

The EU Enlargement, and Immigration from Eastern Europe

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Let me start by sketching a toy model of immigration. Think of all the capital as being in the West (Western Europe). Think of all the labor as being in the East (Eastern Europe). Now remove the barriers to factor mobility. Some capital is likely to move East, in order to work with the abundant labor there. Some labor is likely to move West, to work with the abundant capital here. Make the extreme assumption that, so long as the rate of return is higher in the East, capital moves East, and that, so long as the wage is higher in the West, labor moves West.

How much capital will move East, how much labor will move West is not obvious from this description. There is, it would appear, an infinity of equilibria, one with all the capital and labor in the West, one with all the capital and labor in the East, and all the equilibria in between. What will actually happen? This depends on frictions, or more formally, on relative adjustment costs for capital and labor. If adjustment costs are higher for labor than for capital, most of the capital will end up in the the East, and immigration to the West will be limited. If instead, adjustment costs are higher for capital than for labor, immigration to the West will be much

larger. Small differences in relative adjustment costs can end up making a large difference to the final outcome. If, for example, capital is a bit slow to respond, immigration will start, decreasing the incentives for capital to move East.

Are there reasons for either Eastern and Western states to intervene in this adjustment process? The answer is a very conventional one: If there are no externalities, that is if private and social adjustment costs coincide, then the outcome will be efficient. There is no reason to intervene on efficiency grounds. This does not imply however that, with limited transfers across countries or across groups, both countries gain, or all groups within a country gain. Thus intervention may still be justified, but this time on distribution grounds.

This toy model is just that, a toy model. The distribution of capital and labor between East and West is much less extreme than I have assumed. The long run supply of either capital and labor is not fully elastic: Many workers will not want to move, even in the long run. But it has all the basic mechanisms and so is a useful conceptual framework. It raises a number of issues, among them:

- How can we be sure that some of the countries of Eastern Europe will not simply empty of labor and capital?
- What are the externalities or distributional issues we should be worried about, and do they lead us to want to slowdown immigration from the East?
- Shouldn't we be thinking of immigration and foreign direct investment together, and how much can one help reduce the other?

Let me take each of these three issues, and make a few remarks based on what I have learned both from the papers and from the discussion at the conference.

The potential size of immigration flows.

The basic numbers are as follows: The EU (European Union) has a population of 375 million, including 19 million foreigners, of which about one million comes from the CEEC (“Candidate Eastern and Central Countries”). Current flows from the CEEC to the EU are around 0.3 to 0.4 million, mostly to Germany.

Population in the CEEC is about 100 million. The estimate given in the Brucker et al paper—based on the effect of time variation in barriers to immigration from various countries to Germany between 1967 to 1998—is that, in due time, we can expect about 3% of the CEEC population to move, so approximately 3 million people, at a flow rate of 0.2 to 0.3 million a year.

The empirical work from which this estimate is derived represents genuine progress. But I suspect the estimate is too low. The reason: The countries in the sample used by Brucker et al fall roughly into two groups. Those that are quite similar to Germany in both their income per capita and their culture (for example, France); and those which are quite different from Germany in both dimensions: their income per capita is much lower, and their culture is quite different (for example, Turkey). For either group, a decrease in barriers to immigration is likely to have a modest effect. In the first case, differences in income per capita are too small to trigger a large immigration; in the second, income differences are large, but cultural differences stand in the way. CEECs present a new combination: Income

per capita is much lower than in Germany, but the culture is quite similar to that of Germany. It is plausible that, as barriers to labor mobility are reduced, this combination will lead to much higher migration than estimated by Brucker et al.

In that context (i.e. similar culture, differences in income per capita), the U.S. evidence on mobility across states may be relevant. Here, the raw evidence is quite striking. For example, from 1950 to 1990, the population of Pennsylvania decreased by 60% relative to that of the United States over the last 40 years, that of Illinois by 50%, that of West Virginia by 75%: There is indeed such a thing as states or regions emptying of capital and labor... The econometric evidence is equally striking: The estimates by Barro and Sala i Martin [1991] imply for example that a 10% differential in income per capita leads to a net migration of roughly 0.25% of the population per year. If we take income per capita in the CEECs to be about half that of Germany, and use the Barro Sala i Martin coefficient, this implies a net migration rate of $(\ln(2) - \ln(1)) \times .025\%$, so roughly 1.75%, or 1.75 million. CEECs and the EU are not like the states in the U.S. and this is obviously a generous upward bound. But it still serves as a warning, and to my first conclusion. The estimate of 0.3 to 0.4 million a year may be very conservative.

