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The costs of Eastern enlargement of the EU are exaggerated

The EU has decided in favour of Eastern enlargement, with negotiations for entry slated to start as early as 1998. The first new memberships, however, will probably not occur before the year 2002 (see appendix 1).

Although relatively poor countries will then be joining the European Union, some with consider ably large populations and territory, Eastern enlargement is affordable (see appendix 2).

Scenarios for financing Eastern enlargement inevitably rely on a wide range of hypotheses fraught with considerable uncertainty. There are, however, a number of considerations that point either to a reduction in the potential claims upon the EU budget or to a broader scope for financing enlargement:

1. Enlargement is to take place in stages. Poland, the Czech Republic, Hungary and Slovenia are initially the most likely candidates.
2. The capacity of Central Eastern European countries (CEEC) to absorb EU financial transfers is limited. As such, the agricultural and structural policies of the EU, under current rules, could not be fully implemented in these countries. Transition agreements and step-by-step integration into Community structures are thus also in the interests of the CEEC (see appendix 3).
3. Even modest economic growth will lead to a volume of structural funds in the years 2000 to 2006 considerably larger than that of today (see appendix 4).
4. Because the objectives of current structural policy will have been achieved in numerous regions of the present-day EU, additional resources will be freed for use in the new regions (see appendix 4).
5. Reforms in EU structural policy and in the particularly cost-intensive agricultural policy are necessary anyway, and they are certain to produce further financial leeway. They will also reduce the cost of these policies when applied to the new member states (see appendix 3).
6. Funds from the EU budget will partly replace funds which currently come from national EU member budgets for Eastern Europe (see appendix 5).
7. Refusing new members would also entail costs for the EU (see appendix 5).

The debate about Eastern enlargement of the EU has been accompanied by widely diverging estimates of the actual costs involved. Sceptics prefer to cite maximum figures, while proponents adopt minimum estimates (see appendix 2). However, the magnitude of these costs depends largely on which states become new members, on the timing of their accession to the Union, on the nature of the transition and accession agreements, and on the development of the economies of the Central East European countries (CEEC).

All scenarios for financing Eastern enlargement indicate that the overall economic and administrative absorption capacity of CEEC for financial transfers from the EU is limited (see appendix 3). The significance of this constraint is often overlooked:

* The gross domestic product (GDP) of the so-called Visegrad-4 (Poland, Slovakia, the Czech Republic, Hungary) is about 145 billion ECU, while the GDP of all 10 possible membership countries is about 200 billion ECU. If we assume that they cannot absorb transfer payments of more than 5% of their GDP without serious financial problems and imbalances (see appendix 3), then the maximum **absorbable** transfer would be around 7 billion ECU (or 10 billion ECU for all ten countries).

* If it is further assumed that structural funds make up about 75% of the transfers, then the EU's requirement for mandatory co-financing by the recipient states would entail a further constraint. Presuming a total transfer of 7 billion ECU for the Visegrad-4, structural funds would be about 5 billion ECU. For these countries, this would correspond to 3 to 4% of GDP. With a share of government expenditure in national income of about 30%, this corresponds to around 12% of their national budgets. Since the recipient countries are expected to co-finance 50% of the structural funds allocated to them, this would mean that a further 12% of the respective national budgets would be pre-structured and tied up by these EU-supported programs.

  Considering that the greatest part of government expenditure is pre-set (costs of administration, entitlements, servicing of the national debt, etc.), practically the entire discretionary budget (especially investment) would be transformed from an instrument of national economic policy to one at least co-determined by Brussels. This would hardly be acceptable to the recipient countries.[1] Should current co-financing requirements be strictly applied, the constraints of the new members' national budgets would limit structural transfers to around 2 billion ECU. This would probably also correspond to the administrative capacity for absorption of these recipient countries.

The total EU cost of an initial enlargement to the Visegrad-4 would be about 5 billion ECU. Other forms of aid (PHARE, bilateral collaboration), amounting to about one billion ECU per annum, would discontinue upon membership and should be subtracted from this 5 billion sum. Overall, then, the total required for the Visegrad-4 per annum would be about 4 billion ECU. This is quite manageable.

