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Costs and Benefits of EU Enlargement

While the political benefits of the coming EU enlargement are relatively easy to identify, its economic and financial consequences are less unequivocal. The following article examines the likely costs and benefits of enlargement to both existing and future Members, and in particular how it will affect Germany, one of the few present EU Member States which has direct borders with acceding states.

Negotiations with Poland, Hungary, the Czech Republic, the Slovak Republic, Estonia, Latvia, Lithuania, Slovenia, Malta and Cyprus were concluded at the Copenhagen European Council on 13 December 2002. The Accession Treaty was signed on 16 April 2003 in Athens by the Heads of State or Government of the existing and the future Member States. The ratification process in the existing and future Member States in accordance with their respective national legislation has meanwhile begun. The European Parliament ratified the Treaty on April 9. With the exception of Cyprus, each of the acceding states will also hold a referendum on accession. The people of Malta have already voted for accession, albeit by a narrow majority of 53%. So did Slovenia on 23 March and Hungary on 12 April, Lithuania and Slovakia on 10-11 and 16-17 May respectively, Poland on June 8 and the Czech Republic on June 14. Opinion polls show a majority in favour of the EU in Estonia and Latvia, where referendums take place in September. Accession will take place on 1 May 2004.

Different Aspects of Enlargement

We must differentiate between the political, economic and financial aspects of enlargement. Enlargement was and is a political goal with priority, of value "in itself" for both Europe and Germany. It was always an undisputed issue in the Federal Government. The question of enlargement was never "if" but rather "how" and "when".

The Commission recently referred to enlargement as the "Union's most successful foreign policy instrument".[1] This shows that the main driving force behind the enlargement process is foreign policy. As a direct neighbour of two of the acceding states, Germany has a particular interest in seeing them accede. The wider the common basis of values and rules, the easier it becomes to create open borders. Politically, it is therefore quite easy to identify the benefits of enlargement. But is enlargement viable from an economic and financial point of view as well?

Enlargement is a process, not an event. As such, it already began years ago. The same is true of the costs and benefits. From a macroeconomic point of view, enlargement is without doubt a worthwhile investment. Research institutes may arrive at differing results, yet the conclusions are invariably positive. No institute expects enlargement to lead to negative economic effects. For the EU as a whole, a *one-off* GDP growth effect between zero and 0.8% is expected. Austria can expect the highest effect, namely as much as 1.5%, whereas for Germany the effect is estimated at approximately 0.5% for the period to 2010.[2]

The high growth of the acceding states coupled with rising purchasing power will stimulate import demand and, consequently, the export prospects of the

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[1] Communication from the Commission to the Council and the European Parliament; "Wider Europe-Neighbourhood: New framework for relations with the Eastern and Southern Neighbours", Doc. COM (2003) 104, March 11, 2003, p.4.

[2] Österreichische Nationalbank: Osterweiterung der EU: Auswirkungen auf die EU 15 und insbesondere auf Österreich, in: Berichte und Studien 2/2002.

present Member States. The need for capital goods will rise due, on the one hand, to the adoption of the acquis communautaire, particularly environmental standards, and on the other hand, to the necessary modernisation of industrial plants.

On the whole, enlargement will be of far greater benefit to the acceding states than to the existing EU Member States. They will feel trade-related cost savings far more strongly. Efficiency increases and improvements in competitiveness will be far greater for the acceding states. What is more, they will also profit by adopting a functioning EU economic and legal framework as well as from net transfers. The 10 acceding states can expect to receive up to 4% per annum of their GDP – starting in 2006 after the phasing-in period – from the EU's structural and cohesion funds for projects aimed at improving their economic structures. With the right economic conditions in place the funds will help to accelerate economic growth. In the long term, the acceding states could enjoy a rate of growth some 2% higher than that of the existing EU Member States.

