# Enlargement two years on: Economic success or political failure?

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## EXECUTIVE SUMMARY

Two years after eastward enlargement, the EU is still struggling to come to terms with it. A growing number of people in the 'old' member-states question whether enlargement has benefited the EU. Many think that competition in the enlarged single market has somehow become 'unfair'. They accuse the new member-states of engaging in 'social dumping' and harmful tax competition. They blame high unemployment in their own countries on an influx of Polish plumbers, Hungarian nurses or Latvian builders.

If public hostility to enlargement continues, future accessions will become much more difficult, and the EU risks losing one of its most potent policy tools. Therefore, EU politicians, Brussels officials and the media must explain to Europeans that enlargement has been good for the EU economy as a whole. Trade between the 'old' and the new member-states is thriving. And foreign direct investment from west to east has created thousands of jobs in Central and Eastern Europe while helping West European companies to stay competitive in the face of global competition.

The Central and East European countries have benefited tremendously from integrating their economies with the bigger and wealthier ones in Western Europe since the early 1990s. The objective of joining the EU served as an external anchor for reforms. As a result, these countries have gone from post-Communist chaos to orderly EU membership in less than a decade and a half. And although the pace of reforms has slowed recently, the growth prospects in the region remain good.

For the 'old' member-states, the economic impact of enlargement has also been positive – although it has been much smaller, simply because the economies of the new members are so small. Some EU countries, in particular Austria and Germany, have done particularly well out of exporting to Central and Eastern Europe's fast-growing markets. And many West European companies have profited substantially from investing in retail, telecoms, energy or the media in the new Europe. But enlargement is changing the EU economy in a more profound way. Enlargement has allowed the emergence of a new, pan-European division of labour. This, in turn, will help the EU economy to stay competitive in a globalised world economy.

The economic integration between Western and Eastern Europe started at a time when the EU-15 was coming under growing global pressure, due to the rise of China, India and other emerging economies. Companies from France, Germany, Denmark and elsewhere have reacted to globalisation by outsourcing some labour intensive production processes to places where wages are lower. Many chose the Central and East European candidate countries, not only because of their convenient location but also because accession preparations made their business environments look more and more similar to those in the old EU. Contrary to widespread perception, low taxes and a lack of social protection have not been the main attraction for foreign investors coming to Eastern Europe. The effective tax burden in most of the Central and East European countries is similar to that in the old EU. And the new members have social security systems that are rather too generous, given their levels of income and economic development.

The relocation of production from west to east has helped Europe's companies – from cars to telecoms – to stay competitive on a global scale. Therefore, while some factory jobs may have moved to Hungary, Poland or Slovakia, many jobs in research, design and higher-value added production have been preserved or created in the old EU.

West Europeans not only fear the relocation of their factories to the new EU countries, they are also concerned about East European workers coming in and 'stealing' their jobs. However, those countries that were courageous enough to open their labour markets to East European job-seekers in 2004 have gained economically. Those countries that decided to keep restrictions on the free movement of labour often found them to be ineffective. Finally, fears that eastward enlargement would overburden the EU budget have also proved unfounded. On the contrary, the EU has achieved its biggest ever enlargement 'on the cheap', with only very limited funds earmarked for the poorer new members.

## 1. INTRODUCTION

Eastward enlargement has been one of the EU's greatest ever successes. The prospect of joining the Union has helped ten Central and East European countries to move from post-Communist chaos to orderly EU membership in only a decade and a half. This transformation must count as one of the most impressive examples of 'regime change' ever recorded. It was peaceful, smooth, cheap and entirely voluntary. For the applicant countries, membership in the EU promised to deliver security, democratic stability and economic prosperity. To get ready for entry, they slashed tariffs, sold off state-owned companies, overhauled their banking sectors, cut state subsidies, threw open their telecoms and energy markets and clamped down on cronyism and corruption. And they hastily took over the 80,000 pages of rules and regulations that constitute the EU's *acquis*, its accumulated body of law.

After almost a decade of preparations, the EU finally declared most of candidates fit for membership in 2003. However, when eight of the Central and East European countries (plus Cyprus and Malta) acceded in May 2004, they received only a lukewarm reception. The EU had not been generous in making money available for the newcomers in its common budget. Most of the 'old' EU-15 countries decided to keep restrictions on jobseekers from the new member-states, thus depriving them of one of the fundamental freedoms of the single market. What is more, the Union that the East Europeans joined in 2004 bore scant resemblance to the peaceful and prosperous club they had been looking forward to. Economic growth in the large eurozone countries had almost come to a halt. Deep divisions caused by the Iraq war were slow to heal. An agreement on the EU's new constitution only became possible after months of angry haggling. In short, the EU looked exhausted, and a little less than welcoming.

Then things got worse. Extremist and anti-EU parties did well in the elections to the European Parliament shortly after enlargement. Survey after survey showed that many West Europeans were turning against enlargement. Politicians in France, Germany and elsewhere accused the new members of competing 'unfairly' in the single market, using low taxes to lure West European companies across the border while their workers were undercutting wages and social standards in Western Europe. In May 2005, the French voted against the EU's constitutional treaty. Opposition to enlargement and low-cost competition were cited as key reasons for the French 'non'. Shortly afterwards, the Dutch also voted 'nee', leaving the enlarged EU in a constitutional limbo. Leading French and German politicians presented plans for a 'core' Europe that would invariably relegate most of the new members to the fringes of the EU.

The June 2005 EU summit ended in acrimony as EU leaders fell out over how to distribute scarce EU budget resources among the club's enlarged membership. When the budget was finally agreed at the end of the year, it turned out smaller than expected, with most money still going to previous beneficiaries, such as French farmers or poorer Spanish regions. Meanwhile, the British EU presidency tried in vain to line up its EU peers behind a renewed European reform effort. Instead, there were heated debates about the 'right' economic and social model for the EU. In this antagonistic atmosphere, the EU made little or no progress on long-standing projects such as opening up services markets. By early 2006, the EU's single market – one of Europe's greatest achievements – showed signs of strain, as France, Italy, Spain sought to defend 'national champions' against cross-border takeovers.

Two years after the 25 EU leaders gathered in Dublin to celebrate eastward enlargement, many people now ask whether the EU's biggest ever enlargement has failed. It has not. For the Central and East European countries, the accession process has been the key to their economic success. The objective of joining the EU has kept East European policymakers focused on structural reforms. The gradual trade opening between east and west, alongside large-scale foreign investment inflows, has created an export boom and healthy economic growth rates in the accession countries. The EU is also helping the new members with money out of its central budget, although the sums going to the East are relatively limited.

For the 'old' member-states, the economic benefits of enlargement have been much smaller, but they have still been positive. Many West European countries have done very well out of selling machine tools, consumer goods and services to Eastern Europe's fast-growing markets. West Europeans companies have made big profits from their investments in these countries. More fundamentally, eastward enlargement has given the old EU what it needed most to stay competitive in the face of globalisation, namely a large pool of skilled, low-cost workers directly at their doorstep. West European companies have reacted to the rise of China and India by shifting some labour or skill-intensive production processes to Hungary or Poland. This has helped them to remain competitive and so preserve or create jobs at home. The immigration of highly-skilled and motivated East European workers has also benefited many of the old EU countries – although most of them decided to keep firm control over who comes in and for how long. West European countries will only be able to benefit from the relocation of factories and the arrival of East European workers if they make their labour markets more flexible and upgrade their economies towards higher value-added production and services. Eastward enlargement may therefore bring about what years of anguished political debate have failed to achieve: it will force 'old' Europe to reform.

Economically, therefore, eastward enlargement has been a huge success. But politically, the EU has not digested the accession of the ten new members. Pro-Europeans fear that further integration will be impossible in a Union with 25, and soon 27, members. France struggles to find its place in the enlarged EU, where it no longer calls the shots. German, Dutch and Danish taxpayers complain that they are paying too much for eastward enlargement, calling into question the whole notion of EU solidarity. Austrian, Italian and French workers believe that Polish plumbers and Latvian builders are 'stealing' their jobs, and that 'unfair' tax levels in the East are behind factory closures in their countries.

Such allegations have poisoned the atmosphere in the enlarged EU. In terms of budgetary resources, eastward enlargement has been a bargain: the costs during the first couple of years amount to less than 0.1 per cent of EU GDP. Similarly, allegation of 'unfair' tax competition do not stand up to scrutiny. Slovakia and Hungary may have lower corporate profit tax rates than say, Germany and France. But they also have fewer loopholes. So they still collect more revenue from companies than many of the old EU countries. Moreover, rather than engaging in 'social dumping', the new members also have very high taxes on labour to finance their relatively generous social security and welfare systems.

This paper attempts to give an overview of how the EU has fared in its first two years after enlargement. Section 2 looks at developments in the new member-states, where fast economic growth has continued despite an increase in political stability. In section 3, the economic impact of enlargement on the 'old' members will be investigated. Some EU countries have gained significantly from growing trade and investment flows with the new members. But most importantly, the relocation of some labour or skill-intensive production processes to Central and Eastern Europe has helped to preserve the competitiveness of West European enterprises. Section 4 looks at these new, pan-European supply chains, which will ultimately help to save jobs in Germany or France – provided these countries upgrade their production structures to high-tech industries and value-added services.

Western Europe's need for more flexible labour markets will be reinforced by the immigration of East European workers, which is the subject of section 5. Whether Hungarians or Latvians will seek jobs in Austria or Sweden will to some extent depend on the economic prospects they face at home. This is one of the reasons why the EU is giving regional aid to the new members, to help them catch up with West European income levels. Section 6 investigates the financial costs of eastward enlargement. Section 7 returns to the political dynamics of the enlarged EU. In particular, it debunks the widely held believe that the new member-states engage in 'unfair' tax competition and 'social dumping'. The conclusion looks ahead to future accessions and makes an appeal to EU politicians not to give in to populism by exploiting anti-enlargement sentiment.

Eastward enlargement is both recent and unprecedented, so by necessity the conclusions of this paper are tentative and open to discussion. Since it seeks to provide a broad overview of the EU economic and political system after enlargement, it concentrates on the larger member-states, with due apologies to the smaller EU countries. Since Malta and Cyprus are not included in many of the data used in this study, the new members are referred to as EU-8 while the old ones are denoted EU-15.

**Box 1: Chronology of enlargement**

1973 - Denmark, Ireland and the United Kingdom
1981 - Greece
1986 - Spain and Portugal
1995 - Austria, Finland and Sweden
2004 - Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia
2007? - Bulgaria and Romania (delay possible to 2008)
2009? – target date for accession of the Croatian government
2014? – earliest possible entry date for Turkey
The EU has acknowledged Macedonia as a candidate but has not started accession negotiations. The EU has in principle agreed that the other countries of the Western Balkans can become candidates, namely Albania, Bosnia-Hercegovina and Serbia- Montenegro. Some former Soviet countries, such as Georgia, Moldova and Ukraine, have expressed an interest in joining the EU, but they have not been given a 'membership perspective.

