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Toward Agenda 2007:

Preparing the EU for Eastern Enlargement

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Summary

The European Union is gearing itself up to incorporate a number of Central and Eastern European countries (CEECs) over the next few years. This process, known as "Eastern enlargement," has no precedent. As the EU invites in and incorporates former communist-planned economies now undergoing transitions to market economies, its character inevitably will change.

By the start of the next decade, the EU likely will have grown from its current fifteen members to between twenty-five and twenty-seven member countries. Its geographic area will increase substantially, and its population is expected to jump from the current 324 million to close to 500 million citizens. In addition, the new and enlarged Union will emerge as a much more heterogeneous confederation of European states and will cease to appear as a "rich-man's club."

Through the incorporating of up to twelve lower-income countries, the EU's per capita income will fall and, at least over the medium term, will continue to exhibit a lower per capita GDP than its current levels. Though the EU will appear statistically poorer through its decline in per capita GDP, the value of its final goods and services will be even greater than that of the United States. In numerous economic categories the enlarged EU will parallel and in some cases overtake the U.S. as the world's largest economic unit.

In this working paper, challenges associated with bringing into the EU the former planned economies are contrasted with what the Union faced in previous decades by taking in Ireland in the 1970s and the Southern countries Greece, Spain and Portugal in the 1980s. In addition, the likely patterns of accession of individual countries and groups of countries are speculated about at length. Although European Commission and single member states deny it, much room is left for a political decision over the concrete enlargement scenario. At the beginning of 2002, a "Big Bang" enlargement involving all candidates apart from Bulgaria and Romania, and planned for the end of 2004 or beginning of 2005, seemed to be most likely. However, as we describe below, this scenario involves serious risks.

Eastern enlargement is expected to create both growth and welfare effects that will be shared disproportionately between the current EU members and the accession countries joining the Union as part of Eastern enlargement. Within the EU-15, member countries will experience an asymmetry in the distribution of costs and benefits, an asymmetry that should alter the bargaining structure and power play that seem to have solidified among EU member states since Southern enlargement in the 1980s. It seems fair to forecast that the accession countries will benefit across the board, and that each can expect significant increases in GDP output that should continue over the long run as part of their "catching up."

States with close geographic proximity to the CEECs, particularly Germany, Austria and Italy, are expected to benefit more than their EU-15 counterparts from increased economic opportunities associated with helping the former communist economies rise toward the average EU level. Those countries that have been beneficiaries of generous structural funds—such as Ireland, Spain, Portugal and Greece—can expect to suffer declines in current funding levels as portions of their funds are earmarked to foster growth in the newly entering CEECs. More prosperous members, such as Germany, Austria, the Netherlands and France, also can expect to experience losses in financial redistribution—at least declines in the current levels of their incoming transfers of structural and agricultural funds. Because old member states benefited over decades from an entrenched allocation system, accession countries deserve the opportunity to utilize these reallocated funds to facilitate their cohesive growth as they move toward becoming bona fide EU members.

The CEECs undoubtedly will benefit from a succession of EU fund transfers intended to promote their convergence with the average per capita GDP of the Western EU members. As a result of these transfers, the CEECs can expect one-time jumps in their GDPs of approximately four percent. This annual infusion of EU funds, along with the greater political stability of the whole region, will help these countries attain additional growth and welfare effects over the long term. The CEECs will also benefit from specific effects associated with integration. Most importantly, the current EU with its vast markets and hundreds of millions of consumers with comparatively high incomes will serve as a gigantic economic space both for selling CEEC products and for importing EU investment and consumer goods. Overall integration effects for the CEECs might exceed eight percent of their GDPs (steady-state effect).

All things considered, Eastern enlargement is not expected to cause any dramatic economic shock or induce any sort of financial crises, either to the CEECs or to the existing EU members. The reason is that Eastern enlargement in fact has been underway since the start of the 1990s, when the CEECs opened their economies to freer trade practices and to inflows of foreign direct investments (FDI). Hence, most of the welfare effects have already been absorbed, and the awaited effects on the distribution of incomes and adjustments in labor markets will be ameliorated by labor migration. CEEC integration portends that—over time—labor will move more freely and thereby be allocated more efficiently, and with beneficial results. Additional welfare effects are also expected as real trade costs decline and the risk premiums for investments in CEECs are reduced.

Still, we are aware that—at present—the EU is not in a financial and institutional position to cope with the full range of challenges looming on the enlargement horizon. Neither the reform steps taken under Agenda 2000, nor the ones agreed upon at the Nice Summit in December of 2000, suffice to make the Union fit for Eastern enlargement. An important step forward could be made at the intergovernmental conference (IGC) already planned for 2004. This conference should address the core problems and determine the basic competencies,[1] constitutional issues and decision-making procedures of the EU. In fact, it should proceed to revise the Nice Treaty.

Nevertheless, we expect that details in major policy areas will have to be negotiated later within the framework of a new Agenda 2007. The negotiations on this agenda likely will begin in 2005 and should be finished the following year. If the IGC 2004 fails to introduce major reforms in EU institutions—reforms that should lead to more efficient, transparent and legitimate decision making—Agenda 2007 should complete the process. We expect and hope that Agenda 2007 would serve as a major breakthrough for the future of a United Europe.

Above all, Agenda 2007 must address the disproportionate spending to support the EU's Common Agricultural Policy (CAP), as well as the various spending programs falling under the rubric of "structural funds." Over recent decades the comparatively rich Western European countries readily and easily carried the levels of entitlements supporting the relatively few low-income countries in Western Europe. This constellation is about to undergo profound changes, with challenges that should not be underestimated. For the EU to remain financially fit for the future, limits have to be set on entitlements. In addition, we suggest that the EU's cohesion policy should shift from the present support of less-developed regions to the promotion of economic convergence among countries. This requires a more sensible reallocation of funds, as well as real increases in revenues to cover the EU's growing expenditures.

We propose reforms to the EU's structural policy[2] that would offer member states greater control over choices of investment projects. We recommend that the EU concentrate spending on fewer objectives, and that these spending objectives should be targeted to assist poorer member states upon their accession to the Union. A clearer and more transparent mechanism for financial redistribution will be necessary to avoid endless political horse-trading of transfer payments. We propose a financial redistribution scheme in which the contribution to the budget of each single member state is based on that state's contribution to the EU's GDP and the financial transfers on the relative welfare measured in per-capita GDP (purchasing-power standards).[3]

Step by step, agricultural-policy reforms should focus on further price liberalization, increased national cofinancing, reduction in direct-income supports and dismantling the latter from the means of production (land and animals). In the end, the Common Agricultural Policy (CAP) should be abolished in its existing form and the task of the European Commission limited to ensuring fair competition while setting the general guide-

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[1] "Competence" and its plural form "competencies" refer to the tasks, responsibilities and decision-making power of the different levels of administrative, organizational and institutional structures of the European Union. One speaks of the competencies of the various regions, the nation states, the EU Commission, the European Council and the European Parliament.

[2] The EU's structural policy is sometimes also referred to as a „cohesion policy." Its policy instruments include the use of cohesion funds, structural funds and funds to support social and rural policy.

[3] Eurostat uses the term „purchasing-power standards," which is nearly identical to the widely used „purchasing-power parity." Both concepts measure the real income of people in countries based on their purchasing power.

lines for national income-support measures. As a result of such changes, European policy and institutions could concentrate on those areas that only the European Union can handle properly (single market and security issues).

Eastern enlargement will also create major challenges for the European Monetary Union (EMU). The accession countries will not be offered the possibility to opt out of the monetary union—as did Denmark and Britain. However, we argue that for CEECs still in the throes of a catching-up process, approaching the Maastricht criteria (especially the inflation target) too rapidly likely would restrain economic growth and crucial structural adjustments. Instead, approaching these objectives with a medium- or long-term perspective will foster economic growth. Any unilateral introduction of the euro by a CEEC—as promoted by some economists—would be, in fact, a violation of the spirit of the accession treaties and harmful for larger accession countries.

For the CEECs, joining the EU will mean that they must also become bona fide members of the EMU—and permanently remain in it, abiding by its rules and restrictions. As the EU enlarges, the European Central Bank (ECB) will find its position increasingly pivotal. The euro region will grow substantially bigger as more countries join the European Monetary Union (EMU). In addition, the ECB will be faced with several problems. First, it seems highly unlikely that efficient decision making will be possible with twenty-seven members within the ECB council. Second, as economic conditions within the euro zone become more diversified, a consistent monetary policy will be harder to achieve. If monetary policy is directed toward the major European economies—as it should be—the catching-up economies in the East might be confronted with higher inflation rates. If the ECB wishes to control inflation in the economies on the Eastern periphery, it would have to introduce a more restrictive stance in monetary policy. This, in turn, would affect overall economic growth in the euro zone. Therefore, we believe that it is in the best interests of all parties that a CEEC not enter into the EU and the EMU prematurely, as its national autonomy over monetary and fiscal policy would be lost to a centralized monetary authority—the ECB.

We offer a package of reforms for the EU to consider—reforms that would alter and change the Union's institutions so that it can deal successfully with the "leftovers" from Nice. We suggest that the powers and competencies of different levels of governance be defined more precisely, and that these policy measures be undertaken at the already-planned intergovernmental conference (IGC) scheduled for 2004. The processes of EU decision making need to be streamlined further and rendered more transparent, democratic and effective. In the long run it will be necessary to reconstitute the EU as a uniquely styled union of European states. This union should be more than a confederation yet more loosely allied than a classical federal state, such as the United States of America. We think that when this institution achieves its final form of organizational development it will be described as a "Federation of European States."

I. Introduction

When the Cold War ended more than a decade ago, leaders in both Eastern and Western Europe spoke euphorically. At that time it was fashionable to proclaim openly for the long-hoped-for dream: the political and economic unification of Europe. Today Europeans are faced with actually making their sanguine vision—expressed clearly in the 1957 Treaty of Rome—a reality. However, an array of formidable challenges has emerged as European states attempt to bridge their East-West divide. Both the West European states represented by the European Union (EU) and the Central and East European countries (CEECs) seeking accession still have to complete a wide range of demanding tasks to make their dream come true.

We have chosen 2007 as the year for which the EU needs to prepare. Current structures and budget plans are set to last more or less in their established forms through the end of Fiscal Year (FY) 2006. As currently constituted, the EU will be able to cope with financing a first accession round that could include possibly as many as ten countries before the end of 2006. However, come 2007, the EU in its present form will not be prepared financially to cope with the additional demands and challenges arising from Eastern enlargement.

Never over the long span of history has Europe been unified on such a large geographic scale as it would be under the proposed scheme. Unifying Europe at the start of the twenty-first century involves the EU inviting in selected countries that spent four decades behind the Iron Curtain. This process, known as "Eastern enlargement," portends a substantial increase in the EU's geographic size and population. Shortly after this decade's end, the EU is expected to have increased from the existing fifteen member countries to include as many as twenty-seven. The EU's population is expected to increase from its current 324 million to close to 500 million. Clearly, such an enlargement is without precedent. What helps complicate matters is that along with preparing for accession the CEEC candidates are also undertaking transitions from planned to market economies.

Might Western Europe threaten its own hard-earned prosperity by extending its reach too far eastward? Do benefits expected from enlargement outweigh anticipated costs? Why is it that the EU public expresses so much skepticism over the issue of enlargement? Does Europe's public perceive real dangers associated with Eastern enlargement that the EU elites fail—or refuse—to recognize?

There are other important questions to be addressed as well. Might the CEECs quickly erode their already-weak production capacities when they come head-to-head too suddenly with the more advanced service, manufacturing industries and highly productive farms of Western Europe? Should the EU's Eastern enlargement be seen as a euphemism for a new form of colonialism—a solution quickly pieced together to fill the security vacuum left by the collapsed Soviet occupation? Will Brussels become the headquarters for the staging of a new East European debacle, where it and other Western

European capitals grow ever richer as the CEECs remain relatively poor? These are the sorts of questions that we take to heart and attempt honestly and accurately to address in this working paper.

The approach we take to the subject of Eastern enlargement is influenced by our long-standing concern for the millions of Central and East Europeans whom we judge to have suffered disproportionate hardships during World War Two and the ensuing Cold War. Over more than four decades following the Second World War, traditions that provided the foundations of modern civil society in Western Europe were confronted, challenged and thwarted at multiple levels and sometimes in the most primitive of ways in the CEECs.

As economists, we find particularly disturbing the fact that under the CEECs' Soviet-type planned economies, the populations suffered numerous disadvantages from a system with built-in tendencies for institutional sclerosis. The "information revolution" that started to play such an important role in the 1970s in advanced Western economies could hardly take root and play a role in planned economies where information was deemed a dangerous threat to state control.

While the CEECs stagnated during the Cold War, Western Europe forged ahead. It made great advances in modernizing its economies, with benefits that were widely shared. Even the Union's late entrants and more relatively backward economies such as Ireland's, Spain's and Portugal's made substantial progress toward catching up with the EU average.

We acknowledge that Europeans—both Eastern and Western—do indeed face formidable challenges from such an unprecedented enlargement. However, the rich legacy of economic knowledge stands clearly on the side of enlargement. In this paper we shall present our research results and muster all the scientific and empirical resources at our disposal to attempt to demonstrate that current members of the EU do indeed stand to win through an Eastern enlargement. But the Eastern countries stand to win in a bigger way.

II. Forging Europe's Unity

1. Challenges of Enlargement

For a full decade, the Central and East European countries (CEECs) have undergone transitions. At separate speeds, each has moved from authoritarian, one-party rule to parliamentary democracy and from a planned to a market economy. Some countries are ahead of others. The most advanced reform countries, such as Hungary and Slovenia, have nearly completed their economic transition and are mostly prepared for their accession to the EU, given the full range of criteria they have to meet. Other countries remain farther behind.

The European Commission provides criteria for judging a CEEC's preparation for EU accession. On an annual basis, candidate countries are evaluated by the EU Commission based in Brussels to determine how well each has fulfilled its moves toward democracy and a competitive market economy, following the "Copenhagen Criteria" (European Commission, 2000 and 2001). Likewise, candidate countries are evaluated to see how well they have implemented the *Acquis Communautaire*, the common set of rules and laws adopted by all EU members (Krenzler, 1998). While some of the CEECs appear close to fulfilling criteria for accession, others remain quite far behind. Those countries furthest along likely will be among the first round of entrants—envisaged to be brought into the EU in 2004 or 2005. Those lagging behind cling to the hope of entering in a second or third round in 2008 or 2010.[4]

What makes the EU's Eastern enlargement so challenging as an economic undertaking? We think that the challenges are related to the unprecedented scale of the anticipated expansion, combined with the fact that vast differences exist in the levels of economic development and performance between the prospective CEECs and the advanced members of the EU. Comparative levels of capital endowment and technical development are indeed greater than they were between Ireland, Portugal, Spain and Greece and the Economic Community members at the time of Southern enlargement in the 1970s and '80s. Ireland's and Spain's per capita GDPs were roughly sixty percent of the EU's, while Greece's was fifty percent and Portugal's thirty.

When measured at current exchange rates, the average level of per capita output in ten of the CEECs considered is but sixteen percent of the EU average (see Column Two of Table 1). More advanced CEECs such as the Czech Republic, Poland and Hungary

[4] Which countries will enter in a first round is not completely settled. All indicators suggest that those countries furthest along with fulfilling the economic criteria specified in the *Acquis Communautaire* will enter first. However, political and security concerns are also a factor. Even geographic considerations inadvertently shape the pattern of Eastern enlargement. Within the EU, member countries promote enlargement with varying degrees of enthusiasm. According to a plebiscite conducted in June of 2001, the Irish publicly voiced the greatest skepticism regarding Eastern enlargement, while Germany and Sweden have lobbied most earnestly for an early enlargement with a large group of entrants.

reach levels of between eighteen and twenty percent of the EU average. Slovenia registers at forty-four percent of the average EU per capita GDP. Although the Czech Republic, Slovenia and Hungary reach levels of purchasing-power standards (PPS) equal to—and in some cases greater—than the fifty-five and seventy percent of the EU average attained by Southern countries at the time of their accessions, the ten CEECs register at about forty percent of the EU average (see Column Three of Table 1). With such comparatively poor economies, the CEECs face trying to enter an EU that has raised its standards for entry.

TABLE 1

Indicators of Levels of Socioeconomic Development:
The CEECs Compared with the EU-15
(2000[1])

	Population in millions	GDP per capita in euros	GDP per capita in PPS[2]	PPS as % of EU-15 average	Share of agriculture in total employment (in %)	Share of agriculture in GDP (in %)	HDI indicator, ranking position[3]
Bulgaria	8.2	1600	5400	25	26.6	14.5	57
Czech Rep.	10.3	5400	13500	62	5.1	3.9	33
Estonia	1.4	3800	8500	39	7.4	6.3	44
Hungary	10.1	4900	11700	54	6.5	4.8	36
Latvia	2.4	3300	6600	30	13.5	4.5	50
Lithuania	3.7	3300	6600	30	18.0	7.6	47
Poland	38.6	4400	8700	40	18.8	3.3	38
Romania	22.4	1800	6000	27	42.8	12.6	58
Slovak Rep.	5.4	3900	10800	47	6.7	4.5	35
Slovenia	2.0	9800	16100	74	9.9	3.2	29
CEEC-10	104.7	3800	8700	40	–	6.5[5]	43
Portugal	9.9	10600	16100	76	12.6	3.9[6]	28
Spain	39.4	14200	17300	82	7.4	4.2[6]	21
Greece	10.5	11200	14200	67	17.0	8.1[6]	23
as % of EU[4]	27.8	17	40	–	–	29.8	(15)[7]

[1] Human Development Index (HDI) for 1999; EU-15 for 1999. [2] PPS, purchasing-power standards, is calculated in current euros. [3] HDI ranking is based on a synthetic measure of eight socioeconomic variables, a lower number indicating a better ranking position. [4] EU-15. [5] Unweighted average. [6] Share in value added in 1998. [7] Average HDI-ranking position of EU-15.

Sources: statistics of Eurostat; *Human Development Report*, UNDP, New York, 2001; Osteuropa-Institut München, Working Paper No. 227, 2000

In fact, economic preconditions for accession and then full Union participation are now higher than they were in the 1970s or 1980s when the countries with lower per capita incomes entered. Brussels introduced additional steps for integration in the 1990s, such as the Single Market Program and the European Monetary Union (EMU). Following accession, countries applying to join and remain members of the EMU prudently must bring into and keep in line rates of inflation, federal budget deficits and the ratio between total public-sector debt and total output of final goods and services (GDP). Were this not enough, EU membership also means integrating into—and then surviving in—a single, European-wide market for consumer goods as well as factors of production. Integration has to be achieved in an economic environment in which, even over the long run, levels of labor productivity among members countries will vary significantly. In sum, rising standards make EU accession that much more difficult and costly when compared to earlier accessions in previous decades.

At the same time, the EU institutions, policies and legal framework could be characterized as "moving targets" for the accession countries. The EU is faced with undertaking additional major reforms, which means that the currently established goals and benchmarks the CEECs have to reach on their accession road likely will be raised and thus made even more difficult to achieve. As CEEC entry criteria are raised to ever higher levels, ever greater financial burdens will be placed on the CEECs as they attempt to achieve them. What is more, we expect a growing asymmetry to emerge—a growing differentiation between the costs to CEECs for implementing EU regulations and the benefits new members are likely to receive and realize as EU transfer payments taking the form of agricultural and structural funds. In sum, since EU membership has numerous explicit and implicit costs, preparation for membership can be seen as carrying risks that are without historical precedent.

2. Processes Leading Up to Accession

Eastern enlargement can be understood as a historical response to an opportunity to bring all Europeans finally into the fold and under the institutional wings of the EU. What is important to keep in mind is that the EU's Eastern enlargement involves more than having the CEECs join the European Union. The "return to Europe" is the result of a long and drawn-out process. It could be argued that it started with the periodic resistance to Soviet domination that manifested itself in numerous ways, including violent revolts that resulted in the deaths of many thousands of heroic citizens. However, even the most generously funded intelligence organizations failed to perceive that the Cold War ever would end. And only a few thinkers at the margins of intellectual life ever speculated that the Soviet Union willfully would throw in the towel and undergo an internally directed self-liquidation from the top down. Prospects for Eastern enlargement greatly improved when the Soviet Union lost its vast sphere of influence in Europe. In this section we present a short history of Eastern enlargement from the time when it began to accelerate at the end of the Cold War.

In our view, Eastern enlargement developed from a process of integration that has been achieved by policies drawn up and implemented incrementally over the last decade (see Table 2). Accession is but the final step in a multistep process toward enlargement. And when accession is completed, policymakers likely will discover an array of shortcomings in the EU that fetter the successful integration of a Pan-European economy. These institutional shortcomings will have to be met head on with reform policies.

TABLE 2

Steps Toward EU Enlargement

Type of Agreement or Integration Step	Year	Area
Provisional Trade Agreement	1990	Trade
Europe Agreements	Signed December 1991; trade policies implemented since beginning of 1992	Trade and political dialogue; concrete support of the enlargement process through assistance programs like PHARE
Copenhagen Council Meeting	December 1993	Criteria for enlargement (market economy and ability to cope with EU competition)
Essen Council Meeting	December 1994	Decision on the "preaccession strategy"
Cannes Council Meeting	June 1995	"White paper" as a guideline for preparation for accession
Madrid Council Meeting	December 1995	Important advances on the road to accession, provided by several initiatives
Agenda 2000	Berlin Intergovernmental Council (IGC) in 1999	Preconditions on the EU side for enlargement, such as reforms in structural and agricultural policy, as well as access to financial resources
Negotiations for enlargement	Since 2000 (ongoing)	Establishing the *Acquis Communautaire* (EU laws and regulations in the accession countries)
Nice Summit	December 2000	Reforms in the EU institutions and voting powers

Source: synopsis derived from Mayhew (1998)

A precursor to the start of the CEECs' integration into the EU took place toward the end of 1989 when the then European Community considered offering associate status to the newly forming democracies to their east (Mayhew, 1998, p. 21). However, the kick that truly started the enlargement ball rolling was made in 1990, when the EU offered a Provisional Trade Agreement that gave the CEECs preferential trade access to EU markets. Offering trade access was the EU's response to the economic crises facing the CEECs when the ruble lost its convertibility in COMECON, the Eastern bloc's market. Then the vast Soviet market suffered a collapse in demand, and a major slump in CEEC exports ensued.

