The European Economy after the EU Enlargement

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With the accession of ten new members on 1 May 2004, adoption of the Constitutional Treaty by the European Council in June and its signing on 30 October, 2004, and the forthcoming decision in December to start accession negotiations with Turkey, the European Union is entering a new stage of its institutional, political and economic development. A stage of which we don’t know yet where it will lead to in the medium and long term, and which presents formidable new challenges, but also opportunities. What is at stake, is more than a simple widening or deepening. It amounts to a full-fledged transformation and regime change of the Union: The quantum leap to 25, and in the foreseeable future to 27 members and more, is tantamount to a quality change. In my following remarks I shall confine myself mainly to some economic aspects, while I shall touch upon the constitutional aspects only in passing. In fact, they have been covered extensively in today’s previous sessions.

What Kind of enlargement?

For the members of the former EU-15, enlargement comes at a period of time when many of them are faced with deeply embedded structural problems, signalled by slow economic growth since the mid-1990s, high and persistent unemployment, a low rate of corporate and public investment and unsustainable costs of the welfare state. Will enlargement of the EU increase these problems or can it be expected to help solving them? The new members, on the other hand, have mastered a 15-year period of
radical transformation of their political, legal, economic and social systems. This transformation has been generally successful, as is demonstrated by the high growth rates of these economies. Growth rates that have on average been higher by 2½ percent than for the EU-15. Yet this transformation process is far from being completed, as is shown by their still low per-capita incomes, the high rates of unemployment in some of the accession countries, and the large proportion of people employed in agriculture. Will accession to the EU spur their economic progress and growth, or will it perpetuate the economic and social division of societies?

For the EU at large the decisive question will be whether the EU economic and social model will allow to take full benefit from enlargement, by stimulating institutional competition among member countries and systemic reform? Or whether enlargement will render policy decisions even more complicated, leading to more complex and less efficient package deals? Deliberations on the Constitutional Treaty have shown that national interests sometimes rank higher than efficiency considerations, as is demonstrated by the decisions on the size of the Commission and the Parliament. A first test to the future working of the Union will be the referenda to be held in many member countries on the Constitutional Treaty. Another major test case will be the new financial framework for the medium-term period 2007–2013 which has to be agreed unanimously. Making enlargement a success to the EU at large, to accession countries, and to former member countries is the formidable task to be performed.

While the recent enlargement is by far not the first such process, it is in several respects an innovation:

• Never before has the number of countries admitted as new members been so large: Eight Central and Eastern European Countries (CEEC) and two Mediterranean countries have joined on 1 May 2004, and Bulgaria and Romania are expected to follow suit by 2007.
• Never before has the income gap between the incumbents and the
new members been so large.

- Never before did the accession require such fundamental regime changes both in the EU and in the accession countries.

The present enlargement round is therefore a formidable challenge to the “old” EU as well as to the new entrants.

**Structural Problems**

A first impression of the challenge posed by the present enlargement round (i.e. excluding Bulgaria and Romania) can be gained by looking at some quantitative figures:

- The total number of EU members will increase by two-thirds, from fifteen to twenty-five.
- The surface area will increase by 23 percent.
- Population will increase by 20 percent from 381 to 455 million (US: 291 mn) (2003).
- Yet, at present numbers, aggregate GDP will grow larger by only 5\(\frac{1}{2}\) percent to Euro 10 trn (on PPS basis: 9 percent), roughly equal to the US level.
- As a result, per-capita GDP of the EU–25 will fall by 12 percent (PPS: 9 percent) relative to EU–15, to Euro 21,100 (US: Euro 37,700) (2002).
- With the exception of Cyprus and Slovenia, per capita GDP of the accession countries (at current exchange rates) is less than one half the average of the EU–15, and for seven out of the ten it is less than 30 percent of that average. The picture looks better if measured by Purchasing Power Standards: Then Cyprus and Slovenia rank even higher than Greece and Portugal, and for the rest the range is between 37 (Latvia) and 69 percent (Malta). Yet major differences remain from country to country, and still larger differences if broken down to the sub-national level.
- Comparable gaps between old and new member countries are observ-
able for wages and labour costs: In the accession countries they generally range between 15-25 percent of the German wages.