## 2. EASTERN EUROPE AFTER ACCESSION

Economically, eastward enlargement is yesterday's news. The EU and the Central and East European countries started to dismantle bilateral trade barriers in the early 1990s, even before they agreed timetables for full liberalisation through the 'Europe agreements'. By 1997, the EU had abolished all tariffs and quotas for imports from the candidate countries – with the exception of food products, some 'sensitive' items and services. The deadline for the Central and East Europeans to fully open their markets came somewhat later, in 2002.

The lowering of mutual trade barriers – alongside rapid industrial restructuring – fuelled an export boom across Central and Eastern Europe that has been instrumental for the region's recovery. In the ten years before accession, Hungarian exports rose by 380 per cent (in dollar terms) and Czech ones by 280 per cent. By 2000, the big Central European countries were already sending 60 to 75 per cent of their exports to the EU. In other words, long before membership, they were trading more with the EU than many of the EU countries were trading with each other.

The export boom was closely related to large-scale inflows of foreign direct investment (FDI). Foreign investors did not wait until the accession date to buy up newly privatised companies in Eastern Europe and to take advantage of the region's growing markets and low-cost, skilled workers. It was the *process* of accession, rather than the accession itself, that attracted foreign companies, for several reasons. First, as the East European countries took over EU rules and policies, their business environments started to resemble those in Western Europe. As a result, German, Dutch or British companies felt more at home in the accession countries. Second, as the EU opened up its markets for goods from Poland, Estonia or Slovakia, these countries became more attractive locations for export-oriented production. And third, the prospect of EU membership acted as an 'external anchor' for economic reforms, guaranteeing a certain amount of stability and insuring investors against policy reversals.

As a result, EU companies have ploughed more than €150 billion into the ten Central and East European accession countries since the early 1990s. For the recipient countries, FDI inflows from the EU have typically amounted to 20 per cent of total investment and 5 per cent or more of their GDP. FDI has financed the build-up of massive new production capacities across Central and Eastern Europe, in particular in the automotive sector, but also in electronics, furniture, pharmaceuticals and other manufacturing sectors. And FDI has helped to create modern services sectors such as retail, banking, telecoms and transport.

**Table 1: Basic indicator for the new member-states, 2005**

| | Population, m | GDP, € bn | GDP growth, per cent | Inflation, per cent | GDP per head, per cent of EU average at PPP |
|---|---|---|---|---|---|
| Poland | 38.1 | 240.5 | 3.2 | 2.2 | 46.2 |
| Czech R. | 10.2 | 98.4 | 4.9 | 1.9 | 65.6 |
| Hungary | 10.0 | 87.8 | 4.2 | 3.6 | 59.2 |
| Slovakia | 5.4 | 37.3 | 5.5 | 2.7 | 56.9 |
| Lithuania | 3.4 | 20.0 | 6.7 | 2.7 | 51.5 |
| Latvia | 2.3 | 12.8 | 9.8 | 6.7 | 46.3 |
| Slovenia | 2.0 | 27.4 | 3.9 | 2.5 | 82.8 |
| Estonia | 1.3 | 10.3 | 9.1 | 4.1 | 58.5 |
| Cyprus | 0.8 | 13.4 | 3.7 | 2.6 | 77.2 |
| Malta | 0.4 | 4.5 | 1.0 | 3.0 | 67.8 |
| **EU 25** | 459.0 | 10,793.8 | 1.5 | 2.1 | 100.0 |

PPP stands for purchasing power parity.
Sources: The Economist Intelligence Unit, Eurostat.

In short, gradual economic integration with the EU has been instrumental for the new members' economic success. Since the mid-1990s, the Central and East Europeans countries have consistently outgrown most of the old EU. For example, Poland grew by an average of 4.4 per cent a year in the decade leading up to its EU accession. Hungary expanded by 3.6 per cent on average in 1995-2004, and Estonia by 5.4 per cent. By comparison, Germany mustered an average growth rate of 1.3 per cent in 1995-2004 and France of 2.2 per cent. Even the faster growing Nordic countries could not match the East Europeans' economic growth rates (Sweden: 2.9 per cent, Denmark: 2.1 per cent). The accession countries also did considerably better than those countries that have not applied for (or been offered) the prospect of membership, for example Russia, Ukraine or Moldova, whose average growth rates in 1995-2004 were respectively 2.9 per cent, 1.5 per cent and 1.4 per cent.

**A post-accession boom?**

Given that the Central and East European countries had gained so much already from integrating with the EU, most economists expected only limited further gains to come from the actual accession to the EU. Yet a marked pick-up in economic growth across the region in 2004 seemed to suggest that there was something like a 'post-accession boom'. Average real GDP growth in the new members accelerated from 3.7 per cent in 2003 to 5 per cent in 2004. In how far EU accession was behind the improved performance is open to debate. Many of the Central and East European countries were well into an economic upswing when the accession date approached. Many were also reaping the benefits of structural reforms they had pushed through in the run-up to accession.

In some ways, however, accession may have contributed to the strong economic performance in 2004.[1] Fearing EU-related price and tax rises, East Europeans went on a shopping spree in early 2004, while businesses stocked up on inputs. As a result, consumption boomed in many of the acceding countries ahead of enlargement, helped by double digit credit growth in some countries. As anticipated, in May many East European governments raised value added tax rates and excise taxes on alcohol, tobacco and fuel to comply with EU minimum levels. Some foodstuffs, such as sugar, also became more expensive as the Common Agricultural Policy (CAP) was fully extended to the new members.[2] To some extent, the inflationary consequences of these price rises were contained

1 Katinka Barysch, 'Enlargement – one year on', Country Forecast Regional Overview, Eastern Europe, The Economist Intelligence Unit, June 2005. World Bank, 'EU-8 quarterly economic reports', January 2005 and April 2005.

2 European Commission, 'The economy for the euro area, the European Union, and candidate countries in 2004 – 2006', Economic Forecasts, Spring 2005.

by strengthening currencies and wage restraint. But Latvia, Lithuania, Hungary, Poland and the Czech Republic all saw inflation pick up by two percentage points or more in 2004. Despite rising oil prices, most of the new members managed to contain price rises in the course of 2005, with average inflation rates still below 2.5 per cent in the big Central and East European countries.

Exports also contributed to strong economic growth in the new members in the accession year. A combination of faster growth in their main markets and past inflows of export-oriented FDI were behind the good export performance. But the dismantling of the remaining trade barriers between the old and new members also added to the momentum, in particular in agricultural goods and foodstuffs. Easier customs rules and the abolition of many border controls further encouraged cross-border activity. The number of vehicles passing between Poland and Brandenburg, for example, rose from just over 20,000 a day before May 2004 to 33,000 in early 2005, while the number of lorries going from Berlin to the Polish border roughly doubled. Moreover, the abolition of trade barriers among the new members led to a rapid increase in intra-regional trade. Despite strengthening currencies, most of the new members recorded export growth rates of 20 per cent or more in 2004, before export growth moderated again in 2005.

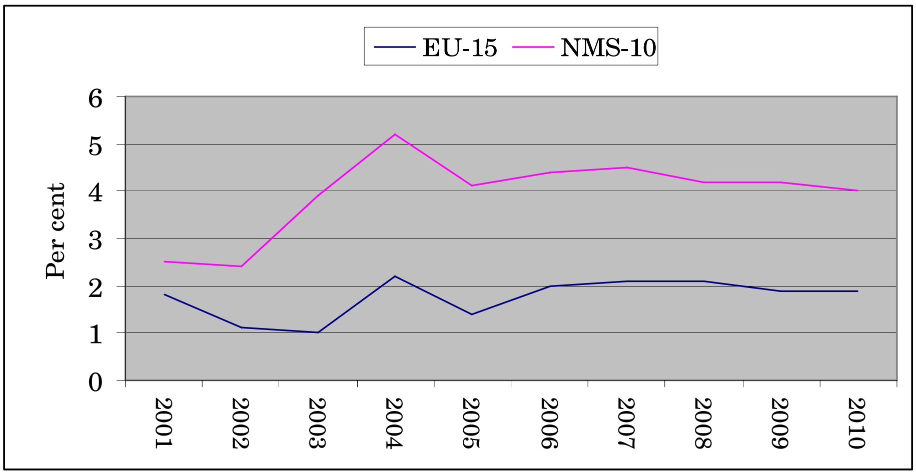
**Foreign investors remain upbeat**

The pick-up in consumption added to growing economic optimism across Eastern Europe, which, in turn, underpinned higher investment rates. All East European member-states bar the Czech and Slovak Republics recorded investment growth rates of 5 per cent of more in 2004 and 2006. Investment was supported by a pick-up in FDI inflows. Again, it is difficult to attribute renewed investor interest to EU membership. Inflows of privatisation-related FDI fell in 2004, although there were some big deals, including stakes in Slovakia's power monopoly and Poland's biggest retail bank. Nevertheless, FDI flows from the old to the new member-states amounted to €13.8bn in 2004, almost double the 2003 number of €7bn, according to Eurostat.

Most large West European companies have been investing in the acceding countries for many years and for them the actual accession made little, if any, difference. On the contrary, some larger corporations fear that EU membership will push up wages and regulatory costs. As a result, they are moving their production facilities further east while using Prague, Tallinn or Budapest increasingly for the outsourcing of IT and other services. Such investment in call centres or R&D is important for the economic upgrading of the new members, but it is less capital intensive so it does not necessarily translate into higher FDI figures.

There is some evidence, however, that accession changed the perceptions of smaller companies in Western Europe. Almost 60 per cent of German *Mittelstand* companies said that Eastern Europe was now their preferred location for outsourcing, according to a 2005 study from The Executive Committee (TEC). Only 38 per cent said they would rather shift production, logistics or marketing to Asia. The need to cut costs was reinforced by sluggish eurozone growth, the strengthening euro and a ripple effect that is itself the result of outsourcing: as more and more companies transferred production to low-cost locations, the pressure grows on their competitors to follow suit.

**Graph 1: Real GDP growth in the old and new member-states, %**




Source: The Economist Intelligence Unit. 2006-2010 = forecasts.

## Post-accession politics

The new members' good economic performance and their continued attraction to foreign investors were somewhat surprising against the backdrop of increased political instability and a slowdown in reforms that followed the actual accession. During 2004, seven out of eight East European members saw a change in government, mostly as a result of political infighting or scandals, rather than orderly elections. In the only country where government held on to power – Slovakia – it lost its parliamentary majority. In many others, unstable coalitions were formed among previous political opponents (see table). In Poland, the 2005 elections produced a populist, right-wing government that is propped up in parliament by radical farmers and anti-Europeans.

