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working paper

Who's ready for EU enlargement?

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1 Introduction

Ten new members are set to join the EU on May 1st, 2004.[1] Although preparations for the EU's eastward expansion have taken more than a decade, there is still great uncertainty about the venture. Public opinion across Europe is sceptical about the merits of enlargement. This matters because the accession treaty needs to be ratified by parliaments in all existing EU member-states, as well as the European Parliament. Meanwhile, the candidate countries have to win public support for EU membership through referenda, and parliamentary votes.

Enlargement will change the Union dramatically, but in ways that are difficult to predict. It could prove to be a huge success, spreading stability and prosperity across the European continent. Or it could be a disaster, seriously weakening the EU. The key to making enlargement a success is good preparation. If the acceding countries cannot cope with the demands of membership, they will threaten the smooth operation of the Union and they could obstruct further integration. If the EU is insufficiently prepared, its decision-making structures could become paralysed. This working paper tries to assess the readiness of both the candidate countries and the EU. It concludes that the candidates are, on the whole, well-prepared for accession. The Union, however, has not done enough to get ready for its biggest-ever expansion.

Although our conclusions are inevitably tentative and open to debate, they help to sketch out the consequences of enlargement for the wider Europe. Enlargement will have an immediate impact on every facet of the Union. The number of participants in EU meetings will grow by two-thirds, making consensus harder to

[1] In addition to the eight East European countries covered in this working paper, the 2004 enlargement will also bring Malta and Cyprus into the Union. Bulgaria and Romania started negotiations in 2000, but will not be ready to join in 2004. Turkey is a candidate for EU membership, but has not started accession negotiations.

find. But the changes will not be purely arithmetical; they will also be qualitative. The new members will add their own priorities and problems to the EU's agenda. The EU's political balance will change, as the new members take sides in long-standing debates. The EU economy will become more diverse after the accession of several poor and industrially backward countries. The EU will have to redesign many of its policies to address the specific needs of its new members. Implementation and enforcement of EU rules will become trickier, since the candidates' administrations are often weak and inefficient. And enlargement poses geostrategic challenges, for the expanded EU will border unstable and impoverished countries to the East. All 25 members of the future Union need to start work now, in the European Convention and other fora, on preparing the EU for these new challenges.

The enlargement timetable

13 December 2002	Close of negotiations at the Copenhagen European Council.
16 April 2003	Signature of the accession treaty.
May 2003-April 2004	Ratification of the accession treaty by EU parliaments and the European Parliament; and by the 10 candidates' parliaments, following national referenda.
1 May 2004	Accession of ten candidate countries.
2006	Earliest date for some new members to adopt the euro, and join the Schengen area of passport-free travel.
2007	Target date for Bulgaria and Romania to join the EU. By that time, Croatia may have caught up with them in its preparations, and Turkey may be about to start negotiations.

The prospective members at a glance

	Population, millions	GDP per head, % of EU average at PPP	Real GDP growth, % change	% of workforce in agriculture
Bulgaria	7.9	28	4.0	27
Cyprus	0.8	80	4.0	5
Czech Republic	10.2	57	3.3	5
Estonia	1.4	42	5.0	7
Hungary	10.2	51	3.8	6
Latvia	2.4	33	7.7	15
Lithuania	3.5	38	5.9	17
Malta	0.4	55*	-0.8	2
Poland	38.6	40	1.1	19
Romania	22.4	25	5.3	44
Slovakia	5.4	48	3.3	6
Slovenia	2.0	69	3.0	10
Turkey	68.6	22	-7.4	35
EU	377.5	100	1.5	4

Data from 2001.*Data for 1999.
Note: PPP means purchasing power parity, a measure of the exchange rate that corrects for misalignments in foreign exchange markets.
Sources: European Commission; Eurostat from national sources.

2 Are the candidates ready?

In general, the answer is yes. The candidates have made remarkably fast progress in preparing themselves for membership. They have overhauled their political systems; liberalised and reformed their economies; and adopted the EU's rules and regulations, accumulated over decades (known as the *acquis communautaire)*. Ten of them are now close to completing negotiations on all 31 'chapters' that make up the *acquis*. The candidates have yet to agree to the EU's offer on its future budget policy, and some are still struggling to strike last-minute deals in competition policy. But there is little doubt that negotiations can be wrapped up by the end of 2002.

The European Commission has taken a tough stance during the accession preparations. Since 1997, it has annually scrutinised progress in all the candidate countries. It has looked at issues ranging from the protection of minority rights, to the safety of nuclear power stations, to hygiene standards in dairies. The Commission's monitoring reports paint a picture of steady progress towards meeting the EU's political, economic and technical entry criteria (known as the 'Copenhagen criteria'). In 2002, the Commission recommended that ten of the 13 applicants should be invited to join the Union – namely Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

Although Latvia, Lithuania and Slovakia only started accession talks in 2000, they have managed to catch up quickly with the countries that have been negotiating since 1998. These candidates' preparations for EU accession have helped to smooth out the very different industrial and administrative structures with which they emerged from communism. The candidates all score well on the EU's Copenhagen criteria, and the remaining gaps in their preparedness for accession are relatively small.

According to the Commission and a range of other sources – including business views[2] – no country among the 10 is lagging across the board. All have their strengths and weaknesses. Hungary has long stood out as one of the best-prepared candidates. Its persistent reform efforts have been rewarded with massive foreign investment and continued strong growth. The Czech Republic, Poland, Slovenia and, to a lesser extent, Slovakia have shared Hungary's economic success, although their EU accession preparations have not always been so smooth. The three Baltic countries have done a remarkable job in getting rid of the legacies of Soviet central planning. Estonia is now among the most liberal economies in Europe. Although Latvia and Lithuania have adopted a more gradual approach to economic reform, their small economies are flexible and increasingly diversified. While differences between the eight East European front-runners are becoming smaller, there is still a clear gap between them and those applicants that will not be joining in 2004.

Both Bulgaria and Romania are progressing well in their accession talks, but they are much less prepared in economic terms. While Bulgaria has made good progress with reforms in recent years, Romania has managed little more than stagnation. Turkey, meanwhile, has not yet started accession negotiations. While we consider the future accession of these countries important (see chapter 3), this working paper concentrates on the readiness of the East European candidates that will join in 2004.

Will the new members play by EU rules?

The EU expects its new members to adopt, implement and enforce existing EU legislation. In the space of just a few years, the

[2] See PricewaterhouseCoopers, 'EU enlargement barometer 2002', November 2002; and Eurochambres, 'Corporate readiness for enlargement in Central Europe', Brussels, 2002.

candidate countries have adopted almost all of the *acquis communautaire* – some 80,000 pages of EU rules and regulations. Nevertheless, some politicians from the existing member-states have voiced doubts over whether the candidates are really ready to join the EU. Putting EU rules on the statute book is one thing, they say, but implementing and enforcing them is another.

Indeed, East European countries are lagging in the implementation and enforcement of EU law. In its 2002 regular reports, the Commission warned the candidates that it was "indispensable" that they strengthen their state bureaucracies and court systems.[3] In the past, the EU has been able to threaten to delay membership for those falling behind on implementation. But after the Copenhagen European Council in December 2002, this threat will no longer be credible.

A new safeguard mechanism

The Commission is under pressure from existing member-states to ensure the candidate countries do not relax their implementation efforts once the accession treaty has been signed. It is therefore planning to set up a special monitoring and safeguard system that will remain in place up to and even beyond accession. Six months before the date of accession, the Commission will draw up a comprehensive report on last-minute preparations. It is not clear, however, what would happen if one of the candidates failed to make the grade in this reporting exercise – especially as, by that time, a number of EU members and candidates will already have ratified the accession treaty.

