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LONG-RUN ECONOMIC ASPECTS OF THE EUROPEAN UNION'S EASTERN ENLARGEMENT

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PREFACE

This study analyses the long-run economic aspects of the European Union's eastern enlargement. The authors address the risks of 'erosion' of the internal market, the impact of enlargement on EMU and on the EU's system of financial transfers. They expose and assess the problems that may arise, and they also present policy options and solutions to overcome the obstacles identified.

This working document has been written for the project 'Enlargement of the EU to Central and Eastern Europe', which the Netherlands Scientific Council for Government Policy (WRR) is currently undertaking. As such, it contributes to answering the central questions of this project: to what extent will enlargement increase (disruptive) diversity within the Union, and, hence, to what extent will reform of the existing institutions be needed to maintain their effectiveness, legitimacy and cohesion?

The authors of this study are Jacques Pelkmans, Daniel Gros and Jorge Núñez Ferrer. They are all members of the research team of the Centre for European Policy Studies in Brussels, as senior research fellow, research director, and research fellow respectively. Jacques Pelkmans is also director of Stichting Euroscope.

Prof. Michiel Scheltema
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SUMMARY

The forthcoming enlargement of the European Union to Central Europe is usually perceived as a problem of increasing diversity. The triple combination of low incomes, a lack of capacity to absorb and exploit the acquis communautaire, and the manifold difficulties of transition has fuelled widespread expectations of a very problematic accession process and fears of a diluted Community. In this context, many policy makers have expressed fears of 'erosion' of the internal market. In addition, concern is building up that the entry of Central European countries (CEECs) into the monetary union may be problematic. Finally, the costs of transfers from the Structural Funds and of those in the framework of the Common Agricultural Policy will increase significantly and this is expected to expose great political sensitivities and dilemma's.

Internal Market

Against this background, the potential, long-run difficulties for the's internal market after the CEECs full participation in 2010 are inspected, beginning with an assessment of their ability to meet the Copenhagen accession criteria. This leads to the observation that the combination of weak administrative capacity, weak judiciary and corruption will be more problematic for the internal market than the so-called 'adoption gaps' in the acquis or the requested transition periods. Those adoption gaps likely to persist in the medium or even long-run, might be found in the areas of state aids, veterinary and sanitary requirements, intellectual property rights, energy, the environment and in the administrative capacities of internal market bodies. As for the transition periods, many of these will have run out by 2010, with the exception of those in environment, agriculture, (perhaps) regional policy and possibly the free movement of workers.

Fears of internal market 'erosion' after the CEECs accession go beyond the notion of adoption gaps or transition periods. They assume that the already fragile acquis will be further hollowed out, or that the present, robust acquis will be undermined by a combination of lower standards of adoption, implementation, surveillance and enforcement in the CEECs, overloading an already overburdened EU system. Based on formal and informal indicators of non-compliance and on a scrutiny of available remedies, it is argued that the internal market is under permanent threat of erosion, irrespective of membership extensions. Provided that these threats and the current weaknesses of implementation and enforcement mechanisms are contained, the internal market's credibility will remain high also after enlargement.

Understandably, fears of erosion are fuelled, too, by the fact that accession is, by definition, a gradual process in which the Copenhagen criteria offer a lot of discretionary room for interpretation. To strengthen the internal market's credibility, we propose a 'core acquis' test that is verifiable, transparent and realistic in the light of the proper functioning of the internal market. It minimises the risk of 'watering down' the internal market while at the same time preventing an 'all-or-

nothing' approach to the acquis from turning into an unjustified obstacle to EU membership. Once the applicant countries have passed this hard test, the accession negotiations can focus on the technical details of transition periods and derogations. The 'core acquis' test is based on the following principles:

- macro-economic stability and market functioning such that transition can be said to be over; what matters here is good economic functioning, less the exact acquis;
- high scores for those elements of the internal market without which goods and services market integration would be inhibited due to extra costs;
- no priority for items of recent 'deepening' of the EU-15 internal market, except when justifiable;
- no priority for items which entail disproportionate (sectoral or macro-economic) costs for the applicant countries, except when justifiable;
- a reintroduction of optional harmonisation where suitable.

Essentially, the core acquis test reflects the idea that the establishment and proper functioning of the internal market serves many aims of the EC Treaty, in particular growth, competitiveness and, to the extent that regulation and market forces can influence this, sustainability, convergence of economic performance and economic and social cohesion. As such, it serves as a foundation for the economic and monetary union in the widest sense. Indeed, the study briefly addresses the question of whether the candidate countries could effectively exploit the economic union they would join for the purpose of long-term catch-up growth. Assuming they have passed the 'core acquis test' and assuming that sensible strategies are in place for spending the structural funds, this is entirely possible. This the study illustrates with a summary view of the medium-term economic strategies of four first wave countries, all of which pursue high economic growth as their overriding objective. It is more demanding, but by no means impossible, for these candidate countries to match the quality of the second concept of economic union, i.e. supporting the proper functioning of the monetary union.

Monetary Union

Concerns about *diversity*, accentuated by letting the Central European countries into EMU, also lead to frequent pleas for postponing their accession to monetary union until transition is completed and real economic convergence has progressed further. The present study shows that it is extremely hard to find empirical economic arguments to support such pleas for postponement. Firstly, the Copenhagen requirements imply that the bulk of the adjustment process in industry and banking will have to come before accession. The screening process – or, alternatively, the 'core acquis' test – is, moreover, likely to uncover any remaining institutional, monetary and fiscal deficiencies ('skeletons in the cupboard') that could damage sustainable fiscal convergence. Secondly, there is nothing in economic theory leading us to suspect that poor countries would not benefit from the price stability that this entails. Thirdly, in terms of economic structures, the advanced Central European countries do not add more variety than already exists

among the current member states; their transition process is virtually over, and their financial, institutional and 'hard' and 'soft' infrastructures are normal for their development levels, perhaps even better. Fourthly, the rapid pace of bank privatisation and take-overs by EU financial service providers has helped to overcome various corporate governance problems – many of which several EU countries faced them selves not too long ago. Fifthly, the prospects of meeting the Maastricht criteria are already quite favourable for the first wave countries, certainly when compared to the Southern member states at the start of the EMU process in the early 1990s. Their average inflation rate is about five per cent, their fiscal deficits are already close to three per cent of GDP and their average public debt is about 30 per cent of GDP. As for the second wave, only Bulgaria's and Rumania's performance (as measured by the Maastricht criteria) differs substantially from that of the 'first wave' (Estonia, Czech Republic, Hungary, Poland, Slovenia). Given that the earliest possible date of EU accession is January 2004 and that the minimum delay between the start of EU membership and joining the Euro area is two years, some advanced candidate countries should thus be able to join the Euro area by 2006.

There is also no reason to be concerned about the *size* of enlargement. By most economic and monetary measures, the candidates' weight is quite small. For instance, the GDP (at current exchange rates) of the ten combined is about seven per cent of that of the Euro area, whereas the combined money supply of the Central Europe's financial sectors amounts to even less than seven per cent of the corresponding Euro area aggregate. Most of this weight is accounted for by the more advanced first wave countries.

There is no need to discourage these countries from meeting the Maastricht criteria or from entering the Euro area fairly rapidly, i.e. within two-years of EU accession. However, the accession process does require some crucial policy judgements about the timing, transitional regimes and conditions of full entry into the Euro area for each of the candidates. The main problems with regard to the Maastricht requirements relate to exchange rates and inflation. Firstly, the exchange rate stability requirements imply that formal membership of the EMS for two years is a prerequisite for entry into the Euro area. For a country such as Estonia, however, which is *de facto* already a unilateral member of the Euro area and which will have had ten years without any exchange rate instability, this arrangement would be inappropriate. Secondly, exchange rate stability may be threatened by speculative attacks following the lifting of capital controls in the final phase of inflation convergence. Thirdly, due to the so-called Balassa-Samuelson effect, the equilibrium inflation differential with the three best performing Euro members may be around 3.5 to four per cent, which is well above the 1.5 percent threshold. In some cases, this may therefore warrant a derogation from the inflation criterion.

In the phase before EU or EMU membership, Central European countries with strong fiscal and monetary institutions that fulfil the Maastricht criteria most of

the time on their own (such as Estonia now) will gain from pegging to the Euro. Since the EU is their major trading partner and since financial markets would thus obtain an anchor for long-run expectations, exchange rate variability and transactional costs would be reduced. Candidates whose fiscal and monetary institutions are rather less strong, whose inflation rates and fiscal deficits are moderate and whose current account deficits make them vulnerable to speculative attacks will probably benefit more from a flexible exchange rate. This will have to be examined on a case by case basis. By contrast, candidates with very weak institutions that are still far off from fulfilling the EU entry requirements and the Maastricht fiscal criteria would gain most from a unilateral total adoption of the Euro as the domestic currency for banking and cash. This would enable them to import sensible macro-economic policies and gain confidence in financial markets. Such benefits can outweigh the costs of losing the exchange rate instrument for coping with asymmetric shocks.

Transfers

Unlike the previous enlargement with Austria, Finland and Sweden, the 'Eastern' enlargement is bound to have a significant and lasting impact on the size of the transfers in the EU budget as well as on the net budgetary contributions of the present Member States. It is particularly the latter that raises the political sensitivity of the transfer implications of enlargement. Budgetary transfers are the result of the operation of the Common Agricultural Policy (CAP) and of the working of the Structural and Cohesion Funds. The present study argues that there are no economic arguments for using the Cohesion Fund and that it should disappear. As to the Structural Funds, it cannot come as a surprise that applying economic and social cohesion criteria to the candidate countries, once 'in', will lead to major transfers to (practically all) their regions. The main issues here are whether further improvement of the Funds could lead to better targeting, and to what extent the effective absorption capacity of the regions in Central Europe can be raised concomitantly.

However, a very problematic issue is the failure of the EU-15 to prepare a budgetary 'envelope', until 2006, which is consistent with enlargement needs. The Berlin European Council results are analysed in some detail, both in terms of strategies of net-payers and other Member States, and in terms of the CAP reform. The political willingness to reform the CAP was sacrificed on the altar of *juste retour*, that is, in return for 'better' net-paying positions of four anxious Member States (including the Netherlands) and with the help of the short-run palliative of postponing dairy reforms until 2005–2007. This delay artificially frees funds for transfers to the new Member States in the years 2003 – 2006 but it magnifies the complications and the CAP transfers in the milk sector of the new Member States. CAP reform in the direction proposed by the Commission in Agenda 2000 was thus watered down considerably, even though these proposals were already very modest indeed (it excluded sugar and failed to tackle compensation payments properly). This, in turn, had two major consequences. Firstly, in terms of CAP reform the EU-15 is not

ready for enlargement. To meet its WTO and budgetary commitments as well as to avoid the absurdity of introducing milk quotas in Central Europe, it must engage in a new CAP reform by 2002–2003. Secondly, the EU budget system, already quite irrational on the expenditure side, has been burdened even further by a 'rebate on the rebate' system, without removing the underlying reasons for the arbitrariness of the net paying positions.

This study provides two scenarios for 2010 assuming the five Central European first wave countries are 'in' and excluding the Cohesion Fund (since the post-2006 developments of the budget, etc. are not known, the authors adopt plausible assumptions, see Annexes). These exercises show that – all other things equal – the net transfers for the five new Member States (assuming four per cent growth throughout, on average two per cent faster than the EU-15) should be expected to be some ten billion Euro higher than the net transfers in 2006 (with the 'five' also 'in'). This amounts to some 26–27 billion Euro, with an annual transfer of some eighteen billion from the Structural Funds. The central political issue here concerns the 'cohesion' countries Portugal, Greece and Spain, assuming that Ireland is no longer eligible. Because the EU's average income will fall, Spain may largely or entirely loose its net beneficiary position, which will come as a shock. Even with (calculated) adjustments, for example by adjusting the income criterion for eligibility of the Structural Funds, Spain might see its net beneficiary position tumble with one or two thirds. Thus, if the EU-15 fails to understand that a CAP reform is indispensable in the next two years or so, and if the major shifts in net-paying positions after 2006 will not be considered politically acceptable, the enlargement process will prompt several severe political crises. The Union cannot afford these, as the 1980–1984 period has taught. For the EU to be ready for enlargement, political leaders should therefore address the CAP and transfers issues urgently, allowing accession to be smooth and beneficial to all.

The study ends with a brief exposition on the rationale of the transfers to the new Member States. This rationale is problematic in the CAP context, although the detailed justification (or the lack thereof) will depend on the emerging agricultural acquis after enlargement. In the case of the Structural Funds, the needs for infrastructure and specific environmental investments are huge. However, the crucial issue will be, firstly, whether the new Member States can design and execute projects and long-run programmes in good sequencing and with maximum positive externalities, and, secondly, whether they can increase their absorption capacity over time.

1 INTRODUCTION

The European Union (EU) is embarking on its fifth enlargement. This process will presumably include ten countries in Central Europe, Cyprus, Malta and, much later, Turkey. Reservations are often voiced about the increasing 'diversity' of the EU after such an enlargement. This diversity may be expressed in larger number of (minor) languages or 'greater distances' in the EU, in sharper contrasts in the recent histories and experiences and therefore in preferences and attitudes towards co-operation and integration. From an economic point of view, the two principal sources of this diversity can be said to consist of two components. Firstly, much greater disparities in per capita income and development with the present EU of fifteen Member States (EU-15). Secondly, a lack of capacity, both economic and institutional, to absorb and usefully exploit the so-called *acquis communautaire*, the entire body of existing EU legislation and practices. The overwhelming part of this acquis relates to the internal market (as defined in the wider sense).

These two principal sources of 'diversity' are probably not completely independent. It stands to reason that low levels of income and development are one cause of a lack of capacity to absorb and exploit the acquis, and a constraint on improving this capacity, especially where hard and soft infrastructure is concerned. In the case of the ten Central European candidate countries (CEECs) the capacity problem is significantly exacerbated by the unique and difficult transition process from a command-and-control economy under autocracy if not totalitarianism, to a market economy under democracy and the rule of law. It is the triple combination of low incomes, a lack of capacity to absorb and exploit the acquis, and the manifold difficulties of transition – be they political, economic, social, legal, institutional or bureaucratic – that has fuelled widespread expectations of a very problematic enlargement and fears of a diluted Community. Other dimensions of diversity – though less central – are likely to augment these fears and expectations.

In this context, many policy makers at the national and EU level, many businesses in Europe and occasionally also labour unions and selected non-governmental organisations (NGOs) have raised the spectre of the 'erosion of the internal market' or of crucial parts of it. More often than not, this is just an expression of a lack of confidence in the proper working of the EU system in terms of day-to-day practical issues for business and trade.

1.1 AIMS OF THE STUDY

At the beginning of a new decade, the issue of internal market erosion has not gone away[1]. There are widespread fears that the EU's criteria for accession, the so-called Copenhagen criteria, leave too much discretionary room for interpretation. Moreover, as the time for accession draws near, there are additional concerns for

the impact of enlargement on the Economic and Monetary Union (EMU) and the EU's system of finances and expenditure. Firstly, many experts argue that the CEECs are much too keen – both for their own good and for that of the Euro area – to meet the nominal convergence criteria of the Maastricht Treaty. By aiming for a speedy entry into EMU, they risk being burdened by macro-economic instability and delays in economic restructuring and catch-up. Related to this are concerns that the new Member States will enter the Euro area without sufficiently sound banking and financial systems and without a firm commitment to price stability and fiscal prudence. Their run-up to, and participation in the EMU may therefore undermine the Euro's credibility. Secondly, there is a common concern that enlargement will cause unprecedented budgetary problems. The bulk of the EU's budget transfers is still dominated by expenditures on the Common Agricultural Policy (CAP) and the Structural and Cohesion Funds. Without fundamental reforms to both policies, the accession of five or more new, major net beneficiaries of the budget will lead to unacceptable financial losses for the present net contributors and beneficiaries. The resulting political crisis may either indefinitely close the door to a second wave of enlargement or end in yet another round of expenditure increases. The enlarged EU will thus risk becoming ever more burdened by inefficient and regressive agricultural policies, obscure rebate and expenditure systems and a loss of political readiness and legitimacy.

This study examines the enlargement dilemma's outlined above. Its first aim is to understand the potential difficulties of enlargement for the internal market. Based on this analysis, the options are examined for the maintenance and proper implementation of the internal market acquis. The second aim of the study is to transcend the perhaps too overtly legalistic a strait-jacket of the internal market acquis by analysing whether, and under which conditions the enlarged internal market can function properly in a wider sense. Can economic agents exploit the internal market, as the core of 'economic union', in such a way that the objectives of the Treaty are served? In particular, can economic union stimulate catch-up growth and serve as a foundation for the monetary union? Linked to the latter issue, the third aim is to examine the implications of enlargement for EMU and the EU's budgetary and transfer system.

1.2 RESEARCH QUESTIONS

In view of these research aims, we have formulated four basic research questions. These are:

1 Which (unresolved) medium and long-run problems concerning EMU will be accentuated and complicated because of the CEECs accession to the EU?
2 What risks do these issues imply for the monetary, economic and financial functioning of the EU?
3 Which policy options and solutions can be identified, given the policy responses to these issues, and the identified risks?

4 To what extent do these options and solutions diverge from solutions tried before, and what are the advantages and drawbacks of such solutions for the EU?

These questions were specified into six elements for analysis, four for the medium term and two for the long run. The six elements are:

For the medium term, i.e. from accession to the participation in the monetary union and the Euro:
- the risks of 'erosion' of the internal market by the accession of the ten CEECs, and the ways to deal with those risks; see chapters 2–4;
- the development of the capacity of the candidate Member States to satisfy the minimally necessary conditions for participation in the Economic and Monetary System (EMS-II); see chapters 5 and 6;
- a possible transition regime for these countries in preparation for the entry into EMU; see chapter 6;
- minimally necessary financial provisions (like the Structural and Cohesion Funds) during this preparatory phase; see chapter 7.

For the long term, i.e. following full participation in the monetary union:
- the potential risks for the functioning of the EMU and the possible policy solutions; see chapter 6;
- the minimally necessary adaptations of the EMU provisions and institutions, and the Structural and Cohesion Funds, for the purpose of the proper functioning of the EMU in the long run'; see chapters 6 and especially 7.

Three qualifications are in order. Firstly, although analytically useful, it is not always straightforward, and sometimes indeed arbitrary, to distinguish between the medium and the long run. Where the long run is made explicit in the text, the underlying assumptions are inevitably somewhat speculative. Secondly, we will only occasionally refer to Turkey and we will ignore Cyprus and Malta for the most part. The focus is on the ten candidate countries in transition. Thirdly, the study is concerned with specific medium to long-run economic aspects of this Eastward enlargement. It does not deal with the typical economic impact analyses accompanying the pre-accession period, such as the costs and benefits of enlargement for both sides (see e.g. Baldwin, Francois & Portes, 1997 for an early attempt, and Mortensen & Richter, 2000, for a survey), nor with the effects of enlargement on trade, foreign direct investments and/or macro-economic variables.

1.3 ANALYTICAL FRAMEWORK IN THE CONTEXT OF EMU

Since Economic and Monetary Union is the unifying concept of this study, it is useful to set out what EMU is, and how the various elements hang together. However, determining what EMU is, turns out to be less obvious than one might

expect. Whereas the treaty carefully defines and specifies monetary union, it does not define economic union.

Based on Delors et al (1989) and Pelkmans (1991), one may deduce two partially overlapping concepts of economic union which are of practical policy relevance today and in the near future. The first one is an *economic union, as a fully-fledged internal market*. This is an ambitious notion, which requires a single market in goods, services and factors of production plus the necessary positive integration (like approximation, common regulation, common policies and expenditures) to make this internal market function properly. For the first notion, the relation between the E and the M of EMU is fairly loose; what is required for the proper functioning of economic union is exchange rate stability; monetary union, e.g. a single currency like the Euro, is not necessary.

The second concept is more ambitious still, in defining *economic union as the economic integration required for monetary union to function properly*. The relation between the E and the M of EMU is firm; they operate as 'twins'. The fundamental difference in ambition follows from the focus on the 'macro-economic stabilisation' function that economic union is to support, in addition to the 'efficiency' function of the first concept. This leads to two extra policy require-ments:

1. an appropriate adjustment capacity of the EU's economy;
2. fiscal policy co-ordination to such a degree (more precisely, with such a degree of binding[2]) that the price stability of the monetary union cannot be endangered.

Figures 1.1 and 1.2 illustrate the two concepts in a stylised way.

The present study is based on the second concept of economic union, because of the overwhelming importance of the Euro zone. However, there are a few caveats that ought to be noted. First of all, the present EU-15 comprises four non-Euro countries – and still three if Greece would join the Euro. For these 'outsiders' the first concept is mixed with some elements of the second, because of the way the Maastricht and Amsterdam Treaties have been written. They have formally en-tered stage II of EMU and this implies a number of obligations on 'sound' macro-economic policy, policy co-ordination, central bank independence, etc. Second, 'economic and social cohesion', in Maastricht elevated to one of the aims of the EC, pertains to all Member States. This prompts the question whether the budgetary plank[3] of economic and social cohesion is merely efficiency-based, and hence supporting the first concept of economic union, or (also) equity-based. If it is also equity-based[4], the further question arises whether there is a logical economic connection with monetary union (the second concept of economic union). We submit that there is a consensus among economists that monetary union, in and by itself, does not require transfers to poor members as a compensation for the loss of the exchange rate instrument. In other words, the Structural Funds are

efficiency-based (first concept) and may also help to ameliorate the adjustment capacity of the EU economy (second concept), but the Cohesion Fund must be seen as a political price for the Maastricht agreement on EMU. One might maintain it for equity purposes, but otherwise it could disappear. Of course, this lengthy excursion into the conceptual approach to EMU does not alter the actual redistributive *result* of the transfers via the various funds for the main, net beneficiaries Greece, Spain, Portugal and Ireland.

Figure 1.1 The basic concept of economic union

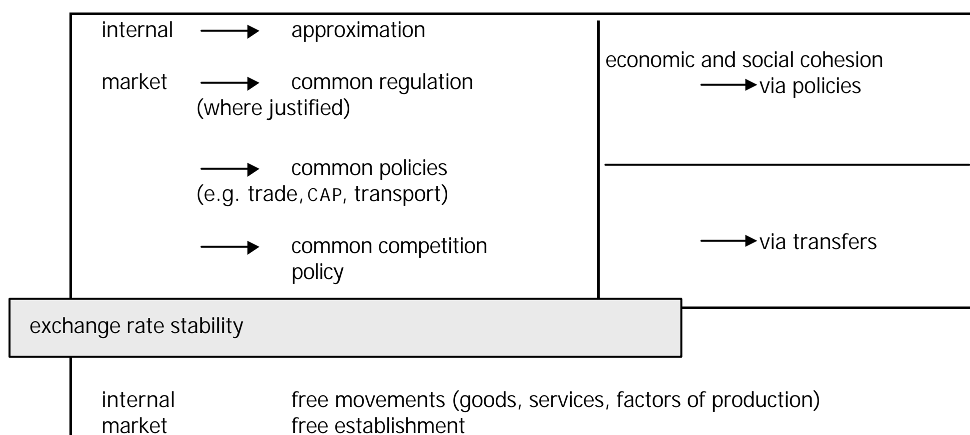


Figure 1.2 Economic union serving monetary union

monetary union
irrevocable exchange rates // Euro
price stability
European Central Bank
entry conditions
policy obligations / Growth and Stability pact

EMU fiscal conditionalities

economic union,
as figure 1.1,
with appropriate adjustment capacity,
Member States' level (structural change / mobilities)
social partners / flexibilities
(possible) stabilisers (Member States'/ EU levels)
regulatory reform at EU and Member States' levels

For the second concept, i.e. of economic union to support a good working monetary union, the appropriate adjustment capacity of the EU's economy is essential.

Rigidities in labour markets and, more generally, structural reforms aimed at facilitating dynamic adjustments to high value-added/high growth sectors in an open-economy are generally seen as problematic for the Euro zone. With Eastern enlargement, concerns about the functioning of the economy underlying a common exchange rate mechanism, or indeed a single currency, run deeper still. Broadly spoken, doubts are raised about the 'completion' of the transition process from centrally planned economies to well-functioning market economies. Moreover, there are doubts about the CEECs capacity to withstand EU and world-wide competitive pressures and to cope with potential asymmetric shocks. Whereas the fiscal aspects of monetary union can be measured and assessed with a reasonable degree of confidence, it is much more difficult to come to firm and unassailable conclusions about the CEECs adjustment capacity five or more years hence, when they might join the Euro area.

Using the second concept of economic union, this report thus focuses on the internal market and its (future) proper functioning to the extent allowed by current indicators and strategic approaches. It also attempts to illuminate the economic significance of these single market issues by placing these in the context of the 'higher' stages of transition and the expected functioning of the economic union (first concept). Building on this, the study of preparations for EMS II (or III) and of entry into the Euro area is more straightforward, because treaty and protocol conditions have been defined precisely. It remains true, of course that in that event the underlying economic union (second concept) is more demanding still, but, as we will point out in some detail, it is exceedingly difficult to employ an empirical analysis because of the rapid changes in core data that can be expected. If well used, the transfers via the various funds can be extremely helpful in improving the robustness, dynamic performance, diversity and hence the adjustment capacity of the enlarged economic union. This is particularly true because of the misdevelopment under communism and the 'development lag' more generally still facing the CEECs. Given this widely agreed potential, the present study concentrates, rather, on the EU side of the transfers, and its problematic political economy.

1.4 STRUCTURE AND OUTLINE OF THE STUDY

All these considerations should help to explain the structure of this study. The first part discusses the potential difficulties for the internal market in an EU of 28 member states in the years, say, 2010–2012. Three chapters address different aspects of this question. Chapter 2 attempts to identify gaps in the adoption of the internal market which candidate countries have difficulties filling even over a period of a decade or so. This incorporates a treatment, in some detail, of their administrative capacity. Moreover, it complements this exercise by identifying the nature of transition periods requested or likely to be requested by the candidate countries, and indeed by the EU-15. Inevitably, in looking to the medium to long run, this chapter has a somewhat speculative character, starting from what we know today.

The exercise is not so much meant to forecast. Rather, it seeks to clarify the volume and nature of the internal market difficulties, which probably require timely and structural adjustments in rules, politics, institutions and mindsets. Chapter 3 moves beyond this in asking what the 'erosion' of the internal market could be, how such (a) notion(s) can be applied to the EU-15 of the 1990s, and what implications this may have for pre-accession and the immediate period after accession.

Chapter 4 inspects an alternative way of addressing the issue, namely, by defining the notion of a 'core internal market acquis'. The idea behind this approach is to dispose of a well-defined and sufficiently detailed test of those (core) elements of the internal market acquis, including the required administrative capacity, which have significance for the actual economic functioning of the internal market. Being late or imperfect on a number of trivial or purely technical elements of the acquis makes adopting the internal market acquis 'incomplete'. However, it does not impinge on the internal market's proper economic functioning. The priorities in pre-accession ought to be on the exploitation of *the internal market as a great economic asset*, and not on a kind of legislative 'count-down'. However, it should be stressed that the core acquis is not a kind of 'watering down'; ultimately, the entire acquis has to be adopted and implemented in a credible way.

With accession of five, six or perhaps even eight candidate countries by 2004 or 2005, the question arises how well and when they are going to fit into the higher stages of EMU, with the accession to the Euro area as the end stage. Although the basic rules and obligations have been laid down in the Maastricht treaty (and protocols) and numerous operational aspects no longer entail uncertainties because the Euro-system is 'up and running', the monetary integration of the prospective Member States calls forth a range of analytical and policy questions. The approach taken in chapter 6 is to focus on those issues that impinge on policy choices that might have to be made by the EU. These essentially relate to the prospects of the candidate countries' meeting the Maastricht criteria, and to the appropriateness of (all) these criteria.

Following the considerations in chapter 5 (that is, a qualitative appreciation of the crucial importance of a well-functioning (enlarged) economic union as the foundation for monetary union with the accession countries), chapter 6 briefly discusses the anxieties or vague references about the 'diversity' of those countries compared to today's Euro-11. Once the overall approach of chapters 4 and 5 is accepted – a core internal market acquis that forms a solid basis for a well-functioning economic union yielding stability and catch-up growth – we examine the merits of the (asserted) requirement of 'real' convergence, whatever exactly this may be. Furthermore, we address the risks of asymmetric shocks in such an enlarged Euro-group. As to the stages preceding the Euro, attention is paid to the nature and potential impact of an EMS-II (or III), which presumably would serve as an antechamber for entering the Euro zone. Immediately before and possibly a few

years after accession, there will also be the likelihood of a higher rate of inflation in the CEECs than in the Euro area, as a 'mechanical' result of high catch-up growth. This is due to the so-called Balassa-Samuelson effect (Annex 1 provides a formal exposition as well as an econometric investigation). Finally, two somewhat special aspects are dealt with. One is 'Euro-isation' as a remedy to obtain stabilisation for transition countries with weak macro-economic records. Annex 2 elaborates on the implications (and conditions) of Euro-isation and adds a (simulated) case study on Estonia. The other is a brief inspection of possible institutional aspects in the long run, when there will be a European Central Bank (ECB) of 28 countries.

The costs of enlargement to the EU-15 are often discussed mainly or even exclusively in terms of the additional spending via various EU Funds for decades to come. The two sources of these costs are quite different: the price/income system of the CAP, and the various Structural Funds. Whereas the second can be justified on dynamic efficiency grounds, the first source is largely equity-based and has generated significant inefficiencies in the use of funds in addition to considerable macro-economic costs. Nevertheless, judging from the *actual* behaviour of the Council and, to an increasing degree also the European Parliament (EP), neither these problems nor the (secularly increasing) *size* of the overall transfers would seem to be regarded as the overriding problem in the EU-15. Rather, it is the unwillingness of Member States to be a *net payer* to the EU budget [5]. This *juste retour* behaviour induces ever higher obstacles to sensible policy making in areas affected by payments from the EU budget. Fortunately, the overwhelming part of EU activity relates to regulation and liberalisation, not to money. However, wherever and whenever transfers are important, and this is bound to be the case for the Eastern enlargement [6], both the timing and substance of EU decision-making tend to be dysfunctional for EU strategies and for the credibility of the Union in the eyes of voters and market players. Indeed, given that enlargement will have to be decided with the heaviest of all decision procedures (ratification) and given that it is a major and irreversible political act, the risks for a conflictuous path of decision-making up to and after accession are magnified.

The emphasis in chapter 7 is less on the total 'costs' in terms of extra transfers (to CEECs as members), although we do derive estimates for a possible 'first' group of five candidates. Rather, it concentrates on the changes in net payments (or net receipts) taking the two sources of transfers (the CAP and the Structural Funds) together. This approach is based on a positive, rather than a normative analysis; despite its clearly dysfunctional character, the conflict potential in the Council is essentially hidden in the implications for net balances.

Starting from a careful analysis of the results of the Berlin European Council (March 1999), several options for the budgetary and net balances positions for 2006 and 2010 are calculated and discussed. The likely impact of adding a second group of applicants for the budget of 2010 is briefly discussed as well. Finally,

some suggestions to minimise or avoid the imminent inter-Member States disputes are presented.

The imperative to focus on the typical zero-sum-game politics of net balances tends to relegate important issues of substance to second place. For the economic union to function properly, Structural Funds should be utilised in the framework of well-prepared and justified programmes for infrastructure (both hard and soft), environment, energy efficiency, possibly nuclear decommissioning and other aspects which raise the overall capacity to compete effectively in the enlarged internal market. It is this efficiency-based approach which holds the key to an improved economic performance – read: catch-up growth – of the candidate countries. The experience of economic and social cohesion funding since 1988 (when the funds were doubled for the first time, and restructured) has shown that effective absorption, rather than 'need identification' as such, is crucial for the transfers to foster economic performance and the investment climate. We shall indicate the more important areas, based on today's needs' identification. Unfortunately, we cannot deal with the development of the indigenous capacity to prepare well thought-out programmes and projects. However, we stress that optimal use of the funds by the new Member States is still the best incentive to improve domestic policy design and executive capacities. It pre-empts a 'hand-out' mentality which could eventually lead to new Mezzogiornos, and it also bolsters the support for these transfers in the net-paying countries.

NOTES

[1] Due to its imprecise notion, 'erosion' is sometimes called 'watering down' or (confusingly) (in) 'cohesion'. Thus, the Economic & Social Committee of the EC, in its Opinion on the Impact on the Single Market of the enlargement of the Union (CES 852/99 of 22/23 Sept. 1999) notes that the "challenges posed by further enlargement of the single market... are much more complex than for previous enlargements... Revolutionary ways will have to be found to determine how best to organize and manage the single market in view of the eventual doubling of the number of participating States, with many small countries, broad linguistic and cultural diversity, and wide discrepancies in development... It will be imperative to ensure that enlargement does not damage the cohesion of the internal market....Ill-prepared enlargement would weaken single market cohesion". (p.3)

[2] Dependent on the extent to which one expects capital markets (alone) to discipline deficit-prone governments (which can no longer rely on monetary financing).

[3] Economic and social cohesion is also to be pursued in the framework of the various (common) policies of the EC, and not merely (or even primarily) via budget transfers.

[4] The EC treaty defines cohesion and solidarity amongst the Member States as one aim.

[5] Approximately three quarters of the EU budget consist of transfers rather than direct EU expenditures.

[6] In contrast to the 1995 enlargement (with Finland, Sweden and Austria) for example.

2 PROBLEMS OF ACCESSION TO THE INTERNAL MARKET

2.1 INTRODUCTION

In the early 1990s, fears of internal market erosion were colouring many speeches and statements of policy makers and business leaders. However, the concept of erosion remained very general indeed. Following the entering into force of the interim stages under the first Association Agreements, there was increasing apprehension that foreign policy considerations and the Union's vocation to let former Comecon and Soviet republics 'return to Europe' would lead to easy, irreversible commitments of giving EU membership. A series of European Council meetings addressed this apprehension with ever more stringent conditionality. Consider table 2.1.

Table 2.1 Accession conditions in various EU summits

European Councils	Conditionalities
Copenhagen (December 93)	1 stability political/constitutional institutions: democracy, rule of law, human rights, respect for and protection of minorities 2 functioning market economy 3 capacity to cope with competitive pressure and market forces in the EU 4 ability to adhere to aims of political union, economic union and monetary union
Corfu (June 94)	5 full implementation of the Europe Agreements
Essen (December 94)	6 ability to assume the obligations of EU membership, to be assured before accession 7 essential element of accession strategy is the candidates' progressive readiness for integration into the internal market, through the phased adoption of the Union's internal market acquis
Cannes (June 95)	8 the White Paper on the preparation... for integration into the internal market acquis of the Union (with its detailed, 438 pp. Annex), accepted
Madrid (December 95)	9 Intensifies pre-accession strategies, emphasising adjustment of (CEEC's) administrative structures, and a stable economic and monetary environment

What in Copenhagen is still termed, very generally, the 'ability to adhere to aims' of the Unions[1], becomes more and more specifically the adherence to the acquis, and subsequently the internal market acquis as its 'essential' element. In an unprecedented move, a White Paper (with a detailed Annex) was produced in May

1995, itemising directive by directive (and/or decisions where relevant) in 23 major areas of the internal market, the expected adoption in stages I and II, and in some areas even a stage III. The PHARE programme as well as flanking actions such as TAIEX and PRAQ were (re-)designed to assist Central European countries to follow the White Paper. This came close to a unilateral *de facto* imposition of the legislative agenda of the potential candidate countries. It is true that Central European countries demanded, as a matter of enlightened self-interest, far more precise guidance, information and technical assistance, to which the White Paper was a very useful response. Nevertheless, the fear of a diluted Community and an 'erosion' of the internal market led to a major push for this quasi-hegemonic approach by the EU.

Extensive expertise employed in the PHARE programmes of seminars and legal assistance for approximation provided the Commission with detailed knowledge of the progress in adopting laws based on EC directives, in addition to the more traditional monitoring by the EU missions. Also, the candidate countries were committed more precisely via agreed pre-accession programmes, (more or less) coherently brought together in National Programmes for the Adoption of the Acquis (NPAAS). This further improved the oversight the EU could exercise on the legislative activities of the accession countries. Since mid-1997, on the occasion of Agenda 2000, the Commission has started to publish very detailed 'regular reports' on the first three Copenhagen criteria of table 1, as well as on the criteria no. 6 and no. 9. Since 1998, administrative capacity in particular has received detailed attention. Moreover, all candidate countries are either involved in negotiations or subjected to a 'screening' process. This takes place at a very detailed level of regulation and of institutional and 'hard' (e.g. testing houses) infrastructure for supervision, inspection, market surveillance, etc. The regular reports, lastly of November 1999, have rendered the pre-accession process a much more functional one, with a primary focus on the substantive conditions for EU membership.

A first indicator for the *establishment* of the internal market of the EU-28 by 2010–2012, is the degree in which the internal market (IM) acquis will be adopted by the new Member States. Equally important, informed expectations about the proper functioning of this IM can be derived from the extent formally adopted rules and obligations, from the acquis, are actually implemented and enforced in markets, and from the capabilities and performance records of the relevant institutions entrusted with these tasks.

Of course, there is no way to establish how much predictive value such indicators have for the situation ten to twelve years hence. We will provide the basic information in summary form, which no doubt can be interpreted by readers in various ways. We shall attempt to interpret the current information to the best of our ability, while stressing that robust conclusions are only possible in fairly extreme instances.

It is crucial to assess the snapshot taken in the autumn of 1999 against the backdrop of an amazing dynamism in the candidate countries. All transition candidates and also Turkey, though to a lesser degree, have upheld a high speed of legislation over a very wide range of policy areas and have engaged in considerable efforts of radical institutional renewal and reform. In looking ahead no less than ten years or so, based on a snapshot of today, it is useful to remember that the White Paper on the IM acquis for the candidate countries was published only five years ago. The first systematic assessment of acquis adoption is just a few years old and solid, well-informed NPAAs with careful domestic planning of legislation exist for barely two years. In ten *more* years, much if not all requirements might well be met. The *incentives* are powerful indeed. To mention the four more important ones:

1 candidate countries invariably consider EU accession as the top priority for policy-making (usually independent from what coalition is actually in power) which generates support for what otherwise would undoubtedly be considered as an endless, legislative steeple-chase;
2 the Regular Reports of the Commission as well as the screening exercises illuminate many details and create fruitful political pressures and media attention;
3 the accession negotiations have been opened with all CEECs and (at least in terms of prospect) Turkey, so that the opening and (temporary) closing of chapters serves as a kind of litmus test for the state of preparation of an accession country. This ‘test’ tends to discipline the domestic political debate and is likely to stimulate progress in the immediate years ahead;
4 finally, there is the market-driven test of foreign direct investments (FDI) inflows which tend to be affected negatively by pejorative scores in the pre-accession activities, and all candidate countries are keen to avoid such a pale image.

A second indicator for the establishment of the IM consists of the formally requested transition periods. Five Central European candidate countries have already been engaged in negotiations with the EU for nearly two years and all chapters have meanwhile been opened. These countries are the Czech Republic, Estonia, Hungary, Poland and Slovenia.

In this chapter, we shall examine both the adoption gaps and the requested transition periods. We proceed as follows. Section 2.2 will present summary tables as a basis for assessing pre-accession as it stands today. How the eleven countries at issue live up to the accession criteria will be discussed briefly because the IM acquis only makes sense once these criteria are fulfilled. Section 2.3 elaborates on selected transition indicators because the link between the adoption of the IM acquis and the transition to a properly functioning market economy is far-reaching. Section 2.4 focuses on selected areas of the IM acquis and identifies adoption gaps. It is followed by a closer look at the current capacity of the agencies and institutions required for implementation and enforcement of a vast range of IM aspects (section 2.5). Finally, section 2.6 examines the requests for transition periods.

2.2 ASSESSING PRE-ACCESSION

In tracing gaps in the current adoption of the IM acquis it is neither possible nor fruitful for the purpose of this study to descend to the level of the greatest detail, even though such detail matters in market transactions. Very detailed assessments are suitable for a full understanding of the accession negotiations or for specialised questions in a given policy or business area. Our focus is on the long-run (prospect of) adoption, in the context of the entire set of the Copenhagen criteria, as well as on the interaction with the process of transition to a functioning market economy. Specific adoption gaps in the more difficult areas can subsequently be identified and discussed, since it will take time to overcome them.

Tables 2.2a and 2.2b provide a bird's eye view of the most recent assessments of pre-accession. Table 2.2a evaluates the five first wave CEEC-accession countries whereas Table 2.2b evaluates the second wave plus Turkey. The inclusion of Turkey is explained below.

The overall picture is first of all determined by the accession criteria (other than the political ones). The realisation of a market economy is confirmed for the first group, whilst the second 'wave' exhibits two confirmations, two countries which are 'close' and two denials for Bulgaria and Romania. As Turkey never was a planned economy, it has no transition legacy. The 'ability to withstand competition' (in Copenhagen defined at the country, not the sectoral or firm level) is hard to interpret for economists; in a well-functioning market economy it is hard to envisage the lack of such an ability. In all probability it refers to the adjustment costs of reallocating human, financial, physical, nature-based and knowledge resources, which are a function of experience, sector specificity, 'new' skills, but also habits, mindsets, general employability and social security systems, etc. The East German example has demonstrated rather dramatically that even the reliance on well-tested (namely, West German) market rules and institutions, a robust social security system and enormous investments – public and private – cannot 'magically' solve this transformation problem without high adjustment costs, material as well as immaterial. In this light, the second criterion ('competitiveness' for short, in table 2.2) being fulfilled only in the medium-term is neither surprising nor alarming. The difference with Turkey is interesting because the customs union with the EU and a wave of privatisations have stripped away a good deal of the possible cushions against fully-fledged competitive exposure .[2] Of greater concern is the assessment for Romania. If Romania cannot face fully-fledged competitive exposure before long, it is liable to get twisted into vicious circles of defensive interventions which will undermine the acquis adoption and discourage entrepreneurial resources as well as foreign investors. The roots of the disappointing performance by this country lie in its fragile coalition; reformers do not have the upper hand and the full implications of the acquis are *de facto* not accepted[3]. Other countries have had periods of hesitation (Slovakia, Bulgaria; in a weaker sense, Lithuania) but Romania is now the only accession country in Central

Europe where support for EU membership is not paired with a strong (medium-term) macro-economic agenda and a convincing NPAA which is faithfully implemented.

Table 2.2a Assessing pre-accession: first wave countries

Accession criteria	Czech Republic	Estonia	Hungary	Poland	Slovenia
1. market economy	Yes	yes	yes	yes	Yes
2. competitiveness	Medium term	Medium term	Medium term	Medium term	Medium term
3. acquis adoption	Stalled	uneven(+)	Considerable	Considerable	Progress
4. administrative capacity	Considerable	weak	Considerable	consid.	Weak
Enforceability					
Judiciary	Mediocre	Mediocre	Improved	Improved	Mediocre
Corruption	Considerable	some	Some	Some	Some
Transition indicators					
Competition policy	Mainly EU-based; operational	EU-based; operational	EU-based; operational	EU-based; operational	Mainly EU-based; Operational
Banking	Bad debts	Relatively sound	uneven progress(+)	Relatively sound	Relatively sound
Privatisation	Half-hearted	far	Far	Improved	Half-hearted
FDI	Strong	strong	Strong	strong	Modest
Adoption (gaps) IM					
state aids control	Mediocre	weak	Satisfactory	Improved	Weak
land reform	OK	incomplete	OK	OK	Incomplete
Veterinary and sanitary measures	Partial	Partial	slow adoption	Partial	Partial
IPRS	Partial	Far	Far	Slow	Progress
Energy	Slow liberalisation	Uneven	uneven(+)	Slow	Slow liberalisation
Environmental strategy	Hesitant	considerable	Hesitant	Weak	Considerable
Standards	CEN/CENELEC	behind	Progress	Much behind	Progress
IM-type bodies	Mixed	mixed	Mixed	mixed	Mixed

Table 2.2b Assessing pre-accession: second wave countries

Accession criteria	BULGARIA	LATVIA	LITHUANIA	ROMANIA	SLOVAKIA	TURKEY
1 market economy	Not yet	Yes	Close	not yet	close	Yes
2 competitiveness	Medium term	Medium term	Medium term	Unclear	Medium term	Yes*
3 acquis adoption	Weak(+)	Progress	Progress	Uneven	progress	Progress
4 admininstrative capacity	Weak	Uneven(+)	Uneven(+)	Weak	Weak	Weak
Enforceability						
Judiciary	Weak	Improved	Improved	Weak	Improved	Weak
Corruption	High	Considerable	High	High	High(+)	High
Transition indicators						
Competition policy	EU -based; operational	EU -based; operational	EU -based; operational	EU -based; operational	EU -based; operational	EU -based; progress in implement.
Banking	Relatively sound	Relatively sound	Relatively sound	Uneven (+)	Weak(+)	Weak
Privatisation	Improved	Far	Progress	Slow	Partial***	Improved
FDI	Low	Strong	Considerable	Low	Hesitant	(?)
Adoption (gaps) IM						
State aids control	Weak	Improved	mediocre(+)	Improved**	Progress	Selective progress
Land reform	Incomplete	OK	incompl.(+)	Incomplete	OK	-
Veterinary and sanitary measures	Weak	Progress	progress	Some	Behind	weak
IPRS	Improving	Progress	far**	Progress	Mixed	Improved
Energy	Slow liberalisation	Slow	improv.	Slow	Slow	Slow
Environmental strategy	None	Progress	progress	None	Weak	None
Standards	Far behind	Behind	far behind	far behind	Far behind	Progress
IM-type bodies	Behind	Mixed	mixed	Mixed	Weak(+)	(?)

*) "Yes", refers to the ability to withstand competitive pressures in the IM; since Turkey has a customs union with the EU and a degree of state intervention comparable to that of Italy or Spain a few decades ago, it can withstand world competition, but at unnecessarily high costs because of too hesitant an adjustment.
**) contrast between legal adoption and violation in markets
***) suspicious privatisations under the Meciar government are currently revoked, and repeated under proper procedures
+ measn that signs point in the right direction (thus, in case of corruption, (+) means a reduction)
Source: the Commission Regular Reports, as published in November 1999

As a result, its scores in all items of table 2.2b are problematic or worse, despite the fact that it has accomplished many aspects of the acquis not specified in this table.

The third criterion, acquis adoption, does not score as well as one might have hoped after five to seven years of transposition. It shows how difficult it is to adopt the huge and complex EU acquis in a transition country *before* membership, even with assistance and domestic political consensus. The assessments employ a gen-

eral wording because there are no 'score boards' (as there are for the EU countries). On the basis of the screening and its updating, such score boards could in principle be made, but these screening meetings and their minutes are not public. Nevertheless, if one observes the annual progress and realises the pressures from negotiations as well as from business, countries other than Romania – and perhaps Turkey and Bulgaria – can approach adoption rates higher than 80 per cent of the White Paper list in two years or so. As the Regular Reports and the NPAAs show, acquis adoption beyond the White Paper is also actively pursued by all candidates.

