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ENLARGEMENT, TWO YEARS AFTER: AN ECONOMIC EVALUATION

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The present study provides the background material on the basis of which the Commission Communication "Enlargement, Two Years After – An Economic Success" adopted on 3 May 2006 was prepared. Only the Communication was formally adopted by the Commission. The report should not necessarily be understood to represent the official position of the European Commission.

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Abbreviations

CAP	Common Agricultural Policy
CARDS	Community Assistance for Reconstruction Development and Stability
CEPII	Centre d'études prospectives et d'informations internationales
EAGG	European Agricultural Guidance and Guarantee Fund
EBRD	European Bank for Reconstruction and Development
EES	European Employment Strategy
ERDF	European Regional Development Fund
ERM II	Exchange Rate Mechanism II
ESF	European Social Fund
EU	European Union
EU-8	EU-10 minus Cyprus and Malta
EU-10	Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia
EU-15	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom
EU-25	EU-10 + EU-15
FDI	Foreign Direct Investment
FIFG	Fishery fund
GDP	Gross Domestic Product
GNI	Gross National Income
HICP	Harmonized index of consumer prices
IMF	International Monetary Fund
ISPA	Instrument for Structural Policies for Pre-Accession
Lhs	Left hand scale
NAWRU	Non accelerating wage rate of unemployment
NRP	National Reform Program
OECD	Organisation for Economic Co-operation and Development
Phare	Poland and Hungary Assistance for Restructuring of the Economy
RCA	Revealed comparative advantage
REER	Real effective exchange rate
Rhs	Right hand scale
R&D	Research and Development
SAPARD	Special pre-Accession Programme for Agriculture and Rural Development
SME	Small- and medium-sized enterprises
TFP	Total factor productivity
ULC	Unit Labour Costs
UNCTAD	United Nations Conference on Trade and Development
VAT	Value Added Tax

1. INTRODUCTION

The second anniversary of the 2004 enlargement constitutes an important occasion, an occasion to celebrate the widening of the EU to embrace new Member States[1].

The 2004 enlargement towards the Baltic and Central and Eastern European nations, nations that had been under totalitarian rule for more than half a century, and Cyprus and Malta can be considered a success. The 2004 enlargement expanded the frontiers of the EU, increased its population and its national income and raised its cultural, historical and economic diversity. The task of expanding the EU-15 to include ten new Member States, the EU-10, was and remains a daunting one. Yet the EU has risen to the challenge. Two years later, peace, democracy and prosperity prevail throughout the wider Europe. Enlargement did not create economic or absorption problems for the EU nor did it stimulate massive migration flows from the acceding nations affecting the labour markets of the incumbents, as some had feared. On the contrary, the process of convergence and wealth creation which had been under way for over a decade continued and accelerated. In light of the wide scope of the EU *acquis* the new Member States were required to adopt, a process of modernisation affected the political and administrative culture of the acceding Member States as well as their economic and ultimately their social environment. Nevertheless, to succeed in the EU the new Member States need to continue the process of adjustment and reform.

Enlargement has acted as a force of modernization not just for the new Member States but also for the EU-15. The extension of the Internal Market and the rapid integration of the new Member States in the EU economy have made it possible for enterprises to take advantage of cost and location advantages and to seek improvements in profitability through the spatial reallocation of production. These efficiency gains, however difficult to measure, will continue to be available to enterprises and to consumers as the EU-25 economy adapts to structural change. Structural reforms are clearly necessary in order for the EU to realize the promise of productivity growth through production relocation and specialization in the Internal Market.

The 2004 enlargement can be considered as one of the great achievements of the EU, and it constitutes a landmark example of the strength of the European approach to integration. The goal of becoming a member of the EU has stimulated democratic and economic reforms as well as human rights and the rule of law across Europe. A deeper understanding developed in the countries of Central and Eastern Europe, that membership of the EU was not unconditional – the European values of economic and democratic pluralism had to first be met as preconditions to membership. This became an important catalyst for reform and for fundamental change, change which, if at all, would not have been possible, as history teaches, without often severe and costly conflict. The contribution of adopting and developing reliable institutions and appropriate governance structures, and the respect of the rule of law, in order to meet the membership criteria have undoubtedly played an important role in the good performance of the new Member States.

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[1] The 2004 enlargement follows five earlier expansions of the EU; in 1973 Denmark, Ireland and the UK joined the Community; in 1981, Greece; in 1986, Portugal and Spain; in 1990 the Community expanded to embrace East Germany following the German reunification; and in 1995 Austria, Finland and Sweden joined the EU; excluding the German reunification, strictly speaking the 2004 was the fifth enlargement of the EU.

As the EU enlarges, it is simultaneously challenged by globalisation, ageing and technological change. However, there are two key differences that distinguish the enlargement from other shocks that impinge on our economies and societies. First, the timetable for enlargement was known with confidence and, thus, the EU was able to prepare itself and the acceding Member States in advance in order to cope with the risks and take advantage of the opportunities associated with enlargement. Secondly, by joining the EU family many of the risks and costs of adjustment were internalized within the EU frame of policies and instruments. The successful implementation of the 2004 enlargement has to a large extent been a reflection of this experience.

The economic and non-economic benefits of enlargement are large, yet they are not available for free. Enlargement does not end with accession, enlargement is a process that continues to require adjustment in a dynamic competitive environment to yield its rewards. As much as the new Member States need to adjust so do the old EU members. These adjustments that enlargement has given rise to will also prepare the EU economies to cope with the challenges of globalization. This is a central message of the study to which policy makers must be alert especially as the EU plans to enlarge further over the next few years.

The purpose of this study is to review the experience with the 2004 enlargement two years on. The report is essentially backward looking and focuses mainly on the economic aspects.

The study is organized around the following themes. Chapter 2 discusses the expectations about the implications of the forthcoming enlargement. This chapter takes a retrospective view, discussing how the impact of enlargement was perceived by the public at large as well as by primarily economists interested in quantifying ex ante the possible effects. The chapter also explores some of the reasons of the generally reticent attitude of EU citizens towards enlargement as a policy and enlargement with specific countries in particular. There is a clearly paradoxical situation expressed in the views of EU citizens in that the benefits of enlargement appear to be generally insufficient to compensate for the increased diversity of the wider EU. Support for enlargement has been at best lukewarm and this ambivalence persists. The purpose of this chapter is essentially to summarize some of these views and to review the ex ante assessment of the implications of enlargement thus setting the stage for the following chapters which discuss the reality of enlargement for the new and old Member States.

Chapter 3 reviews the preparations for enlargement on the part of both the EU and the new Member States. Two crucial issues are involved here, first the requirement for the recently acceded Member States (EU-10) to take on the *acquis communautaire*, a condition for accession and, second, the contribution of the EU in financing these steps. Taking on board the *acquis* has undoubtedly been costly but the EU has contributed significantly through pre-accession aid to this task. Intense pre-accession activity in a number of areas made it possible for the new Member States to meet the so-called Copenhagen criteria and subsequently the conditions in the 31 chapters of the *acquis* involved in the negotiations. The fact that the acceding Member States benefited from EU budget support even prior to becoming members of the EU is indicative of both the foresightedness and of the generosity of the EU-15 in providing the best possible set of conditions to make accession a success. Subsequent to accession the new Member States have been net beneficiaries in the EU budget and will continue to remain so in coming years. The chapter also reviews in some detail the specifics of the reforms undertaken by the recently acceded Member States in recent years.

Chapter 4 examines the macroeconomic performance and outcomes in the EU-25 and especially in the EU-10 starting since the period prior to accession. Issues addressed are economic growth, nominal convergence, macroeconomic stability and the labour market performance.

The subsequent five chapters are at the core of the study, covering a wide range of effects. The impact of enlargement on the level of integration is discussed in chapter 5 which analyses the flows between the new Member States and the EU-15 in goods and services (trade) and capital (FDI). The chapter reviews also the impact on extra EU-25 trade patterns and addresses the issue of outsourcing. Accession implies the free movement of labour; its consequences for migration are assessed in chapter 6. In particular, the fear of massive labour flows from the new to the old Member States is confronted with the facts. The effects of enlargement on taxation and the issue of tax systems in the old and new Member States is examined in chapter 7. The next two chapter focus on the process and effects of enlargement in two specific sectors of the economy: the financial sector (chapter 8) and the agricultural sector (chapter 9). The report ends with the impact of enlargement in the specific policy area of social cohesion (chapter 10), which is under particular strain as the fifth enlargement brought to the EU countries with much lower income levels and characterised by a great social diversity.

2. ANTICIPATING THE IMPLICATIONS OF ENLARGEMENT

The 2004 enlargement process involved both the take over of the *acquis* on the part of the new Member States and the provision of financial and technical support on the part of the EU. A more detailed discussion of the nature and scale of adjustment and support for enlargement is provided in Chapter 3. Among the contributions to this preparation initiated by the Commission was the 2003 Kok Report on enlargement intended to marshal political and popular support for the policy[2].

The present chapter reviews briefly the preparation undertaken in the advance to the May 2004 deadline as well as how much support Europe's citizens have been according to this policy. To put things in context, a survey of ex ante estimates of what enlargement was expected to mean in economic terms is also presented.

2.1 The fifth enlargement, negotiations and financing

The fifth enlargement[3] symbolically started immediately after the fall of the Soviet rule over Eastern Europe when the EU declared that it would welcome the nations into the EU fold. As also stressed in the Kok report (Box 1) the basic reason for the 2004 enlargement was the visionary objective of reuniting Europe in the aftermath of the fall of the Communist regimes in the East and the removal of the East/West divide which dominated the second half of the 20th century. Unlike previous enlargements which had taken place in the context of a divided Europe, the 2004 enlargement was the first to address the issue of Europe's reunification. This reunification aimed at bringing the people of Europe in a constitutional framework that would encourage them to work together in an environment of peace and stability.

Officially, the invitation to apply for membership was made in the 1993 Copenhagen European Council which set out the Copenhagen criteria necessary to be met before membership was considered. According to the Presidency conclusions, "membership requires that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and, protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union. Membership presupposes the candidate's ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union".

During the 1990s there was a gradual integration of the economies of the candidate countries within the EU as various legal and economic restrictions were gradually removed and the

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2 The Kok Report on enlargement is officially a report of former Prime Minister of the Netherlands Wim Kok to the European Commission; see Kok (2003). The Report was prepared on the invitation of the President of the Commission, Romano Prodi, to set the stage, explain the issues and dispel concerns about the impact of the forthcoming enlargement on the EU and its citizens.

3 The 2004 enlargement follows five earlier expansions of the EU; in 1973 Denmark, Ireland and the UK joined the Community; in 1981, Greece; in 1986, Portugal and Spain; in 1990 the Community expanded to embrace East Germany following the German reunification; and in 1995 Austria, Finland and Sweden joined the EU; excluding the German reunification, strictly speaking the 2004 was the fifth enlargement of the EU.

Europe Agreements established the framework for bilateral relations between the EU as a whole and each individual candidate country. This integration process has preceded the formal steps that took place after May 1, 2004 and in many ways the process of economic integration with the EU was virtually complete prior to the date of accession.

Negotiations for the 2004 enlargement officially started in March 1998 with six of the candidate nations (the Czech Republic, Estonia, Hungary, Poland, Slovenia and Cyprus) and in October 1999 were expanded to include Bulgaria, Latvia, Lithuania, Malta, Romania and Slovakia. Negotiations were concluded by December 2002 and the Accession Treaties were signed with the ten acceding nations in April 2003 after referenda were held in all but one[4]. Approval of the Treaties in each of the acceding Member States in 2003 was followed by ratification in the EU-15 legislatures and the official date for enlargement was set to be 1 May 2004. This date was decided in order to make it possible for the new Member States to participate in the June 2004 elections for the European Parliament and in the Inter-Governmental Conference to prepare the Constitutional Treaty.

Negotiations covered 31 chapters of the *acquis* and were spread over 372 sessions that were particularly difficult and complex. A key principle in the negotiations was that no permanent derogation from EU rules was to be accorded to the acceding nations. Because of the technical and practical difficulties to realize all the necessary adjustments, a central issue in the accession negotiations was how costly it would be for the acceding nations to take on the complete *acquis communautaire*. To cope with the adjustment costs, transitional periods ranging from 6 months to 12 years were accorded partly at the demand of the acceding nations and partly on request of some EU-15 states which on occasion felt that a rapid integration of the new Member States could pose particular risks. These transitional periods have clearly interfered with the proper functioning of the internal market (notably as regards the free movement of labour).

The other crucial domain in the negotiations concerned the financial support for enlargement. The March 1999 Berlin European Council allocated €75bn (1999 prices) of pre-accession and accession aid for the period covering the Financial Perspectives 2000-2006. The pre-accession strategy was endowed with €3.72bn per year (expenditure for programs Phare, ISPA and SAPARD) to which special budgetary compensations and transitional benefits should also be added. The December 2002 Copenhagen European Council adopted an envelope of €40.9bn (1999 prices) for the ten acceding nations covering the three-year period 2004-2006. Expenditure commitments in favour of the acceding nations totalling €37.5bn were allocated predominantly for structural policies (€21.8bn) followed by expenditure on the common agricultural policy (€9.8bn) and on internal policies (€4.2bn). The direct cost of financing enlargement was intended to be kept within the EU budget expenditure ceiling of 1.27% of gross national income (GNI). The new Member States are projected to be net beneficiaries in the EU budget over the horizon of the Financial Perspectives. Thus, the EU budgeted ex ante sufficient resources so as to be able to support financially a major expansion while respecting financial discipline[5].

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[4] Cyprus, which endorsed membership through a vote in the legislature, is the sole exception; the rest approved the Accession Treaties by popular referenda.

[5] Further discussion concerning the financial outcomes of these plans is presented in section 3.6 below.

Box 1: The Kok Report

The Kok Report was an important contribution in the preparation for the fifth (2004) enlargement.

The Report was commissioned by Commission President Romano Prodi late in 2002 to be delivered by end of March 2003. Former Prime Minister Wim Kok was given the mandate to examine the implications of enlarging the European Union from 15 to 25 Member States and subsequently more. The Report devoted attention to the key institutional and governance issues involved by the enlargement to the 10 New Member States in view of the then upcoming constitutional debate.

The Report concluded by stressing the importance of improved implementation of EU rules and policies by all, prospective and old, Member States.The Report emphasized that, for all Member States, the enlargement was not a threat but an impetus for renewal.

The Kok Report also recognized that there would be significant benefits for the incumbents. Creating and securing an environment of stability, security and prosperity in the new Member States would encourage investment and reallocation of production in a wider economic space creating opportunities for specialization and promoting entrepreneurship, economic growth and employment in the EU–15 too. These benefits are less immediately tangible and quantifiable than the direct economic benefits and cost which area easier to estimate. Nevertheless, they are crucial determinants of the quality of life of EU citizens and constitute also the basis on which economic prosperity can be built.

To ensure that enlargement is a success, the Kok Report proposed a five–point agenda covering the following issues: acting together in Europe, boosting the European economy, making Europe safer for its citizens, developing our partnership with our European neighbours and giving Europe a voice in world affairs. This strategy was intended not just to provide a framework within which the success of enlargement could be secured but also to respond o the concerns that EU citizens persistently expressed in the advance towards the 2004 enlargement.

Some of the key conclusions of the Kok Report are worth mentioning. On the issue of economic performance, convergence and financial support from the EU budget, the Report was cautiously optimistic that the outlook was promising provided that the EU follows proper and forward-looking policies (see chapter 3). On internal security, illegal migration, the environment, nuclear safety and food standards the report concluded that while significant overall improvements should be expected these would not be automatic but would require appropriate policies (see chapter 4). On the question of Europe's place in the world, the Report stressed that enlargement marked an opportunity to complement Europe's economic power with greater political presence. The Report argued that the EU should reflect on developing a genuine common foreign policy and it should also modernize its foreign policy instruments. Finally, since "enlargement is, in fact, the EU's most successful act of foreign policy" the Report stressed that not only the EU should develop better relations with its neighbours but it should also continue the enlargement process with Bulgaria, Romania and Turkey (Kok, 2003, p. 66).

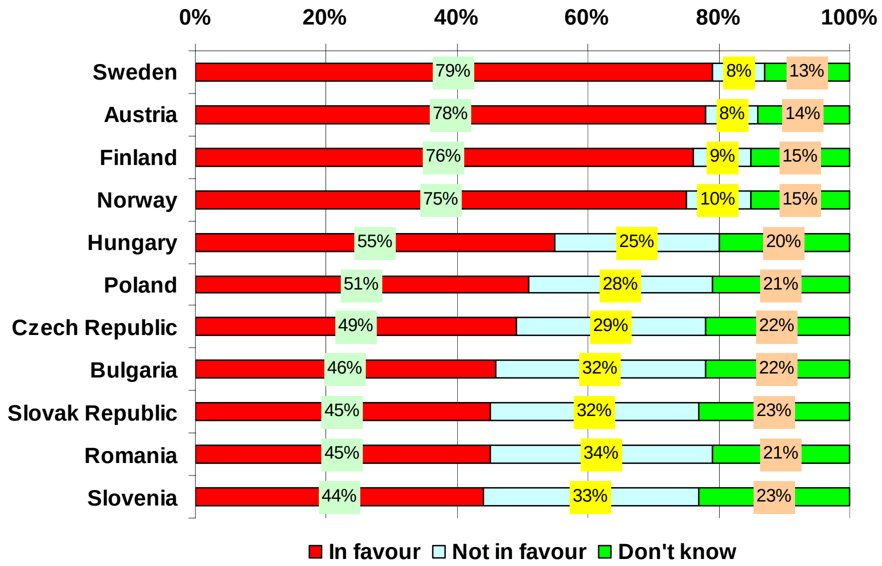
2.2 Enlargement and the citizens

The Kok report found mixed support for enlargement, as evidenced by citizens' attitudes towards enlargement in EU-15 and in the acceding countries. This continues to hold in subsequent surveys. It should be stressed at the outset that while in principle support for enlargement reflects to large extent non-altruistic motives, other factors play an important and perhaps a crucial role too. In particular, survey evidence has found that the perception in the EU-15 about enlargement is influenced by the sense of community and affinity. The way citizens see each other in the EU was not an issue when the EU embraced a limited and relatively homogenous group of nations and cultures. A special Eurobarometer survey found that there was a great distance, indifference and lack of a sense of community between the EU-15 and the then acceding countries and Bulgaria, Romania and Turkey[6].

[6] See Eurobarometer, 2002; the survey found that 91% of respondents had no ties with the candidate countries; 63% had never visited and 70% had no wish to visit any of them; 41% had no desire to know

Clearly, people tend to support a proposed policy depending on whether they expect to lose or gain, and this also holds for enlargement. Furthermore, enlargement will be generating winners and losers among specific economic groups and across the Member States and uncertainty about the ultimate impact of enlargement should in principle be expected to generate concern among risk-averse and rational individuals. As enlargement will necessitate inevitable adjustment, especially on the part of the acceding nations, causing the disappearance of old industries and obsolete skills and the emergence of new ones, it is reasonable to expect that vulnerable segments of society will have reservations about it.[7] Furthermore, disparities in economic performance among the old and the new Member States should a priori be expected to affect the perception of the net benefits from enlargement of the EU and to influence the degree of support for the policy. As will be seen below, the data reveal some interesting patterns in this regard.

Graph 1: Attitudes vis-à-vis prospective candidate countries (1994)



Source: Eurobarometer 42-Fieldwork, December 1994.

There are several reasons to explain support or indifference to enlargement. Undoubtedly, the slowdown in economic growth since 2000, especially in the eurozone, increased uncertainties about the possible economic implications of the forthcoming enlargement; it is also possible

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more about the candidates and 76% did not wish to live there while 73% had no interest in developing business ties with them; finally, 57% of respondents felt that they were not participating in the political debate about enlargement implying that enlargement was an elite-driven, not a populist project.

7 This is perfectly consistent with economic theory. In particular, international trade theory predicts that economic integration (or trade liberalization) will increase the wage of the factor of production in the region where it is relatively abundant and will lower it in the region where it is scarce; in other words, freeing up international trade, through economic integration in our case, compensates for the effect of initial factor endowments on factor prices. This is the so-called Stolper-Samuelson theorem. Accordingly, and assuming that the Central and Eastern European (CEEC) nations are the labour abundant ones, integration in the EU should, a priori, raise the price of labour in the acceding nations and lower it in the incumbents, and vice versa for the return to capital. In reality, there are complications and it is difficult to predict a priori what the job and income consequences of enlargement will be. It is certain, however, that the consequences will be uneven across socioeconomic groups, both in the acceding and in the incumbent Member States and this undoubtedly is contributing to the sense of insecurity and vulnerability that characterizes the survey data on the question of enlargement.

that the period between Europe's liberation from Communist rule and enlargement was too short for citizens to digest and evaluate the monumental changes under way; finally, it is possible that people were asked to leap into the unknown, as the increase in the size of the EU since the beginning of the 1980s had not resolved the question of what the EU was in the process of becoming and this uncertainty was even further compounded by another enlargement initiative.

People appeared to legitimately raise questions about their own and their families' economic welfare and job prospects in an environment of increased uncertainty but also to be uncertain about, if not to question altogether, the direction that the EU was taking. One particular issue, that of "social dumping", which emerged so prominently during the constitutional debate in 2005 and subsequently appeared to be central to the anxieties characterizing the European psychic in the advent of the 2004 enlargement. In general, enlargement was not perceived as a policy to address the fears emanating from rampant globalization.

Before the 1995 enlargement of Austria, Finland and Sweden public opinion in the EU-12 showed a marked preference for wealthy, market-economy nations rather than ex-communist countries[8]. Among the latter, geographical and/or cultural proximity appeared to play a role disfavouring those further away – such as Bulgaria and Romania. The Eastern and South-Eastern countries of Europe seemed to be unknown for public opinion in the old Member States, as confirmed, for instance, by the high opposition to the prospect of Slovenia's entry in the EU. According to the December 1994 survey evidence, some 33% of respondents did not favour Slovenia's entry, for example, compared to 10% or less recorded for the cases of the Scandinavian countries and Austria (Graph 1).

Perhaps this divergence in preferences was also a reflection of ignorance, stereotyping or incomplete information about these potential candidates for EU membership as well as lack of appreciation of the opportunities offered by enlargement as a means to conquer new markets, create prosperity and bring political stability to those economies emerging from Communism. Finally, note that the percentage of respondents who do not know whether they are in favour of enlargement or not increases as the less wealthy former Communist countries are considered. This percentage is generally in excess of 20% and in the case of Hungary's candidature it peaked at 30%.

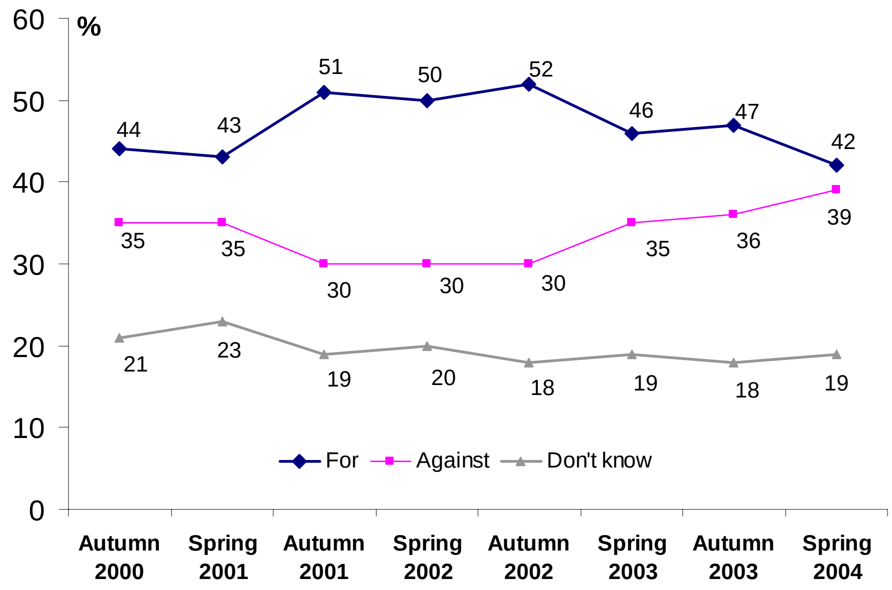
Sentiment about enlargement has fluctuated considerably. As can be seen in Graph 2, support for enlargement peaked at 52% in the period between Autumn 2001 and Autumn 2002. Subsequently, it began to decline as the EU economy entered a period of slow growth, but those in favour continued to outnumber those against: by Spring 2004, 39% of those who expressed an opinion were against enlargement and 42% in favour[9]. The possibility that lack of information about the candidate Member States was a strong feature of the survey data is supported by the virtually constant and relatively high proportion (averaging around 20%) of those who had no opinion to be in favour or against the 2004 enlargement. However, it is also possible that this high proportion reflects indifference on the part of EU citizens regarding

[8] The exact question to which these are replies is: "For which of the following countries, would you be in favour or against it becoming part of the European Union in the future?"

[9] The exact question to which these are replies is: "What is your opinion on each of the following statements? Please tell me for each statement if you are for or against it – Future enlargement of the EU to include other countries in future years".

enlargement and perhaps a misconception that the enlargement shock will not be affecting their prosperity and welfare.

Graph 2: For or against – opinions in EU-15 prior to enlargement



Source: Eurobarometer, issues 54 to 61

One suggestion from this data is that EU citizens are expressing an enlargement fatigue following the rapid growth in EU membership within 25 years since 1981 from nine to today's twenty five Member States[10], even if this fatigue is more pronounced in the post-2004 period. Clearly, the process of gradual enlargement with nations of cultural affinity (one country in 1981, Greece, two – Portugal and Spain – in 1986, and three in 1985 – Austria, Finland Sweden) was easier to implement than the 2004 enlargement. Furthermore, previous enlargements embraced nations culturally and ideologically familiar to citizens in the European Community while the 2004 enlargement brought into the EU fold European nations which, because of communism, had been historically estranged from the mainstream of European culture and discourse. This enlargement brought diversity and unfamiliarity and a sense of foreboding.

In a different but related perspective, it is also possible that citizens saw no discernible end to the enlargement of the Union and no immediate economic benefits appeared to develop as a result of it. Similarly, it is possible that the size of various socio-economic groups which are vulnerable to enlargement is increasing as simultaneously globalization continues to advance at a rapid pace and encroach on wider segments of the economy. However, as shown in this study, these judgements are clearly erroneous and inconsistent with the evidence concerning the impact of enlargement although the sense of insecurity that might be present in the data is understandable.

The erosion of support for enlargement may have been principally a reflection of uncertainty associated with the economic slowdown in several key Member States during this period[11].

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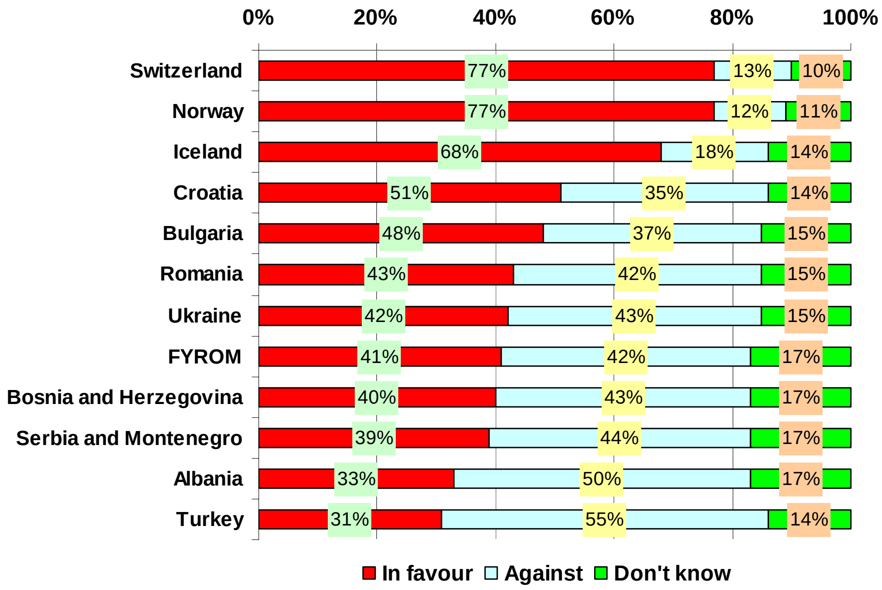
10 See EU-Consent (2006).

11 Data from the Eurobarometer 61, Fieldwork February-March 2004 survey show that support for enlargement to the ten acceding countries in May 2004 was 42% and against enlargement 39%, with 19%

As economic underperformance persisted, a lack of confidence in this policy appears to have increased and enlargement came to be seen less as one of Europe's answers confronted with globalization – nor was it in fact presented in this light – and more the source of problems. Of course, the economic slowdown provided opportunities for a constituency of populists to raise their objections to EU policies more generally, and against enlargement in particular, objections which, in the current environment, have been difficult to counter.

Graph 3: Attitudes vis-à-vis prospective candidate countries (2005)



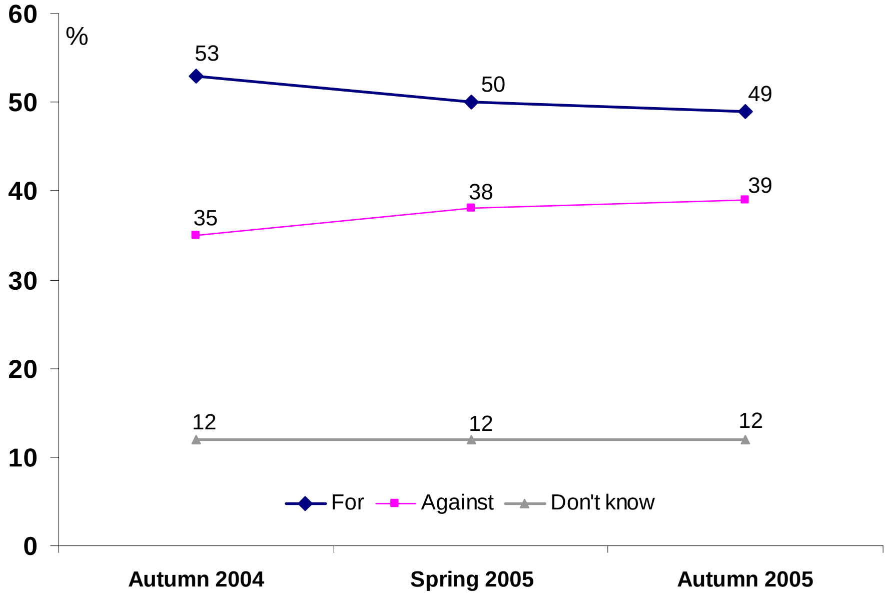
Source: Eurobarometer 64 – Fieldwork: 0ctober-November 2005

The public's ambiguity about the value of enlargement has persisted and is affecting public sentiment towards possible future enlargements. Indeed, mistrust may have in fact increased in the post-2004 period. Graph 3 shows that, consistent with previous evidence, EU citizens continue to favour wealthy European nations for EU membership while those in the Western Balkans are less favoured candidates[12]. While the percentage of those uncertain or unable to answer whether they support enlargement or not has fluctuated within a narrow range, the dispersion of support is quite wide – from 77% (13% against) in the case of Switzerland to 31% (55% against) in the case of Turkey with Croatia holding a rather curious position (51% in favour and 35% against).

unable to offer an opinion. The data appear to confirm that those against enlargement as a policy are broadly against enlargement to the ten acceding countries.

12 The exact question to which these are replies is: "For which of the following countries, would you be in favour or against it becoming part of the European Union in the future?"

Graph 4: For or against – opinions in EU-25 after enlargement



Source: Eurobarometer, issues 62, 63 and 64.

Survey evidence from the EU-25 sample, shown in Graph 4, suggests that enlargement continues to be a policy that enjoys support from around 50% of the respondents[13]. Already survey evidence suggests that citizens in the new Member States are generally satisfied with enlargement even if the evidence is mixed reflecting primarily the impact of transitional measures on worker mobility[14]. Between Autumn 2004 and Autumn 2005 there has been a modest increase in the share of those against enlargement and a corresponding decrease in the share of those supporting it, while the share of those not knowing has remained constant at 12%. The fact that the sample now includes respondents from the new Member States does not significantly alter the share of those against enlargement (compare Graph 2 and Graph 4) but it does alter the distribution of those supporting enlargement (up some 7 percentage points between the Spring 2004 and the Autumn 2005 surveys) and those not knowing (down 7 percentage points between the two surveys

Nonetheless, data from the three Eurobarometer surveys reported in Graph 4 suggest a increase in dissatisfaction, although only modestly, with the policy of enlargement among the citizens of EU-25.

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13 As before, the exact question to which these are replies is: “What is your opinion on each of the following statements? Please tell me for each statement if you are for or against it – Future enlargement of the EU to include other countries in future years".

14 For example, 36% of Czech citizens are satisfied against 20% dissatisfied and 37% neither satisfied nor dissatisfied; no concrete data are reported in EU-Consent (2006) for the other new Member States but, as was inevitable, some positive and some negative implications are identified.

Table 1: Results in referenda on EU accession

Country	Turnout %	Yes %	No %	Support[1] %	Date	Recent turnout[3]
Cyprus[2]	na	58	25	na	Autumn 2002	na
Malta	91.0	54	46	49.1	March 8, 2003	97.0 (2003)
Slovenia	60.3	90	10	54.3	March 23, 2003	70.1 (2000)
Hungary	45.6	84	16	38.3	April 12, 2003	70.5 (2002)
Lithuania	63.3	91	9	57.6	May 10-11, 2003	58.2 (2000)
Slovakia	52.2	93	7	48.5	May 17, 2003	70.0 (2002)
Poland	58.9	77	23	45.4	June 7-8, 2003	46.3 (2001)
Czech Republic	55.2	77	23	42.5	June 13-14, 2003	58.0 (2002)
Estonia	63.0	67	33	42.1	September 14, 2003	58.2 (2003)
Latvia	72.5	67	32	48.6	September 20, 2003	71.5 (2002)

na = not available; 1 percentage of eligible votes who supported accession; 2 Cyprus approved the Accession Treaty in the legislature and the results of the latest opinion poll are reported; 3 participation in the parliamentary elections (year in parenthesis) adjacent to the time of the referendum.

Source: Doyle and Fidrmuc (2004), Table 2.

The difficulties encountered in marshalling decisive support for enlargement are not specific to the old EU Member States. Perhaps not surprisingly, enlargement does not appear to be an overwhelmingly popular policy in the new Member States either, as can be seen from the referenda on whether to join the EU that were held in 2003 (Table 1). This contrasts to the initial enthusiasm which gradually gave way to scepticism and disillusionment in part mirroring similar sentiments in the EU-15. Despite the large economic and non-economic benefits the new Member States are certain to derive, support for membership in the EU was not easy to secure in nine of the ten new Member States and a certain enlargement fatigue on their part was beginning to develop even as the accession date was approaching and people realized that the journey to membership had been arduous and demanding. Thus, support for accession was generally obtained against a background of low popular participation. While a large majority of those that turned out to vote did indeed support accession, support of accession among those eligible to vote (irrespective of whether they voted or not) was generally low – with the exception of Lithuania and Slovenia, where support was over 50%, in the others support was below this mark. This is a puzzle considering that the benefits from this policy for the Central and Eastern European acceding nations should far outweigh the adjustment costs of enlargement[15].

As noted previously, there are several explanations for these outcomes. Doyle and Fidrmuc (2004), for example, explain them on the basis of the respondents' socioeconomic characteristics. They conclude that latent motives of efficiency, associated with improved

15 At the same time, however, the results from Estonia and Latvia should be considered as encouraging in view of the fact that these two nations have been the most eurosceptic among the candidate countries – the results perhaps suggest an increased desire for Europe. Also encouraging is the higher turnout in the referendum in Estonia and in Latvia compared to the latest election turnout, while in the case of Poland the higher than the 50% mark turnout necessary to confirm accession was far in excess of the government's fear that it might not be achieved. Finally, all four previous referenda organized by the Slovak government failed because of insufficient turnout and, hence, the result (52.2% turnout and 93% yes) should also be considered as a good surprise especially in view of the pre-referendum polls that indicated a 35% abstention and an 80% yes vote.

economic opportunities through integration in the EU contribute to support for accession but latent motives of redistribution, associated with the EU social policy *acquis* and related initiatives surprisingly do not appear to generate support for accession. They also suggest that the issue of whether respondents stand to gain or lose as a consequence of enlargement is an important consideration and those supporting accession belong to the same socio-economic groups as generally those supporting liberal, pro-reform parties. It is, finally, possible that the scaling down of support from the EU budget for redistributive (CAP, in particular) policies may have adversely affected sentiment towards accession. Whatever the motives, however, a critical mass of support ultimately emerged.

Overall, the evidence suggests that enlargement as a policy enjoys firm, but perhaps decreasing, support across the EU. Halting this decline in support constitutes a critical challenge because enlargement is not sustainable without firm support from the citizen. Nevertheless, core support for enlargement continues to characterize citizens' views and despite the risks involved one must wonder whether a more promising economic performance in the EU, which would undoubtedly strengthen confidence, would not at the same time allay fears and dispel objections to enlargement as a policy.

2.3 Ex ante estimates of the economic impact of enlargement

Enlargement created great expectations and became the cause for a variety of anxieties that continue to be present in current debates. With a view to understanding more concretely the potential effects of enlargement on the new and the old Member States, several studies were undertaken in the run up to the May 1, 2004 deadline. This section reviews synoptically the findings of these studies. The relevant material and key results are presented in Box 2.

The studies followed different methodologies and approaches to the question but all took an empirical perspective. The approach adopted by researchers varied widely, ranging from the area coverage (EU aggregates versus country-specific), to sectoral detail (such as labour markets, foreign direct investment, public finances), to degree of aggregation (GDP or components, welfare impact), to the estimation technique (general equilibrium model versus partial analysis), to transmission mechanism considered (trade, capital flows, migration), as well as to the assumptions made concerning some key economic forces (such as competition, convergence, industrial restructuring).

Nevertheless, the results from these studies are broadly consistent with each other and suggest notable gains from enlargement. Enlargement was expected (and the empirical estimates bear this out) to be beneficial for all Member States but especially so for the acceding ones, partly because of their smaller economic size relative to the EU-15 where the enlargement shock would be proportionately more pronounced, and also because of their lower level of development that would set in a convergence process with particularly improving performance on their part[16]. Intensifying commercial links, already undergoing a process of deepening with the Europe Agreements since the early 1990s, strong foreign direct investment flows, lower risk premia, greater efficiency through adopting market mechanisms, macroeconomic stability and structural reforms stimulated by membership in the EU were thought to be some of the main factors behind these good results.

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[16] More detailed discussion of these issues can be found in chapter 3.

A study by the Directorate General for Economic and Financial Affairs of the European Commission (European Commission, 2001) estimated additional growth of 1.3/2.1 % per year for the new Member States in 1994-2009, while in the old Member States growth would be a cumulative 0.5/0.7 % higher. Similar orders of magnitude are provided by Baldwin et al. (1997) who saw steady state real income 0.2 % higher in the old and 1.5/18.8 % in the new Member States compared to control. The long-run welfare GDP equivalent estimates of Maliszewska (2003) are somewhat lower – a negligible impact on EU-15, Hungary gains 7 % and Poland 3.4 % and, importantly, the new Member States would lose 0.1 % if enlargement were not to happen.

