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Why Enlarge the EU? A Look at the Macroeconomic Implications

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This is not the first time that the European Union (EU) has broadened its membership. The original European Economic Community, which numbered six (Belgium, France, the Federal Republic of Germany, Italy, Luxembourg and the Netherlands), enlarged four times before reaching its current 15 members. Nevertheless, the enlargement to the east has special characteristics and poses new challenges that make it quite different from previous ones.[1]

Above all, this enlargement is significant for its size. Although it is unlikely that all candidate countries will enter at the same time, the enlargement, in terms of number of countries, population and area is unprecedented: the EU's population will increase by over one quarter, its area by one third. With respect to the past, on the other hand, the

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[1] In 1998, negotiations with the "first group" of candidate countries opened at the Luxembourg European Council: Hungary, Poland, Czech Republic, Slovenia, Estonia and Cyprus. In December 1999, negotiations were started in Helsinki with the "second group": Slovakia, Latvia, Lithuania, Bulgaria, Romania and Malta. In November 2000, the Commission put forward a "road map" for concluding negotiations with the more advanced countries within 2002, allowing the first to enter the EU by 2004. Judging from the assessments of the Commission in November 2001, it seems probable that ten countries (all 12 except for Bulgaria and Romania) could accede between 2004 and 2006.

"economic weight" of the candidate countries is not as "heavy". Excluding Turkey, Cyprus and Malta, the IMF estimates that the candidate countries will not contribute more than 11 percent to the Union's total GDP (at PPP).

The second reason for which the eastward enlargement is special is the difference, above all in terms of per-capita GDP, with respect to current EU members. In fact, the candidate countries are considerably poorer, even though there are notable differences between them. Of the current members, the only ones that had similar characteristics when they entered the EU are Greece, Ireland, Portugal and Spain.[2]

The number of countries involved in the enlargement is also high: again excluding Turkey (which is unlikely to enter in the near future), there are 12 candidate countries, double the number of EU founding members. Numbers count, not only because they contribute to defining the size of the enlargement, but also and above all because they will generate new equilibria in the European institutions. If all candidate countries were to be admitted, they would have enough votes to block any decision, including essential matters on the integration process, such as reform of regional transfers and the Common Agricultural Policy (CAP), the creation of the single energy market, fiscal harmonisation, greater integration of financial markets, etc. That is why this enlargement to the east, unlike the others, makes reform of EU governance urgent and indispensable.

Finally, the third difference with respect to previous enlargements is that the EU's political dimension is quite different from the past. The first enlargement (to Denmark, Ireland, the UK and later Greece) took place at the time of the common market, that is when there was a customs union, mainly involving the free circulation of goods. The second enlargement to Spain and Portugal took place at the time of the single market (free circulation of goods, services, people and capital) and laid the basis for cooperation in foreign policy. The third enlargement in 1995 to Austria, Sweden and Finland, took place during an advanced phase of Economic and Monetary Union (stage two began a year earlier with the setting up of the European Monetary Institute, the precursor of the European Central Bank). This fourth enlargement will take place in a Europe which has already undertaken, in addition to economic and technical cooperation, close cooperation in sectors of predominantly political importance, such as social policy, employment, justice, right to asylum and immigration, foreign, security and defence policy. This

[2] Like the present candidate countries, Greece, Portugal and Spain had just come out of totalitarian and autarchic regimes.

enlargement will also take place at a time when the Union is debating not only its objectives, but also how to achieve them. One can only wonder, therefore, whether the candidate countries have fully grasped the political implications of their adhesion to the European Union and whether they agree with them wholeheartedly.

It is clear from this brief introduction that the new phase of enlargement poses a number of important questions. This article will address some of them, asking questions rather than trying to provide answers.

The macroeconomic impact

According to traditional economic theory (the Heckscher-Ohlin model – HO), each country tends to export that good whose production calls for the most intensive use of the production factor that is in relatively most abundant supply. Supposing that labour is the most abundant production factor in the candidate countries, while it is capital in the current member countries, the effect on the latter of the elimination of trade barriers should be an increase in the relative price of capital-intensive goods and therefore an increase in their production, and a shift in income distribution in favour of profits to the detriment of wages. The reverse would take place in the candidate countries. In the new equilibrium, the price of the factors would be the same in the two countries.

