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CENTRE FOR EUROPEAN REFORM

about the CER

The Centre for European Reform is a think-tank devoted to improving the quality of the debate on the European Union. It is a forum for people with ideas from Britain and across the continent to discuss the many social, political and economic challenges facing Europe. It seeks to work with similar bodies in other European countries, North America and elsewhere in the world.

The CER is pro-European but not uncritical. It regards European integration as largely beneficial but recognises that in many respects the Union does not work well. The CER therefore aims to promote new ideas and policies for reforming the European Union.

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PRICEWATERHOUSECOOPERS

Foreword

PricewaterhouseCoopers is delighted to support this Centre for European Reform (CER) project on the costs and benefits of European Union enlargement. We see the pamphlet as an important and timely contribution to the debate on the future of the European Union.

PricewaterhouseCoopers' own work on enlargement has revealed considerable scope for providing business with more information and a better understanding of the economic significance of the process. At the same time, surveys of public opinion in the EU show that there is a need to increase the level of support for enlargement. In part, this may be because the existing analysis of the costs and benefits of enlargement is limited. I believe, therefore, that this CER pamphlet can play an extremely useful role in improving understanding of the potential benefits of enlargement.

There has been much discussion and speculation about the likely timetable for enlargement. Our own research suggests that business is more concerned about having a more certain timetable, rather than the speed at which enlargement happens. This pamphlet develops the discussion further by exploring the potential costs and benefits of alternative enlargement timetables. It indicates the benefits to be gained from an early and extensive enlargement. It also highlights the risks of allowing enlargement to be delayed unduly.

In PricewaterhouseCoopers we recognise that enlargement of the EU is one of many drivers for change in Europe that could lead to a much more integrated business environment. In the coming years, we expect these drivers will fashion a 'New Europe' in which we all do business. Our aim is to work with our clients to understand and to shape this new business environment and to develop the best possible responses to the challenges presented by the New Europe.

Rosemary Radcliffe
Chief Economist

For further information on PricewaterhouseCoopers' work on EU enlargement and the New Europe, please contact:

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1 Introduction: the scale of the challenge

By 2010, the European Union could cover another third of the map of Europe, with 25 members and nearly half a billion people. It will move from being a rich country club to a continental union. Taking in the ten central European candidates will be the Union's greatest contribution to the continent's stability, security and prosperity in the coming decades – but only if the enlargement process is managed well. The admission of so many countries will change the whole functioning of the EU, for the better in forcing it into long-overdue reforms of its institutions and budget, but possibly for the worse if it does not adapt quickly enough to cope with much greater diversity.

Ever since 1989, eastward enlargement has seemed about five years away – and it still does. But at long last it looks like the EU will admit its first post-communist members in 2004. The exact timing for each individual applicant remains unclear. It depends not only on their technical progress towards meeting the EU's accession conditions, but also on the evolving politics of enlargement among the member governments.

Enlargement looks closer after the firmer commitments made at Gothenburg in June 2001, but it remains an enormous political challenge. Opposition among the existing members comes from those groups that receive EU or national subsidies, feel threatened by wage competition, object to immigration, or simply fear change. Enlargement is an easy target for opportunist politicians who are seeking a popular anti-EU cause. Some of them have begun to play on exaggerated fears of the costs of expanding the EU, and of the potential for mass immigration, thereby distracting attention from the overall benefits.

The arguments in favour of enlargement are overwhelming in political and security terms: it would bind post-communist countries into a strong political community of stable democracies and prosperous economies. These motivations are well-understood and largely accepted across the EU: enlarging the Union to include post-communist countries means re-unifying Europe, after not only half a century of the Cold War but also many previous generations of conflict and political turmoil. At last the European integration project might start to realise its goal of an 'ever closer Union' among *all* the 'peoples of Europe'.

But to realise these benefits, the EU needs to be bolder and more generous. Political leaders have so far been preoccupied with the budgetary costs, as well as the risks of labour market disruption and wage competition. This pamphlet aims to provide a clear overview of the economic benefits of enlargement across Europe, and a realistic assessment of the likely costs. It does not address the security issues surrounding EU and NATO enlargement, or the geo-political implications of these projects, because they are discussed in many other publications. Instead, it focuses on the short-term political challenge of getting to the first accessions, and on the economics of enlargement. Many of the objections to enlargement are based on a misunderstanding of the risks involved, and a failure to understand the opportunity costs of delaying the admission of the candidate countries yet again.

This pamphlet presents four major arguments on the economics of enlargement:

★ ***Enlargement will be good for the European economy***
The economic gains will be considerably greater than the costs over the medium and long term: enlargement will add over 100 million consumers to the single market and it will create many new jobs in both the applicant countries and the current EU. It will provide business with a common regulatory framework that operates across two dozen countries. And the

preparations that the candidate countries are having to make, in order to adapt to EU norms, are helping to entrench their economic and political reforms.

The central European economies are currently small, but most are growing faster than mature EU markets. There is significant economic potential around new growth areas like Warsaw, Budapest and Prague. Moreover, the EU economy will benefit in the longer term from the dynamic effects of economic integration. The probable first entrants are likely to favour an economic reform agenda once in the EU – after all, the applicants have spent the past decade liberalising their economies, and most of them with remarkable speed. The prospects of accession are crucial to attracting higher levels of foreign direct investment (FDI), which are the key to boosting growth and integrating these economies into Europe-wide supply chains and distribution networks.

Enlargement is unlikely to cause disruption to particular sectors or regions – industrial trade is already essentially liberalised, and sensitive sectors in the EU have not suffered significantly from greater competition. But restructuring will occur over the longer term, increasing the international competitiveness of the enlarged European economy. From the point of view of west European companies, bringing more countries into the single market will reduce the risk of doing business in the other half of the continent.

★ ***Enlargement need not be expensive for the EU***

Budgetary constraints mean that there will be few financial transfers to the new members, in comparison with the money granted to Greece, Ireland, Portugal and Spain when they joined the EU. This enlargement will be done at low cost to the public purse, for better or for worse. The applicants' economies have been developing without much in the way of public subsidies, and the prospect of an EU cash handout is *not* the principal motivation for joining.

It is important to distinguish between the unavoidable and immediate costs of accession, and the longer-term costs of meeting investment needs in central Europe – which can be handled more flexibly. The cost of new accessions to the current EU budget, which runs from 2000 to 2006 inclusive, is very small. The maximum allocation to central and eastern Europe over those seven years amounts to €67 billion – just a thousandth of EU GDP per year. That is a tiny price to pay for re-uniting Europe, and a tenth of what Germany paid for its own re-unification after 1990. It is also a fraction of the cost of defending a divided Europe during the Cold War.

In the longer term, however, the accession countries will need EU funds in order to supplement private investment, in order to ensure that they can meet EU standards on the environment and transport. The new EU budget which is due in 2007 will have to establish new policies to deal with the real needs of a more diverse Union.

★ ***Enlargement will not lead to mass migration***
A small number of workers are likely to migrate to the EU-15 after accession, but they will not cause long-term disruption to labour markets. Full free movement of labour is likely to cause a small inflow over the next 30 years, stabilising at the point where central European residents in the EU account for 1.1 per cent of the total population. It will be a trickle, not a flood.

Accession will itself help to control migration: full access to the single market will provide opportunities that will keep central European workers employed in their own countries. Likewise, wage competition would not be reduced if eastward enlargement were postponed. Business is already exposed to global competition, and not only to cost differentials across Europe. EU businesses can maintain profitability by using central Europe as a low-cost production site, and by selling into the region's growing markets, thereby helping to maintain jobs in western Europe.

★ ***There are high opportunity costs to delaying the first accessions*** Any delay to the entry of the best-prepared candidates would cause foreign direct investment inflows into central Europe to drop. Central European markets would become more difficult operating environments without the levelling effect of common rules under the single market. The decline in investment and trade would in turn slow down the process of industrial restructuring that is essential to improving the applicants' competitiveness. If the prospect of EU membership recedes into the distance, the enormous incentive to reform economies and institutions quickly and radically would wane, increasing protectionism and threatening the continuity of reformist governments. The virtuous cycles of reform, FDI, restructuring and growth that are now evident in most of central Europe could be reversed. The resulting instability and economic decline on the borders of the EU would be far more threatening than enlargement itself.

Enlargement can begin without the EU making substantial changes to its existing institutions and budget – there is no need to delay for yet another inter-governmental conference. But in order to guarantee longer-term success, the EU will need to continue its own internal reform programme after the first accessions. Many reforms are long overdue: the Common Agricultural Policy (CAP) needs a major overhaul because of its cost, consumer opposition to intensive farming, and the forthcoming world trade negotiations. The EU also needs to ensure that its regional aid funds actually meet the aim of reducing inequalities and promoting structural change across Europe. And the EU must restructure its institutions to ensure they can cope with greater numbers and more diversity.

The EU must manage enlargement properly if it is to reap all the potential gains. Successful management depends on developing a political strategy to explain the benefits of enlargement to the public and to interest groups. The Irish public's rejection of the Nice Treaty in a referendum on 7 June 2001 could complicate the timetable for enlargement, if it slows ratification of the treaty beyond 2002. It could be a foretaste of the difficulties to come if EU governments fail to explain to their populations why enlargement is good for EU-15 countries as well as for the applicants.

Even once negotiations are finished, each accession treaty will have to be ratified by all fifteen national parliaments, any one of which could throw it out. The delicate compromises reached over years of negotiations will be no use if the results cannot be sold in the member-states.

Why the EU has moved so slowly towards enlargement

The EU has been slow to respond to the end of the Cold War, and its approach to enlargement is symptomatic of that sluggishness. The fall of the Berlin Wall and the collapse of communist regimes in central and eastern Europe raised a set of new challenges which the Union was ill-equipped to deal with. At the start of the 1990s, the EU had only skeletal collective foreign and security policies, and its aid policy was mainly concentrated on the former colonies of its member-states. EU leaders also had their attention fixed on other concerns: the project to create a single market, preliminary plans for establishing a single currency, and the sharp economic downturn in the early 1990s. Many leaders felt it was not the moment for political grand-standing about re-uniting Europe. Re-unifying Germany was the first priority, and the evident financial expense of that unification raised concerns about the cost of enlarging the whole Union.

It took the member-states until 1993 to agree to enlarge eastwards, when they laid down for the first time some formal conditions for new members. But it was a further five years before accession negotiations actually began and, even then, only with half the candidates. The first accessions will probably take place around 2004-05, a decade and a half after the revolutions that ended the Cold War. Although EU leaders often refer to the 'historical opportunity' and even the 'moral imperative' of re-uniting the European continent, few have been willing to advocate the radical reforms of the Union's own institutions and budget that will be needed to integrate so many different countries in the longer term.

The EU has sometimes been called a 'colonial power' in extending its influence eastward, accused of seeking to dominate central Europe as the Soviet Union once did. A favourite tactic of some British Eurosceptics is to compare the European Union with the Soviet Union. "Surely you don't want to replace rule from Moscow with rule from Brussels?" they tease the central Europeans. "You've only just regained your sovereignty after all those years of Soviet domination. Why do you want to give up this hard-won control of your national destiny to live in a German-dominated superstate?"

If this were true, the EU would be the most reluctant coloniser in history: it has been slow to respond to aspirations for membership, and very wary of making open-ended commitments to extending its borders. The EU more resembles a landlord reluctant to build an extension to his comfortable dwelling in order to house his poor relations. Might they be awkward, noisy, and demanding? Might the new extension threaten the stability of the whole edifice? It is far easier to contemplate the renovation and refurbishment of the existing accommodation than embark on such bold new plans.

The desire of central and east European countries to join the EU derives from a complex mixture of political, economic and security motivations. Newly elected leaders in central Europe rapidly signed up to every international organisation, in order to speed up their integration into the world economy and the 'international community' that was replacing the bi-polar world. As the Balkans descended into war, joining NATO and the EU became an increasingly urgent priority for most central European countries.

Many saw the EU as a bulwark against any return to communism, and also against resurgent nationalism. The accession process also became an important mechanism for locking in reforms and sustaining liberalisation efforts despite changes of government.

Membership of the EU offers post-communist countries a way to re-orientate foreign policy westwards and demonstrate that they are forever out of Russia's shadow. It is also a means of cementing the integration of their economies into pan-European markets. And there is a very important psychological dimension: many central Europeans felt they had 'lost' their European identity during the Cold War, and their countries needed to 'return to Europe' to re-gain it. By the end of the twentieth-century, 'Europe' was epitomised by the European Union, even though it only covered the western side of the continent. Joining the Union has become a central strategy to satisfy this desire for inclusion.