The EU helped to restore CEEC trade flows, to a degree, while also promoting the start of an important change in the composition of CEEC output and instilling in the CEEC countries an appreciation of product quality. Offering trade access assisted the CEECs in better mitigating the transition recession of the early 1990s that was directly related to the breakup of COMECON trade and the collapse of the Soviet Union's giant economy.

These agreements between the EU and the CEECs were further developed and institutionalized at the end of 1991, around the same time that the Soviet Union dissolved itself. Taking the form of "Association Agreements" based on Article 238 of the Treaty to Czechoslovakia, Hungary and Poland, these agreements were later formalized and called "Europe Agreements" (see Table 2). Important sections of the Europe Agreements that related to international trade became effective in March of 1992. Toward the end of 1993, these provided a solid framework for the Union to deal with the Visegrad group composed of Poland, the Czech Republic and Hungary. What is special about these agreements, going well beyond issues of trade, is that policymakers envisaged the political dimensions of Europe's unification. The European Council meeting in Essen in December of 1994 introduced practical programs of assistance similar to 1989's PHARE (the French acronym for Poland and Hungary Assistance for Economic Restructuring) to encourage accession of the CEECs to the EU (Mayhew, 1998, pp. 21-25).

At the Copenhagen Summit in 1993, criteria were established—now known as the "Copenhagen Criteria"—laying out the conditions for CEEC accession. These criteria specified that the CEECs first had to start functioning as democracies. In addition, each country had to demonstrate that it successfully could provide the legislative and regulative underpinnings for a functioning market economy—and then make it work. Finally, each country was obliged to prove that its economy could cope with the intensified competitive pressures it would encounter upon accession, when coming head-to-head with the advanced market economies of Western Europe. The Copenhagen Summit's shortcomings were that it failed to specify a timeline for accession and expressed only in general terms the criteria for EU membership, omitting the specifics.

Additional important steps toward CEEC accession have been made at summits organized by the European Council. The Essen Summit, resulting in the "Essen Strategy," along with policies from the General Agreements on Tariffs and Trade (GATT), created concrete tasks for the EU and the CEECs to begin to undertake. A white paper dealing with the preparation for the accession of prospective new members was promulgated. At the European Council's Madrid meeting in December of 1995, single member states took over some part of the leadership role from the European Commission. In Madrid Germany's Chancellor Kohl was a main spokesman for EU enlargement. Finally, with the Berlin Summit in 1999 and the promulgation of "Agenda 2000," concrete offers for negotiations with the first round of proposed entrants were established (Mayhew, 1998, p. 36).

In the field of economics, the CEECs made major steps toward economic liberalization and EU integration within the framework of the Europe Agreements. However, trade liberalization between the EU and the accession countries was conceived to be asymmetric. Asymmetry resulted as the EU lifted trade restrictions caused by tariffs much faster than did the CEECs. Nevertheless, in areas involving trade goods known to be sensitive to import prices, e.g., coal, steel and agricultural products, trade restrictions were removed at a slower pace. As a result, the Europe Agreements were criticized by the CEECs, because the above-mentioned sectors provided the few areas in which they exhibited comparative advantages in production for export. The EU, for its part, feared that CEEC enterprises were not operating on the basis of fair cost calculations, especially in these price-sensitive and import-sensitive sectors. In the 1990s measures to prevent dumping were launched mainly against underpriced goods in these sectors. Leaving aside such trade conflicts, however, major advances in economic relations and especially in trade policy were reached and remained in place until 1997. With the exception of agricultural products, the EU lifted trade restrictions on goods from the CEECs, even for import-sensitive products such as steel and textiles. At the same time, most of the tariffs affecting trade on the CEEC side also were removed, and the remaining tariffs are expected to be fully eliminated in 2002.

What remains to be dealt with forthrightly on both sides of Europe's lingering trade divide is, above all, the abolition of non-tariff barriers to trade (NTBs). In addition, the CEECs still face the challenges of implementing EU standards and norms. Finally, trade in agricultural commodities and foodstuffs needs to be further liberalized by both sides. This process of freeing trade flows is well under way and could possibly be completed in 2002. However, our research suggests that the lion's share of trade between the EU member states and the CEECs has already opened up. Additional trade expansion effects might occur when, for example, border controls are removed. Trade-creation effects stemming from the full opening of borders are estimated to reach from five to fifteen percent of trade volumes (Breuss, 2001; Keuschnigg and Kohler, 1999).

Important steps toward the liberalization of capital flows have been made in the transition countries seeking accession. In most countries benefiting from FDI flows, regulations were introduced speedily in order to establish international standards. By the mid-1990s all CEECs had joined the IMF. Those more advanced CEECs such as Poland, Hungary and the Czech Republic are members of the OECD (Organization for Economic Cooperation and Development). Although some of the CEECs maintain several short-term capital controls, these easily can be abolished in the coming years. Hence most of the so-called "four freedoms" of the EU's internal market already have been realized. These include the unrestrained movement of goods, of capital, of labor and of services. What is left to liberalize further are variables primarily of political importance, and only secondarily of economic importance.

Labor migration, for example, has proved extremely sensitive as a political issue. This is especially true in border states such as Germany and Austria, whose citizenry have voiced fear of an "*Übersiedlungstrom*" driven by a massive resettling of economic refugees from the CEECs to Western Europe. At the same time, migration's economic importance has remained a secondary consideration. From the perspective of business interests in these two countries, an inflow of qualified labor likely would prove a boon. Adapting and implementing EU environmental and social standards is proving a costly and complicated operation for the accession countries. We forecast that transition periods of five to ten years will be implemented to deal with the political issues involving CEEC labor migration and environmental standards.

In sum, though real progress has been made in the last decade, Eastern enlargement continues to be a long, drawn-out process. The EU's enlargement program is expected to be finished when the full range of EU policies is applied fairly to all CEECs and when all transition periods are completed after the initial accession. Thus we expect that the current EU members, as well as the CEECs invited for accession, will be sitting before a full plate of challenges over an extended period of time.

The enlargement ball leading toward CEEC accession and full-fledged membership began to roll in about 1990. We anticipate that the first round of CEEC accession will take place in 2004 or 2005, with the last of the entrants joining in the second decade of the twenty-first century. In addition, we estimate that all transitional arrangements for those countries coming in with the first and second accession rounds finally can be abandoned in approximately 2015. At that time the CEECs should be integrated fully as bona fide members, with all the associated privileges enjoyed and responsibilities shouldered by Western members.

3. Enlargement Scenarios

Although Agenda 2000 neither clearly stated nor formally fixed the terms of Eastern enlargement, it nevertheless was understood that enlargement would proceed in two major rounds, the first of which, referred to as the Luxembourg Round, includes Poland, Hungary, the Czech Republic, Slovenia, Estonia and Cyprus. Originally, these six countries were expected to enter as a group in a first accession round in 2002, since they were deemed furthest along with fulfilling the Copenhagen Criteria. Slovakia (for political reasons), Latvia, Lithuania, Bulgaria and Romania (referred to as the Helsinki Group)[5] were judged to be behind with their transitions from planned to market economies. Thus the leaders and populations of the latter five countries were left to cling to the hope of entering in a second accession round.

Upon more intense scrutiny, however, the differences between likely entrants joining in the first and second rounds are not really so profound. Some countries, for example, have made unexpected progress. Faced with the problem of being left behind or even

[5] These groups are named after cities where European Council meetings took place.

left out, Slovakia's and Romania's voters chose to change their leaders. Also, because of its relatively fast pace and thoroughness of transition, Estonia was added to the first group of entrants. That other CEECs could join the first accession round is also possible, provided that they, like Estonia, make significant progress with their reforms. The Nordic EU states, especially Sweden, have pressed for an earlier entry of the two Baltic states of Latvia and Lithuania.

However, plans changed course rather quickly as the war over control of Kosovo in the spring of 1999 goaded Europe's leaders to consider the profound consequences of destabilized countries and regions in Europe's East and Southeast. For a time, the proposed procedure of a two-group entry was abandoned and immediate negotiations on EU membership were offered to a wider range of countries. This provided those countries with real hopes for a speedy accession. However, accession criteria based largely on furthering the interests of peace and stability in Europe failed to consider each country's progress with fulfilling the Copenhagen Criteria, and with time it became clear that Western members were not prepared to deal with the consequences of an accelerated and unprepared entry of CEECs into the EU. Although not officially declared, an accession round including the most advanced CEECs, to take place between 2004 and the end of 2006, is now seen as the more realistic scenario.

Even though EU member states now have shifted away from rapid entry and back toward stressing the importance of the CEECs' making measurable advances in implementing reform criteria, we do not think that the process will remain so neat and bureaucratically decided. We envision that Eastern enlargement will proceed either with the accession of two main groups or as a "Big Bang."

If it proceeds with the entrance of countries formed into at least two groups, we reason that the first group likely will consist of Poland, Hungary, the Czech Republic, Slovenia, Estonia, Cyprus and Malta. This first group is expected to join the EU in 2004. We consider 2004 to be the key year because the European Council meeting in Gothenburg in June of 2001 established the policy that the countries entering the Union in the first accession round would also participate in the next round of elections to the European Parliament—to be held in 2004. This perspective was confirmed by the most recent EU council summit in Laeken (Belgium) in December of 2001.

Assuming a step-by-step approach, it is most likely that a second group, consisting of Slovakia, Latvia and Lithuania, will join in 2006. Bulgaria and Romania would join later, around 2008. There is a possibility that Croatia might enter with this second group, provided that reforms proceed there**.** Albania, the Republic of Yugoslavia, Turkey and Bosnia might enter shortly after 2010. However, because of historical legacies stemming from their locations on the periphery of important European developments—as well as lingering internal problems—these countries might never be invited to enter (see Table 3).

We think that there is an entirely different scenario deserving of consideration. We describe this as something on the order of a "Big Bang," with the first-round accession of eight CEECs, leaving out Bulgaria and Romania but including Cyprus and Malta. If accession comes as a Big Bang, we expect it to take place somewhat later than 2004. If such a scenario occurred at the end of 2004 or 2005, it could not be undertaken without its fair share of financial risks. Still, it would offer political and administrative advantages.

Waiting until 2005 would assist the EU in buying time, so to speak, which we think it might well need. The EU could use this extra time to add some degree of economic rationality to its structural and agricultural policies. In addition, negotiating between the EU and the accession countries could take longer than anticipated. Finally, the ratification process for the “Accession Treaties” has to be approved by the national parliaments of each of the current EU-15 members. As the Irish rejection of the Nice Treaty demonstrates, such a ratification process likely will be sticky, even if all goes well. If negotiations with Warsaw prove to be longer and more complicated than anticipated, the EU members might give up trying to include Poland in the first accession round, because the entire enlargement strategy of basing accession upon progress in reforms would no longer prove credible. As one can see, there are advantages to putting off a first accumulation round scheduled for an earlier date and waiting for an accession round that takes place in one fell swoop at a later date.

From an administrative standpoint, one of the major advantages of the Big Bang scenario is that no temporary EU external borders or special regulations would be needed. Imagine what it would cost the EU in administrative and physical infrastructure outlays if it has to erect its eastern border first between the Czech and Slovak republics and then needs to dismantle it within a few years time, when it would be moved to Slovakia’s eastern border with the Ukraine! A flexible transitional policy for implementing the EU’s border-control system might mitigate the expected costs, but having to move the EU’s eastern border at least two times likely would prove to be a logistical and administrative headache.

Additionally, the ratification process surely would alter the existing constellation of power relations between EU members, old and new. We think that EU member states might prefer to avoid staggering these changes in order to meet them head on. The Big Bang scenario is not incompatible with the political commitment that new member states should participate in the elections of the EU Parliament in 2004. If it turns out that accession negotiations are completed but not yet ratified, elections could be held in the CEECs and their elected deputies might serve as parliamentary observers until the date when their full membership is finalized.

From a tactical point of view, the European Commission does not and probably should not officially support this Big Bang scenario, but in its latest progress reports and strategy papers the European Commission is showing more and more signs that ten countries will be ready for membership at the same time (European Commission, 2001). We believe that the Commission’s goals are: one, to maintain an advantageous bargaining position relative to the accession countries, and two, to keep pressure for reforms in place so that the candidate countries make needed progress as the dates for accession draw near.

We find that the Big Bang scenario has other shortcomings. If the accession preparation for individual CEECs turns out to be too challenging in the coming years, then a step-by-step approach of allowing accession of those countries fully prepared to meet the EU entry criteria outlined above would prove much more appropriate. The EU cannot operate with too many exceptions to its rules regarding transition periods for CEECs without endangering its administrative capacity and internal coherence (Quaisser, 2001a).

At this point in time, our knowledge regarding which countries will proceed with accession—and when—is limited to intelligent conjecture, based on available research material. It would be naive to believe that Eastern enlargement would proceed according to a detailed and precise blueprint. Too many players are operating with wholly different and sometimes competing interests. Thus, the crucial decisions over procedures for Eastern enlargement will be made based upon a bargaining process that can be expected to "liven up" in the eleventh hour. This is a familiar tendency and pattern that we have observed taking place at almost every EU summit. Eleventh-hour bargaining excitement was indeed the order of the day in Nice. Consequently, we expect that many variables and interests will come into play when the ultimate decisions must be made regarding which particular countries will enter, the specific timing of entry, as well as the conditions for accession.

Nevertheless, real evidence exists that the European Commission would like to finish the first round of enlargement toward the end of 2004 with a bigger group of ten candidates (all CEECs except Bulgaria and Romania). This is not a secret but a clearly formulated aim of the European Commission that it even published in a strategy paper.[6] Many of the existing member states, especially Germany and Austria, also prefer a date of entry for a first round of entrants in 2004 or 2005. But uncertainties remain. What is likely to occur if the Nice Treaty is rejected for a second time in an Irish referendum? The first "No" vote on the part of the Irish citizenry demonstrates that, even for a population that has benefited enormously from the support extended by the EU over the last three decades, there remains little enthusiasm for enlargement among the public. The outcome of the Irish referendum suggests that the road to EU enlargement will be bumpy.

If the current EU-15 members find themselves unable to form a consensus or undertake what we deem are necessary reforms, we think that negotiations will grow increasingly sticky. The result could be that Eastern enlargement is blocked. Thwarting the stream of progress could take place in the eleventh hour through a stonewalling combined with a formal rejection of the accession treaty in one or more of the EU-15's national parliaments. A similar type of rejection could also occur in accession countries when a national population voting in a referendum finds the terms of accession untenable. These two plausible turns for the worse thus demonstrate the level of responsibility of all of the political players: each needs to move quickly and effectively to bring this project, with its great historical overtones, to a successful conclusion.

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[6] The blueprint for accession is described in the EU Commission's *Strategiepapier zur Erweiterung* (*Strategy Paper for Enlargement*), 2000 and 2001.

TABLE 3

Enlargement Scenarios

First Scenario: Smaller Group Entries

Projected Year of Entry	2004	2006	2008	2010, shortly thereafter or never
Countries	Poland, Hungary, Czech Republic, Slovenia, Estonia, Malta	Slovakia, Latvia, Lithuania, Cyprus	Bulgaria and Romania (possibly Croatia)	Turkey, Albania, Republic of Yugoslavia, Bosnia
Inhabitants (millions)	63.0	12.3	30.7 (with Croatia, 35.3)	79.9
Inhabitants as Percent of Current Population of EU-15	16.9	3.3	8.2 (with Croatia, 9.4)	21.4

Second Scenario: The Big Bang

Projected Year of Entry	2005 (EU Commission envisages 2004)	2008	2010, shortly thereafter or never
Countries	Poland, Hungary, Czech Republic, Slovenia, Estonia, Malta, Slovakia, Latvia, Lithuania, Cyprus	Bulgaria and Romania (possibly Croatia)	Turkey, Albania, Republic of Yugoslavia, Bosnia
Inhabitants (millions)	75.3	30.7 (with Croatia, 35.3)	79.9
Inhabitants as Percent of Current Population of EU-15	20.1	8.2 (with Croatia, 9.4)	21.4

Sources: Eurostat, authors' estimations

4. Negotiation and Fulfillment of Entry Criteria

Since March of 1998, the EU has negotiated with the Luxembourg Group, whose member states include Poland, Hungary, the Czech Republic, Slovenia, Estonia and Cyprus. Since February of 2000, the EU started negotiating with the Helsinki Group, whose members include Slovakia, Latvia, Lithuania, Bulgaria and Romania. From a technical point of view, EU negotiations with the Luxembourg and Helsinki groups are subdivided into twenty-nine negotiation chapters that represent major areas of the *Acquis Communautaire*, the common set of rules and regulations adopted by all EU member countries. With most of the countries of the Luxembourg Group, most of these chapters already were closed provisionally at the time of this writing. Within the Helsinki Group and with countries such as Slovakia, Lithuania, Latvia, Bulgaria and Romania, a similar number of chapters were also closed. However, presenting a detailed account of the negotiations is difficult indeed, since they remain in a state of flux, changing almost unpredictably over time.

From the standpoint of technical negotiations, Poland is judged to lag behind as a member of the Luxembourg Group for two important reasons. First, Poland has proved reticent in accepting transition arrangements that would limit the free movement of Polish labor to Western Europe. Second, Poland has proposed an extended transition period for capital flows, especially those that would involve the purchase of its agricultural lands. Poland's balking on issues of outward labor movement and inward capital flows portends that it will fall further behind in its accession negotiations relative to other members of its group over the course of the year ending in July 2002.

It remains likely that the Polish government formed after the September 2001 elections will demonstrate greater flexibility in dealing with these two issues. Nevertheless, these topics remain sensitive, and Poland's failure to comply could lead to a situation whereby the EU member states resolve to vote in favor of a smaller CEEC enlargement that only includes Hungary, Slovenia and probably Estonia and the Czech Republic. For Germany, this would hardly be acceptable, given its historical and current interests in having Poland as an EU member and its desire for open access to purchase Polish agricultural lands.

To promote a speedy negotiation process, the European Commission has asked prospective member states to present the substance of their negotiating positions in areas such as labor-market policies (already achieved), and agriculture and structural funds (still under negotiation). Germany and Austria succeeded in convincing other EU member states that it was in Western Europe's interest to implement a five- to seven-year transition period that restricts the free movement of CEEC labor into the EU. Germany's small political victory was not achieved without frictions. Spain played its "structural-funds card," meaning that Spain would only back Germany's and Austria's labor-market proposal if Spain continued to receive the same level of structural funds as it had in recent years. However, Spain's negotiators were isolated, and Spain's prime minister, Jose Mari Aznar, eventually backed down from this hard line and accepted the German and Austrian proposal.

Nevertheless, the power play is still going on and is expected to last as long as the final rounds of bargaining over the terms of EU entry continue. In the first six months of 2002, when Spain takes its turn with the EU presidency, a decisive round of accession negotiations likely will take place, during which such issues as agricultural-policy and structural-fund reform will be addressed. However, serious negotiations cannot begin until the EU member states work out their positions. This is likely to prove difficult, since the financial implications of reforms could fire up passions that will come out as heated debates and posturing by political leaders in France and Germany, who face election campaigns in 2002. In addition, Cyprus has the potential to provide real strains to the coming negotiations, as this island remains divided into Turkish and Greek zones. (Greece, but not Turkey, is an EU member, and both Greece and Turkey are NATO members.) In sum, expansion eastward will certainly alter the existing balance of power. New political constellations will emerge as EU member states jockey for position within an enlarged European Union.

It remains important to bear in mind that the timing of Eastern enlargement depends not only on the outcome of technical negotiation procedures but also on how quickly and thoroughly the CEECs fulfill the Copenhagen Criteria.[7] Although these criteria are formulated and measured in a manner that is not especially scientific or even systematic, their fulfillment nevertheless represents an important yardstick, and literally serves as the measure for progress toward the CEECs' achieving accession and full-fledged EU membership. The political criterion that all likely accession countries be voters' democracies that also respect minority rights has, to a large extent, already been fulfilled. Nevertheless, there remain deficiencies in political and institutional spheres that also might affect the CEECs' abilities to fulfill economic criteria and achieve expected levels of economic performance (Quaisser, 2002).

Corruption, for example, still remains widespread in some of the CEECs seeking accession. Reforms to legal systems are but slowly succeeding, and inefficient administrative structures are reported to undermine entrepreneurship as well as the implementation of major EU policies and laws. Nevertheless, we believe that raising legal and administrative standards to the EU level is an absolute precondition for accession. Both the EU Commission and individual member states are well aware of the problems that tend to arise if and when entry criteria are not met and practical considerations prove increasingly important, as was the case with Greece's entry in the 1980s. Still, we think that the legal obstacles will be dealt with and, for the most part, overcome in the next three or four years.