The fourth criterion – administrative capacity – attracts six 'weak' scores, two 'uneven' and only three 'considerable'. This is clearly a profound problem that requires structural solutions in the interest of both accession and EU countries. For the credibility of the internal market, but equally for the long-run attractiveness of accession countries for FDI, good institutions are crucial. This is understood everywhere nowadays, but the cleavage between institutional intentions and the realisation of effective administrations is both wide and deep.

It is entirely possible to read this summary of accession criteria in a pejorative fashion. This is particularly true if one takes the accession criteria no. 5, 6, 7 and 8 (see table 2.1) together and interprets them in a strict way. Some observers have argued that these criteria imply a wholesale adoption of the acquis before accession. This is an extreme reading of table 2.1. Such a reading would render the forthcoming enlargement even more unique than any of the four preceding ones, because never before has the conditionality been so severe. Should one employ this extreme reading of table 2.1, then the four accession criteria of table 2.2 (1-4) would spell delays and/or a range of lingering problems after accession. But the far more reasonable reading of table 2.1, with respect to acquis adoption, is to assess 'the *ability* to assume the obligations of EU membership' and this is not the same as a 100 percent adoption at the time of accession. In any event, certain key aspects of the IM acquis can only be adopted on becoming a Member State (e.g. customs tariffs, CAP), and must therefore be implemented *after* the entire ratification procedure, not to speak of negotiated and accepted transition periods (as well as possible derogations). It is in this light that we propose to regard table 2.2. Given the strong incentives on both sides, the process conditions (the accession partnership, etc.), the assistance and the annual progress since the 1995 White Paper, there is *little reason to expect a general 'inability' to assume the obligations in, say, five years from today.* As table 2.2 shows, the first group scores reasonably well on the first two accession criteria, and gives a mixed result on the latter two criteria. On the basis of table 2.2 Bulgaria and Romania would have to progress more, and should accede later. When moving to a date like 2010, however, a sombre assessment can only be rationalised, it would seem, by a very sceptical look at the four incentives mentioned above, or by a sentiment (or prejudice?) that deep crises or policy reversals should be expected.

The Turkish case is interesting for several reasons. First, if indeed Turkey were as determined as the CEECs to accede soon, the consequences of enlargement would radically change. Turkey alone enjoys an economic size *bigger than* the CEEC-10 together, and adds a population equal to that of the CEECs minus Poland. It also has no communist legacy and far lower external trade protection than (most of) the CEECs because of the customs union with the EU. It is a long-standing member of both NATO and the OECD. Second, Turkey suffers from two problems with respect to EU accession: a lamentable human rights record (both laws and deeds), in part derived from the profound problems with the Kurds minority, and a deep divide in domestic politics on the future perspective of the country in terms of values and economic regionalism. If the latter two problems would somehow recede, and macro-economic stability would be better pursued, Turkey could return to strong economic performance it has shown to be capable of. Such a scenario would help greatly to overcome the duality of the Turkish economy and in so doing would underpin stability and security of the future EU-28. An economically performing Turkey would also stimulate economic growth in South-eastern Europe, which now depends rather one-sidedly on the EU-15. This short sketch underscores how crucial Turkey is for the EU *and* for enlargement. It would be a very serious mistake to look at the eastern enlargement of the CEEC-10, certainly in the longer run, as if the case for Turkey is of marginal importance and can be neglected. The authors would especially caution for an implicit assumption that the incentives for the Turkish accession are mainly to be found on the side of Turkey and hardly on the EU side. And in a perspective of ten to twelve years, one cannot avoid asking to what extent the process and consequences of enlargement with CEECs will be affected, and perhaps at times overshadowed (e.g. ratification), by the prospect of Turkish membership. If one were to assume fulfilment of the political criteria, there is little doubt that Turkey would be capable of adopting the bulk of the acquis as rapidly, if not faster, than the CEECs. Whether this would also be true for its administrative capacity, is doubtful.

2.3 INTERTWINED: TRANSITION AND PRE-ACCESSION

The CEECs face the daunting challenge of combining four processes, each one being of a medium-to-long-run character and each one aiming at a formidable achievement in its own right. They strife (1) to become not only formal but mature democracies, based on the rule of law and a resilient and active civil society, (2) to complete the transition to a functioning market economy, (3) to obtain long-run catch-up growth based on a broad-based concept of development, and (4) to accede to the EU in the coming years. In some respects, these processes tend to interact positively, but this is not to say that they are *necessarily* mutually supportive. Factors such as the initial positions at the time of the peoples' revolutions in 1989/1990 and the 'sequencing' of reforms, to mention just two, may cause difficulties or disappointments, which in turn might prompt policy reversals or blockages. Also, the weakness of the civil society or the impoverishment of large

segments of the population or simmering ethnic conflict might undermine important tenets of democracy and the rule of law. This may help a political leadership to power that fails to lend priority to the painstaking tasks of good transition and pre-accession.

For our purposes, we shall focus merely on the interrelationship between transition and EU (pre-)accession. A literal reading of the Copenhagen criteria might suggest that transition *precedes* pre-accession. Although the prospect of EU membership is known to exercise a positive influence on the scores of transition indicators of the European Bank for Reconstruction and Development (EBRD). [4] The EU would seem to be mainly interested in the final result: a functioning market economy. Once this is recognised, the Commission would appear to be relaxed about the 'ability to withstand competitive pressure' in a pan-European market. Thus, it would presumably focus on acquis adoption and administrative capacity building to accomplish a properly functioning internal market and, at the same time, a better functioning market economy for each candidate country.

But ten years of transition have deepened our understanding of the nature of transition and the complex requirements for its completion. A consensus seems to have emerged on the differentiated time-paths for the five core elements of the transition process, namely (macro-economic) stabilisation, liberalisation, privatisation, institution building[5] and what has come to be termed 'social capital'[6]. Even when countries opt for 'shock therapies' in some respects (e.g. price and foreign trade liberalisation, macro-economic stabilisation and mass privatisation), in other respects transition inevitably requires far longer periods of institution building, experimentation with new forms of 'governance' and adjustment of mindsets, vested interests, norms and values.

For the next enlargement of the EU, this must imply that the causation also goes the other way: transition processes profoundly influence pre-accession. It has taken quite a while before the EU has begun to recognise this. In the Accession Partnerships, the newest PHARE programme and the Joint Assessments of medium-term economic strategies, one finds an increasing awareness of the intertwining of the later stages of transition with appropriate pre-accession strategies.

In table 2.2 these complexities cannot, of course, be adequately reflected (see however chapter 4). At the general level of evaluation that table 2.2 should facilitate, a few selected indicators should suffice. Two sets of indicators have been included: one set for 'enforceability' and another for transition. The two aspects of enforceability (judiciary and corruption) are critical *both* for successful transition *and* for the proper functioning of markets under the IM acquis. The five indicators of transition have all been 'scored' with the help of the Commission Regular Reports, which testifies to the interwoveness of pre-accession and transition.

Nowhere in the CEECs and Turkey does the judiciary receive good scores. Other studies have dealt with this problem [7], but it is clear that it takes many years and sustained efforts before mindset, skills, procedures, laws and resources will have been adjusted so as to 'complete' transition and serve the credibility of the internal market. Corruption is another worrying phenomenon which is reported to be present, and often increasingly so, in all CEECs and Turkey. This report does not pretend to provide new data or insights about corruption in Central Europe. But it is useful to be mindful of the following considerations.

Firstly, corruption can take many forms. One should be careful not to mix them up; what matters for the proper functioning of the IM is that regulation and supervision, correcting or preventing market failures, lead to the desired impact on actual or potential conduct of economic agents, and that market participants continue to find the (actual working of the) internal market credible. Thus, lax banking supervision because of bribes or political patronage or neglect of cartels because of privileged networks should be seen as problematic. By contrast, payment to a police officer so as to prevent a traffic fine (a pure redistribution, with a similar deterrence effect) or a hidden present for a tax official to avoid a hefty bill for an individual tax payer, might be regarded as the 'lubrication' of a society with large income differentials and badly-paid civil servants.

Nevertheless, corruption is like cancer. The example of East Asia has long been trivialised by the 'lubrication' theory. The problem is that petty corruption reveals opportunities for big corruption and the cancer then spreads to leading bureaucrats and politicians in power and to business executives, if not cronies, who specialise in rent seeking and perverse incentives. Sometimes, criminal actors enter this game as well. Indeed, for some Central European countries, the Commission and other sources report that business ethics are undermined by organised crime and corruption, as if the two are indistinguishable. This phenomenon can damage transition in several ways. Also, comparing corruption with cancer is helpful in suggesting that the actual functioning of the internal market does not merely depend on formal adoption receiving high scores. Invisibly, other forces may well undermine the benefits of market integration. It is also helpful in suggesting radical measures which require strong political and administrative resolve as well as an independent and accessible system of justice. But precisely these conditions do not fully apply in Central Europe, be it in different degrees.

Secondly, by definition, data on corruption are unreliable. It is true that high degrees of liberalisation and simplification of procedures (e.g. licenses) strongly reduce the opportunities for corruption. Thus, whereas Poland stands out as an example of immediate 'shock' liberalisation, bribes and other corruptive favours are endemic in Poland because widespread licensing prevents economic freedoms from being enjoyed automatically. But beyond such fundamentals, data must rely on anecdotal evidence from individuals, without ever being capable of measuring directly the extent of the problem. It is also exceedingly hard to define precisely

what corruption is and how it manifests itself. It makes one wonder whether interviewees all speak about the same concept and if so, about its extent in the same way. What is next to impossible is to make these soft and unreliable data comparable between CEECs, given different mindsets and practices.

Finally, and most importantly, what evidence is available today would seem to suggest that the combination of weak administrative capacity, weak or mediocre judiciary and corruption is a much more troublesome potential problem for the IM in 2012 than the adoption gaps, if any, will be by that time. This has immediate implications for the last item in table 2.2, the IM-type bodies, where the CEEC record is mixed. If and to the extent that these bodies would operate efficiently and effectively by the time of accession or shortly thereafter, administrative capacity would be upgraded where it matters most for the IM while the problems of the judiciary might become a little less pressing. Administrative capacity is studied more closely in section 2.5.

A second set of indicators consists of five elements which can be viewed as crucial for the emerging market economy, but at the same time overlap heavily with the notion of a properly functioning internal market . Competition policy has been introduced in all candidate countries years ago, it is generally EU-based (even for mergers, at times, although this is not touched upon in the Europe Agreements) and the responsible agencies are operational. Although the actual results, or the activities (sometimes connected to forms of privatisation) are not yet addressed satisfactorily and can undoubtedly be criticised, one ought not to forget that it is the *national* competition policies that carry the full responsibility. Perhaps it is too easily forgotten, that for instance Switzerland introduced competition policy only in the second half of the 1990s. This occurred after severe criticism by the OECD. And the Netherlands was regarded in Brussels as very lax on restrictive business practices as recently as seven or eight years ago. When comparing with EU Member States, more generally, it is useful to remember that the EC Commission assumes a major share of anti-trust and that, in the early 1980s, over half of today's Member States did not avail of national competition laws as strict as those of the CEECs today. The picture is diverse in banking although the policy conviction that bad debts can linger (as in the Czech Republic) or that public banks can be used to prop up firms in difficulty (as in Turkey) is quickly losing ground. The failures of several Romanian banks and, recently, the difficulties of two banks in Hungary and one in the Czech Republic leave high debts in the hands of the government. This revealing 'shock' clarifies the huge resource costs to everybody. In turn, this prompts an improvement of the supervision.

The *degree* of privatisation is only problematic in Romania; the low credibility of Romanian transition and NPAA processes make investors hesitant, so that several major privatisation tenders had to be abandoned because there were no takers. However, the *nature* of privatisation (for example controlled investment funds or management buy-outs) may not always lead to the corporate governance so badly

needed in these countries. If not, this would add yet another breeding ground for corruption and privileged networks, as shown in the Czech Republic, not to speak of Slovakia under Meciar. The inflow of FDI is a simple but forceful market signal of how investors read the overall business climate and its prospects. There is a divide here between the first group and the other ones. Foreign investors tend to regard both the transition indicators of the EBRD and the Commission reports on pre-accession as authoritative signals on how to read the investment climate. Credible transition *and* pre-accession strategies, as rated by the EBRD and the Commission, tend to have a positive influence on FDI inflows. Conversely, low levels of FDI, if combined with a reported lack of credibility, may contribute to a vicious circle of a lack of new opportunities, causing greater resistance to change, hindering transition, which in turn undermines the formal adoption of sensitive acquis items, and thus lowers the scores on pre-accession.

Finally, land reform has slowed down or made more costly the adjustment in agriculture. Pure land restitution has already caused headaches, but only with major land reforms (and a better functioning land market in some CEECs) will this prompt the great productivity improvements this (large) sector so badly needs. It would, in the longer run, facilitate farmers' revenues under a (newly) reformed CAP. There are a range of other structural problems in CEEC farming such as the pre-financing of seeds and fertilisers, infrastructure for slaughter houses, dairies, etc, the weakness of agricultural banking, marketing, quality and distribution as well as retraining. Given the relatively high share of agriculture in GDP (and even higher in employment), the potential of CEEC farming is dramatically under-utilised (not to mention the negative impact of the export subsidies for EU's farm products to these countries). However, one should expect prospects to improve enormously over the next half decade or so, irrespective of the prospect of CAP - type prices. The better this is tackled by structural reform and structural aids, the more rapid agricultural incomes can start rising again, and the less dramatic the shock of the introduction of the CAP acquis will be.

2.4 IDENTIFYING ADOPTION GAPS

The remaining set of indicators comprises seven large items where difficulties in IM acquis adoption might be expected, even over longer periods. One could have included more but this would have biased the survey towards the short-term problems (e.g. telecoms, where market pressures ensure rapid solutions compatible with the acquis), highly specific sectoral issues (such as fisheries) with very different weights for different countries, or, non-IM areas (e.g. regional policy, indicating a readiness to benefit from the Structural Funds; income taxation relieving pressures on fiscal policy). All items selected in table 2.2 are crucial for the establishment and proper functioning of the internal market of the EU-28. A short discussion of these items may help to provide some perspective.

State aids

The sums spent on state aids in the candidate countries as traditionally defined in the EU are low both absolutely and relatively. The reason is simple: all CEECs have gone through a negative income shock comparable to the Great Depression (or worse) and state budgets simply cannot be burdened with such 'aids'. The future problem in the EU-28 might thus well be a trivial one.

The problem in 2000 is that one cannot be too sure about 'non-traditional' aids. Thus, the Europe Agreements and Accession Partnerships expect the candidate countries to set up a *national* independent register and scrutiny of *their own* state aids. It is hardly surprising, given the numerous frictions about the notification of state aids of EU Member States to the Commission (or indeed, frequently, to their own parliaments!), that this sensitive obligation was not addressed until recently. Within the national context alone (that is, without the Commission procedures based on Art 87, EC which do not apply before accession) and given the interventionist traditions of the CEECs, one cannot have too many illusions about the priority given to and reliability of the state aids registers.

The anxiety concentrates on non-traditional relief like tax breaks for major investors (also an issue in the EU itself), covert aids arising from privatisation processes, below- market energy prices for specific sectors or (some) state-owned enterprises and *de facto* written off arrears to the fisc, to social security, to banks (in special rescue cases) and to (other) state-owned companies. In addition, loss coverage still occurs in Central Europe and can have anti-competitive consequences. It is hard to verify how important the economic effects of such 'hidden' aids are, let alone whether they are sustainable over a period up to 2010.

Veterinary and sanitary measures

The EU internal market without frontiers has necessitated an integral domestic quality and control system, from the farm processes even before the produce leaves the farm gate, all the way to the final customer. CEECs cannot therefore continue with dual standards, that is, high quality and controls for exports to the EU and low quality and lax controls for local products or exports to CIS. The thresholds of actual inspection and scrutiny in and by the EU have of course moved up even more by the recent EU crisis in food safety. These costly infrastructural measures are not only critical for exports to the EU, they might eventually prompt transition periods, before the frontiers can be removed fully.

Intellectual property rights

Given the relatively high level of education in Central Europe and the presence of industrial Research and Development (R&D) under communism, it should be possible for the accession countries to shift their industrial (and to some extent, services) structure rapidly to higher value added products. However, the ambitious demands about Intellectual Property Rights (IPRs) under the Europe Agreements, the budgetary constraints for public R&D and the limited opportunities in private

production of R&D-intensive products and services, have all caused a major shock. This shock consists of a dramatic loss of local 'intangible capital' and the drastic depreciation of the value of local skills and expertise. This was exacerbated by the closure or reduction of plants and/or laboratories of companies or state-owned institutes, tantamount to a destruction of human capital and a de-skilling of society. Foreign direct investment, joint ventures and subcontracting as well as retraining and re-skilling have only slowly begun to compensate for these structural losses. Transition and market integration with the EU and world markets have therefore caused a strong and negative hysteresis.

It is in this context that the adoption gaps in IPRs should be seen. This may well have consequences for the enforcement capabilities even in the presence of high scores of formal IPR adoption. It is particularly acute in the area of counterfeiting (i.e. trade marks), where the commercial incentives to cheat are, relatively and absolutely, far stronger than in Western Europe. In this area the de-skilling effect would seem to be less important than the proper functioning of the supervision by the administration and of access-to-justice. In the patents area, membership of the European Patents Office (EPO) was hardly a priority during the 1990s because of the distressing lack of inventions and innovations in Central Europe. Some CEECs have now been invited to join the Munich Convention and EPO in the years 2001 or 2002. There is also a link with the difficulties for very small start-ups to find proper finance, be it from (risk-averse) banks which cannot easily source independent technical expertise to assess new ideas, be it because of the total lack of a venture capital market. These problems are sometimes said to be most acute in the four smallest CEECs (the Baltics and Slovenia).

The uneven scores on IPR in table 2.2 are therefore likely to be the consequences of typical transition problems which will slowly be overcome in the next five years or so. Apart from the pressures of accession itself, both FDI and the imperative to climb gradually the quality ladder of export to the EU via product differentiation and specialisation will constitute strong incentives to close the adoption gaps of the IPR acquis.

Energy

Scores with respect to energy liberalisation are low throughout. Is this a reason for preoccupation for the medium to long run? There are three aspects with distinct implications. By far the most important one is the continued distortion of energy pricing in many CEECs. This is a legacy of the peculiar hegemonial structure of Comecon, in which the USSR provided oil and gas at prices far below world prices to what are now the applicant countries (with the exception of Slovenia). In turn, this has led to the development of an overly energy-intensive industry, to an installed base of highly inefficient private heating systems and huge implicit subsidies to consumers. The economic and social costs of a complete adjustment to market-driven prices, in all three respects, are enormous. Companies, often financially fragile, may (and did) go bankrupt; replacing heating systems through-

out the economy is a severe burden to house-owners and tenants; and giving up subsidies to many relatively poor consumers in countries with long winters is not going to be socially acceptable. In addition, in selected sectors low energy prices are considered a temporary competitive advantage towards competitors from the EU.

Secondly, there is the issue of the opening up of gas and electricity markets, following the 1996 electricity and the 1998 gas directives (and some weaker directives preceding them). Here, it would be unjustified to give much weight to timely adoption. Of course, a combination of selective privatisation and domestic liberalisation (that is, abolition of exclusive rights) may well serve the public interest of the CEECs, but the very partial liberalisation in the directives and their very recent dates militate against a strict attitude about adoption. Thirdly, excessive use of energy as well as underdeveloped emission-abating technology cause serious environmental problems, both locally and in terms of global warming. This represents the potential benefit side of the coin, i.e. of the shift towards full market pricing of energy. Clearly, there are conflicting signals here. On the one hand, certain emissions have fallen drastically (from extreme levels) because non-viable companies went bankrupt and because the rise of energy prices that did occur, reduced energy inefficiency. On the other hand, actual pollution for the level of activity is still high and major investment and restructuring will be required. Moreover, distortions are exacerbated by the exploitation of extremely polluting energy sources (e.g. lignite in the Czech Republic; oil shale in Estonia; to a lesser extent, coal in Romania and Poland). Adjustment in these sensitive instances runs up against local employment interests, the overall (low) pricing, and the failure to internalise the social costs of pollution. In these instances a pure counting of adoption gaps is pointless, if not counterproductive. These specific cases are best addressed in the context of the Structural and Cohesion Funds, with a view to ensuring positive, structural adjustment over a five to ten years period. If the EU cares to remember the very slow adjustment in the market for coal over several decades, one can scarcely plea for the harsh and swift adjustment with economic and social costs that several EU countries were themselves not prepared to accept until recently.

Environmental strategy

In the area of environment, adoption gaps or perhaps more appropriately the widespread 'adoption failure' observed for the ten CEECs (and Turkey) are part of a far larger problem of pursuing a long-run environmental strategy in the candidate countries [8]. Such strategies are indispensable to realising the combination, also over time, of three elements for properly complying with the acquis, namely, (1) transposition of some 300 directives, regulations and decisions plus the Kyoto commitments and other 'softer' elements such as environmental impact assessments as well as the avowed EU policy to 'integrate' environmental concerns in other policies (such as transport, agriculture, etc.), (2) the administrative capacity to monitor and enforce effectively this formal acquis, and (3) the technical and

infrastructural investments needed to meet – both in the public and the private sector – the requirements in those directives. A mere ticking-off of national laws 'transposing' hundreds of environmental directives could theoretically minimise adoption gaps, but it would be meaningless without the other two elements having proceeded quite far as well. Indeed without a conscious strategy, in which priorities and investment planning (and its financing!) underpin the stepwise adoption of the acquis, the credibility of the environmental acquis itself and of the CEECs' governments would be severely undermined.

In part, it is a matter of sheer magnitudes. The administrative capacity is not just about many new institutions and agencies, some of which are decentralised as well, but indeed about considerable investment in monitoring stations, laboratories and their (advanced) equipment. The overall investment in infrastructure in other segments of the public sector – and not least at municipal and regional levels – and in the private sector is even more daunting. A 1998 study (for the ten CEECs) estimated that this would amount to 120 billion Euro. Spread out over a twelve to thirteen year period this would imply annual investment spending in the range of three per cent or more of GDP on environment alone. Last but not least, transposing 300-odd directives into national laws, based on proper understanding, and political debate, not to mention actual and potential impact assessments, is a major task as well. In the 1995 White Paper, all that was proposed for so-called stage-I, was legislation that directly affected the free movement of goods, leaving out directives relating to pollution from stationary sources and relating to processes rather than products. In 2000, then, it is hardly surprising that adoption gaps are very large indeed, if measured against the full set of environmental directives. Compared to the White Paper which deals with the approximation obligations of the associated countries under the Europe Agreements, measuring 'adoption gaps' *for accession* involves dealing with an environmental acquis of five times the number of directives. Many of these have caused difficulties or delays in the EU Member States themselves!

The investment issue is therefore by no means the only issue, but it is no doubt the supreme bottleneck in all the environmental strategies. It is linked to the competitiveness of CEECs' industries over time, to the level and structure of state and local expenditure, and to the strategic choices made in the EU Structural Funds. Moreover, its importance for medium and long-run macro-economic policy and the desired 'catch-up' growth render the environmental investment issues paramount in an already overloaded agenda. From the point of view of market integration, the sensitivity of EU-based business to adoption failures in the environmental area is, to some extent, counterbalanced by sizeable export and FDI opportunities for capital and 'green hi-tech' purchases in the CEECs.

Although the environmental acquis is numerically large, the investment imperatives are mainly limited to a small group of demanding directives, that require widespread and sophisticated technical infrastructure. The principal areas in-

volved are water, waste and power generation. More precisely, the list of 'costly' directives in terms of investment includes:

- Large Combustion Plant Directive (1988)
- Urban Waste Water Directive (1991)
- Drinking Water Directive (1980)
- Air Quality Framework Directive (1996) and its daughter directives
- Integrated Pollution Prevention and Control (IPPC) Directive (1996)
- Hazardous Waste Incineration Directive (1994)
- Municipal Waste Incineration Directive (1989)
- The Landfill Directive (1999)
- Several directives related to solid waste management and recycling schemes

The design and pursuit of an appropriate long-run environmental policy in the candidate countries goes beyond the scope of this study, but the manifold linkages, also over time, with pre-accession and economic policy ought to be appreciated.

Standards

Only the Czech Republic has become a full member of CEN and CENELEC (which presupposes, among other things, an eighty percent adoption rate of European standards as well as some institutional and legal accomplishments). For the establishment and proper functioning of the internal goods market, standards and adequate conformity assessment (testing and certification) are essential. In an overview chapter of adoption gaps it is not possible to do justice to the complexity of this huge area of (complementary) private and public activity. But a few points can be made. First, a distinction ought to be made between the old and the new approach. The old approach does not require standards [9] since all the technical specifications are included in the directives, indeed even testing methods are. This extreme rigidity causes these directives (in cars, motorbikes, chemicals, tractors) to be repeatedly updated with technical progress. The upshot is that CEECs should simply adopt the (updated) directives wholesale and back this up with the necessary conformity assessment and inspection systems. The new approach merely defines the essential safety, health, environmental or consumer protection requirements and allows two ways to comply with them: either via European standards (based on mandates, derived from the essential requirements) or, for those innovating companies wishing to circumvent those standards [10], directly by conformity assessment based on the essential requirements. For the hundreds of thousands of products falling under new approach directives [11], the rapid adoption of the 2000 or so CEN standards especially written under the new approach (and another 2000 under development) as well as the more than 3500 CENELEC standards (the bulk of which is linked to the 1973 Low Voltage directive and some new approach directives) is a *conditio sine qua non* for an economically meaningful adoption of formal directives. To put it a little extreme, were candidate countries to show a perfect score on the adoption of new approach directives and a very poor score on the relevant European standards, the zero-adoption-gap for this area would be meaningless [12] in terms of the acquis.

Secondly, food and medicines are special categories. For medicines, what matters in markets (and to governments) is credibility and an authorisation procedure which is based on solid research results. For exports to the EU this is likely to be done in joint ventures with EU-based companies. The remaining issues have to do with good laboratory and manufacturing practices (for which there are strict standards) and patents. The problems are therefore very much linked to local capabilities rather than to long lists of standards. The alignment to the European Medicinal Agency's decisions (operational since 1995) should present few problems as this can be done gradually; most of these decisions pertain to 'new' medicines, resulting from biotechnology.

In food, a kind of new approach has replaced the so-called 'recipe' directives approach from the 1970s. The essence of this new 'horizontal' approach is a combination of mutual recognition (and proportionality, often boiling down to 'labelling' instead of more restrictive measures) and horizontal directives on labelling and additives. This combination presents difficulties for accession countries, but this *cannot* be read from a low or high adoption rate. One difficulty is to make mutual recognition work (see also chapter 3). The other is to have adequate inspection for food safety in factories, slaughter houses, dairies, shops and open market places. As yet, very few food standards exist in Europe because laws used to be extremely precise and detailed. Here, there is of course a close relationship with detailed veterinary and plant health regulation (see above).

Internal market type bodies

The picture here is mixed. As noted, this is worrying in combination with other aspects such as weak overall administrative capacity, a weak judiciary and the widespread presence of corruption or privileged networks. It is worth noting that the purely administrative establishment of many of such bodies has been accomplished or is under way. Such a notional compliance is of course insufficient. Therefore, the following subsection will elaborate on this problem, since it is not inconceivable that the credibility of the IM of the EU-28 by 2010 might suffer from shortcomings in specific administrative capacities.

Altogether, the cluster of seven items selected above illustrates the manifold demands on the accession countries which need to be satisfied before the extended internal market will no longer suffer from a credibility gap. It also clarifies that a mere scoreboard of (adopted) directives would neither be sufficient nor, in all cases, suitable. For the short and even for the medium run, this cluster indicates a range of serious hurdles. The environmental problems are so costly and sensitive that only well-designed long-run strategies can solve these. Apart from the environment, the scores and performance in this cluster could dramatically improve in five years or so if the pace of reforms in the accession countries remains as high as that of the last five years.

2.5 ADMINISTERING THE IM ACQUIS EFFECTIVELY

Recently, Verheijen (2000) has dealt with the overall problem of obtaining the horizontal administrative capacity to apply the acquis. The present section is complementary to this insightful study, in that it surveys the specific administrative capacities for the effective application of the internal market acquis, in the wide sense.

Both in a transition and in a pre-accession perspective, one can observe an increasing awareness that effective institutions are critical for long-run economic performance in general, and the proper (economic) functioning of the internal market in particular. In the following we attempt to provide some empirical substance to this awareness in the context of accession preparations. Tables 2.3a and 2.3b report two scores for 33 institutions in the ten Central European candidate countries (e.g. enforcement, supervisory agencies, executive offices, independent regulators) required for the proper functioning of the internal market. For Turkey the Commission has not yet analysed administrative capacities in detail. Although a fairly comprehensive summary, both tables are by no means complete[13]. Moreover, some areas would have to be subdivided, in order to obtain a clearer picture of administrative capacity (e.g. environment, energy). Time and space constraints render such detail impossible. Since this chapter addresses whether administrative capacity to apply the IM acquis effectively will be sufficient in a decade from now, these tables provide a useful, first proxy.

These tables lead to the following conclusions. Firstly, both first wave and second wave applicants have accomplished *a far reaching degree* of establishing *the relevant institutions* in at least *some basic form***.** All ten candidates show many 'Ys' (yes), and no country has more than four 'N's (no)[14]. Of course, establishing the formal administrative institutions is a necessary but by no means a sufficient condition for achieving 'effective administrative capacity to apply the IM-acquis'. And given the strong inclination in Central Europe to assign priority to legislation and formalism[15] rather than to meeting objectives and to functioning in a credible way – which is what matters in markets – it is crucial not to be misled by attempts of formal window-dressing. In a long-run perspective, however, it is equally important to appreciate that, more often than not, a legislative foundation for administrative application now exists, and that, frequently, agencies, supervisors and regulators are already operational. Admittedly, these often operate with understaffed and/or underfunded offices, with lingering co-ordination problems or with still insufficient powers.

Table 2.3a Assessing administrative capacity for IM acquis (first wave countries)

	Czech Republic	Estonia	Hungary	Poland	Slovenia
public procurement	Y 4	Y 4	Y 4	Y 3	N
Copyright/counterfeit	Y 3	Y 2	Y 3 (J)	Y 3(J)	Y 3
patent office	Y 4	Y 2	Y 3 (J)	Y 2	Y 3
company registration	(n.r.)	(n.r.)	Y 2	(n.r.)	(n.r.)
Accounting/auditing	Y 3	(n.r.)	Y 3	Y 4	(n.r.)
data protection	N	Y 2	Y 4	Y 3	N
Standards	Y 4	Y 1	Y 4	Y 3	Y 2
Certification	Y 4	Y 1	Y 4	Y 2	Y 1
Metrology	Y 4	Y 1	Y 4	Y 3	Y 2
prudential supervisory agencies	Y 4	Y 3	Y 4	Y 4	Y 3
money laundering	(n.r.)	(n.r.)	(n.r.)	Y (n.r.)	(n.r.)
Securities supervision	Y 4	Y 2	Y 4	Y (n.r.)	Y 3
Insurance	Y 2	Y 3	Y 4	(n.r.)	Y 2
competition authority	Y 3	Y 3	Y 4	Y 3	Y 2
state aids	Y 2	Y 1	Y 2	Y 2	Y 2
telecoms regulation	Y 2	Y 3	Y 3	Y 2	Y 2
postal regulation	(n.r.)	Y 3	Y 2	(n.r.)	(n.r.)
audiovisual	Y 2	Y (n.r.)	Y 4	Y 3	N
customs	Y 4	Y 3	Y 3	Y 2	Y 3
taxation (ind.)	Y (n.r.)	Y 2	Y 3	Y 2	Y 3
veterinary	Y 4	Y 2	Y 3	Y 2	Y 2
phyto-sanitary	Y 4	Y 2	Y 3	Y 3	(n.r.)
CAP-structures	Y 2	Y 2	Y 3	y 2	Y 1
sapard	Y (n.r.)	(n.r.)	Y 3	N	Y 1
fisheries	(n.r.)	Y 2	Y 2	Y 1	(n.r.)
energy (reg.)	N	Y 3	Y 2	Y 1	Y 1
road transport	Y 3	Y (n.r.)	Y 3	Y 2	Y 3
air transport	Y 3	Y 2	Y (n.r.)	Y 4	Y 2
maritime	(n.r.)	Y 2	(n.r.)	Y 4	Y 3
social acquis	Y 3	Y 2(J)	Y 3	Y (n.r.)	Y 3
Regionalpolicy/cohesion	Y 3	Y 1	Y 1	Y 2	Y 1
Environment	Y 3	Y 2	Y 3	Y 2	Y 1
Consumer protection	Y 3	Y 2(J)	Y 3	Y 2	Y 2(J)

Note: all explanations, see table 2.3b.

Secondly, a vertical reading of the scores reveals that the Czech Republic, Hungary and Poland, of the first wave, and Latvia and Lithuania, of the second wave, would seem to be more advanced in administrative capacity. Interestingly, Estonia scores lower than the other two Baltic states, and Slovenia is roughly on par with Romania.

Thirdly, if one would define the lowest two scores (1 and 2) as worrisome areas even for a period as long as ten years, and if one would include the 'N's with a double-count (because the hurdle of realising administrative capacity is much greater), the most problematic countries would be Romania (24), Bulgaria (23), Slovenia (21), Estonia (19), and Slovakia (16). Scores amount to a simple frequency sum, in which an N enters with a double weight (i.e. with a 2).

Fourthly, one should note that rating 4 merely implies an 'effective capacity', based on expertise of EU rules. It does not necessarily mean perfect compatibility, since the Commission Reports assess this only in an approximate way. So, even for countries with many 3's, and 4's, considerable administrative efforts will still be required. [16]

Table 2.3B Assessing administrative capacity for IM acquis (second wave countries)

	Latvia	Lithuania	Bulgaria	Romainia	Slovakia
public procurement	Y 2	Y 3	N	N	Y 2
Copyright/counterfeit	Y 2(J)	Y 2	Y 1 (J)	Y 4	Y 3(J)
patent office	Y 4	Y 3	Y 2	Y 1(J)	Y (n.r.)
Company registration	Y 3	(n.r.)	Y 2	(n.r.)	Y (n.r.)
Accounting/auditing	Y 2	(n.r.)	Y 2	Y (n.r.)	Y (n.r.)
data protection	N	Y 3	N	N	Y (n.r.)
Standards	Y 3	Y 3	Y 2	Y 3	Y 2
Certification	Y 3	Y 3	Y 2	Y 3	Y 3
Metrology	Y 3	Y (n.r.)	Y 2	Y 2	Y 3
prudent supervision aq.	Y 4	Y (n.r.)	Y 3	Y 3	Y 2
money laundering	Y 3	(n.r.)	(n.r.)	Y 1	(n.r.)
Securities supervision	Y 4	Y 4	Y 3	Y 2	Y 2
Insurance	Y 4	Y 4	Y 4	Y 2	Y 2
Competition authority	Y 4	Y 3	Y 3	Y 3	Y 3
state aids	Y 4	Y 2	Y 2	Y (n.r.)	Y 2
Telecoms regulation	Y 2	Y 2	Y 3	Y 1	(n.r.)
postal regulation	N	Y 2	N	N	(n.r.)
Audiovisual	Y 3	Y 3	Y 3	Y 1	Y 3
Customs	Y 2	Y 3	Y 2	Y 3	Y 3
taxation (indirect)	Y 3	Y 3	Y 2	(n.r.)	Y 3
Veterinary	Y 2	Y 3	Y 2	Y 3	Y 2
phyto-sanitary	Y 2	(n.r.)	Y 2	Y 3	Y 2
CAP –structures	N	Y 2	N	(n.r.)	Y 2
Sapard	Y (n.r.)	(n.r.)	(n.r.)	Y 2	(n.r.)
Fisheries	Y 3	Y 2	Y 2	N	Y 2
energy (regulation)	Y (n.r.)	Y 3	Y 1	Y 1	N
road transport	Y 3	Y (n.r.)	Y 2	Y 2	Y 3
air transport	Y 3	Y 3	Y 4	Y 2	Y 3
Maritime	Y 3	Y 3	Y (n.r.)	Y 2	Y (n.r.)
social acquis	Y 3	Y 3	(n.r.)	Y 1	Y 2
regional policy/cohesion	Y 2	Y 3	Y 3	Y 2	Y 1
Environment	Y 2	Y 3	Y 2	Y 2	Y 2
Consumer protection	Y 2	Y 3	Y 1	Y 1	Y 2

Notes: Y = yes; N = no (N may, but need not, mean that there is no administrative capacity at all, merely that this is not acquis-related capacity)
Rating:
1 = no effective capacity
2 = minimal capacity; e.g. because of too few powers, lack of independence, severe shortages, etc.
3 = largely adequate (e.g. co-ordination problems, staff shortages, incomplete scope)
4 = effective capacity (for IM acquis)
J = specifically reported link with (improving) the judiciary
n.r. = not reported
Areas not included are: justice and home affairs, financial control, rail, inland water ways, nuclear energy, mutual recognition of diplomas, food safety other than veterinary and phyto sanitary
Sources: Commission Regular Reports (on all CEECs), November 1999 Sections B.

Fifhtly, a horizontal reading of the tables may well reveal sectoral trouble-spots for the longer run. Low scores across many candidate countries can be found for data protection, money laundering (often not reported), state aids control, a postal regulator, CAP structures, SAPARD (the paying agency related to pre-accession Structural Funds), fisheries, energy, regional policy (and cohesion), environment and consumer protection.

Finally, a horizontal reading of the 'better' administered areas points to competition authorities, metrology and security supervision. The standards and certification areas exhibit very uneven scores between countries. The same holds for public procurement (including complaints) and audio visual.

2.6 REQUESTS FOR TRANSITION PERIODS

Five Central European candidate countries have already been engaged in negotiations with the EU for nearly two years. These countries are the Czech Republic, Estonia, Hungary, Poland and Slovenia. The first step consisted of a so-called screening exercise, in which all aspects of EC law to be transposed and implemented in domestic law have been scrutinised in bilateral meetings between the Commission and the relevant specialist civil servants from the applicant country. Screening started in March 1998 and was completed in September 1999. The screening exercise helped Commission and candidate countries' negotiators identify issues that are likely to arise in the accession negotiations.

The second step consists of the negotiations themselves. Since 10 November 1998, negotiations have been initiated, in four consecutive steps, in four clusters of chapters. Technically, following a Commission proposal (and consultations with the candidate countries), the Council decides on 'opening' the chapters. However, it should be realised that chapters are only opened, in principle, once there is a reasonable prospect that they can also be closed relatively soon. Closing a chapter implies that the relevant acquis is already implemented or is expected to be implemented without difficulties, and, if this is not the case, that a clear case for a negotiating issue can be presented, presumably with a credible implementation plan fitting the NPAA [17]. In turn, this could be the basis for a request for a transition period. If a clear case cannot be presented, the chapter remains open until whatever political, legal or institutional problems have been resolved. The longer a chapter remains open and the larger the number of such chapters, the lower the credibility of the candidate country's statement that it is ready to enter the EU in the short run. In other words, there is a cost to a strategy of unprepared negotiations.

The present section will mainly focus on formally requested transition periods by the first five candidate countries. Even this survey is provided with a few caveats. First, we are not completely certain that we have information on *all* requests; not

all details are always public and requests can also be filed later. Information gaps may be caused by the staging of the negotiations. This is as follows:

- November 1998: a first cluster of seven chapters, namely science and research, telecoms and information technology, education and training, culture and audio-visual policy, industrial policy, SMEs, and common foreign and security policy (CFSP).
- Spring 1999: a second cluster of eight chapters, i.e. company law (including intellectual property rights), consumer and health protection, fisheries, statistics, free movement of goods, external relations, customs union and competition policy.
- Autumn 1999: a third cluster of eight chapters, i.e. social policy and employment, transport, energy, free movement of capital, economic and monetary union, environment, freedom to provide services and taxation.
- Late winter 2000: the last cluster of six chapters (making the total 29) including agriculture, justice and home affairs, freedom of movement of persons, regional policy, financial control, and financial and budgetary provisions (but note that 'agriculture' will only be opened in the summer of 2000 or even later).
- 28 March 2000: the first cluster for the second wave countries was initiated, including five chapters for Romania (SMEs, science and research, educational/vocational training and youth, external relations, and CFSP), one more for Bulgaria (audio-visual) and still two more for Latvia, Lithuania and Slovakia (competition policy; statistics).

Second, not all transition periods can be viewed as indicators of internal market problems. Some requests are tactical (aimed at obtaining reciprocity) and others have a relatively short duration. Third, and too often neglected at present, the EU-15 will also propose transition periods but these propositions are not yet known. However, it would be surprising if the areas affected would not include agriculture (and possibly aspects of fisheries) and the free movement of workers.

Table 2.4 summarises requests for transition periods and special difficulties which might possibly lead to (temporary or permanent) derogations for the first five CEECs. The table covers twelve (large) policy areas, which precede the negotiations of the fourth cluster. Table 2.5 below provides selective information on the fourth cluster.

One can draw the following tentative conclusions from this survey. Firstly, the most striking element of table 2.4 is undoubtedly how much uncertainty still exists about all kinds of aspects of the acquis adoption and implementation and/or the compatibility of domestic law and institutions with EC law. There is no way of knowing whether any of these lingering screening issues might eventually develop into a gap in the IM acquis or a distortive functioning of the IM in 2010. The sheer intensity of the ongoing monitoring and of permanent consultations, alternated with bilateral negotiations, and to be followed by overall scrutiny by the Council,

should be expected to resolve most of these issues. The overwhelming incentive of EU membership and of large-scale assistance (from multilateral, bilateral and private sources) justifies a degree of optimism. Little more can be said at this stage.

Secondly, ignoring all requests for transition periods up until 2006, or, as the case may be, for three years or less, our survey identifies sixteen requests for longer transition periods in all chapters other than environment (but this includes several requests with unspecified periods) and 42 requests in environment. Of those sixteen requests, a few are highly specific and not of a long-run concern. The restrictions of the purchase of real estate by non-residents are also of little or no significance to the internal market. The length of transition periods and the nature of the deviation from EC law in areas such as preferential trade policy (customs union and free trade areas), VAT and excise duties and financial services might affect the internal market by 2010.

Thirdly, it is no surprise that in the area of environmental policy the internal market is likely to remain incomplete by 2010 or so. How problematic is this? There are several legitimate approaches here. From a political perspective, it is entirely reasonable to see this as a temporary price to pay. After all, few would wish to maintain that the CEECs should commit themselves to huge investments, both public and private, crammed into the few years before enlargement. If all required investments would have to be made before accession – quite apart from whether this is technically and managerially feasible-, this would imply annual magnitudes estimated to range from three to five per cent of GDP, dependent on the country. Given the many other costs of transition and pre-accession, and given the imperative of catch-up growth, *the case of gradualism in approximating the environmental acquis is extremely strong.* Stronger still, one could argue in favour of larger Structural and Cohesion Funds dedicated to environmental clean-up and to other non-recurring costs to speed up the realisation of the acquis and to minimise distortions of the future IM. There is enormous scope for spending larger funds on well-identified targets, and there is ample absorption capacity in this area. In this perspective, it would seem justified to criticise the lopsided funding between 2000 and 2006 under Structural and Cohesion Funds, which benefits relatively rich EU countries and regions compared to much poorer CEECS.

Table 2.4 Requests for transition periods and other negotiation difficulties (first wave; twelve major areas from three clusters)

	Company Law & IPR
Czech Republic	information required on intellectual and industrial property rights
Estonia	information required on intellectual and industrial property rights
Hungary	wants a 5-year transition period for regulation on supplementary protection certificate for medicinal products
Poland	information required on intellectual property rights and implementation of regulation on supplementary protection certificate for medicinal products
Slovenia	information required on company and accounting law, on protection of intellectual and industrial property rights, and on implementation of regulation on supplementary protection certificate for medicinal products
	External Relations
Czech Republic	wants a transition period for customs union with Slovakia
Estonia	wants a transition period for free-trade agreements with Latvia, Lithuania, Ukraine
Hungary	wants to keep safeguards on imports from non-EU countries
Poland	wants to maintain the level of economic relations with non-EU partners
Slovenia	wants a 10-year transition period for free-trade agreements with Bosnia, Croatia and Macedonia
	Customs union
Czech Republic	wants to maintain lower duties for some industrial products
Estonia	wants gradual post-accession approximation of duty rates
Hungary	wants several transition periods, for example maintaining a tariff quota for processing materials 5 years after accession
Poland	negotiations on technical provisions will continue (temporary importation, repayment of duties, customs warehousing)
Slovenia	is ready to adopt and implement fully EU law in this area
	Competition policy
Czech Republic	wants aid programmes to be assessed in the light of post-transition needs
Estonia	information required on state-aid and state monopolies
Hungary	wants a 6-month adaptation period for regulations on anti-trust policy
Poland	wants a transition period until 2017 for special economic zones and transition admission for aid for environment, regions and restructuring
Slovenia	will not restructure steel, textile and footwear restructuring on time for accession
	Free Movement of Goods
Czech Republic	wants to maintain special requirements for safety of toys until 2007; will only implement the New Approach Directive for certain electrical equipment
Estonia	will implement EU law by 1 January 2003
Hungary	requests a transition period in pharmaceutical sector; wants to maintain national legislation permitting use of vegetable fats in chocolate products
Poland	Conditions to the acceptance of EU law in the sector of medical devices; reserved position on two aspects in pharmaceutical sector

Free Movement of Capital	
Czech Republic	wants a non-specified transition period for restrictions on acquisition of real estate by non-residents
Hungary	wants a 10-year transition period for restrictions on acquisition of agricultural land and a 5-year period on the acquisition of real estate by foreigners; a transition period on the acquisition of a licence for air transport
Poland	wants an 18-year transition period for restrictions on agricultural land acquisition and a 5-year period for real estate acquisition by foreigners
Slovenia	may request reciprocity in the field of land and real estate acquisition if other applicants be granted transition periods; asks for assistance in case of balance of payments disequilibrium after full liberalisation of capital movements; wants restrictions on capital movements with third countries
Social Policy and Employment	
Czech Republic	No request for transition periods. The EU wants additional information on social protection, labour law, equality of treatment for women and men, discrimination, employment, social dialogue, public health, and health and safety.
Estonia	No request for transition periods. The EU wants additional information on social protection, labour law, equal treatment of women and men, discrimination, employment, social dialogue, public health, and health and safety.
Hungary	Requests a 4-year transition period until 1 January 2006 for tar content of cigarettes (Hungarian maximum limit is higher than in the EU). The EU wants a clarification of the public health implications of this request, as well as additional information on social protection, labour law, equality of treatment for women and men, discrimination, employment, social dialogue, public health, and health and safety.
Poland	Requests a 3-year transition period until 1 January 2006 for EU directive on minimum safety standards for the use of protective equipment by workers. Poland also reserves the right to ask for a transition period for EU directive on work with biological agents. The EU wants further justification of these requests, as well as additional information on social protection, labour law, equality of treatment for women and men, discrimination, employment, social dialogue, public health, and health and safety.
Slovenia	No request for transition periods, but reserves the right to examine the need for a transition period for the implementation of directives on work with physical, chemical and biological agents. The EU wants additional information on social protection, labour law, equal treatment of women and men, discrimination, employment, social dialogue, public health, and health and safety.