The 10 acceding states make up just 8.2% of the combined economic output of the EU 25. This implies two things:

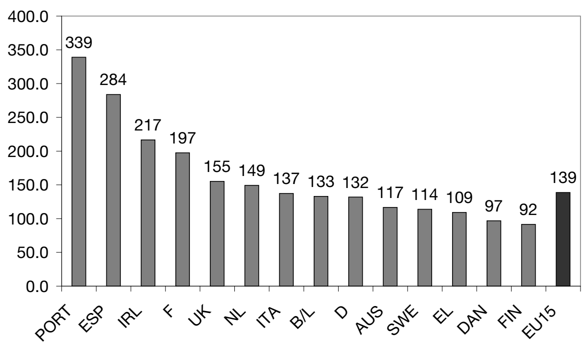
- the dynamic developments in the acceding states cannot seriously be expected to strongly boost the existing EU's sluggish economic performance;
- the effects on economic development of potential problems arising in the 10 future Member States, which are sometimes feared in the existing EU, would also be limited, assuming such problems arise at all.

Germany's trade with the acceding states has expanded rapidly in recent years and it is the highest among all the regions of the world. Germany's trade surplus has decreased over recent years, however. The EU and the acceding states have been enjoying truly liberalised trade for years – with a few exceptions. Therefore, we may ask what additional benefits enlargement will bring. In my opinion, quite a lot. The abolition of goods controls at the border, dynamic economic development in the candidate countries and, above all, the adoption of the EU's tried and tested framework will spur on future trade. Additional or surplus exports to the acceding states will secure or create employment in Germany. But in those areas in which our exports stagnate and domestic products are substituted by imports, negative consequences for employment, income and growth in Germany will result.

To realise the beneficial effects of enlargement, the willingness to undertake structural reforms is therefore very important. In some sectors of industry, particularly those which are wage-intensive, the pressure to undertake structural adjustments will become stronger. Flexible markets, above all flexible labour markets, are in a better position to cope with these changes. How big or small the positive effects of enlargement are also depends on Germany. The more flexible and competitive Germany is, the greater our opportunities in the expanding "new east" will be. And vice versa! In this respect, the future costs and benefits have yet to be determined – they may develop dynamically. In cases where businesses move from Germany to the acceding states, Germany will suffer job losses. If, however, investment leads to additional capacity being created in German companies, this will strengthen German competitiveness as a whole.

Ultimately, enlargement is simply a relatively small part of the globalisation process which brought enormous welfare benefits to Germany after World War II. Less well-known is the fact that trade between most of the other EU Member States and the acceding states is growing at an even faster rate: while Germany's exports have doubled, those from Portugal and Spain have roughly quadrupled and Irish exports have trebled (cf. Figure 1). That clearly shows that not only the Member States close to the border such as Germany and Austria, but indeed *all* EU Member States benefit from enlargement.

Figure 1
Increase of Exports of the EU Member States to Accession Countries, 1995-2001
(1995=100)



Sources: Own calculation on basis of EUROSTAT.

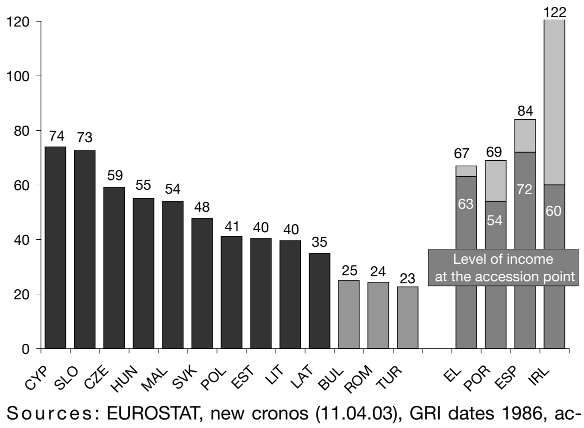
Effects on Employment

The topic “opening up the labour market for the acceding states” has negative connotations for the German public. Economic experts have almost unanimously advised against restrictive transition periods for immigration. The reason is that, all in all, immigration is beneficial. The German government has nevertheless decided to request a seven year transition period, principally to prevent a possible abrupt rise in immigration, for example as a result of a slump in economic performance – thus more as a safety net in particularly difficult circumstances. After all, the rate of unemployment in Poland is almost twice that in Germany. If qualified immigrants take up posts that would otherwise remain vacant, income and employment will rise in Germany: welfare will increase and higher tax revenues will be generated. If, however, unemployment tends to rise as a result of immigration, these positive effects will not occur. This may be the case if work-seeking immigrants fail to find employment or if they replace indigenous employees. In reality both effects will be found at the same time.