The CEECs' fulfillment of the EU's economic criteria for accession appears to be harder to achieve than political and legal criteria. Economic criteria have to be based on available data or estimated data, but even the validity and accuracy of data remain open to interpretation. In addition, institutional changes are hardly measurable in quantitative terms. In its yearly evaluation of progress made in 2001, the European Commission concluded that most of the accession countries (with the exceptions of Romania and Bulgaria) more or less already had achieved the status of functioning market economies. Most of the advanced accession countries already have freed prices and realized a high degree of foreign-trade liberalization. Nevertheless, internally there are some kinds of prices that are still administrated or regulated, such as energy and rent prices, which need to be deregulated further. Market entry and exit are, from a legal standpoint, already secured, but in the real world several obstacles remain. This is especially true for market exit, where we observe an avoidance of the practical implementation of bankruptcy laws.

[7] This chapter is partly based on Quaisser, 2002.

Macroeconomic policy is more or less solid in most of the CEECs, although internal and external capital imbalances still pose permanent threats to economic stability. The Maastricht Criteria, which do not actually specify criteria for EU accession but which do pose benchmarks for joining the European Monetary Union (EMU), have yet to be achieved with respect to inflation and interest rates. However, levels of public debt, especially budget deficits held both internally and externally by advanced accession countries, already fall in the range of acceptability defined by the EMU (see also Section IV, chapter 5), though the recent budget crisis in Poland demonstrates that the fiscal system in the CEECs is far from being in line with EU standards.

The European Commission also considers public consensus over economic policy to be an important criterion for accession. The advanced accession countries have achieved broad public support for market reforms, although some resistance led by persistent opposition groups, whose members are thought to be adversely affected by market-oriented reforms, still exists. However, what appears most important is that the political elites of both left- and right-wing parties have managed to endorse major and substantive market-oriented reforms in the interests of achieving EU accession. Another important element for achieving a functioning market economy has to do with the structure of financial markets. Though the CEECs' financial markets have progressed to a respectable level of functioning, substantial progress still needs to be made. Of all the CEEC countries, Hungary is the most advanced in transforming its financial sector, mostly because large parts of it are now owned by foreign firms.

Much more difficult to achieve is the second set of economic criteria, which ensures that the accession countries will be able to cope with competitive pressures associated with a single European market. In economics the term "competitiveness" stands as a fairly vague term that is poorly defined: it could relate to enterprises, industrial branches or even to an entire national economy. Some economists, such as Paul Krugman in his *Foreign Affairs*' article "Competitiveness: A Dangerous Obsession" (1994), go so far as to reject "competitiveness" as a valuable or even a useful economic term.

The EU, however, stresses the importance of CEEC competitiveness. Its rationale is rooted in the fear that the CEECs' economies might run into deep problems when the countries enter into and then have to face surviving in a single European market. If and when industrial branches in the CEECs face decline, the rising specter of unemployment might further exacerbate a broad range of political tensions. As East Asian and more recently Turkish and Argentinian experience shows, serious financial crises based on a misallocation of capital do indeed occur and could also occur in the CEECs. These could be instigated by macroeconomic mismanagement and/or by microeconomic distortions that result from the competitive pressures of confronting the single market. In addition, accession countries also could face crises affecting their banking sectors, as did the Czech Republic in 1997, and Hungary in 1994 and 1995. In both countries these crises led to substantial devaluations in their respective currencies and caused a serious economic downturn.

Nevertheless, one might argue that a more intense industrial competition would lead in the long run to a more solid and competitive structure, with higher levels of GDP growth for the CEECs. Leaders and the public at large in the existing EU states as well as in the aspiring CEECs have hope that this optimistic scenario indeed may come to pass.

TABLE 4

Ranking According to Various Economic Criteria

(Market Economy and Competitiveness)
The ranking is based on the EBRD Index, our own evaluations as well as the IMD Index

	EBRD 2001[1]	IMD Index 2000[2]	IMD Index 2001[2]
Poland	3.5	38	47
Czech Republic	3.4	40	35
Hungary	3.7	26	27
Slovenia	3.4	36	39
Estonia	3.6		22
Slovakia	3.3	-	37
Latvia	3.2	-	-
Lithuania	3.3	-	-
Bulgaria	3.1	-	-
Romania	3.1		
Portugal	-	29	34
Spain	-	23	23
Greece	-	34	30

[1] The EBRD Index ranges from 1 (worst) to 4 (best) and is based on the annual evaluation of the European Bank for Reconstruction and Development. The presented index is calculated as the arithmetic average of eleven single EBRD indicators. [2] The IMD Index is based on the annual evaluation of the International Institute for Management Development in Geneva. This index represents the ranking position of forty-nine industrialized and emerging economies according to their ability to provide an environment in which enterprises can compete. Number 1 is the best position and number 49 the worst. The index is based on 286 different criteria.
Sources: EBRD, Transition Report (various editions); IMD (2001)

Important for the EU's evaluation of the CEECs' competitiveness criteria is whether accession countries have reached a sufficient endowment of human and physical capital to provide them with a good start when they finally become bona fide EU members. With regard to competitiveness criteria, such Luxembourg Group members as the Czech Republic, Hungary and Slovenia stand in good stead, since each country possesses a developed infrastructure, modern industrial machinery and well-qualified labor. Poland appears to be lagging a bit behind with respect to these criteria. Bulgaria and Romania, two members of the Helsinki Group, seem to possess real deficiencies for fulfilling competitiveness criteria, especially in the field of physical infrastructure. That is the reason why we suggest that these countries should enter at a later date.

Another criterion that needs to be considered and fulfilled specifies that the state sector must retreat from its historical role in a communist system as an active and direct participant in the economy. In addition, the EU's competitiveness criteria require that the reformed CEECs create a well-structured legal system with incentives to support a robust economic performance in the private sector. Laws affecting industrial organization and degrees of competition in an accession economy already have been introduced formally. However, a danger exists that the strict implementation of EU competitiveness policy might cause problems for specific industrial branches in some of the accession countries. Although this should not serve as an argument for delaying EU accession, sooner or later CEEC enterprises will have to adjust to the competitive pressures of a single market. The results will be that competitive pressures will promote structural changes that should serve as the source of welfare gains. We develop this idea further in the section below.

Privatization mostly has been achieved in such countries as Hungary and Slovenia, and to a large extent in Poland, Estonia and the Czech and Slovak republics. But a more detailed view shows several deficiencies. As late as 2001, forty-five of Poland's largest enterprises were still state owned. All CEECs still face the challenge of improving corporate governance and the restructuring of enterprises. Small and medium-sized enterprises seem to be emerging as the motors driving forward economic growth and structural change in the CEECs. However, the benefits they may bring are limited, since the economic futures of smaller firms are not considered to be especially favorable in a world in which capital has a historical tendency to be consolidated and centralized into ever-larger units. An additional problem related to such small and medium-sized firms is the fact that they face real limitations in their access to investment funds. Small players tend also to be excluded from benefiting from the enforcement of a host of legal decrees, because they cannot muster the funds to pay for legal representation or to buy political clout. In general, smaller firms suffer from a lack of political representation, as their disposable funds for lobbying are limited.

In sum, according to our own estimates, Hungary and probably Slovenia have a good chance of fulfilling economic criteria—including what the EU determines as "competitiveness"— by 2002. Poland and the Czech Republic, on the other hand, are likely to fail at achieving the level of competitiveness required for a 2002 accession, although we expect them to achieve it by 2004 or 2005. These two countries face different problems. Poland, for example, has to deal with burdensome legacies from its past as a planned economy, especially its oversized coal and metallurgical sectors. In addition, Poland's agricultural sector has long been based on small holdings that could hardly emerge as viable in the EU. The Czech Republic, for its part, appears unable to solve shortcomings with corporate governance, especially in its banking sector—a sector that is additionally burdened and overshadowed by a mountain of nonperforming loans.

Each of the accession countries being considered has to make substantial progress in the fields mentioned above in order to be prepared for EU accession. However, one should neither require nor expect that the prospective countries solve all their accession-related shortcomings, such as structural and economic problems, prior to accession. This, after all, never was realized practically by some of the most advanced EU countries, such as France, Germany and Italy, even though these countries' economies are noted for achieving comparatively high levels of per capita output. Though there are no efforts on the part of EU officials to advertise it, if and when accession is deemed to be the desirable and appropriate step necessary for Europe's unity, achieving this policy goal could well take precedence over apparent shortcomings in fulfillment of entry criteria. We may all be surprised by the speed and effectiveness of those policymakers facilitating accession, and by their seemingly cavalier approach toward waiving what have been held up as sacred criteria.

III. Economics of Enlargement

1. Review of Growth and Welfare Effects

We find that the rich legacy of economic theory provides a deep-seated logic that supports Eastern enlargement as part of a greater European integration. Thus our analysis goes beyond that of Kampeter (2000), who focuses only on the political rationale for European integration. It also goes beyond the economic analysis—based on traditional trade theory—of Dicke and Foders (2001), who predict no major positive economic impacts of Eastern enlargement but only fiscal costs. Their arguments are based on the assumption that trade and factor markets (labor and capital) with the candidate countries are already liberalized to a large extent. Using regression calculations, they also find no empirical evidence of positive economic effects of past EU enlargements.

However, their analysis does not consider important additional integration effects based on modern integration theory. To support our perspective, we build on a range of contributions to economic analysis that emphasize the benefits associated with economic integration. Studies by Keuschnigg and Kohler (1999a and 1999b); Baldwin, Francois and Portes (1997); Breuss and Schebeck (1996); Brown, Deardorf, Djankov and Stern (1997); and more recently by the European Commission's DG ECFIN (2001) and by Breuss (2001) suggest that the economic benefits of enlargement will outweigh its costs.

Integration theory teaches us that welfare gains and higher rates of economic growth stem from better resource allocation (known as static efficiency) when tariff and non-tariff barriers to trade (NTBs) are removed. Each of the integrating regions is expected to gain if trade creation outweighs trade-diversion effects. Higher dynamic efficiency is driven by rising levels of investment and improved capital efficiency. The more sophisticated general equilibrium models of Keuschnigg and Kohler (1999a and 1999b) also include effects (such as intensified competition) that modern trade and integration theories associate with a united economic area. For example, larger markets lead to increased product differentiation, as they contribute toward expanding output through increasing returns to scale. Formation of a single, integrated EU market diminishes price segmentation, and not only for the purchase and sale of goods and services but also for capital funds and labor.

However, the distribution of growth effects and welfare gains is indeed asymmetrical. Since the CEECs' economies are small relative to those of current EU members (when taken together, they scarcely produce more than four percent of the EU's GDP), existing EU members can expect only modest growth effects resulting from integration. What is more, the lion's share of these growth effects already have been realized and absorbed through a liberalization of trade that began in 1992. Thus, after the start of accession, the average one-time jump in the EU-15's current levels of GDP is unlikely to be higher than 0.2 percent, understood as a change in the steady state of their economies. A recent

EU study (DG ECFIN, 2001) was more optimistic, estimating steady-state effects to reach 0.5 to 0.8 percent of the EU's annual GDP. We think, however, that selected CEECs can expect one-time jumps ranging between five and seven percent of their current output levels (Brown et al., 1997; Quaisser, 2000).

Gravity models depicting EU trade with the CEECs indicate that welfare gains derivable from trade flows already have reached expected postaccession levels, given such parameters as distance and per capita incomes of the CEECs in relation to the existing EU members (Brenton and Gros, 1997; Brenton and Di Mauro, 1998). Gravity models based upon estimated purchasing-power exchange rates forecast higher potential rates for GDP growth as a result of trade expansion (Schumacher, 2001). We also expect additional welfare gains associated with the removal of nontariff barriers to trade (NTBs) upon accession. As border-maintenance costs are reduced vastly, we estimate reductions in real-trade costs between five and fifteen percent of the value of trade flows. We also expect additional welfare gains from the decline of risk premiums for Foreign Direct Investment (FDI) as prospects for economic and political stability in the region improve.

At present, however, theory is anticipating practical experience. Thus our work heeds the advice of Breuss (1999), who is critical of the ubiquitous models based on partial and regression analysis. He argues that such models cannot address adequately the important integration effects that are likely to emerge with Eastern enlargement. In addition, general equilibrium models, such as those used by Keuschnigg and Kohler (1999a and 1999b), only can investigate effects for single countries. General-equilibrium models also are sensitive to such variables as the role played by price elasticity of demand in foreign trade, though these types of models neglect short-term adjustment costs, especially in the labor market (see listing of models and their calculations in Table 5).

The Polish economist W. Orłowski (2001) tries to combine a general-equilibrium model of the European economy with a model of endogenous growth ("Millenium"). Compared to other models, Millenium strongly emphasizes the dynamic effects of enlargement, i.e., the higher propensity for investments. Orłowski calculates net enlargement effects for the EU-15's GDP that far exceed those of other models. He predicts that the GDP steady-state effect between 1998 and 2014 will be about one percent—double that of a nonenlargement scenario. For Germany alone, he estimates a net effect of 2.3 percent of its GDP over the above time period. According to Orłowski, smaller border states to the East like Austria, Finland and Sweden would benefit even more than Germany (4.5 percent of their GDP), while all other EU-15 member states would increase their net effect by 0.5 percent. In the Millenium model the CEEC countries would be the distinct winners, with an increase of fourteen to thirty-five percent of their GDP.

We suspect, however, that Orłowski's model overstates the enlargement effects. Dynamic effects are still poorly understood, especially in transformation countries. The recent study by Breuss (2001) seems to provide a more realistic estimate. He undertakes a fresh evaluation with his world macroeconomic model, taking into account the full range of possible integration effects from such variables as trade, a single market, the movement of FDI capital and labor migration. To estimate the overall welfare effects, Breuss uses information on costs derived from Agenda 2000, which he adjusts to his

TABLE 5

Welfare Effects of Eastern Enlargement on the EU
(Measured as Percent Changes in the GDP Steady State)

Author (s)	Considerations, Progress Toward Integration, Time Frame	Effects[1]	As % of GDP/GNP[2]
Brown, Deardodorff, Djankov, Stern, 1997	Eastern enlargement, welfare effects	Stat	0.1% to 0.2%
Baldwin, Francois, Portes, 1997	Eastern enlargement, welfare effects measured as real-income effects	Stat/Dyn/Inv/Integra	0.2%
Breuss, 1999	Effects of Eastern enlargement for individual EU countries, growth effects from 1999 to 2007	Stat/Dyn	For each country: 0.1% to 0.4%
Keuschnigg, Kohler, 1999	Effects of Eastern Enlargement with five CEECs on Austria's economy. Growth and Welfare Effects (Net Effects considering Costs)	Stat/Dyn Integra/ Migr	Growth.: 1.05% Wealth: 0.51%-1.88%
Keuschnigg, Kohler, 1999	Effects of Eastern enlargement with ten CEECs on Austria's economy, growth and wealth effects (net effects considering costs)	Stat/Dyn Integra/ Migr	Growth.: 1.25% Wealth: 0.58%-1.88%
Keuschnigg, Kohler, 1999	Effects of Eastern enlargement for Germany's economy, growth and welfare effects (net effects considering costs)	Stat/Dyn/ Integra	Growth: 0.5% Wealth: 0.37%
European Commission, 2001	Effects for EU-15 when eight CEECs enter in 2005	Stat/Dyn/ Integra/Migr	0.5% to 0.7%
Breuss, 2001	Effects for EU-15 when the Luxembourg Group enters in 2005 and the Helsinki Group enters in 2007 (net effects considering costs)	Stat/Dyn/ Integra	0.26
Orłowski, 2001	Effects for EU-15 when all CEECs (including Malta and Cyprus but without Bulgaria and Romania, the latter follow some years later; net effects considering costs)	Stat/Dyn/ Integra	1.0

[1] Stat = static increases in efficiency (i.e., reduction of trade costs, as effects of economies of scale); Dyn = dynamic welfare effects (growth stimulated by higher rates of accumulation of physical and human capital); Integra = full-integration effects of the EU's single market (ending price segmentation; introducing monopolistic competition; effects from free flow of goods, capital, labor and services); Inv = effects of FDI considered as reductions of risk premiums associated with investing in CEECs; Migr = effects of migration with respect to a seven-year transition period. [2] If not otherwise mentioned, refers to growth effects. Growth = growth effects; Wealth = welfare effects. The difference between growth and welfare effects is that the latter consider necessary investments for future growth that reduce consumption.

Sources: from relevant literature sources listed in *References* own enlargement scenario. As we show in the following section of this paper, cost calculations tend to underestimate the amount of funds needed to carry out Agenda 2000. Breuss, who also shares this perspective, estimates that, on average and with respect to their real GDPs, the CEECs will gain nearly ten times more from enlargement than the old EU-15 members. Poland and Hungary are expected to increase their real GDP output by nearly eight to nine percent over a decade's time, and the Czech Republic by five to six percent over the same period.

On average, the current EU-15 members would benefit from a one-time gain of about 0.5 percent of their GDP over a six-year period following CEEC accession (2005-2010), but this gain will be distributed unevenly among the countries. Most important to consider is the future character of political bargaining. Tensions related to the controversial question of how such gains will be distributed among the EU-15 have already emerged, and we expect them to grow even sharper as the estimated gains appear increasingly real.

Breuss (2001; see also Table 6) speculates that Austria, Germany and Italy will be among the greatest beneficiaries of CEEC accession, accruing between 0.5 and 0.7 percent as a one-time jump in the steady state of their economies. In the case of Italy, the strong positive impacts also are confirmed in a study by Grassini (2001). Spain, Portugal and Denmark are expected to suffer small welfare losses, mainly because these countries are unlikely to benefit as much from the hoped-for integration effects and probably will experience declines in the levels of funds currently received (Breuss, 2001). In addition, a study on Denmark—based on a macroeconomic model—shows that the overall effects for the economy will likely be slightly negative in the short run, but slightly positive in the long run (Kristensen, Jensen, 2001). In Breuss's view (2001), Eastern enlargement could take the form of some kind of "exogenous shock," leading to asymmetric impacts on different EU countries' business cycles. Enlargement also exhibits the potential to impair the desired effects of monetary policy in the euro zone. Nevertheless, Breuss considers Eastern enlargement to be largely a "win-win" situation for both the current EU-15 and the potential accession countries.

A recent EU Commission study (DG ECFIN, 2001) arrived at similar results. Their study is also based on a macroeconomic model (a slightly modified standard neoclassical growth or Solow model), taking into account what they judge to be important integration effects, as well as what we see as hopeful cost calculations. All CEECs together would expect increases to their GDPs of between one and three percent, depending on the time span considered and whether a more optimistic scenario is considered. These effects are derived mainly from a more effective use of resources caused by structural changes and the introduction of competition. In addition, higher levels of EU transfer payments and growing flows of FDI would increase the investment ratios.

The DG ECFIN Study (2001) purports that the effect of enlargement on the EU-15 will be a cumulative increase in GDP of between 0.5 and 0.7 percent over one decade, starting in 2000 and ending in 2009. Distribution effects among EU member states are expected to be similar to those estimated by Breuss. What is striking in the DG ECFIN Study is that absolute GDP growth effects from migration seem to be larger than from trade. However, it is noted that labor-market rigidities in Europe could prevent a full absorption of migrants, thereby leading to a lower level of welfare effects. The study anticipates beneficial effects on market competition from enlargement, although it confesses that these are difficult to quantify *ex ante*. This also holds for TFP (total factor productivity) increases, which were evaluated with a wide margin of error (DG ECFIN, 2001, p. 35).

TABLE 6

Likely Winners and Losers of Eastern Enlargement
(Long-Term Steady-State Effects in Various Model Simulations)

Winners EU-15	Net Effects Including Costs	Selected Problems to Be Considered
Germany, Austria, Italy, Benelux, (Sweden), Finland, (Ireland)*	Between 0.2 and 0.6 percent of their GDP Orłowski: between 2.5 and 4.5 percent of their GDP	Long-term costs to be covered by net payers probably are underestimated; positive effects from migration might not materialize since labor markets are restricted and inflexible; positive effects of the general catching-up process are not considered. To the contrary, Orłowski overestimates the dynamic effects.
Neutral EU-15		
Great Britain, Denmark, Sweden	Between –0.2 and plus 0.2 percent of their GDP in Breuss (2001); around zero in Kohler (2000)	Short-term effects might be neutral or slightly negative, but long-term effects might be positive (see additional positive effects below)
Losers EU-15		
Portugal, Spain, Greece (Ireland)*	Between –0.2 and –0.8 percent of their GDP Orłowski: 0.5 percent of their GDP	These countries might lose mainly because of reduced transfers from the EU budget; however, reduced transfers are also the result of economic convergence. Positive integration effects might be underestimated, since these countries benefit from indirect effects of other EU-15 countries, through their demand on respective partner-country products.
CEEC		
All CEECs will win	Between 5 and 8 percent of their GDP Orłowski: between 14 and 35 percent of their GDP	As CEECs will have to pay immediately into EU's budget, they might have problems absorbing EU funds; in addition, structural change might cause short-term adjustment costs that reduce economic growth

* With countries in parentheses, results differ between various model calculations. Breuss (2001) covers the effects of the period 2001-2010 and Orłowski 1998-2014, whereas Kohler (2000) represents long-term steady-state effects without time specification.

Sources: Breuss (2001), Kohler (2000), Orłowski (2001)

There are problems related to these model calculations that have to be considered. The EU Commission study (DG ECFIN, 2001) does not mention any negative effects on the economies of EU-15 countries deriving from the enlargement costs. In addition, as already mentioned, other studies are based on rather optimistic cost calculations. Baldwin (1997) and Kohler (2000) use enlargement costs of between 0.11 and 0.21 percent of the EU's GDP. Recent calculations by Breuss (2001) estimate costs in 2010 of 0.3 percent of the EU's GDP. Our calculations (see chapter 2.2.) suggest that if political bargaining does not change, enlargement costs already might rise to 0.35 percent in 2008. Under this assumption, net welfare gains even for "EU-15 winners" (but high net payers) like Germany, Austria and the Netherlands might diminish substantially. However, if the economic catch-up process accelerates compared to existing estimates, their gains would be higher.