Using the same procedure, an additional 2 billion ECU per annum would be needed for the other six candidates for membership. Even if all ten countries became EU members at the same time, the total figure would be well within the realm of the possible.

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1 The former Polish finance minister, Mr Lewandowski, for example, referred to an upper limit of 1% of GDP as the Polish co-financing contribution when addressing the European parliament (Euro East, May 1966, page 4).

APPENDIX 1: COMMUNITY POSITION ON EASTERN ENLARGEMENT

The EU first acknowledged the possibility of CEEC accession in the preambles of the association agreements. At the Council summits of 1993 in Copenhagen and 1994 in Essen, the EU agreed on the criteria for entry and on a pre-accession strategy. Since then, all associated countries have submitted membership applications.[2]

At the European Council summit in Madrid on 16 December1995, the heads of government of the EU asked the Commission to expedite completion of its opinions on the submitted membership applications so that they could be forwarded to the Council as soon as possible after the conclusion of the Intergovernmental Conference (IGC). The Commission was also requested to initiate the preparation of a comprehensive document on enlargement to ensure that all countries seeking entry would be treated on an equal basis. In the case of previous accessions, the Commission only issued opinions in respect to specific individual applications. Now the Commission is being requested to submit a report covering multiple memberships, which corresponds to the political necessity to treat applicants equally in both form and procedure. Only in this way can a subsequent substantive differentiation of the applicants be politically justified.

Negotiations concerning the accession of Malta and of Cyprus into the Union, on the basis of corresponding Commission proposals, are due to start six months after conclusion of the ongoing IGC. In regard to the CEEC, the Council will take into account both the results of the conference and the opinions and reports from the Commission and will, "at the earliest opportunity", make the necessary decisions for launching the accession negotiations with the CEEC. The European Council "hopes" that the preliminary stage[3] of the negotiations with the CEEC will coincide with the start of negotiations with Cyprus and Malta.

The Madrid European Council summit also requested the Commission to undertake a detailed analysis of the European Union's system of finance so that a report could be presented directly following the conclusion of the intergovernmental conference. This report was to address the financial framework of the Union after 31 December 1999, and, in doing so, to take the prospect of enlargement into account. The manner in which these two issues are connected illustrates the extent of political sensitivity regarding the financial repercussions of Eastern enlargement.

The Madrid European Council also called upon the Commission to expand its analysis of the other effects of enlargement upon Community policies, with particular regard to the agricultural and the structural policies. The European Council will continue the review of these questions at its forthcoming meetings on the basis of the Commission reports. This request to the Commission draws attention to the central problem of Eastern enlargement, namely how cost-intensive community policies can be extended to the CEEC.

The European Council in Madrid determined that the purpose of enlargement must be "to strengthen the process of European integration, while preserving the *acquis communautaire*, which includes common policies." This wording complies with the interests of those member states that currently receive payments from the Community budget on the basis of the agricultural and structural policies - who want their continuation to be guaranteed. Depending on the interests involved, member countries do interpret this wording either as a guarantee of continued financial transfers (in absolute or relative values) or merely

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2 Hungary - 1 Jan. 1994; Poland - 8 April 1994; Romania - 22 June 1995; Slovakia - 28 June 1995; Latvia - 13 October 1995; Estonia - 28 November 1995; Lithuania - 11 December 1995; Bulgaria - 16 December 1995; Czech Republic -23 January 1995; Slovenia - June 1996.

3 The wording "at the earliest opportunity" and "hopes that" illustrate that not even a clear ruling was possible with regard to the starting date for negotiations, unlike the case of Malta and Cyprus. The fact that only the co-ordination of the "preliminary stage" is referred to here is a clear indication that everything else is still unclear.

as an institutional guarantee for certain overarching policies without a commitment to the details of their implementation.

The wording "to strengthen the process of European integration" reflects the attitude of a majority of member states that enlargement cannot come without a deepening of the Community, particularly through institutional reforms.

The Madrid European Council also underlined the need to carefully prepare for the task of enlargement on the basis of the criteria laid down in 1993 in Copenhagen and the pre-accession strategy defined in 1994 in Essen. This Essen strategy should "be intensified in order to create the conditions for gradual, harmonious integration" of these countries. Intensification should follow, in particular, through the development of market economies, the adjustment of administrative structures and the creation of stable economic and monetary conditions. The wording "gradual, harmonious" leaves open the question of whether membership should be achieved rapidly, yet with transitional periods, or whether initially there should be a more prolonged introductory phase, possibly involving a staggered integration of particular policy areas into the European Community framework.