**Table 2: Political landscape in Central and Eastern Europe**

**Central Europe's variety show**

| | Government's flavour | Pluses | Minuses | Likely date of next election |
|---|---|---|---|---|
| Bulgaria | Left/monarchist/ Turkish | Strong, EU membership close | Gangsters untamed | 2009 |
| Czech Republic | Left/centre-right | Durable | Scandals, weak | Jun 2006 |
| Estonia | Free-market/populist | Booming economy | Inflation threatens | 2007 |
| Hungary | Centre-left/liberal | Incomes rising | Spendthrift, indebted | Apr 2006 |
| Latvia | Pro-business | Stable, strong economy | Conflicts of interest, complacent | Oct 2006 |
| Lithuania | Ex-communist/ populist/liberal/rural | Euro almost in reach | Scandals, slow reform, unstable | 2007 |
| Poland | Populist | Clean, tough | Squabbling, unstable | 2009* |
| Romania | Centrist/free-market/ Hungarian | EU membership close | Scandals, in-fighting | 2008 |
| Slovakia | Free-market/populist/ Hungarian | Big reforms, strong economy | Scandals, divisions | Sep 2006 |
| Slovenia | Centre-right/centre-left | Stable, euro in sight | Few reforms | 2008 |

Source: *The Economist* *Or later this year

The reasons for this increase in political instability are difficult to fathom. It is possible that EU accession itself has changed the political dynamics in Central and Eastern Europe. In the candidate countries, the objective of EU accession was backed by a strong cross-party consensus, and it dictated much of the policy agenda. The EU's manifold demands left little room for political discussion about the 'right' course of action. All mainstream parties usually supported whatever reforms were needed to get their country ready for membership. In other words, the accession process was the glue that held together Eastern Europe's rather fractious party political systems. After accession, this glue resolved. Policy-making became more controversial and antagonistic, and the newcomers showed signs of 'reform fatigue'.

There are several reasons for the slowdown of reforms. First, many of the pre-accession measures – implementing tougher food standards, say, or liberalising the banking system – were relatively uncontroversial compared with the reforms that are now on the agenda, such as slimming down expensive social security systems and modernising education. Second, five of the EU-8 were getting ready for elections in either 2005 or 2006, so their appetite for painful measures has been limited. And third, the EU no longer serves as an external 'anchor' for reforms. During the pre-accession process, the EU had tremendous leverage over the Eastern European governments. It could always threaten to send a country to the back of the accession queue in case its reform efforts slackened. Accession reduced or even eliminated this leverage. The EU can prod member countries to speed up reforms under its EU 'Lisbon' reform programme. Or it can start a lengthy case at the European Court of Justice against a country that fails to comply with EU law. But neither of these give the EU the same clout as the threat of exclusion or delays to accession.

The European Bank for Reconstruction and Development (EBRD), which tracks structural change across Eastern Europe, reports a slowdown in reforms in the EU-8 since 2004. However, the EBRD lauds further progress in privatisation, financial deepening and corporate governance, which underpinned strong investment in 2004-05. And it acknowledges the EU-8's high levels of achievements in previous years, which leaves them well ahead of the Balkans and the countries of the former Soviet Union.[3] Similarly, the World Bank reports positive changes in many of the new members in its 'Doing business' database. The World Bank singled out Slovakia and Latvia as being among the fastest-reforming countries in the world in 2004. Meanwhile, Estonia and Lithuania are ranked ahead of Germany, France and Italy in the World Bank's assessment of local business environments (although still behind the Nordic EU members, the UK and Ireland).[4] Moreover, a large-scale company survey conducted in 2005 found that Slovakia has the most satisfied entrepreneurs in the whole of Eastern Europe, with rapid improvements recorded in business regulations, property rights, economic management and financing.[5]

Other new EU members have been doing less well, however. In the World Bank's 'Doing business' database, Hungary and Poland are ranked just ahead of Panama and Pakistan. In the company survey, Hungarian and Czech entrepreneurs reported that their business environments were deteriorating in 2005. Czech companies bemoaned infrastructure constraints, skill shortages, labour market regulations, while Hungarian entrepreneurs were unhappy about growing macro-economic risks and limited access to funding. In both countries, companies thought the tax burden was getting heavier. Polish companies worry about economic stability and report only limited changes in their business environment since 2002, when the first survey of this kind was conducted.

3 EBRD, 'Transition report 2005', October 2005.

4 World Bank, 'Doing business in 2006 – creating job', 2006.

5 EBRD and World Bank, '3rd business environment and enterprise performance survey (BEEPS)', 2005.

**Box 2: The new members and the euro**

Central and Eastern Europe has already reaped most of the gains from integrating with the EU. However, a further economic boost could come from adopting the euro. The countries that joined the eurozone in 1999 have seen an increase in competition and growing trade flows among each other. There is also some evidence that the euro influences FDI flows. The new members had initially hoped to join the euro as quickly as possible after their EU entry. Since euro aspirants have to be members of the ERM-2, the EU's revamped 'exchange rate mechanism' for at least two years, the earliest possibly euro entry date would have been 2006 or 2007. However, at the time of writing it looks as if only Slovenia was heading for early euro membership in 2007.

All the other newcomers are struggling to meet one or more of the Maastricht criteria for eurozone entry. Under a strict interpretation of the criteria – something that many eurozone countries and the European Central Bank will insist on – even the Baltic states will probably be forced to delay their entry. The Baltic countries joined the ERM shortly after EU accession and they boast rock-solid exchange rate regimes (they all have currency boards under which their monetary policy is effectively set by the ECB already) and sound budget policies. But high oil prices and other price pressures in their booming economies have pushed inflation rates beyond what is allowed under Maastricht rules (the reference value is the average from the three EU countries with the lowest inflation plus 1.5 percentage points, which in early 2006 amounted to around 2.5 per cent).

Among the Central and East European countries, only Slovakia has joined the ERM so far. Provided it keeps its budget deficit under control, it could join the eurozone before the end of the decade. Hungary will struggle to get its budget deficit to below 3 per cent of GDP before 2008 or 2009. The Czech central bank has mooted mid-2007 as a possible entry date into the ERM, which would make euro entry possible in 2009. However, the largely unreformed social security system will put pressure on the state budget. And an election victory of the more eurosceptic ODS could result in politically motivated delays. Similarly, the new Polish PIS government shows little enthusiasm for the single currency, so ERM entry looks likely over the next couple of years.

**The East's eurosceptics**

Many observers had feared that the new members would be disappointed with the EU, not only because many East Europeans had nourished inflated expectations, but also because the 'old' members gave them a less than warm welcome. Criticism of the EU had already grown ahead of accession. Many Central and East Europeans felt that the EU had 'imposed' its long and complex rulebook, without giving them a say or taking into account their specific needs. They disliked the safeguard clauses that the EU had written into the accession treaty, allowing other member-states to close their markets for East European goods under certain circumstances. They were angered by the fact that most West European countries decided to keep their labour markets closed to East European workers for up to seven years after enlargement. And they resented the fact that they would not receive the same level of EU farm subsidies as France, Denmark or Italy until 2013.

A Eurobarometer poll just before enlargement revealed that only 43 per cent of the people in the acceding countries thought that being in the EU was a good thing – a smaller share than in the EU-15. The outcome of the elections to the European Parliament, which took place one month after enlargement, seemed to support those who argued that Eastern Europe was already tiring of the EU. The turnout across the new members was a shockingly low 27 per cent, below that of 'euroscpetic' Britain.

However, once inside the club, the East Europeans regained some of their enthusiasm for the EU. In the autumn of 2005, 58 per cent of the people in the new member-states thought their country had benefited from EU membership while only 29 per cent suspected that their country had not gained. The share of those who consider the EU to be ‘a good thing’ has risen by almost 10 percentage points since accession.

Even East European farmers – previously the region’s most eurosceptic group – were happy after they received their first cheques from the EU. The amounts may have been lower than those dispensed in the old EU, but in the deprived rural areas of eastern Poland or Latvia, the EU money still went a long way. More importantly, EU farm subsidies came on top of rising food prices and new market opportunities that resulted from the extension of the CAP to the new members. Rather than being swamped by cheap West European food products, the new members’ farm sectors boomed as British and French supermarkets started sourcing their supplies from cheaper East European producers. The World Bank estimates that Polish and Czech food exports roughly doubled in 2004 and those from Slovakia tripled compared with 2003. Export growth, strong domestic demand and the inflow of CAP subsidies translated into a doubling of farm incomes in the Czech Republic, while Polish farmers saw their incomes rise by 75 per cent and those in the three Baltic countries by around 50 per cent, according to Eurostat.

Although there are no signs of growing anti-EU sentiment in Central and Eastern Europe, some observers still detect signs of a backlash against the EU. Eastern European politicians are bound to become more critical of the EU’s policies, now that they no longer have to fear repercussions for their accession prospects. The forthcoming elections in the Czech Republic, Slovakia and Hungary could give politicians the opportunity to capitalise on widespread voter dissatisfaction by blaming the EU for local problems. There are fears that a strong showing of the ODS in the Czech Republic, Smer in Slovakia or Fidesz in Hungary could result in more eurosceptic governments in all three countries. The risk is that such governments, alongside the populist PIS minority government in Poland, could turn the new members into awkward EU partners.

However, it is important to distinguish between electioneering and actual policy changes. So far, the newcomers have usually taken a constructive attitude to most areas of EU policy-making. The occasional fierce disagreement – be it over the EU budget or exemptions from value-added tax (VAT) – only proves the rule. Threats to EU harmony do not come from the new members. They mainly come for those countries among the EU-15 that accuse the new members of destroying jobs, competing unfairly and undermining the EU’s cherished social model.

## 3. THE IMPACT ON THE EU-15

Central and Eastern Europe has done very well out of joining the EU. However, some West Europeans suspect that the East’s economic success has come at their expense. Have cheap exports from Slovakia and Poland priced Dutch and French goods out of the market, they wonder. Have the large-scale FDI flows simply transferred jobs from West to East? A large – and growing – share of West Europeans thinks so. In 2003, 43 per cent of the people in the EU-15 feared that enlargement would push up unemployment in their country. In Germany, the country that had received by far the biggest inflow of East European workers before enlargement, the share was 56 per cent.[6] In a poll conducted in early 2006 (albeit with a different methodology), more than 80 of Germans thought that eastward enlargement endangered their job.

More broadly, West Europeans seem to feel less at home in the enlarged EU. The share of those who consider EU membership to be “a good thing” is falling in all large member-states. Across the EU-15, only half of all people now take this view. Similarly, a growing number of people in Western Europe think that their country has not benefited from being a member of the Union. In traditionally pro-EU countries such as Germany and Austria (the two countries most affected by enlargement) there are now as many people who think their country does not gain from membership as in eurosceptic Britain.

