-reporting of economic activity, especially in the private sector, often as a result of attempts to avoid taxes calculated on the basis of the GDP information collected and the continuing rapid expansion of the private sector (at a pace faster than statistical measurers can keep up with). Uncertainty in determining GDP also arises where a large 'grey' economy may exist, again a problem caused by the often ill-defined size of the private sector. For example, the so-called 'underground economy' has been estimated as amounting to between a fifth and a quarter of Polish GDP and between 10 and 15 percent of the Czech economy (UN ECE, 1995).

In addition, only recently have many of the transition countries adopted the same national accounting and statistical standards used elsewhere in the world. As of 1995, quarterly data was not available for Hungary, Poland and Romania, and high and rising inflation rates in some countries - such as Bulgaria and Romania - have made it difficult to compare GDP statistics for different years (Jilek, 1995). In several countries, statistical offices frequently need to revise figures retrospectively following improvements in their data collection procedures (especially in the Baltic states). For all countries, analysis based on the sectoral contributions to GDP is only available after some delay, weakening efforts to reach a more detailed understanding of structural change within the transition economies.

National sources of data feed into the international datasets, which seek to provide comparative information on the transition economies by treating the data to standardisation procedures. A representative example of the problems arising from this process are GDP comparisons, as seen in the table below. This uses data from national sources, the Wiener Institut für Internationale Wirtschaftsvergleiche (WIIW) and Eurostat (Table 6.1). The greatest difficulty lies with the use of market exchange rates for international comparison. Due to the widespread problem of high inflation combined with undervaluation of currencies (in order to stimulate exports), nominal comparisons of GDP can often be misleading. In Table 6.1, nominal and 'real' GDP statistics for GDP are both provided. The nominal statistics take nationally-supplied figures and undertake simple conversions at annualised market exchange rates. 'Real' GDP is found by using purchasing power parities (PPP) in converting nominal GDP rates. The differences between the nominal and 'real' figures are clear, showing consistent underestimation on the part of nominal figures (particularly in the case of Bulgaria, Romania, Slovakia and the Baltic Republics).

Table 6.1: Different measurements of GDP			
	National statistics	WIIW	Eurostat
	<i>(1993, US\$ mn, nominal)</i>	<i>(1993, US\$ mn, PPP)</i>	<i>(1993, US\$ mn, PPP)</i>
Bulgaria	10,810	32,036	35,640
Czech Republic	31,228	79,183	86,746
Estonia	1,656	Not available	5,705
Hungary	38,438	64,488	60,812
Latvia	2,429	Not available	7,982
Lithuania	2,776	Not available	13,620
Poland	85,580	190,333	179,290
Romania	11,925	68,364	83,060
Slovakia	11,049	34,503	30,560
Slovenia	12,672	15,657	18,420

Furthermore, calculations of PPP can lead to differing values for ‘real’ GDP, again as noted in Chapter 16 and as demonstrated above by comparing figures produced separately by the WIIW and Eurostat. The differences amount to at least ten percent in most cases (and not always in the same direction, as the figures for Poland and Slovakia would suggest). The reasons for the discrepancies can be attributed to different calculation exercises. In both cases, the figures relied on the collaborative work of Western and Eastern European statistical offices in harmonising their data in order to provide comparability. The WIIW used benchmarks generated by the Austrian statistical office through a series of bilateral discussions with its counterparts in a number of acceding countries. These benchmarks became the basis for a later multilateral exercise organised by Eurostat and the OECD and involving a wider range of Western and Eastern European data-gathering agencies, which in turn resulted in producing its own series of benchmarks (the so-called ‘European Comparison Programme’).

With regard to GDP growth, estimations are further complicated by problems arising from the use of varying economic models in international datasets. Table 6.2 demonstrates the variety of estimates that have been made by Eurostat, the Economist Intelligence Unit (EIU), the United Nations Economic Commission for Europe (UN ECE) and the WIIW. For the more advanced economies in the region, the estimates are broadly in line with each other - eg. the Czech Republic, Hungary and Poland - but in the case of the Baltic Republics, the estimates differ substantially, not only in terms of the magnitude of GDP changes but the *direction* as well (ie. growth or contraction of the economy). For example, estimates for Estonia range from -3 to +4.7 percent for 1995. In all cases, national statistical sources are used as a starting point, with adjustments made in order to produce ‘real’ GDP (as described above) and growth rates generated by specific economic models. Differences emerge in the models from varying assumptions about global economic growth, changes in exchange rates and inflation, foreign trade balances, government deficits and where appropriate, political factors influencing the speed and course of economic reform

	Eurostat	EIU	UN ECE	WIIW
Bulgaria	2.7	2.0	2.0-2.2	2.0
Czech Republic	4.8	4.1	3.7	4.0
Estonia	4.5	4.7	-3.0 ¹	N.a. ²
Hungary	1.7	1.5	0-1	1.0
Latvia	-1.6	1.0	-2.2	N.a.
Lithuania	2.5	2.5	-6.5 ¹	N.a.
Poland	7.0	6.0	5.0	6.0
Romania	6.9	3.8	4.2	3.0
Slovakia	7.4	6.0	4.0-5.5	4.0
Slovenia	4.2	5.0	5.0	5.0

¹ - January-September only.

² - data are not available.

Critical differences are evident with regard to GDP per capita data, particularly when comparing the international statistical datasets provided by the WIIW, Eurostat, the EIU and the World Bank (Table 6.3). The differences can be seen when contrasting the other datasets with Eurostat data. In the case of the World Bank, the differences with the Eurostat figures are generally within a limited range of variation, though there are examples of notable discrepancy (eg. Latvia, whose GDP per capita in 1993 was 17.9 percent of the EU average according to Eurostat, but 30.6 percent, according to the World Bank). Much depends on the PPP rates used for the transition economies and how these have been arrived at. In the case of the World Bank, they were often based on extrapolations from old survey results of the local costs of a basket of goods and services, occasionally dating back before the start of transition. The results produced by Eurostat (in conjunction with the OECD) are based on more recent survey work in the transition economies.

	WIIW		Eurostat		World Bank		EIU¹ (1995)	
	<i>US\$²</i>	<i>EU=100³</i>	<i>US\$</i>	<i>EU=100</i>	<i>US\$</i>	<i>EU=100</i>	<i>US\$</i>	<i>EU=100</i>
Bulgaria	3,787	22.1	4,193	24.5	4,107	25.0	4,069	17.9
Czech Republic	7,668	44.8	8,422	49.2	7,546	46.0	8,734	38.3
Estonia	N.a. ⁴	N.a.	3,803	22.2	N.a.	N.a.	8,056	35.3
Hungary	6,275	36.7	5,962	34.8	5,546	37.0	6,527	28.6
Latvia	N.a.	N.a.	3,070	17.9	5,022	30.6	5,067	22.2
Lithuania	N.a.	N.a.	3,681	21.5	3,117	19.0	3,635	16.0
Poland	4,943	28.9	4,669	27.3	4,998	30.5	6,132	26.9
Romania	3,004	17.5	3,643	21.3	2,796	17.0	3,129	13.7
Slovakia	6,478	37.8	5,766	33.7	6,284	38.3	7,708	33.8
Slovenia	7,865	45.9	9,210	53.8	N.a.	N.a.	10,353	45.4

¹ - Economist Intelligence Unit.

³ - EU averages are for the EU-15.

² - US\$ at purchasing power parities.

⁴ - data not available.

The statistics produced by the EIU are based on PPP figures taken from the UN Comparisons Project and estimates derived from their own assumptions regarding US price inflation and national growth rates. Their extrapolations of GDP per capita figures for 1995 again shows the discrepancies that exist between international datasets and the wide range of economic projections that have been made about the acceding countries. For example, when comparing the 1993 (Eurostat) and 1995 (EIU) statistics, the ratio of national GDP per capita to the EU average substantially improves in the Baltic states (apart from Lithuania) while declining in Bulgaria, the Czech Republic, Hungary, Romania and Slovakia. As a result, Estonia's real income levels appear to have overtaken those of Hungary, Poland and Slovakia. Yet when examining GDP growth rates and inflation data in Tables 6.2 and 6.4, Estonia's better economic performance seems to have taken place despite equivalent or higher growth rates and lower inflation rates in the latter two countries, Poland and Slovakia. Similarly, Latvia's growth in GDP per capita relative to the EU seems to have occurred in spite of the apparent contraction of its economy (according to Eurostat and the UN ECE).

Other types of data also need to be treated with caution. For example, industrial output data over time should be regarded carefully because of the difficulties in collection during a period of extensive restructuring. With the combined processes of privatisation, fragmentation of large enterprises, transfer of ownership to foreign entities and widespread new firm formation, output data can be only be indicative at best. Labour productivity figures suffer not only from this uncertainty, but also the differences in employment data definitions used in the acceding countries (as described in more detail in Chapter 5).

At regional level, statistical problems are compounded by issues relating to the reliability of data reporting and collection as well as attribution. For example, in the Czech Republic, gross regional product statistics have not been estimated using the 'production' method of calculation (ie. aggregating data of gross value added within different economic branches), so artificial indices have to be constructed to measure economic activity within the regions. As in Western Europe, attribution of economic activity can also distort regional figures, particularly where activity is measured by place of residence rather than work and there is significant commuting between regions (an important factor to take into consideration in assessing the economic dominance of capital-city regions in the transition countries).

Further regional data issues are discussed in the appropriate sections below.

4.3 Macroeconomic Indicators

In considering the overall economic performance of the acceding countries, it is important to emphasise that economies began the transition period at different levels of economic reform and activity. In the Central European countries (especially Hungary and the Czech Republic), some measures to liberalise economic activity had already been put in place before the collapse of the former Communist regimes. In contrast, other countries had experienced severe decline as a result of economic policies employed in the decades before the transition, notably Romania. Moreover,

liberalisation measures have been implemented at different paces in the transition countries - for example, in Poland, extensive reform was introduced rapidly, whereas governments in Bulgaria and Romania have responded comparatively slowly to the same policy challenges. The different rates were in part a result of the different paces at which political liberalisation has occurred - particularly important in the case of the Baltic states, which gained their political independence later than countries in Central and Eastern Europe. Consequently, different economic performances among the transition countries are to be expected, as the process of reform is likely to last varying lengths of time.

The severity of economic contraction has varied among the different countries (Table 6.4). Two datasets can be used to measure changes in real output between 1989 and 1995: the WIIW and the UN Economic Commission for Europe. In both cases, the scale of change is broadly comparable. The most dramatic fall has taken place in the Baltic states, especially Latvia and Lithuania. The other countries have experienced similar levels of decline, apart from Slovenia and Poland (in the case of the latter, the deterioration in GDP since 1989 has not only been made up, but superseded, according to the WIIW).

	Real GDP change (1989=100)		Inflation rate	Budget deficit
	WIIW	UN ECE	(%)	(% of GDP) ¹
Bulgaria	78.1	71.5	62.7	-7.2
Czech Republic	85.0	83.5	9.1	1.5
Estonia	Not available	63.0	28.9	Not available
Hungary	85.1	81.5	26.4	-6.3
Latvia	Not available	48.8	26.0	-3.9
Lithuania	Not available	31.1	37.0	-1.5
Poland	101.9	96.5	28.0	-2.7
Romania	81.0	74.2	33.1	-3.3
Slovakia	83.7	82.4	9.7	-1.7
Slovenia	92.7	89.3	12.6	-0.3

¹ - minus sign indicates deficit rather than surplus. Data is taken from Eurostat, supplemented by national sources.

Source: Eurostat, except where otherwise noted.

Despite the prolonged period of economic decline, nearly all the transition countries had positive GDP growth rates in 1995 in 'real' terms, apart from Latvia, though this depends on the growth estimate used (Table 6.2). In nearly all cases, the growth rates were faster than the previous year (Podkaminer, 1995). GDP stabilised in the majority of countries in 1994 - in Slovenia, growth was first registered in 1993, and in Poland, the preceding year. In 1994, the region as a whole registered the first upturn in economic activity since the start of transition - a growth rate of 3.7 percent, as compared to 2.6 percent for Western Europe (UN ECE, 1995).

Of the enlargement countries, Poland has demonstrated the swiftest recovery from the period of economic restructuring, in large part because of its early adoption of economic reform policies as part of its 'shock therapy' programme and the size of its economy. Enjoying its third successive year of growth, Polish GDP rose by between five and seven percent in 1995 (depending on the estimate), one of the highest rates in CEE, though its inflation rate continues to be a source of concern. Macroeconomic stabilisation also appears to have been achieved in the other Central European economies as rapid economic expansion in 1995 was reported in Slovenia (its third successive year of growth), Slovakia and the Czech Republic, all of which reported relatively low inflation and budget deficits (the Czech Republic was able to report a budget surplus in that year).

In contrast, Hungary's economic growth has faltered, as the state budget deficit has increased sharply in recent years (reflecting a falling-off of the political consensus for economic reform, increasing pressure on the government to relieve the costs of transition). In combination with a declining balance of payments, this has kept inflation high and contributed to disappointing figures for economic growth. In response, the Hungarian government introduced austerity measures and currency devaluation in 1995.

Slower development has taken place in Bulgaria and Romania, possibly because the reform programmes have been pursued less vigorously in these countries, though the prospects for both countries are improving. Growth has also been occurring in the Baltic states, apart from Latvia, where decline appears to be continuing. However, the economic expansion should be seen against the background of the previous period of contraction. This is particularly the case in Lithuania, where the decline in GDP was the worst of all the transition countries discussed here. The collapse in Lithuania can be attributed largely to local factors, especially the huge increase in the price of imported Russian oil and the knock-on effects on the country's important energy industry.

The ranking of countries differs when using GDP per capita as a measure of economic performance, as shown in Table 6.3 above. Again, different sets of indicators are presented in order to reinforce the statistical variation in measuring wealth in the transition countries. Nevertheless, by the various approaches, Slovenia and the Czech Republic have enjoyed the highest values of per capita GDP by a considerable margin (when calculated by purchasing power parities in US dollars for 1993), followed by Slovakia, Hungary and Poland. At the lower end of the spectrum are both the other Balkan countries and the Baltic states - Lithuania has the lowest figure (which would be in line with the scale of its economic collapse), followed by Romania, depending on the statistical approach used.

As a result of the collapse in output experienced during the transition period, few countries have been able to reach the levels of prosperity that existed before the restructuring. When examined in terms of changes to per capita GDP in the WIIW dataset, the only two countries to have higher values in 1994 than in 1990 are Poland (which was 15 percent larger) and Slovenia (3.9 percent greater) (Podkaminer, 1995). The steepest declines in per capita GDP over the same period were registered in the former Czechoslovakia - the Czech Republic (a decrease of 8.5 percent) and Slovakia

(11.5 percent), though both have made notable recoveries. The Baltic and Balkan countries suffered less severe impacts, but in all cases apart from Estonia, their levels of per capita GDP remain very low. However, given the earlier comments about the differing 'points of rest' of the transition economies, it is not surprising to discover that the country *ranking* by GDP per capita was the same in 1993 as in 1990.

A comparison with the EU averages demonstrates the relatively low levels of GDP per capita in the transition countries (Table 6.3). Even in the most prosperous of the enlargement states, their levels are less than half of the EU average. Even Slovenia and the Czech Republic - the acceding countries with the highest relative incomes - have levels of GDP per capita below the EU Member State with the lowest average - Greece (US\$ 10,704, according to Eurostat).

4.4 Industrial Indicators

The severe decline experienced by the transition economies was most apparent in their collapse of industrial production. Industrial output decreased rapidly in the wake of price reform and early liberalisation measures in the transition countries. As large and increasing shares of domestic industry were exposed to international competition, there was a surge of imports replacing local products in most countries. At the same time, subsidies and the extension of financial credit to state-controlled enterprises were curtailed. In some countries - such as the Czech Republic and Hungary - privatisation of industry has catalysed widespread restructuring of enterprises, entailing the break-up of large organisations into smaller companies with consequent interruptions of production (often caused indirectly through disruptions to supply and distribution chains). In other countries, dependence on a few large companies has exacerbated the fall in output - for example, the sharp production cutbacks of the single Lithuanian refinery, Mazeikiu Nafta, because of the hike in imported Russian oil prices had significant repercussions for the Baltic state's economy as a whole.

Industrial output began to increase again in the majority of countries by 1994 (a year earlier in some countries, notably Poland and Slovenia), though Latvia continues to decline. However, the overall fall in output in the transition period has been greater than the decline in total GDP. The data should be treated with caution because of the statistical limitations in measuring output changes in economies undergoing substantial change, though the two industrial output datasets - from national sources and the UN ECE - appear to be in general agreement regarding trends (Table 6.5). The difference is the result of the extended and often delayed process of industrial restructuring occurring within industry (usually following the more immediate objective of achieving macroeconomic stabilisation), which contrasts with the recovery and growth characterising the service sectors of the economy.

In contrast with output, labour productivity has shown rapid growth following an early period of decline. The drop in productivity in the transition countries has been less dramatic as the case with output, mainly because production has begun to recover while industrial employment continues to fall. Full recovery appears to have taken place in Bulgaria, Hungary and Slovenia, though the statistics should be used cautiously.

	1994 Output (1989=100)		1994 Productivity
	<i>National</i>	<i>UN ECE</i>	<i>(1989=100)</i>
Bulgaria	50.7	50.0	107.1
Czech Republic	68.0	65.1	86.5
Estonia	44-47	38.7	*
Hungary	76.8	79.0	121.4 ¹
Latvia	40.9 ¹	37.6	58.4 ¹
Lithuania	32.6	31.3	55.6 ²
Poland	85.1	84.1	*
Romania	51.6	51.6	92.0 ¹
Slovakia	61.2	64.3	69.8
Slovenia	70.1	70.4	105.6

* - data are not available.

¹ - 1990=100.

² - Lithuanian productivity results are a rough estimate, calculated by dividing change in industrial output by change in the industrial workforce.

Source: national sources, UN ECE (1995).

Recovery has been led by manufacturing with the upturn in Western export markets and successful restructuring in countries where privatisation programmes are far advanced. The process of restructuring has changed the relative importance of certain manufacturing sectors, as increasing domestic and international competition is facilitating the emergence of industrial comparative advantages in each country. The growth industries differ in each transition economy, but in general, there has been a pronounced recovery in consumer products as well as intermediate and investment goods, such as chemicals, metals and metal products. In contrast, industrial output and labour productivity have been increasing more slowly in many traditional industries in the region (such as iron and steel and certain engineering sectors).

With the general decline in industrial output, the share of manufacturing of total output has been falling for all the transition countries, though at different rates - most rapid in Latvia, least in Hungary (Table 6.6). Comparison of the sectoral structures of GDP in different transition economies is difficult because of the limited sectoral data that is available (as noted above). However, where comparative information has been assembled, it appears that the share of manufacturing in total output remains highest in the Czech Republic (45 percent in 1993) and lowest in Latvia and Slovenia (31 percent).

Table 6.6: Share of major sectors of total output (1990-93, percent) ¹						
	Industry ²		Services		Agriculture	
	<i>1990</i>	<i>1993</i>	<i>1990</i>	<i>1993</i>	<i>1990</i>	<i>1993</i>
Bulgaria	50	40	30	47	18	9
Czech Republic ³	58	45	32	50	7	6
Estonia	N.a. ⁴	37	N.a.	53	N.a.	11
Hungary	33	32	55	62	13	6
Latvia	46	31	32	54	22	15
Lithuania	N.a.	39	N.a.	35	N.a.	11
Poland	54	39	36	53	13	6
Romania	46	39	32	40	22	21
Slovakia ³	58	43	32	50	7	7
Slovenia	37	31	58	57	5	5

¹ - totals do not always sum to 100 percent due either to non-attribution of certain economic activities or because of rounding.

² - industry and construction.

³ - 1990 data for the Czech Republic and Slovakia refer to Czechoslovakia. In the case of Slovakia, 1993 data is taken from Eurostat.

⁴ - data are not available.

Source: UN ECE, 1995.

In addition to industry, there has been widespread changes in other economic sectors. As noted in employment terms in Chapter 5, *services* have become more significant in all the transition economies, though it is difficult to measure this accurately in terms of output and productivity. Indicators for services tend to be unreliable, as many service sectors are dominated by smaller firms from whom, data is traditionally more difficult to obtain. Nevertheless, Table 6.6 does show that the share of services in total output grew in almost all transition economies (with the exception of Slovenia, where the share of GDP was high initially), resulting from a combination of the contraction of industrial output during the period of restructuring and the substantial growth in several service sectors (especially retail and foreign trade, construction, tourism, catering, and financial and business services). In contrast, the contribution of transport services to GDP has been declining in the transition countries, apart from the Baltic states where transit services to the CIS countries have been crucial in economic performance. By 1993, services accounted for the largest share of GDP in Hungary (62 percent) and the lowest in Lithuania (35 percent).

Unlike industry and services, *agriculture* continues to show a steady decline. In all transition economies for which data is displayed, its share of GDP has fallen sharply - in the case of Bulgaria, Hungary, Latvia and Poland by as much as half (Table 6.6). Agriculture only continues to account for significant shares of GDP in the less-developed transition countries, notably Romania (where at 21 percent of GDP in 1993, the share was the highest in the region) and the Baltic states (between 11 and 15 percent), and remains higher than the EU average. The smallest contribution of agriculture to GDP among the acceding countries appears to be in Slovenia (5 percent), but this was true at the beginning of the transition period.

The continuing contraction of the agricultural sector can be attributed to several causes. In addition to the direct restructuring of the agricultural sector with the

privatisation and decollectivisation of large state-owned farms, conditions have been made worse by a combination of factors relating to ownership, supply and market structures (CCET, 1994). Poor weather has led to lower yields in some years. Legal uncertainty has continued as a result of debates over land property entitlement in the process of farm land redistribution. In international terms, there has been a deterioration in the agricultural terms of trade, in part arising from the loss of mutual markets in the CEE region with the large surpluses in agricultural products left over from the pre-transition period and the overall decline of household income and food demand. At the same time, several domestic markets for agricultural goods, notably the food industry, have contracted as a result of internal restructuring and the removal of consumption subsidies to industrial users of agricultural products.

6.5 Regional Disparities: Between Countries

A wider discussion of regional development is contained in later sections of the report; the section here should be considered in conjunction with later analysis. The focus in the following sub-sections is the regional dimension of economic development in the transition countries, with emphasis being placed on the regional differences and disparities in the economic indicators for which data is available on a comparative basis. In section 6.5, inter-regional comparisons among the transition economies and the EU are discussed; section 6.6 considers regional disparities *within* the acceding countries, focusing at the sub-regional level.

A consideration of regional disparities across all the transition economies and the EU begins with GDP per capita. However, the statistical comparison of disparities between the EU and new Member States is complicated when national analysis descends to the regional level. Given that GDP has only recently begun to be calculated on a comparable basis in acceding countries, regional income data is rarely available in an appropriate form. As a result, for the purpose of this analysis of regional income data, several stages of analysis have been undertaken.

First, the Eurostat national GDP per capita figures in Table 6.3 were used, as these can provide a direct means of comparison between EU and acceding countries. The best available sub-national income data has been obtained from national sources: in the Czech Republic, Poland, Hungary and Romania, the data approximated to GDP; in Slovakia gross value added was used; and in Bulgaria, only measurements of income from gross material production at regional level were available. As income data at regional level is only partially collected (eg. sectoral shares of output are often absent), artificial indices have had to be constructed in some cases. For example, regional output data for the Czech Republic was found by distributing output at regional level on the basis of national averages and the regional shares of employment in different sectors.

For the six larger transition countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia), the territorial units for which data is available - eg. *voivodships* in Poland, *judet* in Romania - were grouped into larger regions that are broadly equivalent to the NUTS 1 level in the EU. For the remaining countries

(Slovenia and the Baltic states), no regional breakdown was sought given the small size of the countries so they have been left out of the regional analysis.

The regional data were used to construct indices of regional income per capita disparity for each country, with the national average equal to 100. These indices were then related to the Eurostat figures to produce regional GDP per capita values for each region, as well as indices related to the EU average (EU15=100). In addition, GDP per capita figures in US\$ and ECU (for 1993 at purchasing power parity) were derived as well. The figures are presented in Appendix 6.1 at the end of this chapter, though aspects of the data are shown in Table 6.7 below along with Eurostat data on EU regions.

This procedure is relatively simplistic and crude with considerable methodological statistical flaws. For example, while it is generally safe to assume that national purchasing power parities can be applied commonly to different regions within the same country inside the EU, it is more difficult to use a single PPP figure for different regions within transition countries. In the acceding countries, there is often wider inter-regional variations in prices arising from highly-localised shortages, absence of market competitors and deficiencies in transport infrastructure. Nevertheless, the method does provide some initial yardsticks for regional comparisons and enables discussion of comparative regional disparities to take place. At the very least, it indicates the pattern of regional income disparities in the transition countries, which, as shown in the subsequent sub-sections, tends to be reinforced by other regional indicators.

From the calculations, it can be seen that none of the CEE regions exceeds a GDP per capita level equivalent to 75 percent of the EU-15 average (Table 6.7). Only Prague, at 74.8 percent, comes close to this figure, followed by Budapest (62.9 percent). However, there is apparently some overlap between the GDP per capita levels of leading CEE regions and the weakest EU regions. Many Czech regions are higher placed than the weakest Portuguese regions, and the capital city regions of Budapest and Sofia have income per head levels in excess of the weaker regions of Portugal, Greece, Spain and Germany.

Regional GDP per capita disparities in the transition countries are generally smaller than the EU-15 countries (Table 6.7). The pattern appears to be that the smaller the national income level (relative to the EU average), the smaller the regional disparities. As a result, differences between the richest and poorest regions in the CEE countries are broadly comparable with differentials in the poorer countries of the EU - such as Greece, Spain and Portugal - while significantly less than disparities in the richer EU countries - such as Austria, France and the UK (though the Netherlands is a notable exception in having low levels of regional disparities). No country in the CEE has levels of disparity on the scale of Germany (because of the addition of the six east German Länder) or Belgium within the EU.

Within the CEE, Bulgaria displays the largest regional differences, largely due to the dominance of its capital city region, Sofia (as it accounts for over a third of the country's total GDP). In contrast, the smallest differences are apparent in Romania,

largely owing to the low overall income levels in the country, and Slovakia, due to the few NUTS 1 territorial units in the analysis.

Table 6.7: GDP per capita by region: between countries (1993)			
	<i>EU=100</i>		
	<i>Highest</i>	<i>Lowest</i>	<i>Difference</i>
Transition countries			
Bulgaria	61.2	12.2	49.0
Czech Republic	74.8	42.8	32.0
Hungary ¹	62.9	23.8	39.1
Poland ²	46.2	20.8	25.4
Romania ¹	26.6	16.5	10.1
Slovakia	36.8	30.1	6.6
EU countries³			
Austria	124.3	88.0	44.3
Belgium	182.4	91.1	91.3
France	166.2	88.1 ⁴	78.1
Germany	189.7	51.9	137.8
Greece	71.6	56.4	15.2
Italy	130.7	68.7	62.0
Netherlands	110.8	90.4	20.4
Portugal	70.4	42.2	28.2
Spain	97.4	59.8	37.6
UK	116.4	79.3	36.1

¹ - Hungarian and Romanian regional figures are for 1994.

² - Polish regional figures are for 1992.

³ - four EU countries have been left off this list: Denmark, Ireland, Luxembourg and Sweden, because the NUTS-1 designation is for the whole country; and Finland, because there are only two NUTS-1 designated regions.

⁴ - note that the region with the lowest GDP per capita in France is in fact the Overseas Department territories, but the table here only includes mainland regions.

Source: national sources, CEC (1994).

The question arises as to whether there are patterns in regional economic disparities in the transition countries over time. In general, comparative data is not available for the period of transition, so a detailed analysis cannot be undertaken, particularly between countries. However, with a few examples, it is possible to note common trends in regional economic development *within* countries.

- In *Poland*, evidence suggests that disparities may have widened. The ratio of the regions with the highest and lowest average wages in Poland became larger between 1989 and 1994. Moreover, the share of the leading 13 regions in total industrial production increased from 60.7 percent in 1989 to 65.1 percent in 1994.
- Industrial production has become more concentrated in *Hungary* as the counties with the highest industrial sales increased their combined share of national industrial production from 33.4 to 40 percent between 1991 and 1994.

- Lastly, in *Bulgaria*, disparities have also appeared to widen. The difference in regional industrial income as a percentage of the whole country grew between the highest and lowest regions between 1990 and 1994 from a factor of two to over four. Similarly, the share of the top two regions of total FDI stocks doubled between 1990 and 1994, reaching 62 percent in the latter year.

From this data, it would appear that regional disparities are widening in CEE, though care should be taken in interpreting the pattern. Before transition, government policy in most CEE countries aimed to reduce disparities through redistribution of economic activity and efforts to maintain the resulting industrial patterns, so it would be surprising if disparities had *not* widened once the structures reinforcing the existing level of disparities had been removed. At present, what seems to be happening in most countries is that the better-developed regions - particularly the capital cities - are recovering from the period of economic decline more rapidly than regions with poor industrial structures and longer-term economic problems. In the more advanced countries, it remains to be seen whether anticipated economic growth at a national level may be experienced by all regions, or at least can moderate the scale of disparities that exist in the CEE countries. Moreover, industrial adaptation has been delayed in some regions - if not countries - suggesting that new disparities may yet emerge as the process of reform deepens in all the transition countries.

6.6 Regional Disparities: Within Countries

As in some EU countries, the size of regional disparities in GDP per capita *within* countries often equals or surpasses differences *between* countries. This can partly be explained by the localised nature of the restructuring process in CEE which large territorial units conceal. The regions used for data collection are often too large to capture the diversity of GDP per capita variations. For example, border areas often prosper through higher levels of inward investment and cross-border trade than districts situated within the interior of the same region. Significant spatial disparities often occur across very small distances.

Consequently, in addition to comparing disparities in the transition countries at regional - or NUTS 1 level - it is worthwhile considering internal differences within each of the acceding countries, both at regional and sub-regional (or NUTS 2) levels. Statistics on GDP per capita have been provided for the local territorial units in the transition countries - such as *voivodships* in Poland - and converted into index figures relative to national averages. The highest and lowest figures and ratios are summarised in Table 6.8 below.

Table 6.8: GDP per capita by region: within countries (1993)						
	<i>National=100</i>					
	Regional (NUTS 1)			Sub-regional (NUTS 2)		
	<i>Highest</i>	<i>Lowest</i>	<i>Ratio</i>	<i>Highest</i>	<i>Lowest</i>	<i>Ratio</i>
Bulgaria	250.0	58.8	4.3	250.0	58.8	4.3
Czech Republic	152.6	86.8	1.7	152.6	86.8	1.7
Hungary ¹	180.5	68.2	2.6	180.5	59.3	3.0
Poland ²	169.5	73.2	2.3	169.5	63.6	2.7
Romania ¹	124.9	87.0	1.4	130.9	77.4	1.7
Slovakia	109.3	89.4	1.2	279.1	30.6	9.1

¹ - Hungarian and Romanian regional figures are for 1994.

² - Polish regional figures are for 1992.

Source: national sources.

At regional level, the largest range of disparities is in Bulgaria, reinforcing the picture presented in Table 6.7. The main reason for this is the unusually high position of the capital city, Sofia, relative to the rest of the country. Only Hungary and Poland have regions whose GDP per capita figures are comparably larger than their national averages. Considerably smaller differences appear in the Czech Republic and Slovakia, the latter in large part because of the small size of the country (it only has three NUTS 1 regions).

The scale of regional differences does not change significantly for most countries when analysis is made of GDP per capita at sub-regional level, apart from Slovakia, where the ratio between the highest and lowest district is a surprisingly large factor of 9.1. Equally unusual is the fact that the largest sub-regional figure in Slovakia is not the capital, Bratislava (199.4 to the national average of 100), but Kosice. This can be explained by the small size of the sub-regional territorial unit and whether economic activity is attributed by residence or workplace, which can distort income differences. The average population in the Slovakian district is less than a third of that in the Hungarian NUTS 2 units, although the latter is the next largest size of unit among the CEE countries.

Within the CEE countries, the most prosperous regions are almost invariably the capital-city areas of each country. In most cases, these regions tend to have the highest income levels in the country, ranging from 130.9 percent (Bucharest) to 250.0 percent (Sofia) of their national averages (Table 6.8). The importance of the capital-city regions varies between countries, as shown in Table 6.9. Although the definition of the capital-city region is not standardised in this analysis, the figures indicate the clear dominance of capital cities in Bulgaria and Hungary and a more even distribution of economic prosperity in Poland, Romania, the Czech Republic and Slovakia. This pattern of regional development is in line with trends in the EU, where the economic importance of capital-city regions varies from the relatively minor significance of the area around Bonn in Germany to the powerful role of Lisbon in Portugal. It is interesting to note that capital-city regions appear to have a less dominant position in the acceding countries than in the EU Member States with comparable levels of development: Greece and Portugal.

Table 6.9: Importance of the capital-city region	
<i>Regional GDP as % of whole country (1993)</i>	
Transition countries	
Bulgaria	35.2
Czech Republic	18.0
Hungary	34.0
Poland	9.8
Romania	12.8
Slovakia	18.3
EU countries ¹	
Austria	28.7
Belgium	15.3
Finland	33.2
France	28.6
Germany	5.4
Greece	38.3
Italy	10.6
Netherlands	22.5
Portugal	46.5
Spain	16.1
Sweden	23.3
UK	17.3

¹ - Luxembourg, Denmark and Ireland have been omitted from the list owing to the absence of regionalised GDP data for capital cities.

Source: national sources, CEC (1994).

Regional disparities in labour productivity are in line with the differences in regional GDP per capita, though there are some interesting differences (Table 6.9). Highest productivity is not necessarily found in the capital-city regions - eg. Bourgas region in Bulgaria and the Eastern part of Slovakia have higher productivities than their respective capitals - though this could be explained by the high shares of service output in the capital cities (as noted in Chapter 5). The statistics suggest that there is significant overlap between the regions with high incomes and high labour productivities. Further, as with per capita GDP (at least in the case of Bulgaria), the countries experiencing the most economic difficulties in the transition also display the largest regional disparities - Bulgaria and Romania. A more detailed breakdown of labour productivity by region is provided in Appendix 6.2.

	<i>Highest region</i>	<i>Lowest region</i>	<i>Ratio</i>
Bulgaria	200.0	63.0	3.2
Czech Republic ¹	150.1	69.8	2.1
Hungary	129.6	83.4	1.6
Poland	133.6	75.9	1.8
Romania ²	185.7	74.9	2.5
Slovakia	113.0	94.0	1.2

¹ - Czech data are for enterprises with 100 or more employees only.

² - Romanian data are for 1992.

Source: national sources.

Although the acceding countries share common problems, it is important to consider the countries individually. The quoted figures at national and regional levels can be found in Appendix 6.1 at the end of this chapter.

Primarily owing to the high levels of GDP per capita in Sofia, *Bulgaria* suffers from the largest range of regional GDP per capita disparities in CEE. Sofia's high GDP per capita reflects its position as the capital which confers significant advantages (eg. good infrastructure, access to capital, foreign investment, young labour market etc.) over other less favoured regions (apart from Bourgas which, like Sofia, has been able to adapt rapidly to economic restructuring). This contrasts with the situation in the northern Montana region (which has a GDP per capita that was half of the national average) as well areas such as Russe, Plovdiv and Haskova.. In the case of Montana, its mountainous and remote nature has led to extensive out-migration of the young, an ageing demographic structure and consequent serious labour market problems. However, it shares with the other regions with low average income levels, a continuing dependence on declining industrial activities and agriculture.

Hungary also suffers relatively high levels of regional per capita GDP disparities (Table 6.8). Again, Budapest's GDP per capita is substantially above other regions in Hungary. In particular, the capital dominates the country's international outlook, accounting for 58.1 percent of FDI stocks, 57.5 percent of foreign joint ventures and 53.5 percent of exports. Hungary's main regional disparities exist between the east and west, with a dividing line at the Danube: a development pattern which powerfully reveals itself in GDP per capita. For example, the GDP per capita for North-East Hungary stands at a mere 68.9 percent of the national average. The collapse of trade with the former Soviet Union and other CEE countries together with the problems associated with industrial restructuring explain the low level of GDP per capita in the eastern parts of Hungary. The west's greater economic integration with Austria, higher level of foreign investment and more advanced industrial structure all contribute to higher levels of GDP per capita found there.

Countries with lower inter-regional disparities are the Czech Republic and Romania (Table 6.8). The *Czech Republic* is notable for its relatively even regional development pattern, at least in terms of regional GDP per capita. In fact, all regions (except Prague) have GDP per capita between 87 and 99 percent of the national average. The more equitable distribution of GDP per capita in the Czech Republic

primarily relates to its geographic location and historical position as the most developed economy in CEE. With the highest level of GDP per capita in CEE, Prague has benefited from a huge influx of foreign direct investment (63.1 percent of the country's total) which partly explains its high GDP per capita (though as noted in Chapter 7, much of the FDI attributed to Prague has actually been invested in other locations in the country). The lowest income levels in 1993 were in Mid-Bohemia, though large foreign investments (notably Volkswagen's acquisition of Skoda) and increasing industrial output in the region have substantially improved the region's relative performance in more recent years, underlining the absence of particular and deep-seated economic problems in the Czech regions.

In contrast to the Czech Republic, the extremely poor economy in *Romania* may explain its low GDP per capita variations. The low level of GDP per capita in Romania's more developed regions means that regional figures are not inflated by one prosperous area, particularly the capital-city region, whose importance in the economy is not as pronounced as in other transition economies (Table 6.9). Romania's low disparities are more a reflection of national economic weakness than any evidence of well balanced spatial development. Within the country, prosperity appears to be linked to access to foreign trade routes - such as Constanta, with its Black Sea port location - while the main problem areas are continuing to decline because of the legacy of induced industrialisation (especially parts of Moldova and North-East Transylvania). Localised disparities do exist within regions, perhaps most evident in the juxtaposition of Bucharest with the poorer, rural areas to its immediate south, which have experienced large outmigration to the capital city.

In *Poland*, there is a wide spread of income levels across the country. Although Warsaw city has the highest figure (169.5 percent of the national average), other *voivodships* approach it, such as Plock (147.8 percent) and Poznan (131.4 percent). Prosperous areas are characterised by high levels of FDI, advanced privatisation and a large share of GDP accounted for by the service sector. They also tend to be regions which were successful in national terms before the transition period (though not exclusively so as newer areas - such as those located on the western border - have experienced rapid prosperity).

However, it is less the level of disparities within the country than the close proximity of prosperous and poorer areas that is striking. For example, the district of Siedlce in the Warsaw region has a very low GDP per capita (ie. 70 percent of the national average). Although the Warsaw region as a whole has the lowest level of regional GDP per capita throughout Poland, the city of Warsaw itself has the highest level of GDP per capita in the country. Regional capitals play a similar role in widening intra-regional GDP per capita disparities: Krakow in the South-Eastern region of Poland has a GDP per capita 118.3 percent of the national average, while neighbouring districts such as Krosno are significantly lower (69 percent). The reason why Poland displays such stark GDP per capita disparities reflects the very large (regional) territorial units used for data collation which hide the localised nature of regional problems.

Although significantly smaller than the other countries with a regional dimension, a similar pattern in regional disparities has emerged in *Slovakia* relative to the other

transition countries. The capital city has a commanding position within the economy and the western areas of the country - bordering the Czech Republic, Slovakia's chief trading partner - have high levels of income. As elsewhere in CEE, strong districts are characterised by a growing tertiary sector and industries that are adapting to economic restructuring, whereas the weaker areas of the country - notably the north-eastern and some south-central parts of Slovakia - are economically-lagging in large part because of dependence on declining agricultural incomes.

6.7 Summary and Outlook

After a period of severe economic contraction among the acceding countries, the two processes of macroeconomic stabilisation and industrial restructuring have begun to show positive results in the CEE region, though some countries are more advanced in reform than others (particularly the Czech Republic, Hungary, Poland, Slovakia and Slovenia). Nearly all the transition economies experienced positive growth rates in 1994, which are anticipated to increase in the near-future.

The decline has been most sharply felt in the Baltic states, especially Lithuania. In contrast, Slovenia and Poland are the first countries to have achieved approximately the same levels of economic output they had before the transition period, though in spite of the differences in the severity of decline, country rankings by either GDP size or GDP per capita did not appreciably change after 1990 in CEE. Slovenia and the Czech Republic have the highest average GDP per capita figures, the Baltic states have the lowest.

Compared with the EU, the level of economic development throughout CEE remains low. In terms of GDP per capita, all the acceding countries have figures lower than the lowest EU Member State (Greece).

At a regional level, none of the CEE NUTS 1 regions have GDP per capita figures higher than 75 percent of the EU average, though a number are more prosperous than the weaker EU regions. Regional disparities in the acceding countries are broadly comparable with those of the less-developed EU Member States and remain smaller than disparities in countries such as Belgium and Germany. Bulgaria has the widest range of disparities among the transition countries, whereas the Czech Republic displays the most even development in its regions.

When looking within CEE countries - particularly at sub-regional (or NUTS 2) level - disparities are generally greater, though this is often due to the size of the territorial units employed. Common patterns appear, as capital cities tend to dominate national economic activity (though apparently not more so than in many EU economies) and western border regions are often more prosperous than eastern regions (because of the greater trade and investment links with the EU). Although it is difficult to establish time series data showing changes in regional disparities, disparate evidence suggests that regional disparities have been widening significantly in CEE: not only between but within countries, depending mainly on the scale and pace of economic reform and the initial 'states of rest' of the pre-transition economies.

Future economic development at national and regional level in CEE is discussed more fully in later sections of this report. As noted there, estimates of future growth are dependent on the interaction of a series of variables.

- *External*: membership of the EU (as well as the knock-on effects on non-Member trading partners in CEE); export market accessibility; global growth rates; changes in CIS markets and political stability.
- *Internal*: progress towards macroeconomic stabilisation; scope of industrial restructuring measures (particularly privatisation).

The CEE countries considered here will not become members of the EU at the present state of their economic development but within a (currently unknown) certain timespan. As most of the potential Member States are growing at a faster rate than the EU countries it can be expected that, at the time they enter the Union, the income disparities will be smaller than at present. However, the question is, to what extent the disparities can be diminished within a reasonable time? Bearing in mind the problems arising when evaluating current disparities and, furthermore, recognising that the transformation process in the CEE countries is unprecedented, quantification of further developments is a difficult task.

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Appendix 6.1: Regional GDP per capita (1993)

	US\$, PPP	ECU, PPP	National=100	EU=100
Czech Republic	8,422	7,521	100.0	49.2
Prague	12,801	11,432	152.6	74.8
Mid-Bohemia	7,327	6,543	86.8	42.8
S&W Bohemia	7,917	7,070	94.0	46.2
N. Bohemia	7,832	6,994	93.0	45.8
E. Bohemia	8,338	7,446	98.9	48.7
S. Moravia	7,832	6,994	93.2	45.8
N. Moravia	7,664	6,844	91.4	44.8
Poland	4,669	4,169	110.0	27.3
Warsaw city	7,914	7,067	169.5	46.2
Warsaw region	3,417	3,051	73.2	20.0
North-Eastern 3,665		3,273	78.5	21.4
Northern	4,743	4,235	101.6	27.7
Central-Western	4,698	4,195	100.6	27.4
South-Western	4,606	4,114	98.7	26.9
Southern	5,057	4,516	108.3	29.5
Central	5,015	4,478	107.4	29.3
South-Eastern 3,853		3,441	82.5	22.5
Central-Eastern	3,899	3,482	83.5	22.8
Hungary	5,962	5,324	100.0	34.8
Budapest	10,761	9,610	180.5	62.9
Transdanubia	5,201	4,644	87.2	30.4
Great Plain	4,984	4,451	83.6	29.1
North-East	4,066	3,631	68.2	23.8
North-West	5,187	4,632	87.0	30.3
Romania	3,643	3,253	100.0	21.3
Bucharest	4,551	4,064	124.9	26.6
Constanta	3,681	3,287	101.1	21.5
N. Muntenia	3,589	3,205	98.5	21.0
Oltenia	3,533	3,155	97.0	20.6
Banat	3,636	3,247	99.8	21.2
Central	3,725	3,327	102.3	21.8
Cluj	3,660	3,268	100.5	21.4
N. Moldova	3,170	2,831	87.0	16.5
S. Moldova	3,219	2,875	88.4	16.8
Bulgaria	4,193	3,744	100.0	24.5
Sofia city	10,483	9,361	250.0	61.2
Sofia district	2,836	2,533	67.6	16.6
Bourgas	5,015	4,478	119.6	29.3
Varna	4,029	3,598	96.1	23.5
Lovetch	3,371	3,010	80.4	19.7
Montana	2,097	1,873	50.0	12.2
Plovdiv	2,672	2,386	63.7	15.6
Russe	2,466	2,202	58.8	14.4
Haskova	2,713	2,423	64.7	15.8
Slovakia	5,766	5,149	100.0	33.7
Western	6,302	5,628	109.3	36.8
Central	5,154	4,602	89.4	30.1
Eastern	5,595	4,997	97.0	32.7

Appendix 6.2: Industrial productivity by region (1994)

	National=100
Czech Republic	100.0
Prague	142.1
Mid-Bohemia	150.1
S&W Bohemia	81.1
N. Bohemia	120.3
E. Bohemia	69.8
S. Moravia	71.7
N. Moravia	107.9
Poland	100.0
Warsaw city	133.6
Warsaw region	81.7
North-Eastern	81.1
Northern	110.9
Central-Western	99.2
South-Western	84.3
Southern	87.9
Central	122.7
South-Eastern	84.8
Central-Eastern	75.9
Hungary	100.0
Budapest	129.6
Transdanubia	99.7
Great Plain	83.4
North-East	84.9
North-West	104.3
Romania	100.0
Bucharest	185.7
Constanta	119.5
N. Muntenia	134.1
Oltenia	123.7
Banat	89.0
Central	74.9
Cluj	80.6
N. Moldova	90.7
S. Moldova	129.4
Bulgaria	100.0
Sofia city	173.0
Sofia district	80.0
Bourgas	200.0
Varna	111.0
Lovetch	85.0
Montana	63.0
Plovdiv	77.0
Russe	82.0
Haskova	70.0
Slovakia	100.0
Western	97.0
Central	94.0
Eastern	113.0

7. BUSINESS CONDITIONS

7.1 Overview

The restructuring of enterprises has been a key goal in the economic reforms of governments during the transition period. Although the 'starting' conditions, methods and rates of progress of the countries have differed, it has been widely recognised as a central objective of economic policy. In general, it has also been closely associated with the emergence of the private sector within the transition economies. Countries have made efforts to restructure enterprises within the public sector, but these have been subsidiary to the overwhelming goal of achieving economic change through the private sector (UN ECE, 1994).

