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Enlarging the EU: How Can the Costs be Minimised?

Enlargement of the EU will be associated with many costs for all participants – the prospective new members, the old memebers and the EU institutions. A strategy should be pursued that reduces the economic costs as far as possible. This implies a postponement of enlargement until the conditions are more favourable.

Eastward enlargement is next to the euro right at the top of the EU's policy agenda. By the year 2003 five East European countries – the Czech Republic, Poland, Slovenia, Hungary, and Estonia – are expected to join the EU-15. This is a very compressed timetable for such a complex project especially when one takes into account the economic problems of the East European and EU economies. The situation is aggravated by the EU's institutional shortcomings when it comes to such a large project. Also, the plan for enlargement comes at an inconvenient time, since the EU has just deepened its integration from the Single Market to the European Monetary Union (EMU). These are fundamental arguments that point to the necessity of a slower and more cautious strategy of enlargement than that proposed by policymakers.

This paper argues that prior to enlargement the economic, political, and institutional conditions of all the participants have to be improved in order to increase the overall absorption capacity. Only then will enlargement come at reasonable cost, while a hasty strategy is likely to lead to substantial economic costs for all participants. These costs could come in the form of a Europe of different speeds, which would break up the EU's international weight, or, even worse, could lead to an overall stagnation of the European integration process.

An Overview of the Costs and Benefits

The following brief overview of the common costs and benefits for the different groups affected by enlargement neglects the welfare effects of enlargement on the rest of the world, focusing on the EU prior to and after enlargement.

In the *accession countries* the main benefits arise from free access to EU markets. They are based on more efficient allocation, on the growth-inducing accumulation effects of factors (including technological and know-how transfer), and on locational effects, i.e. the improved geographical allocation of economic activities and lower transaction costs.[1] The market enlargement effect allows Eastern European countries to make use of economies of scale or even engage in product differentiation (less likely) where appropriate. In addition it is likely that foreign direct investment flows will increase mainly due to improved economic conditions for investors, such as reduced uncertainty because of increased macroeconomic stability. Another reason for increased investment activities is the lower labour cost/productivity ratio in the accession countries compared to those in the current EU member states. EU membership will also lead to improved international credibility as the new members have to comply with most of the EU provisions and policies; there is thus less leeway for destabilising policies. Other gains[2] will be experienced due to the possibly increased support of the transformation process towards a market economy by the EU in whose interest it is that the East European countries raise their development level. Having access to the EU's various regional funds will also be of benefit to these countries if granted.

The East European countries will also incur high costs of membership. One aspect is the partial loss of policy autonomy. Policy decisions in many cases will have to be in line with the interests of the EU as a whole, like a stricter environmental policy which might not fully reflect their greater environmental absorption capacity. To what extent this problem will materialise will depend on the coalition building of the poorer economies in an enlarged EU and on their ability to influence EU policymaking. Conflicts may also arise

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[1] Richard Baldwin: Towards an integrated Europe, London 1994, Centre for Economic Policy Research, pp.159f.

[2] For a brief overview of other gains from integration, see Philipp von Carlowitz: Regionalism and its Consequences for the World Economy, in: M. Stierle (ed.): Globalisation: Effects on Enterprises, Employment and Government, INFER Research Edition, Vol. 1, Berlin 1999, Verlag für Wissenschaft und Forschung, pp. 17-37.

with regard to the acquis communautaire which was written for relatively rich countries and is therefore in many respects not appropriate for the transformation economies in Eastern Europe. This can lead to policy inefficiencies.[3] The countries are required to accept the entire acquis communautaire, which is "...a heroic task to accomplish",[4] since the adjustment of the economy to the various EU standards is costly. These adjustment costs are slightly mitigated because the East European countries have implemented many standards while building up, for instance, their infrastructure and production sites. Further costs arise from the need for institution-building, including the creation of credibility for required state institutions after the negative experiences under socialism. These institutions have an important role for development and are required to implement and govern the new challenges arising from EU membership.[5] The reluctance of EU members to liberalise their sensitive sectors (45-55% of export volumes to the EU are subject to trade restrictions, which happen to be those sectors in which the East European countries tend to have their comparative cost advantages) creates another important set of problems.[6] The above-mentioned gains from free access to EU markets are substantially reduced. In addition, a restrictive EU agricultural policy can lead to severe misallocation in the East European economies because production is redirected from comparatively competitive agriculture to relatively less efficient industrial production which is not protected by the EU. In addition, should the restructuring exceed the countries' structural transformation capacity then it can initially lead to high unemployment rates and increased poverty in the Eastern European economies, because of high employment rates in the agricultural sector in Eastern Europe (between 6% and 27% of total employment[7]). The associated hardships can only be reduced by a gradual transition to more industrial production.

Overall, it is not at all obvious that the five accession countries will manage to fulfil all of the accession criteria set by the EU in time: a functioning market economy, the capacity to deal with competitive pressure (minimum development level), and the financial ability to assume the obligations of membership.

In the *EU member countries:* benefits could arise in the medium run in terms of new secure markets. This presupposes strong economic development and growth in Eastern Europe. There will be some advantages in terms of the relatively cheap production of labour-intensive goods in geographically proximate locations. On the same note, the external competitiveness of the EU might be slightly improved by migration as it may lead to lower EU average labour costs (realistically assuming wage levels do not adjust to western levels straight away) so that negative employment effects might be partly offset.[8] An indirect economic benefit is the political stability that EU membership is likely to enhance in these countries. This will make it easier to create strong trade bonds and engage in foreign direct investment. Old EU members could make use of the – in some cases – still strong trade links to other Eastern European countries and Russia. Should the EU remove trade barriers in the "sensitive sectors", then the EU would experience major positive consumption effects and dynamic gains from increased competition.

