First draft
Not to be quoted

COSTS AND BENEFITS OF EASTERN ENLARGEMENT OF THE EUROPEAN UNION

by

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Paper submitted to the Fifth Biennial International Conference of ECSA, Seattle, May 29 - June 1, 1997

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Since its inception, the European integration was based on the principles of market economy and development. Elements of "development integration" were present already within the Six for the Italian Mezzogiorno received special resources to narrow the development gap between this part of the Community and other, more developed regions. Each of the four following enlargements represented a mix of market and development integration, evidently, with changing proportions due to the development level of the joining country or countries.

The first enlargement gave birth to the regional fund, while the Mediterranean enlargement created the structural fund. In the meantime, not only less developed countries but also less developed regions of developed member countries got access to these transfers.[1] As a result, at present 52 per cent of the territory of the EU is entitled to benefit from the existing funds in one or another way.

With Eastern enlargement, whatever its scope and sequencing will be, only countries will become member of the European Union (EU) which have a partly substantially lower level of economic development than the EU average.[2] This is true even if there may be a sizeable difference between per capita income determined on the basis of the official exchange rate or at purchasing power parity (PPP). It is understandable that the Central and Eastern European countries (CEECs) seeking accession to the EU are primarily interested in getting access to the EU's financial resources.

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[1] Even the last enlargement which brought into the European Union (EU) highly developed countries, singled out less developed (Arctic) regions to be supported from the structural fund.

[2] Development level is generally measured in GDP per capita terms expressed in one of the key currencies (US$, DM or ECU, most frequently). We are aware of the fact that the level of development of a given country cannot be described just in quantitative terms and by using no more than one indicator. Still, the development gap between the EU and the Central and Eastern European countries cannot be disputed.

The history of successful modernization in various regions of the world shows that, beyond the decisive domestic efforts, small, natural resource-poor and medium-developed countries require substantial external support in the crucial period of take-off. In other words, they look for an external anchor of modernization offering at least three basic conditions: stable external economic environment, free access to markets and net resource flow to the modernizing economy.

Practically since the beginning of the political and economic transformation process, the CEECs have regarded the EU as their main modernization anchor. However, the Association Agreements signed with Brussels could only partially meet this expectation. The EU itself became a moving target and its future seems to be less predictable than during earlier enlargements. EU markets have been opened up, but with delay in various areas of sensitive commodities, and remained rather protected in agriculture. Finally, financial transfer was vaguely referred to in the association documents, and remained limited to the PHARE programme. In addition, the Copenhagen criteria of accession include the EU's ability to enlarge, which, among other factors, may be related to the costs of enlargement as well.

This paper is focusing on three issues. First, a critical overview of earlier quantitative assessments of the costs of enlargement is provided. The second chapter develops a wider framework of how to interpret costs and benefits. In Chapter Three current approaches to the financing of Eastern enlargement will be discussed with special regard to the changing financial situation within the present framework of the European Union.

I. Features of recent assessments of costs

In the first half of the 1990s, various calculations were prepared on the expected costs of a potential Eastern enlargement.[3] They have produced largely different results, based on the different starting conditions chosen and due to

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[3] CEPR (1992), Anderson-Tyers (1993), Holzmann-Thimann-Petz (1993), Brenton-Gros (1993), Baldwin (1994), Stehn (1994), EU Commission (1995), Breuss (1995), DIW (1996), Deutsche Bank Research (1996), Baldwin-Francois-Portes (1997). For an overview study of most calculations see Dezséri (1996).

differences in their methodological approach. Some of them came to the conclusion that Eastern enlargement is impossible to be financed for it would completely explode the present budget and face unsurmountable resistance in the present member countries, both net contributors to and net beneficiaries of the EU budget. In turn, some others argue that enlargement can be financed even without major constraints and by maintaining the framework of the current budget.

Whether it was intended or not, it is quite obvious that all figures carry a political message. Large financial transfers provide arguments for those opposing Eastern enlargement or, at least, wanting to postpone it as far as possible. In contrast, manageable amounts of transfer indicate that Eastern enlargement is feasible and should occur as soon as possible.

