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73

ENLARGEMENT  
OF THE EUROPEAN  
UNION

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Helsinki 1994



# **Enlargement of the European Union with the CEECs.**

**-Problems, Recent Experiences and Suggested Solutions**

**An overview.**

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**ABSTRACT:** This paper discusses the problems of the enlargement of the European Union with the Central- and East European Countries. The concrete developments in the integration between the EU and the CEECs are reviewed in the light of recent experience from integration of rich and poor countries. The German unification and the NAFTA agreement are discussed as potential models for the pan-European integration. Finally, the gradual integration model of Baldwin is shown to be a compromise between the two.

**KEYWORDS:** EU, CEECs, integration

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**TIIVISTELMÄ:** Keskustelualoite kartoittaa Euroopan Unionin ja Keski- ja Itä-Euroopan maiden (CEEC) väliseen integraatiokehitykseen liittyviä ongelmia. EU: n ja CEEC-maiden suhteiden viimeaikaista kehitystä tarkastellaan Saksan yhdistymisestä ja Pohjois-Amerikan vapaakauppa-alueesta (NAFTA) saatujen kokemusten valossa. Baldwinin asteittaisen integraation mallin osoitetaan edustavan eräänlaista keskitietä täydelliseen integroitumiseen tähtäävän "Saksan mallin" ja NAFTA-tyyppisen vapaakauppaintegraation välillä. Raportti on osa VATT:n Globaalitalous ja Suomi -hanketta.

**ASIASANAT:** EU, CEEC, integraatio.



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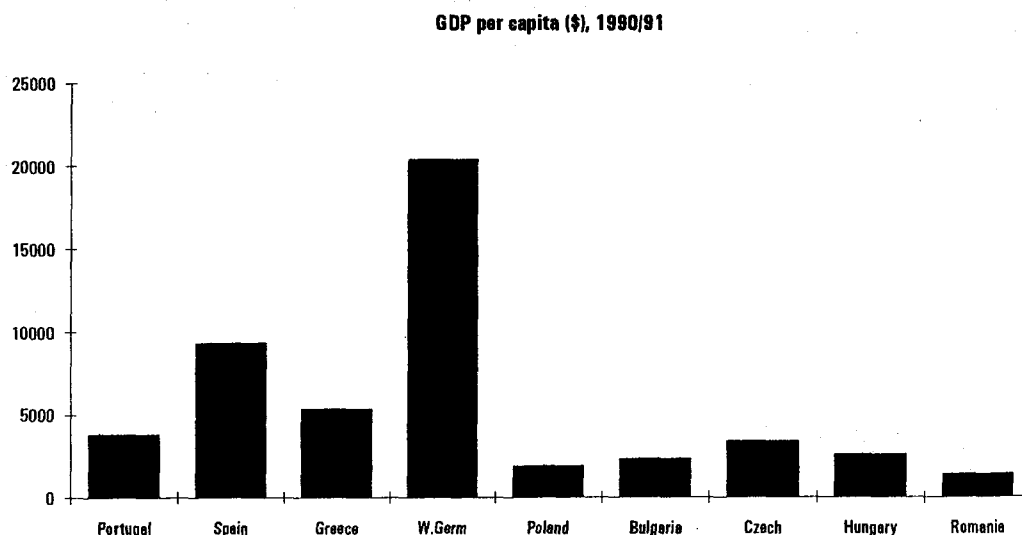
## **Introduction**

The political barriers that divided Europe for many decades were destroyed by the collapse of the socialist-communist system in Central, South-east and Eastern Europe in 1989-90. The Central and East European Countries (CEECs) must once again integrate and construct their economies, which means a lot of work and pain for them. Many questions must be answered: timing and sequencing of reforms, competitive ability and foreign trade, migration and regional aspects, etc. In one phrase, a new "European architecture" must be stated.

This means big challenges to the EU and its Member States. They have to encourage the CEECs' democratic processes (institutions who guarantee human and civil rights), accelerate their economic development and give help in their process of learning the new business culture if it is needed. To support the transformation process financial aid programmes and a free trade agreement in industrial goods with each CEEC has been determined. If the transformation process goes right, the whole Europe can harvest benefits. However, if it goes wrong, peace, prosperity and stability may be destroyed. A solution often mentioned by the CEECs is membership in the European Union, which could accelerate the adjustment process.

In the long run benefits from the European wide economic integration are widely accepted (pure theory of trade). However, in the short run it is generally believed that the CEECs can not be integrated to the EU with a similar procedure as the EFTA countries. This standpoint is based on the big gap in GDP per capita between the EU and the CEECs.

**Figure 1: GDP per capita**



Source: World Bank, World Development Indicators  
 Taken from: CEPR, *Is bigger better?*, 1992

As depicted in figure 1, even the poor countries in EU (Spain, Greece and Portugal) perform twice as good as the CEECs in terms of GDP per capita. Compared with Germany, one of the nearest countries to immigrate, the gap is huge.

From an economic point of view the issue boils down to integration of two areas of different development levels. We have recently observed two real world cases of integration between developed and less-developed economies; reunification of Western Germany with its less developed Eastern part and U.S. integration with Mexico according to the NAFTA agreement. Though these cases are not directly comparable to the EU and CEEC's, we believe that some parallels can be drawn and maybe some lessons learned.

This paper surveys the arguments behind the problems of enlargement, assesses them in the light of recent experiences from the German reunification and the NAFTA-agreement and lists the suggested solutions.<sup>1</sup> The structure of the paper is as follows: Chapter 1 discusses the problems related to pan-European integration as presented in the recent literature. Chapter 2 reviews the concrete developments in the relationship between the EU and the CEECs. Chapter 3 draws some parallels between pan-European integration and the German reunification and the NAFTA agreement, respectively. Chapter 4 discusses various solution models with special emphasis on Baldwin's model of gradual integration. Chapter 5 concludes. The current economic performance of the CEECs is assessed in the annex.

## **1. Problems of pan-European integration**

The problems faced by the CEECs have given rise to a number of articles and papers that discuss the problems related to pan-European integration. In this section, we will try to give an overview about these problems. First we take a look at the economic problems and chances to the EU and the CEECs that would exist if the EU integrates the CEECs in the next years. After that we will discuss the problems of political questions about institutions, elections and strategic or power balance.

There are a lot of problems in the short and medium run depending on the economic structure, some powerful special interests and migration issues of the EU. Extended over all of Europe the EU could prevent a new poverty line between West and East Europe. The main targets of the EU are:

- a common external trade policy
- a common agricultural policy
- a common regional policy (Structural Funds)
- free movement of goods, services, people and capital

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<sup>1</sup> This survey deals with the problems of integrating the most important Eastern European countries who have started their transformation process: Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia.

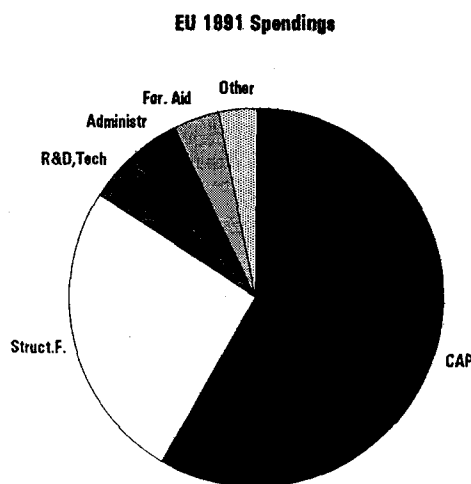
- substantial harmonisation of industrial, health, safety and environmental standards
- a common monetary policy and perhaps a common currency
- a common foreign and security policy of some sort
- a supranational appellate system (Court of Justice) (Baldwin, 1994)

This deep common policy creates dependency between all members of the EU; therefore, an integration of the CEECs cause additional problems and challenges for all member countries. Without care, the short and medium run problems could build long run problems, such as instability, and a decrease in welfare for all of Europe and a backwardness in trade and development.

### **1.1. Budget problems**

To discuss the budget problems of the integration we take a look at the structure of the EU budget first. In 1991, the main spending of the EU (see figure 2) was for CAP (Common Agricultural Policy) 58,4% and the Structural Funds 25,9 %. On the other side the main revenue composite of Value Added Tax (VAT) 54,9%, tariffs 21,5% and GNP based 15,2%. So, we take first a closer look at the CAP and structural spending.

**Figure 2: EU spending**



Source: "L' Europe en chiffres", Eurostat (1992)  
 taken from: pan-European Trade Arrangements..., 1994

The aim of the CAP is to support the incomes and the output of the agricultural sector. First, import barriers protect the farmers from lower world market prices and second, the European Agriculture Guidance and Guarantee Fund (EAGGF) finances pricing, subsidising exports, guarantees sales proportions and subsidises limiting production.

This policy is very expensive and inefficient, because consumers have to pay higher prices than world market prices and scarce inputs are misallocated.

In the CEECs, the useful industrial capital stock per worker is very low in relation to the stock of agricultural land and other farm capital per worker. The agricultural sector seems to be their comparative advantage for the next decades (Anderson, 1994). Not only EU countries, but also CEECs have strong overcapacities in agricultural sector. Anderson estimates that this could cause the budgetary cost of the CAP in the year 2000 to be enlarged by as much as one third. David Begg estimates the budget costs by using a projection at 1989 income levels (CEPR, 1992). His results showed CAP receipts of 1409 million ECU for Poland, 544 for Hungary, 446 for the Czech and Slovakia, 516 for Bulgaria and 809 for Rumania. Together, this is an increase of about 3724 million ECU or 11,5% in CAP expenditures.

On the other side, a big increase is estimated in the expenditures for Structural Funds. The Structural Funds are subdivided into six parts, so called Objectives. 'Objective 1' regions are defined as regions with per capita incomes of less than 75% of the EU average. The aim of this fund is to build up infrastructure and local training. If the CEECs are integrated all their regions will be a part of this fund. Begg (CEPR, 1992) estimated that the expenditures of these funds would increase 11600 million ECU or 80,5%. The revenue side of the (whole EU) budget would increase about 2434 million ECU, which means net budgetary costs of about 12900 million ECU (23,6% of budget size 1991).<sup>2</sup>

To prevent these increases, changes in structures and spending in EU budget are needed. Otherwise, the contributions of the EU members must increase which means a lot of political problems. After enlargement, e.g. Great Britain's GDP per capita is higher than the average one that means high contributions. However, on the other hand Great Britain receives lower earnings from CAP and the Structural Funds.<sup>3</sup> This means a strong disadvantage for Great Britain and the population's support to the membership in the EU could decrease. As a result, many changes could be expected by the former members: net receptors could become net contributors and former EU farmers could lose income and security.

## **1.2. Sectoral problems**

The European Union has a common external trade policy, similar standards and a free movement of goods, services, people and capital without tariffs. This means good possibilities for internal European trade and related to this some sectoral problems. For example, in bigger markets the structure of demand and the number of competitors

<sup>2</sup> Baldwin estimates even budget costs of about 23300 mill ECU, compare Baldwin (1994)

<sup>3</sup> In 1990 UK got just 50 ECU per capita while France get 104, Denmark 207, Netherlands 244 and Ireland 515 ECU. This depends on the economic structure of the UK - agricultural share of GDP is just 2 % - and on the structure of the agricultural sector .

change enormously. At the same time questions of national comparative advantages become more essential. The determinants of national advantage are

- (i) factor conditions like level and structure of education, infrastructure and resources,
- (ii) demand conditions like the nature of home demand for products or services,
- (iii) related and supporting industries and
- (iv) firm strategy, structure, and rivalry like organization, management and co-operation questions (Porter, 1990).

The equipment and structure of production differ between the CEECs and the EU to a great extent. A free trade means big changes in allocation for the CEECs and the EU.

In the EU countries, the structurally weak sectors such as agriculture, mining, iron and steel are supported by the governments of the EU members with subsidies to protect their competitiveness. In the CEECs, the labour-intensive goods like agricultural goods, clothing, textiles have an advantage over the high-tech goods like microelectronics in the short and medium run. Besides, there are a lot of skills or human capital in the iron and steel and chemical sector. If the limited factor, modern physical capital, is accumulated in the CEECs they will become better competitors in these sectors. It will become more difficult to help these sectors to receive their incomes and competitiveness in the former EU because there are overcapacities in East and West Europe as well (Jouko Rautava, 1994). This means a lot of pressure to the governments in the EU countries because lobbies in agriculture, iron and steel are very strong and the main unions like e.g. the German IG Metall have significant power.