Enlargement costs for EU-15 "losing" countries like Portugal, Greece and Spain might be overestimated. When we project further economic convergence with the EU average, these countries would lose transfer payments from the EU structural funds budget even without enlargement. At the same time, positive integration effects for these countries might be underestimated in many of the models, since these countries benefit from indirect effects from other EU-15 countries through their demand on respective partner-country products. However, the situation in the CEECs after accession might be complicated by the fact that they will have to pay immediately into the EU's budget but might have problems absorbing EU funds. Intense structural change also could cause short-term adjustment costs that temporarily reduce economic growth in the CEECs.

Such considerations demonstrate that unifying Europe is an involved undertaking, whose expected outcomes are not reduced easily and readily to quantifiable variables. Economists and their models deal best with such measurable factors as GDP, its growth rates, welfare effects stemming from trade and the like. But many important variables and forces that are not readily quantifiable tend to be overlooked. We find that there are practically no real substitutes for probing analyses seeking to explore important forces and dynamics not adequately presented in mathematical models.

What would we estimate to be the costs associated with failing to proceed with Eastern enlargement? Such costs are indeed difficult to measure and might even be larger than expected. For example, as a consequence of political instability, negative economic shocks might occur. Foreign investors' risk-aversion strategies might cause major capital outflows, resulting in a higher inflation and a downward pressure on a national currency's exchange rate. This could be accompanied by economic policy failures—much more likely to occur without a stability anchor like the European Union—which would result in a deep recession. The most recent crisis in Argentina should serve as a warning. Not much imagination is needed to predict the negative consequences for the existing EU member states. Political stability and the policy orientations of the accession countries toward the EU likely will engender important economic outcomes that are difficult to measure when limited to the standard statistical information one can find in national accounts.

What has been referred to as the "policy anchor" argument needs to be considered. It is based on the observation that the EU has played an important stabilizing role for the CEECs caught in the seas of transition. It has served in this role since the start of the CEEC transition, and we expect that it will continue to do so not only until accession takes place but also later, as the CEECs model themselves into prosperous EU members. Thus we can expect the CEECs to continue along a reform path that takes them well beyond the minimum necessary for qualifying as a market economy. This thorough liberalization will include the carrying through of an effective privatization program that limits state ownership to the production of a portion of public goods. We anticipate the formulation and implementation of a sophisticated macroeconomic policy that dovetails neatly with the monetary policies stemming from the CEECs' membership in the EMU.

2. Costs and Benefits of Eastern Enlargement

Although the road to Eastern enlargement is paved with good intentions, there are high levels of anxiety among the public in both Eastern and Western Europe. The public's level of sophistication tends to be underappreciated by Europe's leaders. If they cannot win over hearts, minds and pocketbooks, leaders pressing for Eastern enlargement even have resorted to such tactics as soliciting the assistance of public-relations firms to conduct advertising campaigns to keep public pressures at bay. We suggest that the level of public skepticism should be understood as a well-founded uncertainty regarding people's personal finances as well as their collective future as Europeans.

Citizens in the East are concerned that economic transformation and EU accession might change their way of life and special traditions radically—and likely for the worse. They fear that EU accession portends being thrust too quickly into a competitive market economy, where time becomes money and anything and everything is transformed into a commodity that can be bought and sold. Additionally, people in the East have a lingering fear that, if and when they finally are invited to join the Union, they will end up as second-class members.

Some of the CEECs seem to be enjoying the window of freedom they currently are experiencing between the breakdown of communism and their incorporation into the EU. The long span of history provides numerous examples of how the people of Central and Eastern Europe have been batted back and forth between major powers in the East such as Russia, and France, Germany and Austria in the West. Does EU accession mean that it is now time for Central and Eastern Europeans to be dominated yet again by the West?

This issue could be illustrated by considering the case of Slovenia and the Baltic states. Over the course of hundreds of years, Slovenia has experienced but one decade, the most recent ten years, as a sovereign, independent country: the first taste of freedom and independence since being dominated by the Habsburgs, the Ottoman Turks and the Yugoslavian Serbs, with a relatively brief but exceedingly tragic round dealt out by the Austrian, Italian and German fascists. The Baltic countries of Estonia, Latvia and

Lithuania, which were incorporated into the Soviet Union as a result of the Hitler-Stalin Pact in 1940, regained independence in 1990. Though EU accession portends to offer numerous benefits, the Slovenians and the Baltic peoples understandably wish to savor this brief, recent interlude of real independence.

Citizens of the EU's current fifteen member states, on the other hand, are afraid that incidents of crime—especially unsavory violent crime—will increase. They expect that enlargement will have negative effects on their labor markets, causing higher levels of unemployment. They anticipate a downward pressure on wages provoked and exacerbated by a freed flow of goods, capital and labor. Doubts have been raised as to whether the accession countries as well as the existing EU members really are ready for an Eastern enlargement, and concern has been expressed that adjustment problems will provoke additional costs. Many West Europeans believe that it is all happening too fast.

Although many of these voiced and perceived fears are unfounded or exaggerated, political and civic leaders in both Eastern and Western Europe are faced with trying to assuage the public's fears. Otherwise, proceeding with Eastern enlargement may be threatened by plebiscites with challenging outcomes.

Behind the uncertainty displayed at the Nice Summit in December of 2000 lies a deeper level of uneasiness. The existing fifteen EU member states worry that Eastern enlargement will place their hard-earned prosperity on the line, since they will be faced with making deep financial concessions. They fear that they will have to forego domestic investments because they will be duty-bound to deliver higher levels of transfers to the CEECs gaining accession. Ireland, Portugal, Spain and Greece, who are currently net receivers of cohesion and structural funds as well as agricultural subsidies, are concerned that their existing levels of transfers will be reallocated toward the CEECs upon their accession. As net payers, Germany, Austria, the Netherlands and Sweden are afraid that they will be expected to carry an even heavier financial burden. How realistic are such fears? In the section below, we attempt to answer this question.

2.1. Effects of Trade, FDI and Migration on the Labor Market

Exports from the CEECs to the EU will be too small to have significant effects on prices in commodity markets in Western Europe. According to Boeri and Bruecker (2000), opening borders will cause but marginal effects on wages and levels of aggregate employment in the West. For those employed in parts of the metal, textile and apparel industries, CEEC import penetration is expected to produce downward pressures on wages while also generating additional unemployment. However, because trade in these goods started to liberalize in 1992, a sizeable portion of the expected losses already have been absorbed (see Quaisser et al., 2000). In addition, we should keep in mind that those sectors are already under competitive pressures from a host of lower-wage countries in various parts of the world.

Aggregate employment for existing EU members as well as entering CEECs is slated to increase. We expect the CEECs to catch up steadily with respect to wage rates, per capita incomes and levels of productivity. Evidence suggests that distribution effects of trade will affect less-qualified labor negatively. However, the affected numbers are estimated to be miniscule relative to Europe's total workforce.

The CEECs' structures of production will transform as their economies catch up with the West. This should result in an increase in intraindustry trade, with positive growth effects for both Eastern and Western Europe. Although one could expect that redistribution effects of an expanding intraindustry trade will register as either marginal or neutral, differences in unit values between EU exports and CEEC imports in identical product categories indicate that vertical, intraindustry trade is prevailing. This form of trade reflects the different factor contents of trade flows, and consequently will have an impact on the distribution of income. However, we anticipate that such results will be offset by the overall growth effects of a more thorough integration, and that horizontal, intraindustry trade will increase over time.

In the presence of large differences in incomes from capital and wages, will capital movements—especially FDI flowing into the CEECs—raise interest rates in the EU? Along with Boeri and Bruecker (2000), we view this fear as unfounded. We deem the magnitude of capital transfers to the East too small to wield influence over the various prices of capital. Capital flows have been liberalized for some years. Large capital flows in the form of FDI are expected to increase as CEEC accession reduces risk premiums on capital invested in the region, but stepped-up flows are not likely to have measurable effects on the prices of capital in Western Europe. Interest rates, however, stand to fall in most of the CEECs, thereby helping to foster economic growth throughout this large region (Buch, 1998).

For a country in transition to qualify for EU accession, it must have completed privatizing its formerly state-owned industries and agricultural lands. A completed privatization program is deemed essential to lure in additional FDI. Flows of FDI show a clear preference for strategic and market-oriented investments. Although labor costs play a role in FDI's allocation, such costs do not appear to have determining effects. An evolving division of labor is expected to contribute to rising aggregate employment in Eastern as well as Western Europe (Quaisser et al., 2000).

Migration emerges as one of the most sensitive of topics. Both citizens and leaders of the EU-15 worry that poorer people from the CEECs will use accession to relocate legally to Western Europe, where they will alter countries' ethnic compositions while burdening already-stretched social-welfare funds. Since trade in goods and services, as well as capital flows, are unlikely in the short term to lead to an equalization of incomes between the EU-15 and the CEECs, gaps in wages between regions are expected to persist over a period of years. Consequently, monetary incentives that are known to promote labor migration—especially higher wage and non-wage compensation—will remain factors in the accession process.

Hence, over the short term, labor migration is expected to have greater effects on the EU labor market than trade and investment. Since Austria and Germany share contiguous borders with some of the CEECs and are relatively close to others, they can expect to absorb the lion's share of Eastern migrants. Estimates from Boeri and Bruecker

(2000) and Bauer and Zimmermann (1999) predict an annual net migration of close to 300,000 workers, with 200,000 of these heading for Germany. However, they believe that the number of annual migrants should halve within a decade. An estimation from the German economic research institute IFO predicts somewhat larger flows of migrants stretching over a longer period of time (Sinn and Werding, 2001).

There are, however, important reasons why fears concerning the scope and scale of migration appear unfounded. Over the next few years, Germany and some other EU member countries are expected to face a growing shortage of labor, especially skilled labor. The likelihood is that migration from the East will help to offset this labor shortage at least to a limited degree. In addition, EU proposals for a transition period to phase in the free movement of CEEC labor leave sufficient flexibility for each EU member to regulate the inflow according to its needs. These restrictions are slated to come to an end five to seven years after enlargement takes place.

Over time, we expect that economic growth, welfare gains and successful structural changes in the accession countries will increase CEEC living standards. Pressures promoting migration thus will subside. Border regions, however, will remain a problem. They may well experience the effects both of CEEC labor making daily cross-border commutes and also of an intensified competition in their service sectors. That is why a special EU program has been designed to deal with the impact of enlargement on border regions. However, the program is politically controversial and the funds supporting it are rather limited.

Redistribution effects associated with Eastern enlargement appear relatively small and comparatively manageable for the EU-15. The CEECs, on the other hand, entered into a difficult phase of structural changes in the 1990s as they undertook transitions from planned to market economies. Upon EU accession, such rates of structural change should accelerate in several geographic areas. However, we need to bear in mind that these structural changes are the sources for the expected welfare gains. Social and economic frictions could be mitigated to some extent by labor-market and social policies.

Increased FDI flows and improved capital efficiency will cause the CEECs' economies to move rapidly in the direction of forming structures of production similar to advanced economies'. Magnified structural changes surely will disrupt familiar patterns of employment. As firms and even some industries in the CEECs are closed while others are expanded, the EU will be faced with assisting the CEECs with funds and professional advice. We would recommend that a substantial source of funds be made available to the CEECs to facilitate structural changes and the construction of infrastructure to promote economic growth.

2.2. Financial Implications

In the 1990s a host of studies estimated the costs of Eastern enlargement. Early studies by Baldwin (1994), Anderson and Tyers (1993) and Courchene et al. (1993) suggest that the estimated costs of CEEC accession would be prohibitive. Estimates were based mainly on regression models of expenditures and structural data of existing EU member states, as well as on voting-power models. Regressions relied on data to project receipts and contributions from the CEECs to the EU budget. The comparatively low population of countries making net payments to the EU budget portended that enlargement would create an even larger financial burden. Baldwin (1994) estimated the total cost for integrating ten CEECs at around 26.7 billion ECUs. To compare this figure with the EU-15's expenditures and GNP (Gross National Product) for Fiscal Year 1995, Baldwin's estimation would approach around twenty-seven percent of the EU's annual budget, or approximately 0.45 percent of one year's GNP.

Despite differences in methodology, various researchers all have calculated the financial costs of the first accession round at between 0.1 to 0.2 percent of the current EU-15's GNP. Starting in 2006, and based on criteria adopted at 1999's Berlin Summit, about 0.113 percent of the EU's annual GNP would be needed over several years to finance Eastern enlargement for the countries in the first accession round. Those five CEECs would increase the EU from fifteen to twenty countries, and of these twenty the CEECs would account for about fourteen percent of the enlarged EU's population. Together, the new EU members would contribute approximately four percent of Brussels's revenues but would expect to receive about 16.8 percent of its expenditures. Although these figures indicate that the early entrants would benefit from transfers, the existing EU member states also would not suffer financially, especially when we calculate the estimated net welfare gains derived through integration.

Hence, at least for the years 2000-2006, the estimated costs of Eastern enlargement appear to be manageable. Owing to reforms in structural policy, Germany's net contribution to the EU budget would change only slightly: from 0.54 to 0.58 percent of annual GDP (Gross Domestic Product). Spain, Portugal, Greece and Ireland are currently net receivers of transfer payments, with net transfers ranging between one and four percent of their GDPs. After Eastern enlargement, these countries are expected to remain net receivers; however, their net levels of transfers are expected to fall to between 0.3 and 0.8 percent of their GDPs (Quaisser, 2000).

Nevertheless, it is important to take into account that Agenda 2000's cost calculations paint an especially optimistic picture because they did not include any direct-income support payments for CEEC farmers. In addition, the structural-funds payments for the new member states do not reach the maximum amounts that could be used under the existing financial scheme. What can we expect if enlargement costs rise faster than anticipated? Will net receivers of EU transfers accept deep cuts in the levels of funds they receive? Will net payers into Brussels's budget be willing to assume larger portions of burden sharing to finance the costs of Eastern enlargement?

The simplest answer to such questions is that the EU budget undoubtedly will become the focus of increased political wrangling between member countries (Mühlberger, 2001). With respect to improved financial positions, the CEECs will emerge as clear winners after enlargement. These accession countries can expect to gain from structural funds at an annual rate of up to four percent of their GDPs. Based on empirical evidence, EU leaders defined these numbers as the maximum amount countries effectively could absorb. These gains should have an important and positive impact on the new member states, especially when considering how difficult it is for them to reduce their budget deficits and thus to qualify for admission into the European Monetary Union (EMU).

Calculations by the European Commission exhibit some uncertainties. The exact dates of accession and the actual number of countries entering in the first and second rounds are not etched in stone. As we suggested above, it seems likely that the first round of entry will not take place till 2004 or 2005. It is worth recalling that the European Council has changed its plans for Eastern enlargement more than once. In recent years, a larger number of CEECs than originally planned has been invited to attend and participate in enlargement negotiations. Bringing in more than the proposed five countries would burden Brussels's budget. However, the weight of the financial burden associated with CEEC accession is expected to decline as enlargement is put off to ever-later dates. As mentioned above, we try in our own calculations to estimate the enlargement costs based on a realistic scenario. We think that Eastern enlargement, starting in 2004, likely will begin with the accession of Poland, Hungary, the Czech Republic, Slovenia, Estonia and Malta.[8] A second group, consisting of Latvia, Lithuania, Slovakia and Cyprus, is expected to enter in 2006. Bulgaria and Romania would follow in 2008.

Enlargement costs for agriculture are calculated on the basis of model simulations that take into account costs of rural development and market intervention, including direct payments to farmers (Frohberg, 2001). Adjusted to our enlargement scenario and expressed in constant 2001 prices, these costs will increase from three billion euros in 2004 to 10.4 billion in 2008.[9] We estimate that structural funds will reach an established ceiling of four percent of the CEECs' gross output (Agenda 2000 assumed only three percent). The full use of the four-percent ceiling is not unrealistic although it might cause short-term absorption problems.[10] Structural funds and direct payments will be phased in and should reach their maximum levels for the first and second rounds of enlargement in FY 2007. These payments are estimated to increase from 8.2 to 21.3 billion euros in 2008, if we include Bulgaria and Romania in the costs for that year. Other costs are calculated as we suggest they will be incurred. For Romania and Bulgaria, enlargement costs are introduced in FY 2008, but the full amount of estimated costs was already considered for FY 2001 in order to facilitate the necessary calculations (see Table 7 for projected costs over time).

[8] Cyprus might be included into that group if the political problems concerning the division of this island between Greek and Turkish zones are solved. Since Cyprus and Malta are comparatively small in size, population and GDP output, their presence or absence affects our calculations only marginally.

[9] We used the market-intervention cost estimates from the Economics Institute in Göttingen, which are about two billion euros higher than those estimated by researchers at the Institute for Economic Research in Halle.

[10] For example: In applying the strict formula of the Berlin summit, most of the new member states (except Slovenia and the Czech Republic) would receive solely for objective-one funding (cohesion funds not included) between four and six percent of their GDP.

TABLE 7

Estimated Costs of EU Enlargement[1]

(Constant Prices of 2001)

	Enlargement Scenario[2]	2004	2005	2006	2008
Total appropriations for commitments (in billions of euros)	Group entry	108.317	111.379	116.951	129.103
	Big Bang	95.680	109.990	115.030	128.492
	Agenda	(106.619)	(109.810)	(112.006)	-
Costs of enlargement (in billions of euros)	Group entry	12.637	16.339	22.400	34.071
	Big Bang	-	14.950	20.479	33.460
	Agenda	(12.076)	(14.770)	(17.455)	-
Preaccession aid[3](in billions of euros)		3.260	3.259	3.259	3.259
Financial margin of the EU, as percent of EU's GNP	Group entry	0.13	0.13	0.12	0.06
	Big Bang	0.23	0.15	0.10	0.07
	Agenda[3]	0.14	0.15	0.16	-
	Agenda[4]	0.17	0.19	0.20	-
	Commission[4]	0.18	0.17	0.19	-
Ceiling on resources, as percent of EU's GNP		1.27	1.27	1.27	1.27
Share of total agricultural expenditures, as percent of EU's GNP (2000 = 0.52%)	Group entry	0.50	0.50	0.50	0.51
Total expenditures for structural policy, as percent of EU's GNP (2000 = 0.41%)	Group entry	0.42	0.43	0.44	0.48
Expansion costs as percent of EU's GNP	Group entry	0.17	0.20	0.25	0.35
Enlargement costs as percent of total EU spending (appropriations for commitments)	Group entry	14.68	17.60	21.9	28.91

[1] If not described differently, all amounts refer to appropriations for commitments. Usually costs are calculated as appropriations for payments, as they represent the real flow of money. Normally these amounts are a bit lower because there is a time lag between when the commitments are made and when the money actually is paid. Because of lack of data, we were only able to calculate in appropriations for commitments. [2] "Group entry" assumes that Poland, Hungary, the Czech Republic, Slovenia, Estonia and Malta will enter the EU in 2004; Latvia, Lithuania, Slovakia and Cyprus in 2006; Romania and Bulgaria in 2008. "Big Bang" assumes that Poland, Hungary, the Czech Republic, Slovenia, Estonia, Latvia, Lithuania, Slovakia, Cyprus and Malta will enter the EU in 2005; Romania and Bulgaria in 2008. For all these scenarios we assume that the remaining preaccession aid will be used for Turkey and selected countries located on the Balkan peninsula. "Agenda" assumes that the Luxembourg Group will enter the EU in 2004 and the Helsinki Group some unspecified time later. The financial proposal of the European Commission from January 30, 2001 is in fact identical to the Agenda proposals for the Years 2004 to 2006. This assumes a EU entry of the Luxembourg and Helsinki groups (except Bulgaria and Romania) in 2004. [3] Appropriations for payments as percentage of GNP, including preaccession aid; [4] Appropriations for payments as percentage of GNP, without preaccession aid.

Sources: European Commission, authors' calculations

Our calculations suggest that the EU will spend about nine billion euros less from 2000 to 2006 than it itself has calculated, mainly because it is clear to us that enlargement will start later than the EU leaders earlier assumed. However, the money saved cannot be used automatically to cover costs in the coming years because the budget is based on the principle of annual accounting. We believe that a political decision should be made by the European Council to increase the available funding for accession countries. This is needed because the actual costs of enlargement are likely to go higher. If we compare estimates for enlargement costs in 2006, the year with the largest amount of payments during the time span 2000-2006, ours is five billion euros higher than Agenda 2000's (see Table 7).

The alternative, "Big Bang" scenario, which we discussed above (chapter II, 3), would not alter these calculations substantially. (This scenario would involve the accession of all countries in 2005, except for Bulgaria and Romania, which would enter in 2008.) Our calculations suggest that from 2000 to 2006 the EU would save about twenty-five billion euros more than it itself calculated in Agenda 2000. Hence, higher expenditures caused by the entry of more countries could be compensated by the later date of entry, combined with a delayed phasing-in period. If we again compare the costs in 2006, then the Big Bang estimation for enlargement costs is only three billion euros higher than Agenda 2000's (see Table 7). If we consider only enlargement costs, the Big Bang scenario is by far the most advantageous for the EU. In fact, our calculations are not too different from those presented by the European Commissioner for budget affairs, Mrs. Michaele Schreyer, in her speech to the London School of Economics in February 2001. She estimated that enlargement costs for ten CEEC countries in the year 2006 will fall between sixteen and twenty-five billion euros (Schreyer, 2001).