The impact on individual old Member States varies, with countries at the EU's former eastern border expected to benefit most from the enhanced trade and investment possibilities. Germany's GDP could be 0.45 % higher in the long run (Keuschnigg et al, 2001) and Austria's 0.56 % higher (Keuschnigg et al, 2002) compared to the no-enlargement scenario. Also Italy is estimated to gain 0.5 % GDP growth in 2000-2010 (Grassini et al, 2001) and, according to Kristensen and Jensen (2001), Denmark's GDP would decrease in the short run (2005-2010) by 0.45 % but it would increase in the long-run (2000-2065) by 1.65 % above the no-enlargement scenario. Köhler (2004) finds a large negative steady state welfare effect in the case of Portugal (1.3 %) and also in the case of Greece, Spain and Ireland, while the other old Member States gain with Austria gaining the most, 2 % above the no-enlargement scenario. By contrast, Barry (2004) argues that Ireland is well placed for enlargement and should not fear foreign direct investment diversion thanks to its technological base, while also immigration of skilled workers is good for the economy. The actual experience of Ireland is already bearing this out[17].

A key concern in the advance towards enlargement was the possible impact of labour migration on wages and the standards of living of some vulnerable segments of the labour market in the EU-15. This is certainly a theoretical possibility and, in practice, one could construct hypotheses where changing trade patterns and changing factor proportions as a result of migration and of capital flows (including foreign direct investment) would have significant effects on factor prices, while possibly large migration flows could directly exert downward pressure on real wages in the old Member States. A related concern, much debated during 2005/2006 in the framework of the Services Directive, is the possibility that migration from the new Member States would undermine the social *acquis* and labour norms prevailing in the EU-15.

In general, no conclusive evidence from aggregate data was produced to support this possibility. In fact, wages of both skilled and unskilled labour would increase in the long run by 0.5 % in Germany (Keuschnigg et al, 2001) and 0.6 % in Austria (Keuschnigg et al, 2002). In Denmark, however, according to Kristensen and Jensen (2001), wages will be lower in the long run (2000-2065). Lejour et al (2001) estimated labour migration to have a long-run welfare impact in the old Member States of 0.6 % of GDP, but the brain drain would cost the old Member States 1.8 % of GDP. As mentioned in the previous section, the effects of enlargement may be found more at the sectoral/regional rather than the aggregate level, affecting specific groups of workers and of skills that these studies were unable (or not designed to) detect. Adjustment consequent upon enlargement, both in the incumbent and in

[17] See, for example, AIB Global Treasury Economic Research (2006) for details especially on migratory stocks in and flows to Ireland.

the new Member States, is clearly inevitable even if the ex ante estimates are too coarse to permit a reliable evaluation.

Looking back on the experience of economic growth and adjustment of the acceding nations since the beginning of the 1990s, the data suggest that the EU-10 performance has not been better than that of other emerging market economies. In more recent years, however, the IMF notes that experience has been notably superior with the three Baltic countries ranking among the top five emerging market performers[18]. Whether this is the result of membership in the EU and a reflection of the impact of the modern competitive environment that has stimulated innovation, entrepreneurship and economic growth[19] or the consequence of more conventional economic factors is difficult to tell a priori. Undoubtedly, membership has made a difference and if that is the dominant reason for the improving performance it implies that its influence might be more durable and sustained over the medium term, conferring consistently benefits to the acceding nations. While recent data indicate the possibility of a two-speed catch up, with the non-Baltic new Member States underperforming, evidence from other relevant data from the new Member States (FDI and trade flows, restructuring initiatives, structural reforms, fiscal data etc) suggest that the process of catching up could continue to be supported on a more sustained basis.

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[18] For a discussion of these issues and pertinent comparisons see Schandler et al (2006).

[19] Schandler et al (2006) note that a key characteristic of economic growth in the central and eastern European countries has been the marked increase in total factor productivity growth (TFP); although not entirely surprising, this still is a characteristic unique among emerging market economies in recent years.

Box 2: Results of studies ahead of enlargement on its economic impact

Author	Year of study	Method	Results: Area covered	Results: Variable	Results: Impact	Results: Period	Any other remark
R. Baldwin, J. Francois, R. Portes	1997	General equilibrium model	EU15	Whole economy	Real income +0.2 %	Steady state	DE and AT benefit more
			CEEC7 (CZ, HU, L, SI, SK, BU, RO)		+1.5/18.8%	Steady state	Lower risk premium is driver for stronger result
			EU15	Public finance	EUR 19 bn (0.2% of GDP)	1999	Enlargement includes CZ, CZ, HU, PL, SI, SK
F. Barry	2004	Economic integration theory	Ireland	Trade	Agricultural trade (beef, diary products) is not threatened.		Overall, Ireland should not fear enlargement
				FDI	No diversion (thanks to technology).		
				Labour market	Skilled migrants beneficial for economy.		
DG ECFIN	2001	Growth accounting analysis	AC-8 CEEC-10 EU-15	Whole economy GDP growth	+1.3%/2.1% +1%/1.8% +0.5%/0.7%	1994-2009 Annual Cumulative	Central/optimistic scenario. Significant impact in EU-10, modest in EU-15.
M. Grassini, R. Bardazzi, A. Missale	2001	Multi-sectoral model (INTIMO)	Italy	GDP GFCF Imports Exports	+0.5% +0.3% +0.6% +1.2%	2000-2010	Specialisation scenario reported. Spillovers double the impact.
B. Heijdra, C.Keuschnigg, W. Kohler	2002	General equilibrium model	EU15	Overall welfare	+0.3% of GDP	Steady state	Trade, budgetary costs and migration effects are considered.
				Smaller than real income effect which does not consider forgone consumption			
W. Kohler	2004		Individual EU15 countries	Overall welfare, % of GDP	+2 (AT)/ -1.3 (PT)	Steady state	Besides PT, also a negative impact in EL, IE and ES.
C. Keuschnigg, W. Kohler	2002	Calibrated general equilibrium model	Austria	GDP Contribution to EU budget Exports Consumption Wage	+0.56% +1.75% of GDP +15.9% +0.7% +0.5%	Long-run scenario is reported. Fiscal position improves, despite higher net contributions to EU. Expected wage spread constant. Only immigration of unskilled may widen the wage spread	
C. Keuschnigg, M.Keuschnigg, W. Kohler	2001	Calibrated dynamic general equilibrium model	Germany	GDP The welfare neutral net contribution Exports Wage income Skilled and unskilled wage	+0.45% +1.08% of GDP +46.7% +0.5% +0.6%	Long-run membership scenario is reported. Expanded activity swells the tax base. Investment led expansion. Some potential for adverse redistributive effects	
T. Kristensen, P. Rørmose Jensen	2001	Structural, dynamic, large-scale macro-econometric model of the Danish economy (ADAM)	Denmark	GDP Exports Imports GDP Investment Employment Wage rate	-0.45% +0.63% -0.6% +1.44% +1.27% +1.28% -0.81%	2000-2010 2000-2065 (scenario of neutralised budget effect)	In the long run, positive effects from immigration and productivity outweigh short-term costs.
A. Lejour, R. de Moij, R. Nahuis	2001	Gen. equilibrium model	EU-15, CEEC-7	Welfare effects	+0.1/+0.6 +5.3/-1.8	Long-run % of GDP	Single market/ labour migration
Maliszewska (CASE Poland)	2003	General equilibrium model	EU-15, Hungary, Poland	Welfare effects of trade liberalisation	+0.03 +7.0 +3.4	Long-run % of GDP	Base scenario
R. Read, S. Bradley	2001	Integration theory	Old and new Member States	Overall economy	Strongly positive	Increased trade and efficiency. Limited migration consequences.	

3. Preparing for Enlargement

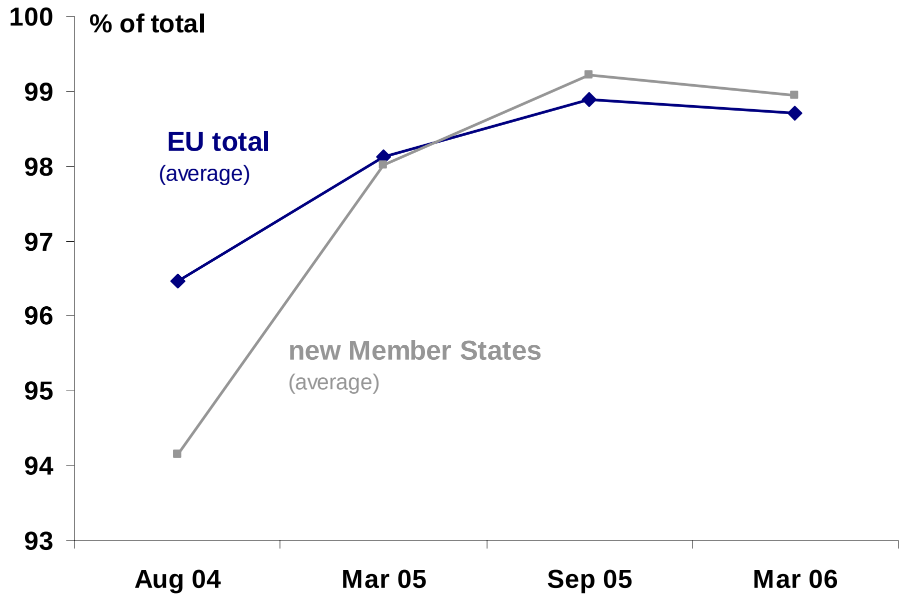
Adoption of the EU *acquis* and of structural reforms in general will undoubtedly generate significant benefits for the new Member States because it will effectively require that the economic, administrative and legal structures will be aligned with those of the EU, thereby laying the ground for sustained convergence and wealth creation. The requirement to adopt the body of the EU *acquis* has been considered by various commentators as particularly onerous for the new Member States. This was also an issue of concern during the discussions leading up to accession and there is no doubt that adopting the *acquis* will be costly. However, solidarity implies significant transfers of resources net of contributions to the EU budget. Thus, the costly transposition of the EU *acquis* in national legislation will in part be compensated by the financial assistance through the EU budget. Section 3.1 will review the transposition of the EU *acquis* in the NMS. Section 3.2 discusses the transfer of resources from the EU budget to the NMS to support the enlargement process while section 3.3 discusses the budgetary impact of these transfers for the EU25. Section 3.4 deals more generally with reforms implemented in the NMS, directly or indirectly related to the 2004 enlargement process, but in any case impacting the NMS performance post enlargement.

3.1. The recently acceded Member States coping with the acquis

The new Member States have made rapid progress in implementing the EU acquis in national legislation. Except in those, numerically very limited areas, where the Accession Treaty allowed the new Member States to defer implementation of the acquis, they have been obliged to fully implement EU legislation. In particular, a considerable number EU Directives had to be transposed, obliging the passing of national implementing legislation. However, the Internal Market goes far beyond the matter of implementing new legal rules. Its economic impact in terms of increased trade, more foreign investment and the creation of a well-performing financial sector represent tremendous benefits for old and new Member States. Concerning legislation, as of 8 March 2006, new Member States had, on average, notified the implementation of 2654 Directives, of a total of 2683 Directives which they were obliged to implement[20]. In other words, for nearly 99% of all Directives that had to be implemented national measures for their implementation had been notified. This high degree of implementation, it terms of notified measures, is now even slightly above the average for all Member States. It took new Member States some time to achieve this high degree of implementation (Graph 5). At the beginning of membership, their average degree of compliance was lower than that for the Union, and some new Member States had in August 2004, a transposition rate of less than 90%.

[20] Not all notified measures, though, necessarily properly transpose EU legislation in national legislation. The Commission examines the proper implementation and challenges Member States in those areas, where notified measures, in the view of the Commission, failed to fully implement EU Directives. However, these cases of improper implementation tend to be a small minority.

Graph 5: Notification of national measures implementing EC directives

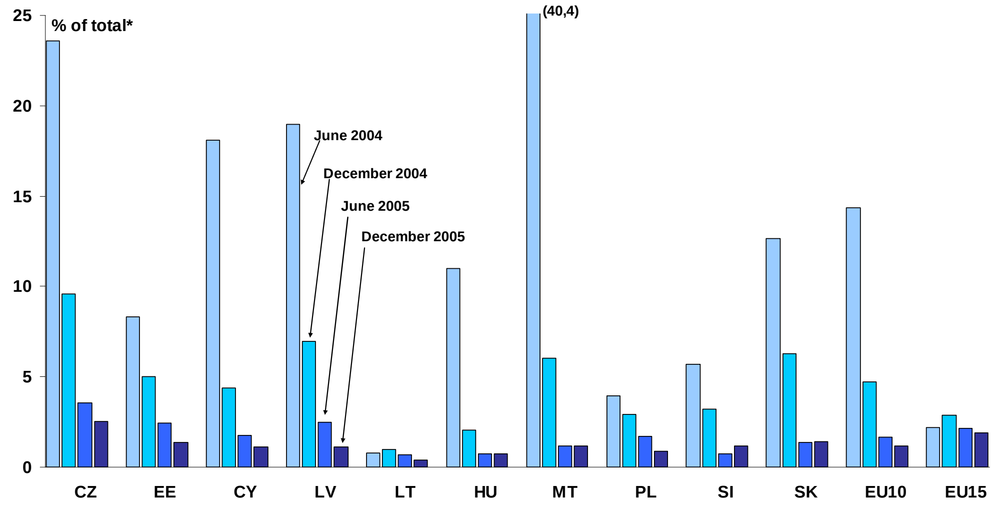


Source: Commission services

This high degree of transposition holds broadly across the different areas of Community legislation. Only in the area of competition, new Member States still showed a certain lag of transposition vis-à-vis the average of all Member States. Although there has been remarkable progress in transposing Internal Market Directives by new Member States since accession, see Graph 6,[21], the new as much as the old Member States are slow in translating the implementation of Directives in their national systems and there have been numerous infractions. However, the number of infringements is greater in EU-15 than in the EU-10 (ranging from 31 in the case of Denmark to 157 in the case of Italy compared to 4 infringements in the case of Lithuania to 18 in the case of Poland; data as of 1 October 2005). Nevertheless, to put things in perspective, three of the five Member States that have fully transposed the whole of the financial services Directives are from the EU-10 (Estonia, Latvia and Poland) and three of the six that have yet to transpose only one Directive are also from this group (Hungary, Lithuania and Slovakia).

[21] At the end of 2005, the average transposition deficit in the EU-10 was 1.2% compared to 1.9% in the EU-15. In Lithuania, Hungary and Poland the transposition deficit is below 1% and the Czech Republic is the only with a transposition deficit above the EU-25 average (Graph 6).

Graph 6: Transposition deficit of Internal Market directives



(*) 31/05/2004: 1527 directives (est.); 15/11/2004: 1579 dir.; 01/06/2005: 1604; 01/12/2005: 1635
Source: European Commission (2004b) and European Commission (2005f).

The cost of compliance with the acquis is difficult to estimate. In particular in environment, infrastructure and transport the acquis obliges new Member States to significant investment expenditure in order to reach minimum standards provided for in the respective EU legal framework. Even direct costs are often not easy to estimate, as it depends on a number of crucial parameters and is spread across a large number of entities. Most estimates agree that the acquis on environment (Hager, 2002), and to a minor part that on transport, incurs to new Member States the by far most significant costs. In particular the so-called *Urban Wastewater Treatment Directive* and the *Landfill Directive* are considered to have a significant cost impact. Estimates for the costs of the environment acquis only vary for the new Member States between around 1 and 3% of GDP over an extended period of time (Antczak *et al*., 2006). The European Commission estimated the total costs of the environmental acquis at around EUR 80 billion – 110 billion, or around 18 – 24%% of 2003 GDP of the new Member States (European Commission, 2003). The World Bank further estimated benefits and costs of the environment acquis for the different countries and concluded that on average, benefits far outweigh the costs of the acquis (World Bank, 2002). Compliance with the transport acquis amounts to significant investment in upgrading transport infrastructure, in particular roads. The Commission estimated the total costs to around EUR 100 billion, or around 22% of 2003 GDP (Van Miert, 2003).

The transposition effort has allowed the new Member States to profoundly reform the way in which their economies were regulated. The adoption of modern regulatory frameworks in areas such as financial markets, company law, accounting or intellectual property has created a better environment for business and growth. This compensates for the costs of compliance with the *acquis* which can be considerable in specific areas, even though these costs are spread over a long period of time and are co-financed by EU assistance.

3.2. EU budgetary resources to the recently acceded Member States

Financial assistance began before accession. In order to underline its commitment to enlargement and help bridge the income gap that exists with the new Member States, the EU has channelled money from its budget to these countries since the early 90’s. Before accession, the transfers mainly occurred via 3 vehicles, namely Phare, ISPA and SAPARD.

The Phare[22] programme was originally created in 1989 to help Poland and Hungary, but over time more countries have been covered: all recently acceded Member States (but Cyprus and Malta), acceding countries (Bulgaria, Romania) as well as the Western Balkans until 2000[23] (Albania, Bosnia-Herzegovina, Former Yugoslav Republic of Macedonia). Following the 1993 Copenhagen European Council paving the way for accession, Phare has two priorities. The first is institution building: with twinning projects involving the secondment of EU experts to national ministries for al least one year the purpose was to strengthen public administrations and prepare for the adoption of EU legislation. The second priority is economic and social cohesion to be achieved via a comprehensive National Development Plan that each country was required to draw up. This plan constituted the key document for programming Phare and foreshadowed the requirements inside the EU to obtain assistance in the framework of Structural Funds Objective 1[24].

On the basis of the Commission Agenda 2000, the Berlin European Council in March 1999 decided to step up pre-accession assistance and ISPA[25] (Instrument for Structural Policies for Pre-Accession) was created. Like Phare, it aims at economic and social cohesion, but focuses exclusively on environment and transport infrastructure. It became operational in 2000 and forms part of the EU’s regional policy.

SAPARD[26] (Special Accession Programme for Agriculture & Rural Development) was created at the same time as ISPA and fosters structural adjustment in agricultural sectors and rural areas.

With about €10bn transferred during 1990-2003, Phare was the largest of the pre-accession programmes. Upon enlargement this type of assistance is being phased out, but it remained considerable in the first years of accession. In 2005 still about €1.8bn (0.3 % of GDP in the EU-10) was transferred, of which Phare accounted for slightly more than half.

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22 Poland and Hungary Assistance for the Restructuring of the Economy (originally).

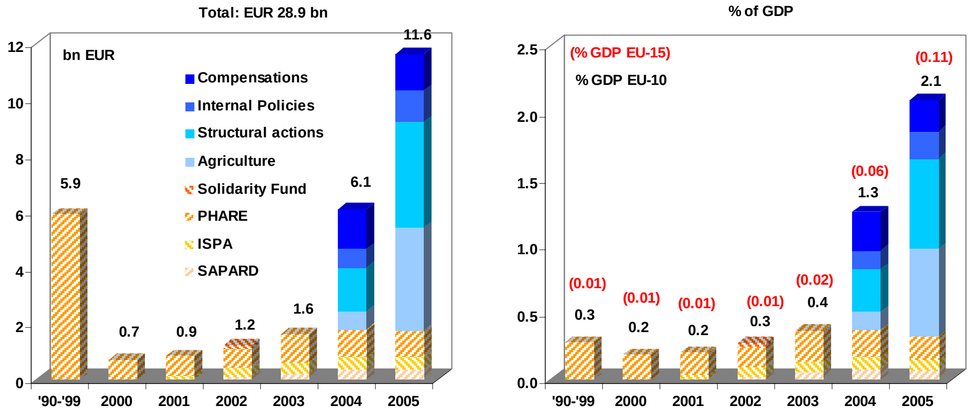
23 From 2001 the CARDS programme (Community Assistance for Reconstruction, Development and Stability) provides assistance in the Balkans.

24 Objective 1 is to promote structural adjustment in regions with GDP/capita less than 75 % of the EU average.

25 ISPA was established by Council Regulation No. 1267/1999 in June 1999.

26 SAPARD was established by Council Regulation 1268/1999 in June 1999.

Graph 7: EU payments to recently acceded countries



Source: DG BUDG, calculations DG ECFIN (2005: estimates)

From accession the regular finance mechanism for all Member States is in place, of which the specificities for the recently acceded countries was decided at the Copenhagen European Council of December 2002. A maximum of EUR 40.2 bn (1999 prices, "commitments" in EU budgetary jargon) was foreseen for the period 2004-2006. It is estimated that actual payments in 2004 and 2005 amounted to about EUR 14 bn, allocated to the 3 recurrent budget headings (agriculture, structural actions and internal policies) and "compensations" (temporary heading following enlargement).

- Close to 40 % of the EU payments to the new Member States in 2005 went to agriculture, sharply up from 15 % in the previous year because of the reimbursement of the pre-financed direct income support to farmers in 2004. Besides income support, farmers benefit from the market intervention mechanisms under the Common Agricultural Policy and from rural development assistance.

- Structural actions involve the 4 Structural Funds (ERDF, ESF, FIFG, EAGG)[27] and the Cohesion Fund which are the main instruments for the EU regional, social, fishery and agricultural policy. Comparable to what is transferred concerning agriculture, close to 40 % of EU payments to the new Member States passes via these channels.

- Internal policies involve nuclear safety, institution building and border control in the Schengen framework. In this domain, the new Member States receive about 10 % of the payments allocated to them.

- Finally, the new Member States not only receive money some of which is conditional, but have also to contribute obligatory to the EU budget. In order to avoid an adverse net balance temporary "compensations" are foreseen. They amounted to 30 % of total payments to the new Member States in the first year of accession and fell to 10 % in the second year.

Not all the assistance foreseen was disbursed. The difference between the maximum commitment under the Copenhagen Package spanning 3 years and the actual disbursements,

[27] European Regional Development Fund, European Regional Development Fund, Finance Instrument for Fisheries Guidance, European Agricultural Guidance and Guarantee Fund

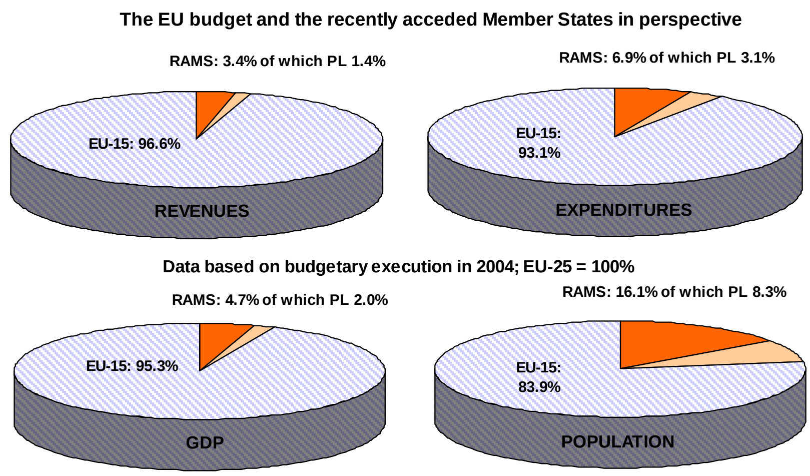
including information only on 2004-2005, is besides differences in the period covered, mainly due to lack of absorption capacity. Indeed, it takes time to design projects qualifying for assistance, hand them in to the European Commission and receive the money. It is estimated that about 85 % of the projected annual payments ("appropriations for payments" in EU budgetary jargon) have been disbursed[28].

3.3. The new Member States and the EU budget in perspective

The amounts transferred are significant from the point of view of the recently acceded Member States, but cannot be considered an unbearable burden from the perspective of the donors. In total about €28bn has been transferred to the 10 new Member States in the last 15 years. The annual amount increased over time and reached about €12bn in 2005, representing 2.1 % of GDP in the recently acceded Member States. This is only 0.1 % of GDP in the old Member States and is a small effort compared to the US Marshall Plan where in 1948-1952 US$13.3bn (of which about 10 % loans) was channelled to Europe, representing 1.1 % of US GDP per year at the time.

The amounts disbursed to the new Member States represent 6.9% of the EU budget (data based on budgetary execution in 2004), which is more than their GDP share in the EU (4.7 %), reflecting the commitment of the richer Member States to help their poorer neighbours.

Graph 8: The EU budget and the recently acceded Member States in perspective



Source: DG BUDG, calculations by DG ECFIN

From 1 May 2004, the new Member States also pay a contribution to the EU budget, which is based on the so-called traditional own resources (agricultural levies, custom duties), VAT receipts, gross national income and a share in the financing of the UK rebate. In 2005, the joint contribution (excluding traditional own resources which cannot be allocated to individual countries) is estimated at EUR 5.4 billion in current prices, which represents, on

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[28] The « true» absorption rate calculated on "commitments" for conditional assistance (mainly Structural Funds) during the whole programming period (3 years) is lower, estimated at about 5 %. Contrary to the disbursement/payments ratio, the absorption rate does not include advances or payments unrelated to projects (e.g. direct payments to farmers or compensations).

average, an effort of 1 % of GDP for the new Member States. They contribute 3.4% to the EU budget, which can be put into perspective against the population share of the recently acceded Member States (16.1 %), which is much larger.

On balance, taken together or individually, the new Member States are net beneficiaries in the EU budget. For the group as a whole, average net EU transfers amount to 0.6 % of gross national income (GNI) in 2004[29] ranging from 0.25 % of GNI for Hungary to 2.1 % of GNI for Lithuania.

Also including the old Member States into the picture, there is a negative correlation between income and the amount of net transfers. Wealthier countries are net contributors to the EU budget and poorer countries are net recipients. With respect to the current situation of the old Cohesion Countries, which have income levels below the EU average (Greece, Spain and Portugal), the new Member States have a less favourable position. This is partly explained because it is the first year of accession and more assistance will be gradually phased in. Ireland, which was a champion in catching-up, is set to see a deterioration of its position due to diminishing payments from Structural and Cohesion Funds and higher contributions to the EU budget in the coming years.

While each new Member State was a net receiver of EU transfers, it is often argued that accession increases a country's budget deficit (Kopits and Székely, 2002). There can be indeed a difference between what a country receives and the impact on its national budget. Some EU transfers, e.g. direct payments to farmers, are registered in the sector of final users and do not affect government accounts. Another very relevant question in this context is to what extent EU transfers not only increase the revenue side of the national budget, but also the expenditure side. If EU transfers are "additional", they may not substitute existing expenditure, but should lead to new projects. In this case the budget balance will not improve; the effect is rather neutral. An explicit additionality requirement exists for Structural Funds in the less developed regions which "(…) may not replace public or other equivalent structural expenditure by the Member State" (Article 11(1) of Council Regulation No 1260/99, OJ L 161 of 26.6.1999). A similar additionality requirement does not exist for the Cohesion Fund, internal policies or transitional expenditure.

In order to foster an efficient use of the money, EU transfers require national co-financing. Depending on the domain, EU funds can be used to finance up to 75 - 85 % of a project; the rest may come from public or private sources. It is estimated that co-financing in 2004 amounted to about 0.3 % of GDP in 2004 for the recently acceded Member States as a whole, ranging from 0.1 % of GDP in the richer new Member States (Slovenia, Malta) to 0.6 % of GDP in the poorer Baltic States which receive relative more EU assistance. Whatever the exact magnitude, co-financing expenditure should not necessarily have a direct and negative budgetary effect since it can come from already existing budget lines.

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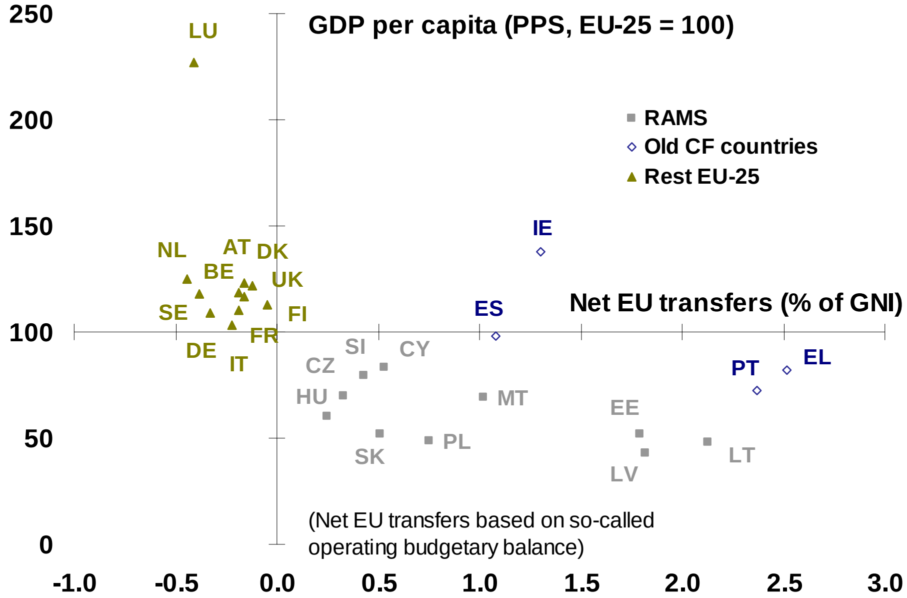
[29] Official estimates for 2005 for the so-called "operating budgetary balance" will be published in September 2006 in the Commission Report "Allocation of 2005 EU expenditure by Member State", available from: http://europa.eu.int/comm/budget/agenda2000/reports_en.htm

Graph 9: GDP per capita and net EU transfers to Member States in 2004



Source: DG BUDG, calculations by DG ECFIN

Taking into account also the budgetary compensations for the new Member States which were specifically designed to improve government finances, it is estimated (Hallet and Keereman, 2005) that on balance (after deduction of the contribution to the EU) the transfers have a positive budgetary impact for each new Member State in 2004. For the group as a whole, the favourable effect is estimated at 0.3 % of GDP in 2004, but the Baltic States received more than 1 % of GDP.

All in all, the budgetary effects of the EU transfers should be favourable, but direct income payments to farmers are only reimbursed from the EU budget in the subsequent year meaning that in 2004 they had to be fully pre-financed (about 0.3% of GDP, the highest figure being 0.4% for Lithuania). From 2005, pre-financing is very small and a function of the annual change in the reimbursements. Advancing payments exerts pressure on government accounts in cash terms to the extent no similar support schemes existed before. However, in the accrual-based ESA95 budget methodology this should not have any effect[30]. Nevertheless, the challenges in restructuring budgetary and administrative procedures to be able to absorb the projected EU payments and contain the deficit should be recognised.

As regards the future, Romania and Bulgaria are expected to join the EU in 2007, conditional on further progress in fulfilling the accession criteria, as agreed at the Copenhagen European Council of December 2002. Both countries, already receive considerable financial assistance, which is planned to increase further. About €1.4bn is foreseen in 2006 as pre-accession aid (of which 2/3 is accounted for by ISPA and SAPARD). Although not all the funds committed will be disbursed, the allocated amounts compare favourably to the €1.6bn pre-accession aid effectively paid to the 10 new Member States in 2003, the year before their accession. The very low income levels of the likely next two Members of the EU explain the generosity. GDP per capita in Bulgaria and Romania represent 30.5 % and 31.3 % of the EU-25 average, compared to 54.8 % for the 10 recently acceded countries as a whole.

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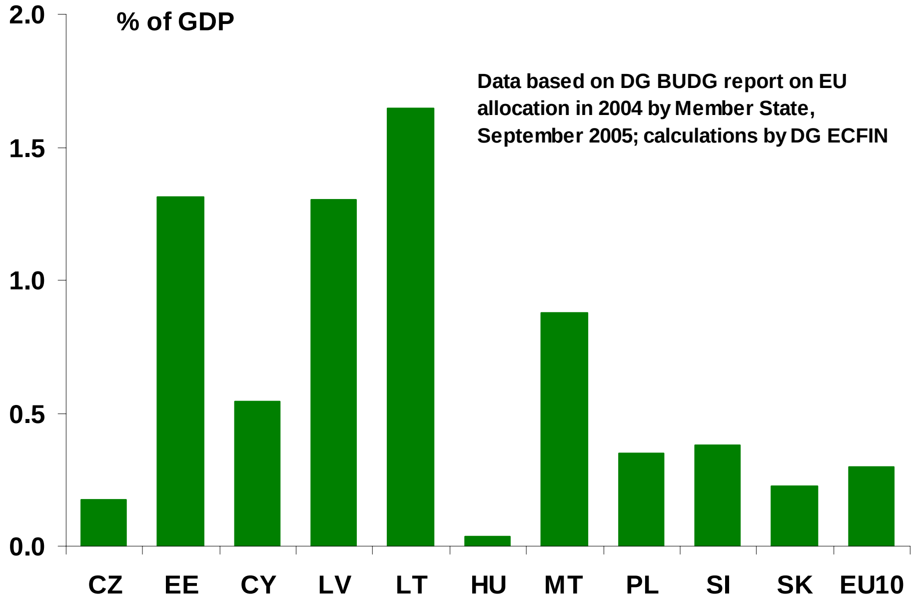
30 Eurostat decision 22/2005 of 15 February 2005.

Graph 10: Net EU transfers to new Member States and estimated budgetary impact in 2004



Source: Commission services

Under the proposed financial perspectives 2007-2013, net EU transfers to all the EU-10 together (taking into account their contributions to the EU budget) are estimated to vary from some 1.6% to 3.3% of their aggregate GDP in the period 2007-2013, with the smaller net transfers observed in the beginning of the period and with the poorer countries expected to receive more. These figures are likely to be on the high side, as full absorption of appropriations for payments is assumed, which may prove difficult. EU transfers to the recently acceded Member States are sizeable and notably larger than in the period 2004-2006. Under the new financial framework 2007-2013, net transfers to the recently acceded Member States are expected to almost triple from an average of 1% of GDP in 2004-2006.

3.4. Economic reforms in the recently acceded Member States

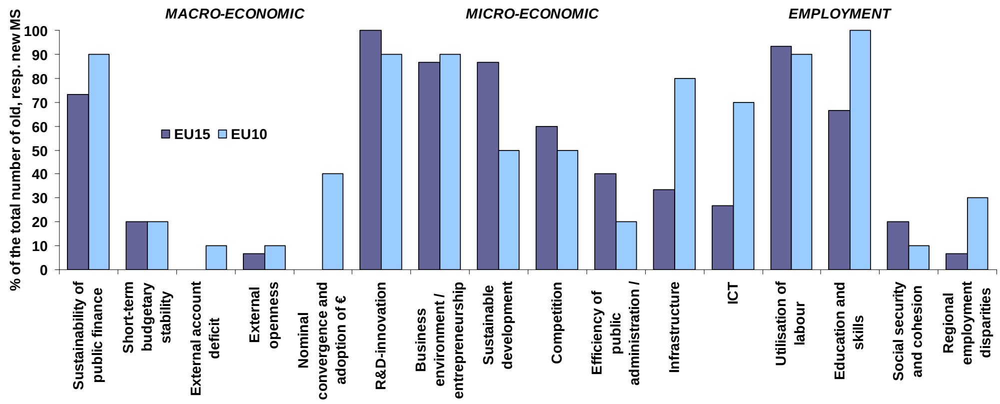
All the new Member States are in the process of completing reforms initiated prior and/or subsequent to accession. This section provides a brief overview of reforms under way and reforms gaps remaining in the new Member States, as specified in their National Reform Programs (NRPs). Although these reforms can go beyond the initial enlargement engagements *strictu sensu*, they are nevertheless an integral part of the EU-10 institutional setting being part of the EU-25, explaining their current and future post-enlargement performance. The discussion concerns developments in macroeconomic and employment policies, microeconomic policies and improvements in the business environment.

Compared to the EU-15, the new Member States have identified in their National Reform Programs, prepared in autumn 2005, key economic challenges in the fields of infrastructure, ICT and skills development. Graph 11 provides a comparative view on the share of new and EU-15 Member States by challenge in the NRPs.

Macroeconomic policies

Overall, macroeconomics policies in the new Member States are guided by euro adoption and the promotion of growth and employment. Ageing is also a particular concern (see report by the Economic Policy Committee and the European Commission, 2006). Several new Member States are preparing or already implementing measures in line with the three-pronged strategy for meeting the economic and budgetary consequences of ageing – reducing debt, increasing employment rates and reforming pension and health care systems, and several have announced an increase of the statutory retirement age (Cyprus, Estonia, Hungary, Latvia, Lithuania, Slovenia and Slovakia) and reforms in the healthcare system (Cyprus, Czech Republic, Hungary and Malta). However, none so far has introduced economic incentives to induce workers to work longer over the lifecycle. Fiscal consolidation remains a challenge especially with regard to adopting the euro, creating budgetary room for the consequences of ageing, for ensuring macroeconomic stability and for finding resources to finance the implementation of the NRPs. This is clearly a priority in countries with high debt or deficits – Cyprus, Czech Republic, Hungary, Malta, Poland, and Slovakia.

Graph 11: Key challenges in NRPs, EU-15 and new Member States



Source: Commission services

Employment policies

Within the framework of reform, employment policies to increase the adaptability of labour markets and to introduce new incentives to affect inactivity, disability, sickness and early retirement have been developed in the Czech Republic but also in Poland. Reform of tax and benefit systems and enlarging the scope and effectiveness of active labour market policies in order to reduce structural unemployment are undertaken in the Czech Republic, Latvia, Malta, Poland and Slovakia. At the same time, lifelong learning and a more efficient approach to problems of skill mismatches need to be introduced in Cyprus, the Czech Republic and Latvia.

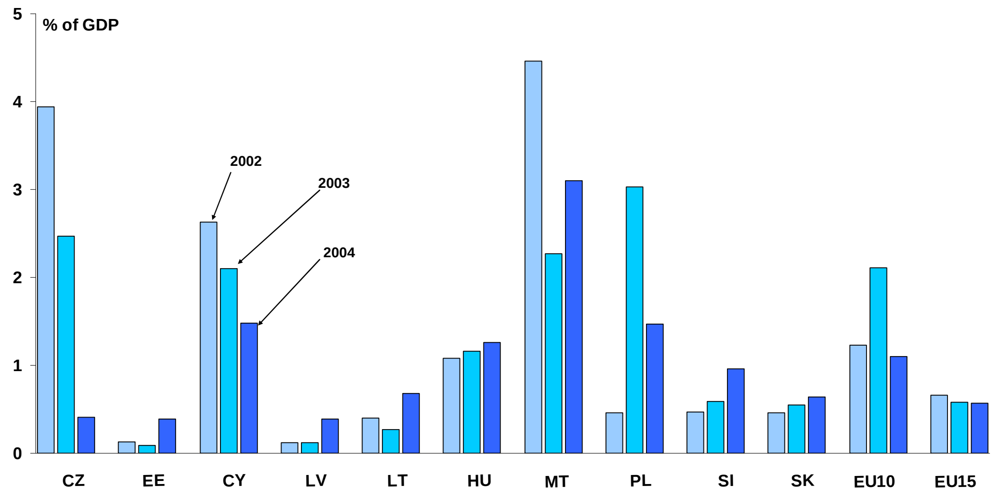
Microeconomic policies

Following accession, competition rules and the position of competition authorities have been strengthened in about half of the new Member States. A majority of them has also made progress in 2004/2005 and has announced further steps in the field of energy liberalization. However, despite progress to comply with EU legislation in the area of telecommunication there is scope for greater competition through more privatization. Moreover, while in small-scale privatization all new Member States have already achieved the standards of a market economy, much needs to be done in large-scale privatization, notably in Poland and Slovenia[31].

An indication of the level of competition in the recently acceded Member States is the fact that price liberalization is virtually all new member state as advanced as in a standard industrialized market economy[32]. The level of state aid has declined in particular in those new Member States that used to grant the highest levels (Graph 12). Nonetheless, the experience is uneven; while in general the share of state aid in GDP in 2004 is still twice as high as in the EU-15, 1.1% on average against 0.57% for the EU-15, in Estonia, Latvia and the Czech Republic, at 0.4% of GDP, it was lower than the EU-15 average.

It is also not satisfactory that sectoral and ad-hoc state aid in the new Member States is still substantially higher than in the EU-15. In 2004, this aid as percent of GDP was about 3.5 times higher than in the EU-15[33] (at 0.85% of GDP in the new Member States and 0.24 % in the EU-15 countries) and a significant widening of differences occurred between 2002 and 2004 in the cases of Poland (difference relative to the EU-15 average increased by 0.9 percentage points) and Slovenia (up 0.5 percentage points).