Jim Rollo and Alasdair Smith estimate the effect of free trade between the CEECs and the EU in the sensitive sectors by using export data of the CEECs from the year 1989. The effects in agriculture vary largely. In some regions the loss of the producers would be very high. For example, Greece (197 million ECU), Niedersachsen (127), Sur in Spain (123), Bassin Parisien (277), Sud in Italy (136), Netherlands (265) would lose a lot in producer's surplus. On the other hand, the increase of Consumer surpluses due to lower prices would have about the same size in the EU. Besides, tax-payers' costs would decrease considerably (1787). However, the net surplus would distribute unevenly. Regions with a high density of population win (Nordrhein-Westfalen 307, Ile de France 303), whereas country-like regions lose (Greece -123, Bassin Parisien -77). The less favoured regions are more dependent on sensitive products (Objective 1 regions). The average employment share of the sensitive sectors in the EC countries is about 16,7%, whereas the share of the eight smaller EC-countries is about 22,8% (Rollo, Smith, 1993).

In different sectors the effect of free trade differs substantially. The losses in producer surplus for the former EU agricultural sector would amount to 3741 million ECU per year because of lower prices. If the EC-prices stay unchanged, the budget effect is huge (see part 1.1.1), because of high fiscal transfers to the CEECs by EC tax payers. If price changes are allowed, Rollo and Smith estimate that the price changes are in the range of 1-8%. The taxpayers would be relieved because of lower payments to the

CAP. The EU could afford to compensate completely the farmers who lose income or work from these integration and price shocks.

In the iron and steel sector the producer losses would be about 120,6 million ECU, especially, the production of Greece and Ireland would decrease of about 8,8%. The losses of the chemical producers would be much higher with about 734,8 million ECU, whereas the losses in the textile sector are estimated to reach 26,5 million ECU for Italy alone (because of an increase in consumer surplus of just 0,8 million ECU, Italy has a negative net welfare effect of about 25,7 million ECU). The production of Germany and the northern EC-countries<sup>4</sup> would decrease a lot, about 17,6 and 11,7%, respectively. The regional producer losses of industry and agriculture together are just a reduction between 0,03 and 0,55% of regional GNP, however, the effects in agriculture are much bigger than in the other sectors.

When assessing these results, it should be kept in mind, that the governments tend to be more sensitive to short-run employment shocks than to long run economic welfare effects from better allocative efficiency.

Grossman and Helpman (1993,1994) show the interaction between lobby groups representing industry or agricultural special interests and an incumbent government. The influence and power of the lobby groups towards the public opinion press the government to reflect the relative political power of its various special interests.

Between 1989 and 1992 Central Europe's share of total EU imports increased from 0.86% to 1.42%, which means an increased rate of about 74%. The share in the sensitive sectors in which the CEECs have comparative advantages increased just from 1,53% to 2,07%, an increased rate of about 35% (Galinos, 1994). Such protectionist institutions like the Common Agriculture Policy, the European Coal and Steel Community, and the Multi-Fibre Agreement were built to protect the sensitive sectors and have been successful in preventing higher market shares of the CEECs by nontariff barriers like anti-dumping and origin regulations.

### **1.3. Migration problems**

Because of the big wage gaps between the CEECs and the European Union many workers could migrate into the high wage regions if the CEECs were integrated in the EU. The size of the East-West migration is difficult to estimate. Looking at the migration effects of the South-North migration: 4,1% of the Greeks, 15,1% of the Irish and 9,5% of the Portuguese population live in other EU nations now (CEPR, 1992). The pain and efforts to live in another country are dependent on the changing of culture, language and climate. It is perhaps easier to migrate from Britain to Australia than from Britain to Albania. That is the reason for the high level of Irish migration to England.

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<sup>4</sup> Benelux and Denmark

Blanchard, Dornbush, Krugman and Layard (1992) estimate that around 3% of the population of Eastern Europe might want to move to the West in the next fifteen years (CEPR, 1992). This means an influx of about 5.7 million people or 1,5% of the population of the EC plus EFTA. At first glance, this seems to be no big problem, but the migration would be most likely concentrated in small regions like Germany and Austria. A reason for this is the geographical situation. Germany and Austria are neighbours of Poland, the Czech Republic (and indirectly Slovakia) and Hungary. Besides, Austria and Germany are rich countries with high wages, high social benefits and smaller cultural differences to the CEECs than the other EU members.

Highly educated people are the most mobile and are able to find jobs in the craft business and industry. In the short run, this means big problems for Germany in the labour and housing markets. Besides, if the immigrants cannot find jobs, the social welfare system would be very stressed. Other regions like France, Spain or Britain would not have such big problems because the distances in culture and geography are higher.

In the long run immigrants are needed in most parts of the current EU. The dependency ratio, defined as the ratio of non-working age population (ages 0-14 and over 64) to the working age population, will increase in the next 40 years. The World Bank projected the dependency ratio of the year 2030: 0,7143 is estimated for the EU-15<sup>5</sup> and 0,61 for the CEECs. Compared with the actual dependency ratio of about 0,49 for the EU-15, the changes are fundamental. This means a lot of problems to finance the benefits for the elderly people and other social welfare payments like health insurance. A migration of young people (emigrants are in general young) could reduce this problem from the EU-15 point of view for the medium run, in the long run they could not help unless their reproductive rate were significantly higher (this is not likely because of the same development of the dependency ratio in their former countries).

An advantage for the CEECs is a possible technological transfer if the workers return to their former countries. This could help to improve technological skills in the long run.

On the other hand, without an integration there is a danger of illegal mass labour migration, if political instability and worse expectations destroy hope for a better future in the CEECs. A lot of willpower is needed to stay and it is easier to leave the native country and settle down in high-developed countries. The EU must also try to give hope by supporting the CEECs and closer co-operation.

As migration determines the allocation of human capital it has important implications to the economic growth and its regional distribution in the long run. Under certain prerequisites<sup>6</sup> the following conclusions for growth in the CEECs can be made.

<sup>5</sup> EU-12 plus Finland, Sweden and Austria

<sup>6</sup> First, we assume a production function with the following production factors: work, instrumental/productive capital and human capital.

The stock of instrumental/productive capital is very low compared with the human capital in some sectors.<sup>7</sup> Therefore, in the short-run work cannot be substituted easily because of the limiting factor modern instrumental capital. In the beginning the CEEC economies will be labour-intensive because of the lack of modern technical capital. The chance of the CEECs to accumulate real capital is very low because of the low level of savings. However, in contrast to the African developing countries there are other good chances for growth in GDP per capita. If there are open capital markets and open goods markets, foreign investors will accumulate the real capital stock. Because of the high level of human capital the yields of the investments are very high.

Hamilton and Winters showed a correlation between high education levels and comparative advantages in high-tech products. An internationally standardised scientific test of students at different levels in several countries underlines this idea. In the test, Hungary has the highest mean science score of all industrial countries in the medium level and the third place in the high level. Poland's education is placed as an average one (Hamilton, Winters, 1992).

New high-tech productive capital can be combined with a large pool of highly educated workers. In this way the growth process can be stimulated and further human and real capital can be accumulated. The problems in the CEECs countries are the big uncertainties about property rights, stabilisation, laws and political developments. Therefore, this equates to the investors a discounting of the expected earnings and less willingness to invest now.

The main items of the EU-integration are on the one hand a better access to international capital markets, but on the other hand problems of migration. The migration problem has in this context a big effect in the long run.

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Human capital means skills, knowledge or rather the stock of embodied knowledge. The technical progress is embodied in human capital and just the accumulation of human capital can also determine the growth of GDP per capita.

An economic transactor has to decide how much human capital he wants to accumulate. However, this will result in high costs for him: he cannot earn money and has to pay money for school. The decision to accumulate human capital can be compared with the decision to invest. You have to put in resources now to get earnings in the future. So, you make the decision to accumulate human capital or instrumental/productive capital. The important factor in this decision is the expected yield structure. If the yield of human capital is bigger, you will accumulate more human capital. In the optimum the yields are equal.

The structure of the production function is the following one:

The relation between human capital and instrumental/productive capital is a fixed one with nearly no possibilities to substitute. You need more high skilled workers if the productive capital stock increases.

The relation between instrumental/productive capital and work is not fixed with several possibilities to substitute. Low skilled workers constantly performing the same repetitive work can be substituted easily (compare Thomas Gries, 1995).

<sup>7</sup> If the human capital can be completed with economical and administrative knowledge, the human capital will be much larger than the technical/instrumental one.



The well-educated people have fewer problems when finding a job in foreign countries, and to learn foreign languages. Because of this, it seems to be possible that most immigrants are highly skilled workers. The wage gap between the CEECs and the EU is so high, that the transaction costs of migration are relative small. This means to the CEECs, a decrease in human capital and fewer chances to receive investments and to reach a satisfactory growth path.

The regional distribution of growth potential determines the long run development and welfare of different regions. The location choice of companies is influenced by growth, trade and geography. Also, human capital plays an important role in the economics of location. Therefore, we will first analyse the regional effects (Gries, 1995) of human capital accumulation and then add questions of information costs and trade.

Human capital is not as mobile as instrumental capital, because highly skilled people can not move as fast as money. Some parts of human capital are rather immobile like institutions (universities) or cultural manners. Other parts are mobile like scientists and blueprints. In the knowledge sector, there are increasing returns to scale, because of technological spillovers. A new innovator profits from experience and work of former innovators. He can exchange his knowledge with other scientists; can be stimulated from their work; and improve his skills to find new products or new solutions.

Because of these spillover effects it is profitable for mobile human capital to migrate to an immobile one. The immobile human capital determines the accumulation of human capital and the possibility to grow. Immobile human capital competes to accumulate a mobile one (Gries, 1995). Reasons for mobile human capital to migrate are the quality of the immobile human capital, the quality of the environment and the expected incomes.

The CEECs as integrated parts of their mobile human capital will migrate to the former EU, because of better environment quality, better possibilities to earn money and huge spillover effects there. Growth in the industrial sector is dependent on the accumulation of human capital, besides product and process innovations are important to keep competitiveness in the long-term. Therefore, chances for modern industry to develop in CEECs are rather bad. A concentration of industry in the western parts would be reinforced.

Trade costs are dependent on transport costs and information costs. In this respect, the information costs are very important, because marketing concepts and marketing costs determine in many cases the competitiveness of companies. Without new and good information it is difficult to be successful in markets. Especially, component suppliers must have close contact with their customers, to be flexible enough for their different wishes.

This means concentrating productive capacities and gaps in value-added pattern between East and West. The CEECs can compete just with low-wage production which means low value-added or they must concentrate on old industries without need

in permanent innovations. The development of the centres of former EU economies would be accelerated by migration of human capital to these places, which would mean growth for Europe as a whole. However, regional inequalities like the 'Mezzogiorno'<sup>8</sup> problem in Italy could be expected in the long run. To prevent this, the immobile human capital must be improved, environment, economic well-being and expectations must be enhanced. These processes would need a lot of time and strain and migration of human capital must be protected. If this is constructed the CEECs will have a good chance to compete in high-tech and modern industry and no big poverty line is to be feared.

#### **1.4. Political problems**

An increase of members in the EU means several political problems. More countries have influence in the decision making and the decision process becomes more complicated. Procedures of voting in the Council of Ministers must change to keep up with working majorities. According to this, the main problem is the number of votes for each member. Strategic questions like small versus big countries or rich versus poor are controversially discussed. In the following part we will have a closer look to these items.