In January 30, 2002, the European Commission unveiled a new proposal to finance its envisaged accession in 2004 of ten new countries (all the CEEC candidates except Bulgaria and Romania, with the addition of Malta and Cyprus). The proposal is based on the levels of funding originally foreseen for the years 2004 to 2006 (see Table 6). By choosing this approach, the EU will have enough resources to finance (under the Berlin ceiling) the accession of ten instead of six new member states and at the same time to provide additional funds for critical issues like direct income payments for farmers, structural policies, nuclear safety, administration capacity and possible budgetary compensation payments for the new member states.

The Commission's new proposal is an attempt to find a financial solution both for the new enlargement scenario and for the increasing demands of the new member states, especially regarding direct payments for farmers. In addition, it attempts to dispel the old EU member states' doubts over the solidity of Eastern enlargement's financing. At first glance, the proposal seems promising, since the EU's financial projections for the years 2004 to 2006 are not threatened and the new spending priorities reflect the needs of the new member states. However, the proposal has some major obstacles that may lead to complicated bargaining. Why is the proposal so hard to accept for both sides?

On the one hand, it seems unlikely that CEEC candidates, especially Poland, will be willing to accept the Commission's position of a ten-year transition period for integrating their farmers into the direct-payment system. In fact, they already openly lament their "second-class membership." This topic remains very sensitive for the new Polish government. About forty percent of the Polish population lives in the countryside, and peasant political parties have a strong voice in the Polish parliament. It should not be forgotten that accession treaties must be accepted in referenda.

Secondly, existing EU net payers like Germany, the Netherlands and Sweden fear that the provisions for direct payments will predetermine expenditures in the financial period 2007-2013. The Commission emphasizes that the proposed transitional arrangement would not prevent any changes in the nature of the system. This statement might be reflecting the hope that changes within rural-income policy—to make transfers digressive over time—will be implemented in the coming years. If this is the case, East European farmers would never reach the estimated hundred-percent level of their projected total amount for direct payments. However, it is unclear if the EU will be able to change the system before the enlargement. If not, net payers fear, enlargement costs might explode, because new member states will not be interested in any substantial reforms that might reduce their transfers from Brussels.

Therefore, the real problems are liable to come up in the financial period starting in FY 2007 (Quaisser and Hall, 2001). Calculations starting in 2007 therefore have to consider a broad range of uncertainties. For example, it is difficult to predict the results of accession negotiations, especially in the field of compensation payments to accession-country farmers. It is also difficult to know with any degree of certainty what the EU's agricultural and structural policies will be after 2006. It seems likely that additional funds for structural changes in agriculture and rural development in the accession countries will be necessary. In the long run, if agricultural policy does not change, the new member states cannot be denied these payments (see chapter IV, 3). For the CEECs, a "second-class" member status is politically and economically unacceptable. Consequently, established levels of agricultural-compensation payments (or, in the future, income-support payments and structural funds) have to be distributed according to a common set of rules.

For the purpose of estimating the EU-15's financial obligations after 2007, we follow an "unchanged political bargaining" scenario. We assume average GNP growth rates of 2.5 percent for the EU-15 and four percent for the CEECs and estimate that the EU-15's spending programs will develop at the same pace as in the 2000-2006 period. In our calculation, EU-15 structural funds will decrease at an annual rate of 1.23 percent, while agricultural funds increase at a rate of 0.63 percent. We also assume that Bulgaria and Romania will enter in 2008 and will start to receive their structural funds at a ceiling of four percent of their GDPs. Our calculations thus render enlargement costs of about thirty-four billion euros for 2008 (see Table 7). That corresponds to 0.35 percent of the EU's GNP. If Croatia is included, costs would increase to about thirty-six billion euros in 2008 (0.37 percent of the EU's projected GNP). Our estimates imply that the net welfare gains the EU-15 can expect from Eastern enlargement, which, according to a host of econometric models, could reach 0.5 percent of the EU-15's GNP, are still likely to offset the costs of enlargement.

We define our calculation as a "unchanged political bargaining" scenario because we assume that old member countries are at least willing to make the same spending concessions for the 2007-2013 financial period as they did for 2000-2006. The most sensitive aspect is structural policy. We assume that existing member countries will accept a decrease in spending of 1.23 percent annually (as they did for the years 2000-2013). This assumption seems justified because overall spending in structural policy could not be calculated according to the "Berlin formula" for objective-one funding but remains essentially a political decision. The "Berlin formula" essentially defines the regional distribution of the overall funds, which are politically decided. With respect to agriculture, existing member states have not been willing to make any substantial concessions in policy reforms but at the same time have not agreed to return to the "agricultural guideline" (where agricultural spending increases by 0.74 percent with one-percent GDP growth).[11] During recent years, agricultural spending was well below this line, reflecting a lack of desire by both single member states and consumers for an increase in agricultural-spending rates—an attitude that is unlikely to change. Because no substantial reforms have been introduced, EU policies will have to be applied fully in the new member states. Our "unchanged political bargaining" scenario is based on slightly different assumptions concerning enlargement costs than the Commission used in its proposal of January 30, 2002.[12]

Concerning enlargement costs, several risks are involved. If structural-policy expenditures increase at the same pace as GDP growth and in accordance with the four-percent GDP ceiling (maximum absorption), this could lead to an explosion in costs. In any case, structural-policy expenditure is to be understood as the most dynamic cost factor over the medium and long term. In addition, an appreciation of CEEC currencies would further increase their GDP and hence lead to higher transfers. Because of these uncertainties concerning agricultural expenditures, CEECs might manage to increase their production potential to a higher rate than anticipated in our cost calculations, thereby requiring a higher level of expenditure for agriculture. This is most likely to occur if CEEC agricultural-production quotas are set at high levels, as has been demanded by CEEC countries in the enlargement negotiations.

It is instructive to confront our outline with two "status quo" scenarios. The first, which we call the "high cost scenario," assumes that spending for old EU member countries remains constant in real terms for structural policy and that agricultural expenses increase according to the agricultural guideline. An alternative scenario ("status quo EU-27, DIW")[13] assumes that all CEEC countries will enter in 2005 and that all EU policies will be applied strictly according to the EU rules (Weise et al., 2001). This has important implications, because after accession the EU average of per capita GDP will decline and a vast portion of EU regions will become ineligible for "objective one"

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[11] The "agricultural guideline," though formally in force, is however not applied to agricultural spending.

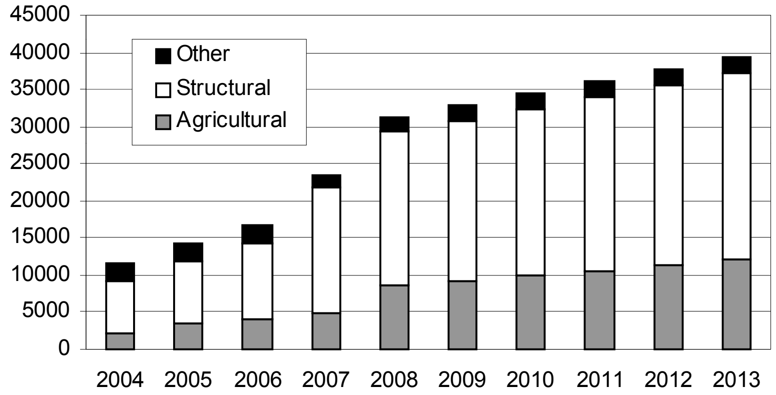
[12] The main difference is that in the EC scenario agricultural spending for the candidates is lower and based on the transitional scheme of ten years for direct income payments for farmers. In addition, expenditures for the "second pillar" of the agricultural policy (rural development), for internal policies and for administration are higher. Other assumptions remain the same.

[13] The DIW also developed other scenarios. We will discuss them in chapter IV, 5.

funding (ceiling: seventy-five percent of the EU's average per capita GDP) and transfers from the cohesion fund (ceiling: ninety percent of the EU's average per capita GDP). The technical assumptions concerning GDP growth are somewhat different from ours (two-percent growth for the EU-15; 4.5-percent growth for the accession countries).

FIGURE 1

Estimated Enlargement Costs (Appropriations for Commitments) **from 2004 to 2013** (in 1999 Prices)



Sources: European Commission, 2002; author's calculations.

Table 8 shows that, even in the "high cost scenario," the EU's expenditures in 2008 would not exceed the EU's ceiling on its own resources (1.27 percent of EU's GNP), but the financial margin (the difference between the estimated EU payments and the EU's own resources' ceiling) would decrease to a critical size of 0.05 percent of the EU's GNP. However, in 2013 the margin would increase again to 0.12 percent. In our "unchanged political bargaining scenario," the margin would reach 0.16 percent of EU GNP, caused mainly by slower-growing expenditures compared to the EU's GNP. If we assume a slower economic growth (two rather than 2.5 percent), then the margin would shrink to a more critical size. In striking contrast to these calculations, the DIW's status quo scenario leads to much lower expenditures, even compared to the existing financial framework (2000-2006). The financial margin would increase from 0.16 percent (pre-enlargement Agenda 2000 estimates) to 0.35 percent in 2007 and 0.49 percent in 2013. Such statistics might lead one to conclude that Eastern enlargement is a substantial cost-reducing program for the EU, because the strict application of EU spending rules would lead to a significant reduction of structural-fund expenditures for existing member states (see Table 8, status quo EU-15 scenario). However, this is not realistic, because it is political bargaining and not abstract spending rules that will determine expenditures.

TABLE 8

Financial Implications of Different Status Quo Scenarios
Financial Margin of the EU, as Percent of EU's GNP

Scenarios	2008	2013
Unchanged political bargaining	0.06	0.16 (0.13)[3]
Unchanged political bargaining, Commission[4]	0.06	(0.11)[3]
High cost	0.05	0.12 (0.08)[3]
Status quo EU-27, DIW[1]	0.35[2]	0.49
Status quo EU-15, DIW[1]	0.46[2]	0.35

[1] GDP data; DIW assumes EU-15 GDP growth of two percent annually. [2] 2007. [3] Number in brackets assumes EU-15 GDP growth of two percent instead of 2.5 percent. [4] Unchanged political bargaining scenario is based on the adjusted assumption of the European Commission's financial proposal of January 30, 2002; see text for more detailed description.

Sources: author's calculations; Weise et al., 2001

In comparison to both the high-cost and the status quo scenarios, our "unchanged political bargaining scenario" is likely to be more realistic. According to our calculations, Eastern enlargement well might prove incompatible with the EU spending ceiling established at the Edinburgh Summit in December of 1992. This is because additional burdens on the EU budget must be taken into consideration, including the financial fallout from the recent BSE crisis, the costs of the EU engagement in the Balkans as well as expenditures inherent in an increasingly independent foreign-affairs posture—especially in military defense. It is unlikely that the net contributors to the EU budget would be willing to raise the Edinburgh Summit spending ceiling in the future. Therefore, before FY 2007, when the new financial plans are to begin, reforms in EU agricultural and structural policies are unavoidable. Such reforms are all the more urgent because Croatia, the Republic of Yugoslavia, Albania and Turkey, with its population of more than eighty million, also might enter the Union between 2007 and 2013.

The DIW scenario shows that the existing net-receiver countries also have a substantial interest in reforms, because the strict application of existing spending rules would lead to a substantial reduction of their net transfers. Net-payer countries, on the other hand, are concerned that political bargaining will lead to higher costs. Their desire for reforms in major EU policy areas stems from the fact that in the past agricultural and structural policies were shaped more by political bargaining than by rational decision making. Each enlargement made these policies more subject to political pressures—and consequently more expensive. Now that spending limits are being considered, the EU needs new policies to deal effectively with the challenges of taking in the CEECs. Still, it would be a mistake to limit reforms to financial aspects. For internal (low efficiency) and external (WTO Round) reasons, changes also will be needed in agricultural and structural policy (see next section).

3. Prospects of CEECs' Economic Convergence with the EU

One of the yardsticks used to measure successful economic integration in Europe will be how well CEECs are able to converge their economies with those of the existing EU members. As we have presented above, preparation for EU accession is certainly an important factor promoting growth, but it is a far cry from being the only decisive factor. In fact, there are different paths toward economic convergence that tend to occur along with and in spite of different types of policies for macro- and microeconomic management. This was made clear after the joining of Ireland and Europe's Southern countries, which took a variety of growth paths toward convergence with EU standards (Dauderstädt, 2001a and 2001b). In this section we would like to present some of these experiences and to pose the question: What might the EU-15 and the CEECs stand to learn from past experiences? A good way to start is by assessing the economic performances and growth patterns of the CEECs from the start of their transitions to the present.

At the beginning of the CEECs' transformation from planned to market economies, a host of experts predicted a rapid "catching up" process. Nevertheless, it was considered self-evident that the first phase of the CEECs' transformation would be accompanied by an economic downturn, taking the form of real declines in output caused by structural and institutional adjustments toward markets in Western Europe. The experts assumed that this short period of contraction would be followed by rapid growth, promoted by the CEECs' highly skilled labor force earning comparatively low wages (Quaisser and Vincentz, 1999).

Initially, therefore, it came as a surprise that the "transition recession" in the first half of the 1990s proved deeper and longer than expected. A severe and enduring economic downturn was especially evident in the CIS (Commonwealth of Independent States), which spun off from the collapsed Soviet Union, but the CEECs also were not spared. The decline in output in these countries registered on average as a twenty-percent decline in GDP (see Table 9).

A new dividing line emerged in Europe's East as the CEECs, driven partly by their hope for EU accession, started to expand their economies in the mid 1990s. While the CEECs at least started to recover losses in output, the CIS economies went deeper into what appeared to be permanent economic crises that stretched across a vast geographic area (Rosati, 1999). This CIS region had to wait more than a whole decade before economic recovery started, in 1999. Russia, especially, achieved high GDP growth rates in 2000 and 2001 (8.3 percent and an estimated five percent, respectively), which were supported by higher oil prices. Nevertheless, this economic growth remains fragile. Prospects for accession to the EU, as well as for the EU's trade liberalization, certainly assisted the CEECs in overcoming their transition recessions. But these changes are not sufficient to explain the striking differences in economic performance between CEECs and those countries composing the CIS.

A plethora of papers has been written regarding the main causes for transition recessions (Balcerowicz, 1995; Gomulka, 1991; Winiecki, 1991; Brada, King, 1991), but not about the causes of the discrepancies between these two groups of countries. We would like to stress that differences in starting conditions, including structures and institutions, were the initial causes of these discrepancies (Rosati, 1999; Quaisser and Vincentz, 1999). In addition, the CIS countries seemed to suffer from a lack of traditional experience in the functioning of market economies. True, CIS policymakers did put together reform plans, but they tended to be inconsistent and their implementation unprofessional. There is another important factor to keep in mind. Once the Soviet habit of secrecy was removed, what emerged in the CIS countries was a hidden but very deep-seated tradition of corruption that, to this very day, stands in the way of policymakers' finding successful solutions to pressing economic problems.

Toward the mid 1990s, when the transition recessions had bottomed out, the CEEC economies increased their output at an annual average of approximately three percent (Quaisser and Vincentz, 1999). The EU members' annual growth rates, on the other hand, only reached close to two percent. Because of these lackluster growth rates, the economic convergence of Eastern and Western Europe has proceeded at a snail's pace. This point can be illustrated using a simple scenario. Assuming that the EU-15's average annual growth rate of per capita GDP hovers around two percent and the CEECs' rises to six percent per annum, which is rather optimistic, most of the CEECs would need between thirty and fifty years to achieve the EU average, depending on each country's individual growth rate. However, the convergence process could accelerate, to a degree, through a real appreciation in the value of selected CEECs' currencies.

The hopes for an accelerated catching-up process also diminished when models of success in other parts of the globe entered into unexpected crises. The foundations of seemingly successful economies in East Asia were shaken dramatically by the various financial and economic crises of the second half of the 1990s. East Asia's major player, Japan, entered into and then remained mired in economic stagnation for the duration of the decade, a situation related to an overvaluation of land prices that precipitated banking and other financial crises that have yet to be solved. The CEECs' aspirations of achieving and then maintaining relatively high growth rates were also dashed. The economies that had been heralded as grand examples of high growth fell down like a house of cards. What also helped destroy illusions was that the growth process in Eastern Europe later came to be understood as nothing more than a slow and difficult recovery back to the pretransition level (Rosati, 1999).

The catching-up process of the New Industrializing Countries (NICs) in East Asia appears to have been based on high rates of savings, high rates of investment and dramatic expansions in exports geared toward earning foreign exchange. The reasons for the successes and failures of the CEECs' growth process are markedly different. Unlike in the East Asian paradigm—based on high rates of savings, high rates of investment, etc.—the CEECs' relative successes could be explained as the results of structural and institutional reforms to what had been planned economies. These reforms introduced macroeconomic stability to the CEECs' economies and brought them a bit closer to West European standards.

It turns out that those countries that were able to achieve macroeconomic stability and implement a broad economic liberalization were also the first to start the wheels of growth turning and thus emerge from the transition recession. This view is supported by various regression analyses (Havrylyshyn and Wolf, 1999; de Melo, Denzinger, Gelb and Tenev, 2001). A broadly extended economic liberalization, which affected both the internal workings of the CEEC economies and their external relations (such as trade and investments), brought improvement to the supply side. This assisted these countries in overcoming the transition recession. A typical pattern emerged where dynamic small and medium-sized enterprises were the first sectors to experience expansion in output and employment. In addition, there is an observable linkage between monetary stabilization and structural reforms. The introduction and enforcement of "hard budget constraints" forced state enterprises to adjust to the challenges of the newly introduced market conditions. Reforms furthering privatization and improving corporate control followed. These, in turn, facilitated needed structural adjustments.

High rates of investments were a basic feature of productivity increases and growth in East Asian economies. This does not hold for the CEECs. Neither in cross-country comparisons nor in a time-series analysis have the investment ratios of individual CEECs explained different rates of growth of output (Quaisser and Vincentz, 1999). Although there is evidence that quantitative investment figures are important, it is the efficient use of investments that has proved decisive. Differences in the financial systems involving corporate control and ownership structures also emerged as significant factors helping to bring transitional economies out of the deep, prolonged recession that started in the early 1990s.

With this in mind, it is important to differentiate between the various periods of recovery and expansion in the CEECs. In the first period of recovery, the transformation process involved reallocating and reorganizing the existing means of production. This helped to facilitate an economic recovery without high rates of investment. In the second period, the classic growth factors—namely, capital, technological progress and labor—played an increasingly important role in raising rates of growth in output. Selected CEECs began to experience this phase of recovery and growth toward the end of the 1990s.

A common feature of the East Asian economies was that they were able to finance high rates of investment through high rates of savings. For some, there was also a large inflow of capital as FDI. Since savings ratios are comparatively lower in the CEECs, their future growth strategies might have to rely more heavily on investing in education and research—in short, in human capital. In the 1990s there was no apparent link between inflows of FDI and rates of economic growth in the CEECs (Rosati, 1999). However, there is some evidence of a link since the start of the current decade. Still, our review of selected experiences of East Asian economies suggests that different patterns of economic growth are engendered by varying types of foreign direct investment. South Korea and Taiwan provide clear examples. In South Korea, growth was built upon massive investments in large Chaebol, while in Taiwan it was built upon comparatively small, family-owned businesses noted for their flexibility in entering world markets. We predict that there also will be different patterns for investment and growth among the CEEC countries.

Rapid expansion in trade has been cited as an important factor engendering high growth in East Asian economies (Stiglitz and Yusuf, 2001). Similarly, there can be no doubt that trade liberalization produced clear results for the CEECs as well, assisting their economies in overcoming transition recessions. It was astonishing how rapidly the CEECs oriented their foreign trade away from the collapsed Soviet Union and toward West European markets in the 1990s. While imports clearly played a role in recovery, it appears that the expansion of exports toward Western markets provided the real starting point for the CEECs' economic growth.

Moreover, research suggests that the changing profile of exports serves as a useful way to follow structural changes taking place in a transitional economy. It is apparent that the CEECs made major steps in the direction of an improved export profile—that is, increasingly knowledge-intensive products were exported with greater frequency. Hungary, especially, vastly improved its export profile, completely eroding or turning into surpluses once-sizeable deficits in capital-, R&D- and skill-intensive industries. Similar but less spectacular changes occurred in the Czech Republic, Poland and Slovakia, where the relatively strong export position of the energy sector has been reduced substantially. This is not the case in Bulgaria and Romania, where the labor-intensive sectors also retain strong comparative advantages (Landesmann, 2000; Quaisser, 1999).

If we consider the examples of selected countries in East Asia or even of Ireland, export-oriented growth strategies proved successful when wages remained low relative to factor productivity. Hence, CEECs would be advised to follow the same growth course—keeping wages low, or at least keeping wage gains moderate relative to productivity growth. At the same time, these countries should rely more and more on increasingly qualified labor. At first glance, the preconditions for such a strategy look fairly good, as we have every reason to expect that the CEECs will benefit from improvements in their labor forces' capability. At the same time, there are concerns related to the increase in real labor costs. A growing pressure for higher wages and the introduction of social standards along the lines of prosperous EU members likely would lead to wage gains moving ahead of productivity growth. If this be the case, social contracts, such as the one established in Ireland, would be needed to keep unit labor costs at a competitive level, especially for exported products. Additionally, the real appreciation of the CEEC currencies, promoted by capital inflows and productivity growth, has had and will have the tendency further to undermine exports' price competitiveness. Considering these tendencies and trends, it is unclear if the CEECs will remain capable of implementing macroeconomic and microeconomic policies that promote the convergence process.

