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The Time Pattern of Costs and Benefits of EU Accession

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Foreword

In 1996, the Economic Transition and Integration Project (ETI) at IIASA initiated a seminar series on the accession of the Central and East European countries (CEECs) to the European Union (EU). The title of this series is “The Process of EU Accession: Preparation by Learning and Exchange.”

This initiative was a logical one, since in recent years ETI has been active in research and policy advice on the international economic relations of transition economies. Moreover, several recent ETI research projects, such as the one on “Output Decline in Eastern Europe,” and another on “Impediments to Exports in Small Transition Economies,” have had strong implications for the CEECs’ integration into the EU.

EU enlargement is a complex process whose importance for the countries concerned can hardly be overestimated. This probably justifies the large number of ongoing academic research projects on the topic. A distinctive feature of ETI’s seminar series is that it is intended to promote an exchange of views and understanding among the transition countries aspiring to EU membership. IIASA, with its diverse composition of members from both parts of Europe (among other countries), including older and newer members of the EU, as well as the Central and East European (CEE) candidates for EU membership, is an ideal research institution for realizing this goal.

The organization of the seminar series is supported by an advisory committee with the following members: András Inotai, Director, Institute of World Economics, Hungarian Academy of Sciences, formerly also Coordinator of the Strategic Task Force for European Integration (Hungary); Danuta Hübner, Deputy Executive Secretary, UN Economic Commission for Europe, formerly Head of the Chancellery of the President of the Republic of Poland; Igor Kosír, General Director, Section for EU Integration and Foreign Affairs, Ministry of Agriculture (Slovakia); and Andrej Kumar, Faculty of Economics, University of Ljubljana (Slovenia).

The first meeting in the series was concerned with the “Strength and Advantages of Eastern Europe: EU’s Net Gains from Accession,” and was held in Laxenburg, Austria, in December 1996. That workshop was intended to help make the CEE applicant countries aware of their strengths and weaknesses in the context of EU membership and build up their self-confidence before negotiations started. The meeting had an interdisciplinary character; in addition to issues of purely economic importance, problems related to the environment, foreign policy, and national security were discussed. A summary of the workshop can be found on the World Wide Web at http://www.iiasa.ac.at/Publications/Documents/IR-97-019.pdf.

A second meeting was held in Budapest on December 1997, on the “The European Union and the Rest of the World: Complements or Substitutes for Central and Eastern Europe?” The seminar investigated the impact that accession will have on applicant countries' relations with the rest of the world, with respect to trade, flows of capital and labor, research and technology, environment, administration, and culture. A crucial issue discussed was whether an increased focus on the EU region, as manifested in the adoption of the common external tariff and common health and environmental standards, distribution of structural and cohesion funds, and provision of agricultural transfers, will enhance only the applicant countries' relations to EU member-states, or there will also be effects for their interaction with the rest of the world. The seminar in Budapest was characterized by substantive presentations, lively debates, and participation not only from the Visegrád countries, Slovenia and EU members-states, but also from the Baltic states, Bulgaria, and Croatia. A summary of the workshop can be found on the World Wide Web in an Interim Report at http://www.iiasa.ac.at/Publications/Documents/IR-99-002.pdf.

A third seminar meeting was held in Laxenburg on December 5-7, 1998, on "The Time Pattern of Costs and Benefits of EU Accession." This report summarizes that seminar.

The underlying idea of the seminar was as follows. The CEECs aspiring to EU membership have already understood that opening their markets to the West and adjusting to the institutional framework, laws, and rules of the EU entails direct and indirect costs, generating considerable tension for the institutions and individuals concerned. At the same time, these nations will certainly benefit from accession. East European experts and policymakers have not yet performed a systematic accounting of the costs and benefits to their countries before, during, and after accession. Especially lacking is an appreciation for the *time pattern* of emergence of these costs and benefits. The lack of such an analysis is a major drawback for the accession negotiations and for public policy. Understanding the temporal and regional pattern of costs and benefits is crucial to planning annual macroeconomic programs, as well as to projecting such indicators as private consumption, investment, and trade and current account balances. An appreciation of these patterns is also crucial to mobilize public support for the accession at the appropriate time.

The costs of converging to the EU are not evenly spread across the societies in transition countries and emerge at various stages of the accession process. Moreover, many of the changes related to accession have diverse economic, social, administrative and political effects. Most analyses of the costs and benefits of accession for the EU member-states and CEECs focus on a single aspect or on a particular time period and calculate the costs and benefits for the incumbents only. The discussion at the seminar encompassed the costs and benefits in terms that went beyond the strictly economic, and focused primarily on the CEEC side. The period in question under consideration is characterized by the following milestones: the start of the transition, the signing of the Europe Agreements, the start of accession negotiations, accession to the EU, and accession to European and Monetary Union (EMU).

The mix of participants at the seminar at Laxenburg was ideal for informed scientific and policy discussion: researchers and government experts gathered from nine candidate countries (all but Latvia, for which the invited expert withdraw at the last moment) plus Macedonia, as well as from European and U.S. universities and the European Commission. A relatively large number of Austrian experts also contributed to the success of the meeting. Of the six sessions at the workshop, the most heated debate was on the costs and benefits associated with agriculture, environment, EMU, and the future of EU transfers. The seminar was co-financed by the Swedish Ministry of Foreign

Affairs and the Austrian Ministry of Science and Transport; IIASA would like to use also this opportunity to thank for their support.

This report is structured as follows. The first section summarizes the most recent developments in the accession process in the individual candidate countries and Macedonia. The second is devoted to the experience of past enlargements and to general issues surrounding measuring the costs and benefits of the coming enlargements. The following section deals with EU's environmental requirements, especially the "hard" costs and "soft" benefits that various studies associate with them. The fourth section analyses expected developments in the monetary and exchange rate policies of the candidate countries, with the emphasis on recent turbulence on world financial markets and issues raised by the necessity of fulfilling the conditions associated with EMU membership. The next section deals with the expected size, role, and possible use of EU transfers in the periods preceding and following accession. The sixth section is devoted to agriculture, one of the most complicated issues that arises in the accession process. The final section summarizes the results of synthetic approaches that employ computable general equilibrium (CGE) models to estimate the costs and benefits of enlargement.

The report is based on presentations and discussions that were taped at the workshop, on papers prepared for the meeting, and on background material and related papers that the participants brought with them to the meeting. Unfortunately, due to technical problems we were unable to record presentation by Sophia Davidova and the post-presentation discussion of agricultural issues. The authors of this report have been able to reconstruct that presentation (from papers by Davidova), but could not summarize that enlightening and lively discussion.

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The Time Pattern of Costs and Benefits of EU Accession

János Gács
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1. Latest Developments in the Process of Accession - Updates from Applicant Countries

1.1 Bulgaria[1]

The account is largely based on the European Commission's first regular report (put out in November 1998) on the progress made in the candidate countries since the initial opinions in July 1997. Not much has happened since 1997 with respect to Bulgaria's political development. The report assesses that Bulgaria fulfils the Copenhagen criteria. There remain two major problems: corruption and the slow integration of the Roma minority. The government has made some progress in the fight against corruption, but much remains to be done, while significant progress has not been made in tackling the problems of the Roma minority problem.

The economy has showed much progress since 1997: following a severe financial crisis, a currency board arrangement was introduced in July of that year. With the fixing of the exchange rate, the major pro-inflationary factors were eliminated and the economy stabilized very quickly. In January-September 1998, consumer prices grew by less than 3 percent, after three-digit inflation in 1997.

The general government budget moved from a deficit to a surplus of about 1.5 percent of gross domestic product (GDP) in 1998. There were two major reasons for this progress: improved tax compliance and a reduction in interest payments on public debt due to a sharp decline in interest rates. The government committed itself to a broadly balanced budget, in order not to jeopardize macroeconomic stabilization. The projected budget deficit for 1999 is 2.8 percent, with a 0.8 percent contingency.

After two consecutive years of sharp GDP decline, the growth of GDP in the first half of 1998 was 12 percent, the major source of which was domestic absorption. The forecasted growth for 1998 as a whole is 3.5-4.5 percent. Owing to rising real wages and easier access to consumer credit, consumption recovered significantly, investment, however, is sluggish and may pose a major obstacle to future growth. The current account showed a slight deterioration, although the deficit is currently under 1 percent of GDP. Exports declined by 12 percent, mainly due to a fall in the prices of Bulgarian major export commodities in the world market, imports, however, increased by 1.4

[1] This section summarizes the presentation by Rossen Rozenov.

percent. The capital account balance is positive due to medium and long term official loans and the inflow of foreign direct investment (FDI).

As for structural changes, one must mention that the privatization process slowed down compared to 1997 and this may pose a major problem for maintaining stability in the future. One of the measures that the government applied to accelerate the privatization process was to hire international consultants to negotiate with potential investors. However, the Privatization Agency has the last word and can easily reject any proposal made by the consultants. Restructuring of the financial sector has gone fairly well. Bank privatization is proceeding slowly, but under the pressure of international financial institutions the process can be accelerated in the future.

The Commission's report on the whole is not very favorable to Bulgaria, despite its recognition of the success of stabilization. While it is acknowledged that with respect to price and trade liberalization a lot has been accomplished since 1997, the Commission draws special attention to the energy sector as an example of distortive price setting, and to trade policy, where the major problem is lack of transparency. The report criticizes the fact that tariffs are adjusted simply in reaction to domestic market exigencies, such as shortages or surpluses of certain commodities. Slow bankruptcy procedures and the lack of administrative reform are also targets of criticism. Most of these weaknesses, especially price and trade policy, are being addressed by the Bulgarian government, with some of them found on the timetable of structural reform measures under the Internal Monetary Fund's (IMF) three-year extended fund facility (awarded in September 1998).

As for the criterion "capacity to cope with competitive pressures and market forces," one has to point the very low share of investment in GDP (11 percent in 1997, probably the lowest in the region). The reasons for this are the still predominant role of state ownership in industry, unclear property rights, the short decision-making time horizon of managers in the state sector, and the cautious lending policy of commercial banks after the bank failures of 1996. Investment by the state is also very low; this problem was recognized by the government, which plans to make significant infrastructural investments for the coming years.

As for the "capacity to adopt the obligations of membership," Bulgaria got better marks in 1998 than in 1997. Stronger efforts are required in the implementation and enforcement of the transposed legislation, with particular emphasis on standardization, control of state assistance, public procurement, justice and home affairs, and an especially sensitive issue, the country's nuclear power plant at Kozloduy.

1.2 Lithuania[2]

In the Commission's 1997 Opinion, Lithuania did not qualify for membership in the 5+1 group of first wave candidates, but was relegated to the slow track group. By 1998, however, Lithuanian politicians and economists were convinced that Lithuania was mature enough to qualify to the first group, so the expectations for the 1998 regular progress report was very high.

[2] This section summarizes the presentation by Egidijus Vareikis.

In evaluating the political criteria, the report agreed with the 1997 Opinion that the country belonged to the group of the most advanced candidates in this respect: it has a functioning democracy and no minority problems. However, the report suggested that Lithuania should intensify the fight against corruption and reform of the judiciary area. This is, however, a sentence found in virtually all the reports on the candidate countries.

As for the economic criteria, the report states that, since the 1997 Opinion, Lithuania has made huge progress in building the institutions of the market, but that it does not yet have a well functioning market economy. In fact, the five first wave countries were named as functioning market economies, while Latvia and Lithuania were said to have made great progress but were not yet well functioning market economies.

The progress report also included a number of expectations and recommendations. Some of these are the following: exports should be diversified through enhanced inflows of FDI; value-added in export products should be increased; priority should be given to completing the structural reform agenda, to implementing and enforcing existing legislation; particular attention should be paid to bankruptcy regulations; macroeconomic stability should be promoted by fostering the sustainability of the external account. While the government agreed that the report's critical remarks and recommendations were appropriate, and efforts should be made to comply with them, it also found that the listed shortcomings are insufficient to prevent starting negotiations about accession.

As for the adoption of the *acquis communautaire,* the 1998 report acknowledges that a number of important agencies and institutions have been established since 1997, but it is too early to judge Lithuania's capacity to implement the acquis effectively. The speed of institution building and strengthening administrative capacity should keep pace with the transposition of laws, particularly those related to the internal market and the environmental sector. There is a need for extensive training to improve staff qualification.

The Lithuanian government has decided to dissolve the delegation responsible for the preparations for the negotiations on accession to the EU, since it considers that the preparatory work has been completed. A new delegation will probably be formed when negotiations begin. The perception in the country is that the Commission's requirements are very strict, but they are good instruments not only for steering the country towards EU membership, but also for transforming it into a West European nation.

1.3 Romania[3]

The presenter compared the results of the recent EU Commission Progress Report (report) with the Romanian government's most recent accession program (program).

As for the political criteria, the report stated that the country fulfills the Copenhagen requirements. The continued efforts of the government were acknowledged in guaranteeing the rights of the Hungarian minority and in improving the situation of children in orphanages. The tasks to be accomplished in the future include intensifying the fight against corruption, and improving the functioning of the courts, the protection of individual liberties, and the rights of Roma. The Commission recommends that an

[3] This section summarizes the presentation by Manuela Unguru.

ambitious reform of the public administration should be implemented efficiently. The government's program states that the international agreements that Romania has concluded provide a basis for the development of democracy and human rights. The major areas identified for further policy measures in the program correspond to the areas suggested by the report.

As for the adoption of the acquis the two documents basically agree with each other. The transposition of EU laws have been accelerated with regard to agriculture, energy, transport, regional development, and some areas of the internal market. Implementation and enforcement capacities, however, still need further development. With respect to the priorities of the Accession Partnership, the report acknowledges that Romania has addressed certain aspects thereof (such as regional development), while other short-term targets were not addressed satisfactorily (including some areas of the internal market, justice and home affairs, and the environment).

As for the economic criteria, the report states that Romania has made very little progress in creating a market economy, and that its capacity to cope with competitive pressures and market forces has even worsened recently. While progress has been made with regard to price and trade liberalization, control over inflation, the convertibility of the leu, and financial sector legislation, these reforms have been hesitant, slow, and hampered by delays in their implementation.

The report contains critical remarks concerning the lack of financial discipline in the public enterprise sector and the weakness of the financial sector. Due to the disappointing pace of restructuring, macroeconomic stability is constantly threatened, leading to a rapid deterioration in the external balances.

The Commission recommended that the government give absolute priority to restoring macroeconomic stability and establishing credibility on international financial markets. The measures required in this connection include a substantial privatization program, steps to attract more FDI, an acceleration of structural reform, and increasing enterprises' financial discipline. The report emphasized that the country needs a medium-term economic strategy to deal with all of these issues comprehensively.

The government program admits that the macroeconomic situation has deteriorated due to a lack of restructuring of large loss-making enterprises, the weak financial situation of the largest public banks, and the continuous pressure for state intervention, which is a constant burden on the budget. The document emphasizes that there was some progress with regard to the restructuring and privatization of large state owned enterprises (e.g. those in the coal and steel sectors) and agricultural companies, and trade liberalization progressed according to the line set by the Europe Agreement. A large number of export quotas were eliminated and import duties were reduced at the beginning of 1998.

The presenter summarized her opinion on Romania's development by stating that while there were favorable developments in terms of the elaboration and formulation of consistent short- and medium-term economic policies, the putting of these policies into practice has remained a major problem. The external constraints in 1998-99, the result of large foreign debt payments and the necessity to curb budget and current account deficits, are much greater than before. They, in fact, necessitate an austerity package, which means that while the implementation of some reforms will accelerate, the consequences of the austerity measures will prevent generating the necessary consensus for further reforms. Moreover, the needed stabilization will lead to a further drop in the GDP (about 2 percent) in 1999.

1.4 Czech Republic[4]

The overall picture of the state of the Czech economy and its progress toward accession is contradictory. One the one hand there are some very discouraging developments which were reflected in the Commission's report on the Czech Republic, which says that progress has stagnated. On the other hand, there are some promising facts, particularly in recent months as a result of actions taken by the new government beginning in the summer of 1998.

Why has progress been so limited in the Czech Republic? Since the autumn of 1997, the economic situation has been such that most Czech economists are using the term "crisis" to describe it. The indicators of this development have been a dramatic deterioration in the trade and fiscal balances and an inability to maintain a fixed exchange rate, leading to the introduction of a floating exchange rate regime.

In November 1997, we witnessed the fall of the government of Václav Klaus. An interim government was in power for six months, and following elections a new social democratic government lacking a parliamentary majority was formed. This chain of events has generated a politically unstable environment, which has deflected the attention of the political parties and their deputies from economic issues, including ones related to EU accession. In addition, one has to admit that Klaus's government was not EU-friendly.

Accordingly, the climate has not been very sound for economic reform, even if the Commission's 1997 opinion found that the Czech Republic fulfilled quite a large number of the Copenhagen criteria. Probably this was the reason why the 1998 report concluded that the situation was neither worse nor better than in 1997. The weak points of 1997 remained weak points a year later.

These weak points were as follows. With regard to the political criteria, the report pointed to lags in reforming public administration in general, and the judiciary system in particular. The draft of a new civil service law is not yet ready, and the law will be passed in 2000 the earliest. The situation of the Roma population is also criticized, since in spite of some initiatives of the government, no real progress could be detected.

As to the proper functioning of a market economy, the Czech Republic still needs to complete structural reform of the banking system. As late as 1998, the four leading commercial banks are state owned and state run. As a consequence, these banks do not follow market criteria in the allocation of capital, which slows the pace of industrial restructuring. Major progress can be expected from the initiative of the new government to finalize the privatization of the banking sector by 2000 at the latest.

With respect to the harmonization of Czech legislation with that of the Union, the opinion criticized the fact that regional policy was nonexistent in the country. There were no regions and no authorities for carrying out regional policy. Recently, some progress can be seen, since there is a new ministry in charge of regional development. Furthermore, the new government has announced that regional policy, especially the setting up regions in 2000 capable of pursuing their own priorities and policies, now has a high priority.

Its is an encouraging development that the new government is an EU friendly one, as indicated in the former's program. Moreover, the government has created a new

[4] This section summarizes the presentation by Ludek Urban.

position, that of the vice premier in charge of European integration. It is also favorable that both this vice premier and the new minister of foreign affairs had lived for long years in the West, so that they have experience and good contacts that will help in the integration process.

1998 has seen the adoption of a medium-term economic strategy of the government (promulgated by the interim government). It is the first such since 1989. The social democratic government announced that it is taking over this strategy, since it sees it as a good basis for devising its own medium-term economic strategy. It will add two important points, namely a time schedule, and the results of a calculation of the costs of accession to be borne by the different players, that is, the government, the regions, firms, and possibly by Czech citizens. The government planned to finalize this strategy and publish and distribute it as a White Book among the general public by the end of 1998. This distribution would be also part of a new communication strategy in EU accession affairs.

Discussion of First Four Country Presentations

A question was raised from the audience whether the presenters or their governments had found the Commission's latest evaluations of their countries appropriate.

Urban recalled that the latest government session had discussed the Commission's report, and, except for minor remarks, was in full agreement with the evaluations and the recommendations. Unguru agreed fully with the critical remarks of the Commission regarding the fulfillment of the economic criteria, but had some reservations about its evaluation of Romania's success in meeting the political criteria, especially insofar as the rights of Roma were concerned.

Rozenov admitted that the conclusions of the report on Bulgaria were justified, although some of the judgements in the document were not supported by quantitative evidence, or seemed to be exaggerated or weakly founded. For example, even though the share of administrative prices in the consumer basket in Bulgaria is 15.8 percent, in Lithuania 16 percent, in Latvia 22 percent, and in Slovakia 20 percent, the report assessed Bulgaria less favorably in this respect than the other three countries.

Variekis, speaking from his position as a government official, reported that the Lithuanian government more or less agreed with the rules of the game; they simply had no other choice. But, as a political scientist, he had to admit that the rules of the game, as they stood, seemed to be very strange. It is impossible to assess every kind of development in quantitative way and then sum up all these results. Who can say that curbing inflation is more important than controlling the budget deficit? In addition, his personal experience in Brussels was that it was difficult for Brussels' machinery to change decisions that had already been made. He already had seen maps and calculations about how the EU would look like after the accession of the 5+1 first wave candidates, which means that if Lithuania could join the first group, those maps should have to be redrawn and the calculations would have to be started again from the beginning.

Prompted by a question on possible catch-up scenarios, a discussion developed about which parts of the EU requirements are easy and fast to fulfill, and which ones not. One discussant claimed that in the field of establishing political rights, rights of the Roma minority, and organizing democratic elections major improvements can be achieved in a short period of time. Economic growth, however, is a much longer time phenomenon. Another discussant emphasized that long-run growth is a not a target in and of itself, but hinges on structural reforms. He stressed that it is easy to carry out inflation targeting, or to achieve macroeconomic stabilization in other ways, in a short period of time, but carrying out structural reforms is more difficult, since the latter is related to political reforms, the reform of redistribution, and the fight against corruption.

1.5 Slovenia[5]

The specific characteristic feature of Slovenia in comparison with other transition countries is that it was the last to sign an association agreement with the Union. The reason was the well-known dispute with Italy concerning the opening of Slovenia's real estate market to foreigners. The association agreement was finally concluded in 1996, but its ratification procedure had not yet been completed by December 1998. However, the lack of such an agreement has not caused disruption, since the cooperation agreement, and subsequently the interim agreement, have provided a good basis for the development of trade. After the ratification of the association agreement, Slovenia will have to accelerate the opening up of its real estate market and reforming its capital market, among other changes.

The accession negotiations have proceeded as they have for the other four countries: seven of the 31 chapters have already been screened, and national positions have been taken.

An important document is Slovenia's "Strategy for EU Accession," especially because it provides a basis for many further documents, including the "National Program on the Adoption of the Acquis" and the "Joint Assessment," which was prepared together with the EU; the latter defines the short- and medium-term tasks of accession. Slovenia sees the completion of the transition process and EU accession as related processes that require the same transition reforms. Even if it were not for the accession, most such reforms would have had to be implemented.

The strategy, which was formulated one year ago, envisaged accession by 2002, and even if external changes push that date off into the future, the country should be prepared for accession by then. It also envisaged that Slovenia would join EMU three years after accession. The strategy lists the following as areas that must receive attention before lasting macroeconomic stability is assured: the social security system; the tax system, with the emphasis on the introduction of the VAT; the financial sector, with banking and insurance being opened to foreign competition; the privatization of banks and public utilities; the completion of the liberalization of prices; enterprise sector reform, including privatization and the abandonment of subsidies.

The Commission's progress report is relatively favorable to Slovenia with respect to institutions and politics. As for the functioning of the market economy and ability to withstand competitive pressures, the report is also favorable but mentions some rigidities, and supports the reforms listed in the strategy. As for its application of the acquis, Slovenia, together with the Czech Republic, got relatively low marks. It was emphasized that in more than half of the respective areas no progress has been made,

[5] This section summarizes the presentation by Vladimir Lavrač.

while in the rest of them progress has been very slow. The problems are the same as in the list presented above with respect to the strategy, such as the failure to introduce the VAT, the lack of a new banking law (the law has in fact been held up in parliament for two years), and the absence of a law on foreign exchange. Within the given rules of the game, the substance of the assessment was found in Slovenia to be justified; the government would like to use it to mobilizing efforts to speed up preparations for membership.

There is a debate in Slovenia as to who is to be blamed for the unfavorable development. The ruling coalition blames the opposition, which it says brings up issues in parliament that distract attention from more important accession matters. The opposition, in turn, charges that the parties comprising the ruling coalition do not have uniform views on matters of accession.

1.6 Poland[6]

One of the most important parts of the accession process in Poland is the governmental structure that coordinates preparations for accession. At present Poland is trying to understand what EU integration means. The current government started its work at the end of 1997 and there is now a consensus that it has failed to understand the meaning of accession.

The first serious drawback was the fact that a minister and not the prime minister led the Committee of European Integration (which was inaugurated in 1996). The committee is made up of representatives, mainly deputy ministers, of ministries of key importance from the point of view of the integration process. The new leadership lost time by not understanding properly the function of this committee. The reorganization of the government structure at the start of the working of the new government had caused some disruption of the real economy, as well as in the field of preparations for EU integration. The prime minister recently resumed leadership of the committee, which should certainly bring improvements in the coordination of tasks across the ministries.

The government bodies controlling the integration process are the following: the Committee for European Integration; the Ministry of Foreign Affairs, which is playing a major part in the carrying out of foreign policy; the Ministry of Finance, which was recently made responsible for the technical tasks related to the Phare program; the Chief Negotiator's team under the Chancellery of the Prime Minister; and one additional minister responsible for EU integration, with a ministry made up of four people, which is responsible for public relations and ensuring social support for the process before the referendum on accession is organized. With such a small staff, fulfillment of this ministry's task seems virtually impossible. The governmental structure described above does not seem to be clear and efficient, especially because there are too many decision centers.

Public support for the EU integration was very high in 1996 and early 1997, reaching 82 percent at its peak, but it has declined since then and currently is around 60-62 percent. The government is making efforts to stop this declining tendency, but it is clear that there are serious problems with public understanding of the accession process. Right

[6] This section summarizes the presentation by Andrzej Kośnikowski.

now, we are eagerly awaiting the start of a government-sponsored information campaign, which will spread appropriate information to every sector of society. Responsible politicians, such as the president and the prime minister, have promised several times that there will be a referendum on accession, but nobody knows what would happen if negotiations are finished successfully but the society votes in the negative in that referendum.

A recent development in the accession process was that, at the beginning of 1998, the government prepared a big, three-volume report showing all the problems that Poland may face during the negotiations. This document took an overview of all Polish legal acts that relate to the acquis; it also showed how to respond to Commission initiatives and formulated negotiation strategies.

In March 1998, Minister Jan Kulakowski was nominated as the Government Plenipotentiary for EU Integration and Negotiation for Polish Membership in the EU. He has had long experience as Polish ambassador and government plenipotentiary in Brussels and is considered one of the most qualified persons to coordinate EU accession issues. The negotiation team is made up of 18 members, usually deputy ministers of key ministries. From time to time the team organizes pre-screening meetings to clarify the problems that they may encounter in Brussels.

The presenter stated that, as a participant in these meetings, he knows that the government understands the importance of finding the essence of problems at an early stage and responding adequately to them. The intention is not to sweep the problems under the carpet, but to try to solve them internally, and only if no solution can be found in that manner will the authorities revert to asking for derogations to be negotiated in Brussels. Poland is following an approach similar the one mentioned above in the report on Slovenia. Namely, the view taken is that, even if reforms seem too concentrated and too costly, they are necessary, irrespective of accession, and it is better if we carry them out in a thorough, systematic way, than if we postpone them

The Commission’s report assessed Poland (along with Hungary) very favorably. It states that Poland fulfills the political criteria. In terms of economic criteria, Poland also got good remarks, although major reforms are still needed. Recently, we saw the launching of an administrative, territorial reform; the pension reform is on its way, although it implies a short-term threat to the budget. The Commission lists several priorities which could have been tackled earlier if Poland not lost time in 1998 in launching its participation in the Accession Partnership.

Discussion of the Previous Two Country Presentations

Based on the country reports, one discussant suggested that it would be interesting to investigate the question of how much EU accession is exposed to domestic party politics. Many parties are not mature yet, and are still making efforts to define themselves and to acquire popularity, sometimes at the expense of EU accession issues. When government positions are allocated among politicians, ones related to EU issues often go to individuals who lack the expertise and commitment needed to do the job. The other issue raised by the reports is whether there is an optimal organizational structure for the accession process, whether you need a minister, government plenipotentiary, or deputy prime minister to properly control the process; whether the accession needs a separate organization, or simply an inter-ministerial organization is sufficient. There seem to be as many solutions for these organizational problems as there are candidate countries, or even more because some countries periodically change their structures. It seems that no one is fully satisfied with the system set up for managing the accession process in his/her country.

Another discussant said that the politicians of the candidate countries do a disservice to the accession process when they focus on organizational issues, rather than on substantive ones. As an example of politicians' ignorance of substantive issues, he recalled a case that had happened the previous week, when Polish parliamentarians visited the Commission and had a meeting with commissioner Hans Van den Broek. The parliamentarians presented such extraordinary, outrageous claims that the commissioner simply walked out, stating that it is Poland that had applied for EU membership, not the other way around. The discussant referred to the Commission's list of short term priorities for Poland published in March 1998, of which many have already been tackled. Some, however, seem to be rather long-term ones (restructuring the coal and steel industry, addressing the issues of environment), while some, such as the establishment of the freedom of the press, was simply false, since the press enjoys a freedom that even exceeds that in the U.S.

That discussant asked Kosnikowski to specify how much time was lost in Poland in 1998 in preparing for membership. Kosnikowski answered that when the new government was formed, the framework of the accession partnership and its short- and medium-term priorities, had to be discussed and efforts were needed to fill in the gaps. At the inter-ministerial level, however, coordination was missing and nothing happened for several months. The Commission was becoming impatient with Poland. Finally, Poland managed to clarify its differences with the Commission and to come up with initiatives and priorities for the accession partnership. The delay cost five-six months.

A discussant representing the Commission addressed the issue of short- and medium-term priorities. If the Commission lists a task among the short-term priorities, it does not necessarily mean that it can be solved in the short term, but that it should be started immediately.

Another discussant suggested that the dwindling support for accession (which may be the case not only in Poland, but in other countries as well) may be the result of the usual scapegoat policies of the governments: they claim that "we have to do this policy and that measure because the EU is obliging us to carry out these terrible policies." This happens also in the incumbent member-states: if something is unpopular, it is said the be demanded by the EU, while if something is popular, it is the merit of the current national government. Kosnikowski replied that he did not think that that would be the case in Poland. The government of Premier Jerzy Buzek is convinced that the reforms needed for accession are good reforms, a fact reflected in television commercials that popularize EU-related reforms.

Vareikis agreed with one of the discussants that many times discussion focuses on wrong issues. Accession is different from association. The latter was based on an agreement which was negotiated, so both sides had a say in its formulation. This time basically the candidate countries, after accepting the rules of the game, receive a list of tasks, and there is no room for arguments: they have to implement the acquis and other requirements even if they not always understand or agree with the priorities emanating from Brussels. As for the issue of public support, Vareikis recalled that *The European Dialogue* (the Commission's periodical for the candidate countries) wrote in its last issue that the candidate countries' enthusiasm for joining the EU was based mostly on misunderstandings about what the EU really was. Perhaps the EU does not want such countries to be overly enthusiastic.

In response to a question, Lavrač stated that all major Slovenian political parties, except for one minor one, support accession. There are differences over certain pieces of legislation, over the protection of certain sectors, or possible positions in the course of the negotiations, but there is a generally favorable attitude to accession among the political parties. Public opinion is also favorable, subject to some fluctuations over time. The outcome of a referendum held on accession also depends on the formulation of the question. If ones asks whether someone is in favor of EU membership, the answer is in the affirmative, but if one asks whether the respondent is willing to sell his/her land to foreigners, the answer is in the negative.

1.7 Estonia[7]

This presentation began by summarizing what was happening in terms of the Copenhagen criteria and then turned to economic developments in the light of the Maastricht criteria.

Looking first at the negotiations, the screening process was rather successful, there were no major setbacks, and Estonia made some progress in the adoption of the acquis. In terms of the political criteria, the only area where there are potential problems were connected with minorities and citizenship laws. Problems are expected in the future with respect to the acquis related to the environment, agriculture, and telecommunications, so the hardest part has yet to come.

Turning to the economic aspects of accession, one can begin with two extremes. On the one hand, in terms of monetary arrangements, monetary stability, and central bank independence, the Maastricht criteria are almost fulfilled. On the other, in terms of purchasing power, Estonia is by far the lowest of the five candidate countries with which the EU has begun negotiations.

Estonia's only criticism of the Commission's November 1998 report on its progress toward accession is the report's low estimated purchasing power for the country. It is very complicated to make such estimates for countries which belonged to the Soviet Union, because the exchange rate of the ruble against all other currencies was not market-determined. All the projects that make comparisons do so with respect to Austria. A big project under Eurostat, which ran until 1993 or 1994, had estimates of GDP per capita for Estonia ranging from $2,000 to $6,000. The Commission has selected the figure $3,500, which is on the low side (as would be even $6,000). Thus, this issue remains unsettled.

Among the various economic criteria, inflation, which is the most important criterion and reflects more aspects than the others, is about 8 percent annually. As in Poland, this reflects convergence of the price structure and level. The question is often asked, why

[7] This section summarizes the presentation of Ilmar Lepik.

inflation has fallen so slowly, since the currency board arrangement should radically bring inflation down immediately, as was the case in Argentina in 1991 and in Bulgaria in 1997. Part of the explanation may be that Estonia started as part of the Soviet Union, with higher distortions than in Central Europe on average.

Estonia experienced 11 percent GDP growth in 1997, which puts it among the fastest growing European countries, although one must keep in mind the low base from which the country started. The reforms in the Baltic states started somewhat later than in Central Europe, the slump ended in 1994, so 1995 was the first year of real growth, which also explains why Estonia's purchasing power is as low as it is.