The most important institution in the EU is the Council of Ministers. In this Council decisions are made about all kinds of problems, CAP relief as well as Structural Funds spending. The number of votes depends on the population size of the country. Small countries have disproportionate high voting power. The Council has 76 votes: Germany, France, Italy and the UK ten votes, Spain eight votes, Belgium, Greece, Netherlands and Portugal five votes, Denmark and Ireland three votes, and Luxembourg two votes. Twenty-three votes of the smaller countries are enough to form a blocking minority (Galinos, 1994). The votes of the big five countries representing two-thirds of the EU population cannot outvote the smaller countries. The ten new countries (CEECs and EFTA)<sup>9</sup> are very small ones. Their common population is lower than Germany plus France. The old procedure of voting can not be retained, otherwise the CEECs have too much power in voting, which means potential changes in CAP, Structural Funds, and other sensitive political fields.

Power in the European Union means the ability to enforce own special interests, even though other members will face disadvantages then. If the CEECs become EU members they can build a majority with other poor countries against the richer ones. The CEECs plus Portugal, Ireland, Greece and Spain could build a community of interests to expand the Structural Funds. Very important issues like fundamental law or fiscal questions must be decided with unanimity. This principle gives all members a lot of power, because even small countries are able to prevent decisions. In this case, several concessions must be made to 'buy' the votes. To sign the Maastricht

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<sup>8</sup> The south of Italy is an underdeveloped region although central government has tried to support its growth process.

<sup>9</sup> Finland, Sweden, Austria, Norway, and the six CEECs

Treaty this concession for the poorer countries was a substantial increase in the transfers to them.

Power is the ability of a country to turn a losing coalition into a winning coalition (Baldwin, 1994). The present political rules and the relationship of population implicate the following votes for the CEECs:<sup>10</sup>

Czech Republic	5 votes
Hungary	5 votes
Slovakia	4 votes
Poland	8 votes
Romania	7 votes
<u>Bulgaria</u>	<u>5 votes</u>
CEECs	<u>34 votes</u>

The Council of Ministers in the EU-22 would have 124 votes. A qualified majority needs 71%, which means more than 88 votes. However, 36 votes are enough to build a vetoing stock. Together with one poor country like Portugal or Greece the CEECs have enough voting power to make package deals.

Besides these voting power problems, there are other political problems. The Maastricht Treaty to build a European Union is essential to deepen the European integration process. The criteria of this treaty causes a lot of trouble for the CEECs. The following provisions must be seized (Grauwe, 1992):

- each country has to achieve an inflation rate that is less than the average of the lowest three rates in the EU, plus 1,5 %;
- annual budget deficits are not to exceed 3% of GDP or the level of government investments;
- total government debt is smaller than 60% of GDP;
- long-term interest rates are not to exceed the average of the lowest three rates in the EU, plus 2%; and
- exchange rate fluctuations must be prevented for at least two years (2,25% are allowed).

No member of the CEECs is able to meet these criteria in 1994: the inflation of Bulgaria 75%, Czech Republic 11%, Hungary 19%, Poland 30%, Romania 170% and the Slovak Republic 16% is much higher than the German 3% one. Besides, the government budget balances in Bulgaria 8%, Hungary 8%, Poland 4%, Romania 4% and Slovak Republic 5% are higher than the demanded one (data OECD, 1994). However, today, just a few of the old EU countries are able to meet these criteria. It is probable that the criteria will be changed. Nevertheless, the CEECs have to stabilise their economies first, there is too much instability in these important criteria.

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<sup>10</sup> Projected by Baldwin

Another point to mention is the shift of the geographical centre of the EU. By means of the northern and eastern enlargement of the EU, Germany will become the centre of the European Union. The CEECs will especially have trade with Germany, the gateway to the East. Trade and traffic in Germany will increase very much, which means an economic concentration in Germany.

The east neighbours of the enlarged EU are countries like Russia, Moldova and Belarus. The future of Russia and Belarus is uncertain, because the democracy process is in danger of new dictators, crime and vacuum of power. Emergencies ask for fast decisions and fast actions. Because of this, a common security and defence policy should be determined to beat up external and internal danger and force.

The war in Yugoslavia has shown the problems of the EU (with just twelve members) to find a common strategy, to handle this problem. Some of the new members have non-military traditions or are neutral; other were enemies in the cold war and have to change their military structure. This means some more problems to find a common security policy to save the EU in an environment of uncertainty and potential dangers.

#### **1.1.5. Concluding Remarks**

A full EU membership for the CEECs in the next few years seems to be very problematic. The agricultural sector seems to be the biggest problem, because the former CAP support system would result in too many expenditures. The CAP would have to be changed, which means lower incomes for former EU farmers. Besides, in the short run emigration of workers would cause big problems in labour markets in the former EU. In the long run emigration would cause regional problems for the CEECs because of less human capital. Also, in the short run some workers of the former EU could lose their jobs or their wages could decrease, because the competition to get jobs would be much harder.

In political terms the main problem is the voting power of the new members. Together with poor former EU countries they would have significant power in voting to get more supports by the richer countries if the current voting system would be retired.

Summarised: an integration of the CEECs would require several changes in structure for the current EU; especially, the structure of the budget must be changed. Besides, problems in the labour markets and for farmers would prevent the agreement of the people of the former EU.

## **2. Concrete Developments in Integration between East and West**

Directly after the historic changes in Central and East Europe the aid of EU was hardly organised, discrete activities played the main role. It was difficult to find a common solution, because of the different positions of the member countries. Germany, directly affected by new neighbours, wanted a more generous common policy against the CEECs, whereas other countries were afraid of changes in the balance of power.

In July, 1989, the PHARE<sup>11</sup> programme was started to give special aid to the transition process of the CEECs. First Poland and Hungary, in 1990, Romania, Bulgaria, the CSFR and for a short time Yugoslavia, and in 1991, Albania, the three Baltic Republics and, in the summer of 1992, Slovenia were recipients of this aid programme. The programme cost the EU budget 500 million ECU in 1990 and was extended to one billion in 1992 (Kramer, 1993).

The main aim of the programme was to help the economic transformation, especially in agriculture, industry, investments, energy, education, environmental protection, trade and services, and in problems of privatisation. In 1992, new guidelines were decided by the EU to take into account the different progress of the CEECs. The programme was prolonged till 1997. Besides, new institutions were founded like the European Bank for Reconstruction and Development (EBRD) to help especially small and medium-sized companies and agriculture. Other aid was given by the European Investment Bank (loans), TEMPUS<sup>12</sup> programme (education), food and medical emergency, and contributions of other institutions like the World Bank. The total help till mid-1992 was 46,9 billion ECU. However, this aid supported just short-run developments and prevented worse political dangers. A stabilised increase and a self-feeding recovery were not put in place (Figure 3).

A reason for this is the pattern of trade in the CEECs. During the 1950s, the CEECs industrialisation was characterised by 'CMEA<sup>13</sup>-autarchy' (Gacs, 1994). International trade reached a high level (Hungary 35-40% of GDP), but was determined by arrangements of division of labour with CMEA countries, especially with Russia. At the end of the eighties, this dependence meant big problems to the CEECs. Co-operation within the framework of CMEA deteriorated, the transferable rouble system was eliminated, inability to pay former trade partners destroyed the old framework of trade.

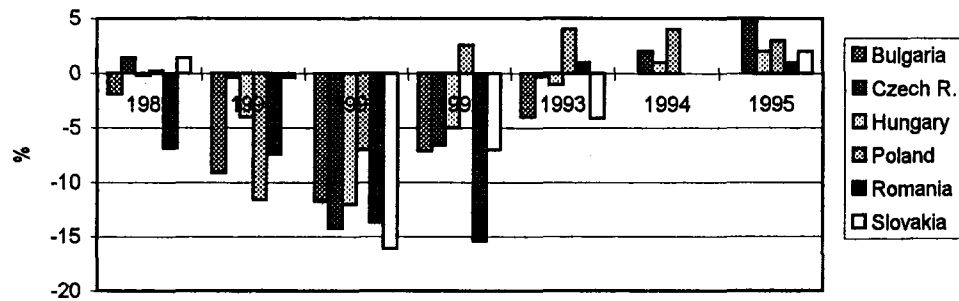
The export sector needed new trading possibilities and tried to get access to EU markets. The main export sectors of the CEECs were iron and steel, textile and clothing, and agriculture. Unfortunately, these sectors were protected in the EU,<sup>14</sup>

<sup>11</sup> PHARE means Pologne, Hongrie: active pour la restructuration economique

<sup>12</sup> TEMPUS: Trans-European Mobility Scheme for University Studies

<sup>13</sup> CMEA (Council for Mutual Economic Assistance)

<sup>14</sup> For example, the thirty most protected sectors produced half of Hungary's exports to the EC, while the thirty least protected ones less than 8% (quotation Gacs (1994)).

**Figure 3: Output change**

Sources: EBRD; OECD, projections<sup>15</sup>

because they are very 'sensitive' ones with overcapacities and problems in competitiveness.

In 1991, the co-operation was intensified by signing the European Association Agreements, between the EU, Hungary, Poland and Czechoslovakia (later with Bulgaria and Rumania). At the Copenhagen Summit in the summer of 1993, main items were included or changed. The following points were decided (Galinos, 1994):

- the recognition of the objective of postcommunist European countries to attain full EU membership ;
- a commitment to harmonise domestic economic legislation with that of the EU;
- promises of further EU financial and technical assistance (no specific amounts were indicated);
- the possible introduction of free trade in services;
- full liberalisation of market access for industrial products within five years;
- elimination of quantitative restrictions on industrial imports, except for imports governed by the Multi-Fiber Agreement and the European Coal and Steel Community;
- granting of tariff and/or quota concessions on industrial imports;
- elimination of some quantitative restrictions on agricultural imports;
- the reduction of duties on food imports; and
- permitting increases in agricultural imports of up to 10% annually for the five years following the ratification.

The European Association Agreements are something new between the EU and the CEECs, because common social values laid the groundwork. Besides, economic issues, political and cultural co-operation was decided, too. In regular intervals there are meetings of the political leaders to co-ordinate further political decisions. During

<sup>15</sup> Data is uncertain (national sources)

the next ten years the Association will try to introduce a free market with the CEECs to get a basis for later integration. Besides, the European Council decided in Copenhagen to integrate the CEECs if they fulfil the necessary conditions.

Therefore, the European Association Agreements mean some advantages for the CEECs, but the important 'sensitive' sectors are restricted as well. Anti-dumping in agriculture, and the special coal and steel arrangements prevent higher earnings of the CEECs and reduce their possibilities to develop. Besides, a further problem for the CEECs is the structure of the agreements. Baldwin called them 'hub and spoke' agreements, describing it like a railway system, with a capital city as its' centre. Trade barriers between CEECs still prevent a better co-operation and give the CEEC members less influence and power against the EU. Because of the tendencies in industry to concentrate in a few locations with good market accesses, the incentives to invest in the CEECs countries are *ceteris paribus* lower than in EU ones. An EU location has access to all markets, EU as well as all CEECs, whereas a CEEC location has just access to his own market and the EU.

The trade between the CEECs and the EU has increased in the first half of 1993 significantly. The trade deficit of the CEECs with the EU increased in this period from 0,56 billion during the first half of 1992 to 3,14 billion in the first half of 1993. The EU imports from the CEECs increased by 5,3% and exports went up by 32,3%. The main part of trade was with Germany with 57% of total EU imports and 53% of total exports from these countries. The main exports of the CEECs were clothing with 1380 million ECU and an increase of about 27,5%. Iron and steel with 384,4 million ECU decreased about 22,4% (Euro-East, 1994). The CEECs were not able to utilise their comparative advantages in all sensitive sectors. Protection and weak economic conditions in all of Europe prevented a better progress.

Situations and circumstances in terms of trade, stability and progress are rather different in the CEECs. The details of single countries are given in the annex of this paper.

In July, 1994, Germany announced that it would place the issue of European Union enlargement eastwards on the main topics. Poland's campaign for European Union membership is supported by several European politicians like Ireland's President Mary Robinson, French Prime Minister, Edouard Balladur and German Foreign Minister, Klaus Kinkel. Even, the USA's President, Bill Clinton points out that Germany plays a key role to do as much as possible to integrate the CEECs into the 'old' continent.

