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FINANCIAL AND BUDGETARY IMPLICATIONS OF THE ACCESSION OF CENTRAL AND EAST EUROPEAN COUNTRIES TO THE EUROPEAN UNION

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FINANCIAL AND BUDGETARY IMPLICATIONS OF THE ACCESSION OF CENTRAL AND EAST EUROPEAN COUNTRIES TO THE EUROPEAN UNION

Abstract

This paper analyses some of the major financial consequences of the enlargement of the European Union to the countries of central and eastern Europe. While all the evidence suggest that the costs of enlargement for the EU-15 Member States will be clearly outweighed by the benefits accruing from that process, the budgetary implications are a major concern for many EU governments. As a reaction to these concerns the Union has proposed a medium-term financial 'perspective' which has the objective of calming those fears. The author considers that the Berlin European Council decisions on financing enlargement are unrealistically low, although the cost of enlargement to the Union is likely to be well below some of the early alarmist estimates. The paper argues that the financial constraints which accession will put on the candidate countries are far more severe. These constraints cannot be overcome solely by the transfer of resources from the Union in the form of structural funds. Successful accession will depend on the granting of generous transition regimes for process directives. But the granting of such transitional arrangements will be difficult to negotiate through the large number of interest groups active in the European Union.

Financial and Budgetary Implications of the Accession of Central and East European Countries to the European Union[1]

From the first moment that it became clear that the newly-liberated countries of central and eastern Europe would ask to become full members of the European Union, the Member States of the Union have been worried about the cost to them of enlargement. Many estimates of the cost to the Union budget have been made, including that of the European Commission for the period 2000-2006, adopted by the European Council in Berlin in March 1999.

Few in the Union have really considered the far more daunting financial challenge of accession posed to the candidate countries. The financial constraint imposed by the needs of the systemic reforms, which are still being pursued, and of accession preparation together pose a major macro-economic threat to the stability of these countries.

This paper looks at both sides of the financial implications of enlargement and accession in turn. While for the Union these implications appear to be relatively limited, they are of crucial importance for the economies of the candidate countries.

1. The background to EU enlargement

Ten countries in central and eastern Europe have applied for membership of the European Union.[2] The EU decided to open negotiations with five of these countries, Czech Republic, Estonia, Hungary, Poland and Slovenia at the Luxembourg European Council in December 1997. Negotiations opened in Spring 1998 and have been continuing since. At the Helsinki European Council meeting in December 1999, the EU decided to open negotiations with the remaining five countries. Negotiations with these new countries started in early 2000.

The first group of five negotiating countries have already completed their negotiating position papers on all the chapters of the negotiations, with the exception of the chapter on institutional arrangements (which logically should await the outcome of the EU's Inter-Governmental Conference on institutional arrangements scheduled to be completed by the end of 2000) and in some cases, the budgetary arrangements.[3]

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[1] This article was originally prepared for the Annual Meeting of the Academy of European Law, Trier , October 29-30, 1999. It was delivered as two separate lectures, which have been combined for this publication.
[2] Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia. The EU is also negotiating with Cyprus and Malta for their accession to the Union.
[3] The material which has to be negotiated (the Community regulation or acquis) is for convenience divided into 31 chapters, which to start with are negotiated individually. Obviously as the negotiations approach their conclusion the key problems will be negotiated together to allow trade-offs to be agreed.

On receipt of the position papers from the individual applicant countries, the European Commission draws up a draft common position of the EU, which is discussed and adopted by the Member States and sent back to the country concerned. At this point the negotiations on the chapter can begin. EU Common Positions exist for about half of the chapters. Indeed some of the negotiating chapters have already been provisionally closed and the Portuguese Presidency of the Union hopes to have been able to open the negotiations on all chapters before the end of its Presidency.

In spite of this progress, no serious negotiation has yet, at the end of March 2000, taken place. The EU Member States have barely become engaged in the negotiations, leaving them largely to the European Commission. The negotiating sessions have been pure formality. The reason for this is that the really difficult complex chapters have not yet been opened. It is probably only when all the difficult negotiating points are clearly on the table that the Member States will begin to play an active role. When this will be is difficult to predict, but it will certainly not be before mid-year 2000, and, with the complicating matter of the institutional IGC concluding at the end of 2000, really serious negotiations may not start before early 2001.

The outlook for the negotiations has become more difficult to predict with the Helsinki European Council decision to extend negotiations to the remaining five countries in central and eastern Europe (and Malta). Clearly there will be an attempt to accelerate negotiations with at least some of these new countries, in order to get them to much the same point in the negotiations as the first group. In all events, the extension of the negotiations will lead to a slowing down in the enlargement process, though this need not be too dramatic.

The real drama is that although the negotiating process is in full swing, the Union does not really have a comprehensive strategy for making a success out of enlargement. Clearly a first condition for success is that the IGC on institutional matters should produce an acceptable blueprint for a rational reform of key parts of its agenda (voting weights in the Council, the extension of qualified majority voting and the size of the Commission). But while success here is a necessary condition for a successful enlargement, it is not sufficient. Negotiations on agricultural policy, on foreign policy and relations with Russia, on justice and home affairs and the environment will all be long and difficult. And it is not at all clear how the new concept of ‘flexibility’ will affect the coherence of an enlarged Union. In addition differences in approach to enlargement persist between Member State governments and in popular opinion.

These uncertainties make policy decisions in the accession countries rather difficult. How should domestic agricultural policy be made in the pre-accession period, with all the uncertainties of the coming negotiations in the WTO and the almost-certainty that the EU will have to consider further reforms in the Common Agricultural Policy? How rapidly should environment policy be pushed forward, given the need to maintain budgetary discipline and international competitivity. And perhaps above all what will be the financial and budgetary impact of accession on the national budget and financial positions of enterprises and consumers in the new Member States? But this latter question is also the worry of finance ministers in the fifteen Member States of the Union.

This paper attempts to gather and analyse the available material on the financial and budgetary implication of enlargement for both the EU-15 and the applicant countries of central and eastern Europe. While it is perhaps unlikely that enlargement will founder on financial and budgetary questions, they have the capacity to sour the relations between the existing Member States and to slow down the structural change and rapid economic growth, which are essential requirements for successful EU membership of the applicant countries.

2. The Financial Implications for the European Union of the Accession of Central and East European countries

A. Introduction

The enlargement of the European Union to the countries of central and eastern Europe is the crucial challenge to Europe in the coming decade. There are time constraints on the completion of the process, which is crucial for peace and stability on the Continent and indeed the preparation for enlargement has advanced rapidly in recent months Five central European countries are deep in negotiation with the European Union and five further countries in the region will be negotiating in 2000. The former group of countries has reached the point where they have completed first position papers and submitted them to the EU. The Union for its part intends to have opened all the negotiating chapters with these countries by the end of June 2000. Several of the easier chapters have already been negotiated and provisionally closed.

In spite of this rapid progress, the real core of the negotiation has hardly begun. On the Union side, there is still considerable uncertainty about the capacity of the Member States to reform the institutions and working practices of the Union. The key negotiating chapters, agriculture, environment, social affairs, free movement of capital and of labour have hardly been considered. The whole success of enlargement remains therefore in the balance.

Of all the problems facing accession, meeting the financial challenge of both economic transition and European integration is likely to be one of the more significant. The severe financial implications of accession for the countries negotiating for membership will pose important problems for fiscal and economic policy over many years. They will also condition to an important extent the nature of the accession treaties which are negotiated. Insufficient importance has been given to this financial constraint in the discussions between the EU and the negotiating countries.

This section considers first the financial and budgetary implications of enlargement for the European Union. The second part looks in some detail at the financing of accession and economic transition in the central and eastern European countries.

While the paper concentrates on the costs of enlargement, it is clear that enlargement is beneficial economically to Europe as a whole (and politically perhaps even more so). Academic work suggests that while the advantages for the central European countries will be considerable, there will also be positive economic impacts on the Union, ranging from significant for the countries geographically close to the new

Member States, to insignificant but generally still positive for those Member States further away.[4] The objective of looking at the financial costs of integration is to optimise the integration and transition processes through appropriate prioritisation and sequencing of the necessary policy and regulatory measures.

B. Enlargement, the Union budget and the Member States

The enlargement debate within the European Union has taken place in conditions which were characterised by the need to limit the impact of new accessions on the Community budget. This has basically two main reasons. It was felt to be especially important in the first years of Economic and Monetary Union (EMU) that members of EMU reduce their government deficits in order to maintain stability and convergence. There would be little support for raising public spending through the Community budget while restricting domestic spending. Secondly there is considerable pressure from net-contributer countries to the Community budget for ’fairer burden-sharing’ while the net recipients wish to maintain at least the absolute level of transfers from Brussels in the future. With no agreement on a fairer financing system, the net contributers only defence is to make sure that the overall level of budgetary expenditure does not rise.

The result is that the eastern enlargement of the Community to a group of countries which have a GDP per capita level of only around 12% of that of the EU at current exchange rates and perhaps 40% using purchasing power parities, will be marked by a variety of attempts to put upper limits on funds transfers to these new and poor countries. This paper suggests that, given the low level of effectiveness of Community spending and the macro-economic difficulties of managing large transfers from abroad, this may not be as negative an outcome for the new Member States as some might think.