The UK, the Netherlands, Sweden and Luxembourg have already signalled their intention to open up their labour markets completely or to a great degree to workers from the future Member States after accession. Since willingness to emigrate falls with the distance the migrant must cover, it is certainly easier for the countries mentioned above to take such a liberal approach. The labour market situation and structural problems in Germany prevent a more rapid opening up of the labour market. It should also be taken into consideration that bilateral contracts for work for a large number of employees from a number of CEECs have already been agreed. Apart from that, the German government’s draft Immigration Act proposes allowing:

- university graduates from the acceding states to take up employment within one year of completing their exams in Germany;
- a regional opening up to qualified applicants from the acceding states.

Figure 2
GDP per capita of the Accession Countries in Purchasing Power Standards 2002
EU(15)=100



Sources: EUROSTAT, new cronos (11.04.03), GRI dates 1986, accession 1981.

Standards of Living

In the history of the EU there has never been such a difference in income between existing and future Member States. Nonetheless, Cyprus, Slovenia, the Czech Republic, Hungary and Malta all have at least as high an income level as Portugal had when it joined (cf. Figure 2). A decade-long net transfer of EU funds to the acceding states must be expected. Development needs time and money. It is also clear that the efforts made by the recipients themselves will be decisive. The EU can only support these efforts, it cannot replace them. Therefore accession to the EU is not a guarantee that the average standard of living in the EU will be reached.

The difference is large and – even assuming optimistic scenarios – it will take time for the future Member States to catch up. It took even Ireland 30 years to achieve the present income level. Spain, Portugal and Greece are also catching up, albeit at a much slower rate. On a rule-of-thumb assessment, Ireland has been catching up at an annual rate of 2% since it joined, whereas the others have averaged about 1%. If we use this rate as a benchmark for the future, it may take several of the acceding states 50 years to catch up. Making up the leeway is also difficult because the EU average is growing and is thus a “moving target”.

Who Will Lose?

Very often agriculture is regarded as one of the losers of enlargement. Farmers on both sides are very concerned. With the exception of Hungary, however, the acceding states are net importers of agricultural produce. This situation is not likely to change in the near future. The agricultural sector in the east is going to benefit from growing purchasing power. It is certain that there will be marked reductions in the number of people employed in agriculture. But would this be different without enlargement?

Labour-intensive industries in the west might come under competitive pressure after enlargement. But fortunately – as a result of the globalisation process – the size of those industries in Germany is relatively small and therefore no major problems should arise.

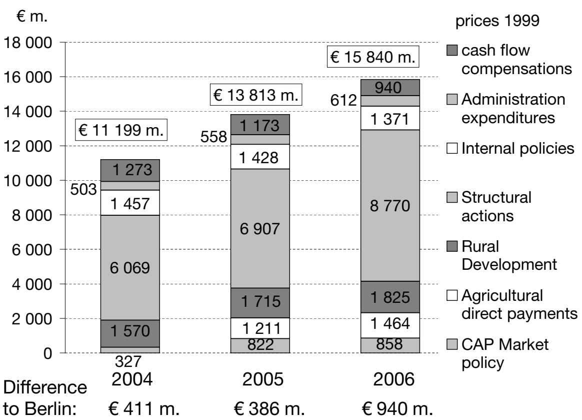
The topic of border regions with the acceding states is a sensitive one when discussing enlargement. It deserves special attention. The fact is that border regions differ in two ways from the other regions in a country.

- Services, particularly manual skills, are highly tradable. Examples are automotive repairs, hairdressing and, in particular, construction related skills.
- The problem of commuting: it is possible to live inexpensively in the east while working for good money in the west. Both factors can weaken the economic basis in border regions of the old members.

Nevertheless it is by no means the case that border regions are *per se* at a disadvantage when it comes to enlargement. Only when there is a combination of structural weaknesses and high population density can enlargement have negative effects. For example, in Germany, no significant problems on the Bavarian-Czech border are expected.

Only a very small percentage of those living in the CEECs have to expect their incomes to fall as a result of enlargement. A somewhat larger percentage of the population represents what are known as "relative losers", i.e. their income grows at a lesser rate than the average as a result of enlargement. This part of the population will be discontented. But the vast majority of the population is going to gain in absolute terms.