The financial burden of enlargement will be substantial under the existing system. As the new accession countries all have an income level far below the EU average they will be eligible for money from various EU Funds. This will mean one of two things:

☐ those groups (farmers, small and poorer regions) currently benefiting from the Funds will lose some of the money and will hence oppose the accession or at least the participation of these countries in the distribution of existing funds;

☐ alternatively, the volume of the Funds would need to be increased substantially. This will be opposed by the net payers into the Funds.

Similar problems will occur in the agricultural sector, which is large in all of the accession countries.

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[3] Richard Baldwin, Joseph Francois, Richard Portes: The costs and benefits of eastern enlargement: the impact on the EU and central Europe, in: Economic Policy, Vol. 24, April 1997, pp. 128.

[4] Willem Molle: The dynamics of economic integration and cohesion in the EU: experiences from the past and challenges for the future, in: M. Fischer, P. Nijkamp (eds.): Spatial dynamics of European integration: regional and policy issues at the turn of the century, Berlin 1999, Springer, p. 159.

[5] For criticism of the acquis communitaire and the role of institutions, see Horst Tomann: Die Osterweiterung der Europäischen Union aus ökonomischer Sicht, Diskussionsbeiträge des Fachbereichs Wirtschaftswissenschaft der Freien Universität Berlin, No. 28, Berlin 1999, pp. 22 f.

[6] Andreas Cornett: The Problem of Transition and Reintegration of the East and Central Europe: Conceptual Remarks and Empirical Problems, in: M. Fischer, P. Nijkamp, op. cit., p. 267.

[7] Paul Welfens: Economic Aspects of the Eastern Enlargement of the European Union, in: Berichte des Bundesinstituts für ostwissenschaftliche und internationale Studien, No. 7, Cologne 1999, p. 9.

[8] András Inotai: Wirtschaft, in: Bertelsman Stiftung Forschungsgruppe Europa (ed.): Kosten, Nutzen und Chancen der Osterweiterung für die Europäische Union (3rd ed.), Gütersloh 1999, Verlag Bertelsmann Stiftung, p. 35. The magnitude of this offsetting effect is going to be low since wages tend to be sticky downwards (due to strong trade unions, for instance). At the same time the positive employment effects will accrue to low wage areas that benefit directly from the increased EU competitiveness. So the gains will be distributed unevenly.

Strong competition for existing agricultural producers in the EU is likely to evolve should the new members get access to the EU subsidies. An interesting aspect is associated with the Structural Fund under Objective 1 (a region with less than 75% of the EU's GDP/capita average): eastward enlargement will lower the average income of the EU so that some countries that are currently eligible for funds will rise above the 75% benchmark and will lose the funds. The share of EU population that lives in Objective 1 areas will rise from 25.2% (EU-15) to 41.7% (EU-26).[9] All of these aspects point towards the necessity to reorganise the financial transfer system, especially since 80% of the EU budget goes into the Common Agricultural Policy (CAP) and the Structural Funds.

With respect to investment flows it is conceivable that some of the investment volume of the richer EU member economies (and even of international investors) will be redirected from the economically weaker EU members to the new members. Further, if the expected increased influx of migrants occurs, it will put a strain on the labour markets and social systems of the richer EU countries, especially those in the geographically proximate Germany.[10] So far there is no proof of substantial migration; we shall have to await the time when the Eastern European countries join the Common Market.

The EU's reluctance to liberalise the sensitive sectors is economically not sound and only represents the concerns of strong interest groups. The volume of EU imports of sensitive products from these countries accounts for no more than 5% of total production of each of the relevant EU sectors. Sereghyova goes even further and argues that opening up the EUs' sensitive sectors can lead to benefits for EU producers if it induces product differentiation. Also, as the wage/productivity ratio is increasing due to rising wages the initial cost advantage gradually diminishes.[11] Specialisation and competition arising from trade liberalisation yield gains from trade for both sides.

Lastly, there is a general and perceivable danger that the goal of price stability will be softened in order to partly finance enlargement. This would lead to a loss of credibility and endanger the internal and external value of the euro and discredit the European Central Bank. The effects of enlargement on the fickle euro depend on their intensity, on the level and speed of integration at which the East European countries will join the EU.

EU as an institution: A possible positive effect is the increased bargaining power on the international level due to the increased economic strength (which will grow as the Eastern European countries develop).[12] Considering the substantial institutional problems the EU currently faces, the main benefit for the EU as an institution may lie with the induced pressure to follow through with required reforms. The reforms need to be aimed at increasing institutional capacity and efficiency. An increase in the number and diversity of the members of the various EU decision-making bodies makes the decision-finding process increasingly complex, which leads to increased transaction costs and delayed decision-making. This reduces the ability of the EU to act efficiently.[13] The EU has become aware of its institutional shortcomings especially with reference to the potential addition of 12 new members. This initiated the EU summit in Nice at the end of 2000. Expectations were high but to a large extent the results were disappointing. As it turned out, the proposed rules for the decision-finding process were more complicated rather than less. The good news is that as of 2005 another 35 chapters will be subject to a qualified majority vote in the EU Council, facilitating the decision-making process in these areas. The bad news is that important areas like cohesion, tax regulations, and social legislation do not fall under qualified majority voting. At the same time the process of qualified majority voting has been complicated, rendering it less efficient:

☐ the qualified majority will require 75% of the Council's votes (instead of 71% as at present) when the EU has expanded to 27 members. This is the result of the new weighting system of votes in the Council, making a decision in a wider union more difficult (and blocking a decision more easily) than in the currently smaller union;

☐ the decision has to be voted for by at least half of the members or in some cases even by two thirds;

☐ on request it has to be checked if the population of the supporting countries covers at least 62% of the

[9] Paul Welfens, op. cit, p. 14, Table 4b.