In transforming the command economies, an unprecedented shift in the ownership structures in the transition countries has taken place, resulting in a widespread 'privatisation' of the economies. In this context, 'privatisation' means the overall increase in the share of private sector activity in the economy, which has occurred through the reduction of state ownership and control over parts of the economy as well as by the expansion of the private sector through new firm formation. However, in the following sections, privatisation refers to the former trend - the transfer of state assets to private ownership and control - while the background of new firm formation is discussed separately. Further, the question of business environment is considered with regard to the development of the private sector in the different acceding countries.

(i) *Privatisation*

All the Central and Eastern European countries considered in this report have undertaken privatisation measures, though often at widely differing rates. Two sets of motives have prompted the decision by governments to reduce state ownership in the economy (Bornstein, 1994). *Economic* motives have predominated, in that private ownership is anticipated to encourage individual enterprises to produce more efficiently by offering managers greater incentives and to support a more efficient distribution of resources between economic activities through the behaviour of private entrepreneurs. However, significant *social and political* considerations have influenced both the decision to undertake privatisation programmes as well as the form of privatisation. Popular support for the restructuring process has been partially secured through a division of enterprise ownership among citizens through mass share distribution. At the same time, the need to secure popular support for privatisation programmes has often limited their scale and the participating industries. Privatisation has also assisted in weakening the influence of 'old-guard' industrial elites which had hitherto controlled the operation of state-owned enterprises.

Privatisation has involved a variety of methods, which have been employed in different combinations in the transition economies (CCET, 1994). First, *restitution* of properties and enterprises seized by the former Communist authorities has had the effect of privatising significant parts of the public sector. Second, most transition

countries have implemented *small privatisation* programmes, in which small-scale enterprises in the retail, construction and commercial service sectors have been brought into the private sector, mainly through sales to employees.

Lastly, the most extensive transfer of state ownership of industrial assets has been achieved through *large privatisation* programmes, or sale of large state-owned enterprises (CCET, 1994). Commonly, this has taken place by the transfer of ownership to a small group or a single buyer - such as existing managers, employers or foreign investors - through auctions, closed tenders and management buyouts. This method has been popular in Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland and Romania. In the case of Hungary, the involvement of foreign parties in acquiring privatised enterprises have played a particularly significant role in increasing the levels of foreign direct investment.

Some countries have eschewed a case-by-case approach in favour of *mass privatisation* methods, by which shares in a large bundle of firms are rapidly and widely distributed among the public (CCET, 1995). A popular system for share distribution has been the use of vouchers, which are allocated among citizens and can subsequently be exchanged for shares in specific privatised enterprises. Frequently, the system is supplemented by the use of investment fund managers as intermediaries, whereby the public take shares in fund groups that in turn invest in the privatised enterprises. The Czech Republic and Slovakia have been the most prominent examples of this form of privatisation - largely explaining the notable progress made by the Czech Republic in reducing state ownership of industry - but aspects of the approach are being adopted in Latvia, Lithuania, Poland, Romania and Slovenia.

There remains a number of common problems in regenerating the business sectors of the transition economies. Privatisation is only a step towards achieving extensive industrial restructuring within these economies. Although it has accelerated the transfer of ownership of economic assets from the state, the process of change in individual enterprises is taking place gradually. It has been hindered by the absence of stable mechanisms for transferring resources between efficient economic activities and enterprises, such as a strong banking system and responsive capital markets, though these are beginning to emerge. In spite of the change of ownership structures, industrial restructuring has also be hampered in some sectors by the continuing existence of inefficient industrial monopolies (though now private rather than public). Further, instability will continue to characterise some industries, particularly over the potentially fractious issue of the environmental liabilities of newly-privatised companies. As a result, it is too early to deduce the emergence of comparative advantage and sectoral competitiveness at an international level.

(ii) *New firm formation*

In addition to the expansion of the private sector through the parcelling up of the public sector in the transition economies, the private sector has also grown through business start-ups. In most transition countries, a package of measures liberalising the business environment has been introduced, allowing individuals to form enterprises with greater ease. As a result, there has been a rapid increase in the number of new

firms, especially in economic activities which were underdeveloped in the command economy, such as commercial and business services, construction, and hotel and catering. The rapid growth - both in terms of new firm formation and in share ownership where mass privatisation has been implemented - suggests that there is no deficiencies in entrepreneurship, despite the widespread lack of business skills and support.

The sectoral composition of new firms has been overwhelmingly within the service and agriculture sectors. Retailing, hotel and catering businesses have been proliferating in the transition countries, particularly in urban areas, reflecting not so much the emergence of new comparative advantages but the traditional gaps that existed in these countries' industrial structures (as described in a previous chapter with regard to the sectoral composition of employment). The fragmentation of large, collectivised farms and restitution of private property has encouraged the emergence of small-scale private firms.

Above all, new firm formation has been distinguished by the surge of one-person companies that have formed in all the transition economies. Self-employment characterises virtually all CEE business structures - especially in agriculture (following de-collectivisation of farms) and services (especially retailing). As a share of the economically-active population, it has grown rapidly - from 4 to 10 percent in Poland and from 6 to 16 percent in Hungary between 1989 and 1994 (CCET, 1996). Although saturation points may be reached in the economies where this process is most advanced (the Central European countries), in all acceding countries, new firm formation is likely to play as large if not a greater role (relative to official privatisation) in the wider 'privatisation' of the economy over the next decade. What has not taken place as yet has been widespread company collapses in the wake of the waves of new firm formation, and doubts remain over the capacity of many CEE countries not only to cope with this but to maintain a continuing cycle of business creation while providing the conditions for the micro-businesses to expand.

(iii) Business environment

With the increasing importance of the private sector in transition economy employment and output, the development of the business environment has become a key issue in these countries. In particular, legal problems, the financial sector and other business support infrastructure continue to represent significant obstacles to the private sector, though the extent of the problems varies by country.

First, the implementation of legislation defining, establishing and monitoring companies has been relatively rapid in all CEE countries. In general, models have been drawn from Western European countries (mixed in with existing traditions in countries where business reforms had been undertaken previously, such as Hungary and Poland), though they have been weakened by widespread avoidance of legal responsibilities (particularly in relation to the costs of setting up particular types of enterprises) and inadequate enforcement mechanisms. Technical problems continue to undermine the operation of certain laws. For example, in Hungary, completion of the bankruptcy law triggered so many legal bankruptcies that the courts were

overwhelmed (CCET, 1996). In Latvia, loopholes in the law determining the capital provision of limited liability companies allowed a firm which purchased and repaired passenger ships to set their stock capital as the value of an audio centre and VCR.

Second, access to capital has been consistently identified by firms - particularly SMEs - as the main restraint they face on their development (CCET, 1996). In this, firms in CEE have much in common with companies in more developed economies, but the problems are more acute in the transition economies because of the continuing restructuring and delayed reforms of the banking structures. In most countries, financial sector reforms were undertaken quickly at the start of the transition, most importantly the breaking up of the traditional state-controlled banks which had centralised all banking functions (Akyüz, 1994). Monetary responsibilities were separated from commercial banking duties to create a two-tier system as in Western countries. In many cases, the newly-formed commercial banks remained in state hands, but were supplemented by the rapid emergence of new private banks and an influx of foreign banks. However, the initial reforms did not address longer-term problems in the banking sectors: the scale of poorly-performing and bad debts; the weak capital base, especially among the numerous smaller banks; the absence of expertise in dealing with SMEs; the lack of national banks with extensive regional networks; dependence on a few large business customers; gaps in bankruptcy legislation; and the lack of protection for depositors (indicative of overall deficiencies in banking regulation).

Banking weaknesses vary among the transition countries. While in hardly any cases can CEE banks compete on an international basis, in countries where economic reforms have advanced quicker, such as the Central European countries, efforts have been made to ensure their stability in the home markets. For example, in the Czech Republic, the problem of bad loans has been actively tackled as a necessary step for the sector's long-term survival (*Financial Times*, 1996). In contrast, the Baltic states have experienced unsettling bank collapses or license revocations in recent years (O'Rourke, 1995). Following a rapid and unstable surge in new bank formation following the initial liberalisation measures, ten banks lost their licenses in Latvia while 13 became insolvent in Lithuania in 1995.

At the same time, several CEE economies are developing more advanced forms of capital provision. For example, active and largely successful stock markets have already emerged in Warsaw and Prague. Capital markets - with significant foreign participation - are becoming a more important source of finance in corporate restructuring, particularly in countries where mass privatisation has been undertaken (such as the Czech Republic and Slovakia).

Lastly, business support infrastructure has been slow to develop in the transition economies. In Western European countries, such infrastructure comprises a mixture of public, private and sectoral organisations, including providers of training, chambers of commerce, business associations, technology centres and public sector development agencies. Public sector support for business will be examined in greater detail in later sections of this report as part of regional policy, but it is useful to draw attention to other areas where gaps appear to exist (CCET, 1996).

With regard to self-help organisations such as chambers of commerce, these have been broadly lacking in the transition economies. Although existing widely in some form in the pre-transition period, their adaptation to the new market conditions has been stalled by financial problems (as potential members can often not spare the necessary contributions), their limited range of services and lack of credibility in their independence. In addition, the slow emergence of business communities - fractured as they are between newly-formed micro-firms and large enterprises under state control or the direction of former socialist managers - has complicated efforts to establish foci for business interests within the transition economies. Moreover, government activities in establishing incubator units, technology transfer centres and other business support agencies have been limited by lack of funds and expertise. As might be expected, they are more widespread in the Central European countries than in less-advanced economies such as the Baltic states.

* * *

The overview above indicates the variety of processes taking place in the business structures of the CEE economies. Measurements of the different pace and extent of these processes are presented in the following sections. The perennial CEE problem of data reliability and availability is considered in the next section before subsequent sections turn to new firm formation and privatisation, foreign trade by CEE businesses, and the scale and source of foreign investment. Regional differences in new firm formation and FDI are then discussed as indications of the existing disparities in business environment. A summary and outlook section concludes this chapter.

7.2 Data Issues

Measuring the private sector in the transition economies presents a number of methodological traps. In considering the various pitfalls, attention is focused on the following indicators: private sector size; new firm formation; foreign trade; and foreign investment. While not invalidating the use of statistical measures on a cross-CEE basis, the problems associated with business statistics for the transition countries have meant that comparisons between countries must be made carefully and regional disparities need to be considered within countries rather than across the CEE region as whole.

Estimates on the size of the private sector must be treated with caution. Extensive under-reporting of private sector activity, as noted in the previous chapter, can be seen in the existence of large 'grey' economies in the CEE countries. Similarly, due to the piecemeal nature of privatisation in several countries, there is often difficulty in classifying what exactly constitutes private sector activity. In the plethora of enterprise forms that have developed in the transition countries, many firms involve joint public and private ownership, cooperative enterprises, and private leasing of public companies and assets. The setting of the various boundaries at statistical level differs across CEE and over time. For example, cooperatives were reallocated to the public sector in Poland in 1993, making comparisons across the transition period difficult (UN ECE, 1995). It is also problematical defining at what point a firm has

been sufficiently privatised to be included within the statistical definition of the private sector (CCET, 1996).

Private sector performance is increasingly measured not just through official statistics but by enterprise surveys conducted of representative samples. Official figures often involve extrapolations of private sector activity from the application of private sector growth rates (in terms of employment) to their existing shares of national economic output. Similarly, other measures can be used to examine overall growth in the private sector, such as changes in their shares of foreign trade and investment. While these approaches can only be indicative, the enterprise surveys have allowed a degree of verification of overall trends

In addition to estimating the private sector's size, it is difficult to gauge new firm formation rates across CEE. Different countries have different classifications of enterprises included in their figures - for example, some countries include privatised farms in their statistics (such as Bulgaria and Estonia) while others separate out agricultural figures (such as Latvia and Romania). Further, several factors both inflate and underestimate true numbers. The cost of business registration and limited law enforcement gives many individuals an incentive to avoid official detection when setting up a company, which could mean that micro-businesses are more prevalent than are statistically visible. On the other hand, many companies that are set up can be passive legal forms (particularly individuals establishing their own companies in addition to full-time jobs), distorting conclusions based on average economic activity. Above all, statistical measures have trailed the rapid expansion of the private sector in the transition countries, as the speed of its growth has outstripped the ability to measure activity.

The main statistical problem has arisen from the difficulty in applying international standards and procedures to national statistical collection. Given the variety of enterprise forms and the speed with which business conditions have been changing, common definitions are not easily found to encompass the transition economies. However, international measures have been more successfully adopted in the case of foreign trade, where national accounts, sectoral classifications and measuring capacity are adequate in the acceding countries (UN ECE, 1995). As a result, CEE official sources are regularly supplying data to international organisations monitoring foreign trade trends, such as Eurostat, the United Nations and the World Bank.

International datasets have also been assembled for foreign investment in CEE, notably by the OECD and the United Nations. However, collecting data on FDI trends is beset with definitional problems. Different organisations include different categories of 'investment' in their data - eg. wholly-owned Western enterprises as opposed to stakes in transition country joint ventures - which has led to a variety of measurements. For example, for Hungary by the end of 1992, the United Nations Economic Commission for Europe estimated that cumulative FDI inflows were US\$ 3.5 billion, but the OECD estimated them to be US\$ 4.3 billion (UN ECE, 1995; OECD, 1993). Further, statistics from sources often do not distinguish between *committed* resources and the actual transfer of foreign capital into the country, and when the sums are measured, in many cases, they do not take into consideration future flows of capital from the foreign investor to the local enterprise - eg. through

reinvestment of profits (CEC, 1995). In some cases, national sources report FDI flows and stocks from the movement of cash investments through the banking system, thereby excluding reinvested earnings and investments in kind (UN ECE, 1994).

7.3 Privatisation and New Firm Formation

Before the transition, all the CEE economies were heavily influenced by direct and indirect state action, though there were differences in the extent in the freedom of decision-making permitted to business enterprises. However, in spite of similar starting positions, privatisation has advanced at different rates in these countries. With respect to *small privatisation*, the process has largely been completed in all the countries. The greatest national variation in the speed and scale of privatisation has been in the *large privatisation* programmes. By the beginning of 1994, the Czech Republic had advanced furthest in privatisation, followed by Estonia, Hungary, Lithuania, Slovakia, Poland and Latvia (Table 7.1). By 1994, privatisation programmes had been slow to be implemented in Bulgaria, Romania and Slovenia, which had privatised less than ten percent of their state-controlled large enterprises (though active privatisation took place in Slovenia in the following year).

In terms of new firm formation, again caution should be emphasised in using the figures. However, the data presented in Table 7.2 appears to reinforce known trends. Private firms seem to be most widespread in the Central European countries, where economic reforms (establishing the conditions for business formation) and industrial restructuring (giving individuals incentives to set up their own firms) have been taking place for longer. The surprisingly low figure for Slovenia could be the result of the distinction between private and 'social' enterprises and other organisations of mixed ownership. Less-developed transition economies have fewer private companies, particularly the Baltic states and Romania.

Table 7.1: Progress in privatisation		
	<i>Share of state-owned enterprises privatised (% , 1994)</i>	<i>Comments on large-scale privatisation</i>
Bulgaria	2 ¹	Progress on sell-offs organised by the state privatisation agency has been delayed.
Czech Republic	75	Largely undertaken early in the transition period in the former Czechoslovakia through a voucher system involving mass distribution and investment funds.
Estonia	70	Large-scale sell-offs by auction and tender through the state privatisation agency beginning in 1993; some voucher privatisation.
Hungary	64	Large-scale sell-offs by the state privatisation agency, principally to company management and foreign interests early in the transition period.
Latvia	20	The slowest of the Baltic states to start privatisation programmes. Large-scale sell-offs by auction and tender through the state privatisation agency are planned; some voucher privatisation.
Lithuania	44	Large-scale sell-offs by auction and tender through the state privatisation agency, mainly in 1994; voucher privatisation based on the Czech model.
Poland	17 ¹	Few sell-offs to workforce and management by state privatisation agency. Political delays in mass privatisation programme.
Romania	7 ¹	Progress on sell-offs organised by the state privatisation agency has been delayed.
Slovakia	44	Part of Czechoslovakian mass privatisation/voucher scheme, but recent switch to sell-offs by tender.
Slovenia	60 ²	Mass privatisation scheme involving share distribution to workers and pensioners attached to individual companies, undertaken in 1995. Company buyouts and sales to investment funds possible thereafter.

¹ - estimated figures.

² - figure for 1995.

Source: national sources.

Annual new firm formation rates appear to be more erratic and show limited pattern. The notably high figure for the Czech Republic seems to be linked to its less severe collapse of national production (and supported by the country's relatively low unemployment rates) whereas Estonia's high figure may be caused by the surge of new firms in response to the low minimum capital bases set at that time by the government. As noted above, the bulk of this new firm formation is composed of self-employment and the growth of micro-companies.

Table 7.2: New firm formation (1994)		
	<i>No. of private firms per 1,000 people</i> ¹	<i>Annual rate of new firm formation</i>
Bulgaria	42.8	4.6
Czech Republic	97.1	19.2
Estonia	36.2	9.0
Hungary	97.6	4.4 ³
Latvia	18.9 ⁴	7.2
Lithuania	28.5	Not available
Poland	48.7	-0.9
Romania	8.6	1.8
Slovakia	57.8	2.7
Slovenia	25.6	1.7

¹ - registrations of new enterprises per 1,000 inhabitants.

² - SMEs are defined as having less than 50 employees, apart from the Czech Republic, Estonia, Romania and Slovakia, where the statistics refer to enterprises with under 100 employees.

³ - Hungarian figure is an annual average for 1989-94.

⁴ - Latvian figure does not include peasant farms.

Source: national sources.

As a result of the combination of privatisation and increasing rates of new firm formation, the private sector makes significant contributions to most transition countries' economic activity (Table 7.3). The private sector has the largest impact in Central Europe (Czech Republic, Hungary, Poland and Slovakia), where it accounted in 1994 for more than half of GDP of nearly all the countries there. The Czech Republic's dominant position can be attributed to its extensive mass privatisation scheme early in the transition period and the rapid growth of new firms and self-employment because of the shallower economic decline experienced here. High shares were reported in the Baltic states as well. The Balkan countries are lagging apart from Slovenia (though the latter's figure is likely to have increased following the progress in privatisation during 1995).

Bulgaria	24
Czech Republic	75-80
Estonia	52
Hungary	55
Latvia	55
Lithuania	62
Poland	55
Romania	35
Slovakia	65
Slovenia	40

Source: national sources.

7.4 Foreign Trade

As part of the reform programmes, the role of foreign trade and investment in revitalising the transition economies has been regarded as essential, a point reiterated in Chapter 15 of this report (where CEE trade patterns are discussed in a longer-term perspective). From early on, measures were also introduced to liberalise domestic trading conditions and to support the development of international trade through extensive industry deregulation (Gács, 1994). In particular, governments increased the access of domestic companies to foreign markets and of foreign firms to domestic markets through a number of actions. Most national trade restrictions by the transition countries have been removed, particularly non-tariff barriers such as the licensing of companies undertaking foreign trade, which led to a rapid growth in the number of domestic firms involved in trade (though it should be noted that this occurred at different times for the transition countries - only from 1991 on, in the case of the Baltic states). Currency convertibility at international rates and the elimination of controls on foreign exchange is in the process of being achieved. In addition, trade agreements have been negotiated with major trading partners, most notably the 'association agreements' made with the EU, abolishing quantitative restrictions and reducing tariffs for most goods traded between several transition countries and the EU.

At present, international trade involving the transition economies represents a small share of global trade. In 1993, trade with the region accounted for 1.8 percent of all imports into OECD countries and only 1.4 percent of OECD exports (OECD, 1995). However, though small in an international perspective, trade has increased greatly in the wake of the programmes of economic restructuring, in spite of the effects of the global recession. Annual transition economy exports grew by 7 percent between 1990 and 1993 (faster than comparable growth in world trade), while imports increased by 29.2 percent, leaving many of the countries with persistent trade deficits - particularly the Baltic states, where trade deficits continue to account for the highest shares of GDP, in contrast with the more prosperous Central European countries (Table 7.4). In addition, the importance of international trade varied greatly among the transition countries. Export/GDP ratios ranged from over 70 percent in the case of the smaller,

Baltic economies to less than 25 percent for larger economies such as Poland and Romania.

Table 7.4: Volume of foreign trade (1994)						
	Exports¹			Imports¹		Trade balance²
	<i>Volume (US\$ mn)</i>	<i>Growth (1994, %)</i>	<i>% of GDP</i>	<i>Volume (US\$ mn)</i>	<i>Growth (1994, %)</i>	<i>% of GDP</i>
Bulgaria	4,316	11.7	54.0	4,123	-14.7	-0.2
Czech Republic	14,297	8.3	57.0	14,731	14.6	-2.5
Estonia	1,632	59.2	70.0	2,075	81.8	-15.5
Hungary	10,737	20.5	29.0	14,621	15.8	-8.8
Latvia	988	-18.1	72.0	1,240	8.7	-11.1
Lithuania	2,029	0.2	71.0	2,353	3.5	-7.9
Poland	17,240	18.3	24.0	21,569	13.4	-0.9
Romania	6,151	25.7	26.0	7,109	9.0	-3.2
Slovakia	6,727	23.5	71.0	6,600	4.0	0.6
Slovenia	6,806	11.9	58.0	7,247	11.5	-1.3

¹ Source: Podkaminer, 1995; World Bank, 1995 (for the Baltic states).

² Source: Eurostat.

Although trade has been increasing for the transition countries in general, the expansion has resulted in an extensive reorientation of their trading relations. Most notably, trade among the transition countries has declined with the collapse of the Council of Mutual Economic Assistance (CMEA). Whereas before the reform period, the CMEA bloc would have accounted for almost half of the region's trade, with the liberalisation of markets and the steep economic decline of former trading partners - particularly ex-USSR countries - there has been a general shift towards Western nations (Table 7.5). This has been more pronounced in the case of the more 'western' transition economies, as the Baltic states still maintain strong trade ties with the countries of the former Soviet Union, especially Russia. Nevertheless, the EU has emerged as a key (if not the main) trading partner of all transition countries - most visible in the case of Poland and Slovenia, less so for Bulgaria and Romania (and the Czech Republic and Slovakia, though trade patterns in the latter two are dominated by mutual trading links). Although the EU had a significant trading presence in some of these countries before the transition period, since 1989, the EU's share of trade has risen substantially in all these countries.

Table 7.5: Direction of foreign trade (1995)						
	Exports (%)			Imports (%)		
	<i>EU</i>	<i>CEE/CIS</i>	<i>Other</i>	<i>EU</i>	<i>CEE/CIS</i>	<i>Other</i>
Bulgaria	38.1	33.5	28.4	40.2	42.9	16.9
Czech Republic ¹	45.9	31.8	22.3	45.1	29.4	25.5
Estonia	53.8	38.2	8.0	66.0	24.4	9.6
Hungary ¹	63.7	21.8	14.5	61.1	22.7	16.2
Latvia	44.1	52.9	3.0	49.8	42.6	7.6
Lithuania ¹	28.8	57.7	13.5	28.8	54.6	16.6
Poland	70.0	17.3 ²	12.7	64.7	15.4	19.9
Romania ³	46.0	13.9	40.1	44.5	23.3	32.2
Slovakia ¹	37.5	54.7	7.8	34.7	54.2	11.1
Slovenia	65.6	24.0	10.4	69.2	16.9	13.9

¹ - 1994.

² - CEE only.

³ - 1994.

Source: national sources.

The dominance of trade by EU countries appears to have resulted from geographical proximity and the 'first-mover' advantages gained by EU companies in quickly exploiting the opening up of markets in the region. The role of EU Member State government policies in supporting companies entering EU markets - especially through export credit guarantee programmes and other schemes financing trade with the transition countries - has also been a significant factor. Similarly, companies in transition countries have been naturally drawn to the large neighbouring markets of the EU which provide easier access because of the lower transport and information costs involved in market entry.

The main trading partner of the region has been Germany by a significant margin, accounting for nearly half of EU trade there (CEC, 1995). German prominence can be attributed to several factors. First, German companies have a strong geographical advantage vis-à-vis the region because of their position. This has been partially strengthened by unification with the former East Germany, a traditional trading partner of many transition countries. Second, historical, social and cultural links - particularly the prevalence of the German language throughout the region - favour German companies. Lastly, Germany is a highly export-oriented economy; as the largest exporting country in Western Europe, it has been well-placed to take advantage of new trading opportunities with its neighbours.

The other main EU nations trading with the region have tended to be the main exporting countries of the EU: Italy, France and the UK (CEC, 1995). As with Germany, these countries have been the principal source of their imports as well as the leading export markets for transition countries, though by the end of 1994, their combined share of trade was still smaller than that of Germany alone. In addition, certain neighbouring countries have established commercial links that dominate their trade - especially the Czech Republic with Slovakia, and Russia and Finland with the Baltic states.

The sectoral composition of trade has been dominated by inter-industry trade based on different factor advantages (Graziani, 1994). Although this is likely to change as the transition countries modernise, current export and import specialisations have formed in the following product areas. In general, exports from the transition economies have been resource-based and labour-intensive. Many of the countries in the region have been well-endowed with resources - particularly metal ores and coal - and agriculture and forestry remains extensive economic activities. Labour rates are considerably lower than in the more-developed Western countries. As a result of this factor endowment and relative costs, current transition economy exports tend to be either primary goods (such as foodstuffs, timber goods and metals) or products in intermediate and often 'mature' industries where labour constitutes a significant share of production costs (notably textiles and clothing). Not surprisingly, in 1992, the leading exports to the EU were clothing, metals and food/beverage/tobacco products (Eurostat, 1994).

7.5 Foreign Investment

As well as trade, foreign investment has been given strong impetus by the economic reforms in the transition countries, again as discussed in detail in Chapter 15. Their economies required sources of foreign capital for the replacement of much of the outdated industrial machinery because of the lack of sufficient domestic investment. Foreign investors could also provide necessary management and production skills training as well as facilitate technology transfer. Western companies were drawn by the promise of expanding domestic markets, the prospect of relatively low-cost labour and, to an extent, the attraction of acquiring specific sectoral competitive advantages. In several transition countries, the sale of certain state enterprises presented opportunities to foreign investors, especially Western multinational companies.

As noted above, statistical sources differ in their estimates of FDI stocks, but overall there appears to be broad agreement on the overall scale and main sources of the inward investment into the region. Where statistics are used below, they should be treated as indications rather than accurate measurements of foreign investment. Despite these statistical variations, the scale of the increase in FDI is clear. For example, at the end of 1989, cumulative foreign investment was approximately US\$ 2.5 billion, but by the end of 1994, this was estimated to rise to US\$ 18.3 billion (UN ECE, 1994). Nevertheless, the scale of investment is small relative to other economies of a similar size. For example, Spain and the transition countries share several important features that could attract FDI - notably low labour costs - but whereas the cumulative flows entering the transition countries were US\$ 8 billion between 1989 and 1993, in Spain, they amounted to over US\$ 60 billion during the same period (Gual and Martín, 1995).

The motives of foreign investors can be divided into two overlapping categories (Halpern, 1995). First, investors have been attracted by the prospect of the costs of skilled labour being relatively cheap compared to Western Europe. These locations appear to provide Western companies with the opportunity of setting up low-cost, manufacturing assembly operations in combination with good access to Western European markets. Second, and more importantly, transition countries present

Western companies with expanding consumer and industrial markets for which direct investment is often seen as a way of establishing a strong market presence.

Hungary has been the main host country for foreign investment in the region. Not only has it received the largest share in bulk term, but the importance of FDI to the economy - as measured by GDP ratios - is also greatest there (Table 7.6). The prominence of Hungary in FDI is at odds with its relatively low importance in trade terms, but this can be explained by its possession of several advantages, enabling the country to be an early primary location for foreign investment in the transition economies, a position which it has been able to reinforce (Hardy, 1994; Houde, 1994). First, Hungary was the first transition country to deregulate its controls on foreign ownership and investment in the country. Second, its successful and early implementation of widespread privatisation of its economy attracted a number of foreign investors through acquisition of state firms. Third, the country has often been cited in surveys of foreign investors as having the most consistent economic and political stability in the region. Lastly, its proximity to major Western European markets - notably Germany and Austria - as well as providing a base for future expansion into the rest of the region has been a substantial motive for much of the investment in the country. It should be noted though that Hungary's recent economic problems and the increasingly favourable attitude (and better economic prospects) of its neighbours (particularly the Czech Republic and Poland) could jeopardise its future position.

In parallel with trade linkages, the EU has been the main source of FDI to the region, with Germany again being the principal EU investing country, followed by Austria, the UK and other countries such as Italy. Strong bilateral links exist in some cases, such as Finland with Latvia (accounting for approximately ten percent of the latter's FDI), and Switzerland and Belgium with Bulgaria (eight percent each of Bulgarian FDI).

	Total (US\$ mn)	% of GDP ¹	Percentage of total FDI					
			US	Germany	Austria	UK	All EU	Other
Bulgaria	532.3	5.3	6.4	38.4	4.9	4.4	70.5	23.1
Czech Republic ²	3,714.3	10.3	18.8	36.3	6.9	°	66.2	15.0
Estonia ¹	217.4	9.3	9.0	°	3.0	8.0	66.0	11.0
Hungary	8,000.0 ³	19.4	24.0	29.0	10.5	°	60.0 ³	16.0
Latvia ¹	309.5	5.2	14.1	7.2	2.7	23.3	57.2	28.7
Lithuania	397.4	9.8	15.3	20.1	4.3	20.9	62.0	22.7
Poland	5,389.5	5.8	31.6	9.5	4.6	5.9	45.0	23.4
Romania ¹	1,402.6	4.7	6.5	9.2	°	5.2	55.2	44.8
Slovakia	732.9	5.9	11.1	17.3	21.4	7.2	63.0	25.9
Slovenia ¹	1,254.0	8.9	*	19.6	20.4	*	75.0	22.0 ³

° - negligible.

* - under five percent.

¹ - by end 1994.

² - Czech data are for 1990-1995. ³ - estimated.

Source: national sources.

Unlike trade, non-EU countries feature strongly in the FDI profiles of transition countries, particularly the US, which has been the main investor in the region (with special prominence in Poland). The US investment presence contrasts markedly with its low level of trade with the transition countries. In contrast, Japan and other East Asian countries - traditionally large investors in Western Europe - have been slow to set up in the transition countries, though some large companies, such as Suzuki in Hungary and Daewoo in Romania, have begun to establish subsidiaries (in the case of Romania, South Korean firms are the leading investors and represent 29 percent of the country's FDI stocks). In Slovakia, the Czech Republic is the most significant investor country (16 percent of the total), principally owing to historical ownership links pre-dating the separation of Czechoslovakia. Moreover, mention should be made of the presence of international lenders - such as the European Bank of Reconstruction and Development - which have been important in financing development projects throughout the region. They have been particularly significant in Poland, where as a whole, they accounted for 10.5 percent of total foreign investment stocks.

FDI seems to be concentrated in certain sectors. This can be largely attributed to two sets of factors. First, FDI transactions in the region often constitute huge purchases by foreign companies (*Business Central Europe*, 1995). For example, the stock of FDI in the Czech road vehicles sector is dominated by the acquisition of, and subsequent investments in, the Czech car company Skoda by the German firm, Volkswagen. The Volkswagen investments of US\$ 700 million represented nearly a quarter of the total FDI stock in the Czech Republic by the end of 1993. Second, privatisation programmes in the different countries have largely determined which sectors have received the most FDI. The select privatisation of parts of the economies has attracted significant amounts of foreign capital into certain sectors, such as food and telecommunications. For example, delays in initiating a large-scale privatisation programme in Poland has resulted in the attribution of less than five percent of total FDI to foreign acquisitions of state-owned enterprises, and the majority of investment taking place through greenfields and joint ventures with existing firms.

7.6 Regional Disparities

Statistics are not readily available on many aspects of private sector development in the transition economies. In particular, there is a dearth of official sources of comparative data across countries and over time for examining regional differences in the growth of new businesses or the extent of privatisation. However, limited use can be made of two sets of figures: the regional distribution of private firms per 1,000 inhabitants and FDI

New firm formation rates are summarised in Table 7.7 (at present, data is only available for five of the selected CEE countries). While the figures should be used with care (noting the effect of different definitional bases, as in the case of Romania and Slovakia), they are still useful to demonstrating common development patterns in the acceding countries. Capital cities emerge as the main regions where new firm formation is most intense, as they have the highest rates in each of their respective

countries. High rates of new firm formation would be anticipated in the major urban centres, for the following reasons.

- They tend to be the areas where privatisation has occurred earliest, usually involving large industrial or utility companies.
- Investment capital is most available, whether from the centrally-located domestic financial sector or from foreign sources.
- The demand for a range of new service sector activities (such as construction, retail, hotel and catering) is highest.

Table 7.7: Regional distribution of private firms (per 1,000 inhabitants, 1994)

	<i>Highest region</i>	<i>Lowest region</i>	<i>Ratio</i>
Bulgaria	78.7	22.0	3.6
Czech Republic	161.5	87.7	1.8
Hungary	158.1	58.1	2.7
Poland	69.6	39.5	1.8
Romania ¹	10.8	1.0	10.8
Slovakia ²	7.3	4.7	1.6

¹ - statistics refer only to the regional distribution of *private SMEs* in Romania.

² - statistics refer only to companies with 25 or more employees.

Source: national sources.

Internal differences within the transition countries are broadly comparable, apart from Romania, where statistical limitations to SMEs distort the regional disparities. The lowest range of disparities appears to be in the Central European countries, suggesting that regional development has been less skewed towards rapid growth in the capital city far exceeding the less-advanced regions.

Another area where cross-CEE regional comparisons is *foreign direct investment*. The statistical picture emerging from Table 7.8 reinforces the observations about regional differences in private sector development noted above. Not surprisingly, FDI is concentrated in the capital cities - most strongly in Sofia in Bulgaria, least in Poland (where as noted elsewhere in this report, economic development is not overwhelmingly focused on Warsaw). This dominance is visible whether measured in terms of total FDI stocks or per capita FDI figures. For example, the largest range of differences occurs in Bulgaria, where FDI per capita is larger in Sofia than the lowest region (Montana) by a factor of 237. Considerably smaller differences are found in the other five CEE countries, ranging from a factor of 12 for Slovakia to 44 for the Czech Republic.

Internal regional disparities are larger in terms of FDI stocks and per capita FDI than for the majority of other economic and business indicators, appearing to underline the attractive power of capital cities for foreign investment. However, the scale of difference may be an illusion created by the way in which FDI is attributed regionally

within the different countries. FDI commitments are listed in the region in which the main headquarters of the invested company are located (usually in the capital cities). If ultimately, some of the investments are made on sites located in other regions at a later stage, these may not be officially recorded.

	Highest region		Lowest region	
	<i>% of whole country</i>	<i>FDI per capita (national=100)</i>	<i>% of whole country</i>	<i>FDI per capita (national=100)</i>
Bulgaria	73.2	1,395.5	4.3	5.9
Czech Republic ¹	63.1	357.3	2.4	8.2
Hungary ²	62.1	329.8	6.0	26.3
Poland ³	38.2	649.8	0.7	13.0
Romania	45.1	387.5	1.7	17.4
Slovakia ¹	66.1	565.8	14.1	47.7

¹ - Slovakian and Czech figures refer to FDI commitments made by the end of 1995.

² - Hungarian figures are for 1993.

³ - Polish figures are for foreign start-up capital only.

Source: national sources.

Cross-CEE statistics can be generated for FDI per capita by applying the regional indices calculated for Table 7.8 to national FDI per capita figures drawn from the United Nations Economic Commission for Europe (UN ECE, 1995). The resulting table is appended to this chapter. It demonstrates that the region with the smallest FDI per capita is Montana in Bulgaria, though Romania has the highest number of NUTS 1 regions with single-digit US-dollar per capita figures. More interesting is the comparison of the regions with the highest levels - ie. the capital-city regions. Budapest clearly dominates with FDI per capita of US\$ 2,209 (in line with the country's high share of CEE FDI), followed by Prague in the Czech Republic. Perhaps surprisingly, Warsaw's figure is below that of countries with smaller national stocks of FDI - Bratislava in Slovakia and Sofia in Bulgaria - demonstrating the extent to which Poland has been an 'underachiever' with regard to foreign investment.

Lastly, Hungary and the Czech Republic are the only countries where there are other regions apart from the capital cities where investment occurs (in national terms) on a relatively significant basis (especially in Mid-Bohemia in the Czech Republic, and to a lesser extent, in the North West region of Hungary). At least in the case of the Czech Republic, this reinforces the point consistently made about this country's more even regional development.

7.7 Summary and Outlook

The development of the private sector and business in the acceding countries has chiefly depended on two processes: privatisation of state industry and new firm formation. During the transition period, the former process has dominated, but in the decade to come, the ability of these countries to provide an environment for supporting new business growth will emerge as a more important factor in their overall development.

Although privatisation has been taking place at different paces using a variety of approaches, it has largely been achieved in the transition countries. It is most advanced in the Czech Republic and Slovenia, though delayed in Bulgaria and Romania. All of the acceding countries are committed to widespread privatisation of their economies, though there are continuing debates over its extent (especially in relation to public utilities) and (in countries where it has been slow to get started) its methods. In any case, the scale of the transfer to the private sector has been greater than in many Western European countries (eg. the Czech Republic).

At the same time, a dual process of commercial liberalisation and introduction of business legislation has encouraged a surge of new business formation. It has been characterised by an expansion of self-employment and the growth of the service sector, particularly in urban areas (such as the capital cities, which all have the highest number of private companies and FDI stocks per capita for their respective countries). As with privatisation, the Czech Republic is the most advanced with its high new firm formation rates, leading to a high share of its economy in the private sector. Bulgaria has the lowest share of its economy in the private sector.

Future development of the private sector will depend principally on the quality of the business environment that will develop in each country. Current obstacles include legal loopholes, deficiencies in bankruptcy law and enforcement, and (above all), weak and undeveloped financial sectors. While the solution to some of these problems will bring evenly-distributed national benefits, other areas are likely to have longer-term regional effects, especially the banking sector, where regional differences in access to capital investment can become more important in future. Following the rapid expansion in the number of companies, disparities in their support environments will determine which regions will allow companies to expand (especially in international terms) as well as foster a renewing cycle of new firm growth to replace lost businesses.

Much of the private sector development that has taken place to date has been linked to filling gaps in the existing economic structure of the transition countries. Greater competition - both domestically and internationally - is likely to lead to a period in which sectoral comparative advantage will become more apparent. Already this has begun to take place in foreign trade and investment, where international links have expanded enormously during the transition period. In international trade, CEE countries generally specialise in primary goods and labour-intensive industrial production. Similarly, foreign investment has been attracted into the CEE region - particularly the Central European countries - in large part due to the relatively lower wage rates.

In future, the development of foreign trade and investment - at least in volume terms - will be dependent on political factors, both internal (national political stability and progress in economic reforms) and external (commercial relations with the EU). As a result, it is difficult to assess how different countries will develop, as much may depend on the sequencing of EU membership (as noted in a later chapter in this report) and the extent to which favourable international business conditions have been established in the respective countries. Nevertheless, the overall pattern of trade and investment is unlikely to change, following the fundamental shift of the transition countries towards dependence on Western Europe.

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Appendix 7.1: FDI by region

	FDI per capita (US\$, PPP)	National=100
Czech Republic	319	100.0
Prague	1,140	357.3
Mid-Bohemia	937	293.8
S&W Bohemia	159	49.7
N. Bohemia	207	64.9
E. Bohemia	32	10.0
S. Moravia	26	8.2
N. Moravia	145	45.4
Poland	42	100.0
Warsaw city	273	649.8
Warsaw region	26	63.0
North-Eastern	7	16.7
Northern	28	66.7
Central-Western	33	79.5
South-Western	33	79.5
Southern	45	107.2
Central	20	46.9
South-Eastern	19	46.2
Central-Eastern	5	13.0
Hungary	670	100.0
Budapest	2,209	329.8
Transdanubia	555	82.8
Great Plain	325	48.5
North-East	213	31.8
North-West	176	26.3
Romania	22	100.0
Bucharest	85	387.5
Constanta	8	36.0
N. Muntenia	11	49.5
Oltenia	20	90.1
Banat	16	74.0
Central	15	66.7
Cluj	22	100.0
N. Moldova	8	34.1
S. Moldova	4	17.4
Bulgaria	23	100.0
Sofia city	321	1,395.5
Sofia district	12	50.9
Bourgas	20	87.0
Varna	17	72.1
Lovetch	27	119.0
Montana	1	5.9
Plovdiv	20	86.6
Russe	7	32.5
Haskova	43	186.0
Slovakia	102	100.0
Western	162	157.2
Central	67	65.2
Eastern	49	47.7

8. PHYSICAL INFRASTRUCTURE

8.1 Overview

Physical infrastructure is one of the key elements currently constraining the form of economic development in CEE countries. Of ten surveys of foreign investors, six list weak infrastructure among the key obstacles encountered in eastern countries (EBRD, 1994). Telecommunications and transport networks developed under centrally-planned economies require substantial investment to modernise and improve provision, and to adapt it to new and emerging patterns of communication and movement which are the result of recent economic and political transformation.

Following the collapse of trade with the former USSR, patterns of commerce are both changing in their dominant direction and becoming more complex. As traffic and trade between CEE countries and between themselves and West European states expands, so the development of adequate international connections and effective strategic-level East-West and North-South transport corridors has become a priority. To ensure the most efficient use of limited resources in creating these corridors and to enable the harmonious development of the Central and East European space, there is also a need to co-ordinate development efforts. EU network policy, and trans-European networks in particular, are laying the foundation for this, enabling projects to be prioritised and coordinated on an international scale. Proposed priority connections between the EU and CEE include the Nuremberg-Prague and Berlin-Warsaw-Moscow motorways. The EU's financial participation in such key projects (for example through PHARE and the EBRD) will help to reinforce progress. PHARE expenditure on transport has risen from zero in 1990 to 231 million ECU in 1994, and is set to rise further in future.

At the same time as international connections require improvement, the strong regional differences *within* countries in the quality of their infrastructure require attention. These are already impeding overall development, and may increase without carefully balanced programmes of investment. Main route networks and transport services currently tend to be focused, often radially, on capital cities, whilst remoter and more rural regions are less well connected. The necessary improvements to strategic routes may increase the differential between the best and the worst connected areas, so laying the foundation for widening economic disparities. There is therefore a need for the parallel development of secondary networks, not only to improve circulation within the more remote areas, but more importantly to ensure their access to strategic routes, and so the benefits these provide (see CEC, 1994 for a fuller discussion).

8.2 Road Transport

The road networks in Central Europe are comparable in density to those of the EU, but are of very uneven quality, with minimal motorway provision and a predominance of poor quality local roads (Gerardin, 1995). Densities vary between countries, with higher overall densities in the Czech Republic, Poland and Lithuania. A 1991 World

Bank survey found that 82 percent of the existing road network required substantial renovation, rehabilitation or reconstruction (World Bank, 1991).

The more rural and remoter areas are the least well connected, with road densities mirroring patterns of population distribution. The main routes are focused on capital cities and, to a lesser extent, on secondary cities, with radial patterns especially evident around Warsaw, Prague and Bucharest (Figure 8.1). Capitals are reasonably well connected to their immediate hinterlands, but not to each other: an effective international network of roads is lacking, with international road travel slowed further by border controls and congestion (Figure 8.2).

	<i>Public Road Network (km) ¹</i>	<i>Motorway (km & % of public network)</i>	<i>Road Density (km/km²) ¹</i>
Bulgaria	36,934	266 (0.7%)	0.33
Czech Republic	55,887	527 (0.7%) ²	0.70
Slovak Republic	17,600	527 (0.7%) ²	0.50
Estonia	14,811	n.a.	0.33
Hungary	29,700	311 (1.05%)	0.32
Latvia	20,688	n.a.	0.32
Lithuania	40,565	n.a.	0.62
Poland	231,700	243 (0.1%)	0.74
Romania	72,816	113 (0.2%)	0.31

¹ - the length and density of the whole network in many cases is greater than the length and density of public roads.

² - Czechoslovakian totals.

Source: Gerardin (1995); Hall, (1993).

The growth of private car ownership and road freight are likely to increase road use beyond its current capacity fairly rapidly. Investment is required in high speed routes appropriate to the emerging patterns of movement. This includes investment in international networks and reduction of delays at international borders. To enhance movement within countries, existing major axes also need urgent renovation. At the local level, many minor roads are unpaved (60 percent in Poland), and few towns have by-passes. Frameworks of local government finance will to a large degree determine what progress can be achieved at this level. In particular, the presence of mechanisms to redistribute local authority resources according to need may be key in determining whether those regions with the least revenue raising capacity will be able to carry out necessary improvements.