The political positions taken by the European Council, particularly the excessively vague ruling on the starting date for negotiations with the CEEC, stem from the specific (and partially conflicting) interests of member states. These are especially pronounced regarding the Union's cost-intensive agricultural and structural policies.

APPENDIX 2: THE CEEC AND THE COSTS OF INTEGRATING THEM INTO THE EU

The ten CEEC have a total land area of 1.1 million square kilometres and a population of 106 million. This corresponds to 33% of the territory of the EU and 29% of its population. On average, more than 25% of the working population (i.e. a total of 9.5 million people) are employed in agriculture (EU: 6% or 8.2 million). Agriculture accounts for 8% of the CEEC's GDP (EU: 2.5%). The combined GDP of the CEEC amounts to approximately 3% of the GDP of the present EU. Even if the CEEC were to achieve far higher growth rates than the EU in the coming years, this would not alter greatly the relative size of their GDP as compared to that of the EU.

At present, the Visegrad and Baltic states achieve, on average, about 11% of the EU per capita income. Based on purchasing power parity values, this relates to about 33%. On this basis, Slovenia and the Czech Republic, at just 50%, are almost at the level of Greece. The per capita income figures of Bulgaria and Romania are approximately 25% of the EU-level.

With a total volume of 81.3 billion ECU (= 152 billion DM) in 1996, the Union's budget is 1.25% of the Union's total GDP and 2.4% of the national budgets of member states. 41 billion ECU (50%) of the EU budget accrues to the common agricultural policy, and 26 billion ECU (31.5%) to structural policy.

Eastern European countries have received EU aid since 1990, with the PHARE program providing 5.6 billion ECU to the CEEC from 1990 to 1994. Overall, the support for the CEEC by the EU (excluding bilateral programs of member states) during this period reached 11.3 billion ECU. Furthermore, the European Investment Bank (EIB) in Luxembourg granted credits under preferential conditions and with a guarantee from the Community. Its volume was similar to the non-repayable aid mentioned above.

An initial, though inadequate, figure for the possible financial repercussions of enlargement can be calculated by simple extrapolation of the present expenditure structure of the Community. If we assume that the agricultural and structural policies will be continued in their present form, then the new member states would be net recipients of Community funds over a prolonged period. Since about 85% of Community expenditures are tied into these two policy areas, the financing requirements would rise due to the disproportionately large agricultural sector and the low per capita incomes of the new member states.

Some estimates, depending on the underlying hypotheses, indicate sums of up to 80 billion ECU per annum. This would correspond to a doubling of the Community budget to about 2.5% of the EU's total GDP. This very large amount is obtained when Anderson's and Tyers' estimate of the costs of an extension of agricultural policies is combined with Grabbe's and Hughes' estimate of the structural fund (see the following table).

However, estimates fluctuate considerably depending on the assumptions regarding anticipated growth rates, exchange rates, prices and the development of agricultural production over the next few years. Accordingly, the following table presents a number of - rather disparate - estimates.

Cost estimates for Eastern enlargement (in billion ECU)

Land/Region	Structural funds [1]	Agricult. policy	Total	Net total [2]	Source
Visegrad-4		37,6			Anderson/Tyers
Visegrad-4	26,0	17,0	43,0		Courchene u.a.
Visegrad-4	45,0	6,6	51,6		SBG (NZZ)
Visegrad-4	7,2	2,4	9,6	7,8	Begg
Visegrad-4				10,8	Baldwin
10 CEEC				26,7	Baldwin
10 CEEC	42,2				Grabbe/Hughes
10 CEEC		9-12			Fischler, EU-Kommission
EU-15 (1996)	27,6	39,5	68,1		
Total EU-Budget			81,0		

1 Including Cohesion Fund
2 After subtraction of new members' EU contributions

If the present rules for the disbursement of regional aid are retained, then a number of aid-receiving regions in the present EU would stop receiving these resources after Eastern enlargement. The reason is that their per capita incomes, after incorporation of the poorer new members, would be above the aid threshold of 75% of EU average income. Consequently, the present aid-receiving countries have already made it clear that they will only consent to Eastern enlargement if it does not result in a redistribution of aid resources to their detriment. At the same time, it is likely that a number of regions will cross this threshold over the coming years anyway because of their successful development efforts. Thus there will be less need for structural funds in the present member states (see also appendix 4). Nonetheless, an expansion of structural funds will be inevitable in the course of Eastern enlargement.