Figure 3
Costs of Enlargement according to Copenhagen Summit 2004-2006 (Commitments)



Financial Package 2004 - 2006

EU enlargement is going to cost €40.85 billion in the next three years (at 1999 prices; cf. Figure 3). This amount is €1.7 billion below the ceiling set out in the financial perspective. Back then, the assumption was that six States would already have acceded as early as 2002. The Commission had proposed fully expending the maximum amount foreseen in the financial perspective. The costs for the acceding states will rise successively (phasing-in), as the absorption capacities of the acceding states will initially still be low. The phasing-in of structural funds will be completed by 2006, but the phasing-in of agricultural policy only by 2013.

In 2006 the volume of enlargement costs will amount to about 15% of the EU budget. Approximately only €25 billion of the costs of enlargement will be called up between 2004 and 2006 and will result in payments from the EU budget. The rest will be made available only after 2006. Once they have become members, the acceding states must start making their contributions to the EU budget. The acceding states' initial demands for rebates in their contributions were not accepted. Poland alone demanded billions of euros worth of rebates. The acceding states will receive a net sum of €15 billion up to 2006. All the existing Member States are involved in financing this contribution. Germany must finance an amount of €2.3 billion from its federal budget, corresponding to some 0.3% of that budget. Currently, Germany provides 23% of the funding needed for the EU budget. Although 10 new Member States will be contributing in the future, Germany's share will sink by just roughly 1% to 22%! All the acceding states together will contribute only 5% to the EU budget.

All the acceding states will be net recipients from the very beginning (cf. Table 1). The results of financial negotiations take the relative wealth within the group of 10 States into account: Cyprus, the Czech Republic and Slovenia are the acceding states with the highest per capita GDP. Latvia, Lithuania, Estonia and Poland have the lowest per capita GDP. Malta and Cyprus did not take part in the pre-accession programmes ISPA (transport and environment projects) and SAPARD (agriculture). They thus have to make up some ground.

Table 1
Net Balance of Accession Countries
2004-2006

Accession countries	Net balance[1] pro capita in €
Czech Republic	76
Slovenia	122
Hungary	135
South-Cyprus	148
Slovakia	154
Poland	181
Latvia	346
Malta	349
Estonia	360
Lithuania	387
average	176

[1] Including pre-accession aid; 1999 prices.
Source: Own calculation.

Lithuania will have to bear high decommissioning costs for the Ignalina nuclear power plant.

The results of the financial negotiations take the special interests of the acceding states into account.

- Budgetary aid: an amount of €4.2 billion in total between 2004 and 2006, although it is not provided for in the acquis and it was not proposed by the Commission. It is made up of three elements.

– Budgetary compensations (€1 billion) are intended to prevent the net position of some acceding states from worsening relative to 2003.

– The Schengen facility (€0.9 billion) serves to secure external borders. Although the costs of participation in the Schengen Agreement are currently being borne by the EU Member States themselves, there appears to be political agreement that the expenses will – at least partly – be financed in the future by the EU budget. The Schengen facility for the acceding states represents a de facto precedent for the future financing of the Schengen costs.

– Cash-flow facility (€2.4 billion) to improve liquidity. The acceding states expressed grave concern in the negotiations concerning the fact that their liquidity and budgetary positions could worsen significantly in the initial phase after accession. Once members, the acceding states must pay their contributions towards the financing of the EU budget. Moreover, the EU programmes have also to be nationally co-financed. However, their fears of becoming net contributors were groundless from the very start.

- Funds for rural development. The amount of funds agreed for agricultural and rural restructuring is relatively generous, reflecting the particularly pressing need for reform in this area in the acceding states. Moreover, flexible transition regimes have been agreed until the end of 2006, for example, aid for part-time farms capable of being developed, and an increase in the maximum EU co-financing rate to 80% (EU 70%) for certain measures.

- The possibility of topping up agricultural direct payments with national funds or rural development funds from the EU.

- The cohesion fund makes up one third of the total structural funds (slightly less than one sixth in the four current cohesion States). These may be used to address the particularly large infrastructure deficits in the transport and environment sectors.

Financial and Economic Policy Conclusions

In principle, the following should be considered under the proviso of the results of the ongoing EU Convention and the subsequent Intergovernmental Conference. In general, the larger the number of EU Member States and the less the homogeneity amongst them, the more likely it is that Europe will develop on a "two-speed" basis. Many believe that this will inevitably be the case at the latest should Turkey accede.