The share of investment in GDP, at slightly below 30 percent during the past three years, has been very high in European terms and rather high in world terms. But Estonia has a share of domestic savings in GDP of slightly below 20 percent, so there is a fairly large current account deficit (of perhaps 12 percent of GDP), as foreign savings are used for restructuring of the economy.

If one puts everything together, including the exceptionally high rate of GDP growth in 1997, a very high investment rate, a high current account deficit, a stock market bubble, it looks a bit like Southeast Asia.

A further economic criterion is interest rates, which are characterized by a dilemma. On the one hand, with high inflation it is not possible to have low rates; on the other, with the pegging to the Deutsche mark, interest rates should converge toward those in Germany. Both arguments are right. Nominal rates are rather high (about 15-16 percent on average), and the yield curve is fairly flat for shorter maturities and declining for longer ones. This is because all longer-term loans are funded from the point of view of liabilities, which means that the cost of funding is low.

A balanced budget is a precondition for a successful currency board arrangement, and the budget has been roughly balanced during the six years that the kroon has been in existence. Due to developments in 1997, the authorities targeted a surplus for 1998, as part of a policy of dampening aggregate demand, under circumstances where the country had experienced more than 10 percent real growth and about a 10 percent of GDP current account deficit.

Public sector debt, both domestic and external, is very low, about 8 percent of GDP. The private sector's net debt position is about 40 percent of GDP, so Estonia is a country with a very low debt burden.

As a result of this good performance, Estonia has received an investment-grade country rating of BBB+ from Standard & Poor's, and A1 from Moody's,[8] which are the same as those received by the Czech Republic, Hungary, and Poland, with only Slovenia having higher ones in the region.

With respect to the Russian crisis, there have been three major issues. First, less than 2 percent of banking sector assets were connected with Russia. Second, before the Russian crisis, the share of Russian trade was 11-12 percent, but it has now fallen to 5-6 percent; no one knows to what extent the Russian share will be restored. Finally, there are two sorts of indirect effects of the Russian crisis on Estonia. One is through bad

[8] Editor's note: Estonia received an A1 rating from Moody's on its domestic currency obligations on February 19, 1999.

loans of enterprises that export to Russia and are in trouble; the other involves refinancing of banks.

1.8 Hungary[9]

The speaker began by noting that the Commission's position in its November 1998 report turned out to be very positive about Hungary. The Commission stated that Hungary has advanced the most among the candidate countries with respect to the adoption of EU rules and the accession process. However, although a lot has been achieved, much more remains to be done and a hard road is still ahead.

As regards political changes, following the general elections in the spring of 1998, the Socialist/Free Democratic coalition has been replaced by a one comprising the Federation of Young Democrats/Smallholders party/Democratic Forum. No major shift in the country's policy toward the EU can be seen, except perhaps for a bit of impatience on the part of the government, trying to get some concrete information from the Commission concerning a definite date of accession, in order to be able to plan more properly.

As regards the coordination of preparation work, the Prime Minister's Office seems to have gained in importance. Within that office, there is a European Integration Department, which participates in the elaboration of national programs, and cooperates closely with the Secretariat of Integration established during the previous government within the framework of the Foreign Ministry.

All ministries have "EU departments," where special tasks related to accession problems are addressed. The Prime Minister's Office further relies on the work of the "Strategic Task Force for Integration," an advisory board responsible for theoretical problems related to the coming accession. A new independent minister has been appointed, partly as a result of problems arising with Phare programs, who is responsible for coordinating these programs. The Integration Secretariat within the Foreign Ministry is currently elaborating a communication strategy, partly with respect to informing the population more properly about how the EU works.

As regards the economic criteria, the Commission's previous evaluation already considered Hungary to have a functioning market economy, which had managed to maintain stability even in a crisis situation. For 1998, economic growth of 5 percent is expected, with a slight increase in the external imbalance, along with a slowing down of inflation.

Export performance remains a major pillar of economic growth, with the machinery industry showing outstanding performance. Investment shows a dynamic growth of 12 percent in 1998 and personal consumption, after years of slackening, is expanding by 3-4 percent. The impact of the Russian crisis has remained manageable.

The national bank has maintained the crawling peg exchange rate regime as the main instrument for reducing inflation, and has stuck to its intention to slow the rate of crawl, even at the time of the stock exchange crisis of July/August 1998. Only moderate

[9] This section summarizes the presentation of Katalin Nagy.

interest rate increases were enforced as a result of financial tensions. Net capital inflows by the end of September 1998 amounted to $2 billion for the year.

In April 1998, the "analytical examination" of the acquis began; by October, eleven chapters had been screened. Hungary's intention is to ask for only a limited number of temporary exemptions. "Derogations" arose in the context of the liberalization of the telecommunications market, the licensing or pharmaceuticals, and the restructuring of the steel industry.

The Commission's progress report acknowledged the progress of structural reforms. A number of measures were taken to combat corruption, international agreements signed, progress made on competition policy (especially concerning state aid control), and a monitoring authority established (which has already presented its first report to the Commission concerning state-aided activities in Hungary).

The privatization process is practically completed, liberalization of capital movements has shown a great deal of progress, banking sector privatization is nearly finished, regulation of mortgage lending has entered into force, and foreign credit institutions are now allowed to operate in Hungary. Pension reform was launched, and with respect to trade policy, EU-conforming measures were undertaken.

An environmental protection program was set up for 1997-2002, which lays out a schedule for adjustment to meeting the environmental acquis. However, the Commission holds that legal harmonization has not progressed as far as expected under this program.

With respect to regional policy, Hungary is much more advanced than the other countries, although institutional reforms lie ahead. The statistical regions have been established, which is the first phase in setting up EU-conforming regions, but the functioning and competence of the regional institutions have to be improved. Consequently, the new government is elaborating a program in this sphere.

A medium-term program, which sets priority targets for EU accession, has been elaborated. It is currently under revision and was planned to be presented to the Commission early in 1999.

1.9 Macedonia[10]

Macedonia at present not being a candidate for accession, this presentation looked at the country's overall relationship with the EU. The speaker recommended the most recent *Transition Report* by the European Bank for Reconstruction and Development (EBRD) to those who want to go deeper into macroeconomic developments in the country.

The speaker called the audience's attention to the continued use of the acronym "FYR Macedonia" in the EBRD report, which shows that the "name game" with Greece is still not resolved. Talks are being held behind the scenes between Macedonian and Greek representatives; the issue has been put aside and economic relations with Greece have greatly improved in the last few years. Macedonians are now more relaxed about this

[10] This section summarizes the presentation of Trajko Slaveski.

issue, and U.S. and EU representatives in the country have stopped using the “FYR” terminology.

Macedonia has not yet reached a Europe Agreement (i.e., an association agreement) with the EU, having signed only a cooperation agreement with the body, which went in effect at the beginning of 1998 (it was signed in April 1997). This agreement was seen in Macedonia as marking a major improvement in relations with the EU. The attitudes of the Macedonian people since gaining independence in 1991 have been strongly pro-EU. No major political party has ever had any doubts that the road to the EU is the proper future direction for the country. As is the case for many of the countries in the region, the building of a closer relationship between Macedonia and the EU depends more on the latter than on the former.

After gaining independence, Macedonia suffered all the external shocks that can hit a country, especially the loss of a large protected market when former Yugoslavia broke up. One Macedonian company, for example, lost 20 percent of its market when Slovenia introduced the tolar in October 1991, another 25 percent when Croatia introduced its own (temporary) dinar in December 1991, and another 15 percent when war broke out in Bosnia-Herzegovina. Other big blows were the break-up of the Soviet Union, observance of the UN Security Council sanctions against Federal Yugoslavia, and the blockade by Greece during 1993-94. One can well ask how the country managed to survive.

The macroeconomic situation, especially the monetary side of matters, looks very favorable at present. Macedonia fulfills the Maastricht criteria in terms of the budget deficit and inflation. Retail price inflation in 1997 was 1.3 percent, and the same figure is projected for the 1998. Back in April 1992, when Macedonia declared monetary independence and issued its own currency, annual inflation was 2,000 percent, and the monthly rate was 86 percent.

This macroeconomic stabilization was achieved after the country became a member of the World Bank and IMF. A strict stabilization program has been in place since the beginning of 1994. Moreover, the country has in recent years received assistance from the international financial institutions in the sphere of structural reforms, which has had a favorable impact on the macroeconomy.

However, the equilibrium is suboptimal, with, for example, the highest unemployment in Europe. The methodology was changed recently to one based on market surveys; the most recent figure found by such surveys was 36 percent. One of the mysteries of Macedonian macroeconomic development is the absence of social unrest. But everyone is aware that the informal economy is very large, the most recent estimate of its size being 35-40 percent of the economy.

The current account is in considerable deficit (7-8 percent of GDP or $275 million). However, during the last few years, despite this deficit, the country’s foreign debt has not increased. The IMF has observed that Macedonia has taken a conservative stance toward foreign debt. Even so, in the last few years, the outflow of money for servicing the foreign debt has exceeded the inflow from funds from multilateral sources.

Foreign direct investment has been very low. However, for a country with 2 million people, there are an estimated 500,000 passport holders living abroad who send remittances to the country; these remittances are greatly underestimated in the official accounts.

Turning to the political situation, a new government was recently elected, composed of parties which were in opposition previously. The party that gained 49 out of 120 deputies in parliament had been absent from parliament since 1994, having boycotted the elections that year on the grounds that the results were fraudulent, so the previous parliament had had no opposition. Macedonia has now joined the club of countries that have experienced peaceful removals of governments formed by the former communists.

Two parties representing ethnic Albanians won a total of 25 seats of 120 in parliament. The coalition of center-right parties, which won the majority in parliament, invited the most radical ethnic Albanian party to join the coalition, and the offer was accepted.

During 1993-94, before it established normal relations with the EU, Macedonia was a recipient of only humanitarian aid from the EU. Under a program covering the period 1996-99, the country will receive over $100 million from different programs. Some 40 percent of these funds will be aimed at improving relations with Greece in areas such as infrastructural development and environmental protection near the border.

1.10 Slovakia[11]

The speaker began by noting that the present moment is a very promising time for Slovakia. The country, in parallel with Macedonia, had an election only several weeks ago. An important change has taken place in Slovakia's political structure.

The former governing coalition was created by the Movement for a Democratic Slovakia of former Prime Minister Vladimír Mečiar, the Slovak National Party, and the Association of Workers of Slovakia. The current coalition is formed by Prime Minister Mikuláš Dzurinda's Slovak Democratic Coalition, the Party of the Democratic Left, the Hungarian Coalition Party of Slovakia, and the newly formed Party of Civic Understanding.

Slovakia is not happy with the Commission's November 1998 report on the country. Slovaks are both realists and optimists, knowing, of course, that the report was prepared only several days after the elections. The new government has a real political and social opportunity to present a new strategy; it has already come up with a new program.

The report referred to "political instability," which was an incorrect term, since the political situation was stable under a single government for four years, but there was an unfriendly and uncooperative relationship among political institutions (i.e., the parliament and government on one side and the president on the other). Other problems cited in the report were connected with privatization, including insignificant participation by foreign investors, a lack of transparency, and some deficiencies in the methods employed. In addition, the report mentioned several times problems related to the situation of ethnic minorities.

[11] This section summarizes the presentation of Igor Kosír.

The situation is now completely different. A new constitutional law has been adopted that allows for serious preparations for democratic presidential elections, whereby, for the first time in Slovakia's history, all citizens will vote directly for the president.

Privatization is a very complex issue. The majority of national property has been privatized; in industry and agriculture, the percentage privatized is over 95 percent. There are, by law, certain strategic enterprises in Slovakia, in the spheres of energy (oil and gas), that cannot be privatized within the next four years. There are also several banks on the list of strategic enterprises; the banking system awaits restructuring and further privatization.

In terms of the problems of minority ethnic groups, there are several such groups in Slovakia. The largest group are the Hungarians, followed at a great distance by Ukrainians (and Ruthenians, a small group closely related to the Ukrainians), Germans, Roma, Poles, and some other small groups. After the elections, the situation has dramatically changed, with the Hungarian politician Béla Bugár becoming the deputy president of parliament and another Hungarian politician, Pál Csáky, becoming a deputy prime minister responsible for minority and regional problems; Jozef Migaš, who is close to the Ukrainian/Ruthenian minority, becoming parliamentary president; and the party of Rudolf Schuster (Party of Civic Understanding), who is a representative of the German minority, entering the governing coalition. This improves the country's international image, and also sends the political message that concrete measures are being taken.

The first foreign visit undertaken by the new government occurred when the deputy prime minister for European integration and the foreign minister went to Brussels and met Jacques Santer and Javier Solana. Dzurinda has been there twice already in his brief tenure. Slovakia is interested in not only European political and economic structures, but also Euro-Atlantic political and security ones.

Paradoxically, Slovakia was evaluated positively by the Commission report from an economic point of view. GDP growth has been among the highest in CEE. During the first half of 1998 it was 6.1 percent, approximately the same as it has been for several years.

However, the heritage of the economic policy of the previous government is controversial, because the economy is seriously unbalanced, both internally and in international economic relations. There will be a new government program, to be realized by the Ministry of Economy and other ministries (i.e., Agriculture, Finance, Construction, and Labor, Social Affairs, and the Family).

Consumer price inflation was a modest 6.2 percent in the third quarter of 1998 relative to the same period in 1997. The unemployment rate was high, at close to 14 percent; the former economic policy was not successful at reducing it. The foreign debt is $12.2 billion, another not very positive part of the economic heritage.

There is the possibility that after several years the political situation may become quite acceptable, but the economic situation may deteriorate relative to previous years. Slovakia has a chance to join the first wave of candidate countries.

Discussion of the Previous Four Presentations

A discussant from the European Commission acknowledged that the regular report could not reflect the political changes in Slovakia. She also admitted that one has to start with messages and that Dzurinda's trips to Brussels and including representatives of minorities in the government should be seen in that light. But she expressed impatience with waiting to see the first actions, to see a real program which goes beyond gestures.

Kosír responded by noting that the new government had only begun work a few weeks previously and that each step requires time. A new government program was adopted the previous week by parliament; it contains concrete political targets for the four-year mandate. In January 1999, discussions will be finalized at the legal level concerning the presidential election, which should take place in March 1999. Kosír continued that he remains optimistic on the economy, even though the new government will have to promulgate a number of restrictive measures and there are economic imbalances at present.

A discussant pointed out that the Slovak government has already put together an austerity package, and that it includes large energy price increases (including one of 33 percent for electricity), which will require a substantial adjustment in a country with 6 percent inflation last year. We can project from this early news that the government will have take tough measures to stabilize the economy.

Kosír added that the new government has created a Ministerial Council for European Integration, which aims to be an efficient task force. Previously, there was the Council of the Government of the Slovak Republic for Integration into the European Union, which integrated all ministries, but it was not efficient. The new council is led by Pavol Hamžík, who is deputy prime minister for European integration; only the ministers of finance, economy, foreign affairs, and agriculture sit on this council.

Slaveski noted that Macedonia's cooperation agreement with the EU contains a financial protocol, which provides for ECU 70 million in financial aid, to finance infrastructure. There is also ECU 140 million to finance two major highways to Greece, financed under favorable conditions by the European Investment Bank. Trade restrictions are eased in a number of sectors, such as textiles; the EU now accounts for about 40 percent of Macedonia's trade.

A discussant underlined the need in Slovakia for major macroeconomic adjustment and structural reforms (especially in the banking sector). According to the discussant, the main message of the Commission's report on that country is that these corrective steps in the macroeconomic sphere can be taken if the political will is there. These measures can be taken fairly swiftly and it also should not take too much time to get the structural reform process started again and achieve a critical mass of such reforms, especially in the financial sector. If this done, it should be possible to receive a positive assessment in the not-too-distant future.

Another discussant said that some of the countries are not yet psychologically ready, but are in the process of political consolidation. Although he agreed with the previous discussant that correct macroeconomic measures can be taken swiftly, the political and social background will take time. He also made the point that perhaps the process of accession and the Commission's reports have not been transparent to the societies, wondering whether the reports have been translated into the national languages and explained to the local populations.

A discussant stated that the real problem that candidate countries face during accession is that they have to deal with two packages: first, that the countries should have sustainable economic growth and current account deficit, and a tolerable budget deficit; and second, that there should be a quick adjustment process in environmental matters, industry, transport, and the social charter. The problem is that these two packages cannot be implemented simultaneously. If the countries must make a painful selection of which is more important, they should choose sustainable economic growth while maintaining macroeconomic stability. The sequencing of the adjustment process should be careful and there must be compromises, otherwise the countries will undertake obligations that they cannot fulfill or will fulfill them and lose stability.

A final discussant addressed the relationship between macroeconomic stability and structural reform, stating that a simultaneity should be attained between the two processes. Otherwise, a disequilibrium will occur in one sector and the benefits in another sector will not be maximized. A macroeconomic imbalance can spread its harmful influence to a structural adjustment process.

Kosír noted in response to the various comments that for the first quarter of 1999 the government has adopted a provisional package of concrete steps on prices (energy prices, transport tariffs), agriculture (efficiency-enhancing measures), among other areas. Slaveski noted that the new Macedonian prime minister would be visiting Brussels at the invitation of the EU Presidency eleven days after taking office, an indication of improving ties between the EU and Macedonia.

2. Joining the Internal Market - Past Experiences and Forecast for the Future

2.1 Joining the Internal Market: Are there Lessons from Previous Accessions?[12]

The presenter started with explaining that he was a back-up presenter: as the organizer of the workshop, he had approached a number of experts on the single market, but unfortunately they all had other commitments. Given the importance of the issue for the candidate countries, he decided that he would delve into the subject himself and share his experience with workshop participants in order to provoke further discussion.

It is well known that each new step toward integration brings gains for the countries involved. These gains can be classified in various ways. One classification catalogues the gains from (1) a better utilization of comparative advantage; (2) creation of larger markets and the economies of scale in both their static and dynamic forms; and (3) intensification of competition. The problem that Central and East European countries face when they, as peripheral nations, join a large existing integrated area, is that

[12] This section summarizes the presentation by János Gács.

whether they will obtain their fair shares from these overall gains or they should expect to incur losses.

The literature usually predicts that integration will bring about a better utilization of comparative advantage. Given certain assumptions (usually neoclassical ones), the gap between low income and high income countries will be narrowed as the former attract additional capital, due to the higher return on capital there. There will be an evening out in the distribution of resources across the enlarged integrated area, with the consequence that the poorer countries will catch up.

The literature is, however, not unanimous about the beneficial effects of economies of scale, but forecasts that a better utilization of economics of scale will trigger agglomeration effects. This means that those regions in which economic activities were already strongly concentrated will attract additional resources, while peripheral regions will see their attractiveness further diminished, with the consequence that there will be a further divergence of incomes across the countries of the integrated area.

If we take the two effects (comparative advantage and economies of scale) together, it is difficult to foresee which will prevail, that is, whether poorer countries will eventually gain or lose from integration. The nature of the outcome can turn out to be accidental in that only a small difference in the conditions among countries may lead to cumulative (positive or negative) effects, which result eventually in large differentiation among the countries that join the integrated area. For instance, multinationals may choose country A over country B for their future platform in Europe on the basis on marginal differences between them. This will result in much faster economic growth in the future for the country which was chosen as the platform for FDI.

For the accession countries the main question is which of two scenarios will prevail. The first is that once they have become members, that is, after adopting the legislation and rules of the EU, their incomes per capita income catch up with those of the existing members. The second scenario is that, given their diverse structures in terms of sectors, institutions, concentration, property rights, and so on, in comparison with the incumbent member-states, there is increasing divergence in their incomes per capita compared with those of the old member states.

The best way to gain insight into this issues is obviously to examine earlier enlargements. The most comparable countries are not those that participated in the previous enlargement (Austria, Finland and Sweden), but rather the Southern or “Cohesion” countries (Greece, Ireland, Portugal, and Spain). The study of their experiences with respect to their joining the EU and the effects on them of the establishment of the single market is the most appropriate in this context. Since Ireland joined the EU much earlier and has had a special relation with the U.K., and Spain is too large to be comparable to the East European candidate countries (except Poland), that leaves Portugal and Greece as bases of comparison.

These two countries have experienced extremely divergent economic performance following their accessions. In terms of catching up, data show that since 1986 Portugal has continuously approached the EU average income per capita, while Greece during its first ten years in the EU saw its income per capita move continuously further below that average. Greece started to follow a catch up trend only recently. The literature that analyzes the results of accession in these two countries and focuses on trade arrives at the conclusion that in both countries there was much trade creation and very little trade diversion. Thus, analysis of static effects of trade does not give an explanation for the differences in growth performance in the two countries..

A study by Hallet[13] investigates the development of these two countries by focusing on trade, but from a perspective that goes beyond static losses and benefits. It also utilizes the results of modern trade theories, such as agglomeration theory, and thus takes into account more than simply comparative advantage.

Hallet analyzes the reasons behind the diverse performance of Greece and Portugal. He finds that a sufficient explanation can be found if one takes into account intra-industry trade, economies of scale, and agglomeration theory, especially a theory developed by Krugman and Venables.[14] He translates the Krugman-Venables theory to into a U-shaped curve, as shown in Figure 2.1. The horizontal axis represents the level of integration (or of trade barriers or barriers to exchange), while the vertical axis shows income per capita at the periphery relative to that in the center.

Assuming a dominant role for imperfect competition in international trade, the periphery country must achieve a certain level of integration in order to realize gains from integration in terms of income per capita. If a peripheral country joins an integrated area in a phase when its trade barriers are still high, the consecutive dismantling of trade barriers within the integrated area will cause losses in terms of relative income per capita income. Hallet collects data on a number of indicators of trade barriers for Portugal and Greece (including ones related to regulation, transport, information, and insurance costs). It turns out that the "U-thesis" provides a satisfactory explanation for the differences in the growth performance of Greece and Portugal following their accession to the EU.

In Figure 2.2, Hallet places the countries on the U-curve according to their indices of integration and growth performance. As the figure indicates, at the time of Greece's accession, it was much less integrated with the EU than Portugal, which joined the Union five years later at a higher level of integration. The curve also explains why at the two countries' levels of integration in 1992, Portugal was already able to experience a steady catching up, while Greece was drifting in this respect. In another figure, Hallet illustrates that in the 1980s Portugal achieved an increasing share in EU trade (a proxy for the level of integration) and thus benefited from integration in terms of economic growth, while Greece experienced a negligible move from its original share in EU trade, which contributed to its unsatisfactory growth performance.

In the remaining part of his talk, the presenter summarized the results of the studies commissioned by the Commission on the results of establishing the single market. He noted that an attempt to focus on the effects of establishing the single market on peripheral countries was made difficult by the fact that the analyses in most cases neglected the regional and country aspects of the process. The reasons for this are probably mostly methodological – a lack of data and reliable models – but also partly political.

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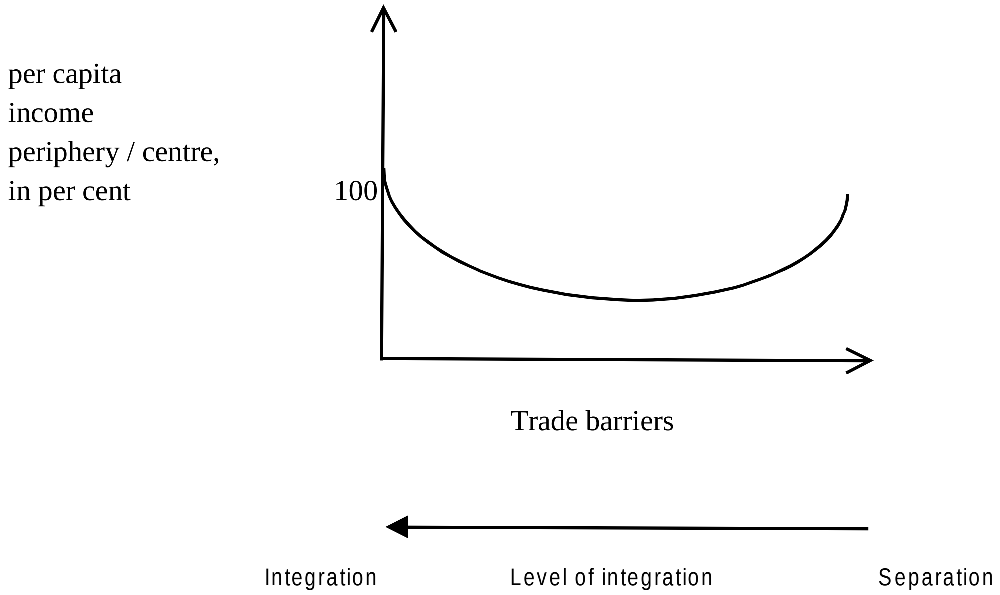
[13] M. Hallet (1995). "Wirkungen wirtschaftlicher Integration auf periphere Regionen: Die EG-Integration Griechenlands und Portugals" ("The Effects of Economic Integration on Peripheral Regions: The Integration of Greece and Portugal into the EC"), *Konjunkturpolitik* 41, 2, pp. 115-147.

[14] P.J. Krugman and A.J. Venables (1990). "Integration and the Competitiveness of Peripheral Industry," Centre for Economic Policy Research, Discussion paper no. 363, January.

Figure 2.1

The U-thesis: Relationship Between the Level of Integration and the Relative Income at the Periphery



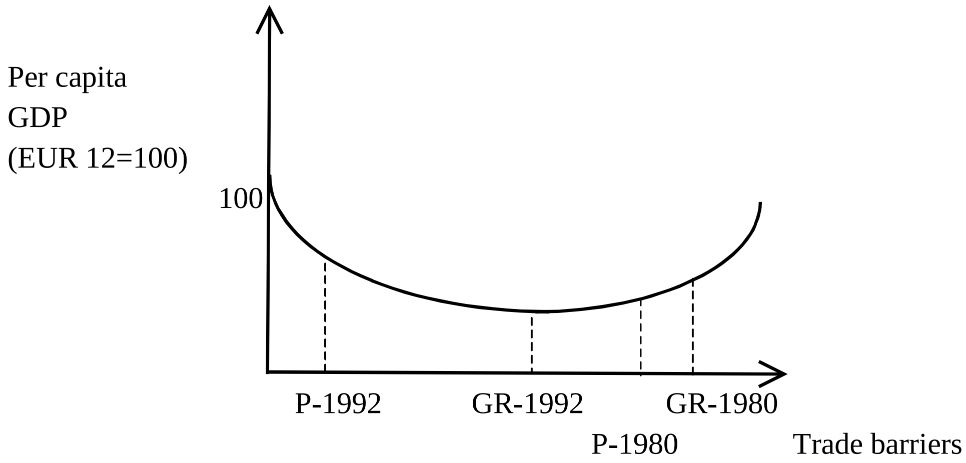
Reproduced from M. Hallet (1995) "Wirkungen wirtschaftlicher Integration auf periphere Regionen: Die EG-Integration Griechenlands und Portugals", *Konjunkturpolitik*; 41(2), 1995, p. 124.

It is not easy to assign trade and FDI specialization effects to specific measures or a specific period. The single market was to be established between 1985 and 1992, so it was not clear from which point in time the initiative really had an impact. It was also mixed up with other simultaneous effects, such as the accessions of Spain and Portugal, the opening up and beginning of the transition in CEE, German unification, and so on. Nevertheless, the studies found that in the period during which the single market was established, there was a very fast growth of intra-EU trade, 80 percent of which could be attributed to the single market. The poorer countries performed better in this respect than the incumbent member countries. For instance, in 1985-93, the average annual growth rate of intra-EU trade in manufacturing was 6.7 percent for the EU-15, while this growth was 7.0 percent in Greece and 13.3 percent in Portugal; similar differences were recorded for trade in services. The process was characterized by sizable trade creation and virtually no trade diversion.

The establishment of the single market brought about an increase in the share of intra-industry trade at the expense of inter-industry trade. Since adjustment costs are much higher for inter-industry trade, the conclusion can be drawn that the adjustment costs triggered by the setting up of the single market were not excessively high. Country-by-country comparisons show that Spain and Portugal experienced an exceptionally fast shift from inter-industry trade to intra-industry trade, but even after the establishment of the single market all peripheral countries (plus Denmark an Italy) carry out a sizable part of their trade along inter-industry lines.

Figure 2.2

The U-thesis: Explanation for the Impact of EC-Integration of Greece and Portugal



Reproduced from M. Hallet (1995) "Wirkungen wirtschaftlicher Integration auf periphere Regionen: Die EG-Integration Griechenlands und Portugals", *Konjunkturpolitik*; 41(2), 1995, p. 135.

In the field of FDI, the single market program brought about especially significant progress. Table 2.1 exemplifies the place of peripheral countries in the EU as hosts for FDI inflows: in 1990-1993 these countries performed quite well compared to the more developed ones, especially Spain, Portugal, and Ireland (the champion of inward FDI). Greece’s performance was again disappointing. An investigation of the activities of the new foreign owned establishments across the Union showed that these establishments were engaged in different activities in the core EU countries than in the peripheral ones. Foreign or joint establishments in the more advanced countries manufacture more processed products, while joint activities in the peripheral countries are engaged in the production of basic or less processed products.

Table 2.1 Significance of FDI Inflows to the EU by Member States, 1986-1993

	Ratio of total FDI to GDP (percent)		
	1986	1993	1990-1993 average
Belgium-Luxembourg	0.75	4.79	4.70
Denmark	0.23	1.04	0.89
Germany	0.13	0.22	0.37
Greece	0.86	0.56	0.64
Spain	1.20	1.32	1.75
France	0.38	0.78	0.89
Ireland	0.25	7.68	9.41
Italy	0.05	0.40	0.40
Netherlands	1.54	2.18	2.74
Portugal	0.65	1.47	2.64
UK	1.04	1.29	1.83
EU-12	0.49	0.94	1.17

Source: "Economic Evaluation of he Internal Market", *European Economy* 1996, No. 4., p. 90.

In summary, no strong conclusions can drawn from the available evidence on the effects of integration and the single market on the peripheral countries of the Union. The picture is very patchy: certain tiles of a mosaic-like picture are visible, while others are not. Analysis of the evidence presented here and further investigations should focus on policies that help avoid the emergence of the trajectory followed by Greece and establishing the conditions for achieving a trajectory that resembles that of Portugal.

2.2 Costs and Benefits of Accession to the EU: Attempts at Measurement in Four Applicant Countries[15]

The literature on costs and benefits of enlargement of the EU has shown a striking asymmetry: much more is written on the costs and benefits of enlargement from the viewpoints of the incumbent member countries than from the viewpoints of the East European candidate countries. This induced a group of economists back in 1996 to start a Phare-ACE research project on four countries (Czech Republic, Hungary, Poland and Slovenia) with the title “The Measurement of Costs and Benefits of Accession to the EU.”

This two-year project started with the elaboration of country reports, which has been completed, and is now in its second stage, which is devoted to preparing comparative studies. The final report will possibly include, among other things, recommendations on the possibilities of measuring the costs and benefits of accession for the candidate

[15] This section summarizes the presentation by Sándor Richter.

countries. The presenter reported in his talk about the preliminary results of this Phare-ACE project.

After considering more ambitious plans, eventually the participants in the project decided to examine the costs and benefits of accession in the following five areas: (1) comprehensively summarizing the research that had already been carried out on those costs and benefits (in a strictly economic sense) in the individual countries; (2) taking a macroeconomic approach to the assessment of the costs and benefits related to EMU; sectoral analyses of (3) agriculture, (4) foreign trade, and (5) regional policies.

If one looks at the ongoing research activities in the candidate countries with regard to EU accession, one finds that in three of the four countries under investigation (Hungary, Poland, and Slovenia), groups of experts had already prepared so-called strategy papers. In Poland, the early version of that paper was updated annually. In Hungary the work was so comprehensive that perhaps every third economic researcher in the country was involved in one or other working group of the so called Strategic Task Force for Integration. Until the summer of 1998, no such strategy paper was elaborated in the Czech Republic, although the new government is making every effort to prepare such a document.

A characteristic feature of the strategy papers was that neither of them has drawn up a comprehensive approach to the costs and benefits of accession. The question of whether on purely economic grounds it is worth joining the EU was not raised in them, and consequently, this question was not answered. The reason for this lack of inquiry was that the decision on accession is considered to be primarily of a political character. Another reason may be that from the historical point of view it is easy to see the benefits of accession: there is no doubt that in the long run accession will be beneficial for the East European countries. However, the interesting questions are (as the title of this workshop indicates), what impact does the time pattern of the emergence of costs and benefits have on the countries, and what are the short- and medium-run aspects of these costs and benefits?

One can apply a rough, common sense approach: if we take only two elements, access to the large EU market and receipt of EU transfers, one can surely conclude that the accession will bring overwhelmingly benefits.

There are serious methodological hurdles as well. Several contributors to the project stressed that the transition to the market economy is not yet over, and the factors related to transition and EU integration are impossible to separate from one another. In addition, the accession process is so complex that it makes any comprehensive modeling effort almost futile. A further difficulty is that the benefits of accession with respect to military positions and foreign security are almost impossible to measure in quantitative terms.