The EU also needs to clarify how the new safeguard mechanism would work after enlargement. This mechanism is intended to protect the functioning of the single market and the Schengen area of free movement.[4] The Commission has promised "swift and

[3] The Commission's regular reports are available from http://europa.eu.int/comm/enlargement/docs/index.htm.

[4] This procedure will be in addition to a general economic safeguard clause – included in previous accession treaties – which allows member-states to protect their economies in case of severe disruption. The previous safeguard clauses were in place for one year after accession, whereas this new regime will last three years.

purposeful measures" if a new member fails to enforce EU law, but has not spelt out what form these measures might take.

The candidates are understandably worried about the new safeguard procedure. Are the remaining gaps in enforcement of the *acquis* big enough to justify discriminatory safeguard measures? And are the candidates' promises to complete their legal frameworks and improve enforcement by 2004 credible? The Commission's regular reports paint a mixed picture. Some legal shortcomings could indeed threaten the smooth functioning of the single market. For example, the Commission has criticised some of the candidates for not adequately applying EU food standards. This may impede trade, especially since West European consumers are very worried about food quality in the aftermath of the BSE crisis. Some countries have restrictions on foreign investment in certain sectors, which go against the EU principle of the free flow of capital. Others have not adopted EU rules on public procurement and may discriminate against foreign companies in public tenders.

The acquis is in place – almost

These shortcomings need to be rectified, but they do not justify any delay in the enlargement timetable. The current member-states have not managed to transpose (adopt into national law) the entire *acquis* either. The Commission's latest figures show that the percentage of single market laws that member-states have failed to transpose now stands at 2.1 per cent, up from 1.8 per cent in 2001.[5] To meet the official EU target of reducing this 'implementation deficit' to 1.5 per cent of laws, France would have to push through 70 EU directives by spring 2003, Germany would have to adopt 73 and the UK 59. Nevertheless, the single market functions reasonably well despite the uneven transposition of some elements of EU law.

The important difference between old member-states and new ones will therefore not be in the domain of written law, but in its day-to-day implementation and enforcement. The existing member-states are not perfect role models in this respect either: the Commission is pursuing some 1,500 infringement procedures against member-states for failing to implement properly single market legislation. But the existing member-states enjoy the advantage of long experience in adjusting their laws and administrative practices to the requirements of EU membership. The candidates have made tremendous progress in recent years in building up the administrative bodies that are needed to implement the *acquis*. They have established food standards agencies, telecoms regulators, labour inspectorates and insurance market supervisors. But many of these bodies are understaffed, poorly funded, or not sufficiently independent of political influence.

[5] European Commission, 'Internal Market Scoreboard 2002', http://europa.eu.int/comm/internal_market/en/update/score/index.htm.

The candidates can close legal gaps in the *acquis* relatively quickly, especially since most have put in place 'fast track' procedures to push through EU laws. But they will not be able to strengthen their administrative capacity without substantial investment in building up new bureaucracies, training officials and, in many areas, developing a new culture of compliance and co-operation.

How to improve governance

Perhaps the biggest problem in East European bureaucracies is the lack of well-trained, experienced and motivated staff. Those with marketable skills – foreign languages, IT proficiency, legal expertise or an understanding of economics and business – have long since switched to better-paid jobs in the private sector. As a result, those stuck in underpaid civil service jobs are often poorly trained and motivated. Many supplement their meagre salaries with bribes. Petty corruption is still a serious problem in some of the candidate countries.

The Commission also highlights the problem of a weak and understaffed judicial system in some accession countries. Although the Commission lauds the "decisive steps" undertaken by the candidates in recent years, it warns that judicial reform is far from complete. The 'brain drain' that has weakened state bureaucracies has also ravaged the court system. The Czech Republic, for example, has more than 270 unfilled posts for judges, and the same number for prosecutors. Many court officials do not have access to computers. Court cases can take years to wind through the system. Slovenia now has a backlog of about 300,000 unresolved cases. And some judges and prosecutors are susceptible to political influence.

Most East European governments are credibly committed to strengthening their court systems, rooting out corruption at all levels and making their bureaucracies more efficient. They have drawn up comprehensive strategies and devoted more financial and human resources to this task. But implementation will take time. In particular, governments will take many years to restructure civil services in a way that makes public sector careers attractive for educated young people.

EU membership as such does not necessarily force countries to root out corruption and improve the quality of their bureaucracies. Several of the current member-states continue to struggle with these problems. Transparency International, a corruption watchdog, ranks Estonia and Slovenia as less corrupt than Greece and Italy.[6] The Open Society Institute, in another monitoring exercise, has found that corruption is worse in some existing member-states than in the best-prepared candidate countries.[7] Moreover, some EU members have bureaucratic procedures that are as lengthy and cumbersome as those found in some East European countries. In Italy, there are worries about the independence of the judiciary too.

The EU's *acquis* provides little guidance for addressing these issues. Peer pressure within the EU can encourage governments to tackle administrative weaknesses and undemocratic practices. But the EU's institutions themselves have little leverage over bureaucracies and different levels of government within the member-states. The new safeguard mechanism to be put in place after enlargement may

[6] http://www.globalcorruptionreport.org
[7] Open Society Institute EU Accession Monitoring Programme, *Corruption and anti-corruption policy*, Budapest: Open Society Institute, 2002, www.eumap.org.

signal that this is about to change. The EU is not only concerned about the consistent implementation of EU laws. It also worries about how the new members will spend the sums they will soon receive from the EU budget, mainly for farm support and the improvement of infrastructure. In the absence of transparency and efficient administrative procedures, government officials may be tempted to dish out huge construction contracts in return for bribes, or channel funds to their friends and cronies. Again, there are lots of precedents from the existing member-states. The press has discovered tales of corruption in EU-funded road-building projects in Southern Europe, and of fraudulent use of agricultural subsidies. With the fight over scarce EU funds hotting up (see chapter 3), the EU will have to keep an ever more watchful eye on their efficient use.

Can the new members compete in the single market?

The EU has made competitiveness one of the key economic conditions for accession. In addition to a "functioning market economy", successful applicants have to prove they have "the capacity to cope with competitive pressure and market forces within the Union". The Commission has adopted a broad definition of competitiveness: macroeconomic stability; a well-trained workforce; solid infrastructure; efficient enterprises; ample financing opportunities; and a well-developed framework for research and development (R&D).[8] In its 2002 assessment of the accession countries progress, the Commission classified all of them except Romania as functioning market economies. But it judged only two of them – Cyprus and Malta – as being ready to cope with the competitive pressures of the single market. The Commission expressed confidence that the eight East European front-runners would make the grade by the time of accession in 2004. But to grow and prosper in a wider EU, the new members will have to do more than just cope with competition. If they want to catch up with West European income levels, they will have to continue modernising their economies and move from

[8] Defined in the Commission's 1997 'Opinions', available on http://europa.eu.int/comm/enlargement.

labour-intensive industries to high value-added manufacturing and services.

A brief look at past economic performance indicates that the new members should have few problems competing in the single European market. In fact, from an economic perspective, enlargement is already a reality. Both the candidates and the EU have almost completely dismantled barriers to bilateral trade. West European companies have invested massively in the East European region. Thousands of East European manufacturers are locked into pan-European supply networks. The candidates have also opened up their markets for services. Western banks have taken over and restructured East European financial institutions. East European economies have flourished, despite the massive pressures exerted by this steady market opening. Over the last five years, countries such as Estonia, Hungary, Poland and Slovenia have mustered growth rates of more than 4 per cent a year, compared with an EU average of 2.6 per cent.