- (Official) rates of unemployment vary between 4.5 percent in Cyprus, 6 percent in Hungary and Slovenia, and 19 percent in Poland (August 2004), again with even wider differences between regions.

These figures point to deeply embedded structural problems in the accession countries which cannot be overcome quickly and easily, and which pose challenges also to the members of the former EU-15. Weaknesses are apparent in the economic structures and the capital stock, in the physical, legal and administrative infrastructures, and in human resources. Large differences in the inflows of foreign direct investment are indicators of the shortcomings of some countries—and of the rather advanced state of others.

**Macroeconomic effects**

What are the likely macroeconomic effects of enlargement in the accession countries and in the former EU-15?

The growth potential for the accession countries is demonstrated by catch-up growth of the four so-called cohesion countries in the EU-15 (Spain, Portugal, Greece, Ireland): Between 1988 and 2000, the first three of them have been able to raise their income levels from 68 to 79 percent of the EU-15 average, and Ireland has even succeeded to shoot upwards from 63 to 119 percent. At the same time, the variance in their national performances demonstrates the crucial role of economic policy and institutions. In the short run some accession countries may be subject to structural shocks as employment in their large agricultural and/or state sectors may decline faster than new jobs can be created in the manufacturing and services industries, and as their Eastern border regions may loose out to the regions in the Western parts of the countries. High public expectations of benefits from accession may therefore well be disappointed, leading to social unrest and to a slowdown of the reform
process. Yet, on balance, the new members should benefit from their accession. With their membership in the EU they have created confidence in their systemic stability, in the sustainability of the rule of law, and in durable access to the large European market—all necessary conditions to stimulate domestic investment activity and to attract foreign direct investment. Moreover, they will benefit from payments under the EU’s cohesion policy. As a result, according to estimates by the European Commission their rate of growth may increase in the medium term by up to 2 percent p.a. (Lammers 2004).

For the *incumbents* the gains are much smaller. While they will benefit from increased trade and specialisation and from migration, they may suffer job losses as firms relocate parts of their production to Eastern Europe under the impact of much lower labour cost, tax advantages and subsidies. And they will have to bear the burden of transfer payments under the Cohesion Policy and the CAP. For the EU-15, total income gains are therefore estimated at only 0.2–0.3 percent of GDP—not per annum but accumulated over several years. This would be equivalent to an aggregate net gain for the old members of no more than Euro 16–23 bn (Lammers 2004). Indeed, accession of the new members has always been justified mainly on political and security rather than economic grounds. Yet, the widening of the EU can be expected to have an unintended additional economic effect on the incumbents, an effect which is not included in the estimates mentioned: Their exposure to strong locational competition from neighbouring low-wage and low-tax regions may provide an incentive to press forward with necessary reforms of national regulatory systems, tax regimes, workings of the labour market, and social security systems. Enlargement may thus well serve as a catalyst to systemic reform in the countries of EU-15, and thus contribute to raising their potential growth rate. Already now this effect is strongly felt in my own country.
In addition to the macroeconomic perspectives, enlargement poses a number of specific economic policy questions. Among them are the future of Common Agricultural Policy (CAP) and of Cohesion Policy, migration, the flow of investment, and participation in economic and monetary union (i.e., in the euro area).

