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How Will the Enlargement Affect the Old Members of the European Union?

The recent enlargement of the European Union by ten countries has changed the framework for economic activities in Europe. This article sheds some light on the resulting macro effects on the old member states and discusses the distribution effects both between the incumbent countries and within these countries as well as the respective adjustment requirements. In conclusion a rough assessment is made of the future growth performance of the enlarged EU.

The enlargement on 1 May 2004 is the fourth time the EU has admitted new members since it was founded as the European Economic Community in 1957. No previous enlargement has taken in as many countries at once. The number of member countries increased by two thirds (Table 1). Also, no previous enlargement has admitted new countries so different in economic terms from the existing EU members. Per capita income in the new member countries, measured at current exchange rates as well as in purchasing power parities, is far below the EU-15 average (Figure 1). The accession of the relatively poor new member countries lowers per capita income (at current exchange rates) in the enlarged EU by 13 %.

Most of the accession countries are small – with the exception of Poland – and they are not very densely populated. As a result, "eastern" enlargement increases the population of the EU by only 20 % and its area by 25 %. Since the new member states are much poorer than the average of the EU-15, their contribution to the economic output of the EU is significantly smaller. Total GDP increases by less than 5 % (measured at current exchange rates). The GNP of Poland, the largest accession country, is equivalent to that of the small old EU country Denmark. In terms of GNP, all other new member countries are less important than Ireland, the smallest old member country besides Luxembourg (Figure 2). At the moment of enlargement, the economic importance of the new member countries will be roughly equivalent to that of the Netherlands or some of the German Länder, e.g. North Rhine-Westphalia or Bavaria.

Given the relatively minor economic importance of the accession countries compared to that of the EU-15, it might be concluded that the effects of enlargement on the old members will be very limited. However, this could be a misleading conclusion for several reasons. Firstly, it is very probable that the relative economic importance of old and new member countries will change. The new member countries are already undergoing a catching-up process. For the last couple of years the growth performance of the acceding countries has been much better than that of the EU-15. Especially large differences exist between the old continental member states France, Germany and Italy on the one hand and the new Baltic member states Estonia, Latvia and Lithuania on the other hand (Table 2). Secondly, the dynamics of the catching-up process in the new member countries, which is driven by market-oriented reforms and which involves the introduction of efficient tax regimes and social security systems, together with the low cost of labour in these countries, will possibly place competitive pressure on the economies of the old member states with far-reaching adjustment requirements. Thirdly, the competitive pressure might be increased by immigrants from accession countries, above all into Germany and Austria, and could necessitate adjustments to the wel-

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Table 1
EU Enlargements 1973-2004

	Increase (%) in				GDP[a] per capita of acceding countries EU=100[b]
	num-ber of states	area	popu-lation	GDP[a]	
1st enlargement 1973 (Denmark, Ireland, United Kingdom)	50	31	32	29	88
2nd enlargement 1981/86 (Greece, Portugal, Spain)	33	48	22	15	68
3rd enlargement 1995 (Austria, Finland, Sweden)	25	37	7	8	125
4th enlargement 2004 (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia)	67	23	20	5	23

[a] Current exchange rates. [b] GDP per capita of incumbent states at the moment of enlargement.

Sources: Eurostat (several years); Deutsche Bank Research: Die deutsche Bauwirtschaft im Zuge der EU-Osterweiterung, Sonderbericht, 11 October 2002, Frankfurt am Main; own calculations.

Table 2
Economic Growth (Increase in GDP) in EU-15 and Accession Countries, 2000-2004

	2000	2001	2002	2003	2004[b]	2000-2004[c]
EU-15	3.6	1.7	1.1	0.7	2.0	1.8
France, Germany, Italy[a]	3.2	1.5	0.6	0.1	1.6	1.4
Others[a]	4.0	2.0	1.7	1.5	2.4	2.3
Accession Countries	4.1	2.4	2.4	3.7	3.7	3.2
Baltic States[a,d]	5.1	6.3	6.4	6.0	5.5	5.8
Others[a]	4.0	2.1	2.1	3.0	3.6	2.9

[a] Weighted by GDP in 2000; [b] forecast; [c] average of yearly growth rates; [d] Estonia, Latvia, Lithuania.

Sources: IMF (several years); Arbeitsgemeinschaft deutscher wirtschaftswissenschaftlicher Forschungsinstitute e.V. (several years); own calculations.

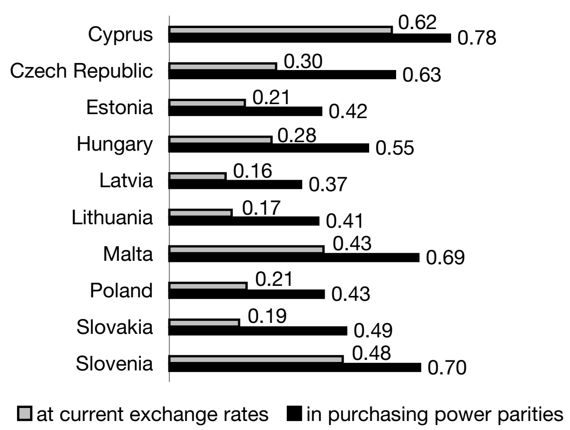
fare state. Fourthly, the political power which the new member countries will bring into the decision-making process of the EU is far larger than their present economic significance. Fifthly, the huge difference in per capita income between the accession countries and the EU-15 in combination with the power of the new member states in the EU's decision-making processes could lead to considerable redistribution conflicts between the old and the new member states. In order to shed more light on the relevance of these arguments we have to ask which institutional changes have taken place on May 1.