Particularly the first, largely exaggerated assessments were based on erroneous assumptions.

First, the present EU transfer mechanism was applied to the candidate countries, as if they were already full members of the Union. However, it is clear that the current mechanism cannot be prolonged for the period after 2000, when new guidelines of the structural fund will be applied. Such a prolongation would be unlikely even without Eastern enlargement.

Second, the CEECs were considered in their current economic state and performance level, largely shaped by the fundamental problems of the first phase of transformation. In fact, in the first half of the nineties, GDP and GDP per capita (expressed in national currency) were rapidly declining almost in all CEECs, as a result of the collapse of the old system and of traditional export markets. Surprisingly, the same calculations related to the agricultural costs of accession, did not rely on the same period, but took the second half of the eighties as a reference level. In this way, assessments have largely overestimated the agricultural potential of most candidate countries. It is needless to say that the CEECs will be at a different level of development once they will be allowed to enter the EU, probably around 2002. They have already started a dynamic growth and have or will have reached the pre-transformation level of economic performance in the mid-nineties. Consequently, even the first countries to join the EU still have 5 to 7 years to further narrow the gap between their level of development and the EU average.

Third, the catching-up potential of the CEECs has been exclusively based on differences in real growth rates between the EU average and the candidate country. The lesson of most rapidly modernizing economies teaches however, that the catching-up process consists of two elements: higher growth rates and currency appreciation. A recent comparative study came to the conclusion that between 1985 and 1994, only 26 per cent of the Irish, 15 per cent of the Portuguese and 10 per cent of the Spanish approximation to the average EU figures can be attributed to higher real growth. The lion's share of the narrowing of the GDP per capita gap was due to appreciation (Artner-Inotai, 1997).[4]

Fourth, it is incorrect and dangerous to throw all CEECs into the same basket. On the one hand, the individual countries require largely different sums of transfer (let alone the structure of such transfers). On the other hand, gradual enlargement will distribute the transfer burden for a longer period, so that only part of the potential transfers will appear during the first enlargement.

Fifth, the approach to the assessment of costs suffers from two basic misperceptions. On the one hand, it only considers the impact of accession on the EU budget, but largely ignores those costs, mainly to be carried by the candidate countries **before** they are expected to have access to these funds. On the other hand, and even more importantly, the approach suggests as if enlargement were a one-way street, with benefits only to the new members and with costs only to the present members.

Comparing the different calculations in time, it is interesting that the amount of net transfer is decreasing.[5]

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[4] In this light, while GDP per capita of the candidate countries fell rapidly between 1990 and 1994, GDP per capita expressed in US$ showed a different trend. Due to currency appreciation and the narrowing gap between exchange rate and PPP-based figures, it rose from 3,000 to over 4,000 dollars in Hungary and from 1,700 to 2,400 dollars in Poland.

[5] Even the same authors have sometimes prepared calculations revealing decreasing costs (see Baldwin's estimate in 1994 and in 1997).

This trend can be explained by more realistic assessments and more refined and sophisticated methodology. Also, most recently assessments are complemented by references to possible or already made gains by the EU. In turn, there is very little change in the narrow-minded pattern of approach based on quantitative and short-term analysis of costs (and benefits). This points to the lack of vision or long-term strategy of the experts (and also of those who commissioned such studies), despite the fact that Eastern enlargement has been fundamentally considered a political step.

After the collapse of the bipolar system in Europe, experts made frequent reference to the so-called "peace dividend". To be sure, a fraction of this money would have been sufficient to establish a strategic framework of financing both of the transformation process and the adjustment to the EU. Also, by comparing even the highest potential additional costs of enlargement and the GDP of the EU, the lack of strategic thinking is more than manifest. For the CEFTA countries[6], the most likely candidates for the first wave of enlargement, net transfers from the EU budget would fluctuate between ECU 17 and 33 bn annually, or 0.3 to 0.5 per cent of the EU's yearly GDP figure.

II. Costs and benefits in a wider framework

There is no doubt that each of the candidate CEECs will enter the EU as a net beneficiary of the transfer mechanism, even if the budgetary rules will be substantially modified. This is very much in line with the developmental pillar of the integration strategy. However, it does not imply that these countries will be the only winners. This statement is even less valid for a longer period, after which, the new members are expected to reach development levels where net financing will be decreasing or totally phased out.