1. Agenda 2000 and the financial provision of the European Union for future enlargement

The budget of the European Union on the expenditure side in commitment appropriations for the first year of the new financial perspective (2000) shows the following breakdown: (1999 prices)

Table 1: Sectoral shares in the EU budget for 2000

Agriculture:	44.5%
Structural operations:	34.8%
Pre-accession aid:	3.4%

[4] for instance:
Baldwin, R., Francois J.and Portes R.: The costs and benefits of Eastern enlargement: the impact on the EU and Central Europe, *Economic Policy*, 1997, volume 24, 125-76.
Commissariat Général du Plan: L'élargissement de l'Union européenne à l'Est et à l'Ouest, 1999, La documentation Française, Paris.
Deutsches Institut für Wirtschaftsforschung: Die wirtschaftliche Integration der assoziierten Länder, 1996, Berlin.

The total budget is planned to be EUR92, 025 million in 1999 prices.

Two areas, agriculture and structural fund transfers, continue to dominate the budget of the Union.

This expenditure is aimed at agricultural subsidy and, in the case of the structural funds, at regions which are relatively poor. On both counts, the ten countries in central and eastern Europe, which have applied for membership, would expect to benefit considerably (table 2).

Table 2: GDP per capita and agriculture as a % of GDP in the Associated Countries

	GDP/cap. 1997 current prices + exchange rates	GDP/cap. 1997 current prices and pps	Agriculture and fishing in gross value added 1995	Agriculture in total employment
	as % of EU average		%	% (1)
Bulgaria	6	23	15.4	24.2
Czech Rep.	23	63	4.6	4.3
Estonia	15	37	7.9	7
Hungary	21	47	6.7	8.2
Latvia	10	27	10.8	17.8
Lithuania	12	30	11.7	22.5
Poland	16	40	7.5	25.7
Romania	7	31	20.7	37.3
Slovak Rep.	17	47	6.0	7
Slovenia	43	68	4.4	6.3
Total	15	40	8.7	22.4
EU			2.3	4.8

Source: Eurostat
(1) statistics for agricultural employment in these countries are difficult to compare to statistics within the EU Member States

Their GDP per capita at purchasing power parities is on average only 40 % of that of the average of the European Union. Although we do not have any reliable figures, the gap in wealth is far greater. This is partly the result of wasteful investment strategy of the Communist regimes up to 1989 and the impossibility of wealth accumulation by the individual. The contribution of agriculture to GDP is still on average between 3 and 4 times that in the EU, while the proportion of the workforce employed in agriculture is also considerably higher, though the figures officially declared are inflated by statistical problems. Of course there are major variations between the acceding countries; Slovenia and the Czech Republic are clearly nearer to being typical Member States in these respects than to the average of the applicant countries.

The structural differences between the countries of central and eastern Europe and the Union led many authors to estimate, on the basis of current policies, that the net cost to the Community budget of accession would be very large. In the first major study of enlargement, Richard Baldwin presented an estimate of ECU26,7 billion per year for the ten new members measured on 1991 income and economic structure. This estimate essentially assumed the application to the new Member States of existing policies under existing eligibility rules. He considered this to be a very low estimate and suggested that the true cost would be much higher.[5]

The estimates of Agenda 2000, and their subsequent adoption in the new financial perspective of the Union, were however based on assumptions of policy changes and changes in the rules of eligibility. In this way the total estimated cost of the accession has been reduced and constrained within unchanged upper limits for payments appropriations in the Union budget. Agenda 2000 expenditure estimates however only cover an accession of the first group of negotiating countries and must be amended to include the second group approved at the Helsinki European Council in December 1999.

1.1 The Agenda 2000 financial package

The agreement achieved at the Berlin European Council in March 1999 was constrained by the factors mentioned above. Four main constraints were agreed which have an impact on the financing of enlargement:

- the own resources ceiling of 1.27% of GNP of the Union was to be maintained for the period 2000-2006
- an unofficial ceiling on structural operations of 0.46% of GNP was to be observed and an overall ceiling on transfers of 4% of national GDP was set for countries in receipt of structural funds (including Cohesion Funds)
- pre-accession and accession expenditure should be ring-fenced so that there could be no transfer of resources between the budget for the EU-15 and expenditure on the pre-accession or accession countries. Amounts available for accession cannot be used for pre-accession expenditure
- an 'innovative' agricultural arrangement for the acceding countries was agreed in Berlin leading to direct income state aid being paid to farmers in the EU-15 but not to farmers in the acceding countries.

In addition two assumptions are made which are built in to the Financial Framework:

- the assumption is also made that the acceding countries will only gradually develop the capacity to absorb large transfers from the EU
- it is however assumed that the new Member States will be contributing from the first day of membership to the own resources of the Union.

Table 3 shows a somewhat abbreviated version of the 2000-2006 Financial Framework of the European Union, agreed at Berlin and contained in the Interinstitutional Agreement between the Council, Parliament and Commission of the Union in May 1999.[6]

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[5] Richard Baldwin: Towards an integrated Europe, 1994, CEPR, London.
[6] Offical Journal: C172/1, 18.6.1999.

Table 3: Financial framework EU-15 in EUR millions and at 1999 prices

COMMITMENT APPROPRIATIONS	2000	2001	2002	2003	2004	2005	2006
1. AGRICULTURE	40920	42800	43900	43770	42760	41930	41660
CAP	36620	38480	39570	39430	38410	37570	37290
Rural development	4300	4320	4330	4340	4350	4360	4370
2. STRUCTURAL OPS.	32045	31455	30865	30285	29595	29595	29170
Structural funds	29430	28840	28250	27670	27080	27080	26660
Cohesion fund	2615	2615	2615	2615	2515	2515	2510
3 OTHER POLICIES	15940	16100	16070	16040	16260	16480	16710
4. PRE-ACCESSION	3120	3120	3120	3120	3120	3120	3120
Agriculture (SAPARD)	520	520	520	520	520	520	520
ISPA (1)	1040	1040	1040	1040	1040	1040	1040
Phare	1560	1560	1560	1560	1560	1560	1560
TOTAL COMMITMENT APPROPRIATIONS	92025	93475	93955	93215	91735	91125	90660
TOTAL PAYMENT APPR	89600	91110	94220	94880	91910	90160	89620
Payments as % of GNP	1.13%	1.12%	1.13%	1.11%	1.05%	1.00%	0.97%
AVAILABLE for ACCESSION			4140	6710	8890	11440	14220
Agriculture			1600	2030	2450	2930	3400
Other expenditure			2540	4680	6440	8510	10820
CEILING ON PAYMENTS	89600	91110	98360	101590	100800	101600	103840
Ceiling on payments as %GNP	1.13%	1.12%	1.18%	1.19%	1.15%	1.13%	1.13%
Margin for unforeseen expenditure	0.14%	0.15%	0.09%	0.08%	0.12%	0.14%	0.14%
FINANCIAL FRAMEWORK FOR EU-21							
ENLARGEMENT (Commitments)			6450	9030	11610	14200	16780
Agriculture			1600	2030	2450	2930	3400
Structural operations			3750	5830	7920	10000	12080
TOTAL PAYMENTS APPROPR.	89600	91110	98360	101590	100800	101600	103840
of which enlargement			4140	6710	8890	11440	14220
PAYMENTS APPR. AS % GNP	1.13%	1.12%	1.14%	1.15%	1.11%	1.09%	1.09%

Source: EU; Inter-institutional Agreement. OJ: C172/1, 18.6.1999

1.1.1. The financing of the Common Agricultural Policy

The reform of the Common Agricultural Policy decided at the Berlin European Council in March 1999 was not driven solely by the needs of enlargement. It was determined by the clear risk that high levels of price support would lead again to overproduction, with, this time, a limitation on export subsidies imposed through the Uruguay Round. The growing awareness that agriculture cannot be totally separated from the rest of the economy and must be competitive on world markets helped to convince delegates of the need for reform. It was also a reaction to the need to restrict subsidy in order to put the EU into a position to make a serious offer at the WTO Millenium Round. Perhaps above all, it was a reaction to the demands of the net contributers to the budget to maintain overall budgetary rigour and tackle the problems of unequal 'burden sharing'.

The core idea of the CAP reform proposed in Agenda 2000 is to continue to shift subsidy from prices to direct income transfers in order to reduce incentives to produce for intervention rather than for the market. This logic appears to be accepted in all Member States. How these transfers are made however is a hotly disputed matter. In the logic of the European Union, direct income transfers are matters for national governments; examples of unemployment benefit or state retirement income come to mind. Such national transfers ensure that the benefits paid are determined by the appropriate cost and standard of living in the country concerned. This argument would lead to a progressive renationalisation ('cofinancing' in Community terms) of agricultural expenditure, while at the same time maintaining a common market for agricultural products. The financing system which in the end prevailed, due largely to the resistance of the French Government to a renationalisation of expenditure, was that state aids paid to an industry in a common market should be outside the power of national governments to determine to eliminate the risk of a distortion of markets. Strangely, this 'non-distortionary' logic, which was applied to the EU-15, was not applied to the question of agricultural expenditure in the new Member States of central and eastern Europe.