Graph 12: Total State aid



Source: Commission services, Structural Indicators

OECD data[34], only available for the Czech Republic, Hungary, Poland and Slovakia, indicate that there has been some progress between 1998 and 2003, especially in Poland, in reducing barriers to competition. In fact, these data suggest that antitrust exemptions and legal barriers to competition in 2003 were lower in these four new Member States than in the old ones. However, the more comprehensive OECD indicator for overall product market regulation,

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31 See EBRD (2005) for a more detailed discussion of these and related developments.

32 See EBRD (2005), p. 4; only in Slovenia price liberalisation has not fully converged to the standard of an industrial market economy but it is close to it.

33 Malta, where the level of sectoral state aid in 2004 was 12.5 times higher than in the EU-15, stands out in these data.

34 See OECD (2005).

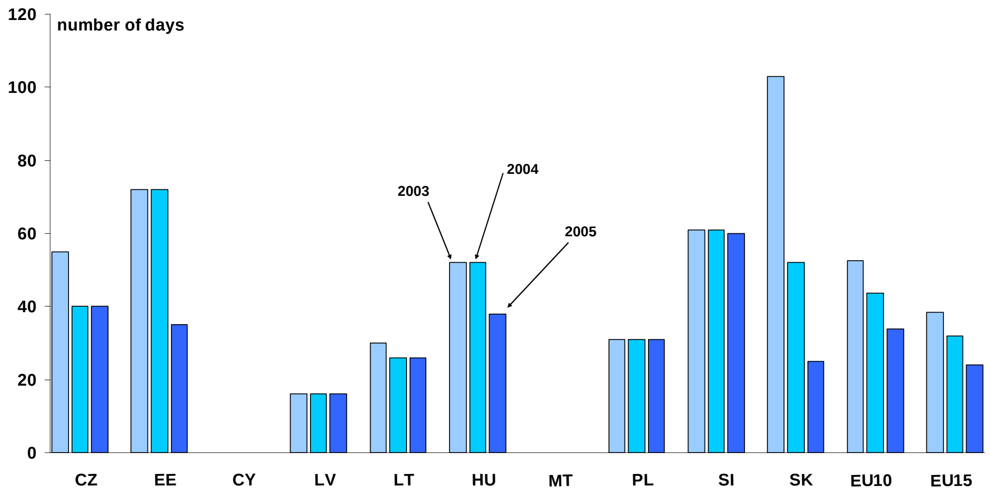
which, beside barriers to competition, also covers administrative regulation and state control, was considerably higher in these four new Member States than in the EU-15 during that year.

Finally, despite considerable improvements between 2002 and 2005, indicators for corruption show that, with some exceptions, corruption remains a much larger problem than in the old Member States[35].

The business environment

Available indicators suggest that the business environment is less favourable in the new Member States than in the EU-15 and developments since accession (to the extent information is available) have been rather mixed.

Graph 13: Starting a business



Source: The World Bank (2006).

In the area of better regulation and impact assessment the new Member States need to improve their competences[36]. Availability on line of e-government is, with the exception of Estonia, lower but use of e-government by enterprises, an important indicator, is higher in the EU-10. The World Bank index of difficulty of hiring shows that the respective framework conditions for enterprises in the new Member States have improved. Whereas prior to accession the indicators showed comparably difficult conditions, by 2005 conditions were more favourable in the new Member States but conditions for firing were less favourable.

All available indicators on starting a business (number of procedures, time and cost) in the new Member States remain unfavourable compared to EU-15 despite progress since accession. The OECD composite indicator on barriers to entrepreneurship[37] also suggests that business framework-conditions were less favourable in the new Member States at least until 2003, the latest data information. More recent data from the European Bank for Reconstruction and Development (EBRD) indicate that improvements in this field in the EU-

35 See EBRD (2005), p. 13.

36 See European Commission (2005e).

37 See OECD (2005).

10 continued in 2004 and 2005 but the gap against the EU-15 still exists, especially in the domain of regulation[38].

A wide range of actions are being taken or announced to further improve the environment for enterprise and innovation in the new Member States. The majority of the countries are envisaging measures to assist small and medium enterprises such as one-stop contact points for advice and registration on starting a new business. Improving access to finance for new, innovative starters is only envisaged by Estonia. Two countries, Malta and Slovenia, also provide favourable tax treatment or vouchers for innovative research by small and medium enterprises.

Only two new Member States, the Czech Republic and Estonia, are introducing impact assessment systems measuring the burden of regulation imposed on business. The others have announced the introduction of impact assessments and the systematic use of better regulation but the plans are vague and of limited scope. Only the Czech Republic has set quantitative targets for reductions in administrative burdens. Moreover, some new Member States established or plan to do so in the near future business friendly tax reforms, shifting the burden of taxation away from labour and simplifying and increasing the transparency of the tax system. And Estonia and Malta have taken measures to support advances in environmental technologies that address ecological challenges, in particular to introduce environmentally friendly technologies and improve energy efficiency.

R&D and innovation

On knowledge and innovation, the most common instrument envisaged by all Member States is to increase public spending on R&D. Nevertheless, Member States have announced measures to increase the leverage of private business R&D, such as the creation or extension of tax credits for private R&D expenditures (Czech Republic, Hungary, Latvia and Malta) while some have also taken action to strengthen science-industry links and improve the institutional framework to support innovation (Slovakia and Cyprus). Only Estonia has taken measures to modernize the management of research institutions and universities. There is clearly room for improving further conditions for private R&D spending, notably by leveraging through public R&D expenditure, and more generally promoting favourable conditions for R&D activities (Czech Republic, Estonia, Latvia, Lithuania, Poland, Slovakia, Slovenia).

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38 See EBRD (2005), p. 64.

ANNEX - MAIN REFORMS AND REFORM GAPS IN NEW MEMBER STATES

A. Main reforms in the field of competition

Czech Republic	Cyprus	Estonia	Hungary	Latvia	Lithuania	Malta	Poland	Slovakia	Slovenia
(1) State aid: Achieved decrease and redirection towards horizontal aspects; reform of competition authorities; (2) Public procure-ment: Significant improvement since May 2004; (3) Advanced privatisation and competition in Network industries.	(1) Network industries: ongoing liberalisation since 2004; set up of regulatory authorities completed; (2) Plans to improve public procurement and substantially reduce state aids.	(1) Pro-active competition policy and strengthening of competition authorities announced; (2) Already satisfactory level of competition on electronic communications market (except ADSL); (3) Strategy to open and modernise electricity markets by 2007/2008.	(1) Increased competition in the network industries over last years; full access to market-based electricity and gas provision scheduled for 2007; (2) Plan to re-duce the level of direct state support and to increase the share of horizontal aids; (3) Improvement of the efficiency of (electronic) public procurements planned.	(1) Formally, network industries have been highly opened to competition since 2004; (2) Competition authorities have been reformed. Further measures are planned; (3) Measures to limit corruption have been taken (better administrative structure and rules).	(1) Liberalisation of electricity market in 2005; (2) Energy: Transnational Electronic power trading system and trans-national power grid announced.	(1) Progress regarding the privatisation programme.	(1) New legislation on state aid; (2) New regulatory body on state aid; (3) Liberalisation of network Industries, especially telecommunications and postal services	(1) Network industries: well advanced privatisation (especially electricity markets); (2) Electronic public procurement planned; (3) Comprehensive reform of state aid planned by 2007 (publication of recipients on central website).	(1) Network industries largely privatised since 2004; (2) Independent competition authority.

The normative measure of the main reforms and reform gaps is based on the specific policies, targets and objectives defined by the "Integrated Guidelines for Growth and Jobs" (http://europa.eu.int/growthandjobs/pdf/integrated_guidelines_en.pdf). Thus, the main reforms and reform gaps take into account the Commission analysis of the National Reform Programmes (http://europa.eu.int/growthandjobs/annual-report_en.htm) and specific analyses carried out by various Commission services in the areas of competition, internal market and enterprise policies. Even though the normative assessment was carefully elaborated, subjective elements could not be avoided. These qualitative reform gaps, some of which are reported in http://europa.eu.int/growthandjobs/annual-report_en.htm, are defined as deviations of actual and planned economic policies from growth and jobs enhancing policies as set out in the "Integrated Guidelines for Growth and Jobs" (European Council on 16–17 June 2005).

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B. Main reform gaps in the field of competition

Czech Republic	Cyprus	Estonia	Hungary	Latvia	Lithuania	Malta	Poland	Slovakia	Slovenia
(1) Public procurement act not specified; (2) No measures against corruption; (3) Scope for more competition in network industries.	(1) In the field of public procurement, administrative capacities still need to be properly developed.	(1) Network industries: scope for closer cooperation between the competition authorities and the market regulators.	(1) Network services: Planned measures to achieve more competition need to be more specified.	(1) Low effective competition in network industries (also due to poor interconnections).	(1) Competition authorities should be strengthened.	(1) High total and sectoral state aid; (2) Low competition in the gas function; (3) Scope for further privatisation	(1) High total and sectoral state aid; (2) Competition in network industries (electricity, gas, railways); (3) Competition authorities.	(1) Detection and punishment of corruption; (2) Fragmented market for services; (3) Low effective competition on electricity, gas and renewable energy markets.	(1) Low effective competition in electricity and gas markets; (2) Highly regulated professional services; (3) Inadequate checks and controls regarding public procurement.

The normative measure of the main reforms and reform gaps is based on the specific policies, targets and objectives defined by the "Integrated Guidelines for Growth and Jobs" (http://europa.eu.int/growthandjobs/pdf/integrated_guidelines_en.pdf). Thus, the main reforms and reform gaps take into account the Commission analysis of the National Reform Programmes (http://europa.eu.int/growthandjobs/annual-report_en.htm) and specific analyses carried out by various Commission services in the areas of competition, internal market and enterprise policies. Even though the normative assessment was carefully elaborated, subjective elements could not be avoided. These qualitative reform gaps, some of which are reported in http://europa.eu.int/growthandjobs/annual-report_en.htm, are defined as deviations of actual and planned economic policies from growth and jobs enhancing policies as set out in the "Integrated Guidelines for Growth and Jobs" (European Council on 16–17 June 2005).

C. Main reforms in the field of the business environment

Czech Republic	Cyprus	Estonia	Hungary	Latvia	Lithuania	Malta	Poland	Slovakia	Slovenia
(1) Impact assessment pilot phase in 2005/2006; as of 2007 mandatory; (2) Reduction of administrative costs for companies by 20% or more as of end 2006; (3) Continuous and ongoing modernisation of taxes since 2003.	(1) Broad tax reform just before accession (2003), leading to a more simplified and efficient system (shift from direct to indirect taxes); (2) Improved access to finance for SMEs and liberalised banking sector.	(1) Existing strategy to improve the regulatory framework, reducing administrative costs and simplifying legislation; (2) Access to finance (especially for innovative firms): development fund as of 2006, business angels will be established.	(1) Compre-hensive and ambitious tax reform in 2006 (corporate taxes, VAT); (2) Strategy on simplification of regulatory environment (electronic company registration, review of administrative burdens).	(1) Compre-hensive action plan for the improvement of the business environment (adopted in September 2004); (2) Admini-strative ter-ritorial reform planned by 2009; (3) Achieved simplification of enterprise registration and tax admini-stration.	(1) Existence of some plans to improve regulation and carry out impact regular assessments.	(1) Access to finance for SMEs and planned scheme for unemployed who wish to start a business; (2) Achieved upgrading of local transport and environment infrastructure.	(1) Better regulation: simplified company registration since 2004; systematic impact assessment for new laws; (2) Single 19% corporate tax since 2004	(1) Business friendly, transparent and neutral corporate taxes since 2004; (2) Improved accounting act, VAT act and commercial register (strict time limits for procedures to set up a business); (3) Plans to introduce systematic impact assessments.	(1) Planned reduction of administrative barriers for business start ups.

The normative measure of the main reforms and reform gaps is based on the specific policies, targets and objectives defined by the "Integrated Guidelines for Growth and Jobs" (http://europa.eu.int/growthandjobs/pdf/integrated_guidelines_en.pdf). Thus, the main reforms and reform gaps take into account the Commission analysis of the National Reform Programmes (http://europa.eu.int/growthandjobs/annual-report_en.htm) and specific analyses carried out by various Commission services in the areas of competition, internal market and enterprise policies. Even though the normative assessment was carefully elaborated, subjective elements could not be avoided. These qualitative reform gaps, some of which are reported in http://europa.eu.int/growthandjobs/annual-report_en.htm, are defined as deviations of actual and planned economic policies from growth and jobs enhancing policies as set out in the "Integrated Guidelines for Growth and Jobs" (European Council on 16–17 June 2005).

D. Main reform gaps in the field of the business environment

Czech Republic	Cyprus	Estonia	Hungary	Latvia	Lithuania	Malta	Poland	Slovakia	Slovenia
(1) Missing reforms on social and health contributions by companies; (2) Underdeveloped access to finance; (3) Entrepreneurship education.	No major reform gap, however the following room for improvements; (1) Clear methodology for impact assessments is missing; (2) Proposed amendment to the bankruptcy law is unclear.	(1) Impact assessment is limited to legislation related to enterprises.	(1) Approach to better regulation not comprehensive enough; bankruptcy prevention and better rescue and restructuring procedures; (2) Access to finance for SMEs; (3) Entrepreneurship education.	(1) Policies to stimulate partnerships between research and education institutions and businesses; (2) High administrative procedures and costs; (3) Poorly developed capital markets.	(1) Reforms announced on impact assessment, administrative cost assessments and national plans for better regulation are too general. (2) Weak science and technology base.	(1) Ad-hoc and split regulatory impact assessment; (2) High administrative burdens for SMEs and complex start-up procedure; (3) Tax compliance and benefit fraud.	(1) Scope for improvement concerning administrative procedures and bankruptcy law; (2) Under-developed transport infrastructure; (3) Low innovation capacity.	(1) Better regulation: simplification and analysis of administrative costs; (2) Access to finance for SMEs.	(1) High administrative procedures for companies; (2) Structures and consultation practices regarding planned impact assessment.

The normative measure of the main reforms and reform gaps is based on the specific policies, targets and objectives defined by the "Integrated Guidelines for Growth and Jobs" (http://europa.eu.int/growthandjobs/pdf/integrated_guidelines_en.pdf). Thus, the main reforms and reform gaps take into account the Commission analysis of the National Reform Programmes (http://europa.eu.int/growthandjobs/annual-report_en.htm) and specific analyses carried out by various Commission services in the areas of competition, internal market and enterprise policies. Even though the normative assessment was carefully elaborated, subjective elements could not be avoided. These qualitative reform gaps, some of which are reported in http://europa.eu.int/growthandjobs/annual-report_en.htm, are defined as deviations of actual and planned economic policies from growth and jobs enhancing policies as set out in the "Integrated Guidelines for Growth and Jobs" (European Council on 16–17 June 2005).

4. MACROECONOMIC ASPECTS OF AN ENLARGED EUROPEAN UNION

This chapter examines the macroeconomic performance and outcomes in the EU-25 and especially in the EU-10 starting since the earlier period prior to accession. Issues addressed are economic growth and nominal convergence and stability (sections 4.1 and 4.2). The labour market performance is examined in section 4.3.

4.1. Economic growth and convergence

The impact of enlargement on key macroeconomic aggregates for the EU as a whole has been relatively modest. This is a result of the comparatively small economic weight of the EU-10, which added around 5% to the Union's GDP measured at current prices and around 9% measured in purchasing power standards. However, the population of the EU increased by much more, by around 20%.

Income per-capita in EU-10 is substantially lower than in the incumbents. As a consequence, prosperity in the EU-25, measured by income-per-capita, is more dispersed than before. In 2004, per capita income in PPS ranged from 43.1% of the EU-15 average in Latvia to 46.0% in Poland to 75.0% in Slovenia and to 77.5% in Cyprus. Only in the case of Cyprus and Slovenia was income per capita comparable to or higher than the least affluent EU-15 countries, Portugal (65.8% of the EU-15 average) and Greece (77.1%).

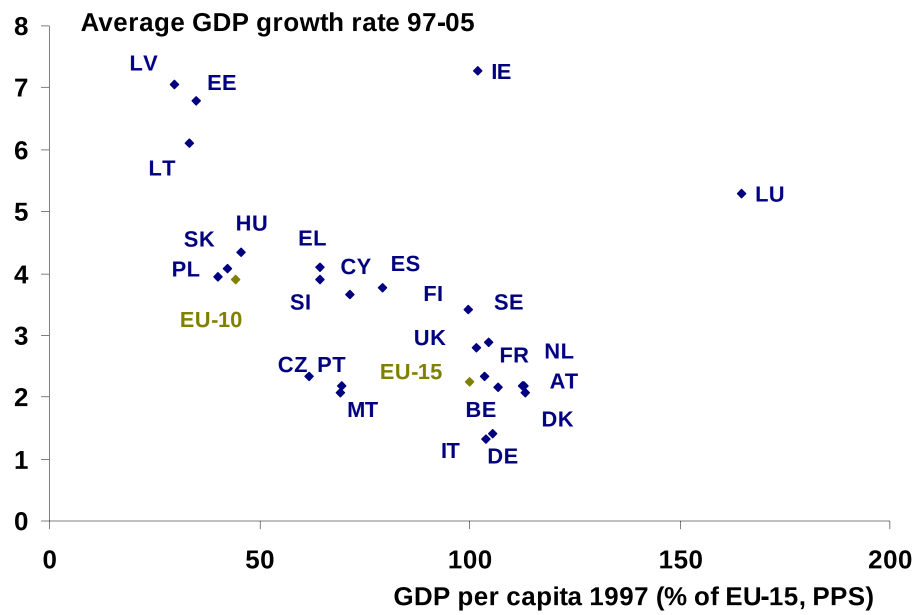
Table 2: Growth and real convergence

Countries	GDP Per Capita (% of EU-15, PPS)		Average of real GDP growth (in %)	Volatility of real GDP growth(2)
	1997	2005	1997-2005	1997-2005
CZ	61.9	67.8	2.3	2.2
EE	35.0	51.7	6.8	2.9
CY	71.5	77.5	3.7	1.2
LV	29.8	43.1	7.1	2.0
LT	33.3	47.1	6.1	3.2
HU	45.5	57.2	4.3	0.5
MT	69.3	64.3	2.1	2.8
PL	40.1	46.0	3.9	1.8
SI	64.5	75.0	3.9	0.9
SK	42.3	50.1	4.1	1.4
EU-10(1)	44.3	52.1	3.9	1.9
BE	106.7	109.1	2.2	1.0
DK	113.3	114.6	2.1	1.1
DE	105.6	100.0	1.4	1.0
EL	64.3	77.1	4.1	0.6
ES	79.3	90.7	3.8	0.8
FR	103.6	100.5	2.3	1.1
IE	101.9	127.7	7.3	2.7
IT	104.0	95.8	1.3	1.1
LU	164.6	214.0	5.3	2.6
NL	112.5	114.2	2.2	1.6
AT	112.9	113.3	2.2	1.0
PT	69.5	65.8	2.2	2.0
FI	99.5	104.2	3.4	1.6
SE	104.6	109.5	2.9	1.2
UK	101.7	107.3	2.8	0.7
EU-15(1)	100.0	100.0	2.3	1.3

(1) Weighted average, except for volatility
(2) Standard deviation of growth rates
Source: Eurostat

Enlargement has been a dynamic process rather than a discrete event and its effects will become visible over time. Preparation for enlargement took several years and by the time they joined, the EU-10 had successfully transformed their economies from centrally planned to functioning free market ones. Compliance with the Copenhagen criteria for accession served as a powerful catalyst for change. Graph 14 shows that convergence and catching up in real income have been at work throughout the period since the late 1990s. Per-capita incomes are now much closer to EU-15 levels than they were in 1997, the year in which enlargement prospects crystallized in the Commission's Agenda 2000.

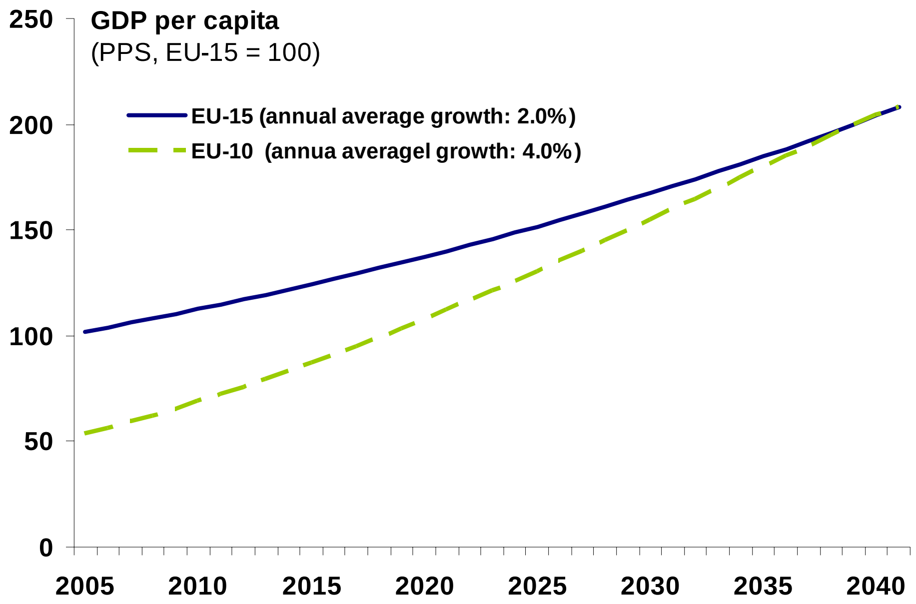
Graph 14: Real convergence and initial per capita income



Source: Eurostat

After the output collapse in the early years of transition, growth rates in the EU-10 have been higher than in the EU-15, but also been more volatile. As a result of this, per capita income in the EU-10 rose from an average of 44 ¼% of the EU-15 level in 1997 to more than 50% in 2005. Graph 15 shows that if the growth rate of the EU-10 is about twice the growth rate of the EU-15, these countries per capita incomes could be catching up EU-15 levels in around 35 years. Particularly impressive catching-up took place in the Baltic countries but also in Hungary and Slovenia. In general and consistent with the convergence hypothesis, Member States with lower initial (1997) per capita income tended to grow faster in the intervening years (Graph 14). Real wages increased by around 1% per year in the old Member States against some 3 ½% in the new ones over the last 10 years.

Graph 15: A long road to convergence



Source: Commission services

The key contributors to actual and potential economic growth in the EU-10 have been capital accumulation and technical progress or total factor productivity (TFP), while the contribution of labour has been mostly negative. Currently, capital-labour ratios and levels of productivity in EU-10 are still much lower than in the EU-15. Potential growth rates (Table 3) averaged 3½ % since the late 1990s demonstrating the highly favourable supply side performance of the EU-10. Their growth differential with the EU-15 has in fact widened from 1¼ percentage points in 1998-2000 to 1½ percentage points in 2001-2005. The better overall performance of the EU-10 is consistent with the predictions of the convergence hypothesis; this convergence will undoubtedly continue to operate over decades (Graph 15).

The negative contribution of labour to potential growth in the EU-10 is a reflection of weak employment growth and, to a lesser extent, of an ongoing decline in hours worked per employee. Another characteristic of EU-10 labour markets is relatively low rates of trend labour force participation rates and persistently high structural unemployment. On participation rates, the EU-10 average of around 65% for the period 2001-2005 compares unfavourably with an average of 73% in EU-15. As regards structural unemployment[39], this is estimated to have risen from an average of 10½% over the period 1998-2000 to over 13% for 2001-2005; over the same period, it fell from 8½% to 7¾% in the EU-15. Despite this extremely weak labour market performance, overall potential growth rates have held up well in the EU-10 primarily because labour productivity growth has been boosted by both capital accumulation and technical progress (the so-called Total Factor Productivity, TFP). The contribution of capital accumulation to potential output growth since the late 1990s has been particularly impressive, amounting to 1.8 percentage points from 2001-2005, three times higher than in the EU-15. TFP-growth over the same period has been twice as high as in the EU-15.

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[39] As measured by the NAWRU (non accelerating wage rate of unemployment).

Table 3: Potential Growth and its Decomposition (1998-2000 versus 2001-2005)

Country	Period Average	Potential Growth Rate	Contributions to Potential Growth		
			Labour (Hours)	Capital	TFP
New Member States					
Czech Republic	1998-2000	1.5	-1.1	1.4	1.3
	2001-2005	2.9	-0.4	1.5	1.9
Estonia	1998-2000	4.5	-1.8	3.0	3.3
	2001-2005	6.9	0.3	3.1	3.3
Cyprus	1998-2000	3.7	0.8	1.4	1.4
	2001-2005	3.6	0.8	1.5	1.3
Latvia	1998-2000	5.9	-0.4	3.0	3.2
	2001-2005	7.3	0.5	3.3	3.3
Lithuania	1998-2000	3.8	-2.1	2.9	3.0
	2001-2005	6.1	0.0	2.8	3.2
Hungary	1998-2000	4.3	0.6	2.3	1.3
	2001-2005	3.8	0.1	2.3	1.4
Malta	1998-2000	2.9	0.4	2.0	0.5
	2001-2005	1.5	0.2	1.3	0.0
Poland	1998-2000	4.1	-0.9	2.6	2.4
	2001-2005	3.0	-0.9	1.5	2.3
Slovenia	1998-2000	4.2	-0.1	2.7	1.4
	2001-2005	3.7	0.1	2.2	1.4
Slovakia	1998-2000	3.2	-1.6	2.7	2.1
	2001-2005	4.7	0.3	1.8	2.6
EU Aggregates					
EU-10	1998-2000	3.6	-0.8	2.3	2.2
	2001-2005	3.5	-0.4	1.8	2.1
EU-15	1998-2000	2.3	0.3	0.8	1.3
	2001-2005	2.0	0.4	0.6	1.0

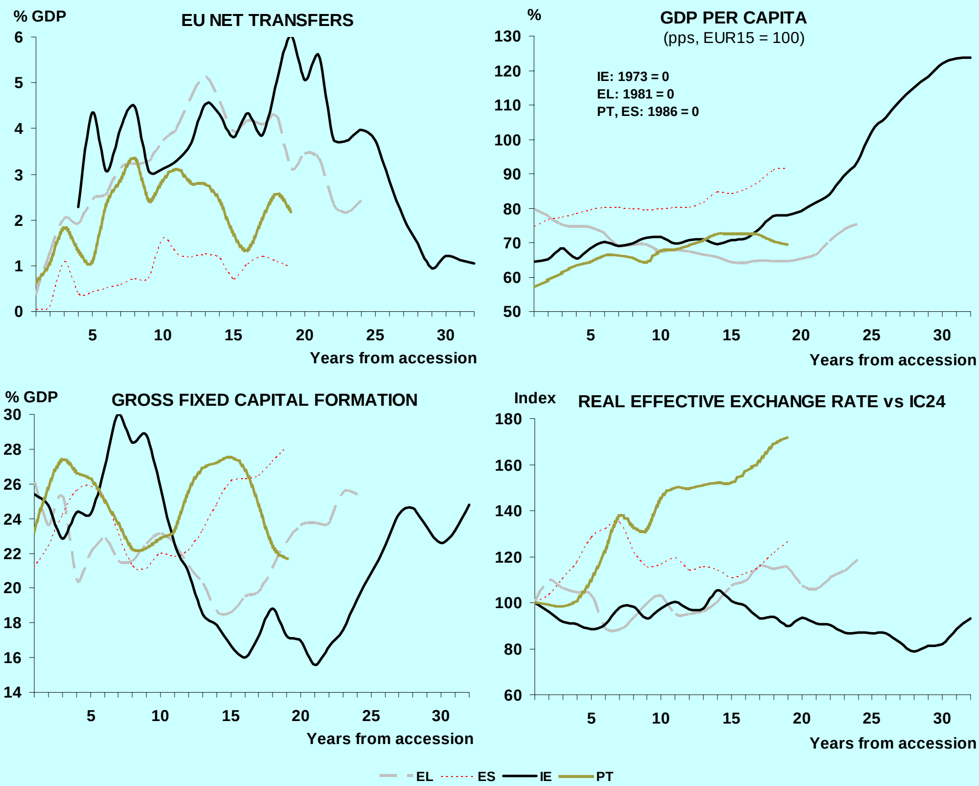
Source: Commission services

As Table 3 shows, all EU-10 countries except Malta had higher potential growth than the EU-15 during the period 2001-2005. Notably, the Baltic Member States had rates in excess of 6% and, in the case of Latvia, even 7%. With a potential growth rate of 4.7% Slovakia was also well above the EU-10 average. In these four cases, the strong TFP growth is particularly encouraging. Amongst the remaining EU-10 members, the Czech Republic, Cyprus, Hungary, Poland and Slovenia saw potential growth between 3% and 4%. For many countries in this group, weak labour markets are hampering their overall economic performance, with the Czech Republic and especially Poland especially vulnerable in this regard.

Past catching-up experience is promising for future convergence. As real, financial and institutional integration continues and EU transfers increase substantially, growth rates in the EU-10 are likely to remain higher than in the EU-15. The envisaged adoption of the euro can also create a new focal point for bolder structural reforms and for durable macroeconomic and fiscal discipline. In certain areas, for example, the restructuring of pension systems, some of the new Member States are already pioneering reforms. However, the process will not be without risks. Structural reforms will raise the return on capital and lifetime income expectations and this could induce instability through additional capital inflows and credit growth. Skilful macroeconomic and fiscal management and strong financial market oversight will be necessary so as to ensure that the momentum of catching-up is sustained without disruptions.

Box 3: Real convergence: some lessons from the "old" cohesion countries

Upon their accession to the EU, Greece, Spain, Ireland and Portugal had some characteristics similar to the EU-10: for example, relatively poorer, large agricultural sectors, benefiting from substantial EU financial assistance. While Ireland and Greece received the largest amounts of EU funds relative to their GDP as compared to Portugal and Spain, they followed very different convergence paths. Greece became relatively poorer during the first 15 years following EU accession. GDP per capita in PPS decreased from about 80% of the EU average in 1981 to some 64% in 1996, and convergence only started accelerating from 2000 onwards. In contrast, Ireland showed a spectacular catching-up trend, notably accelerating from the late 1980s, and reached the EU average by 1997, up from 64% in 1973. Among the main reasons are significantly different economic policies. In particular, inappropriate fiscal policies and strategies to attract foreign direct investment (e.g. re-nationalisation of public companies in the 80s) seem to have played a major role for Greece's performance. The EMU economic policy framework should now set a better basis to avoid fiscal misbehaviour and foster economic activity as compared to the period prior to the late 1990s.



Source: Eurostat and Commission services

From the experience of "old" cohesion countries, the following seem to be essential ingredients for successful convergence:

A high investment ratio, which results in productivity and efficiency gains as in Ireland. As a result, technology and education indicators performed best among the "old" cohesion countries. From 1990 onwards, FDI intensity, high-technology exports as a share of total exports, and expenditure in R&D were well above Greece, Portugal and Spain, while education levels (measured by tertiary education attainment) improved the most together with Spain.

Sound macroeconomic and labour market conditions, which maintain competitiveness. The real effective exchange rate (REER), deflated by unit labour costs, moved relatively well after accession in all cohesion countries except in Portugal, which steadily lost competitiveness. Portuguese unit labour costs increased significantly, reflecting persistent wage growth exceeding productivity gains in a tight labour market, while re-immigration in Ireland relaxed wage pressures and labour shortages. While the appreciation of the REER went hand in hand with low inflation rates for a given period in Portugal, external imbalances started deteriorating notably in the late 90s, enhanced by an expansionary fiscal policy that became pro-cyclical during the recession of 2003. This highlights the importance for the EU-10 to maintain sound fiscal policies over the cycle, but also to continue with structural reforms when exchange rate flexibility will be abolished, so that excessive real exchange rate appreciation is avoided.

Good public governance and a healthy institutional environment, which sets good conditions to increase the economy's flexibility and to profit from EU transfers. Overall, Ireland showed the best performance. The public institutions index – a component of the Growth Competitiveness Index of the World Economic Forum – for the five last years shows that Ireland remained at the top, while Greece and Portugal improved and Spain deteriorated. Likewise, Ireland shows the lowest level of product market regulation, facilitating enterprise creation and business activity, to which also the tax system contributed. The tax wedge declined markedly since 1993 and remained the lowest up to now, while it remained rather constant in the other three cohesion countries.

The full participation of the EU-10 in the Single Market and their ultimate accession to the euro area will have positive effects not only for these economies but for the EU as a whole. Euro adoption will eliminate currency risks, lower transaction cost, and increase price transparency, thereby fostering further economic integration. Building on the already high openness of the EU-10 and the achieved progress in domestic liberalisation, still stronger linkages in goods and services trade, intensified FDI and other capital flows, and successively reinforced labour mobility will enhance product market competition and lead to more efficient resource allocation and specialisation patterns across the Union. While successful catching-up of the EU-10 will restore greater economic coherence, these effects promise to give additional impetus to the EU's growth potential, albeit economic restructuring will be required on the way.

4.2. Nominal convergence, public finance and stability

As mentioned previously, respecting the Copenhagen criteria acted as a catalyst for reform and, consequently, the EU-10 had already broadly succeeded in securing macroeconomic stabilisation by the time they joined the EU. However, challenges remain and adoption of the euro will require further progress in nominal convergence. The recent integration of the EU-10 into the EU-wide economic policy coordination and budgetary surveillance procedures is undoubtedly contributing to reinforcing policy discipline towards this goal.

Table 4: Selected nominal convergence indicators

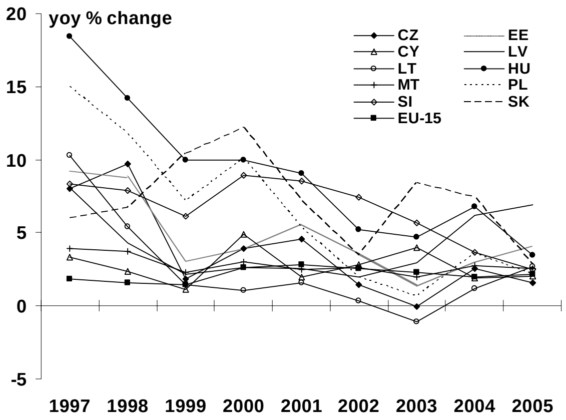
Countries	Inflation(2) (in %)		Interest rates (long term nominal, in %)		General Government balance (% of GDP)		General Government gross debt (% of GDP)	
	1997	2005	2001	2005	1999	2005	1999	2005
CZ	8.0	1.6	6.3	3.5	-3.6	-2.6	15.8	30.5
EE	9.3	4.1	10.2	4.0	-3.7	1.6	6.2	4.8
CY	3.3	2.0	7.6	5.2	-4.4	-2.4	59.7	70.3
LV	8.1	6.9	7.6	3.9	-5.3	0.2	12.4	11.9
LT	10.3	2.7	8.2	3.7	-2.9	-0.5	23.0	18.7
HU	18.5	3.5	8.0	6.6	-5.5	-6.1	60.0	58.4
MT	3.9	2.5	6.2	4.6	-7.7	-3.3	56.4	74.7
PL	15.0	2.2	10.7	5.2	-1.8	-2.5	39.3	42.5
SI	8.3	2.5	n/a	3.8	-2.0	-1.8	24.6	29.1
SK	6.0	2.8	8.0	3.5	-7.1	-2.9	47.4	34.5
EU-10(1)	9.1	3.1	8.1(3)	4.4	-3.2	-2.9	37.4	41.1
BE	1.5	2.5	5.1	3.4	-0.5	0.1	113.6	93.3
DK	1.9	1.7	5.1	3.4	2.3	4.9	57.4	35.8
DE	1.5	1.9	4.8	3.4	-1.5	-3.3	60.2	67.7
EL	5.4	3.5	5.3	3.6	-3.4	-4.5	112.3	107.5
ES	1.9	3.4	5.1	3.4	-1.1	1.1	61.6	43.2
FR	1.3	1.9	4.9	3.4	-1.7	-2.9	58.3	66.8
IE	1.2	2.2	5.0	3.3	2.5	1.0	48.1	27.6
IT	1.9	2.2	5.2	3.6	-1.7	-4.1	113.7	106.4
LU	1.4	3.8	4.9	3.4	3.3	-1.9	5.6	6.2
NL	1.9	1.5	5.0	3.4	0.6	-0.3	60.5	52.9
AT	1.2	2.1	5.1	3.4	-2.2	-1.5	66.5	62.9
PT	1.9	2.1	5.2	3.4	-2.7	-6.0	51.4	63.9
FI	1.2	0.8	5.0	3.4	1.7	2.6	46.7	41.1
SE	1.8	0.8	5.1	3.4	2.5	2.9	62.2	50.3
UK	1.8	2.1	5.0	4.5	1.1	-3.5	44.2	42.8
EU-15(1)	1.9	2.2	5.1	3.5	-0.7	-2.3	67.0	64.6

(1) Unweighted average, except for fiscal figures
(2) HICP, year-on-year % change
(3) Excluding Slovenia
Source: Eurostat

Inflation in the EU-10 has gone down a long way towards EU-15 levels and has in all cases entered the single-digit range (Graph 16). The disinflation trend reflects an overall clear orientation of monetary and exchange rate policies. Fluctuations in the inflation rates can mostly be explained by cyclical and other temporary influences, in particular from the exchange rate, food and commodity prices, and administered price and tax adjustments. Although the cross-country dispersion of inflation has fallen in parallel with its level, there are still substantial differences. In 2005, HICP inflation ranged from 1.6% in the Czech Republic to 6.9% in Latvia. Containing inflationary pressures remains a challenge, as price levels are converging, wage pressures remain strong, indirect taxes are still being adjusted in line with EU legislation, and especially commodity prices keep on fluctuating.

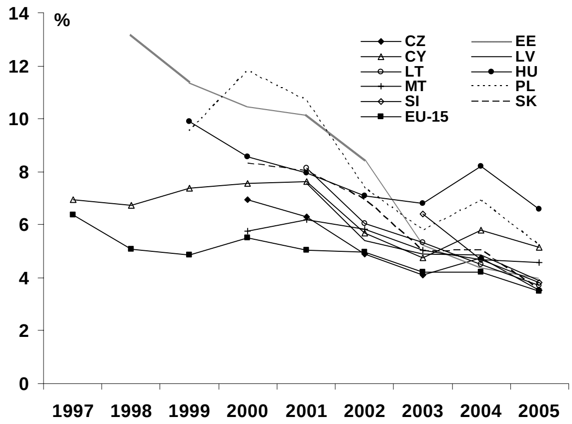
Similar to inflation, interest rates have come closer to EU-15 levels over recent years and have become less dispersed, too. This is a consequence of favourable inflation expectations, declining risk premia, and convergence plays driven by the perspective of euro adoption. However, in a some countries, notably in Hungary, interest rate convergence has recently been reversed (Graph 17).