Scenarios for the financing of EU enlargement to the East depend on a number of hypotheses that are subject to considerable uncertainty. There is uncertainty regarding the future of the Central and East European countries themselves, and there is uncertainty regarding the development of expenditure-intensive Community transfer policies. It is also clear that the outcome of long years of accession negotiations (the negotiations with Spain and Portugal lasted eight years) cannot be precisely predicted. At present, it is important to continue the process of association between the EU and the CEEC and to begin the negotiations on accession as soon as possible.

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APPENDIX 3: REFORM OF THE AGRICULTURAL AND STRUCTURAL POLICIES AND THE CAPACITY OF ABSORPTION OF THE CEEC

Even without Eastern enlargement, reforms in the two most expenditure-intensive policy areas of the EU - agricultural and structural policy - are necessary and are indeed underway. High costs, relative inefficiency and undesirable side effects have necessitated reform. Undesirable side effects are particularly pronounced in regard to the impact of the Common Agricultural Policy (CAP) on the partner countries to the EU, which have successfully pressed for reforms of the CAP at GATT/WTO negotiations.

a) Agricultural Policy

One set of cost estimates for extending CAP to the accession countries is found in a Commission study on "Alternative Strategies for Development of Relationships in the Context of Agriculture Between the EU and Associated Countries with Regard to their Future Entry" prepared for the European Council in Madrid.[4]

The Commission concluded that continuing present agricultural policies while incorporating the ten associated countries into the EU in the year 2000, without a transitional phase, would cost about 12 billion ECU per year.

However, this projection should be qualified: without further CAP reform, a marked imbalance will emerge between supply and demand for agricultural products. Recognising this, the Commission study for reform of the agricultural policy describes in detail a number of alternatives. The study also assesses the consequences of different options for the Community's budget in terms of trends, but it does not quantify them.

In terms of the present structure of the agricultural policy, expenditures will tend to be higher to the extent that:

- agriculture in the CEEC recovers quickly from the economic crises that arose after 1989;
- productivity grows rapidly in the CEEC;
- agricultural prices in the CEEC quickly adapt to (normally higher) CAP pricing levels in the post-enlargement phase.

On the other hand, the required expenditure will be smaller to the extent that:

- CAP reform is continued and EU prices move closer to world market levels;
- steps are taken in the context of the WTO to reduce production volumes;
- direct income aid for farmers in the CEEC is set at lower levels than for farmers in the "old" EU countries, which would be justifiable on the basis of generally lower levels of income in the CEEC.

Nonetheless, current developments in the grain market (an increase in world market prices to above EU levels causing the EU to levy export duties) and the problems of BSE underline that forecasts in the context of agricultural policy are subject to considerable uncertainty.

At any rate, a successful integration of the CEEC's agricultural sectors into the EU can only be achieved if the EU members rigorously pursue the reforms in agricultural policy (decoupling of market policy and income support) initiated in 1992.

The discussion concerning Eastern enlargement is thus less one of finance than of the functionality of agricultural policy in the future. This shifts the focus to the GATT agreements, the development of rural areas and the integration of environmental conservation goals into agricultural policy.

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4 Commission document CSE (95) 607.

b) Structural policy

Regional funds for reducing the gap between affluent and disadvantaged regions provide a counter-balance to the single European market. Comparable systems of financial equalisation exist within the economic areas of all nation states.

In terms of the EU, differences among regions often are as marked as differences among member countries.. The gross domestic product of the ten structurally weakest regions amounts to only 25% of the average GDP of the ten most highly developed regions (in the USA, this value is only about 50%). In terms of the levels of unemployment, the ratio is as high as one to eight.

Different levels of development also exist in regard to the physical infrastructure, the qualification of the labour force, the importance given to research and development and the per capita expenditure for information technologies. The latter, to mention only one example, was 47 ECU per capita in Greece, while in Denmark it was 591 ECU per capita.