In terms of trends in traffic development, road haulage, whilst not generally the main mode used for freight, is increasing, notably in Poland, Hungary and the Czech and Slovak Republics. However, the poor quality and maintenance of vehicles affects the reliability and viability of services. One solution in the case of international road haulage has been to import fleets from the West (World Bank, 1991). Car ownership

rates in turn remain low (Table 8.2), particularly in Romania, in spite of increases during the late 1980s. A significant increase in these rates can be expected in the medium term, the degree of increase depending on overall economic performance and its effect on personal wealth, and also, to an extent, on developments in the public transport networks which currently dominate passenger travel in CEE countries.

	1985	1989	1992	1993
Czech Republic	196	221	244	256
Hungary	133	164	200	205
Poland	98	127	169	167
Romania	42	50	68	
Slovak Republic	136	159	179	185
Slovenia	254	277	304	318
Greece	127	172 ¹		
Spain	240	306 ¹		
UK	313	374 ¹		
Finland	315	387 ¹		

¹ - 1990

Source: Hunya (1995), compiled from national statistics, except for Greece, Spain and the UK, where the source is Eurostat (b), and Finland, where the source is IRF.

8.3 Rail Transport

The problem of rail networks in CEE states is, in the main, one of quality and compatibility rather than quantity. Networks are dense in comparison with the EU 12 average, especially in the Visegrad states, reflecting the important role they played in enabling industrial expansion in the late nineteenth century (Table 8.3). However, as a result of long-standing under-investment, older infrastructure has not been adequately maintained and further modern infrastructure has not been put in place. Given scarce resources, it is likely that the way forward in some cases will be to rationalise railway networks and target investment at the main (eg. Estonia, Lithuania).

Existing rail lines are frequently single track which means that services are often slow and unreliable: only 16 percent of lines in Hungary, 18 percent in Bulgaria and a third in Slovakia are double track (Gerardin, 1995). In addition, there is an almost total lack of fast routes: Czech trains can reach speeds of 160 km/hr on only 12 km of the country's 9,400 km of rails (Calbreath, 95). Safety standards are low, with worn-out tracks and outdated rolling stock, and services are frequently disrupted by breakdowns. There are further complications in Lithuania, where Russian track widths are used. To integrate the rail network into the European system, it will be necessary at least to reconstruct the Sestokai-Kaunas segment which would cost USD

61 million. Some of this at least is likely to be achieved as part of the trans-European network strategy.

Table 8.3: Extent and density of rail networks				
	<i>Length of rail network in 1992 (km)</i>	<i>Length electrified (km)</i>	<i>Percentage electrified (%)</i>	<i>Rail density in 1989 (km/km²)</i>
Bulgaria	4,294	2,636	61.4	0.039
Czech Republic	9,500	n.a.	n.a.	0.119
Estonia	1,026 ²	132	12.8	0.023
Hungary	7,600	2,164	28.4	0.085
Latvia	2,406	271	11.3	0.037
Lithuania	2,002	122	6.0	0.041
Poland	25,254	11,496	45.5	0.085
Romania	11,127 ²	2,367	21.3	0.048
Slovakia	3,661 ¹	1,373	37.5	0.100
Slovenia	1,201	499	41.5	n.a.
EU 12				0.053 ³

¹ - 1994, calculated from Eurostat Yearbook, 1995.

² - 1991.

³ - 1988.

Source: Europa Publications (1994), apart from rail density, Gerardin (1995).

In the absence of adequate financial resources, management reform offers the best short term solution to improving rail services. Rail companies are over-staffed with inflexible management and an uncommercial outlook. The determination to modernise some CEE networks will require both investment in track and rolling stock, and also human resource development in technical fields and management. Different routes have been taken to reform CEE railways, but progress has not always been smooth. Modernisation has met problems in Hungary where, in April 1995, the Hungarian railway MAV's attempts to increase efficiency by rationalising networks led to a four day strike which cost the railway Ft 663m and the Hungarian economy Ft 2.5bn. The Czech Republic is so far the only country opting to privatise its rail network - on a gradual basis, selling off small rural lines first, and keeping main transport corridors under state control.

As with road networks, it is necessary for CEE countries to improve the quality, capacity and speed of their international rail links both with each other and with West European neighbours. The map of current networks is ill-suited to the evolving patterns of international demand, lacking modern and reliable links both between CEE countries and with the West. In addition, international freight and passenger traffic is still delayed unpredictably by elaborate border controls. Amongst the major investments planned, the Czech Republic considering a faster rail link connecting Berlin to Vienna via Prague, and Poland plans a similar link between Warsaw and Berlin.

8.4 Air Transport

Effective international air transport links play a key role in enabling international trade, business development and tourism. With air cargo volumes and air passenger numbers rising quickly in the CEE, air transport is an attractive field for Western investors, and has enabled impressive progress to be made in a relatively brief time in both the improvement of airport infrastructure and the restructuring of airline services (Symons, 1993).

The main current bottleneck in terms of air transport infrastructure is not the number of airports and air companies in existence, but the degree to which they have adapted to new demands. Most CEE countries are well supplied with airports, in part because of the past need for military air bases. However, the safety and security standards of airports, their management and operational services are still undergoing change.

Most international services operate from capital city airports which tend to be the most modern and well equipped. This has implications for the economic development of regions either remote from, or poorly connected, to the capital, and makes integration of air transport with other transport networks imperative. The most important gateways to Central and Eastern Europe are currently the international airports of Prague, Budapest and Warsaw. Warsaw airport is particularly well-equipped to respond to the demands of both passenger and freight traffic, having undertaken substantial modernisation in the early 1990s - planned originally in the late 1980s to cater for rising demand from Soviet markets.

Air companies in CEE countries were previously state owned. Privatisation is now the aim of almost all of these organisations, and should be achieved in most cases by the year 2000 (Symons, 1993). Two key brakes on progress have been unfamiliarity with the operation of the market and the need to create a sound technical base for safe operations. Other constraints are the cost of modernising fleets, coupled with the difficulty of insuring Soviet-built aircraft. Most of the aircraft run by air companies in CEE are still the technologically obsolete Soviet-built models, characterised by high noise levels, fuel consumption and maintenance costs, and requiring frequent and lengthy overhauls. Uneven progress has been made in modernising fleets, with various forms of support enabling companies to purchase or lease aircraft, including bank loans, and help from Western airlines and aircraft manufacturers. Lot, the Polish carrier now has the youngest fleet of aircraft in the world having re-equipped with new Boeings (Moore, 1995).

8.5 Inland Waterways

Inland waterway transport is most significant in the Danube states and least significant in the northernmost parts of CEE where the harsh climate makes waterways unnavigable for over half the year (Gerardin, 1995). There is potential for the Danube river ports to develop substantially as trade patterns evolve, provided that the political situation in the Balkans stabilises. However, port facilities would require upgrading and road and rail linkages with their hinterlands would need to be improved. Parts of the Danube channel also require attention. In addition, there is a need for inland waterway companies to modernise and adapt their fleets. They currently have craft unsuited to modern conditions, and, whilst they have excess capacity for bulk cargo, there are few specialised craft. The situation is particularly severe in Romania (Gerardin, 1995).

Bulgaria	1360.5
Czechoslovakia	325.8
Hungary	98.3
Poland	3369.2
Romania	4004.6

Source: Hall & Kowalski, (1993)

8.6 Telecommunications

Current telecommunications infrastructure is a major and immediate constraint in the economic development of the CEE. There are both quantitative and qualitative shortcomings in the current networks because, until 1989, this sector received minimal investment, defined as part of the 'non-productive' sphere. Resolving the shortcomings is a priority in all the former Communist countries. There is an urgent need for full, reliable and modern telecommunications coverage to accommodate not only increasing but also evolving demand, as commercial communication requirements become more complex and sophisticated. The lack of appropriate provision may impede growth in business, trade, inward investment and tourism.

The underdevelopment of telecommunications networks in the CEE relative to those in Western Europe is demonstrated by the results of an international survey by Ehrlich (1994), reported in Hunya (1995). The survey compared endowments of telecommunications infrastructure in 1990 in 35 countries, including seven which were formerly socialist. Focusing solely on extent of infrastructure (and not the quality or condition of networks, for which comparable information was not available), the survey found that Eastern countries are by far the least well provided for (Table 8.5).

Table 8.5: Relative Development of Telecommunications		
<i>Rank (out of 35)</i>	<i>Country</i>	<i>Aggregate scores for telecommunications infrastructure</i>
1	Sweden	83.5
10	Austria	50.3
16	Portugal	29.4
17	Bulgaria	12.7
18	Czechoslovakia	10.6
19	Yugoslavia	9.3
20	Hungary	8.6
21	Soviet Union	7.2
22	Romania	5.8
23	Poland	5.7

Source: Hunya, (1995).

In 1990, there was a consistently lower density of telephone lines than in Western European countries (Table 8.6), combined with an almost total absence of digitalised lines and telefax facilities.

As with transport, there are clear urban-rural and regional differences in telecommunications provision, with the highest availability and most modern provision available in the main cities and in the most affluent and dynamic regions. In Lithuania, while the average telephone density is 26 per 100 inhabitants, urban densities are 33 on average and rural less than half this at 15. Further, four fifths of telephones are in urban areas. In Bulgaria, differences are even wider. Sofia has a telephone density of 48.8 per 100 inhabitants while some border areas have only 20-25 (compared with a national average of 35.2). In regional terms, if Sofia is excluded from the picture, the West of Bulgaria has the least dense telephone network. The eastern and northern parts of the country are the best provided for.

	1988	1989	1990	1991	1992	Telephone densities - per 100 people (1990)
Bulgaria	2386	2515	2635			29.3
Czech Republic			3023	3126	3238	29.2
Estonia	n.a.	n.a.	n.a.	n.a.		
Hungary		1770	1872	2011		17.7
Latvia			822	836		30.6
Lithuania	n.a.	n.a.	n.a.	n.a.		
Poland		5039	5232	5480		13.7
Romania	2207	2288	2358			10.2
Slovakia		1193	1248	1800		23.5
Slovenia				459		23.6

¹ These figures are in many cases higher than statistics for the number of lines available

Source: Europa Publications, 1994, apart from telephone densities, which are own calculations based on Europa Publications telephone statistics and Dobriš Assessment 1990 population figures (Eurostat, 1995a).

The prospects for improving telecommunications provision are good, both because of the importance of achieving this to the countries involved, and because of growing demand, which makes this a secure and so an attractive field for foreign investment (Hunya, 1995). As Table 8.7 below illustrates, the speed and extent of post-reform improvements has varied between countries, but is in each case likely to accelerate towards the year 2000. Hungary has been making rapid progress with its networks (the number of lines increasing from 1.1 to 2.5 million between 1989 and 1993), whilst Poland and Bulgaria still lag seriously. Romania has undertaken only limited investment in recent years in spite of co-operation agreements with foreign firms (Siemens, Alcatel, Goldstar). Over 3000 villages there still have no access to the telephone network. In developing networks, management solutions are being pursued in some cases as well as programmes of investment: Slovenia has separated its postal and telecommunications services, formerly united in PTT Slovenia with a view to privatising the latter in the future.

	1985	1990	1992	1993	1995	2000
Czech Republic	12.9	15.7	17.6	19.0	-	33-38
Hungary	7.4	10.0	12.5	15.0	30.0	40.0
Poland	6.7	8.6	10.3	-	-	-
Slovakia	-	13.4	15.6	-	20.0	28.8
Slovenia	14.0	21.1	-	25.0	30.0	40.0

Source: Hunya, 1995 (drawn from National statistics and development programmes).

8.6. Summary and Outlook

The adaptation and renewal of infrastructure in the CEE presents a considerable challenge to all the countries concerned. The overall priorities being pursued are to modernise and restructure provision to meet the demands of the emerging market economies, to ensure balanced development of networks between the international, national and local levels, to enable new financing and management methods to be progressively introduced, and to harmonise standards and practices with those in the EU.

While the serious infrastructural deficits of Central and Eastern Europe are a high political priority, progress with resolving them has been impeded by a combination of factors, principally the lack of resources to fund the improvements identified, and the growth in (particularly road) traffic which means little net benefit is being achieved from investment undertaken. Prospects are healthiest in those sectors most attractive to domestic and foreign private sector investment, namely telecommunications and air services. For other sectors, international aid is likely to continue to be of importance in enabling the timetable of renewal to progress.

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9 SOCIAL INFRASTRUCTURE

9.1 Primary and Secondary Education

Education reforms will influence education and skill levels, and so ultimately have an impact on economic development. Basic level education functions well. The main area requiring reform is at secondary and advanced level. Most states in Central and Eastern Europe (CEE) are trying to increase the quality and adapt the scope of education (at secondary level especially), prolong school careers, encourage choice both in types of schools and subjects followed, and reduce the early dominance of narrowly focused vocational training.

The education infrastructure at primary and secondary level has traditionally extensive in CEE, reflected in low rates of illiteracy, with rates of almost zero in Poland, two percent of the population aged over seven in Bulgaria and 3.4 percent in Romania. There is almost 100 percent attendance at primary level, but there are usually lower rates at secondary level (80 percent in Poland, for example). The quality of education provided is generally both lower and more variable at secondary than at primary level.

In terms of coverage, rural, peripheral and economically backward areas tend to be less well equipped than the more prosperous and urban areas and to achieve lower quality standards. Because of rural depopulation and declining birth rates, rural schools are often under-attended and poorly equipped. It is likely that urban/rural spatial disparities in the quality of primary and secondary education provision will be steadily reduced. This may be achieved by rationalising provision whilst at the same time enhancing access arrangements for pupils to overcome the problem of distance. This is an issue in both Latvia and Slovenia. In Bulgaria, too, rural education facilities tend to be under used and poorly equipped. However, the imbalance in Bulgaria extends also to towns and cities where some schools are so overcrowded that shift systems have had to be introduced. There are exceptions to the overall patterns of education infrastructure provision described above. Whilst most of Slovenia displays the typical correlation between degree of economic development and the quality and extent of education infrastructure, the Pomurska region, which is the least economically developed, has good education infrastructure. Such patterns may enhance the prospects of certain regions for future economic development.

Schools are undergoing a fundamental reform, both in the way they are organised and the education they provide, in order to adapt to the new political, social and administrative situation. The previous system of central control and standardisation is no longer appropriate. With regard to administrative and financial arrangements for schools, pre-school and general education has in most cases become the responsibility of local government, although still within the context of a national education system. There is now more scope for responsiveness and flexibility, and for parents and teachers, in particular, to have more influence in the running of schools and in teaching content. In Hungary, however, it is believed that decentralisation of education in the first wave of reform was excessive and that some rebalancing of responsibilities must be undertaken (Bîrzea, 1994).

In addition, the dominance of specialised vocational training at secondary school level is being challenged by moves to prolong general education. Vocational training will in future start later in both Hungary and Poland. Likewise in Slovenia, new legislation has stated that the priority in education should be to provide young people at both primary and secondary level with a broad and good common education which will enable them to adapt easily in the future. The content and coverage of curricula is being modified and, in countries like Poland, Western languages are amongst the new subjects gaining ground. A further change is that of choice, with secondary pupils now in many cases being allowed to select the subjects they wish to study. There has also been a strong move to eliminate the former ideological content of curricula. In some cases, education is now being used to support the renaissance of national languages and culture, often associated with the recent reacquisition of nationhood, as in Lithuania, Latvia and Estonia (Bîrzea, 1994).

A further notable trend is the emergence of diversity in education provision. In the Czech and Slovak Republics, religious, alternative and private schools are amongst those appearing, in parallel with different types of state secondary school. The emergence of private education is taking on a distinct spatial form reflecting patterns of demand, as in Poland where the main urban areas are seeing the strongest growth. Teacher training and teaching methods are also evolving, and action is being taken to improve the status and pay levels of teachers.

Pre-school education was a strong feature of some systems previously, but is now in decline in some cases, principally for reasons of expense. In Latvia kindergartens were widely attended before 1990, but now only just over a third of pre-school children attend. In Poland, decentralisation of responsibility for kindergartens led, unexpectedly, to declining provision as local authorities closed many down to economise (Janowski, 1992).

9.2 University Education

Central Europe has a long and rich heritage of higher education. There are numerous universities in CEE, with provision focused on the capital cities and the main regional centres. The main cities have the largest and most prestigious number of institutions, and the highest number of students. In Slovakia, Bratislava hosts half the country's students in its five universities and 24 faculties. Prague, likewise, hosts five out of 13 Czech academic institutions and most institutes of the Czech Academy of Sciences (Gorzela *et al*, 1994). Regional imbalances in provision are likely to continue and even increase as the biggest and best centres, with the most highly developed contact networks and modern equipment, attract most additional resources and employ them in the most efficient ways. In spatial terms, the proportion of people educated to degree level is lower in the more rural and peripheral regions, reflecting not only education provision but also career opportunities.

CEE universities are highly regarded in the technical disciplines, which grew disproportionately as education was subordinated to the requirements of industry. The humanities were traditionally less well represented and it is principally here that a reorientation is underway to enable courses to correspond better with the demands of

the market economy and business. Investment is needed to reorient and retrain academic staff and to acquire appropriate teaching materials and IT equipment. Technical assistance is providing some support in this area where international exchange of expertise is especially valuable. Overall, whilst technical disciplines still dominate in many cases, such as in Romania where they account for 44 percent of students, there is increasing demand for other courses, including law and social sciences in Estonia, and commerce and management in Hungary. The latter reflects a trend favouring courses which are of direct and immediate relevance to career development.

A lower proportion of the population goes on to higher education in the CEE than in the West, but the proportion is increasing in most cases, in part due to the poor employment opportunities available for the less educated eg. in Slovenia. Student numbers and the number of higher education institutions are growing quickly. In Poland, for example, between 1989/90 and 1993/4, the number of universities and equivalent institutions grew by 44 percent (from 97 to 140), and the number of students by 37 percent, from 374,000 to 594,000 or from 98 to 154 per 10,000 inhabitants. At the same time, an increase of only eight percent in the number of academic staff has meant rising student-teacher ratios. In some cases, as in Lithuania, demand is outstripping provision, leading to 'good' students who would normally be entitled to free places in state universities having to pay for courses. An exception to the general trend is Latvia where student numbers have decreased over time from 47,200 in 1980/1 to 37,600 in 1994/5.

Higher education provision is expanding, but is still insufficient. Additional financing is required to enable adequate growth of this sector. Most universities are currently facing financial difficulties, relying almost entirely on the state for their funding. Some partial solutions are being found to enable higher education provision to expand in the absence of increased resources from the state. The 'higher schools' in Poland, for example, in parallel with their traditional 'free' provision to students supported by the state, are offering new evening courses for which tuition fees must be paid. Others are charging fees to students who would not normally have passed the entrance examinations. In Estonia, a system of tuition loans was introduced in 1994 to replace the scholarship system in 'higher schools'. This recycling of funds should increase resources for education in the medium term without increasing the budget allocation.

The university of Malta, which is involved in teaching, training and research, is state owned and has grown rapidly in recent years, with student numbers doubling to 6000 between 1991 and 1995. Most disciplines are available, and three important institutions have an international character, including the Mediterranean Academy for Diplomatic Studies and the International Maritime Institute.

9.3 Training Provision

There has traditionally been excellent provision of vocational training for pupils of secondary school age in CEE, particularly in areas such as engineering. However, training has tended to be highly specific, limiting the flexibility of the workforce. As a result, the emphasis placed on vocational training at this level is decreasing, in favour of a prolonged general education. At the same time, the need for vocational training amongst adults has increased dramatically in almost all sectors. Those who were formerly employed in declining industries now need more modern or even completely different skills more relevant to the current and future labour market. In turn, different skills are now required in agriculture, local government, administration and teaching.

Appropriate systems of adult education are under development, but in a context of limited funding. Given the importance of training to economic development and rising unemployment, governments now tend to be taking a greater role than they did before 1990 when the main burden of financing fell on trainees and employers. Adult training and retraining has been adopted as a priority in Slovenia, with the emphasis being to train those with obsolete or insufficient skills in areas of chronic under-supply such as information technology and modern languages. In Latvia, regional training centres and public teaching facilities are being set up, whilst in Poland, correspondence courses are emerging as a favoured option. A recent detailed analysis of the labour market in Bulgaria showed a continuing discrepancy between demand for skills and those which are supplied by the education system (Bulgarian Ministry of Foreign Affairs, 1995).

9.4 Healthcare Provision

Under the previous regimes in the CEE, health sectors were given low priority. They “functioned in economies with chronic shortages, and were governed by undemocratic regimes” (Davis, 1993).

	<i>Health Expenditure (% of GDP, 1990)</i>	<i>Health Expenditure per Capita (1990)</i>	<i>Doctors per 1,000 population (1988-92)</i>	<i>Hospital Beds per 1,000 population (1985-90)</i>
Romania	3.9	63	1.79	8.9
Poland	5.1	83	2.06	6.6
Bulgaria	5.4	131	3.19	9.8
Czechoslovakia	5.9	173	3.23	7.9
Lithuania	3.6	159	4.61	12.4
Hungary	6.0	185	2.98	10.1
Latvia	n.a.	n.a.	4.96	14.8
Estonia	n.a.	n.a.	4.57	12.1
Portugal ¹	7.0	383	2.57	4.2

¹- Portugal is provided for comparison

Source: Davis, 1993: from World Development Report 1993, Investing in Health (New York, Oxford University Press, 1993).

Generally, whilst there is comparatively low expenditure on healthcare in CEE countries compared with Western Europe, there is reasonable or good provision of medical facilities and staffing levels are high (Table 9.1). This positive pattern, however, masks a trend of declining adequacy of health care, reflected in falling life expectancies and rising mortality and invalidity rates (Davis, 1993). Once again, the problem is one of quality rather than quantity of provision. There is a lack of modern equipment, pharmaceuticals and sometimes hygiene articles, compounded by a lack of hard currency which limits the ability to import supplies. Inadequacies in provision are magnified by changing patterns of need caused by increasing poverty levels which worsen living conditions and standards of nutrition and so increase vulnerability to disease: male life expectancy has fallen in Lithuania to only 63 years and in Latvia to 61 years. Clearly, the future adequacy of provision will depend not only on how healthcare is managed, but also on economic performance and future demographic trends.

With insufficient resources for higher public expenditure, solutions must lie in spending more efficiently. This is the priority in Lithuania, Latvia and Slovenia. In Latvia, outpatient treatment is being increased to reduce the need for hospital beds. Incentives are being considered in Slovenia as a means to encourage customers and providers to use resources more cost-effectively. A further recurrent reform is the introduction of a system of general practitioners to replace the system of specialist doctors. Such 'family doctors' are being introduced in Estonia, Latvia and Romania. A change in focus towards preventative healthcare is also underway.

Free, universal access to the state-run healthcare system is being maintained in most countries (eg. Romania, Latvia and Slovenia), but the introduction of a health insurance system is under discussion in Lithuania. Private health care provision is also beginning to appear in some states.

Turning to the regional distribution of provision within countries, this tends to be fairly balanced thanks in part to former policies of even territorial development and universal, equal access to social welfare facilities. More specialised services would be spread across countries, at regional centres accessible to their whole regional population. As such, in Slovenia for example, satisfactory health status indicators are being achieved throughout the country.

9.5 Summary and Outlook

Large changes are currently affecting the social infrastructure provided in CEE often with painful consequences. In particular, the forces of industrial restructuring in CEE have widespread ramifications for current vocational and educational systems. The closure of traditional industrial establishments and the development of new industries and technologies are forcing policy makers to develop appropriate methods of skills development needed in a modern market economy CEE. Owing to the severe financial restrictions, however, these changes are being implemented rather haphazardly. It is also notable how some regions and countries, usually the most urbanised and developed, are those best able to accommodate this changing situation.

This restructuring process is most apparent in secondary and higher education where traditional methods of education are too narrow and inflexible to deal with the broader range of skills and technologies now developing. Although some progress in this direction is evident, lack of financial resources often means that contradictory policy goals are being pursued. This is illustrated by the situation in Poland where increasing students are going into higher education while pre-school provision is being reduced. A similar situation exists in the provision of training which -although now being given greater emphasis- stills lacks sufficient resources to deal with the magnitude of the problems confronting CEE. Diminishing resources available for public expenditure and the lack of modern medical equipment, are also placing severe limitations of the level of healthcare throughout CEE. Unfortunately, this is occurring at a time of increased poverty and worsening health records in many parts of CEE.

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10. ENVIRONMENT

10.1 Introduction

Heavy industrialisation - which began in the wake of World War Two, under pressure from the Soviet Union - has caused a rapid deterioration in environmental quality in many regions of Central and Eastern Europe (CEE). Rapid industrial development, the inefficient extraction of raw materials, obsolete technology and a lack of environmental regulatory controls have all contributed to serious environmental problems. Furthermore, the true extent of environmental degradation preceding the economic transformation process was often inaccurate - as a result of unreliable monitoring and/or governmental censorship. As a consequence of this confusion, the perceived image of the CEE region has often led to an over-simplification and under-estimation of both the extent and the spatial pattern of environmental problems

There can be no doubt that the initial concern for the environment had highlighted not only the enormous difficulties facing CEE governments in terms of environmental pollution, but also the need to fundamentally redirect environmental policy and practice. This is perhaps best illustrated by the initial transition period in CEE during which much effort and focus of activity was devoted to environmental issues. Indeed this early concern and realisation of the difficulties faced partly reflects the sustainable policies pronounced by the EU itself, and of the many declarations of intent and problems which had been faced within the original member countries themselves. However, during the formative years of the EU, many of the concerns of the original members of the EU, evolved within a policy framework which considered the economy as a priority, and paid little attention to environmental considerations. Indeed, according to Roberts: "...the EU during its early years of its development placed considerable emphasis on the achievement of economic growth at the expense of the environment" (Roberts 1996). To a certain extent, a similar situation existed in the early period within the former socialist countries of CEE and the Soviet Union, where economic output and industrial productivity took priority over considerations concerning the environment.

Nevertheless, by the end of the early 1970s, the first formal signs of environmental recognition within policy guidance were seen. The need to redirect policy in both an integrative and pro-active manor within CEE can be illustrated through the EU's policy formation regarding the environmental aspects and considerations within both the Single European Act and the Maastricht Treaty. Furthermore, the integration of pro-active policies within CEE environmental policy can be regarded as a fundamental element of the Fifth Environmental Action Programme and Europe 2000+ documents. Indeed, the Fifth Environmental Action Programme emphasises four key aspects of concern for all CEE countries: industry, energy, transport and agriculture. These four aspects will be considered later. These aspects of policy direction are also complemented by measures such as the improvement of environmental data, the promotion of sustainable planning policies, and the use of economic and fiscal instruments. Such elements are important to ensure a sustainable interrelationship between the socio-economic development of CEE countries and the protection of the environment.

While the Fifth Environmental Action Programme spells out the main concerns regarding sustainable development and planning solutions to environmental problems within CEE, the Europe 2000+ document represents a starting point from which actual policy and programme formation can be developed. Europe 2000+ emphasises not only the need to protect fragile environments, but also to ensure the integration of environmental considerations within planning policy and to promote co-operation and integration of environmental policy at a trans-national level. However, the following sections of this chapter illustrate that the translation of such policy statements into practice may continue to prove an extremely difficult task.

10.2 The Impact of Transition

10.2.1 Political Factors

The growing opposition to environmental degradation during the 1980s throughout the CEE can be regarded as a factor in the eventual transformation from a set of centrally-planned to free-market economies. The initial transition period had seen a number of environmental activists and organisations entering the parliamentary framework. In Poland during 1989, for example, there were environmental discussions between Solidarity and the communist government. Similarly, Bulgaria's transition was overseen by Ecoglasnost.

The transformation within government facilitated a more optimistic approach to environmental problems, characteristic of the first two years of the transformation process, during which time, support in the form of western investment and environmental aid, the mechanics of a market economy as well as the construction of more effective legislation illustrated this optimism. Although some improvements had been achieved by 1992, much of the initial optimism had faded. Progress was undeniably slower than expected. For example, many of the newly elected governments, particularly in Poland had short-term objectives which included the closure of the most polluting industrial enterprises. Excluding the 800 sites identified by the provincial governments in Poland, out of the 80 sites identified by the national government as the worst polluters during 1990, only 26 had been closed or restructured three years later.

The focus upon the environment had lost momentum and became less of a priority - indicative of both public perception and government inaction throughout many CEE countries. For example, voting patterns during the 1992 elections in the Czech Republic highlighted this social trend, when the former finance minister, Vaclav Klaus, became the new Prime Minister - while both the ministers of economy and finance became more influential within his government, the ministry of the environment became less influential. Indeed, many of the original individual members within government circles who regarded environmental change as a top priority became powerless and had little influence over national environmental policy. Many of the linkages and influence that environmental NGOs enjoyed have been lost. Although the change in emphasis and priority for the environment within many CEE

countries has altered, and while the process of environmental improvement has considerably slowed down, it has not been completely ignored.

Nevertheless, the process of improvement cannot be stopped - all countries within CEE are obliged to improve laws and standards which will comply with EU norms. While some of the regulations which have been adopted in CEE countries have even been more stringent than Western standards, the implementation of them seem at best a little unrealistic considering the enormous variety and frequency of environmental problems. Indeed, this had been a recognised problem throughout the former Soviet Union and to a lesser extent within CEE. Although both public and government support of the environment has waned, these are not the only factors impinging upon the improvement of environmental conditions.

10.2.2 Impact of Industrial Restructuring

Another factor which has indirectly impinged upon the environment has been the process of structural reform, in particular privatisation. The initial belief that the process of privatisation, foreign investment and the removal of state control beginning in 1990 would quickly improve the deficiencies of industry, now appears overly optimistic. The pace of the restructuring process failed to take full account of the limitations of the free market and the practical considerations of policy implementation. For example, while some sectors of the regions' economy, such as retail and construction, enjoyed some measure of success and relatively quick progress, other sectors, especially heavy industry, made considerably less progress.

The effect of the privatisation process upon the environment was not fully appreciated at this time, as those sectors of the economy which had the worst effect on the environment, such as heavy industry, were weakened during the process of restructuring. As already mentioned, even though significant reductions in pollution emissions have been identified within this critical sector of the economy, these are largely the indirect consequence of reduced productive output rather than by any systemic development.

The beneficial effects of restructuring the economy through privatisation was also hindered by the clear differences between environmental protection in the developed western economies and the economies of CEE. According to Fodor (1994), this imbalance in the level of environmental protection between east and west has stimulated the "flow of active capital (especially in the form of second class, environmentally polluting technologies which are capable of profit-making) to underdeveloped countries means a considerable danger since the main motive is to face less strict regulations."

Experiences within Hungary, indicative of the general situation throughout CEE, illustrates that many business transactions, which increasingly threaten the environment are accepted within economic considerations which overshadow environmental considerations. One problem, again common to most CEE economies, is that many dangers emanating from environmental pollution and resource degradation are often socially accepted, perhaps understandably given their present

situation. To compound this problem, the task of identifying and eliminating elements of the economy which harm the environment, such as outmoded industrial technologies and production and patterns of consumption, is much more difficult, and is according to Fodor (1994) “very difficult in a situation where not only a few critically significant companies and branch specific lobbies are to be fought against, but tens of thousands of business actors and hundreds of thousands of regular customers.” This problem has prevailed throughout the expansion of the private economy. Furthermore, the privatisation process, the proliferation of businesses and the liberalisation of business regulations have all imposed additional strains on the environment.

Although there was a visible indication of a reduction in the level of emissions from environmental pollutants this has been regarded largely as a consequence of a combination of factors: the closure of industrial facilities; the more efficient operation and installation of pollution technologies emanating from direct budgetary allocations and foreign credits; pro-environmental legislation; and the marked reduction of industrial output. Even both unofficial and official reports from a number of environmental ministries within CEE countries had pointed to the fact that as a consequence of the recession there had been a decline in emissions of between a fifth and a quarter in the two years following the transition, with further reductions expected in the following years.

While there may have been some environmental benefits as a consequence of plant closures and the more efficient operation of filters (largely as a consequence of the reduced output of industrial processes), their impact has been limited. As already suggested the main reason for the fall in environmental pollution has been the reduction in industrial output as a consequence of economic recession, rather than the refinement and application of production techniques. The dangers associated with this concerns the potential effect upon pollution levels if they return to their original production levels. Industrial productive capacity had seen cuts of up to one third or more during a period of several years. Although the downturn had begun in several CEE countries prior to 1989, the recession and subsequent downward trend in industrial production became much more widespread during the early 1990s. The decline in production levels became more serious due to both the previous links with COMECON being broken and trade barriers for western exporters removed, respecting the new free market policies. Furthermore, the shock of structural reforms and in many cases the IMF’s stabilisation policies also exacerbated the situation.

The decline in industrial production was, however, uneven, and affected different regions in different ways. For example, in the three years since 1989, Bulgaria had seen a reduction in productive capacity of over 50 percent; Romania by just under 50 percent; Hungary and the Czech Republic with the most competitive industry reduction were more modest at between 30 to 40 percent. Industrial production in regions which had undergone penetration by western suppliers and also where such concerns had depended upon shipments to the former USSR, fell the most dramatically. However, by 1992, evidence was beginning to illustrate some small decrease in the rate of decline throughout the region.

10.2.3 Environmental Regulation

One of the proposed remedial actions which plays a central role within environmental policy, is that of regulation, monitoring and enforcement of environmental standards. Although privatisation opens the opportunity for improved regulation and recognition of environmental responsibilities, in the case of both private and state-owned enterprises these responsibilities have largely been neglected. In many cases foreign investors have minimised their liability for past environmental damage. (This issue will be discussed in a later section.)

Most CEE governments have set schedules for compliance with new standards on pollution, introducing economic incentives to minimise pollution, and enhancing principles governing environmental regulations such as: polluter-pays principle; free-public access to information; and policies encapsulating the principles of sustainable development. However, implementation of the most crucial elements of environmental protection - monitoring and regulation (and therefore enforcement) - in most CEE countries has largely failed due to a number of factors. The first factor concerned the decentralisation of responsibility for both monitoring and inspection. As the responsibility of these two aspects of regulation were decentralised, implementation was the problem - mainly a consequence of a lack of the necessary resources to implement the new regulatory standards. The second constraining factor was the lack of suitable control technology. Much of the pollution control technology used by enterprises was insufficient to curb all necessary emissions of pollutants, and resulted in only a small percentage having the correct equipment to reduce all the pollutants included within the environmental regulations. The third factor stems from the overall recession and the subsequent low priority given to the environment. This resulted in a lax approach to the gathering of revenue from pollution charges and fines.

The problem of contamination from various industrial complexes, stemming from the pre-transition period, has also considerably constrained the process of environmental recovery. The problem of environmental liability for contaminated industrial sites, which lacked credible environmental recovery programmes had little chance of financing the transformation of polluted sites. The problem was twofold: not only was western investment capital unwilling to accept financial responsibility for decontamination, but the large majority of polluted sites - mainly state-owned enterprises - lacked the necessary resources for achieving their own environmental regulations. Indeed, many of the largest industrial complexes which suffer from the worst environmental record, remain state-owned and are faced with the largest financial responsibility, which in many cases remained unfulfilled.

On many occasions, the financial obligations concerning environmental liability have resulted in many potential investors, especially within Western Europe and North America, being discouraged from investing. For example, one survey involving the World Bank and the OECD, concerning the attitudes of potential investors, suggested that as many as two-thirds of businesses questioned, regarded environmental risks as important as non-environmental risks when assessing investment opportunities. Some environmental risks included: liability for past contamination; uncertainty regarding present standards, and the unpredictable nature of clean-up costs. In many

cases involving investment, if the investor did not raise the issue of environmental liability, it was often not addressed. This situation had an obvious negative impact upon the privatisation process within CEE as well as limiting environmental responsibility and recovery.

10.2.4 Role of Foreign Aid

One factor concerning the improvement of the environment regards foreign aid and financial support. The level of support since the early 1990s within CEE countries has provided only a small fraction of the investment which was required. Even during discussions at the 1995 Environment for Europe conference in Sofia, which was primarily concerned with national action programmes, no promises of financial support were given. In fact, Western donors regarded financial support as a catalyst for change, expecting the recipient countries to pay for the bulk of environmental improvements. The total cost of environmental improvements has until recently been unclear. The most recent estimate comes from the PHARE aid programme, and suggests that a substantial improvement will cost in the region of 300 billion ECU over the next 15 years. From Table 10.1, it is clear that there is a considerable shortfall in the level of environmental aid to CEE.

Many Western donors had a considerable influence in the choice regarding which projects secured funding and those that did not. Very often this resulted in the support of projects which were not necessarily the most urgent but which enjoyed greater publicity. Even though many CEE governments began to exert more influence over project funding since the early 1990s, the final decision has remained with the donor organisation.

Table 10.1: Major sources of environmental Aid to CEE, 1990-1995	
<i>Donor</i>	<i>Amount* (in million ECUs)</i>
Austria	59.9
Denmark	92.2
Finland	36.0
France	11.2
Germany	392.4
Japan	13.0
Netherlands	32.0
Norway	27.1
Sweden	51.7
Switzerland	41.5
UK	10.2
USA	74.8
EBRD	667.1
EIB	196.9
GEF	49.4
NEFCO	29.0
NIB	35.3
World Bank	1,243.9

EBRD-European Bank for Reconstruction and Development

NIB-Nordic Investment Bank

NEFCO-Nordic Environment Finance Corporation

(*includes donations and loans, delivered or promised.

Source: Western environmental Assistance and Finance to CEE countries - Brussels task force for implementation of the Environmental Action Programme for CEE (1995)

10.2.5 Waste Disposal

The problems posed by the environmental impacts associated with waste generation and disposal requires a much more concise and reliable source of information regarding different types of waste materials. Although many problems within CEE countries are inherited from the socialist era, new problems are emerging as a direct consequence of the opening-up to western markets. One such problem which poses another stress upon the environment is that of municipal waste. The situation was clearly outlined during 1992, by Stefan Kozlowski, Poland's Minister of the Environment: "Mindless fascination with the western way of life and economic model may lead to an artificial and unwarranted rise in the consumption of goods that are of little worth and use. Consumption is by nature hostile to the environment and in the long run poses a threat to human civilisation as a whole" (Manser 1993).

The introduction of a variety of new consumer goods, with their associated retail operations, has led to a significant increase in the volume of waste produced. To compound the problem of increasing volumes of domestic waste, management

programmes are virtually non-existent. For example, the Visegrad countries dispose of nearly 80 percent of their waste in landfill sites - the highest figure in Western Europe is 60 percent (Bisschop 1996). Recycling has also declined. Western techniques of food processing and storage, forced out a lot of the more environmentally acceptable materials extensively used in CEE markets.

The future prospects seem set to follow the experience of most Western European economies. For example, the investment analysts, Credit Suisse First Boston, have estimated an increase in domestic wastes of 50 percent by the year 2000 (Manser 1993). The pattern of increasing domestic waste is particularly prevalent in the large urban agglomerations, such as Prague, Warsaw and Bratislava. In Prague, for example, according to estimates, waste levels have increased by 50 percent since 1990 (Bayliss 1996). Furthermore, the situation here, similar to other CEE countries, is exacerbated by the lack of a central waste management plan.

While there are many variations in the composition and causes of waste materials throughout CEE, the various processes causing them and measures taken to reduce them are broadly similar. As already mentioned, the process of increasing domestic waste has made a substantial impact upon the environment. Yet another source of waste evolves from the trade in waste materials coming from western European countries. For example, when Poland lifted its trade barriers to the West during the late 1980s, its lack of environmental laws regarding importation of waste materials increasingly threatened the environment. Even when a complete ban on imported waste materials was introduced during 1989, it made little progress. On several occasions, the ban was relaxed on the basis of the economic benefits arising from importation. This eventually led to a partial relaxation and introduction of a less rigid law during 1993, allowing for the importation of secondary raw materials for processing. The significant cost advantages and comparatively lax environmental regulations were a major pull factor for many prospective western firms. This coupled with poor waste management techniques, regulation of waste content, lack of sufficient resources and control over volumes and variation in waste content has caused an increase in the volume of pollution emissions into groundwater and soil resources, as well as causing the formation of other, often more dangerous toxic wastes such as methane, mercury and CO₂. Even though many land-fill sites have been replaced by incineration, this can create new problems, often worse than those originally encountered from landfill sites - ie. dioxins, hydrochloric acid and mercury.

10.2.6 Energy

(i) Energy usage

The main problem associated with environmental pollution within CEE, especially during the initial period of reconstruction, concerns the production and consumption of various forms of energy for industry, agriculture, transport and the domestic sector. While most CEE countries undoubtedly suffered from atmospheric pollution as a consequence of the burning of fossil fuels, problems existed with almost all forms of energy sources and consumption, including chemical factories, steel mills and large district heating systems.

In the main, it was both heavy industry and fossil-fuel power generation - mainly the combustion of lignite and low quality brown coals - which created the most severe local and regional air pollution problems, particularly severe in highly industrialised regions. The combination of heavy concentrations of mining poor quality coal, a high level of industrial development, inefficient energy infrastructure and power generation has left many areas facing long-term pollution problems.

The main problems associated with energy at this time were: the inefficient production and consumption of energy; securing alternative sources of energy; and the structure of the power industry. As a consequence of the low price of commercial and domestic fuel, energy consumption increased alongside economic growth. Not only was energy consumption high, but when compared with all western economies in terms of unit value per output, CEE countries were seven times less efficient. This illustrates the high proportion of energy intensive extractive industries (often spatially concentrated), the greater use of raw materials and energy within manufacturing and the lower added value of raw materials processing than manufacturing. Furthermore, within industry, the production of energy was also significantly less efficient than the west. For example, mining coal was highly energy intensive and has become even more so as coal seams become exhausted.

This is a major problem in CEE: estimates by the European Bank of Reconstruction and Development (EBRD) suggest that the first few years following transition, CEE alongside the former Soviet Union lost approximately one-third of total energy through conversion, distribution and inefficient consumption (Manser 1993). Any efficiency improvement would require: further restructuring of the economy and individual enterprises; new legislative measures; and investments in energy production, distribution and consumption. As already mentioned consumption rates were high, and expected to remain so. While higher energy prices alongside other technical improvements reduced consumption, the burden was placed on the domestic sector.

Other measures to improve environmental conditions lacked the urgency required to initiate the necessary changes. For example, energy conservation was awarded little attention by the most CEE governments, with most schemes reliant on financial support from international agencies. Although energy consumption in most CEE countries fell, it was at a much slower rate than the fall in aggregate output, which equates with an overall reduction in energy efficiency. For example, during 1989 and 1991, while Polish industrial consumption fell by 25 percent, the value of industrial output declined by 33 percent.

(ii) Oil and coal

In terms of production and consumption of energy, the use of fossil fuels, and in particular, low quality brown coal and lignite, has remained the main source of energy for most CEE countries. However, in both Hungary and Romania, oil and gas were also important. The inefficient and widespread use of low-grade coal and lignite led to the creation of highly polluted regions within national boundaries. Again the

'Black Triangle' - covering the border regions of Poland, the Czech Republic and the former East Germany - was undoubtedly the worst area throughout CEE with the highest concentration of industry and with much greater incidences of health problems, with pollution levels up to 200 percent higher than average figures. This is considered a major problem in the Czech Republic, where over half the electricity is generated from high sulphur brown coal. A further problem stems from the fact that extraction is concentrated in one region - Northern Bohemia. The combination of heavy concentrations of mining poor quality coal, a high level of industrial development, inefficient energy infrastructure and power generation has left this area as one of the most polluted regions in Europe, with the highest recorded emission levels of carbon dioxide in Europe.

To exacerbate the problem of both energy and industrial production, the introduction of market prices has stimulated the use of cheap coal and restricted the use of more costly alternatives, such as imported refined energy products i.e. natural gas. Also, the disproportionate increase in lignite prices compared to hard coal, has, in certain instances, led to an increase in lignite consumption for industrial purposes, thus causing further pollution. It is suggested that even if the appropriate technology and capital was available for efficiency improvements, the existing economic, management and resource structures are not sufficiently prepared to operate and absorb such changes to maximise energy efficiency and minimise pollution levels.

(iii) Nuclear power

The nuclear power industry within CEE is perhaps less pervasive both in terms of a source of energy than traditional fuels, and in terms of quantity of pollutants. As the Chernobyl example has illustrated, radioactive pollution is a major cause of both public and official concern and a source of enormous hazard. Indeed, during 1991, Austrian concern over the risks posed by two of the reactors at Bohunice in Slovakia, led to the offer of the subsidised construction of a new conventional power station on the basis of closure of two out of four nuclear plants.

Unlike traditional sources of energy production, which often cover large areas, nuclear sites are spatially concentrated. The case of the nuclear industry in CEE illustrates the problems regarding concentrated sources of pollution but also their dispersal over many hundreds of miles. The former military factory in Sillamae, in the northern coast of Estonia, has not only caused the extensive dispersal of pollutants into the Gulf of Finland, but has also left behind approximately 5 million tons of radioactive and toxic substances, causing enormous difficulties for the clean-up operation. Problems regarding soil and ground-water pollution as a result of nuclear facilities is also a problem in both Hungary and the Czech Republic, where approximately 50 percent and 30 percent respectively, of all electricity is generated through nuclear power. In Bulgaria, six sites are located at Kozloduy; in the Czech Republic four at Dukovany; in Hungary four at Paks; Slovenia has four at Bohunice, with two under construction at Mochovce; Romania has five units under construction at Cernavoda. With increased pressure applied since the transition period, governments in CEE have found it necessary to improve safety standards. This has led to an increase in western companies securing business, largely as a consequence of

the financial constraints CEE governments had when attempting to incorporate safeguards.