[10] El-Shagi El-Shagi: Die EU-Osterweiterung und ihre Konsequenzen für Deutschland, in: Wirtschaftsstudium (WISU), Vol. 29, No. 4, 2000, pp. 596f.

[11] From 1993 to 1994 the wage increase in the Czech Republic was 20% but productivity increased only by 1.8% (for the whole economy). For the other accession countries the figures also indicate a rising wage/productivity ratio (figures form Jana Sereghyova: Auswirkungen des EU-Beitritts zentralosteuropäischer Transformationsländer auf die Erzeugnisse und den Handel mit sensitiven Warenarten, in: Roland Döhm: Osterweiterung der EU – neue Chancen für Europa?, Berlin 1998, pp. 31-50.

[12] For a qualification of this argument, see Philipp von Carlowitz, op. cit., p. 20.

[13] Andreas Cornett, op. cit., p. 260.

EU's total population. These three conditions have rendered qualified majority voting less efficient than it is currently (Annexes I and II of the Treaty of Nice).

The structure of representation in the different institutions remains biased in favour of small and relatively lesser developed countries, which are over-represented. Nice has changed nothing on that front since the new weighting system did little else but confirm the over-representation. Concerning the new weights in the EU Council it can be seen that Ireland has 1/22 of the population and 1/25 of the GDP (PPS) of Germany, yet it holds 1/7 of the votes of Germany in the Council. For Estonia the figures are even more extreme: it has 1/58 of the population and 1/155 of the GDP (PPS) of Germany but 1/7 of the votes that Germany has in the Council. As this distribution of power in the EU institutions hurts the wealthier countries it could lead to disintegration pressures unless a reform of representation in EU institutions is carried through, which is a lengthy process. The institutional deficits remain even after Nice.

The various problems with the budget (Structural Funds and subsidies) also remain, and the CAP reform in the Agenda 2000 leads to no real reduction in protection but rather to a change in the structure of protection.[14] Deubner[15] is pessimistic about the sanctifying effects of enlargement leading to the badly needed reforms; he sees enlargement as aggravating the ailing institutional system due to a further differentiation of institutions and procedures because of the greater number of members and interests; and Nice has done little to change this danger. Also, if enlargement leads to an increase in the size of the EU administration, inefficiencies and more red tape could result unless institutional efficiency is increased concurrently.

We have shown that there are costs and benefits for each group. What has become clear is that substantial reform and adjustment is needed in all the groups discussed in order to avoid the negative effects that an enlargement is likely to carry in the short run.

Will Enlargement Enhance EU Welfare?

Enlargement will tend to increase the net welfare of the integration area the greater the degree of cultural, political and economic homogeneity with the new accession economies. Economic homogeneity[16] refers mainly to similarity in economic development levels. The more similar the development level, the more neutral the economic effects of enlargement. This means that the GDP/capita of new members would not lower the average GDP/capita of the existing integration area. In addition, the higher the development level of the new members, the greater will be the increase in positive welfare effects arising from free market access, like gains from overlapping demand, the use of economies of scale, product differentiation and increased competition. At the same time the costs associated with dissimilar development levels can be avoided, like the greater difficulty finding consensus, the greater diversity of the effects of policy decisions within the integration area and the more uneven distribution of the gains from integration. Hence a similar development level is important for successful enlargement.

A consequence of economic, cultural and political homogeneity is the inducement of intra-industrial trade, which tends to give rise to dynamic gains from trade. Intra-industry trade is prominent when income levels are high, and it is all the higher, the more differentiated preferences are, and the more similar the trading partners are in terms of factor endowment and technology, and when economies of scale and product differentiation exist. The welfare gains are achieved in terms of lower costs per unit and increased product variety. A more dynamic welfare-enhancing aspect is that of the tendency for competition to be stronger with intra-industrial trade than with inter-industrial trade because product varieties tend to be comparatively close substitutes.[17]

Another frequently cited condition is the share of intra-regional trade: the higher it is ("natural trading partners"), the greater will be the benefits from liberalising trade as a large amount of trade is positively affected and less trade diversion takes place. This and lower transport and communication costs within a region cause world trade to be organised mainly on a regional basis. This increases the efficiency of exchange and leads to further specialisation.[18] This criterion – and there are others[19] – already shows that

[14] Hugo Dicke: Agenda 2000, in: Wirtschaftsstudium (WISU), 28, 4, 1999, p. 460.

[15] Christian Deubner: The enlargement: Transforming Western Europe, in: V. Price, A. Landau, R. Whitman (eds.): The Enlargement of the European Union, Issues and strategies, London 1999, Routledge, pp. 119-121.