From the point of view of reducing budgetary imbalances, and particularly the problem of the German net contribution, a renationalisation of part of agricultural expenditure has much to recommend it. If combined with a movement towards world market prices for agricultural produce, not only does it reduce overall EU budget expenditure and return agricultural subsidy to national fiscal control, but it means that the EU budget becomes a more progressively redistributive instrument. In the case of Germany, a partial renationalisation of agricultural expenditure would lead to a decline in German payments to the EU Budget in excess of the loss of EU payments to German farmers. Germany could at the same time reduce its net contributions to the Community budget and increase its support to its own farmers. Exactly the opposite effect would be noted for France.

The disadvantage of renationalisation is that it would destroy the notion of fair competition within the Common Agricultural Policy because Member States would be able to compensate their farmers to varying extents. From a purely economic point of view, the French proposals to reduce price subsidies and to pay (degressive) direct income subsidies are far more likely to lead to an efficient agricultural sector. They will also lead to more efficient agricultural economies prospering at the cost of the less efficient.

The final outcome of the discussion was to reject renationalisation and to agree modest price reductions combined with ‘non-degressive’ compensation payments paid from the CAP budget in order to avoid distortions within the common market.

The logic used to deal with agricultural expenditure in the accession countries ignores the question of differential state aids in a common market. The Berlin agreement on the financing of enlargement is based on the assumption that direct income subsidies will not be paid to farmers in central Europe, in contrast to those in the Union. The Commission justifies this by the 'fact' that EU farmers will be suffering income losses due to the agreed reduction in prices but farmers in the new Member States will not suffer such losses because their own guaranteed or market prices are below those in the EU.

Such a proposal will be difficult to negotiate in the IGCs dealing with accession, at least for those countries where farming still employs large numbers of people. The distorting effect of the differential use of state aids in a common agricultural market to favour certain operators (those in the EU-15) against others (in the new Member States) will make such a package difficult to sell to the populations of the acceding states; it may also be considered illegal. In addition, the basic facts on which the original calculations were based have now changed. In Slovenia and Poland for instance some floor prices are now above those in the EU and farmers will want to be compensated for their losses when they have to adjust downwards to CAP price levels.

In many ways however it would not be good for the adjustment processes in central Europe if high levels of income subsidy were paid to farmers; this would simply be a repetition of the folly of politicians in the Union, who misled farmers and slowed down the inevitable process of adjustment, which is now just beginning and which will be very painful. Rather than creating major distortions in society and slowing the pace of adjustment, politicians from central Europe may negotiate for increased assistance for rural development in the form of structural and infra-structure programmes. But as discussed below, additional transfers from Brussels may bring their own problems of macro-economic management.

The decisions of the Berlin European Council will almost certainly not be acceptable to the acceding countries, as indicated by the position papers of the first group of negotiating countries. The assumption of the Financial Perspective is that in 2006, after three years membership of the Union, the six new Member States will be receiving just 7,5% of Community expenditure on agriculture. The fact that these decisions may be imposed by the EU does not really solve the problem. After accession, the new Member States will be able to push their interests from within the EU for the determination of the Financial Framework for the period after 2006.

It should be noted again that the estimates of the cost of accession agreed in Berlin were the result of a calculation based on the accession of six countries. After Helsinki these budgetary estimates will be revised upwards to take account of the six new negotiating countries.

1.1.2 The financing of structural operations

The structural operations of the Union represent the second large expenditure item in the budget.

In spite of the high purpose laid out in articles 158-162 of the Amsterdam Treaty, the structural funds, unlike the Common Agricultural Policy, have relatively little to do with policy and developed as funds transfer mechanisms to the weaker economies within the Union. From the discussion in the Council, it is clear that the Member States which receive financial transfers regard them as an acquired right, which must be guaranteed even if they no longer meet the criteria established for the transfer of funds. Ireland successfully defended its right to receive Cohesion Fund transfers in the period 2000-2006 in spite of the fact that its GDP at current prices and PPS is estimated to be 117% of the EU average in the year 2001, second only to Luxembourg in the EU. [7]

The enlargement of the European Union was the major factor in the reform of the structural funds, in contrast to the reform in agriculture. The calculation of the transfers required for the new Member States from central and eastern Europe under existing policy was so dramatic from a budgetary point of view that it would have been unacceptable for the EU-15 Member States. It was therefore decided to change the rules and to introduce an overall ceiling to the level of transfers which could be made.

The acceding countries all clearly meet the most stringent criteria for both the structural funds in the narrow sense and the cohesion fund. There is hardly a region in the whole area which has a GDP per capita above the 75% level of average per capita GDP in the Community (it should be remembered that for this purpose GDP is measured at market prices and current exchange rates – there may be a doubt over Ljubljana or Prague). The lack of infra-structure of all kinds - transport, environmental, educational and social - is underlined in every report which comes out of the International Organisations and the European Union. Early estimates of the transfers required for the 10 central and eastern European applicants, based on the transfers which had been made to the 'Objective 1' countries in the Union came to around 80% of the planned structural funds expenditure in 1999. In other words, at constant available resources, transfers to the new Member States would mean the elimination of transfers to most of the current recipient regions.[8]

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[7] EUROSTAT: Key indicators, 7/1999.
It is true that the amount of the transfers from the Cohesion Fund to Ireland in the period 2000-2006 will be limited and are considered as a transition to the withdrawal of support from Ireland.

[8] A.Mayhew; Recreating Europe, Cambridge University Press, 1998.

The strategy of the Union in the reform of the Structural Funds was to pursue the objectives of a concentration of resources and a simplification of procedures (achieved through the reduction in the number of objectives in the funds and simplification and decentralisation of management). But above all the reform was needed in order to make room for the new Member States in a framework where the overall budgetary availability will be limited.

Agenda 2000, as decided at Berlin, proposes a reform of the Funds, with the basic objective of not exceeding an expenditure limit of 0.46% of EU GDP. The core of the reform is the strict application of conditionality for access to the funds.[9] This will automatically lead to many regions which have formerly received structural funds losing them in the future. As the Community begins to build up transfers to the new Member States, transfers to the existing Member States will decline. The period 2000-2006 will therefore be a transitional one, with a large allocation of transitional financial support to regions losing their status as transfer recipients.

To avoid transfers rising to unmanageable levels, the Union has decided to limit the transfers from the Structural Funds and the Cohesion Fund to 4% of the recipient country's GDP. This limit appears to be on the low side for the new Member States, which as mentioned above might have expected much higher transfers under the old rules of the Funds. Three points are worth noting however:

- none of the existing Member States have received transfers above this level from the Structural Funds (though Ireland received considerably higher levels if transfers from the CAP are also included)
- the cofinancing of higher levels of transfers requires national budgetary funds to be made available
- the management of large unrequited transfers can lead to problems of macro-economic instability, as the example of Greece demonstrates (though the good example of Ireland shows that such transfers can be consistent with macro-economic stability)
- successful use of transfers require appropriate and efficient institutions in the recipient state.

The result of applying the new rules in financial terms is that there will be around EUR12 billion available for structural funds in the new Member States in the year 2006; this amounts to around 30% of structural spending in that year. Transfers to the new Member States would then have reached around 3.5% of their GDP assuming unchanged exchange rates and real growth in the region of around 4% per annum. Given the wide difference between current exchange rates and PPS and assuming that this difference will be eroded in the next decade by a real revaluation of the currencies of central European countries, the actual transfer may then represent considerably less than 3.5% of GDP or cost the Union considerably more.

[9] The 'strict application' was of course immediately relaxed by the large number of 'particular situations' agreed at Berlin in a typically EU political deal.

The Union is also basing its estimates on the assumption that the absorption of structural funds transfers in the first few years of membership will be low. This point is valid. The generally rather slow preparation to receive structural funds in the acceding countries and the need to find matching or almost matching funds in the national budget may well combine to make absorption slow.

Overall the proposals of the Union in the Structural Funds area for the period 2000-2006 do not look unreasonable. In spite of the enormous financial needs of the accession countries to fund the transition of the economy and their integration into the Union, larger transfers may well be difficult to absorb and may well cause economic instability. Moderate transfers, perhaps increasing over time but lasting for many years will be more manageable than massive up-front transfers.

The problem of macro-economic control is worth elaborating briefly. Transfers of funds from the EU represent a major increase in demand for goods and services in the economy of the recipient state. In order to avoid sharp inflationary pressures, large trade deficits or both, demand in the economy needs to be reduced in order to 'make room' for the transfers. This requires that the Government reduce public expenditure and indeed will probably mean that it will have to run a major public sector surplus.[10] Macro-economic policy in Ireland since the mid - nineteen-eighties has indeed seen the Government cut back in public spending, avoiding inflation and leading to rapid economic growth. In Greece on the other hand, EU transfers were not compensated by demand restraint elsewhere throughout the nineteen-eighties and the early nineties. The result has been high inflation, a significant trade deficit and stagnation. The larger the transfers the more difficult their economic management becomes.[11]

1.1.3 The ring-fencing of accession expenditures

The construction of the expenditure side of the Financial Framework is interesting in that while the pre-accession funds were included in the budget, the accession expenditures were not. Expenditure on accession is expressed as 'payments appropriations available for accession'. This ring-fencing was originally undertaken under pressure from the net beneficiaries from the budget,

Both the pre-accession funds (EUR 3120 million per annum from 2000 to 2006 in real terms) and the funds available for accession are ring-fenced; that is this money can not be used to finance EU-15 spending and finance marked for EU-15 spending cannot be used for accession or pre-accession purposes. In addition the pre-accession funds cannot be used for accession-related expenditure and vice-versa.