Institutional Changes Caused by Enlargement

It is often argued that the countries becoming member states of the EU are already highly integrated into western Europe. Several pre-accession agreements have already been in force – partly – since the early 1990s, and these agreements have led to intensive trade and direct investment relations between accession countries and the EU-15 before enlargement. This is true. Nevertheless, 1 May 2004 brought about institutional changes altering the environment for economic activities. In order to assess the economic effects of "eastern" enlargement, the following issues are relevant:

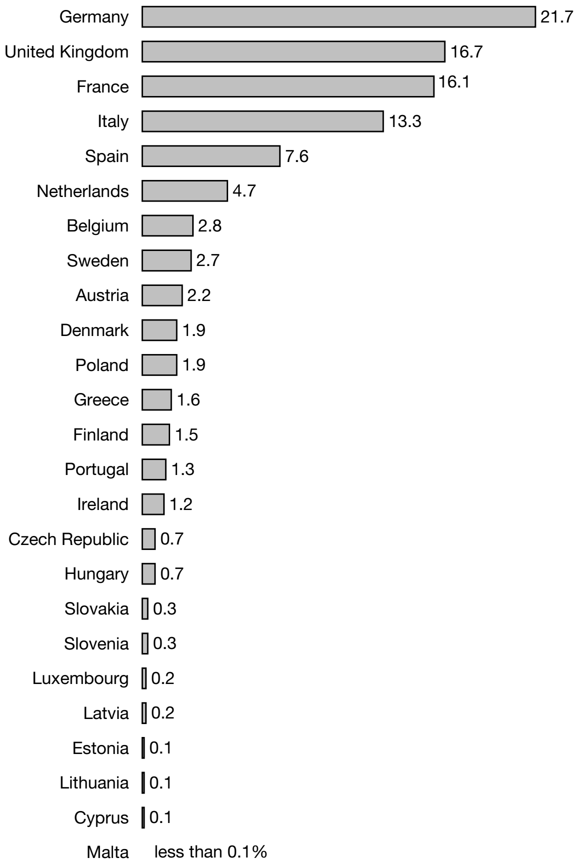
- *Customs Union*: The accession countries will become members of the EU customs union. Any existing tariffs between old and new member countries will be completely abolished. However, with the exception of agricultural and other sensitive products, tariffs between old and new members have already been abolished in the course of the various pre-accession agreements mentioned above. Furthermore, the external tariff of the EU has to be applied to new members' imports from third countries and the new members have to transfer competence in trade issues with third countries to the EU.
- *Internal Market*: The internal market will be extended to the new member states. This means that the four so-called principle freedoms will come into force in the enlarged EU, i.e. the free movement of people, goods, services and capital. Internal market rules should ensure that trade flows as well as cross-border movements of capital and labour are not

Figure 1
GDP per capita in Acceding Countries, EU-15 = 100, 2003[a]



[a] forecast.
Source: Eurostat 2004.

Figure 2
Gross National Product of the Enlarged EU 2004 - Shares of the Member Countries in %



Source: European Commission 2004.

impeded and that firms and citizens will be able to settle in any country of the enlarged EU. Border controls have to be abolished. However, important exceptions will be in force for several years. As long as the new members cannot guarantee the protection of the new EU borders with third countries according to the Schengen standard persons will be controlled when passing a border between old and new members. Furthermore, the old member countries have the possibility to restrict immigration from the new ones for up to seven years and, with the exception of Ireland and the United Kingdom, all of them will make use of this option. On the other hand, the buying of agricultural land and forests in some of the new member countries by citizens of other member states will be limited for the time being.

- *Acquis communautaire*: The Acquis has to be applied fully – with some exceptions for a limited period – in the new member states. It contains all the regulations which have been implemented in the EU from its beginning. The underlying philosophy of the EU is that the application of the Acquis is the precondition for a functioning internal market. It aims to ensure equal economic conditions for all economic agents across the entire EU with regard to social and environmental issues as well as the safeguarding of health care.

- *EU Budget*: The new member countries will be included in the EU budget system. On the one hand, they each have to contribute to the budget (under the current rules every member state has to pay up to 1.25 % of its GDP). On the other hand, they will receive financial resources out of this budget. Due to their low GDP, their financial contribution will be small. Since they are poor, however, and since agriculture is still of far more importance than in the old member states, the accession countries will draw significant sums out of the EU budget. As a result, the new member states will become net receivers, and enlargement will create direct budgetary costs for the old member states.