[16] In traditional trade theory economic heterogeneity usually refers to differences in productivity or factor endowments that lead to gains from trade. These are static gains that arise from an improved division of labour. In a broader sense economic heterogeneity could refer to the economic system, for instance.

[17] Miroslav Jovanovic: International economic integration, Limits and prospects (2nd ed.), London 1998, Routledge, p. 95.

[18] Paul Krugman: The Move Toward Free Trade Zones, in: The Economic Review, Vol. 76, 1991, pp. 5-25.

[19] Increasing heterogeneity in development levels, increasing institutional problems, and increased lobbying by protectionist interest groups as competition gets continuously stiffer.

the idea that the greater an integration area is, the more extensive is the division of labour, which means increasing welfare for the integration area, does not hold in reality. Paradoxically one global integration area (free trade) is optimal, but discriminatory integration is unlikely to lead to free trade as there are limits to the size of this type of integration.

The extent to which the conditions presented relate to the EU-15 situation and how they refer to that of the Eastern European economies is shown in Tables 1 and 2.

A share of intra-regional imports of well above 50%, for most economies well above 60%, in the EU-15 indicates that according to this criterion integration has initially led to substantial welfare increases. This says nothing, however, about world welfare, which could well have decreased.

Looking at the other figures, however, it becomes fairly obvious how diverse economic development levels and structures are in the EU-15. This can best be seen from the GDP per capita which varies from 35,486 euro (Luxembourg) to 13,330 euro (Greece). This is nearly a threefold spread in per capita income, which crudely indicates the extent of differences in development levels. In addition there seem to be very different growth dynamics, as can be seen from the wide spread of growth rates. This could hint at some institutional problems in some EU economies, e.g. Germany. Also, looking at the degree of openness, it can be seen that the export/GDP ratio varies greatly among countries. As to the composition of GDP there is considerable divergence between a country like Greece (8.5%) and Luxembourg (1%) with respect to the share of agriculture in GDP. For the services/GDP ratio the divergence is similar between Ireland (54%) and Luxembourg (77%). In addition the diverse structure of the economy – e.g. very open (Luxembourg, Ireland) to fairly closed (Greece) or a low share in GDP of the agricultural sector (Luxembourg) and a much higher dependence on agriculture (Greece) – hint at the extent of differing interests and hence the associated decision-finding problems at the EU level.

These diverse figures clearly indicate that the conditions for intensive intra-industrial trade within the EU-15 and between all the members are not fully existent. High intra-industrial trade indices are usually higher for trade amongst the more developed EU members. It is thus France, the United Kingdom, and Germany that show an intra-industry index of around 0.8, whereas relatively lesser developed countries like Ireland (0.53), Finland (0.48), and Spain, Italy and Sweden (each 0.61) have lower indices. The East European countries more or less compare to the weaker of the old EU economies' intra-industry index, with the Czech Republic (0.62) leading and Poland (0.41) trailing behind. It needs to be pointed out, however, that these indices have risen continuously between 1991 and 1996.[20]

It can be seen that the EU is already marked by a wide range of development levels and structural heterogeneity impairing its efficiency and welfare. This is going to be aggravated by enlargement as the figures in Table 2 show.

It is the high share of imports from the EU and the degree of openness which compare well with the EU figures. The current account deficits of all accession countries can be largely explained by the high share of imports from the EU and underlines the strong trade dependency on the EU. One could argue that the EU-15 and the Eastern European countries are "natural trading partners".

All other figures indicate huge discrepancies between the EU-15 countries and the 5 new accession countries when comparing the two tables. Despite some strong growth years, the difference to growth in the EU-15 is not substantial enough to expect the five countries to catch up soon in terms of per capita income, especially since their growth rates have been fluctuating greatly in the 1990s. Estimates on the basis of different policy and growth rate scenarios come to the conclusion that it will take anything from 10 years upward (by far the most favourable case) for accession countries to reach a development level similar to that of the poorer EU-15 economies.[21] This definitely exceeds the time-frame of the policymakers' date of 2003.

The GDP/capita (PPS) of the richest accession country, Slovenia, is roughly the same as that of the poorest EU-15 economy (Greece) and only 64.7% of the EU average (1998). Along this line, eastward enlargement will lower the EU average GDP/capita from 21,155 euro to 18,406 euro. The overall GDP/capita index will fall to 75 (from 89 after the last enlargement in 1995).[22] This indicates a strong redistribution effect of enlargement from old members (mainly the weaker ones) to new members, which is likely to lead to opposition by the former group of countries.

[20] Jarko Fidrmuc: Restructuring European Union trade with central and eastern European countries, in: Atlantic Economic Journal, Vol. 28, No. 1, 2000, pp. 83-93.

[21] Marie Lavigne: Conditions for accession to the EU, in: Comparative Economic Studies, Vol. 40, No. 3, 1998, pp.38-57.

[22] EU Commission: Agenda 2000, Luxembourg 1997, p. 22. The calculation here was made for all the East European economies that are negotiating EU accession and not only for the five economies this paper looks at.