This implies that should no accession take place in the period of the Financial Framework, the finance available for accession will not be drawn down. It also implies

[10] this will clearly depend on the volume of unused production factors available to the economy.
[11] Orłowski W: The Road to Europe, 1998, European Institute, Łódż. This book contains a good discussion of the problems of absorbing high levels of foreign transfers.

that if expenditure on accession during the period 2000-2006 should reach the ceiling mentioned in the Financial Framework, this additional expenditure cannot be met from the finance reserved for the EU-15.

While the resources required for structural funds transfers in the new Member States are likely to be sufficient until the end of the period, the finance available for agricultural expenditure appears to be on the low side. Any change in the overall ceiling for accession-related expenditure would require the complex procedure outlined in the inter-institutional agreement on the budget to be implemented. Major changes amounting to over 0,03% of GDP would require unanimity in the Council.

When an accession takes place, the necessary funds earmarked as 'available for accession' will be transferred to the budget, requiring a qualified majority in the Council.

1.2 The financing of the Union budget

The Commission's Agenda 2000 proposals recommended that fundamental changes to the way the EU budget is funded should be postponed until after the first enlargements. This reasoning was applied to ideas of creating a new 'true' own resource, to moving further towards a GDP-based key to financing and to a consideration of the reduction of the British gross payment to the budget.

These proposals did not deal with the main demand from certain of the net contributors to the budget to have a better 'burden-sharing' arrangement. As mentioned above this could have been achieved through a partial renationalisation of the CAP or through a further increase in the weight of the GDP key to budget financing. In fact the main net contributor, Germany, has seen its net contribution to the budget fall in real terms over the period 1994-1998; whereas the transfer represented 0.8% of GDP in 1994, it was only 0.6% of GDP in 1998.[12] While Germany is keen to reduce further its 25% net financing of the budget, the fact that its contribution had been falling no doubt made it easier for the Government not to insist on changes at the Berlin summit.

For the Acceding States the fact that the move towards a more important GDP-based contribution to the budget was put off was a disappointment. On any GDP basis their gross contribution to the EU budget would be very small.

A comparison of the Financial Framework for the EU-15 and the indicative Financial Framework for the EU-21 makes it clear that the EU expects the new Member States to pay their full contribution to the budget on the current financing basis from accession. The tables make clear that payments appropriations rise in the case of EU-21 compared to those for EU-15 by the amount used for enlargement, but that expressed as a percentage of GDP they are lower in the case of EU-21.

[12] Monatsberichte der Deutschen Bundesbank, July 1999.

It is a particularly delicate question whether these new Member States should be asked to pay their full contribution immediately on accession, while they are receiving relatively low transfers during the first years of membership. It would appear more reasonable for there to be a transitional period in which their contributions to the budget only gradually build up to the level of normal contributions.[13]

2. The relative 'cost' of the enlargement to the European Union

The cost of enlargement outlined in the Financial Framework for the period 2000-2006 appears insignificant when related to EU-15 GDP or to public spending in the present Community.

The planned gross expenditure on enlargement in 2006 represents 0.18% of the GDP of the Community of 21 countries or roughly 0.36% of public spending. Put another way, around 16% of the total budgetary expenditure in 2006 will go to the five new members, the remaining 84% being available solely for the EU-15. The net cost to the EU-15 is of course lower by the amount of the gross contribution of the new members.

Under most circumstances this would be considered relatively affordable expenditure. However the demands of Monetary Union and the Stability Pact associated with it, are forcing Governments of all EMU Member States to cut public spending at home. When a finance minister is trying to keep the government deficit down below 3% of GDP, every tenth of the percentage point of government expenditure he can save is vital. And each Member State sees transfers to the Union budget as missed chances to spend money at home and win votes.

For this reason it is likely that the financing of enlargement will remain a live issue in the Community.

3. The longer-term outlook beyond 2006

Clearly expenditure from the Community budget on accession will rise beyond 2006. This will occur for a number of reasons:

- the Financial Framework 2000-2006 assumed there would be 6 new Member States in 2006. Certainly beyond 2006 it must be assumed that there will be at least 12.

The accession of the six countries which were offered negotiations for membership at the Helsinki European Council will bring one large agricultural state, Romania, into the Community, two medium sized countries, Slovakia and Bulgaria and three small countries, Lithuania, Latvia and Malta. On the arrangements agreed at the Berlin European Council these accessions will add a small amount to the overall cost of the CAP

[13] this is in fact the negotiating position taken in the Polish position paper on budgetary questions.

and a somewhat more substantial amount to the Structural Funds. However considering that the CAP will have been reformed yet again, the cost of this policy to the Community budget should have fallen by the time the next Financial Framework is drawn up.

- expenditure on the structural funds transfers to the new members will continue to rise and will approach its 4% of GDP limit

Again the estimates for structural fund spending in the Financial Framework 2000-2006 assumes only 6 accessions. However the exposure of the EU budget to the accession of the remaining six applicants is limited by the Agenda 2000 rule that transfers should not exceed 4% of a country's GDP. In the case of the additional six acceding countries, their GDP amounts at present to around EUR75 billion; this would lead today to a capping of transfers at EUR3 billion. This would be partially offset by the contributions of these countries to the Union budget. If the countries grow very rapidly, then 4% of their GDP will be a larger financial sum than supposed by the EU in the Berlin Agenda 2000 agreement.

- it is unlikely that the new Member States will accept an agricultural package which has distortionary state aids once they are inside the Union

It is inconceivable that the new Member States accept the Agenda 2000 arrangement for agricultural subsidy in the longer term, although they may do so in order to enter the Union more quickly. In the negotiations over successive Financial Frameworks, when expenditure on enlargement is no longer ring-fenced, it is likely that the new Member States will look for equal treatment of their farmers in the common market. Against this however must be set the reform of the CAP which is likely to continue and the results of the WTO Seattle Round, which will agree further cuts in agricultural subsidy. It is likely that agricultural spending in the Union budget will continue to decline as a share of total budgetary expenditure as these reforms bite, although national spending may rise to partly counteract this trend.

- assistance to countries in eastern and south-eastern Europe will probably increase if enlargement is a success.

South-eastern European countries will seek closer ties to the Union and this will not only include Croatia but also Serbia. Under certain conditions, it is probable that more assistance will be given to the Ukraine and Russia as the central European countries become Member States. The political stability of the newly enlarged Union will require stability in Russia and the Ukraine and the EU will at some stage have to devote more time and resources to achieving this. Such a new direction of policy will undoubtedly have budgetary consequences.

The longer term development of the EU budget will certainly be affected by the enlargement. The Berlin agreement on Agenda 2000 looks credible until the first enlargement of the Community has taken place. With the new Member States within the Union the power plays of the different member state groupings in the Council will change and this is likely to lead to an increase in budgetary spending. One area where pressure could be brought would be the creation of a new Cohesion Fund as the new Member States prepare to enter the Monetary Union and prepare to meet the Maastricht criteria. However it should be remembered that financial transfers are not the first concern of the countries chasing accession. Their main objective is certainly political and concerns political and economic security rather than transfers of budgetary funds.

4. The main risks to the budget

Enlargement is probably not the main risk to the Community budget exploding beyond the 1.27% of GDP own resources ceiling. Other developments are likely to raise budgetary expenditure further.

- The resistance of farmers to further reform and further restructuring may lead to an agreed slowing of reform. The state of agriculture in the EU-15 is extremely delicate at present, the CAP having slowed restructuring which has proceeded much faster in other industries. Farming does however occupy a place in our societies which is far in excess of its importance in GDP. It would not be surprising if the demands of farmers led to a slowing of reform in this sector and an increase in agricultural spending. But such a trend would increase pressure for a renationalisation of farm subsidy, which would relieve the EU budget and lead to an increase in national funding. This trend would of course affect the position of certain of the new Member States which would be hard-pressed to find national resources to compensate their farmers to similar levels to those in the older Member States.

- The fiscal implications of Monetary Union are likely to far outweigh the budgetary risks coming from enlargement or agriculture. While it is conceivable that economic imbalances in EMU can be resolved by increased flexibility in real wages or by increased migration of labour, both appear less likely than a substantial increase in budgetary compensation through an EMU redistributionary system. As it is difficult to envisage a member leaving EMU without severe risks to the whole system, there will be considerable pressure to help out countries which get into economic difficulty. This may eventually lead to a centralisation of unemployment compensation as the EMU area moves towards a far deeper integration of its fiscal policy.

- In the opposite direction it is probable that as the Union grows and becomes in many ways more diverse, more flexibility will enter EU policy and be reflected in the budget. This would be in line with a growing trend in the Union at the national level towards fiscal decentralisation. As new policies are developed to which not all members will adhere, the dangers of regional budgetary indiscipline may well increase, although it should be possible to ring-fence these policies and therefore reduce this danger.

C. After accession

The agreement on the financing of accession made at the Berlin European Council will allow enlargement to commence without any danger to the own resources limit of 1.27% of GDP. In some ways, the Agenda 2000 package has changed the rules in the Community and in agriculture has to some extent bent the rules in favour of agriculture in western Europe. However it is unlikely that the new Member States will challenge the Agenda 2000 package in a serious way until they are members. Early membership is of such importance to these economies in terms of lending them the political and economic credibility of the European Union that they will value this above short term disappointments on budgetary allocations.