- *Decision-making*: The new member states are included in the institutions which are relevant for making decisions within the EU, namely the European Council and the European Parliament. The number of seats (European Parliament) and votes (European Council) for every country as well as the voting procedure for reaching decisions by qualified majorities are laid down in the Treaty of Nice, agreed upon in December 2000. In the meantime, the draft Treaty establishing a Constitution for Europe drawn up by the European Convention is on the table, including new decision-making rules. The draft was heavily opposed by Poland and Spain because their voting power in the European Council – compared to that of the large member countries – would be weaker than under the Treaty of Nice (Table 3). Now, after the election of a new parliament in Spain on 14 March 2004 with the consequence of a change of government, it seems that both countries are ready to give up their rigorous opposition. As long as no agreement has been reached upon a European Constitution, post-enlargement decisions will be taken in accordance with the Treaty of Nice.

- *European Monetary Union (EMU)*: The enlargement of the EU on 1 May does not include membership of the accession countries in the EMU at this point in time. The accession countries have to go through

Table 3
Voting Power in the European Council in the Enlarged EU by Country
(in %, EU-25 = 100)

	according to the Treaty of Nice (after 1 Nov. 2004)	according to the proposal for a European Constitution
Germany	9.04	18.22
United Kingdom	9.04	13.15
France	9.04	13.09
Italy	9.04	12.79
Spain	8.42	8.74
Poland	8.42	8.58
Netherlands	4.05	3.50
Greece	3.74	2.34
Czech Republic	3.74	2.28
Belgium	3.74	2.27
Hungary	3.74	2.24
Portugal	3.74	2.21
Sweden	3.12	1.96
Austria	3.12	1.79
Slovakia	2.18	1.20
Denmark	2.18	1.18
Finland	2.18	1.15
Ireland	2.18	0.83
Lithuania	2.18	0.83
Latvia	1.25	0.55
Slovenia	1.25	0.44
Estonia	1.25	0.33
Cyprus	1.25	0.17
Luxembourg	1.25	0.09
Malta	0.94	0.08
EU-25	100	100

Source: T. Fischer, A. Metz: Mit Nizza am Abgrund?, Reform-Spotlight 1, CAP, 2004.

Table 4
Effects of Enlargement – Results of Several Studies

Authors	Increase in GDP in EU-15 (%)	Increase in GDP in accession countries (%)
Brown-Deardorff-Djankov-Stern[a]	0.2	5.6-7.3[c]
Baldwin-Francois-Portes[a]	0.2	1.5-18.8[d]
Neck-Haber-McKibbin[a]	0.0	1.6[e]
Lejour-de Mooij-Nahuis[a]	0.7	6.0-9.6[f]
EU-Commission[b]	0.5-0.7	1.3-2.1[g]
Breuss[b]	0.26	5.7-8.4[h]
Kohler[a]	0.20-0.34	-

[a] Computed general equilibrium models; [b] Macroeconometric models; [c] Czech Republic, Hungary, Poland; [d] Czech Republic, Hungary, Poland, Slovakia, Slovenia, Bulgaria, Romania; [e] previously centrally planned economies of Central and Eastern Europe, excluding the countries of the former Soviet Union; [f] Czech Republic, Hungary, Poland, Slovakia, Slovenia, Bulgaria, Romania; [g] Increase of the average annual growth rate of eight CEECs during the period 2000-09; [h] Czech Republic, Hungary, Poland.

Sources: D. Brown, A. Deardorff, S. Djankow: An economic assessment of the integration of Czechoslovakia, Hungary, and Poland into the European Union, in: S. W. Black (ed.): Europe's economy looks east – Implications for Germany and the European Union, Cambridge 1997; R. Baldwin, J. Francois, R. Portes: The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe, in: Economic Policy, No. 24, 1997, pp. 127-176; R. Neck, G. Haber, W. J. McKibbin: Macroeconomic Impacts of an EU Membership of Central and Eastern European Economies, Ludwig Boltzmann Institut, Forschungsbericht, No. 9917, Vienna, October 1999; A. Lejour, R. de Mooij, R. Nahuis: EU enlargement: Economic implications for countries and industries, CPB Document, No. 011, The Hague 2001; European Communities, Directorate General for Economic and Financial Affairs: The economic impact of enlargement, Enlargement paper No. 4, Brussels 2001; W. Kohler: Eastern Enlargement of the EU: A Comprehensive Welfare Assessment, HWWA Discussion Paper, No. 260, Hamburg 2004; F. Breuss: Macroeconomic effects of EU enlargement for old and new members, Working Papers, No. 143, Vienna 2001; F. Breuss: Benefits and Dangers of EU Enlargement, in: Empirica, No. 29, 2002, pp. 245-274; F. Breuss: EU-Osterweiterung: Ein Wachstumsimpuls für den gesamten Wirtschaftsraum?, in: R. Caesar, K. Lammers, H.-E. Scharrer (eds.): Eine Zwischenbilanz der Lissabon-Strategie, HWWA-Studies, (forthcoming in 2004); own grouping and addendum.

various stages, comparable to those the present members of the euro area had to pass before they joined the EMU. At the end of this process, the countries will be evaluated in the light of the convergence criteria laid down in the Treaty of Maastricht. As things are, the first new member countries will join the EMU in 2007 at the earliest.