It seems to be possible to establish a timetable for the CEECs to harmonise their economies in some important questions (law, competition policies). This could give some of them a realistic chance to become members in the next ten years.

### **3. Assessing the Discussion in the Light of Recent Experiences**

In this part we will look at other 'integration experiences'. We start with the closest possible integration, the German reunification and take then a short look at the NAFTA agreement.

#### **3.1. German Reunification**

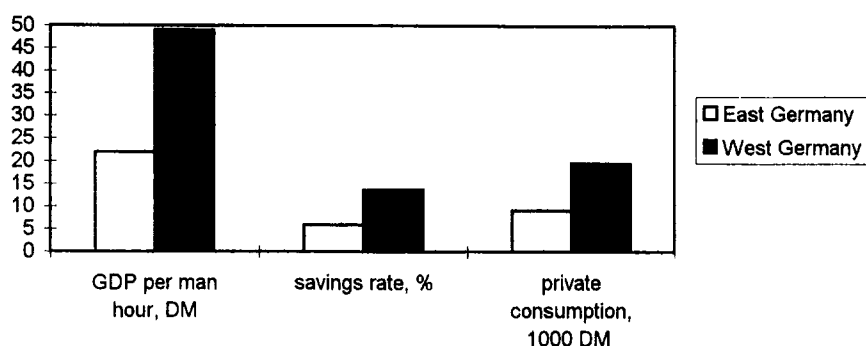
The German reunification on October 3rd, 1990, is different but shares common features to the CEECs-EU integration. However, some experiences from the reunification can help to give a better judgement about our theme. The main differences are the strengthening and the speed of the integration. Timing and sequencing of reforms were determined by fast political and economic unification (institutions, laws, currency). The main political events were mass migration from GDR via Hungary in the summer of 1989; large-scale demonstrations in Dresden and Leipzig in October, 1989; the fall of the Wall in Berlin; and a West German proposal to develop a German confederation in November. In February, 1990, an offer of a monetary union; in March the victory of the CDU in East-German elections; in July the monetary, economic, and social union; and finally the political unification on October 3rd completed the unification process.

In the following part we look at the economic problems and their solutions faced in the adjustment path.

##### **3.1.1. Background**

Two economies of radically different economic order, different levels of industrial development, different structures of labour force and industry were united without separating the economies for a transitional period (institutions, laws, currency). Figure 4 shows the main economic indicators of 1989.

**Figure 4: Important indicators in 1989**



Sources: Statistical Yearbooks 1990 of Statistisches Bundesamt und Statistisches Amt der DDR



The economic unification, like shock therapy, meant several problems for the united regions (Priewe, 1993).

In the former centralised command economy of GDR the government controlled the allocation of resources and the enterprises, because all real capital was state property. In East Germany, 94,7% of labour force worked for state-owned enterprises. After reunification this meant a big problem, because privatisation of these enterprises were needed to improve efficiency and to stimulate progress. In the former GDR there was no competition between the enterprises, which meant low incentives to innovate.<sup>16</sup> Besides, the plan economy model provided other inefficient incentives. Plan fulfilment was the main task of the companies; overfulfilment of the plan meant more difficult new tasks; profits played no role. To manipulate plans and to have better success, information was held back and real capital was hoarded (resources, intermediate products), which meant dead assets. Prices were fixed, so that prices contained no information about production costs.

As a result, a huge factor misallocation made it more difficult to privatise the economy of the former GDR; some sectors of the economy cannot be modernised without high costs. This becomes clear in the export sector, that had problems after the collapse of the CMEA trade to find new customers in the world markets. Another main problem of the economic structure of the former GDR was the size of the enterprises. Excessive in-house productions were the reasons for very large companies, creating a lack of small and medium-sized firms.

The productivity of GDR industries was estimated to be between 33% (Siebert, 1990) and 54% (Cornelsen and Kirner, 1990) of that of West Germany. Because of high increases in wages from 1990 to 1993, fixed by the unions, low-wage products will have no chance in the future.

The capital stock of the GDR had a low technical level, so that it is difficult to estimate the serviceable capital stock. Besides, a huge change in relations of resource prices caused changes in capital equipment; a huge change in product prices caused a new structure of demand (substitution effects) and the need of new product capacities. Because of major problems to evaluate the capital assets and the bridging products during the first time,<sup>17</sup> no balance sheet analysis could help a potential investor to find his project. Therefore, to create a balance sheet was the first step in finding investors.

Likewise, uncertainty in property rights hindered better possibilities of fast privatisation.

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<sup>16</sup> Only incentives to innovate in export sectors (important for foreign currencies)

<sup>17</sup> Former balance sheet departments had other assessment principles

These were the main problems to cope with for a special organisation called Treuhandanstalt (THA), that was founded during the Modrow administration on March 1, 1990. All state property was transferred to this organisation with the task to renew the East German economy. During the de Maiziere administration the aim was modified, the task was to support the privatisation and realisation of the national property according to the principles of a social market economy. The task of the government was to improve the poor and insufficient infrastructure, to support the transformation process in social, political and law questions, and to give structural help.<sup>18</sup>

### **3.1.2. Procedure**

The whole economic system of West Germany was copied to the "New Bundesländer" within one year. Economic policy supports the renewal of the eastern economic structure by privatisation of former state-owned companies, improving the infrastructure, removal of barriers to investments and financial supports of managerial activities (support of investments).

The new economic structure is dependent on the private investments; the government cannot determine the structure, because of international dependence (world markets). In the long run, only big changes in the former GDR's economic structure enable it to catch-up to the West German level.

The key role was played by the THA, that is supervised by the Federal Ministry of Finance. In the beginning, the receipts of privatisation were estimated to be 600 billion DM. The earnings of the THA should have been given to the eastern population. In contrast, the cumulated deficit of the THA was forecast to be 250 billion DM in 1994. The THA was the owner of 126 former centrally managed combines and of 95 regionally managed combines, including 8000-9000 firms with about 45,000 plants and 57% of the total land area (Priewe, 1993). The strategy of the THA is privatisation as the best way of restructuring, at which the THA supports the new companies during the first time. The process of privatisation is divided into four parts (Priewe, 1993):

1. Legal reorganisation:

- change of legal personality;
- subdividing combines;
- re-design of real estate; and
- creation of supervisory boards.

2. Evaluation of the enterprise potential:

- development of individual enterprise plans for rehabilitation;
- evaluation of viability; and
- decision making on closure.

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<sup>18</sup> Länderfinanzausgleich and other regional supports.

### 3. Financial restructuring:

- adjusting balance sheets;
- redemption of debt;
- guarantees for bank loans; and
- increase of equity capital.

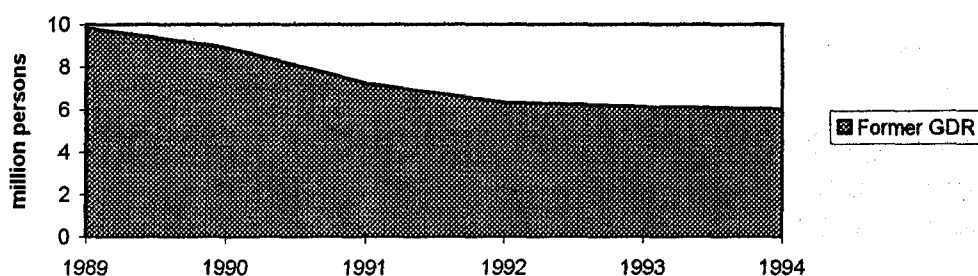
### 4. Pre sale economic restructuring:

- just financial support of THA.

It was very difficult to find investors for the old GDR companies, because many of them were in poor condition. Besides, other reasons shown by Sinn (1991) deteriorate the privatisation process. A general uncertainty, risks in East European markets, contractual job guarantees, old debts, high interest rates (in 1991), environmental damages and portfolio effects stipulated price discounts of potential investors.

In the first years after unification just a few companies in former GDR were competitive or earned profits. The gainful employment in East Germany decreased from 9,8 million persons in 1989 to 8,9 million in 1990, 7,2 million persons in 1991, 6,3 million in 1992, 6,1 million in 1993 and an estimated 6 million in 1994 (Sachverständigenrat, 1993/94).

**Figure 5: Gainful employment of East Germany**

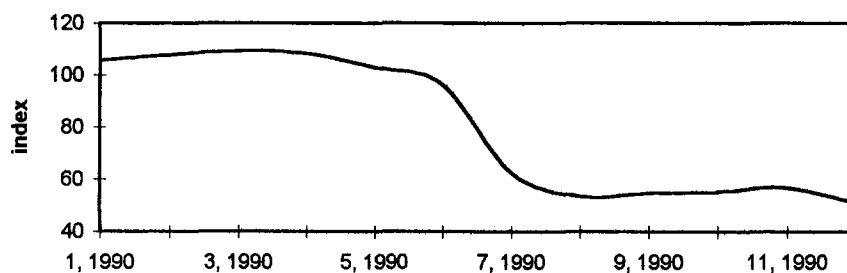


Sources: Jahresgutachten 1991/92 and 1993/94

A big decrease in the industrial output happened in the year 1990. One reason for this is the import of "Western products" by the East Germans. In the first month of 1990 the imports were expensive, because of the Mark-DM exchange rate (1:7, black markets: to 1:20), so that the imports did not increase much. The monetary union on July 1st changed this enormously.

The Eastern companies, who had problems with competition (shown above), had to pay all costs in DM (exchange rate 1:1 and 1:2). Besides, the Eastern consumers had a lot of new money, to buy Western products now. The structure of demand changed rapidly. Imports from the West increased and the demand for former GDR industry products decreased enormously. Therefore, the industry sector fell in a big depression (see Figure 6).

**Figure 6:** Production of industry, 1990, 1985 = 100



Source: Jahresgutachten 1991/92, table B, page 5

The number of short-time workers increased in 1990/91 to 1,9 million persons, which is about 24% of the labour force. At this time 0,8 million workers were unemployed. Together the labour force decreased by about one-third. Because the working conditions in East Germany were poor compared to West Germany (fewer jobs, lower wages), a lot of East Germans started to commute (about 360,000 persons). Also, 0,9 million persons migrated to West Germany in the years 1989 to 1993 .

To find a social solution to the excess supply of labour, early retirement schemes helped about 0,8 million persons in 1992 and 1993. These social plans, infrastructure payments and financial aid programmes cost a lot of money for the German tax payers and social security insurance. In 1993, 48 billion DM net worth supports of the social security insurance and 100 billion DM from public budget were transferred to East Germany (whole budget was about 1071 billion DM). This means 9250 DM per capita in East Germany. Further more, the deficit of the THA is estimated to be about 30 billion DM in 1993, which is a further increase of 1875 DM per capita in the East Germany.<sup>19</sup>

This support is an enormous load, which increases the problems of West Germany's economy, which was faced with recession and an unemployment of 2,3 million in 1993 . The whole public deficit was 123 billion DM in 1991, which was very high

<sup>19</sup> The same dimension of aid per capita to the CEECs would mean costs of about 500 billion ECU (compare: EU budget in 1991 was about 56 billion ECU) for the EU.

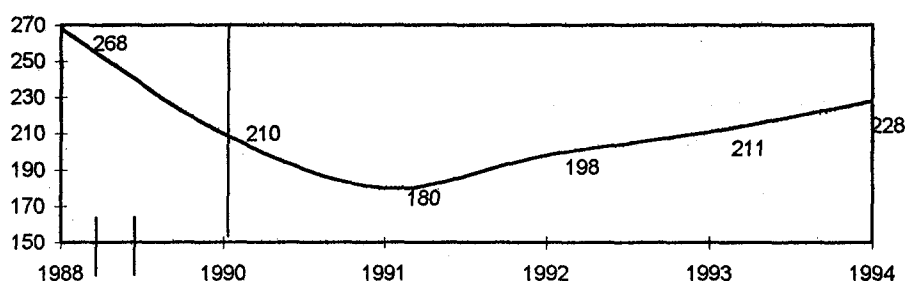
with 4,64% of GDP (compare: 2,45% in 1988, 2,15% in 1985, but 6,18% in 1975).