Contributors to the project also stressed that if we take growth only as the measuring rod of costs and benefits, it is again impossible to separate the factors that impact growth through integration and through other channels. It is also difficult to find a “common denominator” for measuring the costs and benefits in such fields as agriculture, regional policy, and others. Moreover, a certain development can be beneficial for one group in society and detrimental to another group, so it is difficult to arrive at a net cost or benefit for society as a whole. An example of this comes from agriculture: higher agricultural output prices (a probable outcome of accession) may be beneficial for the farmers, but harmful to consumers.

The inability of policy makers and researchers to make a comprehensive assessment of the costs and benefits of accession has significant consequences. One of such consequence is that the candidate countries have not devised an alternative economic strategy for the case of non-accession. Such a scenario would become necessary if the introduction of the euro were not so successful as expected in Europe and turbulence followed in its wake. Alternatively, it could happen that the internal reforms of the EU will not reach the scale necessary to prepare the Union for further enlargement, or consensus may not be reached in the controversial field of EU transfers. Obviously, the world would not come to an end if these unexpected developments materialized; the candidate countries must have plans to carry on with reform and enhance growth in such a case. If such an alternative, non-accession strategy is not available, then a protracted accession process would be seen by the candidate countries as a tragedy.

A further implication of the lack of comprehensive calculations on costs and benefits is that the candidate countries have not considered any “crash scenarios.” Such scenarios would emerge if the economies of the candidate countries would collapse within two to three years of accession due, for example, to increased competition, unsustainable trade deficits, social and political tensions, or unbearable adjustment costs. This means that the candidate countries have not developed early warning systems, so that they will not be able to take the necessary steps in time to avoid these scenarios.

Even in the absence of a comprehensive cost and benefit analysis, we can ask the question: how can a country approach joining the EU in such a way as to gain the most and lose the least in the process? Partial analyses can help suggest the answer to this question

The presenter went on to focus on one particular issue, namely transfers from the structural and cohesion funds to the new members. The Agenda 2000 document laid out the following framework: an upper limit of 4 percent of GDP for each country for the sum of all transfers; a phasing-in process; and a precondition of 2.5 percent average annual growth of GDP within the EU. Most of the analyses of this issue take into account gross figures on total transfers from the EU to the new member countries. However, net figures, obtained after deducting the contributions to the EU budget by new members, are more informative.

Member country contributions are fixed according to rules and are non-negotiable. However, transfers hinge on many conditions, such as the absorption capacity of the recipients, the availability of good projects, and the country’s co-financing capacity. A doomsday scenario here could emerge: in the first three years of membership, EU transfers are of limited size due to the phasing-in principle, while membership fees are fixed. This means that in the years most crucial from the point of view of a possible crash, the new members would hardly receive any assistance from the EU.

The experiences of earlier new members show that in the first years of membership it was not easy for them to obtain EU funds. In Austria, for example, applicants for agricultural funds forgot to fill in some forms, which led to demonstrations by farmers who had not received the transfers that they were due, or had obtained them only with considerable delays, because of the inexperience of the relevant government agencies. The danger of such instances will be much larger in the East European countries, which have considerably less efficient administrations than Austria.

In conclusion, the presenter presented a list of derogations that seem feasible for the candidate countries to apply for in the accession process (see Table 2.2). These are in fact packages of derogations, each consisting of from dozens to hundreds of measures under one item in the table. There are two groups of motives for the CEECs to apply for these derogations. The first three items in column 2 derive from the fact that the CEECs are at much lower levels of development than the EU average and may not compete successfully within the EU in various areas. The other group relates to standards the achievement of which may be hard to finance for the candidate countries in the near future.

Table 2.2. Possible Areas Where the Easter EU Applicant Countries may Require Derogation

DEROGATION	MOTIVES OF THE CEECs	IMPACT ON THE EU
Policy measures against current account imbalances	Fear of competition	Losses through competition under unequal condition
Property rights	Fear of competition	Revenue loss due to barriers to market entry
Competition policy	Fear of competition	Revenue loss due to barriers to market entry
Environment	No funding available	Losses through competition under unequal conditions
Social standards	No funding available	Losses through competition under unequal conditions
Co-financing requirements	No funding available	Moral hazard

The EU may also require some temporary exemptions (see Table 2.3), especially with respect to migration, agriculture, and transfers. The derogations with regard to transfers include the phasing-in principle (an innovation not used in the case of earlier accessions) and the condition that enlargement should be financed by growth in the EU (the assumed 2.5 percent GDP growth). Over the last 15 years the average annual growth rate in the EU was barely above 2 percent, while in the last seven years it has clearly been below 2 percent. The likelihood that the 2.5 percent target will not be achieved is high.

This means that assuming that all five CEEC candidates in the first wave implement the accession requirements by 2002, but the EU does not reach the targeted average 2.5 percent growth, there will be either a postponement of accession or further cuts in the promised transfers to the new members, which would in fact be a further derogation on the part of the EU.

Table 2.3. Possible Areas Where the EU May Require Derogation

DEROGATION	MOTIVES OF THE EU	IMPACT ON THE CEECs
Migration	Fear of competition	Revenue loss due to barriers to market entry
Agriculture	Fear of competition	Revenue loss due to barriers to market entry
Transfers	No funding available	Unrealized revenues

Discussion of Previous Two Presentations

One discussant criticized the presentation of Gács by saying that the theory that he presented is totally at variance with what we have learned about the results of lowering tariffs according to the traditional analysis of welfare gains due to allocative costs. The question is whether there is any empirical evidence for such adverse effects of integration; if it is only the bad performance of Greece that suggests these adverse effects, there could be many explanations besides attributing those effects to the outcome of integration. If there is more theoretical support for the existence of this danger, it should be presented.

János Gács agreed that there are many competing explanations for Greece’s dismal performance, and the one that he had presented clearly focused excessively on trade or exchange in general. The theory of imperfect competition applied to trade based on the strength of agglomeration effects emphasizes the advantage of the center over the periphery. Unless peripheral regions offer countervailing advantages that surpass the drawbacks of being peripheral, those regions will lose from the integration in the short and medium run. Simply offering lower wages may not counterbalance the advantages of the center, if many other barriers to exchange persist. Those in the center would continue investing their resources in the center.

The discussant argued that in the case of all other accessions to the EU, accession was followed by an immediate increase in trade, even larger than in the case of Portugal, so the Greek example may not provide guidance on the effects of future accessions.

Another discussant agreed that if the only evidence on the dangers of accession at an inappropriate phase of development is that we do not know exactly what happened in the Greek case, the argument is weak. Recent years show that we have to control for the “Papandreau effect,” that is, if one pursues macroeconomic stupidity at a large scale, you can not expect to catch up. The Greek lesson is that whichever way liberalization is carried out, accession will not bring benefits automatically. The Iberian case is such a strong success story that we should rather be optimistic regarding future accessions. Another discussant mentioned that with the establishment of the single market, that is, from the end of 1992, trade barriers should be the same both for Portugal and Greece.

A discussant raised the issue of whether cohesion countries have any economic interest in supporting the enlargement of the EU to include the East European countries. The former would lose transfers, would face fiercer competition in the markets to which they supply their own products, and few new trade possibilities will open for them by this enlargement.

Another participant responded that, with such reasoning, the previous enlargement would not have taken place. Even Spain, Portugal, Ireland, and Greece must accept the political logic of enlargement. This was the situation when they joined the Union and the conditions that they had to meet were far less strict than the ones that the CEECs must now accept. There will naturally be bargaining over transfers and agriculture, but if Germany favors enlargement and the cohesion countries decide to block it because of expected losses of transfers, the latter should not expect that Germany will go on financing the whole transfer system.

Gács responded to a previous discussant by stating that Greece was simply taken as an example so as to indicate that we should not take it for granted that the abolition of trade barriers will necessarily and always bring advantages for all participants in the game. Moreover, new theories predict results that run contrary to the predictions of traditional trade theories. Since the new theories are based on imperfect competition and the role of economies of scale, phenomena that are more characteristic of trade today than 15 years ago, we must pay attention to those theories.

Another discussant added that Portugal, as a small open economy, has always profited from further openings or enlargements, and this is what the country can expect from the accession of East European economies as well.

A discussant noted that large conflicts of interest will likely be revealed during the accession negotiations over agriculture. They were already present in a mild form during the negotiation of the association agreements. One of the reasons for future conflicts is that the structures of the CEECs with respect to agriculture and rural development overlap with those of the southern countries. No doubt that there will be tensions here and if there will be difficulties and delays in the negotiations, they will originate with the southern countries.

One participant asked Richter whether recent clashes between French President Jacques Chirac and German Chancellor Gerhard Schröder point to a possible revision of Germany’s contribution to the EU budget and the need to reform the common agricultural policy (CAP). Is it realistic to carry out reliable cost and benefit analyses in such conditions of flux? Moreover, will these arguments among EU leaders not delay the accession process?

Richter emphasized in response that since the EU membership requirements have a “moving target” character, it is indeed difficult to carry out cost and benefit analyses. If the task is difficult, that makes it even more necessary to make calculations under uncertain or changing conditions so as to evaluate the possible outcomes. The results of these calculations, however, are obviously conditional and one must interpret them with due caution. He saw a danger in the worsening political conditions for enlargement following the German elections of October 1998. The CEECs, sensing the less favorable political conditions, may be ready to discard any detailed calculations of economic costs and benefits and may show a readiness to join at any cost. There is an approach according to which “the smaller the number of temporary exceptions that we ask for, the sooner we will get into the Union." Richter expressed the fear that with the worsening of the political situation, this approach, which would not be beneficial to the candidate countries, will gain momentum.

A discussant warned that while transfers are beneficial for recipients (in this case, the CEECs), the contributors are becoming increasingly unwilling to provide them even to the cohesion countries. The candidate countries should focus on more substantive elements of the net benefits of accession than simply the transfers.

Another discussant commented on the derogation packages presented by Richter, which were allegedly motivated by the fear of competition in CEECs. Assuming that the first accession takes place in 2005, that is, fifteen years after the transition started and seven years after an industrial free trade area came into existence between the EU and CEECs, there would be not much justification for such a fear. The only field where such a call for protection of the domestic market would be feasible is services, but in this instance a country does not usually lose employment as a consequence of successful competition from foreigners. For the domestic employees, it does not make much difference if the employer is foreign or a domestic one. The examples of Ireland in the EU, and Hungary and Estonia among the CEECs, show that openness to foreign investors (which is required for competition in services) contributes to, rather than prevents, fast development.

Richter agreed that his scheme was very simple and general. In that scheme, three examples are mentioned. One of them is property rights, for example ownership of agricultural (arable) land. This will in the next five to ten years be a very sensitive issue in the four countries covered by the research project which he described.

Another area where an argument can be made for protection from competition involves current account deficits. In the year of accession and the subsequent two to three years, if these countries do not receive exemptions from EU environmental regulations, and firms are burdened by the enormous costs of investing in environmental compliance, and if in other areas there will be no big transfers because of co-financing requirements or limited absorption capacities, one can imagine a rapid deterioration of the balance of payments. In this case government intervention may help avert collapse. It is better to prepare for the possibility of taking temporary measures than to accede and wait to see what happens.

A discussant stressed that current account imbalances may also emerge as a consequence of intensive FDI inflows and that these should not be prevented. Richter replied that he spoke of unsustainable current account deficits, the source of which may be the part of the deficit not covered by FDI inflows.

Another discussant questioned the rationale of applying restrictions to the sale of land to foreigners: if the land is already in private hands, the East European farmers should have the right to sell it to raise money. Moreover, if, say, Dutch farmers buy land in CEE with the aim of setting up large industrial farms, that would be beneficial and help solve the country's agricultural problems. Richter responded that it is more political arguments than economic ones that support derogations over agricultural property rights.

A discussant wondered whether there was not a time inconsistency between the costs of accession, which accrue in the short run, and the benefits thereto, which show up in the long run, especially if accession negotiations are deferred. Is there no danger of fading social support for accession or even a better organization of the opposition against the accession? Richter agreed that most of the costs will appear in the first three years following accession, while the benefits – taking into account the rule of phasing in - will come only later. Temporary exemptions should serve to limit this discrepancy, by pushing the costs into the future and bringing the benefits forward.

Another discussant questioned the rationale for derogations: the East European countries have even before membership opened their markets in a wide range of industrial goods to the EU countries. Why do they need derogations when membership brings with it increasing benefits? Richter again reminded the audience of the possibility of a crash scenario which can occur as unexpectedly as the output decline that hit the East European countries at the beginning of the 1990s. This time, derogations could prevent the emergence of such unexpected tragedies, which come about due to insufficient preparation for changes which are eventually beneficial.

The discussant replied that this kind of argument helps Western opponents of accession, who argue that the East European countries are not prepared and could use as evidence the fact that East European experts are expecting a crash. Richter warned against mixing political and economic arguments: even if opponents say this because they want to prevent accession, it should not prevent East Europeans from considering all the possible scenarios.

Another participant criticized Richter's comparison of possible accession shocks with the output decline experienced at the start of transition in CEE. Transition was a jump from a relatively consistent system – good or bad – to a lack of a system; the new system had to be created during the transition with the development of the basic institutions of the market. Accession, however, is aimed at joining the group of developed and relatively mature market economies with already built up institutions. We should not expect a similar collapse due to not being prepared for the changes. It is easier to join other market economies than to start building a market economy from scratch.

A discussant agreed with Richter that, given that the obvious goal for the small, open East European economies is to join the EU and adjust their regulations and legal norms to those of the Union as completely as possible (and given that the decision about the time of accession can hardly be influenced by them), there is a danger that these countries will not carry out rigorous cost and benefit analyses of the accession process. There is a great deal of ignorance about the methodology of such calculations in the ministries and other institutions responsible for such assessments. It is no surprise that the costs of no accession have not been analyzed either. This lack of analysis is also characteristic of the EU's side. It does not seem interested in investigating the political and social consequences of postponing the first accession from 2002 to a later year. However, by not identifying the possible gainers and losers from this delay, there is a danger that there will be more losers than there would otherwise have been.

In his final response, Gács emphasized that history shows us that the benefits of accession usually begin considerably before the event occurs, because the prospect thereof already affects the decisions of such agents as foreign investors in favorable ways. The candidate countries must introduce the legal and regulative changes that make them part of the single market much before they become members *de jure* of the

Union. That also means that some of the benefits which were directly related to the establishment of the single market in 1985-92 will already be felt before accession, so the time inconsistency of costs and benefits is probably not as strong as has been emphasized in the discussion.

As for the possibility that public perceptions could be influenced by the alleged time inconsistency, one must recall the very fast turnaround in the public perception of the Union from favorable to unfavorable in Austria, and even more so in Sweden following their accessions. The general feeling is that this change in opinion had little to do with economic developments (i.e., the benefits or the lack of such), but can be explained more adequately by social psychologists than by economists.

In his final remark, Richter stressed that despite the pessimistic approach of his presentation, he has long been a devoted supporter of enlargement. Unfortunately, political and economic discourse on these issues is burdened by real and assumed, overt and hidden, messages and counter-messages that make sincere evaluations impossible. One has to have the courage to relate one’s opinions, which may be opposed to those of one’s fellow scholars, without taking into account political messages.

3. Approaching EU Environmental Requirements

3.1 Environmental Standards in CEE Countries – “Wahrheit und Dichtung”[16]

The presenter began by expressing his gratitude that environmentalists had been invited to a meeting of economists and hoped that this is a sign of changing attitudes on the part of the latter. He mentioned that in addition to being a professor at the Charles University, he is also a member of the negotiating team of the Czech Republic responsible for Chapter 22 (which deals with the environment) and also for such “simpler” chapters as those on research and education. In that capacity he collaborates with the Czech Ministry of Environment, which is responsible for environmental issues during the negotiations.

The environmental chapter is regarded one of the most complicated, difficult, and longest of the 31 chapters about which negotiations are taking place. One of the reasons for this is the fact that there is such a large number of environmental directives and other legal acts which must be transposed from the EU in comparison with the other chapters. This is in contrast with the fact that in no country are environmental ministries regarded as important bodies. As an environmentalist, the presenter expressed his satisfaction that through the accession process the visibility of and emphasis on environmental issues is being enhanced. However, he also acknowledged that this process was inherently difficult, as emphasized by a communication by the Commissioner Ritt Bjerregaard in May 1998 (see Appendix I).

Bjerregaard identified four challenges in the environmental field:

[16] This section summarizes the presentation by Bedřich Moldan.

(1) the legal challenge: the sheer quantity of legislation that must be transposed, including 13 subchapters, each containing many directives and other legal acts, altogether over 300 legal acts, and more than 60 important directives;

(2) the institutional challenge: the legal acts, after adoption must be implemented by institutions;

(3) the financial challenge: the environmental measures and activities must be financed; for instance, in the Czech Republic, the total amount needed to fulfill EU accession requirements is $1-1.5 billion. The country has already spent 2.5-3 percent of GDP on the environment for five consecutive years, but still will not be able to attain full compliance by the time of accession, mainly for financial reasons. Accordingly, the Czech Republic could request a number of transitional periods, although it will make only a few such requests. The Czech negotiating party, and this is true for all the first wave countries, is not counting too much on financial transfers from the EU at this stage of accession. Realistically, such transfers might amount to 5-15 percent of total investment, so the majority of the funding will have to come from the candidate countries.

    The OECD began to publish a series Environmental Performance Reviews for different countries several years ago. The first of such reviews was made in 1995 on the relationship between the economy and environment in the U.S. The empirical evidence found for that country, repeated later for Sweden and other countries, showed that the net effect of environmental measures on the economy (on GDP, for instance) was either negligible or positive, but certainly not negative. It was also found that there is a very small but positive effect of environmental measures on employment.

(4) the sectoral challenge: several sectors are identified by the Commission as the most difficult ones: these are water pollution, air pollution, waste treatment, and nuclear safety. The last of these is important especially in those countries where there are nuclear power stations with old Soviet graphite-based reactors. In this respect, there are large country differences: Poland, for instance, has no such reactor, but faces a threat from such reactors in neighboring Lithuania. In other sectors, however, there are common problems, for instance, those affecting the water sector. Recently, negotiators from six countries met and reached the common understanding that this sector is probably the most difficult one for all the accession countries; it will demand the greatest efforts and most likely the bulk of investment.

The implementation and enforcement of the transposed standards poses a specific problem. In most candidate countries, environmental standards were already in place under the totalitarian system, and in many cases they were even stricter than those in the EU. But these standards were largely for declarative purposes and compliance with them was negligible.

A negligent attitude toward compliance with environmental regulations was an example of the overall perception of the legal system under the old system and is a strong barrier to accession. We must persuade and educate our population of the necessity of following legal prescriptions. The unwillingness to implement rules and regulations also reflected a refusal to accept hard facts and requirements, and a willingness to succumb to illusions and the hope that it will not be necessary to follow the difficult road to genuine solutions. These old attitudes another barrier to accession that the candidate countries must overcome.

3.2 Environmental Requirements of EU Accession – The Commission's View[17]

The Copenhagen Council meeting defined the accession criteria, including political and economic criteria as well as the adoption of the acquis (the transposition of the body of EU legislation), its implementation and enforcement. The 300-odd pieces of legislation mentioned by the previous presenter represents the EU's policy on the environment.

The early directives of the late 1970s and early 1980s included rather narrow directives, such as those on bathing water (1976), wild birds (1979), and the titanium dioxide industry (1978). Recently, not only has the number of pieces of legislation increased (in fact, exponentially), but also the concept has become more comprehensive. Accordingly, we have now a number of framework directives on certain sectors, such as air, waste, water, which will be filled in by specificities at a later stage. A framework directive, the IPPC (Integrated Pollution Prevention Control), covers a broad range of industrial sectors, and requires that they reduce pollution in an integrated way. In addition, there are horizontal directives, two of them very important, one on access to environmental information, and another on environmental impact assessment. Both of them were developed to inform the public and involve it more in the process of decision-making on environmental regulation.

As mentioned earlier, the adoption of the acquis is necessary, and derogations in the strict meaning of the word will not be possible in the course of the next enlargement. However, candidate countries can apply for transition periods. The Agenda 2000 document has already raised the possibility for such transition periods, although they should not be taken for granted but will be achieved as the result of the negotiation process. The candidate countries will have to come up with specific implementation programs, including justifications for transition periods, their suggested length, and a listing of what they are going to do during that period to come closer to meeting the targets. The Commission does not want that they waste the transition period by doing nothing and apply for another transition period again in, say, ten years. In fact, we recommend that the countries also develop implementation programs for those targets that they plan to achieve before accession, in order to lend structure on their thinking on how to achieve compliance.

In early 1997, DG XI launched a study on "Compliance Costing of Approximation of EU Environmental Legislation in the Central and East European Countries" (for the relevant internet address see Appendix I). It was a summary of existing studies, including one study that had been prepared by IIASA, rather than a new one. The results are summarized in Table 3.1. This study does not cover the whole acquis, but only those directives that the Commission considers to be investment-heavy, such as urban waste water treatment plants, large combustion plants, waste management, incineration of hazardous and non-hazardous wastes, and so on. Costs related to legal transposition, administrative changes, monitoring networks, and so on, are not included.

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[17] This section summarizes the presentation by Margareta Stubenrauch.

As the table indicates, the range of estimates for total investment needs is rather horrifying, standing between ECU 108 and 122 billion for all the ten candidate countries. Given Poland’s size, it takes accounts for one-third of the total costs of the ten countries. The distribution of the costs is such that about 40 percent goes for water, another 40 percent for air, and 20 percent for waste. The cost estimates are most accurate for the water sector and less so for the other two sectors. Other studies and calculations by some of the candidate countries have come up with estimates of the same magnitude, although there is a tendency for those estimates to be closer to the lower bound of the Commission’s estimates.

The Commission has not carried out calculations on the benefits of environmental compliance. One reason for this is that it is very difficult to quantify those benefits. Nevertheless, we believe that the adoption of the acquis on the environment in the candidate countries will lead to a better environment, and in the medium term it will also bring economic benefits, because industries will be more competitive, and environmental infrastructure, such as waste management, access to drinking water, waste water treatment, and so on, will be set up in a more sustainable and competitive way.

The Commission is ready to provide assistance to this process. But there should be no illusions: the Union is not going to pay for the enlargement in general, and not for the environmental part of it. The speaker confirmed what the previous presenter had said to the effect that the main efforts will have to come from the accession countries themselves. The countries will have to mobilize financial resources also from elsewhere (from international financial organizations); the Commission hopes that its own support can play a catalytic or multiplicative role in the process. Up to now the major assistance program in this line was the Phare program: between 1990 and 1996 ECU 6.6 billion has been transferred to the transition economies, of which 8 percent has been devoted to the environment and nuclear safety.

More recently, the Phare program has been transformed into one directly oriented to accession. From the year 2000 onwards, we will have a new program for the environment called ISPA (the acronym of Financial Instrument for the Pre-accession Phase in French), worth ECU 1 billion every year for all the candidate countries, split in equal proportions between transport and the environment. Th experience of the cohesion countries (where this instrument was tested) shows that in the early years more money is spent on transport than on the environment. Accordingly, environmentalists urge candidate countries to start developing their environmental projects as early as possible, so they do not suffer from a delay in the utilization of funds available due to a possible lack of projects.

Table 3.1 Total Investments for Approximation for the CEEC (billion ECU)

	Water			Air	Waste		Total investment		Total/capita (ECU)
	Supply	Waste-Water	Total		Min.	Max.	Total min.[1]	Total max.[1]	
Poland	4.4	13.7	18.1	13.9	2.2	3.3	34.1	35.2	927
Hungary	3.5	3.1	6.6	2.7	2.1	4.4	11.5	13.7	1,306
Czech R.	2.2	1.1	3.3	6.4	8[2]	3.8[2]	10.4	13.4	1,427
Slovak R.	1.0	0.9	1.9	1.9	0.3[2]	1.60[2]	4.1	5.4	760
Bulgaria	2.2	2.7	4.9	5.1	1.8	5.1	11.7	15.0	1,668
Romania	3.8	6.3	10.1	9.1	1.0	2.7	20.2	22.0	943
Baltic total				8.45	0.45	0.85	8.90	9.30	1,148
Estonia	0.13	1.38	1.50				1.50	1.50	n.a.
Lativa	0.11	1.60	1.71				1.71	1.71	n.a.
Lithuania	0.11	2.27	2.38				2.38	2.38	n.a.
Slovenia	n.a.	n..a.	n.a.	0.69	1.15	1.15	1.84	1.84	n.a.
Total	17.5	33.1	50.5	48.2	9.7	22.7	108.4	121.5	1,140
% of total max.	14%	27%	42%	40%		19%		100%	

1 Total min. includes the minimum estimate for landfill, total max. includes estimate for waste management
2 70 percent of the total estimate for the Czech and Slovak Republics is attributed to the Czech Republic, and 30 percent to the Slovak Republic.

Source: Compliance Costing for Approximation of EU Environmental Legislation in the CEEC, April 1997, ECD Ltd, CDublin and EPE asbl, Brussels p. 91. (http://europa.eu/int/comm/dg11/enlar/comps.htm)

At the end of her presentation the speaker presented a list of useful European Web site addresses for access to environmental and approximation information, which the reader will find in Appendix I.

Discussion of Previous Two Presentations

A discussant asked whether a process in which energy sources are priced gradually higher every year is under way in order to induce producers to eliminate energy-intensive and polluting industrial structures and technologies? Moldan answered that this process is going on in all the countries. Most advanced are Poland and Slovenia, where the prices of energy are much higher than it used to be. Water in the Czech Republic, for instance is currently ten times more expensive than it used to be in communist times, and restructuring is certainly going on in every country, with beneficial effects on the environment. There has been a steep decline in pollution (i.e., in emissions into water and the air), certainly partly due to the output decline in the transition economies in the early 1990s, but also due to efforts in the spheres of legislation, implementation, and enforcement. In this respect, strategic industries, however they may be defined, have not been exceptions.

Another discussant noted that from the presentation of Stubenrauch he learned that for Poland, investments in environmental compliance would amount to about $4 billion per year if the total amount is spread over ten years. However, calculations for Poland carried out by the Vienna Institute for Comparative Economic Studies showed that, after accession, Poland would get a net annual transfer of $1.5-2.5 billion from the EU (except for agriculture). What will then be Poland's net position? Another participant commented that it is not the EU's task to solve Poland's environmental problems and if there are real ecological dangers, Polish taxpayers should come up with the funds. Moldan repeated that according to Czech estimates, the EU could provided 5-15 percent of the funds needed for environmental compliance. Certainly, there are other opportunities to obtain foreign finance, although not as grants (the 5-15 percent would be in the form of grants).

A discussant explained that, provided that the candidate countries have sound economies, with the correct prices and no distortions, the raising of the necessary funds for environmental compliance, including the installation of the necessary equipment, would not be as much of a burden as it may appear. According to calculations carried out by IIASA's Transboundary Air Pollution Project, most of the necessary investment could be financed from private consumption; this is especially the case for the 80 percent of the costs that arise in the transport sector. For instance, people can buy cars fitted with catalytic converters. Ten years ago, if a car had cost $500 more, it would have been a disaster for consumers, but by now in the majority of the accession countries this additional cost is negligible. Also a slightly higher price of fuel can be easily absorbed by a cut in fuel taxes. Naturally, if prices are not appropriate, if electricity prices cover only 50 percent of production costs, an increment to electricity costs caused by installing filters will seem to cost a lot. But if prices cover costs, the additional costs be no more than 10 percent.

Stubenrauch was not so optimistic as the discussant, but agreed that while no country can comply within two years and without sacrifices, compliance is indeed feasible. The period before accession plus the transition period provide sufficient time for the CEECs to achieve something. As for the benefits, the governments of the candidate countries must make it clear to the public that compliance is not just to satisfy Brussels, that installing waste water treatment facilities brings benefits mostly for the indigenous population, by giving them a healthy and natural environment where their quality of life will be better.

Another discussant said that he was struck that the perception of environmental issues in Europe is so different from that in the U.S. and Mexico in the context of the North American Freed Trade Agreement (NAFTA). Those who were pro-NAFTA did not pay so much attention at the environmental issues, while the environmental card was used as a weapon by the opponents of the agreement. They emphasized that Mexico was poor, and the agreement would put a terrible burden on Mexico if it had to apply U.S. environmental standards. We should also take into account the fact that the difference in level of development was much larger between Mexico and the U.S. than that between any of the candidate countries of the first wave and the EU.

Having common environmental standards in Europe without regard to the level of economic development may not make sense; it is probably dictated more by ideology than some sort of economic logic or optimizing model.. The European position is not necessarily wrong, although it is clear that it is very different from how this issue is dealt with in other kinds of free trade agreements around the world. The poorer the country, the more burdensome the requirement of environmental compliance is for it. For instance, the ECU 12-15 billion in investment indicated in Table 3.1 for Bulgaria equals to one or one-and-a-half year's GDP for that country. With such poor countries, nominally small amounts of outlays are relatively high.

Stubenrauch emphasized in response that the EU is totally different from NAFTA: it is more than a free trade agreement, since it has common standards and the acquis. Moreover, the environmental acquis is as much the part of the legal rules as those of the internal market. As for different standards, a closer look at the directives indicates that there is a certain room of maneuver in their implementation. Certain requirements require uniform compliance, but there are others with which the member states can deal in their own ways. In the future, such large states as Germany, France, and Poland will solve various problems in different ways from such small ones as Luxembourg or Slovenia.

Moldan expressed his feeling that he does not expect that there will be any possibility to apply different standards in various parts of Europe. The continent is relatively small, countries share this space.

A discussant asked whether there is a difference between requiring that environmental standards or apples should be the same and requiring that wages be the same in member countries. Another participant rejoined that in Europe it was decided that different environmental standards would be sources of unfair competition. This mindset may be inexplicable to Americans, but it is how European politicians decided on this issue. Moldan strongly emphasized that environmental standards and wages are completely different. For such very poor countries as Bangladesh, this logic would imply that the inhabitants should drink arsenic-tainted drinking water.

Another discussant noted that environmental requirements are different from other requirements from a political point of view. His experience at the Macroeconomic

Policy Council of Poland's Ministry of Finance suggests that there is social support for environmental expenditures and people would not blame the EU for forcing such expenditures on the country. Restructuring the coal sector is a much more controversial issue in the eye of the public. In certain areas, the accession process makes it necessary and possible to use some tricks, allowing politicians to push responsibility for unpopular actions on to the EU.

A discussant referred to recent reports that presented a very gloomy picture of environmental security in Greece, and asked whether the acquis only applied to new applicants, and whether some of the members, such as Greece, Portugal, and Ireland have already reached the environmental standards that are now strictly demanded of the new applicants.

Stubenrauch bluntly stated that this accession is not about Greece, which joined the Union in 1981. She added that there is an instrument to take member states that do not comply with legislation to court. Moreover, member states, both those with good and bad reputations, are constantly being taken to court, particularly in the context of environmental requirements; even Germany, Austria, and Denmark have been sued. In the long run, being taken to court means something, it is unpleasant to be frequently accused of violating certain common rules. In addition, another instrument ensures that member states who do not comply with certain rules pay a daily fine until they sort out this problem. For instance, there is a law on groundwater (passed in 1980) that Germany failed to implement for 18 years, but when the threat of a penalty was raised, it was able to implement it in a few weeks. For candidate countries, the Union must avail itself of every opportunity to achieve compliance before accession, but after accession the available instrument is to take the country to court.

A participant drew the audience's attention to the fact that the EU's position on environmental matters was hypocritical. Everybody knows that the CAP is one of the major sources of pollution of the natural environment in Western Europe and nobody seems to care about it. Some participants at the seminar disputed whether the coming reform of the CAP would reduce this pollution. One discussant mentioned that there is a principle in the EU that the one who pollutes is responsible for making reparations, but agriculture falls completely outside of the scope of this principle. Incentives in the CAP have until now induced farmers to use more and more fertilizer, but there is also the option of giving money to farmers not to use fertilizers. The most logical and immediate solution to this problem would be taxing the use of fertilizers, especially nitrates.

Stubenrauch emphasized that there is a directive in the acquis on the encouragement and enforcement of the countries' reductions in nitrate pollution. The problem has been recognized, although perhaps not sufficiently. The Cardiff Summit in June 1997 went further than the Amsterdam Treaty (which contained the expression "sustainable development"), and suggested integrating environmental policies into the policies of other sectors more than heretofore. One of the sectors where this review should be carried out in the future is agriculture. A discussant suggested that another strong point in the Amsterdam Treaty, consumer protection, should make an alliance with environmental protection (under DG XI) so as to deal with such sectoral problems as those pertaining to agriculture.

In conclusion, Moldan emphasized that negotiations are a two-way process. The EU itself is continuously changing, but the candidate countries should also do as much as possible to comply with its directives. CEE, however, is not only a liability for the EU but it also has assets which are increasingly recognized by the EU, especially by DG XI. One such asset is the generally high level of bio-diversity of transition countries compared to the member states of the Union. One hopes that they will be able to preserve it and bring it with them into the EU.

4 Costs and Benefits of Joining the EMU – Fast or Delayed

4.1 Costs and Benefits of Accession with respect to Instability of Financial Markets and Vulnerability to Asymmetric Shocks[18]

On world financial markets there have recently been two major occurrences which have had a strong impact on such markets in CEE, and which may have consequences for the design of their strategy for accession to the EU. The first was the combination of the Asian currency crises, the speculative attacks on the Czech koruna in 1997, and some repetitive instability in 1998, and the second was the Russian crisis of August 1998. Discussion of the reasons for the spillover of these crises to the transition economies has pointed to three factors.