In this traditional model, trade and factor mobility are substitutes. Even in the absence of trade, but without barriers to factor mobility, capital and labour tend to go where they are most highly remunerated (relatively more scarce): capital would go east and manpower west, until relative factor prices evened out in the two areas. The effects on relative prices and distribution would be the same.

However, some of the basic assumptions of the HO model should be attenuated. First of all, in the presence of a technology gap, the convergence of factor prices cannot be fully achieved. In particular, if the EU countries have a technological advantage in the production of human capital-intensive goods, trade and factor mobility can become complements rather than substitutes. Integration could result in greater production and export of these goods by Western Europe, thereby augmenting income inequality to the advantage of skilled labour and creating incentives for migration of skilled human resources from east to west. Secondly, given the high initial difference in technology and factor availability, total specialisation of the areas cannot be ruled out: each area would produce (and export) the good whose production is relatively intensive in the more abundant (less expensive) factor and this would lead to lower prices of all goods, to the benefit of consumers. Thirdly, if returns to scale were to increase, integration could increase wealth through greater product diversification and more competition.

In theory, the greater the initial disparity between the areas in terms of development, the greater the potential gains in wealth to be achieved through integration. Indeed, with respect to previous enlargements, the differences today are greater; as a result potential gains should be larger, too. But this statement requires qualification: First of all, eliminating customs barriers and liberalising capital movements should not have a strong economic impact on the wealth of the current member states. The economic weight of the candidate countries with respect to the EU is low, so that integration would have only a limited effect on marginal supply and demand of goods produced and capital invested, and thus on the relative price of goods and production factors. In any case, their share of total EU foreign trade has doubled in the last ten years and, were this trend to continue, could double by the middle of this decade.[3] In that case, by 2005-2006, the exports of current member states towards candidate countries would account for approximately 20-30 percent of their total, a figure anything but negligible.

Furthermore, an assessment of the potential benefits of enlargement has to account for two considerations: 1) The process of economic integration of the candidate countries has already been under way for almost ten years as it was initiated in the nineties with the European Agreements. Consequently, part of the relative gains should already have been achieved; 2) Completion of this process does not necessarily call for EU enlargement, since these gains could also be achieved through the candidate states' adhesion to the European Economic Area (EEA), an area of free circulation of goods, services, capital and persons with the EFTA countries (Norway, Iceland and Liechtenstein). From an economic point of view, the main differences between the EEA and the EU are that EEA agreements do not cover agriculture and fishing, that the EEA is not a customs unions (therefore external tariffs can continue to be differentiated from country to country) and that the EEA does not call for a common trade policy.[4]

[3] D. Gros, A. Steinherr: "Economic Transition in Central and Eastern Europe: planting the seeds", mimeo CEPS (2001).

[4] Consequently, with respect to EU enlargement, the candidate countries' adhesion to the EEA would have less effect on the price of agricultural and fish products, and therefore on wages and employment (and on the remuneration of capital) in these sectors. The implications in terms of trade creation/trade diversion would probably also be different, depending on the external tariff policy adopted by each country.

The labour market is a matter unto itself, in that there are still important barriers to immigration. Until now, these have resulted in a very low percentage of the total (regular) work force (0.3 percent) coming from Eastern Europe. Simulations carried out on the convergence of per capita income in the two areas suggest that disparities will continue for many years, even decades. Therefore, the incentives to migration towards the west will remain high. Even in the presence of an overall welfare gain for the current member states, the countries that are the closest geographically (such as Germany and Austria) will have to bear some costs connected largely to the greater requirements for financing the welfare system.

Furthermore, the competition from immigrant labour could produce a redistributive effect to the advantage of physical and human capital. Again, this phenomenon would probably be concentrated in the more proximate geographic regions, and in the industries with the highest intensity of unskilled labour (such as agriculture and textiles). Thereafter, the impact of immigration on labour income and employment could extend to more qualified labour, which calls for good linguistic skills and has ready access to the labour market. In fact, existing studies show that some eastern countries have high educational and professional standards.