2 The enlargement process so far

All ten eastern applicants are now conducting accession negotiations, but they will complete them at very different times. The five countries that began in 1998 (the Czech Republic, Estonia, Hungary, Poland and Slovenia) are progressing well, forming a group of 'front-runners' in the accession marathon. The European Commission aims to conclude negotiations with the most advanced candidates by the end of 2002. Of the five central European countries that started accession talks in February 2000, Latvia, Lithuania and Slovakia are catching up with the front-runners. However, Bulgaria and Romania remain many years away from accession, although Bulgaria has made better progress in the last couple of years.

Cyprus began negotiations in 1998 and Malta in 2000, and both countries are close to meeting the formal conditions for membership. However, both islands pose other problems: Cypriot accession could be blocked because of the division of the island, and one of Malta's main political parties opposes the country's accession to the EU. Turkey is an official candidate but cannot start accession negotiations until the EU judges that it has met the political conditions on democracy and human rights. This pamphlet does not consider these three countries' progress in detail, since their applications raise different questions from those of the central Europeans; however, they are subject to the same accession conditions.

At the Nice European Council in December 2000, EU member-states expressed the hope that the first accessions could take place in time for new members to participate in the next European Parliament elections in 2004. This was not a firm commitment to a target-date, as some German and French policy-makers were quick to point out: a protocol to the Treaty on European Union allows applicants to take part in European elections before accession. The Gothenburg European Council in June 2001 removed this ambiguity and potential excuse for delay, stating the EU's 'objective' that some candidates participate in the 2004 elections "as members". The Gothenburg conclusions also re-affirmed the goal of concluding negotiations with the best-prepared candidates in 2002.

The Swedish Presidency had to fight hard at Gothenburg to overcome German and French opposition to setting a firmer target-date. Both countries are facing elections in 2002, and are nervous about declining public support for enlargement. The German government was also concerned about the impact of a firmer date on Poland's prospects for early membership. The Gothenburg conclusions re-affirmed the principle of 'differentiation', whereby each applicant country proceeds at its own pace. German policy-makers are concerned that Poland should not be left behind in the first accessions as a result of differentiation. A large majority of the other member-states supported the firmer date commitment, partly because they were rattled by the Irish referendum result. The re-affirmation of the timetable and the clearer target-date are an attempt to keep up the momentum of the process.

EU accession conditionality

The EU has set out three formal conditions for accession:

1 Membership requires that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities.

2 It requires the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union.

3 It presupposes the candidate's ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union. [1]

These conditions were designed to minimise the risk of new entrants becoming politically unstable and economically burdensome to the existing EU. They were formulated as much to reassure member-states as to guide the applicant countries. They provide a safeguard against the EU responding to geo-political and strategic considerations alone, and thus allowing a country to join before it is fully able to compete in the single market. The first and second conditions are essentially about the political and economic reforms that are required to ensure good governance and convergence with west European models. The third is more complicated: the 'obligations of membership' include implementation of the whole body of EU law and practice – formally known as the '*acquis communautaire*'. Moreover, the applicants cannot negotiate opt-outs like those allowed to some current member-states on monetary union and Schengen.

[1] *European Council, Presidency Conclusions, Copenhagen, June 1993.*

All three conditions are very general and open to interpretation, which gives the EU enormous discretion in deciding when a country is ready to join. The candidates have to meet all three conditions. Progress in economic reform is not enough if a country is not implementing EU legislation quickly. Likewise, good progress in taking on EU laws is insufficient if minority populations are being mistreated. Moreover, it is not enough to write the EU's *acquis* into national law: applicant countries also need to demonstrate they have the administrative capacity to implement and enforce these laws.

All ten central European candidates are judged to have met the political conditions – which are now an explicit pre-requisite for starting negotiations. Some of the candidate countries are quickly progressing towards meeting the economic and *acquis* conditions. The European Commission's annual 'regular reports' on the candidate countries show that eight out of ten east European countries are making steady progress towards accession. In particular, all five countries that started negotiations in 1998 are functioning market economies, and close to becoming competitive in the single market.

Latvia, Lithuania and Slovakia are catching up with this group, but the Commission expects that they will not be competitive in the single market until the medium term. The Commission has praised Bulgaria's efforts and progress over the past year, but its assessment of Romania's economy and administrative capacity is bleak. Neither of these last two is likely to join the EU in the near term, and perhaps not for more than a decade.

Progress in negotiations

The European Commission set out a 'road-map' for completing the accession process in November 2000. This envisages finalising all the 31 negotiating 'chapters' by the end of 2001, apart from those with major implications for the EU budget and institutions. In 2002, the issues with financial consequences and the institutional chapter will be addressed, along with any remaining unresolved issues. Although this road-map was endorsed by the Nice summit in December 2000, there have already been hold-ups in 2001 over free movement of people and of capital, despite the efforts of the Swedish Presidency to push forward with an ambitious negotiating timetable. Moreover, the member-states have started discussing the budgetary costs of enlargement in earnest – even though this is not officially on the agenda until 2002. The Commission has so far largely managed the accession process, but from mid-2001 onwards the member-states will start to declare their positions and defend key interests. Now that the member-states are entering the end-game of negotiations, the process will become much more unpredictable.

The five front-runner countries are only now reaching the really difficult points in accession negotiations. In the relatively easy chapters completed in 1998-2000, many technical issues had to be resolved, but no major stumbling-blocks emerged. However, issues such as competition policy, energy, transport and justice and home affairs will all pose further problems later in 2001. The lesson of previous enlargements – even the relatively smooth accession negotiations with Austria, Finland and Sweden – is that unexpected difficulties can arise even in seemingly uncontroversial areas.

In the formal timetable for opening and closing the negotiating chapters, the applicants have so far made impressive progress. More than two-thirds of the negotiating chapters have been provisionally closed with some candidates, and all the chapters have been opened even with some of the second group which started negotiations in 2000. Latvia, Lithuania, Malta and Slovakia are catching up with the six candidates which started negotiations in 1998, opening the possibility that they could join at the same time as the first group. Poland's progress has slowed down as it approaches parliamentary elections in September 2001, although it could close several chapters fairly quickly after the elections. The Polish negotiators are holding out for better deals in several critical areas, hoping that their country's size and geo-political importance will outweigh EU objections.

Several major issues are now close to resolution, such as the right of EU citizens to buy land and second homes in central Europe, and transitional periods on environmental standards. The EU has also found a settlement on the vexed issue of **the free movement of labour**. All the applicants wish to avoid curbs on the freedom of their citizens to live and work throughout the EU after accession. However, Germany and Austria have asked for a long transitional period before the free movement of labour is permitted, in response to their own domestic debates about unemployment and immigration. They have allowed themselves to be pushed into demanding restrictions by anti-immigrant populists like Jörg Haider. EU member-states have adopted a Commission proposal that maintains a seven-year transitional period while allowing flexibility for unconcerned member-states to allow labour mobility more quickly. The EU position allows member-states to restrict the freedom of central European citizens to work in their countries for five years after accession, and for up to seven years in exceptional circumstances.[2] These transitional periods are not required to prevent large-scale movement of workers – as German and Austrian officials admit off-the-record – but they are seen as politically essential, to reassure voters in border regions.

[2] *Note that free movement of workers is a separate issue from free movement of people. This proposal does not in itself prevent central European citizens from travelling in the EU-15 after accession, just from working there.*

Most central Europeans oppose these restrictions, because the freedom to work and travel abroad is one of the major benefits of the fall of communist regimes for ordinary citizens. But in tactical terms, the restrictions imposed on labour mobility have had the positive effect of speeding up agreements in other areas. A 'seven-year effect' emerged as EU negotiators became more generous, seeking to make concessions elsewhere as a trade-off against the restrictions on central European workers. This happened for environmental standards, where EU negotiators started advising the applicants not to reduce their requests for transitional periods, but just to accompany them with financing plans. The latest example of the 'seven-year effect' is the Union's position on free movement of capital, which offered the applicants their own seven-year transitional period before foreigners could buy land or second homes in central Europe. The EU has effectively acknowledged that the candidates should be given time to deal with their own problem areas, especially when there is a much sounder economic case for transitional periods on buying farmland than there is for the EU's restrictions on labour mobility.

The major issues that could still delay or even stall enlargement are connected with the EU budget – specifically agriculture and regional aid – and with border controls. A major fight is looming between the EU-15 countries over the future of agricultural and regional subsidies, and the member-states are far from agreement on a common position to present to the applicants. Most of the bargaining over money is taking place between the current member-states, not with the candidates.

Agriculture is difficult because of the potential cost of extending the Common Agricultural Policy (CAP) as it now stands to central European farmers. It would be expensive to offer full access to the current agricultural funds because the EU would have to pay guaranteed prices and direct income supplements to central European farmers, as it does to their west European counterparts. Poland is the main concern because around one-quarter of its population lives ooff the land. The EU has already rejected Polish demands for transitional periods on a range of agricultural issues, and Poland recently withdrew some of these requests in order to make faster overall progress towards EU membership.

This problem is mainly an issue for EU budget politics, rather than central European agriculture. In a longer term perspective, Polish farmers are not much of a problem for EU agricultural markets, because most farms are very small and produce only for local consumption; the average Polish farm is less than five hectares and has just three and a half cows. Productivity is low and organic methods are common because of a lack of pesticides and fertilizers. Ironically, the supposedly backward Polish farming model looks rather like the one that Renate Künast, Germany's Green agriculture minister, is advocating for the EU: it is extensive, small-scale and organic, it is generally environmentally friendly and creates a pleasing landscape.

The problem for the applicant countries is that EU agriculture policy is a moving target. The general review of agricultural policy that is due in 2002 means that some CAP reform will occur ahead of accession – and more radical reform is likely in the medium term. It would be perverse for the EU to demand compliance with a regime that it is seeking to change. However, applicants will have to conform with food safety regulations before accession in order to export to EU markets.

Given the contentiousness of budgetary questions, the critical phase of agricultural negotiations might be delayed until the end of 2002 or even 2003 – although the EU's road-map says that all outstanding issues should be addressed by June 2002. In any case, little progress can be made until after the French elections in May 2002.

The issue of **regional aid** is also highly controversial for existing EU member-states. Along with other major recipients, Spain is fighting hard to maintain the EU subsidies to its poorer regions, which are due to receive nearly two-thirds of all available structural and cohesion funds under the current EU budget agreement. However, the accession of poorer countries is due to result in all but two of the Spanish regions losing their funding. Under current EU rules, the largest part of the structural funds is only available to regions which have an average GDP per head below 75 per cent of the EU average. After accession, virtually all the regions that fulfil this criteria will be in central and eastern Europe, because the entry of poorer countries will lower EU average GDP to a point below that of the currently poorest regions.

Prior to the Gothenburg summit, the Spanish government tried to trade off the German position on transitional periods for central European workers against its own regional aid demands. These two negotiating chapters are linked only by member-state power politics. But there will be further such stand-offs where budget demands are linked to difficult areas in negotiations. For example, the French government argued that positions on free movement of capital should be linked to agricultural policy, which would have prevented progress in that area until next year. Both these attempts were unsuccessful, but they were important political markers on the positions that these countries will take in 2002.

For the candidates, equality of treatment is the most important issue. Financial transfers are not a major motivation for membership and few central Europeans see the EU as just a giant cash-register. Many ordinary citizens expect joining the EU to cost their country money, rather than induce major transfers from their richer neighbours. The main concern in discussions on entitlements to EU funds is that new members should be subject to the same rules and have the same rights as current member-states. Despite the post-communist countries' need for investment, they place less emphasis on the sum of transfers they might receive. These countries have already lived through the first, difficult decade of transition, during which they turned their economies around and re-built their political systems with relatively little help from abroad.

There is only a relatively small '*acquis*' (body of legislation) covering the issue of **borders and internal security**, but it is highly controversial because of the security implications of the applicants applying EU policies on their eastern and southern frontiers. The enlargement process has coincided with the rapid development of a new policy area for the EU, in the form of justice and home affairs. New member-states have to comply fully with the EU's emerging policies for border management, asylum, immigration, and police and judicial cooperation. Cooperation in these areas, including the Schengen agreement on removing border controls between the member-states, has been incorporated into the EU's treaty framework since 1997. The result is a 'Schengen area' that allows free movement without passport checks, but which requires stricter controls on external borders. After enlargement, the main external land borders of the Union will be the applicants' eastern and southern frontiers.

