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Managing Enlargement

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All the relevant decisions concerning the timing and procedures of the Enlargement have already been made. Yet, there are too many things unsettled on the road to a larger Europe. Transitional arrangements will make the build-up of a Single Market for labour more difficult. Unavoidable reforms of agricultural and structural policies have been postponed and there is a fair amount of ambiguity on the introduction of the euro in the New Member States (NMS).

Under these circumstances, the unavoidable trade-off between the size and scope of the Union can only become more pronounced. The risk is that enlargement goes hand in hand with a weakening of the degree of economic and political integration in the EU. One cannot expect to deal with the implications the enlargement on the implementation of economic policies and on the size and nature of redistributive policies, after enlargement has taken place. This way of proceeding, jumping over the obstacles and then counting on marginal institutional adjustments (which are often presented as merely technical) later on, may backfire. As some reforms, like the reforms of the Common Agricultural Policy (CAP) are bound to become more difficult when the NMS are in.

In this paper we review the state of negotiations over the various Enlargement chapters and then formulate a few proposals as to ways to enlarge the Union without jeopardizing the scope of integration. We will start by considering migration, by far the most sensitive policy issue. Next, we will move on to budgetary rules for a larger Union and consider the financing and allocation of agricultural and structural policies. The third section will investigate monetary policies and rules for the entry into the Monetary Union. Finally, we will speculate on methods to carry out the reforms which we deem more appropriate for a larger and hopefully not diluted European Union.

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1. Migration: an Opening Gambit

Migration is the single dimension of enlargement which will generate the largest gains in terms of GDP growth and aggregate welfare. This is because of the large differences in labour costs between new and old members (up to 85% at current exchange rates and 60% in purchasing power parities). At the same time, migration is the most politically sensitive dimension because it is likely to involve some losers, notably among the unskilled and the least mobile components of the population in the countries of destination. Furthermore, any estimate of its likely magnitude is surrounded by a large degree of uncertainty.

We argue here for short-term transitional migration restrictions vis-à-vis the NMS, possibly co-ordinated at the EU level. Such restrictions do not allow to buy time until migration pressures are reduced as income convergence is a long-term business. However, if properly used, quotas permit to gain a better understanding of the size and nature of the migration flows associated with Enlargement, and consequently better prepare welfare systems and labour market institutions in the origin and destination countries to best cope with these pressures. There is, in other words, an *option value* of waiting before lifting restrictions to the free mobility of labour from the NMS. Such informational gains can be realised if restrictions are co-ordinated among EU Members. Because lack of co-ordination in migration restrictions distorts the geographical allocation of migrants, potentially reducing their contribution to growth and setting in motion a race-to-the-bottom in the setting of migration quotas in the EU-15.

The transitional arrangement agreed upon in the accession negotiations allow instead individual EU Members to postpone the free movement of labour for, at most, a seven- year period (2 years, then extended for another 3 and, if necessary, another 2 years). About half of the EU Members have already announced that they will claim transitional periods. Among them, Austria and Germany, the two countries currently hosting almost 80 per cent of the citizens from the Accession countries residing at present in the EU-15.

In this section we first formulate scenarios of migration and their effects on welfare and income distribution. Next we discuss policy options and develop our proposals.

1.1 Migration Scenarios and Welfare Gains associated with Free Mobility

Studies simulating the impact of Eastern Enlargement on GDP and aggregate welfare expect that the gains from trade for the incumbents are fairly small. Baldwin et al. (1997) estimate a trade effect on the EU-15 GDP *levels* of the order of 0.2 *per cent*. Although the gains in Austria and Germany will be larger by a factor of six and three, respectively (see Keuschnigg/Kohler 1999, 2001), they will be realised only over time, once capital stocks have adjusted to the new conditions.

The effects of migration are potentially more sizeable. Considering the EU as a closed-economy with given endowments of physical and human capital and technologies and assuming that there are *no restrictions to wage adjustment* (there is market-clearing in the labour market), it is possible to estimate[1] that an increase of the EU labour force by one per cent resulting from migration could increase GDP in the EU-15 by 0.6 to 0.7 per cent and, in an enlarged EU by 0.2 to 0.3 per cent, depending on human capital endowments of the migrant population. These gains are (larger between 0.2 and 0.3 percentage points higher) once account is made for the fact that migrants tend to move into the regions with the highest levels of productivity and potentially stronger labour shortage (Borjas, 2001).