(iii) Gas

Although the advantages of gas as a source of power - lower SO₂, particulates and CO₂ emissions, and lower energy cost of extraction - were recognised by CEE governments, the inflated infrastructure costs and time taken to increase supply to a significant level, largely offset the benefits. Other than Romania, and to a lesser extent in Hungary and Poland, over half the gas consumed was supplied by Russia. Furthermore, gas imports were forecast to rise in most countries, other than in Romania where gas consumption was used to compensate for the shortfall in coal and dwindling local supplies. Many CEE countries have sought to diversify the source of their imports from other suppliers, such as Turkey, Norway and Algeria.

10.3 Environmental Challenges

Both the nature and extent of environmental problems stem from a combination of factors: industrial production and waste disposal, energy production, and consumption and agricultural and urban sources. The first main source of pollution within CEE evolves from industrial production and waste disposal. This source of pollution results from the lack of fundamental environmental controls concerning industrial processes and the lack of regulatory controls regarding industrial, municipal waste and effluent disposal. In Poland, for example, industrial waste accounts for over 90 percent of the total waste produced from all sources (Manser, 1994). While a decline has been recorded, this is largely a consequence of reduced output levels with only a small reduction achieved through waste reduction efforts. Poland still remains one of the major generators of industrial waste in Europe - the amounts generated in 1992 were around 1800 million tons, covering a total of 11,400 hectares.

The well-documented dangers associated with concentrated sources of pollution, are further exacerbated by trans-boundary pollution, perhaps best illustrated by the case of Chernobyl. One notable example of trans-boundary pollution is particularly evident in Slovakia. While Slovakia has experienced a reduction in its own emissions of airborne pollutants - particulate matter by 43 percent, sulphur dioxides by 38 percent - it is still thwarted by the problem of trans-boundary pollution. The share of trans-boundary pollutants is higher than any other region in the CEE group, with the share in regional air pollution and acidity of rain water representing around 70 percent of the national total. Latvia also typifies the problems of both atmospheric and water pollution. In Latvia, during 1992, the volume of both domestically produced nitrogen and sulphur oxide represented only 20 percent of the national total - mainly as a consequence of an oil processing plant and cement works in Lithuania. Other countries, such as Bulgaria, are also characterised by west-east transfers of pollutants - it is estimated that the amount of trans-boundary pollutants entering Bulgaria represents about half the volume of national emissions.

One of the first reforms initiated by the new governments of CEE was the reduction of subsidies for energy and raw materials. By reducing the estimated cost of subsidies of US\$180 billion a year, energy price reforms could, according to World Bank estimates, reduce the level of particulate matter in the atmosphere by 80 percent by the end of the century. In Poland, this led to an increase of 400 percent in the cost of lignite, with a parallel reduction in energy consumption in the industrial sector (Manser, 1994). However, in Poland, the Czech Republic, Slovakia and Hungary such reductions were less than the drop in industrial output, which translates as a less efficient use of energy. Increases in energy prices have also been regarded as a tax on domestic users, whose usage is relatively inelastic.

While the impact of *agriculture* upon the environment is not as critical as industrial and energy production, it still remains a significant source of environmental deterioration. Soil degradation, pollution and loss of productive land is caused through erosion, salinisation, water logging, humus loss, the operation of large livestock units, general neglect and by contamination by toxic substances. While pollution from agriculture only emerged as a problem in the 1960s and 1970s, changes in agricultural practices intensified the scale of the problem. The extensive developments in the chemical industry led to the widespread adoption of new fertilisers and pesticides with the aim of increased agricultural production. This led to problems concerning the leaching and build-up of toxic substances in the soil, with eventual reductions in agricultural productivity. The consequences of these processes, such as ground water pollution of domestic supplies and soil contamination, can be regarded as a common problem in CEE countries. In Hungary, while industry uses 75 percent of all water consumed, agriculture accounts for around 13 percent, and is the second largest source of water pollution. The consequences of the rapid growth in agricultural output, which began in the early 1970s, was an increase in ground-water and soil pollution, again a result of a limitless use of chemical fertilisers, pesticides and other chemical inputs.

Another major and developing source of environmental degradation stems from *urban agglomerations*, in particular those areas associated with heavy industry. One important and emerging source of pollution from such areas evolves from traffic. Up until the 1960s the main source of traffic pollution evolved from the relatively uneven spatial rail-network, largely indicative of long-term industrial developments. The main problems areas are situated in the heavy industrial and urban centres with regions such as Upper Silesia, Ostrava/Katowice and North Bohemia all indicative of an over-concentration of rail-traffic networks and subsequent pollution. Since the 1960s, the significance of road traffic as a source of pollution has gradually become more apparent, with significant numerical increases especially evident from the 1970s onwards. Hungary, for example, has recorded an increase in the number of motor vehicles from 238,563 in 1970 to over 2 million in 1990 (Fodor 1994). The growing significance of vehicular traffic as a source of pollution is also evident in other CEE countries particularly Poland and the Czech Republic. In Poland, for example, the level of NO_x emissions is estimated to increase from around 55,000 tonnes in 1989 to around 100,000 tonnes by 2000. The opening up of CEE countries and the new trading links with western Europe will lead to further increases in both passenger and freight traffic. Such increases have led to a higher percentage rate of growth in car ownership than in Western Europe. This considerable increase in the number of

vehicles - often in poor condition and violating emission standards - highlights the growing importance of air pollution as a source of environmental pollution. Without any regulatory policy measures in place, growth will continue to concentrate on road transport of freight and passengers.

10.4 Regional Differences

Areas which are most likely to be affected by pollution are mainly reflected in their level of urban - industrial development and size of population. This is particularly apparent in most CEE countries largely as a consequence of concentrated environmentally damaging production, close to the centres of raw materials and energy resources. The outcome is a strong regional aspect to the pattern of environmental damage. The following sections briefly illustrate this aspect, focusing in particular on the six main CEE countries - Poland, the Czech Republic, Romania, Hungary, Slovakia and Bulgaria.

10.4.1 Poland

Poland has perhaps the worst environmental record with 27 areas considered as ecologically sensitive. The worst areas indicative of the earlier development of heavy industry, and in particular extractive industries. In Poland, the worst areas are located in the south and south-west border regions - Legnica-Katowice copper basin and the Glogow-Ryback coal basin. Two other major areas of pollution are located in the Baltic coastal region; the first to the north, Gdansk, and the other, Szczecin, on the border with Germany in the north-west of Poland. The area with the worst pollution is Upper Silesia. This region contains a total of 742 pollutants registered as causing a major hazard to both public health and the environment. The region produces 25 of all industrial dusts, almost 30 percent of all gases, 25 percent of all non-cleaned sewage and around 60 percent of all industrial solid waste. Depending on the scale of analysis, some areas can exceed average pollution emissions by up to 200 times. The effects clearly endanger public health and exceed averages by: 10 percent more deaths from cancer; 20 percent more due to heart disease; 45 percent more complications during pregnancy and 10 percent more premature births.

Waste disposal and generation are also spatially concentrated - in Poland during 1992, 85 percent was disposed in six *voivodships*, 70 percent of which was produced in the two border *voivodships* of Katowice and Legnica. It is this spatial concentration which often adds to the problems of pollution.

10.4.2 *The Czech Republic*

The Czech Republic (CR), similar to the Polish case, suffers from widespread environmental degradation. Environmental problems in the CR are highly regionally concentrated, with the principal urban areas - especially the capital Prague, Plzen and Brno, as well as the more important industrial centres, such as Northern Bohemia and the Ostrava-Karvina region in Moravia - particularly badly affected. The most severely affected region is Northern Bohemia - especially the area of the Ore mountains together with the adjacent border districts in Germany (Saxony), and Poland (Silesia), referred to as the 'Black Triangle'. Eight out of the largest emitters of SO₂, NO_x and particulates in the CR are situated in Northern Bohemia, and lack adequate pollution abatement equipment. In terms of the emission of SO₂, Northern Bohemia, and in particular the district of Chomutov, ranks as the highest, with almost half the national total is produced. The most obvious sources of pollution mainly evolve from coal extraction, energy production and the chemical industry. Northern Bohemia also produces almost 30 percent of NO_x and 25 percent of particulates; again largely the consequence of coal-mining activities and coal-fired power stations in this region. While Northern Bohemia is indicative of a high overall concentration of pollution, significant emissions can also be found in districts within regions where overall percentage emissions are lower.

This highlights the importance of an examination of pollution problems at a sufficiently detailed scale, and which can identify particular sites which would otherwise remain unidentified within regional or national averages. Districts containing energy and/or chemical production facilities, such as Trutnov in Eastern Bohemia and Hodonin in South Moravia are all significant sources of pollution, even though regional levels appear relatively low. Nevertheless, such emissions, in terms of public health and effects upon the environment are significant. Furthermore, serious emissions are also present within towns with a high density of population and growing traffic problems, Prague being the most obvious example.

Even though the highest emissions of hydrocarbons are found in South and North Moravia, concentrated sources can often create more severe localised pollution concerns. (Again Prague and other large urban agglomerations are illustrative of this type of problem.) Highlighting the need for a considered and concise examination of average pollution figures and geographical variations. The general picture regarding pollution is however, not always a true reflection of pollution deposition. As already mentioned, transfers of pollution can be a considerable problem, not only between regions but between national boundaries too. In 1990, pollution transfers of SO₂ and NO_x into the former Czechoslovakia were estimated at 45 percent and 81 percent respectively. However, transfers to other countries such as Slovakia and Poland were even higher.

10.4.3 Slovakia

In Slovakia, there is a substantial spatial pattern in terms of general trends of pollution. However, utilising a collation of various numerical data from 1993, drawn from both official environmental publications and other sources (NGOs), a general typology of regional environmental quality has been collated. The most important dimension of the typology points to around 41 percent of the population living in an extremely polluted environment. This proportion of the population was mainly found throughout nine regions including: Trnava-Galanta; Upper-Nitra River-Basin; Upper-Vah River Basin; Middle-Hron River Basin; Central Spis; Central Gemer; Kosice; and the Central Zemplin region.

While these regions have experienced a reduction in levels of pollution emissions, largely as a consequence of reduced productive output and general economic recession, and to a lesser extent the changes in product mix and implementation of remedial action, problems still remain. For example, even though there was a partial transition from coal to gas, levels of pollution still remain high when compared to regions within Western Europe.

Levels of SO₂ emissions have gradually reduced since the 1980s. While the Slovak Republic generated 780 thousand tons of SO₂, the figure by 1994 had dropped to 235.7 thousand tons of SO₂. The main source of SO₂ emissions evolved from the following regions: Prievidza; Bratislava; Trebisov and Kosice. All these areas are indicative of heavy industry and high urban density. Similarly, particulate levels have declined. In the nine years since 1985, there had been a drop from 357.7 thousand tons to 87.3 thousand tons. The following districts account for the higher figures: Kosice; Trebisov; Prievidza; and Spisska Nova Ves. A similar pattern is repeated for NO_x emissions with the aforementioned districts accounting for the highest concentrations.

Although Slovakia has experienced a reduction in pollution emissions, care must be taken when assessing the extent of the problem. The significant problem of trans-boundary pollution complicates any firm conclusions regarding environmental deterioration and illustrates the necessity of trans-national co-operation within environmental policy. This is especially pertinent when considering Slovakia's geographical location and resultant climatic patterns. It is estimated that Slovakia suffers from trans-boundary transfers of up to 70 percent, mainly in the form of atmospheric pollution emanating from the Czech Republic, Hungary and Poland.

10.4.4 Hungary

The deterioration of the environment in Hungary is less severe and widespread than in both Poland and the Czech Republic, although the country faces similar severe problems in certain regions and sectors. With the advent of socialism, the outcome of Hungary's rapid industrial development was a relatively concentrated 'industrial crescent', stretching from Ajka, Gyor and Tatabanya in the west to Miskolc and Ozd in the east. While some industry appeared in provincial cities, it was this 'crescent'

where concentrations of industrial activities and domestically produced pollution evolved.

While trends in air emissions levels have improved, especially for particulates and SO₂ (around 30 percent and 25 percent reductions respectively between 1980 and 1993) these were largely a consequence of a reduction in industrial output and economic growth. If we consider the trends regarding the example of NO_x reductions these have been much slower. Again, similar to other CEE countries, NO_x and CO emissions have proved more difficult to cut, due to the significant increase in the volume of vehicular traffic.

As early as 1974, the National Ground Level Concentrations Monitoring Network was established to provide continuous data on the country's atmospheric pollution levels. Results during the 1980s have illustrated a common trend: the three main pollutants - SO₂, NO_x and particulates - are most prevalent around the Greater Budapest area and the Borsod County Industrial Region. Again following the 'industrial crescent', results have shown that the total polluted area of the country amounted to 10,400km² or 11.2 percent of total territory, affecting 44 percent of the total population. With the exception of Budapest, with a population of 2.2 million or 21 percent of the total population, all areas were indicative of heavy industrialised zones.

The problem regarding such a high level of urban population is again compounded by increasing levels of CO. In terms of future problems and dangers to public health, this represents another problem emanating from urbanised areas and is largely a consequence of increased traffic. Over one million tons of CO, 130,000 tons of hydrocarbons, 120,000 tons of NO_x's and 510 tons of lead and lead compounds are omitted to the atmosphere. This is a particularly severe problem in Budapest, where between 1970 and 1990 a six-fold increase in the number of cars took place, where hydrocarbon emissions exceed permissible health standards by 8-10 times, and where early warning alarm systems have been implemented to alert the public of smog. Traffic emissions in Hungary, similar to other CEE countries, stem mainly from inefficient and highly polluting vehicles,

Water pollution within Hungary is largely a result of industrial processes, again mainly limited to the 'industrial crescent'. In particular, the large urban centres such as Budapest and Miskolc are badly affected by discharges of heavy metals and bacteriological contamination from domestic sewage. Even though much effort has been put into treatment facilities, industry, the largest user of water and source of pollution, still emits an annual discharge of 84,000,000 m³ of untreated industrial waste.

Although ground water and surface water quality within Hungary has traditionally been relatively unpolluted, there is now great concern over rising levels of contamination. A number of important rivers, including the Danube, Kapok, Tissue, Ala and Lake Ablation have illustrated significant increases in nitrate and phosphate pollution, as well as increased lead and mercury concentrations. This problem (as a consequence of industrial, agricultural and domestic activities) is not confined to the 'industrial crescent', but is indicative of the situation throughout Hungary. Over 3,000 large settlements throughout Hungary (containing 300,000 inhabitants) rely on

bottled water or other sources, and can be regarded as a consequence of rapid increase in agricultural, industrial and urbanisation activities over the past 30 years.

10.4.5 Bulgaria

Bulgaria, like its neighbour Romania, suffers from relatively high levels of trans-boundary atmospheric pollution with SO₂ transfers representing up to 50 percent of national levels, with the main problem areas in the northern boundary, especially in the areas covered by Ruse-Giurgiu, Nikopol-Turnu, Magurele and Silistra-Kalarush. The Ruse-Giurgiu area, with its Romanian neighbour Giurgiu, still suffers from air pollution problems. Although a noticeable reduction in trans-boundary pollution since 1988 has occurred, there has been a slight increase from the 1993-94 period and is indicative of an increase in production capacity. A similar trend can also be observed in the border regions at Nikopol (one of the most polluted areas in the country), Silistra and Urdin areas.

While trans-boundary pollution remains a significant source of pollution domestic air pollution also contributes to overall level. Similar to many other CEE countries, sources of air pollution are particularly problematic within urban areas and major industrial centres. The principal sources include thermal power plants, chemical plants, metal works, fertiliser and cement factories and oil refineries.

Many urban areas, especially Boutgas, Maritza-Iztok, Varna, Dimitrovgrad, Razlog, Zlatitea-Pirdop Vratza and Plumen are beset with air pollution problems. Thermal plants, for example, generate over 60 percent of Bulgaria's electricity, and accounts for high proportion of SO₂ emissions. The Maritza-Iztok thermal power generation complex, near Plodiv, accounts for around 50 percent of national SO₂ emissions. Again the use of poor quality lignite compounds the problem.

In urban areas, domestic heating fuelled by poor quality coal and lignite contributes significantly to both SO₂ and particulates. Although Bulgaria has a relatively small fleet of vehicles (1.4 million), both the age and design of vehicles increases the volume of emissions. Vehicular traffic contributes to the urban air pollution problem, with around half of all NO_x emissions emanating from this source. Many problems have been encountered meeting air emission standards, and are often exceeded in many urban and industrial areas.

Water pollution is also a significant problem. Quality of surface water in the middle to lower reaches of the main rivers, with the Danube, Maritza, Provadiiska, Iskar and Struma most severely affected. The main source of pollution is industry, particularly chemical plants, metal works and mining activities, although domestic sewage and agricultural chemicals also contribute significantly to ground water pollution. The areas of Bourgas, Stara Zagora and Turgoviste all suffer from high levels of nitrates, sulphates and some heavy metals. While there has been a preservation of pollution emissions into surface waters since 1992, it is largely attributable to a reduction in production of large industrial enterprises and large stock breeding farms. To a lesser extent the expansion of purifying stations in both industrial and domestic sectors has prevented any risk. Improvements to infrastructure and technology, and to the

outdated legislative (pre-1970 Acts) would go some way to improving water pollution problems.

Another important source of pollution stems from the Kozluduy nuclear power station near Vratsa. This power station has provided around 30-40 percent of the country's electricity in recent years. Although safety problems, a series of accidents and a highly critical report by the International Atomic Energy Agency led to the closure of two of its reactors. Plans for developing further nuclear capacity have also been shelved. Furthermore, much concern has been voiced over the extraction and processing of domestic and processing of uranium. The extensive radioactive pollution which has resulted. The government appears intent upon reducing mining activities.

10.4.6 Romania

In comparison to Bulgaria, air pollution in Romania is a severe problem predominantly in urban and industrialised areas. The main source of atmosphere pollution evolves from power stations and industrial plants, in particular the metallurgical and petrochemical industries. Furthermore, the dangers to public health are compounded by the close proximity of industrial plants to urban areas. Indeed, this problem of close proximity to urban areas can be identified in a number of occasions. The high level of pollution which stem from the metallurgical industries at Copsa Mica, Bara Mare and Zlatua, are responsible for high levels of pollution of heavy metals such as arsenic, cadmium and selenium. Although reductions, as a consequence of lower production and economic recession, of pollution emissions have occurred, air pollution remains a problem in these areas with the three main pollutants SO₂, NO_x and particulates are still found in high concentrations. This trend is also indicative of the situation in Bucharest where emissions from industrial plants (notably ceramics, glass, chemicals and engineering), power plants as well as domestic heating and traffic add to the pollution problem. Domestic heating systems contribute significant proportion of urban pollutants, as a consequence at the use of high sulphur gas oil and/or low quality coal. In a similar context, an inefficient and old vehicle fleet also contributes, through the use of fuels with a high level and sulphur content.

Other major sources of pollution stem from petrochemical plants (Brazi-Ploiesti, Onesti, Craiova, Fagaras); cement-processing plants (Bicaz, Baresti-Targu Jiu, Valea Mare Pravat); non-ferrous metals (Baia Mara, Zlatna, Copsa Mica). Acid rain has also become an important issue in Romania, largely as a consequence of the lack of pollution control technologies used in both industrial plants and the power generation industry.

Both ground water and surface water pollution is an extensive problem in Romania. Large urban areas, such as Bucharest, suffer from pollution as a result of untreated municipal wastewater (as late as 1991, Bucharest had no waste water treatment plant). Other large settlements, such as Iasi, Timisoara, Cluj and Brasov also suffered from either a lack of treatment plants and/or inefficient technology.

Discharges from both agriculture and industry mainly pose problems in rural areas, with groundwater pollution principally emanating from agricultural sources in rural

areas, but also from industrial discharges. During the early 1990s, surveys showed that as high as 90 percent of wells contained bacteria in excess of permissible standards, with some agricultural areas recording even higher levels. The predominantly agricultural areas in the south, where irrigation is extensive suffers from high nitrate pollution.

Surface water pollution is also a significant problem. By the beginning of the 1990's around 85 percent of Romanian's main rivers provided water unfit for human consumption. For example, in 1991, over 30 percent of the length of the Somes, Tisa, Mares, Olt, Jiu, Prut and Idomita rivers remained below the lowest standard (Hewitt, 95). While water demand continues to increase, the poor condition of infrastructure and lack of financial resources available, may compound the search for quick solutions, increase the cost of water usage and prevent any meaningful improvement to the condition and quality of water resources.

10.5 Summary and Outlook

Owing to the lack of reliable data (on various pollution variables), the current environmental situation in CEE remains the subject of substantial conjecture. With this in mind, the present situation is obviously difficult to properly assess. However, it is safe to say that the present level of environmental control is fairly weak and hides a picture of serious environmental degradation. Given this, making good reliable comparisons between countries is somewhat onerous. However, there does appear to be a link between the level of economic development and the degree of pollution within CEE. More advanced countries and regions (Poland and the Czech Republic) have managed, albeit to a limited extent, to diversify away from the worst elements of industry. The main spatial differences in pollution levels occur between urbanised areas and more remote rural regions. Having the most concentrated levels of industrial production and mining, the former are blighted with the worst levels. However, spatial differences are complicated by the diffuse nature of pollution.

While a small degree of progress following the transition environmental progress has been made, this has less to do with the stricter demands imposed as a consequence of EU environmental legislation and other international agreements, but as already mentioned, these improvements owe more to reductions in the levels of industrial output and general economic recession, rather than any qualitative improvement to the overall environment.

Slow progress towards environmental improvement can be attributed to the magnitude of the complex problems, the limited financial resources available and the need to maintain present employment levels. In combination, these factors have relegated environmental issues as a policy priority during the transition process. The lack of financial resources required to tackle the problem is particularly important because major changes necessary to tackle the problem require substantial financial outlays. For example, the problems associated with improving environmental conditions cannot be achieved simply through the adoption of EU legislative and regulatory measures - although this represents an important beginning - but more importantly through the strict adherence and enforcement of such regulations. As

stated earlier, this has been a major problem, even in the more advanced CEE countries. Additionally, the political commitment given to environmental issues are often compromised by the need to maintain employment levels in the traditional heavy industries, such as energy production.

In sum, insufficient information, lack of pollution control technology, poor regulation, weak levels of enforcement, inadequate levels of monitoring and limited amounts of financial resources combine to perpetuate the present environmental problems in CEE. Not only is this harming the health and well being of the population, but vital foreign investment may be deterred from investing in CEE owing to the prohibitive costs associated with environmental improvement.

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11. REGIONAL DEVELOPMENT IN CENTRAL AND EASTERN EUROPE

11.1 Introduction

Previous chapters in Parts I and II of this Report have provided a detailed account of the main demographic, employment and economic processes and trends across Central and Eastern Europe (CEE) as well as a description of the provision of physical and social infrastructure and the state of the environment in the region. The chapters have also examined sub-regional patterns at both NUTS 1 and NUTS 2 levels, highlighting regional disparities and the factors explaining the differences.

This final chapter of Part II draws together these various analyses to discuss the overall characteristics of regional development in CEE. It begins with a synthesis of the key regional features of regional disparities in the region followed by a discussion of the regional dimension of transition - how different types of region have been affected by transformation. The chapter then considers the extent to which regional policy responses are emerging in different countries with respect to regional development concepts, strategies, policies and institutions.

11.2 Regional Dimension of Transition in Central and Eastern Europe

The ten acceding countries in CEE have a total population of 105 million. Almost 40 percent of the population is accounted for by Poland alone; over three-quarters are in four of the potential Member States - Poland, Romania, the Czech Republic and Hungary. The population of the region is generally growing slowly or declining (with the important exceptions of Poland and Slovakia), mainly attributable to declining fertility rates and out-migration. The region is experiencing a net loss of people, especially from Romania and the Baltic states. Internally, there are distinctive patterns of population distribution among the CEE countries: on the one hand, a relatively, balanced, multi-polar urban structure in Poland, and mono-centric countries dominated by populations concentrated in the capital cities, such as Hungary, the Czech Republic, Latvia and Estonia, on the other. Inter-regional migration movements appear to be slowing down, although there are still marked rural-capital movements and migration to western regions offering greater employment opportunities; intra-regional movement is also strong, especially a trend towards suburbanisation around some capitals and major urban centres. Regions losing the greatest numbers of people tend to be the less developed rural areas and eastern border regions, the out-migration of younger people exacerbating already imbalanced age-sex structures.

The movement of people is partly driven by political factors (eg. out-migration of Russians from the Baltic states) and the exploitation of new freedoms of movement, especially among ethnic groups. However, it also reflects the major economic upheaval of transformation noted in Chapter 2. Labour markets, for example, are being radically reshaped. At the outset of transition, the share of manufacturing

employment was twice as high as in Western European economies; agricultural employment was also very high; and the tertiary sector was artificially small, especially in the private services sector. Over the past five years, manufacturing employment has contracted by 10-25 percent; agricultural employment has fallen by up to 40 percent in Hungary and the Czech Republic (although less so elsewhere); and the service sector has grown by between one-quarter and one-third.

In the first years of transformation, the collapse of output was such that countries are still struggling to regain their 1989 position. Although economic data is unreliable, most countries appear now to be growing at 2+ percent per year (six percent in Poland); the small scale privatisation programmes have been largely completed and large-scale privatisation is also being followed through. The private sector share of GDP and employment now exceeds 50 percent almost everywhere - Bulgaria and Romania are lagging in this regard - driven by significant growth in the private sector (especially distribution, retail and producer services).

Unemployment rates do not reflect the scale of economic change. Across the region, national unemployment rates are in the range 10-16 percent, except in the Czech Republic and the Baltic states. Rates have been held down by excess employment or labour hoarding and considerable numbers of unregistered unemployed people as well as strict welfare and employment policies. Major shadow economies also exist, estimated at 20-25 percent of GDP and employment in some cases.

The regional effects of transition have been highly uneven. In considering the regional dimension of the transformation, a useful starting point is the conceptual framework proposed by Gorzelak (1994) whereby regions in CEE are classified in terms of their position at the starting point of transition and the degree to which they have been affected positively or negatively by transformation processes (Figure 11.1).

11.2.1 Leading Regions

The leading regions are those that have started out from favourable positions and have demonstrated the greatest potential for rapid restructuring and adaptability to market economic conditions, ie. positive continuity. These 'leaders of transformation' comprise most of the capital cities and other major centres throughout CEE. They tend to have relatively low unemployment and high rates of new firm formation, privatisation and foreign investment. This is particularly important in the case of countries with a monocentric urban structure (Hungary, Czech Republic, Estonia, Latvia) where the capital cities dominate in terms of population, employment, economic activity, intellectual and cultural life etc. Elsewhere, in Poland the best-placed regions are the major agglomerations - Warsaw, Poznan, Wroclaw, Gdansk - which have led the transformation, characterised by diversified economic structures, a high level of investment and proximity to sources of capital. Regions with a strong economic potential and adequate readiness to adapt to transformation also include the Bulgarian districts of Sofia City, Sofia, Bourgas and Haskovo - characterised by diverse and multi-functional economic structures, a favourable geographic location and transport infrastructure as well as a strong business infrastructure with available research potential.

Figure 11.1 : Typology of regions under transformation

		Post socialist transformation	
		Positive	Negative
Position in the socialist economy	Good	Positive continuity <i>(eg. major urban agglomerations)</i>	Negative discontinuity <i>(eg. old industrial regions)</i>
	Bad	Positive discontinuity <i>(eg. western regions)</i>	Negative continuity <i>(eg. eastern border areas)</i>

Source: Gorzelak, 1994

11.2.2 New Developers

Other regions in a favourable position are the ‘newcomers’ to advantageous economic development conditions - especially the western regions of the CEE countries. In the pre-transformation period, these areas were relatively disadvantaged but have been able to benefit from their proximity to neighbouring Western European regions and countries to take advantage of inflows of production investment, tourism, cross-border shopping and cross-border economic development initiatives. In Hungary, for instance, the developing market economy has revived the traditional division between the western and eastern parts of Hungary. In the western regions, development has been assisted by proximity to Austria, relatively rapid transformation of western towns, the tourist attractions of Lake Balaton and the spread of development from Budapest. This category also includes the western areas of the Czech Republic (parts of North, South and West Bohemia).

11.2.3 Disadvantaged Regions

The disadvantaged regions in Figure 11.1 are the old industrial regions. In the socialist period, heavy industrial regions were the ‘drivers’ of economic development, but have been severely affected by processes of privatisation, rationalisation, loss of markets and subsidies (although restructuring has not, as yet, affected all such regions). These regions present some of the most serious economic, social and political challenges to transformation - and ultimately to integration and enlargement of the EU.

In Poland, for example, the major regional threat to transformation is posed by Upper Silesia which is on the verge of massive restructuring and a dramatic increase in unemployment. Coal-mining, heavy and chemical industries, the most important

sectors of the economy, will have to undergo deep structural changes. The process will affect an agglomeration of four million people, the overall employment in endangered sectors numbering approximately 800,000. Some of the most negative aspects of transformation have also been particularly evident in North Moravia (Czech Republic), an area of coal-mining and heavy industry severely affected by structural change; several parts of Slovenia - Podravska (obsolete heavy machinery, textiles and chemical plants, formerly dependent on the Yugoslav market), Zasavska (highly polluted, coal mining area), Posavska (pulp and paper mills); the Koroska region (decline of steel and lead production; and the Bulgarian districts of Plovdiv, Varna and Rousse.

In Slovakia, those regions facing difficulties at the outset of transition were mostly areas whose economic structure was dependent on trade with the USSR. Subsequently districts with concentrations of armaments, machinery and metallurgy industries (Povazská, Bystrica, Zilina, Zvolen, Martin) were affected, with insufficient adaptive capability to react to the structural changes. Other regions particularly affected by high unemployment percent) are those in the east of the country (Michalovce, Kosice-district, Roznavá and Vranov nad Toplou), as well as southern regions bordering Hungary eg. Komárno, Velký Krtíš and Rimavská Sobota.

It should be noted that, although these regions may have experienced 'negative discontinuity' during the transformation process, they cannot be regarded universally as permanent losers. In several cases, they have a favourable geographic location, a relatively well-developed economic infrastructure, and considerable scientific and research potential. While not underestimating the scale of restructuring required, they have the foundations for adaptive capacity that can be exploited.

11.2.4 Backward Peripheries

Lastly, among the different categories of regions in CEE are backward peripheral areas. These have traditionally been the least developed and sparsely populated areas with poor infrastructure, low levels of education and little investment. These can be sub-divided into two groups.

(i) Border regions

Under transformation, the non-western border and peripheral regions have seen little improvement in their socio-economic position and frequently a worsening of economic conditions. In Poland, the eastern part of the country (the 'Eastern Wall') has a weak economy, dominated by the primary sector and with little inducement for transformation and recovery from the other side of the border (Lithuania, Byelarus, Ukraine). The same applies to: the crisis regions of north-eastern Hungary and the eastern border regions (backward infrastructure and society, predominance of agrarian activity and high unemployment); parts of North and South Moravia and East Bohemia (Czech Republic), particularly districts dependent on production and market linkages with Slovakia (especially in food industries); Latgale (eastern Latvia); and the eastern counties of Jõgevamaa, Biljandimaa, Põlvamaa, Valgamaa and Võrumaa

in Estonia, mostly areas dominated by agricultural production oriented to eastern markets and characterised by low qualifications among the labour force and unfavourable age structure. This category also includes some other non-western border regions, for example Slovakian regions on the southern border with Hungary, or Montana and Lovech on the northern Bulgarian border with Romania.

(ii) *Internal rural peripheries*

Apart from border regions, several parts of CEE countries can be regarded as 'internal peripheries' - rural areas suffering from similar difficulties to the border areas eg. low levels of agricultural productivity, out-migration, poor infrastructure and environmental problems. Notable examples are the Great Plain in Hungary and several regions in Romania (Sub-Carpathians and upland areas of Oltenia; Moldavia between the Pruth and Siret rivers; the Apuseni mountains; and the rural area of Banat).

11.3 Regional Development in Central and Eastern Europe

Regional development is a relatively untried area of policy in much of CEE. Prior to the transformation period, regional policy could be equated with centrally determined regional planning and the regional dimensions of national, sectoral plans. Since 1990, regional policies have been slow to emerge, mainly because of the priority being given to macroeconomic policies. Regional development initiatives have also been hampered by disputes over ministerial responsibility, the need to reform territorial administrative structures and the lack of financial resources. Comparative assessment of the regional development situation in the various CEE countries indicates three main patterns: limited emergence of substantive regional policies; weak regional development institutions; and unresolved issues of territorial administration.

Most CEE countries are aware of the importance of regional policy and have begun to develop appropriate concepts and plans. However, governmental administrations are still undergoing a learning process with respect to regional development, and financial resources are limited (apart from funding provided under PHARE and bilateral aid). Consequently, regional policies are not yet being implemented on a systematic basis - with clear objectives, implementation mechanisms and instruments - by central government. The main exception is Hungary where a settlement-based area designation system has been used to define assisted areas eligible for support from a Regional Development Fund mainly providing infrastructure assistance. Some regional incentive aid is provided in Slovenia and the Czech Republic, in the latter case under the so-called REGION programme providing a regionally restricted interest subsidy supplement on top of standard SME programmes.

Elsewhere, there are many examples of *ad hoc* initiatives as well as numerous measures undertaken on an area-specific basis by deconcentrated state offices or local governments. There are also instances of regional development initiatives being undertaken through sectoral policies such as employment or environmental policy. In most cases, these are reactive policies intended to ameliorate symptoms of regional

decline such as unemployment; they are not 'structural policies' oriented towards reconversion and development.

In developing regional policies, politicians and officials are having to confront several challenges and dilemmas. First, they face the question as to whether regional policy is appropriate at the current stage of transition. Although regional disparities appear to be widening and many traditional industrial and less-developed regions are experiencing severe problems, it is arguable that countries such as Poland or Hungary should be using scarce resources for a strong national industrial policy rather than a redistributive regional policy.

Second, most countries lack the legislative and institutional basis for regional policy. Regional development laws have been passed in some countries, eg. Hungary, but, in the majority, there is no constitutional or legal basis for regional policy. As noted in Figure 11.2, there are also deficiencies in the institutional infrastructure for designing and implementing regional policy at both central and regional levels, in both the public and private sectors. At central level, governmental administrations lack clear political and administrative leadership with respect to regional policy, and there is a lack of co-ordination between relevant government departments. In Poland, as elsewhere, there is a degree of competition between politicians for primacy in developing policy concepts and initiatives.

A similar situation exists at regional and local levels. Regional development is currently being conducted by the deconcentrated or regional representatives of central government ministries as well as networks of regional and local development agencies (again largely responsible to central government). As discussed in Chapters 2 and 3, there is a missing intermediate 'regional' level in most countries and little agreement about the optimal solution (Figure 11.3).

Third, the development of regional policy is being strongly affected by external influences. The acceding countries by definition are preparing for potential accession to the European Union. In this regard, most are comparing the compatibility of their own policy-making and institutional structures with those of the EU, especially in the light of possible eligibility for EU structural and cohesion policies. Encouraged by programmes such as PHARE, they are having to address issues such as programming and partnership in the design of regional policy concepts and institutions. Complicating the situation still further is the role of Western bilateral aid at regional and local levels, funding the creation of structures and development strategies that are not necessarily compatible with those of central governments.

11.4 Regional Policy: National Experiences

11.4.1 Poland

At regional level, as in other CEECs, different regions have adapted with greater or lesser ease to the new economic conditions. Four regional groupings can be identified in line with Figure 11.1. Leaders of transformation have emerged, characterised by a rapid move to positive growth, the quick restructuring of industry, the accelerated development of business services, a massive inflow of foreign capital and successful privatisation. The regions containing agglomerations (Warsaw, Poznan, Wroclaw, Gdansk and Krakow), as well as Szczecin and Lodz, all belong to this group.

The new 'winners' of the transformation process are western regions of Poland, able to exploit their geographical proximity to western Europe; by contrast, eastern regions on the periphery represent the least developed and most sparsely populated areas of the country. Transformation processes are relatively slow in these regions, and little economic stimulus is gained from neighbouring CIS states. Lastly, old industrialised regions, usually characterised by highly biased structures as a result of centrally planned industrialisation, have been very adversely affected by restructuring and decline. Upper Silesia poses one of the greatest threats to the process of Polish transformation, although a lack of political will appears to have hindered the start of real restructuring.

In policy terms, Poland is also typical of the majority of CEE countries where the imperatives of macroeconomic and political reform have tended to sideline regional policy issues. Regional development issues have been highlighted in official documentation but have not substantially influenced the activities of national government departments. A comprehensive regional policy concept has not yet been formulated, and the regional aspects of social and economic policies are almost non-existent. However, the profile of regional policy and development has been raised in 1994-95 with the creation of a number of task forces and sub-committees to examine the issue, and a new basis for Polish regional policies may be laid in the near future.

One of the main problems relating to Polish regional policy is institutional - there is no one administrative body responsible for this policy area. Traditionally, the Central Office of Planning prepared regional development concepts, but now has no administrative powers to represent the government in this area. As a result, several ministries operate their own 'regional policies' which are rarely coordinated. The Ministry of Labour and Social Policy has emerged as one of the main government agencies to promote this area of policy. Labour market policy identifies special areas on which some economic instruments are focused, reinforced by direct government finance of infrastructure projects located in regions endangered by structural unemployment. The distribution of this regionally oriented employment support is determined by the levels of regional unemployment as well as the pressure exerted on central authorities by regional lobbies.

A further important institutional development is the operation of some 60 regional development agencies which perform a variety of functions including assistance in the formulation of regional development strategies, the provision of consulting

services and financial cooperation with banks. At national level, the Polish Agency for Regional Development (PARR) provides some central co-ordination, training services and local infrastructure support.

The territorial administrative structure has not changed since 1989. Local governments at commune level remain weak, and the 49 *voivodships* (provinces) have become increasingly dependent on the central state. There is a political and institutional vacuum between the commune and the province (formerly filled with the intermediate *powiat* level), and the current *voivodships* are too small for many regional policy tasks. A recent National Assembly decision foresees a new, decentralised structure - 12-13 regional units with directly elected local governments; 200-250 districts; and c.2,500 communes - although other options also exist.

11.4.2 Hungary

The current regional characteristics of Hungary include a relatively homogenous ethnic, linguistic and historical situation, a weak tradition of federalism and regionalism, a highly mono-centric urban structure (focused on Budapest), and an east-west divide, with eastern regions generally having less favourable development conditions. Analysis at the level of urban districts allows the definition of eight types of region in three groups:

Areas with good economic prospects

- dynamic poles and axes (Budapest and hinterland, the largest county centres, the Danube line)
- regions along the Austrian border
- tourism regions
- stable industrialised regions

Crisis regions

- the outer periphery (north-eastern Hungary, eastern border regions)
- internal rural periphery
- depressed industrial regions

Regions with uncertain future prospects

- unstable urban regions (hinterland of medium-sized towns, areas of Pest county located in the Great Plain)

A fledgling regional policy exists in Hungary. A new Ministry for Environment and Regional Policy was created in 1990, the Regional Development Fund was reorganised in 1992, assisted areas were designated using an extensive set of indicators, and a number of regional aid programmes have been established. However, much of the action to date has been *ad hoc* and is undermined by the lack of both an overall strategy or concept and of an effective medium-level administration. Over the period 1990-94, regional development policy was aimed primarily at the alleviation of poor living conditions in backward regions, but contributed little to improving the potential of poorer regions. The government's current regional policy

takes insufficient account of the conditions and knowledge at local and regional level, and therefore generally fails to tackle the underlying structural problems in depressed regions.

A new Law on Regional Development and Physical Planning was adopted in March 1996, with a number of objectives including: the creation of conditions for sustained, and self-sustaining, growth throughout the country; the reduction of adverse disparities between the capital city and the remainder of Hungary, as well as regional level disparities; the encouragement of regional and local level initiatives and their coordination with national objectives. The main principles of the Law are the same as those for EU regional policy. The Law also lays down the tasks and competencies of the central and regional organisations in this field.

Within the territorial administrative structure (national government, counties and local governments), local authorities have considerable autonomy, but are highly fragmented. Since 1989, there has been a dramatic process of disintegration of local government - the number of local authorities doubled in 1990 alone - inhibiting efficiency and effectiveness. The county level has also been disintegrating, although an amendment of the Act on Self-Government in 1994 redefined the role of the county governments, thus creating in them a suitable framework for the elaboration of grassroots regional development programmes and the decentralisation of central government competencies in this area. The real economic strength of this level, however, is yet to be proved and there is still an urgent need for further rationalisation of the territorial structure.

11.4.3 Czech Republic

Regional disparities in the Czech Republic are increasing. Prague is in the most favourable position in terms of economic development, while North Bohemia suffers the most industrial restructuring and environmental problems. North Moravia also contains a high proportion of mines and heavy industry undergoing reconversion in the Ostrava coal basin. The establishment of new links to Germany and Austria has had positive effects on border areas, stimulating growth, enterprise cooperation and tourism opportunities, and the opening-up of former military areas for economic development has provided an impulse in certain regions. More negative aspects have stemmed from the division of the former Czechoslovakia which resulted in many company links being severed, limiting market opportunities and isolating firms in the (new) border area.

The principles of a regional economic policy were approved by the government at the end of 1992, and are aimed at enhancing the development of so-called 'problem areas' through the direct support of entrepreneurial activities and infrastructure development. In practice, regional policy comprises principally the provision of financial support for SMEs. The designation of problem regions and the system of programmes for this support is changing on an annual basis. A scheme entitled REGION provides additional support (in the form of an interest subsidy worth about 4 percent) within the bounds of existing SME programmes for firms located in designated areas.

The territorial administrative structure of the Czech Republic has not been finally established. The communities are currently the only sub-national level with elected local authorities, and the regions and districts have no political powers. While there is general agreement over the need for regional authorities, there has been no consensus about the number, location and role of such bodies. Three principal options have been discussed: a structure of 17 regions, the principal objection to this being the small size of the regions; 13 regions, which would be a system consistent with the regional structure of 1949-60; and nine regions, which would maintain the existing delineation except for the creation of a new region, Mid Moravia.

11.4.4 Slovakia

The process of economic and political transition has led to the revival of regionalisation and localism in Slovakia, as well as the emergence of significant regional disparities. Border regions are particularly important in Slovakia, as 25 of a total of 38 districts share a border with neighbouring countries. Regional disparities are expected to deepen over the next few years, in a cumulative process of more backward regions becoming increasingly disadvantaged by the prevailing negative conditions. Considerable state support may be required to reverse this process.

The development of a regional level of self government (currently under preparation for 1998) will increase the effective implementation of regional policy. The task of regional development coordination is currently undertaken by the 38 district government agencies (as part of District Offices of the general state administration), which are connected to the new Agency for the Development of Strategy for Society, Science and Technology (as the central body for regional development policy). Some state support is also available for districts with very high levels of unemployment, and a number of more *ad hoc* regional associations of towns and communes operate on a mainly voluntary basis.

11.4.5 Slovenia

As elsewhere, the economic burden of transition to a market economy has not been equally distributed at regional level in Slovenia. The regions of Podravska, Zasavska, Posavska and Koroska, specialising in heavy and/or obsolete industries such as textiles, chemicals, heavy equipment, have been particularly badly affected. These regions were often dependent on the former Yugoslav market, and have higher associated costs eg. those related to environmental clean-up. The Pomurska region is the least developed agricultural region, suffering from de-population, and unable to set off the disadvantages through tourism (as has been the case in other parts of Slovenia). Regions with a higher percentage of tertiary activities have had the fewest adaptation problems - eg. Central Slovenia (including Ljubljana), Obano-kraksa and Gorenjska.

Regional policy has existed in Slovenia since 1971, and a new law was passed in December 1990 for the development of 'demographically endangered areas'. The main targets of current regional policy include the improvement of working and living conditions in rural areas to prevent further de-population and the creation of

opportunities for additional income generation in these areas. The utilisation of local resources and the involvement of the local population are fundamental to Slovenian regional policy. The acute and complex problems of industrial restructuring have generally been treated more as sectoral than regional problems. A new regional development law is under preparation, extending the policy approach beyond the current demographic focus. The draft defines three priority areas for the concentration of resources - the equivalent of Objective 1 and Objective 2 areas and border regions.

The 148 communes are the basic administrative unit below the central government, and, despite recent reforms, a further re-organisation of territorial administration is required. Currently there is no intermediate level, although 12 regions exist for planning purposes, and this represents an obstacle to the implementation of regional policy and the principle of partnership.

11.4.6 Bulgaria

The regional dimension of structural change in Bulgaria is determined by two principal factors - the differentiated spatial severity of the economic crisis and the different capacity for adaptation to new market conditions. This has led to the emergence of three groups of regions:

- regions with strong economic potential and adaptation ability, characterised by diverse and a multi-functional economic structure, a favourable geographic location, developed infrastructure and latent research potential (Sofia city, Sofia, Bourgas, Haskovo);
- regions with significant potential, but a lower adaptation ability, generally industrial and agro-industrial areas with favourable position and transport links and adequate research capacity (Plovdiv, Varna and Rousse); and
- regions inadequately prepared for transition characterised by a lack financial resources and assistance from national level, which compound the existing regional economic problems eg. depopulation, peripherality, economic crisis, structural imbalance (Montana, Lovech).

A Government Strategy for Regional Development has been worked out over the past two years, intended to serve as a basis for the long-term goals and tasks of integrating the country at national and regional levels into the EU. It highlights the equalisation of public investment, reduction of regional disparities, implementation of regional restructuring strategies and cross-border initiatives. Over the past three years supporting research has been undertaken to create development plans for specific regions (Black Sea Coast, border regions, upland areas, Danube river), the establishment of a regional development fund and preparations for analytical studies. An administrative structure is also being established, headed by a Council of Regional Policy reporting to the Council of Ministers. The main difficulty for the implementation of regional policy has been the lack of a legislative basis - it was only in 1994-95 that regional policy became a real priority for the government - and deficiency of financial resources.