Finally, taking a more general point of view, a regional integration process could create problems if the benefits of trade creation (increase in trade inside the new area) are outstripped by the loss of trade diversion (reduction in trade with outside countries). The previous EU enlargements, at least according to the latest Transition Report of the European Bank for Reconstruction and Development (EBRD), produced a net positive effect.[5] The same document emphasises that, in order to prevent the next enlargement from having negative effects, two conditions must be met: 1) EU markets will have to open up, also as regards agricultural products, textiles, footwear and steel and 2) the enlarged EU will have to ensure the free circulation of people between candidate countries (for example, Poland) and neighbouring countries (in particular Russia).

To conclude, an *ex ante* assessment of the macroeconomic benefits of enlargement is difficult. Applying the tools of theoretical analysis, it would appear that, of the various production factors, capital should be the one to benefit in the beginning. Labour, on the other hand, could lose out in terms of wages and/or employment, unless the increased competition and

[5] Transition Report 2001, European Bank for Reconstruction and Development, London, November 2001.

diversification on the product market make up for the loss in income. This is why it is likely that the current objections to immigration from the east will continue for some time, above all in those member countries in which the workers would be penalised the most.

Impact on the EU budget

Given the current community structural policies, enlargement will definitely have a notable negative effect on the present members' standings in the community budget. The current recipients of structural funds (peripheral countries) will lose resources due to a "statistical" effect: the entry into the EU of new countries with below EU-15 average per capita income will lower the average of the enlarged EU, thereby excluding from Objective 1 regions that are now included in it, as the criterion for eligibility is a per capita GDP lower than 75 percent of the EU average at PPP. True, the eligibility threshold could be raised, but there are unavoidable budget constraints.[6] For a country like Italy, its position as a net contributor is likely to become more accentuated.

In any case, enlargement also represents an important opportunity and challenge to rethink the EU's development and cohesion policies in order to make them more targeted and efficient in terms of cost.

At the March 1999 Berlin European Council, some indications were given of the impact that enlargement to the first six candidate countries (Czech Republic, Slovenia, Hungary, Poland, Estonia and Cyprus) will have on the community budget.[7] Considering the overall budget constraint for the 2000-2006 period (1.27 percent annually of the Union's GDP), it was estimated that:

- for the member states, agricultural spending will increase (from 40,920 to 41,660 billion euros), while spending for structural actions will decrease (from 32,045 to 29,170 billion euros);
- for the six candidates, the spending for structural actions and agriculture will increase significantly (from 6,450 billion euros in 2002 to 16,780 billion in 2006);
- the spending for pre-adhesion assistance, finally, will remain constant throughout the period (3,120 billion euros per year), since the entry of

[6] The community budget now devotes 0.46 percent of community GDP to structural actions. Of the structural funds, 70 percent are set aside for Objective 1, but this quota could be increased.

[7] *Presidency Conclusions*, European Council, Berlin, March 1999.

the new members will free funds for other candidate countries.

Nevertheless, the Berlin estimates for the six countries that have made the most progress in convergence and are subject to the strongest approximation, do not paint a sufficiently reliable picture of the potential budget costs. Some authors have attempted more complete estimates considering more countries and including a cost/benefits analysis. Gros and Steinherr, for example, feel that, however small, the benefits deriving from the increased trade with the candidate countries will be more than enough to make up for costs.[8] Yet other studies, like the one carried out by Baldwin, Francois and Portes, reach different conclusions.[9]

In conclusion, it is essential that further empirical estimates of the costs and benefits of enlargement be worked out to provide a reliable basis for discussion of the timeframe and modalities of accession. This need has been repeatedly voiced in the Ecofin Council.