First, there is a common systemic factor. An example of this was the Czech Republic's absorption of the crisis affecting the Thai baht in late June 1997. The Czech Republic was perceived as having an exchange rate regime similar to Thailand's, a leftover of a peg with a widened band that permitted fluctuation, and was experiencing a large current account deficit, as was Thailand. Geographical proximity no longer plays such an important role for financial market spillovers, since financial markets have become so highly integrated.

Another example of systemic factors was the absorption of the Mexican currency crisis of December 1994 by the Philippines. Again, this country was perceived as having similar problems to Mexico. A systemic factor that played a role in triggering the Asian crisis was the relationship between the savings/GDP ratio and the investment/GDP ratio. For instance, Malaysia in 1997 achieved a 42 percent investment/GDP ratio while its savings/GDP ration was only 36 percent. Under these circumstances, it is impossible not to have a large current account deficit, which is in fact what happened in Malaysia, Thailand, the Philippines, Korea and to some extent Indonesia, where an enormous rate of investment emerged in relation to an already high savings rate, inevitably leading to a current account deficit. Similar developments occurred in the Czech Republic, and Poland may not avoid this trap in the future either.

The second platform for spillovers between countries is through bilateral trade and capital flows. Despite the recent contraction of East European countries' trade with Russia, these countries are still linked to their former leading trade partner. In the case of Poland, for instance, currently 8 percent of exports go to Russia and 12 percent to the CIS.

The third platform of spillovers is the so called pure contagion effect, as discussed in the recent literature, by, among others, Richard Cooper, and in earlier literature by Andrei

[18] This section summarizes the presentation by Lucjan Orlowski.

Shleifer. Here a major role is played by herd behavior, whereby in a broad group of emerging financial markets all investors act in the same direction without really thinking about it. Bandwagon effects driven by asymmetric information – which are characteristic of underdeveloped financial markets in emerging economies – may involve moral hazard and, together with other factors, lead to a "flight to quality" on bond and stock markets (i.e., a switch to low-yield bonds on non-emerging markets).

The Russian crisis has had more pronounced effects on CEE than the Asian crisis, so in the following the presenter focused on the Russian crisis. As an effect of the Russian crisis, there had been a reduction in forecasted GDP growth in Poland in 1999 from 6.1 to 5.1 percent. East European countries have experienced a decline (of about 30 percent) in their exports to Russia and the CIS, especially exports of food products, household durables, textiles, and footwear. Only guaranteed exports are currently expected to continue.

There has already been a drop in the volume of so-called cross border (unregistered) sales between Poland and its eastern neighbors. As a consequence, the decline in Polish unemployment has decelerated. Many persons who earned the bulk of their incomes from cross-border sales (even if they had registered jobs elsewhere) have applied for unemployment benefits after losing those incomes. Losses have also been recorded in agriculture and food industry, as well as in sectors effected by declining commodity prices. However, the contraction on East European stock exchanges has been nowhere near as severe in CEE as it was in Russia. From 31 December 1997 to the beginning of November 1998, the Russian stock exchange suffered a 92 percent drop in USD terms, while the Czech stock exchange declined by 14 percent, the Polish one by 16 percent, and Hungary's by 32 percent.

An interesting issue is the nature of possible defense mechanisms, with the help of which East European countries can decouple themselves from Russia. In this respect, one must acknowledge that since the beginning of the economic transformation a significant shift of exports from East towards the West has occurred in the East European region. The shift in the Czech Republic was even more spectacular than that in Poland. One also has to take into account the fact that economic reforms in CEE have advanced rapidly in comparison with the hesitant and indecisive steps taken by Russia.

The CEECs have also shown great inventiveness in arranging sophisticated barter deals when the inability of partners from Russia (or other member-states of the Commonwealth of Independent States) to pay in cash became evident. Another major difference between Russian and its CEE partners is in the field of fiscal discipline: the fiscal mess in Russia is exemplified by (unconfirmed) reports that in the first six months of 1998 the Russian federal government collected only 5 percent of the total tax revenue projected for the whole year. In contrast, the Polish, Hungarian, and Czech governments are committed to low deficits, and tax revenues are increasing. Fiscal discipline is a precondition for solid financial performance, because any loosening on the fiscal side can backfire in very strong contagion effects and the type of liquidity crisis we are observing in Russia.

In CEECs there is a need to change monetary policies from backward-looking discretionary reactions to forward-looking and more stable policies. It has been proved in recent economic history that countries applying direct inflation targeting, for example, the U.K., Sweden (immediately after the crisis of the exchange rate mechanism or ERM), or Canada (in the early 1990s), managed to control inflation much better than countries applying other monetary policies. This policy works if there is a very high degree of instability in the demand for money.

Since the financial crises of 1997 and 1998 have generated such unstable demand, an appropriate monetary policy would be forward-looking policies with direct inflation targeting. This policy allows for smoothing out expectations and thus smoothing out the demand for money, thereby making monetary policy more transparent, predictable, and credible. It better contributes to price stability, the ultimate goal of monetary policy, than other policies.

Another difference between the CEECs and Russia is the limited interference of political parties in privatization plans in the former, as opposed to the strong interference in the latter before March 1998 under the government of Viktor Chernomyrdin. Naturally, the best excuse for decoupling these countries from Russia is their candidacy status with the EU, which gives them a commitment to pursue structural reforms, a clear vision, and incentives to continue those reforms. Russia, however, currently has no such incentives to carry out structural reforms.

The next question is, what should be done to minimize enlargement expenditures on both the EU and candidates' side in response to instability on financial markets and to the Russian economic crisis? The focus should be first of all a fast-track implementation of institutional reforms related to financial markets. In order to diminish spending, for instance, opening up capital markets and allowing competition is a better solution than applying capital controls. A recent WTO report on capital markets conveyed a clear message that the countries that have liberalized their capital accounts have had much lower interest rates and higher degrees of banking competition, which allowed to them to cushion themselves from the financial jitters in Mexico and Asia. Conversely, the countries that apply capital controls and do not allow competition by more efficient foreign banks and other financial institutions are more affected by crises on foreign capital markets.

Another task is to build more transparent and credible monetary and fiscal policies. Transparency means that the leaders of central banks must communicate more directly with society concerning economic issues. So far, this has not been done very well in Poland. The introduction of the Monetary Policy Council of the National Bank of Poland in 1998 has significantly improved the transparency of monetary policy. This council has hosted much discussion of the options and provided a means of control over bureaucrats: the staff of the central bank cannot adopt some sort of discretionary, secret, and unpredictable monetary policy.

To cushion external shocks and minimize asymmetric information in the financial system, monetary policy should be forward looking. There is a need to diminish indexation of prices, wages, and other nominal quantities. Indexation based on adaptive expectations is strong in the presence of backward-looking policies, when the central bank concentrates on interest rate targeting and the policy is implemented through frequent discretionary adjustments. It is better to base indexation on inflation forecasts, rather than on past trends.

As for exchange rate policy, the presenter suggested a flexible exchange rate without rushing to ERM II. It may sound strange, but it is true that establishing the credibility and autonomy of the central bank is better achieved by following a flexible exchange rate with direct inflation targeting than by exchange rate targeting (targeting the euro).

Finally, one has to emphasize the need for capacity building and institutional development in the financial sector. This is the most important institutional task for strengthening the resistance mechanism of CEE economies to financial shocks.

4. 2 Inclusion of the Central European Countries in EMU[19]

The presenter started with the analysis of the current diversity of exchange rate regimes with the help of the upper part of Figure 4.1 In the dimension of flexibility these regimes range from fixed (under currency board arrangements) in Estonia, Bulgaria, and Lithuania to (managed) floating in Slovenia. Between them we find the countries that used to have fixed rates (at least until recently), such as the Czech Republic and Slovakia, and countries with crawling pegs with narrower and wider bands.

What happens as these countries approach EU membership and subsequently participation in EMU? There will be a realignment of exchange rate regimes in these countries toward the fixed exchange (see arrow with continuous line), until, after joining the EMU sometimes between 2005 and 2010 or later, the rates become permanently fixed. However, what we are witnessing recently is that the countries are not moving in this assumed direction, but in the other one, that is, toward more flexible exchange rate regimes in different forms (e.g., floating or establishing wider bands) (see arrow with stacked line). Economic reasons push these countries toward more flexible regimes, while institutional ones will push them in the more fixed direction.

Accordingly, the question arises as to what in fact will change among the economic factors to allow a shift from one trend (stacked arrow) to the other one (continuous arrow), and when? Will financial crises in other parts of the world (with their impact on CEE) cease to occur, or will the circumstances in the countries themselves change so much as to make them able to move toward a fixed exchange rate? There is also the possibility that it will be institutional necessity, rather than economic logic, that forces the countries to move to a fixed exchange rate regime, something that these countries would take as a price for joining the EU.

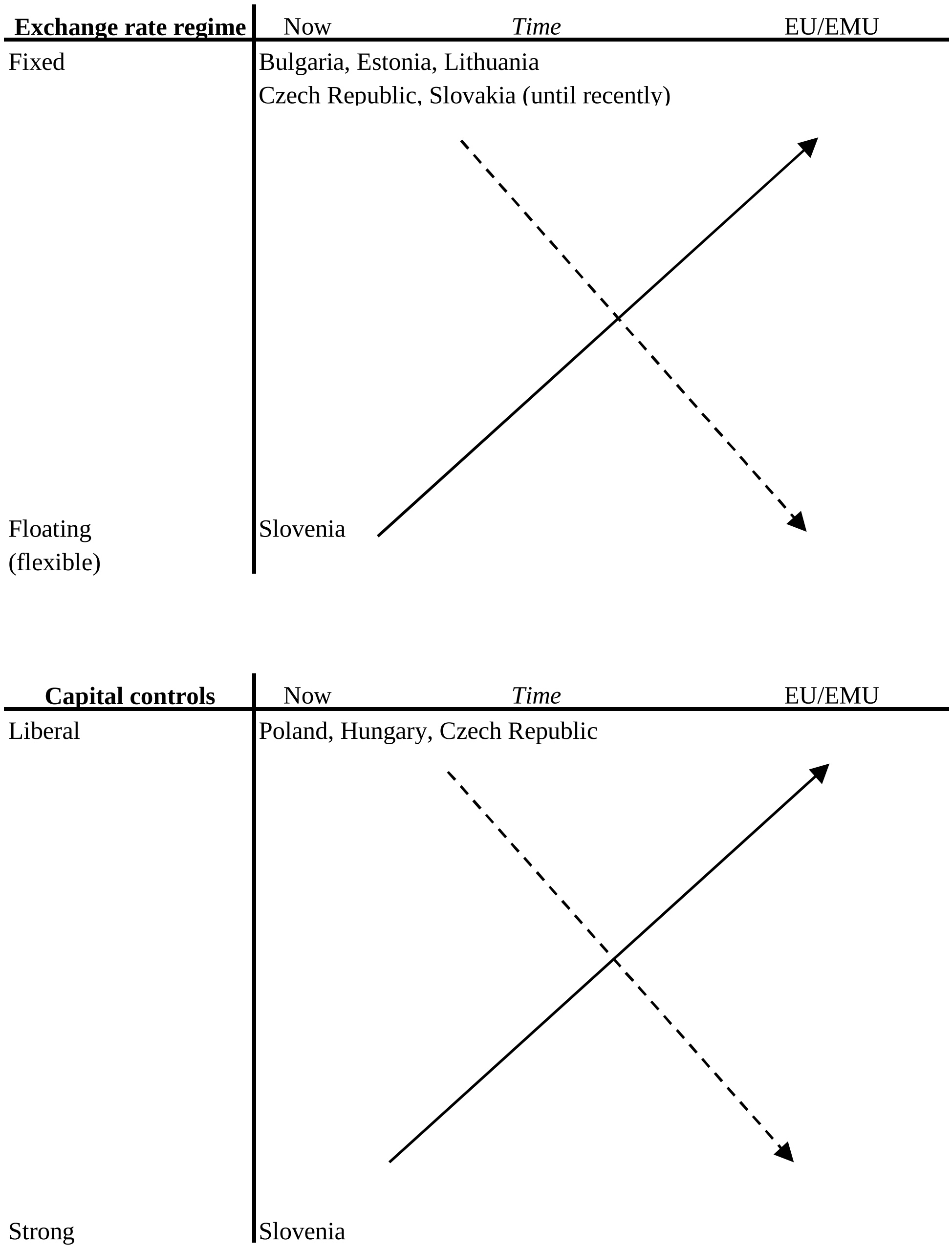
The position of the East European countries in the chart may tempt one to think that this is also a ranking of the economies according to their readiness for monetary integration with the Union. Would this mean that Bulgaria is so mature that it is already in the monetary union? Moreover, are the floaters the bad guys?

A story similar to the one on exchange rate regimes could be told about the extent of capital controls (see the lower part of Figure 4.1). On one side are Poland, the Czech Republic, and Hungary with fairly liberal regimes, while on the other is Slovenia, which is recurrently criticized by the Commission for its capital controls. While the requirement of EU membership would push countries toward more liberal regimes, the current situation (especially the consequences of financial crises) induces them to apply more capital controls. Even if they resist this temptation, they are certainly keeping their

[19] This section summarizes the presentation by Vladimir Lavrač.

present position in terms of capital controls, rather than following the trend toward liberalization necessitated by institutional factors.

Figure 4.1
The Road to the Monetary Union



Taken all this into account, one can pose the question, why and how are the candidate countries expected to join EMU? Given that negotiations on membership have already started, these countries must prepare a strategy on capital liberalization and adoption of the acquis with respect to EMU.

It is clear that, given the Copenhagen criteria, the candidate countries are not free to choose about joining EMU, since sharing the aims of EMU has become part of the acquis. Another question is whether ERM II is obligatory for them. Here the answer is not so straightforward, but basically, for the CEE candidate countries, ERM II is a mandatory phase before mandatory membership in EMU. (It is not yet clear with what kind of bands, whether the current option for narrower or wider bands for pre-ins will be maintained for the CEECs or not.) The question for the CEECs does not concern whether they will become members of ERM II, but timing and conditions.

The formal conditions for EMU membership are the same as for current EU members, namely, the Maastricht criteria. Theoretically, there is also the option, currently followed by Sweden, of tactically pretending that, for the time being, the country is not able to fulfill the Maastricht criteria, and thus postponing EMU membership.

As for the costs and benefits of EMU membership, one should only make analytical, and not political assessments, since this is an obligatory step. In general, we speak of the same benefits and costs, quite well known from analyses, that apply to current EU member states, taking into account the differences in the level of development between the current members and the candidate countries. CEECs would lose, as the current Euroland members do, the possibility of pursuing their own monetary policy, which, in fact, has become relative anyway, given the gradual opening of the countries to the flows of capital.

The other effect is losing the exchange rate as an instrument. This tool has been used in the candidate countries for policy purposes, so losing it will be a real loss. The size of this cost is difficult to assess and one has to consider the particular characteristics of a given country, such as the structural characteristics of its economy, as proposed by the theory of optimum currency areas. For instance in countries with structural characteristics such as Slovenia's, the relations of benefits and costs seems favorable. It is a small and open economy (at least as far as trade is concerned). In addition, as empirical research carried out in the framework of Phare ACE projects shows, Slovenia has a trade structure similar to EU member countries, which indicates that less asymmetric shocks can be expected than would be the case where they are dissimilar. Another finding is that Slovenia's development is relatively well-coordinated with cycles in the EU, especially those in Germany.

How and when should the candidate countries move to the EMU? There are three theoretical possibilities: (1) entering EMU before joining the EU (improbable); (2) entering the two integrations simultaneously (also less probable, although possible in the case of long delays in EU membership negotiations); (3) entering EMU a couple of years after entering the EU (this is the most realistic possibility for both formal and substantive reasons). In fact, in Slovenia's "Strategy of European Integration," it is envisaged that the country will join the EU in 2002 and EMU in 2005.

The explanation for why the third scenario is the most realistic one is first that the candidate countries will probably need a substantial amount of time to fulfill the Maastricht criteria in a sustainable manner, including making the necessary structural reforms. The second (formal) reason is that the country has to take part in ERM II, observing its normal bands and not devaluing its currency, for at least two years before joining the EMU.

Given the high probability of a long period of negotiations, academics have recently developed a novel proposal. In case of a delay in EU negotiations, combined with favorable economic developments in the candidate countries, there should be a change in the Commission's scenario that only after the formal fulfillment of the Maastricht criteria, and following EU membership, can the candidate countries join ERM II. Perhaps the Maastricht criteria should be interpreted less formally, by paying more attention to actual stability and letting the candidate countries join ERM II earlier. The presenter shares this view. The reasons behind the proposal are that if the proposal is accepted, ERM II would really mean a group of countries, rather than only two countries. The strange situation that the candidate countries must wait for two years in the ERM II phase due to formal rules would be avoided. Being formally involved in ERM II from an earlier date, these countries could better prepare themselves for full integration.

Finally, the presenter gave a short account of Slovenia's fulfilling of the Maastricht criteria. The fiscal stance shows a very favorable picture, with a balance of 0 percent of GDP for several years and 1 percent in the last two years. Public debt stands at about 30 percent of GDP (although this is calculated in not quite the same way as the Maastricht terminology prescribes). The annual inflation rate is about 8 percent. While in Slovenia there is no instrument for measuring the long-term interest rate, it can be approximated at 15-20 percent. Finally, due to the floating exchange rate regime and the fluctuating nominal exchange rate (and also because it has not been a member of ERM II for two years), Slovenia does not fulfill the Maastricht exchange rate criterion.

4. 3 Approaching the EMU in the Context of the Currency Board System: The Risks of the Different Scenarios[20]

Currency boards have become surprisingly popular recently. The list of those countries that apply them includes Estonia, Lithuania, Bulgaria, Bosnia-Herzegovina, Argentina, Hong Kong, Djibouti, and the countries affiliated with the Eastern Caribbean Central Bank. From history, we know that currency boards operated earlier in Ireland and Malaysia. As for the future, suggestions have been made to set up currency boards in Indonesia and Russia.

The last decade in Europe has been characterized by the integration of markets, which will likely continue with the integration of the CEECs into the EU. The launching of EMU stage III from January 1, 1999, brings with it new economic realities for the candidate countries. The pre-accession positions of the candidate countries differ greatly in such dimensions as purchasing power, competitiveness, prices and the inflation level, and monetary arrangements. Convergence towards EMU standards is taking place in different circumstances and possibly under different sequencing of reform of the financial sector.

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[20] This section summarizes the presentation by Ilmar Lepik, who, at the beginning of his talk emphasized that his views do not necessarily represent those of the National Bank of Estonia.

Another important factor, already discussed at this meeting, is the turbulence on world financial markets which, unfortunately, coincides with the convergence of CEECs toward EMU standards. This development is, in fact, also a test of the stability of the CEECs' monetary systems, as became evident in the Czech Republic in 1997 during the speculative attacks against the koruna.

It is difficult to estimate the costs and benefits of EMU membership explicitly under the current uncertain time frame, so one can analyze only "what if" scenarios.

As we know, the currency board system is a version of a fixed exchange rate, with very limited possibilities to use the discretionary power of the monetary authorities. Sometimes it is called "a government with tied hands." A consequence of this is that external shocks have an immediate impact on the economy; balance of payments developments determine interest rate developments, so the burden of adjustment falls on the banking sector (and through it on the real sector). The possibility of central bank intervention is very limited.

Maintaining financial stability in a more competitive and integrated environment is crucially dependent on the level of development of the financial system. Under the currency board arrangement, this is first connected with the soundness of the banking system. This argument is supported by the fact that in transition economies security markets are generally less developed than the banking system.

In Estonia, the financial system is fairly deregulated and very open. A currency board system to be effective is presumed not to coincide with capital controls. In Estonia, there have been no capital controls since 1994. The currency board system has facilitated the strengthening of the competitiveness of the fully privatized banking system (the share of the government is under 10 percent). Due to the high level of openness and the absence of capital controls, cost levels in the financial system depend on international capital markets.

Does the choice of monetary system influence the make-up of the financial system? There is usually a differentiation between market-based financial systems (as found in the U.S. and the U.K.) and bank-based financial systems (as found in Japan and Germany). Up to now, there has been no clear answer to the question of which type of systems will be enhanced by currency board arrangements.

In sum, the currency board arrangement represents an extreme version of a fixed exchange rate regime, which therefore demands from the financial system a high level of competitiveness and flexibility. By and large this is also true for the real sector of the economy. Economies based on currency board arrangements rely on rules and markets, rather than on discretionary policies by the authorities. A successful economic policy under this arrangement crucially depends also on fiscal discipline. As the government has no monetary policy, there cannot be much stress put on the fiscal side either.

As to the transition toward membership in EMU one can start with the impact on the real economy. There will be a dual impact on trade relations of economies outside the euro-zone. First, countries exporting to the euro-zone will probably benefit from higher demand in that area. This will apply mainly to countries with close trade relations with the euro-zone countries; Hungary is prominent in this respect among transition countries. In Estonia exports to the euro-zone represent about two-thirds of total exports, while for imports this ratio is three-fourths.

Second, potential trade within the euro-zone could increase at the expense of trade outside the EU. This trade diversion may put additional pressure on the sectors depending on foreign trade with countries outside the euro-zone and lead to improper trade patterns. In financial terms, this leads to specific real exchange rate developments, as inflation differentials will remain between euro-zone and CEE countries in the medium term (with a consequent real appreciation).

In terms of monetary policy, as the European Central Bank (ECB) is committed to low and stable inflation, and thereby reducing the potential volatility of interest rates and capital flows, this will result in a reduction in the fluctuations of the euro relative to other currencies.

Interest rate volatility can adversely affect countries with fixed exchange rate regimes that are either dependent on capital flows or have large external debts (here only debt-creating capital flows are considered as capital flows). As for the countries applying currency board arrangements, the euro can enhance price stability if it replaces less stable base currencies. This means that for Bulgaria and Estonia a task for the next three years is to re-peg their currencies from the German mark to the euro. Since Estonia has been happy with its currency arrangements, the January 1999 introduction of the euro means a *de facto* re-pegging of the croon to the euro.

Low interest rates in the EMU and a larger and more liquid capital market may increase capital mobility. This means that borrowing costs may decrease both for issues in the euro area, as well as all issues denominated in euros. They can also lead to growing direct and portfolio investments in other countries, due to the expected convergence of profitability inside the euro area. Hence, the use of investments intended to diversify risks, interest rates and differences in economic cycles will expand from euro-zone countries to the CEECs.

In conclusion, the presenter assessed the special risks associated with the currency board arrangement. First, there is the risk of being in another phase of the economic cycle than the base currency area; this was the case in Hong Kong in the 1980s. Accordingly, there is the risk of depending on the ECB, while the country is not belonging to the euro-zone. Second, there is the risk of the direct impact of asymmetric shocks. Lacking exchange rate and monetary instruments, there is very little possibility of moderating the impact of these shocks. Finally, under the currency board there is no "lender of last resort" facility, so there are limited possibilities to support the financial sector in the case of adverse financial developments.

Discussion of the Previous Three Presentations

A discussant commented on Figure 4.1 by noting that one must distinguish between two interpretations. The first is that countries have introduced fixed exchange rates or liberalized capital controls because they want to import credibility and hope that they will be able to activate policy instruments for coping with asymmetric shocks. The case of Austria is instructive: it fixed its exchange rate to the German mark at a moment when the conditions for an optimum currency area were not fulfilled. By fixing the exchange rate, however, certain policy instruments were activated which enabled Austria to stick to the goals of the fixed exchange rate. This means that there were certain repercussions for fiscal and wage policies. Italy also tried to import credibility, but it did not activate appropriate fiscal and wage policies, which eventually led to a crisis in September 1992, and the country to move to a flexible exchange rate regime. This is evidently the interpretation that Lavrač has in mind.

But there is also another possible interpretation according to which, although the fixing of the exchange rate activates certain policies, the nature of the asymmetric shocks changes. If such happens, it may be necessary to move to the flexible exchange rate even if the necessary policy instruments to maintain a fixed rate have been developed. The best example of this is France in 1993: with respect to fiscal policy and wage policy, France fulfilled the criteria for maintaining a fixed rate system, but it had to move to a more flexible exchange rate regime because the nature of asymmetric shocks changed (for instance, the “Soros shock” of 1992).

An interesting development in the French case was that despite switching to a more flexible regime (with wider bands), France was not impeded from moving to the third stage of Maastricht. So the EMU stage need not be viewed in a monotonic way, but depends on the nature of the shocks. As for the kind of transition for Poland suggested by Orlowski (a move toward a fixed exchange rate regime with the help of an inflation targeting monetary policy), the discussant warned that here, too, the nature of possible asymmetric shocks should be analyzed, because it may turn out that a more flexible exchange rate regime is needed for the time being.

Another discussant commented on Figure 4.1 saying that it had a drawback in that it did not refer to inflation. Governments have had to give up on fixed exchange rates because of high inflation differentials and the subsequent real appreciations. However, if the source of inflation is still present (the central bank is not independent and/or the budget or the banking system must be bailed out, and so on), these governments are still in trouble irrespective of the fact that it is easier to cope with an inflation differential with the help of a more flexible exchange rate system. If the sources of inflation, especially a loose monetary policy, are not tackled, membership in the EMU will remain a distant goal.

Lavrač expressed agreement with the first discussant’s conclusion that the main reason for moving away from the path that would lead monotonically to the regime required by the EMU is the changed nature of the asymmetric shocks.

Lavrač added that it is worth examining the reasons why Slovenia opted for a floating regime at the beginning of the transition. The explanation is, first, that Slovenia did not want to import credibility but rather wished to establish it internally via its own monetary policy. Second, Slovenia lacked the international reserves necessary for the establishment of a fixed regime. Third, there was the painful memory from the former Yugoslav past of cyclical devaluations of a fixed rate, followed by inflationary periods that provoked further devaluations. The floating regime has in fact worked well: hyperinflation disappeared, the trend in inflation is down. The IMF criticized Slovenia for many years for introducing a floating regime. In 1997, when the nature of the shocks changed, the IMF began to praise Slovenia for keeping the floating regime in effect and suggested that it keep it for the time being. However, in the future, the key international organization for Slovenia will be the European Commission, rather than the IMF.

Orlowski responded to the first discussant’s comment on the importance of importing credibility via a fixed exchange rate regime. In fact, in the early period when a country, such as Poland at the beginning of the 1990s, had to fight high inflation, and the instrumentalization of monetary policy was very primitive, the importation of credibility through a currency peg was justified. The IMF supported this policy not only in such CEE transition countries as Slovenia and Poland, but also in Asia, where such advice was more controversial. However, there is also the possibility of building credibility from within, in the manner of the Bank of England or the Swedish central bank. Given this diversity, perhaps the EU should consider not requiring the candidate countries to join ERM II, but let their exchange rate regimes be flexible, thereby avoiding real appreciation of their currencies and ensure a better risk structure of capital inflows.

Another discussant in commenting on Orlowski's talk acknowledged that the Czech Republic followed a successful anti-inflationary policy beginning in 1992, but that he, as an environmentalist, was not very much satisfied with it. The reason for his dissatisfaction was that while high inflation was eliminated, existing price distortions were maintained, and by now it is increasingly difficult to make adjustments within the sectors of energy, services and especially housing. There are all kinds of arguments, particularly social ones, for maintaining existing, distorted relative prices. It is difficult to agree with these arguments because, without a rapid change of energy prices to a system reflecting costs more realistically, the whole system of prices will be burdened with distortions for a long time, thus preventing progress. The excessive preoccupation with disinflation was counterproductive, and perhaps controlled but higher inflation would have provided more possibility to rearrange relative prices.

A discussant expressed her belief that building credibility is better than importing it, although the former is a long process, as was experienced by Portugal. By applying a fixed exchange rate regime, one can accelerate this process and build up one's own credibility on the basis of an imported one.

The first discussant supported this position. For certain countries, such as Poland and probably Hungary, the concept of building up one's own credibility is a euphemism. The basic problem is not that one cannot eliminate inflation and avoid a real appreciation if one opts for a flexible exchange rate, but how quickly one can achieve success in that manner. The example is not only Portugal but even France: to achieve a certain level of fiscal discipline, it was necessary to import credibility and apply discipline to the country from the outside. To some extent this was the case also in Austria under the leadership of former chancellor Bruno Kreisky, who was not interested in exchange rate targeting, but rather in nationalized industries making profits, even though wages were increasing rapidly.

Another discussant responded to an earlier participant's remarks on inflation in the Czech Republic by noting that it is just a question of having the political courage to liberalize the remaining subsidized prices. That would result in a once for all jump in prices, but not in a permanent inflationary pressure. Experiences with price liberalization in the early years of transition, such as that in Poland in 1990-91, showed the difference between these two phenomena. The discussant also responded to a question from a discussant as to how the ECB would react if a CEEC unilaterally adopted the euro. He suggested that the ECB would not be very happy, but if a given country, say, Macedonia, has sufficient reserves, it could technically make such an arrangement and the economics of this system would work similarly to a currency board.

A participant suggested that in the course of discussing the timing of joining the EMU, the analysis should focus on real restructuring and not only on monetary issues. Are these countries' structures close enough to those in the Euroland area that they could easily join the single currency area? We can say that by the time when the possibility of joining the EMU emerges, a free trade area in industrial goods will have largely existed between the more advanced CEECs and the EU since 1998. But the former EU candidate countries had free trade for more than 20 years with the EU before joining the grouping. Should we not expect real adjustments, and very strong ones in the coming years, and fiscal shocks within the candidate countries related to the restructuring of their welfare systems, which will certainly not take place in the next two to three years? Do we not expect that the candidate countries will grow at least twice as fast as the EU average? Would this not have implications for real exchange rates in these countries and for financial inflows, the impact of which must be tackled by some means (and if there is no scope for an independent monetary policy, by what means)? These are questions about real developments that require answers before we can address the question of the speed of joining EMU.

Orlowski drew the conclusion from comments of various discussants that given the long time needed to develop flexible exchange rates and autonomous monetary policies, the candidate countries should build a relation to the euro already before they join the EU in order to borrow credibility from outside. He added that Polish monetary authority has already proved its credibility through its "ruthless" interest rate policy in recent years, which has led to large sustained interest rate differentials.

Lavrač admitted that the distinction that he had made earlier between imported and locally earned credibility was overly categorical, since both kinds of credibility are needed. This is also the case with exchange rate regimes: actual policies may be more similar than is implied by the fact that they employ different regimes. Even floaters have serious concern about the level or dynamics of their exchange rates, while within fixed rate regimes there are also ways to make exchange rates a little bit more flexible. Credibility, however should be related not only to exchange rates and monetary policy (if this were the case, all currency board arrangements, including those of Bulgaria and Bosnia-Herzegovina, would make for the most credible countries), but to other aspects of economic policy as well.

Another participant noted that the discussion had arrived at the core of the issues. Credibility, whether acquired externally or developed internally, means that in the long run you have to bring down inflation to the Western European level, and this can ultimately be done only by fostering internal credibility. One has to deal with real restructuring, which has a major impact on monetary policy. Everything depends on real reforms. Thus, if Poland wants to join the EU by 2005, it must present a plan that aims at abolishing the practice of granting credits to loss-making companies and policy makers must have the courage to explain this to the public. This is obviously politically very sensitive, but only in this way can real problems be solved.

Another discussant argued that for a less developed reformer such as Bulgaria, the currency board arrangement may appear to be only a single radical tool among many that can generate internal credibility. However, with respect to restructuring the currency board arrangement has induced substantial changes. Much progress can already be seen in the establishment of hard budget constraints for enterprises.

Obviously, one can not expect that a country would jump overnight from a deep macroeconomic crisis to the forefront of the more advanced candidate countries. However, the currency board arrangement has created push effects for restructuring, through the establishment of hard budget constraints, much more effectively than the previous managed floating regime.

Another discussant asked Orlowski about the mechanics of inflation targeting in an environment of financial turmoil. In reply, Orlowski emphasized the importance of fiscal discipline. In order to cushion the inflation target against economic instability, with its monetary implications, very strong fiscal discipline and credibility are needed. In addition, at the proper moment the president of the central bank must describe the strength of the central bank's policy responses to financial market participants. Orlowski cautioned against the placing of short-term restrictions on capital flows. The problems of the Czech Republic in 1996-97 arose not only because its exchange rate had remained fixed too long, but also because of the application of restrictions on capital outflows twice during 1996. This measure backfired, because it signaled to investors that there was a problem with capital outflow.

A participant drew attention to the fact that, earlier in the meeting with respect to environmental issues, and now concerning EMU, a pattern seemed to be emerging. At an early phase of accession, the transition countries could choose the policy mix according to their preferences (e.g., faster or slower disinflation, an earlier or more delayed return to growth), although their choices were often constrained by conditions set by the IMF. Now, however, when accession issues come to the fore, the countries must converge to similar standards, which limits the variety of macropolicies from among which they can choose.