However as full members of the Union, the new Member States are most likely to attempt to rectify any perceived injustices in future budgetary negotiations so that in the longer term some increase in transfers is probable. Accession related increases in expenditure are however likely to be overshadowed by the fiscal consequences of differential economic developments in Monetary Union.

3. The Financial Implications of EU Accession for the countries of Central and East European

A. Introduction

Within the European Union the financial consequences of the enlargement process have been discussed primarily from the point of view of the cost to the European Union's budget. However a considerably stronger financial constraint will be the cost of accession for the countries in central and eastern Europe which wish to join the European Union.

To put this in perspective, the cost of enlargement to the EU budget from the accession of the first six negotiating countries in the region is estimated, as mentioned earlier, to be of the order of 0.18% of EU GDP in 2006.[14] The World Bank estimates that meeting the environmental regulation of the Union alone will cost Poland between 4% and 8% of its current GDP annually for 20 years.[15]

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[14] EU Inter-institutional agreement: Offical Journal, C172/1, 18.6.1999.
[15] World Bank: Poland, complying with EU environmental legislation, July 1998, Washington.

The financial constraints on accession threaten to be amongst the most difficult which the accession countries have to manage. It is true that on accession they will benefit from a considerable increase in financial assistance from the European Union in the form of structural funds and agricultural funds, but welcome as these are, most of the capital for accession financing will come from within these countries or through borrowing from international public or private sources.

The financial requirements of accession are additional to the needs of other parts of the economic and social transition process. Most of the countries in the region are still in the process of restructuring industry, reforming the social services and the health and pension systems. Infra-structure is a major requirement in transport, in the environment, telecommunications, education and training, the health sector and many other areas.

It is interesting to note that measured investment as a proportion of GDP in the Communist period was relatively high; certainly above the level in the majority of capitalist countries. This was the basis on which 'forced growth' depended and was achieved largely by restricting private consumption. However much of this investment went into the development of industrial capacity, which was politically determined. Decisions were essentially based on a set of administered prices, which underpriced energy and did not consider environmental costs. Much of this investment turns out to have been useless, when a set of market prices is applied. The environmental costs which arose from this forced industrial growth are one of the key problems of accession today. Other parts of the national infra-structure were however also neglected; roads, railways, telecommunications. Because of the planned, non-competitive economy and the artificially restricted private demand and the lack of a democratic system, there was far less pressure on governments to provide these services.

Reform in all these areas remains vital to the success of the transition economies in central and eastern Europe. And in many of these areas the cost to both the public and the private sectors will be very high for the foreseeable future. At the same time the need for macro-economic stability forces finance ministers in these countries to be restrictive on public expenditure in the short term, even where much of the investment will give a good return over the medium- and long-run.

These financial constraints also affect the prioritisation and sequencing of measures required for accession. Everything cannot be achieved before accession. The negotiations must lead to an accession path for each country, which does not give rise to macro-economic instability, with high inflation or unsustainable current account deficits. These considerations are reflected in the negotiating positions of the candidate countries and will be important in the final negotiating deals, which the countries strike with the European Union in the accession treaties.

B. The implementation of the Union's regulatory system, regulation and policy - adopting the Community acquis

The criteria established at the Copenhagen European Council in 1993 for the accession of the countries of central and eastern Europe to the Union include 'the ability to take on the obligations of membership'. This is an opaque way of saying that the candidate countries must transpose and implement the complete regulatory system of the Union (the acquis) and its common policies. In the most extreme form this would mean the whole acquis should be implemented before accession. However this has never been insisted on and certain transition periods or, in a few cases, permanent derogations have been agreed with the new Member States.

The acquis of the Union can be divided roughly into three parts;

- *product acquis*, referring to the characteristics of goods or services in the internal market
- *market economy acquis,* referring to rules, which are at the basis of the market economy, such as competition policy, company law, banking or accounting law
- *process acquis*, which deals with how products are produced rather than their characteristics.

These broad categories of course simplify and in some instances confuse. They omit regulation dealing with the free movement of labour and new areas of EU activity, such as the area of justice and home affairs; and in some cases it is difficult to draw the line between product and process regulation. They are however useful distinctions in thinking about the financial cost of accession and the optimum path for the economies in central and eastern Europe to adopt EU regulation.

The core of the European Union is represented by the internal market. Membership of the Union essentially requires a country to join the internal market from accession and to implement all the rules which are essential to the free movement of goods and services within the internal market. Internal market regulation is essentially product and market-economy acquis, dealing either with characteristics of the products traded or with the basic regulation of the market (Ordnungspolitik). If candidate countries to the EU do not introduce and implement this regulation, they will remain candidates. Clearly brief technical transition periods will be possible, where the necessary adjustments to the acquis cannot all be made by the date of accession, but these are unlikely to be for more than one or two years.

Process acquis - the 'how' of production - generally does not affect the characteristic of the product being traded nor the fundamental regulation of the market. It determines under what conditions products are produced and regulates the area of externalities of the production process. Environmental regulation, health and safety at work and other labour-related regulation (e.g. working time) or planning law are the most obvious areas of process regulation. While process regulation does not affect the characteristics of products traded, it clearly affects the costs of enterprises and therefore, if differentially applied, the competitive position of producers.

Most product acquis will be implemented in the normal development of the private sector in market economies. Much of this acquis deals with minimum standards for products entering the internal market or, in the case of traditional product harmonisation, their detailed characteristics (cars, food products and some chemicals). Costs will occur in redesigning some goods or respecting certain rules on the provision of services, but in general these costs will be part of normal business development. They will be financeable to the measure that financial markets operate efficiently. Costs will also arise in the context of ensuring that standards are met. Some of these costs will be met by the state, where state inspection services are used. Given that the practices of inspectorates differ frequently between the EU-15 Member States and the acceding countries, significant costs may occur in additional hiring, retraining staff and retooling inspectorates. Nevertheless these costs will remain in reasonable limits and some are non-recurring.

Market economy regulation aims at ensuring that there is an adequate level of competition in the economy to ensure efficiency and a reasonable level of equity between producers and between producers and consumers. This is necessary for economic reform and development in the countries of central and eastern Europe and does not usually imply many direct costs, though there may be important indirect costs and benefits. The most important problems arise in the effective control of state aids, in the practice of competition policy, in the question of intellectual property rights and patent law.

The heavy financial burden of accession, the subject of this paper, lies predominantly in the area of process acquis.

This differentiation explains the majority of the demands for transition periods made by the candidate countries in their negotiations with the EU. These are concentrated in areas such as the environment and social affairs and employment. There are several requests for special arrangements to be made in the area of the market-economy acquis, where applicant countries have not yet completed the transition process; these occur in areas such as state aids or patent law. There are hardly any requests for special treatment in product regulation.

C. The financial cost of adopting EU regulation

Table 4 gives a general overview of rough estimates of the cost of adjusting regulation in the countries of central and eastern Europe to that of the European Union in certain well-defined fields:

Table 4: Additional costs incurred in Poland due to accession (% GDP / annum)

	1997-2002	2002-2012	2012-
Index of real GDP (1996=100): end period	124	194	329
% of current GDP: brackets adjusted for real GDP growth, end period			
Environment			
Capital costs	2-2.5	2-2.5(1.3)	2-2.5(0.8)
Operating costs	1.0	2.0(1.0)	2.5(0.8)
Social policy			
Health and safety	0.25	0.5(0.25)	0.5(0.15)
Internal market			
Institutional costs	?	?	?
Investment costs	?	?	?
Transport			
Infrastructure	2.0	2.5(1.3)	2.5(0.8)
acquis	0.25	0.5(0.25)	0.5(0.15)

Source: Orłowski and Mayhew, 1998.[16]

Table 4 suggests that the key areas of adjustment 'required' for accession may lead to additional expenditure of 6% of today's GDP and that over a large number of years. The table makes the simple point that if the countries are growing rapidly in real terms, the cost of implementing the acquis is far lower when expressed as a percentage of end-year GDP, assuming that the real cost of implementing the acquis does not rise over the same period. It therefore makes sense to implement some parts of the acquis as late as possible, when the economy is larger. Such 'backloading' of investment would be very attractive for some areas of environmental policy for instance.

i. The components of costs and their incidence

There are at least four elements to the direct cost of the implementation of EU regulation:

- drafting the law, agreeing it at government level and adopting it in Parliament
- developing the institutions necessary to implement and 'police' the law

[16] Mayhew, Alan and Orłowski W.: The impact of EU accession on enterprise adaptation and institutional development in the EU-Associated countries in Central and Eastern Europe, 1998, European Bank for Reconstruction and Development, London.

- implementing the law, which may require new investment
- meeting the operating and maintenance costs of the new investment.

The European Union's acquis is now massive. It consists mainly of directives, which must be transposed into national law in such a way that the result in all Member States are comparable. Obviously the accession countries can bundle this legislation into a smaller number of complex laws which they then pass through Parliament. While the costs of this process are limited, this still presents an important burden for these countries, especially in terms of Parliamentary time.

The institutional constraint to change has been identified as one of the main challenges to transition. The EBRD's Transition Report for 1999 writes, 'It is now even more clear that institutional and behavioural underpinnings of the transition in much of the region are weak and that this weakness creates difficult and long-term challenges'.[17] For the accession countries the institutional challenges which must be faced in implementing EU regulation are some of the most difficult as existing institutions have to be changed radically and new ones established. New institutions have to function for several years before they attract the support of the relevant part of the population they are serving. Changing existing institutions is often more difficult than creating new ones because of the entrenched positions of old institutions and of those working in them.