The financial markets

The EU's enlargement to the east could lead to risks for the financial stability of the candidate countries. These countries need substantial capital flows to finance their gap between investment and internal savings. Until

[8] Gros and Steinherr estimate that the benefits deriving from enlargement of the single market will be in the order of 0.4-0.5% of the EU's GDP, that is, 25 billion euros per year. As for costs, the authors estimate that no more than 16 billion euros will be allocated in structural funds to the candidate countries annually. To this figure, however, must be added the 3 billion euros per year in subsidies to agriculture estimated by the Berlin Council.

[9] R. Baldwin et al. ("Nice Try: Should the Treaty of Nice be ratified?", Monitoring European Integration, vol. 11, London, CEPR, 1997) estimate that, for the current 15 EU members, the net gains could reach approximately 10 billion euros per year. However, they would be distributed in a much more differentiated way, with the greatest advantages going to Germany, France and Great Britain; for Italy, the net gains would be rather small (1 billion euros per year). This figure could even be overestimated in that the analysis, done at the aggregate level, does not take account of the difference in productive specialisation in the various EU countries, which would penalise the Italian economy in which labour-intensive productions still predominate. But the net costs for the community budget deriving from enlargement have to be subtracted from the benefits of enlargement, essentially deriving from greater net EU exports towards the 12 candidate countries. These are estimated at between 10 and 18 billion euros per year. Taking the higher figure, that is 18 billion, as the more realistic, this comes to a net cost of 8 billion euros per year (for Italy the balance, also negative, could come to approximately 1.3 billion euros annually). Moreover, the study overlooks the problem of the consequences for those EU regions, like the Italian South, which currently receive substantial structural funds and which would, presumably, not receive them any longer after the entry of the 12 candidate countries.

now, the privatisation process has largely financed the current accounts deficit through direct investment. In the near future, however, direct investment flows are bound to taper off and be replaced by portfolio investments, more volatile by nature. But not until mature and sophisticated financial markets have developed will incoming flows stop being mediated by the banking sector. And as the experience of the last 15 years, from the Scandinavian bank crisis at the end of the eighties to the Asian crisis in the nineties, has shown, in the absence of a solid, well regulated and well-supervised banking system, that kind of credit expansion can cause an overheating of the economy and produce a significant deterioration in the quality of bank balance sheets. Both factors produce financial instability, and could, in a worst-case hypothesis, lead to a financial "bubble" which, if it were to burst suddenly, could wipe out investor confidence, trigger the flight of capital and perhaps even an exchange crisis.

Many studies show that these risks are greater in the presence of limited exchange rate flexibility, something which already characterises some candidate countries and which will extend to the others after enlargement, with the entry into EMS2.

Furthermore, it is reasonable to assume that the risk of regional contagion among candidate countries is high. It can, in fact, be assumed that investor expectations for the various countries are highly correlated: all of them have the EU as their major trading partner and all have the same objective of entering into the EU and subsequently, the euro area. Any event that would derail this process in one country could – in investors' eyes – change the prospects of the entire group.

From the point of view of present members, the overall costs of a bank and exchange crisis in the eastern countries would depend not only on the size of the crisis itself, but also on its timing. Before enlargement, the costs would be borne mainly by those EU countries with the greatest links to the candidates in terms of trade flows and direct investment. Credit institutions from EU countries have acquired a large part of the banks privatised in the east . After enlargement, there would also be the possible cost borne by the European Central Bank to uphold parity set in EMS2.

The European debate on enlargement has considered these risks. It has in fact been decided that, as a part of a multilateral surveillance process (which will be described later), the European Commission is to present a specific report on the member countries' macroeconomic and financial stability. Of this, one section will be centred on the analysis of the current situation and the development of the candidate countries' financial system. In particular, it will examine the privatisation process, the role of the banking system, its efficiency and stability, the degree of capital mobility, and the state of regulation, prudential requirements and supervision of the financial system.

Multilateral surveillance

A "structured dialogue" procedure was begun in 2001 between candidate and EU countries. This multilateral surveillance process is analogous to the one that already exists for member countries, and is meant to prepare the candidates for the obligations that access to the European Union involves. The objective is twofold: to help the candidate countries develop statistical, analytical and planning capabilities, and to analyse the most important common issues in order to work out the policies needed to deal with them – together.