Structural policy is not only a matter of social balance. It also has an important economic function: the development of structurally weak regions produces new markets and contributes to the strengthening of the European economy. At the same time, infrastructure investments financed from regional and cohesion funds stabilise demand for the investment goods industry, while securing jobs in those member countries which are "net payers" to the Community. Thus, for example, 46 ECU of every 100 ECU of structural aid for Portugal flow directly back to the other member states through their exports to Portugal.

With a budget of 170 billion ECU for 1994 to 1999, the structural funds and the cohesion funds make an important contribution to the financial and social cohesion of the Union. According to information from the member states, during this period, these funds directly and indirectly support 2.4 million EU jobs. The macro-economic importance of the structural funds, particularly in the "cohesion countries," is considerable: they account for 0.5% growth per annum and 4-11% of gross investments.

Following the expiration of the present program phase, reform of EU regional policy will be necessary, irrespective of future enlargement. Such reform will focus on geographical concentration and a stronger emphasis on policy aims and means, as well as on greater efficiency, more budgetary discipline and improved financial management.

The political perspective of Eastern enlargement is only credible for potential new members if it results in their participation in the entire array of Community policy instruments, including the structural funds.

At the same time, Eastern enlargement is neither economically acceptable nor politically tenable without a political guarantee for the continuation of the cohesion policy toward the needy regions of the present Community of 15. The mere enlargement of the EU by the four Visegrad countries would reduce the average EU income such that many regions in Spain and Italy (e.g. Sicily and Sardinia), the whole of Ireland and the Lisbon region would exceed the 75% income threshold and thus not qualify for support.

The hope raised in Germany that it would be possible to reduce German contributions to the EU, while receiving still more money from the structural funds is therefore pure wishful thinking. Eastern enlargement cannot be achieved at zero cost. If additional revenue for the EU cannot be generated, then expenditures have to be examined critically - including those expenditures enjoyed by the richer states.

Longer transition periods are needed in order both to implement the reforms of the structural funds in the Europe of the 15 within a reasonable timeframe and to gradually incorporate the new member countries into the structural policy of the Community.

c) Capacity for Absorption of the CEEC

Financial transfers greater than 10% of the GDP of recipient countries-which would occur should the relevant guidelines be followed fully - would be counter-productive. Without the adoption of severe measures of administrative and political control, financial transfers on such a scale would inevitably bring about the classic transfer problem: the countries making the transfers would experience a demand-side acceleration of growth, while the economies of the recipient countries would be driven into recession by the plentiful supply of foreign goods on favourable terms.[5] The aid administered through the highly interventionist Marshall Plan after the World War II amounted for only 2.5% of the GDP of the recipient countries (Collins/Rodrick, Milward).

Applying current transfer guidelines (which leave Greece with transfers amounting to 3.5% of GDP), the prospective members of the EU in Eastern Europe would receive transfers amounting to 10-20% of GDP. Such sums would not only exceed their administrative capacities but also the budgets and absorptive capacities of these countries because of the co-financing rules. A step-by-step integration into Community structures is thus also in the interests of Central Eastern European states (see appendix 4).

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5 Transfers lead to a revaluation or prevent inflation-induced devaluation of the national currency. In both cases, this gives rise to a decrease in the price of imported goods by comparison with prices of products manufactured in the recipient country.

APPENDIX 4: STRUCTURE AND COHESION FUNDS FOR THE YEARS 2000-2006

In 1999, 0.46% of the GDP of the Community will be allotted for the structural and cohesion funds. If it is assumed that this percentage is also achieved for the program phase of 2000-2006, then about 260 billion ECU would be available for this period. This would amount to 37 billion ECU per annum. During the period 1994-1999, 170 billion ECU, i.e. 28 billion ECU per year, will be spent. Therefore, 70 billion ECU, corresponding to about 32% more funds per year, would be available. At the same time, the upper limit of 1.27% of GDP for proprietary funds of the EU would still be preserved until the year 2006.[6]

If funds of such magnitude are used efficiently, it should be possible to bring about active solidarity between the present as well as the future members of the Community.