While institutional problems of accession are likely to be very difficult, they are unlikely to be financially onerous. It is true that there will be costs of additional staff and of retraining and training and there will also be real investment that is required. But these will be well within the normal possibilities of public or private financing in the accession countries.

The new investment needs are the easiest to comprehend in the adjustment process. What are less obvious are the additional costs which new investment brings in the form of operating costs and maintenance. These may reach levels which are roughly the same as the financial cost of the investment over a series of years. Investment and operational costs are the most significant financial costs and are the elements which are dealt with in this paper.

The financial costs of accession will be borne by the central and regional governments, by private and public enterprises and by the consumer. There will also be financial assistance after accession from the European Union through the Structural Funds and before accession through the EU Pre-Accession Funds. The countries will also have access to international loans, either via the international capital markets or through official loans from the international financial institutions and the European Investment Bank.

It is frequently considered less important if costs have to be borne by the enterprise sector than by central or regional governments. The argument is often that these costs are normal business costs and therefore should be considered in the context of normal

[17] European Bank for Reconstruction and Development: Transition Report 1999, 1999, London, page 4.

business financing. The situation is a little more complex and depends to some extent on the nature of competition in the sector. Where the costs are incurred by business in a sector where there is relatively little competition, domestically or internationally, higher costs will tend to passed on to the consumer and be visible in higher inflation.

Costs which fall on the public sector will also have to passed on to the consumer either as higher charges for public services or through higher taxation. It should however not be forgotten that much of the investment will bring benefits, which exceed the cost of the investment and the additional operating costs. The problem is that these benefits frequently occur over the long term while the expenditure has to be incurred in the short-term.

ii. The key investment sectors[18]

The environment:

Fully complying with the environmental acquis is certainly an enterprise which any member state of the European Union would find difficult. Indeed reading the environmental chapter of the Annual Report on Monitoring the Application of Community Law makes it clear that much remains to be done in the existing Member States.[19] In 1998 alone, the Commission referred 15 cases against Member States to the Court of Justice and dispatched 118 reasoned opinions. Not only do Member States not transpose and implement many measures, they frequently, by accident or otherwise, implement them wrongly. The Annual Report remarks that 'Regarding the conformity of national measures implementing Community law, there are infringement proceedings in all areas of environmental legislation and against all the Member States.' Of course one of the main reasons that Member States are slow in implementing regulation, which they have agreed in Brussels is simply the cost to the national or regional budget or to enterprises.

EU regulation in the environment area consists of well over 400 individual pieces of legislation. The burden of transposition will therefore be significant, as will the institutional elements of the accession preparation. Where candidate countries adopted different environmental policy instruments after 1989, with different needs for institutional control, the institutional problems of adopting the acquis may well be very important. The Regional Authorities in many countries will be required to undertake the investment and to police the legislation and therefore considerable administrative burdens will fall on them.

Though the majority of the candidate countries in central and eastern Europe have already achieved significant environmental improvements since 1989, especially in terms of

[18] for a fuller development of this section see Orłowski and Mayhew 1998.
[19] European Commission: 16th Annual Report on Monitoring the Application of Community Law, 1998, Brussels, June 1999

trans-frontier pollution, major investment will be required to implement EU regulation. The scale of this investment depends on the natural situation of the country (for instance those with a sea-coast will normally have higher investment costs), the structure of the economy today and before 1989, and the investment in environmental improvement which has already been undertaken.

The World Bank has investigated the situation in the Czech Republic and in Poland in some detail.[20]

It estimated that to implement the EU environmental regulation would cost the public sector alone in Poland between $31 and $57 billion or roughly between 20% and 40% of annual GDP. If operating costs are added, the total annual expenditure over a twenty year period would amount to between $6 and $13 billion annually or between 4% and 8% of current GDP. Alternatively expressed this amounts to between $160 and $350 per annum per Polish citizen for 20 years.

Similar calculations for the Czech Republic suggest somewhat lower adjustment costs. The cost per person is put at between $129 and $187 annually for 20 years and between 2.5% and 3.7% of 1997 GDP annually.

Even considering that both Poland and the Czech Republic are already investing heavily in environmental improvement, these are extremely alarming estimates.[21] Although the larger part of the investment and operating costs in both countries will be met by local rather than state authorities, nevertheless the impact on overall taxation levels or on user charges for utilities will be very significant.

Applying the 'polluter pays principle' much of this investment should be made by the enterprise sector in the economy. In certain sectors it may well be impossible for the companies at the present time to bear the burden of additional investment, especially where the companies are already carrying high debt levels. In these cases there may well be the need for additional transitional and degressive state aid after enlargement. This has been requested by both countries in their position papers on competition policy.

The World Bank notes in its report on the Czech Republic that 'the present value stream of investments over seven years until 2005 is 30% higher than if the investments are spread until 2015. The present value of the benefits , however, is only 10% higher'.

There is therefore asymmetry between outlays and returns to environmental investment. While overall there are net benefits from much environmental investment, the main flow of benefits occurs with many years delay. This underlines the dilemma of governments

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[20] World Bank: Czech Republic - towards EU Accession, 1999, Washington DC.
World Bank: Poland, complying with EU environmental legislation, July 1998, Washington DC.
[21] the World Bank study of the Czech Republic, referred to above, notes that the Czech Republic has maintained an investment level in the environment which is higher, as a percentage of GDP, than that in most EU Member States

in central and eastern Europe in their response to the demands from the EU that they accelerate their investment spending on the environment.

The ideal implementation strategy for the environment sector would probably be as follows:

- candidate countries would undertake environmental spending where the short-term returns to the investment were high
- they would also favour early adjustment by companies to regulation, which would be considered as competition-distorting if it were not undertaken early in EU-membership
- it would delay the implementation of regulation in those areas which neither give adequate short-term returns nor are politically sensitive.

Social and employment policy

The belief that EU Social and Employment Policy would cripple the dynamism of the transition economies was based on two errors:

- a confusion between national social policy and Community policy
- the belief that there was no social policy in the transition countries.

Social and labour law in many Member States of the EU is indeed inflexible and appears designed to lead to over-investment in capital equipment and under-employment of labour. However this law is national not part of the European Union's acquis. The latter is restricted to one or two elements of labour law, sex equality regulation and a considerable body of health and safety at work legislation. Social policy has always been regarded as an area of national regulation. This is also notably the case in the area of social transfers, which are always and in all cases met by national governments (though direct income subsidies to farmers may remain an exception).

The countries in central and eastern Europe have all come out of a system where all social needs were met by the state or by state-controlled institutions (state-owned enterprises for instance). Their labour codes or equivalent laws contain already much of the European Union acquis, notably the equality of the sexes in the workplace, rules on maximum working hours and a body of health and safety at the workplace regulation. There is a problem of correct implementation of the national law and there may well be a problem of implementation of Community law, as there is in the existing 15 Member States.

The only area likely to cause major financial costs is that of health and safety at work. These costs will have to be borne by enterprises and may be considerable, especially in some of the older industries, such as base chemicals, where substantial additional investment will also be required for environmental reasons. Nevertheless some of the health and safety regulation is in effect built in to new machines and equipment as existing enterprises modernise and expand. To this extent, enterprises may be able to deal with much of the EU regulation through normal investment programmes. But in other areas such as exposure to biological agents at work or in the training requirements included in some of the directives, costs may be quite considerable.

It is however interesting that only Poland and Slovenia have asked for any transition periods in this area. Even in these two countries, the periods asked for are either undefined in the case of Slovenia or very limited in the case of Poland. On the other hand the World Bank reports in its study of the Czech Republic that 'there is little incentive for compliance (with health and safety at work regulations), since such regulations are not strictly enforced....There has been however no attempt to quantify the likely costs of such compliance from the point of view of Czech firms.' But the Czech Government has not asked for any transition periods.

One of the complications in this area is that it is highly political, because health and safety at work regulations affect enterprise competitivity. There will therefore be strong resistance to demands for transition periods. No transition periods however will simply mean that the cost implications for companies will be greater, as they will have to implement these rules by accession or be subject to legal action.

Transport

The European Union has hard regulation in the transport sector, which the accession countries will have to adopt, and soft acquis, where there is strong pressure on the countries to adjust to the will of the EU-15, but where there is no legal requirement.

The hard acquis is already quite daunting. The technical requirements, which for instance in the road transport sector will require considerable investment, will largely be implemented in the normal course of enterprise investment. Some areas of liberalisation may prove difficult too. Poland and Hungary have asked for transition periods for air and road transport liberalisation. In the case of air transport, the transition period will effectively raise the privatisation value of national airlines, while in road transport it will give domestic companies a little more time to prepare to meet foreign competition.

However it is in the soft acquis area of transport infrastructure that major financial cost will arise.

Objectively the majority of the candidate countries need to make major investments in road and rail transport infrastructure. This was an area neglected by the pre-1989 Communist Governments and economic growth has led to major congestion and growing costs for the economies over the last decade. The Communist neglect has been compounded by the tight budgetary situation in most of the accession countries, which has led to cuts in budgetary funds for maintenance of the existing infra-structure.