Exports to the EU have been one of the key drivers of growth in Eastern Europe since the early 1990s. For example, total Czech exports (measured in dollars) have grown by almost 200 per cent since 1993. For Slovakia, the growth rate has been closer to 250 per cent. Hungary has boosted exports by 290 per cent over the same period. These three countries now send around 70 per cent of their exports to the EU, and obtain a similar share of their imports from the Union. Two further observations indicate that the candidate countries have highly competitive export industries. First, the composition of their exports has changed gradually in favour of higher value-added goods, such as cars, electronics and telecoms equipment. Second, East European exports have continued to grow, despite sluggish EU growth in recent years, which indicates that they are still gaining market shares in the EU.

This phenomenal growth in trade has gone hand in hand with rapidly growing foreign direct investment (FDI).[9] Macroeconomic

[9] FDI should be distinguished from portfolio investment. FDI generally refers to the direct acquisition of a local company (or a significant stake therein) by a foreign company. It also includes 'greenfield' investments in new production capacity and upgrading old plants. By contrast, portfolio investment is capital flows into financial instruments.

stability, decreasing political risk, highly skilled but low-paid workers and an improving business environment have all helped to draw in western companies. The prospect of EU accession has itself done much to make Eastern Europe attractive to foreign investors. The gradual alignment of East European laws and practices with those found in the EU has made western investors feel increasingly at home in the candidate countries.

In the first decade of post-communist transformation, the ten East European candidates had attracted FDI inflows of more than $120 billion. In the Czech Republic and Hungary, the stock of FDI has now reached more than 40 per cent of GDP, while in the other front-runner countries the figures are around 20 per cent.[10] Although privatisation is drawing to a close in many countries, FDI inflows have held up well. Instead of buying smokestack factories, foreign investors are now setting up new plants ('greenfield investment') or ploughing more money into their existing ventures. Sluggish growth in the EU may in fact have accelerated this trend, since the need to cut costs makes East European wages look all the more attractive.

Nevertheless, there is some uncertainty about future levels of foreign investment. Drawing on the experience of Spain and Portugal, many East Europeans expect FDI to boom after accession. But pre-accession FDI flows into the candidate countries are already very high – often in the range of 5-7 per cent of GDP a year. They are unlikely to rise much further, especially since some foreign investors are concerned about rising wages and an end to generous tax exemptions. But Eastern Europe needs FDI so that it can move into the kind of high-tech industries and knowledge-intensive services that are needed for catch-up growth.

Wage costs are rising

Although low wages have not been the only factor attracting FDI into Eastern Europe, they have certainly played a major role. However, real wages (adjusted for inflation) have been growing

[10] UNCTAD, *World Investment Report 2002*, United Nations, 2002.

rapidly over recent years. Since most foreign investors draw up their bottom line in dollars or euros, the continuous real appreciation of East European currencies has further added to wage costs in the region. In the Czech Republic, for example, average wages (expressed in euros) have grown by 10 per cent since 1998. In Poland, wages have risen 20 per cent and in Hungary close to 70 per cent. The combination of rising wages and appreciating currencies has also put growing pressure on domestic enterprises: their wage bills are rising while strong currencies threaten to price their goods out of competitive western markets.

Will these trends undermine Eastern Europe's competitiveness over coming years? Not necessarily. What matters for employers is not the size of the wage bill, but how much they have to pay for each unit of output – economists refer to this measure as 'unit labour costs'. Unit labour costs depend on productivity levels as well as wages. Although it is very difficult to compare such data across countries, economists estimate that productivity in the candidate countries is now around half of the EU average. Their wages, meanwhile, are still less than one-third of the EU average. In 2002, the average wage in the Czech Republic, Hungary and Poland was less than €3 an hour, compared with €10 in Greece, around €20 in France and almost €27 in Germany.

In other words, unit labour costs are still significantly lower than in most EU countries. But they are now rising quickly in some candidates, including Poland, the Czech Republic and, more recently, Hungary.[11] Foreign investors have expressed concerns about these developments, and some have even packed up and moved to Asia, where wages are still much lower. To remain competitive, the candidates will have to ensure that wage growth does not exceed productivity gains. In the early years of transition, productivity growth was largely the result of job losses in formerly state-owned industries, and the transfer of existing resources to new and better-managed enterprises. As basic economic restructuring draws to a close, productivity growth will require more capital

[11] Peter Havlik, 'Trade and cost competitiveness in the Czech Republic, Hungary, Poland and Slovenia', The World Bank, Technical Paper no. 482, November 2000.

investment and the spread of modern technology and management techniques. The candidate countries will therefore need to upgrade their skills levels, invest in new technologies, and create a business environment conducive to innovation and rapid change. In other words, they have to sign up to the economic objectives that the EU defined in its Lisbon agenda.

Can Eastern Europe meet the Lisbon goals for economic reform?

At the Lisbon summit in March 2000, EU leaders adopted an ambitious reform agenda with the aim of making Europe "the most competitive and dynamic knowledge-based economy in the world by 2010". To achieve this goal, the member-states have signed up a long list of targets, such as supporting job creation, helping small businesses, cutting red tape, liberalising markets for energy and telecoms, strengthening education systems, investing more in R&D, and encouraging greater use of information technology.[12]

Eight East European countries – and perhaps also Bulgaria, Romania, Croatia and other Balkan countries – will have joined the EU by the target date of 2010. Will they be able to achieve the EU's ambitious Lisbon targets? Or will they hold the EU back?

Creating jobs

The EU has made job creation one of the key Lisbon targets. In particular, it wants to increase employment levels to 70 per cent of the working-age population by 2010. The EU has made some progress – the employment rate had edged up from 60 per cent in 1999 to 64 per cent by 2001 – but rigid labour markets in some member-states still stifle job creation and keep unemployment levels high.

Eastern Europe's record of job creation is mixed at best. The economic upheavals that followed the onset of transition have destroyed millions of jobs in old-style, uncompetitive industries

[12] Edward Bannerman, 'The Barcelona Scorecard: The status of economic reform in the enlarging EU', CER, May 2002.

and the agricultural sector. At the same time, scores of new jobs have been created in higher-value added manufacturing and the fast-growing services sector. However, job creation in the more dynamic parts of the candidates' economies has not always been fast enough to compensate for lay-offs. Some East European labour markets also suffer from geographical and skills mismatches. Unemployment tends to be very high in declining industrial heartlands and rural areas. But most new jobs spring up in and around urban centres. Moreover, laid-off workers sometimes lack the skills, experience and flexibility to take advantage of new employment opportunities in the services sector or fast-growing export industries.

As a result, employment levels in the candidate countries are generally lower than in the EU and unemployment rates are higher, reaching up to 20 per cent in countries such as Poland and Slovakia.[13] Only the Czech Republic and Slovenia have employment levels that match or surpass the EU's 64 per cent average. In Hungary, Latvia and Lithuania, fewer than 60 per cent of people between 15 and 64 have a job. In Poland, the rate is below 54 per cent. Even more worryingly, employment is falling in most of the candidate countries.

EU enlargement may thus drag down EU averages and make it harder to meet Lisbon employment targets – unless the candidates, with help from the existing member-states, undertake a concerted effort to boost job creation. Since East European labour markets are generally less rigid and regulated than, say, those of Germany or France, the standard cure of deregulation may not be applicable. Instead, the candidates need to invest more in re-training so that workers can take advantage of new economic opportunities. They need to reduce payroll taxes to stimulate job creation. And they need to improve the way that housing markets work, so that the unemployed find it easier to relocate. Perhaps most importantly, they need to do more to attract investment – local and foreign – to declining regions.