While EU accession standards can hardly be termed absurd, the question is whether the required policy mix always makes sense for the countries. Moreover, can these policy mixes be sustained politically? For instance, suppose that one assumes that according to the Balassa-Samuelson model, these countries go through a sustained appreciation of their equilibrium real exchange rate. At the same time, they abandon exchange rate policy and follow an inflation target (so as to converge to the Maastricht criteria). This leaves open the possibility that this policy mix will not be feasible for all the countries, for instance in terms of unemployment or growth (two indicators that are not Maastricht criteria). A similar mismatch can occur with respect to environmental policies. Perhaps in the future the countries will be categorized differently from today (when the focus is on exchange rate or monetary policy), but according to whether the policy mix required by accession to EMU is feasible for them or not.

Another discussant added that the problem is that it is difficult to ascertain *ex ante* whether a country can absorb a policy mix or not. One of the most interesting developments related to EMU is that nobody forecast that such countries as Spain, Portugal, or Italy would be able to meet the criteria so quickly. Then the question arises as to the limits to countries' absorption capacities. Nobody really knows: about 90 percent of economists were wrong in forecasting that the Southern countries would not be able to fulfill the Maastricht criteria on time. But Italy, for instance, which most German economists insisted on not letting into EMU, produced a primary surplus of about 6 percent in 1997.

5. EU and Transfers and Their Use for Institutional Development, Structural Adjustment, and Infrastructure Improvement

5.1 The Impact of EU Transfers on the Development of Infrastructure in Portugal and its Role in Real Convergence[21]

This presentation concerned the impact of EU transfers on the development of Portuguese infrastructure and on the country's real convergence with the rest of the EU. Since the Portuguese accession to the Community in 1986, a rapid catching-up has taken place, due to a combination of a number of factors, in particular, the strengthening of competition stemming from integration, structural reforms, broadly appropriate macroeconomic policies, and financial support from the EU.

With respect to the EU economic and social cohesion policy, there are three main financial instruments that support the implementation of Union policies. The first is a group of funds, such as the Structural Funds (the European version of a development fund), which is oriented toward industrial and infrastructure development; the European Social Fund, which is oriented toward initiatives in the labor market, such as training and mobility policies; and the Guidance Section of the European Agricultural Guidance and Guarantee Fund and the Financial Instrument for Fisheries and Guidance, which is designed to facilitate restructuring of the agricultural and fisheries sector. The second instrument is the European Investment Bank (EIB), and the third is the Cohesion Fund.

Since the reform of the Structural Funds in 1988, EU assistance has been organized by objectives. There are six priority Objectives. The presenter focuses on Objective 1, that is, the development and structural adjustment of lagging regions, defined as those with gross domestic products (GDP) per capita below 75 percent of the EU average.

The whole territory of Portugal is eligible under Objective 1, and this is very important because the Structural Funds are concentrated on Objective 1 regions, and also because in such regions, co-financing can be up to 75 percent of total costs. The Cohesion Fund was created in 1993 with the aim of helping less developed countries within the Union comply with the Maastricht convergence criteria, especially the public finance criterion, without slowing down the catching-up process. The Cohesion Fund finances transport infrastructure and environmental projects.

Turning next to the impact of these funds in Portugal, at the time of the EU accession, the stock of transport infrastructure in Portugal was relatively modest, representing about 40 percent of the EU average. The length of motorways per million inhabitants was only 21 kilometers, about 22 percent of the EU average. In terms of railways, the pattern was closer to the European average. However, for both transport modes, the divergence vis-à-vis the EU level, in terms of travel speed and security, was very pronounced. The death rate from traffic accidents was one of the highest in Europe.

In the telecommunications sector, the percentage of the population connected to telephone lines was significantly below the EU average. Moreover, the quality of services provided was very low, regarding waiting times and unsuccessful calls. As to

[21] This section summarizes the presentation of Isabel Marques Gameiro.

energy, Portugal has a high dependency ratio on imports, which makes the economy extremely vulnerable to oil price and other energy shocks. Energy consumption per capita is low, but it is high in relation to GDP, which indicates a lower efficiency of energy use than the EU-12 average.

Since Between 1989 Portugal has had two community-support frameworks. The first was for 1989-93 and the second for 1994-99. Between 1989 and 1993, the total EU funding to Portugal in the context of the first community-support framework amounted to 2.4 percent of GDP, while infrastructure investment was 0.73 percent of GDP. In the second community-support framework, total EU funds amount to 3 percent of GDP on average, while infrastructure investment will be slightly less than 1 percent of GDP.

Within infrastructure investment, the transport sector has received the major part of the funds, not only in the first community-support framework, but also in the second. However, in the second community-support framework, the environment and water will also receive a significant part of the Structural Funds.

In the past twelve years Portuguese infrastructure development has been remarkable. The most visible improvement in transport infrastructure has involved the road network. Since the main aim was to enhance accessibility through the improvement of links between Portugal and the rest of Europe, links to Spain from the eastern and northern borders were developed.

In the energy sector, electricity production was increased. In order to reduce dependency on oil imports and diversify the sources of energy, the construction of a distribution network for natural gas is now in progress.

The author and her associates have carried out some empirical work on the impact of infrastructure on Portuguese economic development. According to neoclassical growth theory, if economies are similar in their structural characteristics, poor countries will tend to grow faster than rich ones. This process will lead to the spontaneous convergence of income levels between countries, a phenomenon known in the literature as absolute convergence.

However, because countries do not have the same investment rates, population growth rates, technology levels, or infrastructure levels, they do not converge to the same level of income. A rich country has a higher GDP per capita level in the initial period and will grow at a faster rate than the poor country because the former has a higher long-term GDP per capita level.

The EU funds aim to change this scenario, by providing poor regions with the structural, supply-side conditions to converge toward the Union's long-term GDP per capita levels. The goal is to have a situation where a currently poor country and a currently rich one have the same long-term GDP per capita. This is consistent with the traditional neoclassical growth model result, whereby the poor country will tend to grow faster than the rich one.

Under a simplified version of the neoclassical growth model, an equation is estimated which includes the growth of output per worker in country *i*, which is a function of the savings rate, labor force growth rate, the rate of technological progress, and the rate of capital depreciation. The stock of infrastructure is also an explanatory variable. Finally, the initial level of GDP per capita is included in an attempt to capture the convergence effect.

The speaker and her co-authors estimated this equation using panel data for two samples of countries. They used as a proxy of infrastructure development of the 15 member states' electricity-generating capacity and then an index of transport, which captures the growth of railways. In a second sample of countries, they used a broad infrastructure capital stock indicator, which was constructed by Ford and Poret (1991).[22] This indicator includes transport, communications equipment, electricity, gas, and water, and is a better proxy for total economic infrastructure. However, it is not available for all the 15 EU member-states.

The results (presented in Table 5.1) are consistent with the predictions of these types of models. First, the coefficient associated with the starting level of GDP per worker is negative and highly significant in all regressions, indicating that real convergence took place among the European countries in the period considered. Moreover, the coefficients associated with the savings rate and the labor force growth rate have the signs predicted by the model: the growth of GDP per capita is positively related to the savings rate (and the investment rate) of a country, and negatively related to the growth rate of the labor force. Finally, the infrastructure proxies that they used have positive effects on the growth rate of output per worker in the period considered. It can be concluded from these results that not only did real convergence take place in Europe during 1960-90, but also that infrastructure had a positive impact on growth.

Finally, the presenter described some additional results on the Portuguese economy. A number of other studies have tried to estimate the impact of the EU's structural transfers on the GDP per capita growth rate and real convergence in Portugal. The results point to a permanent increase in GDP growth of about 0.5 percentage points, both in the steady state and in the transitional period.

A second issue is the effect of the EU's Structural Funds in on public deficits. Here, there are two contradictory influences. First, there is an increase in capital expenditures due to the principle of complementarity. Second, there is an increase in tax revenues, due to the larger tax base resulting from higher GDP growth. The net impact is an increase in the deficit to GDP ratio of one percentage point.

On the foreign accounts, the result contradicts the idea that international transfers reduce the current account deficit. The first impact on the current account balance is positive, due to the inflow of funds. But there is also a positive impact on foreign direct investment, due to the improvement in the national productivity of domestic capital. This has a very negative impact on the current account balance, since part of this investment is in the form of purchases of traded goods, which increases imports. The net impact is a negative one percentage point (of GDP) in the current account. This is, of course, a short-term impact, because it is well known that in the longer run, the Structural Funds will contribute to the enhancement of the economy's supply potential.

[22] This refers to the following article: R. Ford and P. Poret (1991). "Infrastructure and Private-Sector Productivity," *OECD Economic Studies* 17 (Autumn): 63-89.

Table 5.1 Estimating Convergence in Presence of Infrastructure Variables: Results

Sample Regression:	15 EU countries I	15 EU countries II	8 European countries III
$\ln(y_{t-1})^a$	-0.902 (-7.4)	-0.821 (-14.1)	-0.843 (-7.3)
$\ln(s_t)^b$	0.445 (3.9)	0.449 (4.0)	0.335 (3.2)
$\ln(l_t+0.05)^c$	-0.149 (-2.4)	-0.155 (-2.5)	-0.160 (-2.1)
$\ln(CEG)^d$ $\ln(TRP)^e$ INFRASTRUCTURE $\ln(INF)^f$	0.179 (2.6) - -	- 0.616 (1.8) 	- - 0.457 (2.4)
Wald overall significance test	249 $X^2(4)$	551 $X^2(4)$	173 $X^2(4)$
Implicit η^g	0.23	0.17	0.19
Wald test with $\lambda_1 = -\lambda_2$	0.557 $X^2(1)$	0.554 $X^2(1)$	0.074 $X^2(1)$
Regressions with $\lambda_1 = -\lambda_2$	Ia	IIa	IIIa
$\ln(y_{t-1})^a$	-0.826 (-7.0)	-0.781 (-12.6)	-0.808 (-6.4)
$\ln(s_t)^b - \ln(l_t+0.05)^c$	0.259 (3.4)	0.260 (3.4)	0.246 (2.1)
$\ln(CEG)^d$ $\ln(TRP)^e$ INFRASTRUCTURE $\ln(INF)^f$	0.146 (2.3) - -	- 0.157 (1.6) -	- - 0.466 (2.2)
Wald overall significance test	182 $X^2(3)$	261 $X^2(3)$	91 $X^2(3)$
Implicit η^g	0.17	0.15	0.17
Implicit α^h	0.24	0.23	0.23

t-ratio between brackets

(a) Natural logarithm of GDP per worker at the beginning of each decade.
(b) Natural logarithm of real investment to GDP ratio throughout the decade.
(c) Natural logarithm of the growth rate of the labor force added to the rate of technological progress and to the capital depreciation rate.
(d) Natural logarithm of the electricity-generating capacity per worker throughout each decade.
(e) Natural logarithm of the length of roads and railways divided by area throughout each decade.
(f) Natural logarithm of the broad infrastructure capital stock indicator of Ford and Poret as a share of the labor force.
(g) Annual speed of convergence: $(1-e^{-\eta r}) = \gamma$ with r = 10.
(h) Non-salary's share in income: $(1-e^{-\eta r})\,[\alpha/(1-\alpha)] = \lambda_1 = -\lambda_2$.

5.2 The Commission's Financial Framework for 2000-2006 in Relation to Enlargement[23]

The Commission's proposal dates back to July 1997 when the Agenda 2000 document was published.

Agenda 2000 has three components: it is a preview of the years 2000-2006 and the internal reform needed within the EU; it outlines the approach to enlargement, and includes the opinions on the readiness for starting negotiations of the candidate countries; and it contains financial perspectives, with the EU having to come up with a seven-year budget. The EU is currently under the 1993-99 framework, so it is clear that in 1999 the member states have to decide on the financial perspectives.

The reinforcement of the pre-accession strategy also fits within the approach to enlargement. That strategy involves the Phare project, plus a number of additional matters, all of which are reinforced in Agenda 2000.

More than 50 percent of the population of the EU lives in areas covered and supported by its structural and regional policies. This was proudly announced by the department responsible for these policies a few years ago. It was pointed out to them that such a policy could hardly be accomplishing regional redistribution. Recently, Mrs. Monika Wulf-Mathies, the Commissioner responsible for regional policies has set a target of 30 percent coverage in terms of population. This is an example of the sort of drastic reform included in the proposals under Agenda 2000.

The Structural Funds have been doubled several times, the last instance being in Edinburgh in 1992. The four "cohesion countries" receive most of these funds. Figure 5.1 shows the differences in GDP growth over two periods, 1975-87 and 1987-93. At the start of the latter period, Spain and Portugal joined the EU, and the Structural Funds were beefed up and became an important instrument of the community. Those funds take up more than one-third of the total EU budget.

The speaker noted that while Gameiro had presented a much more sophisticated analysis, he would simply present a comparison of growth rates without looking at why they differ. GDP growth during in 1987-93 in Portugal was almost two percentage points higher per year than during 1975-87. Ireland had GDP growth rates of more than eight percent during this period, which is almost 7 percent more than in the period before. Spain saw a benefit of more than 1 percent, while Greece and Italy actually fall below the line represented by the EU-12 at the time.

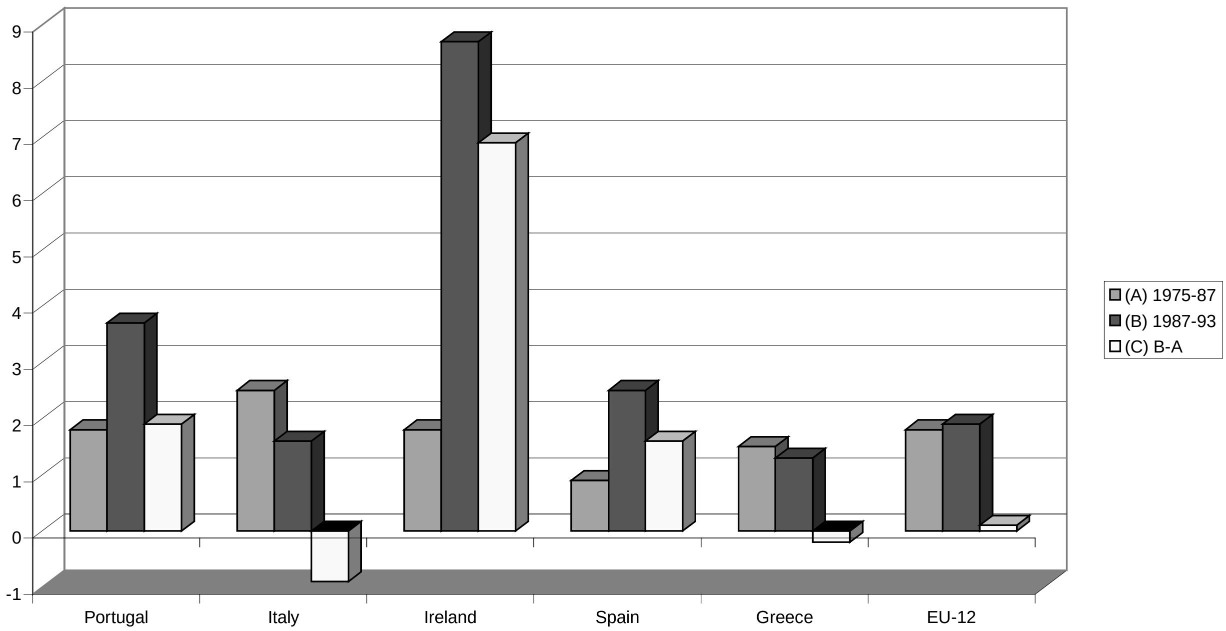
On the basis of this very simple comparison of growth rates, one would conclude that Portugal, Ireland, and Spain have definitely benefited from not only the Structural Funds, but also the opening up of the internal market (and the fact that they were part of that market). The figure captures the effects of EU accession, the Single Market program, other EU initiatives, and the Structural Funds.

The speaker and his associates carried out an analysis in 1996 in their "Single Market Review" that attempted to attribute parts of the differences in growth rates between the two periods to various events (including German unification). This proved to be a very difficult task econometrically and they did not come to definitive conclusions. However,

[23] This section summarizes the presentation of Andries Brandsma.

there is the strong suggestion that the structural reforms have helped, especially in Spain, Portugal, and Ireland. In the last of these, there has been an enormous inflow of foreign direct investment in this period, not unrelated to what was happening in the EU (especially in the Single Market). But it is very difficult to say exactly why a certain set of events takes place.

Figure 5.1
Growth Performance of Less-Favored Regions in the Single Market Program
(Gross value-added per capita)



What was proposed in Agenda 2000 concerning the Structural Funds? Most importantly, the total amount available for these funds for the seven years (2000-2006) was raised in the Commission's proposal from ECU 200 billion in the previous period (in 1997 prices) to ECU 275 billion. Some ECU 45 billion of that extra ECU 75 billion is reserved for new member states.

Why did the Commission package together the new financial framework, enlargement, and the internal EU policy reform? The timing of the budget period, 2000-2006, is such that it cannot be excluded that there will be an enlargement with one, two, or three countries out of the first wave of candidate countries. The Commission had to make some assumptions in making the financial calculations. The ECU 45 billion includes pre-accession aid of ECU 7 billion over a seven-year period (ECU 1 billion per year). It is interesting that even when some candidate countries become member states, the ECU 7 billion figure remains unchanged, so that the more countries accede, the more money there is for the ones in the second and following waves of accession.

There will be an internal reform of EU policies and this is included in the proposals. We have learned that the Structural Funds are too widely spread (so it must be concentrated). The Cohesion Fund, which was introduced *de facto* to compensate Spain and Portugal for making an effort to join the single currency zone, and which is not very large or important for these countries, has conditionality attached to it. When these countries do not follow the convergence programs, and it is their own fault, the Cohesion Fund can be suspended. This threat was never acted upon, although there was one case where that nearly happened. The threat provides leverage at the community level, where a country can be told that the funds that it receives from the EU may be taken back if it does not do the right things.

In the EU there is pressure to keep expenditures at the Union level (i.e., funds received from the member states and then handed back to them) as low as possible. Already in 1997 the Agenda 2000 document included a strange percentage of 0.46 percent of the EU's GNP: this would be the total amount available for regional aid and Structural Funds spending in 2000-2006. The ceiling for total EU expenditure in all the member states and elsewhere is 1.27 percent of GNP, so about one-third is reserved for structural spending, putting the limit about where it is at present.

The second limitation that has been proposed is that no member state will ever receive in one year more than four percent of its GDP in structural spending. Experience shows that 4 percent is about the maximum that Portugal and Greece received during 1993-99, so it is set at that level, with the reasoning that it has proved very difficult for any country to absorb more than that amount of funds.

There is a co-financing arrangement, so that 50-80 percent of the amount spent on any project is co-financed by the community. The member-state has to put in some of its own money, which means that it has to shift priorities toward those of the EU. This ties in nicely with the conditionality that the EU would like to see with respect to this sort of spending.

In the proposal, spending would rise until 2001, and then slowly level off, because fewer regions are selected and in general the regional funds are concentrated on certain core regions. For instance, in Portugal, Lisbon is above the 75 percent line, so the region of Lisbon would lose its Objective 1 status in the most recent proposals, which the speaker has seen. But there is battle going on, so whatever the newspapers may write, the matter is not yet resolved.

In any case, room would be made within the spending on the current member-states, and it would gradually be used for the new member-states. Implicit here is that no country will join before 2001, there will be one or two acceding countries in 2002, and these countries will gradually receive more of these Structural Funds, up to a total of ECU 45 billion (in 1997 prices) over 2000-2006.

The Structural Funds are not the only part of community spending. There is also, of course, spending on agriculture and other programs, such as Phare. Total pre-accession aid is not the ECU 1 billion per year, but ECU 3 billion per year, and that includes per year about ECU 500 million (again in 1997 prices) for agriculture (modernization of farms, agri-food industry, and distribution, and so on). That would rise gradually over a period to reach ECU 2.5 billion after a country accedes to the Union. After a country joins it can, of course, expect a greater amount of support under the Common Agricultural Policy (CAP). The ECU 1.5 billion that remains is just the normal Phare spending which we have seen already in the past.

One thing that was learned from spending under the Structural Funds and the Cohesion Fund is that such spending should be more targeted to particular fields which are necessary for economic development. It should not only be for alleviating the consequences of industrial decline, but should help build up the infrastructure and clean up the environment. Although the Cohesion Fund was created to help the recipient countries prepare for the single currency, it was targeted on infrastructure and environment, and that is what the EU would to like do with respect to pre-accession aid.

Pre-accession aid should again be conditional on a country's performance, so the EU will have to monitor that performance and discontinue funding when, due to its own fault, a country is not performing. One case that got publicity in 1997 involved Poland, where part of the Phare funding (ECU 34 million) was cut because there were not enough projects of sufficient quality. This was a heavy blow for the Polish administration, but they have recovered from it very well. (The minister at fault was not replaced, but he is no longer active.)

Thus, the main points are conditionality and concentration on infrastructure and the environment. Part of this reformed accession strategy is a re-orientation of the Phare program. It used to be very demand-driven, so that if someone came with a good project, which would in one way or another help the candidate country in its development, Phare would be prepared to co-finance it. Now the accession process has progressed and from the opinions it is clear that what the candidate countries' priorities should be. The Phare funds will now be accession-driven, rather than demand-driven, so it must be indicated how a project is related to accession and how it fits into the priorities of the accession partnership and the national program for preparation for membership.

Projects should focus on the key accession priorities. Thirty percent of the funds will be for institution-building (i.e., technical assistance, education, exchange of officials), and 70 percent for "investment in accession," but the latter includes investment in human capital and related matters, so there is a gray line between the two categories. As Gameiro showed, for the investment projects, there is also the EIB, which has huge loans available and is using them for these purposes, so countries can actually receive more than the 4 percent of GDP (in fact, the loans alone are larger than that limit).

The management of Phare up to now was done partly from Brussels. It is clear that if one wants to monitor projects and to be able stop them when they do not fulfill the conditions, it is better to be closer to where the funds are applied. This has led to a decentralization of the Phare's management, meaning that all delegations in the candidate countries have been doubled in size, with people who know about agriculture and all the fields in which this pre-accession aid will be spent.

Finally, there is twinning, that is, the possibility for an official from the government of a member-state to spend from one to three years in a candidate country, and work on well-defined projects. The Commission was skeptical about this process at first. This turns out to be a very interesting exercise, with the Commission functioning a bit like an employment agency. Candidate countries come up with proposals on the assistance that they will need in preparation for membership.

Those proposals, if they fulfill certain standards, are sent around by the Commission across the member-states. Governments from the member-states make offers on these proposals, the people are gathered together, and the candidate countries decide on which offers they like best. The Commission was concerned that this program might develop into a sort of quota system for member-states and candidate countries. It knew that each member-state had one or two favorites among the candidate countries and expected that they would team up and form a straight bilateral relationship, which, in fact, is not desirable at the community level. This fear was not justified; there have been a number of unexpected combinations of member-states and candidate countries. In many cases, two member-states that made offers teamed up to make one common project.

5.3 EU Transfers and Absorption Problems[24]

The speaker said that he would concentrate on Objective 1 regions and countries, because the candidate countries will all have Objective 1 status. The main goal of all EU transfers to all Objective 1 regions is that they should contribute to a rapid convergence of real GDP per capita at the regional level (or the country as a whole, if it has overall Objective 1 status).

If the focus is on economic growth, there are three criteria that one can employ to assess the impact of transfers. The first is a simple effectiveness criterion: does the effect go in the right direction? The second criterion is efficiency, which no one in Brussels talks about on a macroeconomic scale. Since the transfer programs are designed with the objective in mind of optimizing a convergence process, one wants the transfers to have a maximum growth effect in an intertemporal sense, meaning that future output gains must be discounted.

The final criterion is durability, namely that once transfers stop – perhaps because convergence has been obtained – that economies will not begin to decline. Transfers should achieve long-run convergence and independence from the EU as a donor of transfers. This last point is not cited in the EU rules, but makes perfect economic sense.

From this, it follows clearly that EU transfers must be judged on the basis of supply-side models, because demand effects stop immediately when transfers stop flowing. Indeed, as they function, there is a supply-side mechanism behind them. This can be seen from the projects that are supported, whereby more than half of the funds (taking the Structural Funds and the Cohesion Fund together) goes for infrastructure and human capital. The goals are to enhance total factor productivity and to attract private investment to the region or country that benefits from the transfers.

Subsidies to firms to directly enhance productive expenditures represent about 40 percent of the Structural Funds. One can always find market-failure arguments to justify this kind of subsidy, by claiming that the social return on a public investment is higher than the private one. This is especially the case in regions with high unemployment, although the speaker warned about the potential misuse of this type of reasoning.

If one defines the objectives in terms of these criteria, one is better able to comprehend transfer-related absorption problems. The narrow (bureaucratic) definition deals only with the input side: there is no absorption problem if one is unable to spend all the money that one gets. In practice, one meets the problem of “technical absorption

[24] This section summarizes the presentation of Yves Hervé.

incapacity," because many regions are not able to implement programs well, so they do not get paid the funds earmarked for them. These are simply management problems.[25]

The second kind of problem is "financial absorption incapacity," which is often cited in the context of enlargement. Countries may have problems coming up with the co-financing requirements and thus are not able to get the Structural Funds. But these matters are purely input-related, and have no link whatever to growth. The reports from the European Commission evaluating the implementation of the Funds seem to focus only on spending targets.

An economic definition, in view of the criteria presented above, would hold that a transfer-related absorption problem is any economic mechanism that prevents the economy from achieving the highest possible output growth path. When talking about transfers, one tends to forget the donors' interest (i.e., that of the net contributors to the EU budget); donors do not provide money merely out of solidarity, but also because they want the recipient countries to converge as fast as possible.

The philosophy behind the transfers is that, once a country achieves convergence, it no longer receives money. Thus, a way for donors to save money in the long term is for the policy to be successful in terms of growth. The donor is interested in the maximization of growth, however measured. None of this is specified in the rules, but it is evident in the discussion in practice on the German and Dutch positions on the EU, which shows that these countries are frustrated that Spain still wants money from Brussels. One way for Spain to stop getting money from Brussels would be to converge rapidly.

Once one accepts this point, the discussion can shift to defining the absorption problems. One can identify ten such problems, which are subdivided into three categories. The first category is *rent appropriation*, the second is *waste*, and the third is *undesirable factor price adjustments*.

Rent appropriation is never discussed, probably because doing so would be politically incorrect. One form is rent appropriation by the recipient state. For governments, maximizing economic growth is only one of many objectives. The perverse incentive emanating from the rules concerning EU transfers is that the less effective a country is in promoting growth via transfers, the longer it is entitled to get those transfers.

Further, rent appropriation may take the form of *de facto* higher public consumption or social transfers, measured in terms of GDP. This means that a recipient gets the money from Brussels and finances infrastructural projects, but at the same time use other budgetary means to cut down on productive public expenditures and pursue other objectives which are of equal value to it. In this way, EU transfers become a substitute for domestically-financed productive expenditures.

It is completely apparent that this is happening with respect to the Cohesion Fund; for the Structural Funds it is not so obvious, because there are rules that should supposedly prevent such behavior. But rules can be circumvented by choosing investment projects which are suboptimal in terms of growth. Politicians choose investment projects not

[25] According to the speaker, the various forms of technical absorption incapacity include incomplete or overoptimistic planning; insufficient study of appropriate quality; an inadequate institutional and/or legal framework; a lack of well-defined policies; weaknesses in management (including an absence of project managers); and public resistance (e.g., against required expropriations).

because of an economic return to society as a whole, but because, for example, some of them have a higher voter appeal. Examples are sports stadiums and other "white elephants." There do not seem to be rules at the EU level which are able to prevent them.

There is, of course, a commission who is controlling this phenomenon, but there is always the information asymmetry problem in practice; the recipient governments know better what they used the money for than the controllers from Brussels. Moreover, if the conditionality principle regarding the Structural Funds prevents one from deliberately increasing public consumption, one can mask *de facto* public consumption as public investment by inventing some expected economic return.

Rent appropriation can also take place by private-sector agents because such agents are very involved in receiving Structural Funds either directly or indirectly. All the companies that get subsidies are such agents as are consultants which also get money. A potential investor who wants to get subsidies should go the regional government and say that he has an investment project whose economic return is not really interesting to him, but that he is sure that the social return is much higher. The larger the gap, the more he can justify his request for subsidies. But the project in question may be one that the private-sector agent would have financed anyway if he did not receive transfers. In the process, he has appropriated a rent from the EU, without doing anything that he would not have done anyway to contribute to economic growth.

Turning to *waste*, one form of such is administrative costs. Such costs are necessary in an imperfect world, but in a perfect world less money would have to be devoted to administrative control management. In principle, these are not activities with a large value-added on a macroeconomic scale. Where there is rent absorption, there is also rent-seeking, and a waste due to the latter is inevitable in all schemes involving public redistribution of money.

Waste implicitly must be understood in terms of opportunity costs. The issue is not only direct destruction of value-added, but also implicit destruction of value-added via opportunity costs. There are time lags between public sector projects and private sector reactions. Moreover, private investment decisions depend on the full-scale of public investment projects, and the use of transfers can be suboptimal if these public projects are not all finished at the same time.

Imagine that one constructs a road to an industrial park and it is subsidized, and that the road is finished two years in advance of the park, so the road is useless for two years and will not attract any investors. In the meantime, the road will lose value because of capital depreciation. Given such considerations, it may be optimal to delay certain kinds of investment expenditures.

The last point on waste concerns the distortions arising from EU procedures. The EU mainly subsidizes gross capital formation in infrastructure, providing countries with an incentive to do a lot of such spending. But they may not have the means to devote to maintenance operations, which are necessary to preserve the infrastructure over time. Thus, maintenance is disregarded, and capital depreciation is much higher than it would be if it were not these incentives on the part of the EU. There is a suboptimal mix between gross capital formation and maintenance operations.

In practice, investment subsidies to single firms aimed at solving regional development problems invite other firms to ask for such subsidies. Firms may blackmail governments, because even if their projects are economically viable, they can delay them and wait for the regional government to react. This is a classic principal-agent problem. All of the problems discussed here occur because of information asymmetry and are inevitable in these kinds of public support interventions.

Finally, there is the problem of *unpleasant factor price adjustment,* which is never discussed in Brussels. The aspect of this is a classic Dutch disease problem, whereby a region gets money and starts spending it, there are immediate positive demand effects, while supply-side effects take time to materialize.

Suppose that the demand boost falls mainly on non-tradables, such as construction, which benefits disproportionately from public sector projects. When the supply-side is constrained, there will be an increase in the prices of non-tradables, and typically a boost to the economy as a whole, including an increase in the general wage level. This leads to a real appreciation of the currency, as a consequence of which there is a decline in production and employment in tradable industries. Up to this point, there has merely been a reallocation of productive factors, but there is still full employment.

Now imagine that the transfers stop. In such a case, to maintain full employment, one would have to reverse the process, to get people back into the tradables industry, because there has been a decline in the non-tradables sector. There would be a need for downward nominal wage adjustment, which in West European countries is quite a difficult thing to achieve. The experience of eastern Germany in the 1990s is in large part a Dutch disease problem: there was a fiscal boost and an increase in the wage level, and suddenly the construction boom was over and there were no more projects to finance (in 1994-95).

Thus, it can be seen that fiscal transfers on a large scale can have unwanted, perverse effects, if one neglects the fact that labor markets may be inflexible. The experience may differ from country to country, but it is clear that with the entry of the Hispanics into the EU in the 1980s, there was inflationary pressure. Not only were infrastructural funds flowing in (especially to Spain, but Portugal was not very different), but the national governments were pursuing expansionary fiscal policies. There was strong inflationary pressure, and, in Spain, partial de-industrialization of the economy.

In Ireland, this did not happen. They got as much Structural Funds as Portugal in terms of GDP, but there was no inflationary pressure, because in the late 1980s the Irish government started pursuing a restrictive fiscal policy. Thus, everything depends on the fiscal policy mix: transfers alone will not cause Dutch disease problems, at least not on the scale of the EU (although they did at the German level).

An old issue in the literature is immiserizing growth. Imagine that there are critical, protected sectors of the economy – as there are in both Western and Eastern Europe – and that EU transfers are targeted mostly at those sectors. Suppose further that the transfers make the sectors more productive, which was their goal. This “successful” policy induces a structural adjustment in favor of these protected industries, which absorb more resources. This is a perverse policy in terms of opportunity costs and a waste of public funds. In practice, some 10-15 percent of the Structural Funds in Objective 1 regions during 1994-96 went to agriculture and fisheries, which are poor investments from the standpoint of generating maximum growth (although there is obviously a social issue behind this use of the Funds).

Regional transfers may exacerbate regional polarization effects, so they may not actually benefit the targeted regions. One example of this problem is economies of scale, a classical market failure. From the economic geography literature, it is known that if one improves the infrastructure links between the rich core and the poor periphery, the structural adjustment may be totally detrimental to the periphery. This may be an incentive for firms to concentrate production in the richer regions. Mezzogiorno is supposed to be a classic example of such an outcome, whereby large infrastructure improvements in the region have not been good for the region itself.

There are also labor market rigidities. It is widely agreed that the opening up of economies and the resulting structural changes require an ever greater spread in wage levels to compensate for widening spreads in productivity. In Western Europe, a widening of wage differentials would be politically and socially difficult to accept, and such a phenomenon is not visible is most European countries. Politicians see the prevention of increased wage dispersion as a reason for public sector intervention; they have created, as part of the Structural Funds, educational programs to increase labor productivity in the less favored regions.