6 Eurobarometer and EOS Gallup, ’The enlargement of the European Union’, Flash Eurobarometer 140, 2004.

**Table 3: Do you think your country has benefited from EU membership? Per cent of those polled**

| | Spring 2004* | Autumn 2004 | Spring 2005 | Autumn 2005 |
|---|---|---|---|---|
| Belgium | 58 | 72 | 69 | 65 |
| Spain | 69 | 70 | 69 | 69 |
| France | 46 | 54 | 53 | 51 |
| Germany | 39 | 49 | 50 | 46 |
| Austria | 38 | 43 | 41 | 35 |
| UK | 30 | 39 | 40 | 37 |
| Sweden | 27 | 36 | 36 | 32 |
| Hungary | 58 | 48 | 47 | 41 |
| Poland | 50 | 55 | 62 | 63 |
| Czech Rep | 46 | 42 | 56 | 55 |
| Estonia | 41 | 56 | 58 | 56 |

* People in the candidate countries were asked whether they expected their country to benefit.
Source: Eurobarometer.

However, many West Europeans misunderstand the way in which enlargement has impacted on their country. The impact of enlargement cannot be measured directly, since too many other, non-enlargement factors influence trade flows, investment decisions, inflation rates and job-market developments. Instead, economists have used complex models to calculate the theoretical impact of accession. Such studies should therefore not be taken as an estimate or forecast of the real impact of enlargement. They are, however, useful for illustrating broad trends in the enlarged EU.

Economists usually assume that there are four channels through which enlargement can have an impact on the economies of the EU-15:

• trade: the removal of the remaining tariffs and border controls lowers the cost of east-west trade flows;

• the single market: integrating the new members into the single market increases competition, which result in higher productivity and lower prices;

• the movement of factors of production: capital moves from west to east and workers move from east to west;

• financial costs: transfer payments to the new members through the EU budget.

**Table 4: Estimates of the impact of enlargement in 2005-07 (A) and 2008-10 (B), percentage change in real GDP compared to non-enlargement case**

| | Trade | | Single market | | FDI | | Migration | | Budget costs | | Net impact | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | A | B | A | B | A | B | A | B | A | B | A | B |
| Germany | 0.2 | 0.0 | 0.5 | 0.4 | -0.1 | -0.1 | 0.1 | 0.2 | 0.0 | 0.0 | 0.6 | 0.5 |
| France | 0.0 | 0.1 | 0.2 | 0.3 | -0.1 | -0.2 | 0.0 | 0.0 | -0.1 | 0.0 | 0.1 | 0.1 |
| Italy | 0.1 | 0.2 | 0.5 | 0.5 | 0.0 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.5 | 0.5 |
| UK | 0.0 | -0.1 | 0.2 | 0.2 | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 | 0.2 | 0.2 |
| Spain | -0.1 | -0.1 | 0.5 | 0.4 | -0.1 | -0.4 | 0.0 | 0.1 | -0.1 | -0.1 | 0.3 | -0.2 |
| Netherlands | 0.1 | 0.2 | 0.7 | 0.3 | -0.1 | -0.2 | 0.1 | -0.1 | -0.1 | 0.0 | 0.7 | 0.2 |
| Austria | 0.2 | 0.1 | 0.6 | 0.6 | -0.1 | -0.3 | 0.1 | 0.2 | 0.0 | 0.0 | 0.8 | 0.7 |
| Denmark | 0.1 | 0.1 | 0.4 | 0.1 | -0.1 | -0.2 | 0.0 | -0.1 | 0.0 | 0.0 | 0.4 | -0.1 |
| Ireland | 0.1 | 0.2 | 0.6 | 0.8 | -0.1 | -0.4 | 0.1 | -0.1 | -0.2 | -0.1 | 0.5 | 0.4 |
| Portugal | 0.0 | 0.1 | 0.7 | -0.1 | -0.1 | -0.1 | 0.1 | -0.1 | -0.1 | 0.1 | 0.6 | -0.2 |
| Old EU | 0.1 | 0.1 | 0.4 | 0.3 | -0.1 | -0.2 | 0.1 | 0.1 | 0.0 | 0.0 | 0.4 | 0.3 |
| Poland | 2.0 | 2.5 | 1.2 | 2.1 | 0.2 | 0.5 | 0.0 | -0.1 | 1.9 | 3.2 | 5.3 | 8.0 |
| Hungary | 4.0 | 4.2 | 1.6 | 1.3 | 0.3 | 0.8 | 0.0 | -0.1 | 1.5 | 2.2 | 7.3 | 8.4 |
| Czech | 1.8 | 2.8 | 1.0 | 0.5 | 0.1 | 0.4 | 0.0 | -0.1 | 1.1 | 2.0 | 4.0 | 5.7 |

Note: On the assumption that enlargement takes place in two waves, with five countries joining in 2005 and five in 2007.
Source: Fritz Breuss, 'Makro-ökonomische Auswirkungen der Osterweiterung' 2001.

Although the available studies have relied on very different assumptions and methodologies, they have come to broadly similar conclusions: First, the impact of eastward enlargement on the EU-15 has been limited. Second, the impact – though small – has been positive. Third, as pointed out above, much of the impact has taken place already since economic integration between Eastern and Western Europe has proceeded gradually since the early 1990s. Most studies conclude that the cumulative economic gain for the old EU is below 1 per cent over a period of five to ten years.[7]

These results are quite intuitive. The direct impact of eastward enlargement on the old EU has been marginal, simply because the new member-states are so small. Taken together, their GDPs amount to only 5 per cent of the EU-15 GDP, or 10 per cent if measured at purchasing power parity. In economic terms, therefore, enlargement was the equivalent of adding an economy the size of the Netherlands to a single market with 380 million consumers and a GDP worth €10 trillion. While the EU-15 is the destination of 70 per cent or more of East European exports, the new members account for only around 4 per cent of EU-15 trade. Similarly, FDI flows from west to east have been hugely important for the recipient countries, but much less so for the countries where they originate. Even for Germany – traditionally the biggest foreign investor in the EU-8 – investment in the new members has typically amounted to 1-2 per cent of total corporate investment in recent years. In 2004, the old EU-15 invested eleven times more in each other's economies than in the new member-states. Taking these asymmetries into account, it is safe to assume that the impact of enlargement on the new members is roughly 20 times larger than on the old ones.

**Winners and losers**

For most of the EU member-states, trade and investment links with the candidate countries are simply too small to have a direct, measurable impact on their economies. The only exceptions are Germany and Austria, which trade a lot with the region and, alongside France and the Netherlands, account for the bulk of foreign investment there. These countries are likely to be among the biggest net winners from enlargement. Other countries might be indirectly affected by eastward enlargement, for example because their products can no longer compete in the big eurozone markets or because they may lose EU aid to the poorer East European countries. Portugal or Greece may be among the losers in this respect. For smaller, richer EU countries with limited trade and investment links to the East, the impact is fiendishly difficult to calculate. Whether the outcome is positive or negative depends entirely on the assumptions used, for example about future migration flows, growth rates in the new members or the distribution of the EU budget. Take the case of Denmark. While the table above indicates that Denmark would suffer a small net loss in the two years following accession, another study predicts a small aggregate welfare gain of 0.5 per cent[8] (albeit over a longer period) while a third one estimates a bigger gain of 1.3 per cent of GDP.[9]

Removing trade barriers between countries usually benefits both sides. And since Western Europe has traditionally run a trade surplus with Central and Eastern Europe, the impact of trade integration was almost certainly positive for the old EU. According to one study, the EU's trade surplus with the big four Central European candidate countries created 114,000 jobs in the EU throughout the 1990s.[10] Another study estimates that removing the remaining trade restrictions upon enlargement will lift Austria's GDP by 0.25 per cent in 2005-2010, while the Netherlands, France and Italy can also expect small but noticeable benefits. Spain, however, could suffer a small loss from trade integration.[11]

The EU is much more than a free trade area or a custom union. It is a deeply integrated market, where goods, services, capital and (usually) people can move around freely, and

7 Katinka Barysch, 'Does enlargement matter for the EU economy?' CER policy brief, May 2003.

8 Wilhem Kohler, 'Eastern enlargement of the EU: A comprehensive welfare assessment', HWWA discussion paper 260, 2004.

9 Anders Due Madsen and Morten Lobedanz Sørensen, 'Economic consequences for Denmark of EU enlargement', Danish Rational Economic Agents Model, July 2002.

10 Wolfgang Quaisser, 'Kosten und Nutzen der Osterweiterung unter besonderer Berücksichtigung verteilungspolitischer Probleme'. Osteuropa-Institut working paper, No 230, February 2001.

11 Fritz Breuss, 'Makro-ökonomische Auswirkungen der Osterweiterung auf alte und neue Mitglieder', a study by the Vienna Institute of Economic Studies for the Preparity project, April 2001.

where companies face few regulatory barriers to doing business across borders. With enlargement, the size of this market has grown from 380 million people to 450 million, making it the biggest integrated market in the western world. But not only the size, but also the nature of the single market has changed since the accession of the East Europeans countries has been accompanied by the emergence of a new division of labour in the EU.

The impact of integrating the new members into the single market is likely to be bigger for those countries that trade the most with the new members, such as Austria and Germany. But the EU's smaller countries also stand to benefit disproportionately from any extension of the single market because their home markets are too limited to generate 'economies of scale' (the kind of productivity gains that come from mass production). Therefore, countries such as Belgium, Ireland or Finland can expect noticeable gains from the EU-8 joining the single market.

## 4. EUROPE'S NEW DIVISION OF LABOUR

Most economists assume that the impact of enlargement on the EU-15 was marginally positive. However, eastward enlargement is changing the EU economy much more than the macro figures indicate. The key point to bear in mind is that the enlargement process has taken place at a time when *global* competition has become much fiercer due to the integration of China and India into the world economy. German car companies, Swedish mobile phone producers and Italian fashion houses have reacted to heightened global competition by shifting some production processes into Eastern Europe, where wages are cheaper.

According to the European Commission, hourly labour costs in 2003 (the last year for which comparable data are available) ranged from 12 per cent of the EU-15 average in Latvia to 53 per cent in Slovenia. In the larger countries – Poland, Hungary and the Czech and Slovak Republics – wage levels are 20-30 per cent of the West European level. Although productivity levels also tend to be much lower (most estimates put Eastern Europe's productivity at 35-40 per cent of the EU-15 level), this still leaves the newcomers with a sizeable advantage in unit labour costs. This advantage is much bigger in foreign-invested export industries, where productivity is often close to West European levels.