A more balanced view of costs and benefits has to consider that part of these costs and benefits does not result from

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[6] Czech Republic, Hungary, Poland, Slovakia and Slovenia. Romania will become member of the CEFTA as of July 1997, but figures on this country are not included in CEFTA-based calculations made in the last years.

accession but is already present in the pre-accession stage. Although the Association Agreement produced mutually beneficial impacts, the EU seems to have gained more than the CEECs, despite the temporarily asymmetric character of the agreement. This development is clearly manifested in the rapidly growing trade surplus of the EU in bilateral trade relations. While the CEFTA countries used to register a balanced trade with the EU before 1992, their cumulated three-year trade deficit with the EU climbed to ECU 5.4 bn between 1992 and 1994. This was followed by a rapidly increasing deficit to ECU 7.2 bn in 1995 and to ECU 14.9 bn in 1996. Taking into account the ongoing liberalization of imports both in the framework of the WTO and according to the Association Agreement (the return of temporarily granted asymmetry), plus the elimination of still existing (or newly introduced) import surcharge, the competitiveness of imports is likely to be even stronger. Moreover, high(er) growth rates and more investments fuel the "modernization deficit", which may lead to even higher EU trade surplus in the next years.[7]

It is a clear sign of the EU-related benefits generated from bilateral trade that there is a discrepancy between the share of CEFTA in total extraregional trade of the EU and CEFTA's share in total EU trade surplus. With a share of less than 7 per cent in EU trade, CEFTA generates one-third of the EU's trade surplus.

Based on the rather different level of competitiveness and financial capacity of the EU- and CEECs-located companies, as well as due to other, historically grown asymmetries in favour of the EU, such a trade balance could be expected. This is not surprising, since all less developed member countries of the EU revealed and keep on revealing similar patterns. The big difference, however, between the latter and the CEECs is that trade liberalization of Ireland, Greece, Spain and Portugal was linked to EU transfers, while that of the CEECs has not been. As a result, exploding trade deficits with the EU have immediately

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[7] The coping with growing import competitiveness and the sustainability of the current account balance are among the key strategic tasks of the CEECs in the next years.

been - at least partially - compensated by transfers the new members were entitled to. In turn, the Association Agreement foresees the liberalization of trade[8] but no adequate compensation to finance the growing trade deficit.

One of the most difficult methodological task consists in differentiating between costs and benefits generated directly by the accession to the EU and those produced by other factors. In the CEECs, transformation costs should not be included into cost assessments of adjustment to the EU, because the transformation has to be carried out, with or without membership in the EU. Similarly, by far not all cost-generating tasks of the EU are linked to the Eastern enlargement. Adjustment to the global economy, changes in the member countries and the growing financial burdens produced by special EU policies (mainly the CAP but also the inefficient use of part of the structural funds) require a restructuring of the present financial mechanism, again, with or without enlargement. Obviously, the costs of this reshaping cannot be considered as costs of enlargement.

In a broader context, it is commonplace that costs and benefits can never be measured in economic terms exclusively. Enlargement to the East of the EU has a large number of security, political, social and cultural implications. Although most of these factors can hardly be quantified in the same way as in the field of economics, nobody would reject their strategic importance in the shaping of the future of Europe.[9]

Cost and benefit analyses have to pay special attention to the fact that costs and benefits do not manifest themselves simultaneously. Moreover, both costs and benefits may substantially change over time. As a result, short-term balances may look very different than long-term ones. It should not even surprise if the same economic process not only produces

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[8] Excepting agriculture, which, by 2001, the time of implementing free trade in manufactured products, may create an unfavourable asymmetry of trade relations for those CEECs that happen to have a higher share of agricultural goods in their exports to the EU than in their imports from it.

[9] Most cost-related assessments can only be provided in historical retrospection, i. e. in an ex-post analysis.

different short- and long-term impacts but generates contrary effects. In other words, short-term benefits may create longer-term costs and viceversa.