[13] European Commission, 'Employment in Europe 2002', July 2002.

Building a knowledge-based economy

The EU does not only aim to create more jobs, it also wants employment to shift to highly-paid, highly productive knowledge industries. To build a knowledge-based economy, countries need four things: a modern and flexible education system; a strong focus on innovation, which means high and targeted spending on R&D plus efficient links between research centres and the corporate sector; a modern information and communication infrastructure; and, more generally, a business environment that encourages investment and innovation.

The Eastern European candidates score very well in some of these areas, but lag in others. East Europeans regularly come out on top when compared with other countries on literacy, numeracy and other basic skills. Education spending as a percentage of GDP stands near western European averages. Primary schools offer very solid education. Most people go on to some kind of secondary education or training. However, since secondary education is often very specialised, it does not always provide workers with the skills and flexibility required in a fast-changing market economy. University education, meanwhile, is less common than in the EU. Some 10-15 per cent of the working-age population in the Czech Republic, Hungary and Poland have been to university, compared with 25 per cent in the richer EU countries.[14] Although basic levels of education are impressive, the new members will have to press ahead with modernising their education systems, if they want to catch up with EU incomes and competitiveness. They need to tailor curricula fully to the needs of the market economy. At present, they put too much emphasis on basic science and too little on applied science and vocational training. Students score well on technical expertise, but poorly on independent thinking and initiative. Furthermore, governments have done little so far to promote life-long learning.

The new member-states also need to continue their efforts to build an efficient and easily accessible communications infrastructure. Eastern Europe is not far behind the West when it comes to telecoms

[14] Estonia is an exception among the candidate countries, with tertiary enrolment rates of more than 40 per cent.

market reform, and most countries have the basic ingredients for an information society in place. However, low income levels mean that there is still a 'digital divide' between the candidates and the more advanced EU countries. Internet usage has grown rapidly in recent years, albeit from a very low base. Personal computers are still beyond the means of the average household, and telecoms connection costs are higher than in the West, especially if measured as a share of household income. However, once cost constraints are removed, new technologies tend to catch on quickly. Mobile phone usage, for example, has more than doubled in all the candidate countries since 1995.

R&D is vital for the candidates to turn high levels of knowledge into profitable businesses. In general, however, Eastern Europe's investment in research is insufficient. Poland, for example, spends less than 1 per cent of its GDP on R&D, compared with an EU average of 2 per cent and closer to 3 per cent in the US and Japan. What is more, R&D spending is heavily concentrated in a few foreign-owned companies. Most local enterprises are too busy struggling for survival to invest in anything with only long-term benefits. The foreign-owned sector risks becoming an island of innovation and dynamism, while much of the rest the economy is slow to catch up.[15] Governments should therefore put their minds to creating a more favourable environment for innovation and learning, for example by creating tax incentives for R&D investment, strengthening the protection of intellectual property rights, injecting cash into small enterprises and making education reform a priority.

Small enterprises

As part of its Lisbon agenda, the EU aims to support the growth of small businesses, which are assumed to be more innovative and flexible than their larger counterparts. Small and medium-sized enterprises (SMEs) have mushroomed in Eastern Europe, and they now employ up to two-thirds of all workers, which is on par with the EU. Poland has experienced particularly fast growth among its small enterprises. However, most of that country's SMEs have little in common with the high-tech start-ups that the EU hopes will form the backbone of the European economy. The vast majority of Polish SMEs are tiny – 95 per cent are a one-man show – and most do not have access to investment funds. The governments of Poland and the other candidate countries are addressing these problems through wide-ranging SME support policies. The EU is helping with special SME financing programmes.

[15] Tomasz Mickiewicz and Slavo Radosevic, 'Innovation capabilities in six EU candidate countries', London: School of Slavonic and East European Studies, September 2001.

Market liberalisation

Some East European governments have gone further in privatising and deregulating banking, telecoms, transport and energy than some of the existing member-states. Poland, for example, has a more liberal energy market than France, where the government has jealously guarded the monopoly of Eléctricité de France until very recently. Hungary and the Czech Republic have sold most of their banking sectors to foreign investors, while Germany refuses to privatise its regional Landesbanken.

While the candidates are still lagging behind the EU on many Lisbon indicators, they are well placed to catch up quickly. After more than a decade of extremely rapid economic and social change, they are not afraid of the challenges and costs attached to further restructuring. Most of the candidates already have comprehensive policy frameworks in place to improve education systems, boost innovation and support SMEs. Implementation will certainly take time. But the gap between plans and reality is not that much greater than in many current member-states.

The EU is also helping the candidates to meet the Lisbon goals for structural reform. For example, it fosters contacts between scientists in East and West. It has included the candidate countries in its policies to promote technological innovation. And it offers advice and financial help for improving education systems. The EU should continue and reinforce these efforts.

After accession, the new member-states will gain access to billions of euros from the EU's structural and cohesion funds.The case of Ireland demonstrates that EU money, if spent wisely, can make a real contribution to economic modernisation. Ireland decided to invest a large share of its EU money in education, laying the foundations for the high-tech boom that continues to the present day. Greece, on the other hand, used EU money to fund an increase in public consumption. As a result, Greece struggled for years with growing external deficits, high inflation and weak growth and investment rates. The EU therefore needs to make sure that the funds going to Eastern Europe are well spent. The new members will certainly need massive investment in physical infrastructure, but a significant share of EU funds should be spent on human capital, notably on improving education systems.

The EU is right to focus on competitiveness in the candidate countries. But at present it is the existing member-states that appear most fearful of enhanced competition in an enlarged internal market. They have been slow to liberalise trade in 'sensitive' sectors, such as agriculture and textiles. They are jealously guarding each euro they receive from the EU budget. And they are planning to keep restrictions on the movement of workers from the new member-states for at least two years after accession – and possibly up to seven years. While the member-states' concerns are understandable, their attempts to protect their interests are short-sighted.

Economists predict that it will take some of the new member-states decades to catch up with the EU's richer members.[16] In other words, incomes and wages in Eastern Europe will remain much lower than in the richer EU countries for many years after the EU's temporary restrictions on the free movement of workers have expired. However, not only income levels, but also the prospects of future prosperity affect migration. If the new member-states continue to grow faster than the richer EU countries, East European workers will be unlikely to desert their homes in large numbers. The EU therefore has a strong interest in helping the new members to increase their growth potential.

[16] European Commission, 'Real convergence in candidate countries: Past performance and scenarios in the pre-accession economic programmes', November 2001.

When will the new members be ready for the euro?

Many candidate countries, including Hungary and Poland, want to join the eurozone as quickly as possible after accession. Euro accession would remove exchange rate risk and give a further boost to trade with the other eurozone members. It would also result in lower interest rates, which, in turn, could give a boost to investment and growth.

The new member-states will join the revamped exchange rate mechanism (known as 'ERM II') shortly after EU accession. Since the Maastricht treaty requires euro-applicants to stay in ERM II for at least two years, they could join the eurozone as early as 2006. However, not all the new members of the EU will be able to fulfil the other Maastricht criteria – concerning public sector debt, budget deficits, inflation and interest rates – by 2006.

East European inflation rates have fallen rapidly in recent years, although external and one-off factors – such as falling oil prices, good harvests, strong currencies and sluggish growth – played a major role. Some countries will struggle to keep inflation below the level required by the Maastricht treaty, which is no more than 1.5 percentage points above the average of the three best-performing eurozone members. Ten-year bond yields will also have to fall to no more than two percentage points above those in the three eurozone countries with the lowest inflation. That criterion should be easy to satisfy, for interest rates will converge towards eurozone levels as soon as financial markets believe that the country concerned will join the euro – in fact, this process has started already.