At the beginning of the transition there was considerable optimism that transport infra-structure could be developed by the private sector. In general this hope has proved to be ill-founded as all the difficulties with the toll road between Budapest and Vienna have shown. Today it is clear that the state will have to play a more important role in investment finance than previously thought.

The European Union, while having no legally binding acquis in the area of transport infrastructure development, does have a long-term plan to build a European transport network - the so-called Trans-European Networks (TENs). Much of the financial assistance from the Union is likely to be concentrated on the construction of these networks. These are however not necessarily the projects, which give the best returns on investment for the countries concerned. The routes favoured by the EU are usually transit routes to other countries and are generally major motorway projects.

The European Commission estimated in 1997 that an investment of ECU90 billion would be required in the TENs in central and eastern Europe by the year 2006 in order to create a real trans-european infra-structure network. The Commission assumed that 50% of this finance would have to be found from the national budget. Considering the increase in operating and maintenance costs, infra-structure improvements could lead to an additional 2-2.5% of annual current GDP being required for the construction of a modern transport infra-structure over the coming decade. In addition considerable investment in local and regional infrastructure will be required.

Agriculture

Agriculture is an area in which the accession countries will have very different financial burdens to bear through accession; this fact is clearly illustrated through a comparison of the importance of agriculture in the economies of these countries (Table 5).

There will be two main areas of expenditure in agriculture:

- national support payments to the agricultural sector until accession (and perhaps after accession depending on developments in the Common Agricultural Policy of the Union)
- investment in bringing the quality of agricultural products and processed food up to the level required by EU regulation. This includes the respect of veterinary and phyto-sanitary regulations.

In addition considerable investment will be required in rural development in order to create alternative sources of employment in rural areas, as agriculture sheds labour.

Table 5: GDP per capita and agriculture as a % of GDP in the Associated Countries

	Agriculture and fishing in gross value added 1995	Agriculture in total employment
	%	% [22]
Bulgaria	15.4	24.2
Czech Rep.	4.6	4.3
Estonia	7.9	7
Hungary	6.7	8.2
Latvia	10.8	17.8
Lithuania	11.7	22.5
Poland	7.5	25.7
Romania	20.7	37.3
Slovak Rep.	6.0	7
Slovenia	4.4	6.3
Total	8.7	22.4
EU	2.3	4.8

Source: Eurostat

It is too early to say anything about the level of subsidy for agriculture after accession. The CAP is likely to change significantly in the period up to the first accession. Already however, agricultural subsidy is a significant part of public expenditure in several countries in the region.

The cost of meeting the acquis in areas like veterinary and phyto-sanitary standards will be very high. In the case of Poland, only as far as milk production is concerned, it was estimated that the budgetary cost of upgrading all dairies and farms to meet the requirements of the EU would be roughly $3 billion (13 billion złoty) over six years. This expenditure must be made if Polish milk is to enter the other Member States after accession. Otherwise a dual market for milk will have to be established; one purely national for milk, which does not reach EU standards and the other for EU milk As this is also linked in to the question of the elimination of the frontier, it is of considerable significance.

While the costs of accession for Polish agriculture will be higher than in most of the other countries because of its structure, nevertheless the other accession countries will also need to invest heavily to meet EU standards.

[22] statistics for agricultural employment in these countries are difficult to compare to statistics within the EU Member States

Other areas of the acquis

While the above are the main areas where high financial costs may arise from accession, there are many significant cost elements contained in other chapters of the negotiation. The following are merely three examples:

- One general cost which is inevitable is the transfer of all tariff revenues to Brussels to finance the Community budget. These revenues are still significant parts of the national budget in many of these countries, because the level of tariffs is still far higher than in the EU itself. In Poland in 1997, tariffs made up 4.8% of national budget revenues.

- In the negotiations on social and employment policy, the accession countries have to agree to finance the costs of giving medical assistance to their citizens who fall ill in other parts of the EU. For the countries of central and eastern Europe, where the unit costs of treating patients is very much lower than the same costs in Germany or Austria, these additional costs to health budgets may be very significant.

- A third example is that of the requirement to keep strategic oil stocks equivalent to 90 days normal consumption. At present stocks are in general far below this (in Poland around 25 days). The cost of providing storage to meet this requirement is extremely high, which is why all the first group of negotiating countries, with the exception of the Czech Republic, have asked for transition periods.

It is very difficult to make precise estimates of the costs of accession. It must not be forgotten that the accession countries would have made many of the required investments in the normal course of domestic policy implementation. It is rather in the timing and occasionally in the choice of method to reach standards required by the EU that the problems for the candidate countries arise. With first priority being given to continuing the economic transition in order to establish the foundation for macro-economic stability and high economic growth, the timing of the implementation of process regulation is critical. If the whole acquis were to be implemented before accession, this would place an impossible strain on national budgets even if accession were to be delayed several years. The way in which the acquis is implemented is also important. Especially in the environment field, there are methods of reaching the ultimate objectives of Community regulation in more cost effective ways than those mapped out in the Directives. In such cases it is important that the Union is prepared to make compromises.

D. The financing of the economic and social transition

While macro-economic stability and the goal of catching up in income (and eventually wealth) terms with the current EU Member States are the most important domestic policy objectives, they must also be considered the most important objectives for the enlarged European Union. It will be easier to deal with new members, whose economies are functioning well even if they have not implemented all the process acquis by accession than countries in which systemic reforms have not been thoroughly implemented.

In many of the accession countries, the restructuring of traditional industries, many still in state hands, has not been completed. In Poland this is clearly the case in the coal and steel sector, where considerable state finance will probably be required to produce smaller businesses which are likely to survive. The current Polish government has allocated around $2 billion from the national budget for the reform of the coal sector between 1998 and 2002 and estimates that $3 billion will be required by steel restructuring up to 2005 (although here it is not clear what proportion should come from the national budget).

In addition to industrial and agricultural restructuring, governments in the region have to complete the reform of the pension system, of the health service, the education system, the taxation system, fiscal decentralisation and in the case of Poland, the regional and local government systems. These reforms are necessary in order to get these economies in a situation where the strain on the national budget can be managed and where the dynamic growth forces in the economy are released. Most of these reforms will turn out to be very costly and most of the burden will be borne by the national budget. None of these reforms can be delayed, if the transition to the market economy is not to be negatively affected. The fact that some of these reforms have not been carried out yet by countries in the EU-15 (pension reform for instance) in no way makes them less important for the countries of central and eastern Europe.

The burden of these reforms on the budget as well as on the enterprise sector makes the financial cost of accession more acute. The real problem is to manage accession in a way which maximises the systemic reform content of policy and the returns to investment while subject to financial constraints.

E. The financial burden and foreign assistance

Foreign sources of finances will be available for investment in systemic reforms or those related to EU accession. The main sources are as follows:

- foreign direct investment (FDI)
- foreign portfolio investment
- international borrowings
- development loans from International Financial Institutions - World Bank, European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB)
- transfers from the EU: EURO 3 billion per annum until accession for the ten countries in central Europe and perhaps EURO 25 billion per annum after accession of all ten countries.

Of these different sources, FDI is clearly the most advantageous. The investment is long-term and is usually combined with the introduction of improved technology and management skills, which benefit the whole economy. FDI normally results in the upgrading of the national stock of capital, because the investment meets at least standards laid down by the EU. FDI unequivocally raises the potential output of the country and the risk of leakage into consumption is very small.

Portfolio investment from abroad is unlikely to play a very significant role in development and could at worst become a factor of instability. On the other hand loans from international capital markets may be a significant factor in ensuring adequate development both in the public sector (for instance municipal borrowings to finance the development of local services) and in the enterprise sector. These borrowings carry some risk that they may spill over into private consumption however.

The international development agencies will play an important role in meeting the costs of transition and of accession to the EU. These agencies are already deeply involved together in the development of infrastructure, industry restructuring and indeed in equity financing (notably the EBRD). The investments are generally accompanied by highly skilled project and financing teams from the institutions. In 1998 for instance the EIB lent EURO 2,3 billion to the accession countries.

In volume terms, transfers from the EU are likely to be more significant a source of foreign finance than any other source except FDI. These are pure transfers with no repayment requirement. They have to be cofinanced and they may in future have stronger conditionality attached to them than in the past. Nevertheless these transfers may well flow into domestic consumption, if governments do not run appropriate policies.

All of these sources of foreign finance for development together should make up only a relatively small proportion of the capital needed to achieve both the pursuit of systemic reforms and the accession requirements. The largest part of the capital required will come from domestic sources. It is therefore vital that macro-economic policy aims at raising the savings ratio in the countries of central and eastern Europe and fostering private investment.

F. The financial burden and macro-economic stability

Orłowski in his book, the Road to Europe, dwells on the examples of the accessions of Greece, Spain and Portugal.[23] In the first decade after accession, the Greek economy performed extremely badly in spite of large transfers from the EU, while the other two economies (as well as Ireland) fared very much better over the ten years from 1985-1995. The evidence of the Greek drama was to be seen in the very high trade deficit, high rate

[23] Orłowski W.: 1998.

of inflation and low economic growth. The analysis made there has relevance to the accession of the countries of central and eastern Europe.

Development requires productive investment. The investment needs to be directed towards those investments which in a global sense give the greatest returns. For investment to take place, it is important to maintain macro-economic stability, especially low and predictable rates of inflation (limited inflation may be desirable, where it is important to restructure the economy and shift resources between sectors), a manageable current account deficit and a low public sector deficit.