Table 1
Key Economic Indicators of the EU-15 (1998)

	Annual growth rate of GDP[1]	GDP at market prices (current series PPS per head)[2]	Current account balance at current prices (% of GDP 1997)[2]	Exports of goods and services as % of GDP[2]	Imports from EU (% of total imports)[2]	GDP composition by sector[3]		
						Agriculture	Industry	Services
B	2.7	22,542.0	5.2[4]	73.7	62.6[4]	1.9	27.2	70.9
DK	2.5	24,082.0	0.2	36.2	70.3	4.0	27.0	69.0
D	2.2	21,797.0	–0.2	29.2	58.3	1.1	33.1	65.8
EL	3.7	13,330.0	–0.4	18.7	65.1	8.5	23.5	68.0
E	4.0	16,289.0	0.4	27.8	68.5	3.4	33.3	63.3
F	3.1	19,956.0	2.8	26.4	67.6	2.4	28.4	69.2
IRL	8.9	21,668.0	2.7	91.2	61.5	7.0	39.0	54.0
I	1.5	20,286.0	2.9	28.6	61.6	3.3	33.0	63.7
L	5.0	35,489.0	–	115.6	–	1.0	22.0	77.0
NL	3.7	22,754.0	5.8	62.8	57.7	3.2	27.5	69.3
A	2.9	22,432.0	–2.4	45.5	73.3	1.4	30.8	67.8
P	3.5	14,986.0	–4.8	33.9	77.2	4.0	36.0	60.0
FIN	5.0	20,522.0	5.5	42.1	65.7	5.0	32.0	63.0
S	3.0	20,575.0	2.8	47.9	69.2	2.2	30.5	67.3
UK	2.2	20,613.0	1.0	31.3	53.3	1.5	31.5	67,0

[1] EUROSTAT: Eurostatistics: Data for short-term economic analysis, Luxembourg 2000. [2] EUROSTAT: 100 basic indicators from EUROSTAT Yearbook 2000, Luxembourg 2000. [3] CIA: The World Fact Book, Washington D.C. 1999. [4] Belgium and Luxembourg.

Taking a look at GDP composition, one can clearly see that the accession countries have on average a larger share of agricultural production in GDP than the old member states and a relatively smaller share in services. This type of GDP composition more or less mirrors that of the relatively less developed economies in the EU: Portugal, Spain, Ireland and Finland. Denmark is the exception.

Of great concern in the welfare analysis of enlargement is factor mobility. This assumes that enlargement would be at a level that allows for the free flow of factors, hence at least the Single European Market. Concerning labour migration there is likely to be an influx from the East to the West in the short run, mainly induced by the large differences in income. The degree of migration will be reduced by the natural mobility barriers, such as culture, social costs and language problems. In the longer run the likely convergence of income and likely increased influx of foreign direct investments will reduce these flows even further.[23] This is often seen as an explanation for the relatively low migration figure from Spain to France when the former joined the EU: "..., free movement of persons within an economic area does not necessarily result in continuing or increased flows between member countries".[24] It is unlikely that the induced factor flows are sufficient to lead to an adjustment of factor prices that could function as an adjustment mechanism in response to asymmetric macroeconomic shocks in the EU (Mundell criterion).[25] This insufficient factor mobility might be partly compensated for by the high intra-regional trade shares, according to the factor price equalisation theorem.

Looking at capital mobility the picture is brighter. All of the five countries under consideration had clear-cut average net capital inflows for the period 1993-1997 which was to some extent due to the improved country risk ratings for all of the countries (except Hungary). Turning to foreign direct investment flows, they have increased substantially in the 1990s and at least 50% came from the EU countries. Overall capital is fairly mobile and some close ties between the EU and the Eastern European countries have already been established and it is questionable if these flows will increase due to enlargement, since the foreign direct investment flows which were motivated by cheaper production costs have already taken place in response to the economical and political opening of Eastern Europe.

The Kenen[26] argument sees a great product diversity as important for stability because the

[23] Elmar Hönekopp, Heinz Werner: Is the EU's Labour Market Threatened by a Wave of Immigration?, in: INTERECONOMICS, Vol. 35, No. 1, 2000, pp. 4-6.

[24] Francisco Alba, Jean Pierre Garson, El Mouhoub Mouhoud: Migration policies in a free trade area: the issue of convergence with the economic integration process, in: OECD (ed.): Migration, Free Trade and Regional Integration in North America, Paris 1998, p. 267.

[25] This criterion refers mainly to a monetary union. Mundell was the one who investigated the (geographical) extension of an optimal currency union. According to him a monetary union's size is only optimal if full factor mobility within the currency union area exists and thereby substitutes for the missing exchange rate mechanism. Factor price flexibility could be a substitute (Robert Mundell: A Theory of Optimum Currency Area, in: American Economic Review, Vol. 51, No. 4, 1961, p. 662).

Table 2
Key Economic Indicators for the New Accession Countries (1998)

	Annual growth rate of GDP	GDP/ capita at current prices (in PPS)	GDP/ capita (in % of av. GDP/ capita EU-15)	Current account balance at current prices (% of GDP)[1]	Exports of goods and services as % of GDP[2]	Imports from EU (% of total imports)[2]	GDP composition by sector[2]		
							Agriculture	Industry	Services
CZ	-2.3	12,200.0	57.7	-1.9	46.9	63.3	5.0	33.8	61.2
EE	4.0	7,300.0	34.5	-9.3	62.9	60.1	6.2	24.3	69.5
HU	5.1	9,800.0	46.3	-4.9	48.4	64.1	3.0	30.3	66.7
PL	5.0	7,800.0	36.8	-3.6	17.9	65.9	5.1	26.6	68.3
SI	3.9	13,700.0	64.7	-0.02	46.4	69.4	5.0	35.0	60.0

Source: EU Commission: Regular Country Reports on the Progress Towards Accession, various reports, Luxembourg 1999.