The fiscal criteria could be trickier to meet. All the candidates have public debt levels below the Maastricht threshold of 60 per cent of GDP, but public borrowing is high. In 2002, the Czech Republic, Hungary and Poland were heading for budgets deficits of between 5 and 10 per cent of GDP, and they will rise further in 2003. If they wanted to join the euro in 2006, they would have to reduce this to the Maastricht treaty's 3 per cent threshold by 2005 – a major challenge, given that growth prospects are uncertain and many costly reforms are on the agenda.

Since most public spending is fixed in advance – to pay for social security or the state administration – public investment is likely to take the brunt of any cuts. However, the new members will need high rates of public investment to bring their infrastructure up to western standards and modernise their education, pension and health systems. This implies that any concerted efforts to squeeze budgets into the straitjacket of the Maastricht criteria might not only choke off growth in the short term, but also reduce the economies' growth potential in the medium to long term.

In addition to meeting these four criteria, would-be euro members have to peg their exchange rates to the euro for two years within the ERM II. Exchange rate crises like the one that forced Britain out of the original ERM are unlikely. ERM II is less rigid than its predecessor, with currencies allowed to fluctuate by 15 per cent on either side of the central rate. This flexibility will be sorely needed in the years ahead: economies undergoing rapid structural change, such as the accession countries, tend to experience significant upward movements in their real exchange rates (the much-discussed Balassa-Samuelson effect). This real appreciation will show up in nominal appreciation of the currency or in higher domestic inflation, or both. East European governments may therefore find it hard to hold nominal exchange rates stable while also bringing down inflation.

3 Is the EU ready?

The short answer is no. At a series of summits, the current member-states have tinkered with decision-making processes and the EU budget. But they have not undertaken the fundamental reforms that are needed to prepare the Union for a membership of at least 25 very diverse countries. Their failure to overhaul institutions, financing arrangements and decision-making procedures means that the EU may have serious problems in digesting its biggest-ever enlargement.

The effects of enlargement will stretch far beyond the EU's institutions in Brussels. Trade and financial integration between Eastern and Western Europe have already changed the continent's economic landscape. Slovak workers assemble German cars in Bratislava. Hungarian researchers in Budapest develop software for Finnish mobile phones. Latvians attend universities in Scandinavia. Poles shop in British supermarkets in Warsaw. Conversely, scores of Polish builders work on construction projects in Germany. Czech beer has become popular in London. Slovenian professors teach at Italian universities.

Nevertheless, many Europeans remain somewhat sceptical about enlargement. The process cannot be a success unless it is supported by the peoples of Europe. It is therefore unfortunate that the debate about enlargement has become narrowly focused on budgetary transfers between old and new members. The final phase of acrimonious budget negotiations has left many Europeans with the impression that enlargement is a bad deal.

The EU budget

The EU has made little progress in its attempts to overhaul its budget ahead of enlargement. At the October 2002 Brussels summit, Jacques Chirac, the French president, engineered a deal that will keep most EU spending focused on the priorities of the 1950s. The member-states could not agree to implement long-overdue reform of the Common Agricultural Policy (CAP) prior to enlargement. Following an unexpected behind-the scenes bargain between Germany and France, they reached an accord that will limit the nominal increase in farm spending to 1 per cent a year after 2006. But the Brussels deal means that the EU will continue spending half of its budget on a largely unreformed CAP until 2007 at least.

While Germany – which pays for much of the CAP – insisted on capping future farm spending, France – whose farmers benefit handsomely – forestalled any radical CAP reform until after 2006. The deal postponed a big row about the CAP, and allowed negotiations to finish on time. But by 2007, CAP money will have to be shared between 25 members rather than 15. The imperative to reform the CAP is therefore growing.[17]

The costs of including the new member-states in an unreformed CAP could boost EU spending beyond the budget limit of 1.27 per cent of EU GDP. The EU therefore had two options: reform the CAP or pay East European farmers less than West European ones. It opted for the latter. The EU has offered to give East European farmers 'direct payments' (which account for some two-thirds of EU farm subsidies) at a level of 25 per cent of those received by farmers in existing member-states. This share would increase gradually to 100 per cent in 2013.

The deal reached at Brussels forms the basis for the final negotiations on farm policy between the EU and the candidates. Some countries – in particular Poland, which has by far the largest agricultural sector in Eastern Europe – object to not obtaining equal access to EU support. Although some are still hoping for a better deal, the room for manoeuvre is extremely narrow, and the candidates' overriding priority is to complete the negotiations on time. But many people in the candidate countries have been left with the impression that the EU has arm-twisted them into an agreement that is unfair.

[17] Julie Wolf, 'The future of European agriculture', CER, October 2002.

The EU's failure to overhaul the CAP before enlargement could also prove costly in the longer term. First, as argued in the previous chapter, it is in the EU's best interest to support policies designed to boost growth and competitiveness in Eastern Europe. We suggest that the EU should spend more money on education and upgrading skills. Instead, the Brussels deal will make sure that the EU continues to dedicate half of its budget to propping up farm incomes. Second, the new member-states will have to waste precious financial and human resources on building up structures to deal with the administrative complexities of the CAP. They will then have to dismantle them again, when the EU finally manages to reform the CAP. The new members would be better off dedicating their money and political energy to more durable farm-sector reforms.

Third, the decision to limit EU transfers to the new members may create fiscal problems in some countries in the early years of membership. The Brussels budget deal means that their net benefits from the EU budget in 2004 will be scarcely higher than their pre-accession support in 2003. At the same time, the candidates will have to shoulder the growing costs of implementing and enforcing the more expensive parts of the *acquis*, such as environmental standards. Money from the EU's regional support programmes (structural and cohesion funds) could be slow to come in, and much of it will have to be co-financed out of national budgets. The EU has assured the would-be members that they will not end up paying more into the EU budget than they receive in return. It has put money aside to compensate any 'net payers' among the new members in the early years after accession. Nevertheless, accession will provide little financial relief at a time when East European governments are struggling with growing budget deficits (because of slowing economic growth), high unemployment and falling privatisation revenue.

An obstacle to future reform

The Brussels budget deal also entails political costs. The candidates know that they now have little chance of getting better accession terms. If they tried, they would provoke intra-EU squabbles that risked delaying enlargement. However, some East European governments have already vowed to fight for a better deal once they are inside the EU.

Future budget and CAP reform will be more difficult as a result. At present, few East Europeans are convinced that the complex and market-distorting rules of the CAP are the best way forward for their farmers. Nearly all of their governments would prefer CAP reform, including the phasing-out of policies that currently keep farm prices at artificial levels. But the sheer inequity of the Brussels deal – under which richer West European farmers will initially get four times as much money as poorer East European ones – makes them argue in favour of more money from the CAP. Poland, for example, is now pushing for higher direct payments and a shorter transition period. For now, Polish farmers are pitted against Spanish and French ones because the latter receive much more from the central pot. But after accession, the interests of the Polish farm lobby will converge with those of French farmers.

Similarly, Poland could quickly become Spain's main ally in arguing for an increase in the overall size of the EU budget, above the current ceiling of 1.27 per cent of EU GDP. At the moment, most of the candidates are in favour of re-focusing EU spending on the poorest parts of the enlarged Union. But by the time of accession, their governments could be arguing for getting their hands on more money within the current system, even if that meant farmers taking the lion's share of the budget.