The relocation of production facilities to the east has nourished fears of job losses in the EU-15. Most of the FDI into Central and Eastern Europe has happened in sectors that are under fierce global competition, such as cars, pharmaceuticals and electronics. For West European companies, the choice was not between producing at home or abroad. It was between cutting costs or losing market shares – and thus shedding jobs at home anyway. In other words, FDI from west to east may have caused some job losses in West European factories. But by helping German, French or Dutch companies to stay competitive on a global scale, it has also helped to preserve jobs in Germany, the Netherlands or France. According to one survey cited by the *Osteuropa-Institut*, 20 per cent of the German companies with investments in Eastern Europe had shifted jobs eastward, while 60 per cent said their investments had helped to preserve or create jobs at home.

The integration of Central and Eastern Europe into the EU's single market has brought about a new European division of labour, which has benefited both sides. In the accession countries, this process has been accompanied by rapid economic upgrading. Only by moving into higher value-added industries can these countries create the basis for catching up with West European income levels. In the early to mid-1990s, the East Europeans exported mainly labour-intensive goods such as clothing, and capital-intensive ones such as heavy metals and chemicals. From the EU they bought consumer goods and cars, and machine tools to modernise their factories. With the help of large-scale FDI, the accession countries then started to specialise in more skill-intensive industries, and those where economies of scale can be exploited. Today, the old and new member-states sell each other roughly similar goods: cars and car parts, electronics, and pharmaceuticals. This growing 'intra-industry' trade is evidence that the new members are becoming integrated into pan-European supply chains.

Cars and ICT (information and communications technology) are good examples of how the new European economy works.[12] By 2003, motor vehicles, engines and other car parts made up 20 per cent of the exports from the EU-8 to the EU-15, with electronic goods accounting for another 15 per cent or so. Counter-intuitively, the EU-8 have growing trade surpluses in cars with Germany – one of the world's biggest car producers – and in telecommunications equipment with Sweden and Finland, the market leaders in this sector.

**Cars and electronics**

In the early 1990s, Europe's car industry was rapidly losing out to overseas competitors. Although wage bills account for only 10 per cent of the total production cost of a car, even small savings can make a difference in an industry that is so fiercely competitive. So German producers such as Volkswagen ventured into Eastern Europe in a desperate attempt to control costs. Renault, Fiat and other European companies followed suit. So did Korean, Japanese and US producers, seeking access to the entire EU market from a low-cost base. Western car companies not only bought up and modernised existing car plants but also established massive greenfield sites in Hungary, Poland, the Czech Republic and Slovakia. Initially, they shipped components to the East and re-exported the finished models. But soon a whole 'cluster' of components manufacturers spread around the big Central European plants. In some cases, engines and other parts are now shipped to Western Europe, where final assembly takes place.

The automotive sector has become a key growth industry for Central and East European countries. In Slovakia, the sector now accounts for a quarter of industrial production and a third of total exports. In 2007 Slovakia will produce more cars per 1,000 inhabitants than any other country in the world. Car production in the Czech Republic is set to reach 800,000 this year and is rapidly heading for the one-million mark. Volkswagen has ploughed €3.5 billion into Skoda in the Czech Republic, making it the country's largest company with more than 90,000 employees. Hungary, meanwhile, has specialised in components production: one out of 25 cars sold around the world now contains an engine produced in Hungary. Components are also important in Poland, which produces more than 850,000 gear boxes a year. Although Daewoo, Fiat and Ford had to scale back their car production in Poland after 2000, output recovered to more than 500,000 in 2004, of which three-quarters is exported.[13]

Germany is by far the biggest investor in the Central and East European automotive sector. For the German car industry, the relocation of production has helped to cut costs and restore competitiveness. By 2003, nearly one in every five German-brand vehicles produced abroad came from the EU-8, and the Czech Republic had become the third largest foreign location of the German automakers, after Spain and China. Nevertheless, the importance of enlargement for the car sector should not be overestimated. According to the German central bank, of the €100 billion that Germany automakers had invested abroad by 2002, 85 per cent had gone to the US and other EU-15 countries while a growing share was also going to China.

Generally, the impression of many Germans that millions of jobs have moved to the East has not been substantiated by research. The *Osteuropa-Institut* calculates that German FDI in Eastern Europe since the mid-1990s has resulted in no more than 70,000 job losses in the German economy.[14] This is the equivalent of 1.5 per cent of Germany's total unemployment of 4.6 million. And, as this paper argues, many more jobs may have been saved or created through the new European division of labour.

ICT is another example of Europe's new division of labour. Ericsson and Nokia are now producing mobile phone handsets in Estonia and Hungary, while at home they concentrate more on R&D, design and some high-end manufacturing. Although telecoms is a key industry

12 Frédérique Sachwald, 'The impact of EU enlargement on the location of production in Europe', Les Études de l'Ifri 4, March 2005.

13 György Kukely and Tamás Czira, 'The economic and regional effects of the development of the automotive industry in Central East Europe', European Advanced Studies Institute in Regional Science, 2005.

14 Michael Knogler, 'Auswirkungen der EU-Osterweiterung auf die Arbeitsmärkte der neuen Mitgliedstaaten und der EU-15, insbesondere Deutschland', Osteuropa-Institut working paper, No 257, January 2005.

for both Sweden and Finland, neither country has seen a rise in unemployment since production started to move to Eastern Europe. Similarly, Ireland used to assemble one-third of all PCs sold in the EU in the late 1990s. Since then, these assembly lines have moved to Hungary and elsewhere in Eastern Europe, where wages are cheaper. By 2000, ICT already accounted for 10 per cent of value added in Hungary's business sector, the same share as in the UK and more than in France. Ireland's well-qualified engineers, meanwhile, moved on to high-end production activities and related services. Ireland's computer sector has not suffered net job losses. In aggregate, the accession countries managed to increase their global market share in ICT from a mere 1 per cent in 1992 to 4 per cent in 2002. But the old EU-15 has gained even more, raising its market share by ten percentage points, to 41 per cent in 2002.

**Where China really matters**

Central and Eastern Europe has done extremely well out of Europe's new division of labour. But there is no room for complacency. Already, the pace of trade integration is slowing down: exports from the AC-8 to the EU-15 grew by 75 per cent in 1993-95, by 60 per cent in 1996-99 and by 30 per cent in 2000-03. China's exports to the EU-15 rose by around 150 per cent in the latter period. The rise of China is affecting all European countries. But in many ways the new members are more immediately affected than the old ones, because they are specialising in the same products as China, such as textiles and other labour-intensive manufacturing goods, as well as electronics and increasingly cars.[15]

The new members have clear advantages over China or India when it comes to attracting investment, such as a more transparent, predictable business environment, politically accountable government and proximity to large western markets. However, Central and Eastern Europe clearly does not have a future as a location for low-cost manufacturing. It simply cannot compete with China when it comes to producing low-value added, mass manufactured goods, such as textiles or simple consumer electronics. Average wages and income levels in the new member-states are much lower than in the old EU, but they are much higher than in Asia or the former Soviet Union. Polish and Hungarian workers earn $600-700 a month on average, a Chinese worker earns $150. The car industry in Central Europe is still thriving and attracting fresh investments. But some Western investors in electronics and textiles are already packing up and moving their factories to China or Ukraine, where workers are cheaper.

Instead, the new members are now attracting investments in high-tech manufacturing and increasingly also in high-value added services. Nokia and Ericsson are now running R&D centres in Hungary. The Czech Republic is host to data processing operation for Siemens and Lufthansa, as well as clusters of Japanese and Korean electronic producers. In these two countries, the share of people working in medium to high tech sectors (both manufacturing and services) is already slightly above the EU average, at around 12 per cent. But other East European countries are lagging badly behind. In Latvia and Lithuania, only 4 per cent of the workforce is employed in medium to high tech sectors.

Economic upgrading requires countries to have highly developed education systems. Here, Eastern Europe fares well, at least at first glance. On some indicators, the new members outperform even the old EU countries: they boast very high enrolment rates in secondary education and generally score well on basic educational indicators such as numeracy and literacy. The good performance in secondary education and the heavy focus on technical and professional education appears adequate for Eastern Europe's current specialisation in producing cars, consumer electronics and basic manufactured goods.

But these skill levels may not be enough to build what the EU likes to refer to as the 'knowledge economy'. For this, the new members need to invest more in tertiary education, refocus curricula towards languages, IT or management, and encourage general skills such as creative thinking and problem solving. Moreover, the dearth of on-the-job training in Eastern Europe will become a growing problem in a fast-changing economic environment.

15 European Commission, 'The challenge to the EU of a rising China', European Competitiveness Report 2004. Katinka Barysch, 'Embracing the dragon: The EU's partnership with China', CER pamphlet 2005.

## 5. THE MOVEMENT OF WORKERS

When Eurobarometer asked EU citizens in 2003 whether they expected a big influx of East European workers, it was the people in the poorer member-states – Greece, Spain and Portugal – that turned out to be most worried. The richer member-states, such as Germany, France or the Netherlands, appeared more relaxed. In Denmark, around 40 per cent of those polled believed that enlargement would cause big labour movements. However, these perceptions have changed fundamentally since then. Today, it is Germany and Austria that are most concerned about potential inflows of East European workers. These two countries have traditionally been the main destination of East European workers, first because of their geographical proximity but also because the existence of sizeable Polish, Czech of Hungarian immigrant communities makes them look more attractive for newcomers. Some 60 per cent of the million-odd East Europeans that moved to the EU before accession went to Germany, with Austria taking another 5-10 per cent, albeit in a much smaller labour market.

Mainly in response to German and Austrian concerns, the EU decided to impose lengthy 'transition periods' on the free movement of East European jobseekers. Under the terms of the accession treaties, EU countries were allowed to leave existing restrictions in place for up to seven years after enlargement. Initially, most EU governments had vowed to open their labour markets to the newcomers. Then, however, one government after another changed its mind, fearing that a disproportionate share of jobseekers may come to those countries courageous enough to abolish restrictions. In the end, only Ireland, Sweden and the UK opened their labour markets for workers from the new member-states – although they imposed more stringent registration requirements to get a grip on the numbers and they restricted access to social security and welfare systems to put off those potentially wanting to exploit the West's more generous social system. In 12 of the EU-15 countries, Poles, Hungarians or Latvians still required work permits, and there are strict quotas for East European immigrants, either for the whole economy or for individual sectors.

By May 2006, the member-states had to inform the European Commission about whether they would like to prolong the current regime for another three years until 2009. Spain, Finland and Portugal indicated that they would liberalise access to their labour markets. The Netherlands may follow suit. But Germany and Austria announced that they would not lift current restrictions until at least 2009, and possibly 2011. The other EU countries had not made up their minds at the time of writing.

