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The Economics of Enlarging the European Union: Policy Reform versus Transfers

While the European Union will hardly be in a position to receive new members without extensive policy and financial reform, the discussion so far has exaggerated the link between reform and enlargement. It has also tended to neglect the economic benefits to be expected from integrating the CEECs into the EU and has been dominated by concerns about intra-EU transfers. In an attempt to placate those member states which have complained that they pay too much, recent proposals could give rise to more inefficiencies and disparities within the Union.

The forthcoming enlargement of the European Union has been directly linked to the successful reform of major policies and the budget of the Union. In fact, intra-EU policy and financial reform are seen as a precondition for enlargement. Indeed, there is hardly any doubt that the Union will not be in a position to receive new members without extensive reform.

However, the discussion that has unfolded so far on how to modify policies and the financial system of the Union can be criticised in three respects. First, it has virtually ignored important economic effects of the accession of new members. Second, it has exaggerated the link between their accession and reform. And, third, it has pitched the debate in terms of who gains and who loses from enlargement.

Economics makes a distinction between allocation of resources, distribution of income and monetary transfers. The public discussion on the 'economics' of enlargement mixes the reasons for policy reform with the relative gains and losses of each member state. This mixing of issues concerning allocation of resources with questions about transfers obstructs our understanding of the full extent of the impact of enlargement on the economies of the existing and prospective new members.

The allocation of resources is the outcome of the interplay between supply and demand while the distribution of income is the resulting effect on the income and wealth of labour and the owners of the factors of production. Transfers among the member states of the European Union may or may not have a direct effect on resource allocation. However, as it happens, intra-EU transfers do influence resource allocation, even though there are good arguments against such resource-based transfers.

The objective of this article is threefold. First, it explains what exactly we mean when we refer to the economics of enlargement. The debate on policy and financial reform has virtually ignored the important fact that the Union as a whole would experience significant economic gains from enlargement. Second, it considers why policy reform is necessary for successful enlargement and identifies the reasons for which reform would be necessary even if the Union would not receive any new members. Third, it explores the possible consequences of the fact that the issue of policy reform has been dominated by concerns about intra-EU transfers. In an attempt to placate those member states which have complained that they pay too much, recent proposals could introduce more inefficiencies and disparities within the EU.

Analysing the Economic Effects

When countries liberalise their economies by removing barriers to trade, resources are reallocated to the activity in which the value of the output is maximised. This is the reason why liberalisation in general improves efficiency (i.e. resources are put to a 'better' use) and raises overall economic welfare. Similar effects are experienced by countries that integrate their economies by removing bilateral barriers to trade.

However, in the case of bilateral liberalisation, as opposed to multilateral liberalisation, the partner

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countries experience at the very minimum two different and conflicting effects: trade creation, which is the availability of products from the partner country at lower price, and trade diversion, which is the displacement of products from third countries by partner country products. Trade creation raises economic welfare while trade diversion lowers it. This means that the overall net effect of integration depends on the relative magnitude of trade creation and diversion. So the economics of integration, or enlargement in our case, is concerned primarily with the net effect of the overall allocation of resources within the partner countries.

There are also a number of other effects which complicate significantly any definitive assessment of the net effect of economic integration. For example, partner countries may benefit from a favourable shift in their terms of trade with third countries (i.e. they acquire market power), or the 'cold shower' of competition may raise their productivity and stimulate growth, or, oppositely, their regions may experience a decline in economic activity as companies are attracted to the centre of the integrated area. So in addition to trade effects there are many others including competition (internal and external) effects and investment effects. Once the movement of factors of production and capital is included in the equation and once the cumulative growth influences are taken into account, it becomes very difficult to make a priori pronouncements about the effects of integration on partner countries, their regions and industries.

It is not surprising, therefore, that there is as yet no study that has attempted to evaluate all of the possible effects of integrating the countries of central and eastern Europe into the EU.[1] In this context, the most comprehensive study on the economic effects of enlargement and the distribution of losses and gains was published last year by the Centre of Economic Policy Research.[2] Let us consider briefly the main findings of that study.

The CEPR study tried to measure the changes in real income (measured in terms of Gross Domestic Product) arising from several sources of change analysed in three stages.

The first stage examined the repercussions of (a) the complete elimination of tariff barriers in bilateral trade including agricultural trade and (b) the adoption by the CEECs of the common external tariff (which is lower than their own tariffs on third country products). The calculations of the first stage were based on the assumption that the CEECs would adopt all of the EU's standards (health, safety, technical) and would comply with the rules on competition and state aid. The estimated effect on real incomes was an increase of 1.5% of GDP for the CEECs and 0.2% of GDP for the EU15.