Like Britain, Spain and Portugal before them, the East European countries might spend their first years of membership trying to re-negotiate what they saw as unfair accession terms. The new member-states could also be driven by their domestic politics to take an obstructive stance in the negotiations about the EU's next budget plan, which will run from 2007 onwards. That would weaken the sense of solidarity between member-states on which the budget is supposed to be based. It would also make the enlarged EU acrimonious, rather than welcoming. The greatest risk is that the new members will focus their time and energy after accession on fighting for additional euros from the budget, rather than helping the Union to function better and contributing to the formulation of new policies.

Is Europe's public ready for enlargement?

Governments in both the existing member-states and the candidates need to work much harder to prepare Europe's citizens for enlargement. Although on average about half of the EU's people are in favour of enlargement, support varies widely from country to country. While the Scandinavian countries tend to welcome enlargement, in countries such as France and the UK barely one-third of the population supports it. Germany and Austria – two countries that have already reaped significant benefits from their economic ties with Eastern Europe – have solid minorities (of around one-third) opposed to enlargement. Meanwhile, in the candidate countries, initial enthusiasm for EU accession has given way to scepticism, sometimes even bitter resentment. In some countries, less than half of the population now favours accession in opinion polls. In Estonia, only one-third of the people support joining. Eurosceptic parties have made inroads in some candidate countries. Polish farmers, led by the controversial Andrzej Lepper, have already learned from their French counterparts how small groups can hold governments to ransom.

Recent wrangles about the EU budget have further undermined public support for enlargement. On both sides, the costs now appear overwhelming. But this impression is wrong. For the EU, enlargement is a bargain. Budget transfers to the new member-states will be much smaller than those made after previous enlargements. And they will be a fraction of the price that Germany paid for its re-unification.[18] It is the candidates that have borne most of the costs, in terms of upgrading their economies and reforming their state administrations. But they should book these costs as investments in their future growth.

While officials, the press and the public focus on budget costs, the benefits of enlargement are hardly ever discussed. Over the last decade, the candidates have already reaped tremendous gains from integration with the EU: chapter two explained how the accession process has boosted trade, investment and growth in Eastern Europe. There will be further gains in the future – for example, the political benefits of being part of a powerful club; the economic gains from fully integrating into the single market; and lower interest rates after adoption of the euro. East European governments should re-focus the accession debate from EU budget transfers to the economic benefits. The European Commission estimates that EU accession – defined as a 10-year process of integration from 2000-09 – could increase East European annual growth rates by 1.3 to 2.1 percentage points.[19]

The EU's institutions

The EU has failed to reform its institutions and decision-making procedures ahead of enlargement. Because the last two inter-governmental conferences (IGCs) (in 1997 and 2000) failed to prepare the Union adequately for enlargement, the EU will hold yet another in late 2003 or early 2004. However, the European Convention that is currently preparing ideas and proposals for the next IGC is largely focused on changing the way the existing EU

[18] Heather Grabbe, 'Profiting from EU enlargement', CER, July 2001.
[19] European Commission, 'The economic impact of enlargement', June 2001, http://europa.eu.int/economy_finance.
[20] For the CER's view of how to reform the EU see 'New designs for Europe', CER, October 2002.

works. It has not done enough to meet the challenge of preparing the EU for a much larger and more diverse membership.[20]

Paradoxically, the EU's last stab at institutional reform – enshrined in the Nice treaty of 2000 – has made some things worse. For example, the treaty has introduced a complex triple-majority system in the Council of Ministers that increases the chances of gridlock.[21] The most obvious problem posed by enlargement is that of sheer numbers. While the Union has gradually grown in size, its institutions have not changed much from the days when there were only six members. A meeting with six people is quite cosy, and even 12 can have a good discussion. Once there are 15 people around a table, it becomes harder for everyone to have their say, and for the chairman to find a consensus. With 25 voices competing to be heard, a real exchange of views will be next to impossible. At present, Council meetings start with a *tour de table*, in which each minister states his or her country's position on the issues at hand. In the enlarged Council, this alone would take much of a day, leaving little time for real negotiation and debate. The EU will clearly have to change the Council's operating rules.

The EU also needs to reform the European Commission, which is responsible for drawing up legislative proposals and for enforcing EU rules. With 20 commissioners, the EU's Brussels-based executive is already unwieldy and overly bureaucratic. At the Nice summit, the member-states tried to address the risk of overcrowding by limiting the number of commissioners to one per country – at present, large countries have two. But this would still leave the Commission with 25 commissioners after enlargement, each insisting on his or her own portfolio and staff.

The European Convention therefore has its work cut out. It is currently preparing a constitutional treaty that will provide the framework for the EU's institutions and policies in the future. Although its proposals will not be binding, it has a very strong democratic mandate because parliamentarians from both the

[21] Richard Baldwin et al, 'Nice try: Should the Nice treaty be ratified?', Centre for Economic Policy Research, London, 2001.

established and the new member-states make up a majority of its membership. The next IGC will therefore find it hard to ignore the reform proposals that the Convention comes up with.

The Convention's discussions have become focused on problems within the existing EU, in particular the balance of power between the Council, the Commission and the European Parliament. It is also looking at how the individual institutions can be made to work better in the current set-up. But it has so far paid too little attention to the more far-reaching effects that enlargement will have on the Union, such as the need for more flexibility and the emergence of new policy challenges.

Although representatives from the candidate countries are taking part in the Convention, they have not contributed significantly to the debate about institutional reform. In part, this is because their views are not yet fully formed. It is unfortunate that the very first EU debate in which they can play a full part deals with institutions – the area with which they have least experience. The East Europeans have adopted a low profile in the Convention also because they did not want to antagonise the current member-states before accession negotiations were closed. They will probably become more vocal once they have received their official invitations for EU entry at the Copenhagen summit in December 2002. The candidates could play a crucial role in the Convention by challenging it to think much more imaginatively about the main institutional challenge, namely that enlargement will make the EU not only bigger but also qualitatively different.

The Union needs more flexibility

In the past, European integration has had two main engines: the Franco-German alliance and the Commission. The French and German governments have long co-operated to push forward common initiatives, such as monetary union. The Commission, meanwhile, has cajoled member-states to set aside their national interests and reap the economic and political benefits of European integration. Although Paris and Berlin are trying to revive the Franco-German alliance, the two countries are deeply divided on many crucial policy and institutional questions. And the European Commission is a mere shadow of the integrationist force that it was under its former president, Jacques Delors. In future, progress in individual policy areas will be driven by coalitions of member-states. The exact make-up of these coalitions will depend on the issue in question. Some countries will have a strong interest in economic reform, others in tax harmonisation, others in foreign policy. But what if some countries want to move forward in an area while others do not?

The EU's main remedy for reconciling conflicting interests has been a gradual shift from decision-making by consensus towards qualified majority voting (QMV). But a further substantial extension of QMV looks unlikely. Some member-states are staunchly opposed to applying QMV to 'sensitive' areas, such as taxation or foreign policy, which are still mostly subject to unanimity. Instead, the EU will have to resort to alternative ways of achieving co-ordination and co-operation. In particular, it could make more use of the 'open method of co-ordination', whereby governments set targets for themselves and publicly monitor each other's progress. In some sensitive areas, such as tax harmonisation or common labour market policies, the EU may face a choice between finding a consensus acceptable to all members, using the more flexible open method, or allowing a small group of countries to proceed without the others.

The East European members do not like discussions about 'variable geometry', 'differentiated integration' or 'reinforced co-operation' (the EU's preferred term for more flexibility). Although they do not in principle object to making the Union more flexible, the candidates fear that they could end up as 'second-class' members, while the established members press ahead with further integration. But they will have to accept that flexibility is vital if the EU is to move forward.