Another point to mention is the low amount of self-employed people in the East with about 5,5% of gainful people (compare: West at about 10%). The number of self-employed people has continually increased from 1990 until 1994, which shows a change of the economic structure with more small and medium-sized companies and more service enterprises.

After these big problems in 1990 until 1992, the Eastern economy started to grow in 1992 and 1993. Huge public investments (transportation and communication networks), direct aid for private investments and financial supports of the THA, the possibility for the companies to reduce the labour force on an efficient measure through social flank protection, show first small success (Figure 7).

In this figure, the part between 1988 and 1990 should just show the big decrease in GDP in 1989 and 1990. The form of the curve does not correspond to reality in this part, because of a lack of data in 1990 (also see Footnote 20).

**Figure 7:** GDP in East Germany, billion DM in 1991 prices

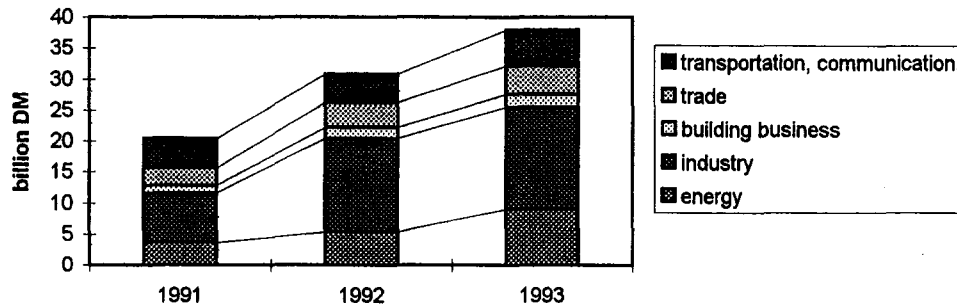


Sources: Jahresgutachten 1993/94, Jahresgutachten 1990/91, own calculations<sup>20</sup>

Investments of West German companies in the Eastern part increased largely in 1992 and 1993, at which industry and energy mostly increased (Figure 8).

After unification most companies sold by THA were trade sector ones. Trade sector and building business were the main supports of growth in 1993 and 1994, at which both were considerably supported by West German transfers. The big investments in 1993, a planned 2,7 billion DM computer chip factory in Dresden by Siemens (The Economist, 1994) and a potential investment of an American computer factory in the same city (FAZ, 1994) of about 2 billion DM give hope to improve the industrial sector in future.

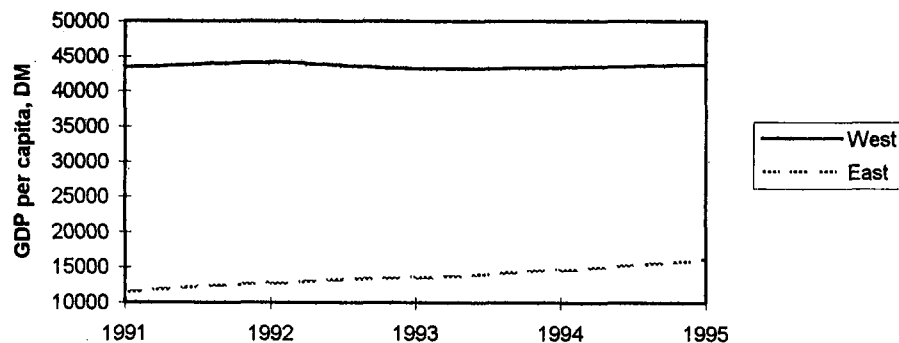
<sup>20</sup> GDP in 1988 is problematic, because of the prices of 1985 and absence of service sector. GDP in 1988 was probably higher.

**Figure 8: Investments of West German companies in East Germany**

Source: Jahresgutachten 1993/94

### 3.1.3. Results

The catching-up process between East and West in Germany will take a long time, because the gap is very huge at the moment (see Figure 9). The East level in GDP per capita will be about 36% of the West one in 1995. Under assumption of the constant growth rate of about 9% in East Germany and 1% in the West part until the year 2000, the share will be 52,5% then.<sup>21</sup>

**Figure 9: Catching-up process**

Sources: Jahresgutachten 1993/94 and own calculations

However, chances for the future are good. The migration between East and West has not been so grave as feared, because of high transfers, which make it possible to have a high level of consumption. The catching-up process seems to be much faster than in the CEECs. The huge pool of skilled workers means good yields for investors of high-tech products.<sup>22</sup> An advantage compared to the CEECs is that there is a good possibility to improve the level of human capital, because the missing

<sup>21</sup> own calculation

<sup>22</sup> Problems during the first time about bad infrastructure and uncertain property rights, which prevented more investments, are mostly solved.

knowledge in administration, marketing and business can be accumulated through good access to West German labour market. The old structure of industry could be changed through a modern one, so that a revival of industry could stop the de-industrialisation in 1990 and 1991. The infrastructure has been improved enormously and modern companies have been built. On the other hand, exports are on a low level, because of marketing problems in new and foreign markets (marketing channels).

Besides, considerable budget deficits prevent having a full scope. Measures to consolidate the budget will be very important in the next few years, to have no big budget constraints in the future (interest payments). The government tries to save expenditures in 1995 and 1996 of about 6 billion DM and increase taxes (Solidaritätszuschlag) of about 70 billion DM in both these years.<sup>23</sup>

Summarised, the fast integration model meant a big collapse of the industry in the Eastern part. High, very expensive supports were needed to stabilise the level of consumption and to improve the infrastructure. After this period a revival of production with growth rates of about 9 to 10 percent gives hope for the next few years.

### **3.3. NAFTA Agreement**

On December 17, 1992 the North American Free Trade Agreement (NAFTA) Treaty between the United States of America, Canada and Mexico was signed. There will be no customs duties in 10 to 15 years and free access to banks and financial markets. So, the NAFTA Treaty means free access to capital and goods markets in the next years. Free movement of labour, which is a part of the EU Treaty, is not an element of the NAFTA Treaty.

Therefore, this treaty means no additional problems of migration. Hope for the Mexicans to develop their economy because of the NAFTA Treaty could even convince them of staying in Mexico.

However, in 1993 the treaty was changed, because the U.S. government feared disadvantages of some sectors of their economy compared to the Mexican one. In Mexico there are very few expensive environmental protection and social laws, so that some Mexican companies have lower costs. These strengthen the cost advantage in some labour-intensive sectors of the Mexicans, who have lower wages (industrial labour costs of about \$1.80 per hour) than the Americans (\$14.77) (International Labour Review, 1994).

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<sup>23</sup> Föderales Konsolidierungsprogramm, compare Jahresgutachten 1993/94, page 146.

Therefore, an Agreement called the North American Agreement on Labour Co-operation, was added to the former NAFTA Treaty. Some basic minimum standards for social laws were fixed, like the right to strike, labour protection for children and young people, minimum wage standards, equal pay for women and men for equal work, and compensation for occupational injuries and illnesses. A special institution, called the Commission of Labour Co-operation, controls the goals. If there are big failures of some companies, trade sanctions will punish the companies.

Besides, an agreement about environmental questions was added to the NAFTA Treaty. It was feared, that the most polluting companies would settle in the regions with the lowest environmental standards and laws. This would increase negative external effects in new locations and unemployment among workers of this sector in former locations. The laws and standards between USA and Mexico differ enormously, which means advantages for Mexico as the location for polluting companies. To prevent these effects, common minimum standards were fixed and tariff penalties could punish polluting companies.

There were several debates in the USA if they should sign the NAFTA Treaty. A free trade agreement means an increase in international trade and a change of factor allocation. This was the reason for several lobbies to influence the decision. They argued, that several unskilled workers would lose their jobs, because of the comparative advantage of the Mexican economy in the labour-intensive sectors. Also, diverse agricultural interest groups tried to influence the NAFTA decision. Finally, U.S. sugar is protected from Mexican competition. Other agricultural goods are protected in the transition period of about 15 years (NBER; No. 4790).

On the other hand, free trade means an efficient factor allocation in a bigger market. The whole region earns profits, because resources are distributed to more productive occupations. Growth is stimulated by an increase of competition and more incentives to innovate. Besides, the high-tech sectors of the USA have better possibilities to export.

In the long run, an increase of welfare is estimated for all countries of NAFTA, because advantages in innovation, efficiency of allocation, and technical spillover effects will stimulate growth (Hetzel, 1994). In the short run, change in allocation means hard situations to several workers. Some workers lose jobs as old skills are not needed, and have to start new jobs with lower wages in other sectors. Some regions with monotone labour-intensive structures will have big problems in handling the changes.

The NAFTA Treaty means free trade with a transition period of 10 to 15 years. Because of this, the government has enough time to find solutions for these adjustment problems in some regions.



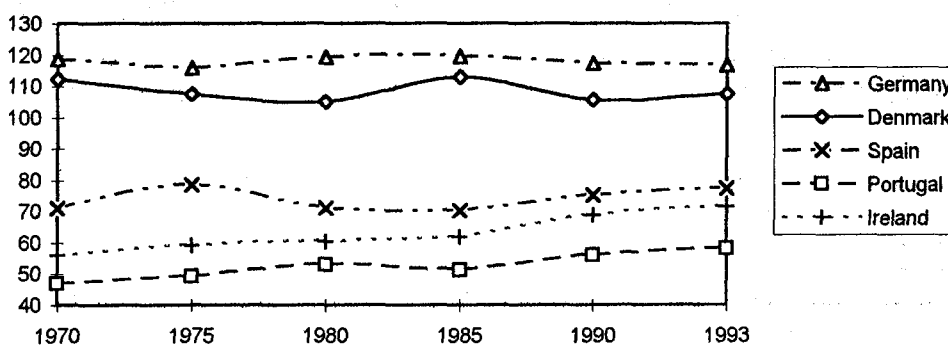
On the 5th August 1994, Argentina, Brazil, Paraguay and Uruguay signed an agreement about a customs union in 1995. The Latin American countries, with several economic problems in the eighties, have grown in the nineties tremendously. They try to large their welfare by more trade. The benefit effects of this trade will be not so huge, because of the same structure of goods and low comparative advantages. An enlargement of the NAFTA to an AFTA<sup>24</sup> could help these countries, but would mean more political problems in the USA than the NAFTA debate. The results of the NAFTA will be shown in some years, when the duties and bureaucratic obstacles are abolished.

#### 4. Suggested Solutions

The CEECs want to join the European Union in order to accelerate their economic development by better trade, better access on capital markets. With the exception of Luxembourg and Greece, the GDP per capita of the EU members have converged in the last 25 years. The catching-up process has been supported by Structural Funds. Nevertheless, there is still a big gap in GDP per capita; the economies converge on a very slow speed (Figure 10).

There are different possibilities to proceed towards an economic or political integration. A very deep and fast alternative is represented by the German unification. A weaker alternative is a NAFTA type trade integration, which concentrates on economic questions, free capital and goods markets.

Figure 10: GDP per capita, index (EC 12) = 100, chosen countries



Sources: EU, OECD; taken from: Jahresgutachten 1993/94

We will first discuss both these possibilities for an enlargement of European integration with the East. After that we take a closer look at an integration model of Baldwin, a so called gradual integration.

<sup>24</sup> American Free Trade Association

#### **4.1. 'The German Way'**

Choosing the 'German Way' would mean a high speed integration of the CEECs with the EU. Within one year all institutions, rules, taxes must be harmonised. Free movements of goods, capital, services and people are allowed; one common labour market allows all people to get a job in all regions of the united area.

As shown above this would mean a lot of problems. The significant wage gap is an incentive for educated people to migrate to Western parts, like in the first phase after German unification. The CEECs would lose a lot of human capital to the West, which means bad circumstances for growth in these regions in the long run. Besides, if there is one common currency, a danger of a collapse of Eastern industry is likely. As seen in the East German example, a free trade with one currency could mean a grave current balance deficit. It is not possible for economic policy to change the exchange rates to prevent a huge decrease in production.