Macro Effects

In recent years, a number of studies have been undertaken in order to assess the impact of enlargement on the old member states. Most of these studies indicate the effects in terms of changes in the GDP of the country under consideration (or that of the EU) after several years of enlargement compared with a hypothetical situation without enlargement. Only some studies explicitly choose a welfare focus.[1] The assessment of the enlargement impact is based either on computable general equilibrium models (CGE-models) or on macro models.[2] As far as the channels are concerned through which the changed institutional environment affects the economies the following, principally, have to be taken into account:

- static gains from trade and dynamic effects of trade integration
- static and dynamic gains of integration through capital flows and cross-border migration
- costs of structural change, especially on the labour markets

[1] E.g. W. Kohler: Eastern Enlargement of the EU: A Comprehensive Welfare Assessment, HWWA Discussion Paper, No. 260, Hamburg 2004; and H. Dicke, F. Foders: Wirtschaftliche Auswirkungen einer EU-Erweiterung auf die Mitgliedsstaaten, Kieler Studien, No. 309, Tübingen 2000, Mohr Siebeck.

[2] In CGE-models the numerical values are set by plausible assumptions. Macro-models are based on equations estimated econometrically.

- effects of the redistribution of resources by EU policies, especially with regard to the common agricultural policy as well as the cohesion and structural funds.

Only a few of the existing empirical studies consider all the above-mentioned effects simultaneously and most of them have certain shortcomings. Nevertheless, these studies provide valuable information and the results are surprisingly consistent. They can be summarised as follows (see also Table 4).

- The economic impact of enlargement on the old member countries is relatively small. Most of the studies assess accumulated income gains in the range of 0.2-0.3 % of the GDP of the EU-15 after several years of enlargement. The rate of growth will not be stimulated on a sustainable basis. In absolute terms, this would mean an income gain of between €16 and 23 billion for the whole area of the EU-15. The calculated welfare gains are also in the range of 0.2-0.3 % of GDP.[3] The gains are the result of static and dynamic effects of trade as well as of factor mobility. Attention has to be paid to the fact that income gains[4] as well as welfare gains[5] will be realised even though these studies take into account the transfer payments which the old member states have to shoulder.
- The new member countries benefit from enlargement much more than the old ones. Most studies calculate income gains to be at least ten times higher. These gains are the result of assumed and expected transfers, as well as that of an intensified integration of markets. In detail, they consist of both static and dynamic trade effects with regard to goods and services as well as static and dynamic effects resulting from increased inflows of foreign direct investment.[6]

With regard to these results, some explanatory notes and reservations have to be made. Some of the studies do not distinguish between integration effects before and after the legal EU membership of the accession countries. Actually, major parts of the calculated enlargement effects do not appear after 1 May 2004, but have in fact already been realised before that date. As mentioned above, the implementation of several agreements has meant that trade between accession and incumbent countries as well as that among the accession countries was already liberalised to a great extent during the 1990s. The accession countries have also removed the most severe obstacles to foreign direct investment. Trade flows – with regard to both their regional orientation and their structural composition – and direct investment relations between eastern and western Europe already show expected patterns taking into consideration differences in factor endowment, per capita income and market potential. Several years ago trade patterns already showed a high similarity to those which had existed before the Second World War.[7]

Consequently, some authors expect the old member states to experience very few further effects as far as the goods, services and capital markets are concerned.[8] What will certainly have an impact on the old members, however, are the economic effects of political integration, which include the fact that the accession countries will receive significant transfer payments and which for the old member states will imply a loss of resources and will thus result in negative welfare effects.

However, it is precisely the available calculations regarding the effects of transfer payments which involve considerable uncertainties. It is true, of course, that the extent to which the new member countries would receive transfer payments up to the end of 2006 was established within the framework of the Copenhagen accession decisions of December 2002. Also, the assessment that the accession countries will continue to be net receivers within the framework of the EU budget beyond 2006 is very probably correct. However, to what extent this will be the case, and how the effects of resource deprivation will be distributed among the old member countries, will be the result of negotiations between the European Commission, the European Parliament and above all the 25 member states. The EU's financial planning and consequent budgetary effects on the individual member states require the approval of all the countries. In February 2004, the

[3] Welfare gains should not be equated with income or growth effects. Income or growth effects ignore foregone consumption for accumulation as well as investment in the steady state solution.

[4] See F. Breuss: EU-Osterweiterung: Ein Wachstumsimpuls für den gesamten Wirtschaftsraum?, in: R. Caesar, K. Lammers, H.-E. Scharrer (eds.): Eine Zwischenbilanz der Lissabon-Strategie, HWWA-Studies, (forthcoming in 2004).

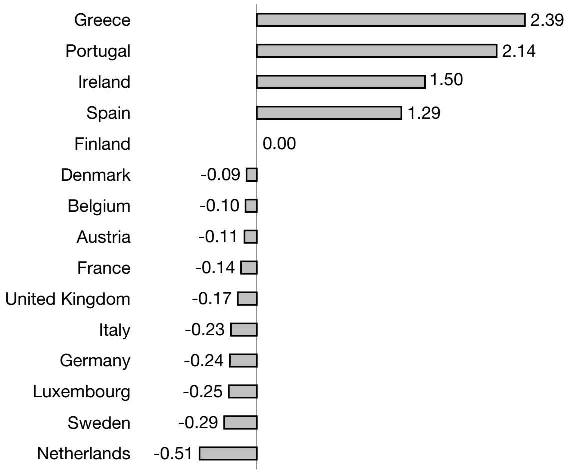
[5] See W. Kohler, op. cit.