However, we should not underestimate those factors that might stimulate growth and thereby promote a more rapid catching-up process. The CEECs enjoy a favorable geographic location at the front door of Western European markets. They also can expect to benefit from EU transfers earmarked for the improvement of their physical infrastructure. In addition, there will be a further expansion of EU production networks that cross the increasingly invisible border dividing the two regions. The inflow of FDI, as well as the long-term orientation of the CEECs' macroeconomic policy toward fulfilling the Maastricht Criteria, should both drive the economies forward and ensure economic stability. If the national economic policy of each of the CEECs seeking EU accession successfully meets the remaining challenges, the prospects for rapid growth over the coming decades are good.

TABLE 9

Increases in GDP for the CEEC Candidates And Some Other Countries Undergoing Economic Transitions

	Accumulated Decline of GDP During the Transition Crisis[1]	Year that Economic Growth Resumed	Average Annual Rate of Growth Until 2001 Since Growth Resumed	Level in Year 2001 Compared with CEEC Level in 1989 and Other in 1991
CEEC-8, Entry Group 1				
Poland	-17.8	1992	4.6	146
Hungary	-18.1	1994	3.7	113
Czech Republic	-18.1	1993	2.0	99
Slovakia	-25.0	1994	3.7	110
Slovenia	-20.9	1993	3.9	121
Estonia	-34.9	1995	4.7	90
Latvia	-51.7	1994	4.0	69
Lithuania	-43.9	1995	3.3	69
Country Average[2]	-17.0	1993	3.7	121
Southeast Europe, Entry Group 2				
Bulgaria	-26.7	1994	0.1	81
Romania	-25.0	1993	0.6	84
Average[2]	-25.2	1993	0.5	84
Southeast Europe, Countries with Stability Packages				
Croatia	-40.5	1994	4.1	89
Macedonia	-36.0	1996	2.8	78
Albania	-39.9	1993	6.6	106
Average[2]	-38.6	1994	4.1	83
CIS				
Russia	-47.5	1999	6.4	63
Ukraine	-63.1	2000	6.5	37
Average[2]	-49.5	1999	6.1	64

[1] For the CEECs since 1989, for the Baltic republics and CIS since 1991. [2] Calculation of averages by weight with GDP portion for Year 2000. Average is based on calculations from nominal exchange rates listed in $US. Growth rate for 2001 estimates.

Sources: IMF, World Economic Outlook, May 1999; EBRD (2001)

IV. Preparing the EU for Eastern Enlargement: Institutional and Policy Reforms

Already by the Copenhagen Summit in 1993, EU policymakers were operating under the assumption that the EU had to prepare itself for the demanding task of taking in between ten and fifteen new member countries. At the EU summit in Amsterdam in 1997, an attempt was made to alter selected EU institutions, but with little success. The next step came with Agenda 2000, which grew out of the Berlin Summit in 1999. Agenda 2000 proposed reforms to agricultural and structural policy. However, shortly after the Berlin Summit it became clear that these changes only could be considered as first steps toward a more comprehensive set of reforms.

The Nice Summit, held in December of 2000, was expected to prepare the EU institutionally for Eastern enlargement by providing at least some preliminary solutions to pressing problems. A certain amount of progress was made. For example, a new set of voting procedures for EU members was established that extended the possibility of majority voting. Additionally, the Nice Summit provided the legal basis for integrating a group of core EU member countries. However, although these sorts of newly introduced procedures are important, they represent little more than a minimum requirement for managing the first round of Eastern enlargement up to 2006. For the period after 2006, a range of effective reforms needs to be hammered out and then implemented.

The provisional character of the Nice Summit results is reflected in the fact that a new IGC (intergovernmental conference) has been planned for 2004. This conference will seek to define more precisely the competencies of each decision-making level. The decision on the scope of institutional issues to be worked out at this conference was decided at the European Council meeting in Laeken (Belgium) in December 2001. European leaders provided the conference with a broad mandate, which in fact may lead to a revision of the Nice Treaty.

The rejection of the treaty by Irish voters in June of 2001 indicates the fragility of the compromises hammered out at Nice. It remains an open question whether yet another Irish plebiscite would bring a greater show of support for enlargement. If the Irish again reject the institutional and decision-making procedures endorsed at Nice, a political crisis that could derail progress toward Eastern enlargement might ensue. Although the European Commission had stressed that the outcomes of the Nice Summit might not serve as a precondition for Eastern enlargement, powerful political forces within the EU Parliament, as well as important EU member states, might not find this view acceptable. If the latter is the case, ratification of the accession treaties might be endangered, and the planned IGC meeting in 2004 automatically would gain a decisive role in making the EU institutionally fit for Eastern enlargement.

1. An Organization in Flux

Without apparent intention, the EU provides an extreme and living example of the Tibetan Buddhist thesis of "impermanence" (Dalai Lama, 1992). Since its inception in the early 1950s, the EU continuously has undertaken institutional and organizational change as its goals were altered periodically in order to make progress toward the underlying dream of European unity. With the twenty-first century now underway, the highest conceivable stage of EU development is still not clearly envisaged. Such visionaries as Robert Schumann and Jean Monnet conceived and articulated visions of a Europe "united," but the specific form or forms it should take was left—and continues to remain—open.

Throughout the year 2000, during the preparations for the Nice Summit, flagrant institutional problems were recognized and dealt with in fiery debates. Such discussions also covered the issue of the *finalité* of the form the Union ultimately would take. Nearly every European leader had his or her two cents to offer, starting with Germany's Foreign Minister, Joschka Fischer, who delivered a passionate speech in May 2000 to an audience at Berlin's Humboldt University.[14] Despite some differences in detail, most of the German concepts favor a federal Europe with well-defined institutions and competencies. The French proposals follow more the concept of a "core Europe," whereas the British view favors a looser confederation of European states. Some of the issues raised in delivered speeches are addressed below, but what is important for us as economists to consider is that over the decades the EU's economic character has altered fundamentally and will continue to do so.

Economically, the European Union has changed from a custom union to a common market to an organization of states many of whose members are linked by monetary union. But not only the stages of integration changed but also the level of economic divergence. Once the EU was characterized rightly as a "rich-man's club" composed of advanced West European economies. With Ireland's entry into the EU in 1973, Greece's entry in 1981 and Portugal and Spain's entries in 1986, the EU changed somewhat as it incorporated countries that for some years would be known as Europe's "poor four." We predict that the next two rounds of expansion will be much more challenging in comparison. The population of the EU is expected to increase by nearly thirty percent with Eastern enlargement. However, total Gross Domestic Product (GDP) for the EU is not expected to increase more than a mere five percent. A significant increase in population, coupled with but a marginal increase in output, spells relative declines in the EU's GDP per capita. The EU is going to look poorer—much poorer—at least statistically. After accession, a decade or more will be required to raise its per capita GDP back to its pre-enlargement level. And this statement assumes that the EU economies respond positively enough to enlargement to raise economic-growth rates.

[14] The British and French prime ministers Tony Blair and Lionel Jospin, the French President Jacques Chirac, the German *Bundespräsident* Johannes Rau and the German Chancellor Gerhard Schröder, as well as many other important representatives of public life in Europe, contributed to this debate. See also the new paper by the influential CDU/CSU politicians Wolfgang Schäuble and Reinhold Bocklet (Schäuble, Bocklet, 2001).

We do not anticipate that any citizen of the existing member states would become poorer as a result of Eastern enlargement. However, indirect effects, such as those stemming from higher budgetary contributions and/or lower transfer sums from Brussels, should have some effect on a country's level of wealth. To meet the challenges of such an unprecedented enlargement, the European Commission should make policies that help the organization run more effectively. The important task for the accession countries is to adopt and faithfully implement the *Acquis Communautaire*, the vast set of rules and regulations adopted by all existing EU member countries.

Was sufficient groundwork laid at the summits in Berlin and Nice? As we have presented in Section III, the results of both summits fell short, representing only the minimum level of changes needed to cope financially with the challenge of incorporating five or possibly eight CEECs before the end of fiscal year (FY) 2006. Starting in FY 2007, the financial requirements for dealing with Eastern enlargement appear to be far greater than the funds the EU would have at its disposal. Therefore, the EU must formulate a new set of policy reforms that could be approved and integrated as “Agenda 2007.” This is necessary to provide the EU with a framework for successfully dealing with the additional financial obligations it will face as a result of Eastern enlargement. We advise that parts of Agenda 2007 should be formulated and approved at the intergovernmental summit scheduled for 2004 (Quaisser and Hall, 2001). "Summit 2004" should specify and clarify the competencies of the different administrative levels of the EU, whether they be Europeanwide, national or regional. In addition, it should initiate the process of introducing major reforms needed in preparation for Agenda 2007. We will deal with some major aspects of Summit 2004 in Chapter V.

2. Decision Making: Voting Power and Finance

In addition to the deficits mentioned above, the results of the Nice Summit and the related fear of exploding costs are especially worrisome for net payers into Brussels’s budget. A country such as Germany has been willing in the past to assume growing burden shares as a way to support a more thorough European integration, and thus to promote peace and stability on Europe’s continent. Unfortunately, the Nice Summit did little to dispel fears of exploding costs.

Though majority voting was extended at the Nice Summit, Spain was able to veto any changes that might alter the financing of structural policies until the start of FY 2007. Spain also expressed an unwillingness to accept cuts in the levels of transfers it receives. In fact, the political power of the net payers into the EU's budget did not change for the better with Nice. Following the Banzhaf Index, which estimates the relative voting power wielded by different parties engaged in various votes, only one out of 2,500 times would Germany, with its sizeable population, be brought into a better voting position as a result of the Nice Summit (Kirsch, 2001).[15] The Netherlands is another net payer that received no measurable change in its real voting power. From the per-

[15] This is estimated in a model based on the Game Theory.

spective of net payers, there is a massive discrepancy between their relative share of funding for the EU budget and the relative levels of political voting power they wield. Additionally, under the existing system of decision making, the move toward including twenty-five or more members of the Union would reduce dramatically the likelihood that a qualified majority in coalitions needed for important decisions could be achieved. Hence, political paralysis is expected to be a real danger for the enlarged Union (Kirsch, 2001; Baldwin et al., 2000).

If we consider an enlarged EU with up to twenty-seven members by 2008, then the net payers would constitute an estimated 62.6 percent of the EU's projected total population. This 62.6 percent would contribute 81.4 percent to the total EU budget. However, following the Nice Summit results, this group would wield but 45.5 percent of the EU's voting power according to the Banzhaf Index. The discrepancy between net budgetary contributions and voting power is especially great for the largest contributors, as their influence is disproportionately and significantly less, especially when compared to the net receivers in the accession countries. Although a qualified majority of votes (71.42 percent) and a single majority of states is needed in making important EU decisions, the relatively large weights of net-receiver countries could result in their voting higher levels of funding for themselves (see Table 10). Fortunately, a form of safeguard clause exists that ensures that a majority decision in the council also represents the majority of the EU population (Wessels, 2001).

TABLE 10

Major Indicators and Voting Power in EU-27
(Projected for FY 2008, Expressed as Percent of a Projected Average of Twenty-Seven Members)

Groups of Countries*	Population	EU's GDP	Budget	Votes--Nice	Banzhaf
High Net Payers	23.94	32.24	33.65	17.97	17.93
Medium Net Payers	38.65	49.13	46.59	29.28	27.54
Medium Net Recipients EU-15	13.25	11.94	12.63	16.81	16.99
High Net Recipients EU-15	2.25	1.58	1.79	4.64	4.97
Medium Net Recipients Accession Countries	4.42	1.42	1.54	9.86	10.64
High Net Recipients Accession Countries	17.49	3.70	3.80	21.45	21.93

* High net payers contribute more than 0.3 percent of their GNPs. These include Germany, the Netherlands, Sweden and Austria. Medium net payers contribute up to 0.3 percent of their GNPs. This group includes Denmark, France, Italy, Finland and the United Kingdom. Medium net recipients of EU-15 funds receive up to three percent of their GNPs. This group includes Belgium, Spain, Ireland and Portugal. High net recipients in the EU-15 receive more than three percent of their GNPs. These include Greece and Luxembourg. Medium net-recipient accession countries that will receive up to three percent of their GNPs likely will include Cyprus, the Czech Republic, Latvia, Malta, Slovenia and Slovakia. High net-recipient accession countries receiving over three percent of their GNPs are expected to include Poland, Estonia, Hungary, Bulgaria, Lithuania and Romania.
Sources: Eurostat, Kirsch (2001), authors' calculations

The danger of additional cost explosions is especially high because EU policies inherited from the past were more the results of political compromise than sound or even moderately rational decision making. Agricultural policy emerged more or less as a concession to French and German farmers, so that they would support European integration in the first place. Structural policy was initiated by the demands of the United Kingdom and Ireland when they entered the Union, and the spirit of these policies was extended generously when the Southern countries joined in the 1980s. Each phase of enlargement made EU policies that much more subject to political pressures, and consequently that much more expensive. This was especially obvious when the Southern countries of Greece, Spain and Portugal joined. Shaped by political pressures, many EU policies are too outmoded for the organization to deal effectively with challenges raised by Eastern enlargement. We fear that a form of horse-trading likely will increase in the coming years as a way to decide the fates of major cost-intensive policy issues.

3. Reform of Common Agricultural Policy (CAP)

There is a broad consensus among economists, other academics and now even among some everyday consumers that the EU's Common Agricultural Policy (CAP) is too costly and leads to an inefficient allocation of resources. Close to fifty percent of the EU budget goes to fund the CAP. Subsidizing agricultural prices is known to promote overproduction. As a result, EU surpluses are either destroyed or are sold as commodities on the world market at prices below the costs of production. Such dumping is known to generate trade frictions between and among EU member countries, as well as between the EU and other countries, and trade blocs such as NAFTA. In addition, the CAP establishes quotas for sugar and includes set-aside programs for farmland.

Highly intensive agricultural production historically has required copious amounts of fertilizers and pesticides—some of which have proved to be detrimental to rural flora, fauna, soil and water systems involving rivers, lakes and estuaries. What is more, CAP price subsidies have a known tendency to benefit large-scale producers and also keep marginal farmers in production. Such farmers earn meager farm incomes and often have to work a second job in town.

In spite of its excesses and deficiencies, Europe’s CAP has proven remarkably resistant to any attempts at substantial reform (Ehrke, 2001). Although Agenda 2000 reduces funds for price supports, while placing more emphasis on direct income supports for farmers, the tendency for market distortions still exists. Hence, further CAP reforms should aim to foster the establishment of unfettered market prices for agricultural products. Reforms should delink direct payments to farmers from their productive capacity and reduce the amount of subsidies. In addition, CAP reforms should introduce national cofinancing for farm-income support. Such reforms are necessary not only to make EU agriculture more efficient but also to prepare the Union for Eastern enlargement. The Berlin Summit in March of 1999 did not exhibit the foresight to provide any expenditures for direct payments to CEEC farmers in its financial plan.

There were some rational arguments behind this decision. According to current CAP rules, income-support measures are paid to EU farmers who suffer from price decreases. Since CEEC farmers can expect to gain from agricultural-price increases as their countries join the Union, there is no real need for special compensation. However, it is not only political arguments (like the second-class status the CEECs might take on) that make it difficult for EU member states to avoid paying direct income-support measures. As these payments are still linked to the scale of production on farms (land and number of animals), they in fact will have a distorting effect on competition if farmers in the CEECs are not integrated into this system. However, accession countries should bear in mind that the existing EU income-support scheme will have negative effects on their countries as well. First of all, it will change the income distribution in favor of the rural population and owners of farms. In addition, those farms might not profit because the use and ownership of agricultural land is widely dispersed in the CEECs.

If such reforms are introduced in the near future—and then are executed consistently without giving in to political pressures—the EU should be able to incorporate the accession countries' agriculture into its income-support system (Schrader, 2000). The EU then should extend financial assistance to the new member countries to promote structural changes in agriculture and further rural development. Such a program, with its progressive bent, would make much more economic sense than merely keeping marginal farmers in production.

There is no lack of innovative concepts for improving EU agricultural policy (Urff, 1997).[16] What has been lacking is the political will to implement them. Nevertheless, several political factors exist that may help promote CAP reforms. For one, France is starting to recognize that it will become a substantial net payer if enlargement costs are excessive.

However, this situation is complicated by the fact that the overall net financial position of each country is determined largely by net positions regarding their agricultural and structural funds. Between 1995 and 1999, France exhibited a positive financial balance in agricultural funds of about 1.9 billion euros (0.16 percent of its GDP) annually, and Germany a negative balance of 5.3 billion (0.27 percent of its GDP; see Table 11). If, in the future, a larger portion of agricultural supports is nationally cofinanced, France is likely to lose relatively more and Germany to gain. However, France's net position, also in agriculture, should take a change for the worse even if the CEECs are integrated following the existing income-support system. France might be willing to promote a CAP reform if it is offered a medium-term phasing-out scheme. That might diminish the political pressure from the agricultural lobby not only in France but also in other member states.

Negotiations within the World Trade Organization (WTO) also might place pressure on the EU to enact deeper agricultural reforms (Anderson, 2000). The results of these negotiations not only will force the EU to reduce price and export subsidies but also will press for delinking income-support measures from the amount of land and numbers of

[16] See Urff (1997) for a synopsis of different reform concepts.

animals. Finally, after the elections scheduled to take place in 2002, France and Germany will be free to work together to overcome the blockades to reforms they have surreptitiously and not so surreptitiously encouraged in recent decades. Signs of commonly held positions already have been observed, but a real breakthrough would be possible only after the 2002 elections.

TABLE 11

Net Financial Position of Selected EU Member States in EU's Common Agricultural Policy (CAP)

Annual Average Between 1995 and 1999 in Billions of Euros and Percent of Member Country's GDP

	Net Position: "contribution to own resources"[1]		Net Position: "member state's contribution to the budget"[2]	
	in billions/euro	in % of GDP	in billions/euro	in % of GDP
France	2.502	0.20	1.971	0.16
Germany	-4.967	-0.26	-5.239	-0.27
Great Britain	-1.272	-0.11	-0.669	-0.06
Spain	2.158	0.43	2.009	0.40

[1] Calculation of the net position is based on each country's contribution to the EU's own resources—i.e., according to its share in EU's GDP. [2] Calculation of the net position is based on each country's real contribution to the EU's budget.

Sources: Weise et al., 2001; authors' calculations

So long as serious reform measures are avoided, the CAP promises to remain a source of conflict among the EU's existing fifteen member states. One of the problems associated with current negotiations is that it is unclear what sort of CAP will exist when new members enter the EU. The current EU member states should press for rapid reforms, because once the CEECs are part of the EU, they might prefer not to undertake agricultural reforms at home but instead to live from the CAP's largesse. The recent BSE crisis provides yet another opportunity to reform the CAP, as the EU's agricultural lobby with its powerful meat industry is under attack as never before. Political pressures by consumers are increasing (Ehrke, 2001), and important reform measures likely will be introduced during the EU's review of agricultural policy planned for 2002 and 2003.

Over the next few years, one of the possible outcomes of reform discussions will be that CAP policies will be altered to consider environmental externalities more seriously. However, the danger is that such changes might lead to yet more bureaucratic regulations, this time in the name of "environmental safeguards." If implemented, these "reforms" might mean that European agriculture fails to improve its international competitiveness, thus leaving intact the hefty financial burden to the EU budget. In addition, it has yet to be established scientifically that bureaucratic regulations concerning ecological farming would lead to better environmental results than would less-intensive forms of conventional agriculture.

A favorable opportunity to push ahead with substantial reforms involving the so-called "second pillar" of the CAP could result from the CAP's "mid-term review" in 2002. This program dedicated to rural development is cofinanced by national and regional governments on an optional basis and at the moment amounts to about ten percent of agricultural expenditures. If it continues without changing, its costs would burden national budgets, but if its cofinancing becomes mandatory for countries—as opposed to optional—it would offer a degree of financial relief to the EU's net payers.

4. Reform of Structural and Regional Policy

The structural policy of the EU faces mounting criticism. Doubts have been raised as to whether it effectively has, over the years, promoted economic convergence among EU regions. The second report on "cohesion" by the European Commission indicates only limited success in the convergence of the Union's regional per capita incomes (EU Commission, 2001b). Between 1988 and 1998, per capita incomes of the poorest areas, which included about twenty-five percent of the EU's population, increased only slightly, from sixty-six to sixty-eight percent of the EU's average. According to the EU Commission's *Report 2001* (EU Commission, 2001b), regional disparities in per capita incomes declined only marginally in the 1988 to 1998 time period, whereas the disparity in rates of unemployment increased substantially (Wegner, 2001). One might argue that without the existing structural policies these figures probably would be even more disparate. Nevertheless, to date structural policy scarcely could be called an EU success story (Boldrin, Canova, 2001).

While regional disparities remain a problem, progress has been made toward convergence in national-income levels. Between 1988 and 1998, poorer countries like Spain, Greece and Portugal increased their average levels of national per capita income from sixty-eight to seventy-nine percent of the EU average. European Commission model simulations from 1997 have suggested that the EU's cohesion policy might have contributed to this increase. However, a solid economic evaluation would have to consider the welfare losses caused by higher rates of payments into Brussels's budget made by net-payer countries in order to finance the transfers.

Most impressive is the catching-up process exhibited by Ireland. In 1973, when it joined the European Economic Community, Ireland's per capita income was but sixty percent of the EU average. Through its years of output growth, especially 1987 to 2000, and its population's historic pattern of out migration, Ireland has raised its per capita GDP (in purchasing-power standards) to about twenty percent above the EU average (Sweeney, 1998). However, in the 1990s, as labor demand increased to accompany Ireland's rapid growth especially in the technology sector, qualified labor began returning to the country.