In the case of Greece, poor policy led to a leak of funds from EU transfers and some international loans into private consumption. Even when used for investment, EU transfers were often used to finance projects, which had a relatively low rate of return. The available finance was not used to build the economy to improve the outlook for longer-term growth but to raise the current standard of living of the population. The additional demand potential from the foreign financing was not adequately compensated for by a reduction in domestic demand, either through raised private savings ratios or through a reduction of the government deficit. The result was higher inflation and a large current account deficit, combined with low investment (partly because of high inflation and high interest rates) and low GDP growth.

The other 'Cohesion countries' managed the situation considerably better. Ireland is the classic case where government consumption was reduced to 'make room' for transfers from abroad and other measures were taken to raise the savings ratio. In this context it is interesting to note that although Greece and Ireland both had indices of per capita real GDP around 70% of the EU average in 1980, Greece remains today at around 70% of the EU average, while Ireland is at approximately 120%.

Large transfers are difficult to manage and carry great risks with them. All the candidate countries will have the right to receive structural fund transfers from the EU, up to a level of roughly 4% of their GDP. If these flows are not to destabilise the economy, governments may well have to run budget surpluses over many years, which will mean cutting back on areas of domestic spending. The idea that receiving unrequited transfers from abroad requires increased savings at home is not a logic which appeals to many voters and therefore governments will always be tempted to divert some of the transfers into current consumption.

In terms of domestic absorption of foreign transfers, it would be certainly better if these transfers could be received over a long period of years but at a relatively low level. That the EU, in its Agenda 2000, has put a cap on transfers to the candidate countries after accession may well turn out to be a blessing.

G. The negotiations and the optimal financial path to accession

Table 6 attempts briefly to set out the cost and optimal adjustment policies for the major sectors of the EU acquis.

The following conclusions might be drawn from the above discussion:

- It is important that both the European Union and the Candidate Countries consider the optimal adjustment path to the adoption of the acquis and reflect it in negotiating positions more closely. This requires thorough impact analysis of all the main areas of the acquis in order to establish an approximate level of the costs involved.
- The objective for both sides in the negotiations should be the same; the adoption and implementation of the acquis, incurring the lowest possible level of costs, minimising the level of macro-economic instability and without prejudicing the course of systemic reform. The EU has every interest in having economically strong and stable new Member States.
- Investment priorities should be determined by the level of returns to investment. However in choosing investments, countries should bear in mind the political aspects of implementing the acquis communautaire
- Long transition periods should be requested and granted in those areas of process regulation, where the returns to investment are low and long-term. In some cases it would sensible to 'backload' the path to full implementation of the acquis by allowing the candidates to leave the heaviest investment charges until well after accession
- Most of the finance for accession adjustment will come from domestic financing, however EU transfers and FDI will be important sources of foreign funding of investment.
- In dealing with large EU transfers, the candidate countries need to raise domestic savings to enable the absorption of the transfers in a way which stimulates investment
- The complexities of dealing with foreign transfers means that ideally they should be kept at a relatively low level though they may be continued over many years.

Of course another alternative strategy might be to delay accession until the candidate countries have completed the implementation of the acquis and reduced the GDP gap with the EU-15.[24]

This would be an extremely dangerous alternative to rapid accession and long transition periods for financially burdensome process regulation. The political situation in central and eastern Europe already derives much of its stability from the perspective of European integration. To remove this pillar to stability by putting off enlargement for another decade or more would invite political and economic instability, which would not leave the European Union itself unaffected.

[24] Baldwin R: 1994.

Table 6: Summary of impact assessment of EU regulation and policies on transition in the Associated Countries of Central Europe

Regulation or policy	Cost implications		Institutional costs	Sectors affected	Optimal adjustment policy	Foreign assistance
	For Enterprises	For state budget				
A. Regulation:						
1. Product-related internal market • New approach • harmonisation	SMEs in some sectors will have problems adjusting to acquis	Passing legislation and information and advice for SME	Moderate cost of adapting institutions to legislation	All sectors, goods and services; food and drink, chemicals especially affected	Implementation at or before accession	Certain specific technical assistance; grant
2. Market economy regulation	Generally low; but intellectual property rights may be a major problem in some countries	Possibly positive through reduction in state aid.	Where AMOs already exist – low. Intellectual property enforcement and civil law problems (access to justice) a problem in some states	All sectors; intellectual property rights may raise costs in pharmaceuticals and various forms of publishing	Implementation; generally immediate; land ownership possible exception	Certain specific technical assistance; grant
3. Process-related						
• environment	Very high in some sectors	Very high	Very significant for some directives e.g. IPPC	Especially energy, mineral extraction, chemicals, metal industries, waste industries, paper and board and parts of the textile and agricultural industries.	'big ticket' directives early preparation for later implementation; long transition periods of up to 15-20 years, back loaded	Grants and loans for environmental investment will accelerate implementation – EBRD, IBRD, EIB,EU, Private sector
• health and safety	Significant in some SMEs in the industrial sector and in certain office employment (cf. directive on use of dis-play screen equipment	Probably low costs	Some additional costs for health and safety inspectorates	Generally across economy; manufacturing, esp. chemicals, mineral working; construction industry	Some transition periods will be necessary together with information and advice for enterprises. Strong political pressure for early implementation	Loans to enterprises may have health and safety components

Regulation or policy	Cost implications		Institutional costs	Sectors affected	Optimal adjustment policy	Foreign assistance
	For Enterprises	For state budget				
B. Policies						
1. Common Agricultural Policy	Potentially significant for agriculture and the food and drink industry. Veterinary and phyto-sanitary controls. Capital investment in dairies and slaughter houses	Potentially very significant; depends on EU reform of CAP	Significant additional costs for supervision of agricultural acquis, market organisation and control	Food and drink; farming and certain manufacturing sectors	Maintain present policy until EU reform decided. Early implementation of veterinary and phyto-sanitary regulation	Agricultural struc- tures improvement and rural development - SAPARD, EBRD, IBRD. TA for marketing and technical adaptation of agricultural regulation
2. Cohesion	None	Cofinancing required; some institutional costs	Urgent institutional preparation necessary	Positive impact on construction, utilities, enterprises undergoing restructuring etc	Rapid increase in absorption capacity through early institutional preparation	Pre-accession structural funds (ISPA)
3. Common commercial policy	Lower external tariff cuts costs for some enterprises and increases competition from third countries for others.	Reduction to zero of tariff revenues. Changes due to abolition of internal frontiers and financing of EU.	Institutional changes due to abolition of internal frontiers.	All sectors. Elimination of Commercial Defence Instruments particularly relevant to 'sensitive' sectors	On accession	Support for training of customs personnel and customs infra-structure
4. Transport and infra-structure (TENs)	Increased regulation for domestic transport; but more competition on domestic markets	Transport infra-structure investment will be very substantial	some increase in inspection requirements	directly transport and construction sectors; indirectly other sectors	Transport acquis on accession; infra-structure spending phased over long-term	speed of infra-structure development will depend partly on availability of foreign capital (EBRD, IBRD,EIB,EU and private sector)
5. CFSP and 'third pillar' policies	Insignificant	Frontier control will create additional costs	Significant changes in institutions controlling frontiers, judiciary etc.	Few direct effects	Adapt to EU policy as it evolves	Technical assistance and some hard investment at frontiers

4. Conclusion

On the side of the European Union, the desire of all the existing Member States to reduce the cost of enlargement to a minimum was manifested in the Agenda 2000 debate at the Berlin European Council in Spring 1999. There is unlikely to be any general change in this approach, given the rigours of living within EMU and the perceived need to reduce Government budgetary deficits.

However the financial perspective agreed in Berlin raises at least four policy questions, which need to be addressed:

- the proposal to pay direct income subsidy to EU-15 farmers after accession, but not to farmers in the new Member States, is obviously a state aid distortion in the single agricultural market and this policy decision will have to be reviewed
- with the extension of negotiations to the remaining applicant countries, a revision of the financial perspectives will be required. There might be a temptation on the part of the EU to delay enlargement until the next financial perspective, which begins in 2007. This may well have serious consequences for stability in the applicant countries.
- it is not reasonable to expect the new Member States to pay the full amount of their budgetary contributions to the EU from accession, which may well lead some of them to be net contributors to the Community budget for the first years.
- a tough and unfair budgetary settlement may be accepted to gain access to the EU, but it will create problems in the future once the new Member States have a veto right over budgetary matters.

For the applicant countries further policy dilemmas arise from the accession process:

- what is the optimum financial path to achieve accession while pushing forward with the transition process?
- how is this path constrained by political factors determined by the EU Member States? For instance what should the medium-term budgetary plan for environmental investment be, taking into account the strong environmental lobby in the Union on the one side and the shortage of resources on the other?
- should agricultural policy be adjusted to that of the CAP in the pre-accession period, even though it would be financially onerous and there is a strong possibility that the CAP will be thoroughly reformed again before accession.

One conclusion should be that in a rational negotiating environment, the financial and budgetary questions should be put clearly on the table. Joint solutions should be sought which lead to the implementation of the whole EU acquis in a period which may extend beyond the point of accession and which optimises the applicant countries' progress in transition and in accession to the Union.

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