[1] Data for Poland from 1997; [2] CIA: The World Fact Book, Washington D.C. 1999.

economy is less susceptible to fluctuations in international demand. A great product diversity is also conducive to intra-industry trade in several industries at a time which leads to greater gains. Taking that argument to assess the impact of enlargement one has to distinguish between sectors.[27] The 5 countries investigated tend to have a fairly diverse product structure in agricultural goods, textiles and clothing. Some of the countries compare fairly well to countries like Germany and France and, in several cases, have a much greater diversification than the poorer EU-15 economies Portugal and Greece. If one turns to more industrialised goods (basic and miscellaneous manufacturing, electronic components, and chemicals), the EU-15 is in general more diversified than the Eastern European accession countries. However, if market diversity is examined, that is the number of export markets to which the countries export, the fairly unambiguous result is that the EU-15 (including the poorer economies) have much more diversified export markets (geographically) than the Eastern European countries.[28] This means that the Eastern European countries are fairly well equipped to deal with fluctuations in international demand for specific product groups, but less so to handle regional economic crises as they depend on only a few export markets.

The enlargement of the EU by the Eastern European countries is thus likely to reduce the welfare of the EU, at least in the short run. In the long run there are likely to be benefits for all members - new and old alike. When and if these benefits will materialise depends on the enlargement strategy pursued.

Implications of Different Enlargement Strategies

Full membership: Accession countries obtain full membership of the Single Market or even the EMU. This is the strategy that was followed in previous enlargements, but is not likely to be pursued in this case because of the greater economic heterogeneity between EU-15 and the accession countries that would lead to the costs discussed above. This is why many authors argue against full membership. For instance Nitsche sees no chance of immediate membership of EMU, Brunner/Ochel see a chance neither for prompt EU nor EMU membership, and Franke even argues against short-term participation in the European Economic Area.[29]

Reasons against a full membership strategy include the costs associated with, for instance, opening up the sensitive sectors, allowing free migration, or giving the new members access to the structural funds and the CAP, both resulting in massive opposition by interest groups such as farmers, trade unions and poor regions. This is of course a general problem of any enlargement, but it becomes more relevant the worse the conditions for enlargement and therefore the greater the potential harm to different interest groups. In addition such a strategy is bound to fail because the EU has not built up the institutional

[26] Peter Kenen: The Theory of Optimum Currency Areas: An Eclectic View, in: R. Mundel, A. Swoboda (eds.): Monetary Problems of the International Economy, Chicago 1969, The University of Chicago Press, pp. 41-40.

[27] This analysis is based on the Trade Performance Index (TPI) that was developed by the International Trade Centre (ITC) which calculates the degree of competitiveness and diversification of economies. See International Trade Centre (ITC) (2000): The Trade Performance Index. Background Paper and various country indexes. Internet: www.intracen.org/itc (access: 20. 7. 2000).

[28] ITC, op. cit., various countries.

[29] Wolfgang Nitsche: Währungsunion und EU-Osterweiterung, in: Wirtschaftspolitische Blätter, Vol. 43, No. 5, 1996, pp. 496-501; Siegfried Franke: CEFTA und Europäische Union. Beitritt oder Erweiterung des Europäischen Wirtschaftsraumes?, in: W. Zohlnhöfer (ed.): Perspektiven der Osterweiterung und Reformbedarf der Europäischen Union, Schriften des Vereins zur Socialpolitik, No. 255, Berlin 1998, Duncker & Humblot, pp. 33-68; Petra Brunner, Wolfgang Ochel: Die Europäische Union zwischen Vertiefung und Erweiterung, in: ifo-Schnelldienst, Vol. 48, No. 32, 1995, pp. 9-20.

absorption capacity for five new, poor members. The East European countries will not only win the benefits of EU membership but will also inherit all the obligations, which they are struggling to meet without substantial hardships, as was shown above.

If, despite the counter-arguments presented, enlargement with full membership is pursued – for political reasons, perhaps – it is likely to create strong tensions within the EU. The main reason is that full membership for the poor Eastern European countries would substantially reduce the immediate benefits of membership for the current members. The causes of the reduction in the benefits of membership have been presented throughout this paper. It was shown, for instance, that the EU-15 is far from being a welfare-maximising integration area and that the situation worsens when enlargement takes place. "Eastern enlargement will greatly increase the EU's economic diversity and thereby multiply the centrifugal forces."[30] In addition the institutional structure of the EU is inefficient in dealing with the challenges of EU-15, and it will be even less adequate after enlargement if not reformed. The inadequacy becomes obvious if not only the increased number of members is considered but also the more diverse issues and interests that will be introduced (e.g. transformation issues). The resulting internal heterogeneity will reduce the international influence of the EU. As the benefits are reduced and many new problems arise it is imaginable that the commitment of members to the EU is dwindling and that the EU might move down on national priority lists.

Step-by Step Approaches: The more realistic and more likely enlargement strategy is that of gradual integration. These approaches take into account the limitations on the EU members' and institutions' side as much as on the new members' side. They suggest proceeding with gradual deepening, partial participation, or on a case-by-case basis, each approach taking the current level of development and level of adjustment to EU standards into account. These strategies acknowledge the increased heterogeneity that an immediate enlargement would introduce into the EU and therefore require a more flexible and adjustable strategy to the individual situation of Eastern European economies. This seems to avoid many of the politico-economic and economic problems within the EU-15 that have been discussed above. A close scrutiny shows that even this approach can detract from the European integration process.