EU member-states currently bordering eastern Europe (such as Germany and Austria) are very keen to avoid any threat of third-country nationals transiting across the new member-states into the Schengen area. The EU is insisting that its visa regime must be applied without exception, and that the applicants must strengthen physical controls on their borders. But these measures will mean cutting the applicants off from neighbouring countries, because they will dramatically reduce small-scale trade, investment and human contacts in border regions.

Preparing the EU for enlargement

The applicants have made enormous efforts to prepare themselves for accession. They have committed some of their most able public officials and scarce financial resources to EU accession. This allocation of time and money has not been matched on the EU side. The European Commission deserves credit for having kept accession negotiations going, but member-states need to play a strong political role in order to complete the process successfully. Accession policy remains highly technocratic and focused on getting the applicants to converge with the EU. But that will be insufficient to ensure the successful integration of many new and diverse member-states. The focus on technical requirements is also inadequate to sell the project to the public.

In a historical perspective, re-uniting Europe is far more important than fiddling with the EU's internal structures and budget. The budget is relatively small, yet those member-states which benefit from it most are insistent that they should continue to receive their EU hand-outs after enlargement – and even the relatively paltry sums allocated to the applicants so far have proved controversial. Few member-states are yet willing to acknowledge the real scale of reforms that will be needed in the longer term. Even the United Kingdom, which has little to lose from enlargement, is unwilling to give up its budget rebate. Britain will pay a third less for enlargement as a result.

The EU's current institutions are inadequate for fully integrating all the would-be members, but enlargement will have to start within the current framework. Enlargement was the ostensible reason for holding an inter-governmental conference (IGC) in 1999-2000. But it was not urgent enough to force current member-states to establish a framework for a Union of 27 or more countries. Waiting for yet another IGC would not necessarily result in a more satisfactory outcome, and it would be too tempting an opportunity for the more reluctant member-states to postpone enlargement still further. It is better to get on with enlargement now. The Union can make another attempt to reform the institutions and budget once the first new members have joined. The Nice European Council made some concrete progress in agreeing on the number of Council votes and European Parliament seats for each new member-state. The outcome was unfair to the applicants – in awarding them fewer seats than their populations merit – but the decisions were psychologically important in helping to make accession feel like a real prospect.

The EU now faces some tight deadlines in preparing itself for enlargement. There is a narrow window of opportunity to reach a settlement on the access of central European farmers to the agriculture budget between May 2002 (after the French elections) and December 2002 (the official end of negotiations with the best-prepared candidates). Regional aid is due for a review in 2003, and the bargaining over the budget is likely to start before the end of negotiations.

Even when the remaining major negotiating issues are resolved, the inadequate preparations for selling enlargement in the EU could snarl up ratification procedures. Already, only 44% of the EU's population is in favour of enlargement, with 35% against. In five countries fewer than a third support it, according to the 2001 Eurobarometer. Opposition to enlargement may be relatively shallow and voters certainly could be persuaded. But the sales campaign has been left very late – the end of negotiations is only 18 months away on the EU's timetable.

Further hitches like the Irish 'no' to the Nice Treaty could delay the timetable for enlargement by altering the politics. The Irish outcome will strengthen the anti-enlargement lobbies in the EU, which may demand referenda on the accession treaties as the Austrian Freedom Party is already doing. It also allows the more reluctant member-states to argue that yet another IGC is needed before the first accessions. And then, there could be a major upset over Cyprus: the eastern accessions could be blocked by Greece if Cyprus were excluded from the first group of new members.

The EU's leaders have to devote more time and attention to preparing the political ground. They will have to connect directly with public concerns over enlargement. This project cannot be driven only by elites. It will change most aspects of the Union, and many people in the EU will be directly affected. Even in the countries where public opinion is more supportive of enlargement, there is a big difference between supporting an idea in principle and being willing to make sacrifices for it. The economic, political and security benefits of re-uniting Europe will be much greater than the short-term adjustments that will have to be made by the Spanish regions, French farmers, and German and Austrian border areas. But people need to be persuaded of this fact.

3 The economic consequences of enlargement

The immediate impact of enlargement on the EU-15 economies will not be dramatic. The ten central European economies account for only 7 per cent of EU GDP: such economic minnows can hardly make a big aggregate impact on the single market. But they represent significant business opportunities that will benefit the EU in the longer term: EU businesses will gain from the addition of nearly a third more consumers to the single market. Moreover, the front-runner economies are growing somewhat faster than the current EU, albeit from a lower base. This section addresses three major questions about the economics of enlargement:[3]

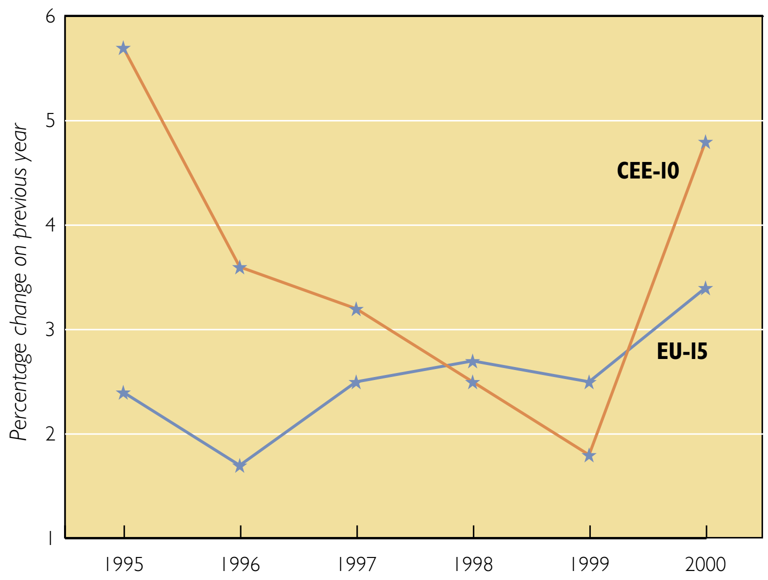
[3] This section of the pamphlet builds on an economic analysis prepared by the CER for the European Round Table of Industrialists' Position Paper on enlargement (published June 2001).

- ★ What are the tangible benefits of enlargement?
- ★ How much will it cost the EU?
- ★ What are the opportunity costs of delaying accession significantly?

The tangible benefits

The EU economy will clearly benefit from enlarging its internal market to nearly half a billion consumers, and from bringing fast-developing markets into the European economy. The top five candidates for accession grew at an average of 3.4 per cent over the

FIGURE 1: AVERAGE GDP GROWTH IN THE EU-15 AND CEE-10

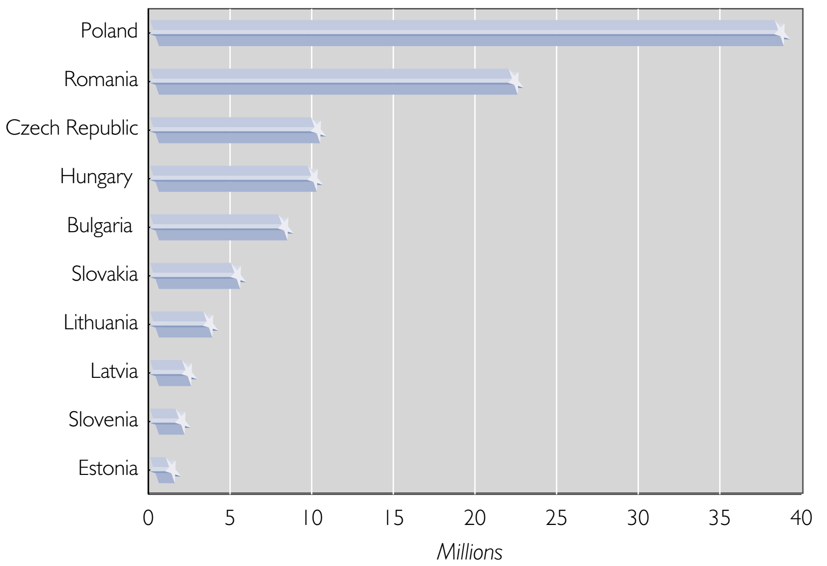


SOURCE: EUROPEAN COMMISSION (2000), ECONOMIC FORECASTS
NOTE: 2000 IS A FORECAST FIGURE

period 1995-99, in comparison with the EU's 2.4 per cent (see Figure 1). Growth rates have been even higher in cities like Warsaw, Prague and Budapest, which offer rapidly expanding markets for west European goods.

Economic integration typically raises overall GDP levels through increased trade, economies of scale and heightened competition – as was the case with the completion of the single market in 1992. These one-off gains are often modest, but the potential of the central European economies is much greater than their current size. They offer more business opportunities than the mature markets of western Europe. Since 1989, the central European economies have rapidly integrated with west European and world markets, re-orienting their trade and attracting foreign direct investment. They liberalised trade rapidly – in fact, it was the EU

FIGURE 2: CENTRAL EUROPEAN POPULATIONS



SOURCE: IMF (2000), WORLD ECONOMIC OUTLOOK

that was slow to allow full access for their products (especially agricultural ones) by maintaining non-tariff barriers and safeguards.

It is hard to calculate exactly how much enlargement will benefit the EU economy. An influential study by the Centre for Economic Policy Research projected that the EU-15 countries would gain a total of about €10 billion from expansion eastwards over the long run. These gains would be unevenly distributed, with Germany alone accounting for about a third of this total.[4] Even on this conservative estimate, 300,000 jobs would be created in the EU-15 if enlargement boosted the Union's GDP by 0.2 per cent.[5] Many more jobs would open up in the applicant countries, of course.

[4] Richard Baldwin, Joseph Francois, and Richard Portes (1997), 'The Costs and Benefits of Eastern Enlargement,' Economic Policy 24.

[5] CER calculation, assuming a continuance of the current labour-output ratio, based on Eurostat and OECD data.

But although the aggregate benefit to the EU would be small, so would the costs. The CEPR study predicts the net cost to the EU (budgetary transfers to applicants minus benefits) to be between zero and €8 billion. Even the higher figure amounts to only a thousandth of EU-15 GDP, making the overall deal a bargain for the EU.

For the current applicants, there are likely to be much greater gains, as these economies are starting from a smaller base level. In the longer term, there will be dynamic effects because economic integration will raise output and growth rates by stimulating entrepreneurship, investment and technology transfers.[6] The CEPR study forecasts long-term total gains to the new member-states of €23 billion, under a conservative scenario, and of €50 billion if membership reassures investors that central European economies are less risky than before.[7] This is a dramatic increase over their baseline GDP.

[6] *This argument is made in detail in David Dyker (2000), 'The Dynamic Impact on the Central-East European Economies of Accession to the European Union', 'One Europe or Several?' Working Paper 06/00, University of Sussex.*

[7] *Calculation made in 1992 ECU.*

Businesses will be able to make decisions on strategy and investment with greater certainty, because the EU will ensure common standards and a level playing-field across 27 or even 30 economies. A common regulatory environment and open borders for trade across a market of that size are enormous advantages for business.

Further integration depends on whether the applicants are able to implement and enforce EU legal and regulatory frameworks effectively. Widespread petty corruption and poor enforcement capacity are problems right across central Europe, and major corruption scandals still emerge from time to time. These problems are on a scale much closer to the problems in western Europe than the situation in Ukraine or Russia; for example, Transparency International ranks Estonia, Hungary and Slovenia as less corrupt than Greece and Italy in perceptions of their public officials and politicians.[8] However, these problems are far from negligible, even in the countries closest to EU membership,

[8] *Transparency International (1999), Corruption Perceptions Index.*

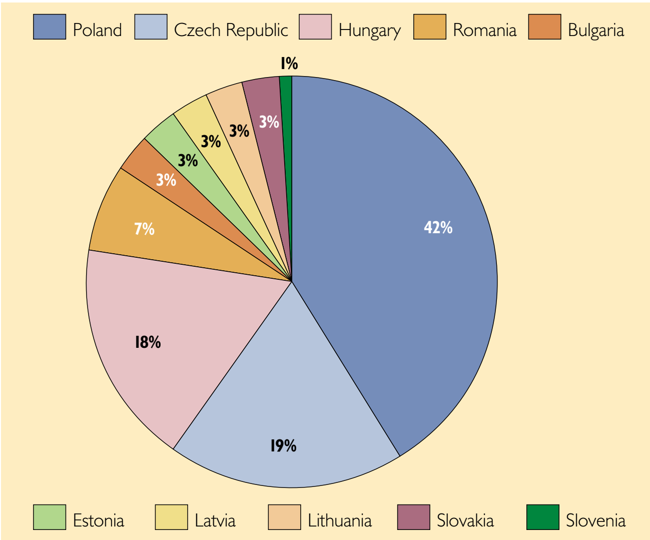
and they certainly raise obstacles to freedom of establishment, trade and investment. The EU's institutions will need to develop much more expertise in tackling such problems, in order to help the new member-states and ensure a level playing-field in the enlarged single market.