A report from the European Commission, published in February 2006, puts some serious doubts on the rationale for continued restrictions.[16] Overall, east-west worker migration has remained limited. Available national statistics suggest that some 1.7 million people from EU-10 (EU-8 plus Cyprus and Malta, which have no restrictions on free movement) have applied for work in the 'old' EU-15 since enlargement. However, this number is highly tentative for several reasons, including:

- for some countries data is only available for 2004 but not 2005;
- in Ireland (a major destination), the statistics include not only applications for work but also for other purposes, such as healthcare or social services;
- many of those who registered or applied for work were already in the EU but working illegally (in the UK the share has been estimated to be as high as 40 per cent); and
- the number of work or residency permits issued does not equal the number of East European workers that have settled in the EU-15 because most permits are issued for only a limited period. In Germany, for example, 95 per cent of the work permits granted in 2005 had time limits, and in Italy 76 per cent of all permits went to seasonal workers.

To circumvent the limitations of statistics on worker registration, the Commission also relies on data from EU-wide labour force surveys. These indicate that the stock of workers from the

16 European Commission, 'Report on the functioning of the transitional arrangements set out in the 2003 accession treaty', February 2006.

new member-states in the EU-15 reached 0.4 per cent of the local labour force in 2005. This means that the Central and East Europeans are by far outnumbered by immigrants from other EU-15 countries (2.1 per cent of the EU-15 labour force) and non-EU countries (5.1 per cent of the labour force).

The distribution of Eastern European workers suggests that national restrictions have not been very effective. The lure of existing immigrant communities and current job opportunities are the main determinants of where workers want to go. Despite strict immigration limits, Germany continued to be the single most important destination of workers from the new member-states: in 2004 and 2005 alone, Germany issued one million work permits to jobseekers from the new members (although the vast majority for seasonal workers in construction and agriculture, as indicated above). Inflows into Austria also rose after enlargement. In 2005 workers from the new member-states accounted for 1.4 per cent of Austria's labour force. In neighbouring Italy, on the other hand, the quota for Eastern European workers remained unfulfilled.

**Table 5: Resident working age population by nationality, 2005, in per cent of total**

| | National | EU-15 | EU-10 | Non-EU |
|---|---|---|---|---|
| Belgium | 91.3 | 5.8 | 0.2 | 2.8 |
| Denmark | 96.4 | 1.1 | N/a* | 2.4 |
| Germany | 89.5 | 2.8 | 0.7 | 7.0 |
| Greece | 94.0 | 0.3 | 0.4 | 5.3 |
| Spain | 90.5 | 1.2 | 0.2 | 8.1 |
| France | 94.4 | 1.9 | 0.1 | 3.6 |
| Ireland | 92.3 | 3.0 | 2.0 | 2.8 |
| Luxembourg | 57.9 | 37.6 | 0.3 | 4.2 |
| Netherlands | 95.7 | 1.4 | 0.1 | 2.8 |
| Austria | 89.2 | 1.9 | 1.4 | 7.5 |
| Portugal | 97.0 | 0.4 | N/a* | 2.6 |
| Finland | 98.3 | 0.4 | 0.3 | 1.0 |
| Sweden | 94.8 | 2.3 | 0.2 | 2.7 |
| UK | 93.8 | 1.7 | 0.4 | 4.1 |
| EU15 | 92.4 | 2.1 | 0.4 | 5.1 |

* Data not reliable due to small sample size. Italy is excluded, since it does not disaggregate by nationality.
Source: Eurostat, Labour force survey 1st quarter 2005 (Ireland 2nd quarter 2005).

Among those countries that had abolished restrictions, the UK received the largest inflows. Some 290,000 people from the new member states signed up to the new 'workers registration scheme' in the 16 months after accession – vastly more than the 13,000 that the government had initially expected. Ireland's fast-growing economy attracted some 160,000 Central and East Europeans between May 2004 and November 2005, the highest share if compared with the local labour force. Sweden saw only very limited inflows, while neighbouring Norway proved a much more popular destination although it relies on a work permit regime.

In those countries that have retained quotas and work-permit requirements, East Europeans have often found work in the black economy, especially in services jobs such as cleaning, caring or catering. Some have also relied on the EU's more liberal rules for the freedom of establishment and the 'seconded workers directive' which allows companies in one country to send workers to another EU country. The number of East Europeans who work in the old EU on the basis of temporary contracts or through setting up their own business is probably limited. But they have caused a disproportionate amount of political upheaval. The alleged job competition from cheap 'Polish plumbers' fuelled anti-EU sentiment during France's referendum on the EU constitution.[17] In December 2004, 14 Latvian builders were forced to stop working in Sweden for what a local trade union had claimed were 'unfairly' low wages. Similarly, in March 2005 the Danish authorities fined a Polish construction company (owned by a Dane) for undercutting local wages. And Germans were outraged in the autumn of 2004

17 According to Newsweek from October 17th 2005, only 150 Polish plumbers work in France, while the French plumbers association reports 6,000 vacancies. British government statistics show that 75 East European plumbers registered for work in the UK between May 2004 and March 2005.

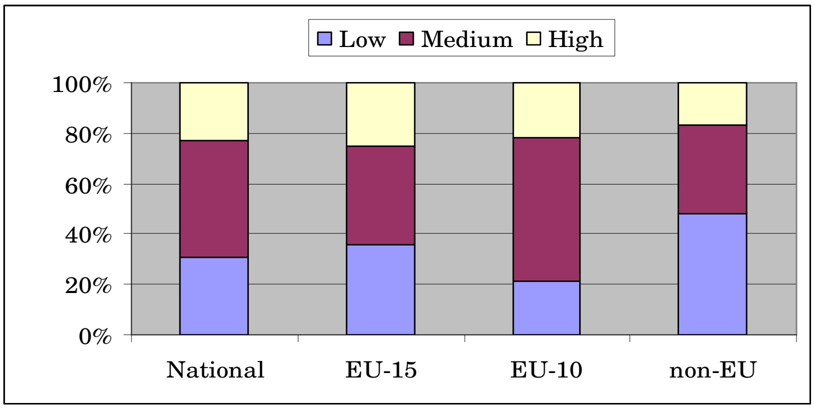
when about 25,000 abattoir workers lost their jobs to Poles or Czech willing to work for €5 an hour or less.

**First victim: the services directive**

Many West Europeans think that the inflow of East European workers has led to 'social dumping', a politically charged term for low-cost competition. Such fears have also been behind widespread opposition to the 'services directive' which aims to remove remaining restrictions to the free movement of services in the EU. However, even the Commission's rather liberal first draft would not have opened the door to widespread 'social dumping'. The 'country of origin principle' contained in the original draft would have made it easier for Polish architects or British consultants to work across the EU because all member-states would have had to accept their home country's rules and qualifications. But it would not have allowed East Europeans to generally undercut West European wages. The directive explicitly referred to the 'posted workers directive' which says that local minimum wages and sectoral wage rules have to be respected. The reason why German abattoir workers lost their jobs to cheaper competitors is that Germany does not have a country-wide minimum wage, only sectoral wage rules.[18] This is why Germany is now debating the introduction of a general minimum wage for all sectors. Meanwhile, the European Parliament has removed the controversial 'country of origin' principle from the draft directive. It also removed a whole host of sectors from the liberalisation drive, including social services.[19]

The Commission, in its February report, argues that fears of the negative impact of East European workers on western job markets and welfare systems are unfounded. On the contrary, the Commission concludes that immigrant workers have contributed positively to the economies of their host countries. Austria is the only one of the major receiving countries where unemployment has increased since enlargement. For the most part, available evidence suggests that Central and East European workers have helped to fill gaps in national labour markets. The Commission found that among the East European immigrants to the EU-15, the share of medium or highly skilled workers is larger than for other immigrant communities, and in many cases larger even than for national workers. However, a disproportionate share of the East Europeans work in construction, catering and agriculture – often in jobs that nationals from the 'old' EU countries are reluctant to accept. The employment of skilled East European workers in menial jobs in the west constitutes a net loss for the European economy as a whole.

**Graph 2: Education levels of national and non-national workers in the EU-15, as per cent of total resident working-age population**




Education levels: low = lower secondary education; medium = upper secondary; high = tertiary.
Origins of workers: EU-15 = from other 'old' EU member-states; EU-10 = from new member-states; non-EU = from outside the EU.
Source: Eurostat, Labour force survey 1st quarter 2005 (France and Austria 2nd quarter 2005).

18 Milosz Matuschek, 'Die geplante Richtlinie ist besser als ihr Ruf', Centrum für angewandte Politikforschung, April 2005.

19 Simon Tilford, 'What future for the free trade in services?', CER Bulletin, March/April 2006.

Some economists think that big inflows of East European workers into Western Europe's inflexible labour markets would push up unemployment and overwhelm generous social security systems.[20] They warn that the move towards full worker mobility must be accompanied by thorough labour market reforms in the West because immigration is much more beneficial for flexible economies. If economies cannot adjust quickly, the immigration of low-cost workers can result in higher unemployment and an increased burden on local social security systems. West European countries will come under growing pressure to implement such reforms, once the transition periods on the free movement of labour have run out in 2010. Even under the most optimistic catch-up scenarios, the income differential between the EU-15 and the EU-8 will not narrow by more than 2 per cent a year. Therefore, the new members' wages will still only be 25 per cent of the West German level in 2010 (and still less than 40 per cent in 2020).

However, the persistence of big wage differentials does not necessarily mean that Western Europe will be flooded with East European workers once the restrictions are lifted. Europeans are not particularly mobile: only a third of all EU citizens have every lived outside the region where they were born, and only 2 per cent reside outside their home country. The East Europeans are similarly averse to moving around, as indicated by very large unemployment differentials within their countries. There is little unemployment – and often even worker shortages – in capital cities such as Prague or Budapest whereas unemployment can reach 30 per cent or more in deprived rural areas and declining industrial heartlands. If East Europeans are reluctant to move within their own countries, they will be even less willing to relocate to a foreign country, where they have to struggle with unfamiliar customs and a foreign language. In Poland, for example, 16 per cent said they liked the idea of moving to Western Europe, according to a survey by the European Foundation for the Improvement of Living and Working Conditions. But asked more specifically whether they are actually willing to pack up and move further than the next village, most have second thoughts. Suddenly the number seriously thinking about heading westwards shrinks to only 1.6 per cent.[21]

Researchers have employed various different methods to predict migration flows, but most of them have come up with broadly similar estimates: between 100,000 and 400,000 East Europeans will head west every year once they gain the right to apply for jobs in the old EU. Assuming that it will take a decade or two until most of those who want to move have actually done so, they predict that maybe 2-3 million people from the new member-states will be living in the old EU by say, 2020. That sounds a lot, but it only amounts to 0.5-0.8 per cent of the EU's current population.[22]

There is another reason why the new members will not be a source of large-scale labour migration in the medium to long run, namely demographics. In most Central and East European countries life expectancy is rising, but birth rates tend to be extremely low, so societies are ageing even faster than those in the old EU. In some of the EU-8, labour forces are already stagnating or even getting smaller, and the long-term outlook is dire. The UN predicts that the populations of Latvia and Lithuania will shrink by one-third by 2050, while the number of Hungarians and Czechs will fall by more than one-fifth. In 20 years time, more than 30 per cent of Czechs will be over 60. As David Willets has put it: "These countries do not have a big future supply of young workers. Recruiting migrants from them is more a matter of 'hurry now while stocks last'".[23]

## 6. UNFAIR COMPETITION IN THE EU?

West Europeans can try to keep East European workers out of their labour markets – at least for a while – but they cannot prevent their companies from moving to the East. The threat of relocation appears to have strengthened the hands of company bosses vis-à-vis their workers. Scores of German companies, from DaimlerChrysler to Siemens, threatened to shift

20 Hans-Werner Sinn, 'EU enlargement, migration and the new constitution', CESIFO working paper 1367, December 2004.

21 Katinka Barysch, 'Storm in a teacup', E!Sharp, November 2004.

22 Katinka Barysch, 'Does enlargement matter for the EU economy?', CER policy brief, May 2003.

23 David Willets, 'Old Europe? Demographic change and pension reform', CER, September 2003.

more production eastward unless their workers agreed to work longer hours for the same money or less. Real wages in Germany have been stagnating for years, and unit labour costs are now back where they were in the mid-1990s. Germany's belt-tightening, in turn, has increased the pressure on its big West European trading partners. Italy, France and others are now struggling to restore their competitiveness vis-à-vis Germany.[24] As a result, unit labour costs in the entire eurozone have fallen by an average of 0.5 per cent a year since 2001.