Which externalities?

The argument is often made that immigration into the EU can help tilt the age composition from retirees towards workers, and thus help balance the retirement system in EU countries. The argument is correct as far as it goes. And if our focus only was on improving welfare in the EU (in its current composition), it would indeed be right. If we think, as I believe we

should, of the joint welfare of the EU and the CEEC, the argument is much less obvious: What helps in the West hurts in the East. The argument must then be that retirement systems are in worse shape in the West than in the East. (Even then, the argument is not straightforward. It requires that the transfer of workers from East to West allows a decline in marginal tax rates in the West, the positive effects of which more than offset the increase in marginal tax rates in the East). But this does not seem to be true: The coming change in demographic structure seems, if anything, more adverse in the East than in the West.

A related argument is that the EU should allow for the immigration of skilled workers. The argument is made on various grounds. Distributional: If a group of workers is going to be hurt, it better not be the unskilled workers in the West. Externalities: Skilled immigrants are less likely to trigger racism. They are less likely to use the welfare system. They may well contribute to growth beyond their direct effect on production: They contribute to the quality of civil society. They may contribute to total factor productivity growth. Again, if our focus was just on the EU, all these arguments might be right. But, again, what helps in the West is likely to hurt in the East. In particular, skilled workers are likely to have larger externalities in transition economies than they do in the EU. I remember how, as transition started in Poland, the quality of the staff at the finance ministry steadily decreased over time: Whoever exhibited talent and knowledge was hired away within weeks by a Western consulting or financial firm. Not to denigrate the usefulness of consulting or financial firms, it was painfully clear that the effect on the quality of decisions at the Ministry, and the cost to Poland, was substantial. For this reason alone, it may well be best if skilled workers

stay in the CEEC, rather than move to the EU.

If, however, skilled workers return home, and do so having acquired new and better skills, the initial loss to the East may be more than offset by the gain later on, and migration may prove useful to both the EU and the CEECs. The few pieces of evidence we have suggest that this effect may be quite relevant ([McCormick and Wahba 2001] for example). Thus, my second conclusion: I find the idea of temporary contracts for immigrants discussed in Chapter 5 of the Brucker et al report to be a very attractive one.

How much difference can FDI make?

Can capital flows to the East (as well as domestic capital accumulation) really stem the flow of immigration to the EU? To get a sense of the answer, consider the evolution of the capital labor ratio in the East (The capital-labor ratio, and by implication, the output-labor ratio is at the center of the adjustment process described earlier). By definition, the rate of growth of the ratio is equal to the rate of growth of capital minus the rate of growth of labor. We saw earlier that immigration may contribute -0.3% (The Brucker et al best guess) to -1.75% (the generous upper bound based on extrapolation of Barro and Sala i Martin's results for the United States to the CEECs) to the rate of growth of labor. How much could FDI contribute to the rate of growth of capital? The answer is: Easily as much. Take for example a ratio of FDI to the CEEC's GDP of 5%. Take a ratio of capital to output of 2. This implies a contribution of FDI to the growth rate of capital of 2.5% , a number above the upper bound on the (negative) contribution of immigration to the growth rate of labor. In other words, FDI can easily

contribute as much as immigration to the process of convergence.

Is a ratio of FDI to GDP of 5% totally unrealistic? Looking around the world, one concludes it is not. Some of the poorer countries of the EU (Portugal, Greece) are now running current account deficits of close to 10% of GDP (although admittedly, FDI accounts only for part of the capital flows.) But the current ratio of FDI to GDP for the CEECs is indeed considerably lower, around 1% of GDP. And much of it represents privatization revenues, acquisitions of existing firms rather than additions to the capital stock.

This leads me to my third conclusion. It may be a good idea, not only conceptually but also politically, to link immigration issues with FDI in discussing transitional arrangements for the entry of the CEECs into the EU. Restrictions on immigration may be easier to sell, and eventually more successful, if coupled with incentives for investment of Western firms in the East.