Administrative and local government reform has only just begun with the enactment of new legislation during 1995. This amended and supplemented the 1991 Law on Local Government and Local Administration, and strengthened the role of local government. The municipality is the administrative unit at which local government powers are concentrated, while state management at sub-national level is carried out at the region. There are no elected representatives at regional level.

11.4.7 Romania

In terms of regional development, problem regions exist can be categorised broadly into two areas.

- *Moldavia and North-East Transylvania.* On the basis of a series of indicators, most of the Moldavian counties (including Vaslui, Botosani, Iasi, Neamt, Suceava and Bacau) rank among the worst in Romania. This situation has arisen due to the dominance of rural activities, the forced industrialisation of the past three decades, and a low level of urbanisation. There is considerable rural poverty in this area.
- *Southern Muntenia:* this area comprises the lowland counties south of Bucharest (Giurgiu, Teleorman, Calarasi, Ialomita) suffering from severe de-population due to the drain of labour to the capital city. The remaining population is ageing and has very low qualifications. GDP per capita is among the lowest in the country, although the unemployment rate has been kept down by the predominance of rural activities.

Other problem regions in Romania include Gorj county, currently facing environmental degradation as the result of mining activities and likely to experience future decline due to the poor quality of the coal mined in this area. Areas with greater potential for economic growth include the Brasov-Bucharest-Pitesti triangle, which could also provide the economic stimulus for the surrounding regions.

No clear programme for the development of a regional policy is yet in existence in Romania, and no specific institutions have been created to take responsibility in this area. Although the formulation of regional policies is officially the task of the National Forecasting Commission, this body currently lacks the necessary resources and expertise. Actions to date have outlined certain territorial planning priorities, some of which could be expanded into regional policy goals eg. the development of the marine coast encompassing the Danube-Black Sea Canal area. Regional development policy must take account of the widening disparity between the labour market supply and the demand for manpower, particularly in industry. A Green Paper on Regional Development, funded by PHARE, is being prepared for the start of 1997.

The reform process has not affected the territorial administrative structure of Romania which comprises 41 counties, towns and communes. The last major re-organisation took place in 1968, and was amended in 1981.

11.4.8 Estonia

The regional development situation in Estonia shows a core-periphery and east-west divide. Tallinn retains a prominent position, accounting for more than 50 percent of all Estonian enterprises in 1995 and the bulk of foreign investment. The rate of new firm formation, critical to the process of regional development, is much faster in Tallinn and the western regions of West Estonia and Pärnu. The re-orientation of the economy has also increased the opportunities for western coastal ports. Eastern, mainly agricultural, regions have lost their former links with the eastern markets as a result of independence, and current border problems and Russian customs policies. These regions are characterised by a low qualified and ageing labour force and a relatively high unemployment rate. The militarisation of parts of Estonia, and the organisation of agriculture into large enterprises, has also made re-employment possibilities in these areas very difficult.

An Estonian regional development concept, approved at the end of 1994, stipulates that regional development should be based on local initiative and the utilisation of local resources. A Regional Development Fund was created to alleviate credit problems in economically weaker regions and border areas. A Regional Policy Council was also established in 1995, comprising representatives from government institutions and local governments, which is designed to coordinate regional policy. Six regional policy programmes were approved by the government in October 1995 for the following areas: peripheral rural districts; islands; villages; mono-functional settlements; border areas; and, Ida-Virumaa.

The counties (15) are the principal sub-national administrative tier in Estonia. The local administrations of municipalities and towns within the counties have created regional associations which form a third tier and the 254 local governments operate at this level. The local governments do operate in reasonably close cooperation with each other, and are linked through three separate organisations.

11.4.9 Latvia

Although Latvia is a small country, regional development problems are evident. Clearly, individual regions have differentiated potential for economic development and growth, related in part to formerly centrally planned industrial location decisions and the migration of population to these centres. Given that many of these industries were Soviet subsidiaries, the majority collapsed following Latvian independence, resulting in the almost total loss of the economic base in many small towns and rural communities.

Further, the population and economic activity is heavily concentrated around the capital city of Riga. This has led to the overpopulation of the metropolitan area, and decreasing economic independence for more peripheral rural regions due to lower population densities. In general, eastern Latvia (the Latgale region) faces the greatest economic problems including low economic potential, few natural resources, low educational levels, and a traditionally high dependence on Russia.

In 1995, the Ministry for Environmental Protection and Regional Development elaborated guidelines for regional policy, and regional development issues are also incorporated to some extent in other sectoral development concepts. The strengthening of the institutional and legal basis for regional policy is planned. The current conceptual statements relating to regional policy, however, provide insufficient detail for detailed programmes, and policy measures have tended to be *ad hoc* and attached to larger development programmes eg. the public investment programme of 1995-97. Other related measures include a programme for the development of Latgale, the reform of local government finances, and a concept for the stimulation of SMEs.

The administrative division of Latvia comprises 568 low-level territorial units (76 cities and 492 rural *pagasts*); there is a two-level local government system with seven cities subordinated directly to the state and all other territorial units divided into 26 districts. A territorial reform of municipalities is expected in the near future, which is likely to reduce their number significantly. Local authorities currently have few financial incentives available to them to stimulate economic development at local level.

11.4.10 Lithuania

Lithuania does not have any sharp spatial disparities, due partly to the size of the country, and partly to an historical programme of uniform development of the regions - although certain regional differences can be identified. Agriculturally, the central part of the country has the best conditions, whereas agricultural production in the eastern regions (Utena, and parts of the Vilnius and Alytus provinces) is currently heavily subsidised. The regions with the most positive economic development prospects are those containing transport infrastructure nodes - eg. the Klaipeda seaport and the intersection of two trans-European transport corridors in Kaunas.

There are currently no specific regional policies operating in Lithuania. Sectoral programmes do contain some regional aspects, and the implementation of plans to establish three free economic zones at the transport intersections of Siauliai, Klaipeda and Kaunas is clearly a spatially specific policy. It is considered that the current extent of regional disparities does not warrant the implementation of spatially targeted programmes. Administrative reform, as determined by the Constitution, is underway to create ten provinces (*apskritis*) with the aim of devolving several state ministerial functions to provincial bodies. The existing structure of upper-level municipality councils (8 cities and 44 regions) and 557 lower level municipalities will be retained.

Figure 11.2 :Regional Development Institutions in Central and Eastern Europe

Poland	No clear leadership among government departments. Several initiatives launched by Central Office for Planning and Council of Ministers. Polish Agency for Regional Development set up in 1993 to promote regional development, finance local infrastructure, training and information. 61 regional development agencies established since 1991 (US\$24m capital) providing training, advice, employment support etc.
Hungary	Ministry for Environment & Regional Policy exists but is relatively weak. Numerous government departments and local agencies operating regional development programmes. Proposals for National Council for Regional Development and county-level regional development councils.
Czech Republic	Ministry of Economy is responsible for regional policy, although other ministries (finance, labour) are also involved. Agency for Regional Development and a Regional Entrepreneurial Fund established in Ostrava.
Slovakia	No regional policy department. At central level, Office for Strategy, Science & Technology works with districts on regional development issues. Development agencies established in some districts.
Romania	Department for Local Administration which co-ordinates PHARE programme is the most important organisation.
Bulgaria	Minister of Regional Development & Construction is in the Council of Ministers which also has a Council of Regional Policy. Government is starting to promote formation of oblast-level regional development agencies, using experience of 2 pilot agencies in Bourgas and Smolyan.
Slovenia	Ministry for Economic Relations & Development is responsible for regional development. Development agencies established in Maribor, Murska, Sobota, Zagorje and Koper. A new Council for Regional Development has been proposed.
Latvia	Ministry of Regional Development & Nature exists. Latvian Development Agency supports a network of business information offices.
Lithuania	Department of Regional Problems & Minorities exists (but with negligible regional policy role).
Estonia	Ministry of Interior responsible for regional policy. New State Regional Policy Council proposed.
Malta	No regional policy institutions - only structural planning organisations.
Cyprus	No regional policy institutions - only structural planning organisation (Planning Bureau).

Figure 11.3 : Territorial Administrative Structures in Central and Eastern Europe

	<i>Regions</i>	<i>Sub-regions</i>	<i>Current status of territorial administrative structures</i>
Poland	49	2500	Reforms under discussion. Two proposals (a) three-tier system of 12-13 regions, 200-250 districts and 2500 communes, and (b) two-tier system with c.25 regions. No decision expected until 1997.
Hungary	20	2920	194 towns also operate as units.
Czech Republic	8	71	Communes exist within the districts. Proposals for reform suggest alternatives of 2-17 regions. No decision until late 1996.
Slovakia	38	121	Reform proposed for creation of 8 regions and 79 districts - disputed by Parliament.
Romania	41	2687	262 towns also operate as units. Informal use of historical provinces. No agreement on territorial reforms.
Bulgaria	9	255	Districts and mayories units exist within municipalities. New process of regional reform began in 1995.
Slovenia		148	Reform of administration expected within next few years, possibly with intermediate regions.
Latvia		492	76 towns also operate as units. Territorial reform expected soon to reduce number of local governments.
Lithuania		44	8 towns and 557 municipalities operate as units. Administrative reform underway to create 10 provinces.
Estonia		15	45 towns and 209 municipalities also operate as units

PART III:

**REGIONAL SOCIO-ECONOMIC CONDITIONS
IN THE ISLAND ECONOMIES**

12. CYPRUS AND MALTA

12.1 Introduction

As was noted in the Introduction to this report, there are sufficient differences among the acceding countries to warrant separate treatment as two groups. Cyprus and Malta are naturally classified together, not only because of their size relative to the transition countries but principally because of their nature as island economies. As neither economy is experiencing a process of political, economic, demographic and environmental upheaval on the scale of the Central and Eastern European countries during the latter's transition period, all issues relating to the internal characteristics of both island economies are examined in this chapter.

The sections below consider the following issues in the island economies: overview of recent political and economic change; demographic trends; labour market situation; developments in their economies and business structures; the quality and provision of physical and social infrastructure; environmental issues; and regional development perspectives.

12.2 Overview of the Island Economies

12.2.1 Malta

Until 1964, Malta was a British colony with an economy heavily dependent on British military expenditure. Malta attained political independence in 1964 and became a republic in 1974. Although usually classified as a developing country, Malta has a relatively high per capita GDP level of US\$ 7,500 (in 1994) and on some social educational indicators would be grouped with developed industrial market economies. The economy is currently experiencing rapid GDP growth rates (six percent per year) and inflation is only around five percent.

A rapid transformation of regulatory and operational structures is currently underway, promoting competition, harmonising taxation laws with those of the EU, and privatising some government bodies (the central bank, postal services). Politics are dominated by two main political parties, the social-democratic Malta Labour Party and the Christian-democratic Nationalist Party. The main differences between the parties relate to economic policy and management (notably the role of the state) and attitudes to EU accession. The Nationalist Party, currently in power until the 1997 elections, favours full membership, whereas the Labour Party opposes accession on the grounds of infringement to Malta's sovereignty.

Malta signed an Association Agreement with the European Union in 1970, and a formal application to join the EU was lodged in 1990. The liberalisation of the financial system and the introduction of VAT have been two of the most important steps taken towards the goal of accession. The dependence of Malta on the EU for imports and as an export market means that a considerable degree of integration already exists. The dismantling of import controls, with an associated potential loss of

output and employment, is cited as the most common disadvantage to accession to the EU, as a result of current fears of balance of payments problems. Conversely, pro-accession arguments state that the removal of protection would encourage efficiency and channel resources into productive and profitable areas where Maltese firms can compete efficiently. Malta could be a favourable geographic position for attracting European-based investment for North African and Middle Eastern markets, and for non-European based investment for the penetration of European markets.

12.2.2 Cyprus

Cyprus was granted full independence in 1960. Economic growth followed, although tension between the Greek and Turkish Cypriot communities during the 1960s and early 1970s impeded progress. The return of political stability in the late 1970s led to renewed foreign investment and a customs union with the European Union. The Republic's economy has prospered, supported principally by agriculture, light manufacturing and tourism. GDP grew by five percent in 1994, a considerable increase from the rate of 0.7 percent the previous year, and inflation is less than four percent. An important contributory factor to the economic growth has been the relatively moderate wage and salary increases set within new collective agreements. Economic factors which continue to cause concern include the over-dependence on tourism, and the technological backwardness by comparison to industrially developed countries. The high level of protection over domestic production also prevents the creation of positive competition within the economy.

Recent institutional reform includes a Stock Exchange Law and Regulations, passed at the start of 1996, which provides the basis for the establishment of a formal stock exchange. Cyprus has a constitution with a presidential system of government and a separation of powers. The Turkish sector declared independence in 1983, but the new republic has not gained international recognition. The economy of the Turkish sector has also been stagnant, hampered by population loss, wartime damage and stringent economic controls.

Cyprus applied for full membership of the European Union in June 1993 and an Association Agreement, as well as a Customs Union Agreement, between the two parties have been signed. The current economic trends in Cyprus mean that it compares favourable with other EU countries in terms of economic convergence, and the 1994 per capita GDP in Cyprus was higher than in Greece and Portugal. There are unlikely to be any very serious problems in the adoption of the *aquis communautaire* in Cyprus.

12.3 Demographic Situation

12.3.1 Malta

The population of the island economies of Malta and Cyprus are very small, amounting in Malta, to only 376,335 in 1995, and 629,800 in Cyprus in 1993. The population density in Malta, is very high, given the small size of the islands, at 1,194 people per km²; it is highest in the inner harbour area (5,213 people per km²). In terms of share by gender, the ratio is 49.3 percent male, 50.7 percent female.

Malta has a positive natural growth rate at the moment, but it is expected to slow down in future. Its population is ageing and population projections indicate that this trend will continue due to relatively low birth rates. However, the Maltese population is still relatively young when compared to other market economies.

The 1995 population census for Malta provides information on spatial distribution. The inner harbour area (comprising towns and villages surrounding the Valetta Harbours) shows a decrease in population with the main decreases occurring in the major urban centres of the inner harbour areas (Valetta, Sliema, Paola and Hamrun). The population increase occurs in the outer harbour area, with the newly established residential complexes with over a third of the Maltese population, experiences the population increase.

As in Cyprus, the overall rate of population increase in Malta will depend to a great extent on the level of inward migration as there are large numbers of Maltese living in Australia, Canada, the US and the UK who are likely to return.

12.3.2 Cyprus

In contrast to Malta, Cyprus is an ageing country, with the proportion of people aged 65 and over increasing sharply between 2008 and 2028. A similar pattern of population change can be observed in Cyprus. The projection forecasts a continuous increase of the population from 629,800 in 1993 to 790,200 in 2018.

Similar trends to Malta can be observed in Cyprus in relation to local population trends, as some districts are increasing their population while others are decreasing. The districts of Ammochostos and Larnaka will become more populous while Lefkosa, Lemesos and Pafos will see a declining population. The migration issue is crucial for the future demographic development of both countries and it is particularly important for Cyprus. Following the events of 1974, one third of the population of Cyprus was forced to change their place of residence. As a result of more recent, internal migration, the rural areas suffered an overall net loss. Migrants, according to the 1992 census of population amounted to 9,994 and came mainly from the UK, Greece and other European countries (of these, a significant proportion were Cypriots).

12.4 Labour Situation

12.4.1 Malta

The Maltese labour force is characterised by a high male participation rate (96 percent of the working age male population) but low female participation (only a third of the female working age population). A large number of people also hold part-time jobs, a factor not fully reflected in the statistics due to the majority of them being in the informal economy. However, even official income tax statistics indicate that in 1995, 11,000 people held part-time jobs together with full-time employment and a further 10,500 had part-time employment only.

There is a high level public sector employment in Malta, and this has led to labour shortages in some areas of the private sector. In general, if the economy continues to sustain an annual growth rate of six percent, there will be insufficient labour to meet the demand. Possible solutions to this would include an increased female participation rate, the employment of foreign labour, or the reduction of possible over-employment levels in the public sector.

The structure of employment has changed markedly over the past 30 years, noted particularly in the rise in manufacturing employment, which has risen from 12 percent of total employment in the late 1950s to 27 percent in the 1990s. The principal sub-sectors affected include food production, clothing, furniture, electrical machinery and transport equipment. However, the share in total employment of the two largest industries, clothing and ship repair, has tended to decline over recent years, suggesting longer-term structural problems. Surprisingly, employment in the tertiary sector has remained virtually constant although its share of GDP has grown. Services accounted for around 35 percent of total employment, with travel and transport related services, and financial services, playing an increasingly important role. The agricultural sector in Malta is very small, contributing only 2.5 percent of total employment (though a larger share of economic output).

Unemployment levels are very low, averaging four percent over recent years. A cyclical pattern is apparent in the unemployment rates, with lower levels evident during the second half of the decade. A large proportion of the unemployed are unskilled or semi-skilled, and a degree of skills mismatch exists between the unemployed pool and the available vacancies. There is a relatively low share of youth unemployment, but a high proportion of long-term unemployed. This suggests the increase of 'hard-core' unemployment which may not fall with increasing demand for labour.

The labour market in Malta is likely to continue to grow over the coming five years, principally reflecting the growth of the market services sector and in tourism and banking and finance in particular. The manufacturing sector is likely to grow only very slowly, if at all, and certain sub-sectors eg. clothing, wood and furniture and ship repair, may even decline. Increased labour productivity could also lead to employment shedding in this sector, although service sector growth will probably absorb the released labour. The projected growth of the economy is sufficiently large to absorb likely increased inflows into the labour market, thereby maintaining the unemployment rate at a low level.

12.4.2 Cyprus

The Cypriot labour market is characterised by conditions of full employment. Participation levels increased by 1.6 percent in 1994, and demand for labour was particularly strong in service sub-sectors eg. private services. Tourism is the leading sub-sector within tertiary employment, accounting (directly and indirectly) for an estimated 20 percent of employment. Employment in agriculture and construction fell slightly, linked in the former case to more attractive employment opportunities in other areas and, in the latter case, to a fall in construction of new tourist accommodation.

On the supply side, the most notable feature is the employment of a large number of foreign workers, generally in low skilled jobs in tourism and agriculture. In 1994, foreign workers accounted for 6.1 percent of total employment. In addition, a considerable number of Cypriot expatriates have returned to the labour market and together these groups have helped alleviate previous labour shortage problems. The potential for labour shortages, however, is still evident, and increases in productivity will be necessary for economic growth to continue. While labour productivity is rising (three percent in 1994), it is still low by EU standards, particularly in the manufacturing sector.

Unemployment in Cyprus is extremely low, at only 2.7 percent of the economically active population in 1994. In 1993, unemployment rose sharply from 1.8 percent to 2.7 percent, related to the restrained economic growth which affected the export sector. However, unemployment is not a serious problem in any region or sector, and even traditionally vulnerable groups, such as women and young people, are not badly affected. The only category of workers where unemployment is relatively higher is those over 50 years of age.

The future development of the Cypriot labour market is likely to see an increase in the dominance of the services sector, and tourism in particular. The low rate of expansion of economic activity, combined with certain qualitative imbalances in the labour market, may lead to rising unemployment in certain sectors (eg. newcomers to the labour market and graduates) and labour shortages in other areas (eg. unskilled and semi-skilled labour), with consequent problems for economic development.

12.5 Economy and Business

12.5.1 Malta

As with the countries of Central and Eastern Europe (CEE), Malta has low income relative to the EU - only 33.6 percent of average GDP per capita in 1993 (Table 16.2) - though it has enjoyed relatively robust economic growth in recent years, as its economy grew by nearly forty percent between 1990 and 1994. However, unlike the transition economies in CEE, economic development in Malta has been subject to longer-term economic forces, rather than a concentrated period of economic

restructuring. Of these longer trends, the most important have been the impact of British troops withdrawing and the small size of the island's economy. As noted above, for the last thirty years, Malta has been adapting to the removal of British military expenditure from the country's economy. The phasing out of British troops from Malta, following independence, triggered a necessary diversification of the Maltese economy, both in terms of trading partners and economic activities.

With regards to the small size of the internal Maltese market, this has meant that industrial expansion has been based on export markets. For example, the trade gap amounted to nearly a third of GDP in 1994, over twice as high as the highest percentage figure for any of the transition countries (Table 7.4). Although the Maltese economy is very open, relying heavily on imports for industrial supplies and exports of goods and services for production sales, continuing balance of payments problems have led to concerns about the lifting of import controls that would be required if Malta joined the EU. There remains a potential danger in the concentration of exported goods in too limited a range of products (clothing, textiles and electrical components) and in the relatively volatile sector of tourism. At present, the most important trading partners are Italy, Germany, France and the UK, and the EU accounts for about three-quarters of Malta's trade. In terms of foreign investment, stocks have increased rapidly over the period 1991-94, and net FDI in 1994 amounted to US\$ 98 million.

Until recently, manufacturing (clothing, textiles and machinery in particular) has been the fastest growing sector. In the last few years, the sector has begun to experience several problems that are likely to influence future industrial development, as many sectors are faced with the need to restructure (eg. ship building and repairing). These problems include: loss of competitiveness due to wage rises (in relative terms, as its international cost competitiveness is being eroded by new competitors, not least the other acceding countries in CEE); poor technology and innovation levels (mainly because of the dominance of small businesses in the economy); and the current protection of domestic production through import levies which would be abolished following accession to the EU. Technically-advanced production processes must be introduced to compete on the basis of high-quality niche markets.

Tourism has become an increasingly significant sector and may, over coming years, become more important than manufacturing in terms of GDP creation. Tourist expenditures in Malta amounted to US\$ 670 million in 1994, approximately a quarter of revenues coming from the exports of goods and services. Unlike other 'export' sectors, tourism has a relatively high multiplier effect, though there is wariness about basing future economic development on so traditionally an unstable economic activity.

The primary sector is less important to the Maltese economy - generating only six percent of GDP, a figure that has been steadily declining over the decades. In contrast, market services (including tourism) accounted for 46 percent of GDP in 1994, and are likely to become more export-oriented with the development of off-shore activities including banking. The public sector is also relatively large in Malta, accounting for a quarter of GDP as well as being a significant employer. However, the ratio of government debt to GDP is not very high EU standards, so the state's economic presence has not been considered a significant issue in the country.

Lastly, the country's business structure is more skewed towards small and micro-businesses than the EU. Statistics are not available for the economy as a whole, but only for industrial enterprises. Only two percent of all Maltese firms had more than 100 employees; 85 percent had less than ten. In terms of companies per 1,000 inhabitants, the Maltese figure of 26.6 is less than most CEE countries, though equivalent to Slovenia.

12.5.2 Cyprus

Cyprus shares with Malta common features that have dictated its economic development. As small island economies, both have been highly dependent on exports and tourist revenues. Both have business structures largely consisting of micro-enterprises (though there is a lack of official Cypriot company data). Although Cypriot income is higher than Maltese (at 53.7 percent of the EU average GDP per capita in 1993, over 60 percent larger than Malta - as well as higher than Greece and Portugal within the EU), both economies have experienced notable economic growth in recent years (five percent in 1994 in Cyprus).

The basic distinguishing feature of the Cypriot economy has been its open nature, and foreign demand represents the main engine of economic growth. The EU dominates Cyprus' trade, accounting for over 50 percent of exports and imports (a smaller figure than the case for Malta), as well as 60 percent of the tourists visiting the island. As with Malta, among the EU countries, the UK is the main trading partner. Cyprus has fewer balance of payments problems than Malta, enjoying a trade surplus of 3.4 percent of GDP in 1993.

The economy is dominated by tourism and services, and the development of transit trade and activities of off-shore companies is a notable recent trend (encouraged by tax breaks). The tertiary sector makes a larger contribution to the Cypriot economy than in Malta, amounting to nearly 70 percent of GDP in recent years. As in Malta though, there has been concern that dependence on tourist revenue would leave the local economy vulnerable to large demand swings, particularly given the high multiplier effects of tourism.

Manufacturing has accounted for a steady quarter of GDP in recent years, though the long-term trend has been decline relative to services. The key sectors - particularly for exporting - are food/beverages/tobacco (especially potatoes and citrus fruit) and clothing/footwear. In trade, the manufacturing sector has witnessed a partial recovery, particularly in food and beverages and paper products, while the clothing and footwear sub-sector has not grown. Nevertheless, the sector as a whole faces similar structural problems experienced in Malta: declining cost competitiveness based on wage differentials and lack of access to new technologies. In the case of Cyprus, there is added concern regarding the labour market, in particular the risk of labour and skills shortages.

Agriculture has a similar limited importance to the island economy in Cyprus as in Malta (approximately six percent of GDP). In contrast, the public sector is smaller in

Cyprus than Malta, responsible for only 14 percent of GDP. Comparisons of foreign investment and business structure cannot be made because of the absence of data in Cyprus.

12.6 Physical and Social Infrastructure

12.6.1 Physical Infrastructure

Priorities in physical infrastructure programmes in Cyprus and Malta reflect their status as small non-self sufficient island economies with significant international tourism sectors. Maritime transport is of particular importance for freight transport, while air services are an essential element of the tourism industry. Advances in telecommunications technologies, in turn, present new commercial and service opportunities to the islands, by reducing the friction of distance between themselves and the mainland.

(i) Road transport

Road networks are dense in both Malta and Cyprus, but many are in poor condition due to inadequate maintenance or the use of inferior materials in their construction. At the same time, motor vehicle densities are high, with 297 cars per 1,000 people in Malta and 254 per 1,000 in Cyprus, as noted in the UN Yearbook for 1990 and IRF respectively. Pressure on the networks in main settlements is particularly intense, leading to serious congestion at rush hours. Programmes of road construction and improvement are in place to address main constraints in the wider networks but, even with additional investment, one area where achieving improvements will be problematic is urban congestion. Few changes to traffic systems are feasible, limited by existing urban layouts which impede road widening and new road building.

	<i>Surfaced roads</i>	<i>Private vehicle density (per 1000 people)</i>
Malta	1,558	297
Cyprus	6,000	254

The environmental implications to island communities of the growth in private transport focus attention on public transport provision. In Malta, this is plentiful and competitively priced, although bus fleets tend to be old and ticketing systems slow. Modernisation plans are underway. In Cyprus, the public transport sector is stagnating, while private vehicle numbers and car rental linked to tourism are increasing significantly.

(ii) *Air transport*

Malta has one international airport handling almost 30,000 aircraft movements per year (an average of 81 flights a day), to and from most European and many North African and Middle Eastern capital cities, while Cyprus has two: Larnaca and Paphos. These handle 39,000 flights per year (106 flights per day), and traffic is increasing - because of incoming tourist trade on the one hand and increased international travel by Cypriots on the other, the latter being due to higher standards of living, and lower air fares as a result of price competition.

With growing demand for air transport services, the airports in Cyprus are undergoing programmes of improvement and development, including new terminal buildings at Larnaca. Malta's main airport is modern and considered to be of adequate standard. Its second island of Gozo, however, is currently only equipped for helicopter landings. Pressure for a fixed wing airstrip here is being strongly opposed by environmentalists.

	<i>Flights</i>	<i>Passengers</i>	<i>Cargo (1993, tons)</i>
Cyprus	39,276 (1993)	4,149,073 (1993)	24,685
Malta	29,634 (1994)	2,560,000 (1994)	

(iii) *Maritime transport*

Malta and Cyprus have long-standing maritime traditions, both serving as transit points in the Mediterranean and relying on sea traffic for goods transport to and from the mainland. Passenger sea traffic is also significant with 7 percent of Malta's tourists reaching the island by sea. Maritime transport also provides the main internal link between the islands of Malta and of Gozo. A ferry connection is used by both domestic travellers and international tourists (most of whom arrive through the main island's international air terminal).

In terms of transit trade, this is in slight decline in Cyprus, where it is in any case more limited than it could be, notably because of the high costs of Larnaca in comparison with neighbouring ports and the fact that it does not operate on a 24 hour basis. In contrast, there has been considerable growth in container traffic in Malta, following the modernisation and expansion of the Malta Freeport. The Freeport, set up by the Maltese Government in 1988, aims to establish itself as a major Mediterranean logistic centre.

(iv) *Telecommunications*

Advanced telecommunications systems “are a means of increasing spatial harmonisation and of enabling a number of physical and geographical obstacles to be overcome without excessive cost and damage to the environment”, as noted in a 1994 European Commission report. Their key role in reducing the isolation of island economies is recognised by both Cyprus and Malta, where ambitious programmes of investment in modern communications technologies are being pursued, principally with the aim of enhancing international connections.

In Cyprus, investment is being undertaken by the Telecommunications Authority in support of a national strategy to make the country the hub of East Mediterranean telecommunications services and to develop the service sector. As a result of increasing use of telecommunications services, mainly by export oriented enterprises, and improvements in the quality and number of services available, the telecommunications sector is experiencing real growth. The sector is also believed to have already stimulated the development of the economy more generally and to have enabled growth in specific service-related activities. However, despite the recent progress in telecommunications provision, there are still waiting lists for private telephones, and the quality of service remains somewhat inferior to European standards.

Malta also has reasonably dense and modern conventional telecommunications networks which have seen substantial recent development: phone densities have risen from 386 per 1000 population in 1991 to 460 per 1000 in 1994. The cellular phone density is also fairly high by international standards. Recent improvements to provision include progress in converting to a completely digital system and the laying of a submarine fibre optic cable between Malta and Sicily in 1995 which will enable Malta to join international data network systems.

In parallel with improvements to telecommunications systems, telecommunications service providers may have to reform. In accordance with EC directives, the liberalisation of telecommunications services, which are currently run by public or semi-public corporations, will be necessary in the event of these countries’ accession to the EU. Cyprus has begun to prepare the process, which will require reform of the Telecommunications Service Law. In Malta, certain operations related to electronic international network services, such as the Internet, have already been privatised.

	<i>Telephone densities (per 100)</i>
Cyprus	51.9
Malta	46.0 (1994)

12.6.2 Social Infrastructure

(i) Education

There are no serious deficiencies in education provision in either Cyprus and Malta, although both present some limitations. These include unequal access to educational opportunities (for females in Malta and for a range of social groups in Cyprus), a need for better co-ordination between technical training and industry, and the need for increased investment in selected education infrastructure.

In both Malta and Cyprus, *compulsory education* is provided predominantly by the state, with private participation being marginally greater at primary than at secondary level. In Malta, about 71 percent of primary education and 75 percent of secondary is provided by the state. Private primary schools are expanding quickly, helped by a good reputation, reasonable fees and the need for additional investment in the state sector.

Secondary education in Malta is streamed by ability. Funding, management and teacher training issues are being blamed for the relatively poor reputation of trade schools, which are not adaptable enough to the needs of manufacturing industry and are inadequately equipped. In Cyprus, the system of state run secondary education is less complex, but is again streamed by ability. Pupils attend Gymnasia for three years, and then either move on to Lyceums or to technical and vocational schools. As with Malta, technical education is not yet of a sufficiently high standard.

The minimum school leaving age in Malta is 16, and approximately 60 per cent of students continue their education after this age. Of these, two thirds follow an academic path, attending sixth form colleges and then university, a quarter opt for technical training at Malta's two technical institutes and the rest pursue vocational training, at vocational schools or under apprenticeship schemes. Although much post-secondary education is of a good standard, the level of co-ordination between education and industry is insufficient to ensure that the curriculum is tied to the rapidly changing needs of industry. In Cyprus, a similar

In terms of *university education*, though they are small in size, both Malta and Cyprus have a university. Malta's state owned university has grown rapidly in recent years, with student numbers rising from 3,500 in 1991/92 to 6,000 in 1995/96. Negligible graduate unemployment suggests that this expansion has been warranted. The university supplies higher education on both Malta and Gozo, and a wide variety of courses are available (eg. in economics, accountancy, education, arts, mechanical and electrical engineering, medicine, law, architecture). The university is forging closer links with industry through the recent establishment of the Faculty of Technology.

The university of Cyprus was only opened in 1992. Previous to this, most Cypriot higher education students opted to study abroad. There were at least 9,000 students studying abroad in 1992/3, compared with 6,000 in Cyprus, but such patterns may change as the Cypriot university becomes increasingly established. In the previous absence of a university, a number of colleges grew in Cyprus, which are affiliated to British or American universities and provide training towards a degree.

(ii) *Healthcare*

In Malta, the quantity of healthcare provision is more than satisfactory, with five state hospitals and one private hospital (with another under construction). In Cyprus, too, provision is high, with one hospital bed per 191 people. Provision of doctors is also very high in both Malta and Cyprus relative to the population. In each case there is one doctor for every (approximately) 400 people.

Healthcare services have developed rapidly in Cyprus between 1989 and 1993, with a corresponding increase in costs. This has been driven by a range of factors including the continuing rise in the aged population, the improvement of diagnostic equipment which is increasing the number of surgical interventions being carried out, the introduction of more sophisticated surgical procedures, more advanced but expensive drugs and the public's rising demands of the health service.

Problems in the healthcare system of Cyprus include the increasing costs of the system, the lack of 'rationing' or control mechanisms which would enable prioritisation, and the uneven spatial distribution of services. The quality of medical care could also be improved. In Malta, one problem has been that the population is too low for some specialised medical provision to be made available cost-effectively. However, one solution which is being pursued is to contract other countries to provide such services, with some complex heart surgery being carried out under agreement in the UK, for example.

12.7 Environmental Situation

The island economies of both Malta and Cyprus, face very different environmental problems than the CEE group. Their relative lack of industrial infrastructure and modern economic development has led to a unique set of circumstances. Both countries face a growing threat largely as a result of increasing economic development, in particular from the tourist industry. The growing demand for residential building, tourist developments and complementary industrial developments has reduced the total area of agricultural land, and placed heavy pressure on non-renewable resources. Tourism in particular has exacerbated many environmental difficulties, such as the increase in traffic pollution, the need for local building materials and the increase in volume and leaching of waste products. The necessity of enacting pro-active environmental regulations and controls is regarded as essential for the protection of both Cyprus and Malta.

12.7.1 Malta

Due mainly to its small size, Malta potentially faces large environmental impacts as a direct consequence of economic development. Malta's natural characteristics, similar to Cyprus, are both unique and fragile and are thus more susceptible to human influence and changes as a consequence of socio-economic development.

While Malta has not been traditionally associated with significant pollution problems, the growing pace of development, and in particular tourism, has given rise to a number of environmental problems. While tourism provides an important contribution to the Maltese economy, it poses a number of problems in terms of environmental impact. Aside from the negative aesthetic impact of tourist developments and the increased levels of traffic, an important source of pollution from this rapidly growing sector stems from waste production and disposal. Although 85 percent of wastes are presently disposed of in landfill sites, alternative plans are underway. The new government strategy and action plan (contained within a 1993 policy document), is based on prevention of waste production, safe waste management through incineration and safer landfill sites. It is hoped that by the year 2010, 40 percent of solid waste will be recycled, 30 percent incinerated and 30 percent dumped. Annual production of waste materials, at around 2.5 to 3 million tons, largely reflects the pace and problems regarding economic development - especially considering the proportion of waste materials - 4 percent domestic waste, 4 percent industrial waste and 92 percent from the building and demolition industry.

Although there is no comprehensive statistical data concerning air, water and soil pollution, assessment of the pollution problem has been recognised by the government as a major problem within the administration of policy. Nevertheless, positive and pro-active measures towards environmental management have recently been undertaken by the government. For example, the Maltese Structural Plan, a legally binding document, not only recognises the pressures and competition of land use and resources, but also suggests pro-active measures for a more efficient enactment of environmental management. Under the terms of the Environmental Protection Act (EPA) of 1991, environmental impact assessments are required under law for projects which constitute a potential impact on the environment. This has led to a more considered approach to the development process and a slowing down of development projects which have a negative impact on the environment.

While the EPA represents a major advancement of policy, and has assisted in fostering greater environmental awareness, the terms of the Act have led to a number of practical problems, especially concerning implementation and in particular enforcement. This has been regarded as a consequence of the lack of appropriate technology for assessment and monitoring purposes and the lack of personnel to undertake policy measures. As yet it is unclear whether or not this is a consequence of the lack of finance, administrative problems or otherwise.

12.7.2 Cyprus

The situation regarding Cyprus has many similarities with Malta, both in terms of the type of environmental problems it faces and in terms its physical characteristics. The principle sources of air pollution are mines and quarries, vehicle emissions and industrial plant. These mainly cause localised problems, such as the leaching of industrial discharges into ground water supplies and the relatively concentrated sources of pollution as a consequence of vehicle emissions within urban areas. However, air pollution problems, similar to Malta, are dispersed relatively quickly as a result of climatic conditions.

The problem regarding the leaching of industrial and in particular domestic sewage into groundwater sources cannot be under-estimated, especially as the proportion of water supplies which comes from this source (over 90 percent), is increasing. Indeed many coastal aquifers are now seriously affected by sea-water infiltration as a consequence of over-extraction. This increasing demand on water resources is largely a consequence of the growing importance of tourism over the past ten to fifteen years. Indeed, tourism is one of the most important contributors to the economy of Cyprus. The growing numbers of tourists visiting the island equates with increasing pressure on the already inadequate sewage facilities and increased pollution of coastal waters. In particular, coastal zones in the south and west of the island, around Paphos, Akrotiri and Limassol, face environmental pressures from tourist development. Indeed, recommendations by the United Nations Development Programme (UNDP) have highlighted the need to protect fragile coastal zones from negative tourist developments, and to diversify tourism by developing the mountain areas of the island and attracting tourists from a higher economic strata. While some tourist developments maintain their own sewage treatment works, the only town that with a sewage system and treatment facilities is Nicosia, although plans were underway to develop further treatment facilities elsewhere on the island. Other problems exist, such and stem from tourist developments, such as increased pressure on land and the creation of waste materials from building and construction.

Since the mid-1980s, the government of Cyprus has made substantial progress in terms of environmental policy formulation. 1985 saw the development of a policy directive, requiring public bodies to undertake an environmental impact assessment of major development projects. Again in 1987, an Environmental Action Plan was compiled with UNDP assistance, which formed the basis of the present environmental policy, incorporated into the 1994-98 Five Year Development Plan.

Current policy now focuses on the following: strengthening existing institutional structures for environmental planning; implementation and enforcement of regulations, etc; modernisation and codification of environmental legislation based along EU lines; rational land-use planning; integrated pollution and waste management programmes with parallel restructuring of industrial enterprises; creation of environmental awareness; active participation of local authorities and the general public and increased co-operation with NGOs. Although these aspects are an important step forward, it is still too early to fully assess the environmental benefits of these more recent policy recommendations contained within the Five Year Development Plan.

12.8 Regional Development

12.8.1 Malta

The Maltese islands are very small, and would be considered a single region within the EU. However, areas with distinct characteristics can be identified within the islands. The inner and outer harbour areas are the most densely and it does not face a serious problem of unemployment in any region or sector. Unemployment was only 2.7 percent of the economically active population in 1994, and even groups considered vulnerable in Europe eg. women and young people, are not seriously affected. Demand for labour is particularly strong in the tertiary sector, which accounts for over 60 percent of total population and contain the principal commercial and tourist centres of Valletta, Sliema, St. Juliens, Hamrun and Birkirkara. The south-east and western areas of Malta are less densely populated, and the western region is characterised by rural areas and the production of agriculture. The population of the northern area increases considerably in the summer with the influx of tourists. Gozo, the second main island, has a relatively low population density and is more dependent on agriculture than Malta.

12.8.2 Cyprus

The small size of the Cyprus means that very few significant regional disparities are evident. In addition, the difficulty of coordinating the funds and activities of local authorities make the implementation of a regional policy very difficult. This has resulted in the emphasis of development policy being on sectoral priorities. These priorities are incorporated into five year Development Plans designed to support efforts to restructure and modernise the economy. The largest proportion of development spending within the 1994-98 Plan is allocated to the transport infrastructure.

PART IV:

**THE IMPACT OF ENLARGEMENT
ON CENTRAL AND EASTERN EUROPE**

13. THEORETICAL ISSUES: SOCIO-ECONOMIC CONTEXT OF ENLARGEMENT

13.1 Enlargement and Competition among Regions in Europe

The enlargement of the European Union will take place within a specific socio-economic framework which will affect both the path of future integration and its impact on existing and future EU Member States and their regions. This framework is determined by global market forces and political as well as economic developments over which EU or national governments have little influence. However, these forces have a direct impact on the EU's future integration policy and therefore have to be taken into account by policy makers. The integration of new countries into the EU will most likely lead to increased competition, not only between countries but primarily between regions (as analysed in more detail in Chapter 17). There will not only be competition between existing and future EU regions but also internal competition among existing EU regions. If regions are viewed as sharing a 'common economic destiny', this competition involves:

- the ability of a region's companies to maintain their hold on existing markets and open up new ones with their products and services, to respond rapidly and flexibly to changes in demand, to react quickly and innovatively to the actions of their competitors, and to adapt rapidly to changes in basic macroeconomic conditions of a structural nature; and
- the ability of public authorities to influence the attractiveness of their region so that companies and employees decide to locate there.

Both these elements contribute to bringing income to a region, generating new investment and creating new jobs. Consequently, a decisive factor for the future economic development of the individual regions will be their ability to compete with alternative locations.

However, the economic development of regions is also determined to a significant extent by macroeconomic trends and national and international environments. Regions have only a limited freedom from these factors and their circumstances are often pre-determined by them. Consequently, the most important issue for regions is how they can best adapt to these overriding trends and the resulting sectoral and regional economic changes. These trends are discussed in the section below from a theoretical perspective and is followed by consideration of the locational factors influencing competition among regions. A more detailed analysis of trends in regional disparities among EU and CEE regions is presented in Chapter 17.

13.2 The Impact of Macroeconomic Trends on Regional Location Factors

One of the factors shaping the future of Europe's spatial development is a series of macroeconomic trends which have been increasingly evident over the last five years and have resulted in significant spatial impacts. Five key trends can be identified:

- globalisation of markets;
- new patterns in the division of labour between firms;
- internationalisation of production;
- shortening of product life-cycles; and
- tertiarisation.

These trends may in principle affect all national economies but only to varying degrees. Significant differences only tend to emerge at the regional level, as certain types of region benefit from these factors, while others have been affected negatively.

13.2.1 Globalisation of Markets

This first trend is the result of a large number of worldwide economic liberalisation measures, as national economic areas have developed into larger international units in recent years. European countries in particular have been affected by this due to:

- the formation of the EU created the largest 'domestic' market in the world;
- the recent enlargement of the EU has opened up its internal market to new suppliers and customers;
- the EU has improved its external trade relations, in particular with the remaining EEA countries, the former COMECON countries and other neighbouring countries; and
- the European Commission has initiated a large number of liberalisation, deregulation and coordination measures.

Not all of these measures have led to markets being widely liberalised - eg. association agreements with countries on the EU's eastern and southern borders have been partly used as trade shields for specific EU sectors - but it is clear that trade links between European countries are increasing as the division of labour has been spreading. A globalisation of markets on a worldwide scale, especially capital and goods markets, is eclipsing developments in Europe. The result of this globalisation is greater spatial mobility of goods and factors of production, extending company sales and acquisition markets. Consequently, companies can take better advantage of size advantages and do business in the regions in which they can obtain the most favourable terms.

This process results in established supplier/customer links between companies and, consequently, regions disappearing. Bulk buyers - eg. in the automobile or the electrical engineering industries - make increased demands on their suppliers and, given that integration has raised the number of potential suppliers, insist on price concessions and terms of supply which can easily overwhelm small and medium-sized companies in

countries with high wages and only limited spatial wage differentiation (eg. Germany). Consequently, as the competition-driven selection process between companies gathers pace, this 'global sourcing' process could be harmful to those regions with few geographical location advantages. To the extent that these regions are unable to alter their wage cost disadvantages, other cost and quality factors have gained in significance. These factors include, among other things, proximity to major European sales centres, transport infrastructure, calculability of transport procedures, exploitation of advantageous contacts, etc. However, these locational conditions are lacking in several EU and prospective EU regions, primarily peripheral, rural areas which will tend to become less competitive as a result.

13.2.2 New Patterns in the Division of Labour between Firms

New forms of division of labour between firms are regularly emerging, with the development of new and closer links between large companies and smaller suppliers being of particular significance. Large companies are reducing their manufacturing capacity and transferring important tasks (such as warehousing, transport and development of production components) to suppliers. This reduction in large companies' warehousing also has spatial implications - as stocks tend to be maintained for only eight hours, smaller storage can be used. In general, suppliers first receive a 'forecast' covering five to ten months, so that the orders for the next 10 to 14 weeks can be specified on a weekly basis, which is followed by the bulk producer's assembly plan, giving a detailed delivery timetable over a period of a few days to which suppliers *must* adhere (Vogel and Gießmann, 1994). For example, this is how the Opel automobile factory in Bochum operates. Consequently, deliveries are made within very restricted, pre-determined 'time windows', which tend to favour suppliers located close to the plant. This creates new dependencies and places greater demands on logistics and transport infrastructure. Consequently, the quality of transport infrastructure has been viewed with increasing importance by many companies, which again works to the disadvantage of rural areas. At the same time, this situation compels suppliers to cooperate more closely - eg. through strategic alliances - which further reinforces geographical concentration of companies.

Experience from countries outside Europe suggests that this trend is associated with a process of selection and concentration in the supply sector. Consequently, the globalisation of sales and acquisition markets and the development of new forms of division of labour between firms is expected to alter significantly the skills of workforce and management, making companies give greater attention to their training policies. For example, increasing internationalisation by businesses requires market/country-specific training and the implementation of trainee and voluntary programmes. Medium-sized companies in rural areas are often unable to undertake training programmes to provide the relevant qualifications. As a result, further concentration is likely to take place among suppliers to the detriment of rural areas.