Energy	
Czech Republic	Requests transition periods for rules on minimum oil stocks until the end of 2005. It wants to delay full liberalisation of its electricity market until the end of 2005 and of its gas market until August 2008. The EU invited Prague to reconsider its requests.
Estonia	Requests a derogation for oil security stocks and oil supply management measures, and wants to include shale oil in obligatory liquid fuel stocks. Estonia says it would be able to start liberalising its electricity and gas markets in 2006.
Hungary	No request for transition periods but EU requests additional information on several issues.
Poland	Requests transition periods for crude oil stocks and for exclusion of fuel oils from its stock obligations, as well as for the delay of the opening of its gas market until the end of 2005.
Slovenia	It requests a transition period for minimum levels of oil security stocks until the end of 2005.
Freedom to provide services	
Czech Republic	Requests a transition period (as yet unspecified) for the acquisition of real estate by foreigners in the area of free movement of capital, which has implication for provision of services. It is also considering a derogation for specialised credit institutions.
Estonia	Requests a transition period for the minimum period of coverage of 20,000 Euro for deposit guarantee schemes and investor compensation schemes until 2010.
Hungary	Requests derogations based on its requests for transition periods in the area of free movement of capital for acquisition of real estate by foreigners.
Poland	Requests derogations based on its requests for transition periods in the area of free movement of capital for acquisition of real estate by foreigners.
Slovenia	Requests transition periods in the areas of banking, securities and investment services.
Transport	
Czech Republic	No requests for transition periods. The EU wants additional information on application and implementation of EU law in this area.
Estonia	Requests a transitional period for application of EU minimum tax rates for vehicles until the end of 2005.
Hungary	Requests a transition period until the end of 2006 for cabotage in road freight transport. It also wants to maintain minimum tax rates for vehicles until the end of 2005 and special user charges on some heavy lorries. In air transport, Hungary request gradual opening until the end of 2005.
Poland	Requests several transition periods, among others for the liberalisation of its passenger cabotage until the end of 2005. It also wants a transition period until the end of 2005 for access to intra-EU routes and for the licensing of air carriers.
Slovenia	No requests for transition periods. The EU wants additional information on application and implementation of EU law in this area by Slovenia.

Taxation Policy	
Czech Republic	Requests a transition period for its reduced VAT rate on heating energy, construction works and construction companies, and telecommunications services. It also requests a VAT exemption for (small) SMEs. It asks for transition periods for applying minimum excise duty rates for mineral oils, cigarettes and tobacco.
Estonia	Requests a transition period for zero VAT rate for electricity, generated by wind and hydroelectric power plants. Estonia also requests a transition period for reaching the minimum excise duty rate on cigarettes and tobacco.
Hungary	Requests a transition period for its reduced rate of VAT on coal and fuel for domestic heating, foodstuffs served or sold in canteens, as well as for the transport and the storage of goods. It also intends to introduce a 5% VAT rate for items currently subjected to zero rate, such as diapers, educational books and pharmaceuticals.
Poland	Has not yet started negotiations on taxation policy.
Slovenia	Wants to maintain its reduced VAT rate on preparations of meals, construction, renovation and maintenance work on housing facilities. It also wants a (procedural) derogation for small SMEs. Requests a transition period for applying minimum excise duty rates for cigarettes and fermented alcoholic beverages until mid-2005.
Environment	
Czech Republic	Requested 7 transition periods of up to 10 years.
Estonia	Requested 8 transition periods of up to 2010.
Hungary	Requested 9 transition periods in areas which require big-scale investment.
Poland	Requested 14 transition periods of up to 10 years.
Slovenia	Requested 4 transition periods.

Source: Eur Activ and own research (early 2000)

From an economic perspective, the distortions of the IM by 2010 might be noticeable in specified product markets as well as (possibly) in transport and energy. More difficult is the case of water, be it drinking water or the acquis in other areas of water management. The enormous investments in water quality are justified mainly by public health standards and the IM impact is significant only in cases other than drinking water. A special case is nuclear energy, with very costly instances of decommissioning as well as problems of nuclear waste. Whether, when and to what extent this would, in 2010, distort input prices of energy in goods and services markets is hard to foresee at the moment. As noted previously, specific directives on waste and power generation are also very demanding in terms of investment. These issues can only be dealt with properly *in the context of an environmental strategy that is well thought-out.*

The overall conclusion from table 2.4 is that the IM of the EU-28 in 2010-2012 will show relatively few gaps or distortions in these twelve areas, except for the environmental area, and that proper negotiations and targeted EU funding can reduce significantly their scope and negative economic impact.

Table 2.5 complements table 2.4 with respect to the newly opened chapters. The picture is not complete, unfortunately, since Hungary has refused to make its

official negotiation positions public. The tentative conclusions for table 2.5 are that (1) few transition periods or derogations are requested outside agriculture, and even those few all fall within the medium-term, (2) many transition periods and quite a few derogations, special safeguards or special treatments will be requested in agriculture, (3) the first-wave countries have clearly co-ordinated their positions on the initial membership contributions, since they all request a gradual phasing-in, over several years, of their contributions towards their regular share of the EU's 'own budgetary resources'.

Table 2.5 Request for transition periods or derogations in fourth cluster (first wave countries; selective info only)

	Czech Republic	Estonia	Poland	Slovenia
free movement of persons (Chapter 2)	1 transition Period no derogation	no transition period mutual recognition of USSR-based diplomas	no transition period no derogations	no transition period no derogation
Agriculture (Chapter 7)	6 transition periods 4 derogations/ special treatment/ safeguards	9 transition periods special state aids derogation 1 veterinary dero-gation (higher re-quests) (one on higher phytosanitary)	3 transition Periods 12 derogations/ special treatment/ special requests	8 transition periods 5 derogations/ special treatment
Regional policy (Chapter 21)	no transition period no derogation	no transition period no derogation	no transition period no derogation	no transition period no derogation
Justice & Home affairs (chapter. 24)	1 transition Period no derogation	no transition period no derogation	no transition period no derogation	no transition period no derogation
Financial Control (chapter 28)	no transition period no derogation	no transition period no derogation	no transition period no derogation	no transition period no derogation
Financial and budget provisions (Chapter 29)	Transition for lower initial contribution to EU	transition for lower initial contribution to EU	transition for lower initial contribution to EU	transition for lower initial contribution to EU reservation ECSC payments

Sources: the CEECs missions with the EU

Finally, five countries of the second wave have initiated negotiations on five to eight relatively unproblematic chapters. Although one should scarcely expect the pre-accession problems of the second-wave countries to show up at this 'easy' stage, we report the main points for the sake of completeness. Romania (5 chapters), Slovakia (8) and Bulgaria (6) did not ask for any transition period. However, both Romania and Slovakia called attention to the potential problem of existing preferential trade; for Romania its free trade area with Moldova, for Slovakia the (deep) customs union with the Czech Republic. In *both* cases the countries seek minimal or no adjustment upon membership. For Rominaia this would imply an EU free trade area agreement with Moldova; as to Slovakia, it prefers to join the EU *on the same date* as the Czechs!

The Baltic countries have been explicit about the preferential trade issues. Neither Lithuania nor Latvia has requested any transition period or derogation, other than for preferential trade[18]. For Lithuania and Latvia the Baltic free trade area (which, for all practical purposes, has eliminated internal border controls) is economically and politically important. Should the three Baltic states not accede together or should the dates be far apart, they will insist on a temporary derogation. In addition, Lithuania currently maintains a free trade area with the Ukraine. The request for a transitional period is of economic interest to Vilnius, but it also has important political significance. The ancient bonds between the two countries (large parts of the Ukraine were under Lithuanian reign, several centuries ago) and the potential importance of the Ukraine to the EU might help to put this on the EU agenda.

Armed with these tables, what can one reasonably say about the IM, ten years hence, in a possible EU -28? Apart from the main conclusions derived directly from Tables 2.4 and 2.5, it is worth remembering the EU's future position. The truly difficult areas in the negotiations are widely expected to be agriculture, regional policy and free movement of persons. Of these, regional policy hardly emerges as problematic from tables 2.4 and 2.5, simply because the central issues in this area are not so much the formal acquis adoption (as shown in the tables) but (1) the central and decentralised effective administrative capacity, including the capability to prepare and submit well-argued projects in detail and the capacity to meet the EU's demanding financial control and disbursement standards for the Structural Funds, (2) the attempts by CEECs to maximise the eligibility of regions, if not the entire country under various funds or schemes (as indeed has already happened for agriculture by the first wave).

In the other two areas, the EU *itself* is a (very large) part of the problem. There is no doubt that agriculture will once again, – as in previous enlargements, especially the Iberian one – give rise to many, presumably quite lengthy and complicated transition arrangements. The repeated insistence at high political level, and by European business, that this be avoided, will be neglected in the actual negotiations. One crucial reason for this neglect is the scope and level of agricultural protection of the EU-15 itself. There can be little illusion about what the transition to a fully fledged IM for agro-food products will look like if one considers the Union's position under the Europe Agreements. Agro-food (and to some extent fisheries) is the only area where no free trade is allowed between the CEEC-10 and the EU-15, indeed where protection on the EU side is (broadly spoken) *far higher* than that of the candidate countries. That this severely hinders the adjustment, modernisation and investment in CEEC agriculture is obvious, and this in a sector where the economic and social price of underdevelopment is extremely high (given that most CEECs have a far higher agro-share in GDP and in employment than Member States). Even more objectionable is the sustained export subsidisation (of probably around half of the EU export volume to CEECs), for which there is no sensible policy argument. It damages and severely distorts local agro-markets in

candidate countries. This mercantilist approach to intra-European agricultural trade has generated an export surplus for the EU for about half a decade now, and even this has not prompted a removal of export subsidies[19].

All this does not mean that the CEECs can not and do not learn to play the agro-game very quickly as well. Tables 2.4 and 2.5 are indicative. In the draft EU negotiation position on agriculture one already finds many instances where the EU requests candidate countries to mitigate or give up overblown or unfounded special requests for (high) quotas and payments. Far more important still is the overall issue of compensations that will be discussed in chapter 7.

The free movement of workers looks unproblematic in tables 2.4 and 2.5, but most readers of this report will know that it is the EU which will no doubt ask for a considerable transition period, and perhaps for special derogations. In fact, it is largely a *faux problème* because the true sensitivities in the EU are prompted by *illegal* workers from the CEECs. This is an enforcement issue that has nothing to do with the acquis. For CEECs' workers legally moving within the EU-28, the greatest handicap (yet, paradoxically, also the greatest attraction) will be the EU principle of 'host country control'. That is, those workers will be contracted at conditions, including wages and non-wage costs, reflecting those of local workers in what is today the EU-15. Essentially, this eliminates the trump card of the CEEC workers: lower wages.

NOTES

1 Note that 'political' union is mentioned, even though EU members do not know what that is. In the run-up to the Maastricht treaty, the negotiations on 'political union' (as an identifiable notion) were abandoned!

2 By no means all, as the November report on Turkey emphasises, e.g. in agriculture, energy and parts of banking.

3 It is fair to notice that the political and economic damage caused by Ceaucescu's repression was incomparably greater than in other Comecom countries.

4 See EBRD, Transition Report (1999) and e.g. Wolf, (1999).

5 Institutions in the sense of the appropriate legal and institutional framework for markets to function properly and in the sense of institutions and agencies entrusted with ensuring enforcement and legal certainty.

6 This quotation from EBRD (1999, p. 5) provides a definition and illustrations: "Social capital may be defined in terms of: voluntary compliance with established laws, trust, co-operative behaviour and basic codes of conduct. By using the language of capital, we emphasise both that it can be enhanced or eroded and that it can complement other factors of production, such as physical and human capital. Defined in this way, social capital can be seen to be fundamental to the development of institutions. Furthermore, appropriate institutions can preserve and foster social capital. With weak social capital, physical capital is abused, destroyed or misappropriated and human capital can be wasted and diminished. Manifestations of weak social capital include: bureaucratic interference of various kinds, especially harassment by the tax authorities; behaviour by those involved in the judiciary which undermines its effectiveness; corruption and other deficiencies in law and order; and unsound or dubious business practices, including asset-stripping and poor corporate governance". See also, Bos, Gelauff & de Mooij (1999)

7 See the forthcoming WRR working Document by Blankenburg.

8 The following is based on, besides the Regular Reports, work done in the CEPS Working Party on 'The environment in European enlargement', with Wolfgang Hager as rapporteur. At the time of writing this Working Party report was still at the drafting stage.

9 The colloquial use of the word 'standard' is *not* appropriate for the understanding of the issues in this subsection. A 'standard' (in ISO and in the EU) is a *voluntary* agreement about particular technical specifications, achieved by consensus in a private standards body, which adheres to strict procedures of public inquiry and transparency. A *European* standard is one adopted by CEN, CENELEC or ETSI; it replaces previously existing national standards, if any; such standards *can* be a 'presumption' of compliance with the 'essential (e.g. safety) requirements' of New Approach directives (following 'mandates, etc.), but in many product markets such standards have no relation with EC regulation and merely serve perceived market needs.

10 Since most of these standards are 'performance' standards (and not 'design' standards), many designs or new ideas are often compatible with European standards. The incentive to innovate 'around' the standard is therefore very

low. With new materials or specific technical progress, however, it remains entirely possible, as indeed it should be.

11 New Approach directives are few in number (20) but they cover, in most cases, a wide range of distinct products. Thus, the toy directive covers an estimated 50.000 different toys, the machines directive some 45.000 different machines and the construction product directive several tens of thousands of products (no precise number) .

12 Not necessarily meaningless for the national economy or for trade. Foreign investors may simply stick to European standards, irrespective of whether the host country has adopted them. With conformity properly assessed in any EU country, export to the EU will be easy. Also domestic companies may do this, for example in a quality strategy (e.g. in combination with ISO 9000).

13 The following areas are not included because of their specificities, or of their limited relation with the IM, or because of reporting deficiencies: justice & home affairs, financial control; food safety other than veterinary & phyto-sanitary; nuclear (safety goes beyond the EU, cf. IAEA); mutual recognition of diplomas; in transport, rail and inland waterways have all been ignored.

14 For some countries, this could be a little higher because of deficiencies in the Regular Reports (n.r. = not reported).

15 See the contributions of Verheijen (2000) and of Blankenburg et al (forthcoming) to the WRR project.

16 Assuming no special difficulties with 'not-reported' areas.

17 The programmes which every candidate country updates regularly under the terms of pre-accession.

18 But Lithuania wants to clarify the position of three 'free economic zones' it has just started to operate.

19 It should be realised that structural weaknesses of CEEC agriculture and problems in land privatisation have exacerbated the problems in achieving domestic competitiveness as well as export positions. Current (spring 2000) negotiations between the CEECs (separately) and the EU about mutual agricultural tariff reductions, based on the so-called double-zero-option, under the Europe Agreement foreshadow the kind of difficulties such mercantilistic mentalities induce. By the time this report was in its final draft, the EU-Poland negotiations had broken off. The EU argued that the December 1999 tariff hikes by Poland had to be undone first. Although these tariff increases probably violate the Europe Agreement, in terms of imbalance of mutual market access plus the (export) subsidies, the Polish tariffs and subsidies still represent a far more modest degree of intervention than for CAP products.

3 EROSION OF THE INTERNAL MARKET

3.1 INTRODUCTION

Assuming for a moment that by 2010-2012 there would be no adoption gaps and all transition periods would have expired, it is often suggested or feared that such a formally complete IM acquis might still be subject to *de facto* erosion. Analytically, it is useful to distinguish adoption gaps and transition periods from IM erosion, because the implications for policy and institutions, and indeed for the business confidence in the potential of the IM, are radically different.

We will begin this chapter by examining several notions of 'erosion' of the internal market (section 3.2) and by proposing different indicators for its measurement (section 3.3). Subsequently, these notions and indicators will be confronted with the internal market of the 1990s on the basis of detailed reports on five years (section 3.4.). The final section will then attempt to extend this analysis to what is currently known about the ten Central European candidates and Turkey.

3.2 OPERATIONAL DEFINITIONS OF EROSION

Erosion suggests either a dynamic process of undermining a given structure or state of affairs, or a major external shock to an otherwise stable system, which subsequently sets in motion a process of erosion. With respect to the Eastern enlargement, it might therefore refer either to (1) a fragile internal market acquis, subject to undermining forces, which would be exacerbated by enlargement or to (2) a robust internal market acquis which suddenly, due to enlargement, would suffer from much lower standards of adoption, implementation, surveillance and enforcement, and a reduced effectiveness of the judicial and EU-level mechanisms to bring those standard back to previously accepted levels

Both approaches presume that an *all-or-nothing interpretation* of the accession conditions, here with respect to the wider concept of the internal market, is neither useful nor appreciated. An all-or-nothing interpretation would suggest that there *cannot* be a problem of erosion because the conditionalities prevent this from happening. Thus, if the internal market acquis of an applicant country is insufficient in terms of adoption, (correct) implementation, hard and soft infrastructure, judicial review and administrative enforcement capacities, the country at stake would fail to meet the conditionalities and would not be allowed in. The analogy with the third stage of EMU (Euroland) is obvious: a strict adherence to a range of entry conditions significantly enhances the credibility of a regime of macro-economic stability in Euroland and removes, beforehand, national incentives (like high outstanding debt) to vote for a laxer policy in ECB, such as reducing the real debt burden.

The all-or-nothing interpretation sits uneasily with the first notion of erosion, because it would be discriminatory, in that a stricter performance standard would be imposed on accession countries than on current Member States. After all, a fragile internal market acquis must be due to undermining forces condoned by the *current* Member States, unless one is willing to argue that the Commission, even when it has the means, does not do everything in its power to act as the 'guardian of the treaty'. Of course, one cannot exclude the possibility that Member States apply double standards, perhaps because of strong domestic pressures, or because of strategic considerations. It could also simply be that individual Member States often have difficulties in recognising the nature and extent of the impact of their own infringements or other undermining conduct on the proper functioning of the internal market. A more functional explanation for the application of double standards would be that Member States and possibly even EU institutions do realise the fragility of the internal market acquis and the undermining forces engendering this, but that they consider the system as stable and satisfactory for the aims of the treaty. In a quasi-federal system – as the internal market regime undoubtedly is – an optimum will have to be found between the demanding *restraints* on national regulatory and fiscal powers and the remaining national *discretion* to satisfy national preferences. A degree of fragility may be seen as the expression of natural frictions in a system that will never be completely frozen. As long as the compliance mechanisms are not seen as overburdened or failing, minor deflections or infringements might be regarded as part of the dynamic search for optimality. An enlargement with possibly thirteen countries may, quite rationally, be considered as risking to overburden greatly this system, and thus cause the much-feared erosion. Once this is observed to happen, individual Member States may mend their ways and become less disciplined when pursuing their own preferences via regulation, exceptions, subsidies, etc. The compliance mechanisms, based on presumptions of infringement as relatively rare exceptions, would then collapse, and the confidence in the proper functioning of the internal market might dwindle rapidly.

The all-or-nothing interpretation may, at first sight, seem to be applicable to the second notion, namely that of a robust internal market acquis, subjected to a shock of consistently lower standards of implementation and enforcement in up to thirteen new Member States. This shock would then clog the compliance system and subsequently weaken the discipline of all Member States. The all-or-nothing approach prescribes that applicant countries with consistently lower standards of implementation and enforcement fail the entry test, and cannot accede until their standards are sufficiently improved. The unprecedented intensity of pre-accession activities by applicant countries, in very close co-operation with the Commission (and indeed in bilateral efforts with Member States, too) as well as the annual EU reports on progress by the accession conditions would appear to be an expression of such an all-or-nothing approach. In none of the four previous enlargements has there been anything remotely comparable in terms of intensity, transparency and duration of efforts. And yet, despite this energetic pre-accession strategy, the fear

of 'erosion' has not receded. One possible explanation for this is that all-or-nothing is *not* an operational method in the case of the internal market acquis, in contrast to the third stage of EMU. In other words, the second notion of erosion might be believed to have been pre-empted by the entry conditions, but in actual practice such conditions will not work in an all-or-nothing way; they leave ample room for discretion. Because of this discretion, erosion is still feared today.

3.3 MEASURING EROSION

Erosion can be measured *formally* with two different sets of indicators: indicators of the nature of non-compliance, and indicators of the kind of compliance remedies applied. If desired, these indicators can be broken down, for example by sectors and by Member States, because this may help assess the extent of non-compliance. It is conceivable to measure erosion *informally*, for example, via panel data from (subjective) business surveys, or via other indicators such as a corruption index. The informal method may capture aspects of erosion that would remain invisible in the formal approach. Here, only the formal method will be applied.

3.3.1 INDICATORS OF THE NATURE OF NON-COMPLIANCE

There are two sets of indicators for non-compliance. The first relates to non-compliance with regard to *directives*, of which there are some 1500 nowadays. Non-compliance can be broken down into the following categories.

- non-communication: either, directives have been transposed but not reported to the Commission, or they simply have not been transposed yet. Non-communication can also refer to the failure of Member States to notify to the 98/34 Committtee *national* laws on product requirements outside the area of EC directives;
- non-conformit;
- bad application.

The second set of indicators refers to non-compliance with respect to *(1) treaties, (2) regulations, or (3) decisions*. Clearly, these indicators have different implications for erosion. A failure to transpose a directive in national law is far more serious than a failure to notify a transposition, even though both failures infringe EC law. Otherwise, however, there is no *a priori* way of attributing a weight to the indicators.

3.3.2 INDICATORS OF THE KIND OF COMPLIANCE REMEDIES APPLIED

Again, two sets of indicators can be distinguished. The first compliance remedy is *judicial enforcement*, which can be termed the litigative route. This enforcement can take place both on the national and on the European level. The national level provides the following options.

- national court action relying on case-law;
- national court action based on a request for a preliminary ruling by the ECJ;
- ECJ appeal ruling (appeal, after national ruling).

The possibilities of enforcement at the European level are more abundant.

- complaints (by business, consumers as well as MEPs. The MEPs can put forward questions and petitions);
- infringement procedures in stages (these stages are as follows: (1) informal consultations, (2) formal notice, (3) reasoned opinion, (4) referral to the ECJ, and (5) ECJ ruling);
- legal action before the ECJ between Member States (this action is hardly ever undertaken: a total of four cases for the ECSC and the EC together, between 1953 and 1998 [1]. Complaints are the preferred route);
- penalties (in case of non-compliance with an ECJ ruling).

In the 1990s the national route has been strengthened for two reasons. First, a non-transposed directive may still confer rights to economic agents (for example, a damage claim for lost business). Secondly, non-notification of national laws (other than transposed directives) on product regulation[2] is not only an infringement of EC law but may render technical specifications legally meaningless and void. It is a matter of judgement whether these developments have much of a deterrence effect on national administrations in the EU-15. The Dutch regulatory crisis in 1997 involving the non-notification of hundreds of laws and administrative decrees under (the then) directive 83/189 seems to suggest that the deterrence effect is considerable. In other words, on this score, erosion is likely to be permanently lower. Whether the threat of damage claims in case of non-transposition has proved to be an effective deterrent, is hard to establish (see also below).

For the purpose of this study, however, the issue is whether this strengthening of the national route of (judicial) compliance would work equally well in the accession countries, once they would be EU Member States. The answer to this query hinges on a judgement of the effectiveness of their national judicial systems and of (low-cost, rapid) access to justice. Such a judgement can be inferred from other WRR-studies [3].

It is fair to say that the EC-level route to (judicial) compliance enforcement has also improved. The Commission has increased its efforts of detection and has introduced a series of internal reforms to enhance the speed and credibility of this route. In addition, the worst kind of infringement in the light of the credibility of

the internal market (and other aspects of Community law) is non-compliance with ECJ rulings. Since 1997, daily penalties are imposed on Member States failing to comply and it would seem that this method has already proved to be highly effective. Obviously, this is critical for the erosion issue *after* enlargement, because there is no reason to expect this discipline not to work equally effectively in the accession countries.

The second set of indicators in terms of compliance remedies encapsulates *compliance through co-operation*. The two indicators are:

- intensified administrative co-operation. Rather than the litigative route on a case-by-case basis, the Commission and Member States have since 1992 engaged in a range of co-operative approaches to fight erosion. Examples include (1) 'package meetings' with individual Member States (but across all areas of Community law), (2) national contact points for the effective channelling of queries, (3) the Karolus and Mattheus programmes for the exchange between Member States of officials working on internal market issues, and (4) greater efforts to upgrade EC law knowledge of judges and other members of the legal profession;
- better mutual recognition in actual practice. Largely invisible but highly significant is the work of the 98/34 Committee (formerly known as the 83/189 Committee). The Committee ensures (1) that national laws with product specifications (that fall outside EC directives) do not contain actual or potential regulatory barriers to trade, (2) that mutual recognition or equivalence clauses are explicitly incorporated. If both (1) and (2) fail because there is no 'equivalence', the Commission will propose an approximation directive. Hence, free movement of goods is protected effectively, almost always without adding new EC regulatory measures and usually without litigative measures.

3.4 IM EROSION WITHOUT ENLARGEMENT

How fragile or robust is today's internal market acquis? Is it possible to operationalise the notion of erosion by studying indicators of the internal market in recent years? The present section provides empirical evidence for the years 1994-1998. As mentioned earlier, it focuses on *formal* indicators.

3.4.1 INDICATORS OF THE NATURE OF NON-COMPLIANCE

It is important to distinguish the overall 'detection rate' of infringements from the rates reflecting indicators of non-compliance, *after* the Commission has been in *informal* contact with the relevant Member State. The overall detection rate, including all non-communication instances is high for the EU-15 (the large majority of these relate to IM areas): it went from 1711 (in 1995), via 2155 (1996), and 1978

(1997) to 2134 (in 1998). Such numbers show that vigilance in compliance and an appropriate compliance machinery is critical for the working, indeed for the credibility of the internal market. The existence and efficacy of a compliance machinery at EU level is therefore a necessary condition to prevent erosion. Other than extra manpower for the Commission and the promotion of awareness in the accession countries about the ease of filing complaints, there seems to be no obvious reason why the EC-level compliance mechanism could not be made to work just as well in Central Europe and Turkey.

The rate of 'non-communication' is considerable, moving from 459 (1995), via 1079 (in 1996) and 760 (1997) to 610 (in 1998). The bulk of these instances are solved almost immediately, after informal signalling or via consultation in the 98/34 Committee. Although this does show that, even after several decades, Member States' bureaucracies still have difficulties in behaving in a 'communitarian' way, it would be incorrect to include this under erosion.

Table 3.1, below combines the indicators for non-compliance with three stages of the infringement procedures (letters of formal notice, reasoned opinions, and referrals to the ECJ), *following* informal consultations. To avoid overburdening the reader with statistics, we report only on those concerning the years 1994, 1996 and 1998. These suffice as illustrations of the issues under consideration.

Table 3.1 is consistent with the view that the Community is continuously searching for the *optimum balance* between appropriate constraints on national regulatory and fiscal powers and the remaining national discretion to satisfy national preferences. The (IM) acquis therefore appears somewhat fragile but it need not mean that the system does not work. One should regard the compliance system both as an indispensable tool for maintaining the credibility and economic effectiveness of the internal market, and as an external disciplinary instrument (explicitly wanted by Member States) for bringing EU-wide aspects under the attention of domestic politics and administrations. Seen in this light, the data in Table 3.1 need not point to an increasingly strong trend of erosion. Nevertheless, it is a strong warning, that the compliance system is heavily taxed. If *after* informal consultation still more than 1100 cases (in 1997 even 1461) are dealt with by a letter of formal notice, which amounts to nearly 30 a week, one might at least conclude that *there is a permanent threat of erosion* which requires unfailing vigilance. There is no clear trend overall, except in the referrals to the ECJ which inch upward steadily [4]. There is also no objective way of inferring whether 123 referrals in 1998 is worrying, whereas 89 in 1994 is not. We submit that the level and trend in Table 3.1 can in any event not be interpreted as the absence of undermining forces in the internal market of today. It is also clear that the ECJ is getting more and more burdened; besides now having to cope with over 120 referred cases, it is also faces a steady rise in the number of preliminary rulings, which reached no less than 264 in 1998 [5].

Table 3.1 Nature and intensity of non-compliance (after consultations)

	Total	Directives: non-communication	Directives: non-conformity	Directives: bad application	Treaties, regulations, decisions
1994					
Letters of formal notice	974	732	32	143	67
Reasoned opinions	546	496	8	28	14
Referrals to the ECJ	89	61	2	10	16
1996					
Letters of formal notice	1142	801	52	174	115
Reasoned opinions	435	320	35	52	28
Referrals to the ECJ	89	61	2	10	16
1998					
Letters of formal notice	1101	615	107	201	178
Reasoned opinions	675	384	59	119	113
Referrals to the ECJ	123	60	5	31	27

3.4.2 INDICATORS OF THE KIND OF COMPLIANCE REMEDIES APPLIED

Let us now turn to indicators of judicial enforcement. National judicial enforcement of EC law is not registered statistically, although the ECJ maintains a comprehensive database. Some 1200 national judgements relating to Community law come to the attention of the Research and Documentation Department of the ECJ every year[6]. The qualitative analysis of selected 'significant' national judgements does not allow a trend analysis. As noted, we do know that requests for preliminary rulings have steadily increased in number. Starting with the Commission report on 1996, the relevant annex reports on national rulings applying the ECJ cases of Francovich and Brasserie de Pecheurs[7], which encourage liability for damages caused by late or non-implementation of directives. Whatever the legal technicalities of the cases discussed, in the three years 1996, 1997 and 1998 only in three instances was the right to obtain damages for losses sustained, upheld in national courts. This is not going to impress national administrations to be well-behaved and act as the timely implementers of EC laws that the Member States themselves have passed in the Council.

EC-level judicial enforcement has been impressive. Complaints hover between 819 (1996) and 1145 (1994), with 1040 in 1993 and 1128 in 1998. Cases detected by the Commission have been fluctuating between 247 and 297 (1993-1997), jumping up to 396 in 1998. In Table 3.1 we have provided statistics about three stages of the infringement procedures.

The interesting new instrument is that of *penalties* in case an ECJ ruling is not complied with. In a survey[8], it appeared that of the fourteen cases where penalties had been applied up to end of 1998, eight had been terminated in a relatively short time. The penalties vary but are apparently not without effect: they range from

7750 Euro *per day* for Belgium in relation to the wild bird directive, to 264.000 Euro *per day* for Germany in relation to the groundwater directive. It would seem that a loophole that could generate a credibility problem for the internal market, has effectively been contained.

From the above it is clear that the litigative approach, though indispensable, suffers from serious limits, apart from costs and delays. The co-operative approach is therefore a very important alternative. Unfortunately, this approach is far less precisely and less regularly documented. The 'package' meetings between one Member State's administration and the Commission, discussing actual and potential infringement cases across the entire spectrum of EC law, are said to be very productive. However, as far as we know, no overall or specific reports on such meetings are published. One might perhaps characterise these meetings as a kind of selective 'screening', in a targeted and well-prepared form, which differs from the overall and, as yet, less meticulously prepared screening of the CEECs under pre-accession. They may also suggest a new co-operative control mechanism for the future IM of the EU-28. The current screening could evolve into a routine instrument (for instance every 2 years) *between the Commission and the new Member States*, until such time that only a*d hoc* package meetings will be necessary, as is now the case with the current Member States. Screening can thus be made routine by targeting a range of well-studied actual or potential infringement cases, known from the pre-accession and negotiation periods or shortly thereafter. Of course, package meetings, though co-operative, will remain an extension of the litigative approach, because unresolved cases will follow the Art 226, EC (formerly Article 169) route.

Since 1994 the EU has developed a framework for 'enforcement cooperation'[9], which cannot be discussed here in detail. Among these proposals implemented were penalties for non-implementation in the IM areas, an elaborate system of contact points in eighteen priority areas of IM legislation[10] and extensive exchange programmes for national officials. Finally, the Commission is expected to publish more interpretative guides. It cannot be emphasised enough that the effectiveness of these concrete measures should be expected to be far greater still with the new Member States. In improving on the current 'twinning' programmes, ministers in important IM areas should ensure that seconded officials from CEECs become truly integrated and learn from the experiences of current Member States, even though this inevitably imposes extra efforts and time upon the hosting officials. Ignoring this rather trivial point threatens to discredit the current twinning, despite its laudable objectives. The emergence of many EU networks of national supervisors, market surveillance agencies, tax officials, safety inspectors (e.g. in transport), regulators and so on is also immensely helpful for improving mutual understanding, ameliorating the resolution of cross-border issues and pre-empting litigative steps by the Commission in its role of guardian of the treaty.

The highest form of co-operation, applicable to all product regulation[11] in the IM, has been institutionalised under the Mutual Information directive 98/34, formerly 83/189. The low-key committee working under this notification directive has proven to be a true bastion against perpetual temptations of Member States, often inadvertently, to erode the internal (product) market. Briefly, and ignoring some details [12], the 98/34 Committee receives national notifications of all *draft* laws (or amended technical annexes, decrees, etc.), except those which transpose EC directives. After notification, the national legislative procedures stop(!), so that the Committee has an opportunity to scrutinise the draft laws with a view to actual or potential barriers to trade in the IM. The Committee has a range of deadlines, ranging from three months to twelve months, dependent on whether 'detailed opinions' (by the Commission and/or Member States) give rise to various 'standstills'. In case of clear incompatibility with EC law and a refusal of the notifying Member State to remove the (future) regulatory barrier(s), the Commission will table a draft directive, and in that case, the deadline is eighteen months for a 'common position' of the Council. However, it would be a serious mistake to regard this ultimate remedy – an approximation directive – as the main power of this procedure. Quite the contrary, the overriding contribution of this remarkable Committee is to *prevent both* future regulatory barriers to goods trade [13] *and* EC-level regulation. Member States are induced, by peer-pressure, by suggestions from other Member States and the Commission and by increasingly stringent case-law on this notification procedure, to employ, both in wording and design of the law, mutual recognition and 'equivalence' provisions. The Netherlands has experienced, in the regulatory crisis of mid-1997, how forceful these procedures are. More generally, the enormous importance of the 98/34 co-operation becomes clear once one realises the magnitude of potential erosion that was pre-empted over the last decade or so. In Pelkmans, Vos and di Mauro (2000) it is shown that, in the eleven years between 1988 to 1998, over five thousand notifications were made, with more than thousand detailed opinions from the Commission and a roughly similar number by Member States. Every detailed opinion is a strong indicator for the emergence of one or more regulatory barriers to trade, to be prevented by mutual recognition (explicitly in the law) or approximation (rarely mentioned). These authors also show a trend increase over this period, even if one abstracts from the large extra Dutch notification in 1997. This trend increase is puzzling. Given the prohibition to create regulatory barriers to intra-EC goods trade (Art. 28, EC) and given the relevant case-law, given mutual recognition based on the *Cassis de Dijon* case, given the accomplished approximation and joint regulation in a number of product markets (especially after EC-1992), one should confidently expect a drastic *decline* in national product regulation. The paradoxical, steady *increase* in notifications under 98/34 strongly suggests that Member States have become a kind of regulatory machine, with the potential to undermine the integrity and credibility of the IM in goods. Recent efforts at regulatory reform, practised by all Member States to different degrees, have thus far not changed this. Annual notifications now hover around six to seven hundred.

3.5 EROSION OF A PAN-EUROPEAN INTERNAL MARKET?

The formal notions of erosion, as applied in sections 3.2 and 3.3 are helpful to identify the current weaknesses of the implementation and enforcement mechanisms. If these weaknesses are well contained, the credibility of the internal market regime will remain high also after enlargement, and economic agents will confidently exploit the numerous opportunities via trade in goods and services, licensing, arbitrage, investment, mobility, mergers and networking in business alliances.

In a study such as this, which attempts to understand the IM of an EU -28 a decade before it will actually be realised, this formal notion of erosion cannot be measured. By definition, it is an *ex-post* measurement. Its composite element can be used for recommendations about reforms both in the litigative and the co-operative routes. It is also possible to assess the current screening exercises, the regular reports about the accession candidates and the nature of the assistance in terms of the 'co-operative' route, because these activities form a prelude to future co-operative activities to prevent erosion. The crucial difference is the contrast between today's incentives to adhere – the desire for EU membership – and tomorrow's legal interpretation against the backdrop of supreme EC judicial review. The authors are therefore not in a position to extend current measures of erosion for a period as long as a decade ahead. One word of caution is in order, however. Since there is no correlation between the detection rate per country and the size and/or level of development of a country, one should expect the general detection rate to increase – ceteris paribus – with the country average times the number of new Member States, after allowing for a few years of transition. With a current average of around 140 per Member State, assuming no change and assuming an enlargement by the CEECs-10 plus Turkey, the overall detection rate in 2010 should thus be around 3700 cases per year. If these assumptions are not violated, such an increase in the overall detection rate in fact represents the maintenance of the status quo, *and should not be misinterpreted as (further) erosion*.

In the light of the Eastern enlargement, the 98/34 Committee is a low-key, but effective mechanism to pre-empt the possible erosion of the internal goods market in an EU-28. It is capable of preventing, in its area of competence, the overburdening of the legal compliance system, which is already heavily taxed today. It will also instil a habit of thinking in terms of 'equivalence' and mutual recognition for the drafters of national product regulation in CEECs, through a process of learning and peer review. This is important in Central Europe, where traditions of legalism, rather than equivalence to achieve the objectives of a law, are so prevalent.

It is recommended that *the candidate countries join the work of the 98/34 Committee* as soon as is realistically possible, in some informal but practically relevant way. For instance, one could proceed as follows:

- a candidate country could attend, or better still, is expected to attend the meetings of the Committee (usually six or seven times a year), in a capacity as observer, as soon as the chapter on the free movement of goods is closed in the negotiations;
- all candidate countries are encouraged, or better still, voluntarily agree with the EU, to establish the national procedures underlying the notification procedures. This requires notification officers in a number of ministries, smooth intra and interministerial information procedures about the early stages of draft laws (a tall order in Central Europe and far from perfect in the EU-15 of today; see for example Verheijen 2000), and a well-informed, well-trained notification official, responsible for notifications to the Committee;
- the 98/34 Committee spends two or three meetings a year (partially) on the voluntary notifications from the candidate countries, *as if* EC law would already apply to them. This investment by the Commission and current Member States is well worth it given the prospects of a better functioning internal goods market upon accession;
- candidate countries pledge to accommodate as much as possible the advisory 'comments' and the 'detailed opinions'. Until formal membership, the 'detailed opinions' cannot lead to infringement procedures, of course, but they are expected to yield powerful learning effects.

Unfortunately, there is no comparable committee for the free movement of services, or other horizontal freedoms, although there are of course many other advisory committees in many IM acquis areas. In principle, observership in these committees, once the relevant chapter has been closed in the negotiations, should be pursued, if only to deepen understanding of, and commitment to the relevant management of the acquis by the accession countries.

Finally, to the extent that the *current* nature and intensity of non-compliance in the internal market is seen as erosion or at least as worrying, it would be advisable to improve matters *before* enlargement, if possible. A significant part of non-compliance is caused by the unwillingness of Member States to accept that a well-functioning internal market requires, in regulation and supervision, certain degrees of centralisation. Since the early 1990s, the Coreper and the Council regularly indulge in self-serving interpretations of 'subsidiarity' which are dysfunctional for the proper functioning of the internal market. A range of directives in various areas (notably, for the liberalisation of network industries, but in such areas as environment, too) are drafted with too much discretion at the national level, which is then baptised as 'subsidiarity'. Of course, this has nothing to do with subsidiarity, which is after all a *two-way-principle* : if assignment of powers to Member States undermines or distorts the internal market, then these powers have to be constrained, or in the extreme, forbidden or transferred. This is just as much 'subsidiarity' as decentralisation or the avoidance of centralisation are, as long as the design of policy instruments does not affect negatively the common goal (Pelkmans 1997). In other words, non-compliance is, to a considerable extent, self-

generated by an ill-conceived design of directives by the Council. In network-industries, the Commission often regards liberalisation as a gradual process, to be implemented in stages, thereby accepting and indeed proposing very partial liberalisation directives that are bound to induce non-compliance. A notorious example are the two telecoms directives of 1990 (ONP and a liberalisation of the services directive). Sun & Pelkmans (1995) analyse in detail the extremely negligent behaviour of practically all Member States. The authors argue that the impossibility for market players to base any strategy or investment on these directives even three years after they went into force implies that Member States must give up their discretion and pursue greater centralisation. National regulatory discretion under subsidiarity must be 'earned' by the Member States. If it is squandered or misused, the common goal suffers and logic commands a higher degree of centralisation.

The problem returned in a different guise during the telecoms liberalisation of 1998. To mention only one example, it was predictable that the licensing directive (97/13) gave far too much discretion to the Member States, given the long history of difficulties between the Commission and the Council in this respect (see Pelkmans & Young 1998). In the recent telecoms review[14], the unsurprising conclusion is that liberalisation is successful at the Member States level, but that there is no single market yet. But it is the single market that forms the legal basis to liberalise in the first place! Therefore, *initially at least*, a central telecoms regulator at Union level would have been able to compensate for the too great a discretion of Member States and could have intervened instantaneously. Lacking such an agency, the internal market suffered.

This brings us to a general point about agencies. One institutional reason why EU agencies remain as weak as they are, if they get initiated at all, is that the 1958 Meroni case has severely restricted the possibilities to delegate powers from EU institutions to 'independent' agencies. This has created yet another all-or-nothing situation, which should be circumvented. The only independent agency nowadays is the European Central Bank, made possible via ratification of a rewrite of the treaty.

It is recommended that it should be made easier (though not easy) to establish independent agencies at the EU level. This can be done as follows. The current IGC should propose a simple article in the treaty that permits the Council and the EP to establish an independent agency, with supervisory and/or regulatory powers. The Council could vote with unanimity, for example. But the burdensome road of ratification is avoided, because the mere idea of having to do this already kills any initiative of an independent agency before it is proposed. Note that this is not a plea for heavy' centralisation. Also, agencies can 'die' via sunset clauses. Surely the telecoms regulator could have been given a lifespan of no more than five years. It is not difficult to find examples where circumvention of the all-or-nothing problem would help devise better agencies, and hence reduce non-compliance. Consider the

now advisory food safety agency, the forthcoming agencies on air traffic controls, and aircraft safety. Consider also the welfare losses because the telecoms agency did not exist when it mattered most, that is, in the first few years; this inflicted costs on, for example, business (Pelkmans & Young 1998). And the list can be extended. There is also room for argument that a few of the existing autonomous, but not independent, agencies could be given more power. The overall purpose of these initiatives must be clear: a better functioning single market, with lower non-compliance.

NOTES

1 Source: ECJ, 1999 *Annual Report 1998*, Table 12, p. 197.

2 Under the Mutual Information directive 98/34 (formerly 83/189).

3 See for example the WRR Working Documents of A.J.G. Verheijen (2000), or Blankenburg (forthcoming).

4 Note that 1993 had 44 referrals whilst there were: 72 referrals in 1995 and 121 in 1997.

5 See COM(1999)301, op.cit., p. 243 in Annex VI. In 1990 the total was 142. See also ECJ, *Annual Report 1998*, Luxembourg, 1999, Table 9 (p. 194). The date show that the total of (new) direct actions, including. referrals by the Commission, is 147. In addition, the ECJ got no less than seventy new appeal cases in 1998.

6 This is far from being an accurate figure. The Commission mentions this in an introduction of a survey of 'significant' national cases. The text of this introduction has been identical in reports over the years 1994-1998.

7 Cases (joined) C-6/90 and C-9/90(1996) (ECR I 05357) and cases (joined) C-46/93 and C048/93 (1996) ECR I-1029.

8 (COM (1999) 301:12).

9 COM (94)29 of 16 Febr. 1994.

10 See e.g. COM (96)20 of 29 Jan. 1996, a progress report on an administrative cooperation for enforcement of IM law.

11 And, since two years, also to certain information services.

12 For a detailed treatment see S. Weatherill (1996) and Pelkmans, Vos & di Mauro (2000).

13 In the treaty (Art 28, EC), somewhat curiously labelled as 'measures with an equivalent effect to quantitative restrictions'.

14 COM(1999) 539 of 10 Nov. 1999, *The 1999 Communications Review*.

4 THE RELEVANCE OF A CORE INTERNAL MARKET ACQUIS

4.1 INTRODUCTION

Having attempted to extract the maximum of information from today's data, so as to make informed guesses about the IM in 2010, we now turn to the problem of actually getting there, and how. The present study does not deal with the negotiations, nor with related issues in the short run. However, in a medium-term perspective, the choice of the accession path or, if one wishes, of a particular enlargement strategy has major implications for the proper functioning of the IM by 2010 in an EU-28. We shall focus on the fundamental dilemma between a *foreign-policy-driven enlargement strategy*, dominated by the primacy of values, pan-European security and stability, and an EU*-performance-driven enlargement strategy*, dominated by the refusal to 'water-down' EU institutions, laws and decision-making and by the assurance that the Union's core assets (the IM, the Euro and the relevant common policies) will not be affected negatively in any way. Of course, one can exaggerate the contrasts between the two ways of thinking. But their logic and the main options for combining the two in a workable compromise have to be understood, *before* basic choices are made which will be hard to undo. After sketching various options (in section 4.2 and 4.3), we shall propose the '*core IM acquis*' as an operational concept to solve the IM-part of the dilemma (section 4.4).