An important objective of the new Member States will be the principle of "equals among equals". Only once they have become members of the eurozone and participate in the Schengen Agreement will they be able to feel that they have full equal rights.

Agricultural policy. The share of the agricultural sector and the number of those employed in farming play a much larger role in the overall economy of the acceding states compared with the existing Member States. The share of agricultural costs, however, is almost 50% of the EU 15 budget, but only 26% of the ten new Members' budget. This is partly a consequence of the ten-year transition period until 2013 for direct payments. Following accession, the acceding states will be keen for their share of EU agricultural funds to increase quickly. The current design of the CAP is not in line with the interests of the new members.

- The CEECs have a very large farm population but this is not an important CAP criterion.

- The CEECs have a huge amount of agricultural land but again this is not a decisive element for support within the CAP.

- Today direct payments to farmers make up the largest share of the CAP budget. Since these are compensations for earlier price reductions they hardly apply to the CEECs.

Structural and regional policy. All of the future Member States are cohesion countries and therefore recipients of the cohesion fund. Almost all the regions in the future Member States fulfil the EU definition of least favoured regions (= Objective 1). The share of expenditure on structural and cohesion funds in the EU total budget will, therefore, most likely increase. The funds are going to be concentrated on the new Member States, to the detriment of those who have been Objective 1 recipients to date, including eastern Germany.

Tax policy. Assuming that unanimity voting on tax-related issues will still be the norm in the future, the accession of new Member States will inevitably complicate compromise. It is interesting that it has proved possible to press ahead with tax harmonisation in some areas in the run-up to enlargement. The fact that decisions will be more difficult to implement after enlargement surely played a role here, as shown in the following examples.

- *Tobacco tax.* The EU minimum level of taxation was raised at the end of 2002. The tax rate on cigarettes in the acceding states is currently well below the EU level.
- *Taxation of savings.* After years of discussion an agreement on a minimum taxation of savings was reached under the Greek presidency among the EU 15.
- *Energy taxation.* The minimum taxation of energy, which Germany had long called for, was adopted by ECOFIN in March 2003. Although the tax rate is so low that only a few old members will be required to raise their rates, it will have far-reaching effects after enlargement, for tax rates in the acceding states are well below the defined EU minimum level.

Stability and Growth Pact. Upon accession, the new Member States will be subject to the obligations set out in the Stability and Growth Pact. Despite the fact that no sanctions will be imposed while the new Member States do not belong to the eurozone should they fail to meet the goals of the Pact, they will still be obliged by the convergence programmes to pursue budgetary discipline. They are threatened with the withdrawal of cohesion funds if they continually fail to respect the convergence programmes.

Should the acceding states adhere to the demands of the Pact to reduce their deficit to "close to balance" and the growth rates be as strong as predicted, their relative debt levels – in % of GDP – should decline gradually. More flexibility may be required here in applying the conditions of the Pact.

Monetary union/price stability. The new Member States will not be able to accede to the eurozone before the end of 2006 or the beginning of 2007. It is doubtful whether the average rate of inflation will in fact rise, not to mention whether the European Central Bank's stability policy will be endangered – as feared by the Bundesbank – once the eurozone has been enlarged. Accession to the eurozone requires that price levels in the candidate countries do not exceed by more than 1.5 percentage points that of, at most, the average of the three best performing Member States in terms of price stability. The small economic weight of the new Member States would also tend to indicate that price stability in the eurozone will not be threatened.

Enlargement policy. The acceding states have already indicated their interest in extending the EU zone of stability and wealth to neighbouring countries. Poland has openly declared its support for the accession of Ukraine in the future, for example. The accession of Slovenia and Hungary should also speed up the integration of the Western Balkan states.

Financial framework 2007 – 2013 (Agenda 2007). To find an agreement on the financial perspective of the EU may be the most difficult task. The decision has to be taken unanimously and will be complicated by the increased number of member states. If, as is suspected, structural and regional funding increases in importance in the EU budget, the relatively well-off members will have to bear this charge. Reasonable calculations for example, assume that Germany's reimbursements, which today constitute roughly half of its contribution to the EU budget across all community policies, may be reduced to a third in an enlarged union. But even if this assumption proves to be true the costs of enlargement will be a reasonable investment in the future of Europe.