Foreign direct investment

One of the key benefits of enlargement is the boost it gives to FDI. Inflows of investment to central Europe have increased sharply since the EU committed itself to enlarging. This has been no coincidence: recent research conducted by the London Business School suggests that the EU's commitment to accession helped to encourage more FDI.[7] Progress towards

[7] *Alan Bevan and Saul Estrin (2000), 'The determinants of foreign direct investment in transition economies', Centre for New and Emerging Markets, Discussion Paper 9, London Business School.*

FIGURE 3: CUMULATIVE FDI FLOWS TO CENTRAL EUROPEAN COUNTRIES (1985-99)



SOURCE: UNITED NATIONS (2000), WORLD INVESTMENT REPORT
NOTE: FDI INFLOWS HAVE BEEN CONCENTRATED IN THE COUNTRIES CLOSEST TO JOINING THE EU

accession reinforces positive perceptions of the front-runner applicants' suitability as investment locations.

FDI inflows have been concentrated in the countries closest to joining the EU: the total sum of FDI in Poland has overtaken that in Portugal and Finland, while Hungary's total receipts are approaching these levels. By contrast, Bulgaria and Romania have received only 10 per cent of total inflows into central Europe, despite having nearly a third of the region's population (see Figure 3).

Inflows of FDI to the region remain relatively small in a global context. In 1999 FDI in the applicants totalled nearly $18 billion, which is just 0.02 per cent of the world total. However, these relatively small amounts should not mask the importance of FDI for transition economies. FDI supplements domestic savings for investment, consequently accelerating growth and development. In the case of transition economies with low levels of domestic savings, the role of FDI is crucial. Its importance is clear from the proportion of total investment that it represents in each country. For developed economies, FDI typically comprises 4 to 7 per cent of total investment; but in the case of central Europe, it accounts for up to 38 per cent (see Figure 4).

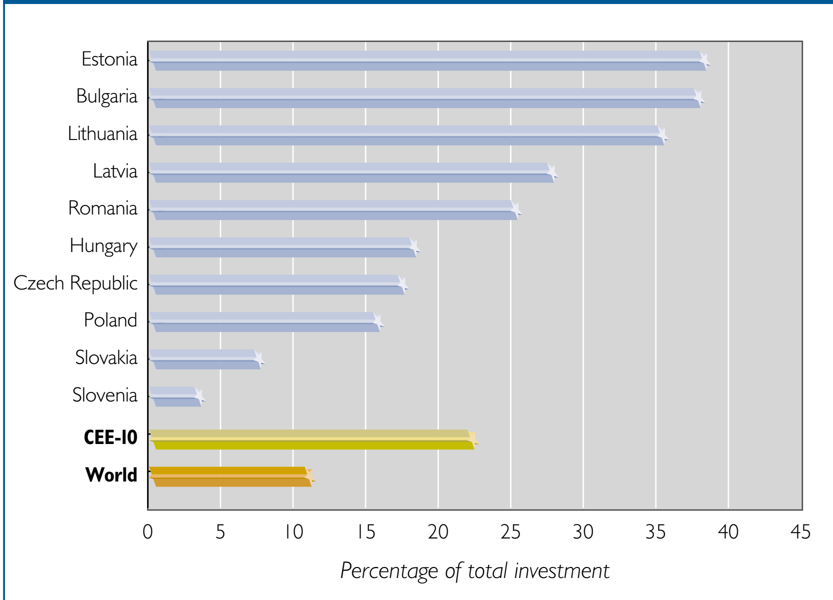
Typically, FDI also benefits economies through technology transfer, the development of managerial skills, marketing and distribution, and reduced environmental degradation. Moreover, foreign investors are actively involved in one of the most important aspects of the transition process: the restructuring of firms. There is even evidence that foreign direct investors in transition economies make a better job of improving the performance of firms after privatisation than domestic owners.[8]

Foreign investors tend to bring better environmental standards and employment practices to central Europe because they already have

[8] See Klaus Meyer (1998), 'Direct investment in economies in transition', Cheltenham: Edward Elgar; Roman Frydman, Cheryl W. Gray, and Andrzej Rapaczynski eds. (1996), 'Corporate Governance in Central Europe and Russia', Budapest, London and New York: CEU Press.

[9] Evidence from Saul Estrin, Kirsty Hughes and Sarah Todd (1997), 'Foreign Direct Investment in Central and Eastern Europe: Multinationals in Transition', London: RIIA/Cassell.

FIGURE 4: FDI INFLOWS AS A PERCENTAGE OF TOTAL INVESTMENT



SOURCE: UNITED NATIONS (2000), WORLD INVESTMENT REPORT
NOTE: FIGURES ARE FOR 1998

systems in place to meet these higher standards in their home markets.[9] They are used to managing staff and dealing with wider corporate responsibilities – including social and environmental factors – in the competitive markets of western Europe. It is true that low costs are one important driver of FDI, and there are certainly some investors who have moved into central Europe to take advantage of lower environmental and labour standards before accession. But for many businesses, growing markets are at least as important as costs. Macroeconomic and political stability, good governance and lack of corruption are also important determinants of FDI, and all of these factors are positively influenced by the EU accession process.

Although positive signs of progress towards accession have boosted FDI into the front-runners, the back-markers have received much lower amounts. This process is likely to be self-reinforcing, potentially trapping the back-markers at a low level of economic development. Less FDI into Bulgaria and Romania will further limit their progress towards EU membership, leading to a vicious circle of low investment, stalled reforms and exclusion from the EU.

It is in the EU's own interest to develop policies that deal with the potentially destabilising impact of diverging FDI levels. The EU needs to pay much more attention to the immediate needs of the countries lagging furthest behind. EU policy-makers tend to assume that accession and transition require the same policies. But although many accession-related policies are also required for successful transition, applicants have to take on numerous EU policies that were developed for advanced, industrialised economies rather than designed for transition needs. Front-runners have to implement these policies as fast as possible in order to join, and the benefits from being fully part of the single market probably outweigh the costs of sub-optimal policies. However, applicants Who cannot join for many years might be better advised to devote their scarce administrative and human resources towards reforms for basic development, rather than making enormous efforts to implement policies that are only really useful for EU accession. The EU accession process fixes a timetable for accession preparations that could be inappropriate for the countries that are furthest from accession, given their urgent development needs and lack of investment capital. They have to address other goals such as primary healthcare and education, which are not connected to accession.

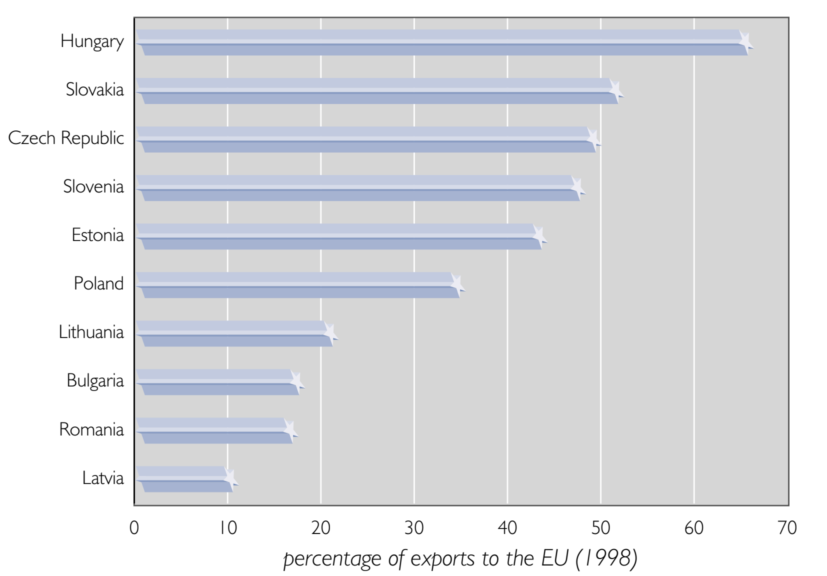
It would help even more if the EU offered more aid, technical assistance and political backing to encourage the implementation of reforms in Bulgaria and Romania. For example, the EU could introduce a special assistance programme to aid the economic development of countries that are left out of the first round of accessions, concentrating on drivers of foreign investment such as legal development, banking sector reform and private sector development.

Trade and competitiveness

Trade between the EU and the applicants has already been largely liberalised. Trade flows grew considerably after the removal of tariffs and other barriers during the 1990s, although agriculture remains heavily controlled, owing to the barriers imposed by the CAP. How will the central European economies fare in the longer term? A key to their long-term competitiveness in the single market is whether and when they shift from labour-intensive goods towards the human capital-intensive products that are mainly traded between the current members.

Higher value, human capital-intensive or high-tech goods take a significant share of exports to the EU from Hungary, Slovakia, the Czech Republic, Slovenia, Estonia and, to a lesser extent, Poland. In contrast, Bulgaria, Latvia, Lithuania and Romania are still exporting primarily lower value-added, labour-intensive products that face

FIGURE 5: HUMAN CAPITAL-INTENSIVE GOODS AS A PROPORTION OF EXPORTS



SOURCE: ALAN SMITH (2000), BASED ON COMEXT DATABASE increasing competition from low-wage economies across the globe (see Figure 5).[10]

[10] *As argued in Alan Smith (2000), 'The return to Europe: the reintegration of eastern Europe into the European economy', London: Macmillan.*

The applicant countries have run increasingly large current account deficits with the EU since 1995, and these are a cause for concern. Do the deficits reflect the import of capital goods and technology, or a structural inability of applicant producers to compete in the single market? Certainly, some temporary factors are involved, such as expansionary fiscal and monetary policies, real currency appreciation against EU currencies, and the high demand for imports of capital goods to modernise industry, agriculture and infrastructure. But some of these trade imbalances may be unsustainable in the longer term because they also reflect large-scale import of consumer goods.

Central European economies will need to undergo considerable industrial modernisation, particularly through the acquisition of foreign technology, if they are to make inroads into higher-value export markets. Economies can then enter a virtuous circle of producing goods for EU markets that earn foreign exchange, which can be spent on more technology imports, which in turn can be used for further industrial restructuring. To do this, they have to move further away from industrial production geared towards former Soviet demand for heavy engineering equipment and relatively unsophisticated consumer goods.

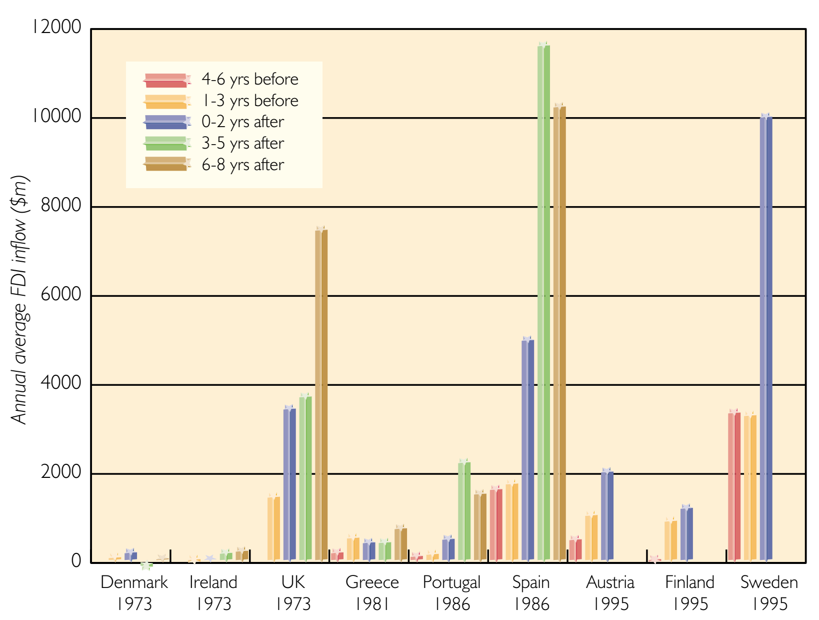
The impact of accession

How much difference will accession to the EU make to economic integration? Additional trade that flows from access to the single market may have a relatively small impact on the applicants' economies, in comparison with the strong effects of the general opening of trade since 1989. Where accession is likely to make a significant difference is in investment: accession will help to build well-functioning, market-based economies by locking the applicants into EU legal and regulatory frameworks. These are critical to overcoming problems of corruption, and to improving administrative capacity and judicial systems.