4.2 TIME-INCONSISTENCY AND TWO ENLARGEMENT STRATEGIES

Apprehension about the EU's Eastern enlargement has survived for almost a decade. This is even true in circles which are manifestly in favour of enlargement on fundamental grounds of security, the sharing of political values, a profound sense of cultural affinity and the tremendous potential of a pan-European market economy. The fears can usually be traced to a suspicion that the enlargement will not be possible in actual practice, without some degree of watering down of the level and quality of EU accomplishments. In an economic perspective this often means that the primacy of foreign policy and security considerations is likely to conflict with the prerequisites for a beneficial enlargement in terms of the internal market (with the required common policies) and EMU. One way of looking at this is to consider it as a 'time inconsistency' problem. A primacy for foreign policy and security considerations typically leads to pleas for:

- accession sooner rather than later, once the political Copenhagen criteria are fulfilled;
- joining all applicant countries in the negotiation process (as indeed decided in Helsinki) because this is perceived as a political impetus in the applicant countries, while it pre-empts sentiments of 'being discriminated';

- regarding a plethora of transition periods and derogations as a (largely) unavoidable nuisance at the nitty-gritty level. It is not only a price worth paying but it is probably best 'internalised' within the strong compliance mechanism of the Union via membership.

Such an approach is considered alarming by many of those who, rightly, emphasise that the attractiveness and influence of the Union is based on its hard core, the Economic and Monetary Union, with the internal market as its solid basis. Putting at risk the credibility and proper functioning of the internal market as well as the stability reputation of monetary union and the Euro should be regarded as an unacceptable and unnecessary cost, which, in adverse scenarios, could even lead to severe strains on the working of the Union as a whole. It would therefore be pointless.

A primacy of maintaining, if not deepening, these highly valuable economic achievements of the Union as its core assets, would typically lead to pleas for:
- strict conditionality about the IM acquis and other important aspects, so as to create a kind of 'immunity ;
- far-reaching assessment of key elements of how the applicant countries would function as future Member States in the economic union. The elements are administrative and judicial capacity, the completion of transition to a well-functioning market economy and the ability to generate catch-up growth. These would facilitate the enormous adjustments and prevent the emergence of new Mezzogiorno's that would receive transfers on a permanent basis;
- a prudent attitude to the negotiations, the opening of which should be dependent on these conditionalities and assessments, and the substance of which should be limited strictly to well-justified requests for transition periods and (exceptionally) derogations. To be sure, negotiations should *not* be another tool to prompt a better preparation, a higher compliance rate of the acquis and a domestic political leverage to overcome resistance against reforms. These achievements should, by and large, be demonstrated prior to the opening of negotiations.

Clearly, those giving primacy to foreign policy would consider this approach as unduly risky and discouraging. After all, it raises the thresholds of eligibility for EU membership. The consequence may well be that political leaders, local business and voters will perceive the prospect of accession as unattainable for several electoral cycles. Political resolve to legislate and reform as well as social acceptance of hardship and adjustment might thus be undermined by a general sentiment that one is sailing on a vast ocean towards an ever receding horizon.

Such a profound conflict between two approaches to enlargement has prompted suggestions to 'split the difference'. The underlying idea of these proposals is to *decouple, to some extent, the political and economic aspects of enlargement, so that the distinct orientations can be served by different accession routes.* As

Philippart and Sie Dhian Ho have shown in great detail, there are many modes and examples of getting around undue forms of rigidity in the Union, although many solutions tend to be carefully circumscribed by conditionalities and scope of application [1]. For strategic choices as the one discussed above, possibilities are few. With the introduction of EMU, however, a strategic difference was made between the first two stages (compulsory for all Member States) and the third stage, for which strict conditionality is applied before entering. Yet, non-Euro countries take part in the macro-economic co-ordination. Stronger, the actual entry decision into the Euro area (of 2 May 1998) was agreed under the UK chairmanship.

This optional thinking suggests analogies with the dilemma for the enlargement process. Could not the huge acquis of the internal market (for purposes of coherence and proper functioning widely defined, i.e. with the relevant common policies) be *subdivided into a 'core' acquis and an additional layer*, rather than rigidly sticking to an all-or-nothing approach? And if one could do this, could accession itself not be divided into two steps, thus solving the time-inconsistency problem?

Of course, the precedent that comes to mind is the European Economic Area (EEA). In stylised form, the EEA is a free trade area in industrial goods (as, indeed, the Europe Agreements), complemented by other free movements, made possible by the adoption of a very large part of the regulatory acquis of the internal market, including competition policy. Again, this is broadly in line with the Europe Agreements. For Norway, Liechtenstein and Iceland, the EEA represents a kind of core acquis of the internal market, *without* (1) an extra layer comprising the CAP, fisheries policy, a no-inner-frontiers approach, free movement of workers and some special exceptions, and (2) a range of political and institutional elements of EU membership, *but with* a unique judicial regime.

Although some of the literature recommends that Central European countries pass through the EEA on the road to EU membership, this idea has never been considered, let alone pursued, seriously in the Council and the other EU institutions. What the CEECs wanted already quite soon after the peoples' revolutions of 1989 and 1990, was EU membership, exactly the opposite of the EEA approach. Austria, Finland and Sweden also opted for EU membership rather than the EEA, but their prime motives consisted of participation in the decision-making [2], given the enormous importance of the EEA acquis. The switch of these neutrals to EU membership was facilitated by the dismantling of the Warsaw Pact and the demise of communism. The prime motives of the Central European applicant countries are quite different; they comprise overriding security aims (indeed, most of them aspired NATO membership as well), expectations of powerful lock-in effects of the transition to market economies, desperate needs for huge transfers and assistance, and needs for permanent agricultural market outlets. Moreover, strong sentiments of a cultural belonging (famously expressed in president Havel's 'return to Europe') did not accord well with half-baked options.

4.3 PARTIAL MEMBERSHIP WITH A 'CORE INTERNAL MARKET ACQUIS'

Were one to pursue a stepwise approach to accession based on a kind of core IM acquis, one should not be ambiguous about EU membership. This excludes the EEA -option. Recently, the Dutch Socio Economic Council (SER) [3] has proposed a 'partial membership' based on what can be seen as a kind of core IM acquis: "... (C)andidate countries that are unable to accede around 2005 are eligible for *partial membership* or an interim stage on the road to full membership. Partial membership should consist of a standard package (no à *la carte* integration) in which rights and obligations are evenly balanced"[4]. The political Copenhagen criteria should first be satisfied and important basic rights from the 'social acquis' [5] ought to be effectively enforced. Partial membership is seen as a manifestation of a multiple-speed approach. Hence, there should be a maximum duration of ten years before graduation to full EU membership.

Figure 4.1 provides a stylised picture of the SER proposal. The core-IM is meant to be an upgraded version of the obligations under the Europe Agreement. Regrettably, this is only sketchily treated in the SER proposal. A careful analysis would show that a lack of precision undermines its credibility in the eyes of policy makers. The Europe Agreements have been drafted for an evolutionary approach in the face of (initially) great uncertainty. This open-endedness is to be applauded if both partners would wish gradually to deepen market integration and co-operation *without* treaty amendments and without unwieldy ratification procedures. On the other hand, for various reasons, the Europe Agreements *as such* are not suitable as a set of binding commitments for preparing EU membership.

First, the free movements are treated unequally. Free movement of (industrial) goods is dealt with in detail, as the essence of the free trade areas between the EU and the respective partners. The free movements of services and of capital is considered an obligation, but one that can be fulfilled at a later stage, without detailed arrangements in the Agreements. The free movement of workers is considered possible (because there is a legal basis) but not compulsory[6]. The right of establishment is also not elaborated in the Agreements, but one can scarcely assume that EC case law can be transposed without prior agreement. Second, the Europe Agreements are extremely casual about the relevant approximation.

Figure 4.1 Partial Membership (SER)

a core IM	institutional
• free movements ⇒ goods ⇒ services ⇒ capital • right of establishment • property rights protection • common trade policy • common competition policy • relevant approximation as under the Europe Agreements	• participation in the Council and in the European Parliament • access to the EC Court **plus** • foreign and security policy • structural and cohesion policy

prerequisites
• political Copenhagen criteria • key rights from social acquis

Ignoring procedural aspects, the substance is summed up in a single, short article! The explanations are found in a combination of timing and expectations when the first Agreements were drafted (in 1992), on the one hand, and the precedents and actual practice in previous association agreements (cf. Pelkmans, 1998), on the other hand. Whatever the original motives, the fact remains that no authoritative interpretation of the Agreement would suffice to commit the applicant countries to an exhaustive adoption of the acquis in the areas specified[7]. The reference to the Europe Agreements is thus a hindrance rather than a help in the preparation for EU membership, indeed even for partial membership. In actual practice, the Europe Agreements have long been transcended by pre-accession arrangements and binding co-operation under the Accession Partnerships. At first these were based on the White Paper for approximation[8]. The only reason this unilateral Commission document was widely accepted as a guidance for the detailed interpretation of the single approximation article of the Europe Agreements, is that it was considered a manual for adopting the acquis *in preparation of accession* One should realise here that this eager acceptance of the White Paper has pre-empted any critical analysis of its status and content. This is also relevant for interpreting the SER proposal. Either one sees the Europe Agreement as the basis for a partial membership with a core acquis. If so, the White Paper provides a 'maximalist' elaboration. Or one wants to prepare for accession. In that event, the White Paper is grossly insufficient in a number of areas. It is silent on other ones (the core issues of the CAP, for example, or the lower stages of EMU) and at best selective on administrative capacity for the IM.

Given the presence of the other elements in the 'core IM' box of figure 4.1, as derived from the proposal, we have interpreted the proposal as including the 'relevant approximation' in the sense of the White Paper. To this framework two common policies are added in figure 4.1. Both entail interesting features. The

common trade policy implies (at minimum) a shift from a free trade area to a customs union (without agriculture). It would bring the 'partial-members' to a status already accomplished by Turkey. Even without agriculture, such a customs union is GATT-compatible because it is explicitly meant to be completed with agriculture later on. But it would create enormous complications during a decade or so. It is clear that partial membership is meant for a second tier of applicant countries, which are behind in acquis adoption and enforcement and which have problems of transition, stabilisation and competitive performance. This therefore implies that an EU-20 or EU-21, would be subjected to complex agricultural transition periods, resulting in *higher* protection against the export from the 'second-tier' countries to the 'first-tier' countries. In any event, the first tier will obtain access to the agricultural market of the EU-15, thus rendering it far more difficult for the second tier to export to the EU-15. To prevent this, the EU-15 would have to extend the free trade areas with all the CEECs to agriculture, so that the second tier is not grossly disadvantaged. For industrial goods a customs union can then be agreed. Yet a free trade area in agriculture, with the EU-15 (or perhaps the EU-20) applying the CAP, is nothing less than a nightmare scenario, due to its complexity and incentives for fraud. And all of this would apply for only a limited period of time, until graduation to full membership. More likely, therefore, the EU would rather opt for compensations in terms of market access on a case by case basis, in analogy to what Tunisia and Morocco obtained with the accession of Spain and Portugal. Such compensatory negotiations would in any event be inescapable once a first group will enter the Union.

Another non-trivial issue related to the customs union for a group of 28 states is the establishment of a *common* competition policy. The Europe Agreements entail a commitment to introduce national competition policies (based on Articles 81, 82 and 86, EC) as well as some kind of self-discipline in state aids. Merger control has been introduced in Central Europe, although it is not in the Europe Agreements. It would require either a treaty change or a kind of EEA arrangement for a *common* competition policy to be possible.

The institutional box in figure 4.1 suggests there is access to the European Court of Justice (ECJ), presumably limited to the areas falling under the scope of partial membership. The legal complications here are enormous. Probably the least complicated solution would be a special court (similar to that of the EEA) for relations with the partial members, subject to a treaty, with full ratification procedures, yet without touching the institutional EU acquis itself. The SER proposal entails three non-IM elements: decision-making, foreign and security policy and structural and cohesion policy. It is unclear what the participation in decision-making (Council, EP) exactly means; participation without votes (as sometimes occurs in EMU issues), full participation or something complex in-between? The political implications of these variants differ rather drastically, both for Brussels/Strasbourg and for the domestic politics of the partial members. This is important because it should accentuate the difference between the EEA route and the membership route.

Thus, the distinction between having Council and EP representatives without votes and intensive co-operation without actually having seats in the Council and the EP may not nearly be radical enough to satisfy the applicant countries. But if it is, it would mean that partial membership should include some degree of voting power, probably related to the scope of the acquis adopted.

The icing on the cake is no doubt the eligibility for the Structural and Cohesion Funds. Thus far, the Union has strictly maintained the strategy that such huge transfers move between Union members. In the case of Central Europe this has led to the perverse result that the greater the difficulties and the lower the per capita income of the country concerned, the *lower* the funds it would receive. The SER proposal can be interpreted as an attempt to break through this dysfunctional approach which causes a lot of resentment. Partial membership would permit the full benefits of the funds to go to all candidate countries – provided they fulfil the criteria of figure 4.1 – which should help to overcome bottlenecks in infrastructure, environment, technology and to finance re-training precisely for those who are behind. In turn, it can be expected to facilitate catch-up growth as well as the adoption of the more costly elements of the IM acquis, including testing and certification. Unfortunately, the (net) paying EU Member States are likely to defend the view that full eligibility of the second-tier for transfers would *reduce* incentives for adopting and enforcing the IM acquis as quickly as possible. Hence, it would be counterproductive. That this argument is rather opportunistic, should surprise no one who has studied the highly politicised and dysfunctional budgetary politics of the Union, or rather its Member States (see chapter seven). That the Netherlands should be expected to join this opportunistic choir cannot be surprising either, after the 1999 precedent of giving priority to *juste retour* to The Hague (in a year of national budget surplus!) over the long-standing Dutch policy preference to reform the CAP. The latter aim was dropped, even though the same Dutch government avowedly continues to regard such reform 'critical' for the enlargement process.

Altogether, the SER proposal is welcome because it represents a constructive and original attempt to address the widespread fears of a distorted functioning or erosion of the IM upon early accession by the CEECs. However, closer analysis reveals serious drawbacks of this alternative. Some of these have less to do with the notion of a core acquis than with the idea of partial membership: amendment of the treaty (with ratification), the complicated institutional and judicial arrangements and the full eligibility for transfers. There are also severe disadvantages in the practical implementation of this core acquis proposal. The combination of agricultural free trade areas with second-tier countries and an industrial customs union (or bilateral customs unions) would be extremely complicated and would perpetuate for perhaps a total of fifteen years a patchwork of product and country specific transition periods for market access. In addition, it would complicate arrangements for CAP floor and intervention prices, EU export subsidies and the so-called 'compensations' [9]. If one were to ignore this somehow and focus solely on a

kind of EEA acquis (that is, without agriculture), the SER proposal's greatest weakness is undoubtedly its silence on the approximation and effective enforcement aspects. Many policy makers and economic agents fear that precisely these aspects might remain very incomplete. Taking the 899 directives (and decisions, etc.) of the 1995 White Paper as the IM acquis to be adopted, and including the European standards and conformity assessment infrastructure underlying it, the main concern about erosion of, or gaps in the adopted acquis will *not* be overcome by the SER's 'core IM acquis'. Indeed, if the entire White Paper were implemented faithfully, many of the worries among business and the EU institutions would recede, and interim solutions may lose any rational. The so-called stage II (and sometimes III) measures mentioned in the White Paper (505 in total) are, by themselves, already quite demanding, leading to widespread fears about their implementation. In the area of the environment, stage I (involving 38 directives including complex annexes for chemicals) is concerned with measures directly related to the free movement of goods. Stage II remains ill-defined in the White Paper, based as it is on a delicate compromise between environment and regulatory costs. In the area of customs law, stage II alone specifies another 184 regulations/directives to be adopted. Similarly, stage I of agriculture specifies 155 (non-CAP) regulatory aspects in the veterinary, plant health, animal nutrition and quality areas. The White Paper also comprises a curious chapter 11 on mutual recognition [10] which presupposes a profound knowledge of this principle and its underlying objectives. Unsurprisingly, even EU Member States repeatedly fail to apply this principle properly[11].

How comprehensive the core IM implied by the SER proposal or the White Paper would be, can also be understood if one specifies its major omissions. In the SER proposal, other than agriculture, the only specific omission mentioned is the free movement of workers. In the White Paper, the common trade and competition policies as well as the CAP are of course lacking, while the first two form part of the SER proposal. This leaves as main omissions selected measures in some acquis areas (notably, environment), the regulatory elements of EMU, and fisheries. All these areas are already being addressed today, to different degrees, by the candidate countries. In other words, if the White Paper is viewed as the faithful implementation of the Europe Agreements' commitment on the (approximation) acquis, *and the 'partial membership' would be conditional upon the wholesale adoption of the White paper,* a large part of the initial concern would be overcome. In that event, it is hard to see any need for a complex and special arrangement for partial membership.

4.4 THE ECONOMIC FUNCTION OF A CORE IM ACQUIS

The SER's concern, shared intuitively by many, is about the *credibility of the internal market* to business and consumers. This is still a problem today with respect to enlargement despite the Accession Partnerships, the Regular Reports,

the enormous assistance and the great efforts undertaken by the accession countries. In the long run, it is likely to be a receding problem, in the same way that acquis implementation and enforcement have proved to be waning problems for the EU Member States over the previous decade (but see chapter 3). A partial membership for slower moving candidate countries based on a kind of White Paper acquis is thus neither appropriate nor feasible. The solution can only be found if a core IM acquis could be defined that would (help) *fulfil critical economic functions* for the acceding countries. Non-core aspects should be politically accepted to get in line gradually – nothing new in the EU – or to be subject to transition periods and (temporary) derogations. While business would prefer an immediate extension of the entire IM to the acceding countries as first-best solution, a coherent 'core' complemented by a clear calendar for other obligations should serve as a good second-best. It is certainly far preferable to messy and arbitrary negotiation results by country with a myriad of ad-hoc compromises. We submit that such an approach would more adequately serve the credibility of the IM, *provided this is based on a verifiable test and on sufficient transparency* before the ratification process. With this approach, one can do away with the counterproductive all-or-nothing assessments of the IM or with the dilemma between an accession that is either too early or too late.

We propose the application of a *core IM test* in the Commission's Avis to the Council on new membership. The Copenhagen criteria are much too vague and general to be verifiable and transparent. Table 4.1 suggests a test of altogether nineteen conditions, complemented by requirements for the applicant country for the period to come, both immediately after the negotiations (before membership) and after membership. The test is based on the following *basic guidelines* for a credible core internal market, even right after accession:

- Macro-economic stability (a treaty condition) and market functioning, such that transition from the command economies can be considered finished; the institutional aspects of this transition should reach internationally accepted standards (of the EBRD), without necessarily being exactly in conformity with the acquis; what matters here is *good economic functioning*;
- high scores for elements of the IM without which *goods and services market integration* would be inhibited due to extra costs;
- no priority for items of recent 'deepening' of the EU-15 IM, except when justifiable;
- no priority for items which entail disproportionate (sectoral or macro-economic) costs for the applicant countries, except when justifiable;
- a reintroduction of *optional harmonisation* where suitable.

A realistic political addition is that, where the EU will (also?) ask for transition periods (probably for the CAP, including for access of agro-food products, and for the free movement of workers), the IM will await completion as well.

Consider table 4.1. A core IM reflects the idea that the establishment and proper functioning of the IM serves many aims of the (Amsterdam) EC treaty: growth, competitiveness, the associated raising of living standards and high levels of employment, and, in so far as regulation and market forces can influence this, also sustainability, convergence of economic performance and economic and social cohesion. The common interest between the CEECs and the EU-15 consists in preserving, if not further deepening and stimulating, the IM as the paramount asset of the Community. It is precisely this aspect that renders the Union so attractive.

However, exploiting this asset does not depend on every single directive. More than that, a considerable amount of approximation and of agricultural and (foreign) trade regulation is only of marginal importance for the competitive dynamism that the IM can unleash. Some technical directives have more to do with a 'level playing field', with codification of already accepted minimum standards, with the technical prerequisites of certain policies (such as quality differences in agro-products for price intervention) or with administrative provisions (for large parts of the common customs code) than with the IM's optimal economic performance. It also makes a difference whether the enlarged EU wants to remove the physical customs frontiers immediately or after a transition period. Furthermore, very recently adopted directives (for some network industries) can hardly be considered essential for the economic working of the IM, if the EU-15 themselves are hesitant about their introduction. None of the *recent* network industry directives actually accomplishes far-reaching liberalisation across borders anyway, except the telecom directive. Finally, certain elements of the IM acquis can *damage the initial* economic performance of the candidate countries, even though they are important for the Union's economic objectives. Thus, sustainability requires huge investments in the environmental acquis (see chapter 2), but this may retard growth in the first years. Similarly, joining the monetary union requires capital liberalisation, but this may hamper short-term macro-economic stabilisation.

The sensible approach to accession is therefore not to consider whether and to what extent negotiations demands can be heeded; such is the task of negotiators once a well thought-out mandate has been agreed. The approach presented in table 4.1 reflects *a strategic perspective underlying such a mandate*, to be applied for example before the end of the chapter-based negotiations, when the Council has to come to an overall assessment. The question asked is not whether 'the' acquis has been adopted, but *what the (economic) importance is of the relevant policy area for the functioning of the IM,* and whether delays are damaging or of lesser relevance. Where the economic weight is trivial, or damage may be inflicted on the CEECs economics, insistence on adoption should be replaced by *clear calendars and strategic policy discussions*. Commitment and (administrative) capacities are critical for credibility in selected cases and these ought to be part and parcel of the 'test'.

Table 4.1 Core internal market test for accession

	Area of acquis, or accession condition	**requirements/score**	**comment**
1.	Medium-term economic strategy	joint assessments signed and pursued	pre-requisite
2.	Market economy	high scores on the 9 EBRD transition indicators*	pre-requisite
3.	Competition policy	implementation of Europe Agreement and at least 3 years functioning of independent competition authority	transparency for state aids is a plus (note: also EBRD indicator)
4.	Customs law/facilitation	high score	Admin. capacity sufficient and modern
5.	VAT/excise duties	high score	admin.capacity must be part of assessment
6.	Veterinary and plant health	high score	admin. capacity must be part of assessment
7.	old approach directives	high score on formal adoption, but optional harmonisation	admin. capacity checked for food, medicines, say, for 5 years
8.	new approach directives	high score on formal adoption, but optional harmonisation	crucial link with standards; see item 12 (5 years for optional harmonisation)
9.	Environment and nuclear energy	high score stage I of White Paper 5-1o years strategic programme precise targets for nuclear energy	Conclude joint assessments (as with economic policy), incl. funding
10.	Network industries	high score for telecoms & broadcasting calendars for gas, electricity, rail and postal services	gas and electricity pricing should be market-based; liberalisation is a lower priority
11.	public procurement	high score on formal adoption	these directives have little economic impact in actual practice; so, low priority; however, good against corruption; helps admin. reforms
12.	Standards and conformity assessment	CEN/CENELEC membership (80% adoption rate of European standards) or proof of immediate prospect; ETSI membership; basic infrastructure for conformity assessment in place	crucial for credibility of new approach For smaller CEECs, Memoranda of Understandings or agreements with EU-based institutes can serve as substitutes
13.	Services (other than network services and professional)	high score road & air, and maritime and inland waterways where relevant high score, all financial services	(see item 2; EBRD scores will be high if acquis is adopted here)
14.	Professional services	calendar mutual recognition	low priority, except accountants
15.	Property rights (intellectual/industrial/commercial)	join Munich Convention credible controls counterfeiting high score formal adoption	(see industry sources)
16.	Social acquis	equality men/women	basic Social Charter aspects adopted, but detailed acquis low priority

	Area of acquis, or accession condition	requirements/score	comment
17.	Regional policy	administrative capacity for submitting projects and for financial controls	little relevance for IM acquis in the strict sense; good use of Structural Funds can help other aspects of IM (see nos. 6, 9 and 12)
18.	Capital movements	calendar, in the light of ERM-2 and EMU	EU should not push this, if counterproductive
19.	CAP, price/income regulation	preparation stage in many product markets	check administrative capacity (esp. against fraud); no high priority, before the date of accession

*) These are: private sector share of GDP; large-scale privatisation; small-scale privatisation; governance and enterprise restructuring; price liberalisation; trade and foreign exchange system; competition policy; banking reform and interest rate liberalisation; securities markets and non-bank financial institutions. Traditionally assessed in chapter 2 of the EBRD Annual Transition Report.

The following points will clarify the choices in table 4.1:

- The first two items are prerequisites for the IM to function properly; this commitment is strengthened via joint assessments, and its objectivity guaranteed by using an external assessor (the EBRD). The third item, competition policy, is also a prerequisite, but here the relevance is the emergence of competitive markets; after membership, much of this policy shifts to Brussels.
- Although there is no 'free movement of goods' obligation yet, a range of areas is critical for enjoying this freedom, in practice, upon membership. Hence, high scores are required for customs (4), indirect taxation (5), veterinary and plant health (6), old approach directives (7), new approach directives (8) and standards and conformity assessment (12). In all those cases, the administrative capacity is so crucial that this ought to be part and parcel of the test.
- The analogy with the free movement of services is incomplete because, here, some network industries (rail and postal) assume low priority for accession whereas the professional services directives, except for accountants, yield little to no effect in the IM. Their liberalisation is therefore not urgent. This leaves a strict test for the relevant modes of transport, for financial services and for telecoms and broadcasting. For gas and electricity ('goods' according to the ECJ), market-based pricing is far more important in the context of the CEECs than immediate liberalisation according to recent directives.
- Other low priority areas include public procurement (although this is a helpful instrument to reduce corruption), the social acquis (except for gender equality and the basic rights) and capital movements (since too early a liberalisation might facilitate speculation in ERM-2, see our chapter 6 on EMU).
- The area of the environment should be approached in a similar fashion as the medium-term economic policy programmes. A ten-years strategic programme, with planning of investments and funding, ought to complement high score for stage I measures in the White Paper (which mostly affect the goods markets). The rational for this approach is set out in chapter 2. *Joint assess-*

ments of these programmes ought to be signed (perhaps as declarations to the treaty of accession) and reviewed regularly. This would also firmly commit the EU to predictable, long-run funding in this area.
- This leaves two instances where good administrative capacity will be required immediately upon accession: regional policy and the price/income policy of the CAP. The latter requires very detailed statistics, storage, intervention bureaus, price information in regions, etc. It goes without saying that these two elements are *not* part of the IM *before* membership. However, both are crucial for the proper functioning of the IM after membership.

It is perhaps useful to emphasise what is *not* explicitly listed in table 4.1, if not already specified above. A number of less important areas in the IM acquis which need not stand in the way of accession include:
- specific public health provisions (cigarette directives)
- bus transport
- corporate taxation
- data protection (and the administrative capacity)
- company law (this is implicit in item 2 of table 4.1, in so far as the EBRD transition indicators are concerned)
- product liability (since most Member States rely on national product liability laws, this directive is not a priority)
- consumer protection (such as the 1992 general product safety directive and its warning system plus directives on misleading advertising)
- several other areas which are of marginal importance for the actual functioning of the IM, such as the (tiny) acquis on SMEs, science and technology, education and training and industrial policy.

The prioritising in table 4.1 should not be interpreted as passing a negative judgement on other, low-priority directives. Their inclusion into the core IM implies a qualitative judgement on the internal market's actual economic functioning, aimed at avoiding significant actual or potential distortions. Thus, the core IM is meant to resolve the time-inconsistency problem set out in section 4.2. It offers a transparent test of the candidate countries' entry papers *which renders a 'watering down' or 'erosion' of the IM so unlikely that the risks can safely be disregarded*. Once this test is passed, the accession negotiations can focus on the technical details of the transition periods and the derogations.

There is one specific aspect in table 4.1 that warrants some elaboration, namely *optional harmonisation*. This is an old technique, employed by the EC during the period of the so-called 'old approach' in the 1970s and early 1980s. To minimise the resistance in the Council (Art 100 approximation, in those days, was under unanimity), approximation in product markets such as cars, motorbikes and tractors was fragmented over many partial or components-based directives. Moreover, adjustment was facilitated by adopting the relevant directive (e.g. on front lamps of cars) and hence respecting the free movement of goods, while at the same

time permitting a transitional period of several years during which national output could adhere to existing local requirements (e.g. halogen front lamps in France).

It is worth stressing that optional harmonisation is not the same as *minimal harmonisation*. The latter refers to a *common* minimum requirement in a directive that is therefore *not* optional. What could be optional is the explicit permission given to a country to employ *higher* requirements in national law. If allowed, this disrupts the free movement in the internal product market. Such an explicit allowance to impose *higher* requirements should not be confused with the *general* freedom of Member States to set higher standards if the free movement is guaranteed by mutual recognition requirements. (The German beer purity law is a case in point). Thus, both optional harmonisation and mutual recognition retain free movement, but in the former case only for products conforming to the EC directive.

Reintroducing optional harmonisation for the coming enlargement has the triple advantage that (1) CEECs can attain high scores on old and new approach directives, also in cases where their industry might fear too rapid and costly an adjustment; (2) free movement will apply immediately upon membership and it is therefore up to demand from the industrial and retail sectors in CEECs, whether they wish to import under EC specifications (in any event, foreign subsidiaries can do this right away if they so wish); (3) CEECs may obtain (say) five years after formal accession for adjustment, and for purchasing the machines as well as human capital investment that they may require. An example of a hypothetical application runs as follows: Renault's investment in the Romanian Dacia car company will result in a gradual but slow process of upgrading hundreds of components and quality and safety standards for Dacia cars. To stimulate the *local* components sector, Renault's collaboration with tool and parts makers will require extensive investments and time-consuming retraining. In the meantime, while local suppliers are being upgraded and retrained, the Dacia company may wish to import directly from abroad. In that case, optional harmonisation will greatly facilitate their strategy, whereas it will also greatly benefit Rumania.

Optional harmonisation need not hinder the functioning of the IM. It can be allowed for candidate countries, and may or may not be used by local business. The only constraint is that exports in the IM that are based on local requirements (and not on the EC directive) cannot be expected to take place on a free movement basis. A possible drawback of this could be that some industries in some CEECs might see these temporary 'dual standards' as a desperate route to remaining 'competitive'. If (lower) quality and (lower) price combine to enable temporary survival, this should be accepted as assisting low-income consumers who tend to have a different risk profile in consumption from their relatively rich EU equivalents. At the end of the period of optional harmonisation, one hopes that not too many consumers are squeezed out of the new products market (they may still linger for many years in the second-hand markets).

NOTES

1 E. Philippart and M. Sie Dhian Ho (forthcoming).

2 Rather than 'decision-shaping' as Delors characterised the close cooperation between the EU and other EEA members.

3 In fact, its International Affairs Committee. All quotations from: SER, *The Eastern Enlargement of the EU*, report 99/16 E (English version), December 1999 (The Hague).

4 P. 12, op.cit. Italics in original.

5 European Social Charter, ILO core conventions, including freedom for discrimination and equal treatment for men and women.

6 Note that the SER report mentions only the free movement of goods explicitly. Since the report is also explicit about the Europe Agreements as the basis, Figure 4.1 includes three free movements.

7 The SER report does not even mention the needed approximation explicitly. This is puzzling because the very reason for its report is the fear that the 'working of the internal market' might be put at risk due to gaps in acquis adoption, etc. The report offers to produce an elaboration, should the Dutch government ask for it, without however giving any indication with respect to this crucial aspect.

8 COM (95)163 of 10 May 1995, especially the very detailed Annex.

9 The compensation issue is discussed in chapter 7.

10 Under the title: free movement of goods in non-harmonised sectors.

11 See COM (1999)299 of 16 July 1999 on Mutual recognition in the context of the follow-up to the Action Plan for the Single Market; and Pelkmans, Vos & di Mauro (2000) for further analysis. See also ch. 3, infra.

5 A SOUND AND DYNAMIC ECONOMIC UNION

5.1 INTRODUCTION

A well-established and properly functioning internal market forms the core of the economic union. The economic union may serve one or two overall aims. Firstly, it should create an adequate framework for EU's dynamic economic development, by combining an IM acquis with effective competition and structural support to low-income regions, aimed at reducing soft and hard infrastructural disparities. Secondly, it can be more demanding still, by fulfilling the basic economic requirements for the monetary union's proper functioning (see chapter 1).

The present chapter briefly addresses both aspects of the future economic union, with a total of 20 or more countries. It does not pretend to do more than offer a perspective on both aspects (in section 5.2), using some illustrations of the current economic strategies of several candidate countries (section 5.3.). A fully-fledged analysis cannot be given, because it would require a far more elaborate framework based on economic theory and empirical evidence. This is not available in the literature. Moreover, the actual experience of the EU-12 and the EU-15 with operationalising the 'E' of EMU has shown that it is exceedingly difficult to define a unique set of requirements for 'sustainable convergence' (Art. 121, EC). It is nevertheless useful to give some thought to economic union in the context of accession.

5.2 ECONOMIC UNION AND ENLARGEMENT

In the present study, the emphasis on the IM acquis or 'core' acquis (in chapters 2-4) might be mistaken for the essence of the (pre-) accession process. For all their painstaking detail, legislation and enforcement merely represent the groundwork. They form a reasonably coherent set of preconditions and rules for overcoming market failures and for allowing market forces to function properly. As such, they should serve the treaty's fundamental aim of obtaining a good economic performance within a proper setting of social and environmental conditions. For the candidate countries, above all, this must mean high economic growth.

5.2.1 SERVING CATCH-UP GROWTH

The first concept of economic union (see figure 1.1, chapter 1) emphasises the efficiency function of the Union. This is obviously the case for the IM, defined as the free economic movements and the right of establishment, plus the proportionate regulation or approximation it takes to overcome market failures or distortions. But it is also true for the transfers emanating from the Structural Funds. In spite of largely opportunistic references to 'solidarity' among Member States, these Funds are not equity-based but efficiency-based. Their underlying logic is, and has always

been (accelerated) catch-up growth. There is both theoretical and empirical economic support for the notion that low-income regions – other things equal – will gradually catch up with high income regions. However, this does require human capital to remain within the region and other policies to support, not hinder the comparative advantages of poor regions[1]. In this setting, catch-up growth can be stimulated, directly and indirectly, by transfers which bring the physical infrastructure (such as telecoms, rail, bridges, tunnels, water treatment, ports, airports) and the soft infrastructure (including vocational training, technical schools, quality of public administration, testing laboratories, project development) up to EU-level standards. Such structural improvements should also help to increase regions' attractiveness for domestic or foreign direct investment. This, in turn, may enhance their growth prospects.

Although Structural Funds serve efficiency purposes, they also engender equity effects. The four present EU-countries qualifying for Cohesion Funds, i.e. Spain, Portugal, Greece and Ireland, have benefited from annual structural transfers amounting to some one per cent of GDP.

Catch-up growth has always been understood to be an objective of the EC treaty, and it has become more clearly codified in the Maastricht and Amsterdam treaties. However, it is above all the internal market combined with competition policy that is expected to serve the economic dynamism expressed in the treaty objectives. Thus it is market forces, working within the IM framework, that should bring about real economic convergence, that is, a gradual reduction of the gaps in income per capita. Structural transfers serve as an additional targeted help for a limited period of time. It is this combination of the IM, competition policy and efficiency-based transfers which forms the first concept of economic union.

If the core acquis test as defined in chapter 4 is passed by a candidate country, one can safely conclude that 'transition' is over, that the country can accede and that it can exploit the economic union to its own benefit and that of the EU-15. The areas that may cause problems in the negotiations (mainly the CAP and free movement of workers) will have to be solved by transition periods and CAP-based transfers, but economic union should help reduce the disparities in rural areas and in industrial regions where conversion is imperative. As to environmental problems, part of the Structural Funds ought to be devoted to long-run environmental investment, implemented within the framework of a ten-year environmental program and jointly agreed between the EU and the acceding country. This would ensure a consistent pursuit of EU-based environmental objectives, while minimising the pressures on the country's public finance and reducing the loss of industrial (agricultural) competitiveness.

5.2.2 SERVING MONETARY UNION

The second concept of economic union seeks, in addition, to create the economic conditions for monetary union to function properly. There are three aspects to the proper functioning of a monetary union: (1) the purely monetary aspects of the basic institutions: rules, protocols, inter-bank market, monetary policy and exchange rate policy (if any), all of which are based on price stability; (2) a set of fiscal constraints without which price stability might still be endangered (e.g. no monetary financing of public deficits; no-bail-outs; excessive deficits procedures; medium-run fiscal stability commitments; all at national level, but commonly agreed and monitored); (3) a flexible economy with a capacity to adjust. Items (1) and (2) relate to the macro-economic stabilization function of the EU (including its Member States) and (3) to the micro-economic foundation needed to minimize the costs of exercising this macro function within the Euro area.

In looking at economic union in this still more ambitious way, a bridge is formed with chapter 6 on the 'fitness' of the candidates to join a kind of EMS II, and on their subsequent passage to the Euro zone. Obviously, it is entirely possible to pass through a period of another few years during which the first concept of economic union is the only practically relevant one. But beyond such a period some candidates might wish to join the Euro and – as chapter 6 shows – qualify on the basis of the (Maastricht) entry criteria. The question then arises whether it is appropriate and economically justified to introduce an entry test based not merely on nominal convergence criteria (of Maastricht) but also whether the candidates can match the quality of the underlying economic union.

Of course, introducing an entry test was never done for the EU-12 or the EU-15. The reason for doing so with the candidate countries is often motivated with references to the fragility of their newly transformed market economies (in particular several market and policy institutions) and by their less diversified economic structures, hidden distortions or liabilities of 'transition'. These are said to limit their scope for adjustment in a single currency area. By implication, EU decision-makers must have been convinced that such fragilities and drawbacks had not (or hardly) played a role in the run-up to the single currency during the previous decade. Although this is left unspecified, all EU-15 countries were believed to match the quality of the economic union underlying monetary union.

The present authors appreciate the prudency of policy-makers and central bankers when it comes to enlarging the membership of the Euro area. However, their fears and reservations advanced in the current debate on enlargement remain rather vague, or seem to be based on anecdotal evidence of lingering transition problems. Given time and resource constraints, the present study cannot go deep into this issue. As mentioned earlier, this would require a special study that elaborates a framework of economic analysis unavailable in the literature at present. Chapter 6 will provide quantitative empirical evidence on some aspects, where appropriate,

and will use as a basis for comparison the situation of four Mediterranean EU countries in the early 1990s (Spain, Portugal, Italy, Greece), who are now all in the Euro area. In the present chapter a qualitative approach is assumed, in tune with the previous chapters. The following and chapter 6 are thus complementary.

For monetary union to function properly, the 'E' of EMU hardly relates to item (1). The monetary aspects have carefully been codified in the Maastricht treaty, its protocols and subsequent legislation as well as the development of the ECB, the TARGET payment system and a host of practical aspects of monetary policy making. A possible exception is the functioning of the banking system under currency boards (e.g. in Estonia, Lithuania, Bulgaria) because banks fail to have experience with active monetary policy (e.g. mandatory reserves with the central banks; etc.). With careful preparation and assistance, however, it is unlikely to cause great difficulties. Its alternative, an 'exit' strategy from currency boards aimed at learning monetary policy and the proper interaction with banking and credit institutions, is hardly enticing if it were done for just a few years. In particular, one could allow a currency board to continue if (1) structural reforms, not least in financial services institutions and the capital market, approach EU standards, and (2) their financial sector participates in the payments system of Euro countries.

As to the fiscal constraints (item 2), these are limited to the extension of the Stability and Growth Pact (that is, medium-term commitments of having no average fiscal deficit), because all the other aspects have been well codified. Joining the pact will only be relevant in six or seven years from today, for the more advanced accession countries. In the meantime it could be argued that structural reform, infrastructure investment and the elimination of bad debts will require very high public expenditures, in turn requiring high domestic savings or permanent high capital inflows. If the latter fall short, flexible exchange rates might be desirable to sustain public investment. However, this is largely an empirical question and, as chapter 6 shows, the experience of the low-income countries of today's Euro area does not support this argument.

The crux of the matter lies therefore in the proper micro-economic foundation (item 3). But there is no 'grand' theory behind this. Below we will deal with the five main elements usually specified when referring to flexibility and adjustment capacity.

1 With transition unfinished, rigidities and a lack of adaptation capacity may linger in the state-owned sectors.

The issue of when transition is finished is exceedingly hard to answer. If we assume that macro-economic stabilization will be firmly achieved (fulfilling the Maastricht criteria will ensure this) and that liberalization of prices and foreign trade is a prerequisite for EU membership embedded in the acquis that will be fulfilled, the 'incompleteness' of transition can only refer to three aspects: privatization, properly functioning market and policy institutions, and 'social-

capital'. The institutions should in principle be captured via the 'core acquis' test of chapter 4. Section 6.2 will empirically assess whether the institutional infrastructure of the candidate countries is at the expected level, given their level of development. Furthermore, until very recently, EU countries tended to cushion shocks of many kinds in certain (often state-owned) sectors via monopoly protection, state aids or otherwise. Since these practices have steadily decreased, they have no doubt improved the resilience of the EU economy. Candidate countries should be capable of doing the same in the period up to possible Euro membership. To some degree, it is part and parcel of the acquis to do so.

2 The far lower level of development of the candidates, usually expressed in the income level or living standard and in the lower degree of diversification of their economy. This limits their adjustment capacity.

Section 6.2 will study a number of indicators of the relative 'poverty' of the candidate countries and of the extent to which they are 'different'. This empirical approach is striking in that, apparently, a wide range of income levels and sectoral structures is compatible with Euro membership. The only systematic difference between the candidates and EU-15 countries lies in the smaller size of their services sector, although this is rapidly changing in Central Europe. By the middle of the decade, this disparity will have shrunk even further.

3 The optimum currency area indicators of the likelihood of asymmetric shocks (will) show that such shocks are more likely for Central Europe.

Section 6.4 will analyse the indicators and the resulting policy issue in some detail. Note however that these indicators do not provide any qualification of the underlying economic union, merely of the (expected) relative costs of absorbing shocks at the national or regional level once the exchange rate instrument will have been eliminated. It may still be true that these economies are as flexible or even more capable of adjusting than the West European economies of the Euro area. Indeed, given the unprecedented economic and social shocks all these countries have been subjected to during transition, a great concern in the EU-15 about the candidates' capacity to adjust would seem to ignore the latter's very recent records in this respect.

4 The flexibility of labour markets, or even more generally, the flexibility of all prices and the smoothness of intersectoral, interregional and intergenerational (re-)allocation of human, financial and physical resources.

The present study does not take a closer look at the labour markets in the candidate countries, or, more generally, at their capacity to absorb (asymmetric) shocks, if indeed these would occur. To do so would certainly be useful. However, the present Euro countries are not exactly shining examples of labour market or economic flexibility themselves. It is precisely in this area that the quality of economic union could be improved considerably, thereby reducing both the actual and perceived costs of monetary policy action. Today's Luxembourg process deals with labour market performance merely by emphasising 'employability', skills, etc.

without addressing the rigidities of employment protection regulations or other notorious inflexibilities in the EU-15. For the moment, a much more open-ended, general process of benchmarking and performance-based regulatory emulation among EU Member States is taking place. It seems that the candidate countries eagerly study comparative performance in this process. Until there is evidence to the contrary, there is little reason to expect the candidate countries to suffer from greater overall or labour market inflexibilities than the current Euro members. If anything, the opposite is true. It is also in part for this reason that the structural transfers will be so crucial for the candidate countries. With well-designed projects and programs, regions can significantly improve their potential value-added and employment over the medium and long run, and thereby gradually reduce the costs of interregional immobilities.

One could add, moreover, the systematic attempt in the Cardiff process to benchmark and review national regulatory reform and to link this to overall macroeconomic performance of the Union and the functioning of its internal market. In a few years, the Cardiff process could well be extended to the candidate countries. In the meantime, these countries and the Commission agree on so-called Joint Assessments of medium-term economic policies, which partly fulfil this function (be it without peer review and in a more hegemonial fashion).

5 With the development of the financial sectors in candidate countries, the risk of financial crisis, following speculative bubbles or contagion from elsewhere, will increase and this would surely undermine the role of economic union in supporting a proper functioning of the monetary union.

When, in 1998, the Asian and subsequent Russian financial crises threatened to lead to contagion of the financial sectors in the candidate countries, nothing happened. Whatever bank runs, closures or public intervention in the financial sectors took place, they were entirely idiosyncratic (e.g. the 1997 Czech crisis; bank failures in Hungary, Romania, Latvia). These failures have clarified to government and the public what the public finance burdens can be of taking over bad debts and of failing to make proper reservations for guarantees. They have brought home the urgency of introducing EU standards of prudential supervision and its permanent and proper enforcement. In the medium run this will enhance the financial mediation rules of financial institutions, which should help economic growth. It should also assist in preparing the ground for the application of the Second Banking directive (mutual recognition of home country control and single banking passport) and its counterparts in insurance.

However, the absence of contagion in Central Europe in 1998 is not a good predictor for a similar course of events in the future. In and by itself it is not a proof that prudential standards have already been achieved, as the idiosyncratic bank failures showed. Perhaps as important is the reason why Central Europe was spared contagion. The key is found in the underdevelopment of the range of services in banking and in the underdeveloped asset markets in Central Europe, as

Weller and Morzuch (1999) and Weller and von Hagen (1999) show. It turns out that banks in Central Europe are still reluctant to lend to the 'real' sector, even though this practice is growing almost everywhere. There is little evidence that they have engaged in speculative financing, which also lowers the chance that maturity risks, interest rate risks and exchange rate risks materialize, as they clearly did in 1997/98 in other emerging markets. However, with clearer property rights, better developed real estate markets and broader and deeper stock markets, speculative asset bubbles can become disruptive. Moreover, relatively little portfolio capital has flown into the candidate countries. With capital liberalization this will increase, which should be an extra reason for prudential supervision and for the central banks to build in additional safeguards in case of contagion, while clearly avoiding moral hazard problems.

On the basis of this qualitative approach, and assuming the Maastricht criteria and the core acquis tests are passed, it is far from obvious why, after some five to seven years, the advanced candidate countries could not join the Euro, should they want to. The arguments underpinning this conclusion will be considerably sharpened in chapter 6, with the help of empirical economic analysis. To ensure an incentive system will be in place for the proper build-up of economic union after EU membership, it is recommended to elaborate and improve the Joint Assessments of medium term economic policy in an agreed framework for another five years or so.

5.3 HOW CANDIDATE COUNTRIES PREPARE

Against the backdrop of the above discussion on the characteristics and functions of an enlarged economic union, it is of course informative to study the medium-term economic policy intentions of the candidate countries themselves. In the following this is illustrated for four advanced accession countries (Slovenia, Hungary, Poland and the Czech Republic) on the basis of the Joint Assessments of the medium-term economic policy priorities. This label refers to the agreement between the European Commission (DG Ecofin) and the relevant country about these perspectives. We do not suggest that these documents are void of window-dressing or politically motivated wishful thinking. However, this joint approach is the best available scrutiny of the seriousness and coherence of their medium-term economic strategy. Given the powerful incentives prior to accession to uphold every country's credibility, the policy information in these documents should facilitate an assessment of the quality of the enlarged economic union in a few years from today.