The second stage attempted to expand the analysis by calculating explicitly risk premium effects and investment effects. The integration of the CEECs in the EU will make them a less risky place for inward investment. The CEECs have lower labour costs than western Europe, which attracts capital, but foreign capital will not be invested in factories and other businesses if the economic and political climate there is unstable. So, the reduction of the perceived risk is hypothesised to lead to a reduction in risk premium which in turn will reduce the relative return demanded by foreign investors and will eventually stimulate foreign direct investment. FDI is one of the main channels through which technology and know-how are transferred from one country to another. The estimated effect on real income was an increase of 19% for the CEECs and still 0.2% for the EU15.

In the third stage, the authors of the CEPR study took into account the EU funds that would be drawn by the prospective new members. The funds that will be absorbed by the new members are perceived as a cost to be borne by the existing members which will either have to pay (if they are net contributors to the budget) or have to forgo (if they are net recipients from the budget). This is a transfer issue.

In calculating the potential amount of EU funds that would be drawn by the new members, the CEPR study relied on estimates from previous studies. As is well known, these estimates vary widely, depending on the assumptions of the researchers concerning growth rates, the applicability of existing agricultural policy rules in the CEECs, the trends in productivity in the CEECs, the trends in world prices, the absorption capacity of the CEECs, etc. The amounts that were expected to be needed by the CEECs in the areas of agriculture and structural operations ranged from ECU 40 billion to ECU 80 billion per year. Having considered the budgetary politics of the EU, the CEPR

[1] Eleven countries are now involved in the process of acceding to the European Union. Ten central and east European countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia) and Cyprus. Turkey has been found eligible for membership but is not involved in that process. Malta was also found to be eligible for membership but until recently it froze its application. The EU will soon consider how to re-introduce Malta into the process of enlargement. The CEPR study which is examined below has not covered Cyprus or Malta. For this reason the paper refers only to the CEECs.

[2] R. Baldwin, J. Francois, R. Portes: The Costs and Benefits of Eastern Enlargement, in: Economic Policy, April 1997, pp. 127-176.

study reached the conclusion that the ten CEECs would receive from the budget ECU 24 billion and contribute ECU 9 billion, so that they would be net beneficiaries to the tune of ECU 15 billion.

Since the next enlargement is unlikely to include all of the applicant countries, the CEPR study concludes that the net cost (benefits less than transfers) to the EU15 will range from zero to at most ECU 10 billion. This is because the estimated benefits from economic integration, which amount to 0.2% of EU15 GDP, are about ECU 10 billion. By contrast the CEECs gain considerably.

These forecast results, like all empirical results, depend on the assumptions behind the calculations. Although the assumptions about the EU15 appear reasonable, those concerning the CEECs are dubious in one important respect. The CEECs are presumed to be in a position to adopt quickly and costlessly EU health, safety and technical standards. This is a rather far fetched expectation which exaggerates the potential benefits of the CEECs, at least in the medium term.

These calculations also show that the overall numbers hide a very uneven distribution of benefits among the EU15. More than 75% of the economic benefits will be reaped by just four countries: Germany, France, Britain and Italy. Germany alone stands to gain over a third of the EU15 benefits. The existing member states which are net recipients in budgetary terms 'lose out' twice: they reap much fewer of the gains from economic integration and in addition they will receive less from the EU budget since some EU funds will be diverted to the new member states.

Economics suggests, however, that as along as overall gains are positive there can be a system of transfers that leaves no one worse off. Recent Commission proposals for reform of the common agricultural policy, the structural funds and the financial system virtually ignore that the EU as a whole would gain both from the integration of the CEECs in the EU and from the reform itself. So by focusing on relative gains and losses those proposals compound the confusion between the overall gains from integration with the distribution of those gains.

Policy Reform and Enlargement

Policy reform has been directly linked to the impending enlargement of the European Union. To some extent that linkage is both justified and correct. The Union is not in a position to apply its main policy instruments in their present form to the countries that have applied for membership. The reasons are well known. Those countries are much poorer and more agriculturally oriented. Application of the present instruments would bankrupt the EU and would cause massive economic dislocation in the prospective new members.

However, present policies would be in need of reform even if no enlargement were to take place. To hitch all arguments for reform on enlargement is tantamount to minimising the internal weaknesses of those policies and maximising the significance of the redistributive effects of the accession of new members.

[3] European Commission: Agenda 2000 for a Stronger and Wider Union, July 1997.

