

Factor Mobility in EU

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Introduction

Although **the freedom of mobility** of labor and capital were objectives emphasized in the Treaty of Rome itself,

only fairly limited progress had been made by the early **1980s** in turning this into reality.

Most EU countries had of one form or another of **capital controls** and **labor movement** faced considerable constraints

through

- ✓ lack of recognition of qualifications
- ✓ and other problems over establishment and transfer of benefits.

The slow progress of factor mobility stemmed from two sources:

In the case of capital,

Member states were worried that having free factor movement would lead to

- destabilizing **flows of capital** that would disturb the performance of the domestic economy.

The main fear was a capital outflow that would

- **depreciate** the currency,
- drive up the rate of **inflation** and
- require **monetary and fiscal contraction** to offset it.

In the case of Labor,

Labor controls were more concerned with inflows.

- Employees in the domestic economy feared that an inflow of labor from other countries would **lose them their jobs**, i.e. countries would export their unemployment.

Much of this was dressed up as

- a need to have **certain skills, standards** and **local knowledge** for the **protection of domestic employee**.

Progress of the Free Factor Mobility

The 1986 Single European Act (SEA) emphasized the importance of breaking through this complex of restrictions and move to a much more open market,

- with freedom of movement of capital and labor being two of **four basic 'freedoms'** set out as the objective of the market.

The 1997 Growth and Stability Pact and **The 1992 Maastricht Treaty**

- had advanced progress further in this context and capital markets have become even more open with the introduction of the **euro in 1999**.

Starting from **2000s** more attention turned to the various problems in the capital markets,

- including **rigidities in capital movements** across EU borders.

Consequently, **the European Commission** undertook an important political initiative aimed at:

- enhancing the development of **the risk capital markets**
- and, more generally, dealing with related problems in the financial markets. In particular, the fragmentation of the regulation of the securities market.

Freedom of Movement of Factors in EU and Economic Theories

The logic behind the freedom of movement of capital and labor, and in general the four basic 'freedoms', is largely built on

- the **neo-classical assumption of perfect competition** and its advantages.

How can the economy allocate resources most efficiently?

- Through markets, assuming economic agents are rational and have perfect knowledge.

In a market, an equilibrium will occur which maximizes the benefits to economic agents given freedom to enter and leave the market.

- This is called a “freely competitive market”, and a system of such markets is called a **market economy**. The basic message of neo-classical economics is that economic efficiency and economic progress are maximized by ensuring that markets work freely and competitively.

Yet the new development in this field is founded on notions based on new growth theory

- with its associated knowledge-based economies, increasing returns to scale, monopolistic competition, and **endogenous growth**.

In the earlier literature, per capita output grows in accordance with the exogenous growth rate of technology, with **policies** that affect savings only altering the level of per capita income.

This means that earlier models of economic growth, basically **static** in character, are no longer useful for analyzing international factor mobility since they consider the **optimal allocation of given factors of production**.

However,

In the new ‘endogenous growth’ literature, a country or region’s factor endowments, are allowed to change over time. And the factor endowments are affected by **innovation and new technologies**

According to the theory,

innovation and new technologies don't occur simply by **random chance**. Rather, it depends of **the number of people** seeking out new innovations or technologies and how hard they are looking for them.

Hence, growth is endogenous in the sense that it depends on the amount of allocated resources based on the accumulation and progress of factors of production, such as human capital.

Consequently, factor mobility could have an important influence on growth and convergence of growth rates between the countries.

Hence, countries that have the same long-run growth rate in technology

- should have the same long-run growth rate in their per capita incomes, irrespective of their prevailing technology, size or level.

Accordingly, The following factors are considered in explaining the forces underlying economic growth and determining the competitive position of individual countries.

- The accumulation of knowledge,
- The generation of ideas,
- The development of human capital, and
- The capacity to absorb new technologies

Thus,

the **long-term growth prospects** of the EU countries importantly depend upon **the flexibility** and **efficiency** of the EU's own **internal factor markets**.

Ongoing reallocation of production factors should help in:

- ❖ Transferring resources to those industries and sectors with comparative advantage, and
- ❖ Achieving increasing returns to scale in the generation and application of new technology.

However, the benefits of free factor mobility are associated with shortcomings:

- ✓ As, globalization has turned physical capital into a much more mobile factor of production.
- ✓ Due to foreign investment, firms may own the export sector of another nation, and these foreign owners may repatriate most of their profits.

Therefore,

growth may be achieved, but only at the cost of international inequalities

This may apply to the eastern enlargement of the EU,

- if increasing flows of profit repatriation eventually outweigh the inward flows of foreign direct investment (FDI) to new member countries

It is thus not surprising to see, at the same time, that:

- the existing member states have been cautious regarding free movement of capital and labor.

The member states have been setting barriers to the factor mobility through:

Increasing the protection of labor through the social chapter in the Maastricht Treaty,

insisting on a transition period for the new member states,

seeking to limit the powers of company takeover.



Thank you