The current EU already provides several examples of policies that only a sub-group of members has signed up to, such as the single currency, the Schengen area and defence co-operation. These precedents are important for the candidate countries, because they will be excluded from some EU policies for some time after their accession. They will be fully fledged members of the internal market, but they will not be able to adopt the single currency for at least two years after EU accession (see box on page 21). Similarly, they will not be able fully to join the Schengen area of passport-free travel until the EU's Schengen Information System computer database is upgraded to accomodate 25 members. In addition, other member-states will have to be satisfied that the new members can control their borders with third countries, such as Ukraine and Belarus, before they will remove internal border controls between old and new members.

The Amsterdam and Nice treaties contain provisions that set rules for eight or more countries to form a 'pioneer group' to push a particular initative. The conditions on the use of this 'enhanced co-operation' are strict, and the procedure has never been used. The candidates have an interest in improving these rules, particularly in ensuring that members of the pioneer group cannot impose onerous entry requirements on later joiners, and that there are not too many clubs within the club.

The EU's future policy agenda

The Convention should not seek institutional change for its own sake, but should ask what kind of institutions the EU will need to master future policy challenges. The Commission regularly surveys European public opinion in its 'Eurobarometer' polls. According to these surveys, people think the EU's top priorities should be: maintaining peace and security in Europe, as well as fighting terrorism, unemployment, organised crime and drug trafficking. But the EU has moved only slowly into these areas. It still spends a disproportionate amount of its resources – financial, institutional and political – on old policies that are of little interest

to most citizens, such as agriculture. The CAP gobbles up half of the EU budget but benefits a tiny fraction of the EU population. Similarly, the structure of the EU's bureaucracy reflects past priorities. Long-established sections of the European Commission (called 'directorates-general') are jealously holding on to their officials. The result is that there are many more bureaucrats in Brussels dealing with the Commission's internal organisation than with 'growth' areas such as competition policy or justice and home affairs, where resources are stretched to the limit.

Foreign policy is another area that will become increasingly important in the enlarged EU. The EU's larger member-states will drive common foreign policy initiatives – owing to their size, and military and diplomatic assets. But the smaller countries will still want to be involved and have their interests represented on the world stage. The EU needs to find an answer to the question of how member-states can meet in smaller groups without provoking resentment that a *directoire* of large states is running foreign policy. The answer may lie in informal coalitions of countries with an interest in particular parts of the world: for example, Germany and some of the new member-states may want to work together on eastern policy, while the southern member-states are more interested in Mediterranean security.

With its enlargement to new borders, the EU will also acquire new responsibilities. It will cover another third of the European continent, and it will share new borders with poor and often unstable countries, such as Russia, Ukraine and Belarus. Eastward enlargement has taught the EU valuable lessons in how to manage relations with countries that want to join the Union. But membership is not on the cards for many of the enlarged Union's neighbours. The EU therefore needs to find a new way of forging bonds that are not based on membership aspirations. A much more coherent EU aid and development policy could help to foster stability on its borders and prevent neighbouring countries from becoming security threats to the enlarged EU.

The EU will also need to pay more attention to external border controls, as well as to internal security. After enlargement, the East European countries will no longer act as an external buffer-zone for illegal migration; they will eventually become members of the Schengen area of border-free travel. This may add to existing concerns among West Europeans that their governments are not coping adequately with new security threats, whether illegal immigration, drugs trafficking or terrorism.

Enlargement will also force the EU to develop more coherent policies on the status and protection of ethnic minorities. Enlargement will increase the diversity of the Union, including the number of national and ethnic minorities living in member-states. Both new and old member-states will need to co-operate to protect groups that suffer discrimination across Europe, especially the Roma.

The institutional architecture of the EU needs to be able to cope with these new priorities. That means the Commission must review its allocation of personnel more frequently and thoroughly, and the member-states must be more ruthless in diverting resources away from old policies like agriculture, or peripheral ones like sport.

New members, new ideas

The East European countries will join the EU as a bloc. But that does not mean that their interests on EU issues will always coincide. Some issues unite them – they are all likely to favour financial transfers to poor regions, for example – but they have different views on many others. Estonia is among the most liberal economies in Europe, whereas Polish and Slovak instincts can be more protectionist. Poland is strongly Atlanticist when it comes to defence. But most other East Europeans are not so worried about potential conflicts between supporting NATO and EU defence policy. A small rural country like Lithuania does not necessarily have the same objectives as the relatively wealthy Central European countries, such as the Czech Republic and Slovenia, with their diversified, export-oriented industries. Poland, with nearly 40

million people, may behave differently in the EU to Latvia, with its 2.4 million population.

Therefore, rather than acting in unison, the new members will team up with the existing member-states, depending on the issue at hand. Enlargement could thus change the debate in areas such as tax harmonisation or defence policy. The new members will also bring in new ideas and priorities. They have a decade of experience in economic reform, so they may become impatient with the EU's slow progress with structural reform. Several of them have active relationships with important neighbours that will be an asset to the Union. Poland's engagement with Ukraine will make Warsaw a strong advocate of a more active Eastern policy for the Union, while Hungary will contribute to the EU's thinking on its southern neighbours in the Balkans.

In 2003, the Convention should start thinking seriously about how enlargement will change the demands made on the EU's institutions. The constitutional treaty under discussion may well be a welcome step-change, but there is a risk that it could be based too narrowly on current structures. The Convention's outcome will not endure for long if it underestimates how much the Union will change after enlargement. The EU's institutional framework has to provide greater flexibility for a more diverse membership. It also has to reflect the Union's growing responsibilities for its new neighbours.

Responsibilities for the wider Europe

The EU is ill-prepared to cushion the impact of enlargement on the countries that will be left outside – from the Balkans to Russia. The expansion of the EU's visa regime to the new members, combined with reinforced external border controls, risks drawing new lines of division across the continent. For the candidates, greater integration with Western Europe has already come at the price of cutting ties with eastern neighbours. But EU enlargement should not mean that the Iron Curtain is replaced by a new visa wall further East. The EU has a strong interest in having stable and prosperous neighbours, rather than poor and unstable ones. Enlargement should make it think about developing a better 'neighbourhood' policy.

As part of their accession preparations, the candidates have tightened controls on the movement of people and goods across their eastern and southern borders. As explained above, border checks between the existing EU states and the new members will stay in place for a number of years after enlargement. However, fences and police forces cannot be the answer to the many problems that are looming beyond the EU's new external border. The result would be an enlarged 'Fortress Europe' surrounded by poor, isolated and possibly unstable countries. The people living in this unstable fringe would have every incentive to move to the EU, whether legally or illegally.

EU enlargement also risks creating a deepening economic divide in Europe. The objective of EU accession has served as a strong external anchor for economic reforms in the candidate countries. Governments could always argue that painful reforms were necessary for EU membership. Non-applicant countries did not have this option, which may be one of the reasons why their economic reform efforts have generally been less successful. Candidate countries proceeded much faster with trade integration than other East European countries. They received more assistance from the EU. And foreign investors have generally preferred the candidate countries, where laws and policies increasingly resemble those of Western Europe and from where access to the EU market is guaranteed. Accession will reinforce these trends, probably leading to an increasing concentration of foreign investment in the new member-states rather than the countries lying outside the enlarged Union. The EU's new neighbours may benefit indirectly, if strong economic growth in the new member-states provides new opportunities for their

workers and businesses. The Union needs to make sure that people living outside its borders will still be able to trade with and commute to the new member-states.

The two remaining East European candidates, Bulgaria and Romania, are aiming to be ready for EU accession in 2007. However, they may have to wait longer if the 2004 enlargement causes disruption, or if other credible candidates come forward – like Croatia – that could join at the same time. The EU must make sure that Bulgaria and Romania are not forgotten, and give them additional aid and political attention to encourage them to catch up. Their progress towards accession should not be held back on account of other applications for membership before 2007.