What matters for the present purposes is the sort of people who are supported by these programs. The problem can only be solved by focusing on the least qualified people, however, it is doubtful whether the EU’s programs focus on such people, because of an information asymmetry problem: richer people have greater interest in and greater possibilities for participating in those programs.

Discussion of Previous Three Papers

A discussant of the presentation by Hervé noted that that presentation showed two things. First, it demonstrated that in economics many things are counterintuitive, such as the fact that aid received by a country is detrimental to its export sectors (i.e., the Dutch disease problem) or the findings of modern economic geography. Second, the presentation demonstrated how recent developments in the political economic literature have done a disservice to the transition economies. When Keynes was writing his *The Economic Consequences of the Peace*, or when the Marshall Plan was designed, people did not speak about rent-seeking, rent appropriation, government failure, and so on. In the discussant’s view, if one relies exclusively on economics, the optimum in the EU access process will not be reached.

Hervé recalled Figure 5.1 (presented by Brandsma), and cited a study by DG II which had tried to assess the impact of the Structural Funds; during 1988-93, the additional average annual growth rate, calculated on the basis of the QUEST model, is 0.3 percentage points for Greece, 0.25 for Ireland, 0.3 for Portugal, and 0.1 for Spain. This is a little less than what Brandsma said. These estimates were derived from simulation models, but in any case, the numbers are all quite low in comparison with the growth differentials that Brandsma presented.

Brandsma expressed his gratitude to Hervé for quoting figures from a study of his, which was carried out with a sophisticated model (QUEST) with forward-looking expectations and supply-side policy responses. It is not such a surprise that with such a model one gets small effects for policies. This is true for sophisticated analyses; in regression analysis, one always has a bias toward zero. This is what he meant when he said that attributing overall effects to particular events was a very difficult exercise.

Brandsma argued that Ireland would have had the same sort of growth rates without the Structural Funds, while Portugal and Spain needed them, and for Greece they were a waste of money; both crude and sophisticated analyses have demonstrated this. He agreed with Hervé that one has to look at the efficiency of the Structural Funds as they were set up; he is still convinced that they had overall positive effects, even on the regional distribution of income, and certainly public relations effects for the EU. He would also agree that conditionality is an empty clause (he has said the same thing internally). But the EU has learned from past experience, and will now concentrate on the three C's: conditionality, concentration of funds, and ceilings for spending.

Brandsma holds that, in general in this type of analysis, the difficulty is that one tries to apply some sort of equilibrium economics to a disequilibrium situation. Transition is a disequilibrium situation, so one has to be very careful with arguments about efficiency and optimality. The modeling exercise in which he participated did take the Dutch disease into account.

There is another "Dutch disease," which is looking in a book-keeping way at net contributions to the community, which for an economist is a nightmare. The Dutch have been net contributors for three to five years, before which they had a huge net benefit from the community (since 1958). He said that Hervé fell a bit into his own trap (the book-keeping mentality), when he said that the member-states want to get rid of future net contributions to the EU. But Hervé responded that countries give foreign aid not simply for people to survive, but to help them solve their problems, so this is not a book-keeping mentality, but a legitimate issue. Brandsma responded that it is not a legitimate argument when one looks only at financial contributions; one has to do a complicated exercise, whereby one looks at economic benefits, namely, the contribution of EU policy to European economic growth.

Hervé continued that the Structural Funds are not for redistribution but for solving problems, and if the regional problems are solved, there is no longer a need for those funds. The problem is perhaps that DG XVI is not interested in such a situation.

Brandsma added that the Netherlands became a net contributor because former Prime Minister Ruud Lubbers and present Prime Minister and then Finance Minister Wim Kok did a poor negotiating job in Edinburgh, giving in to the demands of every country to have its own Objective 1 region. The only thing that they got in return was Flevoland, which was created out of the sea and is a very efficient area for agriculture. Production is high, but there happen to be a lot of commuters from Amsterdam living in that region, which means that GDP per capita is below 75 percent. He suspects that the same is the case for Burgenland (in Austria), which should also be removed from the program.

In answer to a question, Brandsma noted that the 4 percent of GDP cap on transfers refers to gross structural expenditures by the EU in any country, and the limit applies only to the Structural Funds, so under the agricultural programs a country can receive additional funds. Payments also lag behind commitments, so there is always a time profile in any spending program. Generally, there is not a big difference between payments and commitments, although there may be some cases of underspending. There is a big debate, again involving the Dutch, about what should be done with money that is left over: should it be reserved for the country or should it be used as a fund to reward best performers?

Hervé added that what matters is not so much what the Commission says, but the consistency of macroeconomic and microeconomic policies in the recipient countries. There is a case for macro-conditionality imposed by the EU side, not just on spending, but on general economic behavior, more so than there has been with the Cohesion Fund regarding the convergence criteria.

Gameiro said that, in order to avoid some of the perverse effects about which Hervé spoke, it is now widely accepted that infrastructural investment is the most efficient way to use the Structural Funds.

Hervé added that there is an apparent lack of public infrastructure in all the candidate countries. Before one gives subsidies to single Western investors who want to settle in CEE, one needs to improve the motorways and railways in these countries. He further noted that "phasing in" makes sense, whatever the candidate countries may think of it, first of all because of the budgetary limitations, but also for economic reasons. It is true that Spain and Portugal did not face any such conditional phasing in, but the transfers to them started at under 2 percent of GDP, rather than 4 percent. Moreover, if one looks at the implementation of the Structural Funds at the beginning in Iberia, the absorption rates were disastrously low, so organizational problems will inevitably arise.

A discussant said that he was bothered that there was no phasing-in for the new members on the contribution side, but only on the benefit side. Brandsma appreciated the discussants' point that in the first year, for example, it is conceivable that a new member-state could actually pay out more than it receives.

A discussant noted that, according to economic geography, investment in infrastructure in the periphery may lead to more concentration (if it attracts more labor to the center) or more evening out (if it attracts more business to the periphery, which has spillover effects). Another discussant observed that the second effect is more likely, due, for example, to lower factor remuneration in the periphery, and that only exceptionally are there perverse effects.

Hervé noted that the Structural Funds focus on regions, while the Cohesion Fund is aimed at entire countries. Would it be a good thing if because of the Structural Funds the large region around Budapest gets a boost and the overall GDP of Hungary is increasing, while disparities within Hungary rise? Under the EU philosophy, this is a problem, but is it really one or just the price one has to pay for the development of the country, so that development goes through economic poles?

A discussant replied that evidence has shown that the regional funds have worked toward a more equal income distribution over the territory of the EU. Even the agricultural policy, for all its problems, when taken from this point of view, is redistributing well, because the net payers are metropolitan areas, which are richer. Hervé rejoined that the CAP is a perverse form of regional policy because it induces regions to remain agricultural. Another discussant pointed that one has to choose which sort of outcome one wants: to have huge cities (as in South America) surrounded by deserts or to preserve attractive rural landscapes. Then there is the question of whether landscapes should be preserved using pricing policy or regional assistance.

6. Agricultural Scenarios: Costs and Benefits

6.1 Costs and Benefits for Eastern Europe: Various Scenarios Based on Reform of the CAP[26]

The speaker began by noting that one must keep the size of EU agriculture in perspective: it accounts for 1.7 percent of GDP and about 2.5 percent of employment, although it is a relatively larger sector in the CEECs. One should not draw global conclusions about the EU accession process from the problems of this single sector. It would useful to improve the CAP, which has been criticized since the beginning in the 1960s, but it has displayed considerable ability to survive.

As discussed earlier in the workshop, investment contributes to development, adjustment, among other goals. From the beginning, only two-thirds of CAP funds were to be devoted to price supports, but the reality has been totally different, with 95 percent of the funds going to market price supports, and only 5 percent or less went to structural development. Moreover, if prices are distorted, even the structural development funds do not go in the right direction.

In 1975, the Food and Agriculture Organization started to compute an index of the support going to the agricultural sector, known as the producer subsidy equivalent (PSE). Every type of policy measure, including border measures (e.g., tariffs, export subsidies), direct subsidies on the domestic market, and other ways of helping farmers, can be converted into a PSE. This index is the best indicator of EU's price policy at present and of what the CEECs will face when they accept the acquis.

Figure 6.1 presents OECD figures for a number of crops. The figure shows in percentage terms how much of the value of production that the farmer produces is supported by public support. There are three groups of supports: market price support (simply manipulating prices via tariffs and so on), net direct payments (direct subsidies to farmers via the budget), and indirect support (all other ways of helping farmers, through, e.g., extension services and other forms of assistance not targeted toward a single commodity).

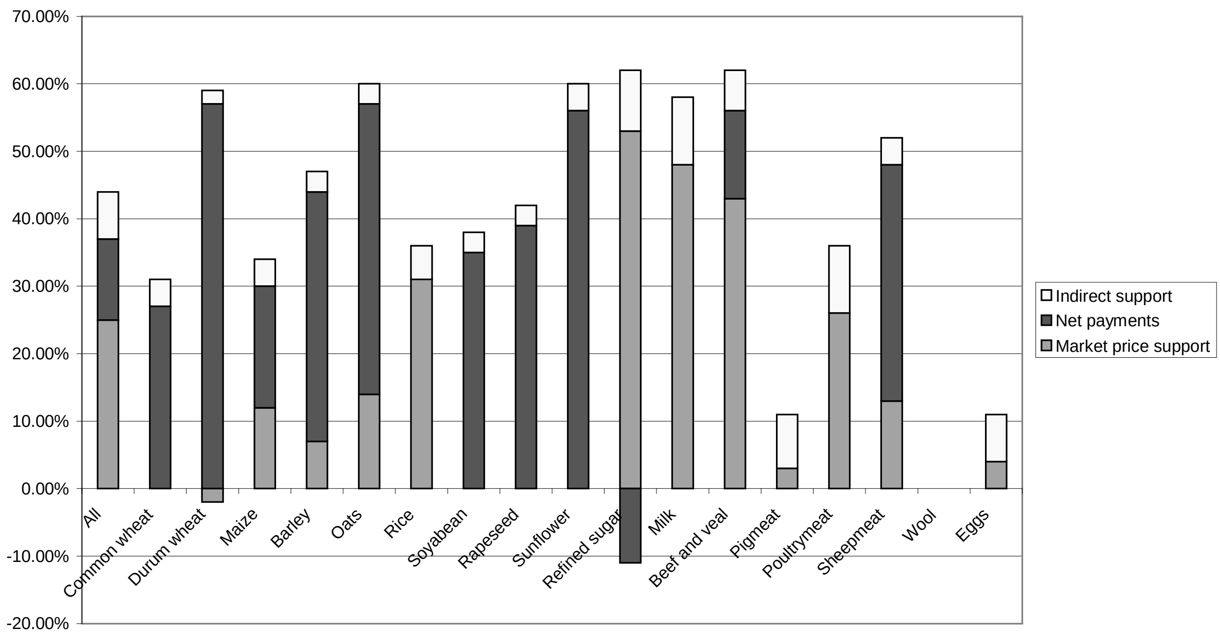
There remains a rather high share of production at the farm level which directly comes from the rest of society as a result of EU policies. However, there have been major changes since 1992: up to that year, cereal-growers were supported mostly by price supports, while since then, they have received mostly direct support. Nonetheless, there are still commodities for which the support is provided totally by consumers, such as milk or sugar.

The agricultural sector taxes itself, taking a share of a value that has been raised by virtue of the support, and then claims that it does not cost anything to the budget. Of

[26] This section summarizes the presentation of Secondo Tarditi.

course, since the price that farmers receives is three times what it would be on the market, they can afford to pay a tax to subsidize their exports and clear the market.

Figure 6.1
Producer Subsidy Equivalents (average 1995-97, %)



There is great diversity across commodities in the level of support, with wool, sunflowers and potatoes not supported at all. If one looks at the same issue in terms of the amounts of money involved, the figures appear different. Some sectors are highly costly, either to consumers or tax-payers, such as milk, beef, and veal, while other products are less important, so overall, in terms of millions of ECU, they cost much less.

Support for agriculture comes in two ways, either via the budget (which is visible) or via manipulation of prices (which is invisible, because prices in the absence of the support policies are unknown). With this in mind, the OECD has been computing since 1978 both PSEs and consumer subsidy equivalents (CSEs). As can be seen from Figure 6.2, some crops (e.g., oil seeds) are totally paid for by the budget, while others (e.g., milk and meat) are largely paid for by consumers.

The speaker next turned to the situation in the CEECs, where agriculture was highly supported in the 1980s. However, due to the transition and the market reorientation of these economies, such support has been strongly decreasing toward zero, and there has sometimes even been negative support.

If one compares the situation in the CEECs with that in Europe, one finds that that PSEs in seven CEECs (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and Slovakia) were on average higher than in the EU in 1986, but in 1997 they were only half the EU level (see Figure 6.3). CSEs have always been much lower in the CEECs than in than the EU.

Figure 6.2
Consumer Subsidy Equivalents (average 1995-97, %)

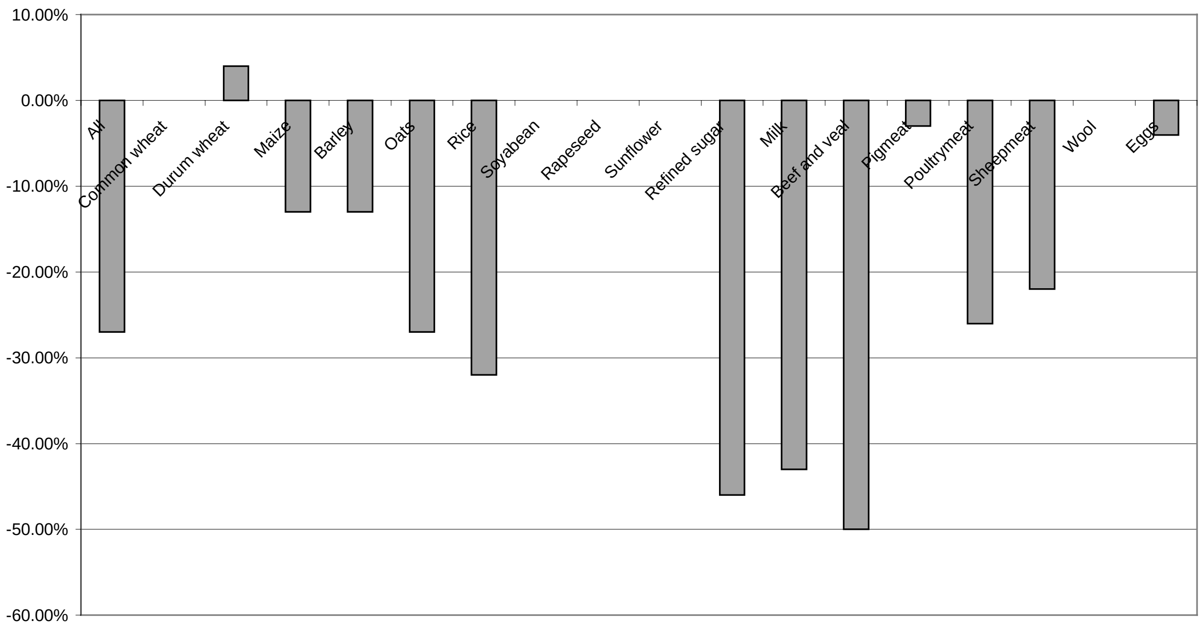
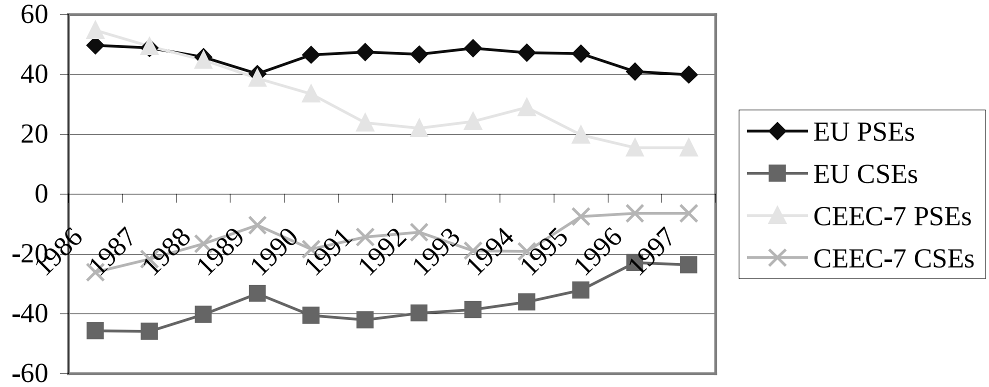


Figure 6.3, Total PSEs and CSEs (percent)



Looking now at Agenda 2000, does it radically change the situation in agriculture? The speaker is pessimistic on this score, because although it does lower the level of prices (e.g., cereal prices by 30 percent), in order not to lower farmers' incomes, they are provided with direct subsidies.

This process began in 1992, before the end of the General Agreement on Tariffs and Trade (GATT) round. In that round, it was clearly stated for the first time that agriculture was an international issue. Before that, farmers had succeeded in having it considered a domestic one, until it was eventually realized that if a country is supporting production, it is exporting more, and this has a strong impact on international markets. The over 100 GATT members agreed to dividing all instruments into "red box" and "green box" ones. The former are all those that manipulate prices, so their effects are less visible in their effects and create distortions, while the latter are targeted, transparent, easily understood, and paid for by the budget. Green box instruments are, if properly done, perfectly acceptable if they hit a particular target that a policy-maker wants to reach.

Thus, starting in 1992, direct payments began to be substituted for price supports, so farmers did not suffer from lower incomes. Direct payments are calculated on the basis of the land, and not on real yields, so as to decouple support from production. All agricultural commissioners have confirmed that these payments would be phased out, because only in that way would the economy be restructured, with surpluses reduced and production desired on the market increased.

However, all of these considerations have disappeared from Agenda 2000. Prices have been reduced for beef and veal, but direct payments per head of cattle have been substituted for them. There is no mention of these payments being limited in time, so they appear to have become permanent. This is a terrible policy: a flow of income is maintained to farmers which does not support structural adjustment. All the waste that has occurred is perpetuated and there is no real convergence, as there would have been if all payments were temporary.

What is the cost of this policy? It is well known that the CAP costs 50 percent of the EU budget (45 percent in 2006) for a sector that accounts for less than 2 percent of GDP. No one mentions that, according to OECD computations an even higher percentage support comes from the consumer.

What will happen when the CEECs join the EU? They will have to raise their PSEs and CSEs to roughly where they were in 1988. However, the World Trade Organization (WTO, the successor to the GATT) negotiations start in 1999, and there is a strong commitment to reducing price support in the future, so they may well have to lower them again. The raising of the PSEs and CSEs would be a complete reversal of the market-oriented policies that the CEECs have pursued up to now.

Is there a rationale for this? There are two allocation mechanisms, one of which is the free market, whereby one tries to match consumer requests with the cost of production (with all the theory behind it), and the other centralized policy, which has a certain logic, whatever its flaws. But the EU's agricultural policy is neither of these; it has no rationale, and reflects only the strength of the various agricultural lobbies (producers of milk, beef, cereals, and so on). Moreover, the level of support makes no sense in the context of the entire EU-15. In the 1960s, there was some relationship to the levels of support that Italy and Germany had provided before the war. Such support levels are particularly illogical for the CEECs, which had a totally different history and environmental and resource mix.

There are four major objectives in sectoral policy, namely *transparency, efficiency, equity,* and *sustainability*. On the issue of *transparency*, while ordinary people may have had other things to think about, the Commission can be criticized for never doing anything to publicize the results of the OECD studies. Every year, the Commission produces long documents on the price levels that it is fixing for the following year. In these documents, there is never a single reference to the cost to consumers (50 percent of the total costs). Neither are there any references to border prices, which are the opportunity costs of any goods. This must change, and consumers have been vocal in asking the Commission to publish every year a budget containing the costs and benefits.

There are also invisible transfers between countries, with net exporters gaining at the expense of net importers. Margaret Thatcher got a rebate for the U.K. on this basis.

On *efficiency,* a number of studies have shown that about 30 percent of the money is lost in surplus disposal and administrative and general services. Thus, even if one accepts the objective of transferring money to the farmers, this way of doing so is quite costly in terms of efficiency losses. The efficiency issue is also reflected in the mountains of butter that were sold to the USSR at prices that did not even cover the cost of the transport. With respect to administrative costs, one must take account not only spending by the EU, but also of that by national governments to implement quotas and land set-asides, instruments typical of centrally planned economies.

In terms of *equity,* the policy is a terrible failure. A high proportion of the money comes from families with lower incomes, who spend up to 50 percent of their incomes on food, and flows to the richest farmers (the Commission has admitted many times that 80 percent of the flows go to the best-off 20 percent of farmers). In regional terms, the policies can be justified, but there are much better approaches to regional issues than this second-best policy.

On *sustainability,* higher prices mean higher input usage and more environmental disruption. In social terms, surplus disposal and other administrative instruments create a lot of fraud, which is estimated to be about 9 percent of costs in agriculture. There is also the problem that farmers are taught that it is better to protest in the street or to cheat than to lower prices to increase their incomes.

In conclusion, it would be unfortunate if the CEECs are compelled to accept the acquis, to maintain incomes through distorted prices which are delaying structural adjustment. Furthermore, why invest in a sector that, for example, in Italy has an average labor productivity that is one-third of what it is in the rest of the economy (at domestic prices; at border prices, it is less than one-fifth)? What entrepreneur would continue to invest in an activity that has such a low return, even ignoring the effects on the environment and other problems? Moreover, the CAP’s depressing and destabilizing effects on world markets will become much larger if all the CEECs join the EU under the present acquis.

Important forces for change are consumers, who are becoming increasingly aware that they are losing a lot of money, and environmentalists. There are still possibilities to reduce support within the Union, which is, after all, the long-term trend in the WTO.

The speaker directed the audience to the Web site http://www.econ-pol.umisi.it/forum, where there is a report by him and his collaborators on agriculture in the aforementioned seven CEECs. They include, for each country, the level of support for each commodity in the past, how that would change with and without Agenda 2000, along with an analysis of the transfers between producers, consumers, and taxpayers based on certain assumed elasticities.

6.2 Everything or Nothing: Scenarios for Hungarian Agricultural Accession[27]

The speaker began by noting that agriculture is and will be one of the most sensitive areas of the accession negotiations. Preparations for these negotiations are very difficult, because the EU does not know exactly the future form of the CAP.

There are three possible scenarios. The first of these is an EU enlargement which excludes the CEECs from the CAP; the second is extending the present form of the CAP to the CEECs; and the third is extending to the CEECs a CAP reformed on the basis of Agenda 2000.

The first scenario would mean that the conditions of trade protection would be very unfavorable for Hungary, since there would remain duties and Hungary's export refunds would remain much smaller than in the EU. There would also be no additional sources of funding for the sector, so Hungary's economic and structural development and modernization would be much slower. These facts would worsen already existing rural social problems. This scenario is clearly unacceptable for Hungary.

As for the second scenario, the CAP has three spheres, namely, common market organization (or rules), legal harmonization, and regional policy. The common market rules are applied to the exports and imports of the EU.

With respect to imports, under this scenario Hungary would face an increase in protection against temperate zone products. However, since the EU has several preferential agreements with the suppliers of tropical products, there would be a reduction in protection with respect to such products. The Hungarian import structure is dominated by temperate zone products, so the country should prepare for increased protection on the average.

On the other hand, agricultural products produced by member states can enter the country without duties or quantitative restrictions, which will reduce prices on the internal market. However, there will be no export refunds for these products, which will tend to increase the prices of imported products. The outcome will depend on whether the former duty or the former refund was higher.

With respect to exports, the size of export refunds is significantly higher in the EU than at present in Hungary, although they were cut in the EU as a result of the latest GATT agreement. Hungary can benefit from the fact that export refunds can be obtained on the basis of tenders. The competitiveness of Hungarian products is enhanced by the circumstances that the neighboring countries are mainly net agricultural importers and production costs in the country are relatively low. However, the export potential of Hungary's agricultural products may be limited by the facts that there are quantity restrictions in the EU for most of the subsidized products and that Hungarian production has fallen drastically in the past few years.

Turning to the internal market, demand and supply can be regulated either by regulating prices or by regulating quantities. Hungarian producers would benefit from intervention buy-ups under price regulation, since they would provide secure markets for those producers. However, quantitative restrictions can be very unfavorable for Hungary,

[27] This section summarizes the presentation of Andrea Elekes.

since they can freeze in place the present production structure and thwart utilization of the full agricultural production potential.

Agricultural accession will also mean changes in price conditions. Producer prices differ greatly among EU member states. In the last few years, real agricultural prices in the EU have fallen, while prices in Hungary have risen, so the gap between EU and Hungarian prices has been reduced. Table 6.1 shows that the differences between Hungarian and EU prices are not particularly large, except for beef [adult cattle], which is one of the most protected products in the EU. Hungarian producer prices are mainly at about the average level within the EU, so there are several European countries where producer prices are lower than Hungary's.

Table 6.1. Producer Prices in the EU and Hungary, 1997 (ECU/100 kg)

	Soft wheat	Barley	Maize	Potatoes	Adult cattle	Pigs	Chicken
Highest EU price	15.660	15.28	15.73	20.7	343.45		120.00
Lowest EU price	9.870	9.71	11.13	4.22	221.87	105.58	66.54
EU-15 price	12.964	12.14	13.56	16.16	254.35	139.55	83.18
Hungary price	10.690	11.28	8.42	7.76	76.00	102.67	87.25
Hungarian price in % of lowest EU price	108.3	116	75.7	183.8	34.25	97.24	131.12

Source: Eurostat, Hungarian Central Statistical Office.

Agricultural accession will also mean changes on the internal Hungarian market. As producer prices increase, there will be an enhanced incentive to produce, and if production grows faster than domestic demand, there will be greater export potential. Hungary will have to sell these products somehow, and the main markets, besides the neighboring countries, will be southern Germany, northern Italy, and in some cases Austria.

On the other hand, Hungary will have to prepare for increased competition on its internal market. As already noted, products from member-states can enter Hungary without duties or quantitative restrictions. Hungary will face competition from the best supplier of agricultural products, and this competition will not focus on primary products, but on processed ones.

From this perspective, Hungary's situation is relatively good, since its food industry is dominated by foreign investors (multinationals). Such investors can be advantageous for the country, given the financing that they provide for modernization of productive assets and the access that they provide to markets. However, such a large presence of multinationals can be harmful as well, because their size and market power may allow them to dictate the conditions of buying and selling.

EU accession would create a boom in the demand for agricultural production equipment and services. Without proper preparation, EU, rather than Hungarian, suppliers would be the beneficiaries of this boom.

Accession would also mean changes in income allocation. Producers' incomes would be influenced in three ways: through changes in agricultural producer prices, through compensatory payments, and through changes in production costs. There will be increases in both producer prices and input prices. Calculations at the beginning of the 1990s showed that the combination of these price changes would have led to a rise in agricultural incomes of 100-165 billion forints per year.

Hungarian agricultural producers would also benefit from the EU's agricultural subsidies and direct payments. At the beginning of the 1990s, one-third of the difference between EU and Hungarian prices came from exports, mostly on account of the higher EU export subsidy. Two-thirds of the difference arose on the internal market, of which 22 percent could be attributed to market subsidy and the rest to higher selling prices.

Since then, the situation has changed. The EU had maintained high prices through which European producers received "appropriate incomes." After the MacSherry reform, these prices were cut, and there is a new element, namely, direct payments. In 1992, before the reform, agricultural subsides to Hungarian producers would have been ECU 1,110 million, while in 1994, after the reform, such subsidies would have come to only ECU 350 million.

The most dramatic change would have concerned export subsidies, which would have been cut over this period from ECU 590 million to ECU 100 million. Producers would have received in compensation direct payments of ECU 570 million, although their total receipts would have been reduced due to supply-control measures.

Turning to the budget, there would have been the positive effect that the national budget would have not had to allocate as much money for subsidies, although it would have lost revenues from duties, which have been an important element on the revenue side. The budget would also have benefited from transfers from the EU and from additional income tax revenue from the higher agricultural incomes. However, rising food prices would induce rising nominal wages, which the budget would have to accommodate, and contribute to an increase in the level of social services.

With respect to the effects on the population, the incomes of the agricultural population would rise, while rising expenditures on food would either reduce nominal incomes (net of such expenditures) or induce additional expenditures for economic organizations or the budget. For the non-agricultural sector, the negative effect of the changes would again be rising wage costs, but favorable market conditions can provide an incentive for increased production.

Finally, the speaker addressed the third option, namely, extending to the CEECs a CAP that has been reformed on the basis of Agenda 2000. One aspect of Agenda 2000 that would affect the CEECs is a reduction in intervention prices. If there will be no agricultural accession, then the reduction of intervention prices would improve the competitiveness of EU producers (see Table 6.2). If there would be no reduction in duties, then the competitiveness of third countries would worsen.

Table 6.2: **Scenarios according to Agenda 2000**

<table>
<tr><th></th><th>No Agricultural Accession</th><th>Until Accession</th><th colspan="2">After Accession</th></tr>
<tr><td>Reduction of intervention prices</td><td>Improved competitiveness for the EU producers. If no reduction in duties, competitiveness of third countries will worsen.</td><td>Smaller gap between EU and CEEC prices.</td><td colspan="2">Less benefit (compared to the present CAP) from the intervention.</td></tr>
<tr><td>Rising compensation</td><td colspan="2">Although the price gaps between the EU and CEECs will be smaller, EU producers will be in a better position to produce.</td><td>No compensa-tion: see no accession</td><td>Compensation: improving income situation and competitiveness</td></tr>
<tr><td>Supply control measures
• No set- aside:
• No oilseed basic area:
• Regional ceilings for number of premium rights, planned introduction of national ceilings for suckling cow premium rights, dairy and sugar quotas:
• 2% rise in dairy quotas</td><td colspan="2">• No direct effect.
• No direct effect.</td><td colspan="2">• Full utilization of CEECs’ agricultural land potential.
• In case of reduction of production of oilseeds in the present member states, Hungary will have advanced market access.
• These measures can freeze present production structures, they can prevent utilization of the full production potential of CEECs.
• Compensation for price reduction.</td></tr>
<tr><td>Financing</td><td></td><td>Pre-accession instruments.</td><td colspan="2">• Possible subsidiarity.
• Co-financing (25% paid by the national governments).</td></tr>
<tr><td>Rural development
• Resources devoted to agri-environmental measures will be increased.
• The LFA-scheme will gradually be transformed into an instrument to maintain and promote low-input farming system.
• Cross compliance (integrating better the environment into the CAP).
• Modulation
• Ceilings</td><td colspan="2">No direct effect.</td><td colspan="2">• As Hungary has significant difficulties in this field, additional EU-sources could help.
• As the CEECs have a relatively low-input farming system, and the level of GDP is also low, additional sources could be available.
• Can be dangerous for Hungary, especially as regards livestock production (stocking density).
• Employment impacts.
• The system favors smaller farms.</td></tr>
</table>

Source: Agenda 2000

Under the "until accession" scenario, the gap between Hungarian and EU prices would be reduced. Under the "after accession" scenario, the benefits for producers would be reduced compared to situation under the present CAP.

Another provision of Agenda 2000 is rising compensation. Under both the "no agricultural accession" and "until accession" scenarios, it turns out that although the price gaps between the EU and the CEECs would be smaller, EU producers would be in a better position to take advantage of the situation. Under the "after accession" scenario, there would be two possibilities: either there will be compensation or there will not be any. Without compensation, the situation would be the same as where there is no agricultural accession, while if there is compensation, Hungarian producers' income situation would be improved.

With respect to supply control measures, Agenda 2000 says that there should be no set-asides. This would allow Hungary to use its full agricultural potential. In the area of oilseed policy, the CAP currently has a basic area restriction for such products. An elimination of this restriction would be favorable for Hungary, allowing it to win additional markets in the EU for its oilseeds.

There are supply-control measures that would remain even under Agenda 2000. This would be very unfavorable for Hungary, since it would freeze the present production structure and prevent the country from realizing its full agricultural potential. Agenda 2000 also calls for a 2 percent rise in dairy quotas, which can be favorable for Hungary, since it is compensation for price reductions, and the country could share in the rising quota.

With respect to financing, under the "until accession" scenario, the pre-accession instruments would be the most important source of financing in addition to national resources. Under the "after accession" scenario, there are new possibilities on the agenda, including subsidiarity or cofinancing, which would mean that 20 percent of the compensation and other payments should be financed by national governments. These measures would be very unfavorable for Hungary.

6.3. WTO Commitments and CAP Adoption in Central and East European Countries: The Case of Romania[28]

Three simultaneous processes shape the agro-food policies of the CEECs: domestic reforms; preparation for accession to the EU; and external trade commitments to the WTO and various regional and bilateral agreements. These processes are interrelated, raising difficult issues for policy-makers, who have to foresee the multi-dimensional effects of their decisions. The situation is likely to become more complicated as preparations for accession to the EU intensify and the Millennium WTO mini-round on agriculture draws closer.