EU accession has had a direct impact on FDI in previous enlargements. The six countries that joined the EU between 1973 and 1986 generally experienced an increase in capital inflows. The economies that were furthest behind existing EU member-states – Ireland, Greece, Portugal and Spain – performed best in terms of stock market performance, FDI and investment-to-GDP ratios (although Greece is an exception, having performed poorly in comparison with the others).[11] As shown in Figure 6, Spain and Portugal experienced a massive jump in FDI in the eight years after accession, thanks to EU-

[11] Baldwin, Francois and Portes (1997), 'The Costs and Benefits of Eastern Enlargement'.

FIGURE 6: FDI INFLOWS TO NEW EU MEMBER-STATES PRIOR TO AND AFTER ACCESSION



SOURCE: PRICEWATERHOUSECOOPERS, BASED ON UN DATA driven liberalisation and the perceptions of reduced risk among investors. The UK and Sweden also gained additional investment around the time of their accessions.

Trade growth was also more impressive: the poorer countries performed better than the older member-states in developing intra-EU trade. For instance, in 1985-93, the average annual growth rate of intra-EU trade in manufacturing was 6.7 percent for the EU-15, but higher for Greece and more than double that figure for Portugal.[12]

[12] *János Gács and Michael Wyzan (1999), 'The Time Pattern of Costs and Benefits of EU Accession', Workshop Report, International Institute for Applied Systems Analysis, http://www.iiasa.ac.at/Publications/Documents/IR-99-002.pdf.*

There are two important caveats about comparing the eastern and southern enlargements of the EU, however. The positive one is that Greece, Portugal and Spain joined the EU before the single market programme and monetary union. So they were joining a much less integrated and smaller EU market than the new applicants. The central European economies are already experiencing faster trade growth than Portugal and Spain did on accession – so accession prospects are delivering greater benefits already. The boost to FDI from actual accession could be greater still because international companies are likely to establish production facilities in central Europe to supply pan-European markets.

The second caveat is that the southern enlargement showed how countries have to establish sound macroeconomic policies and good governance if they are to benefit from EU membership. The case of Greece illustrates that if EU aid money is used to prop up failing industries and to finance a ballooning public sector deficit, economic growth will suffer. The new member-states must ensure that they use EU transfers for viable investment projects, and to cushion rather than delay the effects of necessary industrial restructuring. Central Europe needs to follow the examples of Ireland and Portugal rather than of Greece.

The good news is that EU accession itself encourages sound macroeconomic policies and viable investments, especially now that member-states' performance in reforming their economies is ranked publicly through the 'Lisbon process'.[13] The EU is now much more concerned to support fiscal discipline and economic restructuring than it was when Greece joined. It places far more constraints on domestic policy now that the single market and monetary union are in place. EU institutions and inter-governmental benchmarking will maintain the pressure for improving governance. Membership will help to keep new members locked into sound policies, and pressure from the Commission will encourage them to strengthen their institutional capacity to regulate markets effectively.

13 See Edward Bannerman (2001), 'The Lisbon Scorecard', London: CER.

The costs of enlarging eastwards

There are three potential costs to enlargement: the costs for public finances, the costs of labour market disruption, and the costs of wage competition. None of these costs is likely to be significantly greater than the benefits, because the conditions for membership are being applied fairly strictly by the EU. The accession conditions provide a safeguard against a country entering the EU before its economy can cope. Indeed, the European Commission has demanded high standards of implementation of its rules and regulations from the applicants. The applicant countries have been engaged in economic reforms over the past decade that are arguably more radical than those attempted by any EU member-state – albeit with mixed degrees of success. But fears of the costs remain politically potent.

The EU's budget

The impact of enlargement on the EU's public finances is in reality a political rather than an economic issue. The actual cost of enlargement to the public purse will depend solely on how generous the EU decides to be. It is unlikely to be very costly to the EU's budget, despite the fact that the central European economies are much poorer than most of the existing EU members. This is because the current members have already decided to allocate only a small amount of money to enlargement: less than 10 per cent of the total EU budget is earmarked for the applicants and new member-states.

In previous enlargements the EU budget has offset the costs of adaptation for new members by providing fiscal transfers. Even when net contributors to the EU budget joined (as with the accessions of Austria, Finland and Sweden in 1995), they received EU funds for some of their regions. However, this time around the net contributors to the EU budget are firmly against any substantial increase. The Maastricht convergence criteria for monetary union have helped to engender an atmosphere of fiscal stringency; member-states struggling to get public finances into shape for the single currency had no desire to allocate more money to the EU budget. A number of the major net contributors – including Germany, Austria, Sweden and the Netherlands – also want to reduce the level of their payments into the EU budget.

The two main components of the EU budget are the CAP and the structural and cohesion funds, which together account for around 80 per cent of total expenditure. EU member-states agreed the terms of the current budget for the years 2000-06 inclusive at Berlin in 1999, but they postponed the hard decisions on long-term financing arrangements for the enlarged Union, especially the CAP. The costs of dealing with crises like BSE in cattle may also cause an early revision of the current budget for agriculture.

The current budget for 2000-06 was drawn up under the working assumption that six countries would join the EU in 2002 (five central European countries plus Cyprus) – even though entry now looks unlikely before 2004. Compared to the ceiling on the funds for all EU payments (on the bottom line of Figure 7), the transfers that the

Figure 7: Budgeted EU spending on the applicants/new members (€ million, 1999 prices)

	2000	2001	2002	2003	2004	2005	2006
Pre-accession funds	3,120	3,120	3,120	3,120	3,120	3,120	3,120
Transfers to new members (assuming six new members in 2002)	–	–	4,140	6,710	8,890	11,440	14,210
Total (maximum) pre-accession & enlargement spending	3,120	3,120	7,260	9,830	12,010	14,560	17,330
Total EU budget (ceiling on payments)	89,590	91,070	98,270	101,450	100,610	101,350	103,530

Source: Berlin European council (1999), Presidency conclusions

EU has set aside for enlargement are small. The vast majority of funds will continue to go to the current EU-15 countries, even after the six front-runners join. Moreover, the €67 billion allocated to the applicants over seven years is about a tenth of the sum given to the former East Germany after unification: net fiscal transfers from the German federal budget to the eastern Länder amounted to more than €600 billion from 1990-99.[14]

[14] 1.2 trillion DM, according to the German federal finance ministry.

Spending on enlargement will rise each year to an annual maximum in 2006 of about €225 per head for the new members. By contrast, the budget gives Portugal and Greece €400 per head from the structural and cohesion funds alone in that same year. The remaining applicants will receive a maximum of only about €75 per head by 2006 if all the remaining pre-accession funds are redistributed to them, and only €30 if they get the same amount as in 2000. Moreover, the total receipts of new members after accession are capped at 4 per cent of their GDP. This ensures that they can absorb transfers and it keeps the EU budgetary costs in check. But this ceiling has a perverse outcome: more money goes to the richer countries (because they have a larger GDP), and they will receive increasing amounts as their economies grow. From an economic development perspective, it would make sense to give more money early on, when investment needs are greatest.

The politics of the budget will change over the next few years. The Berlin budget deal was only the first step towards solving the financial issues associated with enlargement. In the current budget, the money for the EU-15 is ring-fenced from spending on pre-accession countries, so enlargement cannot be financed from other parts of the budget. This separation was not designed just to protect the funds for the applicants, but also to reassure the current member-states that their cash will be protected over the budget period. However, once Poland and other countries join, they are likely to form new alliances with Spain and the other major recipients of EU funds to demand a larger budget. Whether or not

FIGURE 8: TOTAL INVESTMENT COST TO THE APPLICANTS OF APPROXIMATING TO EU ENVIRONMENTAL STANDARDS

	Total investment (€bn)	
	Estimated minimum	*Estimated maximum*
Baltics (total)	8.9	9.3
Bulgaria	11.7	15.0
Czech Republic	10.4	12.4
Hungary	11.5	13.7
Poland	34.1	35.2
Romania	20.2	22.0
Slovakia	4.1	5.4
Slovenia	1.84	1.84
Total	108.4	121.5

SOURCE: EUROPEAN COMMISSION (1997), APPROXIMATION SEMINAR
NOTE: THE COMMISSION CALCULATED INVESTMENT WOULD BE SPREAD OVER 20 YEARS

the EU later decides to increase the overall size of its budget is a political rather than an economic issue. However, the EU-15 ought to contribute to bringing new members up to EU standards.

Investment to meet EU standards

The EU has focused the aid that is available over the next five years on paying for the direct costs of accession. But the total amounts available to accession countries are small, relative to estimated investment needs. The main costs of enlargement for the applicants will be the money needed to meet EU standards on protection of the environment and of workers. The World Bank has estimated that in the next few years Poland alone will have to spend some $6.6 billion to meet EU directives on regulatory and administrative structures.

Improving the environment in central Europe, in particular, will require enormous sums. The exact amount depends on how quickly and how closely the EU requires the new members to match EU environmental standards. The European Commission estimates the investment needed for the ten central European applicants to meet EU environmental standards to be €108-120 billion over 20 years – which is an average of €1,140 per central European citizen (see Figure 8). This sum dwarfs current Phare[15] and other aid spending on the environmental sector. According to the World Bank, Slovakia alone would have to make annual investments of at least 1.5 per cent of its GDP over the next 20 years, just to comply with EU environmental legislation.[16] For Poland, the World Bank estimated that complying with Poland's own regulations and the EU's environmental regulations will require investment representing between 1.2 to 2.0 per cent of the country's GDP per annum over a period of 15 years.[17] However, the European Parliament and independent analysts argue that these calculations are overly optimistic.

[15] 'Phare' is the EU's main aid programme to central Europe. The acronym stands for 'Poland and Hungary Assistance for the Reconstruction of the Economy', but the programme has been extended to cover all ten applicants for membership plus several former Yugoslav republics and Albania.

[16] World Bank 1998, 'Slovakia: Country Economic Memorandum', Washington DC.

[17] World Bank 1997, 'Poland: Country Economic Memorandum', Washington DC.

The European Investment Bank is using some of its funds to help central Europe, but much more money will be needed over the longer term. Even after the basic clean-up of the worst polluted areas, it will be enormously expensive for the central Europeans to conform with all the EU air and water quality standards. Businesses will provide some of the money, when they are forced to reduce their environmental impact through EU regulations. But clean-up and waste treatment will require public investment too. Much of the cost is likely to be met by the candidates themselves, with help from international financial institutions like the European Investment Bank, from firms investing in new technology, and from public-private partnerships for infrastructure projects.

The EU has closed the environmental chapter in negotiations with four countries, and other front-runner candidates should follow quickly. Transitional periods before applicants are obliged to meet EU standards are permitted, but the EU wants to keep them short and have a clear end-date for each one. Environmental transition periods are supposed to be restricted to directives that do not affect the single market – for instance, exceptions are acceptable for drinking water and air quality standards, because they are not related to production of goods and services. However, immediate compliance is required on limiting factory emissions, as this affects competition.

Applicant countries also face major expenditure on transport infrastructure, and farms need investment to bring agricultural production up to EU veterinary and phyto-sanitary standards. EU agricultural policy will change, as a result of World Trade Organisation negotiations and the move away from intensive agriculture – so it is difficult to estimate costs at present. As for transport, the EBRD has estimated investment needs to average 2.6 per cent of the applicant countries' GDP a year over the next ten years (see Figure 9).

FIGURE 9: THE APPLICANTS' TOTAL INVESTMENT NEEDS IN THE TRANSPORT SECTOR

	Total investment (€bn)	*Annual investment as % of GDP**
Bulgaria	5.3	4.6
Czech Republic	10.2	2.0
Estonia	0.6	1.1
Hungary	10.2	2.2
Latvia	2.0	3.4
Lithuania	2.3	2.3
Poland	36.4	1.3
Romania	11.2	3.5
Slovakia	6.5	3.5
Slovenia	5.7	3.1
Total	90.4	2.6

SOURCE: EBRD (2000), TRANSITION REPORT
*TOTAL INVESTMENT DIVIDED OVER TEN YEARS AS A PERCENTAGE OF 1999 GDP

Even once negotiations are completed, investment needs must be addressed by the enlarged EU. Although transitional periods spread the cost of meeting EU requirements, some industries that have not invested in cleaner technologies and improved energy efficiency may face problems of competitiveness. The immediate costs of accession can be kept in check, but in the longer term the EU ought to establish a fund for investment in environmental standards and infrastructure. Money from Phare will stop once applicants join, but regional aid and other funds should be targeted on these areas.