Because of free trade, relative prices of goods and resources change immediately, so that the allocative efficiency is disturbed. The allocation must be adjusted to these changes, which means huge problems in competition in the short run. A decrease in production together with mass unemployment would destabilise the political progress in questions of democracy. A lot of transfer payments would be needed to hold the level of consumption, to prevent poverty and a revival of old extreme parties. To accelerate the accumulation of real capital, infrastructure, to give financial aid to big eastern companies hundreds of billions of ECU would be needed (compare Footnote 19).

As shown above, West Germany transferred a lot of money to stabilise the political situation. The communist party PDS has increased to 20% in elections in the former GDR regions, nevertheless. Besides, the problems to have efficient institutions that play a key role in transformation problems (Holger Schmieding) would be much bigger for the CEECs than for the former GDR. A lot of West German knowledge about administration (bank sector, taxes, business, marketing) was transferred to East Germany. The CEECs would not have these advantages; they have to learn all things by their own.

Summarised, the situation for the CEECs is worse than the situation for the GDR. It is not possible to support the CEECs in same way as East Germany. Therefore, the restructuring of state-owned enterprises is an essential condition for progress and development. The experience of the Treuhand shows, that there are a lot of problems to privatise the companies. The size of the enterprises is too big; the management has a lack of knowledge in business and especially in marketing; and old debts and a low technical level of the real capital stock are reasons for a very complex and difficult task.

Because there are not so many financial resources, it is impossible to privatise in the way of the Treuhand. Several stages are necessary to privatise the companies. A sudden competition on world markets as private companies would mean bankruptcy for many companies. Some important sectors, in which comparative advantages are expected could be supported by the government.

The countries have to make some important decisions. They have to find out: which companies have to be preserved, because they could be good competitors in the long run; which companies must be supported, because of the social consequences of their closure; which companies are able to compete on world markets immediately; and which companies have to be closed (United Nations, 1994). Because of low financial resources neutral institutions like the German Treuhandanstalt with a lot of economic knowledge should manage this complex tasks.

#### **4.2. NAFTA-type Integration**

The 'NAFTA-type' integration would mean free access in goods and capital markets for the EU and the CEECs. The Association Agreements are very similar to this type of integration. The 'NAFTA-type' would be different because all countries have free access to the markets of all other countries. The CEECs would have also to agree about free market access to each other.

Because there is no free movement of people, the migration and induced growth and regional problems would not be so important.<sup>25</sup> Besides, budget problems in the EU would not to be feared, because the CEECs would have no access to the CAP and the Structural Funds. The former EU would be able to decide how the support should look like and how much money would be transferred. No coalition of poor countries in the Council of Ministers could determine the spending and earnings.

Another point to mention is the structural policy. The EU is able to protect the 'sensitive' products with special agreements. As shown in the ANNEX these products are very important in the export sectors of the CEECs. Protection of these sectors means lower chances for the CEECs to accelerate their economic development.

Main advantages of a 'NAFTA-type' integration would be free goods and capital markets. As Gries (1994) shows, the chances for growth in GDP per capita are very good if both markets are free, because a big pool of human capital can be combined with modern real capital, which means high yields for the investor. A disadvantage compared to a German-type would be the low quality of institutions (laws, public administration, political stabilisation), which would mean uncertainties to invest.

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<sup>25</sup> Compare 1.3. Migration problems

Besides, compared with the German-type the economic policy would have more possibilities to handle short run problems. Currency devaluation could improve the chances to export, and competition can be protected. This would be very important for the CEECs because restructuring of the economy would take a long time. Most of the existing production structure must be shut-down, so that a whole new economy must be created (Blanchard, Dornbusch, Krugman, Layard, Summers, 1991).

However, a closer integration in the future and the chances to be supported would increase hope of people from the CEECs.

#### **4.3. Gradual integration - The Baldwin model**

Baldwin created a model for European integration with two stages and three concentric circles. The inner circle is the EU 16. The integration of these countries is very deep, like agreed in the Maastricht Treaty.<sup>26</sup> The outer circle is a new framework called Association of Association Agreements (AAA). Members of the AAA are the EU countries and the CEECs. This AAA membership is something like an intermediate step to full EU membership.

The AAA means free trade for goods and capital like the NAFTA integration. All advantages about growth for the CEECs, sectoral problems and budget questions for the EU are equal to a 'NAFTA-type' integration. No free movement of people, their own currency, agriculture policy and no access to the Structural Funds, as well as their own policies in other fields (security, defence) are the main differences to the EU-integration.

Considering all of Europe, the integration of other countries like Moldavia, Croatia, Slovenia, Estonia, Latvia, Russia, Belarus and Albania is easier if there is an intermediate step with free trade in industrial goods. The CEECs who catch-up in questions of stabilisation and welfare can become members of the EU. The AAA helps the CEECs to improve their economic situation by multilateral free trade and lower uncertainties about future policies, which means better chances for foreign investments.

New institutions are necessary because of practical reasons. Rules of origin must be determined, because of tariff problems of the EU countries with external countries. It must be impossible for a member country of the AAA to buy goods in foreign countries and sell them to EU countries without tariffs that are protected with tariffs by the EU. To handle these problems and new regulations in international commercial relations an institution must be established which can solve these

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<sup>26</sup> Compare to Maastricht: 1. Problems about pan-European integration

problems to reduce trade friction costs. If the AAA copies the Common External Tariff (CET) structure of the EU, the rules of origin can be eliminated.

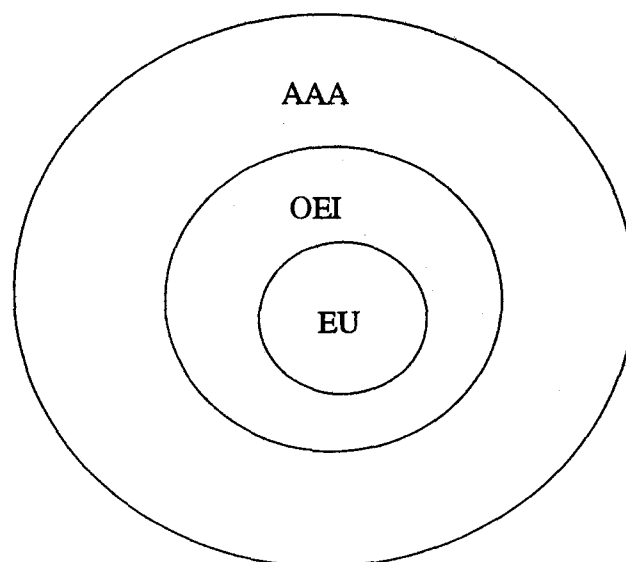
The AAA could accelerate the expansion of pan-European trade and integration in market structures. Nevertheless, some CEECs like Poland, the Czech Republic or Hungary, who installed several important institutions and rules in the last years, would likely want to join the EU.

Therefore, a second stage is to be built called the Organization of European Integration (OEI). This integration is the middle circle in Baldwin's model, between the EU and the AAA. This integration stage is similar to the EEA Agreement,<sup>27</sup> but without migration. Several differences to the AAA integration are to be found in questions of technical regulations, administrative burden for companies, restriction on competition for public purchases, service transactions, VAT harmonisation, etc. The main difference to the EU-integration is the deeper integration of the EU in questions of Common Agriculture Policy, transfers, migration, Economic and Monetary Union.

Supra-national bodies are necessary to organise and handle the problems connected with this OEI intermediate step. A new institution called 'OEI Administration Authority' could help the CEECs in problems of market economy, especially in questions of antitrust laws, administration of health and safety standards, financial institutions and capital markets. This intermediate step could improve the economic system of the CEECs, rules and institutions, to make it easier to integrate them finally in the EU.

Summarised, the Baldwin Model can be shown in Figure 11.

**Figure 11: The Baldwin Model**



<sup>27</sup> Agreement between EC and EFTA

Countries are members in their own circle and all outer circles. All CEECs would be members of the AAA, the most advanced CEECs members of the OEI and the AAA, and the EU-countries members of all organisations.

To have an integration model for all of Europe, the outer circle should be expanded to all European countries fast. As countries became richer and less agricultural they can move into the inner circles. Summarised the main advantages of Baldwin's model are:

- Migration problems would not play an important role, because the free movement of people is not allowed in the two outer circles. Besides, an integration of the CEECs with clear rules and conditions to join the EU in future means hope for the people in the CEECs to stay in their native country. The huge stock of human capital in the CEECs compared with real capital means incentives for direct investments in industry. A membership in an Association with the EU and other CEECs could decrease the uncertainties to the investor.<sup>28</sup>
- Budget problems are solved, because the main dangers: an increase in payments for the Structural Funds and CAP payments are not necessary in the first years, because the CEECs need some years to fulfil the criteria to join the inner circle. In this transition period, the EU has enough time to change the budget structure without radical effects for supported regions and farmers.
- In the same way, the 'sensitive sectors' need not to be afraid of a sudden decrease in production. Supports and protection can be decreased in a gradual way, so that the companies have enough time to increase their competitive ability by innovations and creation of new products. This gradual decrease of protection means better chances for the CEECs to improve their economic situation by increased chances in exporting. Besides, the CEECs have enough time for restructuring their industry, and support by the government (public ownership) in the transition period is possible.
- In the short run, political problems in voting power in the EU would not be expected, because the CEECs need time to fulfil the criteria to join. However, other problems can be expected. The AAA institutions and rules must be agreed on with all CEECs, first. This means a lot of problems, because package deals to join this AAA integration are likely<sup>29</sup>. Besides, the tasks, jurisdictions and competencies of the AAA must be determined, because a kind of voting or decision power for the CEECs in this Association must be expected if more and more East European Countries join this AAA.

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<sup>28</sup> Compare the experiences of the German Unification: in the beginning the uncertainties about property rights, Eastern markets, quality of real capital stock and environmental damages prevented more investments.

<sup>29</sup> Compare the problems of an enlargement of the EU-12 to an EU-16, which seems to be very easy compared with an Agreement of such different countries.

## **5. Conclusions**

In the short run, a full-scale integration of the CEECs with the EU seems to be impossible. There are several reasons, that cause too many problems for both sides, the CEECs and the EU. The main reasons for the EU are budget problems, sectoral problems in the agricultural sector, iron and steel, textiles, chemistry, social problems because of migration (housing and jobs). Therefore, a fast integration like the German unification can not work well. As the German unification has shown, migration and budgetary problems due to structural changes are enormous.

Another lesson of the German unification is the collapse of the industry sector in the former centrally planned economies. This caused several problems in terms of unemployment and social pressure. As shown above, the EU is not able to give as much help to the CEECs as West Germany gave to former East Germany. Therefore, a shock therapy cannot work and a slower integration with restructuring the economy in decades is necessary.

In the long run, advantages of an integration seem to be clear. A free trade in Europe could stimulate growth, because factors can move to the most productive use. The chances for the CEECs to develop are quite well, a huge stock of human capital completed with business and administration skills will stimulate direct investments, if goods and capital markets are free (Gries, 1995). Therefore, a mass migration of human capital must be prevented.

As an integration in the next few years seems to be impossible and an integration in the long run seems to improve the welfare in all of Europe, the main problem is to find the right path for the transition period.

At the moment, CEECs and EU have stated European Association Agreements. This agreement means free trade in industrial goods between each CEEC and the EU. In addition the hub and spoke problem (Baldwin, 1994), which marginalizes the CEECs, the most important sectors are protected by the EU. Therefore, the chances of the CEECs to develop have not increased significantly. An example of this is the situation in Hungary (see ANNEX). The main export sectors of the CEECs, textiles, agriculture, iron and steel are 'sensitive sectors' of the EU, which have problems in competition and overcapacities.

However, the CEECs want to be members of the EU and a NAFTA-type integration is not enough for them. The EU countries could protect their agricultural sector if they were partners of the CEECs. The CEECs need more than free trade in industrial goods, because agricultural products could be the most important export products of them. In a closer integration model they would feel like equal members in the European integration and not feel like second-class partners.

Baldwin tries to adopt a middle course. He suggests to create a special structure, which is characterised by three circles. The inner one is the EU with full economic and political integration. The outer one consists of all countries of Europe, integrated like a customs union or a NAFTA-type integration. The middle one is something like an intermediate step, like the European Economic Area without agriculture, migration and voting power. This intermediate step prepares the CEECs to join the EU later. Conditions must be created to have clear rules, when the CEECs are allowed to move to an inner circle. These could be economic indicators as well as questions of political stabilisation.