Graph 16: : Harmonized Index of Consumer Prices, 1997-2005



Source: Eurostat

Graph 17: Long term nominal interest rates, 1997-2005

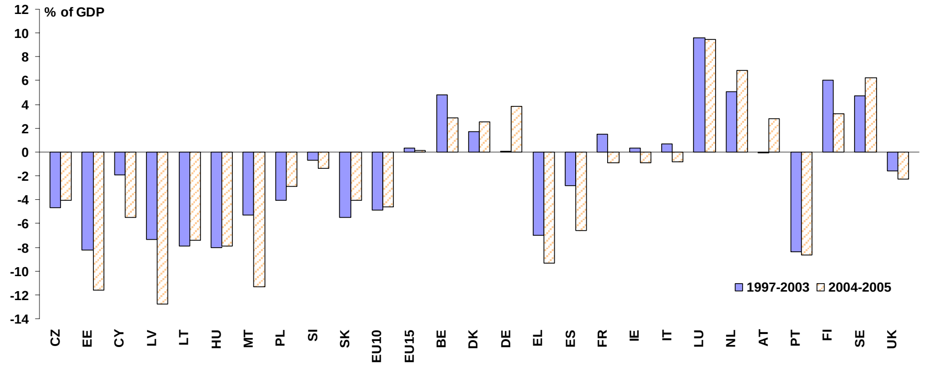


Source: Eurostat

Developments in public finances have varied widely across the EU-10 – see data in Table 4. In the former centrally-planned economies, budget balances were strongly affected by transition-related reforms, such as bank restructuring operations. Many countries, in particular the Baltic Members, made progress in reducing their fiscal deficit between 1999 and 2005, while the position of others deteriorated (Hungary, Poland). In 2005, Estonia and also Latvia were exceptional in registering a budget surplus, and the third Baltic country had a deficit well below the Maastricht threshold of 3% of GDP. The Czech Republic, Cyprus, Poland, Slovenia and Slovakia (net of pension reform cost) also featured a deficit below the threshold, while Malta exceeded it by a relatively small margin and Hungary by a very large one. Except for Cyprus and Malta, public debt ratios in 2005 were below the 60% of GDP Treaty reference value in all EU-10. Estonia had a very low public debt, while Hungary was close to the reference value.

Exchange rate regimes in the EU-10 range from a freely floating currency in Poland to currency boards with the euro in Estonia and Lithuania. Past regime choices were influenced by the degree of openness of the EU-10 economies. In future, regimes will increasingly be determined by aspirations for euro adoption. The Baltic countries, Cyprus, Malta, Slovenia, and Slovakia already joined ERM II. While not a member of ERM II, Hungary is pegging its currency to the euro with fluctuation margins of +/- 15%. The Czech Republic has a managed float, and Poland features a free float. Experience across the EU-10 to date illustrates the implications of monetary and exchange rate regimes for deficit and debt levels. In the Baltic Members the introduction of hard pegs was underpinned by medium-term goals of budget balance and low public debt. In most central European Member States, by contrast, more flexible exchange arrangements went hand in hand with higher deficit and debt levels. Encouragingly, as the latter countries enter ERM II and advance on their way to the euro, the relatively large size of their government and the composition of expenditure suggest remaining scope for growth-enhancing fiscal consolidation, which is also supported by EU transfers.

Graph 18: Current account balance, 1997-2005



Source: Eurostat

As is typical for converging economies, current account deficits have been significant in most EU-10 countries throughout recent years. They have been very large in particular in the Baltic Members. There, they have been predominantly driven by the private sector, as fiscal balances were only in a relatively small deficit or even in a surplus. In contrast, in the other EU-10, fiscal deficits played a much larger or dominant role as domestic counterparts of current account deficits. To a considerable extent, the current account deficits of the EU-10 have been financed by foreign direct investment so far. However, as privatisation-related FDI has ceased in some countries and is declining in others, current account financing may have to rely more on short-term, and potentially more volatile, capital inflows in future.

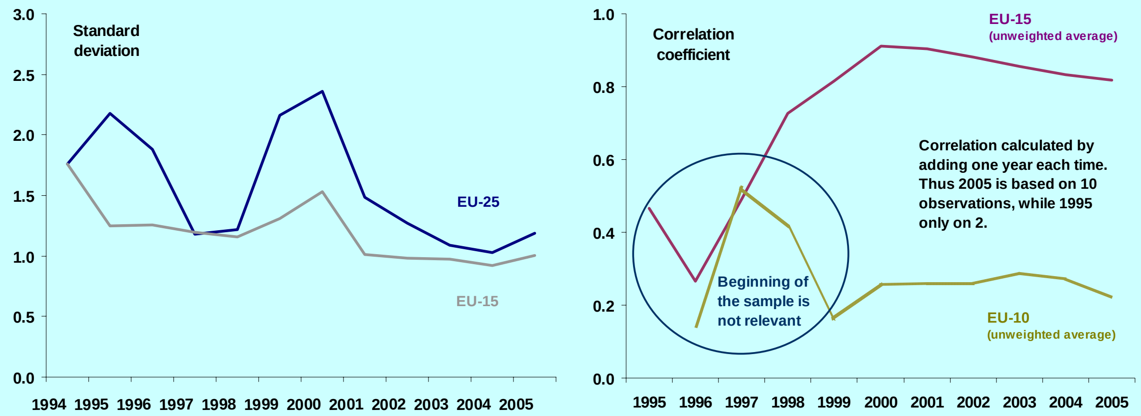
Box 4: Business cycle synchronisation

The synchronisation of business cycles between old and new Member States is of interest because it is an indicator of convergence in general reflecting integration of trade, capital and labour markets. A high degree of cyclical synchronisation is desirable because it is an essential ingredient for successful conduct of economic policies, in particular of monetary policy.

There are several techniques to measure synchronisation from simple calculations based on standard deviations and correlations to a sophisticated analysis of the similarity of shocks in vector autoregression models, applied to different variables like GDP and components, industrial production or survey confidence indicators. The focus is on the cyclical component of growth or the output gap which cannot be observed and thus has to be estimated. Depending on the approach followed, results can vary widely, particularly at the country level.

Frenkel and Nickel (2002) found a negative correlation between demand shocks in most new Central European Member States and the euro area (except for Poland and Hungary). On the other hand, supply shocks were correlated positively (with the exception of Poland). The EU-8 adjusted more slowly to the same shock than the EU-15. However, some countries (Hungary, Estonia, Latvia and Slovenia) were not significantly different from Greece. According to Fidrmuc and Korhonen (2003), most new countries showed very little correlation of both supply and, especially, demand shocks. However, supply shocks in some of them (Hungary, Estonia and Latvia) seemed already quite highly correlated with the shocks in the euro area. Korhonen (2003) analysed the similarity of monthly industrial production indices for the euro area and the new member states. The short-term impact of a euro area shock was fairly close to unity for most countries. It was smaller for Slovakia and Lithuania, while for Latvia it was twice as high as in the euro area.

According to Artis *et al.* (2004), correlation of cycles in the EU-8 was lower than in EU-15. However, the Baltic countries appeared an exception. The move towards higher synchronization was also generally lower compared to the previous enlargements (except for Poland, Slovenia and Hungary). Horvath and Rátfai (2004) detected no statistically significant correlation of supply or demand shocks between the EU-8 and three EMU core countries (Germany, France and Italy). Nevertheless, Hungary, Slovenia and Estonia seemed to have a significantly positive correlation with a number of other new member states. Babetskii *et al.* (2004) compared the time-varying correlation of demand and supply shocks in the old cohesion countries and in the EU-8. They detected an ongoing process of convergence of demand shocks and a divergence of supply shocks. Babetskii (2005) examined the relationship between economic integration (measured with increasing trade intensity and declining exchange rate variability) and indicators of supply and demand shock asymmetry. He observed that higher trade intensity contributed to more symmetry of demand shocks. The conclusions about the impact on supply shock symmetry were mixed. Smaller exchange rate volatility made demand shock converge and was neutral for supply shocks.



Source: Commission services

he low degree of synchronisation with the EU-25 business cycle is a distinguishing feature of the recently acceded Member States as a whole, reflecting mainly their different stage of development. However, behind this aggregate picture are wide country variations. It is usually found that countries like Slovenia, Hungary and Poland display a greater degree of business cycle synchronisation, attributed to a high level of trade integration, while the Baltic states are further away, which is linked to a greater sensitivity to commodity prices.

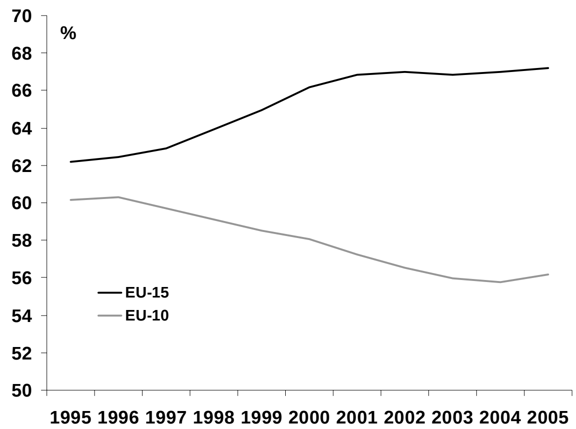
The dispersion of output gaps in EU-25 seemed to have narrowed over time suggesting a greater synchronisation, but the cyclical behaviour of the new Member States remains very different from overall EU-25 developments, as reflected by their low correlation coefficient compared to the old Member States.

4.3. Labour markets

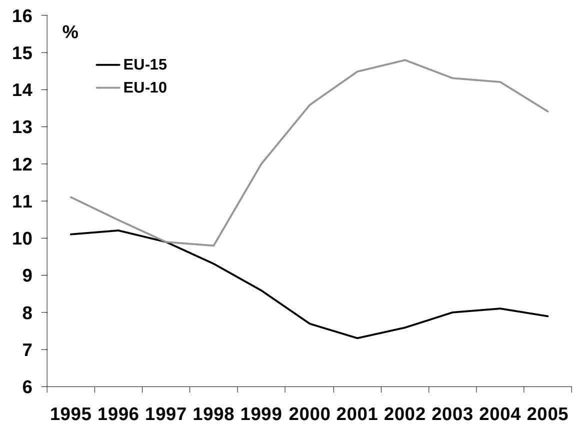
4.3.1. Labour market performance

During the 1990s, the central and eastern European Member States (EU-8) experienced sharp declines in employment and a rapid increase in unemployment. These dramatic changes mostly reflected a combination of cyclical factors and structural adjustments associated with the transition to a market economy. By contrast, Malta and Cyprus, which did not experience the same economic transformation as the transition economies, enjoyed stable and low unemployment rates during the same period. Until recently, labour market conditions have continued to worsen in the EU-8 countries despite robust economic growth, suggesting that unemployment is to a large extent a structural phenomenon. Overall, the labour market trends in the EU-10 in the period preceding accession contrast sharply with the experience of the EU-15 which recorded a steady increase in employment and a decline in unemployment (though in part reversed in recent years) in the second half of the 1990s (Graph 19 and 20).

Graph 19: EU-10 and EU-15 Employment rate



Graph 20: EU-10 and EU-15 Unemployment rate



Source: Commission services (Ameco)

EU accession has coincided with signs of improving labour market conditions in the EU-10. On the back of strong economic growth boosted by accession, employment ceased to drop in the EU-10 in 2004, has expanded by about 1.5% in 2005. Employment growth was above 2% in Lithuania, Poland and Slovakia. As a result of the overall employment creation, the average unemployment rate for the EU-10 decreased by 0.8 percentage points over 2004-05 to reach 13.4% of the labour force. Nearly all the EU-8 countries recorded a decrease in unemployment rates. While the employment rate for the EU-10 remained broadly stable at 56% of the working age population in 2004, it increased by almost 3 percentage points in Slovenia, and by 0.5 percentage points in Latvia and Poland. By contrast, employment rates fell by about 0.5 percentage points in the Czech Republic and Slovakia.

Similarly, labour market developments in the EU-15 have been positive over the past two years. Employment growth accelerated to 0.6 % in 2004 from 0.4% in the previous year, and increased to 0.7% in 2005.

Table 5: EU-10 and EU-15: labour market characteristics in 2004

(in percent)	Employment rates[1/]				Partici-pation rates[1/]	Unemployment rates			
	Total	Female	Youth	Older workers		Total[2/]	Youth[2/]	Long-term[3/]	Low-skilled
Czech Republic	64.2	56.0	27.8	42.7	70.0	7.9	19.3	51.0	22.8
Estonia	63.0	60.0	27.2	52.4	70.0	7.8	15.8	52.2	15.9
Cyprus	68.9	58.7	37.5	49.9	72.6	6.1	13.7	26.2	5.8
Latvia	62.3	58.5	30.5	47.9	69.7	9.0	13.7	43.8	13.7
Lithuania	61.2	57.8	20.3	47.1	39.1	8.2	15.3	51.2	14.0
Hungary	56.8	50.7	23.6	31.1	60.5	7.1	19.5	44.0	11.0
Malta	54.0	32.7	46.2	31.5	58.2	8.0	18.3	46.7	5.7
Poland	51.7	46.2	21.7	26.2	64.0	17.7	36.7	54.0	28.4
Slovenia	65.3	60.5	33.8	29.0	69.8	6.3	15.6	51.5	9.0
Slovakia	57.0	50.9	26.3	26.8	69.7	16.4	30.5	64.7	48.3
EU-10	56.0	50.2	23.9	32.3	65.5	13.4	30.4	53.8	:
EU-15	64.7	56.8	40.0	42.5	70.6	7.9	16.7	42.5	10.1

1/ As a percentage of working age population.
2/ As a percentage of labour force. Data for 2005.
3/ As a percentage of total unemployment.
Source: Eurostat

Despite some convergence in recent employment trends, the labour market situation in the EU-10 still differs widely from that in the EU-15 (Table 4). At 56% the employment rate in the EU-10 countries as a whole is substantially lower than in the EU-15. Employment rates range from around 52% in Poland to close to 69% in Cyprus. This compares with rates in the EU-15 ranging from about 58% in Italy to almost 76% in Denmark. The poor employment performance of the EU-10 affects disproportionately certain age-cohorts and groups. The employment rates of young and older workers are particularly low at 24% and 32%, respectively, compared with an average of about 40% for both groups in the EU-15. Also, female employment rates in the EU-10 countries are low compared to the EU-15. While female employment was high at the start of the transition process, it fell to close to 50% on average in 2004. This is the opposite of the upward trend in the EU-15, where female employment now stands at around 57%.

While the EU-10 countries had participation rates significantly above the EU average in the early 1990s, they now record rates on average 5 percentage points below the EU-15 average. The persistent decline in labour market participation in the EU-10 countries contrasts with rising participation rates in the EU-15. However, the gender disparities are slightly less pronounced in these countries than in the EU-15, as the difference between the participation rates for men (72%) and for women (59.2%) stands at about 13 percentage points, compared with a gap of 16 percentage points in the EU-15.

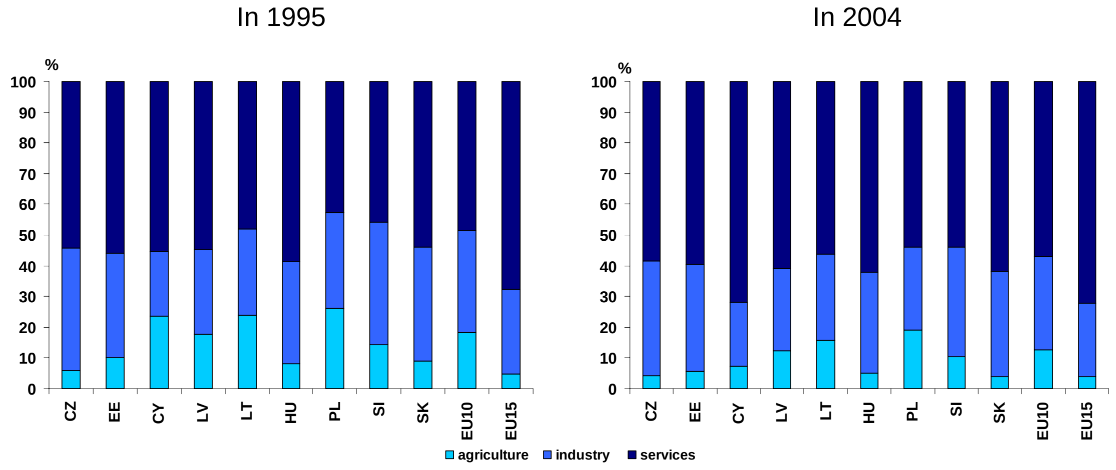
At 13.4% the unemployment rate in the EU-10 is 5.5 percentage points above the EU-15 average. However, large differences exist across countries. Unemployment rates range from about 6% in Cyprus and Slovenia to 16.4% in Slovakia and 17.7% in Poland, reflecting to varying degrees labour shedding resulting from restructuring, cyclical influences and structural rigidities. By comparison, rates among the EU-15 Member States are as low as around 4-5% in Denmark, Ireland, Luxembourg, the Netherlands, Austria and the United Kingdom, while they peak at some 9-10% in Greece, Spain, France and Germany. In addition, the EU-10 labour markets have the following features: (i) a high long-term unemployment rate – in 2004, long-term unemployment accounted on average for about 54% of all unemployed compared with an EU-15 average of 42.5%; (ii) a high youth unemployment rate – youth unemployment is on average 30%, i.e. almost twice as high as that of the EU-15; (iii) a high share of unemployed among the low-skilled; and, (iv) significant regional disparities in unemployment.

The persistence of high levels of unemployment and its concentration among certain groups and regions suggest that structural rigidities hamper the smooth functioning of the EU-10 labour markets. In this regard, the policies needed to improve labour market conditions do not differ significantly between the EU-10 and the EU-15 countries, although the former, especially the central and eastern European Member States, face a more challenging situation. These policies are outlined in the Integrated Guidelines[40] for the period 2005-08 adopted by the Council in July 2005.

The transition process in the EU-8 countries has led to a substantial increase in the size of the private sector as well as to large shifts in the sectoral composition of GDP and employment. In the 1990s, the general trend was towards a shift of the labour force from agriculture and industry to services. The structural changes were less striking in Malta and Cyprus. Despite these changes, the sectoral composition of employment of the EU-10 countries remains substantially different from that of the EU-15.

Employment in agriculture has decreased, but still accounts for 12.5% of total employment in the EU-10 countries (19% in Poland) compared with a mere 4% in the EU-15. As an employer, industry continues to have a larger role in the EU-10 than in the EU-15. The share of employment in industry is particularly high in the Czech Republic, Estonia, Slovenia, and Slovak Republic, where it stands at around 35%, well above the EU-15 average of 24%. Employment in the service sector has increased in the EU-10, but at 57%, it is still well below the EU-15 average of 72%. In all EU-8 countries, services account for a lower share of employment than in the EU-15. By contrast, employment in the service sector is traditionally high in Cyprus and Malta, where tourism is of key importance for the economy.

Graph 21: EU-10 and EU-15: Sectoral composition of employment



Source: Eurostat

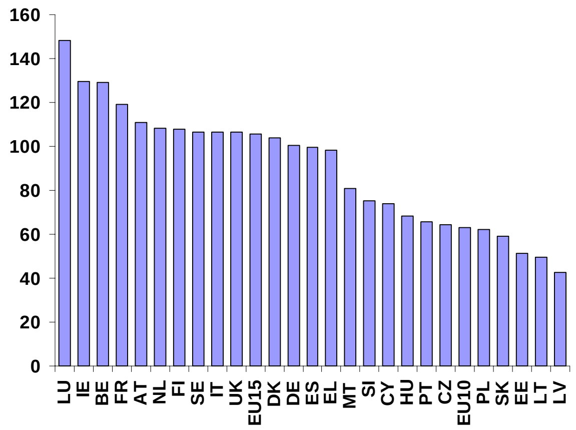
4.3.2. Labour productivity and unit labour costs

Even though the EU-10 Member States have achieved substantial gains in labour productivity over the past decade (in part reflecting labour shedding), their productivity levels remain

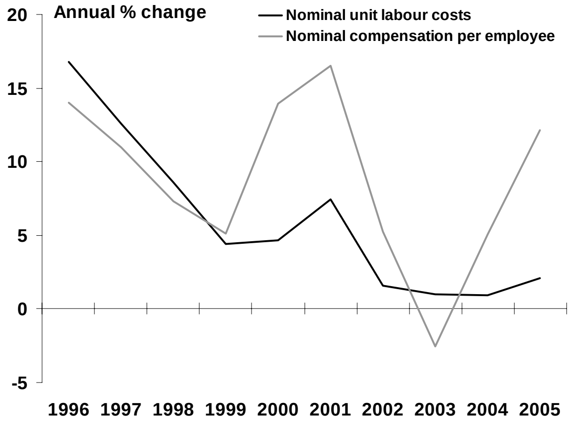
[40] European Commission (2005), *Integrated guidelines for growth and jobs (2005*-2008), COM(2005) 141

substantially lower than those in the EU-15. The average labour productivity per person employed (in purchasing power standards) of the EU-10 was less than two thirds of the EU-15 level in 2004. Labour productivity ranged from less than half of the EU-15 level in the Baltic countries to above 70% in Malta and Slovenia (Graph 22).

Graph 22: Labour productivity per person employed, 2004



Graph 23: EU-10: Wages and unit labour costs.



Source: Eurostat, Commission services (Ameco)

At the same time, average wage growth in the EU-10 has decreased markedly since the second half of the 1990s (though with a temporary surge in 2000 and 2001), and has been a key factor behind the remarkable deceleration of unit labour cost growth (Graph 23). Wage growth accelerated in 2004, largely reflecting the pick-up in inflation and a catch-up on the previous year’s loss in purchasing power. Wage growth slightly decelerated in 2005. Meanwhile, labour productivity growth has been strong since 2001, thus contributing to maintaining subdued unit labour cost growth. Over the period 2002-04, unit labour costs in the EU-10 increased on average by 1.2% per year compared with an average annual growth rate of 2% in the EU-15. However, in 2005, unit labour cost growth in the EU-10 is expected to have outpaced that in the EU-15.

5. ENLARGEMENT AND THE LEVEL OF INTEGRATION

The fifth enlargement offers opportunities and challenges which are very similar to and difficult to disentangle from those related to the broader trends in production, trade and investment made possible by trade and capital account liberalization, the intensive use of modern technology and the emergence of new participants in the international division of labour. The structural changes caused by enlargement are not different compared to those caused by globalization. Therefore, this chapter starts with evaluating the 2004 enlargement in the broader context of globalization (section 5.1). The intensity of effective integration of the new Member States into an enlarged EU-25 as measured by the flows between the new Member States and the EU-15 in goods and services (trade) and capital (FDI) is analysed in section 5.2 and section 5.3, respectively.

5.1. Enlargement and globalisation

The fifth enlargement coincides with the vigorous unfolding of globalization. In a manner similar to structural changes that globalization is propagating internationally, enlargement is inevitably affecting cost and profit opportunities across the Single Market and is providing incentives for adjustment. These incentives are clearly present for enterprises to rationalize their production and distribution strategies, through the development of integrated production networks[41], by incorporating the new Member States within their production value chain.

The enlargement of the EU is also affecting the extent to which various traditional government policies can be sustained in the face of open markets and, therefore, it is acting as a catalyst for policy review and for the development of new policies. The competitive pressures that are being unleashed with enlargement within the framework of the Internal Market are providing powerful incentives for entrepreneurs and for governments to revisit conventional strategies developed to cope with the challenges of a more sheltered environment.

The fifth enlargement, more than others in the past, has many characteristics that mirror closely the broader features of globalization, chief among which being the cost differentials in favour of the new Member States, advantageous location opportunities, cultural ties, advantages for enterprises to divide the production chain and engage in vertical specialization as well as the promise of new markets and not least benefits for consumers in the form of product variety and lower prices. These are made possible both by the process of globalization and by the accession of the new Member States in the EU. As small nations, the new Member States would not have been effective in pursuing on their own successful strategies for industrial development while the close integration of Europe’s regional economies through accession is making this possible in a “regional globalization” context.

[41] The term integrated production networks (IPNs), used in Borrus and Zysman (1998), refers to relationships among firms that organize, across national borders, the research and development, product definition and design, procurement, manufacturing, distribution, and support services in a given industry. IPNs involve a division of labour where different functions are carried out across national borders by different firms often sub-contracted to do so; thus, parent firms economize by not owning or directly managing these parts of the production chain. IPNs provide opportunities for enterprises in the new Member States to become essential components of the new division of labour across the EU and more widely.

Recent data indicate the scale of changes that are taking place in the EU's trade performance internationally. First, intra-EU-15 trade throughout the 1990s has been levelling off but intra-EU-25 trade has been compensating for this[42]. Nevertheless, the emergence of countries like Brazil, Russia, India and China, has contributed to a modest reduction in intra-EU-25 trade in recent years. Secondly, the share of the EU in value added in world manufactures has also been declining reflecting the redistribution of manufacturing activities internationally and, in particular, the vertical decomposition of production. This reduction, which is occurring across the EU-15 and in the EU-10, is not a recent phenomenon but has been going on for some time[43]. This suggests that there are deeper structural reasons that account for the intensity of competition from abroad that has been an issue of concern in the EU. And, third, as will be discussed in section 5.3 below, foreign direct investment (FDI) flows towards the new Member States have been particularly vibrant and motivated both by access to market considerations and by strict comparative advantage reasons – European enterprises restructuring their production processes in order to benefit from location and cost advantages offered by the acceded countries.

The strong growth in technologically sophisticated industries in the new Member States and a corresponding reduction in specialization in low-skill, labour-intensive products while intra-industry trade also appears to be flourishing within the enlarged EU-25[44], reflects the advantages from an as yet narrower–scale development of an international value added chain, which enlargement is offering European enterprises. Typical examples, studied by Radosevic and Sachwald (2005), are those of the *automotive sector* (see also the extensive and thorough study of the European automobile sector in European Commission, 2003a) and of the *information and communication technology (ICT) industries*[45].

The automotive industry's expansion in the new Member States is a remarkable development that has stimulated significant foreign direct investment flows and has led to the establishment of production facilities initially to service the host market and, to overcome the limitations of the domestic market size, to export finished products to the EU subsequently. Poland, the Czech Republic, the Slovakia and Hungary have emerged as major production opportunities for the European automotive industry offering traditional expertise, cost advantages and proximity to the wealthy European markets[46]. Value added in the automobile sector of these countries is similar to that in Austria and the Netherlands and despite the small share it represents in the EU value added and employment, the automobile sector is a major contributor to the economies of the these nations[47]. Capacity utilization rates in the automobile sector in (the boom year) 2000 in new Member States and on other Eastern

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42 See in particular Radosevic and Sachwald (2005), figures 1 and 2, for details on these developments; see also the discussion and data in European Commission (2006b), especially chapter 2.

43 According to Radosevic and Sachwald (2005), Table 1, the share of Western Europe in world value added in manufacturing has declined from 32.1% in 1980 to 26.2% in 2001; the share of Central and Eastern Europe world has declined from 19.9% to 2.7% while there have been significant increases in the share of developing countries, South East Asia's in particular which has risen from 4.1% to 16% over the same period.

44 See for a discussion and details on these developments European Commission (2003a), especially chapter 4, "EU enlargement and competitiveness of manufacturing".

45 Apart from the references on other industry case studies cited in Radosevic and Sachwald (2005), see also the case studies reported in Zysman and Schwartz (ed., 1998).

46 See European Commission (2004a), especially chapter 4, "The European automotive industry: Competitiveness, challenges and future strategies".

47 See detailed and comparative data on these, by member state, in European Commission (2005d).

European countries reached close to 70%, comparable to that of Asian producers and some 10 to 15 points lower than in the EU-15 and the US, respectively, but also reflecting already overcapacity problems. Moreover, a complex pattern of vertical specialization has developed in which R&D and sophisticated production work takes place in the EU-15 while automobile assembly is located in plants in the new Member States[48]. This separation between product development and manufacturing and assembly activities, which is by no means unique to the automobile industry, characterizes the specialization and profit opportunities offered by the emergence of new competitive locations. Enlargement has provided scope for specialization and for rationalization for the European automobile industry and has improved significantly its competitiveness. What would otherwise be taking place across national borders in a fragmented Europe, if at all, is now part of the EU Internal Market and governed by its rules.

The case of the ICT industries is also typical[49]. Among the new Member States Hungary and the Czech Republic stand out with their increasing specialization in ICT products. The electronics industry is expanding from local to international markets through rationalization of production facilities and growth of clusters, and product development increasingly separated from manufacturing. Outsourcing is now common along the supply chain and Hungary in particular has benefited significantly from this. Accession to the EU has stimulated significant foreign inward investment (encouraged also by the government) which, taking advantage of available skills, led to Hungary becoming one of the major locations in European electronics. Cost advantages and availability of skilled labour as well as staying close to the final market destination are key factors that have affected the emergence of Eastern European locations in the electronics value chain. EU and international producers are in a position to exploit the competitive advantage offered by the new Member States by positioning the restructuring of the value chain to incorporate these is producing significant benefits.

The EU's fifth enlargement will undoubtedly be only one stage in the unfolding process of globalization. As the new Member States catch up with the EU-15 their cost advantages will be eroded. With the EU's external policies developing further to support and strengthen the rule of law, of liberal economics and of democracy in other non-member neighbouring countries, these will also become attractive locations to produce causing further vertical disaggregation of the production chain. At the same time, plants in the home countries will be upgraded to comply with the decomposition of the value chain. The consequences of the latest enlargement predict reasonably well how economic activity will unfold on a European, continent-wide, scale in coming years.

5.2. Trade integration in an enlarged European Union

5.2.1. Trade in goods

Trade flows between the EU-10 and the EU-15 increased markedly in the period preceding EU accession. Both the prospect of EU accession and trade liberalisation through the Europe agreements triggered a surge in trade in the second half of the 1990s. The Europe agreements

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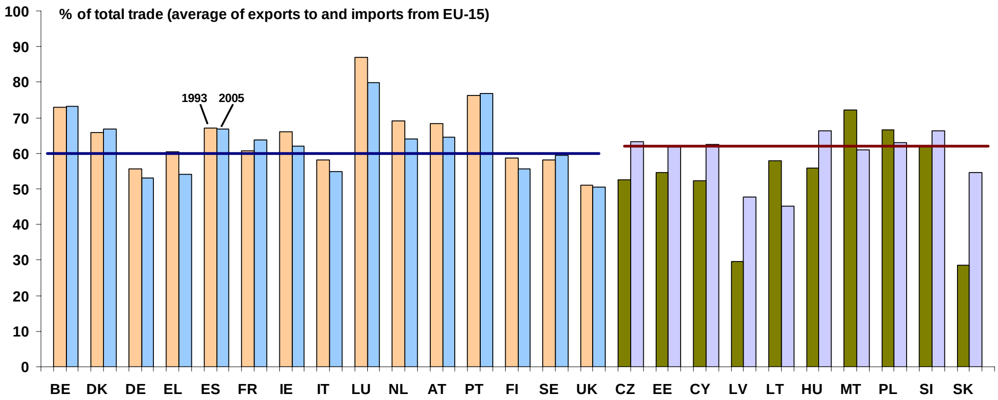
48 In skill taxonomies the motor vehicle industry is classified generally as low skill– or at best intermediate skill– intensive industry – see O'Mahony and van Ark (2003), especially chapter II. Hence, the disaggregation of the value chain into assembly work in plants in some of the new Member States and product development, design and R&D work in the EU-15 places of establishment is consistent both with existing cost differentials and with factor endowments between the two locations.

49 See Borrus and Zysman (1998).

– which were signed with each candidate country and came into force between 1994 and 1999 – established free trade between the EU and the EU-10 countries, on the basis of reciprocity but applied in an asymmetric manner (with more rapid liberalisation on the EU side than on the side of the candidate countries), and with restrictions in a few sectors (e.g. foodstuffs, textiles and clothing). As a result, the EU-15 became rapidly the major trading partner for all EU-10 countries: in 2003, the EU-15 accounted for 67% of the total EU-10 exports and 58% of their total imports, compared with 57% and 55%, respectively, in 1993 (Graph 24).

Graph 24: Trade integration with EU-15, 1993 and 2005



Note: For 2005, estimates based on data up to June 2005.
Source: Commission services' calculations based on IMF Direction of Trade Statistics

Since accession, the EU-15 share of the EU-10 trade has remained broadly stable at 62%. This reflects a high degree of trade integration of the recently acceded Member States in the EU-15, which even slightly exceeds that among the EU-15 countries, as intra-EU-15 trade accounts for 60% of the total EU-15 trade. As the EU-10 countries are small and open economies, with a degree of openness[50] above the EU-15 average, it is not surprising that they tend also to be more highly integrated with the EU-15 than the old Member States. However, large differences exist across countries, with some Cyprus, the Baltic countries, and Slovakia having less intense trade relations with the EU-15.

Looking ahead, enlargement is likely to lead to a further increase in trade between the EU-10 and the EU-15, especially in the areas for which trade liberalisation under the Europe agreements was limited. Also, the adoption of the euro should in time boost trade, by eliminating exchange rate uncertainty, lowering transaction costs and increasing price transparency.

While the direct effects of accession itself on trade integration between the EU-10 and the EU-15 have been limited, accession has clearly led to an increase in trade flows between the EU-10 countries. Since the mid-1990s, the EU-10 countries have kept significant trade links between themselves, as intra EU-10 trade accounted on average for 12% of total EU-10 trade over the period 1993-2003 (Graph 25). Following accession, the share of intra-EU-10 trade rose to 14% in 2005. This increase in regional trade is due to the fact that accession has not only removed remaining trade barriers between the EU-10 and the EU-15, but also improved access of the EU-10 countries to their peers. Interestingly, the countries that have most benefited from these trade creating effects of accession are among those that are less integrated with the EU-15, namely Estonia, Lithuania and Slovakia. These countries maintain

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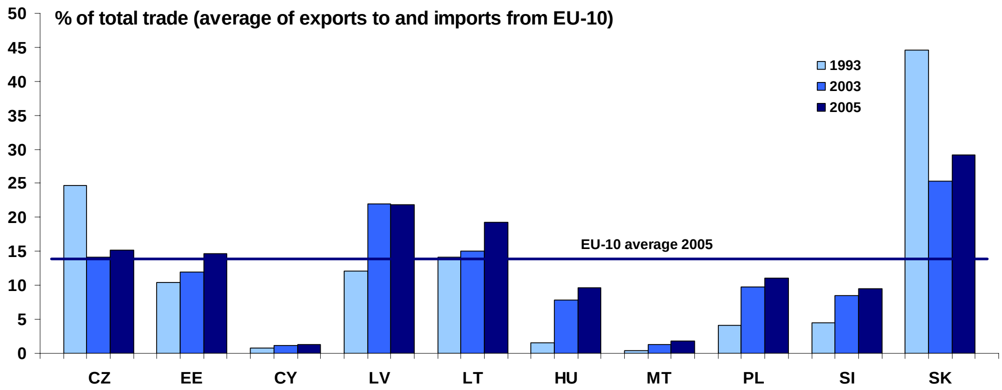
50 In 2004, the EU-10 countries' trade (exports plus imports) accounted on average for 93% of GDP compared with an EU-15 average of 55%.

a substantial share of their trade with the EU-10, ranging from 15% for Estonia to 29% for Slovakia.

Graph 25: Intra-EU-10 trade, 1993, 2003 and 2005

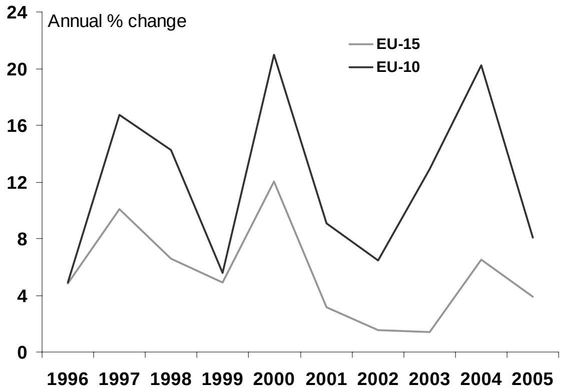


Note: For 2005, estimates based on data up to June 2005.
Source: Commission services' calculations based on IMF Direction of Trade Statistics

Overall, enlargement has led to growth in trade in the enlarged Union without possibly causing trade diversion away from non EU-25 countries (Box 5 for a brief discussion). The share of non-EU countries in the total EU-15 trade increased by about 1 percentage point to 35% between 2003 and 2005, whereas in the case of the EU-10 countries, it remained virtually stable around 25% over the same period.

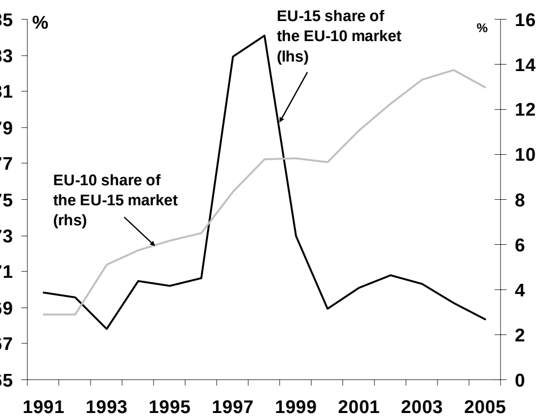
As shown in Graph 26, export growth in the EU-10 has been more dynamic than in the EU-15 over the past 10 years. The strong export performance of the EU-10 is also reflected in the substantial increase of its market share in the EU-15 since the early 1990s. Over the period 1993-2003, the EU-10 increased its market share in the EU-15 (excluding intra-EU-15 trade) by 8 percentage points (Graph 27). Since accession, the EU-10's market share has remained virtually stable, accounting for 13% of the extra-EU-15 imports of goods. The Czech Republic (with a market share of 3.7%) is the largest exporter to the EU-15, followed by Poland (3.5%) and Hungary (2.8%).

Graph 26: EU-10 and EU-15: Exports of goods in volume, 1996-2005



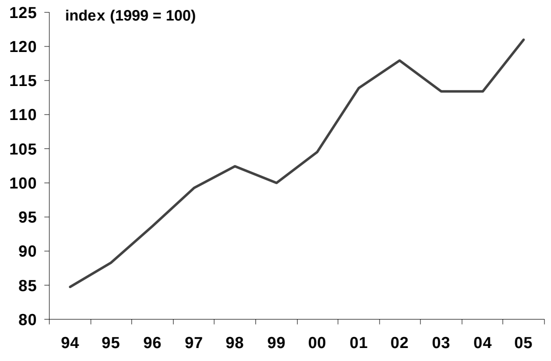
Source: Commission services (Ameco)

Graph 27: EU-10 and EU-15: Export market shares in value terms, 1991-2005



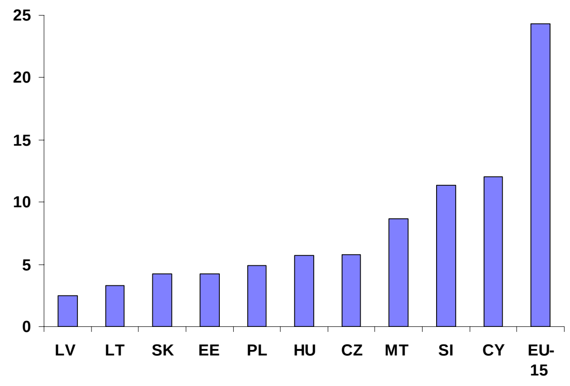
Note: Excluding intra-EU-10 and intra-EU-15 trade.
Source: Commission services' calculations based on IMF Direction of Trade Statistics

Graph 28: Real effective exchange rate of the EU-10 vis-à-vis the EU-15 based on unit labour costs in total economy, 1994-2005



Source: Commission services

Graph 29: EU-10 and EU-15: Average hourly labour costs in euro, 2004



Source: Eurostat

By contrast, the EU-15 countries as a whole recorded an increase in their share of the EU-10 market over most of the 1990s, but experienced losses in recent years, which have offset the initial gains. They remain, however, major exporters to this market: they accounted for around 70% of the extra-EU-10 imports of goods in 2005, with Germany remaining the top EU-15 exporter to these countries. Over the period 1993-2003, Germany, Austria and Italy experienced large gains in the EU-10, while in the past two years only the Netherlands has recorded an increase in its market share. In the EU-10 market, the EU-15 countries face increased competition among themselves, specifically from the Visegrad countries (the Czech Republic, Hungary, Poland, and Slovakia), which have all achieved significant market share gains since 1993.