The impact on labour markets and migration flows

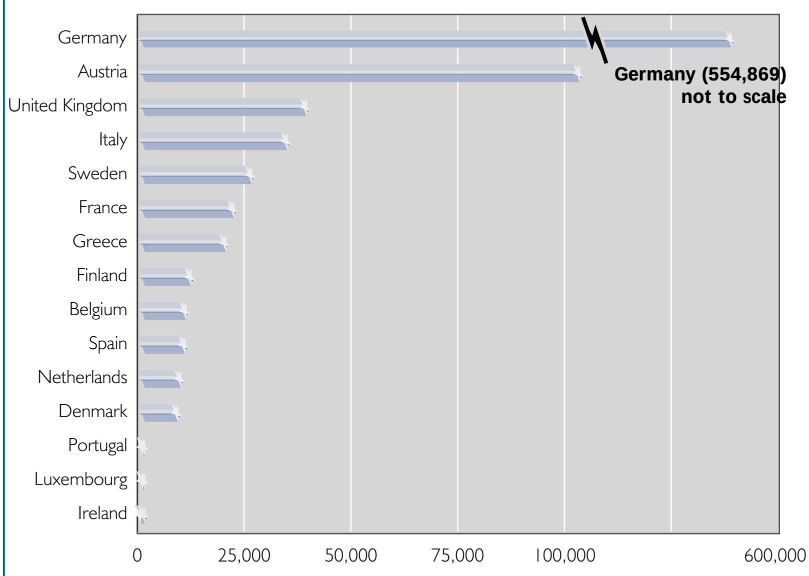
The potential disruption of EU labour markets through the mass immigration of central European workers has been much exaggerated. At present, there is not a large number of residents from central Europe in the EU (see Figure 10). There are about 850,000 residents in the EU from the applicant countries, which is

0.2 per cent of the EU-15 population. They account for less than 1 per cent of the national population in all EU countries except Austria, where they are slightly above 1 per cent.

One extensive study by the European Integration Consortium (EIC) suggests that if all ten central European applicants joined the EU, with free movement of labour applying, only about 335,000 people would move immediately to the EU-15 countries.[18] This is a small number as a proportion of the EU's present population of 370 million. According to the EIC's comprehensive analysis,

[18] *Estimates by European Integration Consortium (2000), 'The Impact of Eastern Enlargement on Employment and Labour Markets in the EU Member-states', Berlin and Milan.*

FIGURE 10: CENTRAL EUROPEAN CITIZENS RESIDENT IN EU-15



SOURCE: EUROPEAN INTEGRATION CONSORTIUM (2000)
NOTE: FIGURES FOR AUSTRIA, FRANCE, IRELAND AND LUXEMBOURG ARE ESTIMATED, BASED ON NATIONAL RECORDS OF LABOUR PARTICIPATION OF FOREIGNERS. FIGURES FOR THE UK AND ITALY ARE 1996, THOSE FOR THE NETHERLANDS ARE 1997, ALL OTHERS ARE FOR 1998.

the EU's stock of residents from central Europe would rise slowly over the following 30 years to reach a peak of 1.1 per cent of the population – far from swamping the EU-15 as many politicians have claimed. Moreover, this number of new residents will be complemented by the new jobs that enlargement will create, even on a conservative estimate of the boost to GDP growth.

Only about a third of the people who moved immediately after accession would be seeking employment in the EU – many would be joining families or studying. Future east-west migration is not expected to affect wages and employment at aggregate level in the EU, although it may have some impact on the regions immediately bordering the new member-states. However, these regions are also benefiting from the new opportunities for trade and investment that the end of the Cold War has brought.

The idea that there are masses of unskilled people just waiting for accession to move west is ill-founded, if politically potent. Relative political stability in central Europe, steady economic growth among the front-runners and foreign direct investment are already discouraging large-scale movements of unskilled workers. By the time of accession, the new member-states will have met the accession conditions of stable democracy, a functioning market economy and the capacity to cope with competitive pressure in the single market – conditions which remove the main incentives to migrate. Already, most central European citizens can travel freely in the EU,[19] and those with good skills are also able to gain work-permits: there are Polish bankers in London, Hungarian IT specialists in Austria, and Estonian telecoms engineers in Finland, for example.

[19] As of June 2001, only Romanian citizens needed a visa to travel in the EU's Schengen zone. However, some EU countries require visas from particular countries, eg the UK for Slovaks and Bulgarians.

Previous EU enlargements have only resulted in modest levels of migration, despite wide disparities in employment and income between the southern European members, when they joined in the 1980s, and richer northern Europe. Similarly, there is relatively low labour mobility within central Europe at present, despite the income gaps between capital cities (like Warsaw and Bratislava) and surrounding towns and countryside.

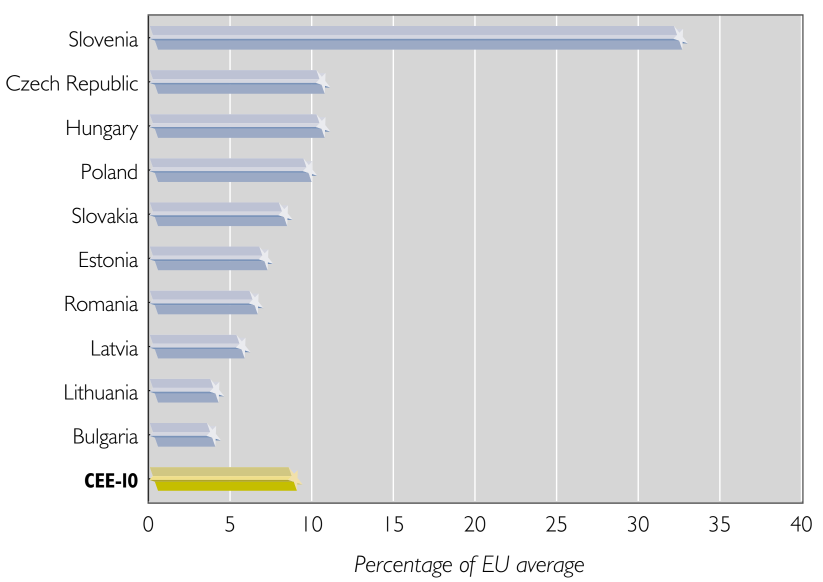
Free movement of labour is one of the four freedoms of the single market, so the EU's insistence on a transitional period for central European workers will restrict economic integration. Moreover, such limitations reduce labour mobility, which is one of the prerequisites for a single currency area to work effectively. Although the applicants will not join the euro immediately on accession, the introduction of more restrictions on workers runs counter to Commission and OECD recommendations that labour mobility in the single market needs to be increased.

EU leaders have so far been defensive rather than pro-active in managing this issue politically. The German government was active in demanding a transitional period, rather than pointing out that net immigration from the ten central European countries into Germany has not been large. From 1990-97 it was 585,417 people, equivalent to 0.71 per cent of the country's population. Many of these people were returning ethnic Germans, and many others did not stay for long. In fact, in 1997, more foreigners left Germany than entered the country. Part of Germany's sensitivity about migrants from the East results from public and press perceptions that the country has taken an unfair share of the refugee burden from south-eastern Europe. This affects German views on overall levels of immigration.

Potential costs of wage competition

Many industries in the EU fear that they will lose business to the low wage economies of the applicant countries. This form of wage competition is to some extent already taking place; trade in industrial products has been broadly liberalised. Some very labour-intensive industries, such as textiles and footwear, could be vulnerable to wage competition after accession. On average, central

FIGURE 11: WAGES IN CENTRAL EUROPE



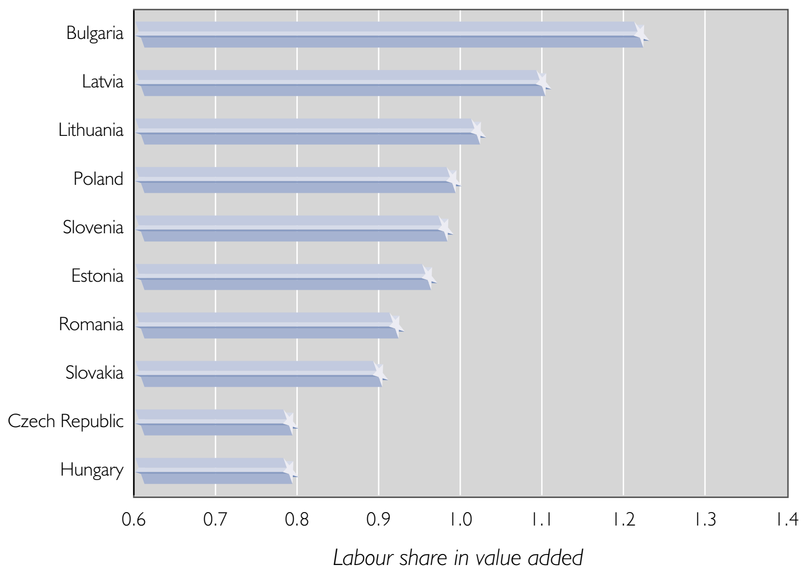
SOURCE: EUROPEAN INTEGRATION CONSORTIUM (2000), CALCULATED FROM OECD AND NATIONAL SOURCES

European wages are only 9 per cent of the EU average (see Figure 11), although this gap is due to exchange rates as well as labour productivity. The gap is particularly wide between central European wages and those in Germany, the country that borders two of the applicants: Polish and Czech wages are only about one-tenth of the EU average.

However, it is not a simple matter of east Europeans taking west European jobs. Rather, cheaper east European workers tend to join a supply-chain, in which they might perform the labour-intensive aspects of production, while workers elsewhere carry out other roles. Moreover, wage competition is not the only factor involved in investment decisions: market potential and productivity are also very important. Productivity in central Europe is considerably lower than in the EU, as shown by the difference in unit labour costs (see Figure 12). Unit labour costs (which are the cost of labour required to produce one unit of output) are lowest in the countries that are most advanced in transition: the Czech Republic and Hungary both score well. By contrast, Bulgaria has much higher unit labour costs, even though manufacturing wages are much lower than the other applicants – hence the fact that it is a less attractive investment destination.

Low productivity in the lowest-cost countries continues to be a major deterrent to investment. The central European economies will not become direct competitors with poor regions of the existing EU until they have experienced widespread skills upgrades. As central European workers develop their skills – partly thanks to economic

FIGURE 12: UNIT LABOUR COSTS



SOURCE: LONDON BUSINESS SCHOOL CALCULATIONS, BASED ON EBRD AND ILO DATA integration with the EU and international markets – they will compete more directly with west Europeans. However, this is not a simple regional trade-off: both central European and EU economies are engaged in international markets, so there is also global wage competition to take into account.

Moreover, some of the direct investments in the applicants actually preserve jobs in the EU by making companies more competitive internationally. Although some companies are moving manufacturing operations from the EU to lower-cost locations, the cost savings and increased profits may boost related business activities back in the EU. For example, a company may move a manufacturing plant to central Europe, but expand its services in western Europe at the same time.

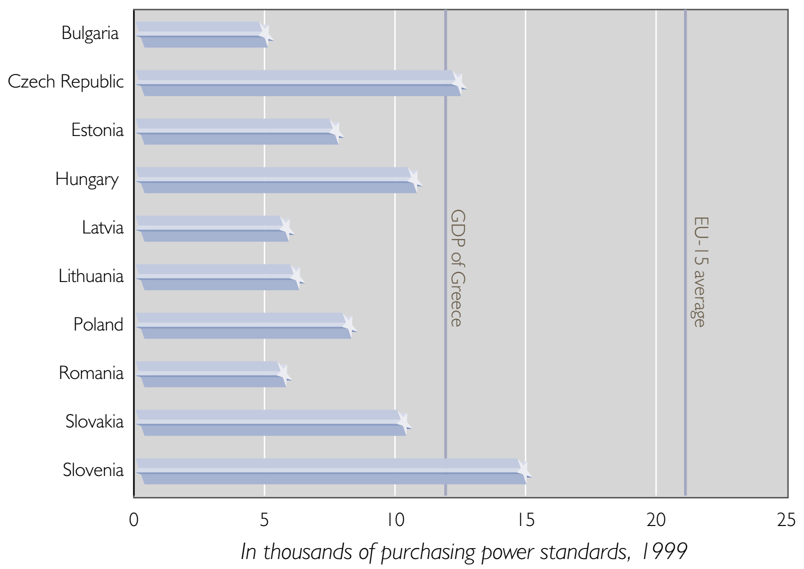
Risks and open questions

Income inequalities between new and old member-states

Despite economic growth in the aspirant members, there is still a large wealth gap between them and the current 15. In 2000, EU GDP per capita averaged €20,500, but the Czech average is only €11,380, while Hungary's is €10,384 and Poland's €8,061. However, the richest central Europeans have converged with the poorest EU countries: Slovenian and Czech GDP per head has now overtaken that in Greece, in purchasing power standards at least.