The most prominent proposal of a step-by-step approach is that by Baldwin.[31] He proposes that East European economies that are bilaterally associated with the EU (e.g. through Europe Agreements) should be joined together in an association in order to organise negotiations more efficiently. This suggestion calls for an institutionalisation of the gradual liberalisation and enlargement process. Initially only preferential access to the EU market for industrial goods is extended, excluding sensitive sectors to make negotiations run smoothly. This stage with gradually increased liberalisation will persist until an intermediate step evolves which allows the more advanced economies that have adjusted to the requirements of the EU to proceed individually or as a group to the next level until full membership is obtained. This obviously facilitates negotiations but differentiates strongly between old members, which have access to all EU resources, and new members, which have only partial access. On top of that, some of the current preferential treatments to the Eastern European countries like free access to the EU market for industrial products holds very little preference since global protection levels for industrial goods are low anyway, thus reducing the gains from trade.

The groups that could evolve in the course of such a step-by-step enlargement will in all likelihood be defined along the lines of economic development levels and the extent of compliance with EU provisions. Even though members of the deepest integration level are participants in the lower levels there is a division into different groups. Figure 1 shows a possible outcome.[32]

The figure shows that the outer circle has no route into the "Europe circles". It comprises all countries that have no accession agreement with the EU. The European countries that are linked to the EU via association agreements can potentially move up step-by-step into the ultimate level of EMU. When integration proceeds with exemptions in, for instance, sensitive sectors, then this is not the same as to say that the level of a full free trade area is achieved. The dotted lines indicate that the hierarchy is permeable and that countries can "move up" depending on their economic progress and level of compliance with EU-made rules. As long as the different levels of integration that arise are permeable – that is as long as the process is dynamic – such an enlargement strategy might succeed. On the way, this will necessarily result in a Europe of different speeds, which in itself need not be a problem. If, however, the dynamics cease – and there are strong arguments that this could happen – then Europe may be perma-

[30] Baldwin et al., op. cit., p. 150.

[31] Ibid.

[32] Note the similarity with the graph in Baldwin (op. cit., p. 222). The graph in this paper differs in that it includes more "in-between" levels of integration and could be extended to many intermediate levels.

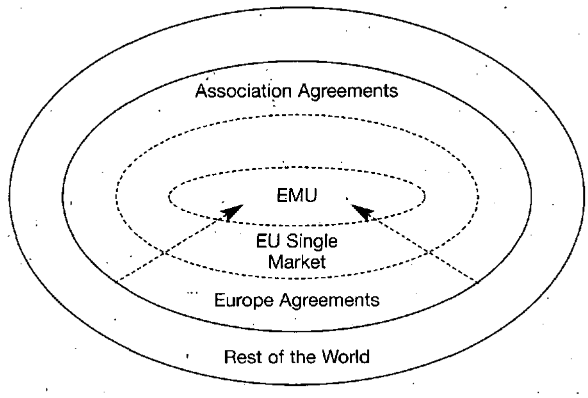
nently arranged in several different groups; in this case the dotted lines turn solid and Europe would be divided into different groups at different integration levels in the longer run.

Despite Baldwin's statement[33] that this step-by-step approach will not lead to a postponement, there are good arguments to believe that on this route enlargement might stagnate. Countries like Turkey and the Maghreb countries have been associated members for many years without any real progress in deepening the association because the EU considers their economic and political progress insufficient. This could also happen to the Eastern European countries. In addition, the deepening of the EU-15 proposed in the Treaty of Amsterdam makes enlargement much more difficult and costly for the EU and the new member economies. Therefore, some see the danger that deepening leads to an indefinite postponement of enlargement.[34] At the same time enlargement was not an explicit issue in the Amsterdam negotiations in 1997, which can be interpreted as reluctance by EU decision-makers concerning enlargement. This reluctance can also be seen in the unwillingness to allow for open immigration policies. This could easily be extended into a reluctance to open up the EU markets completely and lead to a stagnation of the deepening of the integration level for accession countries. In addition, the slow progress – whether justified or not – might lead to frustration on the part of the Eastern European economies and a loss of public acceptance. This might induce some of the countries not even to attempt deeper integration into the EU, leading to a loss of dynamic in the European integration process.

It might even be possible that more developed member economies decline to participate in deeper integration levels once the "collectivity of deepening" is broken by the existence of different levels of integration within the EU. So far deepening was carried out simultaneously by all the members in order to keep the legal standing of all members identical. This was first violated when EMU was introduced (e.g. by the United Kingdom's not joining EMU). The result in the longer run could be the above-mentioned stagnation of the overall integration process. Reasons why members might oppose further deepening include the required increasing economic homogeneity and forgone policy autonomy at deeper levels of integration, which might raise the integration costs to an extent where they exceed the marginal benefits associated with the deeper integration.

Sequencing Strategy: In contrast to the step-by-step strategy discussed above, which aims at integrating the East European economies by gradually deepening and furthering integration, the sequencing strategy argues that prior to integration the economic and institutional conditions in all participating factions needs to be established, since the costs of enlargement will otherwise be unnecessary excessive.

Figure 1
Possible Outcome of a Step-by-step Enlargement Strategy



Source: Own graph.