In the Agenda 2000 and subsequent documents, the Commission indeed acknowledged that reform of the common agricultural policy is inevitable.[3] WTO negotiations on further liberalisation of agricultural trade are scheduled to start in 1999, while world food prices are not predicted to rise significantly. Both of these developments suggest that the present policy, if continued unchanged, will lead to the re-emergence of food surpluses with considerable waste of Community resources.

Characteristic of the neglect to account of and emphasise the gains to EU itself from reform of the CAP is the belated publication (more than a year after publication of Agenda 2000) of a Commission-sponsored study carried out by the Universities of Amsterdam and Bonn on the impact on incomes from CAP reforms. Researchers at the two Universities found that if the Commission's plans were adopted household food bills would be cut by at least 2% and EU GDP would rise by 0.2-0.4%.[4]

The Commission plans centred on a reduction in intervention prices by 10-30% and an increase in direct income support. In addition, the Commission argued that its proposed changes could be implemented within the framework of the existing CAP guideline which allows CAP expenditure to grow at 74% of the EU's GNP growth.

Two questions, however, have been left unanswered.[5] First, will farmers continue to receive public assistance indefinitely, irrespective of what they produce or whether they remain 100% farmers? Second, farmers in the new member states will not be eligible to receive direct income support. How will the CAP function if it is based on non-uniform principles?

With respect to structural operations, the Commission correctly points out that it does not make much sense to aim to reduce income disparities when at present over 50% of the EU population is eligible for support under objectives 1, 2, 5b and 6.[6] The Commission, therefore, proposed to replace the current seven objectives with three and to concentrate structural operations so that the new objectives 1 and 2 would cover only 35-40% of the EU15 population. Again it has maintained the ceiling for structural funds which stands at 0.46% of the EU's GNP.

However, the Commission included Canary islands and the present objective 6 regions under the new objective 1 and accepted that there would be transitional arrangements for the regions that lose EU funding. These arrangements could last until virtually the end of the next financial perspective in 2006. Hence, the fudging of the boundaries of the various objectives has already begun.[7]

Although member states' views differ significantly on the proposed reform of the CAP and structural operations, it is on the budget that the battle lines have been drawn most starkly. The Commission argued in Agenda 2000 that it would be possible to accommodate new member states within the present budget ceiling of 1.27% of the EU GNP. Its calculations purported to show that the new member states could receive over EUR 17 billion in 2006 and the EU would still have a contingency budgetary margin of about 0.3% of GNP.

Four member states, Austria, Germany, the Netherlands and Sweden, have declared that they, like the UK, also 'want their money back'. Until very recently, the Commission had never acknowledged that there was such a thing as a 'net contribution' problem. This policy appears to have changed with the publication at the beginning of October 1998 of a document on the financial system of the European Union.[8] Now the problem of financing enlargement is compounded by arguments as to who should pay for it.

Financing the European Union

Despite arguments about the unfair budgetary burden borne by some member states, the financial system of the EU has become more equitable. Equity in this sense is indicated by the member states' capacity to contribute to the financing of the Community's activities. The EU derives its revenues from four so-called 'own resources': customs duties, levies on agricultural imports, a part of the VAT receipts of member states and contributions based on the size of the member states' GNP. The first two resources are also called 'traditional' own resources. In 1988, the shares of the four financial sources in the EU budget were as follows: customs duties and agricultural

[4] Economic Impact Analyses of CAP Reform Proposals, IP/98/892, 15 October 1998.

[5] For a review and assessment of the proposals in Agenda 2000 see M. Soveroski (ed.): Agenda 2000: An Appraisal of the Commission's Blueprint for Enlargement, Current European Issues, European Institute of Public Administration, Maastricht 1997.

[6] For a thorough appraisal of the EU's structural operations see the European Commission's First Report on Economic and Social Cohesion, November 1996.

[7] For a critical view of the latest proposals see F. Bollen: Reform of the EU Structural Funds: Ten Questions on the Magnitude and Direction of Reform, Briefing Paper, European Institute of Public Administration, September 1998.

[8] European Commission, Financing the European Union: Report on the Operation of the Own Resources System, 7 October 1998.

levies (29%), VAT (60%) and GNP-related payments (11%). In 1999, it is forecast that the composition of revenue will have changed as follows: customs duties and agricultural levies (16%), VAT (35%) and GNP-related payments (48%). Since VAT is a tax on consumption it is a regressive form of taxation. The poor pay proportionately more of their income than the rich. Therefore, the relative increase of the share of the GNP-related payments has injected more equity in the system because it reflects more closely the wealth and thus the capacity to pay of the member states.