We shall restrict ourselves to a simple overview, based on thirteen elements which relate to the discussion in section 5.2. Consider table 5.1.

Table 5.1 Selective Indicators of economic strategy; 4 CEECs

	Czech Republic	Hungary	Poland	Slovenia
Catch-up growth	5% (2003)	6% (2003)	6% (2002)	5% (2002)
Fiscal (deficit)	5.9% (2003)	< 3% (2002)	< 1% (2002)	Balanced
Social security	minor issue	some cuts in 1999	reducing burden	reforms ongoing
Taxation	minor issue	some reform in 1999	reform, simplifications	reform ongoing
Price liberalis.	to be completed (energy 2002)	---	---	to be completed
Firm restruct.	priority	SMEs priority	priority	high priority
Privatization	priority (banks)	high share achieved	remaining uncompetitive industries	difficult cases to be tackled, with aid
Utilities	EU -model	railways reform	EU -model	drastic reform for several years
Income/wage	Dutch model, social pact	productivity rule	---	collective bar-gaining, Social Agreement
Labour market	---	more flexibility/mobility	more flexibility/ mobility	more flexibility/ mobility
Pension syst.	priority of reform	reform 1998	priority of reform	priority of reform
Banking	reforms under way since '98	ready for single passport upon accession	more competition; enforcement standards	more competition and better supervision
Insurance	more competition	consolidated supervision in 2000	more liberalisation, full EU compliance	Recapitalisation, better supervision, better EU compliance

Source: Joint Assessments, concluded in late 1998, 1999 or 2000

What all four countries have in common is a very strong desire to achieve catch-up growth. All Joint Assessments comprise macro-economic simulations for a 'do-nothing' scenario and for a scenario capturing the policy intentions as summarized in table 5.1. In all cases the overriding objective to opt for the 'active' scenario is higher (catch-up) growth. Even in the case of the Czech Republic, the economic outlook is purposefully stretched to 2003/2004 because only then will the serious consequences of the 1997/98 crises have been overcome so that the growth rate can reach five per cent again. Some countries (e.g. Hungary) already take account of EU transfers from Structural Funds (though not yet from the CAP) by 2003.

It is also striking that all four strive for balanced budgets or very low deficits – only the Czech Republic acknowledges that this will only be possible by 2005 or 2006. All four explicitly maintain this stance despite considerable pressures in (too high and/or rigid) social security expenditures (including in e.g. Poland, which faces problems with health reform) and despite lingering problems in getting enough tax yield and in reducing tax distortions and complications.

The remaining indicators signal some lingering transition problems, but they also show policy concerns that are markedly similar to those in Western Europe. Firm restructuring remains a priority in three countries, invariably concerning the hard

'left-over' cases. In Slovenia the losses incurred by those cases are relatively high. In those three instances privatization is part and parcel of the restructuring approach. The utilities sectors are on the way of becoming properly regulated (e.g. natural monopolies like water/sewage) or of being liberalized under EU-based regulatory regimes. Transitions problems also persist in the financial services sector, be it in different degrees. What is important for the EU-15 is the explicit understanding and full acceptance that banking and insurance need to be (more) open to competition, more effectively regulated and supervised and subsequently far more 'deeply' developed in terms of branches and types of services. In other respects, such as wage determination, pension systems and the functioning of the labour market, the typical policy intentions hardly differ from what one observes in EU Member States.

Table 5.1 provides indicative evidence that concerns about the quality of economic union after accession can be usefully embedded in a special framework agreed between the EU and the respective acceding countries for a period of another five years or so. It enables a close scrutiny of the determinants of economic growth in Central Europe and confirms the joint commitment to avoid 'new Mezzogiornos' by striving for high catch-up growth. Such a framework has the great advantage of going beyond the legalistic and institutional approach, indispensable to the verification of acquis adoption, and of focusing instead on the socio-economic objectives of the Union that are pursued via a properly functioning economic union.

Furthermore, this approach attempts to link micro and macro-economic aspects and can thereby help to establish the confidence that the Euro area's underlying economic union after enlargement is of sufficient quality to support the proper functioning of an enlarged Euro zone. In so far as table 5.1 can be regarded as 'hard' evidence, the more advanced candidate countries seem to understand the national prerequisites for beneficial participation in a robust and dynamic economic union. In the long run, the special framework of assessment should be abolished, allowing the new members to become normal partners in the EU's various co-ordination processes (including Cardiff, Luxembourg and Cologne).

NOTES

[1] An example of a 'hindering' policy was the Spanish practice of nation-wide wage bargaining, which allowed wages to rise irrespective of regional productivity developments.

6 EMU, THE EURO AND ENLARGEMENT

6.1 INTRODUCTION

The purpose of this chapter is to discuss the implications of enlargement for EMU. No complete treatment of this issue is attempted, since it is impossible to do justice to the manifold aspects that would have to be discussed. We concentrate on those issues that impinge on policy choices that might have to be made by the EU: the candidate countries' prospects of meeting the Maastricht criteria, and the appropriateness of these criteria for the candidates. We also discuss whether unconventional approaches to EMU, such as the unilateral adoption of the Euro, should be considered by some candidates.

This study does not contain the two catchwords that dominate most other discussions on enlargement, namely 'real' and 'nominal' convergence. These two concepts are usually seen as each other's opposite, with the implicit (and sometimes explicit) understanding that 'real' convergence is more important than mere 'nominal' convergence. The underlying idea is often that successful participation in EMU requires that the participating countries have a similar economic structure. However, this distinction is not useful. There is no operationally useful definition of real convergence, nor a generally agreed measure which one could use to determine differences in economic structure. In the absence of such a measure, GDP per capita is often used as an indicator of 'real' convergence. In our view this has no basis in economic theory. Nothing in economic theory suggests that poorer countries should benefit less from price stability, or that poorer countries need more exchange rate adjustments than richer ones.[1] We realise that there is a widespread vague impression that the candidate countries are different from the present EU members and that one should wait a long time, until they are 'like us' before they should join EMU. However, we have not been able to find any hard economic indicators that would support this point of view.

The structure of this chapter is as follows. It begins by examining several basic assumptions on the size and specificity of the EU's Eastern enlargement (section 6.2). It then discusses the likely shape of the evolving Euro area and the CEECs' prospect of meeting the Maastricht criteria (6.3 and 6.4). Subsequently, section 6.5 discusses the main problems for these countries once they have joined the EMU, whereas 6.6 explores the use of the Euro before EU or EMU membership and Euro-linked exchange rate arrangements. The chapter ends with some policy conclusions (6.7).

6.2 BASIC ASSUMPTIONS AND CHARACTERISTICS OF THIS ENLARGEMENT

An important assumption underlying this study is that accession of the more advanced candidates will take place fairly rapidly, for example between 2003 and 2005. Most of the second wave should be able to follow a couple of years later. It is not useful to dwell at length on the precise date. But this assumption implies that by 2010 most of the present candidates will have had already a number of years to adjust and converge within the EU, possibly even within EMU, as argued below. Moreover, it is useful to recall that most candidates will have to eliminate their low remaining border protection against EU imports over the next years, so that their industries will at any rate have to compete in an open market with EU enterprises. All this implies that most of the adjustment in industry will have to come before accession. By way of comparison: Spain was given seven years gradually to eliminate rather higher tariff barriers and was then granted several years of exemption from many single market directives. It thus had to undergo the adjustment while being inside the EU (a different EU, then called EC).

In the following section some variables will be reported for two groups of candidate countries called 'first wave' and 'second wave'. This distinction is no longer formally correct in the sense that all candidates are formally at the same stage of their accession negotiations. However, in reality the (formerly) first wave countries are in general much further advanced in the negotiations. This does not necessarily imply, however, that actual accession will take place in two waves. At present it seems that the first group to enter the EU might be as large as seven or eight, with only Bulgaria and Romania clear laggards. However, since this is not certain and since the latter two constitute about two thirds of the 'second wave' the distinction between two waves is maintained for expositional purposes.

6.2.1 SIZE OF THIS ENLARGEMENT

It is often argued that the coming enlargement is unprecedented in terms of the increase in population and other indicators. However, this is not the case if one considers the size of the countries that joined during previous enlargements, in relation to the size of the EC they joined at the time (see table 6.1). The future enlargement is indeed significant in terms of population because all ten CEECs (CEEC-10) would increase the population *of the EU* by over one quarter. (The increase is equivalent to the increase in the German population due to unification). However, by most economic measures the candidate countries' weight is negligible, even if one assumes that their economies will grow rapidly.

Table 6.1 Size of the next enlargement comparing with the previous ones

	Population	GDP	Trade
United Kingdom + Denmark + Ireland as % of EC-6	33.5	27.9	13.1
Spain + Portugal as % of EC-10	17.5	8.3	4.7
CEEC-10 as % of EU-15	28.0	4.1	10.9

Source: Own calculations of EU and EBRD data

Table 6.2 below shows that in terms of GDP evaluated at current exchange rates, the ten accession countries combined would be about 1/15th (six per cent) *of the Euro area*. This corresponds roughly to the weight of the Netherlands alone. More than two thirds of this is accounted for by the first wave. In terms of monetary indicators the story is not much different. Since the candidate countries have rather small financial sectors, their combined monetary supply amounts to generally slightly more than eight per cent of the corresponding Euro area aggregate. This implies immediately that even serious problems with the banking sectors in the CEEC-10 could never materially affect monetary conditions in Euroland. Moreover, in the financial area most of the weight within the CEEC-10 is accounted for by the relatively more advanced first wave of applicants.

6.2.2 SPECIFICITY OF THIS ENLARGEMENT

Are the candidates much poorer and 'different'?

It is generally known that the candidates are much poorer. The most widely used indicator of living standard is GDP per capita at purchasing power standards (PPS). On this account the first wave is on average at about 50 per cent of the EU-15 average. This is somewhat lower than the values for Portugal and Greece at the beginning of the 1990s (several years after their accession to the then EC and eight years before their participation in the Euro area).

In terms of broad indicators of economic structures it is difficult to find strong systematic differences between the candidates and the poorer member countries. The share of agriculture in GDP of around five per cent is already rather low both in the first wave and in most of the second wave countries. Nor is the share of industry in GDP notably different from that of some current member countries. The fundamental reason why it is so difficult to make any firm judgement about systematic differences in economic structure is that there are large differences even among the present EU members. For example, in terms of the share of industry in GDP the range is large even among the small group of so-called 'Club Med' [2] countries. In both Portugal and Italy the share of industry is rather high, at around 30 per cent of GDP. This cannot be considered a sign of high (or low) level of development since Italy's GDP per capita is slightly above the EU average whereas Portugal is the poorest member country. By contrast, industry is much less important in Spain and Greece, providing only around fifteen per cent of GDP.

Table 6.2 Accession countries: indicators of relative size (1998)

	Population in mln. Annual average	GDP at current exchange rates (% of Euro area GDP)	GDP in PPS (% of Euro area GDP)	Money		
				M0: Cash (% of Euro area total)	M1 (% of Euro area total)	M2 (% of Euro area total)
Czech R	10.3	0.9	2.1	1.75	0.82	1.13
Estonia	1.5	0.1	0.2	0.12	0.06	0.04
Hungary	10.1	0.7	1.7	1.24	0.55	0.90
Poland	38.7	2.4	4.7	3.11	1.35	1.90
Slovenia	2	0.3	0.5	0.21	0.11	0.27
Wave 1(sum)	62.6	4.4	9.2	6.4	3	4
Bulgaria	8.3	0.2	0.6	0.38	0.11	0.11
Latvia	2.4	0.1	0.2	0.22	0.07	0.05
Lithuania	3.7	0.2	0.4	0.25	0.09	0.06
Romania	22.5	0.6	2.1	0.38	0.16	0.31
Slovak Rep	5.4	0.3	0.8	0.57	0.27	0.40
Wave 2(sum)	42.3	1.4	4.1	1.8	0.7	0.9
1990/1 data						
Portugal	9.9	1.3	2.2			
Spain	38.9	9.8	11.0			
Italy	56.8	21.0	21.4			
Greece	10.2	1.7	2.3			
Club Med (sum)	116	34	37			

Source: ECB, *Monthly Report*, February 2000, IMF, *International Finance Statistics*, April 1999

Deposits	
Demand deposits (% of Euro area total)	Time, Savings, Foreign Currency Deposits (% of Euro area total)
0.69	1.38
0.05	0.03
0.08	0.83
0.96	2.36
0.09	0.39
2	5
0.05	0.11
0.04	0.03
0.06	0.04
0.09	0.25
0.22	0.50
0.4	0.9

Table 6.3 Accession countries: structural indicators

	Per capita GDP in ECU (% of Euro area per capita. GDP)	Per capita GDP in PPS (% of Euro area per capita GDP)	Share of industry in GDP (%)	Share of agriculture in GDP (%)
Czech Republic	24	60	32	4
Estonia	16	36	18	6
Hungary	21	48	25	5
Poland	18	36	24	4
Slovenia	44	68	28	3
First wave (average)	**25**	**50**	**26**	**5**
Bulgaria	7	23	22	19
Latvia	12	27	21	4
Lithuania	13	31	21	9
Romania	8	27	32	16
Slovak Rep	17	46	27	4
Second wave (average)	**11**	**31**	**25**	**10**
1991 data				
Portugal	37.1	61	31	5
Spain	68.8	76.5	17	4
Italy	101.1	101.9	31	4
Greece	43.3	59.4	15	14
Club Med (average)	**63**	**75**	**24**	**7**

Source: ECB Monthly Report, February 2000; European Commission, 1999 Regular Reports, Statistical Annex of European Economy and "The agricultural situation in the EU 1994 Report". The data on employment for Estonia are for 1997. For Greece the data are for 1993 (except for the share of agriculture in GDP which is for 1992

Employment in agriculture (% of total civilian employment)	Employment in industry (% of total civilian employment)	Degree of openness (exports plus imports, as % of GDP)	Exports to Euro area as % of total exports
6	32	61	59
9	26	85	30
8	28	46	68
19	25	26	59
12	34	57	62
11	**29**	**55**	**55**
26	26	46	39
19	21	54	28
21	21	53	28
40	25	30	58
8	30	69	53
23	**25**	**50**	**41**
18	34	34	80
11	33	18	65
9	32	19	53
21	24	22	62
15	**31**	**23**	**65**

Since three of these four countries are already successful members of the Euro area (and the fourth, Greece, is set to join in 2001) there exists apparently a very large range of economic structures that is compatible with membership in EMU. On the basis of the limited data available, it appears that the candidates do not fall outside this range.

In terms of employment the differences in economic structures would appear to be larger, particularly with respect to Romania, Bulgaria and Poland, where a huge part of the labour force is officially employed in agriculture. However, while this will undoubtedly create social problems in these countries and large dilemma's for the Common Agricultural Policy, it is less relevant for the issue of EMU membership since value added in this sector is such a small part of GDP. Moreover, one cannot avoid questioning the reliability of the data and of the definitions used for identifying farmers, particularly of those concerning Poland and Romania. In the former communist countries many people classified as farmers exercise this activity only on a part time basis. It also appears that their average age is close to 60, so that their numbers will anyway shrink rapidly over the next years. A comparison with the Club Med is again instructive. The average here is actually the same as for the first wave, since most Club Med countries share with many applicants a relative low productivity in agriculture (the ratio share in GDP is only a fraction of the share in employment). Thus the concerns regarding the large shares of employment in agriculture for the candidates are likely to be overstated.

Are the candidates still in the transition phase?

Is this enlargement different because the CEEC-10 are 'transition' countries, i.e. countries that do not yet have an established institutional infrastructure for a market economy? We would agree that the institutional infrastructure in the accession candidates is weaker than in most present EU members. However, it seems that this weakness is just a consequence of their low level of income (per capita).

Gros and Suhrcke (2000) find that the more advanced candidate countries in Central Europe have institutional frameworks judged by foreign investors, and in surveys, to be 'normal' for their level of development (or even slightly better than one would expect). There is little reason to believe that progress will not continue as the overall catch-up process continues. Gros and Suhrcke (2000) also show that the more advanced candidates have actually financial sectors that are appropriate *for their level of development*. In this area it appears that the transition is over. This does not mean that there will not occur any problems in this area. The problems that erupted in the Czech banking sector over the last years serve as a reminder that serious corporate governance deficiencies might persist even in systems that were regarded as rather strong. But a number of EU countries faced rather similar problems not so long ago. Moreover, given the rapid pace of bank privatisation and take-overs by credit institutions from the EU (a phenomenon

which is sometimes still politically controversial), most of these problems should be overcome soon.

At any rate the screening process should uncover any remaining institutional deficiencies. This will guarantee that at the time of their accession the candidate countries should possess an institutional framework that is compatible with a smooth functioning of the EU.

6.3 THE EVOLVING EU

The Euro area in 2010 will be different from that in 2000. Euro notes and coins will have been in circulation for some time, with all the potentially very important psychological consequences this step will bring. Moreover, the Euro area will be more integrated in economic terms as well. Recent research suggests that a common currency should lead to an increase in trade by a factor of two to three. Not all of this increase may have taken place by 2010, but a further significant increase in intra-trade is to be expected. A similar phenomenon is to be expected in the area of capital markets, which are today still to some extent segmented because of national regulations.

It is also likely that *de facto* a growing acquis in terms of economic and fiscal policy co-ordination will develop as economic integration within the Euro area progresses. The main area where substantial progress is needed (and some progress is likely) is that of the co-ordination of taxation of mobile factors, such as capital. The proposed withholding tax on interest income is the most important concrete example of a growing acquis in this area. This particular measure should enter into force before enlargement takes place and would thus have to be taken over by the candidates, but this should not constitute a major problem. It should also be in their interest to do so. Fiscal policy co-ordination in the sense of co-ordinated demand management, e.g. through the Euro-11 Council should also start becoming effective by 2010. Yet it is not part of the acquis in the sense that the Stability Pact is.

However, all of this should not constitute a major problem, especially not for the new member states. Most of the candidates are anyway small open economies for whom the need for fiscal policy co-ordination should be easier to see. After all, there is nothing inherent in fiscal and tax policy co-ordination that makes it more difficult for poorer countries.

6.4 PROSPECTS OF MEETING THE MAASTRICHT CRITERIA

In the debate about enlargement it is often taken for granted that EMU membership will come long after EU membership because the candidates are supposedly not

ready to meet the Maastricht criteria. The reason for this is simply that most assessments of their prospects of meeting these criteria depart from current data. These lead to the inevitable conclusion that the CEECs are still a long way off from joining the Euro. That this approach is misleading, can be shown if one uses the same approach to draw conclusions on the prospects of the present Southern member countries for entering EMU in the early 1990s.

What will be the earliest time that at least some CEECs could aspire to join the Euro area? The starting point has to be full EU membership. Since this requires ratification by all fifteen national parliaments, this is unlikely to happen before January 1, 2004, even if the negotiations are concluded quickly. The minimum delay between the start of EU membership and joining the Euro area is two years of membership in the ERM (if the Treaty is interpreted not too restrictively as was done for Greece and Italy). If advanced member countries join the ERM-II immediately upon joining the EU, i.e. in early 2004, they could just join EMU by July 2006. The decision to admit the candidates to the Euro area could be taken by a European Council meeting of early 2006, based on data for 2005 [3]. However, assessments of a Member State's readiness for EMU membership are usually based on past data. The latest available macro-economic data for the candidate countries (see for example the Monthly Bulletin of the ECB from February 2000) refer to 1998[4], at least seven years before Euro area membership will become legally possible.

By comparison, the decision on which countries could form the initial group for EMU was taken in 1998 on the basis of 1997 data. Judging the suitability of the CEECs on the basis of 1998 data would thus be similar to having made a prediction about the size of EMU in the early 1990s on the basis of data from 1990 or 1991. How do the candidates measure up to this yardstick? Table 6.4 below shows the main variables that are relevant for the Maastricht criteria: inflation, fiscal deficit and government debt. The table is organised in three groups of countries: the (formerly) first wave of accession candidates, the second wave, and the Southern member countries of the EU. Within the last group the data for Greece are taken from two years later because this country will join EMU about two years after the others.

The bottom panel of table 6.4 provides an average for the three groups. A comparison between the data for the CEECs and the corresponding data for the Club Med leads to one clear conclusion: the first wave of accession countries is definitely much closer to meeting the Maastricht criteria than the Club Med countries were at a comparable time before their start of EMU. In particular,

- The average inflation rate for the first wave is about five per cent, which is about half the inflation rate of the Club Med in the early 1990s;
- Fiscal deficits are already now close to three per cent of GDP in the first wave, which is even less than half the deficits of the Club Med at the time (8.6 per cent);

- The same observation applies to public debt. The average for the first wave is only about 30 per cent of GDP, versus about 80 per cent for the Club Med in the early 1990s.

Table 6.4 Maastricht relevant macro-economic indicators (1999)

	Long-term Interest Rates	Consumer Price Inflation	General Government Balance (% GDP)	Public Debt (% GDP)
Czech Republic		2.7	-3.6	40
Estonia		4		5
Hungary		9.3	-4.6	52
Poland		6.1	-3.4	26
Slovenia		4.9	-1	23
Bulgaria				95
Latvia		2.1		6
Lithuania		1.2		13
Romania		39.5	-4	18
Slovak Republic		6.9	-3	54
1991/3 data				
Portugal	18.3	12.2	-6	66.1
Spain	12.4	6.4	-4.5	43.9
Italy	13	7	-10	100.6
Greece		14.2	-13.8	110.2
Averages				
Wave 1		5.4	-3.2	29.2
Wave 2		12.4	-2.3	37.2
Club Med	14.6	10.0	-8.6	80.2

Source: European Parliament, Briefing No 34; debt data for the CEEC-10 is 1998; CPI data for Jan-June 1999 (annual percentages changes) from ECB Monthly Bulletin, February 2000

Moreover, in Italy and Spain the debt to GDP ratio actually *increased* by over twenty percentage points between the early 1990s and the date of accession to EMU. By way of comparison: it has fallen over the last five years in most candidate countries (by over 20 percentage points in Poland, Hungary and Slovakia).

It is interesting to note that in terms of the fiscal criteria the second wave actually performs on average as well as the first. In terms of inflation, the worse performance of the second wave is due mainly to Romania, which has an inflation rate of over 60 per cent. In terms of public debt Bulgaria stands out with a level of 95 per cent of GDP. Both Romania and Bulgaria recognise that they are likely to join the EU two or three years after the others. Excluding these two countries would mean

there is no real difference in the macro-economic performance of the two groups, as measured by the Maastricht criteria.

The data thus clearly suggest that the candidate countries likely to join the EU first are already much closer to satisfying the Maastricht criteria than the Southern member states of the EU were in the early 1990s. Moreover, experience has repeatedly shown that a short and sharp adjustment is politically and economically less painful than a protracted, and hence supposedly soft one. The case of Greece, which was until recently regarded as a lost cause, provides a further illustration of this. The relatively small fiscal adjustment that is still required of the candidates could thus come rather quickly. It is also likely to be politically much easier to implement than the slow adjustment of some established member countries. Thus, the 'strikes against Maastricht' that occurred in France, are highly unlikely to take place in any of the candidate countries.

This relatively good starting position of the candidate countries obviously does not mean that there will be no problems with the Maastricht criteria. However, as will be shown below in a systematic discussion of these criteria, such problems may be of a different nature from what is widely expected. In this respect, we will emphasise the importance of political will and the likely problems with the inflation criterion.

6.4.1 THE DEFICIT CRITERION

Achieving a fiscal deficit below three per cent is essentially a question of political will. Most of the candidates already satisfy this norm, and none of them has structural problems that would constitute an in-surmountable obstacle. However, one can highlight certain features of their public finances that will make this achievement harder. These are, among other factors, their pension systems, the age profile of their populations, participation rates and also the structure of their fiscal revenues (since enlargement will affect some revenues, for example through the need to adjust VAT rates). Some revenues (e.g. inflation tax and customs duties) should almost disappear already before enlargement.

Preliminary indications suggest that the importance of the inflation tax is much over-estimated. Many estimates of the potential inflation tax in the CEECs arrive at figures of about two to three per cent of GDP. This is based on simple arithmetic: a cash to GDP ratio of between five and ten per cent, combined with nominal GDP growth rates of twenty up to 30 per cent (allowing for five per cent real growth and an inflation rate of between fifteen and 25 per cent). This set of figures is not far removed from the recent experience of several CEECs (see Hochreiter and Rovelli 1999). However, most of them have reduced inflation much below the figures mentioned above, because they are aware of the overall benefits from price stability and of the other, less visible, negative effects of inflation on public sector rev-

enues. Measured seigniorage [5] is thus never a good guide to the impact of inflation on public sector revenues (the so-called Olivera-Tanzi effect).

It appears, moreover, that over the last several years countries like Poland and the Czech Republic have actually had almost no seigniorage income at all because their central banks had to offset interest income against the losses on huge sterilisation operations. A more systematic investigation of this would require a closer look at the profit and loss accounts of all central banks. This is outside the scope of this chapter. (Central bank accounting for profits and losses is notoriously opaque, see chapter 3 of Bini-Smaghi and Gros 2000). However, the result for two of the largest CEECs indicates that the importance of seigniorage has been much over-blown.

Even if the CEECs current performance in terms of public finances would not prove permanent, there is no reason to assume that any problems could not be redressed quickly. Firstly, the experience of Italy, Spain and Portugal has shown that once the political will to achieve fiscal convergence becomes apparent and strong initial steps are taken, a virtuous circle can be set into motion whereby financial markets start to anticipate a probability that the country in question will succeed. This leads to lower interest rates, which make it easier to achieve lower deficits and thus in turn validate even stronger expectations of success. This is why reductions of fiscal deficits of up to four per cent of GDP became possible within a short period of time (say one to two years) once the political decision was taken. Secondly, one should not under-estimate the extent to which the fiscal criteria will influence policies in candidate countries even long before entry.

Correcting a fiscal deficit within a couple of years 'merely' requires a determined Finance Minister with solid backing in Parliament. By contrast, implementing all the internal market measures requires an administrative infrastructure that cannot be built up in such a short period of time. Training tens of thousands of civil servants and organising them in complex structures to apply a maze of complicated new laws and regulations is a task for a decade, or more. In this sense we would argue that satisfying the deficit criterion is a relatively straightforward task.

Infrastructural needs

It is sometimes suggested that the Maastricht criteria are not appropriate for the candidates, because they need to invest more in infrastructure and may need to incur deficits on this account. This argument is based on assumptions that are questionable: that the infrastructure of the candidates is inadequate, that more infrastructure investment will increase growth and that this investment has to be financed by the government.

The public infrastructure of the candidates is certainly less developed than that of current EU members. The candidates have fewer motorways and paved roads per inhabitant and per square kilometre, fewer fixed telephone lines, etc. However,

this does not immediately imply that they therefore also need more investment in this area. What they possess may well be adequate for their level of development. Gros and Suhrcke (2000) show that the candidates actually have a larger stock of infrastructure than one would expect on the basis of their income per capita. It is thus difficult to argue that public infrastructure is their main impediment to growth, just as it is questionable whether they need more public investment *relative* to their income.

Public investment and growth

Within the EU one actually does not find any correlation between public investment and growth in GDP. Ireland, by far the fastest growing economy of the EU over the last decades, has a somewhat lower than average ratio of public investment to GDP. We calculated the correlation coefficient between growth in real GDP and the percentage share of general government investment in GDP. This correlation is negative or close to zero for the 1970s and 1990s. Only for the 1980s does one find a positive correlation, which is however due to the special case of Luxembourg.

Public financing of investments in infrastructure?

Until the early 1980, Ireland followed the so-called golden rule of running large deficits, which were supposedly justified by public investment. This led to a large build-up of public debt. Growth started to take off only after Ireland abandoned this policy and sharply reduced its deficits. In view of the changes in financial markets that have taken place over the last decade, it is now generally recognised that most infrastructure projects could also be financed and sometimes even operated with substantial private sector involvement. Major projects, such as motorways are already been undertaken on a mainly private sector basis within the candidate countries. The merit of letting the private sector run at least some infrastructure elements is, for instance, apparent in the telecommunications sector. All in all, there is thus no reason to assume that the candidates would need to run larger deficit on the grounds that they have a stronger need for infrastructure investment.

6.4.2 THE DEBT CRITERION

The debt criterion will probably not constitute a major additional hurdle. Most candidate countries have at present a debt to GDP ratio below the 60 percent ceiling. But again the current data are not very informative. As the Czech case has shown, the process of cleansing the accounts of a banking system can at times bring to light large liabilities of the public sector. Debt to GDP ratios might thus increase in some candidate countries as they clean up their banking system. However, most of this will be achieved before accession (see, for instance, section 5.3). With healthy growth, a deficit below three per cent should lead to a rather large fall in the debt to GDP ratio. The debt criterion should thus be satisfied, even if debt ratios are temporarily driven above the 60 percent threshold due to

any ‘clean up’ problems. Given that these kinds of issues constitute the main danger for public finances, we will concentrate on sources of hidden debt, such as non-performing loans, or loss-making public sector enterprises.

Skeletons in the cupboard: the sustainability of fiscal convergence

The fiscal performance of the candidates looks almost too good to be true. Are there any important skeletons in the cupboard? It is sometimes argued that the public debt levels of the candidates are low, but that large contingent liabilities might be hidden in the banking system in the form of non-performing loans that the government will have to take over when the banking system is finally cleaned up. In other words, low debt to GDP ratios may simply be a symptom of an unfinished transition. Table 6.5 below shows the figures for non-performing loans as a percentage of GDP, calculated on the basis of EBRD data. Whereas the numbers are high for countries that have faced crises in their banking system, such as the Czech Republic, Slovakia and Romania, we can conclude that in general the problems are not as big as one would expect. Taking into consideration the rather low debt to GDP ratio, we can say that even if all the bad loans will have to be added to the public debt, the outcome will in any case not exceed the 60 percent reference level for the debt criterion.

Table 6.5 Accession countries: non-performing loans (as a % of GDP)

	1994	1995	1996	1997	1998	1999
Czech Republic	n.a.	18.01	15.65	15.86	14.37	15.57
Estonia	0.52	0.41	0.46	0.65	1.30	1.09
Hungary	5.34	2.76	1.72	0.90	1.42	0.81
Poland	4.58	3.46	2.57	2.28	2.55	3.47
Slovenia	4.94	3.61	4.07	3.72	3.90	3.92
First wave (average)		**5.65**	**4.89**	**4.68**	**4.71**	**4.97**
Bulgaria	0.01	0.01	0.01	0.00	n.a.	n.a.
Latvia	2.63	2.01	2.03	1.53	1.22	n.a.
Lithuania	5.46	2.51	3.42	2.92	1.38	1.53
Romania	4.11	10.12	12.44	8.44	11.56	4.45
Slovak Republic	17.90	23.92	19.14	18.23	19.75	n.a.
Second wave (average)	**6.02**	**7.71**	**7.41**	**6.22**		

Source: Own calculations on EBRD data

All objective indicators suggest that the problem is likely to be more limited in most candidates than in member countries that have already qualified for the Euro. The best indicator for measuring the importance of contingent liabilities to public debt is the so-called ‘stock flow adjustment’ item that appears in the official statistics of the public finances of member states. This item captures the increase in the debt to GDP ratio that cannot be explained by the deficit, and that must therefore reflect the assumption by the government of liabilities outside the normal budget. A good starting point is again the experience of the Euro area countries. Over the period 1992–1997, a period that should have been relevant for the Maastricht criteria, the cumulative stock-flow adjustment for Germany

amounted to almost fourteen per cent of GDP. The German debt to GDP ratio thus increased by fourteen percentage points more than one could have expected from the Germany's nominally low deficits over this period. The underlying reason was that the government kept the Treuhand, the German privatisation agency, off budget. When this agency had to be unwound, the German government had to assume its debts, which were huge. This is thus a classic case of how an unfinished transition can leave large contingent liabilities.

Fortunately, however, the Treuhand experience is extremely unlikely to repeat itself. The candidate countries have already largely finished privatisation, so that any debt accumulation should already have taken place. Moreover, unlike in the former GDR, wages in the candidate countries are not totally out of line with productivity. This means that privatisation actually yields revenues, not debts, as was the case in Germany. (This explains why debt has actually declined.) But are there other sources of potential government liabilities? The experience of Greece suggests that losses of state owned enterprises, which are too politically sensitive to fail, might sooner or later show up in the budget. This might happen either directly, when the enterprises are privatised or re-capitalised, or indirectly via the banking system, when the government has to pay up for non-performing loans (turning an implicit guarantee into an explicit one).

Table 6.6 shows the debt dynamics in some EU countries prior to their own membership in the Euro area. It is apparent that in Germany and all the 'real Club Med' countries (Portugal is only an honorary member of this club) the debt to GDP ratio actually increased by more than ten percentage points of GDP during the five years preceding the examination that allowed them to proceed. For the applicant countries these data are only available for a somewhat shorter period. It is apparent that these countries had quite a different experience. Many witnessed a considerable fall in their debt ratio. In terms of the unexplained part, i.e. the stock flow adjustment, however, there is little difference between the Euro area countries and the applicants. In both groups there is a tendency for this item to be positive (implying that there was a source of debt that did not appear in the deficits), but there are no signs that the applicant countries are worse offenders.

Table 6.6 Debt dynamics compared

	Stock-flow adjustment	Increase in the ratio of debt/GDP
Cumulative 1992–1997		
Germany	13.7	17.4
Greece	28.1	10.7
Italy	10.7	12.9
Portugal	-4	1.4
Spain	11.3	20.9
Cumulative 1994–1998		
Czech Rep.	9.8	10
Estonia	1.5	4.6
Hungary	20.1	-24.9
Latvia	2.1	-2.6
Lithuania	0.8	6.6
Poland	-4.5	-26
Slovakia	11.0	-29.6
Slovenia	15.8	5.4

Source: European Commission (1998) and own calculations

How large is the potential for hidden liabilities in the banking systems of the candidates? A brief look at the data on the size of the banking systems (see table 6.7 below) suggests that it cannot be very large, for the simple reason that in most candidates the banking sector is rather small and lending by the banking system to the corporate sector (as percentage of GDP) is even less important if compared to that of EU member countries. The comparison with the Euro area (see table 6.2 above) gives an even clearer image of the insignificant size of the banking sector in the CEECs. The main exceptions to this general rule are the Czech Republic and Hungary, which are generally considered to have advanced most in the process of transition.

Table 6.7 Accession countries: monetary indicators (1998)

	M0: Cash (% of GDP)	M1 (% of GDP)	M2 (% of GDP)	Deposits	
				Demand Deposits (% of GDP)	Time, savings, foreign currency deposits (% of GDP)
Czech Republic	11.33	29.14	87.56	19.88	58.38
Estonia	8.57	23.04	37.39	14.78	14.57
Hungary	9.56	23.25	83.25	2.86	41.74
Poland	7.16	17.10	52.68	9.89	35.58
Slovenia	3.90	11.61	59.54	7.76	47.99
Bulgaria	11.03	17.00	30.60	6.55	21.00
Latvia	12.24	20.88	33.16	8.77	12.46
Lithuania	8.51	16.98	25.31	8.33	8.33
Romania	3.62	8.14	18.90	3.72	15.60
Slovak Republic	10.15	26.85	85.58	17.73	58.73
Club Med					
Portugal				30.22	67.38
Spain				20.29	43.98
Italy				27.26	18.43
Greece				8.24	51.01

* = 1997 data

Source: IMF, International Financial Statistics, April 1999 and own calculations

Deposit money banks	
Claims on non-financial public enterprises (% of GDP)	Claims on private sector (% of GDP)
9.26*	65.17*
0.31	25.27
..	..
5.97	20.61
..	32.52
4.92	14.24
0.63	14.13
0.82	9.48
3.47	12.75
14.60*	44.18*
	88.31*
	92.49
	57.60*
	36.41*

6.4.3 THE INTEREST RATE AND EXCHANGE RATE CRITERIA

Interest rate convergence will result from a stable exchange rate. For this reason the exchange rate stability criterion can be viewed together with the criterion on interest rates. Most candidate countries already now orient their exchange rate policies towards the Euro. As our analysis of inflation trends will show, there is no reason why they should not be able to achieve exchange rate stability comparable to that within the pre-1992 ERM. However, a problem might arise because the Treaty speaks of '*the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other member state.*'

This is a provision that needs to be re-interpreted in the light of enlargement. Taken literally, it would seem to imply that formal membership of the EMS for two years is a pre-condition for admission to the Euro area. In order to give candidate countries a chance to join the Euro immediately upon enlargement they would have to be allowed to join the EMS already before joining the EU. Whether or not non-EU members could join the ERM-II as it exists, or whether one would need to construct at least formally a sort of ERM-III needs to be discussed. If neither of these solutions can be implemented, insisting on formal EMS membership would seem to be manifestly absurd in cases like Estonia. This country is *de facto* already a unilateral member of the Euro area and, by the time it joins the EU, will have had ten years without any exchange rate instability.

There is another problem with the exchange rate stability criterion. Experience has shown that the most serious difficulties arise during the final phases of inflation convergence if capital controls have already been lifted. A number of candidates are entering this dangerous period right now, and one cannot exclude that they will have to face speculative attacks on their currencies. The argument that the perspective of enlargement protects them against attacks similar to that against the Russian rouble, is not convincing, as is shown by the episodes of speculative attacks even within the EU.

The ERM-II will in any way be quite different from its predecessor. The existing formal provisions for the ERM-II have not been tested yet. They are so vague as to give little guidance to the market, should problems arise. In our view the ERM-II (or any ERM-III arrangement) is likely to remain *de facto* a unilateral peg. The key factors determining the nature of the relationship between the Euro area and the candidate countries' currencies are their huge differences in size and reputation for price stability. The Euro area is likely to remain at least twenty to 40 times larger than the accession countries combined. This is even more lop-sided than the relative weights that made the links of the Dutch Guilder and the Austrian Schilling to the Deutschmark (DM) so one-sided.

If the ECB were to follow a policy of never intervening, the ERM-II would function in a similar way as these links to the DM. However, if the ECB were to deviate even a little from a policy of 'benign neglect' it would immediately dominate the relationship. Even unlimited intervention by the ECB in favour of any currency of the candidate countries could never endanger price stability in the Euro area. If markets understood this they would not even test the resolve of the ECB. But how the ECB will handle this issue is not yet clear.

6.4.4 INFLATION

One of the criteria in Article 109j (original numbering) is 'the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing members in terms of price stability'. The numerical ceiling of 1.5 per cent is fixed only in an accompanying protocol. This is important because in the case of the CEECs one could argue that if they grow fast enough to catch up within a reasonable period they should have an inflation rate, as measured by the consumer price index (CPI), that is substantially above that of the Euro area.

This is suggested by the so-called Balassa-Samuelson (B-S) effect which is based on the empirical regularity that productivity grows faster in the traded goods sector (essentially industry) than in services (many of which are not traded). If the candidate countries maintain a stable exchange rate against the Euro the prices of traded goods should increase in line with prices in the Euro area. But prices of services are likely to increase faster since wage increases are determined, at least partially, also by the high productivity industrial sector. A fast growing country could thus have a substantially higher inflation rate than the Euro area even while pegging tightly to the Euro, and without running up external imbalances. It is often objected that this idea is inconsistent with the experience of Ireland, which over the last decade achieved very rapid catch-up without noticeable higher inflation. This argument is analysed briefly in box 6.1, where it is found that Ireland constitutes a special case which seems unlikely to repeat itself (see also Annex 1 containing a formal exposition of the theoretical underpinning of the Balassa-Samuelson effect).

Although the B-S effect is often mentioned, there are few reliable estimates of its magnitude. The ECB's Monthly Bulletin of October 1999 dealt with this issue from the point of view of the Euro zone. The ECB does not provide a precise estimate of the B-S effect, but it claims there is a close association between absolute price differentials and the inflation rate (measured over the period mid-1998 to 1999). However, the differences are not very large within the Euro zone. For example, Portugal, whose price level stands at close to 70 per cent of the EU average, had an inflation rate that was about 1.5 percentage point higher than that of the Euro zone's core, whose price level corresponds roughly to the average.

The price levels of the candidate countries are generally even lower than that of Portugal – as one would expect given their even lower level of income per capita. Would this lead to much larger inflation differentials? Annex 1 provides a brief econometric investigation of this issue. The main results is that if one uses the experience of the countries in the Euro zone, one finds that given the very low level of prices in the candidate countries the equilibrium inflation differential could be around 3.5 to a full four per cent. This is considerably above the 1.5 per cent threshold of the Maastricht inflation criterion.

A more thorough empirical analysis is needed to see whether the orders of magnitude found here are confirmed by other approaches. If this were the case, one could argue that the B-S effect could be strong enough to warrant derogation from the inflation criterion. Such derogation would not require a change in the Treaty, but only a change in the protocol (or its interpretation, which should be teleological, not literal).

However, even if the ceiling of 1.5 per cent is not changed, the B-S effect is unlikely to represent an absolute obstacle. As the catch-up process continues it is likely that the price level of Estonia will increase towards the EU average over the next year (which implies higher inflation in Estonia), but the effect should diminish over time. Moreover, the B-S effect should operate on average, over longer periods of time. Actual inflation will fluctuate around this trend. It is thus likely that there will be years during which actual inflation is below the trend, providing an opportunity for candidates to 'squeeze in' (as happened with Portugal, Spain and Greece).

An alternative to a re-interpretation of the inflation criterion would be for the applicant countries to engineer a trend appreciation against the Euro (so that tradable prices decline and service price can remain stable). While this is very attractive in theory it would be difficult to engineer in reality. Experience has shown that using the exchange rate to steer domestic inflation along a narrow path is very difficult because it can sometimes lead to overshooting and thus to large imbalances.

Box 6.1

The theoretical considerations behind the B-S effect imply that the quicker the catch-up in terms of productivity the larger could be the measured differential in CPI inflation. At first sight this seems to be incompatible with the experience of Ireland, which had extraordinarily high growth during the 1990s. Its GDP per capita rose from about 75 per cent of the EU average to over 115 per cent (measured in PPS). During the same period CPI inflation in Ireland was almost exactly equal to the Euro-11 average and the exchange rate of the Irish pound versus the synthetic Euro was approximately stable. However, there are two features of the Irish case that explain this apparent discrepancy with the predictions based on the Balassa-Samuelson approach:

- Most of the sudden acceleration of growth in Ireland during the 1990s came from an increase in inputs of labour; productivity growth actually decelerated during the 1990s, falling to 3.2 per cent from 3.8 per cent during the 1980s (see table 6.8).
- The price level in Ireland has always been close to the EU average (maybe because of the long-standing currency union with the British Pound). This can be seen from the fact that for Ireland GDP per capita, measured at PPS, has always been rather close to GDP per capital measured at current exchange rates. For Ireland the difference between the two has usually been around 5 per cent, even when its GDP stood only at around 60 per cent of the EU average. By contrast, for Portugal, which experienced a much slower but continuous catch-up in PPS terms, the difference in these two measures of GDP per capita is ten times larger, hovering typically around 50 per cent (see also table 6.8).

Table 6.8: The atypical catch-up of Ireland

Ireland

		Occupied pop.	Prod.per cap. of occ. pop.	GPD growth	GDP per cap. measured at		Ratio (2)/(1)
					current exchange rate (1)	PPS (2)	
'70					60.8	61.2	1.01
	'70s	0.9	3.7	4.7			
'80					60.8	65.5	1.08
	'80s	-0.2	3.8	3.6			
'90					70	73.3	1.05
	'90s	3.1	3.2	6.5			
2000					111.8	115	1.03

Portugal

		Occupied pop.	Prod.per cap. of occ. pop.	GPD growth	GDP per cap. measured at		Ratio (2)/(1)
					current exchange rate (1)	PPS (2)	
'70					35.1	50.4	1.44
	'70s	0.	4.7	4.7			
'80					29.1	55.4	1.9
	'80s	0.2	3	3.2			
'90					37.1	61	1.64
	'90s	0.5	2.11	2.6			
2000					49.8	75.4	1.51

Source: Statistical Annex to European Economy, November 1999

6.4.5 THE FINAL CONVERSION RATE TO ENTER THE EURO

While this issue is not part of the convergence criteria it might turn out to be one of the more difficult economic decisions that have to be taken prior to joining the Euro area. It is extremely difficult to determine the equilibrium exchange rate for transition countries because estimates are invariably based on past date and the candidates have all undergone fundamental economic adjustment. It is also very difficult to judge when the adjustment will finish so that the equilibrium can be determined with more confidence. *A priori*, one could argue that this uncertainty constitutes an argument for a prolonged period of exchange rate flexibility. However, foreign exchange markets face the same uncertainty and freely floating exchange rates could then be very unstable. Combined with the fact that freely floating exchange rates are prone to prolonged periods of overshooting, one could therefore argue that it might actually be preferable for the candidates to keep their exchange rates rather stable (as long as there are no clearly identifiable developments that require unambiguously an exchange rate adjustment). Since domestic prices and wages are also rather more flexible in the candidate countries than in the more established EU economies, this should allow the internal price level to adjust over time to let the economy find the appropriate equilibrium. Given the B-S effect mentioned above, this should not involve large economic costs as most of the adjustments are likely to be on the upside. The final Euro conversion rates could thus simply be the rates with which countries have been able to live for some time. This implies in particular that countries with well functioning currency boards should be able to join without having to abandon this system.

6.5 PROBLEMS FOR THE CEECS IN THE EMU?

We have argued that there are unlikely to be any special reasons why achieving (and maintaining) fiscal stability will be noticeably more difficult for the CEECs than for EU member countries. What then will be the main problem for candidates once they have joined EMU? Most economists agree that this is the issue of dealing with asymmetric shocks without disposing of the exchange rate as an adjustment instrument.

6.5.1 RISKS OF ASYMMETRIC SHOCKS?

An asymmetric shock is a sudden and unexpected disturbance that hits unequally a member state of the Euro area. Such a shock may consist either of a disturbance of a given region or sector in a particular way, or a shock that is common to the entire economy but that has differential effects on regions (or member states) because of differences in economic structures or divergent policy responses. As for economic shocks having a rather equal impact on the Euro area as a whole, the

exchange rate continues to serve as an instrument of adjustment, since the Euro is floating against the dollar and yen.

In concrete terms the most important asymmetric shocks to have hit the European economy in the last decades have been the two oil shocks of the 1970s, some episodes of sharp turns in US monetary policy and, at the beginning of the 1990s, the German reunification shock. But the shocks that may affect the CEEC-10 in future are likely to come from different sources. There may be some unfinished transition problems left, or shocks that hit most other EU countries equally could hit the candidates in a differentiated way.