In contrast, Greece's economic development has remained as disappointing as it was before it joined the community in 1983 (Dauderstädt, 2001a). As recently as 1998, Greece exhibited a GDP per capita that was but fifty-five percent of the EU average, and Greece's consumers benefited from a purchasing-power standard that was but seventy percent of the EU average. More recently, accompanying a shift in Greece's economic policy, some positive trends in economic growth and stability are starting to show. In January of 2001, Greece entered the euro zone, even though its economy remains plagued by a host of problems, including an entrenched tradition of corruption that cripples its movement toward modern economic growth (Boltho, 2000).

From an economic standpoint, EU regional policy should concentrate on funding the production of public goods where it is deemed necessary. Fund transfers designed to foster successful economic transitions within the EU's internal market also would be economically justifiable. In addition, such transfers would help to mitigate whatever social tensions might arise. If markets fail and negative externalities occur, then public-sector interventions would appear to be both rational and socially responsible (Mallossek, 1999).

From this perspective, it does not seem reasonable that the EU should assign nearly thirty-five percent of its budget to structural funds. However, the thrust of EU policy goes well beyond such economic arguments. In fact, its structural policy is designed as a form of redistribution scheme between and among richer and poorer member states. Even more than "structural funds," the term "cohesion fund" underscores the overriding political purpose of the transfers. To date, large sums of such funds were given to Ireland and the Southern countries of Greece, Portugal and Spain. But what makes this policy instrument suspect is the fact that member states with higher per capita incomes also receive sizeable shares. Approximately fifty percent of the EU's population lives in areas supported by these funds.

In the financial period 1994-99, France and Germany received about twenty-three percent of all structural funds. Once established, this type of financial redistribution has a strong tendency to be subject to political horse-trading that continues to persist even when its original purpose is outdated. There is a deep-seated tendency for every beneficiary country to attempt to optimize its funding. Axt (2000) describes this system correctly, as a trap of interlinked interests. This kind of policymaking could be described as a form of political bargaining (also called a "system of concordance") aimed at harmonizing interests and dividing them proportionately. Structural funds also could be considered as side payments to "buy" political decisions in fields essential to other net-payer member countries. This makes it extremely difficult to succeed with any substantial changes within the system.

Spain and Ireland, for example, are clear beneficiaries of this laxness. During former enlargements of the EU, a misallocation of funds could be shouldered readily by the prosperous member states. This will not be the case with Eastern enlargement, as there will be a major redirection of massive financial flows that cannot be borne by more prosperous member states without noticeable losses. However, if the extensive rules governing the distribution of these funds were strictly applied, the financial implications would not be placed above the overriding motivation to alter structural policy. We might illustrate this with the example of the most important structural-policy instrument—"objective-one" funding.

"Objective-one" funding is transferred to regions with per capita GDPs (measured in purchasing-power standards) below seventy-five percent of the EU average. With Eastern enlargement, the EU regions that currently appear poor will be made to appear statistically richer as the average level of per capita GDP across an enlarged Union falls. About twenty-seven regions with approximately forty-nine million inhabitants will face losing their transfers because their regional GDP levels will rise above the seventy-five-percent line. At the same time, the number of inhabitants below this line would increase from seventy-one million to 174 million persons, that is, to about thirty-six percent of the enlarged EU's population. If the Union accepts Spain's recent proposal to retain the existing levels of structural and cohesion policies in the enlarged EU, Brussels expenditures would increase to a level that would be wholly unmanageable. Moreover, the new member states would get much less per capita funding than the earlier beneficiaries of cohesion funds. Consequently, we propose that all EU members, both rich and poor, redirect their assistance funds to foster growth in accession countries.

There is another point to be stressed. After accession, fulfilling the goal of the Union's structural policy—to promote economic convergence and diminish income disparities between EU regions—will be harder to achieve. In spite of the rosy picture painted in neoclassical theory (namely, that factor incomes will tend to equalize through integration), the EU still faces substantial inequalities that we expect to linger even over the long term.

In addition, because agglomeration effects tend to be strong, an enlarged EU will change from its present characterization as a "rich-man's club" to that of a heterogeneous collection of countries characterized by a sizeable East-West development gap. As the EU's structural policy shifts away from supporting less-developed regions, it should concentrate more on promoting the convergence of member *countries*. Regional policy emerges as one of the defined competencies of each EU member state, while criteria for structural and cohesion funds are reformed and altered so that such funds are reallocated toward poorer member countries.[17]

That is to say, the reforms should give member states greater control over the choice of investment projects. But to avoid misuse, EU-wide standards for the allocation of funds should be designed and administered consistently. The Commission, with its tendency to become overloaded by administrative details, should be freed from the *ex-ante* selection of projects and should concentrate instead on *ex-post* evaluations. This is especially important because the commission will have to take over the responsibilities for steering and controlling policy in the new member states. If a misuse of money is proved, sanctions could be implemented, i.e., a country would have to repay funds and

[17] See footnote one.

would also be penalized by being allocated less money for the next financial period. We suggest that a larger part of allocated funds should be given in the form of preferential credits (or with a greater share cofinanced) and within the framework of international banking institutions, such as the European Investment Bank (EIB) or the European Bank for Reconstruction and Development (EBRD).

Funds should be distributed among member states according to their national GDP per capita, measured in terms of purchasing-power standards (PPS). We suggest that the maximum amount of funds be fixed in advance and presented as an absolute sum or specified percentage of either the EU budget or total EU GDP. In support of Eastern enlargement, EU structural policy should concentrate on the lowest-income countries among the new member states. Such a concentration is justified by the fact that the poorer the country, the greater the adjustment costs connected with structural change.

5. Financial Redistribution and Budgetary Reforms

In outlining a new framework for the European budget, our starting point is to calculate the net financial positions relative to the EU budget of such large EU countries as France, Germany, Spain and Great Britain, plus the future EU state Poland. Because of their relatively large sizes, France and Germany currently play comparatively important roles in the process of European integration. France is a medium net receiver of EU transfers, whereas Germany is a substantial net payer. Politically and economically, Spain is the most powerful of the EU's net-receiver countries, with strong aspirations to stay in this position. Great Britain, while exhibiting strong reservations toward further EU integration, demonstrates a more liberal approach toward existing EU economic policy. In addition, former prime minister Margaret Thatcher was able to achieve a remarkable degree of relief for Britain's budgetary position.

Of the new member states, we expect that Poland readily will establish itself as the most powerful, articulating specific interests and concerns—especially related to agricultural policy—which well may generate some real headaches for Brussels. Assuming that a first accession round takes place at the latest in 2005 and includes Poland, we expect that the latter country will emerge as a major political player in the budgetary decisions over the financial period 2007-2013.

In discussing budgetary reform, two particularly important questions emerge. First, how will the net financial positions of major EU member states change under plausible reform options? Second, which financial scenarios are selected countries likely to choose? We shall consider the four scenarios presented above: the unchanged political bargaining, high cost, status quo EU-27 calculated by the DIW and status quo EU-15 calculated by the DIW (see chapter III, 2.2. and Lippert, Bode, 2001). In addition, we shall present two reform scenarios calculated by the DIW, plus our own proposal. To facilitate calculations, we assume that EU enlargement involving all candidate countries (except Cyprus and Malta for data reasons) will be completed by 2007.

The DIW’s first reform proposal—which it calls “moderate reforms”—predicts that the income level qualifying regions for structural-fund payments, within “objective-one” funding, would be increased from seventy-five to up to eighty-six percent of the EU’s average GDP measured in purchasing-power standards (PPS). Agricultural policy still would be based on direct income payments, but would have to be cofinanced by national budgets. This means that EU agricultural expenditures could decline in relative and absolut terms.

In the radical reform scenario proposed by the DIW, structural policy is designed in such a way that structural-funds payments will be directed not to regions but to those countries with a per capita GDP level below eighty-five percent of the EU average. For agricultural policy, direct income payments would be delinked from the means of production (such as scale of production and technical level) and, eventually, totally abolished. In order to diminish the adjustment pressures, each of these options would have transitional periods that should end at the same time as the next financial planning period. Hence, 2007 and 2013 are our reference years.

We begin our analysis by discussing the real situation in 1997 and the projected one for 2002. With the 1999 Berlin decisions, the net financial positions of Germany, Great Britain and Spain improved between 1997 and 2002, whereas that of France deteriorated. These differences partly reflect changes in the distribution of structural-fund expenditures (calculated using a clearly defined formula), as well as changes in the correction mechanism for the “British rebate.” The latter was introduced in order to reduce the budgetary imbalances of high net-payer countries like Germany, Austria and the Netherlands (see Agenda 2000b). In applying the Berlin decision of Agenda 2000 strictly to old and new members (meaning that East European farmers would receive no direct payments), the results are the following: in 2007 Poland would receive about 2.48 percent of its net GDP, while in 2013 this level would increase moderately to 2.63 percent. The net financial positions of current EU member states would decline, though Spain would remain a net receiver of EU transfers.

Comparing this scenario with the situation without enlargement allows us to determine the net cost of enlargement for single member countries. It turns out that France would suffer the most significant losses in its net financial position (minus 0.19 percent), followed by Germany (minus 0.17 percent) and Spain (minus 0.14 percent). The United Kingdom would be much better off, as the “British rebate” reduces its net enlargement costs to 0.06 percent of its GDP. We believe, however, that this rebate is unfair to other EU members—especially with respect to enlargement costs—because it reduces the relative burden of Britain's funding of the EU budget. The substantial corrections that should be made will be easier to achieve once major agricultural reforms are implemented.

In all other scenarios presented in Table 12, the contribution of single member countries to the EU budget corresponds to their relative shares in the EU’s overall GDP. This seems justified because the importance of all other sources of the EU budget, such as tariffs and parts of the value-added tax, is expected to diminish over time. In addition, the “British rebate”—assuming a radical reform of the CAP takes place—probably would not survive for too long. Consequently, the relative sizes of the GDPs of single member countries increasingly would determine their net budget contributions.

Comparing the years 2007 and 2013, the DIW status quo EU-15 scenario demonstrates that even without enlargement Spain would experience a net decline of 0.43 percent of its projected GDP in 2013. This lowering of the projected GDP would result mainly from the expected convergence process, which would lead to fewer transfers of structural-fund payments to Spain. Spain would remain a net receiver, but by 2013 those receipts would decline to approximately 0.88 percent of its annual net GDP. This point is important because Spain would not be in the position to bargain over its reduced transfer payments. By contrast, the status quo EU-15 scenario demonstrates that France (plus 0.04 percent of GDP), Germany (plus 0.08 percent) and the UK (plus 0.09 percent) would improve their net financial positions between 2007 and 2013. France would become a net receiver of EU funds and Germany and the UK would remain net payers, though they would contribute no more than 0.25 percent of their GDPs to Brussels's budget. What is most important in comparing the DIW scenarios status quo EU-15 (without enlargement) and status quo EU-27 (with enlargement, including direct payments to East European farmers at current levels) is the fact that with enlargement Spain is slated to lose relatively more (minus 0.72 percent by 2013) than the net-payer countries, which would be losing between minus 0.22 and minus 0.25 percent of their annual projected GDPs. This is because with enlargement the average per capita GDP would decline for the EU as a whole, and most of the Spanish regions then would not qualify for current levels of structural funds. As a new member state, Poland would receive about net 4.7 percent of its GDP annually from 2007 to 2013.

In our "unchanged political bargaining" and "high cost" scenarios (which are, in fact, very similar), the higher enlargement costs (compared to the DIW scenarios) would lead to a substantial deterioration of the net positions of existing member states. Still, the costs would be much more equally shared among countries, with the exception of the UK. However, it is unlikely that in 2013 France and the UK would accept a net financial position of minus 0.47 percent, or minus 0.42 percent of their respective GDPs, or that Germany would accept paying 0.73 of its net GDP to Brussels. Spain would lose slightly more than Germany and France but would retain a much better net position (plus 0.88 percent) than in the DIW status quo scenarios. Clearly it would be in the interests of Germany, the UK and even France to apply strictly the Berlin rules for distribution of funds, and not to play an "unchanged political bargaining game" as in the earlier financial period. For Poland, as a new member state, the situation appears more promising in our scenario, with that country's economy exhibiting growth rates of four percent of its annual GDP. However, Poland's preference might not be so clear because it also would be a substantial net receiver in the DIW status quo scenarios. Since it would not change its net position substantially, Poland might opt for a strict application of existing EU rules, which also would take into consideration the interests of other important EU partners such as Germany and France.

Compared to the status quo EU-27 scenario, France would be slightly worse off under both the moderate and the radical reform DIW scenarios mainly because of reduced agricultural funds (where France traditionally has exhibited large surpluses). Interestingly, however, France would be better off with the radical reform approach than with the moderate one mainly because of the radical approach's overall reduced EU expenditures, which would decrease France's contribution as a net payer to the EU budget. Spain would gain in the moderate reform option largely because structural-funds payments would be reduced at a slower pace than in the status quo. Spain, however, clearly would lose in the radical reform approach, eventually turning into a net payer in 2013. Consequently, it is unlikely that Spain would vote for the radical option. In contrast, Germany and the United Kingdom would improve their net financial positions more dramatically with the radical reform approach, while Poland's net financial position would deteriorate slightly in both reform scenarios. However, Poland is more likely to oppose the radical reform option, especially those aspects of it (such as agricultural co-financing) that require it to assume additional financial burdens.

Our starting point for creating an improved financial system for EU budget allocation is the belief that, even in the DIW's radical reform approach, there is much room left for political bargaining about the overall amount of expenditures as well as "side" payments. One important consideration is that the design of transitional arrangements for agricultural and structural funding is primarily a political decision. Secondly, de la Fuente and Doménch (2001) showed in regression calculations that the degree of redistribution among member states (related to the net budget positions and per capita GDPs in PPS) was not equal in the past. To put it another way: Why does Ireland receive (in net terms) much more per capita related to its national wealth than does Spain, and why are Germany and the Netherlands much higher net payers than France and Denmark? As it turns out, these disparities would not be eliminated by the DIW reform proposals. Figure 2 shows that in 2013 the correlation coefficient between per capita income and net financial transfers per capita in the DIW scenario is very low (0.285) and still remains low (0.647) if we do not consider Great Britain (see Figure 2).[18] This suggests the unequal treatment toward different countries when considering income levels measured as GDP per capita.

This leads us to propose a fundamental reform of the EU financial system, a reform based on horizontal financial redistribution among member countries. Funds should be distributed according to countries' national GDP per capita, measured in terms of purchasing-power standards (PPS). Basing our ideas on the proposals of Mallosek (1999), we suggest that the maximum amount of funds be fixed in advance and presented either as a lump sum or as a specified percentage of either the EU budget or total EU GDP. This would represent a major political step, which should be taken at an intergovernmental conference in 2005. Two possibilities related to this decision need to be considered: one, to adopt this procedure only for structural-funds payments and treat spending in the agricultural sector separately or, two, to use this method for the distribution of overall spending, in the form of agricultural and structural expenditures. However, to support Eastern enlargement, EU funds should be concentrated on the lowest-income countries among the newly admitted accession states. Such a concentration is justified

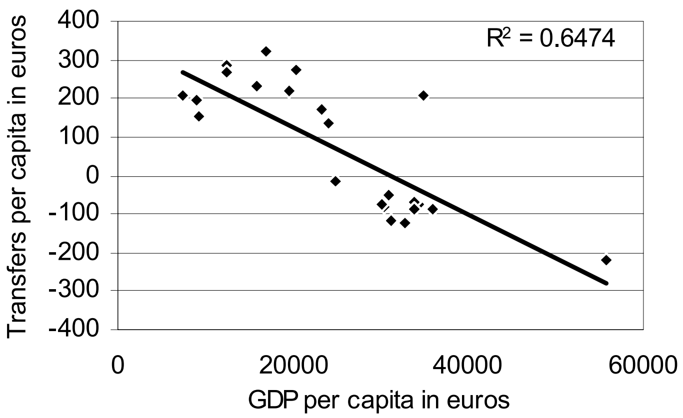
[18] Great Britain's fiscal imbalance is corrected by the British rebate, which was not considered in the DIW data.

by the fact that the poorer the country, the greater the adjustment costs connected with structural change.

FIGURE 2

Relative Net Financial Position Per Capita vs. Per Capita Incomes in the Radical DIW Reform Scenario

(2013, Great Britain not considered)



Sources: Weise et al., 2001; authors' calculations

To present our new financial scheme in detail: At the beginning of the financial period in 2007, the overall amount of structural funds should be set at a level of 0.35 percent of the EU's GDP. This is the level established until 2004, when enlargement is to begin. The amount of structural funds calculated for 2007—about thirty-seven billion euros—should stay constant in absolute terms for the whole financial period from 2007 to 2013. This would reflect the political decision to reduce structural spending over time, because GDP growth should cause the share of structural funds to shrink to 0.30 percent of the EU's GDP. The structural-fund payments would be distributed reciprocally based on the ranking of per capita GDP (measured in PPS) among member states in each financial year. Hence, the distribution of funds would alter following changes in this ranking. To determine the funds for each country, a special "distribution factor" (DF) would be calculated to represent the differences between the EU per capita GDP average and the per capita GDP of individual member countries. For example, Poland's per capita GDP would amount around fourty-nine percent lower than the EU average and Germany's twenty-eight percent higher (the DFs then would be 2.04 for Poland and 0.78 for Germany). Having thus calculated the DFs, we would be able to determine the absolute amount of funds to be distributed among member states.[19]

[19] The absolute amount of funding is determined by the following formula: Funds country i = (pop i × DF i) × (funds tot/pop tot). Funds country i = the funding for country i; pop = population of country i; DF i = distribution factor of country i; funds tot = fixed amount of total structural fund spending; pop tot = total population of the EU.

The DF also could be adjusted to fit the desired slope of the redistribution curve. To allocate more funds to new member states, we could use the square of the DF. This, however, would lead to disproportionately large funding of poorer countries, caused by the exacerbated differences in per capita GDPs. Even using the normal DF would lead to transfer payments to Bulgaria of more than twenty percent of that country's GDP. Therefore, we should consider other options. We could, for example, fix spending at the already existing cap of four percent of GDP—the threshold for absorption capacity already determined by the EU. We also could choose a flatter redistribution rate. If we opt for a flatter curve while also using the square root of the DF, this would lead to higher levels of funds being calculated for existing member states. In fact, for the poorer member states the four-percent cap or ceiling still would be required. For agricultural funding we use the amounts calculated on a yearly basis in the DIW radical reform scenario. Overall agricultural expenditures amounting to 0.46 percent of the EU's GDP would shrink to 0.26 percent, adjusted to our price basis of around thirty-two billion euros. The distribution of agricultural expenditures is given by the DIW scenario. In fact, overall spending in agricultural and structural spending would shrink between 2007 and 2013 from 0.81 to 0.57 percent of the EU's annual GDP.

The results of these calculations are presented in Table 12, in the category "New Financial System, plus Agriculture" (NFSA). Under the NFSA scenario, net-payer countries would be better off than under other scenarios, with the exception of status quo EU-15. In addition, Spain would gain compared to the DIW's radical reform scenario, with its net position in 2013 estimated at nearly 0.2 percent of GDP. However, Poland's net position under the NFSA is expected to change for the worse compared to most other scenarios, mainly because of the flat redistribution rate. From an estimated 3.02 percent of GDP in 2007, it is expected to decline to 2.02 percent in 2013. Hence, Poland might oppose this distribution scheme, although it would be no worse off than under the Berlin Agenda scenario. With the proposed redistribution rate, substantial transfers amounting to more than sixty percent of the EU budget would be retained for the old EU-15 member states. However, nearly five billion euros would be saved in 2007 and around two billion between 2007 and 2013 by setting funding for new members Bulgaria, Romania, Latvia and Lithuania at a five-percent ceiling that includes agricultural spending. These savings could be used for additional spending outside the EU, i.e., directed toward a stability pact with strategic partners beyond the EU's borders.

Nevertheless, the scenario presented above clearly exhibits some shortcomings, in addition to those related to Poland's likely opposition. Although the distribution problems are mitigated, the existing imbalances in agricultural expenditures still would lead to an uneven distribution of funds and hence to a not transparent determination of the net financial position of each member country (see Fig. 2). To avoid this problem, we could use the DF for the distribution of total expenditures, which are fixed at the same amounts as in the NFSA scenario. In this new NFSR (New Financial System, Redistribution) scenario, France and Spain would lose relative to the NFSA scenario, whereas Germany, the UK and Poland would gain. Given these unequal results, reforming the EU's financial system in the direction of greater transparency will require implementing bold decisions.