The four net contributing countries mentioned above pay net amounts (after the UK rebate) which are equivalent to 0.6% of the GNP of Sweden, 0.6% for Germany, 0.4% for Austria and 0.3% for the Netherlands. The UK, before it receives its rebate, pays in the EU budget a net amount equivalent to 0.3% of its GNP.

Three observations have to be made at this point. First, budgetary balances have little to do with gains and losses from EU membership.[9] For example, in 1997 the share of traditional own resources (duties and levies) in the overall revenue of the EU was 19%. The overall contribution of the Netherlands to the total budget was 6.4%. However, the Dutch share in the traditional own resources was 12.2% of all the member state payments in the form of duties and levies. Traditional own resources represented 36% in the total Dutch payments, almost twice as much as the Community average. The reason is that the Netherlands collects the customs duties at the port of Rotterdam which is the main commercial entry point into the EU. Ironically, the Dutch government appears to have forgotten that until the early 1990s the Netherlands was a net beneficiary.

Moreover, it has been estimated that about 40% of the expenditure on investment projects and capital equipment co-financed by structural funds in the cohesion countries flows back to the richer member states because they are the main producers of capital equipment and providers of business services.[10]

Close examination of the budgetary arrangements of the EU reveals that not only do they convey little information as to the overall net costs and benefits of EU membership, but in some respects they actually distort the real impact of membership. For example, a significant part of the national contributions is based on the VAT system of indirect taxation. At present, the VAT system functions according to the 'destination' principle which taxes goods and services at the place of their consumption. This requires that exports are zero rated. The consequence of this zero rating of exports is that the total VAT revenues of a net exporting country are lower than they would otherwise be, but its national income is not. Correspondingly, the revenues of a net-importing country are higher than they would otherwise be, but its national income is not. Although there is agreement among member states that by 1999 the VAT own-resource of the EU will be capped at 1% of the VAT receipts (which means that payments into the budget reflect more closely the capacity to pay), until recently net-importing countries which were by and large poorer countries were contributing more than their true capacity to pay.

Second, the UK rebate is an anachronism. It was introduced at the time when the CAP absorbed over 70% of the EU expenditure (the UK had a relatively small agricultural sector), most of the UK external trade came from outside the EU and tariffs were at much higher levels (both of the last two factors meant that the UK paid more tariff revenue into the EU's coffers). At that time, the UK did indeed pay proportionately more money into the budget and received proportionately less. The situation has changed significantly. In 1997 the share of the UK in the financing of the EU was 12% while its share of the overall Community GNP was 16%. It is the country with the largest difference between its capacity to pay and its actual payments.

Third, with the exception of the UK, the remaining member states have a rough parity between the size of their GNP and their shares of the EU revenue (VAT and GNP-related contributions). This means that deviations from that rough parity are caused mainly by two factors: (a) the traditional own resources, on the revenue side, and (b) the agricultural policy and structural operations, on the expenditure side. When considering how to restore that parity, the traditional own resources should present no major problem because the relatively higher contributions of the Netherlands and Belgium are, one would say, fictional as these countries would not collect tariffs on behalf of the rest of the EU if the EU did not exist. So this kind of money does not exactly belong to them.

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[9] For a critical appraisal of the EU financial system see B. Laffan, M. Shackleton: The Budget, in H. Wallace, W. Wallace (eds.): Policy-Making in the European Union, Oxford University Press, Oxford 1996; G. Denton: An EU Perspective on Financial Transfers, paper presented at the conference on 'Negotiating for Effectual Enlargement', European Institute, Lodz (PL), 18-20 June 1998.

[10] See European Commission: First Report on Economic and Social Cohesion, op. cit.

A more serious problem is the targets and direction of EU spending. The Commission, in its document of October 1998, considered without formally endorsing the 're-nationalisation' of part of the CAP spending. The reasoning is that the CAP still absorbs half of the EU budget. If Community spending on farmers is reduced, the net contributors will also experience a reduction in their overall payments to the EU. On the basis of the information provided in the document it is not possible to say whether that would indeed be the outcome for the net contributors. The benefits from the CAP are notoriously skewed. It has been estimated that about 80% of the benefits go to only 20% of the farmers.[11] This is because large farmers and farmers of temperate products (which receive relatively more support) gain disproportionately from the CAP. It remains to be seen whether re-nationalisation will redress budgetary imbalances.