This process is currently most advanced among suppliers in the automobile industry (Koch, 1991; Fieten, 1991; Kaila and Kauranen, 1990; Little, 1991). In recent years, several bulk buyers have only been able to make a (marginal) profit by operating at full production capacity. Consequently, the sudden fall in demand in 1993 compelled many

manufacturers to reduce costs, often by forcing price concessions from (and passing on cutbacks to) suppliers. This 'business failure' of bulk buyers together with the relief strategy described above is exacerbating the selection process among suppliers in rural areas. On the basis of Japanese experience, the process could lead to the loss of up to a third of all jobs in the European manufacturing supply sector (as well as in the companies supplied). From the point of view of volume, such a loss of employment is on the same scale as major reductions in the workforces of automobile manufacturers themselves, but it is not as striking because the redundancies are more widely spread.

In most cases, European suppliers can only survive this process of increasing competition if, despite their higher prices, they distinguish themselves from foreign suppliers through the reliability of supplies and the guaranteed quality of their products. However, for supplies to be reliable the transport infrastructure must function effectively. In this respect, it is not the provision of roads in rural regions that matters so much as the quality of connections in an wider road network as a determinant of locational competitiveness. Consequently, peripheral areas are inevitably at a disadvantage.

13.2.3 Internationalisation of Production

In many cases, the current weaknesses of Europe (and Germany in particular) as an economic location - high wage costs and incidentals, inflexible working hours, large number of regulations, high taxation - encourage companies to consider transferring parts of production, especially labour-intensive manufacturing aspects, to the relatively lower-cost Central and East European countries. However, the adequately functioning infrastructure, the quality of the workforce, the proximity to sales centres and the favourable location for a future market in CEE still favour West European locations - at least for product development and sales functions. As far as standardised goods are concerned, many western investors have chosen Hungary, the Czech Republic and Poland as locations for export-orientated, labour-intensive production due to the low wages and the well-trained/skilled workforce. For example, the average manufacturing wage in Hungary - including additional labour costs - is 55 percent of that in Portugal and 12 percent of that in western Germany (O.V., 1994).

The term 'internationalisation' incorporates a number of different concepts. It could mean direct investment in establishing and expanding foreign sales/marketing systems and international R&D agreements (Buckley and Casson, 1976; Braun, 1988; Stehn, 1989). In many cases though, it also involves transferring the manufacture of standardised production components from peripheral EU regions to countries outside the EU where the advantages of low wages or low wage incidentals can be exploited, leaving the core parts of the business - such as assembly of component aggregates, planning, marketing, decision-making, sales, and R&D - in the local (western) location, primarily areas with large population densities or centrally-located cities. Whereas previously so-called 'extended workbenches' were established in rural regions of Western Europe (in part because of subsidies, in part their assumed labour reserves), companies now often prefer foreign locations such as neighbouring Central European countries.

This internationalisation is particularly prevalent in sectors characterised by limited innovative activity, labour-intensive and standardised production, and a relatively unskilled workforce. Such sectors are more likely to be found in rural and peripheral areas. Consequently, on balance, internationalisation in Europe will have a negative effect on this type of region. In particular, the existing marginal spatial wage differential in the national economies of western countries is no longer sufficient to guarantee that a country's employers will focus on their own (national) labour reserves when deciding on a location. This opens up interesting options for investors in a united Europe, often associated with generous regional incentives in Ireland, Spain, Portugal or Greece. In actual fact, for many employers the only factors favouring highly developed and expensive north-west European locations are market proximity and the guaranteed reliability of supplies (Gretz-Roth, 1991; Gauler, 1992). However, this means that criteria such as proximity to major centres and extensive access to important sales areas are gaining in importance. Given that such circumstances are primarily found in areas with large population densities, peripheral, rural areas remain less-competitive.

Conversely, foreign investors who want to establish and extend their sales in the EU tend to target directly areas with large population densities or proximity to attractive cities. Locations easily accessible from abroad (eg. via a major international airport), with a central position in the heart of Europe, a good image, etc. are given particular preference. Such conditions are not found in most rural areas and, consequently, it can be assumed that the internationalisation of production will, to a large extent, negatively affect regions already at a disadvantage.

13.2.4 Shortening of Product Life-Cycles

In the modern information society, technological change and spatial diffusion of technical knowledge are taking place at a faster rate. In part, this is a reflection of the tendency towards shorter product life-cycles in many industries. As a result, individual companies have less and less time for the profitable exploitation of innovative services. Competition in obtaining new information and quickly imitating new processes or products is intense. Whereas previously, one product development might have been sufficient to last the lifetime of a company, at present, continuous development efforts must be made and new products introduced onto the market as quickly and widely as possible.

Such a development often affects small and medium-sized companies, which predominate in rural areas. For several reasons, small companies are often not in a position to promote innovative activities or follow up technological changes quickly enough (Braun, 1991). For example, they frequently suffer from limited capital resources and are particularly dependent on obtaining credit in the form of foreign, interest-bearing loans. Insufficient income normally leads to solvency problems, which reduce the financial scope for important investments in new products and production processes, however necessary.

Also, many small companies are not in sectors providing directly to end-users, so consequently have limited ability to respond to falls in demand through changing their pricing policy or by switching production to market niches or abroad. As a result, they

are vulnerable to market fluctuations. During temporary drops in the number of orders, these companies must continue to pay the wages of qualified employees and skilled workers in order to retain them, which further reduces their scope for funding technical progress.

Family businesses, which predominate in this category of company size, often also experience problems associated with a change of generation (implemented too late) in the company management, the use of income outside the business (for example to buy out heirs) and the lack of qualifications of the (old) owner of the company (primarily technical as opposed to business knowledge, though marketing issues are often neglected and there is a failure to adapt product ranges or rationalise sales). Although there is no compulsory retirement for independent operators or businessmen, it can still be assumed that in the majority of small and medium-sized companies, in view of the age structure of their heads, there will be a 'changing of the guard' in the next few years. This too may lead to specific development risks and regional policy challenges for peripheral, rural regions.

However, a more serious threat is the fact that small and medium-sized companies find it difficult to introduce new products onto the market and tend to limit their development plans to a gradual expansion of the sales of existing products (for example first at a regional level, then a national level, next Europe and finally the rest of the world). If other companies act more quickly, the development trap problem occurs - ie. with shorter product life-cycles, there is no longer enough time to recover all the development costs. If these problems mount up in small and medium-sized companies and such companies are more likely to be found in less-developed regions, specific development risks can occur in these areas.

13.2.5 Tertiariisation

The tertiariisation of production has been observed and analysed for some time. It manifests itself in two ways:

- as above-average growth of the so-called official tertiary sector, as shown in official statistics ('external tertiariisation'); and
- as an increase in the proportion represented by services in the product value ('internal company tertiariisation').

So-called business-related services are of particular significance in the context of external tertiariisation (Löbbe *et al*, 1992). The tertiary sector has expanded significantly in recent years when measured in terms of the number of employees. Among those included in this sector are those offering legal advice, tax consultants, accountants, management consultants, architects, consulting engineers, advertising agencies, data processing companies, secretarial offices, and credit enquiry agencies. All of these business-related services are increasingly taking on the character of a tertiary infrastructure, resulting in positive development effects which primarily manifest themselves at the regional level. The locational requirements of these sectors are normally high and are limited to areas with large population densities. Consequently, it

can be assumed that the development of an ever more important tertiary infrastructure will mainly favour areas with large population densities.

However, this point also applies to the second form of tertiarisation noted above - ie. the increasing share of manufacturing represented by services. The growing division of labour between firms, the internationalisation of production, the greater significance of technical progress and the increasingly complex economic and social systems mean that in order to guarantee the survival of companies, more and more in-house services are required. The need for market scanning, customer support, consultation, employee training, logistics management, etc. continues to increase and is leading to a tertiarisation of industrial production. This alone is too much for many small and medium-sized companies and because of the spatial distribution of sizes of companies, rural areas are disproportionately affected.

This regional effect is further reinforced by a functional concentration. Recent studies show that production sectors with a high proportion of services are more likely to be found in cities (Bade, 1985 and 1987; Reissert, Schmid and Jahn, 1989). This process of functional concentration occurs not only in the secondary (industrial) sector but also in the tertiary sector where it affects mainly the banking, insurance and financial sector. Many companies in this sector are currently examining their network of subsidiaries, which expanded during the 1970s and 1980s but have recently been cut back, particularly lower management levels. In rural areas, this has led not only to a decrease in employment in the tertiary sector but also to a decline in overall locational attractiveness, given how important infrastructure is to many tertiary institutions. If there are no cities or areas with large population densities and their associated range of service functions nearby, the trend towards a growing disparity between urban and rural areas will inevitably increase.

13.2.6 Interim Conclusion

To summarise, specific development risks for the less-developed regions of Europe could arise from the factors set out above. These risks are on the one hand, the result of a particular sectoral and company size structure in these areas, and on the other hand also caused by location-related circumstances and the relevant predominant settlement pattern. As an implication of the structural trends described above, all employer surveys point to greater value being attached to transport infrastructure and locational conditions. The latter relate above all to the accessibility of important sales centres from an extensive area in a Europe which is becoming increasingly integrated, and to the population within reach of individual locations. The population factor is of particular importance to those foreign investors who are interested in Europe with regards to sales and distribution. At the same time, demands in centralised supply sectors are growing. The 'location trump cards' of rural and peripheral areas in Europe, which for a long time were their labour and land resources and their natural leisure value, are in many cases no longer sufficient to survive the ever more intensive competition among economic locations in Europe, particularly given the wage cost advantages of neighbouring countries outside the EU.

13.2.7 Implications of the Integration of Central and Eastern Europe

Another important factor which will affect spatial development in Europe, particularly in rural and peripheral areas, relates to the economic and political opening up of neighbouring Central and East European countries to the West together and the transformation of their economic systems. In the longer term, the former - if both trends can be sustained - may result in immense potential with regards to purchasing power and growth, but in the short and medium term, it may put immense strain on financing and cause increased structural adaptation processes in Western Europe.

In this respect, special attention should be given to the expected sectoral restructuring processes. It should be emphasised that the granting of financial aid will not be sufficient to support neighbouring Central and East European countries. Such financial commitments often take the form of 'alibi activities' and only provide these countries with a short breathing space. Consequently, it will be much more important to integrate the Central and East European economic areas too, giving them the opportunity to trade with or within the EU (as examined more fully in Chapter 15). According to the so-called 'Chenery hypothesis' and recent studies by the RWI, it appears that the products which these countries can produce successfully and introduce into West European trade are mainly agricultural goods, standard and luxury foodstuffs, textiles and clothing, leather, steel, and simple types of plastics - sectors which are predominant in the rural areas of *Western Europe* (Döhrn and Heilemann, 1991). Hence, trade integration with Central and Eastern European countries exposes rural areas in Western Europe to greater competition.

This possibility has been confirmed in recent studies (Klodt *et al*, 1994). The regional structure of direct German investment already shows a clear orientation towards the east. Other forms of partial transfer of production, such as the use of 'passive' processing or job-order manufacturing, are gaining in importance as well. In the majority of cases, this focuses on labour-intensive products and production involving easily transferable technical knowledge.

The sectors mentioned above can only survive in Western Europe if they can at least compensate for the major wage cost disadvantages through their proximity to large sales centres, good customer contacts, adherence to delivery dates, quality guarantees, etc. However, here too, locational criteria such as position in the extensive network, accessible population or population density are of prime importance. Above all, it is areas with large population densities which have the required criteria. Consequently, the economic opening up of the EU towards Central and East European countries could work to the disadvantage of peripheral, rural areas in Western Europe.

13.3 Factors Influencing Locational Competitiveness among Regions

In the previous section it has been shown that, in the longer term, peripheral, rural areas can expect to encounter development risks which could cause traditional town/country disparities to be exacerbated, thus creating challenges for regional policy. This has occurred because of:

- their sectoral structures;
- alterations in locational requirements result from changing economic conditions (eg. the increasing importance of transport infrastructure, preference for cities with a well-developed tertiary sector, etc.); and
- conditions related to their settlement pattern (low population density, unfavourable position, limited infrastructure, etc.).

There is a list of factors which may influence regional development processes. Setting aside the macroeconomic growth rate, it has been suggested that regional variations in sectoral and company size structures can influence growth prospects, depending on the proportion of stagnant or growth sectors in the regional economy. However, such differences are only of limited explanatory assistance as they provide little information on the role and significance of the actual locational conditions. Other location factors appear to be of more relevance, such as infrastructure and settlement pattern, relative availability of different production factors, transport costs, etc.

Based on recent research (Hamm and Klemmer, 1993; Klemmer, Eckey and Bremicker, 1988), it is now considered that previous regional development processes were usually successful if there was:

- a well-functioning infrastructure;
- a favourable settlement pattern;
- adequate, qualified workforce potential;
- a good location with respect to markets;
- sufficient land available;
- sufficient provision of business-related services; and
- a strong regional image and economic climate.

As far as theoretical hypotheses are concerned, infrastructure is without doubt one of the most important determining factors for regional economic development (Pfähler, Hofmann and Lehmann-Grube, 1995). However, there is still considerable uncertainty as to the influence of individual infrastructure components. In many cases, it is not known whether infrastructure is a prerequisite for or the result of economic development. Within the complex locational factor of 'infrastructure', it is also useful to differentiate between network and regional infrastructure facilities. The latter relate to local institutions (for example for the provision of health care, education, etc.) with local and regional delivery of services, while the former relates to factors which always affect the entire national economy if there are changes in investment (eg. in roads, telecommunications or power supplies). Whereas in the case of regional infrastructure facilities, the significant correlation between infrastructure and regional development gives no indication as to what factors cause which impacts, in the case of network infrastructures (especially road networks), the situation is different. Thus, a new motorway construction influences not only the accessibility of the region in which the road investment is made but also that of the other regions in an entire network by changing the distance values between individual areas over time. Such changes are not the result of regional development processes but are impulses triggering development. This increases their declaration value.

Also, as already mentioned, there is evidence of a general revaluation of the importance of road infrastructure, especially for long-distance travel. On the one hand, organisational and logistics requirements for the transport of goods are increasing while on the other hand, a transport infrastructure which is adequate both quantitatively and qualitatively is a prerequisite for an economy operating on a worldwide level with an effective division of labour. Consequently, the local and regional range of long-distance connections will over time become an increasingly important locational factor. For these reasons, a region or centre appears particularly attractive in the longer term if it has access to an efficient (internationally-oriented) airport or it forms part of the European high-speed rail network and the capacity of the trunk road network is adequate. The telecommunications and power supply infrastructures are also of significance. These infrastructure effects cannot be understood through regionally-related infrastructure indicators either. The latter are only useful if they relate to institutions where effective output is limited to a given region.

The more limited settlement pattern - as described by population figures and density and centrality values - is also of great significance (Eckey *et al*, 1985; Klemmer, Eckey and Schwarz, 1976; Klemmer, 1986; Klemmer, Aarts and Cesar, 1993). In this respect, nearly all empirical studies available to date show that to explain the variance in regional development levels, particular attention should be paid to the 'population density' variable. On the one hand, it is an indirect indicator for understanding positive conurbation advantages and regional sales opportunities; on the other hand, however, an increasing population density can also be associated with increased conflict over land utilisation, mixed location situations and damage to the environment - ie. above a critical level, it can also exert an influence which may constitute an obstacle to development. In this scenario, high population densities can result in bureaucratic delays for planning approval, a lack of industrial land, expensive environmental regulations, damage to the environment, etc.

In particular, the north-western regions of the EU with their high population densities have high wages. Measured in terms of wage costs, many other regions in Europe prove to be more attractive locations. The fact that shifts in production have to date remained limited, as shown by studies of industrial structure, is primarily due to the spatial immobility of highly-qualified employees (Löbbecke *et al*, 1989). Consequently, 'human assets' are one of the most highly-valued locational factors in most employer surveys. In large part, the reason why many western German companies invest in the new German Länder may be attributed to the lack of skilled labour and available land at established locations. However, defining this human asset in statistical form usually presents difficulties because in most cases the only way it can be clarified is to resort to educational and training certificates which can adequately express all the qualification components.

Against a background of the internationalisation of the division of labour, reduced depth of manufacture and a requirement for just-in-time supplies, transport development and geographical location are again becoming a more central factor in explaining differing regional development processes. In this respect, a differentiation is made between locational conditions depending on whether they relate to extensive or smaller areas. In the former case, they relate to the location in a network defined on the basis of an extensive area (for example the old German Länder, the whole of Germany or the heart

of Europe); in the latter case, they relate to establishing the importance of the surrounding area to centres.

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14. EXPERIENCES AND LESSONS FROM FORMER INTEGRATION AND ENLARGEMENTS

14.1 German Reunification

The reunification of Germany is a concrete example of the particular effects and problems of integration which can be expected when the former socialist countries enter the EU. For all the differences which exist between the former German Democratic Republic (GDR) and the other former COMECON countries, there are significant similarities to and, consequently, experiences from German reunification that can be taken into account when considering the future integration of these countries. With this in mind, a brief overview of the economic problems of German reunification is presented below, followed by a series of thesis-type conclusions for the other Central and Eastern European countries undergoing transformation.

14.1.1 Regional Policy Challenges of German Reunification

With the creation of economic and monetary union on 1 July 1990 and the subsequent reunification on 3 October of that year, the economy of the former GDR was exposed to international competition overnight and underwent a fundamental revaluation - measured in terms of the efficiency standards of the national economies of the west. Prices, exchange rates, interest rates, taxes and above all the demand situation changed within a very short period of time. This revaluation of the former GDR's economy revealed a much greater difference in prosperity between West and East Germany than expected. This related not only to the per capita national product, average income, the provision of goods and services and infrastructure, but also to environmental conditions. At the same time, a restructuring process on an unprecedented scale was initiated, which has already led to fundamental changes though is far from complete. In the first three years, it was even reflected in an increase in the German domestic development gap in respect of the national production of goods as well as in higher unemployment in East Germany. Only recently have signs increasingly pointed to a successful economic reversal.

According to the most recent analyses and forecasts, production in the new German Länder is currently showing a strong revival - growth of 5.8 percent in 1993 and 8.5 percent in 1994, and in 1995, the economy is expected to increase by 6-7 percent in real terms, taking it back above the West German level (which in 1993, declined by -1.7 percent and grew in 1994 by only 2.4 percent and by 2 percent in 1995). The most encouraging fact is that this catching up process is broadly-based so that as well as the services and construction sectors it has now taken place in manufacturing. In 1994, per capita investments in capital equipment were higher in eastern than western Germany for the first time, leading to a further increase in labour productivity.

In this respect, it is above all small and medium-sized companies which have shown the most progress. The only longer term risks are the industrial heartlands, with their large concerns, and peripheral, rural areas. Overall though, the eastern German labour market

has traversed its low point and is showing the first signs of improvement. In 1995, the level of unemployment is expected to fall by nearly 100,000 from its level in 1994 of 1.14 million (Study Group of the German Economic Research Institute, 1995).

However, it must be remembered that the catching-up process began at a low level. The real per capita gross domestic product in the new German Länder is still only just over half of the western German level. Due to the difference in productivity rates and the increase in wages, unit wage costs in the East are still 30 percent above the level in the West, though the gap has halved since 1991. However, eastern Germany's 'prosperity' is still only half accounted for by its own input - consequently, government financial transfers to eastern Germany, which in 1995 may amount to approximately DM 194 billion, remain essential. On a net basis though, taking into account the additional tax income flowing in the opposite direction, the need for support will decline over time. The most important basic condition for a longer term reduction of wealth disparities in Germany will be continuing economic growth in the West.

The catastrophic state of the eastern German economy (as suggested by 1990 statistics) exceeded all previous pessimistic expectations. Due to statistical manipulation, over-estimation of individual reports of success and a problematic data base, the alarming condition of the economy in the East had not been properly recognised by western economic research prior to reunification. Today, however, it is generally agreed that the economy of the former GDR was above all characterised by the following problems, which continue to have an effect and, consequently, can still be described as the main structural problems of the new German Länder:

- fall in domestic demand in the new German Länder as a result of the inferior quality of many products and an over-estimation of the quality of some western products, as well as a decline in exports due to the unilateral sales re-orientation of the collapsing COMECON area;
- poor labour productivity in most manufacturing sectors in comparison with the national economies of the West;
- sectoral deficiencies due to delayed industrial restructuring and efforts to become self-sufficient in the past;
- alarming deficits with regards to material and institutional infrastructure and human resources; and
- extensive waste in resources and environmental pollution in practically all sectors of the eastern German economy.

In order to be able to become self-sustaining, regions need manufacturing sectors which are not only able to offer goods for regional sales, but are well-adapted to the inter-regional division of labour and international trade. Consequently, the rapid decline of most eastern German regions was principally the result of a significant fall in demand which affected all sectors, whether or not directly dependent on final consumer markets. It became painfully apparent that most eastern German companies lacked sales and distribution channels in the national economies of the West - notwithstanding inferior quality and productivity deficiencies - and that therefore they had to compensate for earlier neglect in developing marketing, sales and distribution systems, which is always a time-consuming process. As a result of the extreme domestic orientation for the sale of goods in the GDR, demand decreased sharply in nearly all sectors. Further, supply

contracts were cancelled because eastern German suppliers could not compete with firms in the West in terms of quality, price, and delivery service and times, making overall order-related production times up to a year longer than normal market completion times in the West (Ruben, 1992). Lastly, as a result of industrial combines being split up into individual companies with differing capabilities, many closely-knit combine-oriented supply contracts were abruptly terminated. Early in 1991, the final component supporting sales, trade with other COMECON countries (accounting in most cases for three-quarters of GDR companies' goods exports) also collapsed.

To the extent that this fall in demand is attributable to a lack of competitiveness with regards to quality and price and the collapse in exports to neighbouring eastern European countries, it is hoped that it is only a temporary phenomenon. This will be true if eastern German companies can quickly address the problems of the inferior quality of their goods and their poor value for money - which has been determined in part by the productivity gap - as well as become better integrated into western sales and distribution systems through investments. Although the Central and Eastern European countries will need western financial aid for transforming their economic systems, the establishment of a company-specific logistics system for distribution and better marketing will be the decisive starting point for solving many problems.

In view of the difficulties former GDR companies are experiencing in developing new markets in the old German Länder or penetrating existing ones without support from companies in the West, efforts will have to be concentrated, above all, in markets in the east and, consequently, aid for neighbouring Eastern European countries represents an important measure for supporting demand. However, because of the economic difficulties of these potential consumer countries, success in sales sectors in the east will only be achieved in the long term. Consequently, in many cases where the location of companies in the new German Länder is at risk - for example in the iron and steel producing industry - the fall in demand will be of an enduring nature and force inevitable production adjustments with corresponding job losses.

The sector close to the consumer stage is also suffering from a fall in demand. However, this was and is often less due to the developments in respect of purchasing power than in many cases to a more temporary reaction of the private consumer. Unlike the real gross domestic product, private consumption in the new German Länder rose in real terms by 18.2 percent in 1992 (1993: 11.3 percent; 1994: 7.6 percent) and in 1995 it will grow by another 5.0 percent. These figures reflect a stabilising of private consumption in the new German Länder thanks to the immense financial transfers from western Germany to eastern Germany. In 1991 these (gross) transfers to eastern German regional administrative bodies and social security institutions still amounted to approximately DM 133.5 billion; for 1995, however, gross transfers of around DM 200 billion are expected which means that the transfers from West to East in the last five years amount to a total of nearly DM 850 billion (i.e. approximately six percent of the West German GDP each year) (Arbeitsgruppe, 1994). The result is that to a significant extent the new German Länder do not make their income by way of their own production but it is financed externally and, at the same time, the transfers prove that the 'sharing' called for in many speeches has been in practice for some time. Other Eastern European countries whose economies are also undergoing a painful conversion process can only dream of such an initial situation; in

these countries, production, the labour market and - due to the drop in employment and income - private consumption are falling, all building up to a negative process difficult to halt.

Thus, the fall in demand noted for 'locally' produced products in the sector close to the consumer stage is more the result of the reaction of consumers who at present still favour western products - be it out of belated revenge on former GDR products or euphoric over-estimation of the quality of western products. Some East German companies also find it difficult to integrate their products into the sales and distribution systems of trading chains organised by western Germany. In the longer term, however, such problems should be resolved, allowing eastern companies to also have a share in the expansion of private consumption in the new German Länder.

As far as labour productivity is concerned, most eastern German sectors only attained 20-40 percent of the comparable western German level. The gross domestic product per gainfully employed person in the new German Länder in the second half of 1990 was on average only DM 12,500, just under 29 percent of the corresponding comparative value in the old German Länder. This marked productivity deficit was a result of the guaranteed employment which, compared with Western companies, led to an economically unviable personnel surplus (hidden unemployment) and to an excessive manufacturing depth. An aggravating factor in many cases - due to the failure to make essential investments to replace items - was obsolete physical capital assets, often still characterised by a considerable degree of disproportionality (incompatible old and new machines next to each another).

For example, the large blast furnace in Duisburg-Schwegern (13.6 m furnace) with a volume capacity of 3,600 m³ was able to produce more pig iron than all the former GDR's small and obsolete furnaces put together. In 1989, the blooming and slabbing mill in Thale was still operated using a steam engine dating from 1912 and there is no hot wide strip mill at any steel location in the new German Länder. As regards the railways, there was concrete sleeper destruction over approximately 3,000 km, due to obsolete bridges and worn-out foundations. The East German State Railways had high diversion factors, in some cases by a factor of four, and a predominance of twin-axle coaches with an average weight-bearing capacity of only 35 t. which limited the transport capacity, and the average age of around 20 for the passenger coaches gives an indirect indication of the problems in respect of the comfort of rail transport. The age structure situation was not much better for other transport routes and modes of transport. For example, whereas in the old German Länder only approximately 14.5 percent of all bridges on trunk roads date back to before 1940, this was the case for nearly 70 percent of trunk roads in the former GDR. This list of deficits could easily be added to.

In order to keep as many companies as possible operational, it is necessary to increase labour productivity as quickly as possible; this can only be achieved by reorganising company production operations and by way of extensive rationalisation investment. The first measure, which may on its own be able to increase productivity by 40-60 percent, requires all business activities with no influence on viability/profitability (for example forwarding, gangs of navvies, company crèches, rest homes, etc.) to be excluded or discontinued and, consequently, implies in most cases making 40-70

percent of the previous work-force redundant, leading inevitably to increased unemployment. An additional measure must be to reduce the age of the physical capital assets by way of rationalisation investment. Such investment at least safeguards some jobs and in the current phase it is at least as important as investments for expansion and foundation. However, these measures often fail due to insufficient financing and, consequently, investment from Western companies is required.

If the sectoral structure of the former GDR is compared with that of the Federal Republic in its former form, at the time of reunification, East Germany was at around the 1958 to 1964 development stage. Indications of this are the great importance of sectors several stages from the final point of demand and the under-development of parts of the tertiary sector. The latter factor is of particular significance given the increasing tertiarisation of production evident above all in the West. This trend manifests itself by way of an increase in the proportion represented by services in the product value, an increase in significance of the tertiary sector and a growing utilisation of external services. The latter is also, in part, associated with an externalisation of in-house services. The process of services representing an increasing proportion of the product value is partly also a result of new forms of division of labour between firms/globalisation and internationalisation of production. There is considerable catching up to be done in the new German Länder as regards these tertiary activities.

On the other hand, the number of jobs in large parts of the so-called social consumer sector - in particular the highly subsidised public health, social, cultural and education sectors - needs to be reduced. This is also the case for the so-called 'prosthetic industries' - ie. economic sectors which had to be held up artificially by government planning as a result of the division of Germany and the conscious exclusion of the East German economy from the international/inter-regional division of labour which evolved. In the same way someone who has lost a leg uses an artificial limb in order to still be able to 'function' to a certain extent, the former GDR needed to establish artificial sectors (for example large parts of the iron and steel producing industry) in order to sustain the economy. Once the subsidies provided to date have run out and the fight for self-sufficiency has been outgrown, these sectors will become obsolete as they cannot survive without subsidies and must be dismantled, laying off the work-force. Unlike in human medicine, the leg grew back - to keep up the analogy - by way of reunification, making sectoral prosthetics redundant.

There are also significant deficits in the material, institutional and personnel infrastructure/federal structure. The transport infrastructure is of particular importance amongst the items of material infrastructure. It is a prerequisite for the inter-regional division of labour and can end up limiting development.

14.1.2 Conclusions for Other Countries Undergoing Transformation

It is to be assumed that most Central and Eastern European countries undergoing transformation will be faced with similar structural challenges as the former GDR shortly after reunification. This means that in these countries too when compared with West European standards and structures:

- many products are of inferior quality, causing sales problems at home and abroad;
- most potential export sectors do not have their own sales/distribution channels in the West and, consequently, in the short term, without the co-operation of Western European countries companies, find it difficult to penetrate Western markets to bring in foreign exchange;
- the exchange of goods between former COMECON business partners has more or less collapsed and, consequently, the traditional export support has disappeared;
- labour productivity in many economic sectors is low due to physical capital assets becoming obsolete, poor in-house organisation and the inferior qualifications of some of the work-force and management;
- the material infrastructure is full of holes, in particular in the telecommunications, roads and supply and disposal sectors; and
- there is a lack of efficient administration, above all at the lower regional administrative body level.

In terms of regional policy, this means that a country which is faced with such problems and is to be integrated into the EU must be protected by way of an exchange rate determined by the market if its export basis, an important prerequisite for development, is not to crumble as happened during the process to create economic and monetary union between the (then still) GDR and West Germany because the exchange rate was determined politically. The per capita GDP in eastern Germany sank to 35 percent of the EU average after reunification - ie. below the level of Greece and Portugal. At that time, all the new German Länder qualified for West German and EU regional policy development subsidies. The situation has now improved and regional disparity as regards the development process has been revealed, peripheral, rural areas and certain former industrial areas in particular emerging as problem areas.

Unlike East Germany though, Central and Eastern European countries can, with the help of properly functioning exchange rates, lessen the shock of integration into the EU economic area with its market economy and in the short term maintain a certain degree of competitiveness, even without major investments. However, in view of their lack of self-financing power, Central and Eastern European countries too are in great need of an influx of foreign capital in order to reorganise the badly structured and in some cases obsolete physical capital assets; this not only requires the introduction of the basic conditions of a market economy - above all granting foreigners proprietary rights - but also interventions in respect of structural policy.

It was demonstrated in East Germany that reorganising worn-out physical capital assets and building up new ones, including an appropriate infrastructure, is not only a question of the ability to finance such significant investments. A further, more significant factor associated with its implementation is the problem of the limited

absorbing capacity of regions and national economies as regards the monetary capital available for investment purposes. This absorbing capacity is characterised by planning regulations, bottlenecks in government and private consultancy planning capacity and capacity bottlenecks in the construction industry with major suppliers; experience in eastern Germany showed it to be no more than 20 percent of the relevant total value of goods produced and services rendered for the region. In the new German Länder it was above all the limited government and private consultancy planning capacity which was evident.

These experiences in eastern Germany make it clear that time is needed to reorganize and adapt the existing physical capital assets/rebuild a capital fund. The results of calculations for eastern Germany indicate that it will take at least 15 to 20 years to eliminate the disparities in the level of prosperity within Germany. For Central and Eastern European countries, however, in view of the fact that they are also faced with serious financing bottlenecks, the period required to reach a level of prosperity comparable with that of Western Europe will be even longer. Consequently, in order to prevent the economic forces being wasted, Central and Eastern European countries should, to an even greater extent than eastern Germany, set priorities and give preference to those projects and regions which promise to result in the growth of the entire national economy. This requires regional policy to be orientated towards growth and not towards balance and equality.

However, there are also considerable differences between East Germany's initial problems in respect of structure and those of Central and Eastern European countries. The specific problems of eastern Germany are that:

- the creation of economic and social union on 1 July 1990 meant that the existing productivity deficits and trade disadvantages could no longer be counterbalanced by altering the exchange rate;
- due to the great risk of skilled workers moving away, East Germany's wages had to be adapted to the level in the West as quickly as possible;
- this wage adjustment was not justified either in terms of level or by developments in respect of productivity and, consequently, it contributed significantly to workers being made redundant;
- adopting West Germany's social security system made the work factor even more expensive due to the high wage incidentals;
- consequently - setting aside for the moment the well-qualified workforce -, eastern Germany has no cost advantage or resultant locational advantage over Central and Eastern European countries as regards the work factor but badly needs to rapidly reorganize its physical capital assets in order to legitimise payment which is not orientated towards productivity;
- in many cases, however, western Germany's difficult licensing law was too much for the new administrative bodies being set up, above all at municipal level; this led to investments being held up; and
- in many cases to start with the complex and unclear property laws (lack of documentation and vague claims of former owners) prevented investment.

It was above all the increase in wage costs which scared many investors off. As far as this cost factor was concerned they found the locational conditions to be better in most Central and Eastern European countries than in eastern Germany. In the initial stages the confused ownership circumstances and the need to get used to the new legislation also constituted an obstacle to investment. Consequently, unlike eastern Germany, Central and Eastern European countries could and should above all exploit the advantage of wage trends adapted to productivity. In particular, attempts should be made to increase the sectoral and regional wage differential in order to be of interest to investors at home and abroad. However, without the guarantee of clear proprietary rights and additional regional policy measures, even this orientation towards productivity will not be sufficient to make Central and Eastern European countries attractive enough as locations.

In comparison with Central and Eastern European countries, eastern Germany's development has been assisted by:

- the rapid adoption of West Germany's basic legal conditions, ie. by way of the formal transformation of the economic system (creation of a legal, economic, social and administrative union) overnight, above all guaranteeing legal certainty;
- an immense transfer of capital amounting to over DM 850 billion between 1991 and 1995 and leading to the stabilising of domestic demand in the eastern German regions and, as a result, to much investment in the non-basic sector (eg. services, craft, residential building) dependent on regional demand; and
- immense government investment in central infrastructure sectors with the result that most regions in eastern Germany are today deemed to be adequately developed as regards roads and telecommunications.

The most important reason why western companies invested in eastern Germany, however, was not so much the actual regional development (GRW, EU) but rather the stabilising of purchasing power by way of financial transfers and the fact that western Germany was operating at full production capacity in the period 1990 to 1992. Thus, in 1993, well under 10 percent of the gross financial transfer of around DM 170 billion went to regional development as such; the majority of the remainder went towards stabilising consumer demand and, consequently, favoured the non-basic sector. In many parts of the services sector it was above all western German companies which asserted themselves strongly and they very quickly dominated the regional markets. In this respect, Central and Eastern European countries have the advantage of better protecting sectors with lower productivity - eg. trade - against foreign interests in a part of the economy not characterised by international trade and, consequently, unproductive jobs can be saved, at least on a temporary basis.

The regional policy activities for eastern Germany were only to a limited extent an expression of a new development strategy or institutional form, the established development concept of West Germany and EU regional policy being adopted to a much greater extent. This meant a large degree of subsidising and developing specific areas and financial support for developing physical capital assets. Academics' demands which initially pleaded for greater spatial emphasis on development and a

temporary acceptance of regional disparities did not get much of a response. In view of the major regional problems and very limited financial resources in Central and Eastern European countries, however, in their case, the extent to which greater emphasis development would in fact make sense should be examined. This would require priorities to be set on a spatial basis with a view to concentrating infrastructure expansion and development efforts on those locations and regions whose circumstances promise the fastest development effects.

Based on the results of Treuhandanstalt privatisation activity, structural research in Germany (Löbbecke *et al.*, 1993) and recent regional research, it is known that regional development processes are normally successful if there is:

- an adequately functioning infrastructure;
- a favourable settlement pattern;
- adequate qualified workforce potential;
- a good location;
- sufficient land available;
- adequate provision of business-related services; and
- a good image and economic climate.

Within the complex locational factor 'infrastructure', a general upward revaluation of the importance of the telecommunications and road infrastructures in particular has been in evidence for some time now. On the one hand, organisational and logistic requirements for the transport of goods are on the increase and, on the other hand, a telecommunications and transport infrastructure which is adequate both quantitatively and qualitatively is a prerequisite for an economy operating on a world-wide level and with division of labour. Consequently, the successful and rapid expansion of the telecommunications network was one of the most important achievements in improving eastern Germany's quality as a location and it merits full recognition. In this respect, Central and Eastern European countries should above all focus their efforts on expanding the networks on an insular basis and linking the regional networks using mobile radio.

The local/regional availability of long-distance road connections is also becoming increasingly important as a locational factor. A region or a centre only appears attractive in the longer term if it has an efficient (as internationally orientated as possible) airport or there is one nearby, it is guaranteed to form part of the European high-speed rail network and the capacity of the trunk road network is adequate. This assessment can presumably be integrally transferred to the regions of Central and Eastern European countries. Due to the simple fact that airport connections cannot be provided in an unlimited number of regions, emphasis development would appear to be advisable here too, possibly with smaller countries joining forces to build an airport.

Against a background of internationalisation of the division of labour, reduced depth of manufacture and a requirement for just-in-time supplies, however, development by way of other modes of transport and geographical location are also becoming increasingly important. In this respect a differentiation is made between locational

conditions relating to extensive or smaller areas. In the former case they relate to the location in a network defined on the basis of an extensive area (European and national level); in the latter case they relate to establishing the importance of the surrounding area to centres. In any case, location and transport infrastructure are significantly interdependent. Although the location - for example in relation to spatially pre-determined sales centres or centres which have evolved - is determined in geographical terms, road construction, in particular establishing and expanding the long-distance road network, is able to influence the accessibility circumstances in a road network which are defined in terms of timings. Thus, the connection between a departure point and a destination can be described as good if the destination can be reached within the shortest possible amount of time.

If all possible destinations in a road network defined in detail are taken into account, the position of a region within an extensive area can be described for specific modes of transport - for example by establishing the average journey time to all regions of Europe, weighted with their population figures - thereby making the measurement accessible. In order to determine these location indicators, increasing use is being made of digitised traffic networks, the edges of which are characterised by length and the speed to be travelled at and into which both the points of departure and the destinations have to be fitted. Integration-orientated road planning would first have to integrate the regions classed as capable of development into a European road system in such a way that - defined over the entire network - there are clear improvements in accessibility circumstances, as defined in units of time, in the regions of Central and Eastern European countries to be developed. A rapid expansion of the transport infrastructure orientated towards the existing European traffic network would have to be one of the most important prerequisites for successful economic development of Central and Eastern European countries and their regions. Only in this way can these regions be integrated into the pan-European division of labour and use this 'hard' location factor which is often of key significance for investment decisions to compensate for the disadvantages of other - eg. 'soft' location factors.

In addition to these locational conditions defined in terms of an extensive area and specific modes of transport, there are also locational aspects relating to small areas. With finished products ever more sensitive to time and transport factors and the resultant increase in consultation comes a necessity to look for a location close to the sales location. Expensive but highly perishable products need to be close to a large market as do low-value mass-produced goods for which, however, transport costs are a sensitive factor (this applies to mining, stones and earth, the furniture industry, paper and the printing industry, standard and luxury foodstuffs and the construction industry). The smaller the company, the greater the significance of proximity to regional markets can be. Smaller companies from time to time rely on regionally limited advertising media, are not able to maintain significant dispatch and forwarding facilities and produce goods where the proportion of services is high (products requiring a great deal of maintenance, construction). One possibility for clarifying this component influencing location is to establish the populations accessible in one, two and three hours using specific modes of transport. In Germany, for example, foreign investors are above all interested in those centres from which more than five million people can be reached by road within three hours.

The settlement pattern is also a significant factor; this can be described by way of population figures and density and centrality values. Nearly all empirical studies available to date indicate that there should be more than 250,000 people in a centre which is to develop the characteristics of a growth pole. However, people alone are not sufficient, as shown by experience in East Germany; in order to attract outside investors the necessity to establish a services infrastructure is more important. Institutions making up the business-related services sector include those offering legal advice, tax consultancies, accountants, auditing companies, management consultancies, architects, consulting engineers, advertising agencies, data processing companies, secretarial offices, and credit enquiry agencies. Painfully apparent in many regions of eastern Germany was the lack of good hotels, the limited number of restaurants and the absence of some important institutions in the health sector.

The most difficult concept to grasp is that of regional image. In this respect the old marketing adage applies: it is not the facts as such but opinions about those facts which are decisive for the acceptance of products and locations. Such image factors relate above all to how well known a given location is internationally and how the local/regional quality of life is rated. Thus, in eastern Germany locations along the classic Eisenach-Gotha-Erfurt-Weimar cultural axis and the cities of Berlin, Dresden, Leipzig, Halle and Magdeburg attracted above-average interest. Consequently, the towns favoured are those with a clear urban/sophisticated nature (measured, for example, in terms of social variety, population density, level of inhabitants' qualifications, etc.), a historical tradition, important historical monuments or significant cultural institutions or which exert an influence over the entire region. For this reason it is to be expected that the larger centres in Central and Eastern European countries which function as capitals (eg. Prague, Budapest, Warsaw) and are also of appropriate historic significance will be attractive to foreign investors. These conditions are often grouped together under 'soft' locational factors; it is difficult to measure these components because synergy effects mean that different sized segments always have to be grouped together. However, in the context of the intensifying international location contest, regions must develop specific marketing strategies in order to attract international attention.

Grounds for setting spatial priorities in the initial phase are also included under image considerations. Thus, it appears important to create 'show regions' or regions on which hopes are pinned in order to improve the chances of a country being accepted which foreign investors may regard sceptically. In selected cases there is also the possibility of creating free trade zones to achieve this breakthrough.

Experience in eastern Germany again stresses the importance of the lower regional administrative bodies (municipalities) as regards the success of regional economic processes. They are not only responsible for the way regions portray themselves but can also create a good economic climate through good co-operation between those looking to set up in the area and the authorities, a particular task of these authorities being to prepare planning, develop industrial areas and approve investments. Red tape at this level can become a key obstacle to development. In order to guarantee that the regional level functions efficiently, however, appropriate basic institutional conditions for its activities must first be created. To date this has only been done to a limited

extent in Central and Eastern European countries and, consequently, special attention must be paid to this aspect in the transformation process of these countries.

Given the above, the integration of East Germany into the Federal Republic of Germany offers an interesting insight into the possible problems of integrating other countries, in particular Central and Eastern European countries, into the EU. If these countries and the EU learn from these lessons, a series of difficulties under which eastern Germany is still suffering can be avoided in Central and Eastern European countries. This applies in particular to monetary union which took place too early and was orientated towards political rather than economic standards in the form of fixed exchange rates and a wage policy not tied to productivity.

14.2 Southern Integration

The two southern enlargements of the EU during the 1980s – the accession of Greece in 1981 and of Portugal and Spain in 1986 – may bear provide several lessons for a potential eastward enlargement, because the parallels in different respects are obvious.

- Both regions are situated on the periphery of the EU.
- The southern enlargements were not only motivated by economic considerations but also by the political goal of stabilising the democratic order in the new EU-members (Hallet, 1995). The same would be true for an eastward enlargement.
- Income disparities in the EU grew substantially after the southern enlargements and the same will happen after an eastern enlargement.
- At the time of entering the EU, the economies of the new, southern EU-members were market economies in principle but still strongly influenced by the government and, in part, they suffered from autarchic tendencies in the past. The Central and Eastern European countries face the same problem, although to a greater extent.

Bearing in mind these parallels some lessons can be drawn from procedures and results of the southern integration which may also be valid for the potential Member States.

The first conclusion is rather simple: accession to the EU cannot be completed overnight but has to follow a timetable leaving room for adjustments necessary on both sides, in the acceding countries as well as in the EU itself. In the case of Portugal and Spain all EU rules came into force within a span of seven years. As the potential Member States in Central and Eastern Europe show a higher backlog behind the EU in terms of income-levels, openness of their economies and political stability than the Iberian countries at the time of their accession, the transition period can be expected to last much longer.

A second conclusion becomes evident when looking at the development of per capita income. One of the most important goals the potential Member States want to achieve is to reduce their disparity in per capita income. The experience from the southern

enlargements is that membership in the EU offers the chance of disparity reduction but is not a guarantee of being successful in doing so. Relative to the EU average, per capita income increased considerably in Spain as well as Portugal after they became members of the EU. Greece, however, was not successful in reducing income differences. This is not the place for analysing in detail the success of Portugal and Spain on the one hand and the failure of Greece on the other hand. But it is striking that monetary indicators such as inflation and interest rates, as well as fiscal indicators, also show convergence in Spain and Portugal whereas they remained far above EU-average in Greece for a long time (Hallet, 1995). Furthermore, Greece obviously neglected capital formation for a long period, especially in the second half of the 1980s because the share of investment in GDP was markedly below the corresponding quota in Portugal and Spain. Thus, economic policy in the potential Member States should have great influence on cohesion.

A third experience is related to trade and economic integration. A good deal of the increase of intra-EU trade after 1985 can be attributed to trade-creating effects as well as trade-diverting effects of the southern enlargement, especially with respect to Spain. In 1986, Spain's share of intra-EU imports was only 3.7 percent, and it accounted for only 3.6 percent of intra-EU exports. Up to 1994 the shares rose to 6.7 percent and 5.5 percent respectively. At the same time the EU's share in Spanish trade grew considerably, especially in its trade with industrial goods (for a more detailed analysis see Hohlfeld, 1995). Although the trade of the EU with the Eastern European countries has grown considerably since the start of transformation, becoming members of the Union would mean another impulse for trade.

A last conclusion may be drawn with respect to EU policies. The increasing income disparities generated by the southern enlargements gave momentum to redistributive policies in the EU. Each deepening of integration was accompanied by a strengthening of this redistributive element: the Single European Act gave rise to the Structural Funds, in the Maastricht Treaty the Cohesion Funds was introduced. As discussed in Chapter 17, after an eastward enlargement of the EU, income disparities would become even wider. Thus, there is some logic in assuming that this enlargement will be accompanied by a call for additional redistributive efforts. However, the share of low income regions in the EU will grow, and thus the burden the high income regions have to bear would rise considerably - assuming that subsidies per capita to the potential members will be equivalent to the payments to the southern EU members. It becomes evident that there is increasingly a need for reform of EU policies.