The issue of asymmetric shocks is the central element of the so-called Optimum Currency Area approach (OCA). It should thus be the decisive criterion for economists. Unfortunately, however, so far it has turned out to be impossible to provide quantified estimates of the importance of asymmetric shocks. Therefore, firm conclusions on this issue cannot be drawn. The OCA literature usually just considers a number of indicators of potential vulnerability to asymmetric shocks, but it has never provided quantitative estimates of the costs of asymmetric shocks.

There are six widely used criteria for assessing the relative suitability of EU economies for membership of the Euro area. These indicators are founded on the OCA theory and they all concern the structure and past performance of the real economy. These are:

- Trade-related:
  - similarity of trade structures;
  - intra-industry trade intensity;
  - exports to EU as percentage of GDP;
- Macro-economic:
  - correlation of GDP growth rates;
  - correlation of industrial production growth;
  - correlation of unemployment rates.

The first three refer to the structure of trade whereas the second three refer to the degree to which the national macro-economic variables have tended to evolve in step with the EU. This second group is likely to give misleading indications in the case of the CEEC-10 because the correlations would have to be based on data from the last five to ten years, which were a period of rapid change and shocks of exceptional magnitude.

The data on trade structures might be more useful because some research seems to indicate that after a very rapid change during the early 1990s the patterns of exports and imports of the CEECs have now settled down. However, even in this domain one must expect important changes by 2010. The cases of Portugal and Greece, the two member countries with the lowest income per capita, may be instructive in this respect because *a priori* it is widely expected that these two

countries should suffer more from asymmetric shocks than other members of the Euro area. However, this has not happened so far.

Most studies on the trade structure of the candidate countries come to the conclusion that the more advanced group (the Czech Republic, Hungary and Poland) is increasingly entering a mature pattern of intra-industry trade. They exchange differentiated products in similar industries, mainly with the EU (see for instance Freudenberg and Lemoine 1999). This would imply that although these countries are recognisably different from present EU members, the likelihood of asymmetric shocks through trade is already low and diminishing. However, this is not the case for the Baltic countries and the Balkan states, which also lag in preparing for membership. In the case of the Baltic countries it might be that their small size forces them to specialise in a limited number of industries. But given their very high degree of openness – exports account for over 50 per cent of GDP see table 6.3 above – they have an interest in joining a large currency area. It is thus difficult *a priori* to make any firm judgement on the likely importance of asymmetric shocks for the candidate countries should they join the Euro early.

We also note that a key problem with the asymmetric shocks approach is that it is not borne out by the data. Belke and Gros (1999) analyse econometrically the importance of (1) the external demand shocks and (2) changes in the real exchange rate over the last twenty years in explaining fluctuations in unemployment and manufacturing production for all EU economies. They find that external shocks have little impact on unemployment but are more important in the evolution of employment in manufacturing. However, the results differ strongly from country to country, and for about half of the EU member countries there is no significant relationship. Taking into account various potential shock absorbers (exchange rate movements, fiscal and monetary policy) does not affect the results. The exchange rate in particular does not seem to have a strong impact as a shock absorber. Belke and Gros therefore conclude that the loss of the exchange rate instrument should not lead to massive unemployment problems for EU countries.

It would be tempting to replicate this analysis for the candidates. However, this is not possible since there are not enough data available. The massive shock following the initial reforms in these countries have rendered only a few years available for observation. A different approach is possible, though.

Another indicator used to determine the suitability for countries to form a monetary union is the degree of real exchange rate variability of their currencies. The rationale of using this criterion is as follows. When we observe that the real exchange rate between two currencies is stable, it could be that in these two countries there were not many (asymmetric) shocks requiring real exchange rate changes. Therefore, for these two countries the cost of forming a monetary union (and thus losing nominal exchange rate flexibility) is small (see De Grauwe and Heens 1993). In this perspective it is interesting to look at the exchange rate

variability of the candidate countries. If it is high one could argue that they 'need' nominal exchange rate flexibility, at least at present, but also potentially in future as well. The experience of the Club Med countries before they joined the Euro will again constitute the benchmark.

We start with variability measures based on the bilateral real exchange rate (BRER) between the currencies of the ten candidate countries vis-à-vis the DM for the period 1996-1998, which are compared with the ones of the Club Med currencies in the early 1990s. We use the DM as the standard because this allows us a comparison with the Club Med countries, whose choice was to join a DM block. We measure the variability each year by the standard deviation of twelve-monthly changes in the bilateral (real and nominal) exchange rates. (One has to look at changes because exchange rates are non-stationary.) The methodology is described in the annex. We present two different data sets for the Club Med: one based on the calm period 1990-92, and another for the turbulent years 1993-1995, which just preceded the decision to join EMU.

As expected in the case of countries without macro-economic stability and high inflation, the variation in the BRER is large. For these countries, a high real exchange rate variability does not signal an adjustment need of the real sector but rather weak macro-economic management. We therefore leave aside countries in a situation close to hyperinflation (Romania and Bulgaria until 1997). Our analysis is thus based on a comparison of the eight candidate countries with stable macro-economic environments (the CEEC-8) and the Club Med countries.

The resulting numbers (see table 6.9 with standard deviations of the bilateral exchange rates towards the DM) are astonishing; the variability of both the real and nominal exchange rate is, on average, of the same magnitude for the CEEC8 as for the Club Med. This means that the candidates with only moderate inflation rates have already now achieved a level of real and even nominal exchange rate variability that is almost the same as that of the Club Med countries during the early 1990s, i.e. before the ERM crisis.

Table 6.9 Variability of the bilateral real exchange rates in CEEC-8 and Club Med countries (measured by standard deviation)

	CEEC-8	Club Med	
	Average 1996-1998	Average 1990-1992	Average 1993-1995
Monthly data			
Variation of RER	1.9	1.8	2.2
Variation of NER	1.6	1.5	2.1
Variation of relative CPI	0.6	0.9	0.7
Quarterly data normalised to a monthly rate			
Variation of RER	1.2	1.3	1.4
Variation of NER	0.9	1.1	1.3
Variation of relative CPI	0.4	0.5	0.3

Table 6.9 shows that for all country groups real exchange rate variability is slightly higher than nominal variability. This implies that exchange rates have typically *not* moved to offset inflation differentials. On the contrary, they have tended to move in the opposite direction. This would suggest that in reality exchange rates constitute a source of shocks rather than function as shock absorbers (see Gros and Thygesen 1998).

We normalised the quarterly variability measures to a monthly rate, in order to make them comparable. Table 6.9 suggests that variability is slightly lower if one looks at changes over quarters. It is also apparent from these data that the variability of the relative price levels is much lower than that of either nominal or real exchange rates. Real exchange rate variability is then dominated by nominal exchange rate variability. This is a well-known phenomenon, which can be seen clearly in figure 6.1. The average degree of real exchange variability is the same for the CEEC-8, but do they show higher degree of real variability for a given level of nominal variability? Box 6.2 shows that this is not the case.

The regression using *quarterly* data (changes in the real and nominal exchange rates and in the CPI) yields very similar results. With quarterly data real exchange rate variability is actually slightly larger in the Club-Med than in the candidates, even when using the period preceding the EMS crisis for the Club-Med countries. The regression results using quarterly data are reported in table A5 in the annex 3 and the relationship between nominal and real variability shown in figure 6.2.

Figure 6.1 Bilateral exchange rate variability (vis-à-vis DM) of the CEEC-8 currencies (1996-1998) and the currencies of the Club Med countries (1990-1992 and 1993-1995). Monthly

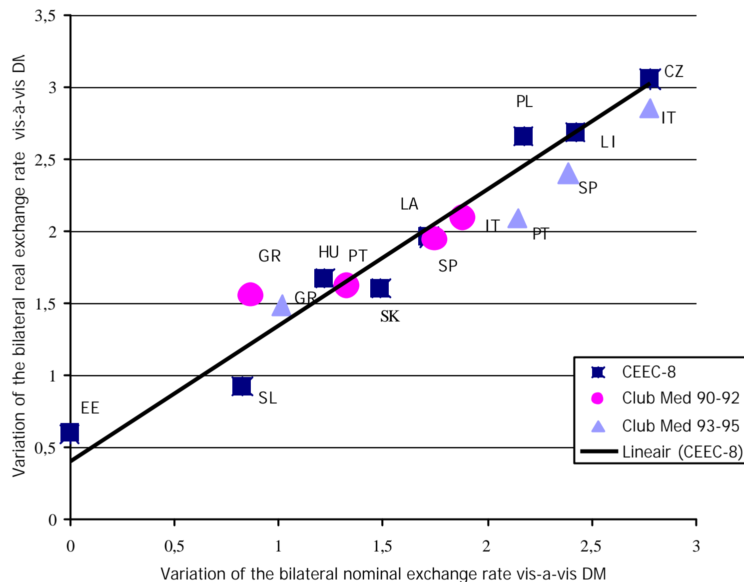
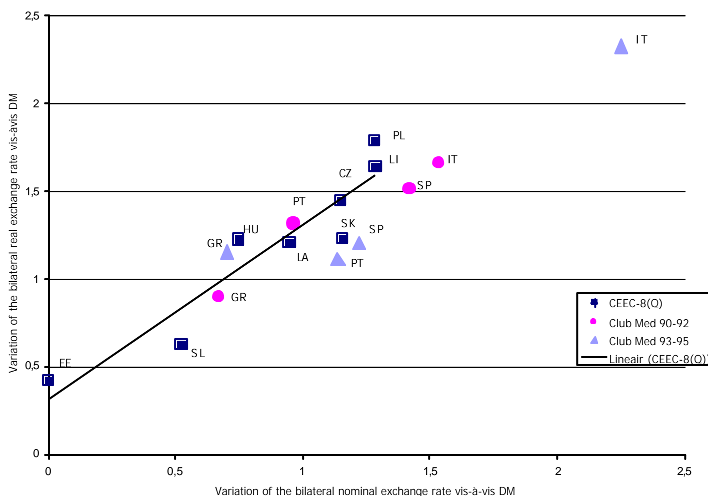


Figure 6.2 Bilateral exchange rate variability (vis-à-vis DM) of the CEEC-8 currencies (1996-1998) and the currencies of the Club Med countries (1990-1992 and 1993-1995). Quarterly normalised to a monthly rate.



Box 6.2

The visible relationship between real and nominal exchange rate variability in figure 1 can also be captured by a regression equation. The regression result is:

$$y_{brer}=0.5+0.9x_{nrer}^{CEEC-8} \quad -0.02x^{\text{Club-Med dummy}}$$
$$\quad 0.12) \qquad\qquad (0.24)$$

where y_{brer} is the standard deviation of the monthly changes in the natural logarithm of the real exchange rate (averaged over the three years 1996-98), x_{nrer}^{CEEC-8} is the standard deviation of the monthly change in natural logarithm of the nominal exchange rate in the CEEC-8s (again averaged over the three years 1996-98) and $x_{nrer}^{Club-Med}$ is a dummy variable for the Club-Med countries. We introduce this dummy in order to check whether the CEEC-8 show a different relationship between nominal and real exchange rate variability. Since the dummy is close to zero and not significant this does not seem to be the case. Re-estimating the regression without the dummy led to very similar results.

Regression statistics without dummy				
Adjusted R Square	0.92			
Standard Error	0.20			
Observations	12			
	Coefficients	*Standard Error*	*T Stat*	*P-value*
Intercept	0.47	0.13	3.55	0.005
BNER	0.91	0.08	11.68	0.000

The adjusted R2 value shows a strong cross-sectional relationship between the real and the nominal exchange rate variability. The same phenomenon can also be seen in the raw data from the strong correlation between the real and the nominal exchange rate changes (see table A4 in the annex 3).

CEECs behave in the same way as those of the Club Med countries which were considered ready to join the Euro as part of the initial group. Our overall conclusions on the asymmetric shocks issue are thus the following:

- quite a number of structural indicators will continue for some time to indicate that most of the CEEC-10 may be more likely to be affected by asymmetric economic shocks than most EU-15 countries;
- however, looking at the actual incidence of such shocks in the past in countries for which similar expectations existed (Portugal, Greece) this finding cannot be taken at face value;
- still, the real exchange rate has proved to be a useful instrument for adjustment in some EU countries, especially when domestic prices and wages were not in line with long-run equilibrium values;

- The loss of the exchange rate instrument with adoption of the Euro must be balanced by a higher degree of internal flexibility in terms or prices and wages and labour markets more in general.

6.6 USE OF THE EURO BEFORE EU OR EMU MEMBERSHIP AND EURO-LINKED EXCHANGE RATE ARRANGEMENTS

The conventional view of the Euro area enlargement process is: converge first, and durably, and then join. While probably appropriate for EU members, this view may not be adapted to the new situation (post-Russia/Asian crises, the introduction of the Euro) facing some candidate countries. Already two candidates (Bulgaria and Estonia) and one non-candidate (Bosnia) have become virtual members of the Euro area, with formerly DM, now Euro-denominated currency boards[6]. There will be more clients for this kind of monetary regime in the wider Europe. Argentina's interest in total dollarisation also draws attention to the extra advantages of an even more radical option: wholesale unilateral adoption of the Euro. These arguments are sufficiently new and important to deserve a more systematic presentation.

In thinking about the exchange rate arrangements between the Euro and the rest of (non-EU) Europe, three groups of countries should be distinguished, according to their *relative strength in terms of fiscal and monetary institutions*. These are:

The very strong countries, i.e. those meeting the Maastricht criteria most of the time on their own (Switzerland, Estonia). They would gain in terms of transaction costs from pegging to the Euro because the EU is their major trading partner and because by doing so they would give financial markets an anchor for longer-term expectations, thus reducing exchange rate variability due to financial shocks. For these countries the classic criteria of the OCA become relevant, notably to the extent that their economic structure is close to that of the EU.

The 'middling' countries, with moderate inflation rates (now usually below double digit) and moderate fiscal deficits, such as most of the candidates countries in Central Europe and also Cyprus. However, since some of these countries have rather large current account deficits they are vulnerable to speculative attacks. They are also involved in an intensive process of structural change, the outcome of which is uncertain. They may therefore need some flexibility in their real exchange rate for some time. The costs and benefits of different exchange rate regimes are often finely balanced and must be considered case by case.

The very weak countries, i.e. the ones that are very far from fulfilling the requirements for EU membership in general and the Maastricht fiscal criteria in particular. These countries would gain from being able to enter the Euro area, because

they could import sensible macro-economic policies and decisively gain the confidence of financial markets. Since the alternatives are hyperinflation and/or enormous risk premia on foreign debt, the benefits of this confidence effect and of a stable currency can far outweigh any potential costs of not being able to react to asymmetric shocks with exchange rate changes.

Gros (2000) provides an analytical model for these considerations. He shows that the standard model used by economists to analyse the need for seigniorage income and the temptation by governments to use surprise inflation yields exactly this conclusion.
What should the 'basket cases' do?[7] One way for non-EU countries to anchor themselves to the Euro area is to opt for a currency board, as Bosnia, Bulgaria, Estonia and Lithuania have already done. The first three chose the DM as the anchor and are now *de facto* members of the Euro area. As these examples show, a currency board can deliver the benefits of credibility with financial markets and low inflation. However, as the experiences of Argentina and Hong Kong also show, even currency boards that are run very conservatively can come under attack. This deficiency has recently prompted the Argentine government to consider plans to switch totally to the US dollar.

The radical solution of unilateral, total adoption of the Euro as the domestic currency for banking as well as cash, offers even more benefits compared to the standard currency board, because it might be the only practical way to achieve tolerable real interest rates. The delicate issues of banking supervision that such a move would raise would in reality not be that important with respect to the applicants, since they are taking over the acquis in this area and their financial systems are small relative to that of the Euro area.

An advantage of a currency board over full 'Euroisation' that is often stressed by economists is that it allows a country to keep some seigniorage revenues. However, these revenues are small under price stability (typically less than 0.5 per cent of GDP under a currency board arrangement). Moreover, one could think of a simple arrangement under which the EU would address this issue by lending countries that opt for Euroisation the Euro cash they need at zero interest rates. Annex 2 provides the calculations for the case of Estonia.

6.7 SUMMARY AND POLICY CONCLUSIONS: ECONOMIC AND INSTITUTIONAL CONSEQUENCES OF ENLARGEMENT FOR EMU

From a strictly *economic point of view* the present EU-15 will not be strongly affected by the EMU aspects of enlargement. For them, and also for the Euro area members, it does not matter whether the candidates enter the Euro area quickly. Even if trade with the ten candidates doubles over the next decade, as we expect, it

will remain small compared to intra-EU (or intra Euro area) trade and a small fraction of the Euro area's external trade. Because their financial systems are minuscule compared to that of the present Euro area and because their banking systems are increasingly dominated, if not outright owned, by institutions from the EU, it is unlikely that they could damage the Euro area.

Prior to 1999 it was often argued that with a 'large' EMU, i.e. one including the 'Club Med' countries, it would be more difficult for the ECB to conduct a tight monetary policy. Experience since then has shown that the opposite is true: Southern member countries, such as Portugal and Spain at present and Greece in future, are growing faster than the former 'core' countries, France and Germany. Moreover, as the poorer member countries catch up with higher growth rates of GDP, their relative price level also catches up so that their measured inflation rates are higher as well. The relatively poorer member countries thus prefer a tighter monetary policy than that conducted at present by the ECB. The latter's policy is informed by the Euro zone average, which is dominated by the 'old' core (France and Germany).

A similar mechanism is likely to operate when the CEECs join the Euro area. Even if they continue to grow fast, by the time they obtain a seat in the ECB their incomes are still likely to be substantially below the average EU income. If the experience of Portugal, Greece and Spain is any to go by, their growth might actually accelerate once inside EMU, thus lifting the Euro area average a little. This implies that the Euro area of 2006, which will be enlarged with several CEECs, should be more dynamic and could sustain higher interest rates. Both elements, stronger growth and somewhat higher interest rates, should support a stronger Euro. On purely economic grounds the Euro should thus become stronger when the Euro area is enlarged with a number of high growth countries with strong public finances.

It goes almost without saying that EU enlargement without quick entry into the Euro area should not pose significant institutional problems in the EMU domain. he institutional provisions for EMU already provide for the existence of member states with a derogation, and enlargement might anyway take place before all 15 present EU members have joined the Euro area.

However, enlargement may create institutional problems in the EMU area when all candidates have joined the Euro. The Governing Council of the ECB, for instance, would then comprise 33 members (six from the Executive Board of the ECB plus 27 governors from national central banks - including Malta and Cyprus). This issue is similar to the general issues raised by enlargement for the governance of an EU of more than 25 members and in this sense it is not specific to EMU. However, the structure of the ECB allows for a relatively simple solution, as proposed in Bini-Smaghi and Gros (2000). One could just imitate the example of the US Federal Reserve System and limit the number of national central bank governors to nine. A system of rotation, similar to that of the rotating presidency of the EU but with less frequent

changes, could then ensure that all countries participate in determining the Euro area's monetary policy.

We have found that a rapid integration into the Euro area is advisable for most candidate countries, taking of course into account their individual situations. This conclusion runs counter to the perceived wisdom in the EU's financial institutions (national ministries of finance, the Eurosystem, the ECOFIN, etc.) where it is taken for granted that the candidates are 'different' and will need a long period of convergence during which the exchange rate instrument will remain important. We have not been able to find any empirical evidence for this point of view here. The main reason for this might simply be that the CEECs' economies are still involved in a process of transition that causes so many shocks to so many different industries that these somehow offset each other. In this way, convergence will not lead to the kind of *macro-economic* shocks that would justify the use of macro-economic instruments, such as the exchange rate.

It is also often argued that the unfinished transition process leads to large social costs, which would require governments to relax fiscal policies and allow deficits to rise above the Maastricht threshold. But this is not inevitable. Already now, with still considerable adjustment problems to be tackled, deficits in most candidates are close to satisfying EMU norms. Moreover, it is unwise to throw money at adjustment problems, as the experience with sunset industries in the EU has shown repeatedly. EMU membership would thus have the desirable side effect of limiting any attempts to use fiscal policy as a way of delaying unavoidable adjustments.

Our first conclusion is that there is no need to discourage the candidates from their goal of joining EMU as quickly as possible. But the specific situation of the candidate countries raises two systemic policy issues concerning the path towards EMU that still need to be addressed by the EU institutions. Firstly, there is the issue of whether the standard *Maastricht criterion for inflation convergence* will be suitable for applicant countries that are still in the process of catching up with EU productivity levels. After all, this means that they are growing fast and generating high price rises in services. This raises the additional question whether this criterion is still consistent with exchange rate stability. Secondly and more fundamentally, the nature of the transition process in most of the accession countries poses delicate issues of policy judgement over *when, or in what conditions, these countries should join the Euro area fully*. Crucial choices will have to be made regarding the monetary-transitional regimes (accession to the ERM of EMS II [8], or adoption of a Euro-denominated currency board system). The strongest transition economies (such as Poland) may find it advantageous not to hurry in joining the Euro. They would retain some flexibility for their real exchange rate, having established adequate credibility and avoided serious currency instability. On the other hand, in the present monetary environment after the Russian crisis, countries with very weak monetary institutions may push even more strongly and urgently for securing an anchor to the Euro. For these cases the less conventional option of

adopting the Euro unilaterally as the official national currency and using it in cash form (without of course seeking a place on the board of the European Central Bank) might be the appropriate solution. While such Euroisation would formally involve a unilateral decision of the candidates, it is clear that the EU's position towards such a move would be crucial in their choice. It is therefore important for the EU itself to develop a stance on this.

NOTES

[1] It is interesting to note that the so-called Washington consensus is based on the idea that free trade, sound fiscal policies and stable prices are good for any country, independently of its level of development and economic structure. However, while this approach is applied everywhere by the two Washington institutions, the IMF and the World Bank, it seems that some people do not consider it valid for the candidate countries.

[2] Portugal does not have a coast on the Mediterranean Sea, but it is nevertheless usually counted as an honorary member of Club Med.

[3] A similar procedure is being adopted in the case of Greece: a European Council meeting in early 2000 will be based on data from 1999 and Greece would then be able to join almost immediately.

[4] A recent study prepared for the European Parliament provides a somewhat more recent data set with provisional data for 1999.

[5] Although there are many definitions of Seigniorage, we define it here as the savings in interest payments accrued to the government from the privilege of issuing currency. See for details: Bini Smaghi and Gros (2000).

[6] Under such an arrangement, there is a fixed exchange rate peg to an anchor currency, automatic convertibility, a prohibition on domestic credit creation by the central bank and a long-term commitment to the system, often spelled out in the central bank law. Credibility is ensured by sufficient backing of foreign exchange reserves to cover all monetary liabilities, a sufficiently restrictive fiscal policy based on broad political support (to avoid speculative attacks) and a healthy financial system or a readiness to let weak banks fail (European Parliament 2000). The CBA has a mechanism that automatically reacts to foreign exchange inflows and outflows through changes in the money supply which result in interest rate changes.

[7] Ecuador, a dream basket case, has recently started to implement a plan to fully dollarise its economy.

[8] We have assumed that enlargement is not delayed by intra-EU difficulties. If it were, one would also have to address the question whether a *modified pre-accession ERM* could be offered to those countries whose convergence record is very good, (including capital market liberalisation), but whose formal EU membership have delayed for reasons outside their control (delay in ratification in EU).

7 BUDGETARY TRANSFERS IN AN ENLARGED EUROPEAN UNION

7.1 INTRODUCTION

EU enlargement will have a profound impact on traditional EU behaviour towards budget financing. The present net contributors will increase considerably their budgetary outlays, while net beneficiaries will loose considerable benefits and even risk joining the group of net contributors. If, as of today, the CEECs would be EU members, applicant countries in the first group[1] would now pay three per cent of the total contribution to the EU's GNP, and those of the second group[2] less than 0.1 per cent. With an area and a combined population of roughly a third of the EU, the balance of costs and benefits for the EU-15, *as far as budgetary transfers are concerned*, thus risks being highly negative and contentious. Would the budgetary resources for transfers not be increased to the extent required by today's criteria applied in today's EU-15, then enlargement would imply a lowering of the cohesion ambition for the larger EU. Of all the political problems bound to arise, this is the most fundamental one.

The present chapter analyses the origins and nature of these problems and their potential solutions. It begins by discussing the development of the budgetary issue and the behaviour of the Member States towards intra-EU transfers in section 7.2. Subsequently, the results of the reforms agreed at the Berlin European Council of March 1999 are examined (in section 7.3). It continues by presenting several scenario's for the likely implications of enlargement on the EU budgetary and net balances positions for 2006, after accession of the first five candidates (Czech Republic, Estonia, Hungary, Poland and Slovenia) and the additional effects by the year 2010 of the second group of five candidates (section 7.4). These scenario's show that continuation of the present policies is bound to push the EU into a crisis situation. Therefore, after briefly discussing the policy rationale of budget transfers to the CEECs (in 7.5), alternative strategies are presented for reforming the CAP and the Structural Funds to the needs of an enlarged EU (7.6 and 7.7). The main conclusions and recommendations of this chapter are summarised in section 7.8.

7.2 THE EU BUDGET: A HISTORY OF GROWING POLITICAL TENSIONS

The Single European Act (SEA) of 1987 introduced a new article that codified social and economic cohesion as formal objectives. It gave the EU budget a crucial role in the European Community's integration process (Stackleton, 1990). However, with its growing size and distortiveness, what was once a building block has increasingly become a stumbling block (Laffan 1997). As we will explain below, the budget's imbalances are partly the result of its particular policy mix and partly a consequence of existing differences in economic structures among EU Member States.

The EU's budget is dominated by expenditure on agricultural and structural policies. Both policies give rise to conflicts about eligibility and distribution. The Common Agricultural Policy (CAP), originally created to suit the needs and the objectives of the Community of Six, has grown into an open-ended spending spree that is badly targeted and distortive. It mainly benefits the larger, more prosperous farms (often in more prosperous regions) and it supports some products substantially more than others. This has caused a perverse distribution of funds (see Annex 4, plotting for 1996 and 2006 a *positive* correlation between funds received and farm value added).

Since the 1980's, disputes over the CAP's financial structures have compounded policy complications. In 1984, the United Kingdom obtained a rebate on the budget, to compensate for the smaller size of its agricultural sector and its particular trading pattern and VAT rate. Four years later, growing budgetary problems prompted the introduction of a milk quota system. Subsequently, in 1992 and 1999, the Commission also imposed tighter budgetary controls. However, while these reforms have reduced the fluctuations in expenditure levels, the agricultural budget has steadily increased. The reason is that farmers are given compensation payments in exchange for reductions in intervention prices.

Compared to the CAP, the EU's structural policy is fairly coherent and effective. Its main aim is to reduce interregional disparities and ensure a harmonious cohesion process in the EU by promoting regional and national economic development and efficiency. Thus, its long-term target is to 'emancipate' underdeveloped regions up to a level where they no longer need financial support. However, the multiplication of funds under the SEA has prompted increasingly serious disputes between net beneficiaries and the net contributors. In particular, the logic of paying Cohesion Funds to the Southern Member States has received widespread criticism.

According to article 269 of the Treaty, the budget should be financed entirely by the EU's 'own resources': customs duties, agricultural levies and a proportion of VAT of one per cent in the Member States. However, with expenditure on agricultural and structural policies constantly rising, upholding this requirement became increasingly difficult. In the end, shortages in the own resources had to be covered by a fourth resource, based on the GNP shares of the Member States. This is by now the EU's largest budgetary resource.

The 1990s were a time of transformation in the debate on the European budget. The EU entered a difficult period through a combination of weak economic growth, globalisation and political turmoil after the fall of communism, German Unification and transformation crises in Eastern Europe. Negotiations on the Delors II package reduced the ceiling on expenditure from 1.37 per cent of GNP to 1.27 per cent. The best reform would have been to increase agricultural policy efficiency by cutting its costs. However, it is one of the EU's paradoxes that whereas net contributors to the budget complain about its size and about their 'net' balance,

they still tend to refuse drastic CAP reforms that would substantially reduce the budget. This is because the CAP favours larger farms and more 'Nordic' products disproportionally. Agricultural cuts thus reduce the net contributors' receipts from the EU budget. Moreover, since all net contributors have important and politically active farm lobbies, a reduction of CAP expenditures is politically unpalatable.

The EU's decision-making process aggravates this problem. As Scharpf (1988) has discussed in more detail, the Council of Agricultural Ministers fosters the *status quo* on the CAP. Formally, a reform in agricultural policy requires at least a qualified majority in the Council. In practice, however some Member States have more power than their official share in the votes; France and Germany have generally possessed close to a veto on many issues, the CAP being a notorious case in point (Webber 1998, 1999).

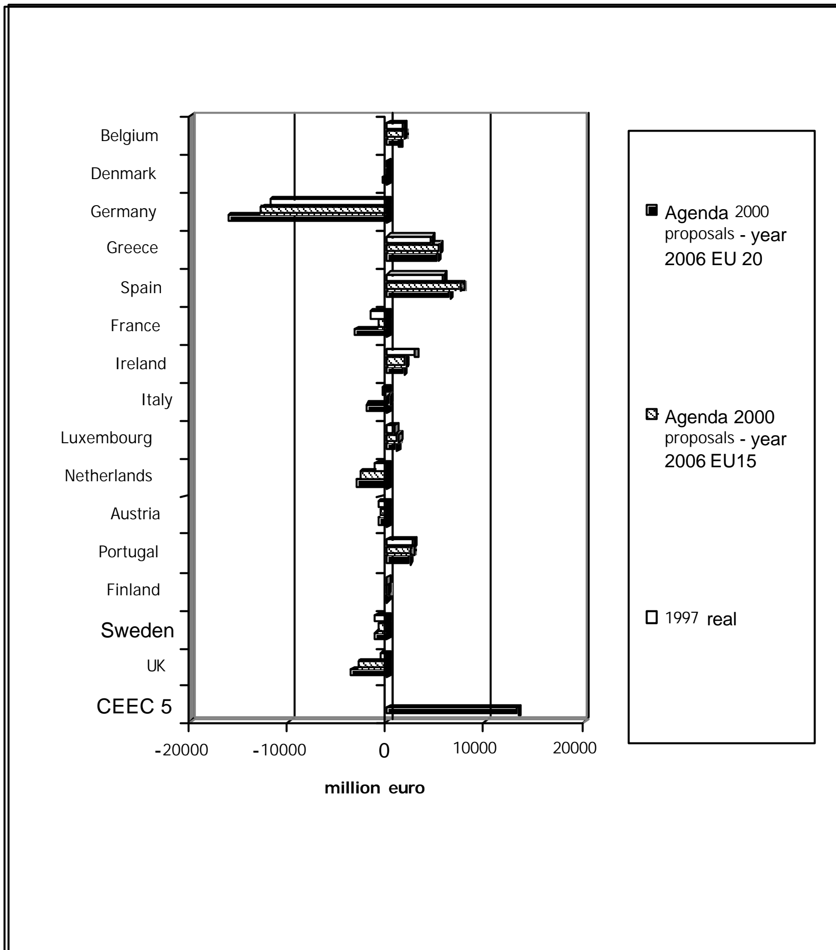
Against this background it is not surprising that the Commission's initial proposals for a future financial framework after enlargement were so controversial.[3] Set out in the so-called Agenda 2000, they aimed at preparing the Union for enlargement and at improving its negotiating position in the WTO talks. For agriculture, they suggested continuing the reform path taken by MacSharry in 1992. This implied substantial further cuts in the institutional prices for cereals, arable crops, beef and milk, compensated partially by direct payments to farmers. A 'horizontal' regulation introduced cross-compliance with environmental conditions, modulation and degressive direct payments to farmers. It also suggested changes in the financing of agriculture and introduced a system of support for rural development. For the Structural and Cohesion Funds, the Commission proposed to concentrate expenditure much more on smaller areas within the EU and to reduce the number of policy objectives and initiatives. Excluding the amounts set for the acceding Member States, the EU-15 were expected to spend 32 billion Euro more during the programming period.

Mainly as a result of these planned CAP reforms, the financial framework for the EU-15 (Commission, 1998h) presented an important real rise in budget expenditure. Although still below the ceiling of 1.27 per cent of GNP, it would have worsened balances of the net contributors. (Figure 7.1[4] shows an estimate of the net balances in 2006 for the EU-15 and an enlarged Union, compared with the year 1997 [5]. This expenditure, combined with the expected (and to some extent unpredictable) extra costs of enlargement, worried the net contributors considerably.

At the start of the Agenda 2000 negotiations, four net contributors (Austria, Germany, the Netherlands and Sweden) proclaimed their budgetary burden to be excessive. This movement culminated in a proposal by the Austrian Presidency to reform the own resources system in order to correct these excessive net balances.[6] It suggested introducing a generalised correction mechanism similar to the UK rebate system. However, after Spain threatened to veto the final EU summit in Vienna, this proposal quickly disappeared from the table. Thus, the negotiations

for Agenda 2000 plainly illustrated that EU Member States were not ready to accept the consequences of enlargement.

Figure 7.1 Net balances in 1997 compared with the Agenda 2000 proposals in the year 2006 (1999 prices)



Data source: Annex 5

During the subsequent negotiations under the German Presidency, new proposals for budgetary rebate were tabled, as well as several other measures for reducing the budgetary burden. These measures included:

1. Changing the budget own resources system by scrapping the VAT resource and only keeping the traditional own resources (TOR) and the GNP resources;
2. Introducing a correction mechanism for 'excessive net contributions' for Member States; [7]
3. Renegotiating the British budget rebate;

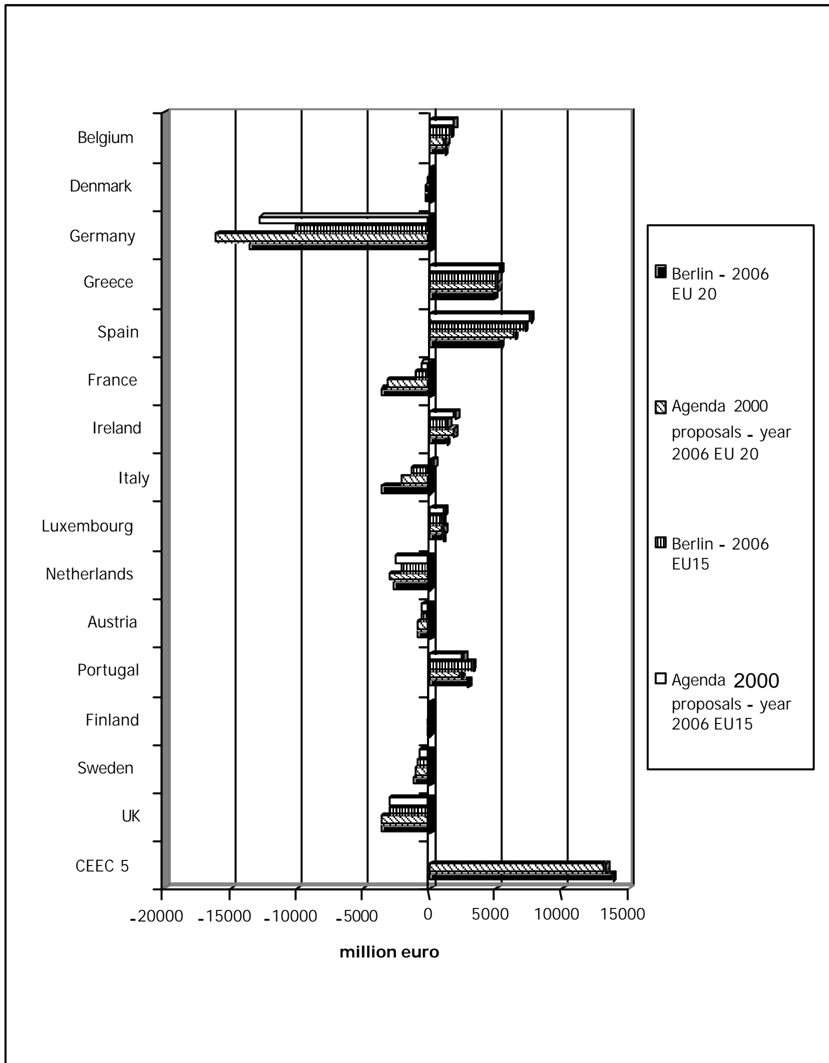
4 Co-financing direct payments to farmers;
5 Phasing out Cohesion Funds for the Member States that have entered road towards the single currency;
6 Reducing or limiting Structural Funds expenditures;
7 Imposing a ceiling on agricultural spending of an annual average equal to the expenditure for 1999 (40.5 billion Euro) for the period 2000 to 2006.

Since Núñez Ferrer and Emerson (2000) have discussed these negotiations elsewhere in greater detail, their course and outcome will be summarised only briefly.

The enlargement problem was overshadowed by a fabricated budgetary problem of ‘excessive’ net contributions. Fabricated, because the underlying problem resides in the inefficiencies in the expenditure side of the budget, which some of the net contributors themselves refused to change. The predominant view swung against agricultural reforms. The only countries calling for a radical and urgent change were the UK, Sweden and Italy, forming the so-called 'London Group'. However, there was no clear common position. Italy's commitment to reform was particularly unstable due to its interest in a milk quota settlement. This and other similar weaknesses soon eroded the coalition. Other hidden agendas on the net contributions affected the UK’s and Sweden's resolve for a reform.

As a result, the Berlin agreement of March 1999 was highly unsatisfactory. The final package agreed was to a certain extent similar in structure to the original Commission proposals. France gave the *coup de grace* to the Agenda 2000 package by further reducing the CAP reforms and by delaying the reforms of the milk quota system to a period probably after enlargement. In fact, by reducing agricultural expenditure only cosmetically, it became politically easier for Spain and the UK to harden their stance on the Structural Fund reforms and the rebate. Since France and Germany had not made any significant concessions on agriculture, neither country accepted fundamental changes on the funds and the rebate.

Figure 7.2 The Agenda 2000 proposals compared with the Berlin outcome in the year 2006, EU-15 and EU-20 (1999 prices)



Data source: Annex 5 and 6

Figure 7.2 shows the (simulated) results of the negotiations on net balances. However, these results are misleading. First, the outcome of the Berlin European Council assumed that CEECs were not eligible for the direct payments of the CAP. Second, the financial framework resulting from the Summit assumes that the (five) candidates will accede in 2002 and will still be in a transitional period by 2006. The actual impact of enlargement on the EU's budget will therefore be different. Delaying enlargement to 2003 or 2004 will reduce its impact on expenditures in 2006. However, the ultimate impact will be much larger, due to the expected

introduction of direct payments to the CEECs, the further rise in Structural Funds and the delayed completion, in 2008, of the milk reforms.

7.3 THE BERLIN REFORMS AND THEIR EXPECTED CONSEQUENCES FOR THE EU-15

Let us now look at the Berlin reforms and their expected consequences in more detail. Officially declared a major success, the reduction in CAP expenditures is more fictitious than real. The 'reformed' CAP is less expensive than that proposed in the original Agenda 2000 because reforms were largely postponed. Ironically, once most reform delays are over, our estimates of the agricultural budget expenditures for 2006 approximate the levels originally planned in the Commission's financial framework. Expenses would reach similar levels after 2006, but without the same depth of reform. Put differently, the CAP's burdens are shifted to a next generation, and they will be aggravated by enlargement.

The CAP reform is based on the assumption that enlargement will not entail any direct payments to new members. Originally published in the Madrid Summit's White Paper of 1995, this view already proved unsustainable by 1999 (Buckwell et al., 1995; Münch, 1998 and many others). Today, the EU's Commissioner for agriculture even openly admits this. One estimate by Münch suggests that the total cost of these direct payments would reach approximately 6 to 7 billion Euro (Münch 1998).

Price cuts for cereals, and consequently also the size of direct payments, have been reduced. In addition, the mechanism for annual cuts in direct payments has been abandoned. Milk reforms have been postponed until 2005, while the milk quotas were immediately increased for various Member States. Not only does this exacerbate the EU's existing expenditure problems, it will also further compromise the Union's international commitments in the field of agriculture.

There are many valid arguments for denying direct payments to CEECs. The Commission (1996) lists several which still hold today. However, most of these could also apply to current Member States. In addition, CAP regulations fail to give any legal basis for denying direct payments to some countries (see Buckwell and Tangerman, 1999; Moehler et al, 1999; Brenton and Núñez Ferrer, 1999; Núñez Ferrer and Emerson, 2000). It also stands to reason that reforming direct payment levels and criteria after accession of the first group of six applicants (including Cyprus) would be very difficult. After all, the ministers of the CEECs will be present in the Council, and the number of decision-makers will have risen to 21.

The milk reform has been postponed again, until 2005, because immediate reforms were considered too costly. What will this mean? First and foremost, it

reduces CAP expenditures for the period up to 2005. The milk quota reform is now scheduled to take place one year after the accession of the first group of CEECs. Unfortunately, this may imply that the CEECs will first have to adopt a highly complicated milk quota regime and then participate in its reform. Thus, if quotas are not abolished or reduced before enlargement, the regime may become very costly indeed. Moreover, if the CEECs implement the quota system and also guarantee high milk prices, their farmers have every reason for claiming direct payments as soon as the EU wants to reduce these milk prices. There will then be no getting round the compensation problem.[8]

Reforms of the own resources were aimed at correcting 'excessive' net contributions (as well as reducing 'unfair' benefits). To this end, reductions were scheduled of the VAT call rate to 75 per cent by 2002 and to 50 per cent by 2004. For traditional own resources, the percentage retained as the share of so-called collection costs will be increased from 10 to 25 per cent. The system for financing the UK rebate by the other fourteen Member States has been altered in an ad hoc fashion. It has reduced the rebate contributions of Germany, the Netherlands, Austria and Sweden to 25 per cent of the unadjusted amount. The UK rebate itself has remained practically untouched. It is thus fair to conclude that the rebate reform is yet another corruption of the EU's financial system. Firstly, rather than reforming imbalances on the expenditure side, Member States have introduced complicated and questionable rebate systems. The new ingenious 'rebate on the rebate' for example has no clear theoretical foundations, shifts the budgetary burden to poorer regions and merely accentuates the Union's transparency problem. Secondly, the rebate's effectiveness is highly questionable, because the increase in expenditures due to enlargement will affect net contributions to such an extent as to make rebates insignificant. (See table 7.1, which compares the results of the rebate system inside the EU-15 in 2006, with an enlarged Union of 20).

Table 7.1 The effect of the rebates for net contributions, EU-15 and EU-20, million ? (1999 prices)

	Net balance Berlin outcome, old mechanism, EU-15 – 2006	Berlin outcome EU-15 – 2006	Berlin outcome EU-20 – 2006	Year 2010, potential balances (1)
Germany	-11366	-10071	-13529	-15881
Netherlands	-2569	-2164	-2782	-3413
Austria	-787	-653	-998	-1213
Sweden	-960	-843	-1215	-1439
UK	-2736	-3007	-3673	-4025

(1) This is a potential scenario (scenario 2) presented in section 7.4. It represents a maximum expenditure case (Tables A18 and A21 and A22 in Annex 7).

For Germany the rebate reduced the net contributions in the EU-15 by 1,4 billion Euro. This is assumed to stay valid in all scenarios. Without a strong reform of the

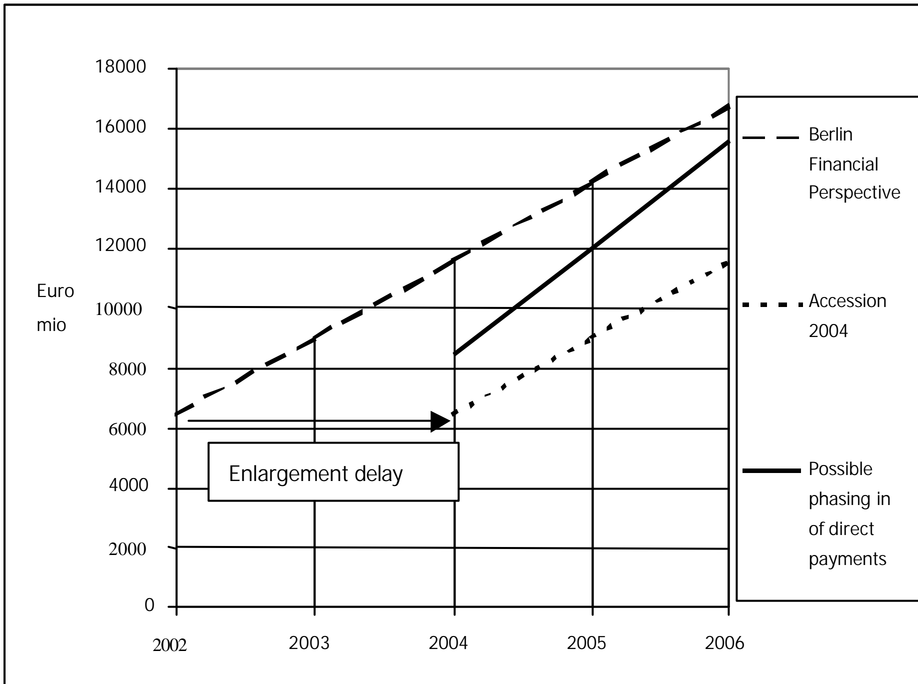
Union, the rebates will remain in place. It is clear that a rebate that is based on the British rebate has its limits. The rebate for the net contributors will increase after enlargement, but this increase is relatively small compared to the increase in contributions. The UK has also to deduct its advantage (see technical annex 8) and the rebate from expenditures that were previously earmarked for pre-accession (and that will change into items of enlargement expenditure). It has been assumed that the UK cannot demand a rebate on the EU's two billion Euro worth of new expenditures.

7.4 THE AGREED EU BUDGET AND ENLARGEMENT

What can we say about the realities of a budget in an enlarged EU of 20 or more members? There is no doubt that solutions can be found, even though the Berlin summit outcome has complicated future negotiations for enlargement and reform quite considerably. Basically, the EU has three options. The first would be to avoid reforms, continue with the present policies and 'squeeze' through the enlargement. The second would be a fast and thorough reform of the way the union works, from the budgetary expenditure side to the institutional framework. The third option would be to delay indefinitely or block enlargement altogether.

The analysis presented here is primarily concerned with the consequences of the first option, since this is the most likely scenario under the current circumstances. Postponing enlargement to 2004, for example, will free enough financial resources annually to allow generous transitional transfers to the CEECs for direct payments. If the first year of enlargement is assumed to cost an amount similar to that scheduled for 2002, then an enlargement in 2004 will have a five billion Euro margin. The financial framework agreed in Berlin allocates eleven billion Euro in 2004 to enlargement, five billion more than the amount planned for 2002. Figure 7.3 shows this effect.