However, if re-nationalisation is accepted as a principle, it would not necessarily work just on its own. It would probably have to be accompanied by supplementary measures to prevent member states from cheating (e.g. subsidising too much). Perhaps a new layer of bureaucracy will have to be established. That would raise the operating costs of Community policies, but the real costs would be hidden as they would not appear on the EU budget. So in the process of addressing budgetary imbalances there could be substantial waste of resources, not because administrative mechanisms are inherently wasteful but because the EU could have reduced those imbalances directly by lowering support to farmers.

The main problem with the idea of re-nationalisation is that it opens the flood gates for using the budgetary spending and Community policies to balance national payments and receipts. Indeed this was suggested in a recent report by the Court of Auditors on the Union's financial system.[12] But, if what member states get out of the budget is equal to what they put in, it would make a mockery of the principle of economic and social cohesion. A case in point is the possibility, considered in the report of the Court of Auditors, of extending the system of the UK budgetary correction to all member states that experience

[11] See European Commission: First Report on Economic and Social Cohesion, op. cit. and G. Denton, op. cit.

[12] Court of Auditors: Special Report on the System of Own Resources Based on VAT and GNP, No 6/98, July 1998.

budgetary imbalances. After all, the 1984 Fontainebleau agreement that introduced the UK correction mechanism opened it to 'any' member state with serious imbalance. If that correction would apply to other member states and if the extra cost would be borne by the remaining member states, the latter (most of which would be the relatively poor member states) would have to pay an extra ECU 12 billion into the EU budget.

An arrangement whereby member states' payments and receipts balance out would also contradict the rationale for Community action. Community activities are supposed to achieve particular policy objectives. By spreading spending across member states, Community policies will be prevented from focusing on their targets. It would also create a financial system which is even more complex and difficult to understand than the present one.

A far better long-term solution is, first, to eliminate the idea that the EU budget depends on national contributions and, second, to determine spending according to whether the recipients indeed comply with objective eligibility criteria. Even though revenue is derived from the so-called own resources (which means that they belong to the EU), member states still do their sums as if the budget were an accounting system in which each member state's receipts and payments must balance out. Probably the best way to streamline the budget on the revenue side is to empower the EU to levy a tax to be calculated on the basis of the contributory capacity of each member state (a proxy for this capacity is the size of the national GNP). However, that would require a unanimous decision which, as the history of the EU suggests, would be quite difficult to achieve.

Conclusion: What Kind of Reform?

Undoubtedly, some of the statements by the member states and the Commission could be characterised as relatively harmless pre-negotiating posturing. They cannot be expected to reveal their true positions before they start, what most observers believe will be, tough negotiations. However, rhetoric is not costless or riskless. Member states are in danger of being held hostage to their own statements by domestic lobbies and special interest groups. It is one thing to be sensitive to the needs of national lobbies, but a totally different thing to allow EU policy to be determined by these lobbies.

To sum up, for the following reasons the prospects for policy and financial reform are not very bright:

☐ The debate on policy and financial reform appears to have ignored the economic benefits from integrating the CEECs into the EU. Those benefits are generated by the more efficient allocation of resources.

☐ The discussion on policy reform has also lost sight of the fact that reform is needed irrespective of whether the Union enlarges or not. The right kind of reform will itself improve the allocation of resources within the Union.

☐ The countries that stand to gain most significantly from enlargement are largely those that have complained about their budgetary imbalances. If in the process of the financial negotiations within the EU they obstruct enlargement, they risk losing the economic gains from enlargement.

☐ Some of the ideas put forth for policy reform and for the correction of financial imbalances are dangerous in the sense that they have the potential of creating precedents, that they will undermine the principle of cohesion and will lead directly or indirectly to non-uniform application of Community rules. They may create divisions and discrepancies either among the existing member states or between the existing and prospective member states.

☐ The Union's financial system needs more ambitious and extensive reform than what has been put on the table so far. As the membership of the Union expands it will be progressively more difficult to satisfy all the member states by devising policies that offer something to all. It would also be difficult to implement a financial system that is based on the complex arrangements of the present one.

It would be very ironic indeed if in their attempt to reduce the perceived 'cost' of enlargement to be borne by each member state, the Union ended up creating a complex system that facilitated agreement now by giving something to every member but would ultimately prove to be unworkable when new members enter the Union. After all, the purpose of the current policy and financial reform is to prepare the Union to accept new members. It appears that reform is going the opposite way, even though it may facilitate the enlargement process in the short term.

In conclusion, the debate on policy and financial reform has too narrowly focused on relative gains and losses. The challenge of the enlargement is not just how to accommodate new members; rather, it is how to improve the policy efficiency and financial effectiveness of a Union that will soon become truly European in a geographic sense.