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15. IMPACT OF EU ENLARGEMENT: TRADE AND INVESTMENT

15.1 Macroeconomic Developments: Internal Specialisation and Division of Labour

Transformation in Central and Eastern Europe (CEE) brought about manifold change in economic relations between the formerly centrally-planned economies and the European Union, as noted in Part II (especially Chapters 6 and 7). First, this change took place at the institutional level. Trade agreements were negotiated mostly in 1989, in some countries even still under the old economic regime. At the next stage the 'Europe Agreements' came into operation, at first with Poland, the Czech Republic, Slovakia and Hungary and afterwards transferred to other partners. Finally, Poland, Hungary, the Slovakia, and Estonia have applied in the meantime to become members of the European Union. All these arrangements resulted in a stepwise liberalisation of trade.

Second, an even more dramatic change can be observed in the field of trade. This change cannot be measured by the volume of trade only, although the increase of exports (+151 percent between 1988 and 1994) as well as imports (+110 percent) with EU12 is impressive. It must also be taken into account that at the same time there was an enormous structural change in trade. Third, foreign direct investment (FDI) in CEE increased considerably. Under the central planning regime almost no FDI took place at all. In 1994, cumulative total FDI can be estimated to approach almost US\$ 18.3 billion - not too much in relation to the capital needs of CEE but high relative to past experience.

All these changes in the prospective New Member states had consequences for the macroeconomic performance and for sectoral change in CEE and in the EU as well. For the eastern side, transformation put pressure on highly protected industries with the consequence of a significant decline in production. Not all sectors were hit by these developments to the same extent. In particular, the service sector - heavily underdeveloped in all centrally planning economies - grew after the liberalisation of markets. On the western side, some sectors - in the beginning especially producers of consumer goods - benefited from the increasing demand in CEE, others - often producers of intermediate goods - were confronted with a decline in demand for their products. At the same time, some sectors felt increasing competition from imports from the transforming economies.

This chapter concentrates on two aspects out of this set of consequences: the development of trade relations between the EU and the CEE countries and the development of FDI. Due to their greater economic importance, the report concentrates on the perspective new Member States in Eastern Europe. Some remarks about Cyprus and Malta are made in a separate chapter. (There is also some unavoidable overlap with Chapter 7.)

15.2 Trade and Division of Labour

15.2.1 Volume and the Direction of Trade

Trade between the transition countries and the EU traditionally was rather small. Before the start of transformation, the share of transition countries - which is not exactly the same definition as the transition countries² - in extra-EU exports and imports rarely exceeded seven percent except exports in the 1970s and imports in the early 1980s. Between 1975 and 1988 the share in exports has been declining. The rise in the share of imports was due to higher oil prices, as crude oil and natural gas became the most important goods imported from the Soviet Union. Since 1990 a sharp rise in export as well as import share can be recognised.

The situation before 1990 must be considered as 'abnormal'. The transition countries are the EU's neighbours to the East and bearing in mind the impact of geography on trade, intensive trade relations should be expected. However, trade relations have been distorted by the central planning system for reasons which need not be discussed here. In recent years several attempts have been made to quantify this distortion. Furthermore, these calculations may also help to evaluate the increase in trade since 1990 and to shed light on future trade.

One of the first analyses in this direction was made by Collins and Rodrik (1991). They based their estimations on historically observed trade patterns from the interwar period and assumptions about the 'openness', ie. the share of exports in GDP. For 1988, they estimated the hypothetical volume of trade between the EU12 and CEE including Yugoslavia and the Soviet Union to be US\$ 147 billion in the case of Central and Eastern European imports and US\$ 144 billion in the case of exports. Both figures mean a tripling of actually observed trade in 1988. Alike in all calculations that follow, their prediction of the long run effect depends greatly on their assumptions about the development of income in CEE. Assuming that per capita income in the transforming economies will reach the EU average, they predict exports as well as imports of US\$ 380 billion (Collins and Rodrik, 1991).

Several other calculations employ gravity models to estimate 'normal' trade relations and to forecast future trade. To compare their results is a difficult task. First, they base the estimates on different years and different samples of reference countries. Second, the definition of 'Central and Eastern Europe' varies across the papers. Some include Yugoslavia and the GDR, others exclude the Soviet Union as will be indicated in the survey to follow.

One of the first analyses in this direction is made by Havrylyshyn and Pritchett (1991). They give no estimate of hypothetical trade under market conditions as they normalise their results to actual trade. Furthermore they restrict their analysis to non-oil trade. However, their calculations give an impression of the redirection of trade that can be expected after transformation. In 1986/87 more than half of Central and Eastern

² The figures for the Eastern European Transforming Countries include trade of the former Soviet Union and Yugoslavia in the total.

European (including Yugoslavia, excluding the Soviet Union) imports and 62 percent of the exports were intra-CMEA trade. The authors' prediction was that this share would decline to 11 percent (imports) and 17 percent (exports) while at the same time Western Europe's share would rise from 39 percent to 83 percent (imports) and from 26 to 80 percent (exports) (Havrylyshyn and Pritchett, 1991). One interesting aspect of Havrylyshyn's and Pritchett's results is that Western Europe will also gain at the expense of America and Asia.

Hamilton and Winters based their analysis on a gravity model using 1985 data (Hamilton and Winters, 1992). They stated that an even wider gap between actual and potential trade than Collins and Rodrik and other analyses. They predicted Central and Eastern European exports (including the GDR and the Soviet Union, excluding Yugoslavia) to EU12 of US\$ 133 billion in 1985 compared to actual trade of US\$ 27 billion. For the import side the relationship is even more dramatic: potential trade of US\$ 142 billion comparing to an actual value of US\$ 22 billion. They also make predictions for individual Western countries: the gap between actual and potential trade would be relatively small in the case of Japan and Germany, widest in the case of the US. Even for Japan, however, potential trade was three times the actual value, whereas for Germany the factor was approximately 5.

Döhrn and Milton used a gravity model based on the network of trade among 26 industrialised and newly industrialising countries (Döhrn and Milton, 1992). The stability of the coefficient of this model was tested for the period 1983 to 1989, and the estimations for CEE used 1988 coefficients. Using World Bank income data, this study came to a more moderate judgement of the distortion of trade. Whereas actual 1988 exports of the transforming countries (excluding Yugoslavia) to industrialised countries and the NICs amounted to US\$ 36.6 billion, hypothetical exports of US\$ 52.6 billion were calculated. Breaking down this result by individual market economies, they came to the result that estimated German and Japanese trade was even higher than its actual value, whereas the distortion was relatively high in the case of most other EU countries. On the Central and Eastern European side they furthermore noted a bias in favour of the Soviet Union, where the gap between actual and predicted trade was relatively small. Döhrn and Milton also tried to quantify long-term effects. For this purpose, they assumed a doubling of per-capita income in Eastern Europe within ten years. This would imply that future trade would be four times as large as 1988 actual trade, which also meant a moderate growth compared to the projections of Collins and Rodrik.

Finally, a recent study of Festoc has results that are reasonably in line with the above studies (Festoc, 1995). For 1992, after four years of adjustment, it stated that EU exports to Poland, Hungary and Czechoslovakia were on average 60 percent below trade potential. For EU imports from these countries the gap had narrowed to 30 percent on average. Concerning imports Germany was the only country that had fully utilised its potential; in the case of exports its degree of utilisation was highest.

Together, the papers cited give some hints at future trends in EU - CEE trade. The common features are the following.

- Trade has been significantly distorted in favour of intra-CEE trade and thus, with the beginning of transformation, there has been a reorientation.
- Historically West-East trade was biased in favour of the Soviet Union which, because of its rich endowment with natural resources and its political influence, had easier access to Western markets.
- Among Western countries, the utilisation of trade potential differs significantly. In the case of Germany differences between actual and potential trade were particularly small.
- Large differences exist concerning the magnitude of the distortion. In principle these discrepancies are the consequence of different estimates of actual and future income in the transition countries. Collins and Rodrik based their calculations on PlanEcon figures, Hamilton and Winters on the Summers and Heston figures. From today's point of view both seem to represent the upper limit of GDP estimates. Döhrn and Milton relied on World Bank estimates of US\$-GDP, which are at the lower end of estimates found in the literature.³

These common features are mirrored in EU15 1988 exports to CEE. Approximately 40 percent of all exports were shipped to the Soviet Union and another 20 percent to Yugoslavia that was more open to international trade than the CMEA countries (Table 15.1). Nearly 40 percent of all EU15 exports into the region came from Germany whereas the German share in total extra-EU exports was only 30 percent. A second important exporter was Italy whose share in trade with CEE also exceeded its share in Extra-EU trade. Furthermore, the new EU-members, Finland and Austria, have a significant presence in Central and Eastern European markets. Finland was almost exclusively oriented towards the Soviet Union. Austrian exports were concentrated relatively strongly on Hungary and Czechoslovakia.

By 1992 a significant change in EU-CEE trade had already taken place (Table 15.2). The clearer shifts were those between the Central and Eastern European trading partners. Trade with the former Soviet Union and the former Yugoslavia lost its importance. Actually, it remained nearly constant in absolute terms, although Russia still is the most important partner in CEE. Trade with Poland, Czechoslovakia, Hungary and Romania tripled within a span of only four years whilst trade with Bulgaria had been declining. In this regard, the expectations presented above were met. Rather astonishing are the results with respect to the structure of the Western trading partners. It was not those EU members with poorly developed trade that succeeded in catching up - such a shift is suggested by the gravity models but the opposite was the case: Germany, Italy, and Austria, which belonged to the most important exporters in the past, gained in importance. Italy expanded its exports to the southern transition countries whereas Germany and Austria increased their shares in the Central European markets, namely Czechoslovakia, Poland, and Hungary.

³ It should be noted that the different GDP estimates also show up in the data base and thus in the coefficients of the models used for estimation. Thus, the influence of the use of different income figures should not be overestimated.

Germany also expanded its market share in the former Soviet Union. On the other hand, Finland, whose trade was concentrated almost exclusively on the Soviet Union, suffered from a sharp (absolute) decline in exports.

15.2.2 Composition of Trade

More important than those changes in the geography of trade were the shifts in its composition with respect to goods. Traditionally the exchange of goods between the centrally planned and the market economies covered only a very limited number of products. Raw materials and highly standardised low-tech goods dominated Central and Eastern European exports, because they could easily be sold abroad using price as the only marketing instrument, and offered the opportunity - according to the concept of central planning - to allow quantities of exports to be fixed. Eastern imports concentrated on investment and intermediate goods that were scarce or could not be produced with the technology available in their countries. Consumer goods were imported by CEE only in rare cases. In addition, trade was influenced by strategic considerations; exports of goods that could be used for military purposes were prohibited.

This situation resulted in some cases in an extremely high concentration of exports as well as imports on a relatively small number of products as can be seen from the coefficients of concentration in Tables 15.3 and 15.4 for 1988. This concentration was higher for EU imports than for exports. There also seems to be a correlation between concentration and per capita income on both sides - East and West. With the start of transformation and the opening of the transition economies, their external trade underwent a marked structural change. Altogether, its concentration was reduced compared to 1988, but there are significant differences between the transition countries. In general the changes were more marked with respect to EU imports than with respect to exports. Furthermore, changes in trade with Hungary, Romania, and Bulgaria were more intensive than changes in trade with Poland. Czechoslovakia and the Soviet Union were the only cases where deconcentration of EU exports was larger than of EU imports.

However, just as the composition of trade under the central planning regime was at least not strongly influenced by comparative advantages, the newly arising trade structures were distorted, reflecting skewed sectoral structures in the centrally planned economies. For many reasons, sectoral structures in CEE were shaped by the industrial sector, especially the so-called heavy industries. This was a consequence of the Stalinist strategy of development as well as of the Marxist disregard of service sectors. It also may reflect the planners' preferences for large-scale production processes that offered easier access for planning techniques than production of consumer goods for individual needs (Döhrn and Heilemann, 1992). Altogether, at the end of the central planning era, in many transition countries there were large capacities in the field of iron and steel, basic chemicals, cement, and related products. The goods produced in these plants were - in the short run - highly competitive on Western markets as the capital costs of the factories could be regarded as sunk, losses were often covered by the state as these enterprises were not privatised in many cases, and an undervalued currency supported exports.

Thus, export structures in the first years after transformation may not serve as a guide for the future division of labour. The advantages of the existing industries will vanish, especially because in many cases these plants cannot be modernised due to a lack of financial resources. Therefore, in the long run, trade will increasingly follow the direction that is outlined by comparative advantages. Considering factor endowment, human capital, and the state of development, for many of the transition countries these advantages still lie in the agricultural sector (in the case of Poland also: cf. Misala, 1992). To what extent these advantages show up in the external trade depends not least on how the Common Agricultural Policy will react to this new situation. As the Central and Eastern European countries are equipped with a well-trained work force, skilled-labour intensive products can be expected to have growing importance for their exports.

The structure of imports of the transition countries can be considered as distorted also. There was an enormous backlog demand for many consumer goods that were imported as soon as the borders had been opened. The import structure shifted towards consumer goods, but this shift will also be transient, because there is a need for imports of investment goods to modernise and restructure production in the transforming economies.

15.2.3 Consequences for the EU Member States

Bearing in mind all these reservations about the prognostic power of the recent composition of imports and exports of the transition countries, one should, for lack of other information, try to evaluate the consequences of the increase of trade with CEE for the individual EU members. In this context, two consequences will be considered. The first is that the EU-members will compete to a different extent with the Central and Eastern European countries on their export markets, subsequent called the 'competition effect'. The second consequence results from the fact that the import needs of CEE fit to a varying extent into the export structure of the EU-countries, which can be addressed as 'demand effect'. Both effects can be quantified by comparing export and import structures of the EU members and the Central and Eastern European potential members.

The competition effect is measured by comparing export structures of the EU countries with the export structures of the transition countries. The demand effect is calculated from EU exports and CEE imports. As harmonised detailed data of the CEE trade are still missing, some proxy variables had to be used in the calculation presented here. The imports of the EU from CEE have been taken to measure the exports of these countries, while the exports of the EU12 to the transition countries have been taken as Central and Eastern European imports. Furthermore, the relevant data for the new EU members Austria, Sweden, and Finland are still missing in the Eurostat database, so the analysis is restricted to the EU12 members. The comparison of structures is based on two-digit CN figures taken from Eurostat sources, excluding trade with crude oil and natural gas (CN 27) which turned out to have a distorting influence in some cases. All figures relate to 1992.

The similarity of structures is – formally speaking – measured by an index based on the cosine of the angle between the vector of the share of the individual products in EU exports and CEE exports and imports respectively (Hufbauer, 1970). It is calculated as:

$$\text{Cos}X_i Z_i = \frac{x_{in} \cdot z_{jn}}{\sqrt{\sum_n x_{in}^2 \cdot \sum_n z_{jn}^2}}$$

with: X_{in} : Exports product n from of EU country i

Z_{jn} : Exports resp. imports of product n from/to CEE-country j

This coefficient can be interpreted in a similar way like a correlation coefficient: a value of 1 means that both structures compared are absolutely the same, whereas 0 indicates that both structures have nothing in common.

The competition effect seems to be not too strong, bearing in mind that the similarity index used has a maximum value of 1. The differences between the individual EU countries are not too large, with Portugal slightly above and Greece and Ireland below average (Table 15.5). More significant are the differences concerning the demand effects. Whereas the structure of demand in CEE almost perfectly fits into the export structure of the United Kingdom, Italy, and Germany, the southern EU members - Portugal and Greece - and to a lesser extent, Belgium, have an export structure that makes it hard to benefit from growing demand in CEE.

Altogether, the competition effects seem to influence all EU members in the same way. The demand effect benefits especially the larger, highly industrialised EU members and the smaller and less developed EU members will gain less. However, the competition effect will place the southern EU members more at a disadvantage the more that CEE trade is determined by agricultural and skilled-labour intensive products.

15.3 Foreign Direct Investment and Internationalisation of Production

Before 1988, Western FDI in CEE was almost negligible. A few joint ventures had been established, but in general the economic order in the centrally planned economies militated against more intensive relations. After 1988, FDI went up sharply compared to the previous situation, although only moderately with regard to the enormous capital needs. In 1993 and 1994, total FDI inflows in CEE were estimated to have reached US\$ 6.5 million, most investment taking place in Hungary, the Czech Republic and Poland (Table 15.6). Other indications of the growth of FDI - as well as a discussion of the reasons for the increase - are presented in Chapter 7.

Contrary to the situation with respect to analyses of the influence of transformation on trade, there have been only few attempts to quantify the long-term consequences for FDI. Looking at per capita FDI may serve as an initial, relatively simple reference

model, giving a fairly good picture of the future extent of FDI in CEE. As pointed out in the latest Transformation report of the European Bank for Reconstruction and Development, per capita FDI, calculated from aggregate inflows between 1988 and 1994, ranges among the transition countries from US\$ 670 in Hungary - which is outstanding by far - and only US\$ 23 in Bulgaria (EBRD, 1995). By comparison, FDI stocks in Germany reached US\$ 1,500 per capita. In smaller EU countries such as the Netherlands (with a size comparable to Hungary, the Czech Republic or Bulgaria) they reach more than US\$ 5,000. Regional-level differences are discussed in Chapter 7.

A more complex reference model can be derived from a gravity model type analysis of the international network of FDI. Like traditional gravity models of international trade, such a model quantifies the influence of the size of the investor's and the host's country, of other push and pull factors, and, finally, of physical and cultural distances on FDI flows (Döhrn 1995). Applying the coefficients estimated in such a model to the German - CEE FDI relations, Döhrn estimates a 'normal' extent of FDI stocks at given income levels of US\$ 12-18 billion compared to actual (1993) stocks of US\$ 3.4 billion. In the long run, with Central and Eastern European incomes rising, this analysis comes to an estimate of FDI stocks of between US\$ 29 and 34 billion.

As stated above, Western FDI in Eastern Europe has increased significantly. Nevertheless, FDI stocks in the transition countries are far from reaching their 'normal' level yet. Up to now, investors from the EU were more active in CEE than US and - above all - Japanese investors. In the Czech Republic for example about 60 percent of accumulated inflows up to September 1995 came from EU countries, only 14 percent from the US (see also Chapter 7). However, all figures on FDI coming from Central and Eastern European data sources are subject to much uncertainty, in part due to enormous differences in the definition of FDI and the practices of collecting the data, in part because data are very much influenced by some large acquisitions in the context of privatisation. For instance the FDI inflow into the Czech Republic following the privatisation of the SPT telecom in early 1995 can be estimated to amount US\$ 1.3 billion - approximately 25 percent of total FDI stocks in the Czech Republic.

Data collected by EU countries on FDI stocks in CEE are far from being complete. Only six EU countries report data on this subject. According to this incomplete information, FDI stocks from EU countries reached more than ECU 5.4 billion in 1993 compared to ECU 3.1 billion in 1992 (Table 15.7). The most important investor country is Germany followed by Austria and Italy. EU investment exceeds US as well as Japanese investment by far. For 1993, Japan reports FDI stocks in CEE of ECU 0.6 billion (US\$ 0.7 billion). US investment totalled ECU 1.4 billion (US\$ 1.6 billion) in 1993. (A breakdown of key Western investors by CEE country is presented in Chapter 7.)

15.4 Trade with the Island Economies

A first glance at population indicates that the influence of Malta and Cyprus on EU trade and economic development will not be too strong. In Malta there are around

350,000 people, the population of Cyprus is 710,000. For comparison, even the smallest country among the Central and Eastern European transition countries, Slovenia, has a population nearly three times as large as the population of Cyprus. Nevertheless per capita trade of these countries is relatively high, as described in Chapter 12. In 1991 and 1992, for example, EU12 exports to Malta and Cyprus even exceeded exports to Bulgaria by far. Further, EU-Exports to the Island Economies have been growing significantly.

EU imports from the Island Economies were higher from Malta than from Cyprus, although size would suggest the opposite. This is because Malta has become a favourite location for offshore assembly plants. More than 40 percent of EU imports from Malta in 1994 consisted of products that were imported after outward processing. In the case of Cyprus, this special form of trade is not very important.

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Table 15.1: EU Exports to Eastern Europe (1988, ECU mill)

	Poland	Czechoslovakia	Hungary	Romania	Bulgaria	former Yugoslavia	former Soviet Union	Total
BLUE	117	77	110	22	68	166	448	1008
Denmark	85	43	40	4	13	53	125	361
France	272	195	189	101	130	519	1644	3049
Germany	1380	1161	1321	276	736	2933	4117	11925
Greece	10	23	9	26	27	45	69	210
Ireland	15	5	12	0	9	13	21	74
Italy	316	237	268	61	172	1313	1772	4139
Netherlands	218	126	149	40	57	236	383	1208
Portugal	3	3	6	4	5	6	56	84
Spain	44	37	25	2	29	49	225	411
UK	263	196	152	65	123	278	769	1846
EU-12	2722	2103	2280	602	1369	5611	9629	24316
Austria	255	321	468	35	166	534	756	2536
Finland	58	56	49	1	19	26	2691	2899
Sweden	182	101	124	14	49	214	242	927
EU-15	3217	2581	2922	652	1604	6385	13318	30678
Japan	218	41	86	44	136	103	2647	3275
United States	254	46	64	169	107	447	2346	3433
Share in of individual countries in Exports to Eastern Europe								
BLUE	11.6%	7.6%	10.9%	2.2%	6.7%	16.4%	44.5%	100.0%
Denmark	23.4%	12.0%	11.0%	1.0%	3.5%	14.6%	34.5%	100.0%
France	8.9%	6.4%	6.2%	3.3%	4.3%	17.0%	53.9%	100.0%
Germany	11.6%	9.7%	11.1%	2.3%	6.2%	24.6%	34.5%	100.0%
Greece	4.6%	11.1%	4.2%	12.4%	13.1%	21.5%	33.1%	100.0%
Ireland	20.0%	6.1%	15.8%	0.4%	11.7%	18.1%	28.0%	100.0%
Italy	7.6%	5.7%	6.5%	1.5%	4.2%	31.7%	42.8%	100.0%
Netherlands	18.0%	10.4%	12.3%	3.3%	4.7%	19.5%	31.7%	100.0%
Portugal	3.2%	3.8%	7.4%	5.2%	6.3%	7.6%	66.5%	100.0%
Spain	10.6%	9.0%	6.1%	0.4%	7.2%	12.0%	54.7%	100.0%
UK	14.3%	10.6%	8.2%	3.5%	6.7%	15.0%	41.6%	100.0%
EU-12	11.2%	8.6%	9.4%	2.5%	5.6%	23.1%	39.6%	100.0%
Austria	10.1%	12.6%	18.5%	1.4%	6.6%	21.1%	29.8%	100.0%
Finland	2.0%	1.9%	1.7%	0.0%	0.7%	0.9%	92.8%	100.0%
Sweden	19.6%	10.9%	13.4%	1.5%	5.3%	23.1%	26.1%	100.0%
EU-15	10.5%	8.4%	9.5%	2.1%	5.2%	20.8%	43.4%	100.0%
Japan	6.7%	1.2%	2.6%	1.4%	4.1%	3.2%	80.8%	100.0%
United States	7.4%	1.3%	1.9%	4.9%	3.1%	13.0%	68.3%	100.0%
Share in EU15 Exports to individual countries								
BLUE	3.6%	3.0%	3.8%	3.5%	4.2%	2.6%	3.4%	3.3%
Denmark	2.6%	1.7%	1.4%	0.5%	0.8%	0.8%	0.9%	1.2%
France	8.4%	7.5%	6.5%	15.5%	8.1%	8.1%	12.3%	9.9%
Germany	42.9%	45.0%	45.2%	42.4%	45.9%	45.9%	30.9%	38.9%
Greece	0.3%	0.9%	0.3%	4.0%	1.7%	0.7%	0.5%	0.7%
Ireland	0.5%	0.2%	0.4%	0.0%	0.5%	0.2%	0.2%	0.2%
Italy	9.8%	9.2%	9.2%	9.3%	10.7%	20.6%	13.3%	13.5%
Netherlands	6.8%	4.9%	5.1%	6.1%	3.6%	3.7%	2.9%	3.9%
Portugal	0.1%	0.1%	0.2%	0.7%	0.3%	0.1%	0.4%	0.3%
Spain	1.4%	1.4%	0.9%	0.3%	1.8%	0.8%	1.7%	1.3%
UK	8.2%	7.6%	5.2%	10.0%	7.7%	4.3%	5.8%	6.0%
EU-12	84.6%	81.5%	78.0%	92.4%	85.4%	87.9%	72.3%	79.3%
Austria	7.9%	12.4%	16.0%	5.4%	10.4%	8.4%	5.7%	8.3%
Finland	1.8%	2.2%	1.7%	0.1%	1.2%	0.4%	20.2%	9.5%
Sweden	5.7%	3.9%	4.3%	2.2%	3.1%	3.3%	1.8%	3.0%
EU-15	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Table 15.2: EU Exports to Eastern Europe (1992, ECU mill)

	Poland	Czechoslovakia	Hungary	Romania	Bulgaria	former Yugoslavia	former Soviet Union	Total
BLUE	393	202	203	47	40	132	410	1427
Denmark	377	101	42	11	15	62	289	898
France	632	469	271	444	174	565	1606	4161
Germany	4042	3977	2307	642	430	2509	6576	20482
Greece	55	48	27	82	127	69	94	502
Ireland	22	18	12	2	1	8	148	211
Italy	884	641	630	390	170	1473	2182	6369
Netherlands	695	295	233	95	50	253	598	2218
Portugal	3	3	7	4	5	14	41	78
Spain	123	78	71	21	12	55	303	663
UK	802	278	215	82	78	159	622	2235
EU-12	8029	6109	4016	1820	1101	5298	12870	39244
Austria	495	968	1092	84	97	654	565	3956
Finland	273	60	72	6	11	34	757	1213
Sweden	288	186	149	35	34	113	401	1205
EU-15	9085	7323	5329	1945	1243	6099	14593	45618
Japan	183	133	184	23	28	34	923	1510
United States	483	307	217	184	64	236	2811	4303
Share in of individual countries in Exports to Eastern Europe								
BLUE	27.5%	14.2%	14.2%	3.3%	2.8%	9.3%	28.8%	100.0%
Denmark	42.0%	11.3%	4.7%	1.2%	1.7%	6.9%	32.2%	100.0%
France	15.2%	11.3%	6.5%	10.7%	4.2%	13.6%	38.6%	100.0%
Germany	19.7%	19.4%	11.3%	3.1%	2.1%	12.2%	32.1%	100.0%
Greece	10.9%	9.5%	5.4%	16.4%	25.3%	13.7%	18.7%	100.0%
Ireland	10.4%	8.5%	5.9%	0.8%	0.3%	3.7%	70.5%	100.0%
Italy	13.9%	10.1%	9.9%	6.1%	2.7%	23.1%	34.3%	100.0%
Netherlands	31.3%	13.3%	10.5%	4.3%	2.2%	11.4%	27.0%	100.0%
Portugal	4.2%	4.0%	9.2%	4.7%	5.9%	18.6%	53.3%	100.0%
Spain	18.6%	11.8%	10.7%	3.2%	1.8%	8.2%	45.7%	100.0%
UK	35.9%	12.4%	9.6%	3.7%	3.5%	7.1%	27.8%	100.0%
EU-12	20.5%	15.6%	10.2%	4.6%	2.8%	13.5%	32.8%	100.0%
Austria	12.5%	24.5%	27.6%	2.1%	2.5%	16.5%	14.3%	100.0%
Finland	22.5%	4.9%	6.0%	0.5%	0.9%	2.8%	62.4%	100.0%
Sweden	23.9%	15.4%	12.3%	2.9%	2.8%	9.4%	33.3%	100.0%
EU-15	19.9%	16.1%	11.7%	4.3%	2.7%	13.4%	32.0%	100.0%
Japan	12.1%	8.8%	12.2%	1.6%	1.9%	2.3%	61.1%	100.0%
United States	11.2%	7.1%	5.0%	4.3%	1.5%	5.5%	65.3%	100.0%
Share in EU15 Exports to individual countries								
BLUE	4.3%	2.8%	3.8%	2.4%	3.2%	2.2%	2.8%	3.1%
Denmark	4.2%	1.4%	0.8%	0.6%	1.2%	1.0%	2.0%	2.0%
France	7.0%	6.4%	5.1%	22.8%	14.0%	9.3%	11.0%	9.1%
Germany	44.5%	54.3%	43.3%	33.0%	34.6%	41.1%	45.1%	44.9%
Greece	0.6%	0.7%	0.5%	4.2%	10.2%	1.1%	0.6%	1.1%
Ireland	0.2%	0.2%	0.2%	0.1%	0.0%	0.1%	1.0%	0.5%
Italy	9.7%	8.8%	11.8%	20.0%	13.7%	24.1%	15.0%	14.0%
Netherlands	7.6%	4.0%	4.4%	4.9%	4.0%	4.1%	4.1%	4.9%
Portugal	0.0%	0.0%	0.1%	0.2%	0.4%	0.2%	0.3%	0.2%
Spain	1.4%	1.1%	1.3%	1.1%	1.0%	0.9%	2.1%	1.5%
UK	8.8%	3.8%	4.0%	4.2%	6.3%	2.6%	4.3%	4.9%
EU-12	88.4%	83.4%	75.4%	93.5%	88.6%	86.9%	88.2%	86.0%
Austria	5.5%	13.2%	20.5%	4.3%	7.8%	10.7%	3.9%	8.7%
Finland	3.0%	0.8%	1.4%	0.3%	0.9%	0.6%	5.2%	2.7%
Sweden	3.2%	2.5%	2.8%	1.8%	2.7%	1.9%	2.7%	2.6%
EU-15	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Table 15.3: Concentration of EU-Exports to Eastern Europe							
	Poland	Czecho-slovakia	Hungary	Romania	Bulgaria	former Yugoslavia	former Soviet Union
Concentration-Index¹ 1988							
BLUE	0.151	0.146	0.168	0.202	0.227	0.132	0.452
Denmark	0.162	0.316	0.167	0.319	0.311	0.189	0.301
France	0.118	0.119	0.157	0.217	0.128	0.249	0.209
Germany	0.117	0.162	0.121	0.250	0.130	0.168	0.243
Greece	0.466	0.434	0.295	0.402	0.219	0.241	0.411
Ireland	0.393	0.314	0.309	0.452	0.511	0.352	0.437
Italy	0.189	0.185	0.143	0.180	0.155	0.103	0.220
Netherlands	0.118	0.127	0.175	0.323	0.145	0.197	0.196
Portugal	0.287	0.514	0.611	0.626	0.854	0.463	0.371
Spain	0.174	0.370	0.203	0.323	0.340	0.245	0.243
UK	0.111	0.129	0.131	0.177	0.158	0.114	0.137
Austria	0.145	0.141	0.103	0.242	0.141	0.119	0.397
Finland	0.195	0.370	0.222	0.401	0.323	0.277	0.251
Sweden	0.175	0.200	0.174	0.229	0.238	0.161	0.223
Japan	0.461	0.250	0.246	0.502	0.304	0.245	0.355
US	0.337	0.244	0.135	0.407	0.541	0.169	0.559
Change in concentration index 1992/88²							
BLUE	-0.019	-0.076	0.008	0.100	0.014	0.003	0.287
Denmark	-0.002	0.095	0.030	0.103	0.055	0.028	-0.027
France	0.014	-0.029	0.044	-0.094	-0.317	-0.096	-0.008
Germany	0.003	0.034	-0.007	0.059	-0.042	-0.010	0.104
Greece	0.042	0.052	0.042	0.041	-0.052	0.013	0.182
Ireland	0.072	-0.287	-0.011	0.155	0.082	0.096	-0.047
Italy	0.031	0.004	0.016	0.007	0.007	0.022	0.032
Netherlands	0.038	-0.009	0.054	0.197	0.012	0.041	0.074
Portugal	0.085	0.226	0.285	-0.179	0.219	-0.164	-0.082
Spain	-0.078	0.097	-0.069	0.133	0.114	-0.130	0.093
UK	-0.290	0.005	0.007	0.018	-0.015	0.012	-0.001
Austria	0.040	0.037	-0.007	0.086	0.031	0.042	0.206
Finland	-0.106	0.171	-0.111	0.087	-0.054	0.060	0.120
Sweden	0.063	-0.096	-0.071	-0.066	-0.011	0.004	-0.004
Japan	0.062	-0.127	-0.197	0.230	-0.110	-0.132	0.175
US	0.123	-0.099	-0.132	0.238	0.270	0.016	0.200
Authors' calculations. - ¹ Herfindahl concentration index based on 2-digit SITC Rev 3 figures.							
- ² (-)indicates a decrease in concentration.							

Table 15.4: Concentration of EU-Imports from Eastern Europe							
	Poland	Czecho-slovakia	Hungary	Romania	Bulgaria	former Yugoslavia	former Soviet Union
Concentration-Index¹ 1988							
BLUE	0.199	0.155	0.303	0.197	0.300	0.183	0.462
Denmark	0.168	0.167	0.150	0.271	0.202	0.146	0.441
France	0.121	0.150	0.236	0.310	0.188	0.252	0.482
Germany	0.167	0.114	0.121	0.280	0.154	0.329	0.393
Greece	0.541	0.273	0.227	0.178	0.145	0.147	0.482
Ireland	0.713	0.331	0.321	0.318	0.240	0.298	0.549
Italy	0.264	0.157	0.183	0.571	0.181	0.131	0.492
Netherlands	0.154	0.130	0.992	0.311	0.186	0.985	0.929
Portugal	0.262	0.256	0.247	0.454	0.356	0.310	0.238
Spain	0.178	0.159	0.280	0.269	0.611	0.214	0.692
UK	0.121	0.156	0.121	0.219	0.262	0.142	0.416
Austria	0.347	0.222	0.188	0.193	0.294	0.140	0.436
Finland	0.350	0.224	0.170	0.303	0.421	0.635	0.493
Sweden	0.164	0.120	0.153	0.330	0.318	0.168	0.449
Japan	0.381	0.246	0.293	0.603	0.397	0.586	0.346
US	0.266	0.198	0.176	0.496	0.391	0.170	0.343
Change in concentration index 1992/88²							
BLUE	0.054	0.019	0.133	-0.040	0.023	0.006	0.051
Denmark	-0.078	0.014	0.019	0.039	-0.236	-0.008	0.018
France	-0.005	0.008	0.005	-0.091	0.006	-0.210	0.028
Germany	0.021	0.010	-0.010	-0.113	-0.081	0.034	-0.005
Greece	0.323	-0.038	0.002	-0.011	0.029	0.023	0.097
Ireland	0.121	0.106	0.072	-0.343	-0.062	-0.081	0.134
Italy	-0.002	0.024	0.048	0.316	0.030	0.034	0.020
Netherlands	0.011	0.020	0.769	-0.003	-0.028	0.576	0.243
Portugal	0.100	0.064	-0.004	0.185	0.005	-0.040	-0.121
Spain	-0.062	0.031	-0.047	-0.200	0.414	0.056	0.189
UK	-0.024	0.010	-0.045	-0.129	-0.008	-0.004	-0.021
Austria	0.051	0.085	0.040	-0.038	0.027	0.045	-0.105
Finland	-0.073	-0.009	-0.009	0.008	-0.134	0.469	0.169
Sweden	0.042	0.001	-0.011	-0.272	0.046	-0.322	0.089
Japan	0.113	-0.035	0.087	0.038	-0.059	0.197	0.005
US	0.147	0.041	-0.030	0.178	0.023	0.006	0.048
Authors' calculations. - ¹ Herfindahl concentration index based on 2-digit SITC Rev 3 figures.							
- ² (-)indicates a decrease in concentration.							

Table 15.5: Consequences of increasing trade with Eastern Europe for the EU countries (1992)

	<i>Competition effect¹</i>	<i>Demand effect¹</i>
Belgium ²	0.674	0.679
Danmark	0.563	0.813
France	0.605	0.859
Germany	0.617	0.942
Greece	0.495	0.262
Ireland	0.466	0.825
Italy	0.672	0.960
Netherlands	0.621	0.858
Portugal	0.715	0.571
Spain	0.612	0.745
United Kingdom	0.592	0.958

Authors' computations. - ¹For details c.f. text. - ²Including Luxembourg.

Table 15.6: Annual Foreign Direct Investment Flows in Eastern Europe								
1988 - 1994; US\$ mill								
	1988	1989	1990	1991	1992	1993	1994	1995 ^a
CSFR	0	257	173	583	1073	-	-	-
Czech Republic ¹	-	-	-	-	988 ^a	517	878	2560
Slovak Republic ¹	-	-	-	-	85 ^a	199	204	200
Poland	15	11	89	291	678	1715	1875	2000
Slovenia	-	-	-	-	113	111	84	150
Hungary	14	184	311	1462	1479	2350	1145	1400
Albania	0	0	0	0	20	58	53	70
Bulgaria	0	0	4	56	42	55	105	86
Romania	0	0	-18	40	77	97	340	380
Estonia	-	-	-	-	82	162	214	180
Latvia	-	-	-	-	29	45	214	150
Lituania	-	-	-	-	27	61	60	60
Russian Federation	-	-	-400	-100	700	400	637	1000
Ukraine	-	-	-	-	170	200	91	100
Kazakstan	-	-	-	-	-	473	330	300
other CIS Countries	-	-	-	50	35	223	300	300
Total	29	452	159	2382	4525	6667	6530	8936

Source: IMF, EBRD. National Sources. - ¹Without FDI-relations between the Czech and the Slovak Republic. - ^aestimated.

Table 15.7: FDI-Stocks from EU-countries in Eastern Europe		
ECU mill.		
	1992	1993
Austria	815	1323
France	295	452
Germany	1451	2627
Italy	210	601
Netherlands	131	233
UK	191	150
Total of countries listed above	3093	5386

Source: OECD.

16. EU ENLARGEMENT AND COHESION: NATIONAL DISPARITIES

16.1 National Disparities Between the EU and New Member States

Evidently there are major disparities between the countries of the EU and the potential Member States in Central and Eastern Europe (CEE) and the Mediterranean. This applies, in particular, to disparities in GNP/GDP per capita. However, the measurement of economic disparities across different countries presents formidable difficulties as noted in Chapter 6; this applies to market economies with well-established statistical systems let alone to CEE countries that are developing their statistics. Specifically, there are several distortions in the statistical database for the transition economies.

- GDP as well as unemployment figures are subject to much more uncertainty due to underreporting of economic activity, especially in the private sector, a large shadow economy, and over-employment in the non-privatised sector.
- The definitions used in the transforming economies are not fully compatible with those in the OECD, an objection which especially holds with respect to employment statistics but partly is also true for the national accounts because in some countries figures are still derived from an accounting system that is inherited from the central planning era.
- Income comparisons based on market exchange rates are 'unfair' to the potential Member States. Most of them tend to undervalue their currencies in order to stimulate their exports. So exchange rates will not reflect purchasing power and GDP figures converted with market exchange rate will exaggerate 'real' disparities.

Bearing in mind these reservations, income disparities can be measured in several ways. For this Chapter, an initial calculation of GNP per capita has been based on dollar exchange rates employing the 'atlas' methodology developed by the World Bank. Other figures and approaches are discussed in Chapter 6. These figures tend to underestimate income in the potential Member States for the reasons mentioned above. A second estimate of GNP per capita, based on Purchasing Power Parities (PPP) - ie. taken from Eurostat sources. Both sets of figures relate to 1993.

Further data is provided for GDP per capita based on PPP from Eurostat sources with the figures presented in US\$ as a basis for the subsequent discussion of regional disparities (Table 16.1). However, these PPP figures are also subject to much uncertainty. For example, the estimate for Bulgaria went down from US\$ 5,130 in 1992 to US\$ 4,193 in 1993, which was much more than fall of \$-GDP.

Nevertheless, all calculations illustrate the wide income disparity between the EU and its potential Member States. GNP per capita in the potential members ranges from US\$ 1,140 in Romania (six percent of the EU average) to US\$ 10,380 in Cyprus (54 percent of the EU average). Only the per capita incomes of the island economies lie

within the income range of EU countries; Cyprus and Malta have an income nearly the same as Portugal or Greece. Furthermore, Slovenian income (US\$ 6,490) is only slightly below the Greek level (US\$ 7,390). The residual potential member states have reached an income level that is considerably lower than Greece, the country with the lowest per capita GNP in the EU.

However, the ranking of individual countries as well as the extent of the disparity relative to EU income depends on the conversion factor used. In dollar terms, Hungary has the highest income after Cyprus, Malta, and Slovenia, whereas in PPP-terms, Slovenia has the highest in CEE. Bulgaria and Romania have the lowest incomes in dollar terms but Bulgaria ranked higher in PPP terms. With respect to the 'development gap' between the CEE countries and the EU average, the average per capita income of the potential Member States reaches only 11 percent of the EU-average on a dollar basis, but nearly 30 percent on a PPP-basis. Thus, the picture obtained of the current disparities is strongly influenced by the exchange rate used for conversion.

As discussed more fully in Chapter 5, the results concerning disparities in unemployment rates differ considerably from those presented for GNP per capita. Unemployment rates in the potential Member States lie within nearly the same range as it is observed in the EU (Table 16.2). Thus, on the current pattern, with respect to unemployment, disparities would not increase after an enlargement of the EU. But one should look at this result only with reservations. Although the data on unemployment have been taken from OECD sources and, therefore, are based on harmonised definitions, the institutional differences between the states are still enormous. In part - the Czech Republic being a remarkable exception - low unemployment rates in the economies in transition only reflect insufficient progress in the transformation process. Furthermore, hidden unemployment can be expected to be larger in the CEE countries than in the EU.

16.2 Future Evolution of National Disparities

The CEE countries and the island economies considered here will not become members of the EU at the present state of their economic development but within a (currently unknown) certain timespan. As most of the potential Member States are growing at a faster rate than the EU countries it can be expected that, at the time they enter the Union, the income disparities will be smaller than at present.

However, the question is, to what extent the disparities can be diminished within a reasonable time? Bearing in mind the problems arising when evaluating current disparities and, furthermore, recognising that the transformation process in the CEE countries is unprecedented, quantification of further developments is a difficult task.

In the long run it should be expected that differences between market exchange rates and purchasing power parities will vanish. This does not mean necessarily that the CEE countries will experience a nominal revaluation of their currencies, but a real revaluation will take place because nominal devaluation will not completely cover inflation rate differentials. Thus, it can be expected that PPP-converted income will

be more appropriate to measure future disparities than dollar-converted income. Only for those countries where no PPP estimates exist is there a necessity for relying on dollar GNP.

A second factor that is crucial for future disparities is the growth rate in CEE. It is the ambition of all these countries to improve the living conditions of their population and, eventually, to reduce the development gap with Western Europe. Since 1994, Central European transforming economies have developed along a relatively stable growth path. In 1994, the average (weighted) GDP growth in the region was 3.7 percent, that was slightly above growth in the EU (2.8 percent). In 1995, average growth was stronger, exceeding 5 percent compared to 2.7 percent in the EU. All projections indicate similar rates for 1996. Thus, the CEE has now reached growth rates that are 2-2½ percentage points above growth in the EU, though the Baltic states are still performing worse.

One way to provide a scenario of future income disparities is to assume that the potential Member States will continue to grow at a rate that is two percentage points above EU growth (which is assumed to reach 2½ percent). Bearing in mind the fast-growing Asian 'tigers', this means a rather conservative assessment, although it fits quite well into the experience of the economies at the southern periphery of Europe. In order to provide a more optimistic scenario, an additional calculation is presented based on a GDP growth that is four percentage points above EU growth. This implies an average annual growth of GDP in CEE of 6-7 percent. Taking 1993 as a starting point for the scenario, and reviewing development over a period of ten years, calculations lead to an estimate of disparities in 2003 as shown in Table 16.2.

Although these calculations, admittedly, have been simplified, one point is evident. Even under relatively optimistic assumptions about the growth perspective in the potential Member States, income disparities will remain high for many years. Whereas eight of the potential members will reach a per capita income comparable to the EU members with the lowest income, four of the potential members will not even reach this income. Approximately 6.5 percent of all EU citizens live in a country whose per capita income is lower than 70 percent of the EU average. Assuming that all potential Member States would have entered the Union by the end of 2003, this quota would rise to more than 25 percent. (Income disparities within the individual countries are not taken into account in this calculation.)

Comparable calculations for unemployment rates are more difficult, and this Chapter refrains from presenting concrete data. Concerning cohesion, it is clear that the share of high-unemployment regions in the EU will rise after the accession of the potential Member States, although to what extent is unclear. These issues are discussed in more detail in the following chapter.

Table 16.1: Income disparities in the EU and the potential member states (1993)

	GNP per capita 1993 US-\$ ¹		PPP estimates of GNP per capita 1993		Population Mill.
	\$	EU=100	\$	EU=100	
Luxembourg	37320	193.0	27334	159.7	0.4
Denmark	26730	138.2	19306	112.8	5.2
Sweden	24740	127.9	16821	98.3	8.7
Germany	23560	121.8	18542	108.3	80.8
Austria	23510	121.6	19115	111.7	7.9
France	22490	116.3	18733	109.4	57.7
Belgium	21650	111.9	19688	115.0	10.1
Netherlands	20950	108.3	17777	103.8	15.3
Italy	19840	102.6	17586	102.7	57.8
Finland	19300	99.8	15483	90.4	5.1
United Kingdom	18060	93.4	17012	99.4	58
Spain	13590	70.3	13189	77.0	39.1
Ireland	13000	67.2	13954	81.5	3.5
Portugal	9130	47.2	11660	68.1	9.8
Greece	7390	38.2	10704	62.5	10.4
EU-Average²	19340	100.0	17118	100.0	369.8
Cyprus	10380	53.7	0.7
Malta	7970	41.2	0.4
Slovenia	6490	33.6	9210	53.8	2
Hungary	3350	17.3	5962	34.8	10.3
Estonia	3080	15.9	3083	18.0	1.5
Czech Republic	2710	14.0	8422	49.2	10.3
Poland	2260	11.7	4669	27.3	38.4
Latvia	2010	10.4	3070	17.9	2.6
Slovakia	1950	10.1	5766	33.7	5.3
Lithuania	1320	6.8	3681	21.5	3.7
Bulgaria	1140	5.9	4193	24.5	8.5
Romania	1140	5.9	3643	21.3	22.8
Average of potential Member States	2191	11.3	4890	28.6	106.5

Source: World Bank and Eurostat. - ¹Atlas methodology.- ²Weighted.