Figure 7.3 Effect of a delay to 2004 of the enlargement



The research presented here focuses on a way to avoid a future budgetary and political crisis by introducing reforms *before* enlargement. Two scenarios are examined, both assuming that present policies will continue and that in the negotiations for the next financial framework for 2006-2012, most variables will remain untouched. The latter assumption is based on the expectation that an EU of twenty countries (or, including Cyprus and Malta, of 22) will not agree on any reforms for agriculture and Structural Funds that would reduce the benefits just agreed a year or two earlier. After all, the new Member States will be undergoing a transition period in which they will adapt their own policies to fully reap the benefits of the EU's CAP and Structural Funds. Cutting these benefits will thus be unacceptable to them. In both scenarios, the CAP will therefore continue very much as it is, and it will implement the milk reforms proposed in Berlin for 2005-2008. It is assumed that the CEECs will be eligible for all direct payments in agriculture. The cost calculation for the EU's dairy policy are rather rough, since it is neither clear what the intervention costs will be nor to what extent the CEECs will benefit. It is also assumed that the CEECs will receive direct payments and so-called national 'envelopes' for dairy cows.

The Structural Funds are a crucial variable. EU regulations specify that regions with a GDP per capita below 75 per cent of the EU average are eligible for support under the so-called Objective 1. With enlargement, the EU average GNP per capita

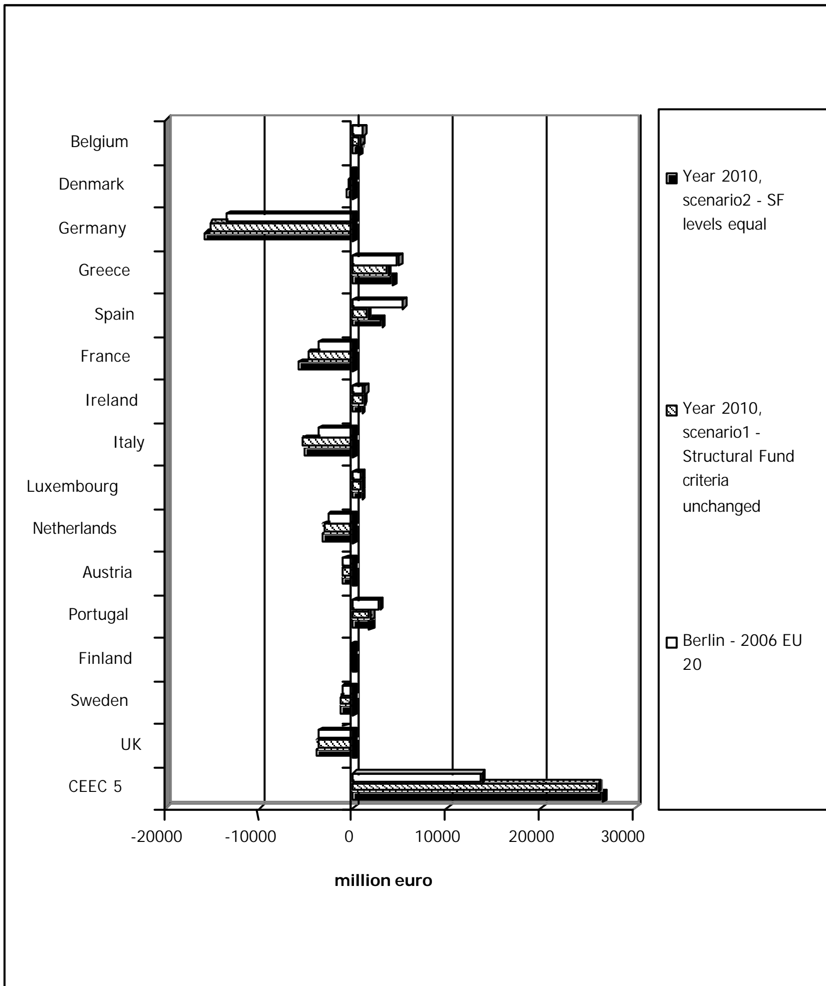
will fall. Using the latest data available from Eurostat[9] and assuming a real growth of four per cent in the applicant countries, the average real GDP per capita in 2006 for the EU will be seven per cent lower. Potentially, this may eliminate all regions with a GDP per capita over 68 per cent of *today's* EU average[10] from the range of Objective 1. This could have important repercussions for the present Member States, since most regions in the CEECs will be eligible. It is in this respect that both scenarios differ.

Both scenario's assume that Cohesion Funds are all phased out by 2010. The first scenario shows the impact on the net contributions and the size of the budget of a continuation of the present policies *without* a change in the rules of Objective 1 eligibility. The losses in Objective 1 funds are replaced by Objectives 2 and 3 at a third of the value. The second scenario shows a situation in which *the present 15 Member States maintain their level of receipts*. To see the medium term effect of a continuation of the present policy, both scenarios are calculated for the year 2010. The results are depicted in Figure 7.4, Table A18 in Annex 7 shows the data.

The consequences are clear. Continuation of the present policies is bound to push the EU into a crisis situation. Particularly important is the relatively small effect on net contributors, if the eligibility criteria for Objective 1 of the Structural Funds remain unchanged. The biggest shock is on the net beneficiaries, especially on Spain, which has the largest number of Objective 1 areas with GDP per capita levels above 68 per cent. Politically, this scenario is unsustainable since Spain will do everything in its power to protect its receipts. A collapse in the net balances by one third or even two thirds (for Spain) is therefore bound to provoke a strong response.

A coalition of Cohesion countries may well force a solution that will help maintain the levels of receipts, e.g. by increasing the threshold of GDP per capita to 82 per cent of the EU average, thus neutralising the effect of that change on the average. The net contributors would bear the brunt of this outcome. Politically this would lead to a stalemate, plunging the EU into a crisis. Here, Spain also poses a problem. The loss of Cohesion Funds and the rise in GNP contributions as it grows richer, causes it to pay more for enlargement. The Spanish borderline case is thus difficult under any angle. The political atmosphere will be tense, precisely because there is such a strong element of zero-sum gain politics in these scenarios. Moreover, the deterioration in the net contributions of Italy and France will become serious enough to raise yet another net contributors' problem.

Figure 7.4 Scenarios 1 and 2, year 2010 – compared with the Berlin financial framework year 2006 (1999 prices)



Data Source: Annex 7

The picture shows how politically crucial the issue of enlargement really is. The budgetary costs are substantial. The Berlin European Council has made it impossible to limit transfers to the CEECs by its inability to reform the CAP's direct payments. The Structural Funds expenditures are also sizeable. Assuming these reach the four percent limit of national GDP agreed in Berlin, the expenditures in the CEECs could potentially rise to eighteen billion Euro for the first group of applicants. The combined extra expenditure for the CEECs could well be over ten billion Euro on top of the sum of seventeen billion Euro envisaged in the financial framework for enlargement in 2006.

An even bigger problem is the introduction of five new members into the future negotiations on the EU budget. The new members will be major net beneficiaries of the EU budget. Since a timely opportunity to revisit the transfer system was missed, present net contributors and net beneficiaries are certainly going to be hit by the enlargement beyond the line of political acceptability. Furthermore, there is the question of the second enlargement. Even if this one seems distant at the moment, it might well take place before or by 2010, i.e. shortly after the end of transition periods of the first five CEEC entrants. This will bring a second round of similar problems. Most likely, the countries opposing a further enlargement may well be the new Member States. They will be worried by the loss of their newly obtained benefits. If they join forces with some cohesion countries, pressure against the second enlargement will be strong, and another crisis might be looming.

7.5 THE RATIONALE OF EU BUDGET TRANSFERS TO THE CEECS

The preceding sections discussed the political problems of introducing the CEECs into the EU's transfer system. They clearly show that Member States have neglected the 'how and who' of transfers. However, another equally relevant dimension to the transfer issue is that of the policy rationale for transfers to the CEECs. One of the points to bear in mind is that the problems related to the Structural Funds and CAP transfers for the CEECs are neither new nor purely related to enlargement. Policies inherit their faults and inefficiencies from the present EU-15. The main problem enlargement adds is that the EU will increase considerably its area of disadvantaged regions. By introducing its own policies in the CEECs, the EU will exacerbate the weaknesses already present. Most of the problems in the CEECs are in fact quite similar to those in other low GDP regions in the EU. The exception to this is the environmental problem, which is much larger in the CEECs than in the EU.

The main challenge for the EU, as far as transfers are concerned, is to increase the three 'E's' – economy, efficiency and effectiveness – of its policies. The old balance of power that led to consensus on the single market and EMU through side payments, is becoming unsustainable. Enlargement will certainly widen the cohesion process, but it may lose depth if the cohesion funds are diluted. If the EU wants to widen the cohesion process to the CEECs, there are basically only two ways open: increasing expenditure proportionally to the increase in coverage while protecting expenditure levels in current cohesion regions, or improving policy efficiency. The latter option, as we will argue below, is the more attractive of the two. It would allow some reduction in expenditure at the regional level while maintaining the speed and depth of the cohesion process.

7.6 ADAPTING THE COMMON AGRICULTURAL POLICY TO ENLARGEMENT

It is elementary yet still far too easily accepted as 'unavoidable' that the CAP is an inefficient policy both for the existing EU-15 and for the newcomers. Introducing this policy in the new Member States would cause severe distortions at all levels, sectoral and national. The solution to these problems lies neither in attempts to exempt the new members from direct payments nor in the introduction of transition periods. The first option represents a futile attempt to maintain the CAP's benefits for the present 15 while avoiding politically problematic transfer of funds by imposing a costly policy on new members. The second option only postpones these problems, and does nothing to solve the underlying issues.

The price support system and the set-aside schemes (which, due to insufficient price reforms are still not completely decoupled) will introduce incentives to intensify production. Intervention buying (a budgetary expenditure) will increase as a result of the combined effect of price protection and structural transformations [11], unless world prices stop declining. However, hoping for higher world market prices (or for a further weakening of the euro) can hardly be considered an enlightened policy position.

Direct payments are also a bad policy for the CEECs. This policy was introduced to stabilise the budget in the EU-15 and to compensate farmers for the reduction in intervention prices. Both during the negotiations for the MacSharry plan and the Agenda 2000 reforms, policy makers failed to define the eligibility criteria for the funds in a proper manner. As a result, the direct payments boil down to open-ended handouts to farmers in exchange for production restricting set-aside schemes. As these regulations stand, the CEECs would become automatically eligible to such payments. Yet this policy is bound to be both distortive and inadequate for the new members (see Commission, 1996; Buckwell and Tanger mann 1999). This should not be interpreted as implying that the agricultural sectors in the CEECs should be deprived of the levels of support enjoyed by their richer western counterparts. Farmers in Central Europe probably need at least the same level of support. However, for various reasons, direct payments are bad instruments for fostering restructuring or even for supporting farm incomes efficiently. Firstly, they push up some farmers' incomes to levels that are excessive compared to those of the non-farming population. Secondly, they sharply increase land prices in favour of landowners and to the detriment of tenant farmers. Thirdly, they arbitrarily affect the choice of agricultural products since protection is not equal across products. This will probably result in a large switch to highly protected products. Therefore, expenditures in areas suffering from the typical problems facing the agricultural sector in CEECs should be targeted much more at restructuring and at low income farms. In a very clear, detailed and balanced report, a group of external experts for the Directorate General for Economic and

Financial Affairs has discussed such viable, long-term solutions at length (Commission 1998).[12] The reform proposals presented below are inspired by their work.

The present system of direct payments, based on the principle of price compensation, should be decoupled from production and should not be available to any farmer entering the market after this reform. This eliminates the problem of eligibility to farmers in the CEECs. These direct payments should also be phased out and replaced by a system of support, which is also applicable to new Member States. Production decisions and set-aside areas should be voluntary and based on market conditions. This would bring the EU's direct payments in line with the WTO's so-called 'green box' rules. New de-coupled payments should be 'Green Payments' linked to improved environmental farming techniques, or 'Structural Payments' linked to better living conditions, infrastructure, alternative employment, cultural heritage preservation, etc. in rural areas.

A greater share of the CAP budget should therefore be directed to rural development programmes. Farming is not the only activity in rural areas. However, it is the lack of other services and activities in these areas that, in the decades to come, will increasingly foster depopulation and degradation. These programmes can create alternative occupations for people retiring from farming. The CAP should therefore officially start addressing these problems, perhaps under another title or with separate funds. Apart from the compensatory payments, which are phased out, all funds should be available for the CEECs after accession. Export subsidies should be abolished and intervention prices should be set low enough to ensure that this policy is sustainable. All these changes are important for the EU, and crucial for the CEECs.

The latest evaluation of the Agenda 2000 reforms suggests that the EU will face severe problems if it maintains subsidised export limits for dairy products (Commission 2000a). The quota system will damage restructuring of this sector, especially in Poland. Moreover, quotas may be very difficult to keep as producers increase their efficiency. Therefore, the system of milk quotas should preferably not be introduced in new Member States. This requires the elimination of the quota system in the present EU-15. While this seems politically difficult, an effort in this direction should be seriously considered.

Enlargement is now nearing and the negotiations for agriculture have officially started. For the negotiators, it is said to be 'inappropriate' to reform the CAP at this stage. This, however, is at best a half-truth since the negotiations deal with an acquis that is unclear. It does not provide a clear position on direct payments, for example. Thus, if the EU wants to avoid serious misgivings within the CEECs that may even hamper treaty ratification later on, it should reform policies while the entry negotiations are still in full flow.

Reforms require a parallel transition period in the EU and the CEECs. Both transitions should eventually result in a common policy by the year 2010 and an overall expenditure at or below present levels. This might seem ambitious, but it still falls short of what is probably needed for the second rounds of enlargement, in which Romania's agricultural situation will create even more problems than that of Poland.

7.7 ADAPTING THE STRUCTURAL FUNDS TO ENLARGEMENT

The EU has a number of eligibility criteria for the use of Structural Funds. Expenditure programmes are selected on a project basis, leaving the EU quite a large freedom to choose its structural support goals. In this sense, the Structural Funds criteria can be assumed to be as well or as badly targeted for the CEECs as they are for the present Member States. Still, the CEECs have some particular characteristics and needs that are more poignant. In an extensive review, the Commission has tried to address their spatial development needs (Commission, 2000b). Most of the ideas formulated below originate from this document. Before embarking on an analysis of the rationale of the expenditure needs, however, two points are worth stressing. Firstly, most applicants need to create new structures, both at the national and regional level, to absorb the EU's large support flows. Central governments often resist such new structures for the regions. Secondly, EU Member States have thus far failed to reach the necessary consensus to adapt their policies and to change their decision-making system for regional aid.

The Commission report (2000b) analyses the national and regional resources that determine the CEECs long-run development potential. This research is based on a *potentiality factor approach* (Biehl 1986,1991). The idea of this approach is simple. It determines the development potential of countries or regions by looking at geographical, agglomeration, sectoral and infrastructural factors. The Commission's document gives some first indications on the potentialities and problems in the CEECs. Unfortunately, data problems do not allow for an analysis that is as comprehensive and detailed as that done for the present EU countries, but they do allow for setting guidelines for EU support targets. After all, efficient targeting of support is a must, both for the CEECs and for the EU-15.

While the problems facing the CEECs are similar to those of the present Member States, their intensity differs considerably. The Unions' heterogeneity after enlargement is thus a serious issue. Firstly, quantitative and qualitative infrastructure endowments are much lower in the applicant countries than in the EU. This has the crucial economic consequence that an infrastructural investment of a certain level in the CEECs will have a lower impact than a comparable investment in the Member States. The reason is that investments in infrastructures and services require careful co-ordination, since there are strong complementarity effects. Thus, composing a balanced package of measures is crucial. Secondly, there is a

strong need for managing natural resources and cultural heritage as important elements in an integrated sustainable development strategy. The accession countries possess large unpolluted natural areas on the one hand, and areas with heavily concentrated polluting industries on the other hand. Regulation alone is therefore not enough. Furthermore, since the heavily polluting industries were initially all state-owned, their re-conversion, when economically sensible, has to be funded publicly. The financial burden of these measures will be very high, whereas the national budgets of the applicants are very small. The EU will thus play a crucial role in funding this re-conversion. The Commission has already warned that this financial burden should not be used as a justification for allowing environmental problems to linger on. Several of these problems create negative externalities across national borders, creating the unacceptable side effect of 'eco-dumping'.

The Commission's report stresses the need for a co-ordinated cross-border development strategy using measures similar to that of the INTERREG programmes. Structural policy should also concentrate on the development of well-structured and managed regional authorities, which can organise the implementation of projects. In addition, support programmes have to take into account the development potential of regions and the factors determining utilisation rates. Moreover, since the development needs are so large and so structural, the EU has to be prepared to commit itself to sizeable, long-term investments.

7.8 CONCLUSIONS AND RECOMMENDATIONS

This research has pinpointed the main problems and contradictions of the EU budget. Unless the EU's system of distributing resources and its underlying policies (notably the CAP) are drastically reformed, these problems will only grow with enlargement, and they will culminate in a political crisis. Net contributors and the present net beneficiaries risk losing considerably. While the first group of applicants might still be allowed to 'squeeze' through without reforms, this is hardly possible for the second group.

One could argue that there is no reason to enlarge, since the EU has no obligation to take on new members. This is formally correct. However, it is worth realising that the EU's main reason for existence has been, and still is to create and preserve stability in Europe. Similarly, the rationale behind the present enlargement is *not the transfer of money to the CEECs nor the introduction of milk quotas or any other agricultural policies, but the preservation of stability in the new Europe*. At present, the EU has not brought its policy priorities in line with this rationale. To put the point more poignantly: can Poland only participate in the EU's common foreign and security policy if it also introduces the EU's highly inefficient and distortive system of milk production controls? This question by itself demonstrates how unreasonably influential the CAP's role really is within the *acquis commun-*

autaire. It seems utterly misplaced that an inefficient agricultural policy that benefits a very small group of (mainly rich) farmers, receives about the same policy attention on the EU agenda as the political and economic stability of Europe.

The EU's system of financial transfers lacks transparency and objectivity. Its largest part, the expenditure related to the CAP, damages the processes of integration and enlargement. Therefore, it is proposed here to reform both the CAP, the Structural Funds and system of own resources. New reforms in the EU should be negotiated before the first enlargement. A failure to redress these shortcomings before enlargement would require reforms with over 20 members taking part in decision-making. Reforming an enlarged EU whose new members are undergoing a difficult economic transformation will only render this process more difficult. Indeed, the chances of another crisis, this time *with* some candidates in as members, are very real. Furthermore, a larger Union with obscure and unclear expenditure systems, corrected by even more obscure and blurred rebate systems, will reduce citizens' confidence in EU institutions. For this reason, renegotiating these issues *should start before the next financial framework* for 2006 to 2012. *This means that proposals should come forward in 2001 for decisions to be taken in 2002*.

CAP support should be de-coupled from production. Food safety and quality, the protection of the environment and of cultural heritage as well as the establishment of alternative activities in rural areas should become the foundations of support, whether financed by CAP funds or in new funds. The CAP should thus cease to be a system to foster intensive production.

The Structural Funds have clearer targets and coherent aims, and they lack the fundamental flaws inherent in the CAP. Their effectiveness can be improved without deep reforms. Thus, some criteria (such as the special eligibility criteria of a population density under eight persons per square kilometre and some other special concessions in Objective 1) should be revised. However, p*roblems of absorption capacity and the quality and selection of projects* are the real issues.

For the CEECs, very large investments will be inevitable for a long time. Structural Funds will have to be particularly well co-ordinated to cope with a large number of problems. It is important to focus on the need for long-term sustainable growth in general, and the creation of infrastructure and environmental protection in particular, two areas in which the applicants' problems are more severe than those of the present EU-15. The EU has to put more emphasis on the effectiveness and efficiency of structural funding, to ensure that the depth of the cohesion process is not damaged due to the expected fall in the budgetary funds available per citizen as EU finances will be stretched.

The continuation of the Cohesion Fund is more questionable, since it lacks economic rationale. Here it is proposed either to abolish this Fund for members of the

EMU or to abolish it altogether, unless the new Member States are given the option to apply for Cohesion support when they want to join the EMU.

The own resources system should be revised to reduce the lack of transparency. In addition, *budget imbalances should be targeted at source*, i.e. in the expenditure not in the own resources side of the budget. *The rebate systems should be abolished.* This can go hand in hand with reforms in the expenditure side. Agricultural policy changes should greatly reduce imbalances and therefore invalidate any arguments for rebates. The overall budget expenditure on agriculture should also fall if the funds are distributed on the basis of better-defined and better-targeted objectives.

It is recommended to move to a budget based solely on customs duties/levies and GNP keys. The elimination of the VAT resource should be completed. This would also further facilitate the elimination of budget rebates. Although this is not in the spirit of the own resources notion of Article 269 of the EC Treaty, it is the best available solution given the present incomplete harmonisation of indirect taxation.

It is important for European citizens to see that the EU possesses coherent and clear policies capable of responding to new challenges in an organised and competent manner. However, Member States' continuing dispute over net budgets and rebates is evidence to the contrary; it fuels dissatisfaction with the Union's performance. Unfortunately, the Berlin European Council has shown that as far as the budget is concerned there is still very little political will among the Member States to put their weight behind redressing the budgetary distribution criteria.

A serious problem underlying these issues is the EU's decision-making process, which is completely overshadowed by national interests to the detriment of policy effectiveness and rationale. The increasing heterogeneity of interests and weight of the agricultural sector that enlargement will bring, will have to be counterbalanced by a reform of the institutions. The EU is still debating reforms, and it is unclear what their outcome might be. This chapter does not address the options for institutional reform. However, our analysis clearly suggests that increasing Qualified Majority Voting (QMV) in the Councils is probably not enough. Institutional reform which does not curb the automatism of shifting CAP reform decisions from a QMV-based Council to a *de facto* consensus-based European Council will not be suitable for solving the crisis-prone problems of transfers before and after enlargement.

NOTES

1 Czech Republic, Estonia, Hungary, Poland and Slovenia.

2 Bulgaria, Lithuania, Latvia, Romania and Slovakia

3 The European Commission's *Agenda 2000* document included an assessment of the readiness to accede to the EU of the ten applicant countries from Central and Eastern Europe. It was followed by detailed reform proposals for the Common Agricultural Policy (CAP) (Commission 1998a), the Structural (Commission 1998b) and Cohesion Funds (Commission 1998c, 1998d), the Instrument for Structural Policies for Pre-Accession (ISPA) (Commission 1998e, 1998f) and a financial perspective for the Union with and without enlargement (Commission, 1998g).

4 Technical details and assumptions used throughout the text can be found in Annex 8. When comparing the budgetary balances, the special circumstances of the year 1997 have to be taken into account. The expenditures were considerably higher than the contributions due to the rollover from funds of the previous year. Furthermore, the UK's net contribution is small, because of the combination of a particularly high rebate combined with receipts of funds due to other factors such as the BSE crisis. Refunds for the definitive calculations of past rebates and exchange rate fluctuations caused the high rebate. All the details are explained in Commission (1998h).

5 1997 was the most recent year with comprehensive data on expenditures when the model was built. Given the margin of error in calculating the Structural Fund allocations and the expenditures for the CAP, the net balance estimates have to be taken with care. The 1997 budget itself is affected by the differences between appropriations and actual expenditures and the corrections to the UK rebate, which occurs with a two-year time lag.

6 This was based on the Fontainebleau European Council of 1984, according to which 'any Member State sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time' (European Council 1984).

7 The mechanism to cut the net contributions to the Budget would follow a system similar to the one presented by Commission (1998h). Member States, which exceeded in their net contribution to the EU budget 0.3 per cent or 0.4 per cent of GNP, would be eligible for a rebate of 66 per cent of the sum over this level. This follows the rationale of the system for the UK rebate, with the exception that the UK's threshold is 0 per cent, which makes it valid for the whole net contribution.

8 Brenton and Núñez Ferrer (1999) have estimated that liberalising the milk market in an enlarged EU with compensation payments would cost between 6 billion (with 50 per cent compensation) and 12 billion Euro (based on full compensation).

9 It is important to note that some regions will not be eligible. Eurostat recently released the latest statistical data on CEECs showing that some regions are getting close to the EU average. Prague even has a GDP level above the EU average (Eurostat news release No 48/2000, 18 April 2000).

10 Except for regions were GDP per capita is not the eligibility criteria, i.e. ultraperipheral regions and regions with a very low population density.

11 There are a number of estimates on the size of the production increases. A particularly detailed study can be found in the EU Research Project "Agricultural Implications of CEEC Accession to the EU" (FAIR1-CT95-0029).

12 This research was chaired by Professor Alan Buckwell of Wye College. The ideas presented in the report, which are now ironically gaining importance due to necessity, were too reformist and ahead of time. The publication after the formal proposals for the Agenda 2000 may have been a coincidence, but certainly undermined the political appreciation for the report and its influence in the reform debate.

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ABBREVIATIONS

B-S	Balassa-Samuelson
BRER/BNER	Bilateral Real Exchange Rate/Nominal Exchange Rate
CAP	Common Agricultural Policy
CEECS	Central and East European Countries
CEN	European (Non-Electrical) Standards Body
CENELEC	European Electrical Standards Body
CEPS	Centre for European Policy Studies
CFSP	Common Foreign and Security Policy
CIS	Commonwealth of Independent States
Coreper	Commitee of Permanent Representatives
CPI	Consumer Price Index
DM	Deutschmark
EAGGF	European Agricultural Guidance and Guarantee Fund
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECJ	European Court of Justice
Ecofin	Council of Economic and Finance Ministers
ECSC	European Coal and Steel Community
EEA	European Economic Area
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
EP	European Parliament
EP	Estonian National Bank – Eesti Pank (see annex II only)
EPO	European Patents Office
ETSI	European Telecommunications Standards Institute
EU	European Union
FDI	Foreign Direct Investments
GATT	General Agreement on Tariffs and Trade
GDP	Gros Domestic Product
GDR	German Democratic Republic
GNP	Gros National Product
HICP	Harmonised Index of Consumer Prices
IAEA	International Atomic Energy Agency
IGC	Intergovernmental Conference
ILO	International Labour Organisation
IM	Internal Market
IMF	International Monetary Fund
INTERREG	Community Initative for Border Regions
IPR	Intellectual Property Rights
IPPC	Integrated Pollution Prevention and Control
ISPA	Instrument for Structural Policies for pre-Accession
MEP	Member of the European Parliament

NATO	North Atlantic Treaty Organisation
NGO	Non-Governmental Organisation
NER	Nominal Exchange Rate
NPAA	National Programme for the Adoption of the Acquis
NVA	Net Value Added
OCA	Optimum Currency Area
OECD	Organisation for European Co-operation and Development
ONP	Open Network Interconnection
PHARE	EU Aid Programme for Central Europe
PPP	Purchasing Power Parity
PPS	Purchasing Power Standards
PRAQ	EU Assistance Programme for Technical Standards
RER	Real Exchange Rate
QMV	Qualified Majority Voting
R&D	Research and Development
SAPARD	Special Accession Programme for Agriculture and Rural Development
SEA	Single European Act
SER	Sociaal Economische Raad (Socio-economic Council, the Netherlands)
SME	Small and Medium Sized Enterprise
TAIEX	Technical Assistance Information Exchange Office
TARGET	Interbank Payment System, run by the European Central Bank
TOR	Traditional Own Resources
UK	United Kingdom
US	United States
VAT	Value Added Tax
WRR	Wetenschappelijke Raad voor het Regeringsbeleid (Scientific Council for Government Policy, the Netherlands)
WTO	World Trade Organisation

ANNEX 1 THE BALASSA-SAMUELSON EFFECT

This annex discusses the likely size of the Balassa-Samuelson effect (B-S effect) for the candidate countries by using two approaches: the first starts from the theory, whereas the second is purely empirical and based on the Euro area experience.

1.1 THEORETICAL CONSIDERATIONS[1]

In theory, if all goods and services were freely tradable across borders, arbitrage would lead to a situation in which price levels (expressed in common currency) would be equal and strict purchasing power parity would hold. However, this is rarely the case in practice, and a number of studies have shown that price levels do differ markedly across countries. These differences are so large that they cannot be accounted for by transport costs, taxes and tariffs. In fact, there is a systematic tendency for prices to be lower in poorer than in richer countries and, when examined more closely, this pattern seems to be accounted for by differences in the prices of 'non-traded' goods and services, e.g. housing and personal services. Moreover, there is a tendency for countries which are experiencing more rapid growth of productivity – and, therefore, improvements in living standards – to experience faster increases in price levels (again, correcting for exchange rate movements). The Balassa-Samuelson approach (Balassa 1964, Samuelson 1964) explains these differences by linking the behaviour of non-traded goods prices to productivity growth. One should emphasise from the outset, that the B-S effect is a medium to long run phenomenon and should thus be viewed as a long run tendency that might be perturbed in the long run by monetary factors.

How relevant is this phenomenon? The ECB (1999) claims that a number of recent papers have found evidence in favour of the B-S hypothesis. Typically, these studies have used econometric techniques to detect the existence of long-run relationships (co-integration) between relative price levels and relative productivity. In this framework, the direction of the applied studies has been twofold. A first class of studies focuses on the relationship between long-run changes in relative prices and productivity differentials across countries, while another analyses the link between the productivity differentials and inflation differentials across sectors within countries. The general conclusion of the first approach is that there is evidence of a relationship between the evolution of relative price levels across countries and that of productivity differentials. Following the second approach, a clear causality between productivity growth in the traded goods sector and inflation in the non-traded goods sector has been identified. Indeed, recent studies show that, while some of the more restrictive assumptions of the hypothesis are not supported by the data, there is still clear evidence that the B-S effect has been at work within the Euro area.

In order to explore the B-S effect in more detail, it will be convenient to use a few equations that capture the basic economic mechanisms at play. The usual approach is to take the case of two countries within a monetary union, denoted as country A and country B, respectively. Looking first at what happens within one of the countries (A), let us consider the simple example of an economy with two goods (one traded and the other non-traded), two factors of production (capital and labour), competitive markets, constant returns to scale production functions in the two sectors and free access to global capital markets. On the basis of these assumptions, it can be shown that the rate of price increase in non-traded goods compared with traded goods in any country will be given by:

$$d(P_{NT}-P_{T}) = (SL_{NT}/SL_{T}) \times d(PROD_{T}) - d(PROD_{NT}) \qquad (1)$$

where $d(P_{NT})$ and $d(P_{T})$ are the rates of change in non-traded and traded goods prices respectively, $d(PROD_{NT})$ and $d(PROD_{T})$ are the productivity growth rates in the two sectors, and SL_{NT} and SL_{T} are the shares of labour in each sector's output. It is usually assumed that non-traded goods production (e.g. services) is more labour-intensive than traded goods production (e.g. manufacturing), so that the ratio SL_{NT}/SL_{T} should exceed 1. However, important sectors of non-traded goods are highly capital intensive (e.g. housing, some financial services). Moreover, many services are highly skill or human capital intensive (again financial services, health care). It is thus not straightforward to determine by how much the labour intensities really differ. [2]

Equation (1) implies that if productivity growth in the traded goods sector is faster than in the non-traded goods sector, non-traded goods prices will tend to rise more rapidly than traded goods prices. The mechanism through which this occurs is straightforward. A rise in productivity in the traded goods sector will tend to drive up wages in this sector, but since this increase in wages is matched by increased productivity, it will not give rise to higher traded goods prices. However, since labour is assumed to be mobile across sectors, firms in the non-traded goods sector will have no option but to offer higher wages in order to retain their workers.

In the non-traded goods sector the increase in wages will not be matched by a productivity increase, thereby raising costs. This increase in costs will lead to an increase in prices in the non-traded goods sector. By construction, the overall rate of change in the consumer price index, d(CPI), in this country will be given by a weighted average of the rates of change in traded and non-traded goods prices:

$$d(CPI) = a\, d(P_{T}) + (1-a)\, d(P_{NT}) = d(P_{T}) + (1-a) \times s \times [d(PROD_{T}) - d(PROD_{NT})] \qquad (2)$$

where a is the share of traded goods in consumption and s represents the ratio SL_{NT}/SL_{T}. Neglecting this last factor for the reasons mentioned above, the overall increase in the consumer price index will be determined by the increase in traded

goods prices and by the difference in productivity growth between the two sectors. The more rapid productivity growth in the traded goods sector (relative to the non-traded goods sector), the higher the increase in the consumer price index will be (ceteris paribus).

Similar relations can be derived for country B. By definition, the rate of increase in traded goods prices will be equal across countries. For the sake of simplicity, two additional assumptions are usually made in concrete applications of this approach: first, that productivity growth in the non-traded goods sector is equal in the two countries and, second that the share of traded goods in consumption is also identical in both countries. In this case, the difference in the rate of change in consumer prices between country A and country B will be given by:

$$\Delta CPI = d(CPI) - d(CPI^{B}) = (1-\alpha) \times s \times [d(PROD_{T}) - d(PROD_{T}^{B})] \qquad (3)$$

This is the formula generally used. It implies that the inflation differential between the two countries, given the assumptions made, should depend only on differences between the rates of productivity growth in the *traded* goods sectors of both countries. This equation can be used to compute a reasonable upper bound, based on the two key parameters: $(1-\alpha)$, the share of non-traded goods in consumption, and the difference in productivity growth. Unfortunately data on the latter are not easily available on a consistent cross-country basis. Industry or manufacturing is often used to represent the traded goods sector. But as the definition of what constitutes industry differs from country to country the data are often not really comparable across countries. However, an upper bound on productivity in the traded goods sector can be obtained from the data on GDP per person employed.

GDP per person employed represents the economy wide productivity growth. Assuming, as above, that productivity growth is the same in the non-traded sector the overall productivity differential, $\Delta PROD$, should be equal to:

$$\Delta PROD = \alpha \times [d(PROD_{T}) - d(PROD_{T}^{B})] \qquad (4)$$

Combining the last two equations the Balassa-Samuelson effect can thus be written in terms of the more easily observable differences in overall productivity growth:

$$\Delta CPI = d(CPI) - d(CPI^{B}) = \Delta PROD \times s \times (1-\alpha)/\alpha \qquad (5)$$

Since it is difficult to put a number to the ratio in the labour shares, we follow the ECB (1999) in assuming that it is unity, so that we can concentrate on the role of the other two parameters. The largest productivity differential that one finds within the EU-15 over the last three decades is about 2 percentage points. Table 6.8 from box 6.1 in the main text contains the relevant data, as in reality the countries with the fastest productivity growth have always been cohesion countries. Thus,

for example, during the 1970s Portugal had the highest productivity growth (4.7 %) of the EU-15, which was about two full percentage points above the EU-15 average (which was 2.7 %). During the 1990s Ireland had the fastest productivity growth (3.2 %), which was slightly less than two percentage points above the EU-15 average (which was 1.7 %). The figure 2 might thus be a reasonable upper bound for ΔPROD [3].

The only parameter that one then needs to gauge is a, the share of traded goods in consumption. Being forced to put a concrete number on this parameter for the candidate countries leads immediately to a conceptual difficulty. Table 6.2 above showed that there are large differences in the measured openness of the candidate countries, but all of them are definitely much more open than the Euro area itself.

It is apparent from equation (5) (or equally from equation (4)) that, ceteris paribus, more open economies should be less affected by the B-S phenomenon, simply because most of their production is traded. For example, in Estonia exports and imports amount, on average, to about 75 % of GDP. If one takes this as a good proxy for a, the upper bound of the inflation differential that the B-S effect might cause for Estonia would be only:

$$\Delta \text{CPI(upper bound Estonia)} = 2 \times (1-a)/a = 2/3 = 0.66 \qquad (6)$$

By contrast, for Poland, for which exports and imports amount only to about 25 % of GDP the upper bound would be much higher:

$$\Delta \text{CPI(upper bound Poland)} = 2 \times (1-a)/a = 2 \times 3/1 = 6.0 \qquad (7)$$

These two examples show the over-riding importance of the openness parameter. The key problem here is seldom noticed: the empirical measures of openness have little to do with the theoretical concept. The usual measure of openness, used so far uncritically here, relates the value of trade (exports and/or imports) to GDP. The latter is a value-added concept, whereas the former represents gross sales. That this traditional measure of openness cannot represent the share of traded goods in production - or consumption for that matter – becomes immediately clear if one considers the case of a country for which exports (or imports) amount to more than 100 % of GDP. This would imply that the share of non-traded goods would have to be negative.

A more appropriate measure of openness should relate the *value added* in the traded goods sector to GDP. For example, consider a country, which imports intermediate goods of 100 Euro. Domestic labour (and perhaps capital) is used to increase their value by 25 %, resulting in exports of 125 Euro. These exports would allow the country to import also final consumer goods of 25 Euro. If non-traded goods production (assuming they do not require any imported input) amounts to 100 Euro, total value added, or GDP, would amount to 125 Euro. Openness as

traditionally measured would thus be equal to 80 %, whereas the share of traded goods in consumption would be only 20 %. As this set of numbers might actually describe the Estonian case one must be extremely careful in using the ratio of exports to GDP as the relevant measure of openness.

These difficulties in measuring the size of the traded goods sector are compounded by the uncertainties in the nature of the catch-up process in Central and Eastern Europe. In particular the assumption that the rate of productivity growth should be the same might be inappropriate because under central planning this sector was the most underdeveloped of all.

Overall, it is thus extremely difficult to provide a precise estimate of the B-S effect based on theory alone. The only certainty is that any reasonable bound must be rather wide and that more open economies are less likely to show large inflation differentials with the Euro zone for the simple reason that more of their consumption baskets consist of imported goods.

1.2 EMPIRICAL INVESTIGATION BASED ON EURO AREA DATA

A number of studies argue that a substantial proportion of the inflation differentials that remain between the countries participating in the Euro zone are due to the convergence of prices to a common level. Such price level convergence could be expected to take place in the Euro area for two reasons. First, the completion of the internal market and increased cross-border price transparency contribute to reducing differences across countries in the prices of traded goods. Second, with regard to goods which are less easily traded across national borders (e.g. housing and services), convergence of productivity and living standards across the Euro area would create a tendency towards price level convergence. This latter effect is commonly known as the Balassa-Samuelson effect described above [4]. The forces leading to a convergence of non-tradable goods prices are mainly related to real economic convergence. Countries that are in a catching-up process tend to have high productivity growth rate in the internationally exposed sector, but not in the non-tradable goods sector. If nominal wages grow by the same rate in tradable goods and non-tradable goods sectors due to labour mobility or centralised wage setting procedures, then costs will grow faster in the non-tradable goods sector and this will be reflected in higher inflation. Increased mobility of capital and labour across the single market and the Euro area will promote an equalisation of factor prices, which will tend towards equalisation of non-tradable goods prices [5].

In both sectors, convergence of price levels would give rise to some differentials in inflation rates across countries in the transition period, with ‘low price level’ countries tending to experience somewhat faster rates of price increase than ‘high price level’ countries.

The ECB's Monthly Bulletin of October 1999 dealt with the estimates of the B-S effect from the point of view of the Euro zone. It provides a scatter diagram in which the inflation rates in the Euro zone countries are related to differences in price levels. Empirically the study finds that there is a strong negative correlation between the relative inflation rates and the relative price levels.

What would be the magnitude of the estimates of the B-S effect for the candidate countries?In order to go beyond the eyeball econometrics suggested by the ECB, we run a regression equation that relates the difference between the Harmonised Index of Consumer Prices (HICP) inflation rate in the countries of the Euro zone and the average HICP inflation in the Euro area with the relative price level (of consumer prices, on the basis of OECD data). The regression uses the natural logarithm of the independent variable (the relative price levels). The result is:

$$y_d^{HICP} = 18.9 - 4.13 x_{rpl} \qquad (8)$$
$$(1.39)$$

The R^2 value tells us that almost 50% of the change in inflation differentials is explained by the variation of the relative price levels. The standard error of the regression is 0.584.

Using equation (8) we now want to calculate the value of y_d for the candidate countries. But the problem is that the data on the level of relative prices for these countries are not available. Therefore, we will estimate these using the figures for the comparative price levels in the OECD member states calculated monthly by the OECD Statistical Directorate.

The variation in the relative price levels is closely correlated to differences in the degree of economic development. Therefore by means of regression analysis we can describe the relationship between the comparative consumer price levels (we choose as reference the price levels in Germany) and the ratio of GDP in dollars measured at purchasing power parity rates (PPPs) and at current exchange rates (considered the independent variable).

The sample is made of the 29 OECD countries. The data on GDP is taken also from OECD database. The result of the regression is:

$$y_{rpl} = 4.453 - 0.897 x_{GDP} \qquad (9)$$
$$(0.23) \qquad (0.062)$$

where y_{rpl} is natural logarithm of the relative price levels and x_{GDP} is the natural logarithm of the ratio of GDP in dollars measured atPPPs and at current exchange rates.

Table A1

Regression Statistics				
Adjusted R Square	0.88			
Standard Error	0.17			
Observations	29			
	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	4.45	0.022	196	4.07E-44
x= ln of the ratio of GDP at current exchange rate and PPP	-0.89	0.061	-14.5	2.9E-14

The estimated coefficient in the regression line is -0.9, which implies that a 10 percentage points increase in the ratio of GDP measured at PPPs and at current exchange rate would be associated with 9 percentage point decrease in the relative price level. The coefficient of determination, R^2, is 0.88 , which indicates a strong relationship between the level of consumer prices and the ratio of GDP at current exchange rates and PPPs. The standard error of the regression is 0.117. Since t=2.052 from the t-tables with 27 degrees of freedom, the 95% confidence interval for the estimated y is $y_{rpl} \pm 2.052 \times 0.117 = y_{rpl} \pm 0.24$.

Using equation (9) we can estimate the relative price levels in the candidate countries. The data for the GDP for the candidate countries is taken from Eurostat. The estimated price levels in these countries resulting from the calculations are shown in Table A1. As expected they are much lower than the levels in the Euro zone countries. Romania and Bulgaria have the lowest levels with prices just over a quarter of prices in Germany.

Having calculated the relative price levels for the candidate countries we can now try to give an answer to the question: what will be the differential with the HICP inflation in the Euro area across the candidate countries? Using equation (8) and the figures for the estimate price levels, we calculate the value of y_d^{HICP} for the accession countries. The results show on average a difference between the HICP inflation in CEEC-10 and the Euro zone of 3.8 %.

As the data on headline inflation may be distorted by special temporary factors, it would also be interesting to measure the differences between the core inflation rate of the Euro area and the inflation rates in the candidate countries. We can do this by taking as the dependent value $y_d^{core} = y_{MS}^{core} - \overline{y_{11}^{core}}$, where y_{MS}^{core} is the core inflation (theall-items HICP excluding energy and unprocessed food) in the individual Member States of the Euro zone and $\overline{y_{11}^{core}}$ is the core inflation in the Euro zone. The independent value considered is, as in the case above, the natural logarithm of the relative consumer price level in the Euro area countries. The exam-

ination of residuals shows that the observation for Luxembourg is an outlier. Therefore we introduce a dummy variable.
The result is:

$$y_d^{core} = 21 - 4.61x - 2.08x_{lu} \qquad (10)$$
$$\qquad (1.08) \qquad (0.47)$$

The R^2 value shows that almost 80% of the variation of y_d can be explained by the variation in the price levels. The standard error of the regression is 0.45 somewhat lower than above. Since t=2.228 from the statistical tables with 10 degrees of freedom, the 95% confidence interval for the estimated y_d^{core} value is
$y_d^{core} \pm 2.228 \times (0.45) = y_d^{core} \pm 1.003$

Table A2

Regression Statistics	
Adjusted R Square	0.77
Standard Error	0.45
Observations	11

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	21	4.83	4.35	0.0025
X_1 ln of relative price level	-4.61	1.08	-4.28	0.0024
X_2 dummy variable for Luxembourg	-2.08	0.47	-4.38	0.0027

Using equation (10) we now calculated the y_d^{core} for the accession countries. We note that the difference with the core inflation of the Euro zone is slightly bigger than with the HICP inflation (4.2% comparing with 3.8%).

These results are based on the 12-month average inflation July 99-98/ July 98-97. We repeated the same procedure for the whole year 1999 and for the 24-month average 1998-1999 and we obtained a difference in the core inflation between the candidate countries and the Euro zone of a similar order of magnitude (3.7% and respectively 3.5%).

NOTES

[1] The following is based on ECB (1999).

[2] ECB (1999) assumes ('for ease of exposition') that this ratio is unity.

[3] The difference would be somewhat, but not dramatically, larger if one were to use the average of the three worst performers (in terms of productivity) as the basis for comparison.

[4] ECB Monthly Bulletin, October 1999.

[5] European Commission, DE ECFIN, Annex to the Inflation Report, November 1999.

ANNEX 2 WHY IT PAYS TO JOIN THE EUROSYSTEM

It is not widely recognised that the candidate countries will reap substantial gains in terms of seignorage once they enter the Euro zone. This note provides a rough estimate of this gain and its main determinants. We first present the theoretical grounds upon which we based our calculations and then we add a case study taking the example of Estonia, a country that is *de facto* a unilateral member of the Euro zone with its Euro-denominated currency board.

2.1 SEIGNIORAGE GAIN FROM MEMBERSHIP OF THE EUROSYSTEM (COMPARED TO E STATUS QUO SCENARIO WITH STABLE PROCES

2.1.1 THEORETICAL FRAMEWORK

In this note we will use the 'opportunity cost[1] concept of seigniorage (and concentrate on the ratio of seigniorage to GDP), which corresponds to the (interest) earnings a central bank would have if it concentrates purely on monetary policy (i.e. providing monetary base) and undertakes no other commercial operations. Unfortunately, in reality many central banks in the candidate countries fulfil a number of other functions, which are more of a commercial nature. This makes it difficult to evaluate their accounts.

Seigniorage income with a *national currency* (nc) will be equal to the product of the interest rate r_{nc} (the interest paid on government debt) and the ratio of cash to GDP in the country i ($m_i = M_i/Y_i$)

Thus, s_{nc} can be written:

$$s_{nc} = r_{nc} \times m_i \qquad (1)$$

When the country is a *full member* (fm) of the Eurosystem and participates fully in the sharing of seigniorage its part in the Eurosystem's monetary income[2] will be given by the product of the share of country i in the capital of the ECB (α_i), the reference rate (the interest rate used by the Eurosystem to calculate the monetary income of the participating national central banks) and the amount of cash in the Euro zone (M_{euro}):

$$S_{fm} \equiv a_i \times \text{monetary income of Eurosystem} = a_i \times r \times M_{euro} \qquad (2)$$

We write the seigniorage income in the case of full membership as S_{fm}, with capital S in order to distinguish it from s_{nc}, where the lower case s represents the seigniorage as a ratio to GDP.

α_i is given by :

$$\alpha_i = \frac{1}{2} \times \left(\frac{N_i}{N_{euro}} + \frac{Y_i}{Y_{euro}} \right) \quad (3)$$

N_i and N_{euro} represent the population of the country i and respectively of the Euro area and Y_i and Y_{euro} are the GDP of the country i and of the Euro area.