An important methodological point is that advantages and costs could be separated also in space. Obviously, the individual member countries of the EU are interested in enlargement to a different extent. Their cost-benefit balance is different, but so is that of the candidate countries as well. More importantly, regions and sectors within the same country reveal different interests and counterinterests. Consequently, they produce different cost-benefit calculations. In this context, the careful survey of potential winners and losers is extremely important in order to make the process of Eastern enlargement less complicated **on both sides.** Also here, it has to be stressed that the categories of winners and losers are changing not only in space and across sectors but also in time.

The costs and benefits of enlargement are, to a substantial extent, dependent on two additional factors. First, the more the EU (and its member countries) and the candidate countries are prepared, the less the costs and the larger the benefits will be. Also, available resources will be used more efficiently, a problem some EU member countries were facing in the last decade. In other words, costs and benefits are policy-dependent variables on both sides.

Secondly, the size of costs and benefits is fundamentally influenced by the form and timing of the resource transfer. Large gaps, both in time and in sums, between adjustment costs and in financial contributions may create substantial structural distortions which, sooner or later, will have to be eliminated at much higher costs (or with less gains). More importantly, too high costs may lead to the stopping or even to the collapse of the adjustment process, with incalculable consequences not only for Eastern enlargement but also for the stability of Europe. Beside the above mentioned growing trade deficit, reference can also be made to the increasingly high adjustment costs. Evidently, adjustment to the EU rules of the game is a precondition of membership. However, the financial burden of adjustment (including the enforcement of several thousands of laws) may not be in harmony with the financial capacity of a transforming economy. Adjustment to the acquis communautaire is considered as a necessary investment into the future, when benefits to be generated by membership are expected to cover the financial gap. It remains, however, an open question, whether and which transforming country will be able to pre-finance this gap, and how long should this gap be opened.

Certainly, the PHARE programme is considered as a convenient tool to prepare the CEECs for membership. However, one has to bear in mind the serious limitations of PHARE, not only in technical, but first of all in financial aspects. Assuming that the total yearly available amount of PHARE could be used by the entitled country, Hungary would enjoy a net EU transfer of ECU 8 per year. In comparison, the net EU transfer to Ireland amounts to ECU 650, to Greece to ECU 430, to Portugal to ECU 255 (all according to 1994 figures). It is hardly possible to successfully prepare for membership from the currently available funds, let alone, to fulfil conditions which were either softer or did not exist at all during earlier enlargements.[10]

Unfortunately, very little attention has been given to the potential impact on the cost-benefit-balance of different pre-accession fundings. This is not an unknown practice of the EU, because Portugal has got substantial funds from the EU budget to finance infrastructure projects well before its membership materialized. In August 1996, EU commissioner Fischler raised the possibility to establish a pre-accession fund for the agricultural adjustment of the CEECs to (changing) EU conditions. However, no strategic approach was produced in order to provide EU funds to the CEECs already before their membership

[10] It is worth mentioning that some member countries can only fulfil the Maastricht criteria of budget deficit limited to 3 per cent of GDP, because they enjoy large net transfers from the EU budget. Without this support, they would be far from qualifying for membership in EMU. According to a recent Hungarian study, net EU transfers finance 9 per cent of the Greek, 4.6 per cent of the Portuguese and 2.9 per cent of the Spanish budgetary expenditure. Consequently, their budget deficit (in GDP terms) can exceed by 3.4, 2 and 1.1 percentage points the 3 per cent Maastricht criteria, and still they would qualify for membership in EMU. By applying similar conditions to Hungary, it could have a budget deficit of almost 10 per cent and still qualify for EMU (Éltető-Inotai, 1997).

and, in this way, reduce not only the costs of adjustment, including political and economic instability in the pre-accession period, but also the amount of transfer that would be necessary after accession. Although no quantitative assessment has been made, it is by far not unlikely that, in total, a transfer strategy split into a pre-accession and a post-accession period could result (could have resulted) in substantial savings for both sides. In addition, most of the pre-accession support would flow back to the EU member countries in form of financing imported inputs.[11] More importantly, savings would not be limited to the area of financing but also to other areas with substantial costs and benefits in the longer term (multiplier impacts of infrastructure development, institutional structure, education, social cohesion, political stability, etc.)