A disadvantage of this model is the complicated structure of the institutions and the intermediate steps. Already in the current EU many people do not know how the decision-making process works. The readiness of the citizens to take part in it could decrease because the structure is not easily comprehensible. However, the main problems of a deeper, and more comprehensible integration model such as migration, budget questions, sensitive sectors and voting power would be solved in a gradual model, because the CEECs would become closer partners in inner circles one by one. In the meantime, if necessary, the EU can change the budget structure, the voting system and improve the structural change in some regions<sup>30</sup>.

In the long run, the model could become more easily comprehensible when the CEECs would become members of the inner circles and the intermediate steps could be dissolved. The voting power in the EU would be changed then. However, if the economic situation and welfare of the CEECs are on a higher level, this should not be such a big problem. Large decision-making power of the CEECs in CAP and Structural Funds would not cause so much trouble then.

If the European Union expands to the East and North, a change in power positions is something natural. More countries in the deep integration model like the EU mean changes in political and economic structure in all of Europe. After these changes, there will be losers and winners, however, Europe as a whole will win.

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<sup>30</sup> Especially, the regions that are dependent on the 'sensitive sectors'.



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## **ANNEX**

### **Situation of the CEECs**

#### **Poland**

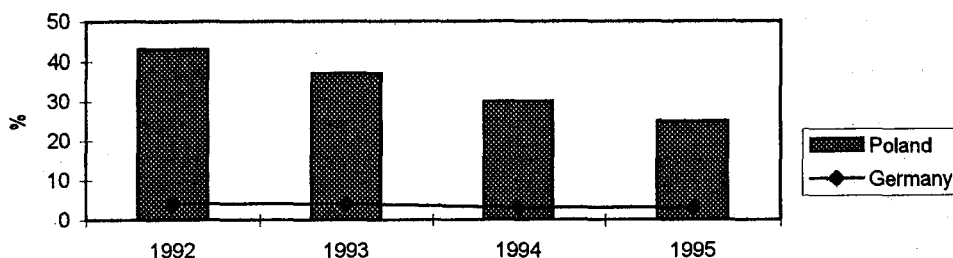
After agreements about economic co-operation (19/9/1989), the European Association Agreements have been effective since February of 1994. It took from the December 16, 1991 to February 1, 1994 to get the agreements of all countries of the EU. On the May 1, 1992 the trade agreements of the Association Agreements were valid as a provisional treaty. Poland was affiliated on the European-wide Business Co-operation Network, the Euro-Info-Network and other institutional organisations.

Poland has been helped by several financial aid programmes so far. From 1990 to 1993, Poland was supported by 805 million ECU from the PHARE programme, 303 million ECU from the EIB,<sup>i</sup> and 7346 million ECU from the European Bank for Reconstruction and Development. The main parts of this support were utilised for telecommunication and other infrastructure.

Since 1991, the EU has been the most important trading partner for Poland. The main export commodities for Poland are metal and manufacturing products (19%), textiles (16%), agricultural products (13%), and mining (10%). The main import commodities for Poland are machinery and electrical supplies (25%), textiles (11,5%) and chemical goods (10,9%). The commercial balance sheet for Poland in relation to the EU is negative, but the exports increased from 1992 to 1993.

The main recent developments are shown in the following figures:

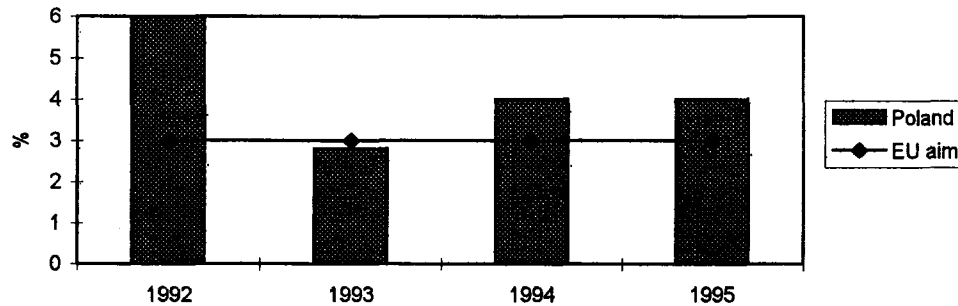
**Figure 1': Inflation<sup>ii</sup> in Poland**



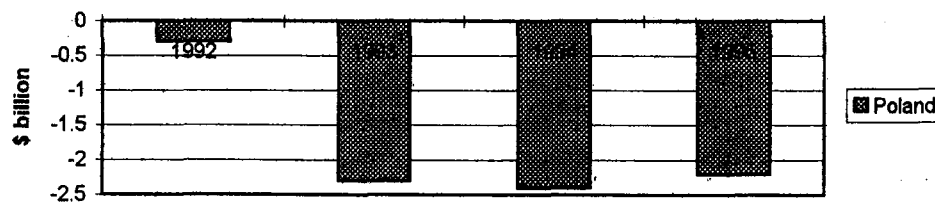
Source: OECD

<sup>i</sup> European Investment Bank

<sup>ii</sup> Inflation is compared to that of Germany.

**Figure 2': General government budget deficit, % of GDP**

Source: OECD

**Figure 3': Current balance**

Source: OECD

The most important export products of Poland are the 'sensitive' products of the EU. Because of this, protection impedes better market access for the exports. Faster development and better situation in current balance and debt could be stimulated by giving better access in these sensitive sectors.

### Hungary

The European Association Agreements were subscribed with the same procedure as in Poland. The main supports were<sup>iii</sup> PHARE (305 million ECU),<sup>iv</sup> EU loan (1050 million ECU), EIB loans (305 million ECU),<sup>v</sup> and payments of the European Bank for Reconstruction (5093 million ECU). In 1992, the main export products were agricultural goods (21%), textiles (16,5%), machinery and electrical supplies

<sup>iii</sup> 1990- 1993

<sup>iv</sup> Mainly for agriculture, environmental protection, energy, infrastructure, social security, developing of human resources and transforming the industry.

<sup>v</sup> Telecommunication, tourism and energy

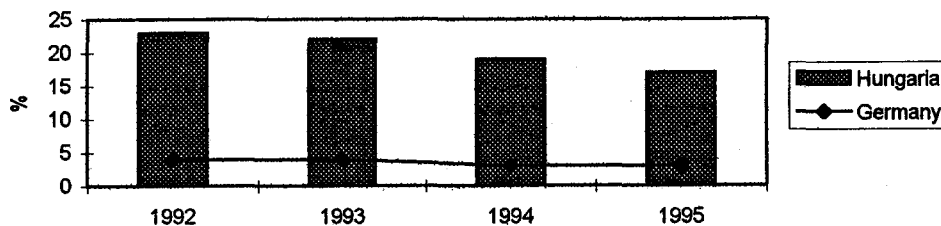
(16,4%). The main import products were machinery and electrical supplies (26,8%), textiles (13,6%) and transportation (12%).

As shown above, the human capital of Hungary is very high, which could mean changes in comparative advantages in the long run. This means, that the commodity pattern could be changed as well.

Nowadays, in the economy of Hungary the footwear, clothing and leather goods industries play a central role. This sector is the third (9,48%) one of total employment after food (18,3%) and mechanical engineering (12%).<sup>vi</sup> However, 86% of labour force of this sector were involved in output that was exported to the EU. The main part of this, manufacturing of ready-made clothing is very strongly protected<sup>vii</sup> by the EU without a decrease in 1992. These products could stimulate the Hungarian economy, if the trade protection were stopped.

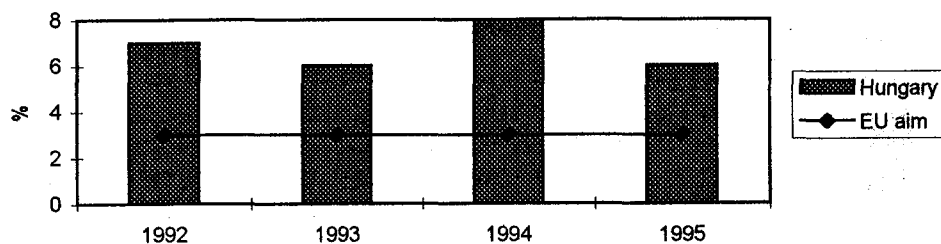
The main economic developments of Hungary:

**Figure 4': Inflation**



Source: OECD

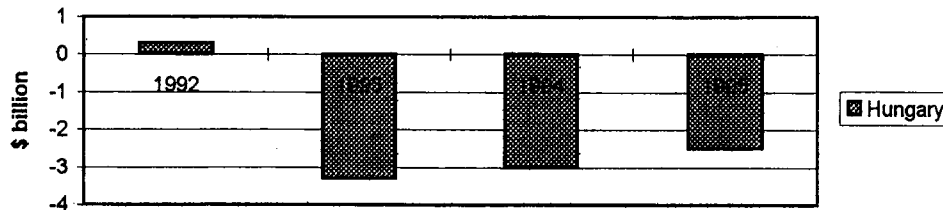
**Figure 5': General government budget deficit, % of GDP**



Source: OECD

<sup>vi</sup> Data from 1991

<sup>vii</sup> The highest index of trade protection in 1991 and 1992, compare Gacs.

**Figure 6': Current balance**

Source: OECD

The main problem of Hungary compared with other CEECs to fulfil the Maastricht conditions is a very high budget deficit with eight percent of GDP in 1994 (three percent are allowed). Better conditions for exporting could improve aggregate demand with the consequence that no demand restrictions prevent a decrease in budget deficits. Even in this case, exports play a key role in developing. Therefore, the EU should decrease their hard protection restrictions in some important sectors of Hungary (shown above).

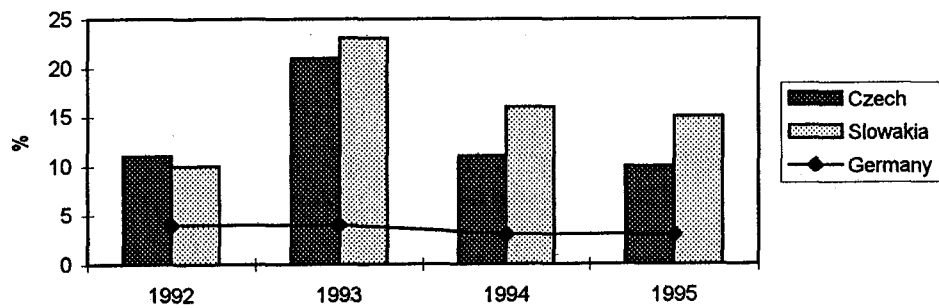
### **The Czech Republic and Slovakia**

The main developments in both these countries are similar to Poland and Hungary. Trade agreements between the EU and Czechoslovakia were superseded by European Association Agreements, which was delayed through the separation of both former parts of Czechoslovakia. New items in this agreement are questions of human rights (even in agreement with Bulgaria and Romania). The main help programmes until 1993 were PHARE (233 million ECU), aid for problems in balance of payment (375 million ECU),<sup>viii</sup> EIB (222 million ECU),<sup>ix</sup> European Bank for reconstruction (2188 million Czech and 2420 million Slovakia). In 1992, the main export sectors of Czechoslovakia were crude metals (18,28%), textiles (12%), machinery and electrical supplies (11,65%). The main imports of Czechoslovakia were machinery and electrical supplies (38%), and transportation (12,1%). The imports with 1310 mill ECU significantly exceeded the exports with 1058 mill ECU.