Table 16.2: Scenarios of future income disparities (per capita income, 1993-2003)					
	1993	2003			
		Growth 2% above EU		Growth 4% above EU	
		\$	EU=100	\$	EU=100
Based on \$ exchange rates					
EU-Average	19330	24744	100	24744	100
Cyprus	10380	16120	65	19485	79
Estonia	7970	12377	50	14961	60
Malta	6490	10079	41	12183	49
Slovenia	3080	4783	19	5782	23
EU-Average	17118	21913	100	21913	100
Bulgaria	4193	6512	29.7	7870	35.9
Czech Republic	8422	13078	59.7	15808	72.1
Estonia	3803	5906	27.0	7139	32.6
Hungary	5962	9259	42.3	11192	51.1
Latvia	3070	4768	21.8	5763	26.3
Lithuania	3681	5717	26.1	6910	31.5
Poland	4669	7252	33.1	8765	40.0
Slovakia	5766	8955	40.9	10824	49.4
Slovenia	9210	14303	65.3	17289	79.0
Romania	3643	5657	25.8	6838	31.2
Authors' computations					

17. EU ENLARGEMENT AND COHESION: REGIONAL DISPARITIES

As noted in the previous chapter, the measurement of disparities across Central and Eastern Europe (CEE) and the European Union at the national level is fraught with methodological problems. The comparison of disparities between the EU and the acceding countries is further complicated when the analysis descends to the regional level. The nature of economic transition has led to wide variations in the development patterns of different regions in CEE, often relating to the timing and extent of reform programmes (and other political factors) than to an underlying pattern of economic forces. Clearly, this makes predictions of future disparities a difficult exercise, particularly relating to the impact of EU enlargement.

As a result, the following chapter employs a mix of quantitative as well as qualitative approaches to provide some comparison of sub-national disparities between the EU and CEE and consideration of regional economic consequences. It begins with a comparative assessment of data for GDP per capita and unemployment rates in the two parts of Europe, followed by a discussion of the regional implications of enlargement. Special attention is given to regions bordering between the EU and CEE. Given the different circumstances of the island economies of Cyprus and Malta, these are examined in a separate section of this chapter.

17.1 Statistical Review of Regional Disparities

As a starting point for discussion it is worth considering the extent of the regional disparities in the EU and CEE. As noted in earlier chapters (Chapters 6 and 16), GDP has only recently begun to be calculated on a comparable basis in CEE countries, and measurements/ estimates are still subject to major variation depending on the definitions and assumptions used. More than at national level, regional income data is rarely available in an appropriate form for comparative purposes. For the current exercise, several stages of analysis have been undertaken.

The starting point for analysis of GDP are the national GDP per capita figures presented in Table 17.1 (restating the data presented in Chapter 6). These provide a direct means of comparison of EU and CEE countries. As noted earlier in this report, the best available sub-national income data for 1993 was obtained from national sources and used to construct indices of regional income per capita disparity for each CEE country based on a national average equal to 100. These indices were then related to the national GDP (at PPP) per capita figures to produce regional GDP (PPP) per capita values for each CEE region as well as indices related to the EU average (EU15=100). Again, as discussed in Chapter 6, this is a relatively simplistic and crude procedure with considerable methodological statistical flaws but it does provide some initial yardsticks for regional comparisons and enables some discussion of comparative EU/CEE regional disparities to take place.

Regional GDP per capita disparities in CEE are generally lower than in current EU countries. Only Hungary and Bulgaria display regional differences on a scale comparable with those of most EU countries, attributable to the overwhelming dominance of the capital city regions, Budapest and Sofia, in each case. Without the capital cities (also in the case of Poland and the Czech Republic), regional disparities are very minor indeed by EU standards, although clearly significant within individual national contexts as noted in Chapters 6 and 11. Overall, CEE country disparities appear to in line with the poorer Member States of the EU, notably Greece, Spain and Portugal.

None of the CEE regions exceeds a GDP per capita level equivalent to 75 percent of the EU15 GDP per capita average. Only Prague has an income level approaching this figure, although Budapest and Sofia City are within 15 percentage points of the 75 percent threshold. However, there is apparently some overlap between the GDP per capita levels of leading CEE regions and the weakest EU regions. The Czech regions are higher placed than the some of weaker EU regions (in Portugal), and the capital city regions of Prague and Budapest have income per head levels in excess of the weaker regions of Portugal, Greece, Spain and Germany.

Apart from the Czech Republic, all of the non-capital CEE regions are below 35 percent of the current EU average, and numerous regions (north-eastern Hungary, Moldova in Romania, northern Bulgaria, eastern Poland) are below 25 percent, the lowest regional income figures being 12 and 14 percent in Montana and Russe in Bulgaria.

Following on from the forecasting exercise presented in the previous chapter at national levels, the same growth scenarios were calculated for the CEE regions on the basis of growth rates exceeding the EU growth rates by two percent and four percent respectively up to 2003 (Table 17.1). While the exercise incorporates simplistic assumptions - that national growth rates can be applied universally in the regions, suggesting that internal regional disparities are unlikely to change (which the evidence of Chapter 6 suggests is *not* taking place) - it can at least indicate the range of disparities that may result. Attribution of specific figures to particular regions is less important than the general trends involving all CEE regions.

According to the most optimistic scenario, Prague would exceed the EU average by 2003 and Budapest would be approaching the average. Most of the Czech Republic and parts of Poland and Hungary would also be better-placed than many weaker EU regions. Given that regional disparities in CEE currently appear to be growing, it could be anticipated that the leading regions (as well as major agglomerations in Poland) would be performing still better at the end of the period.

The projections also underline the fact that much of CEE would still be facing a considerable development gap relative to the EU; even with a sustained high rate of growth, it is unlikely that the more underdeveloped parts of CEE would share in the growth rates with a much wider range of disparities than indicated in the figure. In the optimistic scenario, only six percent of the total population of CEE would have regional incomes above 75 percent of the EU average. This would still leave a

combined area of below-EU average incomes that would be nearly 1.5 times as large (in population terms) as the equivalent area within the EU-15.

A similar comparison of regional unemployment rates in EU and CEE reveals, not surprisingly, a more mixed picture. There is no clear difference in either the level or the regional disparity of regional unemployment between EU countries and the new Member States. Poland, Slovakia and Bulgaria have a very wide range of regional unemployment rates, comparable in extent to those in Spain, Finland, Italy or Germany. Other CEE countries have lower ranges of regional unemployment although, as in EU Member States, sub-regional disparities can be extremely wide.

With respect to the composition of unemployment in the EU and CEE, the figures for long-term unemployment in CEE, taken as a whole, are similar to those in the EU where 48 percent of the unemployed in 1994 had been without a job for more than 12 months. In both areas, considerable disparities were apparent between countries in the long-term unemployment rates. Among EU Member States, figures varied from between just over 30 percent in Denmark to over 60 percent in Italy in 1994, and in CEE (using ILO definitions), nearly 70 percent of the unemployed in Bulgaria could be classified as long-term as opposed to much lower rates of between 30-40 percent in the Czech Republic and Poland (Employment Observatory, 1995).

The experience of the dynamics between long-term unemployment and overall unemployment rates differs to some extent between the EU and CEE. While trends to date in CEE have shown that a longer-term decline in overall unemployment levels is necessary before the long-term unemployed begin to benefit (and to a lesser extent than others), in the EU as a whole, the rate of long-term unemployment stopped increasing when overall unemployment stabilised. The exception was in Spain, where long-term unemployment at the end of the 1980s only fell following a longer period of decline in overall unemployment (Employment Observatory, 1995).

The link between long-term unemployment and overall unemployment is more marked in CEE than in the EU, although there also appears to be a similar correlation. This suggests that factors other than overall unemployment play an important contributory role in EU countries to the rise of long-term unemployment, and that the reduction of unemployment levels alone may not be sufficient to resolve the problem of the long-term unemployed. This weaker relationship is more evident at regional level in the CEE countries. Lastly, some of the highest youth unemployment levels in the EU are found in southern EU countries, which have conditions perhaps more similar to those in CEE (Begg and Mayes, 1993).

In consequence, whereas an analysis of regional GDP per capita figures points to a widening of disparities at regional level following accession of the transition countries, the picture is less certain with regard to unemployment. Although unemployment may well rise in the acceding countries as industrial restructuring progresses against the constant threat of a sharp relative decline in their international competitiveness (particularly their wage cost advantages), there is no indication that the problem differs in scale from that in the existing EU.

17.2 Current Regional Disparities

As the previous section has demonstrated, at least in statistical terms, significant differentials exist between EU and CEE regions, at least in income levels. Before assessing the regional impact of EU enlargement on regions, it is first necessary to review the processes by which disparities are currently influenced at a European level. As discussed in Chapter 13, it should be emphasised that regional disparities are primarily influenced by national factors. Regional disparities in Western Europe are mainly the result of the different socio-economic development levels of the EU Member States. In the case of the acceding CEE countries, this is also true, though it has taken a more dramatic form. The former economic and political system in CEE is not only responsible for sectoral but also for serious regional distortions. The location of industrial activity was largely determined by political factors - the removal of these factors with the collapse of the command economy has an impact at both national and regional level. Hence, whether a region is to 'gain' or 'lose' during the period of transformation (at least in the short term) depends on:

- the region's capacity to integrate into the wider European division of labour;
- its relative competitive advantages; and
- its geographical location advantages, both in terms of national economic activity as well as in the attraction of international foreign investment.

Consequently, the enlargement of the EU and transition in the acceding countries can be considered as different parts of a common process for CEE regions: the progressive liberalisation of the transition countries and their gradual adaptation to the wider European economy. From this perspective, *current* EU-CEE regional disparities are the result of the first part of this process, particularly the national-level changes in the different CEE countries and the subsequent local effects of industrial restructuring. The effects of actual enlargement - the completion of the liberalisation of CEE markets - will take place as the acceding countries join the EU.

Western European experience indicates that the removal of regional disparities in the CEE countries will depend on stable growth in national economies. Only when the balance between newly-created and disappearing jobs is positive will an economy have the potential for geographical redistribution of economic activity. In fact, most CEE states and the island states (which are of less importance in terms of regional policy) have again been exhibiting real growth rates from 1995. It must however be noted that apart from Poland, none of the accession countries has reached the initial level of GDP existing before transition.

Furthermore, in the industrial sector in particular, there are no discernible trends that would suggest a lasting and successful integration of the CEE economies into the Western European division of labour. Up until now, the CEE states have been successful above all in areas where their cost advantages (based on low wages, exaggerated by undervalued currencies in purchasing power parity terms) have encouraged a partial relocation of trade and production for wage cost-sensitive semi-finished products and finished products intended for price-sensitive market segments. In these areas, the CEE states are still dependent on western European business partners, as very few of their companies have as yet firmly established, experienced

sales organisations in the EU. A development process based on independent product development is still associated with considerable difficulties for the countries seeking admission.

As noted in Chapters 7 and 15, CEE countries face strong competition in all the potential markets in which they may develop. On more technologically-sophisticated product markets, the acceding countries are not competitive with most EU Member States, Japan, the USA as well as a large number of threshold countries. Moreover, with labour-intensive, relatively simple products, they are in competition with the threshold countries and developing countries such as India, which frequently enjoy significant advantages in terms of productivity at comparable wage levels. On markets where the CEE states are most competitive, such as agricultural and textiles products, they presently face significant trade barriers, especially in the EU.

Consequently, it can be regarded as reasonably certain that the expansion of the EU eastwards would lengthen the belt of structurally-weak regions in the west and south of the Community towards the east. CEE is also situated relatively peripherally to the economic core areas of the EU, and also exhibits considerable handicaps with regard to its integration into European transport infrastructure (as described in Chapter 8). The extent to which processes of growth can be triggered in these regions similar to those in Ireland or Portugal will vary from case to case. At least at the macroeconomic level, it needs to be assumed that the present Member States will be faced by a high demand for investment support in the acceding countries which:

- is partly in competition with the demand from the traditional subsidy areas in the EU; and
- has the handicap that the EU Member States as a whole will have relatively underused industrial capacities, at least in the coming years, which would make it possible for them to supply the CEE markets in competition with local producers.

Lastly, it should not however be forgotten that the problems described here must be seen in relation to the time needed to complete economic restructuring. Experience with the EU Structural Funds and the integration of the former East Germany suggest that the integration of the CEE states into the EU will not be a process lasting years, but decades. In consequence, there will be no abrupt adaptation either for the present Member States or for the CEE countries themselves, but rather a continual modification of background conditions which will allow sufficient time for different regions to redefine their strategies and their adaptive measures.

To date, the transformation process has led to a process of geographical concentration in the CEE states which confirms the polarisation theory: the relative winners are the capital cities (and in the larger countries individual secondary centres and regions close to the borders of the EU). The losers, on the other hand, are the rural regions, monostructural industrial areas and regions which border the CIS states. Evidence cited in Chapters 6 and 11 suggests that this trend is likely to continue in the near-future, as the adversely affected regions tend to have serious deficits in:

- *infrastructure*: especially transport infrastructure, as the current provision has reached its capacity and resources may have to be targeted in some areas at the expense of other regions (Chapter 8);
- *human resources*: as the demand for specific technological and management skills increases with the expansion of business in the transition economies, leading to potential gaps in some regions (Chapter 9);
- *environmental conditions*: as there is a mismatch between regions experiencing severe environmental problems and the resources available to cope with the problems without jeopardising industrial development (Chapter 10); and
- *business environment*, especially the capacity of local companies to maintain competitiveness through continuous innovation.

At the same time, CEE governments lack the instruments for redressing these economic imbalances, especially in shortages of regional policy strategies, resources for the expansion of the infrastructure and an experienced local administration.

However, when analysing CEE-EU disparities, CEE regions have only been able to exploit their potential competitive advantages over the regions of the present EU Member States to a small extent. The regions in CEE countries that are currently strong are not directly competing with their nearest counterparts in the EU in income terms. Capital-city regions like Prague and Budapest have not presented an international economic challenge to other city regions in the EU or even to EU regions of their equivalent per capita GDP income levels (which tend to be more akin in basic characteristics to the less-developed regions of their own countries). In the current state of transition, the main effects of economic growth in the 'winner' regions have been largely limited to their national countries - whether in terms of acting as internal population magnets or concentrating the country's foreign investment - and (to a lesser extent) to partial competition with other CEE capital cities.

17.3 Future Regional Disparities

Future regional disparities will be dependent on the closer integration of CEE and the EU, which will take place through a combination of informal trade and investment ties as well as formal measures such as the enlargement of the EU. Establishing causality between wider regional integration and specific regional disparities is notoriously difficult and is made more complex in this case by the variety of active factors: the sequencing of EU membership (which country or set of countries joins first and the knock-on effects on the remaining non-EU states); progress in European Monetary Union and what that will require of the CEE governments; and the availability of financial assistance and EU agricultural and regional policy funds to the acceding countries.

Nonetheless, given the certainty of increasing EU links for most if not all CEE regions, these regions can improve their economic development if they have a specific competitive advantage with regard to their competitors. The competitive advantage of CEE regions are mostly their low wage costs relative to Western levels. Even if low wages are by far not the only location factor important to investors, and even if they can be seen as a sign of low labour productivity, they are of particular importance for labour-

intensive production of low-tech goods. Low wages can compensate for other less positive factors of a region and can therefore be a decisive factor for foreign investors. In this, CEE regions with low wage levels could be direct competitors for Western regions with low productivity and unfavourable location (especially in terms of proximity to the core markets of the EU).

The relationships between regions are also a crucial factor in the relative development of different regions. These links can take the form of development poles, which are often sector-oriented. Sectors like the automotive industry or the chemical industry are concentrated in the EU in certain regions as a result of the mutual reinforcement of regional comparative advantage over time. Consequently, it is very important for the regions of the acceding countries to become part of these different regional networks and thus be integrated into existing regional specialisation patterns. This integration is likely to succeed best if:

- to create the infrastructure prerequisites to connect themselves into the EU road and railway network; and if
- they adapt to the special infrastructure needs of industries they want to attract.

To consider how this might affect regional disparities, it is useful to break down the impact into *trade* and *investment* effects.

17.3.1 Trade Effects

As shown in Chapter 15, the scale of trade between the EU and CEE should expand. For example, calculations for specific sectors have been made in relation to the four Visegrad countries by Landesmann (1995): by 2010, Central Europe has been estimated to account for 8.9 percent of total EU imports of metals, 8.8 percent of non-metallic metals, 8.3 percent of food/beverage/tobacco products, 7.3 percent of paper/printing markets and 7.2 percent of timber imports. With the continuing adaptation of CEE countries to their revealed comparative advantages, 'traditional' CEE export strengths - such as clothing, metals production and food industries - will continue to dominate, though newer niche sectors in mechanical and electrical engineering are expected to expand.

Similarly, the threat of cheaper production in CEE damaging EU companies has been examined by Neven (1995). Neven classified industries according to the factor content of CEE trade with individual EU countries and assessed comparative advantages by export/import ratios by each industrial group. The risk of EU import replacement is greatest in industries intensive in unskilled labour (clothing, furniture) and with mixed labour/capital intensities (such as motor vehicle engineering, textiles and certain food processing sectors).

Such 'virtual' comparative advantages can be applied to determining the vulnerability of EU regions to CEE competition. Using a gravity model of trade and output effects of full integration between the EU and CEE and market liberalisation within the CEE, the impact of increasing CEE exports on EU regions has been examined (CEC, 1993). By 2010, it was found that the total project change in the manufacturing output of the EU

lagging regions (as defined as Objective 1 and 2 regions) would be *positive*, amounting to a rise of 1.5 percent on output levels in 1987. Although some regions will remain exposed to changes in EU-CEE trade, it should be remembered that the overall output effects of growth in EU-CEE trade are likely to remain a limited share of total EU trade.

At the same time, CEE imports will increase as well, offering trade opportunities for regions specialising in mechanical and electrical engineering (especially those with historical or geographical ties to the region, as discussed in a later section of this chapter). It is worthwhile highlighting the rapidly increasing demand for services in CEE - especially business and financial services - which is likely to benefit EU capital-city regions.

17.3.2 Investment Effects

In Chapter 15, it was concluded that foreign investment in CEE would increase. From an EU regional perspective, the key issue is whether this will constitute FDI *creation* or *diversion*. CEE economies are likely to attract investment in sectors in which they have significant comparative advantages, significant consumer demand or large market shares in the EU. To date, the majority of investment has been linked to the second sectoral category - new trade opportunities within CEE - but there remains scope for surges of assembly operation establishments based on low labour costs.

To date, studies suggest that the potential for competition between EU and CEE regions can be overstated. European Commission research on the FDI intentions of major European investors concluded that the types of investments being considered for CEE locations have been initially different from those planned for sites in Western Europe (CEC, 1993). Another study by Gual and Martín (1995) on the implications of full market integration of CEE countries with the EU for Spain concluded that Spanish FDI inflows would not be affected by the expansion of foreign investment in the CEE area (just as the enlargement of the EU with Spain and the subsequent rush of FDI to that country did not appear to damage investment stocks and flows in existing EU regions). Instead, the impact within CEE should be more substantial, as FDI flows seem likely to continue to focus on regions that have already attracted investment.

17.3.3 Vulnerable Regions

Overall, continuing integration of the CEE countries in the EU would in *the medium term* increase competition for regions specialising in the following: agricultural products, for simple mechanical engineering, chemicals and plastics industry products, and also in the price-sensitive lower market segments of the automobile industry, consumer electronics and shipbuilding. Although the impact of enlargement is unlikely of itself to catalyse dramatic changes in CEE or EU, for many regions it could reinforce an existing cycle of declining competitiveness.

However, in *the longer term*, there will be compensating effects, as:

- the product structure of agriculture in southern Europe, as already emphasised, is complementary to that of the CEE states;
- price advantages and therefore competitive advantages on non-EU markets can be achieved by combining the human resource, research and development and capital-intensive input products manufactured in western Europe with the labour-intensive input products from the CEE states;
- the undervaluation of the CEE currencies to date will not be permanent and this will compensate for the present extreme wage cost advantages; and
- the development of incomes in the CEE will lead to an increase in the demand for capital goods and higher quality consumer goods which better reflect the export structure of the Member States of the EU.

To summarise, those EU regions most at risk are those which are:

- less-developed and dependent on agriculture, with a typical production range for central Europe (grain, vegetables, fruit, cattle and pig farming) - such as the Spanish regions of Asturias and Extremadura, the Italian regions of Calabria and Basilicata and almost all of Portugal;
- dependent on industrial operations with labour-intensive, not particularly human resource intensive production and with low labour productivity, particularly regions specialising in textile production (eg. Merseyside in the UK);
- dependent on primary chemicals plants or shipyards with a relatively low level production range and low labour productivity, such as the north-eastern coastal areas of Germany;
- dependent on manufacturing assembly activity and low labour productivity, such as the declining industrial areas of the Ruhr in Germany and north-western France;

On the other hand, the integration of the CEE states in the EU would:

- also confront the rural regions with considerable problems of adaptation - in the agricultural sector, these regions would have to make enormous cuts in employment to become competitive in the Single Market, with the consequence that the existing job market problems would be further exacerbated;
- put increased pressure to adapt on the regions characterised by heavy industry, a large proportion of which are monostructural; and
- force many large businesses which are still government owned to adapt their corporate structures and thus cause a significant reduction in jobs.

As noted in Chapter 14, experience of the integration of eastern Germany shows that particularly the capital goods industries in the former planned economies are hardly in a position to respond to the competitive pressure from western enterprises.

17.4 Special Impacts on Border Regions

Current border regions between the EU and CEE can be considered a special situation. On the EU side, the border regions are in most cases the weakest regions of the Community, whereas the CEE border regions are often the fastest-developing regions of the transition countries. In spite of the CEE border regions catching up, there are in whole of Europe no disparities in income comparable to those between the EU and CEE border regions. On a world scale, similar disparities exist only between the USA and Mexico.

The example of the German border regions shows that the 'cutting-off' effects of these borders can worsen the economic prospects of the EU regions. An accession of CEE countries to the EU would have similar effects as the EU's Single Market by creating closer economic ties between the border regions on both sides through removing current barriers to the free movement of goods, services, capital and people. On the western side, these effects would include:

- During the cold war the economies of the western region were cut off from their neighbouring regional partners in the east. Central locations such as Vienna were deprived of their economic hinterland, which is particularly important with reference to the geographical division of labour between the centre and its surrounding catchment area. Now that political and economic barriers are down, a number of western regions have regained their eastern hinterland, a factor that may be of increasing importance in Germany as German companies take advantage of lower wage costs in neighbouring CEE countries and shift their production activities.
- A geographical division of labour is redeveloping between the western border regions and their regained hinterland, which is nevertheless only comparable with the pre-war situation if certain reservations are taken into account. This is partly attributable to the fact that after the partition of Europe, the Western regions aligned their economic activities westwards and have accordingly been firmly integrated in the European division of labour for decades now. It must also be said that the eastern regions are not yet in a position to offer serious competition in existing purchasing and sales market. Their products and services are often not up to Western standards, although they can offer price advantages.
- The partition of Europe pushed the western regions to the periphery of the EU. Their economic dynamics remained far less highly developed than those of central regions of the community and often lagged far behind the average. Now that the borders have reopened, while still not being in the economic centre of Europe, they are no longer the outlying regions of the EU. This means that they are of greater interest to investors looking for access to eastern markets who nevertheless do not

wish to invest directly in the eastern regions because they require a good infrastructure and secure political and economic framework conditions.

- The considerable differences in economic development between the western and eastern boundary regions are primarily noticeable in disparities in pay and income. This means that the population of eastern regions are attracted towards the west in order to look for work and that they are prepared to accept pay well below levels for western workers. There are now large numbers of east-west commuters and this may tend to push wages down in the regions affected. This puts the jobs of the Western workers at risk but strengthens the competitiveness of the regions owing to the drop in labour costs.
- The border regions situated along major transport routes are experiencing an economic revival owing to the transit traffic which has increased considerably since the frontiers were opened. It is observable that small and medium-sized businesses in particular are opening branches along these transport routes.

From the eastern perspective, a comparable but distinctive set of effects is likely to proceed from integration:

- As CEE regions, too, have regained their neighbours, they are in a position to exploit the natural advantages of their locations (relative to other regions in their respective countries), especially proximity to western markets. Although the range of products offered by the eastern regions cannot really compete with western goods, as far as labour intensive low-tech products and simple services are concerned, the eastern regions have the advantage of a low-wage labour force.
- The daily numbers of eastern commuters to western border regions has a considerable effect on the income of the eastern border regions. This 'export' of labour induces regional multiplier effects, which are also to the advantage of the regional economy.
- Some of the eastern border regions too, are profiting very greatly from transit traffic. There is a development in services on offer along the major transport routes which may seem small by western standards but is a significant source of income to the regions concerned.

On the whole it can be said that both the western and eastern border regions are profiting from the opening of the economic and political frontiers. The reasons for this are, in particular: regained location advantages; trade opportunities; and falling labour costs due to the supply of workers prepared to commute to the west. With regards to the effect of integration of central and eastern European countries in the EU on the border regions, it can be assumed that this will be in the same direction as previous developments. These developments will become even more pronounced when trade barriers are reduced further and the principle of the free movement of labour is also applied in full to the population of eastern Europe.

Cooperation between western and eastern border regions has a particular part to play in the preparation of successful integration. There are now a number of such

cooperative ventures which are supported both by national governments and the EU Commission. These are the so-called Euroregions which are developing especially along the border between Germany and Poland, including the following examples.

- *Euroregion Neisse*. The coordination of cross-border cooperation has progressed furthest at the junction of the three regions Saxony, Lower Silesia and north east Bohemia. As early as 1991, the first contacts were established between the regional operators who were looking for an acceleration in expansion of cross-frontier infrastructure, support for trade and industry and mutual assistance in disaster relief management. A joint coordination centre was established in the German town of Zittau and statutes were drawn up for the venture. A characteristic feature of these parts of the Euroregion are, in addition to weaknesses of economic structure, the consequences of the collapse of the eastern European markets and a high degree of environmental pollution, especially in Poland (Altman, 1993). The main points of emphasis in cross-frontier cooperation are accordingly improvement of ecological conditions, expansion of the economic and ecological base and joint planning for the remodelling of the landscape.
- *Euroregion Spree-Neisse-Bober*. The German-Polish Euroregion Spree-Neisse-Bober was established in December 1993. This consists of 18 Polish communities in the Grünberg region and 5 German counties. This region is, in part, very rural and, in part, characterised by obsolescent industry. On the German side there is a tendency to concentration of population. A geographical distribution of economic potential is less favourable on the Polish side of the border as the area here is more rural and less fully populated. The development strategies pursued here relate to support for small and medium sized businesses and the orientation of agriculture towards 'organic' products. The location advantages of this region are derived from the cross-border traffic corridor and the roads running eastwards. Border traffic has increased enormously in the last few years and it is anticipated that it will increase even more as integration progresses. Improvement of transport infrastructure and border crossing is accordingly urgently necessary to positive economic development in this region (Okuniewski, 1994).
- *Euroregion Pro-Europa-Viadrina*. Nineteen Polish communities belonging to the Landsberg region, four German counties and the City of Frankfurt an der Oder joined together in the Euroregion Pro-Europa-Viadrina in 1993. The main pillars of economic development in this region, as in the two regions already mentioned, are an improvement of trade and industry relations and the exploitation of regained location advantages. This Euroregion also profits from its geographical proximity to the Berlin conurbation. The Berlin area is undergoing a dynamic development which is attributable both to unification and its regained status as Germany's capital city.

In conclusion, the creation of Euroregions on the western boundary of the central European countries is another expression of the efforts made at decentralisation by these countries. Nonetheless, a centralist policy towards local authorities and regions still predominates. In the future, however, the economic development of the border regions will no longer be affected so much by decisions of central government as by the investment decisions of international corporations. The issue of equality of

opportunity, as far as the attraction of foreign capital is concerned, is a source of some anxiety on the eastern side. In the first place, the western side is better prepared to devise realistic development scenarios and purchase know-how from high-priced consultants; in the second place, the western regions have better access to state funding, especially subsidies, and are accordingly better able to promote investment. This may culminate in a race for funds that the east cannot win. Accordingly, the eastern border regions must put their money on the development of their infrastructure and the conservation of the 'natural' advantages of their locations such as low wages and inexpensive real estate (Pyszkowski, 1992).

17.5 Special Impact on the Island Economies

Given their level of economic underdevelopment, the island economies would most likely have Objective-1 status in an enlarged Community, although at least Malta has a relatively high growth. Due to their small size, regional economic problems do not exist in the islands economies, though a severe political problem exists in Cyprus because of the political division of the island. This problem affects the island's economic development negatively.

As described in Chapter 12, the two island economies of Malta and Cyprus have both an income level below the EU average, but relatively high real growth rates and a stable economic environment. There are special economic opportunities in combining EU membership and the traditional close relationships of the islands to North Africa and the Middle East. It should be possible to develop special programmes for both island states in cooperation and with the help of EFRE and ESF. As a result, the island economies can help to connect European financial services, the supply of European manufacturers, and other special services with the Arab markets.

A second important opportunity for the island economies is tourism. Both states have several advantages in this sector, which are complementary to those of other regions of the EU. It is important to develop concepts, particularly in relation to the environmental aspects of the industry, the need to address special areas of tourism (conferences, for example) and the need for marketing strategies targeted to the EU market.

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Table 17.1: Regional GDP per capita (1993)

	US\$, PPP	ECU, PPP	National=100	EU=100
Czech Republic	8,422	7,521	100.0	49.2
Prague	12,801	11,432	152.6	74.8
Mid-Bohemia	7,327	6,543	86.8	42.8
S&W Bohemia	7,917	7,070	94.0	46.2
N. Bohemia	7,832	6,994	93.0	45.8
E. Bohemia	8,338	7,446	98.9	48.7
S. Moravia	7,832	6,994	93.2	45.8
N. Moravia	7,664	6,844	91.4	44.8
Poland	4,669	4,169	110.0	27.3
Warsaw city	7,914	7,067	169.5	46.2
Warsaw region	3,417	3,051	73.2	20.0
North-Eastern 3,665		3,273	78.5	21.4
Northern	4,743	4,235	101.6	27.7
Central-Western	4,698	4,195	100.6	27.4
South-Western	4,606	4,114	98.7	26.9
Southern	5,057	4,516	108.3	29.5
Central	5,015	4,478	107.4	29.3
South-Eastern 3,853		3,441	82.5	22.5
Central-Eastern	3,899	3,482	83.5	22.8
Hungary	5,962	5,324	100.0	34.8
Budapest	10,761	9,610	180.5	62.9
Transdanubia	5,201	4,644	87.2	30.4
Great Plain	4,984	4,451	83.6	29.1
North-East	4,066	3,631	68.2	23.8
North-West	5,187	4,632	87.0	30.3
Romania	3,643	3,253	100.0	21.3
Bucharest	4,551	4,064	124.9	26.6
Constanta	3,681	3,287	101.1	21.5
N. Muntenia	3,589	3,205	98.5	21.0
Oltenia	3,533	3,155	97.0	20.6
Banat	3,636	3,247	99.8	21.2
Central	3,725	3,327	102.3	21.8
Cluj	3,660	3,268	100.5	21.4
N. Moldova	3,170	2,831	87.0	16.5
S. Moldova	3,219	2,875	88.4	16.8
Bulgaria	4,193	3,744	100.0	24.5
Sofia city	10,483	9,361	250.0	61.2
Sofia district	2,836	2,533	67.6	16.6
Bourgas	5,015	4,478	119.6	29.3
Varna	4,029	3,598	96.1	23.5
Lovetch	3,371	3,010	80.4	19.7
Montana	2,097	1,873	50.0	12.2
Plovdiv	2,672	2,386	63.7	15.6
Russe	2,466	2,202	58.8	14.4
Haskova	2,713	2,423	64.7	15.8

	US\$, PPP	ECU, PPP	National=100	EU=100
Slovakia	5,766	5,149	100.0	33.7
Western	6,302	5,628	109.3	36.8
Central	5,154	4,602	89.4	30.1
Eastern	5,595	4,997	97.0	32.7
Slovenia	9,210	8,225	100.0	53.8
Estonia	3,803	3,396	100.0	22.2
Latvia	3,070	2,742	100.0	17.9
Lithuania	3,681	3,287	100.0	21.5

Table 17.2: Unemployment rates in the CEE and Baltic acceding countries, 1991-1995

Country	UN ECE					WIIW					DIW <i>et al</i>					National figures				
	1991	1992	1993	1994	1995	1991	1992	1993	1994	1995	1991	1992	1993	1994	1995	1991	1992	1993	1994	1995
Poland	11.8	13.6	16.4	16.0		11.8	13.6	16.4	16.0		11.8	13.6	16.4	16.0		11.4	13.6	16.4	16.0	14.9
Hungary	7.4	12.7	12.6	10.4		7.8	13.2	12.6	10.9		7.8	13.2	12.1	10.1	11.0	2.1	8.2	13.3	12.8	10.5
Czech R.	4.1	2.6	3.5	3.2		4.1	2.6	3.5	3.2		4.1	2.6	3.5	3.2		4.1	2.6	3.5	3.2	2.9
Slovakia	11.8	10.4	14.4	14.8		11.8	10.4	14.4	14.8		11.8	10.4	4.4	14.8		11.8	10.4	14.4	14.8	13.1
Bulgaria	11.5	15.6	16.4	12.8		11.1	15.2	16.4	12.8		11.0	15.2	16.4	12.5		11.3	12.0		12.4	12.0
Romania	3.1	8.2	10.4	10.9		3.0	8.4	10.4	10.9		3.0	8.4	10.2	10.9	14.0	4.0				12.9
Slovenia	10.1	13.4	15.5	14.3		10.1	13.4	15.4	14.2		10.1	13.4	15.5	14.3	13.0	5.7	7.8	9.8	9.4	8.8
Estonia	0.1	1.9	2.6	2.2							0.1	1.9	2.1	1.8				4.7	5.1	5.0
Latvia		2.1	5.8	6.5								1.1	4.7	6.4			0.9	4.6	6.4	6.5
Lithuania	0.3	1.0	3.4	4.5							0.2	1.3	4.4	3.8		0.2	1.3	4.4	3.8	

Country	Employment Obs. (unemployment rate - LFS)				Employment Obs. (registered unemployment rate)				
	1992	1993	1994	1995	1991	1992	1993	1994	1995 (QII)
Poland	14.0	14.4	12.9		9.7	13.6	14.9	16.5	15.2
Hungary	9.9	11.9	10.7	10.1	4.1	10.3	12.9	11.3	10.1
Czech R.	4.1	4.0	3.7		2.6	3.1	3.0	3.3	2.8
Slovakia	12.5	13.7	12.5		6.6	11.4	12.7	14.4	13.3
Bulgaria	21.4	20.5	15.7		6.7	13.2	15.7	14.1	10.7
Romania		8.2	8.0		3.0	8.4	10.4	10.9	9.9

18. POLICY ISSUES: THE IMPLICATIONS OF ENLARGEMENT FOR EU STRUCTURAL AND COHESION POLICIES

18.1 Financial and Institutional Issues

The implications of EU enlargement have been subject to various sets of projections over the past five years. In 1990, Commission calculations suggested that applying the same criteria to the underdeveloped parts of the EU and Central European economies would require an increase of 22 billion ECU in the EU budget, increasing the proportion of own resources from 1.2 percent of Community GDP (1992 position) to 1.6 percent. Other research (eg. Begg, 1995; Cichy, 1995; Pautola, 1995; Brenton and Gros, 1993; Eser and Hallet, 1993; Noetzold, 1993) has cited estimates ranging from 12 billion ECU to 26 billion ECU as the additional annual cost to the Structural Funds of admitting the four Visegrad countries - Poland, Hungary, Czech Republic and Slovakia. Together with agricultural support, and taking account of receipts from the Visegrad states, this would imply an increase in the EU budget of up to 68 percent (equivalent to around two percent of EU GDP). Similar estimates for the accession of the Balkan states (Bulgaria and Romania) and the three Baltic states suggest an additional annual increase in the Structural Funds of between 8 billion ECU and 16 billion ECU.

Taking the current Structural Fund receipts of the four EU cohesion countries as a starting point, the annual per capita receipts of the eligible populations, over the 1994-99 period, range from an average of 188 ECU per year in the Spanish Objective 1 region to 268 ECU per year in Ireland. Given the income levels indicated in Table 3.1, all of the acceding countries would - under current economic conditions - qualify for Objective 1 status. With a total population of over 105 million, the 12 potential Member States would receive Structural Funds support in the range 20 - 30 billion ECU.

On the same basis, current expenditure on Cohesion Fund (based on 1995 allocations) range from 38 ECU per head in Greece to 55 ECU per head in Ireland. Applying these factors to the population of the acceding countries would indicate a cost to the Cohesion Fund ranging from 4 billion ECU to 6 billion ECU.

As noted by previous researchers, such figures imply a significant increase in the EU budget. However, several factors need to be taken into account. First, there is the issue of the impact of transfers. Current EU expenditure on the Structural and Cohesion Funds will, at 1999 levels, be equivalent to 0.36 percent of EU GDP. Given the relativities between the average income of the EU and that of the new Member States (Table 17.1), the current level of EU expenditure would be equivalent to approximately five percent of the GDP of the 12 acceding countries. This underlines the point that even small amounts of support, by EU standards could have a major impact on investment and purchasing power in Central and Eastern European countries.

Second, as seen in Chapter 17, the evolution of national and regional trends among the acceding countries indicates that the vast majority of the regions of the accession countries will remain below the threshold of 75 percent of EU GDP per capita.

Assuming that the current threshold is maintained (since adhesion of even the Visegrad states alone would push the EU GDP per capita average considerably downwards), the optimistic scenario would remove 5-10 percent of the CEE population. Applying the principle of concentration further to focus aid on the worst-placed regions among the new Member States - eg. those below 65 percent of EU GDP - would conceivably remove up to 20 percent of the CEE's population, reducing the cost of EU structural policies further.

Third, even if the current EU Member States were willing to sanction a significant increase in the EU budget (eg. by doubling current expenditure on structural policies), a crucial factor is whether the CEE countries have the economic, financial or institutional capacities to absorb transfers on the scale indicated above. The ability of countries or regions to absorb transfers depends on their economic policies, notably macroeconomic conditions promoting increased competitiveness and productivity, and the institutional capacities to select, manage and implement 'good' projects achieving an economic rate of return. The differing potential of transfers is shown by the contrasting development trends in recent years of Portugal and Greece, both of which have been receiving similar amounts of EU structural support (about four percent of national GDP by 1994) (CEC, 1994).

A key question is whether there is a limit on the level of transfers that can be effectively absorbed by a country. Experience from oil-exporting countries illustrates the divergent effects of sudden, large-scale financial inflows, ranging from the competently-managed Norwegian economy to the negative experiences of some developing countries (Venezuela, Iran, Nigeria). Such examples emphasise the critical importance of competent institutional management. This can be underscored by recent lessons from the transformation process in eastern Germany where transfers from western Germany have been equivalent to 51-58 percent of eastern German GDP (much of it in the form of social security support), and 15-23 percent of investment, over the 1991-95 period. Experience from eastern Germany suggests that the upper limit of a sustainable growth rate may lie between six and eight percent, depending on wider economic conditions (RWI, 1991).

The importance of institutional capacity in the CEE accession countries would justify firm application of the principles of the Structural Funds. For example, the need for 'good' project selection within a strategic framework supports a programming approach to economic development. Indeed, several of the CEE countries (eg. Hungary, Poland, Romania) are already developing institutional structures and regional policy mechanisms, with help from PHARE, that will be compatible with the Structural Funds.

A partnership approach, especially between the EU and national governments in the acceding countries, will be crucial. As noted in Chapter 11, there are still important institutional deficits in administrative structures in most countries, most notably a lack of regional and local government competencies. Local authorities are often fragmented, too small and inefficient. Hierarchies of territorial administrative units have generally not been agreed, especially the form and number of intermediate regions. Statistical indicators and data are sometimes inadequate for planning purposes. In particular, co-operation between both different levels of government and actors at national, regional or local levels is absent or inadequate. Until these issues are resolved, it is unlikely that

sub-national levels will be able to play a significant role in the design and implementation of development programmes in the way that EU Structural Funds are currently operated. In any case, several of the accession countries (the Baltic states, Cyprus, Malta, Slovenia) are too small to justify extensive regionalisation of programme administration, at least in the first instance.

Finally, on the question of additionality, the potential for co-financing of Structural Fund expenditure by national governments may be limited. There are precedents for this situation among the less developed EU regions. Under current EU structural policies, the Cohesion Fund provides 85 percent of funding and the Structural Funds 75 percent in Objective 1 regions; in the case of one Portuguese programme the EU contribution was 100 percent. Although budget deficits have generally been low - c.2-3 percent of GDP - or even in surplus (the Czech Republic, Slovenia), the financial resources available to most CEE economies for economic development are small by EU standards. However, it is perhaps questionable whether a low or zero level of 'own contribution' by the accession countries is advisable. Such high levels of external financing are not likely to foster good administrative practice with respect to cost-effective project selection, monitoring and evaluation. In this situation, alternative forms of instrument should be considered such as loans and credit instruments.

18.2 Funding Priorities

18.2.1 Infrastructure

A core problem facing the integration of the CEE states in the European Union is in the area of infrastructure. This is still orientated towards the economic configurations of the former COMECON area as a consequence of the cold war. The rural areas and regions remote from the borders of the EU also still suffer from these effects. Thus, the EU could fully include the CEE states in the planning of European networks, notably infrastructures of European significance from now onwards. Those routes from which the greatest direct and indirect networking effects emanate should receive special priority. Without an integration of the CEE states in the European transport, telecommunications and energy networks - as is clearly shown by experience with the integration of eastern Germany - favourable economic developments in regions other than those of the capital cities and the regions close to the borders of the EU can hardly be expected.

18.2.2 Joint Ventures

Enterprises in the CEE states face the difficulty of having lost most of the markets secured by COMECON, and at the same time having to establish their own sales channels which had formerly been blocked by the national foreign trade authorities. On the one hand, they lack the necessary knowledge of market conditions and the requirements of western markets, and on the other, the establishment of sales networks demands considerable investments in western currencies which these businesses do not have. In the medium term, this problem area can only be approached by a promotion of joint ventures between businesses in the CEE states and businesses in the Member

States of the EU. Here, the Commission could also create specific promotion opportunities, which would also increase the incentives for businesses from the Union to enter into joint ventures, particularly for cooperation in sales.

18.2.3 Research and Development

Under the planned economic systems, research and development were unilaterally orientated towards the needs of heavy industry and the needs of the armaments industry. All CEE states have the difficulty that, with the exception of licensed products, products whose technical standard and design quality would make them saleable on western markets are rare. From the other perspective, East Asian suppliers in particular are fully competitive with the CEE businesses in terms of price. With regard to application-orientated research and development, it should be considered whether special aid could not be provided to businesses outside the central regions and thus compensate for the disadvantages which result from their present peripheral locations.

18.2.4 Agriculture

In all of the CEE states, agriculture is still of above average importance in comparison with the EU. The unfavourable settlement structure (expressed in lower population densities and a lower quota of central locations) means that very many regions will continue to be dependent on this sector in future. If migration away from these regions is to be avoided, these businesses will have to be put on a permanently competitive basis. It is recommended that special assistance be provided to the peripheral rural regions in the CEE states for the conversion and modernisation of their farming operations. It should be ensured that predominantly those regions are assisted whose location, settlement structure and natural circumstances permit few alternatives in the way of industrial development.

18.2.5 Regional Policy

As noted earlier, are serious gaps in all CEE countries with regard to regional policy. This applies both to concepts and to implemented actions. In many countries, there is also a need for administrative reforms which facilitate decentralised decisions on the regional level. With regard to the expansion of the EU, it therefore appears urgently necessary to provide aid to the countries seeking admission as rapidly as possible to allow them to develop a regional policy which is compatible with the Structural Funds. This concerns both the necessary statistical basis and preparations for the establishment of regional development programmes.

The stage of development of all the acceding countries do not justify a traditional regional policy. The bottlenecks in all countries are:

- the rudimentary networks of infrastructure. It makes it impossible to link the problem regions of Hungary or Poland to the markets of the EU, stops the engagement of western firms and is an incentive for the inhabitants to leave the regions;

- the human capital of these regions is extremely specialized in agriculture and partly in heavy industries; and
- the social infrastructure has a poor quality.

The EU could therefore assist by building an appropriate infrastructural network. It is necessary to see that in the future European networks will not be networks of the Union, but integrated networks of the Union *and* the transition country. Without such networks, there will be no chance to strengthen the process of cohesion.

The process to build such a network is a programme likely to last more than a decade. It depends on absorption capabilities in the acceding countries themselves. For the EU, it is not only a problem of planning and engineering, but a financial problem too. The traditional funds of the EU have to serve special objectives, which are not compatible to these new requirements in the transition states, though it may be possible to create a new 'Eastern Europe Development Funds' to finance these first steps.

Only when the bottlenecks in infrastructure have disappeared, the strategy and concepts of EFRE, EAGFL, and ESF will be valid to solve the remaining problems.

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