The substantial market gains of the EU-10 in the EU-15 have been realized despite an erosion of the EU-10’s cost competitiveness since the mid-1990s. The Unit Labour Costs (ULC)-based real effective exchange rate of the EU-10 vis-à-vis the EU-15 has recorded a cumulative appreciation of over 40% between 1994 and 2005, suggesting some deterioration of the EU-10’s cost competitiveness (Graph 28). In absolute levels, however, the EU-10 countries still enjoy very competitive positions. In particular, hourly labour costs in the recently acceded Member States remain considerably lower than in the EU-15 (Graph 29). In 2004, the average hourly labour cost in the EU-10 was four times lower than in the EU-15.

Box 5: Trade creation and trade diversion: QUEST simulations

Growth in the new Member States has on average exceeded growth in EU-15 by 1.5% points per year over the period 2001 to 2005, fuelling strong exports from EU-15 to the new Member States. The question arises whether the trade between EU-15 and EU-10 has increased at the expense of intra trade among the old Member States and at the expense of trade with the rest of the world. How forming a customs union between the EU-15 and the EU-10 might affect trade (and economic welfare) depends on the sum of trade creation and on trade diversion. The origin of trade creation is the substitution away from a more costly supplier (the rest of the world in our case) for a less expensive one following the imposition of the common tariff; trade diversion involves the substitution of a less costly supplier for a more costly one within the customs union again following the imposition of the common tariff. Clearly, what is involved here is trade patterns and relative costs pre- and post-accession as well as the height of the external tariff. This is a comparative static approach to the question. In practice, transport costs, the substitution and income elasticities, changes in the terms of trade as well as dynamic effects associated with increasing returns will affect the relative size of trade creation and trade diversion and of economic welfare. It is virtually impossible to provide a precise answer to this question (although much work was done in the 1960s/70s, the heyday of customs union theory, to determine whether the European Economic Community was creating trade or diverting trade) especially taking into consideration the dynamic effects.

Some aggregate empirical evidence has been obtained from simulations with DG ECFIN's macroeconomic model QUEST II. The results, which reflect the increase in exports induced by higher income growth and not the effects of increased trade integration, show that accession of 10 new Member States has not only led to an increase in exports to EU-10 but has also slightly increased exports within the old Member States and exports to the rest of the world. According to the model simulations, there is no evidence of trade substitution towards more costly suppliers although some trade diversion may have in fact taken place at a disaggregated level. By not accounting for these effects, the overall impact of enlargement on trade growth may not be accurately estimated, and export growth may be underestimated.

Table 6: Trade growth following enlargement

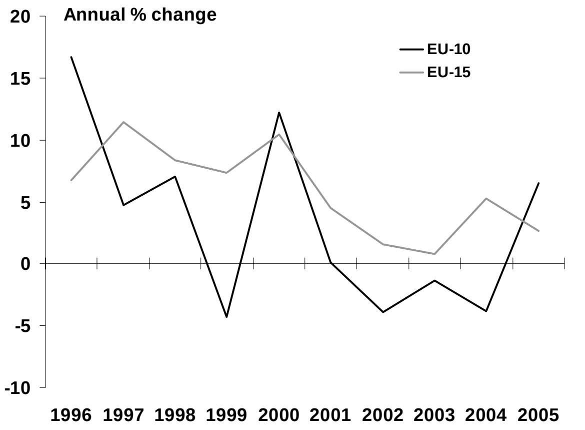
Cumulative percentage increase in exports after 5 years, following the positive income shock in EU-10 of 1.5 % point observed in 2001-2005				
	Total	Exports to:		
	Exports	EU-10	EU15	Rest of the world
EU15	0.8	4.6	0.2	0.2
RAMS	2.1	5.5	0.2	0.2

Source: ECFIN's QUEST II model

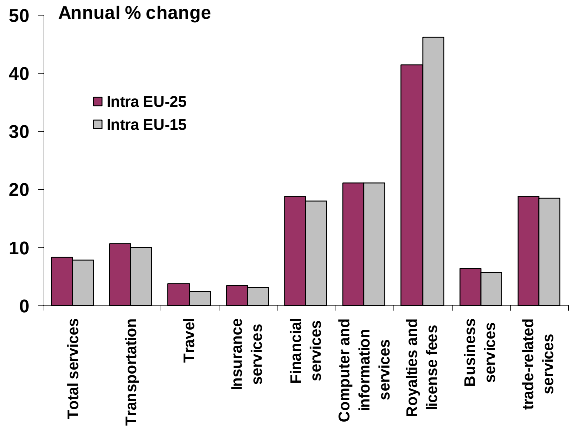
5.2.2. Trade in services

Unlike trade in goods, no significant impact of accession on trade in services between the EU-10 and the EU-15 has been visible to date. Exports of services in volume terms in the EU-15 expanded rapidly in 2004, while they declined in the EU-10 (Graph 30). Moreover, balance of payments data show that in 2004, trade in services among the EU-25 grew at about the same pace as that among the EU-15, suggesting that trade in services between the EU-10 countries or between the EU-10 and the EU-15 remained subdued (Graph 31). In the enlarged Union, the highest growth rates were recorded in the areas of royalties and license fees, computer and information services, as well as financial and trade-related services.

Graph 30: Exports of services in volume, 1996-2005



Graph 31: Exports of services in value, 2004

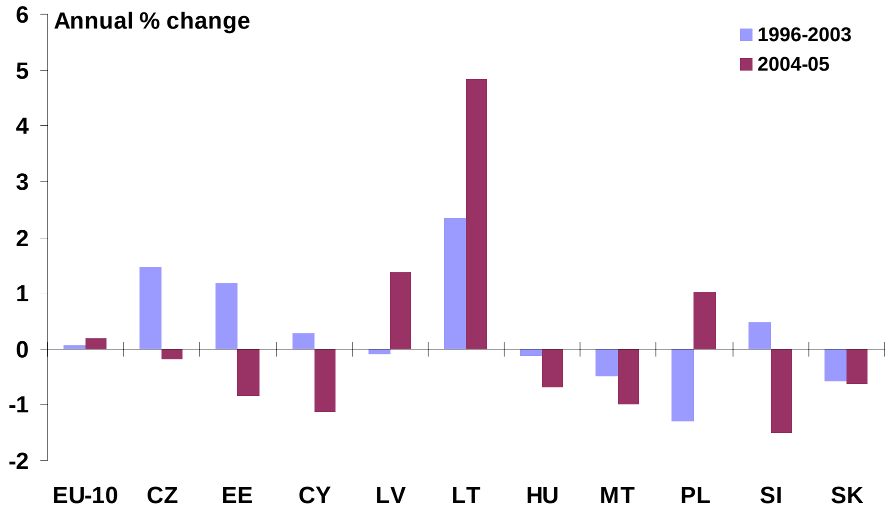


Source: Commission services (Ameco) and Eurostat

5.2.3. Terms of trade and real incomes

A country's terms of trade are defined as the ratio of its export prices over its import prices. When export prices increase faster than import prices, a country can buy a higher volume of imports for a given volume of exports. This leads to an increase in real income. By contrast, decreasing terms of trade constitute a loss of welfare as a lower volume of imports can be acquired.

Graph 32: EU-10, terms of trade for goods and services



Source: Commission services (Ameco)

Over the period 1996-2003, the new Member States as a whole experienced positive, albeit small, terms of trade gains (Graph 32). In 2004, these countries recorded on average a further improvement in their terms of trade, with a positive impact on real income estimated at 0.2% of GDP. Gains of a similar size are estimated for 2005. However, these effects have been unevenly distributed across countries. Over the period 1996-2003, only the Czech Republic, Estonia and Lithuania recorded large income-increasing terms of trade effects (Mora, 2006).

Over the past two years, Lithuania, an exporter of refined oil, has again benefited from a strong improvement in its terms of trade, while the nominal appreciation of the exchange rate and rising food prices have led to improving terms of trade in Latvia and Poland, two exporters of foodstuffs. Meanwhile, the other recently acceded Member States have been subject to income-reducing terms of trade effects.

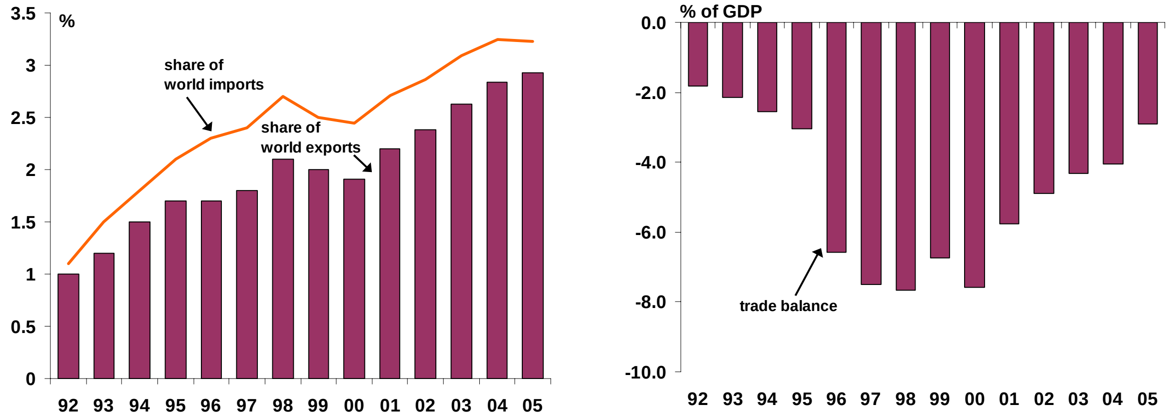
5.2.4. Trade performance on world markets

5.2.4.1. World market shares

A strong, one-off, positive effect of enlargement on export growth was recorded in 2004 in both the EU-10 and the EU-15. EU accession boosted exports of goods in the two groups of countries, with a more dramatic impact in the EU-10 (Graph 33). Export growth of the EU-10 surged to 20% in volume in 2004 from an average of 11% over the period 1996-2003. Meanwhile, the EU-15 experienced a similar, albeit more modest, acceleration of export growth. This was largely a one-off effect as export growth decelerated significantly in 2005 in both the EU-10 and the EU-15.

The EU-10's world market share has grown significantly over the period 1992-2003. On the export side, its share has grown from 1% in 1992 to 2.8% in 2003 and its import share has grown even more strongly over the same period, from 1.1% to 3.1%. Upon enlargement, the average tariff applied by the EU-10 decreased from 8.9% to 4.1%, which is the EU average applied tariff. Given the persistent out-performance on the import side, it is not surprising to find that the EU-10 has had a substantial negative trade balance over the period as a whole. As Graph 33 indicates, the trade deficit grew from below 2% of EU-10 GDP in 1992 to between 7-8% over the period 1996-2000 before falling back over the years to 2005 to around 3%.

Graph 33: EU-10's world export / import market shares and trade balance



Source: UN Comtrade

While the EU-10 is increasing its share of overall world markets, there are nevertheless concerns regarding the persistent nature, and more importantly, the size of its trading deficits. The continuing elevated level of these deficits could be pointing to the possibility of structural deficiencies at the skill/technology levels or to specific weaknesses in particularly dynamic product areas (see below).

5.2.4.2. EU-10's trade performance in terms of its skill and factor intensity

A breakdown of EU-10 trade can be developed on either the technology level of products or on the intensity with which they use different factors of production.

Using these classifications, measures of revealed comparative advantage (RCA) for the EU-10 and EU-15 at the net level (that is, exports less imports) are calculated[51]. Focussing on the trade balance has the potential to increase our understanding of the large shifts in specialisation which are taking place at the world level. An analysis at this level is becoming increasingly important as the outsourcing phenomenon gathers pace. The growing fragmentation of international value added chains is leading to a growth in intermediate imports, with imports of parts and components and semi-finished goods being used to maintain the export market shares of many countries. The maintenance of export market shares via a strategy of large scale delocalisation of the input supply chain often leads to a deterioration in a country's overall trade balance. In these circumstances, focussing solely on the export side would be insufficient to reflect the true underlying position of the country in question.

In practical terms, while the actual trade balance can provide a useful indicator of the specialisation patterns for the specific areas, to calculate an accurate measure of a country's comparative advantage one must first adjust the actual balance to take account of the effects of the business cycle.

Graph 34 gives the "structural" trade balances as calculated by the CEPII (Fontagné and Mimouni, 2000) approach for the different skill and factor intensities described earlier for the EU-10 and EU-15 groupings. These figures can be interpreted as indicators of the comparative advantage of these EU groupings in terms of the specialisation patterns of their respective industries. Graph 34a shows the strong low-technology and medium-low technology specialisation of the EU-10, with a significant proportion of its internal resources being directed towards sectors which use labour and capital intensively. Graph 34b goes on to show the RCA's for the EU-15. While the absolute figures cannot be compared across the groupings, the EU-15 is particularly strong in the medium-high technology category and to a lesser extent the medium-low technology area where the EU-10 is also strong. In terms of the factor intensity breakdown, the EU-15 does well in the "difficult to imitate research" goods category and in industries which use capital intensively. It does very poorly, as one would expect, in raw material intensive industries.

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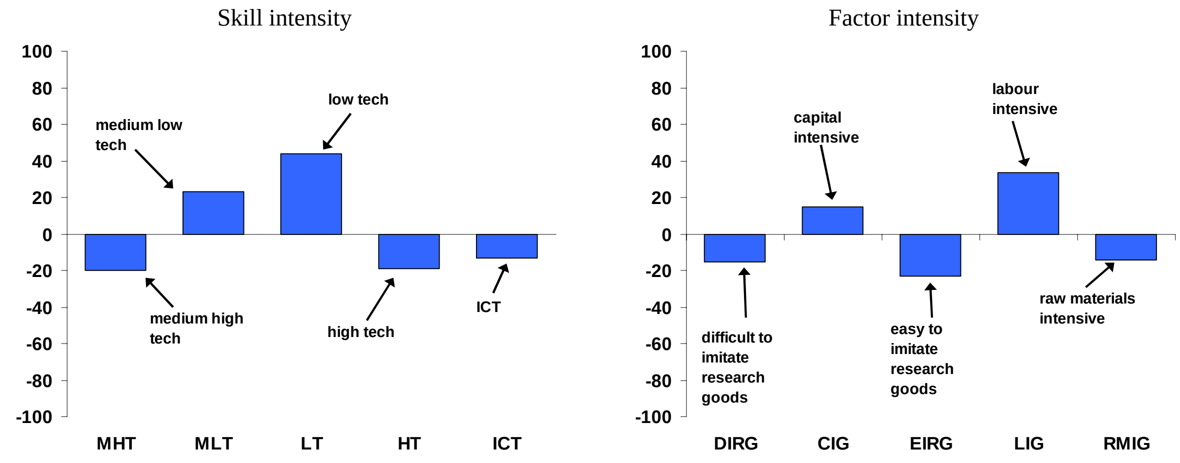
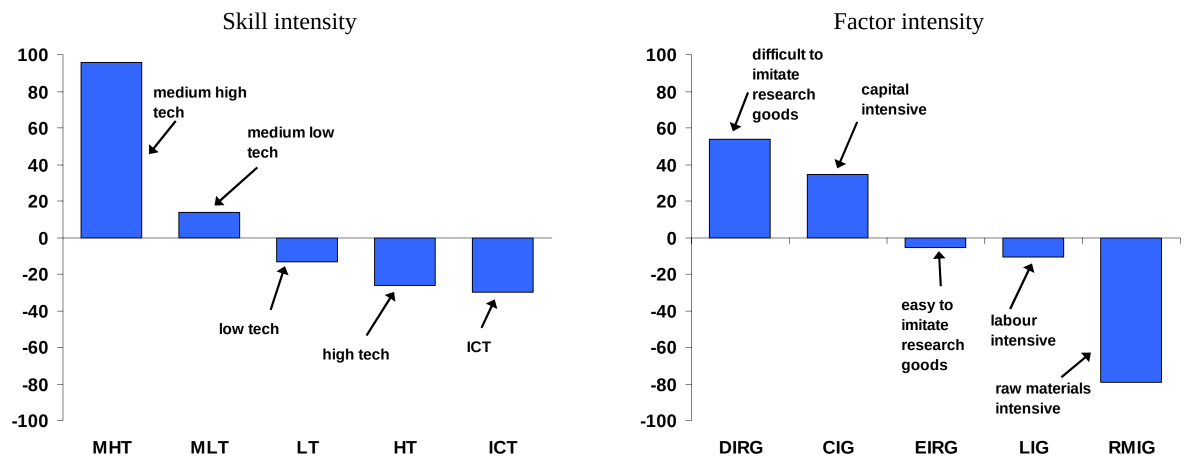
[51] For a detailed discussion of the methodology, measures and classifications used, see European Commission (2005) Annual Review.

Graph 34: EU-10 versus EU-15's comparative advantages

34a - EU-10



34b - EU-15



Source: Commission services

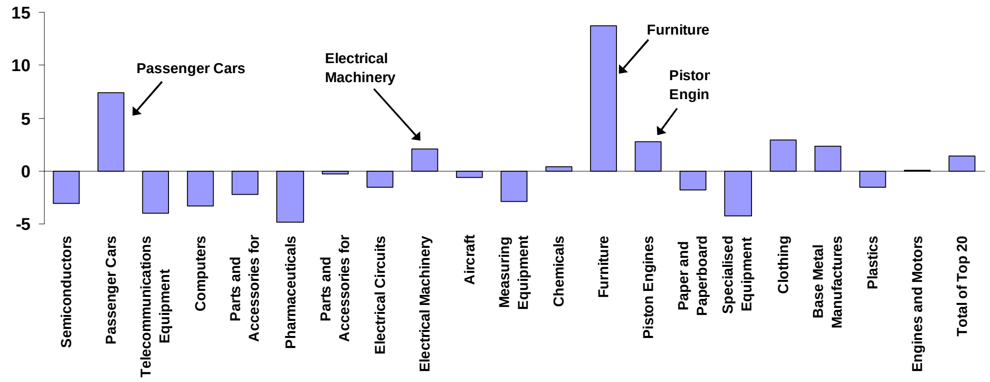
What is most interesting from the data in Graph 34 is the complementarity between the trade structures of the EU-10 and EU-15. The low tech, labour intensive, specialisation patterns exhibited by the EU-10 grouping contrasts with the medium high tech industrial structure of the EU-15 in which R&D and physical capital are both used intensively. These specialisation patterns suggest that production sharing has a strong geographical dimension (European Commission, 2005b), with the EU-15/EU-10 complementarities being mirrored in Asia between China, S.E. Asia and Japan.

5.2.4.3. EU-10's trade performance in the most dynamic product areas

While breakdowns of trade into specific skill or factor intensity groupings are enlightening, it is important to supplement this with an overview at the product level.

At the 3–digit SITC level, there are 266 product groupings. It is not feasible of course to provide an analysis of each of these groupings and consequently one must rank them using particular criteria. For this specific exercise, it was decided to rank the 266 products on the basis of their overall contribution to the non-fuel export growth rate. This ranking involves taking both the export growth rate for each product as well as its overall share in total non-fuel exports to calculate its respective contribution. The top twenty products are presented on the horizontal axis in Graph 35.

Graph 35: EU-10 – Revealed comparative advantage for the top 20 product groupings



Source: Commission services

Semiconductors were the single most important non-fuel export product reflecting both its very high rate of growth (13.6%) as well as its large weight in non-fuel world exports (4.4%). This single industry contributed nearly 8% to the overall growth of non-fuel exports over the period 1992-2003, well in excess of the next most important industry, passenger cars. Intermediate and capital goods are particularly well represented in the top 20 products linked to the global increase of foreign direct investment. By contrast, the consumption goods category is poorly represented, with just 12% of the growth rate of the top 20 attributable to this particular type of goods. The high skill and capital intensive goods dominate the ranking.

Given the dominance of medium and high-technology goods, the EU-15 holds a strong comparative advantage in what have been the 20 most dynamic products. The EU-10 on the other hand is just in broad structural balance (Graph 35). Concerning individual products, the EU-10 has structural deficits in 12 of the 20 product categories, with significant deficits in ICT related industries, pharmaceuticals, measuring equipment and specialised equipment. The EU-10 displays strong comparative advantages in cars and furniture, with other areas of specialisation including electrical machinery, piston engines, clothing and base metal manufactures. In overall terms, apart from car-related industries, the EU-10 as a whole is very focussed on low technology, labour intensive sectors such as furniture and clothing.

5.3. Foreign direct investment and enlargement

This chapter provides an overview of the new Member States' performance as hosts of foreign direct investment and a summary assessment of the impact of intra-EU capital flows on the economies of the old and new Member States.

Since the mid-nineties the presence of foreign firms in the new Member States has grown significantly, which is a sign of increasing economic integration with the rest of the EU. By promoting further specialization based on comparative advantage and the consolidation of the Internal Market this process brings benefits for all parties involved. Nonetheless, among the old Member States the shifting of economic activities to the EU-10 has raised concerns about job losses and threats to the economic and social norms prevailing in the incumbents. However, the available evidence suggests that these concerns are exaggerated. Enlargement, nonetheless, is setting in motion an adjustment process, which can be substantial in certain industries or regions, and policymakers should to be alert to the need for transitional support, where appropriate, for those adversely affected by structural change. As a consequence, the Commission has acknowledged the need to anticipate and accompany change in its Communication on restructuring, in which it laid out an approach aiming at better integrating the different Community instruments, especially the Structural Funds, in order to mitigate the associated costs (European Commission, 2005i).

For the new Member States, FDI is a key factor in the process of economic modernization. FDI complements domestic sources of funding and contributes to raising productivity growth through changes in the sectoral composition of production, technology transfer and greater competition pressures. The challenge for policy making in the new Member States is to sustain their competitiveness as hosts of multinational firms' activities in the long-run while promoting spillovers to consolidate of industrial restructuring and prevent the emergence of a dual economy characterized by performance differences between the foreign and the domestically-owned firms. The implementation of the structural reforms included in the Lisbon strategy namely those aimed at improving market functioning and the promotion of knowledge-based society are crucial.

Section 5.3.1 describes the main features of inward FDI in the new Member States. The main motivations for intra-EU FDI flows and the possible implications for the old Member States are examined (section 5.3.2), in particular the possibility of job relocation (section 5.3.3). The importance of foreign multinationals in the ongoing restructuring process in the new Member States is analysed in section 5.3.3 and identifies some policy implications.

5.3.1. Inward FDI in the new Member States

One of the most visible aspects of the ongoing process of economic integration of the new Member States in the EU is the rapid growth of foreign direct investment flows into the former. While virtually residual until the mid-1990s, the 2004 stock of inward foreign direct investment in the new Member States reached 191 billions euros, which represents 40% of the local GDP. However, the share of the new Member States in the total inward foreign direct investment stock of the EU-25 remains very limited (around 4% in 2004, Graph 36).

Among the new Member States there is a clear concentration of foreign direct investment in the three largest economies (Poland, Hungary and Czech Republic), which in 2004 absorbed almost 80 % of the total accumulated inward foreign direct investment stocks (Graph 37).

Among the smaller new Member States, Estonia stands out as an important hub for foreign production (Graph 38). In 2003, the stock of inward foreign direct investment represented almost 70% of the Estonian GDP which contrasts for example with the situation in Slovenia and Poland where the ratio of foreign direct investment to GDP is much smaller.

The EU-15 is by far the main investor, with a share of 77.5% of the total inward stock in the new Member States in 2004. The Netherlands is the largest individual investor, followed by Germany and France[52]. Not surprisingly there is a clear pattern of regional integration illustrating the importance of geographic and cultural closeness (Table 7). Germany is particularly active in the neighbouring Czech Republic, Hungary, Poland and Slovakia while

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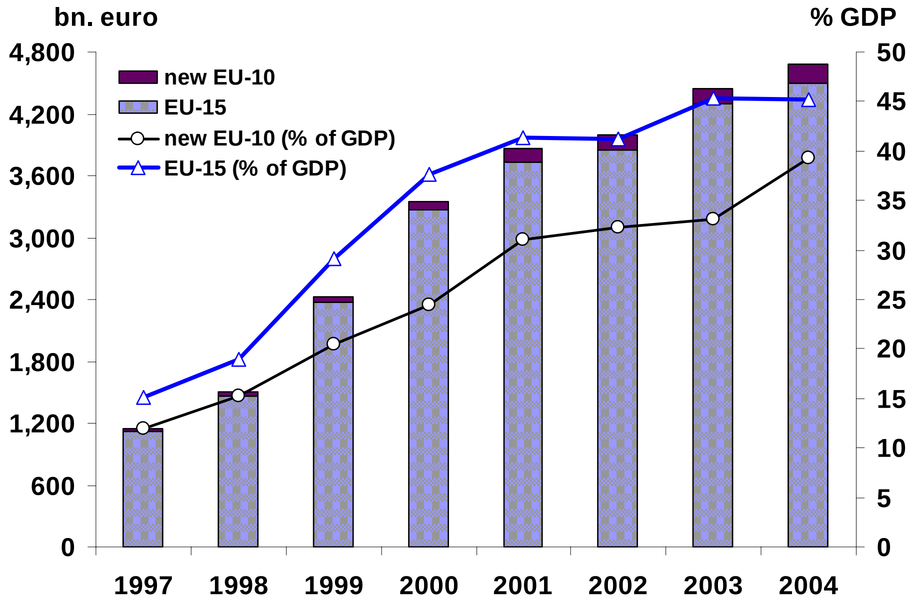
52 The Netherlands is home to many holding companies, many of which are foreign-owned. In fact an important part of the investment originating in the EU15 is undertaken by affiliates of extra-EU multinational enterprises, see Hunya (2005).

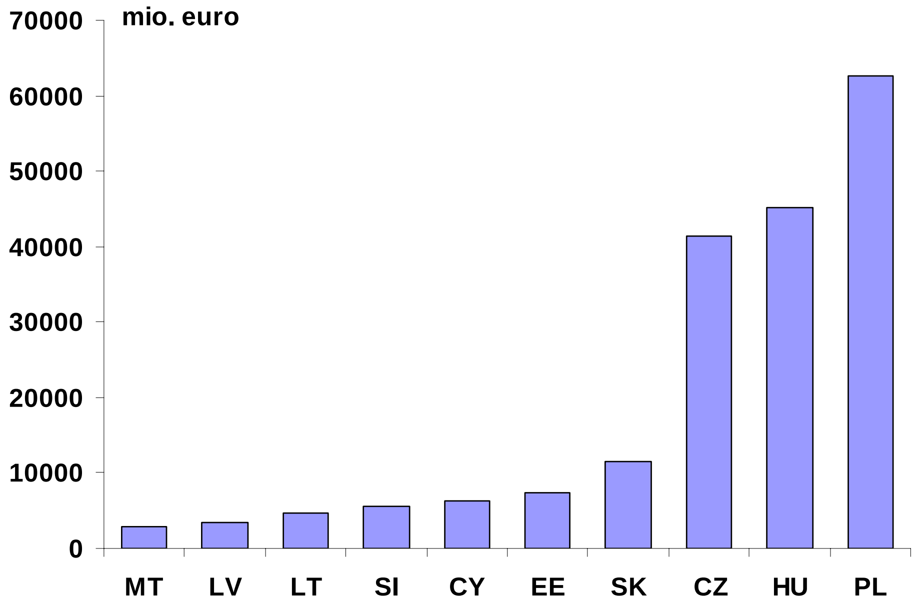
Austria favours investments in Slovenia, Czech Republic, Hungary and Slovakia. The Scandinavian countries are in turn among the main investors in the three Baltic States.

Graph 36: Evolution of inward FDI stocks in the EU15 and NMS



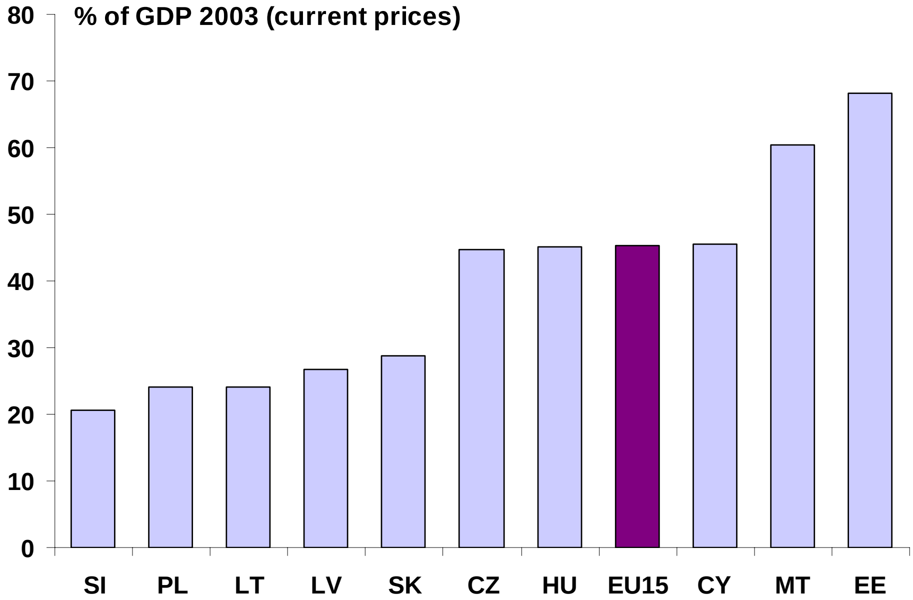
Source: Eurostat

Graph 37: Inward stocks in the new Member States in 2004



Source: Eurostat

Graph 38: Inward foreign direct investment stocks



Source: Eurostat

Table 7: Three main investors according to the 2004 inward FDI stocks

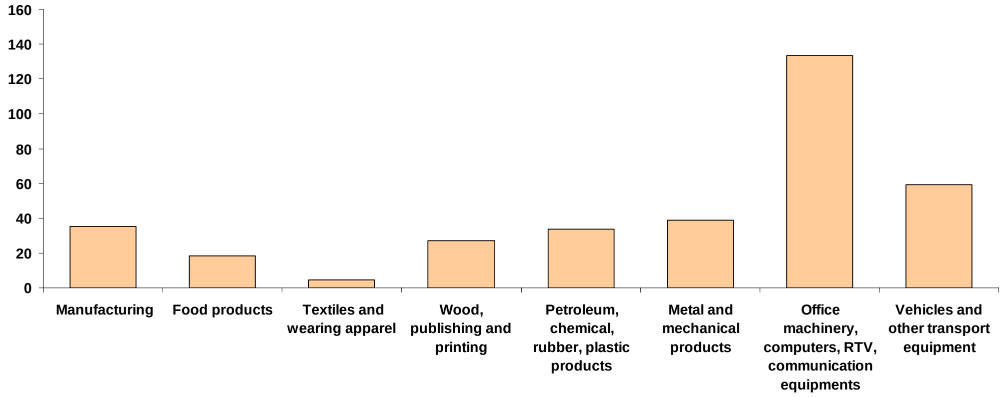
	Rank		
Hosts	1st	2nd	3rd
CY	DE	CH	GR
CZ	NL	DE	AT
EE	SE	FI	US
HU	DE	NL	AT
LT	DK	SE	DE
LV	DE	SE	DK
PL	NL	DE	FR
SI	AT	CH	DE
SK	NL	DE	AT
NMS	NL	DE	FR
EU15	UK	US	NL

Note: For the Czech Republic, Estonia, Hungary, Slovenia, aggregate new Member States and the EU15 data from 2003 was used. No data was available for Malta.
Source: Eurostat

The largest part of the inward foreign direct investment stocks in the new Member States is concentrated in services, with a share of 55% in 2003 *vis-à-vis* 37% in manufacturing and 8% in electricity, gas, water and construction[53]. However, there are noticeable dissimilarities between the various economies. While in Hungary and the Czech Republic manufacturing take up an important share (over 40%), in Cyprus and the Baltic States inward foreign direct investment stocks are overwhelmingly concentrated in services.

[53] These figures exclude data for Slovenia and Malta.

Graph 39: Evolution of inward stocks in the period 2000/03 (selected manufacturing sectors)



Source: Eurostat

Within manufacturing, since the beginning of the decade inward foreign direct investment stocks in modern and more skill intensive sectors like office machinery, computers, radio, television and communications equipment as well as transport material have increased more rapidly (Graph 39). However, while in the Baltic States and to a lesser extent in Poland foreign direct investment is still concentrated in traditional industries like food processing, textiles and clothing and wood products, in Hungary and the Czech Republic foreign investors concentrate in modern manufacturing sectors (Table 8). Transport equipment, the largest sector in terms of foreign direct investment in the new Member States is noticeably concentrated in the Czech Republic, Hungary and Poland, the largest and most centrally located economies. Graph 39 and Table 8 present some relevant data, the former based on the distribution of FDI across principal manufacturing activities in the period 2000/2003 and the latter the distribution in 2003 across nine sectors in eight Member States.

Table 8: Stocks of inward foreign direct investment in the new Member States by manufacturing sectors in 2003

(in percent of total)	Food products	Textiles & wearing apparel	Wood, publishing & printing	Petroleum, chemicals, rubber & plastic products	Metal & mechanical products	Office machinery, computers, radio, TV and communication equipment	Medical, precision and optical instruments, watches and clocks	Vehicles & other transport equipment	Other
CZ	11.1	2.3	7..3	13.5	16.4	5.6	1.8	22.7	17.8
EE	21.3	7.9	19.2	9.4	8	3.4	0.5	8.2	
HU	13	1.8	4.5	20	11.7	12.1	0.8	24.7	2.2
LT	37.6	9.5	8.2	21.1	3.2	4.2		5.7	
LV	27.7	11.2	27.7	11	8.7	0.2	0.2	0.2	12.9
PL	18.9	1.4	11.3	17.9	9.9	4		16.7	
SK	18.6	2.1	4.5	23.7	28.9	2.5		-1.2	
Total	15.5	2.2	8	17.4	13	6.7		19.4	

Source: Eurostat

5.3.2. FDI, intra EU relocation and the EU-15 economies

The EU accession crowned a process of gradual structural transformation of the new Members States which has laid down the foundations for institutional, political and macroeconomic stability while making possible the liberalisation of international trade and investment flows.

This process provided an opportunity, particularly to EU-15-based firms, to take advantage of better production costs conditions by internalizing the labour cost advantages offered by the new Member States. Firms in EU-15 choose to fragment their production processes relocating some parts to the new Member States either by setting up affiliates (offshoring) or by purchasing inputs to local producers (outsourcing). Ample availability of skilled labour, low transport costs due to geographical proximity, cultural and linguistic ties and full EU membership in May 2004 have contributed to making the new Member States particularly attractive[54]. Despite incipient efficiency (cost-reduction) gains that led to EU-wide production sharing, strategic motivations like improving market access are often more important drivers for multinational enterprises' investment in the new Member States - see Lankes *et al.* (1996) and Abraham et al (1999).

Regardless of motivation, enlargement prompted an EU-wide phenomenon of industrial restructuring that led to some shifting of economic activities from the old Member States to the new. This issue has been one the most prominent in the political debate on enlargement. In particular, the notion that the relocation of activities from the old to new Member States reduces production and employment in the former is cause for major concerns in EU-15. However, accurately quantifying the extent of intra-EU relocation of activities remains difficult. While increasing FDI flows from the EU-15 to the new Member States are often taken as supporting this idea, these are imperfect indicators. Not all foreign direct investment is associated with shifting domestic production to overseas locations and not all relocations necessarily imply FDI flows.

The evolution of trade in intermediate goods can shed additional light on the issue. The EU-15 is the main trading partners of the new Member States and the exchange of intermediate goods has become the most important component of trade for the new Member States. The trade balance in intermediate goods represents on average around 7% of GDP of the new Member States GDP in the period 1998-2003 (European Commission, 2005). These trade flows reflect a EU-wide production sharing phenomenon through which the new Member States have become assembling platforms using inputs imported from the EU-15 and exporting back to the EU-15 final (assembled) goods or inputs for further processing activities. The new Member States' involvement in this process is undergoing a progressive upgrading; since the early 1990s the share of primary goods in their trade flows has decreased while the share of more sophisticated parts and components has increased (European Commission, 2005). Sectors like transport material and information and communication technologies dominate the trade of intermediate goods. Trade of services between the EU-15 and the new Member States remain relatively subdued, indicating that supplying local markets is the main motivation for foreign investors in these sectors rather than outsourcing or the establishment of export-oriented activities (European Commission, 2005).

5.3.3. Relocating jobs from EU-15 to EU-10?

A long standing debate has developed that concerns the labour market effects of enlargement in the old and new Member States. Specifically, the fears relate to the possibility that the potential combination of relocation of economic activities to the new Member States together with foreign direct investment flows and labour migration from the new to the old Member States would engender job losses in the latter. Despite the evidence pointing to an ongoing phenomenon of EU-wide production sharing, the concerns raised among the old Member

[54] Survey evidence of firms' strategies confirms the importance of the new Member States in the location strategy of EU firms. In the most recent A.T. Kearney ranking of the most attractive off-shoring locations in the world the Czech Republic (4th), Poland (10th) and Hungary (11th) ranked among the top eleven off-shoring destinations in the world.

States about employment losses are exaggerated. While intra-EU relocations may have significant impact in certain sectors like textiles, transport material and information and communication technology producing sectors and in the EU15 regions where they concentrate, there are no reasons to believe that a massive shift of activities and jobs from the old to the new Member States is underway.

The impact of FDI, relocations and migration on employment in the EU-15 appears to be quite limited. First, the phenomena of relocation and migration have been rather modest. The EU-15 remains by far the largest host of FDI within the enlarged EU. The ability of the EU-15 to attract investment has not been drastically challenged. Moreover the new Member States received only a small fraction of the EU-15 outward foreign direct investment. For example, in 2004 the share of the new Member States in the outflows of the EU-15 was 4% while 53% went to the EU-15 and 12% for the US. In addition, only a small share of the foreign direct investment by EU-15 firms going to the new Member States involves the substitution of activities previously carried out in the home country. With respect to migration from EU-10, the flows appear to small to have a significant impact on the labour market (see chapter 4).

Table 9: Selected studies on the employment impact on the EU-15

Study	Countries covered	Methodology	Main findings
Impact on employment levels			
Dutch Ministry of Economic Affairs (2005)	The Netherlands	Survey	1% to 1.5% of the jobs lost in the Netherlands (around 9,000 jobs annually) from 2000 to 2005 can be directly attributed to relocations of economic activities (52% towards Central and Eastern Europe).
Marin (2004)	Germany, Austria	Computation based on survey data	Investment of German (Austrian) firms in the new Member States between 1990 and 2001 have created 460,000 (200,000) abroad while relocation of activities destroyed 90,000 (22,000) jobs in Germany (Austria). The job destruction corresponds to 0.3% (0.7%) of total employment in Germany (Austria).
Substitution effect between employment in EU-15 and in the new Member States			
EC (2005)	Belgium, France	Econometric study	A reduction of 10% in labour costs in Central and Eastern Europe affiliates reduces parent employment by 0.3% and 0.2% in Belgium and France respectively. Given that the differences in average labour costs between France and Belgium and the new members states the potential reduction on parent employment is around 2%.
Becker *et al.* (2005)	Germany, Sweden	Econometric study	A 1% increase in the wage gap between Germany (Sweden) and locations in Central and Eastern Europe is associated with 900 (140) fewer jobs at German (Swedish) home sites and 5000 (260) more jobs at affiliates in Central and Eastern Europe. In relative terms a 10% reduction in Central and Eastern Europe leads to a reduction of parent employment of 0.5% and 0.9% in Germany and Sweden respectively.
Konings *et al.* (2005)	Sample of EU countries	Econometric study	For the period 1993-98 no evidence is found of substitution effects between parent employment and employment in affiliates located in the European low wage regions including those in Central and Eastern Europe, In contrast such effect is found for affiliate employment in other high wage costs regions.