The range of economic performance and income across central Europe is wide. The Czech Republic, Hungary, Poland, Slovakia and Slovenia enjoy GDPs per head between one-third and two-thirds of the EU average, whereas the rest are below one-third of the EU average (see Figure 13). GDP per capita in Slovenia is 71 per cent of the EU average, while it stands at less than a third of that average in Bulgaria and Latvia.

FIGURE 13: GDP PER CAPITA



SOURCE: EUROSTAT (2001)
NOTE: PURCHASING POWER STANDARDS (PPS) ARE AN ARTIFICIAL CURRENCY THAT REFLECTS REAL DIFFERENCES IN PRICE LEVELS BETWEEN COUNTRIES

There are considerable inequalities between regions in central Europe as well, so it is important to look beyond the national averages for income and employment. Regional unemployment rates vary enormously, and income levels in the capital city usually greatly exceed the national average. Rapidly growing cities like Prague, Bratislava and Budapest may be ineligible for some of the EU's big regional aid funds by the time of accession. The average income in Prague is now 119 per cent of the EU average, although other capitals range from 98 per cent (Bratislava) down to 25 per cent (Sofia).[20]

[20] *European Commission (2001), 'Unity, solidarity, diversity for Europe, its people and its territory: second report on economic and social cohesion', Brussels, January.*

The speed with which economic disparities between new and old member-states narrow will depend on whether the applicants grow faster than the current EU. The EBRD estimates that they could achieve long-term average annual growth rates of 4 to 7 per cent.[21] But to realise this potential they need both high investment and rapid productivity growth. The World Bank estimates that the front-runner candidates are 20 years away from average EU incomes. And during that time, EU incomes will continue to grow, so catch-up will require much faster growth or significantly more time, possibly as much as 40 years.[22]

[21] *EBRD (1999), 'Transition Report', London.*

[22] *World Bank (1997), 'World Development Report', Washington DC.*

Given this outlook, the enlarged EU faces the prospect of having to deal with considerable disparities between member-states' income levels over a long time period. New budget-lines may have to be devised to mitigate the differences in income and employment between cities and regions in the enlarged EU. After all, inequality has social and political as well as economic consequences. But such funds need to be used more effectively than the structural and cohesion funds have been.

Monetary union

When and how should new member-states join the euro? Euro membership is an integral part of the accession conditions. There is no mechanism for negotiating an opt-out like those for the UK and Denmark – although Sweden's delayed euro entry might provide a precedent. However, the timing of entry is an open question because it will not happen immediately on accession.

All ten applicants for EU membership are already making preparations to join monetary union eventually: they are maintaining fiscal and monetary discipline, and many are pegging their currencies to the euro. Although no applicant is required to adopt the euro immediately upon accession to the EU, several of the applicants are officially aiming to do so. Joining EMU is seen as an important way of enhancing economic credibility – as it was for countries like Italy and Greece. However, even the most advanced central European countries face substantial obstacles in their attempts to converge with the euro-area. Real convergence is likely to take much longer than simply meeting the formal Maastricht targets on inflation, interest rates, public debt and fiscal deficits.

Applicants have to adopt the legislation and policies for economic and monetary union, even if they do not adopt the euro straightaway. Prior to accession, applicants must adopt specific legislation to liberalise capital movements, prohibit direct public sector financing by the central bank, and ensure that monetary authorities are independent and committed to a price stability goal. Applicants have to put in place policies "which aim to achieve real convergence in accordance with the Union's objectives of economic and social cohesion, and nominal convergence compatible with the ultimate goal of adoption of the euro."[23]

[23] *As stated in the EU's first 'Accession Partnerships' of March 1998, which set out detailed tasks for the candidate countries.*

When they join the EU, new members will have to coordinate their economic policies with other member-states, submit convergence programmes, avoid excessive deficits, and later participate in the exchange rate mechanism. This means adopting the same kind of fiscal and monetary discipline as existing euro members. As the Mediterranean countries found, attempts to meet the Maastricht convergence criteria can lead to a quite stringent contraction in public spending, and very little flexibility in monetary policy.

Most of the ten applicants have outstanding government debt that is below the 60 per cent of GDP threshold set by Maastricht, while eight of the ten candidates have budget deficits at or below 3 per cent of GDP. However, several governments are also ultimately responsible for considerable hidden debts in the form of bad loans on the books of state-owned banking institutions. As major privatisation programmes come to a conclusion in the front-runner countries over the next couple of years, governments will lose a source of windfall income and have to work harder to keep their balance-sheets out of the red.

It will be more difficult for the fast-growing applicant countries to meet the Maastricht inflation targets and reduce interest rates to euro-zone levels. Attempts to meet them should help to stabilise consumer-led monetary growth in the strongest central European economies. A managed exchange-rate regime like the European Monetary System would also remove the temptation to make competitive currency devaluations.

However, the danger of trying to meet the Maastricht criteria too early is that monetary union may reduce the ability of policy-makers to deal with internal and external shocks to their still-vulnerable economies. The impact of the Russian crisis in 1998 was short-lived, but it showed that some sectors in the Baltic states are still exposed to the Russian economy. Recession in Western Europe could have a greater impact, because the applicants' trade and investment depends largely on the EU.

The applicants are not under any pressure to join the euro prematurely, because the European Central Bank and member-state policy-makers are very cautious about letting them in. Many central European enterprises probably lack sufficiently healthy balance sheets to survive the costs of adjustment in a single currency area, particularly domestic wage shocks. Early entry to monetary union would expose the uncompetitiveness of parts of central European industry, because the region's weakest sectors would no longer be able to hide behind depreciated exchange rates. Moreover, the EU's restrictions on the free movement of labour after accession will further reduce labour mobility in the euro-zone, preventing the kind of adjustments needed to reduce disparities across a single currency area.

The danger of new dividing lines in Europe

The EU has put considerable pressure on the front-runner countries to tighten controls on their eastern borders, and to require visas from nationals of neighbouring east European countries. Such policies will make it more difficult to conduct intra-regional trade and cross-border investment, inhibiting economic integration between the applicants and their eastern neighbours. The visa requirements have also increased fears in non-applicants like Ukraine, Moldova and the western Balkan countries that they will be excluded by the enlargement process. The imposition of a visa wall means moving the former Iron Curtain further east, and that would jeopardise the EU's long-term interests in regional stability through integration between the current applicants and their non-applicant neighbours. Restrictions on labour mobility will also mean that borders are not fully open for pan-European business – one of the main aims of enlarging the single market.

The Schengen area is beneficial in many ways: it allows goods, people, services and capital to travel freely around the EU without obstacles like passport controls and border guards. The problem for the applicants is that Schengen is a bargain: joining this free movement zone means that borders on the inside of the zone become porous (as frontier controls are removed) but borders on the outside have to become much harder to penetrate, because they are the only external barrier to unwanted people from third countries. The development of a common visa regime means that once foreigners have a Schengen visa and enter one member country, they can travel freely throughout all the rest – from the Arctic Sea in Finland to the Mediterranean shores of Spain.

Because the EU countries are afraid of migrants and criminals from the countries to the east and south of the applicants, they will allow new members to join Schengen only if they put up high barriers and introduce visas for Ukrainians, Russians and Belarusians, as well as other third-country nationals. There can be no exceptions from the EU's common visa list, says the EU, although it might allow cheap, multiple entry visas for some categories of visitor.

This is a difficult dilemma for the applicant countries: the Schengen rules run directly against the eastern policies of applicants like Poland, which are based on building bridges with Ukraine and Russia.

The problem is that the applicants' negotiating power is very small: Schengen is an integral part of the European Union, and the politics of fear are driving countries on the EU's current border to stress full compliance with visa policies and border controls before new members can join. There can be no opt-outs for new members, even though current members have such arrangements – Britain and Ireland have special arrangements so that they are partly outside the Schengen regime, while Norway and Iceland are partly inside it despite not being members of the EU. Unfortunately, candidates for membership cannot negotiate such exceptions – they have to accept the rules set by the current members, and these current members are determined to protect themselves against threats from the East. Schengen is not only about technical standards or legal harmonisation, it is also a matter of confidence. The German and Austrian populations want to feel confident that they are protected by a high fence on the borders of central Europe – otherwise, their parliaments could block enlargement to central Europe altogether.

To an extent, this stress on border controls is irrational: organised crime is much better fought through targeted, intelligence-led policing in cities, rather than through border controls and visas alone. Criminals usually have access to passports and forged documents, which means that new border controls will have a much bigger effect on Ukrainian traders and Belarusian peasants than on organised crime.

The applicants can only respond by using wisely the large amounts of EU money that they receive for strengthening border controls. The money should be spent on new border infrastructure so that people do not have to queue for hours at border crossing-points. The applicant countries also need to train a more efficient, competent and incorruptible border guard, so that circulation of people and goods around the new eastern border is fast and not dependent on bribes. This would reassure the EU while also helping to reduce the obstacles to trade and travel – and help to keep a balance between opening frontiers to the West while having to close them to the East.

The opportunity costs of delaying enlargement

If the EU significantly delayed the accession of countries that are nearly ready to join, the consequences for both the applicant countries and the EU would be serious. The EU would lose credibility in the eyes of both east Europeans and the outside world for reneging on its promises. That would lessen the credibility of the EU's conditionality for aid and other benefits that it gives to countries beyond the applicants, weakening the Union's capacity as an external actor.

The EU would lose the benefits of full integration with rapidly developing economies and reformist governments. The central European countries have transformed themselves over the past decade, and they will be keen to encourage the EU to reform its institutions and budget. Moreover, delay could foster Euroscepticism in central Europe, making these governments less friendly and more awkward partners for the EU.

Fears of migration, budgetary costs and wage competition could still derail the accession process, particularly in the ratification stage. The political salience of these issues would increase if the process were delayed until a time when the economic climate is more difficult. EU governments would come under greater pressure from trade unions and some businesses not to enlarge during a period of rising unemployment. The temptation would be for EU member-states to respond to these problems by refusing to open up their agricultural and labour markets to central Europe.

For the applicants, the biggest measurable opportunity cost of delaying enlargement would be a drop-off in foreign investment. That in turn would have a dramatic effect on industrial restructuring and competitiveness in central Europe. Any delay to the first round of accessions could also disrupt these countries' preparations for EU membership. The European economy enjoyed a long period of growth during the 1990s, easing the transition of most applicants into international markets. The global economic climate is already less favourable for countries such as Croatia, Romania and Yugoslavia – whose transformation has been postponed – to liberalise and restructure their economies, than it was for Hungary and Poland. If accession took place during a recession, it would be much harder for the prospective new members to make the necessary adaptations and investments to meet EU norms.

There would be political costs as well. Governments in the applicant countries would lose the incentive to make painful and difficult reforms. The accession process has been a very important stimulus to rapid economic liberalisation. It has helped policy-makers to overcome domestic opposition to reforms that are essential to developing their economies and opening markets to EU firms. The accession process has also ensured the continuity of reformist policies, despite frequent changes of government and the fragmentation of some countries' party political systems. This stabilising effect on the new democracies would be lost if the prospect of accession became unattainably distant.

If the central Europeans lost the EU as an incentive to carry out reforms and improve governance, the shock could knock some countries out of their current virtuous circles of reform and restructuring, encourage the emergence of populist politicians, and increase the scope for protectionism and corruption. The emergence of authoritarian governments with failing economies and weakly regulated markets would not be good for Europe's prosperity or security.

4 Three scenarios for managing the first accessions

The EU will find political management of the accession process very demanding, as its leaders are now realising after the Irish referendum. In the end-game of negotiations and the subsequent process of accession treaty ratification, the member-states will be back in the driving-seat. The process will move away from its technocratic focus on the adoption and implementation of laws and regulations, and back towards the geo-political and economic dimensions which were the original motivation for the whole project.