**Common Agricultural Policy**

As far as the common agricultural policy (CAP) is concerned, accession to the EU may raise agricultural output in the new member states, after some adaptation period, by up to 30 percent, and perhaps even more. If that happened, it would lead to massive agricultural surpluses in the EU which would be inconsistent with the present level of farm prices. Reform of the EU's agricultural policy may help mitigate these effects. The systemic change from price support to direct income support to farmers will reduce the incentive to increase production and will shield farmers to some extent from the impact of falling farm prices on their incomes. Contrary to earlier intentions and decisions of the Fifteen, income support will now be gradually extended to the new members, too, but it will take until 2013 for them to become fully eligible. Relative to the size of their farm land and their farm population the new members are financially at a disadvantage. It is still an open question whether reform of the CAP will make further progress, with additional major agricultural states now in the EU. New coalitions may emerge in the Council. At stake are the medium-term ceiling for total agricultural spending agreed between the Fifteen and the compromise on direct payments to the new members reached at the accession negotiations. According to the New Financial Framework 2007–2013 presented by the European Commission in Spring 2004, spending for agriculture would remain constant in real terms over the medium term, and even slightly decrease relative to 2006. It remains to be seen whether this target can indeed be achieved.
Cohesion Policy

A second topical policy area will be *cohesion policy*, and more particularly *structural policy*. Under present rules regions with a per-capita GDP of less than 75 percent of the EU average qualify for financial support under the EU Structural Fund, or, to be precise, under the most important “Objective 1” of that Fund. This means that, with only minor exemptions, the total territory (and population) of the accession countries will qualify. At the same time, with enlargement the average income level of the wider EU will fall by about 12 percent. As a consequence thereof, one half of the area presently benefiting from EU support, with about 45 million inhabitants, would fall out of the system—if that system remained unchanged. On the insistence of Spain and other beneficiaries there is now general consensus that payments to the regions concerned will be gradually phased out, rather than stopped all at once. In order to satisfy the demands of both old and new recipients, more money will be needed. The problem is mitigated to some extent by the provision of an upper ceiling of 4 percent of GDP for annual EU payments to backward regions, to take account of the limited capacity to absorb public funds efficiently. This ceiling will apply mainly to the accession countries. Yet, the Commission’s proposal for the New Financial Framework 2007–2013 still foresees an increase in annual spending for Cohesion policies of about 25 percent compared to 2006. Net contributors to the EU budget have already made it clear that they are unwilling to raise their contribution over and above the present level of 1 percent of GDP. At the forthcoming negotiations on the medium-term financial perspective 2007–2013 a hard bargaining can be expected.

Impact of migration

Another controversial issue is the impact of *migration* on the labour markets and social systems in both the target countries (especially Germany and Austria) and in the source countries (in the short run
especially Poland, later also Bulgaria and Romania). According to projections the flow of migrants from the accession countries to EU-15, if unrestricted, might turn out to be as high as 330,000 in the first year of accession and might still amount to about 150,000 p.a. after ten years. As a result, the total stock of immigrants from that region would rise from 1 million now to 3 million by 2010, of which two thirds would live in Germany (Bruecker 2000). Other estimates arrive at even higher (Sinn 2001) or at lower (Straubhaar 2001) figures. Faced with the prospect of a large inflow of foreign workers, at a time when unemployment in Germany is still high, the German government has successfully demanded that a transition period of seven years be negotiated with the accession countries during which the flow of immigrants can be restricted. This may, however, only lead to postponing the problem. In fact, for the time being potential target countries are not showing any readiness to gradually “phase in” a growing number of migrants in the years to come. The lifting of the barriers after seven years may therefore expose them to a sudden inflow for which they are ill-prepared. The problem may be mitigated to the extent that income and employment will rise in the course of the coming years, both in the Central and Eastern European source countries and in Western Europe.