The Union has already built a substantive relationship with the Balkan states through trade, aid and political engagement. It has opened up the prospect of membership to a number of countries in South-eastern Europe, some of which are keen to start accession talks as soon as possible. Croatia, for example, is likely to apply for membership in 2003, and others may soon follow. However, it will take the Union some time to digest the 2004 enlargement, which will reduce the member-states' appetite for further expansion.

For countries that cannot join the EU for many years, the Union must offer meaningful relations in the meantime. For example, the EU could offer its neighbours progressive access to the single market, similar to that now enjoyed by the members of the European Free Trade Agreement (EFTA), provided they align their laws and policies with those in the EU. The EU could also invite its neighbours to participate to some extent in other policies. For example, those countries that affected by EU border rules or foreign policies should be consulted more in the decision-making process.

The EU's relations with the countries of the former Soviet Union are less well developed than those with the Balkans. The EU has regular meetings on economic and political relations with Russia and

Ukraine, but these have not always lived up to expectations. Russia is of particular importance to the EU since it supplies a large and growing share of the EU's energy. Yet bilateral relations are fragile, as the recent dispute over EU visas for Russians living in Kaliningrad showed. Relations with Belarus and Moldova are poorly developed and characterised by frequent tensions. Although the EU may not wish to develop stronger ties with undemocratic regimes, such as the one ruling Belarus, it could and should engage more directly with civil society organisations and educational establishments in these countries.

When will Turkey join the EU?

After years of delay, the EU accepted Turkey's application for membership in 1999. But it has not started accession negotiations, citing concerns about democracy and human rights in the country. Following significant progress with political reforms in the course of 2002, and the election of a new government in October, the prospects for Turkey's application have improved. At the Copenhagen summit, EU member-states will have to decide whether to give Turkey a date for the start of accession negotiations. In this decision, the EU will be influenced by progress towards a political settlement in the divided island of Cyprus, and by Turkey's efforts to press ahead with political reforms. Although Turkey lacks powerful allies in its quest for membership – apart from the United States – there are few EU politicians who oppose it openly. Two countries who had opposed Turkey's application, Germany and Greece, are now taking a more supportive stance.

Turkey has made good progress towards meeting the political conditions set by the EU for starting negotiations. In the summer of 2002, the Turkish parliament, abolished the death penalty in peacetime, extended cultural rights to the Kurdish minority, and strengthened the protection of human rights, such as freedom of expression. Turkey's newly elected government, led by the AK Party, has vowed to continue reform. However, Turkey remains a long way from meeting the EU's political, economic and legal requirements for accession. Unlike the East European countries, Turkey will also face an uphill struggle to overcome widespread hostility towards its application, not only in political circles but also among the European public. According to the Commission's October 2002 Eurobarometer poll, 47 per cent of EU citizens oppose Turkish membership, while only 31 per cent are in favour – the lowest level of support for any of the applicants. With a population of 69 million people, a history of political and economic instability, and income levels that are far below the EU's poorest member-states, Turkey would be difficult to integrate into the EU. But the concerns of EU politicians and voters go beyond this. Many feel uncomfortable with adding a large Muslim population to the predominantly Christian EU. Others fear that problems with absorbing Turkey could slow EU integration, or that its successful candidacy may encourage other countries to apply.

Nevertheless, the EU should stick to its formal position, rather than give Turkey the impression that it will never be allowed in, irrespective of how much progress it makes. Comments to this effect – like those of Valéry Giscard d'Estaing, who recently warned that Turkey's entry would be the end of the EU – risk undermining the modernisers in Turkish politics, as well as reducing the EU's own leverage. The EU has a strong interest in helping the Turkish leadership to follow a reformist path. The best way to do this would be for the EU to set an indicative date for the start of accession talks, establish a clear timetable for reassessing progress, and provide a clearer set of benchmarks for Turkey's preparations for eventual membership.

4 Conclusions

The ten countries set to join the EU in 2004 have made huge efforts to reform their economies, clean up their bureaucracies and conform to EU norms. They are as well prepared as previous applicants, given that the conditions for membership have become much more onerous – there was no single market when Spain or Greece joined, no monetary union when Austria acceded, and no defence policy for Sweden to sign up to. They still have to address a series of shortcomings, including their weak and inefficient bureaucracies. But with a strong track record of economic and political reform, there is every reason to believe that the new members will continue working towards fulfilling EU requirements.

EU leaders, on the other hand, have done a poor job getting the Union fit for enlargement. With accession around the corner, the Union's institutions and policies still reflect the past rather than the future. The budget is largely devoted to outmoded policies, while its institutions are inflexible and often inefficient. EU policy-makers are unsure about future challenges. Enlargement will intensify some existing problems, such as economic disparities and the insufficient implementation of EU laws. But it will also force the EU to face new policy challenges, such as the protection of minorities and relations with countries beyond its expanded borders.

Previous enlargements of the EU – in 1973, 1981, 1986 and 1995

– have tended to follow a pattern of 'enlarge and then reform'. As a result, successive expansions have given momentum to European integration – from the evolution of regional policy and the single market after Greece, Portugal and Spain joined in the 1980s, to the expansion of the Schengen area and the launch of the euro after Austria, Finland and Sweden entered in 1995. This time the challenges will be much greater, so the reforms should have started earlier. But the EU has proved unable to achieve meaningful change without a firm deadline. The need for further EU reform must not be allowed to affect the enlargement timetable. Any hint that there might be a delay would slow the momentum of institutional reform and allow the EU's leaders to put off overhauling the budget and CAP yet again.

Any foot-dragging on the part of the EU would also deliver a blow to already fragile public support for enlargement. At present, the risk that an EU parliament might refuse to ratify the accession treaty, or that voters in one of the candidate countries might reject accession in a referendum, appears small. However, acrimonious battles about the EU budget have done nothing to endear enlargement to the European public. Political leaders from both the candidates and the current member-states have to do a better job explaining the economic and political benefits of enlargement. The EU is about to complete its biggest and most important project of the decade: the re-integration of the former communist countries of Central and Eastern Europe into the European fold. Institutional flaws and money wrangles should not be allowed to divert attention from the significance of this achievement.

Summary of recommendations

★ The EU should not use remaining shortcomings in the candidate countries to hold up enlargement. The candidates, under the watchful eyes of the Commission, will have to work hard to sort out all the remaining legislative shortcomings by the 2004 accession date. They will also have to continue their efforts to strengthen administrations and reduce corruption.

★ The EU should focus its financial transfers on helping the new members stay competitive within Europe and on a global scale. Continued fast productivity growth in the candidate countries is a precondition for income catch-up. The new members will require massive investment to continue the shift from heavy industries and labour-intensive manufacturing to high-tech goods and knowledge-intensive services. More EU money should go into improving human resources in the new member-states, in particular to modernising education systems and retraining workers.

★ More generally, the EU should use its next budget plan (for the period 2007-13) to redirect spending from outdated and distorting policies such as the CAP to investing in its future. The prime targets of budgetary transfers should be the poorest regions, many of which will be in the new member-states; and policies that support competitiveness, both in the old and the new member-states. The EU must devote additional resources and political attention to Bulgaria, Romania and Turkey, to ensure that they do not fall behind.

★ The European Convention is currently discussing many crucial reforms, to keep the EU running smoothly in the future. It should address the challenges of enlargement more imaginatively. The EU needs new mechanisms to accommodate flexibility and differentiated integration, without creating a permanent two-tier membership. The Convention should also think about what kind of rules and institutions the EU needs to master new policy challenges, including relations with the Union's new neighbours.

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