Moreover, eastward enlargement took place at time when many West European countries were (and are) undergoing painful structural reforms, such as the loosening of job protection rules and the reduction of welfare entitlements. It is impossible to say how far wage restraint and labour market reforms have been the direct result of eastward enlargement. Even if Eastern Europe disappeared from the face of the earth tomorrow, social and demographic trends (ageing, the erosion of traditional family structures), European integration (the single market, monetary union) and global competition (from China, India, the US and others) would still force the old EU countries to adjust. However, many people in these countries fail to grasp globalisation and deny the changing nature of their own societies. When they fear losing their jobs, they quickly point their fingers at Eastern Europe. France's frantic debate about *delocalisation* is mainly aimed at the new member-states (and the countries still queuing for membership, such as Bulgaria, Romania and Turkey). Some Germans fear that eastward enlargement is turning their country into a 'bazaar economy' where only a limited number of finished products is assembled while most of the work is outsourced across the eastern border.

Such fears have gone hand in hand with perceptions that the new members are using 'unfair' means to lure companies eastward, namely low levels of social protection, low taxes and a lack of workers' rights. In short, many people in Western Europe think of the East Europeans as ruthless 'Anglo-Saxon' capitalists whose addition to the EU is undermining the cherished 'European social model'.

The real situation across the new members is of course much more complex. The new members boast relatively flexible labour markets, a feature that they share with the UK, Ireland and the Nordic countries. But unlike these countries, much of Eastern Europe suffers from very high unemployment rates, higher even than those found in Germany, France or Italy. In countries such as Poland and Slovakia, unemployment stands at 15-20 per cent. The new members also resemble the large eurozone countries in that they have generous social security systems that are funded out of payroll taxes.

**Tax dumping?**

Most of the Central and East European countries lowered their corporate tax rates in the run-up to accession to compensate for the abolition of discriminatory tax breaks, which was required by EU state aid rules. Many countries also introduced 'flat' rates of personal income tax. Slovakia went furthest in its tax reforms by standardising taxes on profits, income, capital and value added at a low rate of 19 per cent. Tax cuts have spread throughout Central and Eastern Europe and now appear to be extending into the old EU, fuelling fears that there is a 'race to the bottom' in tax rates. Austria cut its corporate tax rate from 34 per cent to 25 per cent in January 2005. Three months later, the German government announced a cut in the federal profit tax rate from 25 per cent to 19 per cent (the plan subsequently ran into opposition and the Merkel government is now planning corporate tax reforms in 2007).

It is not clear whether such reforms are the direct consequence of EU enlargement or part of a broader international trend towards lower direct taxation (income and profits) and higher indirect taxes (VAT, property). But it is important to quash the myth that Eastern Europe is a low-tax paradise that flourishes at the expense of its high-tax neighbours. Generally, taxation levels in the new member-states are lower than in the EU-15, but not much. In 2003 (the last year for which comparative figures are available), the ten accession countries collected the equivalent of 36 per cent of their GDP in taxes, compared with just over 40 per cent in the EU-15. There are big differences among the newcomers. Lithuania's tax level is below that of

24 Alan Ahearne and Jean-Pisani-Ferry, 'The euro: Only for the agile', Bruegel policy brief, February 2006.

Ireland 's (at 29 per cent of GDP), while Hungary and Slovenia collect as much tax as Germany (around 40 per cent).[25]

It is true that headline corporate tax rates in the new members are now much lower than in the EU, typically 15-20 per cent compared with 34-38 per cent in Germany, Italy and France. But this does not automatically mean that East European governments are shy to tax local companies. Tax revenue consists of two components: the tax rate and the tax base (on which the tax is levied). West European tax systems tend to be riddled with exemptions, and many offer generous depreciation rules to encourage certain investments. So the 'effective' tax rate on corporate profits is often much lower than the headline rate. Estimates of the effective tax rates vary widely. According to some calculations, the effective rate of corporate taxation in Germany is only half the headline rate of 38 per cent. Some of the country 's largest companies enjoy so many tax breaks that their effective tax rate is zero.[26] Other estimates show that the effective tax rate in the East European members is now a lot lower than in the old EU, for example, around 18 per cent in Poland and Hungary, compared with 35-36 per cent in Germany and France.[27]

Another (albeit similarly flawed) way of gauging the real tax burden is to look at how much money national treasuries actually obtain from companies. According to the European Commission, Germany collected corporate taxes worth only 0.8 per cent of its GDP in 2003, and France 2.2 per cent. Compare that with allegedly low-tax countries such as Ireland and the UK (3.8 per cent and 2.7 per cent of their GDP, respectively) or Slovakia and Hungary (2.8 per cent and 2.2 per cent of GDP respectively). Even Estonia, which does not tax reinvested profits at all, still managed to collect more than Germany in corporate taxes as a share of its GDP.

But even if one assumes that effective corporate tax rates in Central and Eastern Europe are significantly lower than those found in the old EU, it does not necessarily follow that tax policy is behind Eastern Europe's investment boom. Investor surveys show that tax levels are just one factor among many that companies take into account when they decide where to set up shop. Others, such as economic and political stability, the quality of the labour force, wage and productivity levels, market size or proximity to major markets, usually rank higher.[28]

**The East European social model**

The perception that Eastern Europe loves low taxes has been reinforced by the fact that four of the new members have introduced 'flat' income tax rates.[29] Estonia started the trend in 1994, and the other Baltic states and Slovakia have since followed. Opposition parties in Hungary, Poland and the Czech Republic have called for the introduction of flat taxes, as have some politicians and economic experts in the old EU.[30] There are specific reasons why flat taxes were a good idea in Eastern Europe, most notably the weakness of the local tax administration and the pervasiveness of tax evasion. And there are good reasons why West European countries may prefer to stick with their more sophisticated and progressive tax systems, for example social fairness (higher tax rates for big earners) and the use of the tax system for specific policy objectives (encouraging pension savings or home ownership). But even if the large EU countries
are unlikely to follow the flat tax trend, some of them may go part of the way by simplifying their tax systems and reducing the top rate of income tax rates.

25 European Commission, 'Structures of the taxation systems in the European Union', 2005 edition.

26 Katinka Barysch, 'Is tax competition bad?' CER Bulletin, No 37, August/September 2004.

27 Zentrum für Europäische Wirtschaftsforschung and Ernst & Young, 'Company taxation in the new EU member-states', July 2004. However, these estimates probably under estimate effective tax rates in the new members, see James Owen, 'Tax issues in the new EU members', Economist Intelligence Unit Country Forecast: Regional Overview Eastern Europe, December 2004.

28 James Owen, 'Do low corporate tax rates attract foreign investment? A look at recent evidence for the EU', The Economist Intelligence Unit Country Forecast, Regional Overview Eastern Europe, September 2005.

29 Flat income taxes have also been introduced by Romania, Ukraine, Russia, Serbia and Georgia.

30 Among Western Europe's most prominent proponents are Paul Kirchhof, Angela Merkel's economic advisor during her election campaign; the Conservative Party shadow chancellor, George Osborne, in the UK; the Dutch government's Council of Economic Advisors; and the Greek finance minister, Giorgios Alogoskoufis.

With their low income tax rates and widespread tax evasion, Eastern European countries collect much less money from personal income taxes than West European ones (5 per cent of GDP compared with 10 per cent in the eurozone in 2003). Instead, governments in the new member countries rely on other ways of taxing wages, namely social security contributions. As a result, payroll taxes in the new members are usually above those found in most of the 'old' member-states. In Poland, Hungary and Slovakia, for example, social security contributions add almost 40 per cent to labour costs, more than in Italy or Germany, and twice as much as the UK. According to the European Commission, the ten new members in 2003 collected on average 13.3 per cent of their GDP in the form of social security contributions to pay for their healthcare, pensions and social welfare systems – almost exactly the same share as in the old EU-15.

**Table 6: Labour market indicators**

| | Unemployment rate 2005, per cent | Employment rate 2004, per cent | Hourly labour costs 2003, € |
|---|---|---|---|
| Czech Rep | 8.0 | 64.2 | 5.5 |
| Estonia | 7.5 | 63.0 | 4.0 |
| Hungary | 7.1 | 56.8 | 5.1 |
| Latvia | 9.0 | 62.3 | 2.4 |
| Lithuania | 8.2 | 61.2 | 3.1 |
| Poland | 17.9 | 51.7 | 4.7 |
| Slovakia | 16.4 | 57.0 | 4.0 |
| Slovenia | 5.8 | 65.3 | 10.5 |
| EU-15 | 7.8 | 64.7 | 24.3 |

Source: European Commission.

Rather than being 'ultra-liberal' and socially minimalist, the Central and East Europeans spend too much on social security, given their rather low level of income and economic development. In Hungary a quarter of the working age population relies on some kind of social transfers as their main source of income. In Poland, one in five people of working age obtains state benefits and less than 2 per cent of all benefits are means-tested. The new members will have to work hard to create social welfare and security systems that are better targeted and less costly. Like in the West, such changes are politically controversial and often involve big upfront costs. This is tricky given that the new members are keen to join the euro and so need to reduce their budget deficits. At the same time, they need to find ways of getting millions of unemployed people back into work.