The key problems have been shown to be associated with the diverse development levels and the insufficient EU institutional infrastructure and its lack of efficiency. These and the related issues lead potentially to such a strain that the entire EU integration process may be slowed down or might even come to a halt. It is therefore suggested narrowing the gap that exists in development levels, improving the institutional capacity and rules of the EU, and implementing long required economic reforms in the current EU economies, to make them as economically stable as possible prior to enlargement.

What does the sequencing strategy suggest? It is vital that the institutional reform of the EU take place prior to enlargement, in order to build up the required capacity. Looking at the results of Nice it is doubtful whether the EU has moved in the right direction to improve efficiency. Decision-making has become more complex and less transparent. The bureaucratic effort involved has increased and is likely to increase the red tape and administration costs. The negotiations and results of Nice support the point of view put forward in this paper that the problems inherent in the EU institutional system is too profound for the EU to be ready for enlargement in 2004 or 2005 (even though the EU claims to be ready). In addition the proposed amendments laid down in the Treaty of Nice will only come into force in 2004 and 2005 (other important decisions have been delayed until then), the

[33] Baldwin, op.cit., p. 209.

[34] Petra Brunner, Wolfgang Ochel, op.cit., p. 16.

proposed time of the first new accessions. This late date will create unnecessary strain on capacities. Despite Nice, much institutional reform in the EU remains to be carried out before enlargement can take place at tolerable costs.

Also, the lower level of votes required for a blocking majority needs reconsideration. It might lead to strategic voting by smaller member economies (or three large economies) which could destabilise and immobilise the EU. Also the rules concerning the transfer system, like the structural and cohesion funds, need to be amended to take into account the increased number of less developed regions in the enlarged EU. In addition, the interests of the current net recipients of these funds and those of the net contributors need to be considered to avoid conflict over these issues in an enlarged EU. Lastly, considering the immense challenges posed by the European Monetary Union, it is doubtful if existing capacities are sufficient to take up the extra challenge of enlargement at the same time. The argument is quite strong that the new European currency should first be firmly established, which implies certain policy adjustments like fiscal policies, before getting involved in a new venture.

The East European economies need to push their adjustment to required EU standards at a pace that is compatible with their economic transformation capacity in order to avoid excessive costs and economic hardships for the population. In addition, the transformation towards a market economy needs to be pursued intensively as one measure to decrease the existing development gap.[35] The integration suggested by the step-by-step approach is limited to the non-sensitive sectors which means that those sectors and aspects of EU integration in which the Eastern European countries are mainly interested, like agriculture, textiles and the various funds, will initially be excluded. This means that the core gains from integration that favourably influence development are not likely to materialise under the half-hearted step-by-step strategy. The sequencing strategy suggests a continuous liberalisation that goes across industries. Rather than have full liberalisation in some (irrelevant) sectors and other sensitive sectors that remain protected; trade in all sectors with the East European countries should be liberalised at a more moderate rate at first, gradually increasing. With this they can reap some gains from trade which will eventually be greater as the cuts in the protection level grow deeper; this will help their development process.[36] The advantage of this approach is the avoidance of misallocation and the inefficient restructuring of the new members' economies towards the preferentially treated sector, even if the comparative cost advantage lies in the other sectors. The development process in these countries can further be supported by aid from the EU in terms of infrastructure projects or cooperation. The usefulness of such a cooperation policy can be seen from the trade facilitation programme of APEC which is an integral part of open regionalism and includes the region-wide provision of public goods, measures reducing transaction costs and some policy coordination.[37] In addition policies should gradually converge, so that when enlargement comes there is less adjustment shock. These measures will also tie the East European economies well into Western Europe so that any security motives for joining the EU immediately are accommodated.

Lastly, the old EU members need to proceed first with their own economic policy reforms in terms of more flexibility on factor markets, the reform of social systems (e.g. Germany), privatisation of state-owned enterprises (e.g. energy sector in France), and the like. Only when there is macro-economic stability within the EU will the economic capacities be available to absorb the economic challenge of including the economically weaker East European countries into the EU.

All of these conditions need to be fulfilled for enlargement to proceed smoothly without exerting unbearable strain and costs to the EU, its members and the accession economies. Once the problems of all the actors have been solved and the development gap has narrowed (for instance, accession countries should be within reach of the least developed current members) then integration should take place on a broad scale, avoiding too many steps on the way which all run the danger of losing the dynamics of the overall European integration process. The costs of this strategy will be much lower than those of all the others but it requires more time.

[35] There are strong arguments favouring an immediate integration since that will be conducive to the transformation towards a market economy and to economic development. This need not be disputed but this route to development is very costly to the other members and the EU as a whole as has been pointed out.

[36] That market access restrictions by the EU can hamper the development process in lesser developed countries is shown by El-Shagi El-Shagi: Fatale Wirkung – Der wachsende Protektionismus der Länder der Euopäischen Union und seine Folgen, in: Zeitschrift für Kulturaustausch, Vol. 44, No. 3, 1994, pp. 304-306.

[37] Fred Bergsten: Open Regionalism, (Working Paper, No. 97-3), Institute for International Economics, Washington D. C. For a discussion of open regionalism and APEC, see Philipp von Carlowitz, Tim Goydke: APEC and its Open Regionalism: Success or Failure?, forthcoming in: Aussenwirtschaft, Vol. 56, No. 1, 2001.