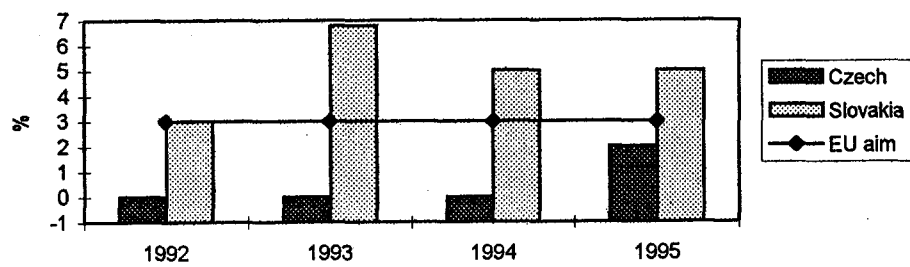
The main economic developments of Czech Republic and Slovakia:

<sup>viii</sup> May 1991

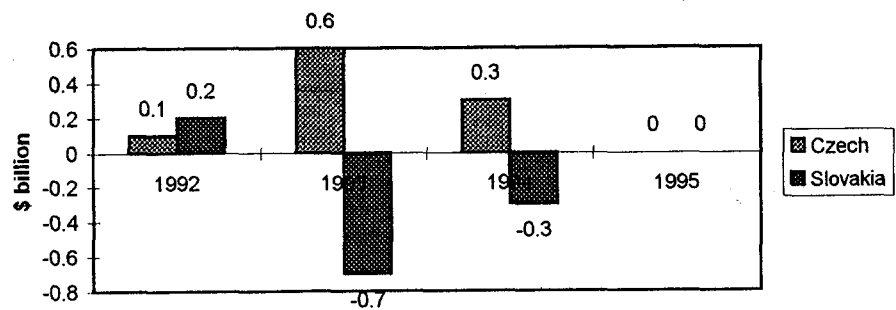
<sup>ix</sup> Especially for manufacture, energy, telecommunication, tourism and car industry (SKODA).

**Figure 7': Inflation**

Source: OECD

**Figure 8': General government budget deficit, % of GDP**

Source: OECD

**Figure 9': Current balance**

Source: OECD

The economy of the Czech Republic is the best of the CEECs in accord with the criteria of Maastricht. An astonishing fact is the good performance in government budget deficits. One important reason for this is unemployment with just five percent of labour force in 1994. Besides a surplus in the current balance makes it possible to have a thrifty budget without destroying the necessary aggregate demand. The inflation rate in Czech and Slovakia are less than in other CEECs. The main disadvantage of Slovakia compared with the Czech Republic is the structure of the economy, because heavy industry and weapon factories are generally declining, but still relative important for Slovakia.

### **Bulgaria and Romania**

The trade agreements between Bulgaria and the EU expired with the same procedure like the other countries, however, some months later. The European Association Agreements are similar to the Czech Republic and Slovakia, but are still not in force. Contrary to Hungary, Poland and the former Czechoslovakia, Bulgaria and Romania have no access to the European-wide Business Co-operation Network and to the Euro-Info Network.

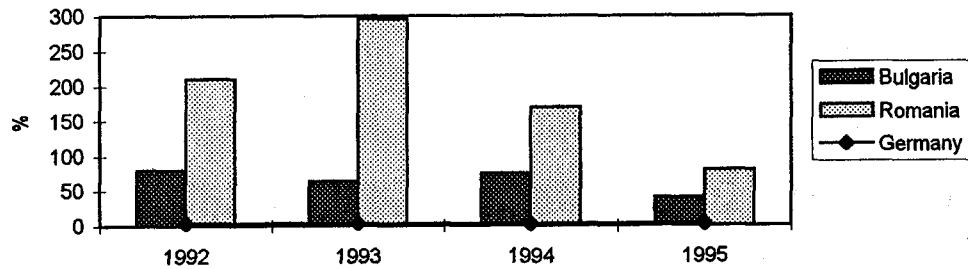
The main aid programmes were PHARE (287 million ECU Bulgaria and 360 million ECU Romania), loans from the EU (400 million ECU Bulgaria and 455 million ECU Romania), humanitarian help in 1991 and 1992, EIB loans (196 million ECU Bulgaria and 144 million ECU Romania) and European Bank for reconstruction (4572 million ECU Bulgaria and 7595 million ECU Romania).

In 1992 trade with the EU, imports of about 1112 million ECU faced exports of about 897 million ECU in Bulgaria. This means a big trade deficit with the EU. The main export products were textiles (22%), agricultural products (20,4%) and crude metals (13,8%). The main import products were machinery and electrical supplies (19,8%), transportation (19,5%), textiles (12,2%) and agricultural products (11,2%).

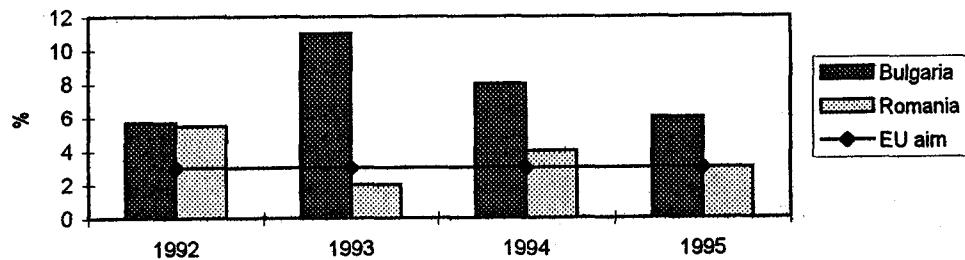
Romania imported in 1992 a volume of about 1852 million ECU and exported 1402 million ECU. The main export products were textiles (35,3%), crude metals (10,7%). The main import products were machinery and electrical supplies (21,7%), agricultural products (17,5%), textiles (17,5%) and transportation (12,9%).

The main economic developments are shown in the following figures:

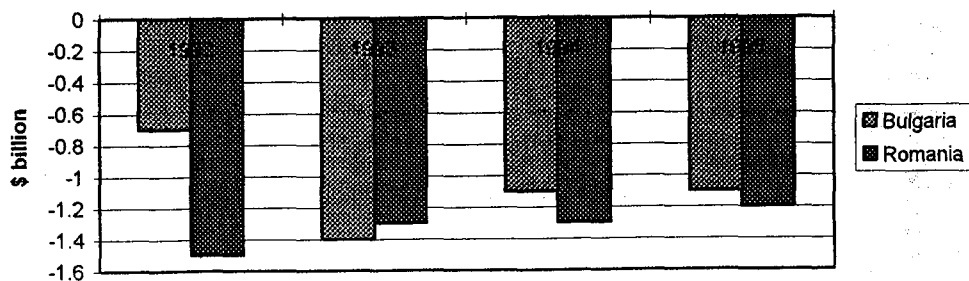


**Figure 10': Inflation**

Source: OECD

**Figure 11': General government budget deficit, % of GDP**

Source: OECD

**Figure 12': Current balance**

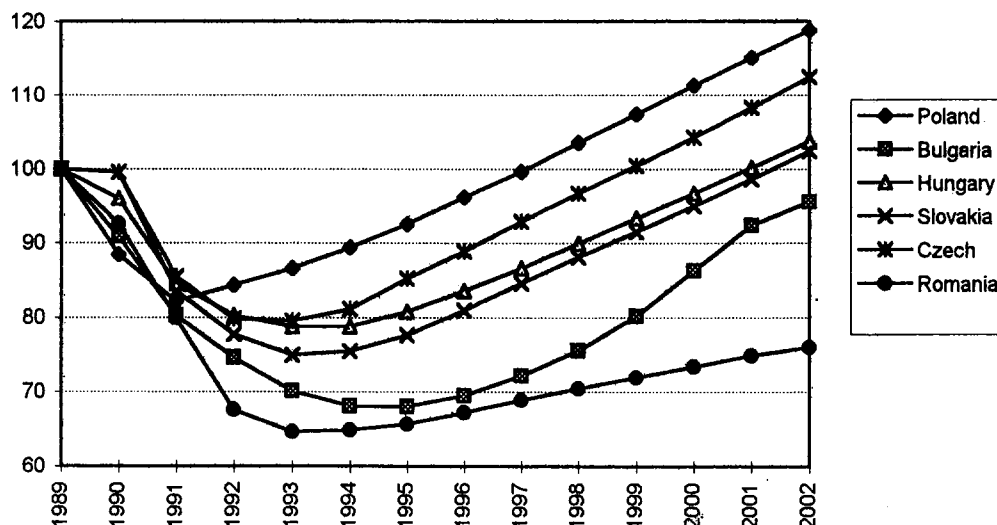
Source: OECD

Bulgaria and Romania have the most problems of all CEECs. High inflation together with high unemployment (1994: 17% in Bulgaria, 13% in Romania) and

big budget deficits result in a dangerous situation. Political problems in leadership increase, the transformation process loses more and more advocates in the population. An increase in supports of the PHARE programme as well as technical and administrative aid could improve this situation. Besides, better market access in textiles and iron and steel could accelerate the developing process. Both countries will need a lot of help to fulfil conditions of integration, to cope with the transformation in the areas of efficiency, institutions and aggregate demand (Holger Schmieding, 1993).<sup>x</sup>

In the long run a revival of the CEEC economies is expected. The United Nations projected the development for the countries in transition.<sup>xi</sup> Even in this long term projections the situation in growth of GDP per capita differs significantly.

**Figure 13': GDP per capita, base line projections**



Sources: United Nations, Economic and Social Council, Economic Commission for Europe EC.AD/R.76/Add.2; OECD; EBRD<sup>xii</sup>

As depicted in Figure 13', Poland is estimated to develop faster than the other CEECs. On the other hand, Romania develops very slow. For the other countries the situation is rather similar, after a collapse in 1990 until 1992 the economy grows with a per capita rate of about three to four percent.

<sup>x</sup> He argues that an institutional near-vacuum is a major cause of the crisis.

<sup>xi</sup> Thirtieth session, 6-10 June 1994 (post meeting outlook, autumn 1993)

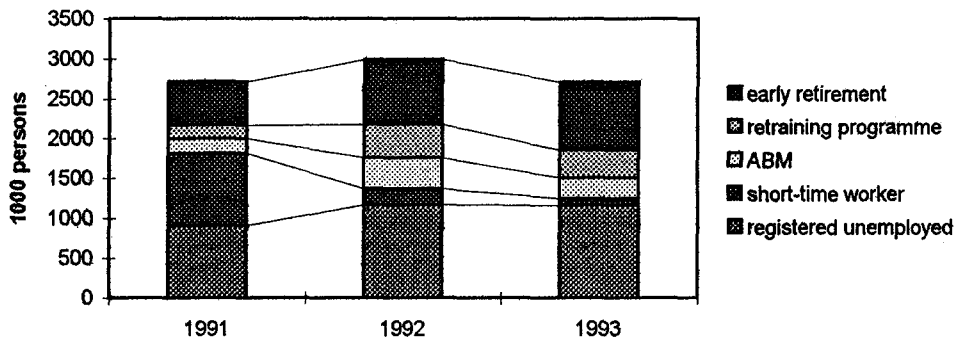
<sup>xii</sup> The data from 1989 - 1992 is taken from Herr, H.J. 'Budgetkrise und Entwicklungsperspektiven.' The data from 1992-1994 is taken from OECD; data from 1994-2002 is taken from United Nations. The GDP per capita in 1989 was set to 100. The data of the Czech Republic and Slovakia is problematic, because the United Nations projection is for Czechoslovakia as a whole.

Poland will reach its starting level in 1997, the other countries some years later. In the year 2000 just Poland and the Czech Republic will reach their GDP per capita level of 1989. The recovery of Romania will take some more decades.

### Unemployment in Eastern part of Germany

After the German unification, the East German economy was integrated during some months. This shock therapy destroyed main parts of the industry; new factories had to be build, which has taken a long time. Therefore, mass unemployment increased between 1990 and 1993 significantly. To stabilise the social and the political environments, social benefits played an important role. Figure 14' shows how unemployment developed and how social benefits were structured.

**Figure 14': Unemployment in East Germany**



Source: Jahresgutachten 1993/94

Between 2.5 and 3 million workers were supported by social benefits in East Germany. This means about 40% of the potential labour force. Early retired people and people in re-training programmes like ABMs mean not so much social pressure than unemployed people who get welfare payments while doing nothing. This social benefit system is very expensive for the supporting partner; a copy of this system to solve the CEECs-EU integration problem is impossible because there is not enough financial resources.<sup>xiii</sup>

<sup>xiii</sup> An integration of about 90 million persons means another dimension than 16 million East Germans.