In the more realistic case where wage setting takes place under a regime of bilateral monopoly (employers' associations and trade unions bargaining over wages) and hence there is some unemployment, the total gains in GDP in the host country fall by 0.2 to 0.3 percentage points and in the whole region by 0.1 percentage point, depending on the assumptions on the elasticity of wages with respect to unemployment and, again, the human capital endowments of migrants. Note that these reductions in the welfare gains are presumably temporary, since wages tend to adjust to an increased labour supply in the long-run, even in presence of monopoly power. Additional gains from migration can also be expected in the long-run as capital adjusts to match the new supply of labour.

As to the distribution of these gains, they will only materialise in the host countries unless there are remittances to the countries of origin. Indeed the gains from international migration accrue mainly to the migrant themselves. Their wages are likely to increase by more than 100 per cent, even if we consider differences in the costs of living between the present EU and the home countries. Depending on the human capital characteristics of migrants, wages of manual workers in the recipient countries may fall in a range between 0.1 to 1 per cent, while wages of skilled workers may either increase or fall by up to 0.4 per cent, depending on the skill composition of migrants. In any event, skilled migrants typically first compete with unskilled natives for unskilled jobs and then gradually move up the skill ladder. Thus, pressures are likely to be more serious on the unskilled in the countries of destination.

In presence of wage rigidities, an increase in the workforce through migration by one per cent may increase the unemployment rate by 0.1 to 0.3 per cent in the destination countries in the short run, depending on the human capital characteristics of migrants. The impact of migration on wages will be clearly lower in this case.

Overall, international migration generates sizeable gains, but potentially some redistribution, penalising the unskilled in the countries of destination and involving, at least temporarily, some unemployment in the countries of destination of migrants.

The simulations above do not take trade into account, which reduces migration pressures, either by inducing factor price convergence or by changing the product mix in such a way to exploit the comparative advantage deriving from different endowments of labour, human as well as physical capital. European countries are open economies, with a large trade turnover. This may contribute to explain why there is no evidence to date of significant displacement effects (i.e. of increases in unemployment) in the open economies of the EU as a result of migration. Estimated wage effects of migration are also of a second order of magnitude (e.g., see Villosio/Venturini, 2002 for estimates on Italy) perhaps because of the spatial

[1] These simulations are based on a simple one-good economy with Cobb-Douglas technologies. Output is produced with physical capital, skilled labour and manual labour. The factor shares rely on estimates for the EU and the CEECs, respectively. For a description of the model and the underlying assumptions see Brücker (2002).

arbitrage function of migration, that is, the fact that the migrants self-select into those regions with the highest level of productivity. By doing so, they induce a faster convergence of wages within each country, but do not reduce average wage levels. However, if the marginal demand for labour will originate in the non-tradable sectors (job creation in recent years has been largely concentrated in services), then some of the predictions of the above, closed-economy, framework are relevant in assessing the likely impact of migration.

1.2 The case for temporary restrictions

A restrictive approach towards immigration from the NMS would unambiguously reduce *aggregate* welfare in an enlarged Union. Yet, there is a fair amount of redistribution and labour market adjustment involved by migration as discussed above, fiscal effects associated with the access to the welfare system should be carefully considered and political constraints should not be neglected. In light of the considerable uncertainty about the scale of migration induced by enlargement, quotas to work permits might be an appropriate tool for a transitional period allowing countries to best prepare to manage these flows.

Consider first the fiscal spillovers associated with migration. Immigrants are disproportionally represented in the ranks of unemployment benefit and welfare recipients. Not all the differences in access to welfare between immigrants and natives can be explained by observable characteristics of migrants (i.e., the number of dependent children, their marital status and skill level). In some of the European countries with the most generous welfare states (Denmark, Belgium, The Netherlands, Austria and France) there are indeed indications that a rather mild form of "residual dependency" is present thereby non-EU citizens receive social transfers more than can be predicted on the basis of their characteristics[2] (McCormick et al., 2002).

The response to this problem is not to restrict access to welfare by migrants, but to allow them to better integrate into the country of destination and get a regular job. Migrants with a legal job contribute to pay-as-you-go pension schemes more than they can possibly get out of them, due to their relatively young age. Moreover, the educational level of migrants – which, in the case of Eastern Europe, is well above those of traditional migrants -- has already been financed by the source countries. The first generation of legal migrants is indeed typically a net contributor to public finance, as suggested by many studies on the US (see Borjas, 2000) and by a recent study on Germany (see Bonin et al. 2000) as well. The mirror image of the fiscal gains in the destination countries is a fiscal loss for the NMS, which have financed part of the human capital investment subsequently exploited elsewhere, and suffer from reduced tax and social security contributions. Note that the ageing of populations is a problem common to the accession countries.