[6] See F. Breuss, op. cit.

[7] D. Piazolo: The Integration Process between Eastern and Western Europe, Kiel Studies No. 310, Berlin-Heidelberg 2001, Springer; P. Brenton, F. di Mauro, M. Lücke: Economic Integration and FDI: An Empirical Analysis of Foreign Investment in the EU and in Central and Eastern Europe, in: Empirica, 1999, No. 26.2, pp. 95-121.

[8] E.g. H. Dicke, F. Foders, op. cit.

Figure 3
Net Beneficiaries of and Net Contributors to the EU Budget, 2002
(in % of GDP)



Source: European Commission 2003.

European Commission presented its financial planning proposals for the period 2007-2013, which provide for a substantial increase in expenditures even in relation to GDP. Some net donors – Germany, France, the United Kingdom, the Netherlands, Austria and Sweden – have already spoken out against the Commission's proposal. Others, the traditional net beneficiaries Spain, Greece and Portugal and of course the acceding countries, are in favour of extending the budget as proposed by the European Commission (for contributions to the EU budget by country see Figure 3). Negotiations on the EU budget and its related fiscal effects on individual member countries will probably continue into 2006. It is not improbable that a decision on the budget and related transfer payments will be linked to negotiations on the European Convention's draft Treaty establishing a Constitution for Europe.

The available calculations partly fail to take into account the full costs of extending the acquis communautaire to the accession countries. Although the accession countries have been granted a whole range of transitional arrangements regarding the application of this set of EU rules, adopting the acquis communautaire will nonetheless create costs for economic activities in these countries and so reduce the production cost advantages they will otherwise enjoy. This in turn implies that the adjustment pressure on producers in the old member states brought about by enlargement will be lower. This is probably an important reason why manufacturers in the old member states demanded the full accession of the eastern European reform economies into the EU rather than just their association.[9] In any case, the application of the acquis in the accession countries prevents what would otherwise be a possibly stronger increase in GDP. From this point of view, enlargement is less favourable for the accession countries than a situation in which they are merely associated with the EU economic area.[10]

These comments on the results of available empirical studies have no material effect on the general finding that the effects of enlargement on the existing EU – seen in its entirety – are small. On the contrary, both the justified postulation that many of the expected effects have taken place before May 1 and the indisputable fact regarding the additional costs with which producers in the new member states are faced after May 1 seem to indicate that the effects on the economic area of the existing EU will be even less substantial. However, these assessments are only true for the old member states as a whole. On the other hand, enlargement entails considerable adjustment costs that are extremely unequally distributed among the old member states and, within these states, are unequally distributed among the various sectors of the economy, regions, production factors and individual people. These distribution effects harbour a considerable conflict potential with an uncertain end as far as economic policy reactions to these effects are concerned.

Distributional Effects: Benefits and Losses by Countries

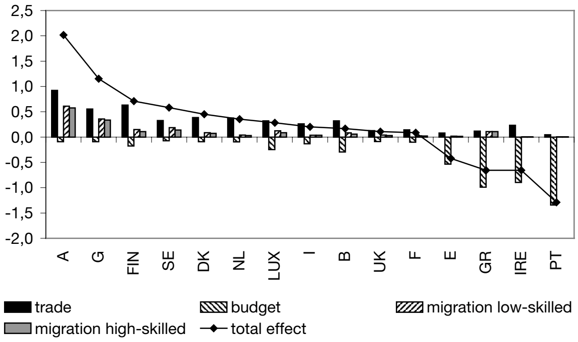
According to the available studies, Germany and Austria – and, to a significantly lesser extent, Finland – can achieve relatively strong welfare improvements and income gains (Figures 4 and 5).[11] These are the countries directly bordering on the accession countries or which are closest to them. On the one hand, these income gains and welfare improvements are the result of trade effects and on the other hand – particularly as far as Austria and Germany are concerned – are due to potential immigration from the accession countries.

[9] This is demonstrated for example by a statement issued by the Bundesverband der Deutschen Industrie (BDI): "Only if there are realistic prospects of a swift and complete implementation of the acquis will the accession of the reform economies be possible without serious distortions of competition and encumbrances on the economy on both sides" (BDI 1997 cited in H. Dicke, F. Foders, op. cit., p. 137; author's translation).

[10] H. Dicke, F. Foders, op. cit.; see also: H. Gabrisch: Osterweiterung der EU: Mehr Realismus ist notwendig, in: Wirtschaft im Wandel, No.13, 1998, pp. 3-10.

[11] See F. Breuss, op. cit.; W. Kohler, op. cit.; European Communities: The economic impact of enlargement, Enlargement Paper No. 4, Brussels 2001. According to Breuss this list also includes Italy.