Second, the evidence available so far does not make a strong case for large negative effects on old Member States employment from enlargement. Table 9 summarises the empirical evidence on the employment effects from relocation (for more discussion and a more comprehensive survey see European Commission, 2006b). While there is some evidence of substitution between home employment in European multinationals and employment created in their affiliates in Central and Eastern Europe this effect also appears to be small. In fact, the employment creation effect in affiliates in the new Member States is considerably greater than the employment reduction at home, reflecting the significant productivity gap that still exists between the EU-15 and the new Member States. There is however some evidence that the skill composition of labour demand in the EU-15 may change because of intra-EU relocation. In Germany, the outsourcing of activities to Central and Eastern Europe appears to have contributed to decrease in the relative employment of manual workers – see Geishecker (2006).

It is clearly important to adopt a dynamic perspective when analyzing the impact of relocation, or more generally of the changes in the production structure across the enlarged EU, on the EU-15 economies. By promoting specialization according to comparative advantage and the consolidation of the Internal Market, the process of spatial redistribution of activities yields benefits to all participants. Consumers benefit from lower prices. Firms, in particular those located in the EU-15, gain from increased import demand in the new Member States that will boost further intra-EU trade. Additionally, EU-15 firms will eventually become better prepare to benefit from opportunities opened up by free trade as they improve their competitiveness through access to lower cost inputs. This will eventually lead to more jobs creation. However, inevitably this process involves adjustment costs affecting disproportionably certain sectors, regions and lower-skilled workers.

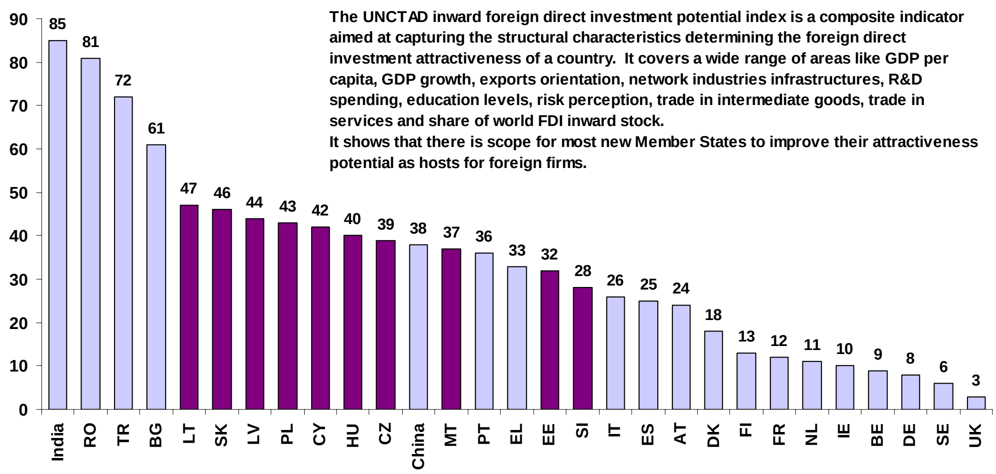
5.3.4. FDI and the economies of the new Member States

While intra-EU relocation of activities is likely having a modest effect on the EU-15 economies, inflows of FDI in the new Member States have significant impact. Although concerns have also been raised in the new Member States, concerning for example the loss of national ownership, the notion that foreign multinationals brings important benefits is widely accepted. In fact, foreign direct investment is generally seen as a catalyst for economic growth and industrial restructuring.

First, inward foreign direct investment inflows complement domestic sources of funding increasing the potential for further production increases and employment creation. Secondly, the presence of export-oriented foreign multinationals promotes comparative advantage led specialisation improving the domestic allocation of resources and leading to higher aggregate productivity levels/growth rates. In addition to this direct impact, foreign direct investment may also promote positive indirect effects (spillovers) if the presence of foreign multinationals improves the productivity performance of the domestically-owned firms they interact with (competitors, suppliers and clients) via technology transfers and enhanced competition pressure.

While it is widely believed that, in principle, FDI will have direct benefits for the recipient new Member States, evidence on the emergence of positive spillovers is less clear (Görg et al, 2004). To increase the scope for such indirect benefits the new Member States need to improve their competitiveness in attracting further FDI, particularly of higher technological intensity, and to create a business environment that is conducive to greater linkages between foreign and domestic firms. According to UNCTAD data presented in Graph 40, several new Member States need to improve their potential as hosts of FDI.

Graph 40: Inward foreign direct investment potential index (country rankings 2001-2003)



Source: UNCTAD

In principle, the greater the volume of foreign direct investment flows, the greater the scope for demonstration/imitation effects as well as competition effects which eventually lead to spillovers effects. However, despite their intrinsic advantages, particularly within the EU-25 (low production costs, good skill endowment and geographic proximity to EU-15 consumption markets) the new Member States fail to match the attractiveness potential of most EU-15 economies (Graph 40). This can be attributed to a large extent to the inefficiencies of the business environment and the strictness of market regulations that still characterise the new Member States – see the discussion in Box 6.

Box 6: The business environment for foreign firms in the recently acceded Member States

The business environment of the new Member States is still characterised by significant structural weaknesses that increase the cost of doing business for foreign firms, namely:

- Restrictiveness of product markets

The OECD product market regulation indicator shows these countries are generally among the most regulated OECD economies (see Conway *et al,* 2005)[55]. There are however important differences among the economies analysed. In the Czech Republic, Hungary and especially in Poland regulation is substantially stricter than the OECD average. Barriers associated with State control are particularly important in Poland and Hungary while barriers to entrepreneurship stand out in Poland and the Czech Republic. Specific restrictions on foreign direct investment are stricter in the new Member States than in the OECD on average. Slovakia stands out as the least restrictive of the new Member States.

- Ease of doing business

The World Bank ranks the new Member States worse than all the EU-15 Member States with the exception of Italy and Greece in terms of ease of doing business[56]. The Baltic States whose ranking compares favourably with many EU-15 economies are the best performers. It is difficult however to make a general claim about the origins

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[55] The OECD product market regulation indicator is computed only for the new Member States that are members of the OECD: Poland, Hungary, the Czech Republic and Slovakia.

[56] For further information on methodology, see http://www.doingbusiness.org/EconomyRankings/Default.aspx?direction=asc&sort=1.

of the deficiencies affecting the business environment of the new Member States. In Poland and Hungary the main problems are the excessive bureaucracy and costs associated with the starting of a business and dealing with licenses. In Slovenia it is the strictness of the hiring and firing legislation, comparable to the strictest EU-15 economies in this respect like France, Spain and Greece.

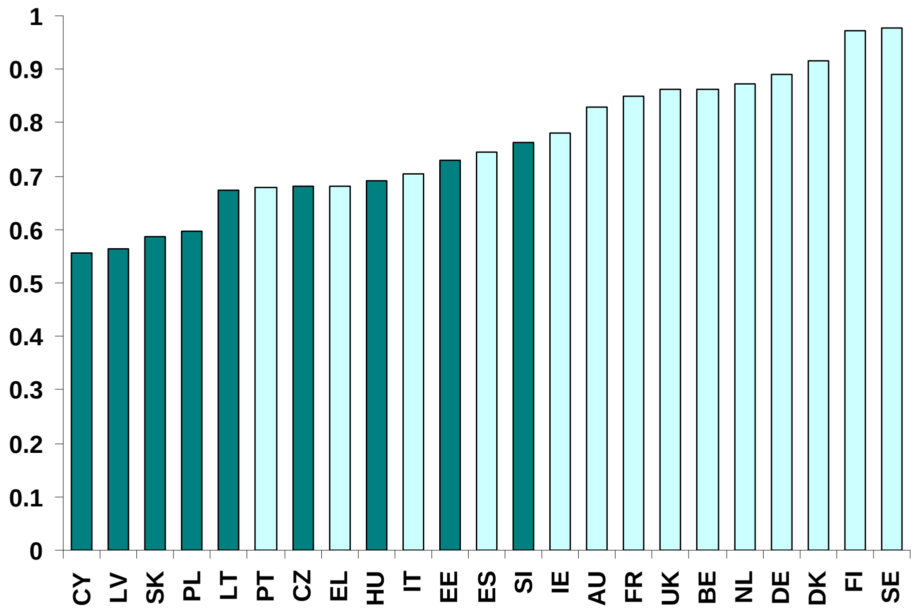
Incentive schemes, such as tax breaks and other financial incentives are used by new Member States to attract foreign direct investment. While the distribution of foreign direct investment across countries is determined primarily by economic fundamentals, such incentives can affect the location choice of multinationals with similar economic fundamentals (Blomström *et al.*, 2003 and European Commission, 2006b). However, these incentives and the downward trend in the level of corporate tax rates in the new Member States may see the effectiveness reduced due to the complexities and inefficiencies of their tax systems which still impose important burdens on businesses. For example, according to World Bank in Slovakia and Poland the fiscal obligations require entrepreneurs to pay 31 and 43 taxes respectively *vis-à-vis* the OECD average of 17. The unpredictability and inefficiency of the legal system is also particularly harmful for foreign investors who are less familiar with the specificities of the local business environment. The lack of transparency and consistency in law enforcement, particularly at the local level, also increases the risk perception of foreign investors, see OECD (2004).

Another factor that hinders the attractiveness potential of these economies is the relatively backwardness of their technological profile *vis-à-vis* most EU-15 economies. However there are important differences amongst the new Member States (Graph 41). Slovenia, Estonia, Hungary, the Czech Republic and to a lesser extent Lithuania clearly outperform their counterparts. Moreover while there is a noticeable catching up process in Latvia, the Czech Republic and Slovakia, Cyprus and Poland seem to be diverging *vis-à-vis* the EU-25 (Graph 42).

Low levels of technological intensity and the relative backwardness of local producers explain why, within the EU-wide production sharing phenomenon, the new Member States have so far been focused on assembly and simple operations reducing the potential for technology diffusion (Damijan, 2005). In addition, the technological gap between local firms and foreign multinationals also means that often the former cannot withstand the added competition pressure from multinationals.

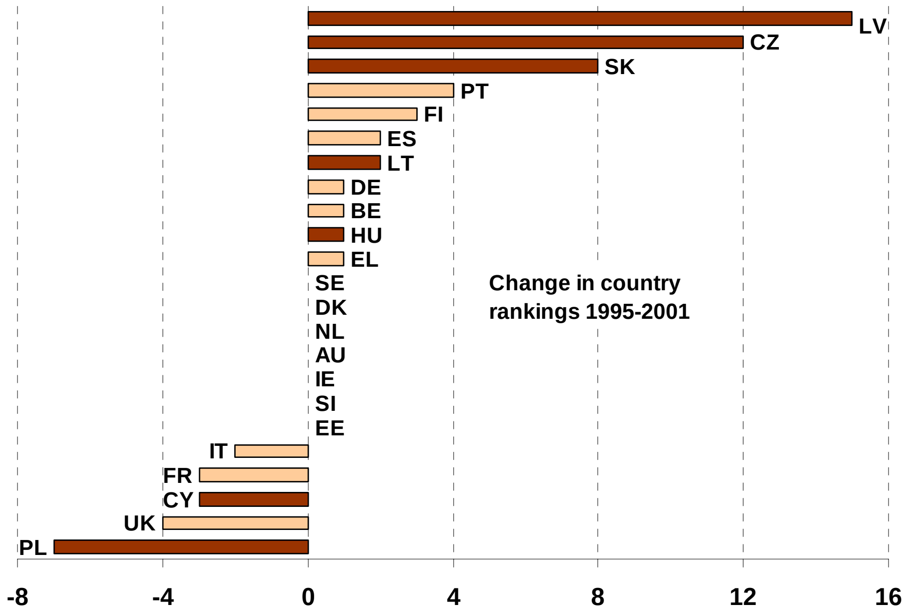
Ultimately, catching up to EU-15 will gradually erode their labour cost advantage *vis-à-vis* the EU-15. The role of their institutional idiosyncrasies and technological profile will necessarily become increasingly important to ensure their long-run competitiveness *vis-à-vis* the more technology-driven EU-15 economies and low cost locations like Romania and Bulgaria (due for EU accession in 2007) as well other dynamic economies like India and China. In this light, ensuring that the business environment is conducive to stronger competition levels and becomes more innovation-oriented will contribute to reduce the new Member States vulnerability *vis-à-vis* alternative locations for production. Additionally such policy measures will also contribute to improve the absorptive capacity of these economies eventually facilitating the intra-firm diffusion of technology.

Graph 41: Technological activity index (2001)



Source: UNCTAD

Graph 42: Technological activity index



Source: UNCTAD

6. MIGRATION AND FREE MOVEMENT OF WORKERS

Accession to the EU implies ultimately unrestricted mutual access to each member state's labour market. Freedom of mobility is after all one of the four freedoms established by the Treaties. This chapter reviews issues related to migration and freedom of movement of workers and of people, and concludes that the potential threats that have dominated emotively recent enlargement debates are overplayed; they are not supported by evidence nor is the potential for large migratory flows from the new Member States to the EU-15 is consistent, on the basis of recent trends, with rational reasoning.

6.1. Potential migratory flows

Given that barriers to trade, FDI and other capital movements had already been largely removed prior to enlargement, the free movement of persons and workers constituted the probably most significant dimension of economic integration which were to change after accession compared to the status-quo. As of 1st of May 2004, the movement of persons within the enlarged EU is to be considered as a matter of internal mobility.

It goes without saying that any projection of east-west migratory flows following enlargement is subject to a considerable degree of uncertainty, and analysis of developments thus far is hampered by data limitations. Certainly, the large gaps in per capita income and wages across the enlarged EU provide high incentives for east-west mobility, which are likely to persist for quite some time; furthermore, geographical proximity and established historical and cultural ties may ease migration flows.

There have been more that thirty studies on the potential migration effects of enlargement with most estimating the long run migration potential for the EU of between 2-4% of the source populations of the CEECs. Cumulated over 15 years, the absolute net number of migrants has been estimated at around 3 million people. This would correspond to about 1.2 percent of the projected working-age population of the former EU-15 in 2020. The short-run annual impact under the assumption of a completely unrestricted flow of workers was estimated at 300-350 thousand in the first few years following enlargement (ECFIN (2001); Boeri and Bruecker, 2003).

Even after allowing for a significant upward margin of error, these numbers are simply not large enough to affect the EU labour market in general. In summary, thus, these projections suggested that from an overall economic perspective potential east-west net flows of labour following enlargement do not appear to pose any serious threat to jobs and wages in the EU as whole. However, assuming that migration streams from the EU-8 could flow along existing immigration networks and geographic distance, there were serious concerns that some countries and regions, in particular Austria and Germany, could indeed face some short-run adjustment problems to cross-border labour flows, including commuting, which were feared to cause labour market disturbances.

As in previous enlargements, temporary arrangements with respect to labour mobility to ensure a smooth process of integration have been agreed upon and included in the accession treaties. The system of provisional arrangements combines a two-phased transition period of 5 years (with a review after 2 years) and a possibility for a prolongation for individual Member States, if requested, of a maximum period of 2 years. As a result the *acquis* will be applied fully after a maximum period of 7 years in all Member States.

However, the economic rationale for maintaining restrictions on the free movement of workers after the date of accession is weaker than often assumed in the popular debate. While the income gap between the new Member States and the EU-15 is likely to diminish to some extent over the transition period, the basic incentives to migrate will – in all likelihood – not be fundamentally different from now. In any case, applying temporary curbs on labour mobility from the new Member States will only delay the overall movement of workers and, in the meantime, introduce “biased” destination patterns of the flows into the EU-15, with the risk to distort mobility even on a more permanent basis[57].

Box 7: Transitional arrangements on free movement of workers

1. Free movement of persons is one of the most fundamental freedoms guaranteed by Community law. It includes the right for EU nationals to move to another EU Member State to take up employment and to establish themselves in the host State with their family members. EU Member States are precluded from directly or indirectly discriminating against migrant workers and their families on the basis of their nationality. EU migrant workers and their families are entitled to equal treatment not only in employment related matters, but also as regards public housing, fiscal advantages and social advantages. Removing barriers to mobility between and within Member States is also placed central in the renewed Lisbon Agenda.

2. The transitional arrangements (TA) set out in the Accession Treaty of 2003 allow for limited derogations from the principles set out in the preceding paragraph, during a transitional period which will irrevocably come to an end on 30 April 2011. The restrictions can only be applied to migrant workers, and not to any other categories of EU citizens. Further, the restrictions can only apply to obtaining access to the labour market, and can only limit the eligibility for employment in a particular Member State. Once a worker has obtained access to the labour market of a particular Member State Community law on equal treatment as regards remuneration, other employment related matters, and as regards access to social and tax advantages applies. In other words, no discrimination whatsoever is allowed on the ground of nationality between legally employed workers, regardless of whether they come from EU-15 Member States or EU-10 Member States. Further, there are no transitional arrangements for the application of the Community law on the coordination of social security schemes.

3. The transitional period is divided in three distinct phases, according to the "2-plus 3-plus 2 years" formula. Different conditions apply during each of these phases.

4. The Accession Treaty provides that for the first two years of the TA, EU-15 Member States will apply national measures, or those resulting from bilateral agreements to regulate access to their labour markets by EU-8 nationals. The diverse national measures taken during this first phase of the TA resulted in legally different regimes for access to the labour markets of the EU-25. Sweden and Ireland decided not to apply restrictions on access to their labour markets by EU-8 nationals. The UK has no ex-ante restrictions either but has a Workers Registration Scheme. All other EU-15 countries maintained a work permit regime, sometimes combined with quotas. No TA exist for Cyprus. Malta issues work permits for monitoring purposes. Poland, Slovenia and Hungary apply reciprocal restrictions to nationals from the EU-15 Member States applying restrictions. All EU-10 Member States have opened their labour markets to workers of EU-10 Member States.

5. The first phase of the transitional arrangements started on 1 May 2004 and ends on 30 April 2006. The Accession Treaty states that before the end of this phase, the Council shall review the functioning of the TA on the basis of a Commission report. On completion of this review, and no later than at the end of the two-year period following the date of accession, the EU-15 Member States must notify the Commission of their intentions with regard to the second phase of the TA. In the absence of notification, Community law on free movement of workers will apply for the second period (1 May 2006-30 April 2009). Those who wish to continue applying national measures will still be allowed to do so. Four Member States (Greece, Spain, Portugal and Finland) have decided to lift restrictions for the second, three-year phase of the transitional arrangements, while six others (Belgium, Denmark, France, Italy, the Netherlands and Luxembourg) have decided to alleviate them.

[57] Moreover, restrictions on legal work could actually lead to a proliferation of undocumented work, bogus "self-employed" work, and fictitious service provision and sub-contracting.

6. As a general principle all national measures relating to labour market access should cease to apply by 30 April 2009. Nevertheless, a Member State may continue applying national measures (subject to the notification procedure as above) for a maximum period of two further years but only in case of serious disturbances of its labour market or a threat there of.

7. In any event, the Accession Treaty provides that Member States that decide to lift restrictions from 1 May 2006 will have, throughout the remainder of the transitional period, the possibility to reintroduce restrictions using the safeguard procedure set out in the Accession Treaty, should they undergo or foresee disturbances on their labour markets. The Accession Treaty also lays down that, notwithstanding restrictions applied by Member States, they shall give preference to workers who are nationals of EU-8 Member States over workers who are nationals of third countries as regards access to their labour market.

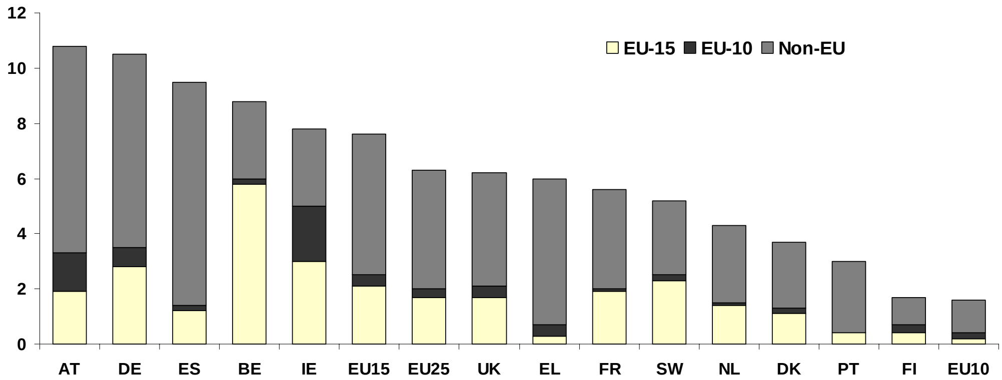
Note: Freedom of movement of workers (Art. 39 EC) must legally be distinguished from freedom of establishment (Art. 43 EC) and freedom to provide services (Art. 49 EC). The posted workers' Directive, which relates to the latter freedom, is not subject to transitional arrangements although Germany and Austria are allowed to apply restrictions on the cross-border provisions of services in certain sensitive sectors involving the temporary posting of workers. The posted workers' Directive applies to undertakings established in a Member State which in the framework of the cross-border provision of services, post workers to work temporarily in a Member State other than the State in which they habitually carry out their work in performance of their contract. The Directive seeks to guarantee that posted workers enjoy, whatever the law applicable to the employment relationship, the application of certain minimum protective provisions in force in the Member State to which they are posted. To this end, Article 3(1) of the Directive provides that posted workers have to be guaranteed, during the period of posting, a number of terms and conditions of employment in force in the host Member State such as the minimum rates of pay, the maximum work periods and minimum rest periods and the rules regarding health, safety and hygiene at work.

6.2. Developments so far

Developments so far have indeed broadly corresponded to prior expectations (see for a comprehensive analysis European Commission, 2006). Since enlargement there has been an increase in the number of EU-8 workers in EU-15 Member States. However, despite this increase, the relative impact, as measured by the number of permits issued for reason of employment as a proportion of the host country's working age population, is rather limited. Furthermore, the number of resident and work permits issued at any point in time overestimates the actual number of EU-8 nationals that have settled in the host country, because it does not take into account people returning to their countries of origin, i.e. the outflows, and the length of the work permits. The same is true in view of the fact that the data may reflect temporary factors such as regularisation of illegal migrants who have moved to EU-15 Member States over several years. Overall, the percentage of EU-8 nationals in the resident population of each EU-15 Member State was relatively stable before and after enlargement, with increases in the UK and, more conspicuously, in Austria and in Ireland.

According to the Ministry of Labour in Poland, in the first year of Poland's EU membership the volume of migration amounted to 407,150, including 340,530 seasonal workers. The largest number of Poles, 250,000 people, worked in Germany. Some 15 per cent of the total number of Poles working abroad found employment in countries which fully opened their labour markets: 10,000 in Ireland, 12,000 in Sweden and 40,000 in the UK. Overall, including short-term stays the UK registered some 350,000 workers from the new Member States in the first 20 months since May 2004, mainly from Poland and Lithuania; in Ireland, around 140,000 Social Security numbers were issued to people from the new Member States.

Graph 43: Share of foreign nationals in resident working age population, 2005



Source: European Commission (2006a)

There is no evidence that migration flows from the EU-8 have caused significant labour market disturbances in the EU-15 countries. However, the emerged destination patterns lend some support to the view that mobility flows may have to some extent been “diverted” to countries with unrestricted access and highly absorptive labour markets such as in Ireland and the UK.

It may also be interesting to note that in most Member States the percentage of foreign nationals from non-EU countries is significantly higher than the one for EU nationals. This implies that migration from third countries is a much more important phenomenon than intra-EU mobility, both within the EU-15 and the EU-25.

An important conclusion from both the east-west migration potential studies and the developments so far is the need to differentiate between various types of migration, in particular distinguishing between short-term and more permanent movement. Existing survey studies do suggest, for example, that the propensity for permanent emigration is fairly small for Czechs, Poles and Hungarians, while the preference for short-term migration, including cross-border commuting, seasonal and casual work is clearly much higher. Such patterns of "incomplete migration", where those involved make frequent short-duration trips abroad to earn a living while maintaining a home in the origin country, already existed before enlargement, both in legal and illegal forms[58]. Thus, it is not implausible to assume that incomplete migration will continue to be the more important type of east-west labour flows following accession than conventional migration.

6.3. Further comments on the potential of east-west labour flows

Given the unique combination of long common borders with almost no geographical barriers and high permeability between countries with very different income levels, one might also envisage, in particular, an upsurge in cross-border commuting, perhaps on a weekly or even longer term basis. Indeed, combining the high wage levels in economies such as Austria or Germany with the low cost of living at the original place of residence may form an attractive option for workers from the neighbouring countries. It is difficult to project cross-border

[58] Salt et al. (1999) distinguish two types of so-called labour tourists: (a) short-term income-seeking workers, often without appropriate documents whose average stay is 2-4 months, currently estimated to number 600-700.000 annually (Morawska, 1999); and (b) a smaller group of contracted temporary workers, about 300.000 in number.

commuting potentials; in particular, historical experience offers little guidance, since earlier enlargements of the EU did not encompass integration of high wage and low wage economies with such high population densities in the immediate vicinities of the borders. Existing estimates of the commuting potential between Austria and its CEEC neighbours, for example, put the numbers at between 40 000 up to 110,000 over the first five years, with some estimates as high as 200,000 or more over a ten year period.

A related phenomenon, probably again affecting particularly border regions adjoining the EU8, has been the cross-border provision of services, including construction, through posted workers or self-employed. Following the "Rush Portuguesa" judgement, the EC Directive 96/71/EC has brought an obligation to uphold certain minimum wage and working conditions prevailing in the countries receiving temporarily posted workers. However, recent EU experience clearly suggests that legal enforcement can be difficult to achieve; lacunae in enforcement by national authorities of existing Community and national legislation may indeed have created an adverse and wrong impression of enlargement and of the benefits of free movement of workers in some countries. But perhaps more important, even when the respective minimum requirements as regards wage rates and other employment conditions are honoured, the labour cost of posted workers may fall considerably short of the going effective wages for native workers.

The likely types of east-west labour flows are intimately interrelated with the personal profiles of the migrants. To the extent that labour flows will continue to be predominantly of the temporary, incomplete migration type, the majority of migrants can be expected to be young, single males, while family migration may be of somewhat less importance, at least in the initial years. However, concurrent with EU enlargement, about 1 million citizens of new EU members now lawfully residing in one of the old EU-15 Member State have acquired the right to bring in dependent family members, representing a considerable potential for family reunification. The same will be true for another 650,000 legal residents of Bulgarian, Croatian and Romanian nationality after their accession.

An important question concerns the skill distribution of migrants. In general, emigration is selective, in that the better off move: the old adage that "migrants move from positions of strength" seems to be applicable. However, the jobs taken in destination countries are frequently of a lower qualification level than those left, with migrants going into construction, manufacturing and low skill service jobs. Morawska (1999), putting together evidence from various studies, suggested that 12-14 per cent of post-1989 westbound migration could be classed as highly skilled comprising, *inter alia*, managers, scientists and researchers, and students (cited in Salt, 1999).

In general, human capital endowments of the CEE countries, measured by formal indicators such as school enrolment rates and average years of schooling, are higher than those of countries with comparable income levels, exceeding also those of the Southern EU Member States, and almost matching those of the other EU Member States. However, formal enrolment rates may not be easily comparable given the fairly different educational systems; moreover, there is evidence that the quality of education falls considerably short of average standards in the EU.

EU-10 nationals currently in the EU-15 are disproportionately represented in the medium skill category (up to 60%). In general, lower reservation wages (in the sense of accepting jobs of a lower calibre than, in principle, being qualified for) may put immigrants on a competitive advantage relative to the indigenous workforce. However, both insider-outsider and efficiency wage considerations do suggest that "underbidding" may not be a real-world option in many cases. At the upper end of the job spectrum one might find a group of highly skilled immigrants, comprising for example groups such as professional support personnel and managerial representatives or scientists, researchers and specialists in various fields, in particular where a "common language of understanding" can be easily established.

A special migrant group is likely to be formed by students from the EU-8 receiving tertiary education in countries of the EU-15. At present, their number is still relatively low, according to recent statistics. While a trend increase in these numbers appears fairly likely, it remains unclear, though, what proportion of the foreign students will enter the labour force of their host country during or after their studies.

Box 8: Student exchange programme

The exchange programmes for young people and students are among the most visible political initiatives and the most promising in terms of the furthering of European integration.

Among them, the most significant are Erasmus, Léonardo da Vinci, Comenius, Grundtvig, in a transverse way Jean Monnet, or in a rather different context the Youth Programmes. Within the framework of the enlargement policy, they were incorporated very early into the pre-accession process. We thus have had a certain period of time to evaluate the successes of this policy in the new Member States.

If, for example, we choose the Erasmus programme which is probably the most illustrative one, we understand very well this rapid and very interesting development.

From 1998/99 to 2003/04 the ten new Member States had almost 75000 students receiving Erasmus grants, with a constant progression (from less than 5000 the first year to almost 20000 in 2004). Among them, Poland passed from 1400 students in 1998/99 to 6300 in 2003/04, to a total of almost 24,000 students, and the Czech Republic from 900 in 1998/99 to 3600 in 2003/04, giving a total of more than 13000 students.

The favourable results of this policy should not, however, be appreciated only by quantification of the number of grants allocated by country, but also by the fact that the students of the European Union increasingly requested to go to carry out at least a six-month study period in one of the new Member States. Thus, while in 1998/99 the Czech Republic and Poland had attracted slightly more than 200 students each, in 2003/04 Poland received about 4,500 and the Czech Republic roughly 4,200. This favourable development is noted, on a lesser scale, given the size of the countries, in all the new Member States.

This involves, therefore, fantastic mixing of young people between the 25 Member States of the European Union which shows the major success of this policy, while, few years before, the exchange was completely pointless. Although formally independent of the enlargement policy of the European Union, this policy can, to a rather large extent, be given credit for this development, such has been the enthusiasm that it had generated among youth.

The favourable results achieved as regards students' mobility under the Erasmus programmes are also found among teachers, since between 1997/98 and 2003/04 there were almost 20,000 teachers of the new Member States who achieved mobility in the European Union, of which more than 3,000 alone were Czech.

Since 2000/01 more than 2600 of the teachers of the European Union have also had the possibility of going to carry out a training period, of different lengths of time, in one of the new Member States. Two thousand six hundred went to Poland between 2000/01 and 2003/04 and more than 2200 to Romania.

The other programmes of the Union (Léonardo da Vinci, Comenius, Grundtvig, Jean Monnet, Youth, etc) have experienced comparable developments.

With these policies, we have one of the illustrative examples of the success of European integration and of the incorporation of the new states, who currently establish the foundations for the Europe of tomorrow.

7. ENLARGMENT AND TAX SYSTEMS

The new Member States' tax systems are in many respects different from those in EU-15. In some cases, this may be to their benefit as their overall tax revenues and nominal and effective corporate tax rates are lower than in the old Member States thus creating stronger incentives to engage in productive economic activity. However, indirect taxes and social contributions play a more important part in budget revenues in the new Member States, affecting adversely labour utilization. Moreover, developments affect the corporate tax advantage built up by new Member States in recent years. First, there are signs that these advantages developed during the 1990s are beginning to erode as preferential tax regimes had to be abandoned upon accession. More recently, some new Member States have moved towards establishing a flat tax system.

It is important to recall that taxation is only one factor in corporate location decisions and perhaps a less important one than others. Disadvantages continue to characterize the new Member States as attractive locations for production compared to other locations in the EU and elsewhere – their markets are smaller both in terms of size and purchasing power and their economic governance and institutions are continuing to develop. While it is true that economic development cannot be built on taxes alone, a lower tax environment may offset some of these disadvantages but it may not offset other disadvantages present in the business environment. Even though differences in tax structures can, *ceteris paribus*, be an instrument in the new Member States' convergence process, it cannot substitute for the fundamental reforms in the business environment that ultimately determine the allocation of economic activity in space.

7.1. Significant differences in tax systems

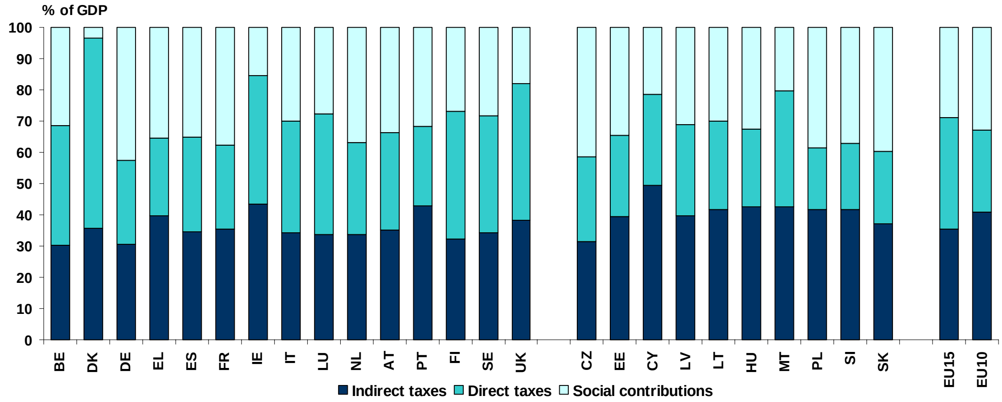
Bearing in mind the inherent heterogeneity of tax systems, it is perhaps not surprising that there are significant differences between the new and the old Member States' tax systems. To begin with, the new Member States raise less tax. A majority of them (Lithuania, Latvia, Malta, Cyprus, Slovakia, Estonia and the Czech Republic) raise less tax but in three countries (Hungary, Poland and Slovenia) revenues raised are not very different from the majority of the EU-15. There are, however, considerable differences within the EU-15 ranging from Ireland's tax revenues of just above 30% of GDP to Sweden's higher than 50%.

The structure of tax revenues differs between new and old Member States, as the former raise relatively little revenue from direct taxation (personal and corporate income tax) and proportionately more from indirect taxation (VAT in particular) and social contributions (Graph 44). While direct tax revenues represent more than one third on average in total revenues in EU-15, these are closer to 20% in the new Member States.

The new Member States collect less tax from the corporate sector than the old and, as can be seen in Graph 45, corporate tax revenues are less important both in terms of its share of GDP and relative to other tax sources.

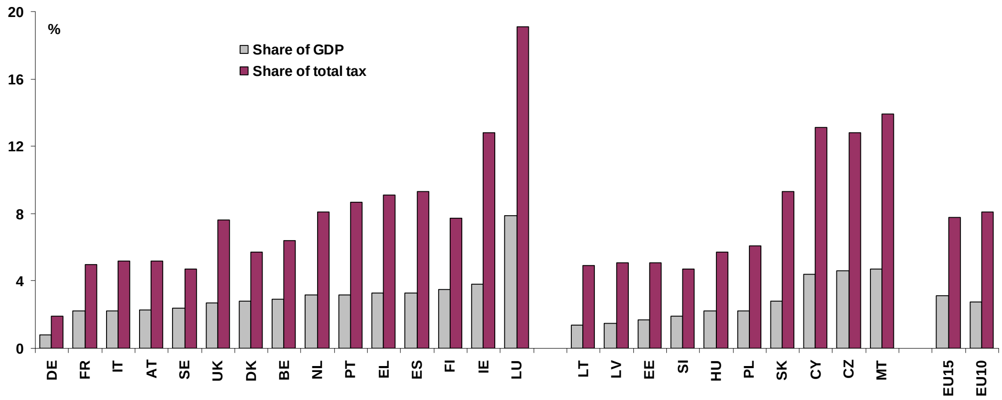
Corporate tax rates are generally lower in the new Member States. While the average corporate tax rate in EU-15 is around 30%, it averages nearly 10 percentage points lower in the new Member States (Graph 46). However, corporate tax rates in the new Member States vary widely, and the differences fall comfortably within the range of Ireland's 12.5% and Germany's rate just below the 40% mark. Finally, while EU-15 Member States have reduced rates and have broadened tax bases since the 1980s the new Member States have cut rates more aggressively, especially since the late 1990s.

Graph 44: Structure of tax revenues 2003



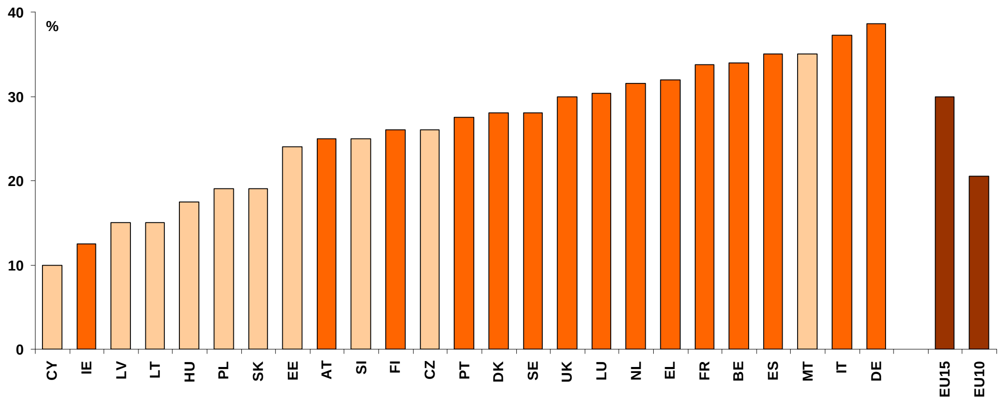
Source: European Commission (2005)

Graph 45: Corporate tax share, 2003



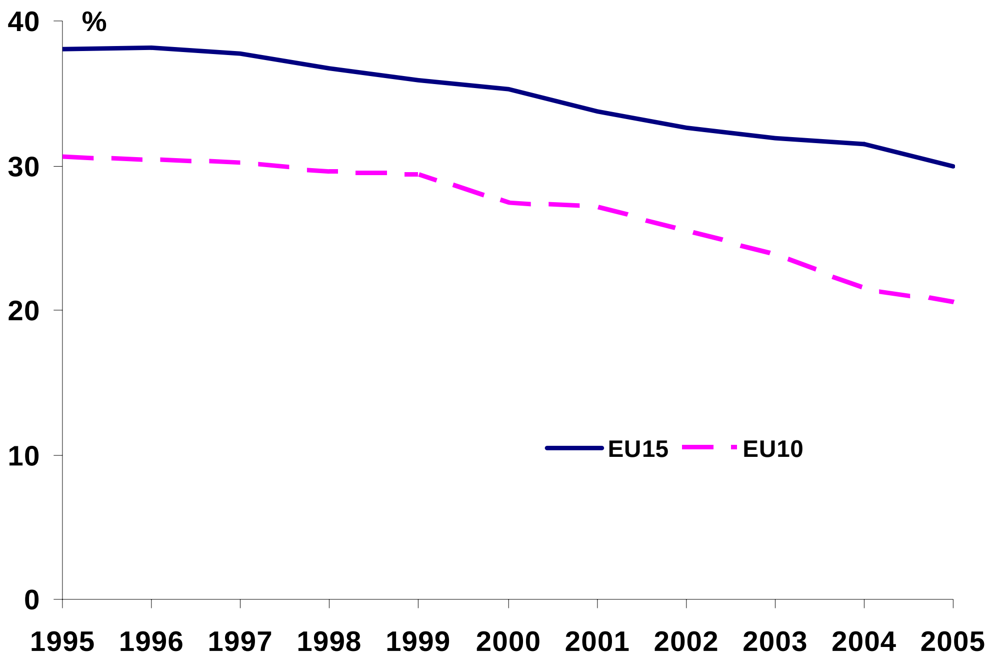
Source: European Commission (2005)

Graph 46: Nominal corporate tax rates, 2005



Source: European Commission (2005)

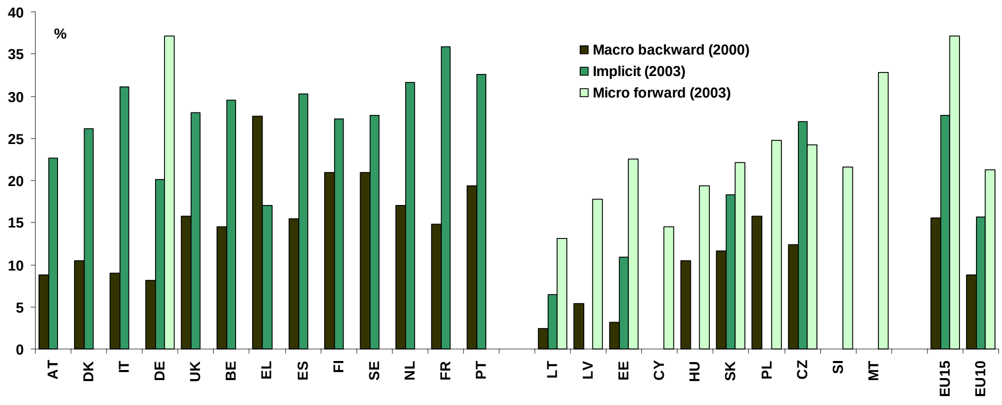
Graph 47: Evolution of corporate tax rates



Source: Commission services

Nominal tax rates provide little meaningful information about the effective tax burden borne by corporations (as note previously, Germany collects relatively little corporate revenue in spite of its high corporate tax rate) unless the definition of the tax base is considered and, in the case of corporate taxation, the base in question is the taxable profit on which the rate is applied.