This leads me to the last point. All quantitative assessments are based on different scenarios of Eastern enlargement. None of them has calculated the costs of a potential "non-enlargement". It can hardly be denied that the costs of the latter would be much larger than even the highest calculated costs of enlargement.[12]

III. Plans of and interests in financing Eastern enlargement

The more the starting of official negotiations on membership comes nearer, the more short-sighted (pragmatic?) views appear concerning the financing of enlargement.

In fact, there are three different interests in the package to be shaped. The current net contributing countries would like to avoid any increase in their contribution. Just the opposite, if possible, they would like to reduce this sum. The current net beneficiaries are fundamentally interested not only in maintaining their net beneficiary position but also the size of

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[11] According to EU estimates, about 46 per cent of the structural fund transfers to less developed EU countries finances imports from EU member countries.

[12] In 1985, the launching of the Single Market project was substantially supported by the "negative argument" of what would the non-implementation of the project mean for the European Community (Cecchini Report).

benefits. Finally, the candidates (new members) are interested in getting a just piece of the cake.

In theory, this conflict of interests can be solved in various ways. First, the EU budget can be enhanced, which would be supported by the present and would-be net beneficiaries, but probably strongly opposed by the net contributors. Second, the volume of the budget can remain the same, but a redistribution would occur in favour of the newcomers and to the detriment of the present net beneficiaries. In this case, the net contributors and the new members would belong to the supporters while the present net beneficiaries would strongly oppose the project. Thirdly, newcomers may not be admitted to the transfers, which would immediately question both the readiness of the candidates to join and, more importantly, the seriousness of the EU's political will to enlarge the Union. Finally, a compromise may be developed with the sharing of the additional burden by a bit more contribution by the net contributors, less benefit given to the present beneficiary countries and financing of the newcomers according to special terms.

Unfortunately, until most recently, the budgetary discussion was conducted from rather extreme standpoints and with a low level of flexibility. In fact, the present budgetary guidelines as well as the structure of the budget still offer some room for manoeuvring. First, the 1.27 per cent limit has not been reached by the member states, so that some additional money may be available without increasing the amount of national contributions or to redistribute the existing funds. Second, part of the money available in the structural fund cannot be used in lack of adequate projects and co-financing capabilities of the potential benefitting countries. This "frozen reserve" could be unlocked for newcomers. Third, as Eastern enlargement does not take place immediately, there are still a few years ahead in which the EU is expected to produce a modest annual growth. Thus, 1.27 per cent of this growth will automatically be added to the EU's central budget. Last but not least, during the next years, the reform of the CAP may result in substantial savings in the agricultural expenditure amounting to almost half of the total budget of the EU. Therefore, resources may become available even without expanding the present budget.

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At the moment, neither the volume nor the rules of the entitlement to the structural fund are known. The Commission has to prepare the guidelines for this fund for the period between 2000 and 2004 in the next months. Decision is expected to be taken by late 1998 the earliest.[13] However, there are several approaches focusing on the pattern of (re)distribution of budgetary resources.

The fundamental interest of the present members has already been mentioned. Since less developed countries will join the EU, the average per capita GDP will be lower, so that some countries or regions which until now have enjoyed EU transfers as below the 75 per cent line, may not belong to the beneficiaries after enlargement (if the present rules will be applied also after 2000).

Although nobody denies that the new members will desperately need EU funds, various arguments may be used to limit the volume of flows to these countries.

First, present net beneficiaries will use all available instruments to maintain their privileged position. They may link their ratification of the treaties on accession to the continuous financing of their economies. Or, mainly Mediterranean EU members could establish a linkage between funding the newcomers and creating new transfers for themselves. Arguments concerning growing Central and Eastern European competition may be used in this context. This could easily lead to a situation in which the total costs of Eastern enlargement could substantially exceed amount of direct resource flow towards the new members.

