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IZA World of Labor REPORT: The Effect of the Accession to the European Union on the Productivity of domestic Companies

Recently there has been a lot of discussion about the pros and cons of being part of the European Union. There seems to be an underlying notion that becoming a member of the EU benefits local firms. A new report by IZA World of Labor shows that while firms in the new EU member states of Eastern Europe are indeed more productive than those in other transition economies, there are number of negative side effects.

Economic theory favors the argument that EU membership improves productivity of companies. First, the significance of Foreign Direct Investment (FDI) flows into the new member states (NMS) has led to a large foreign ownership presence, with those firms enjoying the comparative advantage of cheap labor and bringing with them management expertise and technology that enhances productivity. Second, the opening of domestic markets to foreign imports has forced domestic firms to improve productivity or exit the market. Third, firms (albeit mainly foreign ones) have the advantage of joining the largest single market and customs union in the world, which has brought access to international production networks (IPNs) and significant increases in exports.

However, according to Jens Hölscher and Peter Howard-Jones of Bournemouth University not all companies benefit to the same degree and there are some negative side effects. Recent research shows that it is the least productive firms in particular that gained the greatest productivity improvements. The intensity of competition in a previously protected economic environment forced firms lagging in productive performance either to improve or exit the market. Furthermore, productivity in many sectors appears to be largely driven by foreign firms with their superior technology and management.

While privatization led to the takeover of a large number of companies by foreign investors, in a number of sectors there seems to be little knowledge spillover to domestic firms from the presence of foreign firms. Furthermore, foreign investment focused often on the comparative advantage of the respective countries i.e. cheap labor. Multinational enterprises expanded their international supply chain by incorporating the NMS, thus boosting exports. But high foreign inputs reduced value added components, thereby diminishing the opportunity of an export multiplier and increased profits. This in turn has diminished the potential role of local domestic suppliers, reducing the potential for managerial and technology spillovers.

The authors summarize: "*Overall, EU membership benefits firms; however, certain aspects of the way the Aquis Communitaire was implemented, particularly the lack of control of FDI flows, the underdevelopment of financial intermediation, and the exploitation of host country comparative advantage, negatively impact NMS' national welfare and the productivity of domestic firms.*"

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Notes for editors:

IZA World of Labor (http://wol.iza.org) is a global, freely available online resource that provides policy makers, academics, journalists, and researchers, with clear, concise and evidence-based knowledge on labor economics issues worldwide.

The site offers relevant and succinct information on topics including diversity, migration, minimum wage, youth unemployment, employment protection, development, education, gender balance, labor mobility and flexibility among others.

Established in 1998, the Institute of Labor Economics (www.iza.org) is an independent economic research institute focused on the analysis of global labor markets. Based in Bonn, it operates an international network of about 1,500 economists and researchers spanning more than 45 countries.