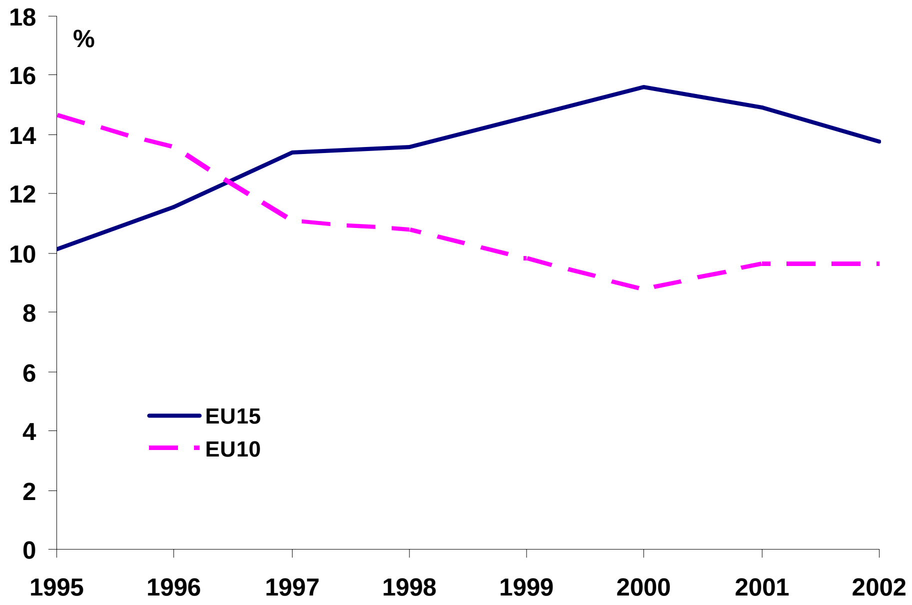
Graph 48: Different measures of effective corporate tax rates



Sources: World Bank, 2004 (Macro backward looking); European Commission, 2005 (Implicit rates on capital); ZEW, 2004 (Micro forward looking)

There is often a wide difference between profits in the financial reporting sense of the word and what constitutes profits for tax purposes, as tax authorities often grant various exemptions and allowances: (i) tax authorities can exclude some income from the tax base (exemptions), (ii) they can also allow corporations to make deductions from their gross income (allowances), (iii), authorities can apply a reduced rate (rate relief) to a specific class of taxpayers, (iv) they can allow deductions from tax liabilities, or so-called tax credits, and (v) authorities can also grant companies a delay in paying their taxes (deferral)[59]. Inevitably, each country has its own history of exemptions etc, and for these reasons it is difficult to compare corporate tax bases across countries. However, the overall tax pressure can be estimated through the so-called *effective tax rates*[60]. Three versions of these estimates are presented in Graph 48. The estimates confirm that the effective corporate tax rates in the new Member States are significantly lower than in the EU-15[61]. At the same time, the new Member States are not alone in having low effective corporate tax rates. Just as noted previously with the nominal tax rates, the data in Graph 48 show that the experience in the EU-15 is quite diverse[62]. Therefore, it is difficult to conclude that the new Member States are unique in pursuing low corporate taxation, for whatever motive.

Graph 49: Evolution effective average corporate tax rates



Source: World Bank/Laursen (2004)

Nevertheless, some estimates suggest that while the new Member States built up a significant tax gap with the EU-15 during the second half of the 1990s but this gap has since been closing – see the data in Graph 49. One reason for this may be that the new Member States had to eliminate preferential tax regimes aimed at attracting investment during the accession

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59 The World Bank (2004).

60 There are two approaches for calculating effective rates. One method looks at historic data ("backward-looking" or "implicit tax rates). It either uses national accounts (macro) or firms' financial data (micro), subsequently dividing that with a measure of the tax base (e.g. GDP, aggregate corporate profits…). Another method constructs a hypothetical investment project and based on a number of assumptions calculates the tax burden for the assumed life of the project ("*forward-looking*"). Each method has its weaknesses. For example, macro-backward looking approaches tend to underestimate effective taxation. For further details see Nicodeme (2001).

61 Data from the World Bank (2004). The approach is macro backward-looking: corporate tax revenues taken from a European Commission database; data on the tax base taken from the Commission's AMECO data base and represented by gross operating profits of financial and non-financial corporations.

62 In view of the data and methodological problems such results should be interpreted with caution. For example, as illustrated later in the text, different measures of effective rates estimated on the basis of differing methods often arrive at widely divergent results.

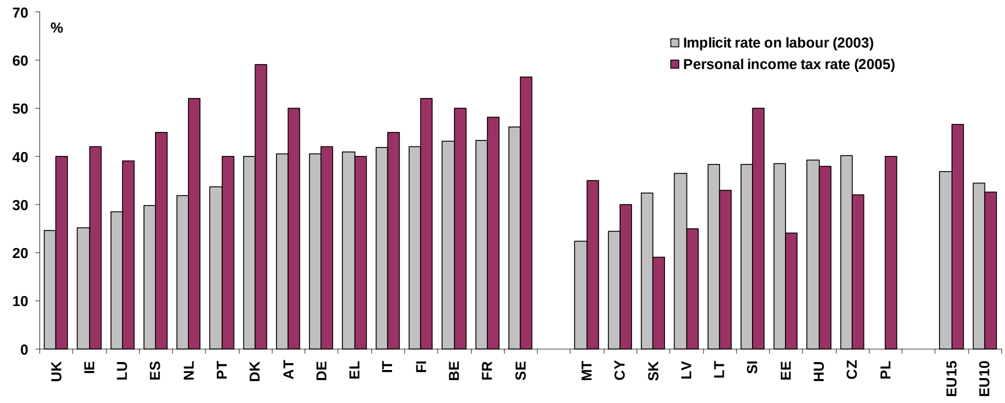
process, as in the large majority of cases these were inconsistent with EU state aid rules. To compensate for this base broadening, the new Member States have resorted to cutting corporate tax rates. The net effect, as suggested below, appears to be a small increase in the effective tax burden. Another reason is tax reform in the EU-15 that has contributed to decreasing effective rates.

7.2. Taxation and attracting international investment

In the relocation debate, the argument has been advanced that relocation may be driven by differences in corporate tax rates between Member States. However, international investment appears driven mainly by other factors, such as unit labour costs or agglomeration economies (geographical location advantages, market size, external economies, the general business environment, human capital) leading to spatial concentration. Moreover, the effect of taxation on corporate revenues, and hence on investment decisions, is likely to depend more significantly on several other aspects of the overall tax system, including labour taxation, the tax base and the overall transparency and integration of the corporate tax system. Direct personal income tax rates and revenue raised from such taxes are lower in the new Member States than in the EU-15 but the implicit tax rate on labour is not significantly different between new and old Member States (Graph 50). Moreover, social security contributions constitute an important part of the new Member States aggregate tax revenues (Graph 44) and this undoubtedly has an impact on companies' decisions where to locate as they raise, *ceteris paribus*, the cost of labour. Very important from a corporate perspective is also how well integrated a particular tax system is with other countries' tax systems. More specifically, rules on (i) double taxation, (ii) shifts of corporate income between parent and subsidiaries and (iii) transfer pricing fundamentally affects the final corporate tax burden associated with any particular country.

Despite a decline in corporate tax rates and changes in tax rate differentials between countries, taxes paid by EU companies as a share of GDP remained fairly stable in the last decade, both in old and new Member States. Reasons for this are likely to include a general broadening of tax bases or, for some Member States, increased profits reflecting higher returns to capital. Furthermore, there remain differences in effective rates which indicate that tax arbitrage is far from perfect. Overall, this seems to confirm that corporate tax rates as such have been less relevant in affecting investment decisions. The literature often suggests other factors as equally or more important (see European Commission (2006b) for a discussion of some of these issues). Typically, taxation should intervene as a determining variable quite late in the investment location decision process. First, firms decide in which regions to locate, determined by factors such as market size, external economies and overall investment climate. Then, firms would in principle assess the state of micro-economic conditions. Beyond that stage, the precise decision in which country to locate becomes increasingly a function of tax variables. And, finally, taxation can have quite important effects on the form and the financing of the investment, for example, in which market to raise funds to finance the project (host, home, third country), in what form and for what duration.

Graph 50: Tax burden on labour

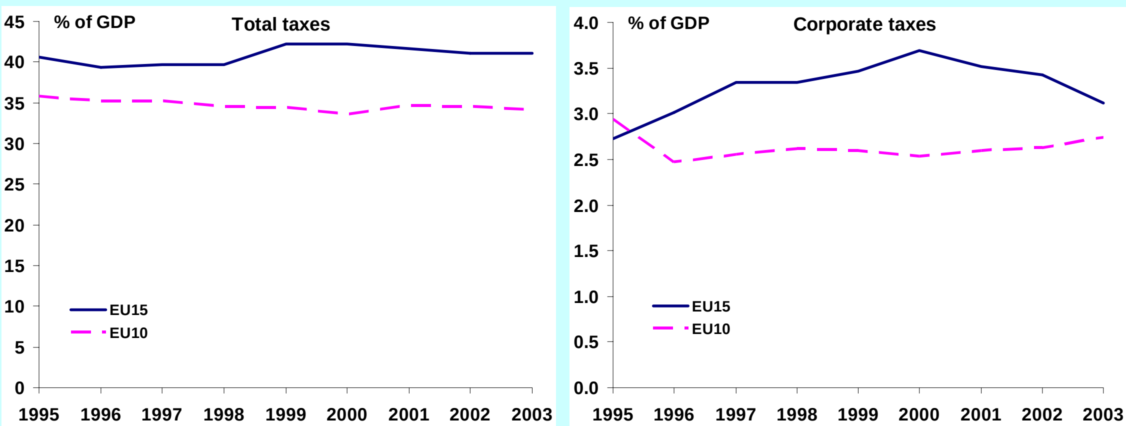


Source: European Commission (2005)

Box 9: Tax levels and the new Member States

Countries compete to attract economic activity; one of the instruments they use is taxation. Concern has been raised that countries may compete excessively with each other in this regard and thus be unable to finance an optimal level of public goods. It is suggested that such behaviour could lead to a “race to the bottom” in tax rates or revenues. In recent years, there has been a proliferation of special tax regimes favouring a variety of investment activities and some apparently have been effective in attracting international investment. Tax regimes and preferences, including the commitment to low (effective) tax rates, constitute attractive location characteristics for international investors even if they play only a secondary role in final investment decisions.

The notion that differences in the tax treatment of various sources of income and of spending may be harmful is a contentious one. Many economists regard such differences as reflecting national preferences if not outright as beneficial. They ensure, for example, that taxes are efficiently used and they exert, ceteris paribus, downward pressure on the price, in this case tax levels. Moreover, there is a legitimate case for differences in taxation between countries, as countries have different preferences over the level and type of taxation. Indeed, in a seminal article on these issues,, Charles Tiebout stated that societies desire different levels of public services and therefore are prepared to pay different taxes optimal (Tiebout, 1956). An international tax system that allows a company to locate in one country because this country provides a level of public services to its liking is thus optimal. Are, therefore, such differences in tax systems always beneficial according to Tiebout’s logic? Tiebout’s assumption only holds if the beneviciaries, including corporations, benefit from *less* public service if they go to a low-tax jurisdiction. However, the problem with the variety of special regimes targeting specific sectors or activities is that beneficiaries of lower tax territories continue to benefit from a high level of public services (Avi-Yonah, 2000).



Source: Commission services

If mobile factors of production choose to locate in low tax jurisdictions, then it is theoretically possible that factor mobility will limit the extent to which tax levels can be raised. Since the most mobile factor is capital, this implies that such limits, if not downward pressure, would be encountered principally in the taxation of capital forcing e boarder decline in tax levels. However, empirical evidence of such a “race to the bottom” is not conclusive. There has indeed been a general decrease in nominal and effective corporate tax rates, but this has not so far affected the level of tax revenues. The decrease in the share of corporate taxes in GDP since 2000 reflects cyclical factors and is probably more due to the economic slowdown than differences in the tax treatment of corporate entities per se. However, such differences may be affecting the distribution of the tax burden. While corporate tax revenues as part of total tax revenues have remained stable over time, it is often argued that taxation of labour has become the principal bearer of the tax burden[63]. Indeed, economic theory suggests that the incidence of corporate taxation would ultimately be borne by labour, the relatively less mobile factor of production. Apart from any equity argument that the tax burden should be more evenly borne by labour and capital, it is argued that the increased taxation of labour would hamper employment creation as it increases the cost of labour. This argument needs, however, to be qualified. Labour yields substantially more tax revenues than corporations. However, revenue from labour taxes has remained stable. In 1995, taxes on labour amounted to 20.4% of GDP in EU15 and 17 in the new Member States. The corresponding estimates for 2003 were nearly identical: 20.4% for EU15 and 15.8% in the new Members. This would imply a refutation of the argument of a wide shift of the tax burden towards labour.

[63] See for example OECD (1998) and CEPS (2000).

8. ENLARGMENT AND FINANCIAL MARKETS

Financial system efficiency impacts on economic performance mainly[64] via the intermediation of savings to investment. By ensuring a more efficient allocation of resources and wider opportunities for risk sharing, an efficient financial system increases the productivity of investment and may increase the level of savings available for productive investment. In addition, financial-system efficiency can facilitate macro-economic management by enhancing the transmission mechanism for monetary policy (Angeloni et al, 2005). While there is no conclusive view on the optimal structure for an efficient financial system, there is a growing consensus that access to both direct (i.e. market-based) and indirect (i.e. bank-based) finance should be available, with the respective share of each depending on the prevailing framework of laws applying to the financial sector.

The EU-10 Member States are a heterogeneous group. Eight of these Member States were transformed from centrally planned to market economy prior to accession and have a small, largely bank-based financial system. Malta and Cyprus were both established market economies prior to accession and have financial systems more similar to the EU-15.

The impact of accession on the financial sector of the EU-10 cannot be isolated from the impact of other fundamental influences. Such influences include the broader process of globalisation, amid the liberalisation of capital movements, financial innovation and rapid advances in information technology. The impacts of globalisation on the financial sectors of the EU-10 have been heightened by efforts to create a single EU market for financial services in the EU and by the plausible prospect of adopting the euro in the medium term.

Overall, improved access to foreign financial markets has allowed companies and households in the EU-8 to find cheaper financing and has stimulating growth in firms sales, assets and leverage (Gianetti and Ongena, 2005), thereby supporting the catching-up process. Although the direct impact of enlargement for EU-15 financial systems has been more limited, it has offered new growth markets and opportunities for portfolio diversification. Moreover, by highlighting some of the challenges in managing a highly integrated financial system, it has initiated a debate on necessary reforms of the EU supervisory framework.

8.1. Financial deepening in the new Member States

The financial sectors of the new Member States are small relative to the EU-15 average. Total financial assets in the these Member States range from about 200% to 450% of GDP, compared to a range of about 550% to 1300% in the EU-15 (Table 10). Bank intermediation (as measured by the ratio of credit institutions’ assets to GDP) is low and capital markets are even less developed. In contrast, the structure of the financial system in Cyprus and Malta is much closer to that of the EU-15, although their capital markets are comparably small and illiquid (Graph 54).

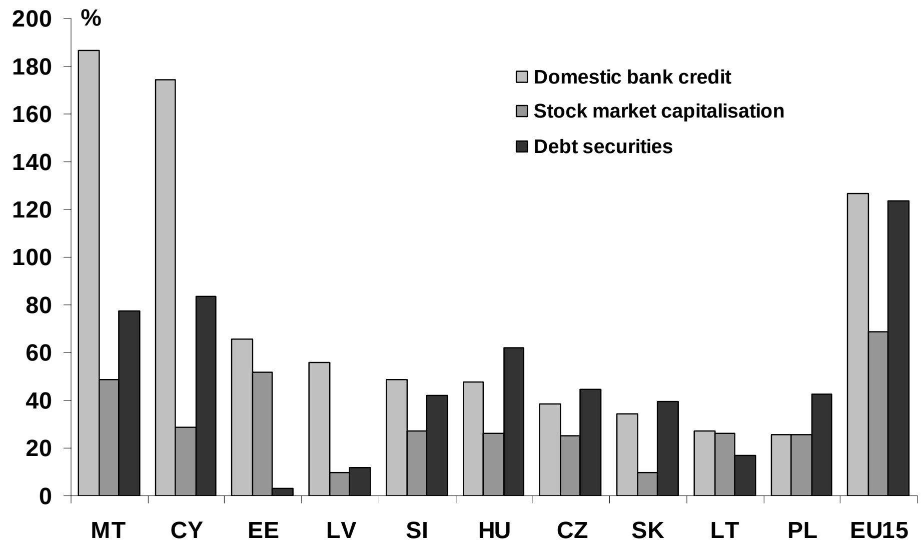
64 See Levine (1997) and Thiel (2001) for comprehensive surveys of this literature.

Table 10: Total financial assests as % of GDP in EU-10 and EU-15, 1998-2004

	1998	1999	2000	2001	2002	2003	2004
NL	947.4	1025.5	1253.7	1191.0	1144.7	1215.7	1271.6
UK	979.7	1061.5	1098.2	1063.5	996.7	1067.8	1124.1
BE	924.0	990.0	988.4	1005.0	951.6	996.5	1035.9
CY	**788.1**	**1061.3**	**954.7**	**916.2**	**941.8**	**929.9**	**n/a**
FR	744.7	869.0	881.5	848.0	808.4	849.6	891.9
DK	719.1	792.1	788.5	791.6	788.7	829.3	906.9
SE	741.1	788.5	822.3	831.0	783.3	806.6	829.2
PT	659.2	693.3	708.4	708.6	696.3	736.7	737.2
DE	643.0	699.5	713.8	716.0	678.5	696.8	702.4
ES	589.6	619.3	624.7	626.0	598.5	638.8	671.2
AT	501.0	544.2	561.3	576.8	577.6	594.9	620.8
IT	544.9	609.9	623.8	595.6	578.9	594.1	610.2
FI	455.3	549.6	526.4	511.6	501.7	543.8	570.3
SI	**n/a**	**n/a**	**n/a**	**391.4**	**413.1**	**415.5**	**422.8**
CZ	**410.6**	**416.9**	**424.3**	**413.9**	**392.6**	**397.1**	**n/a**
EE	**n/a**	**n/a**	**n/a**	**n/a**	**n/a**	**370.5**	**412.9**
HU	**323.0**	**327.6**	**323.2**	**317.6**	**302.2**	**322.2**	**332.3**
PL	**239.3**	**248.1**	**240.2**	**252.2**	**272.1**	**261.5**	**258.9**
LV	**n/a**	**n/a**	**n/a**	**n/a**	**231.4**	**251.7**	**n/a**
LT	**180.6**	**187.7**	**188.0**	**187.2**	**195.9**	**202.4**	**220.8**

Data unavailable for Greece, Ireland, Luxembourg, Malta and Slovakia
Source: Eurostat

Graph 51: Financial structures in EU-10 and EU-15 average at end-2004



Source: European Banking Federation; Federation of European Stock Exchanges; ECB; Eurostat; Commission services calculations

Institutional reforms in preparation for accession have facilitated financial deepening. The EU-10 were required to remove remaining barriers to the free movement of capital[65] and to bring the legal and regulatory framework for their financial sectors into line with those applicable to the EU as a whole. By 2004, practically full compliance had been achieved in

65 OECD membership had already been instrumental in liberalising capital transactions in several of them.

respect of the free movement of capital and company law, some countries having retained specific transitional arrangements in relation to the freedom to provide financial services and/or a limited number of derogations in the taxation area. Since they have joined the EU, most of the new Member States have been particularly efficient in transposing the financial services directives of the Financial Services Action Plan. The substantial progress made in developing the conditions of effective prudential regulation and supervision necessary for an efficiently functioning financial system have been confirmed by assessments undertaken by the IMF (Financial Sector Assessment Programs) and indicators of financial reform published by the EBRD (Table 11).

Table 11: EBRD transition indicator scores, 2005

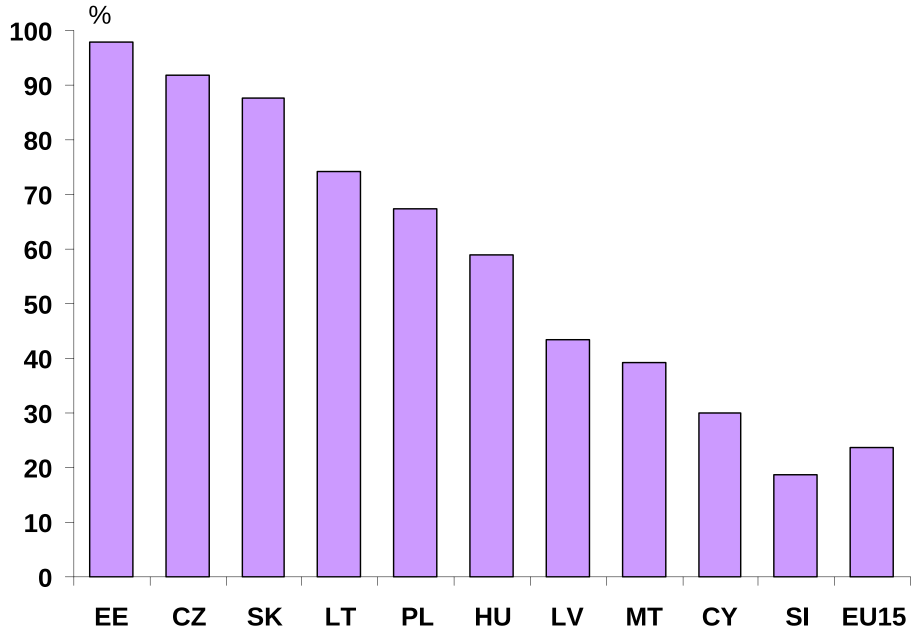
	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions
CZ	4	4-
EE	4	3+
HU	4	4
LV	4-	3
LT	4-	3
PL	4-	4-
SK	4-	3-
SI	3+	3-

Note: the transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planed economy and 4+ representing the standards of an industrialised market economy
Source: EBRD (2005)

The period prior to accession has been characterised by a significant increase in foreign participation in the financial sector. In consequence of the reforms linked to accession and by the privatisation of state-owned banks as part of the transition to market economy, foreign investment - mainly from other EU Member States - in the financial sectors of the EU-8 rose substantially in the 1990s. Foreign-owned banks represent between 40% and 98% of total domestic banking assets in the EU-8, with the exception of Slovenia which also retains a large share of banking assets in state-ownership (Graph 52).

Foreign participation has made a substantial contribution to financial development in the EU-8. By opening their financial sectors to foreign investment, the EU-8 have recapitalised their banking systems, often following episodes of financial distress in the earlier years of transition. Foreign participation has also boosted bank efficiency via the transfer of technology, administrative techniques, expertise in risk management and improved corporate governance. The foreign-owned banks have introduced new lending techniques in their local affiliates, in particular leasing, which is a very useful financing instrument for SMEs (although financing costs remain an important impediment for many SMEs). Foreign-owned banks have also been a significant source of funds for domestic private investors, with evidence suggesting that they tend to more involved with lending to the private sector than domestic banks (Naaborg et al, 2003). Having focused almost exclusively on large foreign and local corporate clients in earlier years, foreign banks have gradually increased their small business and retail lending. Foreign ownership has also strengthened competition and has resulted in a decline net interest rate margins in almost all of the EU-8 Member States, especially in the housing loan market but less so in the market for corporate loans where rates were already low (Eesti Pank, 2005). Nevertheless, net interest margins in the EU-8 remain relatively high (Graph 53).

Graph 52: Foreign-owned banks sector in the EU-10 and EU-15, 2004

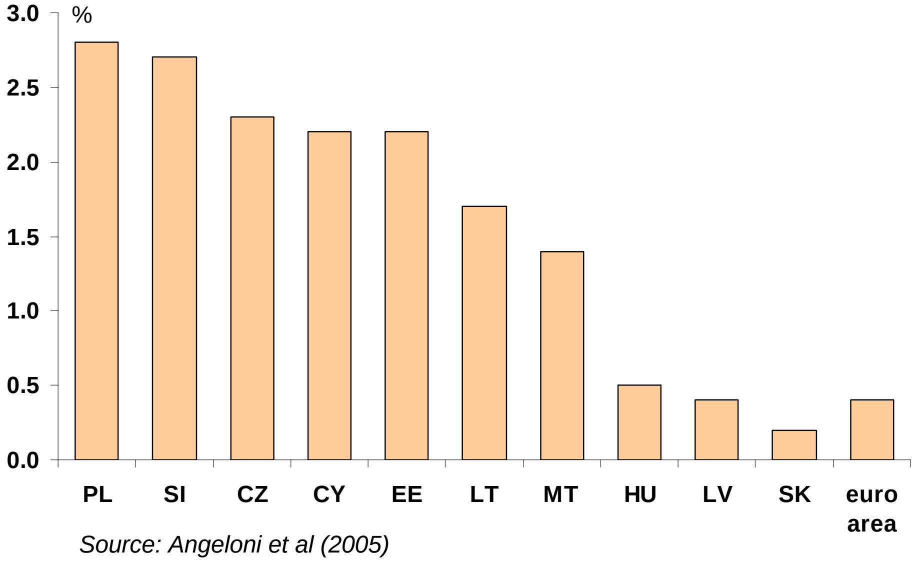


Source: ECB

Accession has facilitated the integration of the EU-8 equity markets with the larger EU-15 market. With the status of regulated markets, the equity markets of the EU-8 have attracted investment from financial intermediaries and investment funds abroad – again mainly from EU-15 Member States. Foreign investment has boosted liquidity and reduced systemic risk in the EU-8 markets, thereby allowing for a sustained increase in equity prices. Since November 2001 (when EU enlargement was formally announced), equity prices in the EU-8 Member States have dramatically risen (Graph 55). This evolution is consistent with markets correctly pricing the reduction in risk in an integrated market (Dvorak, Podpiera, 2005), but also reflects supply-side constraints and the low liquidity in most of these markets, whereby price movements in a small number of companies may influence the overall level of the market. Foreign investment has also been evident at the level of market infrastructure, either via acquisition (e.g. the Baltic stock exchanges have been bought by the Nordic stock exchange OMX) or via strategic partnerships (e.g. the Warsaw stock exchange cross-membership and cross-access agreement with Euronext). These developments have increased equity-market efficiency by enhancing liquidity, allowing extended trading hours, providing a possibility for remote membership, lowering transaction costs and disseminating pricing information.

The EU-8 markets for debt securities have been expanding rapidly in the last decade and this trend has continued after accession. Despite this expansion, these markets remain small and illiquid relative to the markets of the euro area and other EU-15 Member States and are dominated by government issuance. The most significant impact of accession in these markets has been on prices, which have risen steadily and narrowed yields spreads relative to the euro area benchmark. The convergence in EU-8 yield spreads accelerated in the context of accession, amid so-called convergence plays by investors anticipating medium-term adoption of the euro (Graph 56).

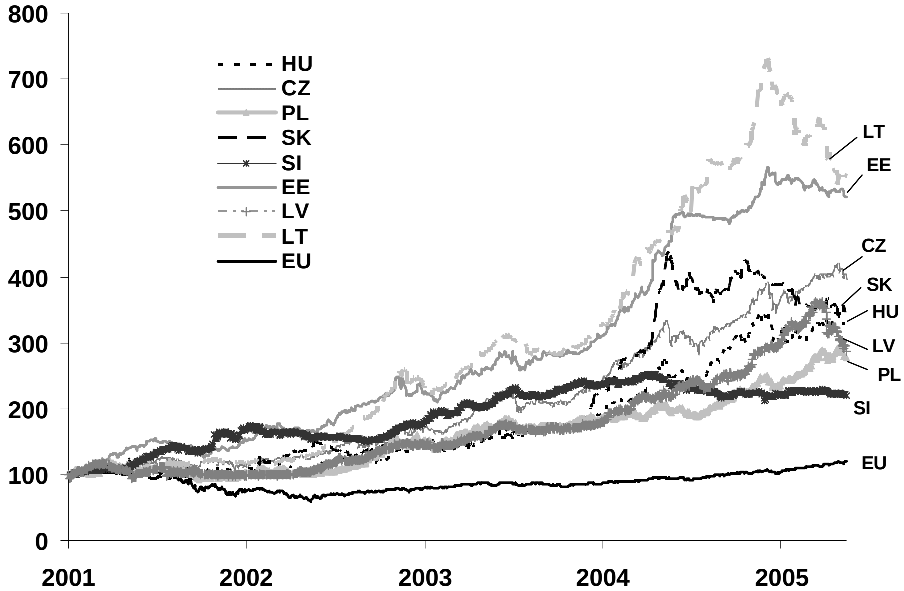
Graph 53: Net interest margins in the EU-8, 2004



Source: Angeloni et al (2005)

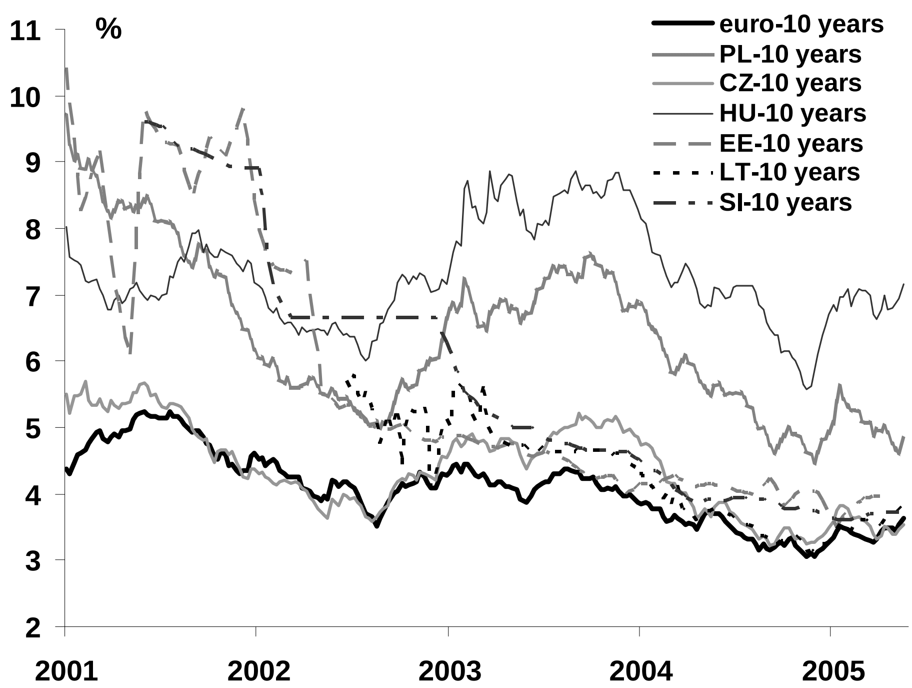
The most obvious effect of financial deepening in the EU-8 has been the expansion in private sector credit. Most of the EU-8 Member States have experienced a surge of private sector credit growth in recent years, with year-on-year rates ranging between 15% and 70% in 2005 (Graph 57). Much of the expansion in private credit is denominated in foreign currency, particularly euro (Graph 59). Taken together with intra-company loans between foreign parents and local subsidiaries, it is clear that access to foreign-currency borrowing in the EU-8 has become increasingly used to compensate for the relative underdevelopment of the domestic financial sector.

Graph 54: Stock market indices in the EU-8 since November 2001



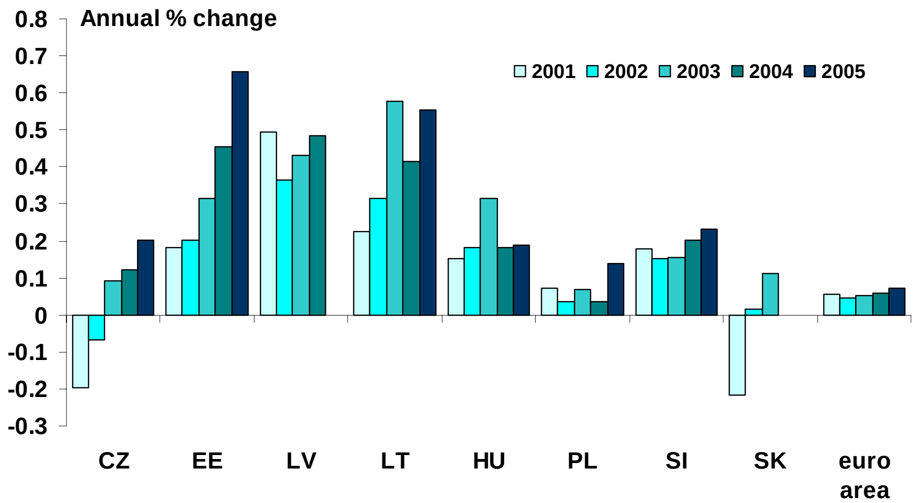
Source: Ecowin

Graph 55: Bond yields in selected EU-8 Member States and the euro area



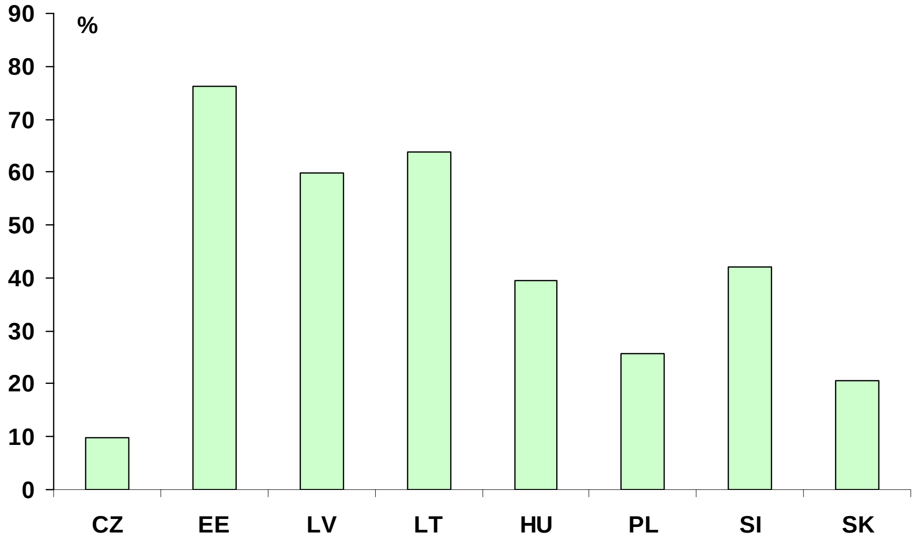
Source: Ecowin

Graph 56: Credit growth to non-financial corporates and households in the EU-8



Source: Ecowin, Eurostat, National Central Banks, Commission services calculations

Graph 57: Foreign currency loans to corporates and households in EU-8 (end 2005)



Note: for Latvia and Slovakia, 2004 data
Source: Ecowin, Eurostat, National Central Banks, Commission services calculations

8.2. Challenges and benefits in old and new Member States

The economic benefits of financial integration for the new Member States are accompanied by significant challenges. These challenges relate mainly to macro-economic management and safeguarding financial stability.

In terms of macroeconomic management, a major challenge is presented by the rapid expansion of credit. Control of credit growth becomes a particular challenge in those Member States operating a fixed-exchange rate or some other form of hard currency regime, where the authorities have limited options without free access to monetary policy. This challenge intensifies further in the context of an accelerated catching-up, where the absence of a perceived currency risk in the context of a credible currency peg, tends to attract capital inflows which further fuel domestic credit growth. If the credit is not adequately managed, there is a risk of destabilisation in the economy in the context of a boom-bust scenario. In extreme circumstances, problems in the real economy could spill over into the financial sector and threaten systemic stability. Such stability risks would be intensified by the existence of a high share of un-hedged foreign currency-borrowing in the economy[66].

With respect of safeguarding financial stability, high foreign banking ownership can present a particular challenge. Foreign-owned banks exert a stabilising influence on the banking sector because they more diversified in terms of risk within the overall group and the parent bank may play the role of "lender of last resort" in the event of financial distress. Evidence suggests that foreign-owned banks have been rather stable credit sources, even when domestically-owned banks have reduced their credit supply (De Haas, van Lelyveld, 2004). In fact, foreign ownership may have been an important factor in sheltering the banking sectors of

[66] On the other hand, the external net liability position of the banking sector of most of the EU-8 Member States remains limited (with the exception of Estonia and Latvia), while the majority of foreign currency loans are held by larger multinational firms and is largely hedged via export earnings or via derivatives (Papademos, 2005). Moreover, the debt-servicing burden of firms and households relative to income is still considerably lower than in the EU-15.

the EU8 Member States from the effects of the Russian crisis in 1998 (ECB, 2002). However, concern has been expressed that the foreign owners could make decisions concerning their local affiliates which could impact systemically on the domestic financial sector. In such circumstances, a conflict could emerge between the requirements of home country control in prudential supervision and host country responsibility in safeguarding financial stability[67]. As financial integration proceeds, the potential for such conflict is set to increase, requiring enhanced co-operation between national prudential supervisors.

The direct impact of accession on the EU-15 financial sectors has been overall limited, reflecting the relatively small size of the EU-8 financial sectors. However, accession has offered EU-15 financial intermediaries the opportunity of new growth markets and improved portfolio diversification. For example, Austria has been one of the main beneficiaries of EU-8 accession. The Vienna stock market index has been on a steep upward trend since the beginning of 2003, with prices rising by some 260% compared to less than 70% in the main euro-area indices More than 80% of the companies listed on the Vienna exchange are engaged in business in the EU-8 Member States. Austrian banks and insurances companies are particularly exposed to the EU8 and the sector has been characterized by strong growth and continued high profit margins (OeNB, 2005). Sweden has also made important investments in the EU-8. One important example is the acquisition and consolidation of a large part of the banking system in the Baltic countries by Swedish banks. The integration process has spread to other parts of the financial system also, with the stock exchanges of Sweden, Finland, Denmark and all three Baltic States now merged into one single stock market, OMX. The financial sectors of Belgium and Italy also have significant exposure to the EU-8 (Table 12).

Table 12: EU-15 banks' balance sheet exposure to EU-8 markets (as % to total foreign claims)

	AT	IT	PT	FI	BE	SE	DE	FR
EU8	**27.5**	**10.4**	**7.4**	**7.0**	**5.6**	**5.4**	**2.9**	**1.8**
CZ	**9.2**	0.5	0.1		2.9		0.4	1.2
EE	0.1			2.9	0.0	2.7	0.0	0.0
HU	**6.3**	2.4	0.4		1.1	0.0	0.9	0.2
LV	0.1	0.0		1.5		1.0	0.1	
LT	0.1		0.1	2.4	0.0	1.2	0.1	
PL	3.3	4.6	**6.9**	0.2	1.0	0.5	1.1	0.2
SK	**6.0**	2.3		n.a	0.4	0.0	0.1	0.0
SI	2.4	0.2		n.a	0.1		0.2	0.1

Source: Rosenberg (2006)

The challenges emanating from a highly integrated financial system such as between the EU-15 and EU-8 have helped to stimulate debate on reform of the EU supervision framework. As indicated earlier, increased integration entails new supervisory challenges. The integration of the financial sectors of the EU-8 and EU-15 has accelerated the recognition of these challenges at the EU level. Improving the EU framework for financial supervision and crisis prevention has become a priority. Concrete steps are being taken to enhance the cooperation and coordination between all relevant authorities and to overcome the challenges encountered within the current framework.