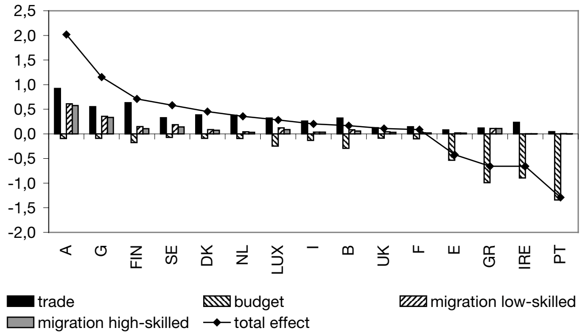
Figure 4
Welfare Effects of Enlargement for EU-15 Countries[1]



[1] In % of GDP.

Source: W. Kohler: Eastern Enlargement of the EU: A Comprehensive Welfare Assessment, HWWA Discussion Paper No. 260, Hamburg 2004.

Figure 5
Income Effects of Enlargement for Thirteen EU Countries[1]



[1] In % of GDP; Greece and Luxembourg not included.

Source: F. Breuss: EU-Osterweiterung: Ein Wachstumsimpuls für den gesamten Wirtschaftsraum?, in: R. Caesar, K. Lammers, H.-E. Scharrer (eds.): eine Zwischenbilanz der Lissabon-Strategie, HWWA-Studies, (forthcoming in 2004); own graphic representation..

The least significant positive effects[12] or even considerable negative effects[13] take place in countries that are furthest from the economic region of the accession countries, i.e. in Spain, Portugal, Greece and Ireland.[14] This is partly due to redirected flows of foreign direct investments into the accession countries,[15] and partly because of extremely small positive trade effects and above all the loss of transfer payments from the EU budget.[16]

Adjustment Pressure on the Low-skilled

The "eastern" enlargement process naturally has different effects on individual industries within the existing EU. In the advanced countries, the additional exports are concentrated on human capital intensive industries. Import pressure in western Europe emanating from the accession countries increase above all in labour-intensive and less technology-intensive industries. It should be borne in mind, however, that in some cases the level of qualification among workers in the accession countries is high. The competitive advantage of the accession countries is mainly based on their low labour costs. Consequently, the "eastern" enlargement will above all result in an intensification of labour cost competition in the old EU member states in more or less every branch of the economy. The specifics of enlargement (completion of the internal market with its four principle freedoms) as well as the geographical proximity of the accession countries to western Europe mean that increasing labour cost competition will not be limited to manufacturing industry and tradable goods, but will also impact the construction industry and a number of services.

Increasing pressure on labour costs is not only the result of more imports. A further contribution is also made by direct investments carried out in the accession countries with the intention of taking advantage of low-wage locations in eastern Europe. It is true, of course, that direct investments are made in the accession countries not only for cost reasons, but also in order to develop regional markets there. Moreover, any additional potential for cost-oriented direct investments appears limited, because producers from western Europe have already exploited this potential to a large extent prior to accession. Even so, the competitive pressure on jobs and wages in the old member states generated by the relatively simple option of further cost-oriented direct investments is considerable. Relocations of this kind are relatively simple due to the short geographical distances and minor cultural differences involved. This competitive pressure is exerted on employees in many industries, also on those in which the advanced EU-15 countries, in principle, have competitive advantages, such as car manufac-

[12] According to European Communities, op. cit.

[13] According to F. Breuss, op. cit.; and W. Kohler, op. cit.

[14] According to Breuss Ireland is not one of the countries with the least significant positive or considerable negative effects. Ireland experiences relatively strong income gains from the realisation of the internal market which more than offsets the losses from transfer payments. F. Breuss, op. cit.

[15] According to F. Breuss, ibid.

[16] According to W. Kohler, op. cit.

Table 5
Immigration from Accession Countries[a] into EU-15
Results of Several Studies

Authors	Number of immigrants per year over a 15 year period	Total number of immigrants after 15 years	Immigrants in per cent of population in EU-15[b]
Bauer/Zimmermann	135,000-210,000	2-3 million	0.5-0.8
Boeri/Brücker	200,000 at the beginning; decreasing over time beyond 50,000	2.4 million	0.6
Sinn et al.	240,000 at the beginning; decreasing over time to 125,000	3.4 million	0.9
Straubhaar	74,000-111,000	2.3 million	0.6

[a] Without Cyprus and Malta; [b] including those immigrants who were already living in EU-15 before enlargement.

Sources: Deutsche Bank Research: Die deutsche Bauwirtschaft im Zuge der EU-Osterweiterung, Sonderbericht, 11 October 2002, Frankfurt am Main; T. Bauer, K. F. Zimmermann: Assessment of possible migration pressure and its labour market impact following EU enlargement to Central and Eastern Europe, Study for the UK department for Education and Employment, IZA (Bonn), London (CEPR) 1999; T. Boeri, H. Brücker: The Impact of Eastern Enlargement on Employment and Labour Markets in the EU Member States, Europäische Kommission, GD Employment and Social Affairs, Brussels 2001; H.-W. Sinn et al.: EU-Erweiterung und Arbeitskräfteemigration, ifo Beiträge zur Wirtschaftsforschung, Munich 2001; T. Straubhaar: Ost-West-Migrationspotenzial: Wie groß ist es?, in: Jahrbücher für Nationalökonomie und Statistik, Stuttgart 2001, pp. 2241; own addendum.

turing.[17] The German car-maker Audi, for example, was very quick to move its entire engine production to Hungary.