Various studies have examined the interdependence between the adoption of the CAP and the CEECs' WTO commitments in agriculture, as well as the general effects of the Uruguay Round Agreement on Agriculture (URAA) on the CEECs and the former Soviet Union. However, most of these studies either consider the CEECs as a single

[28] This section summarizes the presentation at the workshop by Sophia Davidova of a paper written by herself, Lionel Hubbard, Daniela Giurca, and Mirela Rusali.

region or focus on those "first wave" countries which are most advanced in their preparations for accession. Relatively little research has been undertaken on the countries expected to be in the "second wave."

This presentation focuses on Romania, which is an interesting case, first, because of the size of its agricultural sector and its importance to the national economy, and second, because the country, alone among the applicant nations, has developing country status.

This presentation addresses two main questions:

- Will Romanian agricultural policy be constrained by the (assumed) new commitments resulting from the Millennium WTO mini-round?
- Will Romanian's WTO Commitments raise problems for the EU, which might result in sensitive areas during the negotiations for accession?

The presentation examines the situation in Romania in 2006, which is taken to be the notional year for accession. Projections under different assumptions are generated using a partial equilibrium, comparative static, multi-market model developed for the purpose of estimating the economic costs and benefits of Romanian accession to the EU.

The first part of the presentation dealt with Romania's WTO commitments.

Enjoying the status of a developing country has enabled Romania to set high tariff bindings[29] for agricultural products. The maximum weighted average import tariff is 161.5 percent. There are large differences between nominal protection, the tariff bindings, and published tariffs (Table 6.3).

Romania opened eleven minimum access quotas.[30] With the exception of seed potatoes, all are for processed foods, for example, skim milk powder, cheese, pasta, chocolate, ice cream, alcohol and cigarettes. The in-quota quantities are rather small, while the in-quota tariff rate is high, at around 100 percent. For this reason, minimum access is not explicitly included in the following analysis, as it is assumed that it cannot greatly affect the tradable surplus.

Romania, as with most developing countries, did not record the base level of domestic support in its GATT schedule and used the *de minimis* clause. As a result, the value of distortive support should not exceed 10 percent of the value of output of each product in the case of product-specific support, and 10 percent of the value of the total agricultural output in case of non-commodity-specific support. This common practice has been defined as a weakness which puts developing countries at a disadvantage and is more serious in the case of Romania, faced with the prospect of EU membership and the adoption of the CAP.

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[29] Editor's note: tariff bindings are maximum duty rates that are committed in the WTO and hence difficult to raise.

[30] Editor's note: It was agreed at the Uruguay Round that GATT members would open so-called minimum access import quotas, with in-quota rates lower than the tariff bindings. These quotas were set equal to 3 percent of domestic consumption at the beginning of the implementation period, and 5 percent thereof in the final year of that period.

Table 6.3 Nominal Protection Coefficients (NPCs), Tariff Bindings and Published MFN Tariffs in Romania, 1997

Commodity	NPCs	Bindings (percent)	Published Tariffs (percent)
Wheat	1.00	276	25
Maize	1.10	276	30
Sunflowers	1.04	184	30
Sugar	1.16	192	25
Milk	1.28	141	35
Pork	1.24	355	60
Beef	1.31	336	50
Poultry	1.36	134	60

Source: Gorton, M. and D. Deaconescu (1998) "Domestic Resource Costs and the International Competitiveness of Romanian Agriculture," PHARE Project Romania: EU Alignment and Policy Reform. Working paper; Romanian Customs Tariff.

Romanian export subsidies (budgetary outlays) are expressed in constant 1986-89 lei. In this way they are protected from inflation erosion. However, the budgetary allowances are far lower than in other CEECs which are major agricultural producers. According to USDA estimates, expressed in 1992 U.S., the final-year commitments for Romania (in 2004) amount to $147 million, while for Hungary and Poland in 2000 they are $419 million and $500 million, respectively (Plunkett and Maxwell, 1994).[31] The list of export subsidies is short, but it incorporates the most important agricultural products, including some of the products for which the EU provides such subsidies.

Overall, the Romanian commitments seem inconsistent. They allow for very high tariff protection and at the same time put tight constraints on (coupled[32]) domestic support, with a relatively modest use of export subsidies. In the general case, this means that Romania cannot make extensive use of the high bindings and is bound to follow relatively liberal agricultural policies if it wishes to export agricultural products. From an economic point of view, this is advantageous, particularly as the country still faces massive restructuring of the agro-food sector, with efficiency and international competitiveness as implied objectives. However, from the point of view of accession to

[31] D. Plunkett and D. Maxwell (1994). "Future Prospects for Central and Eastern European Agriculture," U.S. Department of Agriculture, Economic Research Service. Working paper.
[32] Editor's note: that is, coupled with production.

the EU and adoption of CAP, these constraints on domestic policies might bring about difficult issues during the accession negotiations.

The next part of the presentation dealt with the approach, assumptions, and information sources used in the investigation.

Romania's current WTO commitments expire in 2004. As the analysis is focused on the year 2006, under both accession and non-accession scenarios, three main groups of assumptions were necessary:

- for developments in Romania to 2006;
- for world and EU agricultural prices in 2006;
- for the outcome of the Millennium mini-round on agriculture.

The base year is 1997, annual average GDP growth over 1997-2006 is assumed to be 3 percent, and the growth of agricultural productivity to average around 2 percent per year. The real exchange rate is constant at the average 1997 level.

The policy assumptions under the accession scenario include adoption of EU prices/protection rate, implementation of production quotas for sugar, milk and tobacco, and direct payments. For production quotas and direct payments, two alternatives are run: one with an average (standard) quota reflecting historical, pre-accession developments during the period 2001-2005; and the other with a low quota during 2001, the first year of the period. As a reference point, the situation with unconstrained production is shown by an analysis of the Aggregate Measure of Support (AMS). There are serious doubts on whether direct payments will apply to the new EU members. As a result, the two alternatives are run with both zero and full direct payments.

The basis used for import flows is 1997, due to the erratic trade policy in Romania before 1997; by mid-1997, under the conditions of the World Bank's Agricultural Structural Adjustment Loan, Romania had liberalized and stabilized to a certain degree its foreign trade policy. In 1996 the arithmetic average of tariff protection of agriculture was 85.5 percent and the production weighted average was even higher, 102 percent (Davidova, 1997).[33] Tariffs were often changed and low tariff quotas were opened for specific users. For this reason it was difficult to define the trend in agricultural imports. As a result, the assumption employed is that the growth rate of imports through 2006 is zero.

One of the crucial determinants in the analysis is the rate of protection in Romania in the base year and in 2006 under "non-accession." For 1997, for cereals, sunflower, sugar, milk and meats, NPCs calculated by Gorton and Deaconescu (1998)[34] were used. For dairy products the preferential duty under the Europe Agreement was used, while for the remaining products the published tariffs were adjusted to take into account preferential imports under various trade agreements.

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[33] S. Davidova (1997). "Bulgaria and Romania en route to CEFTA and their Agricultural Policies," in *Regional Trade Arrangements and Agricultural Policy in Central and Eastern Europe*, pp. 131-159. PHARE Multi-country Trade Development Programme and Wye College, Wye College Press.

[34] M. Gorton and D. Deaconescu (1998). "Domestic Resource Costs and the International Competitiveness of Romanian Agriculture," PHARE Project Romania: EU Alignment and Policy Reform. Working paper.

However, the fact that internal prices are lower than expected, given published most-favored nation (MFN) tariffs, is not only due to preferential imports. Another reason is the underdevelopment of markets and the low level of market efficiency. It is assumed that market efficiency will increase in the analyzed period, but that price transmission will continue to be imperfect. For this reason, two alternatives are run in the analysis of AMS and export subsidies under the non-accession scenario: protection rates equal to 0.5 and 0.25, respectively, of the 1998 published tariffs. There are two exceptions, milk and tobacco, which are not included in any preferential trade agreement. For these, under the first alternative the 2006 protection rate is set equal to 1998 published tariffs, and under the second at 0.5 of these tariffs.

Projections for world prices are based mainly on OECD or World Bank data. For the EU, the proposed Agenda 2000 prices were used, where possible, and for products for which there are no proposals, the EU protection rate in 2006 was assumed. For several products, for example, pork and poultry, the assumed protection rate was zero.

The assumptions in the present presentation are conservative and simple:

- Implementation of the new WTO commitments will begin in 2004.
- The outcome will be at least equal to what was achieved during the URAA. The commitments for cuts in tariff bindings, domestic support, and export subsidies will be the same as in the URAA. The mini-round will be more radical in cutting distortive domestic support, namely by including the EU’s direct payments. If, upon accession to the EU, direct payments apply to Romania, they will be included in the amount of distortive support.
- After the expiry of its URAA commitments in 2004, Romania will change its WTO status from developing to developed country, in preparation for EU accession.

The discussion of market access and alignment to the EU focuses on the tariff bindings and not on the applied tariffs. The reason is that upon enlargement third countries are likely to pay attention to the bindings, because they are negotiable within the WTO.

The basic criterion for choosing tariff positions for comparison between Romania and the EU was the share of the import value of the respective group in total Romanian agricultural imports. For an indication of the order of magnitude of possible compensation claims, it is assumed that by 2006 the other CEFTA countries will be EU members. Consequently, they are excluded from the group of third countries.

In the analysis of AMS all distortive support was treated as product-specific and the *de minimis* clause was applied product-by-product.

In order to be able to use projections from the model, the same level of disaggregation of products at which export subsidy commitments are expressed was necessary, which required certain disaggregation.

Since recently Romania protected its budgetary outlays against inflation erosion by expressing the commitments in constant 1986-89 lei, the commitments for 2006 were recalculated in 1997 prices.

The results of the investigations were the following.

a. Tariff Bindings and Compensation

Figure 6.4 shows that, in the general case, Romanian tariff bindings, including the ones for the core CAP products, are higher than those in the EU. Thus, compensation might not be a sensitive issue during the negotiations for Romanian accession to the EU. However, exceptions are bananas, citrus fruit, sugar, and rice, and these are Romania's most important agro-food imports (23 percent in 1997).

Figure 6.4a
Tariff Bindings 2006
Romania and the EU, Core CAP Products
(%)

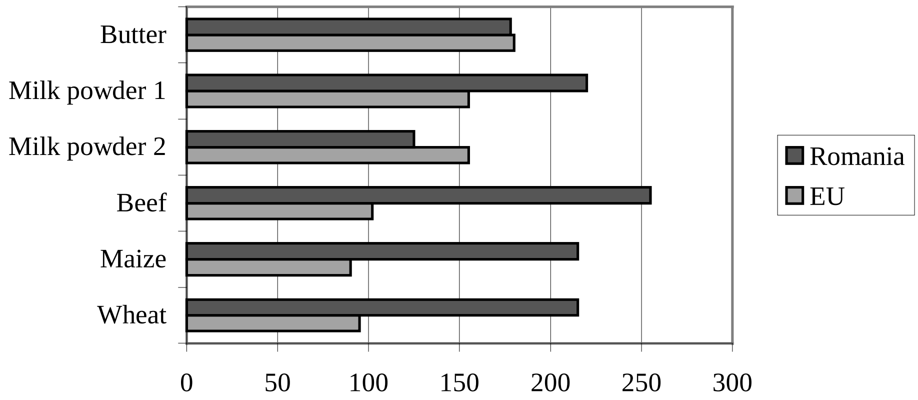
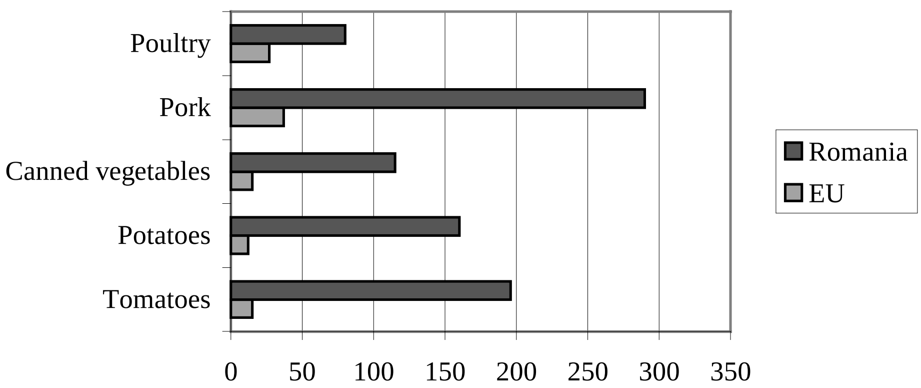


Figure 6.4b
Tariff Bindings 2006, Romania and the EU, Other Products
(%)



From the potential compensation to third-country importers (see Table 6.4) the most interesting case is that of sugar, because not all the sugar is imported under MFN. Approximately one-fifth of the value of sugar imports comes from Moldova, with which Romania has had a free trade agreement since 1994. In this case, the value of compensation might be higher, because of the larger gap with the EU's projected binding for 2006. The total value of compensation, however, is not substantial, so this issue is not expected to create problems during the accession negotiations.

Table 6.4 Estimation of Potential Compensation to Third Countries

Romanian tariff line	Description of products	Romanian tariff bindings 2006 (%)	EU tariff bindings 2006 (%)	Imports from third countries ('000 USD)	Com-pensation ('000 USD)	Rank in Romanian agro-food imports, 1997
		1	**2**	**3**	**4 (2-1)*3**	**5**
1701	Cane or beet sugar	158	173	21,091	3,164	1
	incl. from Moldova	0	173	17,562	30,382	
805	Citrus fuit	16	29	7,343	955	3
803	Bananas	62	134	16,076	11,575	4
1006	Rice	120	143	18,252	4,198	5
	Total				**50,273**	

b. Domestic Support

The AMS might be a substantial constraint on the domestic policy measures. According to the simulations, in 2006 (under non-accession) only sunflowers and beef fall within the constraints, when there is a protection rate of 0.5 of the published 1998 tariffs, and the same two, plus pork, do so when there is a protection rate of 0.25. Under the accession scenario, this group also includes eggs. All the other products exceed their commitments.

Accession simulations are interesting in order to see the effects of the adoption of various EU policy instruments. The change of quota from standard to low does not substantially affect the results. However, direct payments make a crucial difference. If they are applied to Romania but are not accepted by WTO as de-coupled, then the overshoot will be around 4 billion ECU. Although the AMS will be aggregated with the EU upon accession, the contribution of Romania to the total commitments of the enlarged Union might create a sensitive area for discussion during the negotiations, particularly if the WTO mini-round treats the direct payments designed under Agenda 2000 as not fully de-coupled.

c. Export Subsidies

One can compare the commitments and the assumed need for subsidies. It turns out that Romania will have bigger problems meeting its WTO commitments if it stays outside the EU. Even if only 50 percent of the current applied tariffs become operational, the country could not export its surplus because of the WTO constraints. In the 2006 non-accession scenario, with 0.5 of published tariffs being reflected in farmers' prices, problems arise for wheat, maize, sunflower seeds, cheese and wine; and with 0.25, for wheat, maize and sunflower.

Romania is internationally competitive in cereals and sunflowers and is also a traditional wine producer, with a strategy to increase its outlets on the world market. In order to achieve this under the WTO, the country has to operate domestically at world market prices, because otherwise it will continuously exceed the external constraints.

Under the 2006 accession scenario, the situation is better because the domestic prices are closer to world market prices. Producers of cereals will operate at world market prices and be competitive without export subsidies. Problems occur for three products only, namely, sugar, cheese and wine. The price reform in the wine sector has not yet started and the Luxembourg Council Meeting in June 1998 extended the price *status quo* for another year. There are not yet proposals for changes in the sugar regime. If reforms of these commodity regimes are pursued, it is likely that these two products would not create a problem upon accession, or would be less of a problem than is projected here.

Thus, upon amalgamation of the Romanian and EU schedules, Romania might aggravate the EU situation for sugar, wine, and cheese; the extent to which this happens will also depend on the share of Romanian exports to third countries. On the other hand, with the assumed 3 percent annual increase in real incomes in Romania, by 2006 the country will be in deficit for meats. As Romania will be in the single market, this could relieve the problem the current EU members might have in meeting the export subsidy commitments for meat, particularly beef.

In sum, one may conclude that Romania will not create a problem for the EU upon accession with respect to the harmonization of tariff bindings. In most cases, the re-alignment will mean that Romania will have to decrease its bindings. Requests for compensation for decreased market access will be only for a few products and the amounts are not significant. The example of the zero tariff import of sugar from Moldova, within the framework of a bilateral free trade agreement, shows the interaction between existing arrangements and future accession to the EU.

During the pre-accession period, domestic support and export subsidy commitments might create a problem for Romania for several main agricultural products. This problem is not yet visible because of the lack of competitive domestic markets and the resulting lack of transmission of border measures to farmers' prices. However, with the progress of reforms and market developments, the constraints set by domestic support and export subsidy commitments will become tighter. This makes a strong case for why pre-accession Romania must employ policy measures which do not affect farmers' prices (i.e., de-coupled support) and must not rely on high tariff protection.

7. Survey of Computable General Equilibrium Model Calculations

7.1 CGE Model Estimations of Costs and Benefits of EU Enlargement: A Survey[35]

The speaker began by noting that his task was to provide a survey of existing model simulations of the costs and benefits of EU enlargement for the EU countries. However, no model calculates costs endogenously, so only the benefit side is modeled, lending a certain asymmetry to the approach.

Looking first at the cost estimations, the starting point of the analysis is the development gap between the EU incumbents and the applicant countries. Table 7.1 contains the latest GDP figures for 1997 in purchasing power parity terms, as calculated by Eurostat. These reflect a considerable upward revision relative to the ones for 1995 (which were used in Agenda 2000), and one can ask whether such a swift catch-up within two years is possible.

In reality, the change between the two years is largely explained by a revision in the methodology of the GDP calculations. The more recent figures include a bit more of the "black economy" and the service industry.

If one draws an "Objective 1 line" at 75 percent of the EU average GDP per capita, countries below the line are eligible for the largest transfers under the Structural Funds. All the eastern applicant countries would be Objective 1 countries, while among the incumbents currently all of Greece, Portugal, and Ireland (although it is already above the line), and certain regions of Spain so qualify. Under Agenda 2000, there is discussion of whether the EU should continue to provide them with transfers, although Ireland argues that it still needs them.

As already noted, the *costs* of enlargement are an external matter as far as the models are concerned, and one must look at the European Commission's budgetary plans. The latest financial perspectives are from March 1998; it covers 2000-2006 (see Table 7.2), and implies – for technical, not political reasons – that the first accession (of five countries) will occur in 2002.

The accumulated cost of enlargement for the EU over 2000-2006 is 80 billion euro in total, including 16 billion euro for the CAP, and 47 billion euro for the Structural Funds, and the rest are for administrative matters and external and internal policy measures. The new countries are subject to a ceiling of 1.27 percent of GDP on their own gross payment to the EU budget, although the normal percentage is 1.15 percent of GDP. Deducting this leaves a net cost of euro 60 billion over the period, and dividing by the projected GDP of the EU 15 over that period, we derive a net cost of 0.15-0.2 percent of GDP for the EU on the average.

[35] This section summarizes the presentation of Fritz Breuss.

Table 7.1 Basic Economic Indicators, 1997

	Area	Population	GDP		GDP per capita		Agriculture	
	(1000 km²)	(Mill.)	Current prices (billion ECU)	PPP rates (billion ECU)	Current prices (in ECU per head)	PPP rates (in ECU per head)	% of total Gross Value Added	% of total employment
Bulgaria	111	8.4	9.0	36.7	1,100	4,400	12.8	18.0
Czech Republic	79	10.3	45.9	123.8	4,500	12,000	3.0	6.0
Estonia	45	1.5	4.2	10.3	2,800	7,000	8.0	9.2
Hungary	93	10.2	39.6	90.3	3,900	8,900	6.6	8.6
Latvia	65	2.5	4.9	12.7	2,000	5,100	7.6	15.3
Lithuania	65	3.7	8.4	21.3	2,300	5,800	10.2	24.0
Poland	313	38.6	119.7	291.2	3,100	7,500	5.5	21.3
Romania	238	22.7	30.6	131.8	1,400	5,800	19.0	34.6
Slovakia	49	5.4	17.2	48.2	3,200	8,900	2.6	6.0
Slovenia	20	2.0	16.1	25.8	8,100	13,000	4.4	6.3
CEEC-10	**1,078**	**105.3**	**295.6**	**792.1**	**2,800**	**7,500**	**6.8**	**21.1**
in % of EU-15	*33.30*	*28.11*	4.18	*11.11*	*14.84*	*39.47*	*400.00*	*413.73*
Belgium	31	10.2	217.0	218.4	21,275	21,500	1.3	2.7
Denmark	43	5.3	137.0	114.8	25,849	21,800	2.4	3.9
Germany	357	82.1	1,838.0	1,712.2	22,387	20,900	0.8	2.9
Greece	132	10.5	105.9	138.2	10,086	13,100	6.7	20.3
Spain	506	39.3	465.4	586.0	11,842	14,800	3.5	8.6
France	544	58.7	1,217.0	1,161.5	20.733	19,800	1.9	4.8
Ireland	70	3.7	55.3	67.1	14,946	18,300	4.1	11.2
Italy	301	57.6	1,001.8	1,126.8	17,392	19,200	2.7	6.7
Luxembourg	3	0.4	14.8	13.3	37,000	31,500	0.7	2.4
Netherlands	42	15.7	318.5	309.6	20,287	19,800	2.8	3.8
Austria	84	8.1	181.5	172.6	22,407	21,300	1.0	7.4
Portugal	92	10.0	87.1	133.3	8,710	13,400	3.3	12.2
Finland	338	5.1	101.8	96.2	19,961	18,700	0.8	7.9
Sweden	450	8.8	192.4	165.4	21,864	18,700	0.5	3.3
United Kingdom	244	59.1	1,134.5	1,116.0	19,196	18,900	0.8	2.0
EU-15	**3,237**	**374.6**	**7,068.0**	**7,131.4**	**18,868**	**19,000**	**1.7**	**5.1**

Source: Agenda 2000: Volume II - Communication: The effects on the Union's policies of enlargement to the applicant countries of Central and Eastern Europe (Impact study); statistical appendix, *Bulletin of the European Union*, 5/1997; update with data from DG VI.
Financing the European Union: Commission Report on the Operation of the Own Resources System, DG XIX, Brussels, 7 October 1998; Appendix 8.
Eurostat, *Statistik kurzgefaßt: Wirtschaft und Finanzen*, 28/1998.

Table 7.2. Financial Perspective for an Enlarged EU-20: 2000-206 Appropriations for Commitments; EUR million - 1999 prices

	1999	2000	2001	2002	2003	2004	2005	2006	2000-2006 total
1. Agriculture (CAP) (Heading 1)[1]	**45.2**	**46.1**	**46.9**	49.4	**50.8**	**52.1**	**53.6**	**55.0**	**353.8**
a) EU-15	45.2	45.5	46.4	47.3	48.2	49.2	50.1	51.1	337.8
b) 5 CEECs (accession)[2]				1.6	2.0	2.5	2.9	3.4	12.4
c) Pre-accession aid (5 CEECs)[3]		0.5	0.5	0.5	0.5	0.5	0.5	0.5	3.6
2. Structural operations (Heading 2)[4]	**35.7**	**36.6**	**37.5**	**40.4**	**41.4**	**42.4**	**43.4**	**44.6**	**286.3**
a) EU-15*)	35.7	35.6	36.4	35.6	34.6	33.4	32.4	31.4	239.4
b) 5 CEECs (accession)[2]				3.8	5.8	7.9	10.0	12.1	39.6
c) Pre-accession aid (5 CEECs)[3]		1.0	1.0	1.0	1.0	1.0	1.0	1.0	7.3
3. Internal Policies (Heading 3)[5]	**6.4**	**6.4**	**6.7**	**7.6**	**7.8**	**8.0**	**8.2**	**8.5**	**53.2**
a) EU-15	6.4	6.4	6.7	6.9	7.1	7.2	7.4	7.6	49.3
b) 5 CEECs (accession)[2]				0.7	0.8	0.8	0.8	0.9	4.0
4. External Action (Heading 4)	**6.9**	**6.9**	**7.1**	**7.3**	**7.4**	**7.6**	**7.8**	**7.9**	**51.9**
a) EU-15	6.9	5.3	5.5	5.7	5.9	6.1	6.2	6.3	41.0
c) Pre-accession aid (5 CEECs)[3,6]		1.6	1.6	1.6	1.6	1.6	1.6	1.6	10.9
5. Administration	**4.7**	**4.7**	**4.8**	**5.3**	**5.4**	**5.6**	**5.7**	5.8	**37.2**
a) EU-15	4.7	4.7	4.8	4.0	5.0	5.1	5.2	5.3	35.1
b) 5 CEECs (accession)[2]				0.4	0.4	0.5	0.5	0.5	2.1
6. Reserve (EU-20 = EU-15)	**1.2**	**0.9**	**0.9**	**0.6**	**0.4**	**0.4**	**0.4**	**0.4**	**3.7**
A. Approximations for Commitments	**100.1**	**101.5**	**103.8**	**110.6**	**113.2**	**116.0**	**119.0**	**122.0**	**786.1**
as % of EU-20's GSP	*1.28*	*1.27*	*1,27*	*1.27*	*1.27*	*1.27*	*1.27*	*1.27*	*1.27*
a) EU-15	***100.1***	***98.4***	***100.7***	***101.0***	***101.1***	***101.3***	***101.7***	***102.1***	***706.2***
as % of EU-15's GSP	*1.28*	*1.234*	*1.23*	*1.20*	*1.17*	*1.15*	*1.12*	*1.10*	*1.17*
b) 5 CEECs (accession)[2]				**6.5**	**9.0**	**11.6**	**14.2**	**16.8**	**58.1**
as % of CEEC-5's GSP				*2.21*	*2.97*	*3.68*	*4.32*	*4.91*	*3.67*
c) Pre-accession aid (5 CEECs)[3]		**3.1**	**3.1**	**3.1**	**3.1**	**3.1**	**3.1**	**3.1**	**21.8**
as 5 of EU-15's GSP		*0.04*	*0.04*	*0.04*	*0.04*	*0.04*	*0.03*	*0.03*	*0.04*
B. Approximation for Payments	**96.4**	**98.8**	**101.7**	**107.3**	**110.2**	**112.7**	**115.6**	**118.8**	**765.1**
as % of EU-20's GSP	*1.23*	*1.24*	*1.24*	*1.23*	*1.24*	*1.23*	*1.23*	*1.23*	*1.23*
a) EU-15	**96.4**	**95.7**	**98.5**	**99.8**	**100.4**	**100.7**	**101.1**	**101.4**	**697.6**
as % of EU-15's GSP	*1.23*	*1.20*	*1.20*	*1.19*	*1.17*	*1.14*	*1.12*	*1.09*	1.16
b) 5 CEECs (accession)[2]				**4.4**	**6.7**	**8.9**	**11.4**	**14.2**	**45.7**
as % of CEEC-5's GSP				*1.51*	*2.21*	*2.82*	*3.48*	*4.16*	*2.89*
c) Pre-accession aid (5 CEECs)[3]		**3.1**	**3.1**	**3.1**	**3.1**	**3.1**	**3.1**	**3.1**	**21.8**
as % of EU-15's GSP		*0.04*	*0.04*	*0.04*	*0.04*	*0.04*	*0.03*	*0.03*	*0.04*
C. Own Resources Ceiling	**99.1**	**101.6**	**104.1**	**110.4**	**113.3**	**116.1**	**119.1**	**122.2**	**786.8**
1,27% of EU-20's GSP									
a) EU-15	**99.1**	**101.6**	**104.1**	**106.7**	**109.4**	**112.1**	**114.9**	**117.8**	**766.6**
b) 5 CEECs (accession)[2]				**3.7**	**3.9**	**4.0**	**4.2**	**4.3**	**20.1**
D. Margin Total (C-B)	**2.7**	**2.8**	**2.4**	**3.1**	**3.1**	3.4	**3.5**	**3.4**	**21.7**
as % of EU-20's GSP	*0.04*	*0.03*	*0.03*	*0.04*	*0.03*	*0.04*	*0.04*	0.04	*0.04*

*) 3.0 bn EUR of which are reserved for the Cohesion Fund per year.

1 The Ceiling corresponds to the agricultural guidelines.

2 Assumption: Accession starts in 2002 with 5 CEECs: CZ, EE, HU, PL, SI (+Cyprus).

3 Pre-accession strategy concerns the 5 CEECs: BG, LV, LT, RO, SK.

4 Less 3.294 bn EUR; this is the amount in respect of the EEA financial mechanism and the adjustment proposed by the Commission to take account of the conditions of implementation of the 1997 budget.

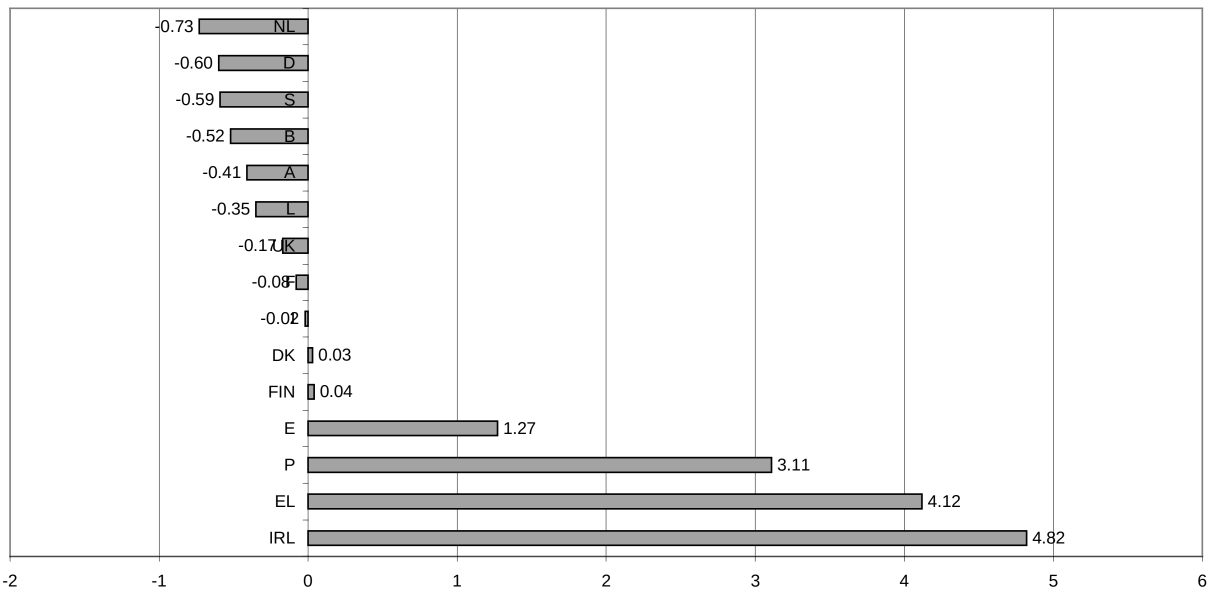
5 Five financial priorities: TEN, research and innovation, general and job education; environment; sustainable technologies.

6 Via increasing the funds for the PHARE program.

Source: Commission Communication to the Council and to the European Parliament on the Establishment of a New Financial Perspective for the Period 2000-2006, Brussels, March 18, 1998.

The next question is how this net cost is distributed among the incumbent countries. The discussion of this question has not yet been completed (see Figure 7.1).

Figure 7.1, Net Contribution to the EU Budget in 1997
(in % of GDP)



Source: Financing the European Union. Commission Report on the Operation on the Own Resources System, DG XIX, Brussels, October 1998, Annex 8, Table 5 (exclusive administration costs).

The groups at the top of the figure (i.e., the Netherlands, Germany, and Sweden), led by Germany, are asking for relief. If one adds the 0.2 percent of GDP enlargement cost to the 0.6 percent of GDP that Germany is already paying, Germany would have to pay 0.8 percent of GDP. The net receivers at the bottom of the table would see their net receipts reduced by enlargement, so their parliaments may be reluctant to ratify it, which all of them must do.

Turning to the calculation of the *benefits*, in order to do so one needs a model, ideally with as many theoretical refinements as possible. There are various theories of integration. Among the allocative effects, trade creation is most important, with trade diversion not mattering much, since Eastern and Western Europe are already highly integrated via the Europe Agreements.

There are also Single Market effects: full market integration would lead to a broader market, with larger economies of scale and a greater variety of products. A model should also take into account imperfect competition (e.g., monopolistic competition). Accumulation effects are also possible: a larger market would mean more investment and capital accumulation, and this will increase GDP in the long run.

A new theory, not typically included in the models, is that on the geography of trade, which holds that integration of regions at different levels of development may lead to a core/periphery pattern of specialization. Under such a pattern, the main production activities take place only in the core. This is a potential danger if the new applicant countries are not able to catch up very quickly.

Integration into the EU is now a very complicated matter. When in 1973 Denmark, Ireland, and the U.K. joined the EU, they were simply entering a customs union. But now there is the Single Market, greatly complicating integration for new members, who must adopt both the Common External Policy and the Common External Tariff.