Last year, the 13 countries for the first time presented their Pre-Accession Economic Programmes, an initial step towards the development of the analysis and planning capacity that is indispensable above all for entering the Union, but also for being able to participate in the multilateral surveillance procedures provided for by Economic and Monetary Union. Furthermore, some broader issues were addressed, such as macroeconomic and financial stability, budget policies and exchange rate regimes. This round of meetings has already produced one significant result. The importance of real convergence of the individual candidate countries during the transition period has become evident and the European Commission has been requested to study the matter.

In fact, at least in the short term, the catching-up done by the candidate countries could lead to a rise in the real exchange rate (Balassa-Samuelson effect) and therefore cause a trade-off between real growth and price and exchange stability. As already mentioned, with privatisation coming to an end – and with it the influx of capital through direct investment – financing the external debt could become a problem. In a context of complete liberalisation of capital movements (no country has asked for a derogation on this), tensions could arise on financial and exchange markets. Since the criteria for nominal stability are set down in the Treaty of European Union, and since the candidate countries would like to accelerate their entry into EMS2 and thus Monetary Union, there is the risk that they could give priority to nominal stability rather than real stability, that is adopt an exchange rate policy that is too rigid with respect to what would be required to catch up.

Impact on community institutions

The European Union, with its present 15 members and its institutions, is characterised by complex decision-making processes. Enlargement to ten more members by 2006 (not to speak of other possible candidates in the future: besides Romania and Bulgaria, also Turkey) poses a number of problems of Union governance, making institutional reform a prerequisite for the success of enlargement.

Reform will have to tackle a number of issues. Traditionally it was thought that the most important was the decision-making procedure; two reforms were proposed:

- Reducing the areas subject to unanimous voting and therefore extending the qualified majority vote;
- Changing the current system of qualified majority voting (QMV).

And indeed, in December 2000, these important issues were discussed at the Nice summit and the basis laid for important institutional reform, with an extension of QMV to numerous areas formerly subject to a unanimous vote. Nevertheless, the Nice summit did not solve the problem. On the contrary, the new Nice Treaty makes the requirements for reaching a qualified majority even more stringent.[10] For example, QMV has been extended to structural spending but not before 2007, making it possible for the new countries that enter before that date to veto possible reforms.

The problem of governance has been addressed repeatedly in the economic literature. The best known studies are by Baldwin, Giavazzi et al,[11] who measure the "efficiency" of the decision-making process in terms of "probability of approval" of a provision in the European Council. Given the system of voting established by the Nice Treaty, that probability decreases from the 8.2 percent in the present Council of 15 members, to 2.1 percent in an enlarged EU of 27 members. This is even lower than what would result from applying the current system, that is without the Nice reform, to 27

[10] The current system defines a qualified majority as being over 71% of votes in the Council. The reform (which will come into force in 2005) states that 1) total votes must equal more than 71%, which will become 74% when all 12 candidates have entered; 2) more than 50% of countries must be in favour; 3) votes must represent over 62% of the EU population.

[11] R. Baldwin, E. Berglof, F. Giavazzi, M. Widgren: "EU Reforms for tomorrow's Europe", CEPR Discussion Paper no. 2623 (November 2000). For each QMV system established, the number of coalitions able to pass a motion is divided by the total number of coalitions possible.

countries. The authors conclude that only a simple majority system, in terms of both votes and population, can ensure high decision-making efficiency for any number of countries in the European Council. Such a system would prevent an "eastern coalition" of candidate countries from creating a decision-making bloc in an enlarged Council.

This problem is especially serious if one considers the paralysis that already exists in a number of sectors. One example: integration of financial markets. Contrary to expectations, a single market for financial services has not yet been set up in Europe. This is mainly due to the sluggishness of the European decision-making process in adopting common legislation. The blame can be meted out evenly to the Commission, the Council, the European Parliament (EP), and the member states. Reform of the decision-making mechanisms, whereby the Commission would be delegated direct legislative powers, has been discussed for a year and a half now, but no agreement reached between the EP and the Commission. The time wasted bears heavy costs for the European economy and for the euro. We can only wonder whether in similar cases, deciding at 27 will be faster or slower than at 15, and what added costs it could accrue for Europe and the individual member countries.

