Arbeiten aus dem

OSTEUROPA-INSTITUT MÜNCHEN

Working Papers

No. 240 February 2002

Toward Agenda 2007:

Preparing the EU for Eastern Enlargement

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ISBN 3-921396-73-5

* The authors would like to thank Manfred Wegner, Franz Neueder, Roman Czech, Norbert Mühlberger, Volkhart Vincentz and other colleagues not mentioned here for their insightful comments on various drafts of this working paper. In addition, we are grateful to the Alexander von Humboldt-Stiftung of Bad Godesberg, whose generous support allowed us to work together in Munich over a period of some months. This working paper is partly based on the authors' article "Making the European Union Fit for Eastern Enlargement," published in the 3/2001 issue of *International Politics and Society (Politik und Gesellschaft),* the journal of the Friedrich-Ebert-Stiftung. With all due consideration for the generous assistance of others, the authors take full responsibility for the contents, and especially the points and positions developed in this working paper.

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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."