The competitive pressure on workers is not only generated by increasing import competition and labour cost-induced direct investments, but also through outsourcing away from the old member states and into the accession countries. The extension of the European economic area offers ideal conditions for the application of today's technical possibilities to split up value-added chains. In addition, outsourcing is encouraged by the geographical and cultural proximity of the eastern European countries to western Europe, in particular to Austria and Germany. Many companies, and increasingly small and medium-sized firms, have already taken the opportunity to relocate parts of their value chain outside the existing EU boundaries. This is particularly true of labour cost-intensive production processes. While large companies can also achieve this goal by means of direct investments, small and medium-sized firms prefer to enter into cooperation agreements with manufacturers in the accession countries. Primarily, labour cost-intensive intermediate products are first outsourced and subsequently procured. In this way it is possible for companies in the existing EU countries to maintain or to improve their competitiveness. The profits of these companies increase; the procurement of intermediate products from abroad generates a corresponding loss of value added creation at home, which is suffered in the main by suppliers of labour.

Traditional import competition, labour cost orientated FDIs, and outsourcing all work in the same direction: they put pressure on workers' wages and jobs in the old member states, particularly where qualifications are low. This pressure would further increase if the free movement of people between the accession countries and the existing EU were to be admitted as of 1 May 2004. Studies on potential migration from the eastern European accession countries come to the conclusion that within a period of 15 years, a (net) influx of migrants amounting to 0.5 to 0.9 % of the EU-15 population can be expected (see Table 5).

This influx does not appear all that large. However, because the competitive pressure on the labour market for low-qualified workers in the existing EU is already considered to be very high, and because migration would have been concentrated on certain countries, the old member states have been granted the right to limit immigration from eastern Europe for up to a maximum of seven years. This limitation has been introduced despite the fact that, as one of the four principle freedoms, the free movement of people is one of the constituent elements of the internal market. The instigators of this transitional arrangement were Austria and Germany, the two countries that would be faced with the largest inflows of migrants. With the exception of the United Kingdom and Ireland, all the old member states will make use of the option to limit immigration.[18] By limiting immigration, the old member states are relinquishing some of the potential welfare benefits and income gains of the EU enlargement. For Austria and Germany in particular, immigration would, according to the studies cited above, have been an important means of gaining welfare and income benefits from the enlargement.

[17] J. Spatz, P. Nunnenkamp: Globalisierung der Automobilindustrie: Wettbewerbsdruck, Arbeitsmarkteffekte und Anpassungsreaktionen, Kiel Studies, No. 317, Berlin –Heidelberg 2002, Springer.

[18] Workers from the accession countries are allowed, initially, to migrate freely to Ireland and the United Kingdom. However, the British government has announced that it will introduce restrictions should the labour market come under pressure.

The European Welfare State under Pressure

It is doubtful whether the migration potential from eastern Europe will have decreased significantly after the seven-year transitional period. Even if the accession countries continue to catch up significantly in terms of wages and living standards, the income differential between western and eastern Europe will still be large. Thus, immigration limitation will not substantially remove pressure on wages and jobs, but will merely have a delaying influence. Moreover, given that competitive pressure exists anyway as a result of increasing imports, labour cost induced FDIs and outsourcing, extensive adjustment measures will be necessary in the old member states. These involve above all labour market flexibility, wage settlement procedures and the social security systems in as far as they set minimum wage standards. In order to prevent a large number of workers losing their jobs, market-oriented wages and improved incentives to take on work are required. Income security in cases of need should not thwart incentives to take up paid employment in the market. This calls the traditional social state in some member countries into question. The large continental European countries, Germany, Italy and France in particular, have problems in this respect. Yet it is precisely in Germany – because of its proximity to the accession economies – that the need for adjusting the welfare state is particularly pressing. If the necessary policy adjustments do not take place, then not even the relatively small welfare gains that can be expected according to the above-mentioned studies will materialise.

The discussion on immigration from the accession countries has also thrown up questions from another angle regarding the future of the social state in its continental European form. Immigration from the accession countries does not or does not exclusively take place because migrants can earn higher incomes here that exceed the costs of migration. In fact, the redistribution of wealth as practised by the welfare state in itself is an incentive to migrate. Since social services and also the free use of public infrastructures is, in some of the existing member states at least, of a far higher standard than in the accession countries, migration is encouraged not only by market-oriented incentives, but also by state-induced enticements. In extreme cases the incentive to make use of these services is in itself sufficient to induce migration, even if there is no prospect of earning a higher labour income than in the home country. This potential migration places pressure on the social state in those countries of the existing EU characterised by extensive redistribution systems. For this reason, the traditional welfare state in its western European form is considered by some to be incompatible with free workers' migration in an extended Europe to the extent that immigrants are given immediate access to the full range of state services and benefits in the destination country. If immigration is not limited, or if immigrants are not excluded – at least for a certain time – from state services and benefits, then the social state in Europe will not be able to survive.[19] The United States is cited as evidence for this theory: within the USA, the free movement of people and unlimited claims on state services by immigrants are guaranteed in every federal state. Since each federal state decides by itself to a large extent which services are provided, so the argument goes, it would have been impossible for a welfare state to develop along the lines of those found in western European countries.