This note concentrates on the fiscal (seigniorage) implications of joining the Euro zone. As this can be done only if the Maastricht criteria for inflation and interest rates are satisfied one has to assume that the country that is about to become a full member of the Eurosystem has achieved the same degree of price stability as in Euroland, and has approximately the same interest rate. Hence one has to assume that $r_{nc} = r$.

It follows that the ratio of the seigniorage under the full membership case to the national currency scenario is given by:

$$\frac{S_{fm}}{S_{nc}} = \frac{1}{2} \times \left[\frac{y_{euro}}{y_i} + 1 \right] \times \frac{m_{euro}}{m_i} \quad (4)$$

(4)

where the lower case y refers to income per capita, at current exchange rates, not at PPP.

A more significant variable should be the *net gain* (as a percent of national income) which can be written as:

$$\text{Gain}_i = r \times \left[\frac{1}{2} \times \left(\frac{y_{euro}}{y_i} + 1 \right) \times m_{euro} - m_i \right] \quad (5)$$

2.1.2 WHAT WOULD BE THE TYPICAL PARAMETER CONSTELLATION?

There is a considerable diversity in the pattern of cash holdings. m_{euro} is about 5-6 %, m_i varies considerably from a low of around 4 % in high inflation Romania to around 14 % in the case of Bulgaria and close to 10 % in Estonia. In general the candidates have higher cash to GDP ratio than Euro area member countries because they have less developed banking systems.

The key item in equation (4) and equation (5) is the expression y_{euro}/y_i, which varies a lot among the candidates but it is always far above unity; a value of about 10-20, resulting from about 20, 000 Euro per capita for the Euro area and as low as 1-2,000 Euro per capita for some candidates (of course, this is based on GDP in nominal terms. For most candidates GDP at PPP is much higher because non-tradables prices are much lower).

The *gain* could thus be large. With a ratio of y_{euro}/y_i equal to 15 equation (5) would yield:

$$Gain_i = 0.05(8 \times 0.05 - m_i) = 0.05(0.4 - m_i)$$

Even a country with a cash to GDP ratio of 10 % (i.e. a rather strong domestic seigniorage base), the gain would be 0.05× (8×0.05-0.1)=0.05×0.3=0.015=1.5% of GDP (see table A3 below for a rough calculation of the gain for the 10 candidates). However, since the 10 candidate countries, even combined, account only for a small percentage of Euro area GDP, their gain (the Euro area's loss) is minuscule if calculated as percent Euro area GDP.

Table A3 Seigniorage gain for the candidate from membership to the Eurosystem (compared to a status quo scenario with stable prices)

	m_i	a_i	y_{euro}/y_i	GDP in mln euro	gain in mln euro	gain as % of GDP
Czech Rep.	11.3	2.14	4.2	50100	109	0.22
Estonia	8.6	0.29	6.7	4600	33	0.73
Hungary	9.6	2.04	5.0	41900	174	0.41
Poland	7.2	7.17	5.7	140700	900	0.64
Slovenia	3.9	0.49	2.4	17400	54	0.31
Wave 1				**Sum: 254,700**	**Sum:1270**	**Average: 0.46**
Bulgaria	11.0	1.47	15.5	11000	212	1.92
Latvia	12.2	0.45	8.7	5700	48	0.84
Lithuania	8.5	0.71	7.9	9600	88	0.91
Romania	3.6	3.89	13.6	33900	683	2.01
Slovak Rep	10.2	1.06	6.1	18100	102	0.56
Wave 2				**Sum: 78,300**	**Sum: 1,132**	**Average: 0.15**
Total				**Sum: 587,700**	**Sum: 3,671**	**Average: 0.82**

Source: Own calculations based on Eurostat data

2.1 IMPLICATIONS OF EUROISATION FOR THE ACCOUNTS OF THE CENTRAL BANK – THE CASE OF ESTONIA

This part applies the theory presented above to the case of Estonia, thus providing a brief analysis of the direct implications of the adoption of the Euro in cash form ('Euroisation') for the national central bank. The key point that emerges is that the

often voiced fear that a country that 'Euroises' somehow 'loses' its money, is unfounded.

Another more general point that emerges is that in analysing the financial implications of Euroisation one should avoid focusing too much on the stocks (of assets and liabilities). The allocation of returns from these is more important. In other words, it is less important to see how many cows one will have in the stable than to know from how many cows one actually gets the milk.

Euroisation should be compared to the standard procedure for joining EMU, which will constitute the starting point of our analysis.

2.1.1 STANDARD EMU ACCESSION PROCEDURE

On 'Euro day' the Estonian National Bank-Eesti Pank (EP) will hand over all the Kroon cash and will receive the equivalent amount in Euro cash. Its balance sheet is not affected, but the profits and loss account will be by this move. From that point onwards it will obtain about 0.3% of the earnings of the Eurosystem. The share 0.296 % is based on the capital key (which, in turn, is based on population and GDP weights) [3].

The base on which the Eurosystem earns its own so-called monetary income is the amount of Euro cash in circulation (around 360 billion Euro at present). After joining the Eurosystem, EP will thus earn a monetary income of 0.296 % of 360 billion Euro, or over 1,000 million Euro. The profits of EP should thus increase (because at present it earns only seigniorage on its national cash base of 400 million Euro). How much Estonia gains will depend on the interest rates (the so-called reference rate, used to calculate the monetary income of the Eurosystem). Estonia will gain seigniorage revenues because its share in the overall monetary income of the Eurosystem is based on population weights. Estonia accounts for almost 0.5 % of the (present) Euro area population, but only about 0.1 % ($100 \times 400/360.000 = 0,11\%$) of its monetary base (cash in circulation [4]).

How much could Estonia gain? Assuming that the reference rate (i.e. the interest rate used to calculate the monetary income in the Eurosystem) is 5 % the seigniorage gain to Estonia from joining the Euro area would be:
$0.05 \times (360000 \times 0.00296 - 400) = 0.05 \times (1060 - 400) \tilde{} 30$ million Euro, per annum. This is more than the total seigniorage income of EP at present. Joining the Euro area would thus more than double the seigniorage income of Estonia. The gain would amount to about 0.7 % of GDP. Other candidate countries could expect gains of a similar size. [5]

Another implication of full membership in the Eurosystem is that EP will have to 'transfer' (in reality only earmark) about 120 million Euro worth of dollars to the

common reserve pool of the Eurosystem (Estonia's share of 50 billion Euro [6]).
EP will basically keep the returns on these dollars. This operation is thus mostly an accounting procedure; it should have no impact on the profit and loss account.
In sum, there will be no big impact on balance sheet, but a big gain on profit and loss account.

2.1.1 EUROISATION (I.E. ADOPTION OF EURO CASH BEFORE ACCESSION TO EUROSYSTEM)

Hypothesis 1: No help from EU

Step 1 (early 2002): EP uses 400 of its reserves to buy Euro notes and coins from commercial banks (not the Eurosystem) in the Euro zone [7]. The balance sheet of EP will shrink by this amount and it will earn less seigniorage (the loss will be equal to the foregone interest on the 400 million, at interests of 5 % this would mean about 20 million Euro p.a.).

Step 2 (accession to EU (=2003?+2?): The day Estonia joins the Eurosystem as a full member it will hand over the old Kroon notes (which it should have kept somewhere) and receives in return 400 million in Euros. It can then use these Euros to re-constitute the reserves it had spent earlier under step 1. Its balance sheet will thus increase, but its profit and loss account will be affected in the way outlined above, i.e. Estonia gets from this day its share (0.3 %) of the monetary income of the Eurosystem and contributes only about 0.1 %.

The contribution to the common pool of foreign exchange reserves will also be needed. But this has no financial implications, as outlined above.

It is actually not important that 'Estonia gets its money back'. Assume that EP does not keep the old Kroon cash, or that the Eurosystem refuses to exchange 'old' Kroons against Euros. It would appear that in this case Estonia will lose the reserves it used initially to buy Euros. However, this is *not* the case. In case Estonia is not allowed to exchange its old Kroons into Euros, the balance sheet of the EP will not increase upon accession to the Eurosystem. This would have one key implication: EP would not have to contribute to the overall monetary income of the Eurosystem because its monetary base would be zero. (In accounting terms EP would not have any liabilities under 'notes in circulation'.) In this case EP would thus obtain each year the share of the monetary income of the Eurosystem calculated above (0.3 %), but it would contribute nothing. The lower contribution to the Eurosystem would be exactly equal to the lower interest earnings on the reserves 'lost'.

In conclusion, during the transition period (of unilateral Euroisation) Estonia will experience a smaller balance sheet and be subjected to a loss of monetary income. The loss of seigniorage is transitory whether or not Estonia 'gets its money back'.

Can Estonia finance unilateral Euroisation? The broad answer seems to be yes. The latest available balance sheet of EP shows foreign exchange reserves worth around 760 million Euro. Cash in circulation amounts to about 400 million. But EP has also 240 million Euro worth of liabilities to domestic banks resulting from high-required reserves. If the reserve coefficient is lowered to the Eurosystem's rate of 2 % this item might shrink to 40 million [8]. If the freed reserves are made immediately available EP would thus need another 200 million. It would thus be left with about 160 million Euro of reserves (during the period of unilateral Euroisation).

The contribution to the common reserve pool of around 120 million would anyway be needed only after Estonia has joined EMU as a full member. Hence these reserves would remain at the full disposition of EP. The day Estonia joins EMU it will have to devote 120 million to the common reserve pool. But at that moment it will also get the 400 million back, so that there will be absolutely no problem with paying its contribution to the common reserve pool, even if this has been increased in the meantime.

Hypothesis 2: Support from EU

The EU (i.e. the general budget, which is under the control of the European Parliament) would give Estonia a loan of 400 million Euro at either zero, or a very low interest rate. The proceeds from this loan would be used to exchange all existing kroons into Euro. The loan would have to be repaid the day Estonia becomes a full member of EMU.

It is worth emphasising that the ECB should not have any role in this operation. The support from the EU is of a fiscal nature: to ensure that the fiscal cost of Euroisation does not fall on poor Estonia so that the rich EU does not benefit unfairly from unilateral Euroisation. The ECB has no stake in these fiscal and political considerations, it should be left alone to its task of maintaining price stability in the Euro area. It might be asked for its opinion on this issue. But the final decision pertains to the political instances, i.e. the Council (ECOFIN and the European Council) and the European Parliament.

If the EU supports Euroisation the composition of the Balance sheet of EP would change during the transition period, but the sum of assets and liabilities would not be affected (compared to the status quo). Instead of recording a liability under 'currency in circulation' of 400 million Euro, there would be a 'foreign liability' of an equivalent amount. On the asset side nothing changes. The profit and loss account is affected only to the extent that Estonia has to pay interest on this loan (which EP can do since it continues to earn interest on its reserves). Whether EP's profits increase or fall depends on the difference between the rate of return EP earns on its reserve assets and on any interest rate Estonia may have to pay on its liability to the EU. (The net effect on the profit and loss account should be limited, and could go either way, depending on the maturity of the instruments involved.)

The day Estonia joins EMU the loan will be repaid (with the reserves). From that day on Estonia will receive its share of about 0.3 per cent of the monetary income of the Eurosystem. A contribution to the common reserve pool will also be needed. But, again, as shown above, this has no financial implications.

NOTES

[1] See Gros and Vandille (1993) for a discussion of various concepts of seigniorage.

[2] For a detailed discussion of the arrangements for seigniorage sharing under EMU see Gros and Schobert (1999). It is assumed here that the transitional period during which there will be only partial sharing of seigniorage has already ended.

[3] These shares must refer to the euro-11 average. The entry of Greece and later perhaps Denmark would not greatly affect the share of Estonia. Even the participation of the UK would not change the net gains calculations below because the fall in the share of Estonia would be offset by a higher euro area total. The shares used here are based on current GDP of the applicants not the average for the last five years because GDP of the applicants is growing quickly in euro terms and one can expect that by the time of accession the backwards looking average should then be about equal to the GDP of 1999.

[4] Only cash in circulation is relevant for seigniorage because the required reserves, which are part of the monetary base, are remunerated at market rates.

[5] A note on this issue is available from the author upon request.

[6] Or rather 0.3 % of the approximately 40 billion the Eurosystem has called up (the 11 euro countries account for 80 % of the EU-15 if one uses the capital key).

[7] More in detail: step 1a: Estonian Central Bank buys euros with its own reserves from commercial banks in the euro area. On the balance sheet of EP non interest bearing euro cash is now reported on the asset side. Step 1b: EP buys its own kroon cash in Estonia with this euro cash, its balance sheet shrinks by 400 million.

[8] Another option would be to apply the reserve coefficient of 2% only to new deposits and freeze the existing stock of required reserves (as was done in the case of Portugal) and make them available to commercial banks only when Estonia enters EMU. In the meantime EP would pay interest on the frozen deposits). In this way EP would have an additional 200 million of reserves available during the transition period. However, this is only a second best solution and should be avoided, as there is no need for it.

ANNEX 3 THE VARIABILITY OF THE REAL EXCHANGE RATE – METHODOLOGY AND DATA

We calculate the real exchange rate vis-à-vis DM from the equation:

$$RER_i = E_{(i,\ DM)} \times CPI_{Ger} / CPI_i$$

Where $E_{(i,\ DEM)}$ is the nominal exchange rate of the currency of the country i vis-à-vis DM, CPI_{Ger} and CPI_i is the consumer price index in Germany and the country i.

We calculate the monthly real exchange rate using the monthly nominal exchange rate vis-à-vis DM and of the monthly CPI (1995=100) over the period 1996-1998 for the CEEC-10 and over 1990-1992 for the Club Med countries. The data are taken from the International Financial Statistics (November 1999) of the IMF.

We measure the variability each year by the standard deviation of 12 monthly changes in the natural logarithm of the bilateral (real and nominal) exchange rates. We use the same methodology to measure the variability of the relative CPI.

The relationship between real and nominal exchange rate variability that is visually apparent, can also be captured by a regression equation. The regression result is:

$$y_{brer} = 0.5 + 0.9x_{nrer}^{CEEC-8} - 0.02x^{\text{Club-Med dummy}}$$

(0.12) (0.24)

where y_{brer} is the standard deviation of the monthly changes in the natural logarithm of the real exchange rate (averaged over the three years 1996-98), x_{brer}^{CEEC-8} is the standard deviation of the monthly change in natural logarithm of the nominal exchange rate in the CEEC-8s (again averaged over the three years 1996-98) and $x_{nrer}^{Club-Med}$ is a dummy variable for the Club-Med countries. We introduce this dummy in order to check whether the CEEC-8 show a different relationship between nominal and real exchange rate variability.

The results are:

Regression results with dummy				
Adjusted R Square	0.92			
Standard Error	0.21			
Observations	12			
	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	0.48	0.15	3.23	0.01
BNER CEEC-8	0.91	0.08	11.06	0.00
Club Med Dummy variable	-0.02	0.13	-0.17	0.87

We repeat afterwards the same procedure using the quarterly data. With and without dummy, the regression equation looks as follows:

Regression results with dummy variable using quarterly data				
Adjusted R Square	0.85			
Standard Error	0.47			
Observations	12			
	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	1.14	0.35	3.28	0.01
BNER CEEC-8 (Q)	0.91	0.11	8.03	0.00
Club Med Dummy variable	-0.27	0.30	-0.90	0.39

Regression results without dummy variable using quarterly data			
Adjusted R Square	0.86		
Standard Error	0.47		
Observations	12		
	Coefficients	*Standard Error*	*t Stat*
Intercept	1.14	0.35	3.30
BNER	0.88	0.11	8.20

The strong correlation between the nominal and the real exchange rate variability can be seen also from the table below, which contains the correlation coefficients between the bilateral nominal and real exchange rate and the relative CPI.

Table A4 Correlation coefficients matrix

	Monthly			Quarterly		
	BRER-BNER	BNER - CPI	BNER-CPI	BRER-BNER	BNER-CPI	BNER-CPI
CEEC-10						
Czech Republic	0.97	0.45	0.21	0.95	0.70	0.46
Estonia		1.00			1.00	
Hungary	0.89	0.73	0.35	0.94	0.89	0.68
Latvia	0.96	0.55	0.30	0.98	0.84	0.73
Lithuania	0.98	0.54	0.35	0.99	0.87	0.79
Poland	0.96	0.64	0.41	0.98	0.88	0.75
Romania	0.79	0.45	-0.20	0.62	0.36	-0.51
Slovak R	0.96	0.23	0.15	0.97	0.32	0.28
Slovenia	0.85	0.47	-0.06	0.93	0.58	0.24
Club Med						
Greece	0.36	0.83	-0.21	0.65	0.67	-0.12
Italy	0.98	0.27	0.08	0.98	0.46	0.28
Spain	0.94	0.42	0.10	0.98	0.38	0.18
Portugal	0.92	0.61	0.24	0.95	0.79	0.56

The table below show variability of the bilateral (real and nominal) exchange rate of the candidate countries currencies compared to that of the Club Med currencies.

Table A5 Variability of the bilateral exchange rate vis-à-vis DM

CEEC-10 Average 1996-1998	Variability of BRER		Variability of BNER	
	Monthly	Quarterly normalised to a monthly rate	Monthly	Quarterly normalised to a monthly rate
Czech Republic	3.1	1.4	2.8	1.2
Estonia	0.6	0.4	0.0	0.0
Hungary	1.7	1.2	1.2	0.7
Poland	2.7	1.8	2.2	1.3
Slovenia	0.9	0.6	0.8	0.5
Wave1	1.8	1.1	1.4	0.7
Bulgaria	7.1	8.5	15.2	13.1
Latvia	2.0	1.2	1.7	1.0
Lithuania	2.7	1.6	2.4	1.3
Romania	6.9	4.3	6.5	4.6
Slovak R	1.6	1.2	1.5	1.2
Wave2	4.1	3.4	5.5	4.2
Average CEEC-8	**1.9**	**1.2**	**1.6**	**0.9**

NB: For Bulgaria the monthly data for 1997 cover only the months August-December

Club Med	Variability of BRER				Variability of BNER			
	Monthly		Quarterly normalised to a monthly rate		Monthly		Quarterly normalised to a monthly rate	
	1990-1992	1993-1995	1990-1992	1993-1995	1990-1992	1993-1995	1990-1992	1993-1995
Greece	1.6	1.5	0.9	1.2	0.9	1.0	0.7	0.7
Italy	2.1	2.9	1.7	2.3	1.9	2.8	1.5	2.3
Spain	1.9	2.4	1.5	1.2	1.8	2.4	1.4	1.2
Portugal	1.6	2.1	1.3	1,1	1.3	2.1	1.0	1.1
Average	**1.8**	**2.2**	**1.3**	**1.4**	**1.5**	**2.1**	**1.1**	**1.3**

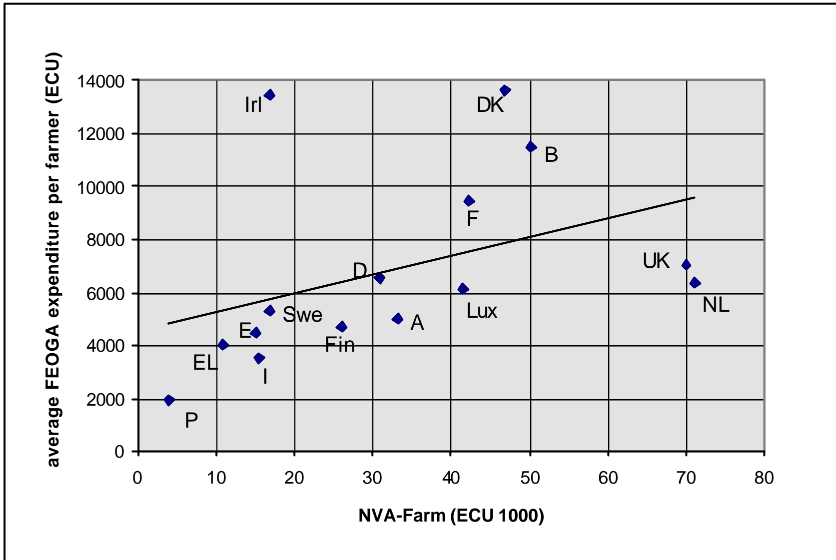
Source: Own calculations based on IMF, International Financial Statistics, November 1999

Variability of relative CPI	
Monthly	Quarterly normalised to a monthly rate
0.8	0.5
0.6	0.4
0.8	0.6
0.8	0.6
0.5	0.2
0.7	0.5
3.6	15.3
0.5	0.3
0.6	0.4
4.0	3.9
0.5	0.2
1.9	4.0
0.6	**0.4**

Variability of relative CPI			
Monthly		Quarterly normalised to a monthly rate	
1990-1992	**1993-1995**	**1990-1992**	**1993-1995**
1.5	1.3	0.7	0.6
0.4	0.4	0.3	0.2
0.6	0.3	0.3	0.2
0.6	0.3	0.5	0.3
0.9	**0.7**	**0.5**	**0.3**

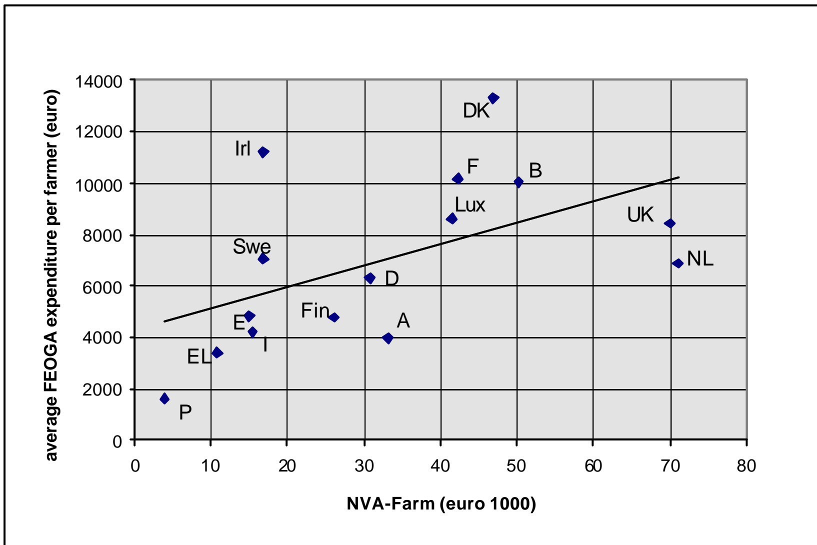
ANNEX 4 AVERAGE FARM NET VALUE ADDED COMPARED TO PER FARMER RECEIPTS FROM EAGGF [1]

Figure A1 Year 1996



Data source: Commission (1998i)

Figure A2 Year 2006 estimates



Source: Own calculations

NOTES

[1] European Agricultural Guidance and Guarantee Fund.

ANNEX 5 EU BUDGET 1997 COMPARED WITH AGENDA 2000 PROPOSALS – MILLION EURO

Table A6 Net contributions, Agenda 2000 proposals, EU-15 (1999 prices)

	1997	Agenda 2000 - - year 2006 EU-15	Agenda 2000 - - year 2006 EU-20+
Belgium	1781	1824	1248
Denmark	98	-41	-416
Germany	-11919	-12775	-17638
Greece	4489	5373	5102
Spain	5761	7589	6310
France	-1828	-743	-4015
Ireland	2914	1941	1785
Italy	-587	269	-2424
Luxembourg	744	1153	1113
Netherlands	-1273	-2694	-3563
Austria	-909	-661	-1146
Portugal	2783	2529	2290
Finland	1	86	-193
Sweden	-1243	-797	-1320
UK	-685	-3053	-3912

Table A7 1997 own resources (1999 prices)

1997	TOR	VAT	GNP	UK correction	TOTAL
Belgium	1091	944	955	102	**3092**
Denmark	300	641	560	65	**1567**
Germany	3571	10414	7575	514	**22074**
Greece	170	575	433	48	**1226**
Spain	657	2680	2018	228	**5584**
France	1613	6536	4987	582	**13719**
Ireland	234	261	198	22	**715**
Italy	1166	3587	3814	450	**9017**
Luxembourg	23	86	62	7	**178**
Netherlands	1798	1749	1335	151	**5033**
Austria	265	1077	768	86	**2196**
Portugal	161	552	367	41	**1121**
Finland	150	488	419	47	**1105**
Sweden	378	1129	825	89	**2420**
UK	3167	5020	3660	-2558	**9289**
Total	**14745**	**35739**	**27977**	**-126**	**78335**

Table A8 Expenditures 1997 (at 1999 prices)

	Agriculture	Structural	Cohesion	Other internal	TOTAL
Belgium	1023	372	0	2819	**4215**
Denmark	1286	176	0	176	**1638**
Germany	6012	3783	0	894	**10689**
Greece	2841	2154	596	183	**5774**
Spain	4792	5575	1059	334	**11760**
France	9519	2560	0	828	**12906**
Ireland	2116	1040	221	123	**3500**
Italy	5296	3012	0	645	**8953**
Luxembourg	24	21	0	888	**932**
Netherlands	1828	438	0	398	**2665**
Austria	896	379	0	168	**1443**
Portugal	683	2521	539	209	**3953**
Finland	594	395	0	174	**1163**
Sweden	777	240	0	228	**1245**
UK	4577	2007	0	833	**7417**
Total EU (1)	**42265**	**24673**	**2415**	**8901**	**78254**
				non EU	**5435**
Total					**83689**

Only expenditures inside the EU

Table A9 Estimated own resources in the year 2006 for the Commission proposal (1999 prices), EU-15

	TOR	VAT	GNP	UK correction	TOTAL
Belgium	1133	790	1757	202	**3881**
Denmark	290	516	1143	131	**2081**
Germany	3219	8080	14825	1703	**27826**
Greece	166	456	826	95	**1542**
Spain	705	2096	3898	448	**7146**
France	1547	5194	9973	1145	**17860**
Ireland	221	273	478	55	**1027**
Italy	1202	3402	8211	943	**13758**
Luxembourg	14	61	125	14	**213**
Netherlands	1589	1428	2648	304	**5968**
Austria	276	820	1479	170	**2745**
Portugal	166	425	729	84	**1404**
Finland	124	395	850	98	**1467**
Sweden	387	820	1595	183	**2986**
UK	2791	5619	9764	-5574	**12600**
Total	**13829**	**30374**	**58301**	**0**	**102504**

Table A10 Estimated expenditures for the year 2006, Commission proposals (1999 prices), EU-15

	Agriculture & rural dev.	Structural	Cohesion	Other internal	TOTAL
Belgium	1062	308		4086	**5455**
Denmark	1476	146		255	**1878**
Germany	7647	4001		1296	**12944**
Greece	3107	2796	630	265	**6798**
Spain	5765	6191	1740	484	**14180**
France	11861	2638		1200	**15699**
Ireland	1833	889		179	**2900**
Italy	6415	5510		935	**12860**
Luxembourg	41	21		1287	**1349**
Netherlands	1774	546		577	**2897**
Austria	1228	402		244	**1873**
Portugal	960	1935	630	303	**3829**
Finland	859	320		253	**1431**
Sweden	1046	585		330	**1962**
UK	4810	2140		1207	**8158**
Total EU	**49884**	**28430**	**3000**	**12900**	**94214**
				non EU	**8290**
Total					**102504**

Table A11 Estimated own resources in the year 2006 for the Commission proposal (1999 prices), EU 20+

	TOR	VAT	GNP	UK correction	TOTAL
Belgium	944	395	2632	229	**4199**
Denmark	242	258	1713	149	**2362**
Germany	2682	4040	22211	1929	**30862**
Greece	138	228	1325	115	**1806**
Spain	587	1048	6690	581	**8906**
France	1289	2597	14942	1298	**20126**
Ireland	184	137	716	62	**1099**
Italy	1002	1701	12302	1068	**16073**
Luxembourg	12	30	187	16	**245**
Netherlands	1324	714	3967	344	**6349**
Austria	230	410	2215	192	**3048**
Portugal	138	213	1251	109	**1711**
Finland	104	197	1273	111	**1685**
Sweden	322	410	2390	208	**3330**
UK	2326	2810	14629	-6690	**13074**
CEEC -5			3228	280	**3508**
Total	**11523,93**	**15187,1**	**91673,27**	**0**	**118384**

Table A12 Estimated expenditures for the year 2006, Commission proposals EU-20+ (1999 prices)

	Agriculture & rural dev.	Structural	Cohesion	Other internal	TOTAL
Belgium	1062	308		4086	**5455**
Denmark	1476	146		255	**1878**
Germany	7647	4001		1296	**12944**
Greece	3107	2796	630	265	**6798**
Spain	5765	6191	1740	484	**14180**
France	11861	2638		1200	**15699**
Ireland	1833	889		179	**2900**
Italy	6415	5510		935	**12860**
Luxembourg	41	21		1287	**1349**
Netherlands	1774	546		577	**2897**
Austria	1228	402		244	**1873**
Portugal	960	1935	630	303	**3829**
Finland	859	320		253	**1431**
Sweden	1046	585		330	**1962**
UK	4810	2140		1207	**8158**
CEEC -5	3400	12080		1300	**16780**
Total EU	53284	40510	3000	13300	**110094**
				non EU	**8290**
Total					**118384**

ANNEX 6 EFFECTS OF THE BERLIN AGREEMENT, 2006 – MILLION EURO

Table A13 Net balances 1997, Agenda 2000 proposals and Berlin Conclusions, year 2006 (1999 prices)

	1997 real	Agenda 2000 prop. year 2006 EU-15	Agenda 2000 prop. year 2006 EU-20+	Berlin - 2006 EU-15	Berlin – 2006 EU-20
Belgium	1781	1824	1209	1552	1095
Denmark	98	-41	-347	-113	-411
Germany	-11919	-12775	-16001	-10071	-13529
Greece	4489	5373	5093	5151	4854
Spain	5761	7589	5845	7169	5361
France	-1828	-743	-3160	-1134	-3729
Ireland	2914	1941	1854	1383	1258
Italy	-587	269	-2166	-1469	-3606
Luxembourg	744	1153	1031	990	957
Netherlands	-1273	-2694	-3134	-2164	-2782
Austria	-909	-661	-991	-653	-998
Portugal	2783	2529	2210	3221	2883
Finland	1	86	-156	-12	-233
Sweden	-1243	-797	-1176	-843	-1215
UK	-685	-3053	-3677	-3007	-3673
CEEC 5	0	0	13564	0	13767

Table A14 Estimated own resources for the year 2006, Berlin outcome, EU-15 (at 1999 prices)

	TOR	VAT	GNP	UK Correction	TOTAL
Belgium	944	395	1992	240	**3571**
Denmark	242	258	1297	156	**1953**
Germany	2682	4040	16814	326	**23863**
Greece	138	228	937	113	**1415**
Spain	587	1048	4421	532	**6588**
France	1289	2597	11311	1361	**16559**
Ireland	184	137	542	65	**928**
Italy	1002	1701	9313	1121	**13136**
Luxembourg	12	30	141	17	**200**
Netherlands	1324	714	3003	58	**5099**
Austria	230	410	1677	33	**2350**
Portugal	138	213	827	100	**1277**
Finland	104	197	964	116	**1381**
Sweden	322	410	1810	35	**2577**
UK	2326	2810	11074	-4273	**11937**
Total	**11524**	**15187**	**66123**	**0**	**92834**

Table A15 **Estimated expenditures for the year 2006, Berlin outcome, EU-15 (1999 prices)**

	Agriculture & rural dev.	Structural	Cohesion	Other internal	TOTAL
Belgium	1042	269,352		3579	**4890,6**
Denmark	1356	109,313		223	**1688,3**
Germany	6616	4084,24		1135	**11835**
Greece	2671	3026,75	527,1	232	**6457,1**
Spain	5128	6233,2	1455,8	424	**13242**
France	10922	2133,52		1051	**14106**
Ireland	1636	454,643		157	**2247,4**
Italy	5640	4122,3		819	**10581**
Luxembourg	34	11,703		1127	**1173,4**
Netherlands	1692	388,248		506	**2585,4**
Austria	1073	215,54		213	**1501,8**
Portugal	862	2747,78	527,1	266	**4402,3**
Finland	768	267,537		221	**1256,5**
Sweden	916	318,26		289	**1523,8**
UK	4318	2277,6		1058	**7652,9**
Total EU	44674	26660	2510	11300	**85144**
				non EU	**7690**
Total					**92834**

Table A16 **Estimated own resources for the year 2006, Berlin outcome, EU-20 (1999 prices)**

	TOR	VAT	GNP	UK Correction	TOTAL
Belgium	944	395	2380	298	**4016**
Denmark	242	258	1549	194	**2243**
Germany	2682	4040	20087	419	**27228**
Greece	138	228	1198	150	**1714**
Spain	587	1048	6050	757	**8442**
France	1289	2597	13513	1690	**19089**
Ireland	184	137	647	81	**1049**
Italy	1002	1701	11125	1391	**15219**
Luxembourg	12	30	169	21	**232**
Netherlands	1324	714	3588	75	**5700**
Austria	230	410	2003	42	**2685**
Portugal	138	213	1132	142	**1624**
Finland	104	197	1151	144	**1596**
Sweden	322	410	2162	45	**2939**
UK	2326	2810	13230	-5812	**12553**
CEEC – 5			2919	365	**3284**
Total	**11524**	**15187**	**82903**	**0**	**109614**

Table A17 Estimated expenditures for the year 2006, Berlin outcome, EU-20 (1999 prices)

	Agriculture & rural dev.	Structural	Cohesion	Other internal	TOTAL
Belgium	1042	269		3579	**4891**
Denmark	1356	109		223	**1688**
Germany	6616	4084		1135	**11835**
Greece	2671	3027	527,1	232	**6457**
Spain	5128	6233	1455,8	424	**13242**
France	10922	2134		1051	**14106**
Ireland	1636	455		157	**2247**
Italy	5640	4122		819	**10581**
Luxembourg	34	12		1127	**1173**
Netherlands	1692	388		506	**2585**
Austria	1073	216		213	**1502**
Portugal	862	2748	527,1	266	**4402**
Finland	768	268		221	**1257**
Sweden	916	318		289	**1524**
UK	4318	2278		1058	**7653**
CEEC - 5	3400	12080		1300	**20780**
Total	**48074**	**38740**	**2510**	**12600**	**101924**
				non EU	**7690**
Total					**109614**

ANNEX 7 SCENARIOS FOR THE YEAR 2010

Table A18 Net balances 1997, Agenda 2000 proposals and Berlin Conclusions, year 2006 (1999 prices)

	Berlin outcome - 2006 EU-20	Year 2010, scenario1 - Structural Fund criteria unchanged	Year 2010, scenario2 - SF levels equal
Belgium	1095	810	569
Denmark	-411	-569	-666
Germany	-13529	-15342	-15881
Greece	4854	3712	4164
Spain	5361	1582	3043
France	-3729	-4856	-5831
Ireland	1258	1037	876
Italy	-3606	-5357	-5163
Luxembourg	957	948	937
Netherlands	-2782	-3185	-3413
Austria	-998	-1117	-1213
Portugal	2883	1819	1797
Finland	-233	-416	-398
Sweden	-1215	-1387	-1439
UK	-3673	-3909	-4025
CEEC 5	13767	26230	26642

Table A19 Scenario 1 – No change in the Structural Funds' criteria Own resources, year 2010, EU-20 (1999 prices)

	TOR	VAT	GNP	UK Correction	TOTAL
Belgium	944	395	2538	348	**4225**
Denmark	242	258	1652	227	**2378**
Germany	2682	4040	21416	491	**28629**
Greece	138	228	1278	175	**1819**
Spain	587	1048	6451	885	**8971**
France	1289	2597	14407	1977	**20271**
Ireland	184	137	690	95	**1106**
Italy	1002	1701	11862	1628	**16192**
Luxembourg	12	30	180	25	**247**
Netherlands	1324	714	3825	88	**5951**
Austria	230	410	2136	49	**2825**
Portugal	138	213	1207	166	**1723**
Finland	104	197	1228	168	**1697**
Sweden	322	410	2305	53	**3090**
UK	2326	2810	14105	-6836	**12405**
CEEC - 5			3364	462	**3825**
Total	**11524**	**15187**	**88642**	**0**	**115353**

Table A20 Scenario 1 – No change in the Structural Funds' criteria. Expenditures, year 2010, EU 20 (1999 prices)

	Agriculture & rural dev.	Structural	Cohesion	Other internal	TOTAL
Belgium	966	269		3579	**4815**
Denmark	1333	109		223	**1666**
Germany	6931	3363		1135	**11430**
Greece	2685	2503		232	**5420**
Spain	5223	4346		424	**9993**
France	10981	2134		1051	**14165**
Ireland	1603	323		157	**2082**
Italy	5804	3182		819	**9806**
Luxembourg	40	12		1127	**1179**
Netherlands	1540	388		506	**2434**
Austria	1120	189		213	**1523**
Portugal	885	2287		266	**3438**
Finland	777	176		221	**1174**
Sweden	968	246		289	**1503**
UK	4446	1769		1058	**7272**
CEEC - 5	10400	18064		1300	**29764**
Total	**55702**	**39361**	**0**	**12600**	**107663,5**
				non EU	**7690**
Total					**115354**

Table A21 Scenario 2 – Structural Funds' criteria changed to protect EU-15 levels - Own resources, year 2010, EU-20 (1999 prices)

	TOR	VAT	GNP	UK Correction	TOTAL
Belgium	944	395	2663	365	**4367**
Denmark	242	258	1733	238	**2471**
Germany	2682	4040	22473	515	**29710**
Greece	138	228	1341	184	**1890**
Spain	587	1048	6769	929	**9333**
France	1289	2597	15118	2075	**21079**
Ireland	184	137	724	99	**1145**
Italy	1002	1701	12447	1708	**16857**
Luxembourg	12	30	189	26	**257**
Netherlands	1324	714	4014	92	**6144**
Austria	230	410	2241	51	**2933**
Portugal	138	213	1266	174	**1791**
Finland	104	197	1288	177	**1766**
Sweden	322	410	2418	55	**3206**
UK	2326	2810	14801	-7174	**12762**
CEEC - 5			3530	484	**4014**
Total	**11524**	**15187**	**93015**	**0**	**119726**

Table A22 Scenario 2 – Structural Funds' criteria changed to protect EU-15 levels - Expenditures, year 2010, EU-20 (1999 prices)

	Agriculture & rural dev.	Structural	Cohesion	Other internal	TOTAL
Belgium	966	171		3579	**4716**
Denmark	1333	105		223	**1662**
Germany	6931	3905		1135	**11972**
Greece	2685	3027		232	**5944**
Spain	5223	6169		424	**11816**
France	10981	1967		1051	**13999**
Ireland	1603	201		157	**1961**
Italy	5804	4042		819	**10665**
Luxembourg	40	11		1127	**1178**
Netherlands	1540	354		506	**2399**
Austria	1120	201		213	**1534**
Portugal	885	2333		266	**3484**
Finland	777	263		221	**1261**
Sweden	968	311		289	**1568**
UK	4446	2010		1058	**7513**
CEEC - 5	11000	18064		1300	**30364**
Total	**56302**	**43134**	**0**	**12600**	**112035,9**
				non EU	**7690**
Total					**119725,9**

ANNEX 8 TECHNICAL ASPECTS AND ASSUMPTIONS USED IN THE CALCULATIONS OF NET BALANCES

The estimates of budget expenditures and own resources are the result of two models. The first model estimates expenditures for agriculture. The second model estimates the expenditures for structural funds and uses the results from the agricultural model to estimate the total EU budget expenditure. The same model then calculates the contributions of each member state to the EU budget, following closely the own resources system as described by the Commission (1998h).

The system used to calculate different scenarios and the final results following the decision in the Berlin European Council is as follows. A base scenario is constructed, which simulates the budgetary expenditures and the contributions of each member state in the hypothetical case that the Agenda 2000 proposals are accepted and implemented in full. The base scenario is therefore the estimated budget for the year 2006. All differences between this scenario and any other agreements in the Council, hypothetical or real, are simulated by changing the parameters in the models.

8.1 BASE SCENARIO

Agriculture

The agricultural model analyses the effects on the budget of changes in the CAP for cereals, oilseeds, beef and dairy, since these are the main items of reform. The proposals and the final decision of the Agenda 2000 reforms for Agriculture specify for each member state the number of hectares, heads of cattle and tons of milk, which will be eligible for direct payments. Together with the average regional base yields for oilseeds and cereals, the model calculates what the expenditure on direct payments would be, if the Member States claim all quota allocated to them.

Expenditures on other items are assumed to be equal to the 1997 figures (Commission 1998i) for all remaining products (set at 1999 prices). For cereals and beef, no export refunds or storage costs are included. Since the maximally allowed national support claims have not been used in full, this partially counterbalances any excessive fund allocations by the model. For dairy, the difference between the Commission predictions (Commission, 1998a) and the calculations of the expenditure on direct payments for milk is assumed to be expenditures for other costs and export refunds. This difference is distributed among the Member States according to their corresponding 1997 share in the expenditures.

Structural Funds

For the Agenda 2000 initial proposals, the Structural Funds model allocates the funds using the following criteria:

1 The Structural Funds budget line in the proposals has to be fully utilised in 2006.
2 The expenditure on Structural Funds for 1997 (at 1999 prices) are used as a base for estimation as follows:
   - New Objective 1: Regions which have exceeded the 75 per cent of the average EU GDP per capita have been removed from the areas eligible for Objective 1 support. The average yearly expenditure for these regions between 1995 and 1999 has been deduced from the 1997 expenditure. The funds have been redistributed among the Member States according to the share of Objective 1 allocations in the Member States, assuming that the global expenditure on Objective 1 does not fall. The expenditures on Objective 6 have been added to Objective 1.
   - New Objective 2: Objectives 2 and 5b have been added.
   - New Objective 3: Objectives 3 and 5a have been added.

After these operations 4,5 billion Euro were not allocated (excluding pre accession aid, which is treated as external expenditure). These funds have been redistributed among the Member States according to their shares in total receipts under the structural funds.

Cohesion Funds

The 3 billion Euro programmed in the financial framework for 2006 have been distributed as follows:

- No funds for Ireland.
- The distribution among the remaining three countries Greece, Portugal and Spain uses 1997 shares as a base. These were 18 per cent for Greece, 55 per cent for Spain and 18 per cent for Portugal. Assuming a similar distribution, their shares have been increased by 3% each to cover the exit of Ireland.

Own Resources

The methodology used follows the rules of the calculation of budget balances including the UK budgetary rebate as presented by the Commission (1998h). The UK rebate has been calculated by using a few simplifications, but by trying to stay as close as possible to the actual mechanism. The methodology is as follows:

- TOR and VAT are the same as estimated for 1999 by the Commission (1998h) throughout the simulations.
- The UK rebate is equal to 66% of its budgetary imbalance. This imbalance is calculated by multiplying the difference between the UK's average of the sum of the percentage shares in VAT and GNP payments and its share in allocated expenditure times allocated expenditure. In the actual rebate only the share in VAT is used, using the old pre–1988 contributions system as a calculation tool and then deducing the UK advantage after the 1988 reforms, which have introduced GNP as a resource. Our calculations try to evade complications by using the average of the sum of shares in VAT and GNP contributions. For similar

reasons the Commission (1998h) does not use the UK advantage in its own simulations either.

- The rebate used is for the net contributions made in the year analysed. The actual two-year time lag in the budgetary procedures is eliminated for the sake of mathematical simplicity.

Enlargement

The costs of enlargement have been introduced in the financial framework. The first group of five countries form one block in the model. Their contributions for the budget are based solely on their GNP share, as it is not possible to know their future VAT and TOR payments.

Other costs

Other costs constitute the sum of internal policies and administration budgeted. Costs for external action are added to the EU-15 expenditures separately. There is no reduction in funds for external action related to pre accession measures, because it is assumed that the second group will be getting increasing amounts of support in the future.

Net balances

Net balances calculations follow the system used by the Commission and described in its own publication (1998h).

8.2 SIMULATIONS

Two hypothetical policy scenarios and the actual outcome of the Berlin European Summit are presented in table A23.

Table A23 Simulation scenarios, changes with respect to base scenario

Scenario	Agricultural Policy	Structural and Cohesion Funds
Berlin Council conclusions	The expenditures for the CAP are recalculated using the finally agreed lower direct payments per hectare. The expenditures for the dairy policy also follow the new direct payments regime which adapts the refunds and storage expenditures in accordance with the new budget line in the financial perspective.	The Structural Funds are allocated according to average yearly allocations following the distribution of the funds as published by the Commission (1999). The Cohesion Funds are allocated with the same shares as in the base scenario, but using the budgetary outlay agreed in Berlin.
Year 2010 Scenario 1 – Objective 1 criteria stay	The expenditures for the CAP are expected to be the same as in 2006, except for the dairy payments. These are estimated in the agricultural model for the EU-15 following the quota allocations and the amounts agreed March 23 in the Agricultural Council for direct payments and national envelopes. Intervention and storage costs are reduced by slightly more than half from the 1997 costs (Commission, 1998i). No payments for dairy were calculated for the CEECs. Direct payments for the CEECs were assumed to reach 7 billion ?, as estimated by Münch (1998).	It was estimated that if the CEECs have a real economic growth by 4% a year compared to 2% in the EU-15 (except for Spain 4%, Greece and Portugal 3%), the EU average GDP per capita at PPP in 2010 would fall by 7%. Every region of the EU with above 68% of EU GNP today has been assumed to be ineligible for Objective 1 funds (the increased economic growth has not been applied to Objective 1 regions, they grow at the same speed as the EU average growth rate). A share of funds for the Objective 1 (as yearly average 2000-2006) for the countries has been deducted equal to the share of regions that become ineligible. 1/3 of the funds remain as Objective 2 or 3. Cohesion fund has been eliminated. The CEECs are assumed to get 4% of their GDP in 2010 as structural funds. This is 18 billion ?.
Year 2010 Scenario 2 – Objective 1 are changed to maintain benefits from structural funds	Equals scenario 1	Same receipts as in 2006, except for the cancellation of the Cohesion Funds.

Own resources	Other costs
The amount retained as collection costs by the Member States form TOR increases from 10% to 25%. VAT is cut by 50%. In both cases, the base scenario figures are used as reference. The UK advantage is taken into account and deducted from the rebate. Contribution towards the UK rebate cut for Germany, the Netherlands, Austria and Sweden is 25 per cent of the sum under the original system. Remaining Member States (excluding the UK) make up for the rebate according to their GNP share. It is assumed that 2 billion ? for the pre accession measures will become expenditures for new Member States. The UK cannot include these for the rebate calculation.	The amounts for administrative expenditures and internal action are changed according to the financial perspective agreed in Berlin. External action is also amended accordingly.
System equals Berlin 2006	System equals Berlin 2006
System equals Berlin 2006	System equals Berlin 2006.