TABLE 12

Projected Net Budgetary Positions of Selected EU Member States and of Poland
(in Percentage of GNP or GDP; Years 1997, 2002, 2007 and 2013)

	Year	France	Germany	GB	Spain	Poland
Real	1997[1]	-0.08	-0.60	-0.17	1.27	-
Berlin Agenda	2002[1]	-0.17	-0.49	-0.15	1.36	-
Berlin Agenda	2007[1]	-0.28	-0.54	-0.32	1.01	2.48
Berlin Agenda	2013[1]	-0.30	-0.53	-0.28	0.79	2.63
Berlin Non-Enlargement[2]	2013[1]	-0.11	-0.36	-0.22	0.93	-
Unchanged Political Bargaining[3]	2007	-0.33	-0.61	-0.38	1.03	5.85
	2013	-0.47	-0.73	0.42	0.88	5.70
High Cost	2007	-0.33	-0.61	-0.38	1.04	5.85
	2013	-0.47	-0.73	-0.41	0.89	5.70
Status Quo EU-27	2007	-0.23	-0.52	-0.54	0.62	4.74
	2013	-0.20	-0.49	-0.49	0.16	4.71
Status Quo EU-15	2007	-0.02	-0.32	-0.34	1.31	-
	2013	0.02	-0.24	-0.25	0.88	-
Moderate Reform	2007	-0.28	-0.46	-0.48	0.65	4.20
	2013	-0.28	-0.46	-0.48	0.27	4.33
Radical Reform	2007	-0.21	-0.45	-0.47	0.56	4.13
	2013	-0.25	-0.39	-0.40	-0.07	4.21
New Financial System, plus Agriculture	2007	-0.08	-0.36	-0.34	0.25	3.06
	2013	-0.10	-0.26	-0.25	0.19	2.02
New Financial System, Redistribution	2007	-0.27	-0.32	-0.25	0.18	3.66
	2013	-0.18	-0.22	-0.17	0.13	2.31

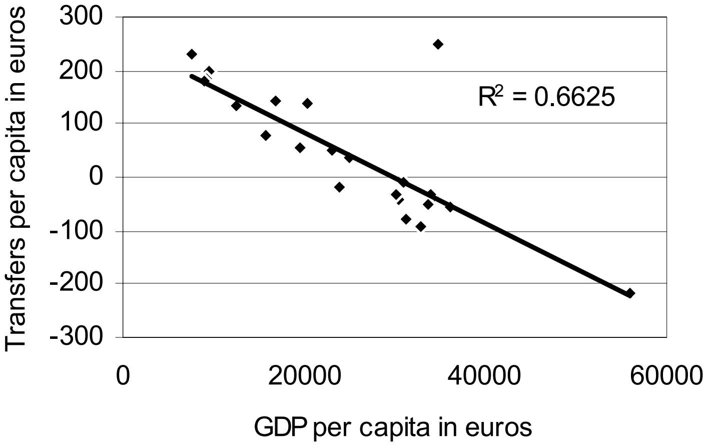
[1] in percentage of GNP; [2] Berlin calculation without enlargement; [3] unchanged-political-bargaining scenario. All assumptions behind the calculations are explained in the text.

Sources: authors' calculations; Agenda 2000 (2000b); Weise et al., 2001

Behind our recommendation to reduce spending on agriculture and structural funds by following a transparent horizontal redistribution mechanism is the firm belief that CAP (Common Agricultural Policy) and structural policy should be abolished in their existing forms and limited to regulatory supervision of national programs. The overall savings in agricultural and structural spending offer additional room for national governments to set their own priorities in regional and agricultural policy. Such priorities, however, would have to conform to the rules and legislation of the EU, especially in the field of competition. With the expected savings, the EU also could increase its spending on such vital issues as improving internal and external security, promoting EU-wide programs to improve the functioning of its internal market and monetary union, advancing EU-related education programs, and offering economic support to strategic partners outside the EU.

FIGURE 3

Relative Net Financial Position Per Capita vs. Per Capita Incomes in the New Financial System, plus Agriculture Scenario (2013)



Source: authors' calculations

6. Reforming the Central European Bank (ECB)

With accession, the new EU member states will have not only the possibility but also the long-term commitment to join the European Monetary Union (EMU)—provided they fulfill the Maastricht criteria. In signing the protocol for EU membership, the CEECs will be obliged to enter the EMU and will not be offered the choice of opting out like Denmark and Britain. Most of the potential accession countries already have achieved the Maastricht criteria with respect to their public debts and budget deficits. However, the fiscal situation remains fragile in some countries (see the current budget crisis in Poland) and the definitions of "public debt" and "budget deficit" may still differ within the EU and the CEECs. Additionally, some CEECs exhibit inflation and interest rates that are out of line with Maastricht. It also remains highly questionable whether most accession countries could reach sufficient levels of stability with regard to their national-currency exchange rates within a ERM-II framework (see Table 13).

Nevertheless, most of the accession countries already have achieved a remarkable degree of macroeconomic stability. This could be illustrated by comparing their situation with that of the Southern EU member countries in 1990 and 1991, before the Maastricht process started. Compared to Greece, Spain and Portugal, most of the accession countries belonging to the Luxembourg Round are performing better economically in all areas (see Table 13). The procedures they have undertaken for EU accession and integration, as well as a credible stability policy that complies with Maastricht criteria, are likely to have positive effects on their most important financial indicators. The Southern countries' tremendous improvements in financial stability during the 1990s clearly demonstrate the positive impact of joining the EMU.

Besides the economic criteria and technical requirements, such as embracing the *Acquis Communautaire,* the candidate countries must join the European Exchange Rate Mechanism II (ERM-II) at least two years prior to EMU accession. Candidate countries must prove that their currencies are stable, meaning that their currencies need to hover between plus or minus fifteen percent of a fixed parity established by the ECB in cooperation with their respective national banks. In fact, a currency board or a system of fixed exchange rates towards the euro—as it now exists in such countries as Estonia, Latvia, Lithuania and Bulgaria—does not, in and of itself, constitute sufficient preparation for entering the EMU. When a country with a currency-board system wants to join the ERM-II, its request has to be proofed by the EU. The central rate then will be based on an agreement between the CEEC and EU authorities. Other CEECs seeking accession must prove that, in a system of floating exchange rates, their national currencies are indeed stable, solid and credible in international currency markets. Any attempt to weaken these criteria should be rejected by the ECB and the existing member states.

However, there are few experts in the CEECs who recommend the unilateral introduction of the euro before their country fulfills the Maastricht Criteria or becomes a member of the EU. From a technical standpoint, this "euroization" (like the "dollarization" of some Latin American countries) would mean that national currencies are replaced by the euro through fixing exchange rates irrevocably or replacing their national currencies with euros. But any country taking this approach would give up its own monetary policy and any "seignorage" gains—namely, incomes from the emission of central-bank money. In addition, they would have no influence on the decisions of the ECB.

There are several possible advantages to "euroization." For one, those countries whose national currencies are integrated into the EMU can expect immediate lower rates of interest. Decreased costs of capital should promote domestic and foreign investments and reduce interest payments on debt. Countries also can expect higher levels of economic stability. Experience indicates that, over the long term, financial stability promotes economic growth.

Nevertheless, there are dangers associated with entering the EMU prematurely. If a CEEC enters before its financial system and industrial economy are mature enough to orient economic policy toward Maastricht criteria, this could lead to an overly restrictive monetary and fiscal policy that could fetter economic growth. We believe that a flexible approach would be needed, an approach that is tailored to the economic situation of the prospective country. For small, export-oriented countries such as Estonia, which is already operating with a currency-board system, a rapid adoption of the euro would be preferable, provided that its financial sector is indeed solid. When exchange rates are no

TABLE 13

Countries' Compliance with Maastricht Criteria

	Long-term interest rates in percent[1]	Inflation in percent[2]	Fiscal balance as percent of GDP[3]	Public debt as percent of GDP[3]	Currency exchange rate[4]
Maastricht Criteria					
	Ref. (7.5)[6]	Ref. (2.0)[6]	-3.0	60.0	ERM-II System[5]/Deviation from the parity: plus or minus 15%
Euro zone 2001 (estimates)					
	5.4 Ref. (6,9)[7]	2.3 Ref. (3.3)[7]	-0.8	69.5	Three steps to Currency Union, starting Jan. 1, 1999 fixed exchange rate; Jan. 2002 introduction of the euro as cash
CEEC-Luxembourg Group, 2001 (estimates)[2]					
Czech Rep.	5.3	4.8	-5.2	29.0	Managed Float (ref.: euro); Dev[9]: 4.3%
Estonia	6.8	6.1	-0.8	6.1	Currency Board (ref.: euro); Dev[9]: 0%
Hungary	6.9	9.6	-3.7	64.4	Crawling peg (ref. euro); Dev[9]: -4.2%
Poland	9.0	6.0	-4.3	42.8	Float, (ref.: euro); Dev[9]: -8.3%
Slovenia	n.a.	8.6	-1.1	25.5	Managed Float (ref. euro); Dev[9]: 7.4%
CEEC-Helsinki Group, 2001 (estimates)[2]					
Slovakia	7.7	7.6	-5.2	42.7	Managed Float (ref.: euro); Dev[9]: 1.7%
Latvia	10.2	2.9	-2.2	10.2	Peg (ref.: currency basket); Dev[9]: 4.2%
Lithuania	6.3	1.5	-1.4	25.0	Currency Board (ref.: euro); Dev[9]: 7.6%
Romania	49.2	35.0	-4.0	30.7	Managed Float (ref.: USD); Dev[9]: 38.6%
Bulgaria	5.0	7.7	-1.7	97.5	Currency Board (ref.: euro); Dev[9]: 1.5%
EU-Southern Countries 1990/91					
Portugal	16.8	12.4	-5.1	64.2	Float
Spain	14.7	6.5	-4.3	43.2	ERM[5]
Italia	13.4	6.4	-11.0	97.3	ERM[5]
Greece	n.a.	15.6	-12.8	97.5	Float
Group Averages					
Luxemb.	8.2	6.9	-3.1	34.4	
Helsinki	14.7	10.9	-2.9	41.2	
Sl., Lat., Lit.[8]	8.1	4.0	-2.9	25.9	
EU-South	15.0	10.2	-8.3	75.6	

[1] For the euro zone and if available for the CEECs, interest rates for ten-year state bonds; shorter maturities taken for Bulgaria, Estonia, Latvia, Lithuania, Romania and Slovakia. [2] Inflation rate for consumer goods. [3] Definitions might differ from those of the EU. [4] For the CEECs, deviation from the last three-year average exchange rate against the euro. [5] EMS: European Monetary System.[6] For interest rates, maximum of two percentage points above the best performers; for inflation, maximum of 1.5 percentage points above the best performers; reference values during the euro introduction (beginning 1999). [7] Reference values during autumn 2001. [8] Slovakia, Latvia, Lithuania. [9] Dev: Deviation.

Sources: Osteuropa-Institut München (2001), DB-Research (2001), Gros (2000) longer flexible, all adjustments will be left to the "real" economy. In the case of weakening competitiveness, wages have to adjust or high unemployment will occur. Additionally, fiscal policy has to be kept tight in order to avoid financial crises that would end up damaging the economy as a whole. In fact, a rapid "euroization" would intensify pressures for structural and institutional changes. The crisis in Argentina may serve as a warning example for a premature fixed-exchange-rate system where reforms failed to improve the flexibility of factor markets and the competitiveness of industries. Will CEECs be able to cope with these challenges?

European monetary policy undoubtedly will become more complicated when the CEECs integrate. This is because the structural differences and varying trade orientations between Western and Eastern Europe might cause different adjustment reactions in their real economies. Adjustment reactions could include external shocks arising from swings in oil prices, as well as instability stemming from external financial crises (asymmetric shocks) that affect an EU member country. Because the EMU zone can have only one monetary policy, no measures like exchange and interest rates will exist to mitigate different and desired adjustments in the real economy of one or more member countries. Since the euro is relatively weak against the US dollar, there has been (at least until the writing of this working paper) no "hard test" of a single EMU member state's ability to adjust to an increase in competitive pressure from outside this monetary zone. However, sizeable currency-account deficits already have emerged—as large as three to four percent of GDP in Spain and Greece and up to twelve percent in Portugal. These deficits normally are financed within the framework of the EMU. Still, if they turn out to be chronic and are the result of structural forces, they might, when combined with a crisis in the financial sector, engender problems that spill over into the larger euro zone.

We also need to consider that the existing member states of the EMU face potential dangers when countries with large differences in economic development and structures enter. As more and more countries with levels of per capita GDP well below the EU average enter the EMU, the monetary-policy priorities of the European Central Bank inevitably will become a source of conflict. We expect that some of the CEECs will experience a "catching-up" process that results from higher rates of growth of factor productivity, especially in the sectors involving tradeable goods. Different rates of productivity growth in tradeable and nontradeable sectors well may contribute toward the buildup of inflationary pressures (the so-called Samuelson-Balassa Effect). If this be the case, an early entry of the CEECs into the EMU might cause an upward pressure on the average level of prices, and hence induce at the very least a measurable rate of inflation in the EMU zone.

With substantial differences in the causes of inflationary pressures and their manifestations in rates of inflation among EMU member countries, even an acceptably adequate monetary policy is going to be extremely difficult to achieve. Since the composition of the ECB Council likely will change in favor of countries that are catching up with the EU average, there might be additional dangers for the larger EMU member states. We expect to observe at least two possible reactions.

First, if majority voting by the ECB Council takes on a more restrictive posture in the face of higher overall inflation rates, this would decrease the rates of economic growth in major EU countries. Secondly, if the ECB's future board members orient themselves more toward promoting short-term economic growth and an expansionary monetary policy, the euro zone likely would suffer from a higher rate of inflation. Either way, a consistent and fair monetary policy would be difficult to achieve. Additionally, an ECB Council with members representing the twenty-five or even twenty-seven countries making up the EU after Eastern enlargement scarcely would serve as an example of streamlined management. The criteria for the formation of the ECB's Board of Directors should be reformed before Eastern enlargement proceeds much further (Baldwin et al., 2000). A rotation of votes seems to be unavoidable. If the balance between the ECB Board of Directors and the ECB Council is to be kept consistent, this inevitably implies assigning relative weights to votes—a politically sensitive procedure. In addition, rules for a country's entry into the EMU should include evidence of progress toward convergence.

V. Conclusion: The Road Toward Agenda 2007

Eastern enlargement is a worthwhile project—an undertaking that is deserving of full support by all current and aspiring EU members. History teaches us that since its start in the 1950s the European Coal and Steel Community and the ensuing organizations leading up to today's EU successfully have fostered economic integration. In turn, economic integration has engendered a comparatively high level of prosperity, which now is widely shared among the more than 300 million EU citizens. Such a broadly shared prosperity has served as the foundation for Europe's peace as well as its internal and external security. And these, in turn, will help to secure Europe's economic prospects for the long-term future.

Consequently, there are good reasons for yet-greater amounts of funds to be contributed by the existing member states. Further reforms nevertheless are needed to keep costs under control and to ensure that an expanded EU remains operational with what likely will include twenty-seven or even more member states by the second decade of the twenty-first century. Reforms should improve the organization of EU institutions and better its agricultural and structural policies. Improving the performance of the European Central Bank also will be necessary to cope with the challenges of Eastern enlargement.

Many problems would be solved if the EU were to make an institutional and organizational shift away from its existing status toward something more on the order of a federation of states. However, a united Europe cannot be built following an idealistic blueprint, and no single European summit can be expected to bring a fundamental breakthrough achieving the EU's final form. We believe that the old method of modifying the Union without any final design in mind ("Monnet's proceeding") should be replaced by a dialogue regarding its *finalité*. Considering the fact that Eastern enlargement will endanger the operation of the Union, any partial solution to pressing problems needs to fit a coherent concept. If this is not the case, the centrifugal forces of the Union could cause it to spin apart, or to face a paralysis making it unworkable. But it remains important to consider that European integration has been "path dependent" since it was initiated in the wake of the destruction left by World War Two. The Union's institutional evolution has always involved and will continue to involve a step-by-step solution of various problems, including those arising from Eastern enlargement (see Table 14 for plausible scenarios toward Agenda 2007).

Our vision of a well-functioning Union with twenty-seven or more members is that of a "Federation of European States" whose overriding paradigm should be *subsidiarity, solidarity* and *competition*. *Subsidiarity* implies that the legislative and executive powers of the Union are strong and prevail in those areas where only EU institutions can treat major policy questions effectively. With respect to economics and finance—which are of major interest to us in this paper—the Union should improve its handling of legal and competitive issues in the single market. Additionally, the EMU will require a close coordination of major economic-policy areas, especially in economic and fiscal policy. Apart from some general regulations to ensure that agricultural markets function properly and that income-support measures are not distorting competition, agricultural and rural policy should be shifted toward the administrative control of nations or even regions. This also could hold for structural policy, which we believe should be concentrated on producing EU-wide public goods. Regional policy should be left to the competence of single member states.

The second-mentioned principle, *solidarity*, comes into play when the Union promotes the convergence of member states that are far behind the EU average in per capita income. We recommend a newly designed "cohesion" fund, which would provide additional support to low-income EU member states with a consistent economic program. This financial redistribution—as outlined above—should be limited and be based on general guidelines (only investment expenditures) in order not to undermine the principle of *competition,* especially with respect to tax policy. In the long run—in the context of a federation of European states—we recommend an automatic financial transfer system. This system should be based on a clear and transparent mechanism that allows for a fair distribution of funds according to the relative wealth of each nation.

With this "Federation of European States" as a goal, a number of major steps must be made before 2007. The accession negotiations in the last quarter of 2001 and in 2002 not only should establish the terms of reference under which the new member states enter the Union but also should determine how the old member states are affected by enlargement. It would not be ideal if the entering CEECs were treated as second-class members of the Union, although they will have to endure financial "transitional periods" up to 2006. Hence we suggest that measures be taken to streamline EU policies and to make them more effective and financially solid, thus allowing sufficient levels of funds to be available as transfers to the CEECs. Can this be done?

We believe that a window of opportunity exists to make such changes before the end of 2004, when the first CEECs are expected to enter. Negotiations on enlargement are not affected by this time frame because accession countries must take over the *Acquis Communautaire* before they enter, but it nevertheless is politically important to integrate them already in the decision-making process. So, what are the steps ahead? After the 2002 elections scheduled to take place in many European countries, including France and Germany, a realistic possibility exists that the EU's mid-term review of agricultural policy will engender major reforms. In this area, it is most important that a firm decision be made and supported in order not to return to the "agricultural guideline"[20] but to stick to smaller increases in the agricultural budget. WTO negotiations in succeeding years will encourage further reforms (especially delinking direct payments from the means of production), which then should allow the EU to incorporate CEECs under fair and equal terms. With respect to structural policy, we recommend the adoption of a provisional deal, based on the principle of "burden sharing." Such a deal must be made—especially

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[20] The agricultural guideline determines the increase in the agricultural budget of 0.74 percent out of a one-percent increase in the EU's GDP. During the last years the increase was in fact limited to an increase of 0.52 percent.

with Spain—in order successfully to complete the accession negotiations by the end of 2002 or 2003.

However, net payers, especially Germany and Austria, can be expected to dig in their diplomatic heels if they are forced to give up their priority of a rapid enlargement and their demand for transitional periods with respect to their labor markets. Such transition periods seem to be acceptable to all countries because they also were used at the time of the Southern enlargement. In addition, accession countries are demanding transitional periods for foreign citizens' attempts to buy land in the CEECs, particularly in Poland, land that largely has been closed to foreign purchase since the end of World War Two.

The next important step should take place at the intergovernmental conference (IGC) planned for 2004. Already at the Laeken Summit in December 2001, member states started to clarify their positions for the upcoming conference, agreeing on an ambitious approach. The conference should address the core problems and determine the basic competencies (decision-making power at the EU, national and regional levels) constitutional issues (role of the EU-Parliament, EU-Commission and European Council) and decision-making procedures of the EU. In fact, it should proceed to revise the Nice Treaty. Majority voting could be decided more precisely when competencies are clarified. In addition, the conference should serve as an opportunity to delegate responsibilities for agricultural and structural policies to member states. The final outcome should be a European Constitution.

It remains an open question whether EU member states will be willing to accept the far-reaching changes that could be classified not so much as reforms but as a reconstitution of the European Union itself. However, it is promising that at the EU summit meeting in Laeken European leaders decided to change the procedure for the intergovernmental conference (IGC) in 2004. By creating a special constitutional convention to meet from March 1, 2002 on, European governments may have changed forever the way to launch EU reforms. This even could help the EU achieve greater support from its population. The convention, headed by the former French prime minister Valéry Giscard d'Estaing, is made up of fifteen representatives of EU member states (one for each state), thirty representatives of national parliaments (two for each country), sixteen representatives of the EU parliament and one representative of the European Commission. In addition, the accession countries will send their own representatives (following the above formula), though these will not have a voice in the actual decision making until their countries become full-fledged EU members. The convention approach may constitute a substantial step forward in overcoming the "horse-trading" procedure of the IGCs. However, final decisions on reforms will have to be made at an IGC.

We hope far-reaching reforms will be launched at the IGC in 2004—reforms that will include the decision on a EU constitution. Nevertheless, we expect that details in major policy areas will have to be negotiated later within the framework of a new Agenda 2007. The negotiations on this agenda likely will begin in 2005 and should be finished in 2006. The agenda not only should address the financial perspective of the years 2007 to 2013 but also should propose a new design for EU policies. The outcomes of these policy decisions will determine the EU's financial plans from 2007 through 2013. If there are any leftovers from the IGC 2004, Agenda 2007 should complete the process of introducing major reforms in EU institutions—reforms that should lead to more efficient, transparent and legitimate decision making. We expect and hope that Agenda 2007 will serve as a major breakthrough for the future of a United Europe.

Reforms are needed not only because the EU is expanding to absorb the CEECs but also because European economies are faced with the ever-growing challenge of global competition. Successfully implementing effective reforms also will help convince the citizens of Europe that fulfilling the high ideals of unifying Europe, as expressed in the Treaty of Rome in 1957, is indeed a worthwhile project deserving of broad support.

TABLE 14

A Road Map to Agenda 2007

2001-2002	Negotiations over Eastern enlargement
2002	Elections in many European countries, among them France and Germany
End of 2002; beginning of 2003	Mid-term review of agricultural policy
End of 2002; beginning of 2003	End of the negotiations over enlargement, important decisions on the terms of entry for the first round of accession countries
2003	Checking of cohesion-funds criteria (Ireland probably will be excluded from funding)
2003	Intensive negotiations in the WTO round on agriculture and other conflicting issues
2004	Intergovernmental conference on the European Union's decision-making structures
2004 or 2005	First accession countries enter the European Union
Our proposal: 2006	New intergovernmental conference: Agenda 2007, on the financial perspective for the years 2007-2013 and further institutional and policy reforms

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