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67 EU regulations state that responsibility for supervision of a subsidiary are mainly the host country supervisor's, the one of branches are the home country supervisor's.

9. AGRICULTURE

The agricultural sector is still of relatively greater importance in the economies of the new Member States and its accommodation within the framework of EU support was regarded as and remains a major challenge. This chapter analyses the impacts of enlargement on the agricultural sector in the new as well as the old Member States. It shows that the convergence process has led to considerable structural adjustment with the share of agriculture in GDP, and employment in agriculture declining rapidly. It also concludes that EU support and an inflow of foreign direct investments contributed to restructuring and modernisation of agriculture and food processing in the new Member States.Trade creation has dominated trade diversion as a result of enlarged agricultural markets. Furthermore, accession has considerably increased farmers' real incomes in EU-10 without deteriorating farmers' incomes in EU-15.

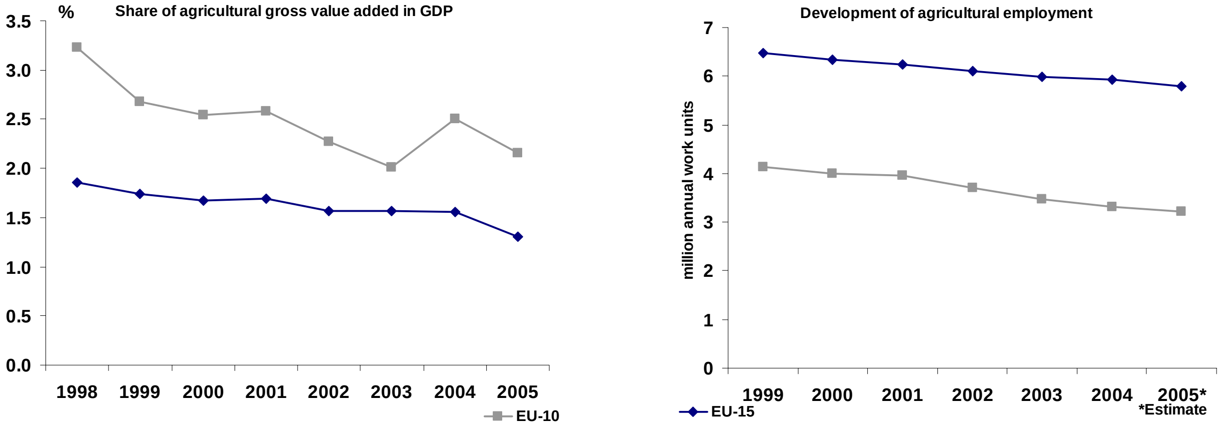
9.1. Agriculture in the enlarged EU

The enlargement to central and eastern Europe was widely expected to have considerable impacts on agriculture in both the old Member States and the acceding countries. Some figures underline these expectations: the EU’s utilised agricultural area increased by 25%, agricultural production expanded by 10% for most products, and the number of farmers increased by more than 50%. These figures indicate the large agricultural production potential of the new Member States which, however, has not been fully exploited.

The agricultural sector in the new Member States faces challenges typical of economies in transition. The productivity of farming is still below the level in the old Member States. For instance, the average soft wheat yield in EU-10 still amounts to just two-thirds of the EU-15 yield. This lower factor productivity is linked to limited capital endowments alongside a low use of inputs such as fertilisers, pesticides or mechanical equipment. Unfavourable farm structures associated with low profitability are likely to hamper access to capital and, hence, to contribute significantly to the low productivity of agriculture in the new Member States (Pouliquen, 2001).

A characteristic of less developed economies in general and for the transition economies in central and Eastern Europe in particular is also the relatively higher importance of agriculture in the economy (Graph 58). Although the share of agriculture in the economy is also declining in the old Member States, the catching-up process with higher growth rates causes a stronger decline of the relative importance of the farming sector in the new Member States. Thus, the share of agricultural gross value added in GDP decreased in EU-10 from 3.2% in 1998 to 2.2% in 2005. This share amounted to merely 1.3% in EU-15 in 2005, whereas the marked decline in 2005 is influenced by statistical adjustments due to the decoupling of direct payments.

Graph 58: Importance of activity and employment in agriculture in old and new Member States

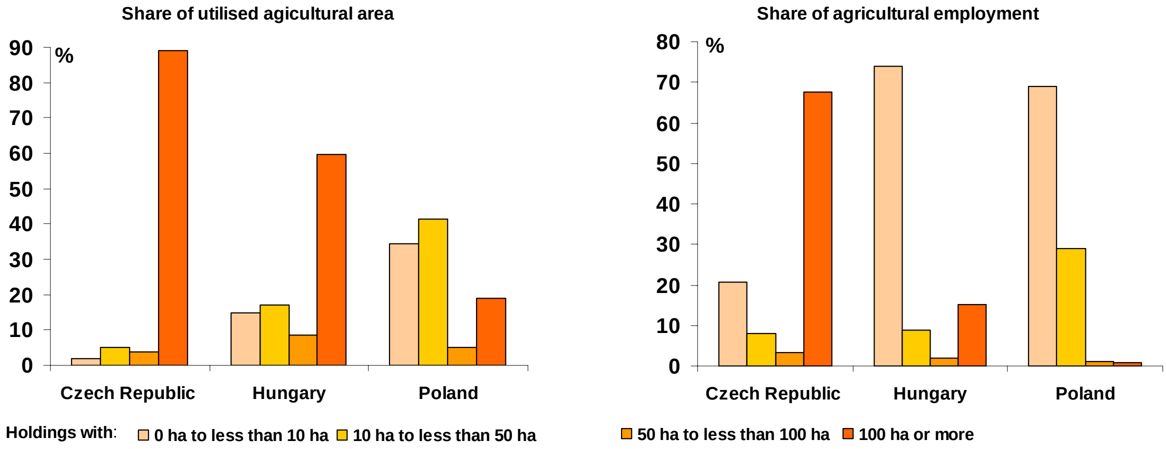


(1) Gross value added at basic prices is calculated from the production value less intermediate consumption and taxes on products and plus product related subsidies. Due to decoupling in 2005 direct payments are not product related anymore, hence, the decoupled part of direct payments is not added to the gross value added any longer.
(2) One annual work unit is based on 1800 working hours per year.
Source: Eurostat database, own calculations

The difference between old and new Member States is even stronger as regards the share of agriculture in total employment. In 2004 the share of agriculture in total employment was 12.5% in the new Member States, but merely 3.8% in the old Member States. The relatively high share of agricultural employment in EU-10 indicates a lower labour productivity as well as a social buffer function in economic transition which helps to cope with few off-farm income alternatives and less developed social security systems. This social buffer function might also explain the widespread existence of subsistence-like farming in some new Member States. However, the employment share is quite heterogeneous in both the old and the new Member States. Poland (19.2%), Lithuania (15.8%) and Latvia (12.5%) show relatively high shares which relate to a large extent of subsistence-like farming and are comparable with employment shares in Greece or Portugal at the beginning of the 1990s. On the other hand, the share of agricultural employment in Slovakia (3.9%) or the Czech Republic (4.2%) is rather low and already similar to the average level in the old Member States.

There is also a different dynamic in the development of agricultural employment in the old and new Member States (Graph 58). This can be demonstrated on the basis of annual work units which allow for a better comparison of farm structures with different shares of part-time farming. To this end, the total annual working time of the persons employed in agriculture is converted into full-time work units. Again, the importance of agricultural employment is shrinking in both cases; however, this shrinkage is stronger in the new Member States. In these countries the agricultural labour force declined between 1999 and 2005 by 22%, twice as strong as in the old Member States (11%). This means an average annual decline of agricultural employment of 1.8% in the old Member States and 4.1% in the new Member States.

Graph 59: Farm size, utilised agricultural area and agricultural employment (2003)



Source: Eurostat database (farm structure survey), own calculations

There are substantial differences in farm structures between the new Member States (Graph 59). Czech agriculture is dominated by large-scale farms with more than 100ha which cultivate almost 90% (all figures for 2003) of the total utilised agricultural area and employ 68% of the agricultural labour force. In other words, Czech agriculture with its converted former state owned farms and cooperatives, an average farm size of 79ha and a labour input of 4.6 annual work units per 100ha is already quite competitive in structural terms as compared to the average of the old Member States with a farm size of 20ha and a labour input of 5.0 annual work units per 100ha. On the contrary, the Hungarian and Polish agricultural structures are influenced by small-scale or subsistence-like farming. Although about 60% of the utilised agricultural area in Hungary is used by holdings larger than 100ha, more than 70% of the labour force is employed in farms smaller than 10ha. The Polish agriculture is dominated by small and medium-sized farms in area use as well as employment terms, though 20% of the utilised agricultural area is used by farms larger than 100ha. The average farm size of 5.6ha in Hungary and 6.6ha in Poland and the respective average labour input of 12 and 15 annual work units per 100ha indicate for both countries a considerable need for structural adjustments in the coming years. The same holds for food processing in the new Member States which has been characterised by over-capacities and small-scale plant structures, in particular in the dairy and meat sector (IAMO, 2004).

Important challenges for agriculture in the new Member States remain, related to both the ongoing transition process in general and the accession to the EU in particular. In order to support the development of a competitive agricultural sector it is of key importance to set an appropriate institutional framework which, for example, ensures access to capital or lays the legal basis for functioning land markets. Furthermore, any success of agricultural restructuring depends on income alternatives outside agriculture or well developed social security systems (Popp, 2005). This need is to be addressed by general economic and social policies as well as regional or rural development approaches rather than by policies directed to the agricultural sector. A challenge directly linked to accession has been to prepare the farming sector and the food processing industry in the new Member States for adopting the EU food and processing standards.

9.2. Implementation of the Common Agricultural Policy in the new Member States

Association agreements and further bilateral agreements paved the way for a gradual liberalisation of trade between the EU and the candidate and the adoption and implementation of the *acquis* in the candidate countries. In addition, the Community has provided support through the Special Accession Programme for Agriculture and Rural Development (SAPARD) between 2000 and 2006 to assist candidate countries in restructuring the farm and food sector and implementing the Common Agricultural Policy (CAP). SAPARD has offered funds to support investments in agricultural holdings and food processing, economic diversification, rural infrastructure and other rural development measures.

This support for modernising and restructuring farms, food processing plants and the rural economy has been enhanced after accession by means of rural development programmes. In addition to measures already applied in the EU-15, specific measures are available in the new Member States such as income support for semi-subsistence farmers undergoing restructuring, support for meeting EU standards or the provision of extension and advisory services.

Farmers in the new Member States have received direct payments from the first year as members of the EU, although not at the full rate applied in the EU-15. Instead, direct payments will be gradually phased in, starting with 25% of the EU-15 level in 2004 and reaching the full rate of EU-15 payments in 2013. The new Member States are entitled to top-up these payments with complementary national payments and parts of their rural development funds. Furthermore, all new Member States except Slovenia and Malta have chosen the option to apply transitionally the simplified Single Area Payment Scheme (SAPS) with a uniform amount of direct payments per hectare of agricultural land.

The CAP market measures with common tariffs to third countries, export subsidies, intervention purchases as well as certain production limitations like sugar and milk quotas now also apply in the new Member States. Transitionally, the limitation of crop production through obligatory set-aside of a certain part of farmland does not affect new Member States applying SAPS payments before 2009.

9.2.1. Increased support for agriculture

First and foremost, enlargement in agriculture means to expand market and income support for European farmers to the new Member States. Most of them provided high support for agriculture before transition. At the beginning of the 1990s in many countries agricultural support was reduced drastically; in the Baltic countries the support of the agricultural sector even turned temporarily into taxation (European Commission, 1998). Although support for agriculture increased again before accession in several countries, it did not reach the EU level (Graph 63)[68]. In the 1990s the central and eastern European countries applied several intervention measures in the agricultural sector, ranging from border measures and domestic floor prices to different types of direct payments, input subsidies, investment aids or tax exemptions. In the years before accession these measures were adjusted towards the CAP instruments; the requirements for intervention purchases were adjusted and quota systems for sugar and milk were introduced.

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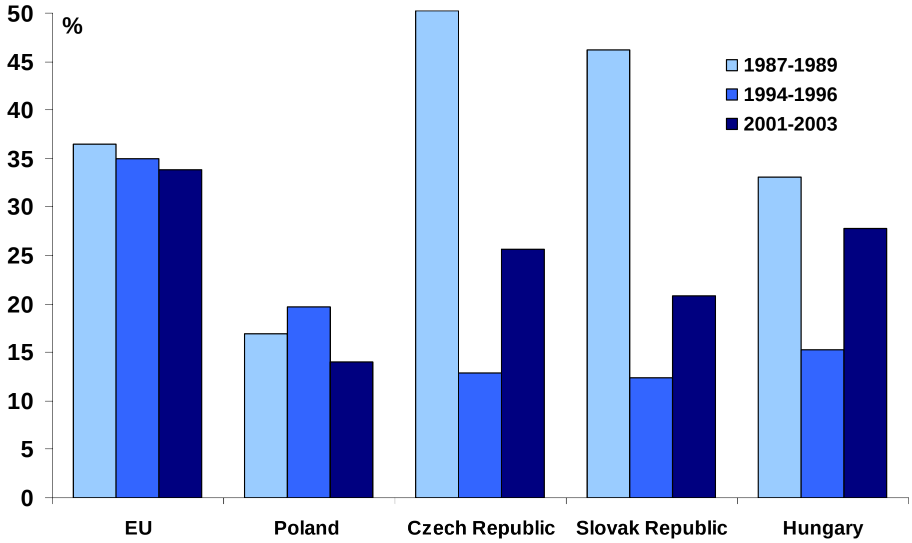
[68] Pre-accession agricultural support similar to the EU-15 level was reported only for Slovenia on the basis of non-OECD estimates (European Commission ,1998).

Graph 60: Average annual agricultural support in selected new Member States of farmers' revenues



(1) The support for agriculture is measured by the OECD producer support estimate (PSE) which calculates the support through price support and direct payments as percent of farmers' revenues.

Source: OECD database

Increased agricultural support in the new Member States implies a discriminatory treatment of other sectors with possibly higher growth potential. Furthermore, increased agricultural producer prices have been observed for many commodities in the new Member States, especially for meat and dairy products. Land prices also seem to have increased in the wake of higher support. However, landowners are not necessarily part of the rural population, and sharp increases in land prices are reported to have hampered restructuring in some countries (Popp, 2005). The introduction of production limitations such as milk and sugar quotas has probably hampered the improvement of productivity and competitiveness of the agricultural sector in the new Member States. The intended future introduction of obligatory set-aside should have a similar effect.

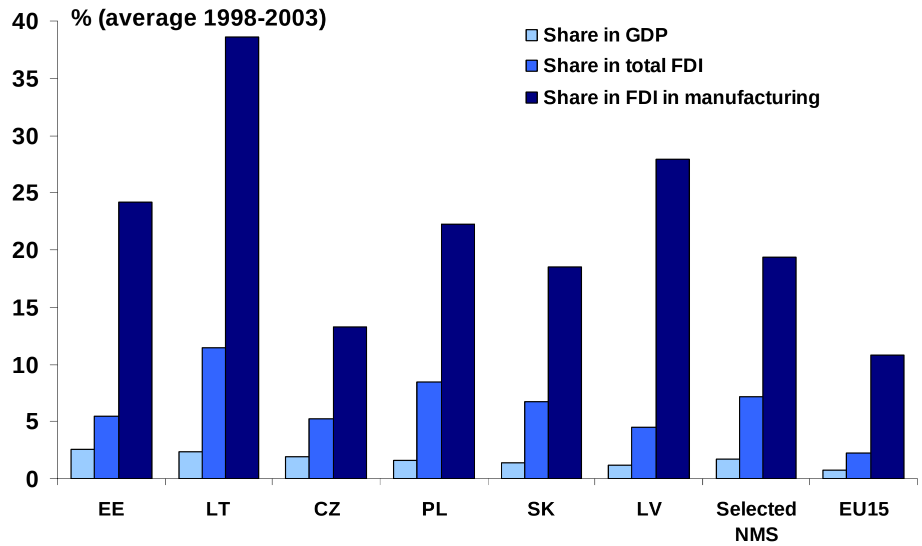
9.2.2. Significant restructuring of food processing

The accession to the EU and the implementation of the CAP has also affected the food-processing sector. While the number of enterprises in food processing increased in the beginning of the 1990s due to decentralization and privatization, more recently the trend has been reversed, with declining numbers of enterprises and employees in the dairy and meat processing sectors (IAMO, 2004). This concentration process is not related exclusively to accession but also to adjustments typical of economic transition. However, the obligation to fulfil EU hygiene and quality standards and the EU support through SAPARD and rural development funds for restructuring and modernization of food processing and the adoption of EU standards have also contributed to this development.

EU enlargement should improve the conditions for foreign investments in food processing. Foreign investments probably foster concentration and this might result in even more foreign investments as large entities are likely more attractive to investors (IAMO, 2004). Such FDI (Graph 61) in food processing has been encouraged not just by low labour costs and cheap raw material but also by the expected access to EU-15 markets and, potentially, prospects to conquer new markets in the East of the enlarged EU (IAMO, 2003).

Food processing in the new Member States benefited particularly from FDI in the years preceding accession. The relative importance of FDI in food processing is considerably higher in the new than in the old Member States (Graph 61). On average, the share of FDI in food processing in GDP was more than two times higher, in total economy-wide FDI about three times higher and in overall FDI in manufacturing almost two times higher. While Estonia, at 2.6%, had the highest share of FDI in food processing in GDP, the highest shares of FDI in food processing in total economy-wide FDI (11.5%) and in overall FDI in manufacturing (38.6%) were in Lithuania. The share of FDI in food processing in GDP as well as in total FDI and in FDI in manufacturing in all new Member States exceeded the corresponding average in the EU-15; however, some EU-15 Member States with a particularly strong food industry, such as the Netherlands (3.6% in GDP) or Denmark (30.7% in overall FDI in manufacturing), saw even higher shares of FDI in food processing.

Graph 61: Relative importance of FDI in food processing in selected Member States



(1) FDI are measured as inward position.

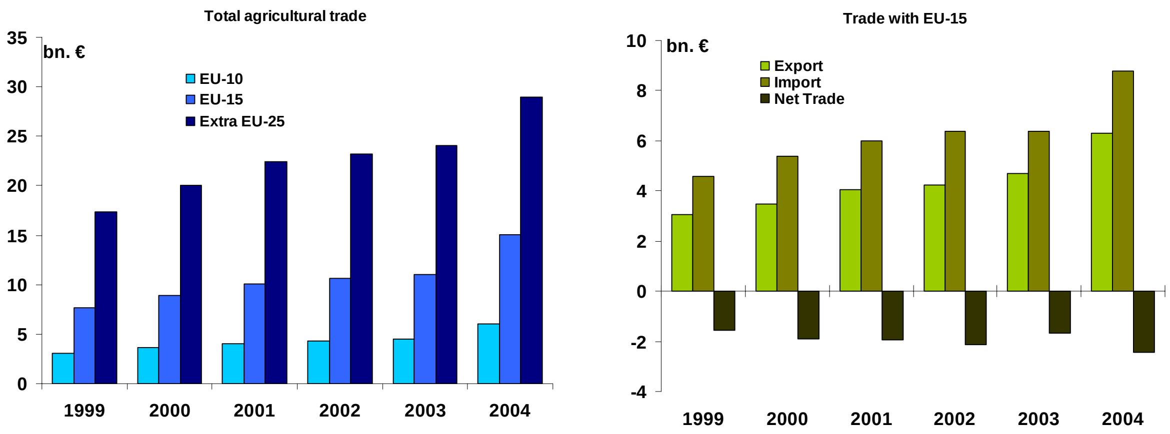
Source: Eurostat database, own calculations

Despite progress in restructuring the food-processing sector, further effort is required to improve the competitiveness of the food industries in the new member to levels comparable to their counterparts in the EU-15. The average revenue per dairy processing enterprise in all acceded CEECs except the Czech Republic (IAMO, 2004), was in 2004 less than 10% (2%) of the level of their competitors in Germany (the Netherlands).

9.2.3. Intensified agricultural trade

Accession to the EU means abolishing trade barriers within the union, but implementing common tariffs to third countries. Total agricultural trade of EU-10 has been steadily increasing in recent years (Graph 62). This increase has appeared with respect to trade within the EU-10, with the old Member States as well as with third countries. Within five years from 1999 to 2004 agricultural trade almost doubled within EU-10 and between EU-10 and EU-15 and increased by two-thirds between EU-10 and third countries. The biggest increase of more than 30% for trade with the EU-15 and within EU-10 was observed in 2004, the year of accession. Both imports from and exports to EU-15 have increased. However, imports have increased slightly more strongly than exports and, thus, the agricultural trade deficit of the new Member States with the EU-15 has also increased, although Hungary has remained a net exporter[69]. Furthermore, the share of processed products in EU-10 agricultural exports increased from 19% in 1999 to 25% in 2004, while this share in imports from EU-15 remained rather stable at about 31%.

Graph 62: Development of agricultural trade of the new Member States



Source: Eurostat database, own calculations

The data suggest that accession has intensified agricultural trade of the recently acceded Member States with EU trading partners without diverting trade from third countries – trade creation has dominated trade diversion. In addition, export performance in high-value processed products has improved, reflecting likely the restructuring of the food processing industry in the new Member States, which has been supported by SAPARD and the inflow of foreign direct investments. In turn, agriculture in the old Member States has also benefited from increasing exports to the new.

9.2.4. Increased agricultural incomes

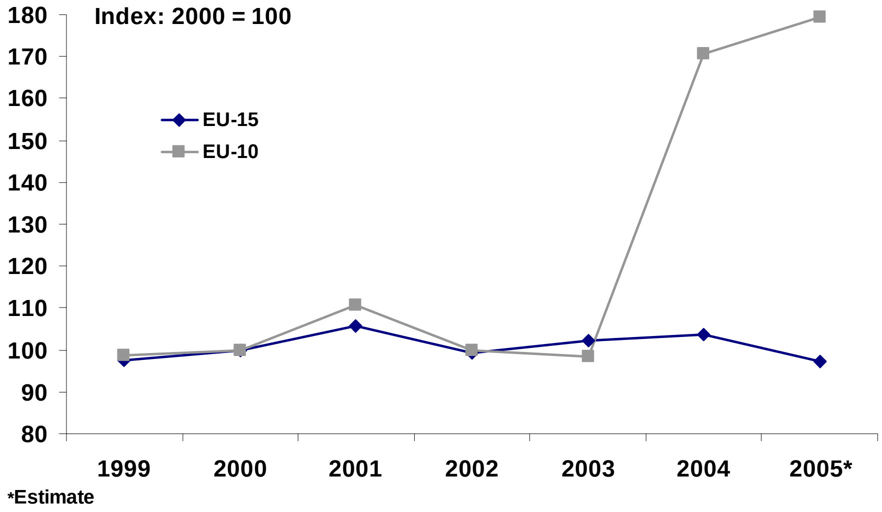
Accession led to a dramatic increase of average real agricultural incomes in EU-10, up in 2004/05 by more than 70% as compared to the average between 1999 and 2003 while agricultural income in EU-15 remained stable (Graph 63). Farm incomes more than doubled in Estonia (+132%) and Latvia (+106%) and almost doubled in Poland (+95%) and Lithuania (+92%). However, the absolute average income per annual work unit in the new Member States is still far below the level in EU-15. The average net value added per annual work unit in nominal terms amounted in EU-10 to about 10% of the EU-15 level between 1999 and 2003 and to 16% in 2004/05. This income gap can be attributed to the lower productivity, less favourable farm structures in many new Member States with a higher labour input and the still lower support through the CAP.

Accession has resulted in substantial real income increases for farmers in the new Member States, most likely reflecting primarily the introduction of direct payments. By providing incentives for farmers to stay in the sector and delay restructuring, these could prove inconsistent with promoting competitiveness in agriculture. There is also a question of whether these income increases could sustain inequality, as other sectors have not benefited

[69] Hungary is also an overall net exporter of agricultural products. While Poland became an overall net exporter of agricultural products in 2003, it is still in a net import position with the EU-15.

from comparable income increases. Overall, however, concerns that EU-15 farmers could suffer from new competitors in the acceded countries have not materialized.

Graph 63: Agricultural income in the old and new Member States



(1) Agricultural income is measured by Eurostat income indicator A. This indicator corresponds to the real net value added at factor costs of agriculture per annual work unit; that means, intermediate consumption and consumption of fixed capital are deducted from revenues, and the value of subsidies less taxes on production are added.

Source: Eurostat database, own calculations

10. SOCIAL COHESION

Enlargement has challenged social cohesion across the Members States. Increased diversity and disparities are major features of the enlarged Union, with increased income disparities between the Member States as well as risks of weakening of social cohesion within Member States in the context of change driven by globalisation, technology and demography. Increased diversity also concerns industrial relations and systems of social protection. Hence the challenge of fostering social cohesion within the Union and of promoting social inclusion within each Member State while supporting the adaptation of employment and social policies to change.

The EU Social Agenda supports the Lisbon strategy by promoting the employment and social dimension of economic growth. In its second phase covering the period up to 2010, the Agenda aims in particular at promoting more and better jobs and at modernizing the European social models and strengthening social cohesion through the identification of priorities that should guide EU action in this domain – the Commission has defined these areas in European Commission (2005h). Implementing the EU Social Agenda requires the mobilisation of various instruments: legislation, social dialogue, policy coordination, and financial support through the European Social Fund. New Member States fully participate in the implementation of the EU Social Agenda.

Policy coordination is increasingly used to make progress in the areas of employment, social inclusion and social protection. The major approach in this respect is the so-called "open method of coordination", agreed in Lisbon, which consists in defining objectives and guidelines at EU level while Member States are responsible for transposing these guidelines in their national policies and practices and for participating in peer review processes making possible to assess progress and adapt EU strategies and objectives. The new Member States began preparing for participating in these policy processes while preparing for accession.

Demographic, economic and societal developments underpin the need for adjustment and reform, and have contributed to broadening and raising the ambitions of the social policy agenda beyond combating and preventing poverty to raising labour supply and assisting citizens in acquiring adaptable skills for the new economic realities[70].

10.1. Promoting more and better jobs

The Lisbon strategy's target for an employment rate of 70% by 2010 remains an ambitious one not least for the new Member States (as much in fact as the other strategy objectives). As noted earlier (see section 3.3.C and Table 5), their labour market situation needs to be improved further and the strategy's reforms are crucial in this respect. Having undergone significant and radical reforms since the fall of communism, the new Member States have yet to achieve sustained employment gains to foster social cohesion and collect the resources necessary to support their social agendas. The European Employment Strategy offers guidelines and recommendations and a comprehensive approach to address labour market changes as well as employment policy challenges. The assessment of national reform programmes of the new Member States indicates that there are insufficient provisions for adaptability in labour markets. Investing in human resources is also a major priority to

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[70] See European Commission (2005h) for details and a discussion of the priorities in the European Social Agenda out to 2010.

address. Labour market segmentation is becoming a serious problem especially as regards core labour force participants and atypical and temporary employees who are facing risks of marginalization and social fracture. The poor labour market performance in general is currently obscuring these issues. However, they raise significant policy questions and they should be addressed taking into consideration historical and institutional traditions.

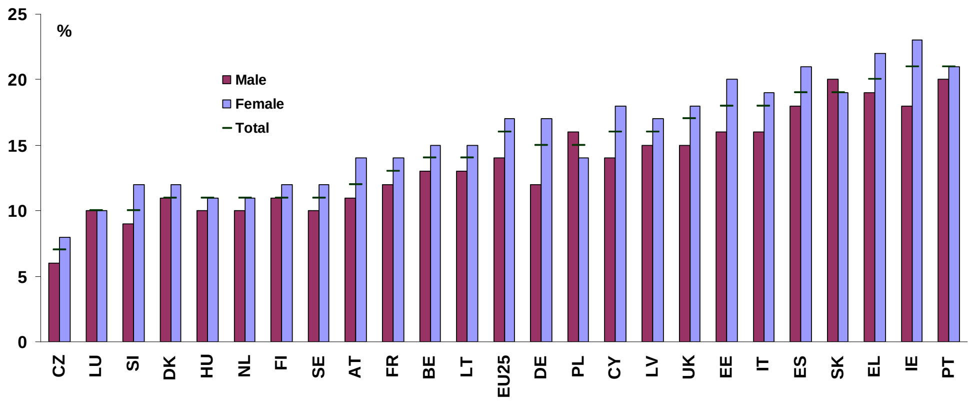
The European Social Fund (ESF) is the main financial instrument to support Member States efforts to implement the European Employment Strategy, as well as the objectives of the social inclusion policy. The European Social Fund is clearly benefiting considerably the new Member States and is contributing to strengthening their incentives to modernize and ease the transitional costs of reforms.

10.2. Promoting social inclusion

Enlargement increased the income disparities between the Member States significantly : the income poverty threshold in the richest Member State was "only" 3.3 times higher than in the poorest, after enlargement this coefficient increased to 7.5, expressed in purchasing power parities (PPS). However, the distributions of the at-risk-of-poverty rates are rather similar.

As shown by figures on income poverty measured referring to the national (and not to the EU-wide) income distribution: the average at-risk-of-poverty rate in the EU-25 was 16% in 2003 while national figures ranged from 8% in the Czech Republic and 10% in Slovenia to 21% in Ireland, Portugal and Slovakia. In most countries, the at-risk-of-poverty rate was one percentage point higher for women.

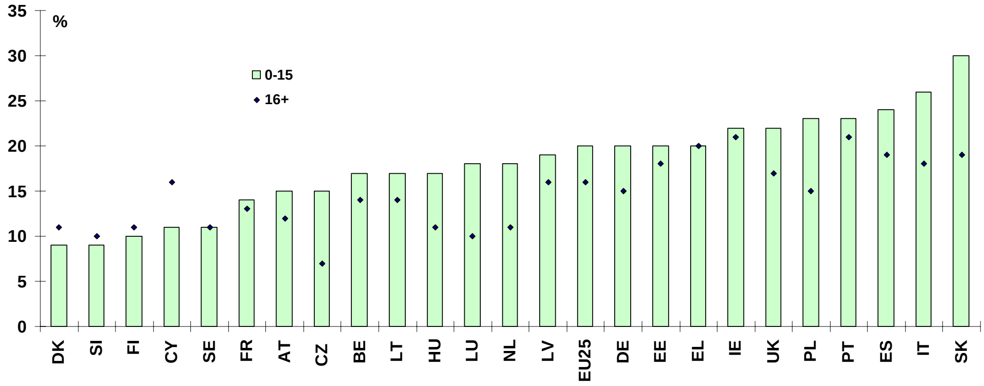
Graph 64: At-risk-of-poverty rate by country and gender (2003)



Notes: provisional data for NL and SK. Data for MT not available.
Source: Eurostat. 2003 survey data (referring to 2002 income year).

Income poverty among children is a matter of serious concern, the EU sets itself the objective to move towards the elimination of social exclusion among children and give them every opportunity for social integration. Children generally experience levels of income poverty that are higher than those for adults.

Graph 65: At-risk-of-poverty rate of children (2003)



Social exclusion may be associated with various forms of discrimination. In this respect, enlargement brought new issues to the fore such as the integration of Roma communities, the treatment of national minorities and the situation of stateless persons in certain Member States. The Commission is monitoring developments on these issues.

Promoting access to employment is crucial for fighting poverty and social exclusion. The potentially negative impact of living in a jobless household goes beyond the lack of work income, as it extends to the lack of contact with the labour market. In the EU-25, the percentage of people aged 18-59 and living in households where no-one works was 10.2% in 2005. However, the rate of poverty for those in work is still relatively high also. In the EU-25 it corresponds to 9% ranging from 3% in the Czech Republic and 4% in Slovenia, Belgium and Finland to 13% in Greece and Portugal and 15% in Slovakia.

An indicator in the area of health that can be seen as expressing the health status as well as the general well being of nations is life expectancy. This is a complex indicator reflecting several dimensions and socio-economic factors. The EU is characterised by high life expectancy at birth, but most of the new Member States have low performance in this respect, in particular for men, with national figures around 65 years in Estonia and Latvia (EU-25 average just below 75). Life expectancy for women is around 6 years higher than men, ranging from 76 in Latvia to 83.5 in Spain.

The analysis of poverty and social exclusion in all 25 Member States confirms the seven key policy priorities for social inclusion in the EU: increasing labour market participation, modernising social protection systems, tackling disadvantages in education and training, eliminating child poverty, ensuring decent accommodation, improving access to quality services and overcoming discrimination and increasing the integration of people with disabilities, ethnic minorities and immigrants. These priorities are reflected in the National Action Plans against poverty and social exclusion elaborated by Member States.

10.3. Modernising social protection

All Member States are confronted with the need to reform their social protection systems in order to meet the long term challenges of demographic ageing. In new Member States, structural change of social protection systems started before enlargement, but still continues. The open method of coordination in the field of social protection is a good tool for exchanging experiences and mutual learning with a view to ensure social adequacy as well as financial sustainability of social protection.

Total expenditure for social protection is generally lower by as much as ten percentage points in terms of GDP in the EU-10 compared to the EU-15 average of around 27%[71], and this is primarily a reflection of lower spending on health care. In most EU-25 countries expenditure on pensions constitutes the largest social protection item and the new Member States, broadly speaking, spend less in terms of GDP than the EU-15[72] although the difference is not as marked as in the case of health care.

Recent long-term projections show that pension costs will lead to significant increases in public spending in most Member States by 2050. On the basis of current policies, public expenditure on pensions is projected to increase on average by 2.2 percentage points for the EU-25, with a large dispersion among Member States. A decomposition clearly shows that the rise in old age dependency ratio is the dominant factor pushing up public spending in the coming decades. However, other factors, partially as a result of the pension reform efforts, will offset 70 % of the demographic pressures (100 % in new Member States): a decrease in the share of people in receipt of pensions relative to the population aged 65 and over and a decrease in the relative benefit level are the main factors, with more or less equal weight (in EU-25).

In most Central and Eastern European Member States pension systems were transformed substantially in the 1990s establishing a new architecture combining a public pay-as-you-go scheme and a mandatory private funded scheme for people below a certain age and voluntarily available to older persons while maintaining the old system for those who did not want or were not obliged to join the new system.

In health and long-term care, where spending averaged 8 % of GDP in 2003, Member States continue to aim to ensure access for all to high quality care, while adjusting their systems to the growing demand linked to patients' expectations, health technology development and ageing populations. There still remain a need to continue changes fro too much acute hospital care capacities to more preventive and primary care. The aim of ensuring access continues to be a fundamental challenge. Serious inequities, relating to supply difficulties, geographical barriers and gender, remain, as do disparities in how different socio-economic groups draw on health systems, and in the health outcomes they experience.

Although there have been substantial achievements in the transformation of the health care systems in these Central and Eastern European Member States, the need and actions for further, fine tuning or correcting, reforms continues in most of these Member States. Co-operation within the EU helps them find and compare examples of similar reforms and their effects from other Member States, both old an new.

The open method of coordination has proved to be a good tool for the Union and Member States to advance their understanding of social protection issues by defining common objectives, reviewing progress and promoting a learning process. New Member States in particular say they have benefited from the exchange of experiences and mutual learning.

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71 Data for 2001/2002, see Eurostat (2005), p.135; the share in GDP in 2001 was highest in Sweden at 31.4% and lowest in Latvia and Estonia at 14.3%. The difference is also notably large when measured in PPS per head of population.

72 There are exceptions here, notably Poland (around 14% of GDP, data for 2001) and Slovenia (somewhat less than 14% of GDP); see Eurostat (2005), p. 138.

10.4. Developing social dialogue

Enlargement offers a major opportunity to develop the scope of European social dialogue[73]. Through social dialogue, European social partners have the possibility to become true legislators in social and employment-related matters, and their adopted texts have become part of the *acquis*. Moreover, social dialogue is a tool to manage reforms and change on employment and social policy issues at all levels – from the company level to the branch and the inter professional level. Benefiting fully from the provisions of EU social dialogue requires that, first, national social dialogue systems of the new Member States work effectively and, second, social partners participate actively and be integrated in European social dialogue mechanisms.

Differences in traditions and practices in the new Member States have presented a considerable challenge for European industrial relations. In contrast to the EU-15 where greater emphasis is placed on bipartite collective bargaining the main form of social dialogue in the new Member States is tripartite with national consultations. Where it does occur, collective bargaining is largely limited to company level. Weak social partners and limited financial resources act as constraints on their effective participation in and on maximizing the benefits from the provisions of the European social dialogue. The Commission has stressed the need for the national social partners to develop stronger sectoral and bipartite dialogue structures and has made recommendations for improving the capacity and involvement of the social partners and for monitoring its impact in the new Member States. The European social partners are also playing an important role in assisting social partners to develop further their capabilities and in addressing a variety of industrial and labour market problems. Through these efforts both the quality of industrial relations and the social partners' participation and integration in the European social dialogue mechanisms have improved. Nevertheless, important challenges such as improving the effectiveness of national social dialogue and supporting the integration and active participation of national partners in the European social dialogue mechanisms remain to be fully addressed.

Anti-discrimination

New powers were introduced in 2000 to enable the EU to take action against discrimination on grounds of racial or ethnic origin, religion or belief, disability, age and sexual orientation[74] and these have led to a considerable reinforcement of protection against discrimination across the enlarged EU. New legislation has been introduced in virtually all the new Member States that has required the application of clearer and more detailed definitions to different forms of discrimination – direct and indirect discrimination, harassment, victimisation, instructions to discriminate. Access to justice has been improved for victims of discrimination and new provisions on the burden of proof have made it easier to bring discrimination cases to justice. Nevertheless, there continue to be shortcomings in the transposition and implementation of anti-discrimination legislation in several of the new Member States and the Commission is monitoring the situation.

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[73] Social dialogue is formally recognised in articles 138 and 139 of the Treaties in its dual dimension of consultation and bargaining.

[74] These took the form of two Directives, 2000/43/EC of 29 June 2000 (OJ L 180 of 19.7.2000, p22) implementing the principle of equal treatment between persons irrespective of racial or ethnic origin, and Directive 2000/78/EC of 27 November 2000 (OJ L 303 of 2.12.2000, p16) establishing a general framework for equal treatment in employment and occupation; an action program to combat discrimination (Council Decision of 27 November 2000, OJL303 of 2.12.2000, p23) was also set up.

EC anti-discrimination legislation requires each member state to designate a specialised body to, among other, assist victims of discrimination. This has led to the creation of new institutions in some new Member States – such as the Equal Treatment Authority in Hungary – while in others powers of existing bodies have been reinforced and/or extended – for example, the Latvian National Human Rights Office. Also, the EU-supported network Equinet has promoted the exchange of information and experiences between old and new Member States and all new Member States participate in the EU action programme to combat discrimination. The action programme has supported a range of activities which include training for judges and legal advocates; research and legal expertise; the extension of EU-level NGO networks; training and capacity-building activities for NGOs; and awareness-raising activities to inform people of their new rights and obligations under European and national anti-discrimination legislation. Finally, new issues have been brought to the fore such as the Roma communities, the relationship between the protection of individual rights to equal treatment and the collective rights of national minorities, and the situation of stateless persons in certain Member States; these have obviously resulted in a broadening of the policy agenda.

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