Second, countries not qualifying for membership in the EMU will certainly try to exploit the EU budget as much as possible in order to get additional funds for compensation (certainly to be called "support to qualify for membership as soon as

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[13] This timetable may become a barrier to meaningful negotiations on enlargement during 1998, because various issues will be linked directly or indirectly to the availability of the structural fund to the would-be members.

possible"). This could divert otherwise available funds from financing Eastern enlargement to other purposes.

Third, net contributors may develop a tougher attitude by referring to the priority of meeting the Maastricht criteria of budget deficit defined as 3 per cent of GDP as a maximum. Considering that more than one country is struggling with the 3 per cent limit, all kind of savings may become important.

Fourth, Eastern enlargement and the restructuring of the structural fund overlaps with substantial problems of maintaining the previously developed social welfare system. As a result, national budgetary considerations may play an increasing role in determining the volume of the EU budget for the period after 2000.

There is a rather strong view in various EU member countries and even within the Commission that conflicting financial interests could be harmonized by offering the new members "special conditions". This could be the non-participation in some transfers (as agriculture) or the gradual approximation to the volume they would be entitled to. Both ideas would hardly be acceptable by the new members, and, in addition, this approach would contradict the basic EU principle of solidarity. Newcomers would consider such a proposal as offering them secondary membership. One exception might be if a special fund providing the necessary amount of money would be created just for the new members. (However, its financing would raise new questions.)

Another attempt is the postponement of accession, even through opening up, to some extent, the door of structural and agricultural funds to the CEECs. Long preparatory periods, "enriched" by some EU transfers could, according to this view, delay the next enlargement and, thus, preserve the traditional pattern of budgetary expenditures. (The Christodolu Report contains elements of such a "philosophy".

Finally, the limitation of EU transfers in accordance with a maximum share in GDP has been considered. The idea is based partly on the lasting experience of the EU that some of its member countries cannot efficiently absorb the money they are entitled to. Partly this approach roots in the bluntly exaggerated calculations on the costs of enlargement. According to some figures and based on the prolongation of the present transfer mechanism, the CEECs could be entitled to yearly transfers of up to 20 to 30 per cent of their GDP. Obviously, such a relatively huge inflow could not be used efficiently and would produce some very unhealthy domestic economic problems (e. g. inflation). However, the individual CEECs are in rather different position. The transfer to be directed to the more developed Central European candidate countries amounts to 8 to 12 per cent, which can be considered as the upper limit of efficient absorption for some years of heavy investments (mainly in infrastructure). More importantly, the absorption capacity of the individual economies is largely different, due to the different level of microeconomic development. Hungary, for example, could easily absorb US$ 1 to 1.5 bn of foreign direct investment each year, without considering large-scale privatization revenues and headline-making greenfield investments. Much more investment in physical infrastructure (let alone the restructuring of the budget) would be required. Regarding the absorption capacity, previous EU experience may be misleading at least for three reasons. First, the CEECs have a higher level of general education than some less developed EU countries had in the last ten years (or have even today). The level of education affects positively the absorption capacity of an economy. Second, the CEECs have a favourable geographic location by not representing geographic end-point of Europe. Therefore, infrastructure projects crossing their territory may exert a substantial multiplier effect on the economy and enhance the absorption capacity. Finally, as a result of transformation they dispose of a rather high social and institutional flexibility, which, again, used to be positively correlated to efficient absorption.

Concluding remarks

The distribution of gains and losses is always a highly sensitive issue even within national economies. It is an even more delicate problem in an international organization. The situation is further complicated by the changing financial capabilities of the present EU members and by the substantial need of international resources (EU transfers) in the CEECs on the threshold of rapid modernization. Thus, extremely difficult negotiations can be expected both regarding the reshaping of the structural fund for the period between 2000 and 2004 and with the candidate countries to be invited as potential new members of the Union.

Missing a strategic view and probably a **grand design** for the Europe of the 21st century, negotiations may come to a stalemate, be blocked and give wide opportunities for blackmailing. This, however, would be disastrous not only for enlargement in general, but also for the future of Europe, in particular. Responsible politicians, all over Europe, should be aware of the fact that the future of the continent and the comparative advantages deriving from Eastern enlargement on the global scale must not be jeopardized by short-sighted and narrow-minded "figure battles".

Budapest, April 27, 1997

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