Consider next political-economic constraints. Assimilation of migrants is a time-consuming process. Insofar as assimilation is required for migrants have a legal job,

[2] This seems not to be the case in Germany, the country where migrants from the NMS are currently concentrated (Ripahn, 1998).

migration can contribute to expand the tax base only if takes place with some gradualism. Failure to acknowledge this problem may lead to stronger political opposition to the liberalisation of labour flows from the NMS. Public opinion surveys suggest that many Europeans, notably those least mobile (Boeri et al., 2001) fear that migrants are a fiscal burden. This induces Governments to adopt overstrict (unrealistic) migration restrictions which are poorly enforced, hence lead to illegal migration and illegal jobs. Migration amnesties are subsequently carried out and, as a result of these, many formerly illegal migrants acquire the right to receive transfers from the country of destination, without paying taxes and social security contributions (as they continue on their informal jobs). This increases the opposition of natives to migration flows.

Summarising, migration is badly needed because European workers are immobile, but the immobility of Europeans make them less keen to accept migrants. The result is illegal migrants, who do not pay taxes and social security contributions who after amnesties receiving transfers and services from the State. This further strengthens the desire to limit migration. In order to break this vicious circle, some gradualism in migration flows is required.

1.3 Which type of restrictions and at which levels then?

Transitional restrictions for migration have costs and benefits. The costs are in terms of deferred welfare gains from migration, the benefits arise from the information that can be collected about the actual nature and magnitudes of migration pressures (the option value of waiting). For sure, migration restrictions cannot be used "to buy time until income convergence is achieved" as income convergence to the level of the present countries of the EU with the lowest income per capita may require up to 40 years (Boeri and Brücker, 2001).

Migration quotas should be preferred to other type of restrictions on the ground that they allow one to realise at least part of the potential welfare gains from migration and, at the same time, provide information on migration pressures. If migration quotas are not filled, they can be lifted before time. Thus, generous migration quotas may serve to deal with political-economic constraints while they minimise the costs of foregone welfare gains.

Quotas could be established at the levels which can be predicted on the basis of past migration episodes. Figure 1 presents a migration scenario, which is based on a time-series analysis of migration into Germany from 18 source countries in the period 1967-1999.[3] The underlying econometric model conceives differences in per capita income levels and employment opportunities as the key economic determinants of migration. Furthermore, institutional barriers to migration, language, and geographical factors are considered. For the given differences and growth prospects of per capita GDP as well as labour market conditions in Germany and Central and Eastern European countries, an initial net inflow of between 200,000 to 270,000 persons p.a., and a long-run stock of the migrant population of around between 1.9 and 2.3 million

[3] See Brücker (2001) and Boeri/Brücker (2001) for details of the econometric model and the scenario.

persons is expected for Germany. Note that at present around two-thirds of the migrant population from the NMS in the EU-15 reside in the Germany. An extrapolation of the figures for Germany to the EU-15 yields thus an initial increase in the migrant population by 335,000 to 400,000 persons, and a long-run stock of between 2.8 and 3.6 million persons. This corresponds to between 2.8 and 3.5 per cent of the population from the NMS. Less than 40 per cent of the migrant population from the NMS participate as employees in the labour market at present.