## 7. IMPLICATIONS FOR THE EU BUDGET

Many West Europeans think that eastward enlargement has come at a huge cost for the EU budget. In a survey ahead of accession, more than three-quarters of all people in Germany and the Netherlands expected enlargement to be "very expensive" for their countries. In Spain, Greece and Ireland (and also Denmark) the share was lower, at 60-65 per cent, but still substantial.[31] There is no doubt that the rise in the EU's membership from 15 to 25 will put additional strains on scarce EU resources. But the financial burden has to be put into perspective.

First, the size of the overall EU budget is much smaller than most people think. EU spending usually amounts to around 1 per cent of EU GDP, or 2 per cent of what the EU governments spend through their national budgets. Some 80 per cent of EU spending goes to just two policies, namely the Common Agricultural Policy (CAP) and the aid for the EU's poorer countries and regions through the so-called structural and cohesion funds. Since the new members are both poorer and much more agricultural than most of the EU-15 countries, analysts initially expected eastward enlargement to substantially increase the size of the EU budget.

31 Eurobarometer, 'Attitudes towards enlargement,' 2004.

**‘Compensation’ for the winners?**

However, the EU has found various ways to limit transfers to the new member-states, and thus keep the overall size of the budget small, despite the big increase in membership. With regard to the CAP, the EU had initially decided that the new countries would be excluded from the ‘direct payments’ that make up the bulk of CAP spending. The reasoning was that direct payments were designed to compensate farmers for price decreases that resulted from market liberalisation. Since farm prices in Central and Eastern Europe were (and are) lower than in the West, the extension of the CAP could be expected to result in price rises, not falls. Therefore, it would not make sense to ‘compensate’ say, Polish or Lithuanian farmers.

However, East European farmers were so upset about this alleged discrimination that the EU-15 eventually agreed to a compromise. East European farmers would initially obtain 25 per cent of the levels of direct payment that their West European counterparts are entitled to. This share would rise gradually, to reach 100 per cent by 2013. Although CAP payments to the new members are set to rise, the exact amounts will depend on various unknowns, such as world prices for farm goods and future decisions of CAP reform, as agreed for example in the Doha world trade talks or a forthcoming EU budget review in 2008-09. What is clear already is that the current CAP will not be to the advantage of the new members. First because the share of non-direct payments, such as help for rural development, remains very small, at 10-15 per cent of total CAP spending. And second, because the CAP disproportionately benefits large agricultural enterprises: some 80 per cent of all CAP money goes to just 20 per cent of the biggest farmers.[32] The average farm size in the new member-states, however, is much smaller than in the EU-15. Poland’s many thousands of subsistence farms, for example, are too small to qualify for any support.

That leaves the structural funds as the main source of transfers from west to east. Most of structural fund money is paid out to ‘objective 1’ regions, those with an income per head that is below 75 per cent of the EU average. With exception of some rich cities such as Prague, the new members qualify in their entirety. They also fully qualify for spending under the (much smaller) cohesion funds that go to countries (rather than regions) with a per capita income of less than 90 per cent of the EU average. In the name of solidarity, it would make sense to concentrate the EU’s limited resources on its poorest countries and regions. The UK in 2003 made such a proposal, arguing that the current practice of paying out around half of all structural funds to the richer member-states (under various objectives, such as helping regions with declining industries or low population density) did not make sense.[33]

However, those countries that currently benefit the most from EU regional aid cried foul. Therefore, the EU’s next budget for 2007-20013 still allocates half of all structural funds to the richer EU countries. Moreover, the leaders of the EU-15 have decided to cap the flow of funds to the new members at 4 per cent of their respective GDPs, arguing that the newcomers lacked the capacity to ‘absorb’ larger amounts.

**The prices of re-uniting Europe**

In the current budget, the EU has earmarked some €40 billion for the new members for the period between 2004 (when accession took place) to 2006 (when the current budget runs out). But since the new members also have to pay their contributions into the EU budget (some € 15 billion in 2004-06), their ‘net’ benefit is smaller, at around €25 billion over three years. This sum amounts to less than 0.1 per cent of the EU’s combined GDP – a tiny price to pay for the reunification of Europe.

On current trends, the new members will not even be able to spend the limited resources earmarked for them in the structural funds. Many governments have struggled to find enough viable projects that qualify for EU support under the Commission’s rather strict rules. Some countries have also been hampered by their precarious domestic budget situations, since structural fund projects must be co-financed out of domestic sources. By September 2005, the Czech Republic, Estonia and Latvia had not yet submitted applications for more than half

32 Jack Thurston, ‘Why Europe deserves a better farm policy’, CER policy brief, December 2005.

33 HM Treasury and Department of Trade and Industry, ‘A modern regional policy for the United Kingdom’, March 2003.

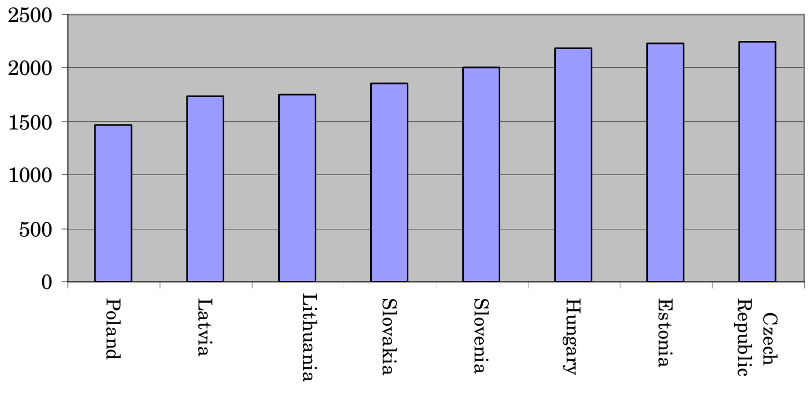
of the funds allocated in the 2004-06 period.[34] And even those countries that submitted enough applications had signed contracts for only a small number of them, and the amounts that had reached the final beneficiaries (local administrations, schools or businesses) were tiny. Delays in spending EU regional aid are not uncommon in the old EU. According to Commission figures from March 2005, Greece and the Netherlands had managed to sign contracts for only around 40 per cent of the structural fund money allocated to them in 2000-06. But the newcomers are doing much worse, which suggests considerable bottlenecks in the planning and disbursement process.

During the next budget period, which runs from 2007 to 2013, the new EU countries should be able to handle structural fund money more effectively. Their administrations will have become more adept at following the EU's complex procedures for applications and disbursements. Moreover, the EU will ease some of the rules according to which structural funds are paid out. For example, the minimum co-financing requirement will drop to 15 per cent and recipient countries will be given an additional year to spend the funds.

The new rules follow an initiative of the British EU presidency in the second half of 2005. Prime Minister Tony Blair had scaled back the total amounts allocated to structural funds in an attempt to get all 25 EU countries to agree on the new budget framework. To counter fierce criticism from the new members that the "EU was taking from the poor and giving to the rich", Blair had proposed to ease the rules to enable the new members to at least spend a bigger share of their curtailed regional aid allocations. The new members will also be allowed to "top up" both regional aid (through more generous state subsidies to companies in the poorest regions) and CAP payments (through co-financing direct payments out of national budgets).

However, despite some last-minute amendments, the new member-states were left with the impression that the old EU was trying to achieve enlargement "on the cheap". The Council's version of the budget foresees total spending of €862 billion over seven years.[35] Of this, some 15 per cent, or €128 billion, will be regional aid to the new members. Whether this money will help the new members to catch up with West European income levels will very much depend on whether East European governments spend the money wisely. Ireland, for example, invested its EU money into education and infrastructure, as part of a broader national development plan. Greece, on the other hand, used to squander the additional funds on consumption.[36]

**Graph 3: Expected receipts per head, 2007-2013, in 2004 prices, €**




Source: World Bank, on the basis of European Commission data.

34 World Bank, 'EU-8 quarterly economic report', February 2006.

35 At the time of writing, the fate of the new EU budget hung in the balance after the European Parliament rejected the EU leaders' draft in January 2006. The Parliament, the Commission and the Council were hoping to reach a compromise in time for the budget to come into force in 2007.

36 Katinka Barysch, 'Will EU money be the tune to the new members' catch up song?' Transition, number 4-6, volume 14, World Bank April/May/June 2003.

## 7. CONCLUSION

Economically, eastward enlargement may be exactly what the EU needs to return to higher growth. The new members are too small to act as the economic engine of a sluggish eurozone. However, the availability of a large pool of low-cost, highly skilled workers at their doorstep has helped West European companies to better cope with globalisation. And it has put pressure on governments in the old EU to make their labour markets more flexible and their business environments more attractive.

Politically, however, the EU is still struggling to digest its biggest ever enlargement. On many of the bit topics currently on the EU agenda, the new members' positions differ from those of the big eurozone countries, for example on the reform of the EU budget, the free movement of labour, tax policies or how to deal with Russia. Finding a consensus in the enlarged EU has therefore become more difficult. But the main reason why the political atmosphere in the EU has become somewhat antagonistic is that politicians and the media in some eurozone countries have exploited populist fears of low-cost competition from the East. The German government, for example, has threatened to cut off regional aid to those countries that refuse to raise their corporate tax rates.

Many people in the old EU countries have turned against enlargement. In the EU-15 there are now as many people opposed to future enlargements as there are in favour. France and Austria are planning to hold referendums on all future accessions after Croatia. Other EU countries may follow suit. Some 70 per cent of French people and 80 per cent of Austrians are currently against Turkish membership in the EU. Only 35-40 per cent of voters in the EU-15 support the accession of Western Balkan countries such as Serbia and Macedonia. While public opinion might change fundamentally by the time these countries are ready for membership, popular opposition weakens the credibility of the entire accession process. The EU will find it more difficult to act as an external anchor for Turkish reforms. It will have less leverage in the key decisions that are coming up in the Balkans, for example about the status of Kosovo or the split of Montenegro from Serbia. And it will have little influence over political and economic developments in neighbouring countries such as Moldova and Ukraine.

If the EU wants to restore enlargement as its most successful policy tool, it needs to deal with the misperceptions that fuel public opposition to enlargement. EU politicians, Brussels officials and the media need to make a much bigger effort to show how enlargement has benefited both Western and Eastern Europe. They need to explain that globalisation would have forced old Europe to change anyway, and that enlargement has helped many West European companies to stay competitive. They need to stop exploiting fears of Polish plumbers and instead pursue the kind of reforms that would allow their economies to benefit from a larger participation of East European workers.

Eastward enlargement represented a unique opportunity to reform many of the EU's more ineffective policies, be it the CAP, the rotating EU presidency or the 'triple majority voting' system in the Council of ministers. However, so far these reforms have not taken place, which is one of the reasons why the EU sometimes finds it difficult to cope with enlargement. Two years after the Central and East European countries joined the EU, the enlargement agenda is still far from being finished.