Of the 260 billion ECU for the period of 2000-2006, for example, it would be possible to spend 200 billion for the present members and 60 billion for new members. The CEEC would thus benefit by about 8.6 billion ECU per year - a remarkable increase compared to the 1 billion ECU spent annually through the PHARE program. This would stimulate growth in the recipient countries while increasing exports from other parts of the EU.

With approximately 200 billion ECU, the Community would also have adequate means to support the poorer regions of the present member countries. Solidarity with regions whose GDP per capita is still below 75% of the EU average of the 15 could still be maintained to the full extent.

This will be all the easier inasmuch as it can be assumed that many of the present top-priority regions will no longer be below the 75 percent average in the future. This will not just be because the Community average would be forced down by enlargement, but also because - as Monika Wulf-Mathies stressed in the German parliament - the goals of structural policy are being achieved.

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6 This information is based on the statements made by Monika Wulf-Mathies in the Committee for European Union Affairs in the German on 19 June 1996.

APPENDIX 5: THE COSTS OF NOT ENLARGING THE EUROPEAN UNION

The issue of financing Eastern enlargement raises fundamental questions about the overall thrust of all the Union's future policies, and in particular, how they should be paid for. Indeed, what is really at issue is the willingness of the Union's member states and citizens to support European integration and European policies with the requisite financial commitment.

Substantive discussion of these questions requires a critical analysis of the EU's spectrum of tasks and the EU's success in achieving those tasks. In this context, it should be reaffirmed that certain policy tasks are best carried out at the European level. In adopting these tasks, the principle must be observed that the Community be granted the requisite resources for the policies it is assigned to pursue. Financing priorities must be derived from political priorities, not the other way around.

When contributions to the Union and payments from the Union are compared, not only the financial but also the political and social advantages and disadvantages of economic integration must be considered.

A purely budgetary approach would be mistaken since some member states, such as Germany, would benefit in a wide variety of ways from Eastern enlargement. Germany has security interests in the area and it derives economic advantages from its geographic (and cultural) proximity. One half of EU trade with Central and Eastern Europe is with Germany.

The Madrid European Council stated that Eastern enlargement, by "ensuring stability and security for the continent," offers new prospects for economic growth and general prosperity - not only for the countries wishing to join but also for current members of the Union. Consensus exists that Eastern enlargement offers all member states both economic and non-economic advantages.

The discussion of costs and benefits of Eastern enlargement also suffers from the fact that the costs of either delaying or rejecting enlargement are difficult to gauge. Even the cost of enlargement is most often discussed in terms of absolute figures and not in relative terms when compared with other EU budget items or the overall budgetary burdens of the EU member states.

We should therefore recall what kind of funds are already flowing from Community and member state budgets to the ten CEEC. From 1990 to the end of 1994, transfers amounted to a total of 33.8 billion ECU, i.e. 11.3 billion ECU from the Community budget and 22.5 million ECU from member states' budgets. Additionally, loans of about 19 billion ECU were granted by international public financial institutions (EIB, EBRD, World Bank). Overall, Eastern Europe obtained 74.7 billion ECU from the G-24 during this period.[7]

When some or all of the CEEC enter the Union, transfers from the Community budget would replace many direct and indirect transfers from member states' budgets. These transfers can currently be valued at 7-10 billion ECU per annum.

Nor should one exclude more hypothetical opportunity costs: the former Yugoslavia brutally demonstrates what kind of financial burdens can arise when political instability gets out of control - not to mention the resulting political confusion and the unspeakable human suffering. The costs for accommodating and supporting refugees must be added to the costs of the international peace-keeping force and the ongoing aid programs in the former Yugoslavia.

Finally, recall that the end of the Cold War has also led to savings. While the defence expenditures of EU member countries in the 1970s and 1980s was on average 3.5% of GDP (3.2% in Germany), this went down to 2.5% of GDP (Germany 2%) in the 1990s.[8] This corresponds to savings of more than 1%

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7 Towards greater economic integration. The European Union's financial assistance and trade policy for Central and Eastern Europe and the New Independent States. European Commission, 1995.

8 Figures from 1995 NATO Handbook, Appendix, Table 3.

of GDP! By comparison, the Union's budget comprises only 1.25% of the GDP and 2.4% of all public expenditure of the Union.