Capital Flow and relocation of industrial Production

An even hotter issue, especially in Germany, France and some other industrial economies of the EU, is presently the issue of capital flows, and indeed the relocation of industrial production from the incumbents to the new members. With their well-educated and well-trained population, a sound legal and administration system supported by membership in the EU, and labour costs which are 15–25 percent of the German level, the Central and Eastern European countries qualify as attractive locational alternatives to production sites in Western Europe. This attractiveness is further enhanced by corporate tax rates which are far below rates in, e.
g., Germany and by generous investment subsidies financed, directly or indirectly, by the EU. As a result, a growing number of firms not only build up additional production capacities in the East, but relocate part of their production from the West to the East. The resultant employment and tax losses have led political leaders in Western Europe to demand an end to this "unfair" tax competition, as they call it, and to plead for a harmonisation of corporate taxes at levels close to the higher levels ruling in Western Europe. Moreover, EU funds raised from taxpayers in Western Europe should not be used to support plant relocations but be spent for infrastructure investment or the support of additional production facilities only. At the same time, Western trade unions call for "social harmonisation" to reduce the gap between labour costs in the new and the old member countries. It is obvious that these demands will not be satisfied because this would deprive the new member countries of every chance to catch up. The controversy will however shape the forthcoming negotiations on the medium-term financial perspective of the EU.

**Participation in the ERM**

Finally, participation of the accessions countries in the Exchange-Rate Mechanism II (ERM II) and in Economic and Monetary Union (EMU) implies major challenges for them since they are still at an early stage of their catching-up process. Meeting the convergence criteria, a precondition for EMU membership, is no guarantee that early participation will on balance be advantageous. For countries which are still undergoing major economic and social changes, and where the price and wage levels are still far below the levels in the developed EMU economies, limiting or even renouncing the option for their own monetary and exchange rate policy may render economic management unduly difficult. As the European Commission's Comprehensive Monitoring Report of November 2003 rightly pointed out: "Exchange rate regimes should not be looked at in isolation and participation in ERM-II should contribute to achieve real and
nominal convergence. Although ERM-II provides a degree of flexibility, staying outside the ERM-II for some time may be useful in the light of large and volatile capital flows, large fiscal imbalances, or risks of large economic shocks.” Up to now three accession countries have entered the ERM II: Estonia, Lithuania and Slovenia. Estonia and Lithuania maintained an euro-based Currency Board system, and all three have a reasonable to good track record so far in meeting the convergence criteria. They are therefore expected to be admitted to the euro area by 2006/2007. The other accession countries generally aim for participation in EMU before the end of this decade, a quite ambitious aim.

Management change in the ECB

For the European Central Bank (ECB) the widening of membership makes changes in the management structure an absolute must. Already today that structure, with a Governing Council of 18 (six Board members and twelve national central bank governors), is far from efficient. However, the opportunity to streamline the decision-making bodies has been missed. On the contrary, on the recommendation of the ECB the European Council decided on 21 March, 2003, to further raise the number of voting members in the ECB Council to 21 in the medium term, and all national central bank governors continue to be entitled to participate and speak in the Council meetings. This is fully in line with the decisions taken in the IGC on the size and composition of the European Commission and the European Parliament. The quality of the ECB’s decisions will certainly not be enhanced by this ruling. It remains to be seen whether in a more distant future a better institutional structure can be agreed: with a slightly enlarged Executive Board responsible for current monetary management, and a large Governing Council setting the guidelines for such management and meeting but once or twice a year.
Decisive for the future

Considering the economic challenges, the present decade may well stand out as a period which will be decisive for the future success or failure of the European integration model. Will the EU fall victim to its own past success—and to its limited capability to reform? Or will the member countries and the EU at large be able to adjust actively and in time to the new challenges? Will enlargement on balance produce more economic problems to old and new member countries or will it be part of their solution? Will the Union continue to operate largely as a unity or will it be shaped by changing coalitions or development of a European core group? Whatever the answers may be in the end, European economic performance, the design of medium-term economic policies, and the processes of economic decision-taking in Europe will provide ample material for scientific observers both within Europe and in Japan and the rest of the world.

1) PPS = Purchasing power standard
2) For data see: Eurostat 2004
3) Source: European Commission Press Release of 5 October 2004
4) Under the assumption that national income levels remain constant.