A special feature of the Europe Agreements is asymmetric tariff reduction. The speaker and Jean Tesche have made some calculations on the effects of asymmetric trade liberalization between Hungary and Austria (Breuss and Tesche, 1994[36]). Since 1997, the EU has had no tariffs on "normal" products (i.e., not including agricultural commodities), while the CEECs will not have to reduce their tariffs until 2001-2003.

The four freedoms under the Single Market – namely, those pertaining to labor, services, goods, and capital – are a major step forward. Acceding countries must also accept the Common Competition Policy, which assures fairness on the Single Market. In addition, countries will have to enter the CAP, which will be costly, especially keeping in mind the fact that the shares of the agricultural sectors in the acceding countries are higher on average than in the EU. (It is clear that CEECs are not ready to enter into the Economic and Monetary Union, so that it is not important for the moment).

Summarizing the results of modeling exercises of integration effects of enlargement, one can divide the work into two categories, CGE models and macro models (see Table 7.3). Within both categories, there are world models and single-country models.

Focusing on the CGE models, the speaker discussed two of them, one by Brown *et al.* (1997)[37] and the other by Baldwin, Francois, and Portes (1997)[38]. Brown *et al.* include the Czech Republic, Hungary, and Poland, divide the EU into EU-North and EU-South, and include some other international regions. They include 23 sectors. Baldwin, Francois, and Portes have 13 sectors and subdivide Europe rather crudely into the CEEC-7 and EU-15. There is also the Keuschnigg-Kohler model for Austria (Keuschnigg and Kohler, 1997, 1998)[39], and other CGE models for Hungary, Poland, and Slovenia.

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[36] F. Breuss and J. Tesche (1994). A General Equilibrium Evaluation of Trade and Industrial Policy Changes in Austria and Hungary, *Weltwirtschaftliches Archiv* 103, 3, pp. 534-52.

[37] D. Brown, A. Deardorff, S. Djankov, and R. Stern (1997). "An Economic Assessment of the Integration of Czechoslovakia, Hungary, and Poland in to the European Union," in Stanley Black (ed.), *Europe's Economy Looks East: Implications for Germany and the European Union*, pp. 23-60. Cambridge: Cambridge University Press.

[38] R. Baldwin, J. Francois, and R. Portes (1997). "The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe," *Economic Policy* 24 (April): 127-70.

[39] Ch. Keuschnigg. and W. Kohler (1997). "Eastern Enlargement of the EU: How Much is it Worth for Austria?" Europa-Institut, Universität des Saarlandes, Forschungsbericht 9710, November. Ch. Keuschnigg and W. Kohler (1998). "Eastern Enlargement of the EU: A Dynamic General Equilibrium Perspective," Saarbrücken-Linz, September.

Table 7.3 Integration Effects of EU's Eastern Enlargement in Model Simulations

Country/region	Integration effects	CGE models		Macro models	
		World	**Single country**	**World**	**Single country**
CZ, HU, PL, EU-North, EU-South, EU-EFTA, NAFTA, 15 IC+LDC, ROW 23 sectors	TCR, EOS	Brown-Deardorff-Djankov-Stern (1997)			
9 regions: CEEC7, EU15, EFTA3, Ex-USSR, NAFTA, APEC, North-Africa plus Middle East, Sub-Saharan Africa ROW 13 sectors	TCR, FMI DYN, EOS	Baldwin-Francois-Portes (1997)			
Hungary-Austria 14 sectors	TCR, Migration	Breuss-Tesche (1993, 1994, 1997)			
Eastern Europe, B, DK, D, E, F, I, NL, A, FIN, UK, USA, Japan, China, ROW				Breuss (1998c)	
Austria 18 Sectors Austria	TCR, FMI, DYN, EOS TCR, FMI, DYN		Keuschnigg-Kohler (1997, 1998)		Breuss-Schebeck (1996, 1998)
Poland	TCR, NPS		Orlowski (1996)		
Hungary, Poland	TCR, NPS		Braber-Cohen-Rėsėsz-Zólkiewski (1996) Hare-Rėvėsz-Zalai (1993)		
Slovenia	TCR, NPS		Potočnik-Majcen (1996)		

TCR = trade cost reduction (tariffs + NTB); FMI = full market integration (effects of the Single Market: no price segmentation - monopolistic competition, effects of free movements of trade, services, capital and people); EOS = economies of scale; DYN = dynamic integration effects (growth via accumulation of capital and human capital); NPS = national policy simulations (not related to enlargement).

Source: Breuss (1998c); Breuss-Tesche (1993, 1997); Orlowski (1996); BCRZ (1996); HRZ (1993); Potočnik-Majcen (1996).

With a specially constructed version of the University of Michigan CGE world trade model, Brown *et al.* (1997) calculate the economic effects of EU-CEEC integration on trade, output, and employment by sector, as well as the real returns to capital and labor and the economic welfare of their various regions. The model is calibrated to reference year 1992. The model is static and allows for only two kinds of integration effects: (1) trade cost reduction via the elimination of tariffs and non-tariff barriers; and (2) rationalization of production processes by capturing economies of scale and increasing product variety. The model finds a win/win situation, with both regions gaining, a bit more so the eastern region.

Baldwin, Francois, and Portes (1997), employing a model that was initially constructed to evaluate the results of the Uruguay Round on world trade, examine two scenarios. First, there is a conservative case in which only trade costs are reduced, leading to an increase in real income in the CEEC-7 of 1.5 percent and in the EU-15 of 0.2 percent. The less conservative case includes the aforementioned accumulation effects, due to increased investment stimulated by a reduction in the risk premium. In that case, real income in the CEEC-7 rises by 18.8 percent (with no change from the first scenario in the EU-15).

The speaker described some simple calculations of his own on the net benefits of enlargement, whereby the costs thereof are deducted from the gross benefits, as derived by Baldwin, Francois, and Portes (1997). The net gainers in the EU are the richer countries and/or the ones that already trade very heavily with the eastern countries, and the losers are the Cohesion countries. This raises a problem for ratification of enlargement in such countries as Ireland and Portugal.

While the world models just described do not include externally calculated costs, the single-country CGE of Austria by Keuschnigg and Kohler (1997, 1998) do so, as does the macro model of that country by Breuss and Schebeck (1996, 1998)[40]. The Kueshnigg/Kohler dynamic CGE model has two steady states, one at the beginning and the other after integration. They find that the difference between these two steady states amounts to 1.5 percent of GDP in the long run.

The Breuss and Schebeck (1996, 1998) macro model has year-by-year effects, which it finds to be relatively minor, even considering that Austria has the highest trade shares with the CEECs. This naturally implies that the other EU incumbents would see even smaller effects.[41]

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[40] F. Breuss and F. Schebeck (1996). “Opening up of Eastern Europe and Eastward Enlargement of the EU,” WIFO, *Austrian Quarterly*, 2, pp. 97-107. F. Breuss and F. Schebeck (1998). ”Kosten und Nutzen der EU-Osterweiterung für Österreich,“ *WIFO-Monatsberichte* 71, 11, pp. 741-50.

[41] Other articles cited in Table 7.3 include M. Braber, S. Cohen, T. Révész, and T. Zólkiewski (1993). “Policy Modeling under Fixed and Flexible Price Regimes: SAM-CGE Transitional Applications to Poland and Hungary,” *Journal of Policy Modeling* 18, pp. 495-529; F. Breuss (1998c). “Economic Evaluation of EU Enlargement on EU Incumbents,” paper presented at the WIIW 25th anniversary conference on “Shaping the New Europe: Challenges of EU Eastern Enlargement: East and West European Perspectives,” Vienna, November 11-13; F. Breuss and J. Tesche (1993). “Hungary in Transition: A Computable General Equilibrium Model Comparison with Austria,” *Journal of Policy Modeling* 15, pp. 581-623; F. Breuss and J. Tesche (1997). “A General Equilibrium Analysis of East-West Migration: The Case of Austria and Hungary,” in G. Biffl (ed.), *Migration, Free Trade and Regional Integration in Central and Eastern Europe*, pp. 101-26. CCET, OECD, WIFO, Schriftenreihe des Bundeskanlzeramts, Vienna; P. Hare, T. Révész , and E. Zalai (1993). “Modeling an Economy in

Finally, another critique of all these modeling exercises is that they do not take into account potential migration. A number of estimates have been made of potential migration from east to west. The Deutches Institut für Wirtschaftsforschung (DIW, 1997)[42] in Berlin estimated in 1997 that up to 1.2 million people per annum would come to the EU from the CEEC-10 (up to 680,000 from the CEEC-5).

Fassman and Hintermann (1997)[43] from the Austrian Academy of Sciences made a Gallup poll asking people whether they would like to migrate. More than 3 million answered in the affirmative, although only some 700,000 had made preparations for migrating (from the four Visegrád countries). Of that total, 45 percent would like to go to Germany, 29 percent to Austria (about 200,000), 7 percent to Switzerland, 4 percent to the U.K., 2 percent to Italy, and 2 percent to France.

Walterskirchen (1998)[44] from the Österreichisches Institut für Wirtschaftsforschung (WIFO) made estimates partly based on the Fassman/Hintermann calculations and came up with lower figures. He finds that in 2005 under full freedom of labor movement, Austria would receive 42,000 immigrants annually, of whom 24,000 would be commuters from such places as Bratislava, Győr, or Sopron. This issue will have a big impact on the negotiations, with Austria and Germany saying that they would only accept enlargement if there is a transition period for free movement of labor.

7.2 Results of CGE Calculations of the Costs and Benefits of Accession for Slovenia[45]

The speaker began by noting that for Slovenia (and other candidate countries), there are three important questions with regard to costs and benefits of accession: why measure costs and benefits; what to measure; and how to measure it.

Turning to the first question, the common view in Slovenia is that in the short run there will be net costs to accession, but that in the longer term there will certainly be benefits. But simply saying this provides insufficient information to the government or enterprises, and citizens, who must make decisions contingent on what will happen when Slovenia joins the EU.

All the countries discussed at the workshop are in transition, and it is difficult to distinguish between the transition and accession processes, which are mixed together in many ways. One needs to deduct the costs and benefits of the transition process from the total costs and benefits of the two processes in order to find those related only to

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Transition: Trade Adjustment Policies for Hungary," *Journal fof Policy Modeling* 15, pp. 625-52; W. Orlowski (1996). "Price Support at Any Price?" World Bank, Policy Research Working Paper no. 1584; and J. Potočnik and B. Majcen (1996). "Slovenia and the European Union: An Analysis of Potential Effects of Approximation with the Use of the General Equilibrium Model, " *IB revija* 30, 1-2, pp. 4-18.

[42] DIW (1997). "Europäische Union: Osterweiterung und Arbeitskräftemigration," 64. Jg., 5, Berlin, 30 January.

[43] H. Fassman and Ch. Hintermann (1997). "Migrationspotential Ostmitteleuropa. Struktur und Motivation potentieller Migranter aus Polen, der Slowakei, Tschechien und Ungarn." Institut für Stadt und Regionalforschung, ISR-Forschungsberichte, Vol. 15, Vienna.

[44] E. Walterskirchen (1998). "Auswirkungen der EU-Osterweiterung auf den österreichischen Arbeitsmarkt," *WIFO-Monatsberichte* 71, 8, pp. 531-40.

[45] This section summarizes the presentation of Boris Majcen.

accession. The costs and benefits of the pre-accession period, and those of the Europe Agreement, under which Slovenia had to open its economy to imports from the EU, are an important issue that should not be overlooked.

It is crucial to estimate the costs and benefits to particular sectors, and not just in the aggregate. Sectoral estimates are very difficult to make within a model, but it may be very important to have such estimates; the government, for instance, needs to know how many additional lawyers must be hired or agencies created as a result of the adoption of EU legislation.

There are potentially major differences among countries in this regard. A country that has transformed its economy and prepared itself completely for accession and not asked for any derogation periods will experience all the costs and benefits prior to and at the time of accession, while one that puts off certain decisions will delay some of the costs and benefits until after it accedes. One must also distinguish between short- and long-term effects, and discussions tend to ignore the former.

On the question of how to measure costs and benefits, one must take into account that one is dealing with a structural problem, with structural changes occurring within particular sectors, and those changes affecting those sectors and other ones. Another problem is that the EU itself is a moving target: Slovenia does not know when it will join the EU and whether the CAP or other structural policies will exist at that time.

Partial analysis of what is happening in particular sectors is particularly important, as is a complex analysis of the consequences of the changes in those sectors. One needs to create appropriate conceptual tools. There are possibilities other than CGE modeling, one of which is partial equilibrium models, which have been used in Slovenia to examine the agricultural sector. There are also macroeconomic econometric models, possibly combined with an input/output table, as Breuss has done for Austria.

Relative to all these methods, there are huge problems arising from the nature of the transition period and with finding appropriate data. Slovenia is a new country, with data series covering four or five years, and it is difficult to estimate the parameters of any model. There is also the fact that the structure of the economy is changing quickly. There are estimated input/output tables for Slovenia for 1990, 1992, 1993, and 1995, and there are social-accounting matrices (which are necessary for CGE analysis) for 1988, 1990, 1992, 1993, 1995, and 1996. There is also the problems caused by changes in statistical classifications and by the quality of the data.

There was one partial equilibrium model which estimated the costs and benefits of Slovenian integration into the EU, but it did not model factor markets, only production and trade relations. There were three possible scenarios, namely the adoption of new customs tariffs (as happened in 1996), the implementation of the Europe Agreement (which began in 1997), and accession to the EU.

Slovenian researchers have also employed the Hermin macro model, which has four sectors, namely tradables (i.e., manufacturing and mining), services, agriculture, and government. This is a very specific macro model in that it uses calculation procedures to estimate the parameters of the behavioral equations. There have been some static and dynamic simulations, with he first projections being on the development of the Slovenian economy during 1996-2010. The authors have had problems in this dynamic analysis with the estimated multipliers and the work is not yet completed.

Turning to CGE models of Slovenia, such models can be used to examine the elimination of import barriers, the rationalization of the production process (scale economies and production variety effects), reduction of real production costs, technology transfers, and new investments in human capital. Until now, however, such models for the country have looked only at the elimination of import barriers.

Slovenian CGE models are based on various social-accounting matrices, for the years 1988, 1992, 1993, and 1995. They were first employed by Timothy Buehrer in 1994 and separately by Janez Potočnik to estimate the effects of the lost domestic (that is, former Yugoslav) market. The main issues – studied by several authors in Slovenia – involve the simulation of the effects of further foreign trade liberalization, namely the new customs tariffs, the Europe Agreement, and the EU's Common Customs Tariff. There are also estimations of what will happen with the adoption of CAP in its different stages of development.

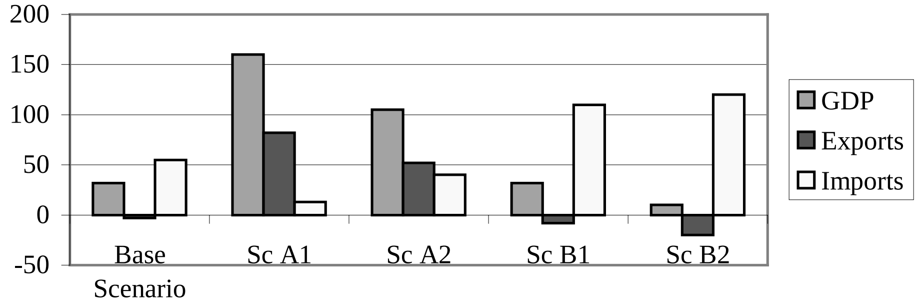
One CGE model which the presenter was involved in constructing was prepared for estimating the effects of the Europe Agreement. It is a static CGE model, based on the social-accounting matrix for 1992. There are 27 product sectors. The authors carried out 24 different scenarios or simulations, based on varying assumptions about what is happening with the balance of payments and government consumption.

The sectors are divided into groups. The first group contains sectors which are very export- and import-oriented, with below average rates of nominal protection; their share of total 1992 GDP was 27 percent. The sectors in the second group experience negative reactions in every simulation. They are closed sectors with above average rates of protection; they produced 47 percent of value-added in 1992. The third group consists of sectors which are sensitive to government policy measures. If the government fixes the exchange rate, government expenditure declines due to lost tariff revenue (whether or not the government increases taxes to make up for that lost revenue), which has a major effect on these sectors.

The presenter and his associates have also applied CGE modeling techniques to the study of four agricultural scenarios. These were the complete adoption of the CAP as it was in 1992 (Sc A1); new members not being entitled to the compensatory payments under the 1992 reforms (Sc A2); moderate further reform of the CAP in the direction of the liberalization of agricultural policy on the basis of the 1992 reforms, with such payments continuing (Sc B1); and the same moderate reform as in the previous scenario, but with such payments being discontinued (Sc B2). The starting point is the Europe Agreement. Under the first scenario, there is strong growth of GDP, exports, and imports, while these variables move in the opposite direction when one assumes that the CAP is transformed (see Figure 7.2).

Recently, a new model has been prepared for the analysis of costs and benefits of accession for Slovenia, but even it uses the social-accounting matrix for 1993. The model has two regions, one being the EU and the other Slovenia, in order to take into account the effects on Slovenia of transfers from the EU and the effects on the EU of changes in the CAP. The work is still at an early stage, but there are already some estimates of the changes in GDP, exports, and imports. There are two simulations, one looking at the effects of the new tariff schedule and the other examining accession. For the present, only the tariff changes are modeled, not the CAP.

Figure 7.2
Real Growth Rates of GDP, Exports, and Imports, Compared with Base Scenario, Manufacturing
(base scenario=100)



See text for explanation.

The total change is a modest increase of 0.35 percentage points in GDP growth. But this is a static model with fixed capital and labor, so the increased growth comes only from the pattern of reallocation of factors across sectors. Negative GDP effects are projected to occur only in the other manufacturing sector; even the agricultural sector has a “plus,” due to the estimated tariff and subsidy changes. This will not happen, however, because the CAP will be changed in the coming years. The main gainers are chemicals, metallurgy, and machinery and transport equipment. Some parameters of the model remain to be estimated, and there has not yet been any sensitivity analysis of the elasticities.

Discussion of Previous Two Presentations

One discussant raised objections to the results presented by Breuss on the impact of EU enlargement on Portugal on two grounds. First, Portugal is a small, open economy, and trade liberalization is always beneficial to such an economy. The historical evidence on the country supports this contention. This was demonstrated in the 1960s, when Portugal entered into the European Free Trade Area, and the 1980s, when it acceded to the EU.

Second, relative to the Structural Funds, it is often forgotten that for the net contributors the funds also have benefits. In Portugal, the Structural Funds had an immediate impact on domestic demand and investment, which led to a large increase in imports from Germany, the country’s major trading partner. The funds had a negative impact on the current account of one percentage point, though.

Another speaker observed that, while he did not want to disparage the excellent work of CGE modelers, politicians in the incumbent countries (e.g., Alois Mock and Jörg Haider in Austria) with divergent views of the benefits to those countries of Eastern enlargement can stress different factors so as to back up those views. In the case of German unification, no one bothered to calculate the costs and benefits.

On the geopolitical plane, with the formation of the North American Free Trade Association, the Association of South East Asian Nations, and possible future cooperation between Japan and China, it is necessary to think in terms of continually strengthening cooperation within Europe; this is true regardless of the numbers emerging from the models. If the EU accepts some countries which are not yet ready, it will necessitate transfers of funds and other programs, but such enlargement is necessary in order to cope with the effects of global competition.

Another speaker began by complimenting Slovenia on being the leader in the region in modeling the effects of accession on their country. He added that Slovakia is preparing a team of researchers from Komenius University, the Bratislava University of Economics, and state central administrative bodies to carry out this sort of work for that country. He continued by noting that in Portugal, there have been important differences in how well regions have done after accession, with, for example, Algarve seeing positive results and Alentejo less so; still, there was a dramatic overall improvement in a period of 15-20 years.

A discussant reacted to Breuss's statement that the trade diversion effects of EU accession would be negligible by noting that in the case of applying the acquis communautaire to agriculture these effects would be negative and huge. The acceding countries would be compelled to import and produce at much higher prices. If indeed those countries are forced to adopt the acquis as it is, the degree of trade diversion will be extremely high, since they currently protect their agricultural sectors less than the OECD nations do. While the EU is liberalizing its trade sector under the WTO process, the accession of the CEECs to the EU would mean a step backward for the continent as a whole.

He also took note of the result reported by Majcen that Slovenia's GDP is higher when the CAP is not reformed and lower when the CAP is reformed. This is a peculiar result, because in a partial equilibrium framework, when there is an increase in a tariff, there is a transfer between consumers and producers, and the net effect on welfare is indicative of a misallocation of resources. Thus, it does not seem that a reform of the CAP, entailing a lower level of protection, could reduce any country's GDP. He asserted that the Slovenian modelers' approach reflects a producers' bias toward agricultural policy.

Another discussant noted that since the CEECs now receive implicit transfers in trade of agricultural products being large net importers of subsidized EU products, the elimination of these implicit transfers once they join the CAP should perhaps be included in the costs of accession. He also raised the question to Breuss of whether there is an inverse relationship between the costs of accession and geographic proximity (i.e., whether the CGE estimates are consistent with gravity models).

In response to these questions, Breuss began by noting that the first discussant was correct in the normal case, whereby a small country wins in integrating into a large one. But with respect to enlargement, everything depends on the starting point, which is the trade and integration situation in 1997. Portugal hardly trades with CEE at all – less than 1 percent of its exports go in that direction – and it is difficult to see how such a country could win much.

According to the original figures by Baldwin, Francois, and Portes (1997), there were zero gains for Portugal, and net costs of 0.17 percent of 1992 GDP (by now, the cost figure might be 0.2 percent of GDP). Actually, these authors had every country paying nearly the same as a percentage of GDP, which cannot be true, since this matter is the object of negotiations. The issue will have to be decided during the German presidency of the EU during the first half of 1999. In response to the discussant's interjection that Portugal will be influenced indirectly by the effects on more directly impacted incumbent countries (by analogy with the recent international financial crises), Breuss noted that such indirect effects are likely to be small.

Breuss noted that the Structural Funds, while representing costs to the donor countries, provide benefits for the recipients (which receive more than 4 percent of GDP net), which can improve their infrastructure, capacity, demand, and so on. The countries that export to the recipient countries profit from this; indeed, if they did not do so, they would never have agreed to creating the funds. But no one has done a cost-benefit study of European integration looking at the asymmetric distribution of costs and perhaps the asymmetric distribution of benefits. Germany, for example, frequently makes the politically motivated statement that it benefits from the EU's structural policy, but there are no studies on this.

Breuss agreed with the discussant who noted the enormous historical importance of European enlargement (and German reunification before it), which makes the various calculations of the economic costs and benefits of that process pale into insignificance. Some 0.2 percent of GDP as a cost to a rich country is a very small figure. However, the EU is a "bazaar," in which everyone tries to get something out of the process. He cited the example of Spain's blocking Austria's accession (which was slated for January 1, 1995) until December 28, 1994, demanding that the Commission allocate Spain increased fishing rights in Iceland. In the end, the Commission bought fishing rights from Russia and gave them to Spain.

The financial plan assumes that accession begins in 2002 with five countries. But if one looks at the exact figures, the costs increase slowly year-by-year, leading to relatively low costs by the year 2006. The CEECs may well assert that they will need the same amount of money every year and these cost estimates may prove too low.

Breuss also noted that he has never heard a complaint from the CEECs about the assumption that the Structural Funds must be limited to 4 percent of GDP. Will Greece, Portugal, and Spain also accept this limit? He conceded the points made by discussants that trade diversion may be significant in the case of the CAP, and that the elimination of implicit transfers once the CEECs join the CAP should be included in the costs of accession.

On gravity models, work done by the Research Institute for European Affairs at the Vienna University of Economics and Business Administration concludes that trade between the EU and the CEECs has already reached its potential, with such countries as Austria and Germany having already surpassed that potential in the aftermath of the Europe Agreements. However, if one includes a dummy variable for EU integration, there is a jump in projected trade of 40 percent.

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In closing the workshop, János Gács noted that there had been little discussion of the costs and benefits related to the associate status of the candidate countries, with the exception of the presentation by Majcen. Perhaps this was because the experience has been overwhelmingly positive. Another possibility is that the impact of association has been dominated by other impacts: the more advanced countries have had to face the external shocks of the last year-and-a-half, while the less advanced ones (e.g., Bulgaria or Romania) have had difficulty stabilizing their economies.

There was considerable discussion at the workshop of the costs, threats, and uncertainties of the accession process and how these costs will be distributed before and after accession. There are fundamental questions about the concepts of costs and benefits, whether the costs also imply some benefits. This is especially so because there are many costs that must be borne at some point in the future and thus are related to the transition, rather than exclusively related to accession.

However, in the case of agriculture, many would reject this assumption. With respect to the environment, many would question whether all the costs that the acceding countries will have to pay before or soon after accession would have been paid anyway. The costs and benefits of agricultural and environmental policies are not even clear within the present EU. A more minor instance of this phenomenon is regional policy, where again many changes that have to be made would not have been made, if the countries were not preparing themselves to participate in EU policies.

It became clear from the discussion that there is very little transparency in the working of many institutions, such as the European Commission. This is especially so with respect to informing the general public of what is taking place.

We know rather little about certain aspects of the costs and benefits of accession. Moreover, experts must determine what they should suggest to governments as to the most appropriate order in which the various costs should be incurred. The Commission’s opinions lay out what should be short-term targets and long-term ones for the countries, but the basis of this distinction is vague. In terms of priorities, there should be a balance between the sustainability of the stability of these still fragile economies and the structural reforms required by accession.

The concluding discussion focused on the association agreements. One discussant wondered whether the expectations of the EU and the CEECs in 1991 about the association agreements had been met. He was referring to the huge trade deficits of all the CEECs (except for Hungary in 1997), and the structural patterns of exports (which have not been concentrated in the “sensitive” commodities, but on machinery and sophisticated commodities). Since the assumptions about association were so far off base, one wonders about the validity of the assumptions being made about accession.

He also stressed the need for experts to report on the economic costs and benefits of accession, without worrying about the political implications of those reports; politicians will interpret findings in any way they choose. At conferences on integration, there is increasing mixing of technical experts and people representing government positions (some of whom are also academically trained economists), and it is important to be clear which hat a speaker is wearing.

Another speaker noted that the Commission, unlike the OECD, never carries out studies of the distribution of the costs and benefits of policies. It would be a good idea if the CEECs request that it does such studies with respect to enlargement. A final discussant observed that future deliberations might beneficially emphasize institutional preparations with respect to financial markets, the agricultural sector, and so on.

APPENDIX I: USEFUL EUROPA SERVER ADDRESSES FOR ACCESS TO ENVIRONMENTAL AND APPROXIMATION INFORMATION

1. "Enlarging the Environment"
Bi-monthly Newsletter.
http://europa.eu.int/comm/dg11/news/enlarg/index.htm

2. Guide to the Approximation of EU Environmental Legislation
Master document: (EN)
http://europa.eu.int/comm/dg11/guide/contents.htm
Bulgarian
http://europa.eu.int/comm/dg11/guide/contents.htm
Czech
http://europa.eu.int/comm/dg11/guide/contents.htm
Estonian
http://europa.eu.int/comm/dg11/guide/contents.htm
Greek
http://europa.eu.int/comm/dg11/guide/contents.htm
Hungarian
http://europa.eu.int/comm/dg11/guide/contents.htm
Lithuanian
http://europa.eu.int/comm/dg11/guide/contents.htm
Polish
http://europa.eu.int/comm/dg11/guide/contents.htm
Romanian
http://europa.eu.int/comm/dg11/guide/contents.htm
Russian
http://europa.eu.int/comm/dg11/guide/contents.htm
Slovak
http://europa.eu.int/comm/dg11/guide/contents.htm
Slovenian
http://europa.eu.int/comm/dg11/guide/contents.htm
Turkish
http://europa.eu.int/comm/dg11/guide/contents.htm

3. Compliance Costing for Approximation of EU Environmental Legislation in the CEEC.
http://europa.eu.int/comm/dg11/enlarg/compcos.htm

4. Progress Monitoring Manual
http://europa.eu.int/comm/dg11/enlarg/home.htm

5. Communication on Accession Strategies for the Environment Meeting the Challenge of Enlargement with the Candidate Countries in Central and Eastern Europe
http://europa.eu.int/comm/dg11/docum/98294sm.htm

Translations:
French, German, Danish, Dutch, Finnish, Greek, Italian, Portugese, Spanish, Swedish
http://europa.eu.int/comm/dg11/docum/98294sm.htm

Appendix II: Workshop Program

Program for the workshop on

The Time Pattern of Costs and Benefits of EU Accession
Seminar Room, IIASA, 3–5 December 1998

Thursday, 3 December

13:30 Opening and Introduction of the Workshop: ***János Gács***

13:50 *Chair*: *Lucjan Orlowski*
Latest Developments in the Process of Accession — Updates from Applicant Countries

Bulgaria:	***Rossen Rozenov***
Lithuania:	***Egidijus Vareikis***
Romania:	***Manuela Unguru***
Czech Republic:	***Ludek Urban***

14:30 Questions and Discussion
15:00 *Coffee Break*

15:30 SESSION 1: Joining the Internal Market — The Time Pattern of Implied Costs and Benefits

János Gács; Joining the Internal Market — Are There Lessons from Previous Accessions?

Sándor Richter: Costs and Benefits of Accession to the EU: Attempts for Measurement in Four Applicant Countries.

16:10 Discussion

17:00 SESSION 2: Approaching EU Environmental Requirements

Bedrich Moldan: Environmental Standards in CEE Countries — "Wahrheit und Dichtung".

Margareta Stubenrauch: Environmental Requirements of EU Accession — The Commission's View.

17:40 Discussion
18:20 End of Discussion
18:30 *Social Event*

Friday, 4 December

09:10 *Chair*: *János Gács*
Latest Developments in the Process of Accession — Updates from Applicant Countries

Slovenia: ***Vladimir Lavrač***
Poland: ***Andrzej Kośnikowski***

09:30 Questions and Discussion
10:00 *Coffee Break*

10:30 SESSION 3: Costs and Benefits of Joining the EMU — Fast or Delayed

Lucjan Orlowski: Costs and Benefits of Accession with respect to Instability of Financial Markets and Vulnerability to Asymmetric Shocks.

Vladimir Lavrač: Inclusion of Central European Countries in the EMU.

Ilmar Lepik: Approaching the EMU in the Context of the Currency Board System: The Risks of the Different Scenarios.

11:50 Discussion
12:30 *Lunch*

14:00 *Chair*: *Vladimir Lavrač*
SESSION 4: EU Transfers and Their Use for Institutional Development, Structural Adjustment and Infrastructure Improvement

Isabel Marques Gameiro: The Impact of EU Transfers on the Development of Infrastructure in Portugal and its Role in Real Convergence.

Andries Brandsma: The Commission's Financial Framework for 2000–2006 in Relation to Enlargement.

Yves Hervé: EU Transfers and Absorption Problems.

15:00 Discussion
15:40 *Coffee Break*

16:10 SESSION 5: Agriculture Scenarios — Costs and Benefits

Secondo Tarditi: Costs and Benefits for Eastern Europe — Various Scenarios Based on the Reform of CAP.

Andrea Elekes: Everything or Nothing — Scenarios for Agricultural Accession.

Sophia Davidova: The Effects of WTO Commitments on Accession under Different Scenarios: The Case of Romania.

17:10 Discussion
18:00 *End of Session*

Saturday, 5 December

09:30 *Chair: János Gács*
Latest Developments in the Process of Accession — Updates from Applicant Countries

Estonia:	***Ilmar Lepik***
Hungary:	***Katalin Nagy***
Macedonia (a non-candidate):	***Trajko Slaveski***
Slovakia:	***Igor Kosír***

10:30 Questions and Discussion
11:00 *Coffee Break*

11:20 SESSION 6: Survey of Relevant Computable General Equilibrium Model Calculations

Fritz Breuss: CGE Model Estimations of Costs and Benefits of EU Enlargement: A Survey.

Boris Majcen: Results of CGE Calculations for Costs and Benefits of Accession for Slovenia.

12:10 Discussion
12:45 Concluding General Discussion
13:10 End of Workshop and *Lunch*

Appendix III: List of Workshop Participants

List of Participants for the Workshop on

The Time Pattern of Costs and Benefits of EU Accession *Seminar Room, IIASA,*

3–5 December 1998

Dr. Peter Backé
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Mr. Stephan Barisitz
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University of London
United Kingdom

Ms. Andrea Elekes
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Gödöllő University of Agricultural Sciences
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Dr. Isabel Marques Gameiro
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Banco de Portugal
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Mag. Katharina Helmstedt
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Federal Ministry for Economic Affairs
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Dr. Yves Hervé
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European Institute
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Department of Soil Science
Comenius University
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Slovak Republic

Doc.Dr. Igor Kosír
General Director
Section for EU Integration and Foreign Affairs
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Dr. Andrzej Kośnikowski
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Chancellery of the President of the Republic of Poland
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Dr. Ilmar Lepik
Senior Expert
Central Bank Policy Department
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Dr. Boris Majcen
Senior Research Fellow
Institute for Economic Research
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Professor Bedrich Moldan
Environment Center
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Macroeconomic Policy and Forecasting
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