Looking beyond EU enlargement and considering that the candidate countries will subsequently accede to EMU, there also seems to be a problem of governance for the ECB. In this regard, the Nice Treaty introduced some enabling clauses that allow for institutional changes to be made to the current arrangements without having to convene an Intergovernmental Conference. However, this solution leaves open a number of delicate and complex questions. While acknowledging the difficulties encountered in Nice when addressing this problem, some more thought should be given to possible alternatives to the present one man/one vote system. According to current rules, each country that joins the Monetary Union has the right to one representative on the bank's Board of Directors, and therefore one vote in decisions concerning the prime rate. The problem is that the new member countries will be mainly small, with high growth rates and structurally higher inflation. Their economic and monetary policy priorities will probably be different from those of the core countries.

As can be seen from the Declaration of the Laeken European Council (December 2001), the problems related to EU governance in terms of decision-making mechanisms – that is, those addressed in Nice – are neither the only ones nor the most important. As already mentioned in the introduction, the EU is much more than a single market today: it is a political union or, rather, it is becoming one. In this perspective, the real problem is to establish a definite constitutional framework within which to manage the political challenges that an enlarged Union will increasingly have to face. The Union must be brought closer to the European citizens. The current danger is that the European Union will become totally unmanageable in the face of such challenges, making it even more distant from citizens, persuading member states to make a rapid about-face to try to recover national sovereignty.

The three main problems that have to be addressed are:

- A clear delimitation of the competences of the Union and the member states (or possibly, the regions) at the political and implementation levels;
- Democratic legitimacy and transparency in European institutions: this includes the roles and the composition of the European Parliament, the designation of the president of the European Commission, the role of the European Council and the transparency of its decisions;
- Simplification of the Treaties. Four treaties are currently in force, with provisions concerning the objectives, the powers and the political instruments of the Union scattered among them: they should be simplified and some feel that this could give way to the drafting of a real European Constitutional Charter encompassing the Charter of Fundamental Rights approved in Nice.

Given the importance of these issues, the Laeken European Council decided to convene a Convention on the Future of Europe, which started work on 28 February 2002, to study the problems of the new Europe's institutional set-up, including institutional reforms and governance. The hope is that – thanks to the work of the Convention – the Intergovernmental Conference in 2004 will be able to propose a new treaty that modifies and integrates the reforms set down in Nice. Without such changes, enlargement could lead to the Union's implosion.

Conclusions

It is evident that, as important as they may be (especially for the candidate countries), economic considerations are not the only motivations behind the EU enlargement process. From the point of view of the candidate countries, in fact, the EU is much more than a simple free trade area: it offers an integrated common market based on a single currency, free movement of capital, labour, goods and services, and above all it is supported by a solid regulatory framework and an institutional system that promotes dialogue on and coordination of economic policies. It is this solidity of the institutional framework, in addition to the substantial financial support that these countries expect to receive during and after the convergence process (CAP, structural funds, development aid, etc.), that makes entry into the EU particularly attractive. Furthermore, the prospect of entering the EU in the relatively near future constitutes an important incentive for undertaking structural reforms that have often been put off because too costly, not only economically, but also politically. External conditionality could turn into an engine for institutional and economic renewal in the candidate countries, as occurred in a number of countries that now belong to the Union. Finally, adopting the EU's legal and institutional *acquis* will contribute to strengthening the credibility of those countries' economic policy authorities, and this is an objective that no trade union can achieve.

From the current member countries' point of view, the question "Why enlarge?" is becoming more and more topical and increasingly dramatic. As seen, there are not and never have been only economic answers to this question. In fact, the economic advantages deriving from the EU's enlargement process are not spectacular, at least not in the short term. Thus, the main objective of the enlargement process is political. And it is precisely on its political significance that there has been the least debate. In fact, there has been no debate at all, if the word "debate" means involving all democratic actors, starting with the people, in the decision-making process.