The 2004 target commits the EU to a very tight timetable. The 'road-map' for negotiations would allow the EU to sign accession treaties with some of the front-runner candidates at the end of 2002, which would then go to each of the 15 member-states' parliaments for ratification in 2003. It is hard to guess how long the ratification process might take, but the earliest possible entry date is 2004. Traditionally, accessions have taken place on January 1, but the Council may agree to a mid-year date. This timetable allows little room for political upset and unexpected hitches, which have always occurred in previous enlargements. In addition to continuing negotiations with the applicants and settling the financial and institutional questions between themselves, the member-states have to continue working on ratifying the Nice treaty in parallel. The Irish government has not yet committed itself to plans for another referendum, and the institutional chapter cannot be closed until Nice is ratified, so further hiccups are possible.

The exact date of the first accessions depends on the member-states' calculations of how to group candidates. It would be relatively straightforward to take in a group of the best-prepared smaller countries. The crucial question is whether Poland has to form part of the first group. It would be technically easiest for the EU to take in three or four of the front-runners first, and leave Poland until a second round, given the size of its population and agricultural sector. However, this is politically unfeasible for Germany, which sees Poland as a priority state for enlargement owing to its size, strategic importance and, above all, Germany's own sense of historical responsibility. For Germany, enlargement without Poland is unthinkable.

The issue of Poland – along with the recent rapid progress towards accession by Latvia, Lithuania and Slovakia – is encouraging discussion of a 'big bang' approach. This would see ten countries admitted together – eight of the central European applicants plus Cyprus and Malta. The EU would then come under pressure to make more far-reaching internal reforms of its institutions and the budget before such a 'big bang' enlargement could take place – and that might push the accession date several years further away. However, this approach has merits as well. The pros and cons of managing enlargement in three different ways are presented below.

Scenario 1: Big bang

A single 'big-bang' first round of accessions is the most likely scenario, although the timing is uncertain. By 2003, five of the central European countries – the Czech Republic, Estonia, Hungary, Poland and Slovenia – will be ready for accession.

It is feasible that Latvia, Lithuania and Slovenia will catch up quickly enough to join around the same time as the front-runner countries. They might finish negotiations slightly later than the first group's deadline of end-2002, but the front-runners will have to await ratification by all 15 member-states, so this delay could be used to allow another three countries to join the first five. From the EU's point of view, it is little extra effort to bring in another three small countries at the same time, because the major deals will already have been made for Poland and the other front-runner countries. The deals on agriculture, regional funds and free movement of people for the first five could be swiftly extended to the next three. Malta and Cyprus could also join this group, as they are nearly ready, making a total of ten accessions.

Benefits:

★ It brings Poland securely into the first round, helping to win German support for enlargement.

★ EU national parliaments and the European Parliament would ratify a block of accessions in one go, rather than many different treaties. This would make the ratification process faster, and might help to overcome objections to individual countries.

★ The EU could absorb some of the countries that may not join NATO relatively quickly. This consideration is especially important for the Baltic states.

★ This scenario avoids some of the problems for borders that a phased enlargement would create. Hungary would not be divided from its neighbour Slovakia, and there would be no new Schengen borders between the Czech Republic and Slovakia, or between the Baltic states.

Costs:

★ This scenario risks a further delay to the first accessions, if some applicants take a long time to finish negotiations.

★ Reluctant member-states could use the size of the group as an excuse for delay, because the institutional and budgetary implications would be proportionately greater.

★ This scenario leaves Romania and Bulgaria isolated outside the enlarged EU.

Scenario 2: Quick but small

If the EU is unable to resolve its internal problems with the budget and institutions, or if there are major conflicts in the end-game of negotiations, another scenario emerges. A small group of countries which are ready could join in 2004. They would not be made to wait for others to catch up.

This scenario has the advantages of being quick and ensuring that enlargement gets off the ground. A small first enlargement is better than a long postponement. It would make enlargement less frightening to reluctant member-states if just a few countries were admitted first. This scenario is still possible, although several key member-states would strongly prefer to bring in more countries the first time around.

Benefits:

★ Enlargement would get underway in 2004, avoiding further delay.

★ Later entry for Poland means fewer transitional periods would be needed in agriculture and other areas.

★ Without Poland in the first round, the EU could put off difficult reforms until the next budget period, giving member-states more time to resolve institutional and budgetary questions, especially the CAP.

★ The accession of a few countries gives the remaining candidates a strong incentive to complete preparations more quickly.

Costs:

★ A small first enlargement would start a long period of phased accessions, with negative implications for borders and bilateral relations, particularly Czech/Slovak relations.

★ What about Cyprus? A shorter timescale gives less time to find a political settlement for the whole island. If there is no settlement, the whole enlargement process could be deadlocked.

Scenario 3: Long delay

There are a number of political pitfalls which could cause a long delay to enlargement. Greece could veto eastward enlargement if Cyprus were not allowed to join in the first round of new accessions; France might block it, arguing that further institutional reform was necessary; or one of the parliaments might refuse to ratify the accession treaties. Likewise, the EU might find that it has to re-open budget deals and cannot close them again. Or there could be an economic crisis in the euro-zone or another shock like the Irish referendum result.

If such a delay pushed entry dates to 2008 or beyond, the EU would find that more countries had joined the candidate list. Croatia and other Balkan countries should have joined the ten central European applicants, Cyprus and Malta.

Benefits:

★ Later entry would mean that fewer transitional periods would be needed on either side.

★ It would allow the EU to put off difficult reforms until the next budget period, with more time to resolve institutional and budgetary questions. It would allow the CAP to be slowly wound down, with new members coming in only when direct payments had been reduced.

★ All the applicants would finally be ready to enter together: a super-big bang would really become feasible, bringing in 10 or more countries.

Costs:

★ EU accession would lose its effectiveness as a device for forcing through economic and other reforms in central Europe.

★ This scenario would be particularly expensive for business, because of the delay in introducing a level playing field across European markets.

★ The costs to the EU of not being forced to reform faster could be great: extra time would not necessarily lead to a more satisfactory settlement on the CAP. On the institutional side, the latest series of inter-governmental conferences does not inspire confidence that more time produces a better deal if it merely puts off the end-game.

★ More illegal migrants might seek work in the EU as legal routes would be closed and their home economies would be worse off.

★ By the time of accession, there could be growing disillusionment and euroscepticism in central Europe, creating awkward partners within the EU. There is a strong danger that if they are kept in the waiting-room until 2010, many central Europeans will turn against integration.

★ Further postponement of enlargement would carry significant opportunity costs. The failure of the EU to pass the necessary internal reforms would undermine its credibility in the eyes of the current applicants. It would also discourage the Balkan countries that are using the prospect of membership as a motivation for painful reforms. This is hardly a good example to set for democratisation and good governance in the rest of Europe.

5 Conclusions and recommendations

The main benefits of enlargement for the EU-15 countries are not economic, but rather about stability and security. However, achieving these gains will in turn depend on greater prosperity in central Europe, less inequality and deeper economic integration. This pamphlet has argued that although the economic benefits to the EU-15 will not be large in the short term, neither will the costs. And in the longer term, the whole European economy will gain substantially from enlargement.

Whether the EU goes for a big bang or a small first wave, it is critical that the first accessions (however many of them) should take place in 2004. That is already more than 15 years after the fall of communism in central and eastern Europe, and more than a decade after the EU made its first commitment to enlarge eastwards. The timing matters for EU institutional and budget reforms as well: the next IGC will start in 2004, as will the debate about the next budget. If it is not clear that enlargement is going to happen in 2004, EU leaders may be tempted to delay the necessary reforms still further. EU governments should start by ratifying the Treaty of Nice, which had already slipped down the legislative timetable before the Irish referendum result. If the new Treaty is not ratified by all 15 countries by the end of 2002, it could be used as yet another pretext for delay.

The major political risks to the enlargement process are fears of large migration flows, wage competition, and the cost to the EU's budget. Estimates of all these risks tend to be much exaggerated, as the economic analysis in this paper demonstrates. Moreover, none of these risks will be diminished if the EU fails to enlarge: migration will be much easier to control if it is mainly legal rather than illegal; the EU will face global competition regardless of enlargement; and the costs to the EU-15 will be much lower than comparable projects such as the integration of Greece, Portugal and Spain into the EU, or the re-unification of Germany. Enlargement will be beneficial for the EU, but only if it is managed well. And successful management depends on political leaders selling enlargement's benefits to the public in the existing EU, and on their reforming the Union to cope with greater diversity after enlargement.

Here are five recommendations to EU leaders, to encourage them to maintain the political momentum towards enlargement:

★ ***Stick to the timetable***

To overcome opposition to enlargement, the EU needs to stick firmly to 2004 for the first accessions. A secure timetable is essential, so that businesses can plan their investment and trading strategies across Europe. At a political level, the EU needs a clear strategy to overcome interest group objections. Without the discipline of a deadline, member-states will carry on fiddling with the institutions and arguing about the budget forever.

Member-states must not allow their own preparations to fall behind. The front-running applicants are aiming to be ready to join by 2003, but it is very difficult for their governments to persuade legislatures and ministries to speed up preparations if the EU's commitment wanes. The EU needs to keep to its own 'road-map' for negotiations, completing chapters on time and not letting its own budget squabbles delay the signing of accession treaties. Only if the EU respects the timetable agreed at Nice for provisionally closing chapters is there any hope of concluding negotiations by the end of 2002.

★ ***Set clear entry requirements***

The EU should establish a more specific set of criteria for judging transparently and publicly when the conditions for accession have been met by each country. The Copenhagen accession conditions are very general, and there are no clear benchmarks to show when they have been met. The EU needs to show that its decisions on each applicant's readiness are impartial and objectively based on evidence. That would in itself prevent any backsliding among large and strategically important countries like Poland. It would also reassure doubters that new members will be fully compliant with the entry criteria, and politically stable and economically competitive. The EU should offer flexible transitional arrangements in areas that will change before or just after accession, like its agricultural policy.

★ ***Prevent gaps between the applicants from widening***

It is in the EU's own interest to provide more assistance to the countries furthest from entry, which are receiving relatively little aid – in comparison with poor EU countries and the front-running applicants – under the current EU budget. In the accession process, the EU should give a clear priority to those tasks which would have an immediate impact on their economies, particularly those that encourage FDI inflows. The EU also needs to devote considerably more resources to help the back-markers to catch up, through targeted funds for building infrastructure and tackling corruption. At Gothenburg the European Council promised more help (but not necessarily more aid) to Bulgaria and Romania; now it must put its money where its mouth is. The EU itself will suffer if Bulgaria and Romania – currently the most stable states in south-eastern Europe – become unstable economies with weak democratic institutions on the fringes of the enlarged Union.

★ *Open borders fully for business*

The EU should keep new barriers in eastern Europe to a minimum. Visa restrictions and cumbersome frontier checks inhibit cross-border trade and investment. The goal of EU border policies for its new eastern frontier should be to encourage economic integration and facilitate the exchange of goods, services, people and ideas. The EU needs to make special arrangements for border areas like the Carpathian region. It should also make it cheap and easy to obtain multiple entry visas for people living in border regions. And it should provide aid to the new member-states to help pay for new border crossings and more consulates to issue visas.

★ *Persuade public opinion*

The EU's prime ministers need to use a better sales-pitch for enlargement. They all say they are in favour, but they are letting small-minded concerns distract attention from the gains of re-uniting Europe. The leaders need to get out on the stump and sell those gains actively. The main benefits they should stress are stability and security in Europe. However, politicians also need to put people's fears into perspective by using the results of economic research, to show the real extent of costs and risks. Rhetoric about re-uniting Europe is not enough on its own. Leaders have to start explaining the concrete benefits in terms of growth, investment, competitiveness and security. They have to address head-on the fears about jobs, wages, migration and the budget. There are plenty of good arguments to be made – as this pamphlet tries to demonstrate – but politicians have to devote time to using them, and not just leave communication on enlargement to the Commission. Otherwise there will be more shocks like the Irish referendum.

This pamphlet concludes that the EU's political leaders must now live up to the Union's promises to let the post-communist countries play a full part in Europe. The safest course of action is often the boldest: Europe's leaders need to start selling enlargement actively to their own populations. The end of negotiations is only 18 months away. It is time to start demonstrating how the whole of Europe will profit from EU enlargement.

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