It is relatively unlikely, however, that the European welfare state would indeed come to an end without a restriction on the free movement of people or a limitation of access to state services and benefits for immigrants in an extended Union. If this theory were correct, then such a development should already have taken place in the existing EU prior to enlargement. Compared to the USA, the willingness to migrate within Europe is relatively low; this is presumably due to a considerable degree to language barriers. Nonetheless it is true that the enlargement of the EU, via potential immigration together with an increase in import competition, FDI outflows and outsourcing, will exercise pressure to trim down the welfare state. Especially old member states with extensive redistribution mechanisms and superior social standards will be forced to dismantle these at least in part.

The alternative solution would be to harmonise redistribution systems and social standards across the whole of Europe or to centralise them at the EU level. As far as social standards are concerned, the EU already has the capacity – although very limited – since the Maastricht Treaty (1992), to decide on certain social standards with a qualified majority. Moreover, it has already made use of this capacity.[20] The European Convention's draft Treaty establishing a Constitution for Europe provides for an extension of this capac-

[19] H.-W. Sinn et al.: EU-Erweiterung und Arbeitskräfteemigration, ifo Beiträge zur Wirtschaftsforschung, Munich 2001.

[20] R. Vaubel: Political Integration with Majority Decision: Lessons from the History of Hamburg, the United States and the European Union, paper presented at the regional meeting of the Mont Pelerin Society, Hamburg, April 2004.

Table 6
The New Financial EU Framework 2007-2013
– Commitment Appropriations –
Proposal by the EU Commission
(in per cent of total)

	2006	2007	2010	2013
Competitiveness for growth and employment	7.3	9.1	12.9	16.3
Cohesion for growth and employment	32.1	35.6	33.6	32.2
Preservation and management of natural resources[a]	10.2	10.1	10.2	9.8
Agriculture: market related expenditure and direct payments	36.2	32.6	29.3	26.7
Citizenship, freedom, security, justice	1.1	1.2	1.8	2.3
The EU as global partner	9.3	8.5	9.3	9.9
Administration	2.8	2.8	2.8	2.8
Compensations	0.9	-	-	-
Total (€ million at 2004 prices)	120,688	133,560	146,670	158,450

[a] without agriculture.

Source: Commission of the European Communities: Communication from the Commission to the Council and the European Parliament, Information Note Common Financial Framework 2004-2006 for the Accession Negotiations, Brussels 2004; own calculations.

ity, e.g. regarding protection against dismissal from employment. Even though the Convention's draft recognises the member states' authority "to define the fundamental principles of their social security systems", it nonetheless opens up the possibility of harmonisation as long as the financial equilibrium of these systems is "not significantly" disturbed. There will certainly be attempts made by those groups in society that stand to suffer as a result of changes in the social state and by their political representatives to escape adjustment pressures in this way. Should this path be taken, however, then the EU would relinquish all the welfare improvements that are in principle possible as a result of the enlargement.

Conclusion and Outlook

According to available empirical assessments, any direct boost to economic growth in the western European economic region brought about by the enlargement of the EU on 1 May 2004 is only minor and temporary. However, it will intensify distribution conflicts among the existing member states and, in particular, place considerable adjustment pressure on wages and jobs among low-qualified workers. Furthermore, it will necessitate adjustments in those member countries with extensive social services and welfare benefits. The adjustment process will be particularly perceptible in countries close to eastern Europe. It is up to the politicians in the member states to initiate the necessary steps. There are considerable differences between the member states in their willingness to make adjustments. The three large continental European countries of Germany, France and Italy have substantial problems in implementing the necessary reforms. Failure to achieve far-reaching reforms in these countries would call the expected positive effects, which are already modest, into question. A similar effect would be achieved by any steps taken towards a pan-European harmonisation of social policy.

As far as the new member states are concerned, enlargement will afford an additional boost to their already dynamic catching-up process. However, the economic momentum of the accession countries will not be enough to generate a perceptible increase in the growth rate of the EU as a whole. The new member states are economically still too insignificant for their – in some cases very good – growth performance to make a significant impact on the EU's economic growth statistics.

Nor can EU policies be expected to boost growth in the enlarged European economic region. While the European Commission plans to strongly increase EU expenditures for competitiveness, growth and employment in the next budget period, it is doubtful whether these measures will actually encourage economic growth. Moreover, the largest shares of expenditures are still earmarked for agriculture and cohesion policy (Table 6). The latter is aimed at promoting regions with development deficits, irrespective of whether or not these regions contribute to the competitiveness of the EU as a whole. Even in 2013, according to current plans, two thirds of the EU budget will thus continue to be pumped into areas that promise no stimulus to economic growth. There is no basis for the optimism that post-enlargement EU expenditure will be geared more closely to efficiency criteria and be less driven by national and sectoral distribution interests.

Since the beginning of the 1980s, economic growth in the EU has remained behind that of the USA. Enlargement on 1 May 2004 will do little to change this situation. Neither enlargement nor any other foreseeable EU policy initiatives will afford Europe an economic boost that could help it catch up with the momentum of the US economy for any significant length of time. What would be needed instead are far-reaching institutional reforms to stimulate economic activity by the member countries, especially by the large continental ones.