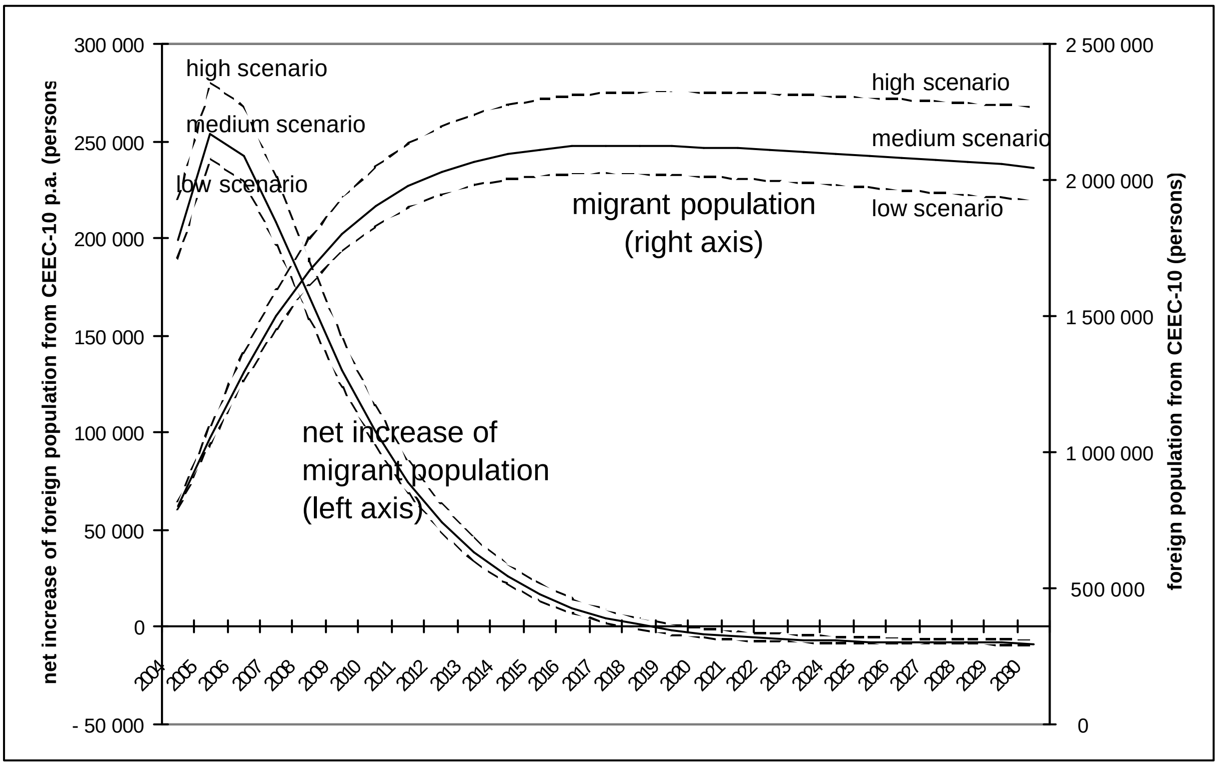
Around 56,000 citizens from the NMS resided in Italy in 1999, which corresponds to a share of 6.4 per cent of the migrant population from the NMS in the EU. If this share remains constant, the migrant population from the NMS would increase to between 190,000 and 225,000 persons in the long-run. Many other studies, based on a broad range of methods, yield similar results (see e.g. Layard et al., 1992; Hille/Straubhaar, 2000).[4]

Thus, we advocate the introduction for at most 5 years of EU-wide quotas of about 400,000 work permits per year for workers coming from any of the New Member States.

EU-wide quotas are to preferred to national restrictions because the regulation of immigration at national levels during the transitional periods creates two economic problems. Firstly, if country specific restrictions are binding, migration flows may be distorted away from the countries and regions where migrants can be more productive, which creates an efficiency loss per se. Secondly, national governments may decide to introduce more restrictive migration policies than in case of co-ordination, as they may fear that migrants will tend to move to the less restrictive countries, potentially setting in motion a race-to-the-bottom in the setting of migration quotas.

[4] There exist however also a number of outliers. An estimate by the Ifo-Institute got for the long-run migration potential a considerably higher estimate (Sinn et al., 1999), while the findings of Fertig and Schmidt (2000) are well below the presented estimates. It is beyond the scope of this paper to discuss the different results. See Boeri et al. (2002) for an in-depth discussion.

Figure 1: Immigration Scenario for Germany



2. The Budgetary costs of enlargement

The potential budgetary cost of enlargement has been one of the main concerns in EU-15 since negotiation over the accession begun. This narrow aspect has dominated the debate on enlargement. In the end, agreements have been reached that imply that enlargement can take place without any change in the overall budgetary envelope, established at 1.27 per cent of the EU GDP. Moreover, the two main pillars of the budget, the Common Agricultural Policy (CAP) and structural funds have not been modified. We argue below that this is unfortunate, as enlargement could have been a golden opportunity to reform the inefficient policies in the Union, both in agriculture and in the area of structural funds.

2.1. What has been agreed

The European Council of December 12-13, held in Copenhagen, fixed the expenditure flows for the period 2004-2006, while leaving unchanged the flows for the period 2007-2013, as decided at the Council of October 24-25 in Brussels. The main prescriptions of Agenda 2000 have been confirmed: the EU budget will be maintained below the ceiling of 1.27% of EU GDP and transfers to NMS cannot surpass 4% of the GDP of the recipient country.

The other fundamental aspect agreed upon in Copenhagen is that enlargement does not modify any of the key policies affecting the EU budget: both agricultural and structural policies have remained unaffected. Negotiations simply established that new countries will achieve equal treatment only gradually. In the case of the CAP; the transition period will last until 2013.

Boeri et al. (2002) estimate that enlargement would cost slightly more than 50 Euro per capita in the EU-15 in the first year of accession. This tax is bound to fade away as income convergence gains momentum. It is obvious that by accepting a large number of NMS characterized by much lower income per capita levels, the EU must be prepared to tolerate a net transfer to the NMS.

Table 1 provides some forecasts on the EU budgetary expenditures in 2013, simulated by extrapolating flows on the basis of a status quo scenario (no policy change with respect to the present arrangements), assuming that Romania and Bulgaria will also join the EU. The total amount of the transfer would be of the order of 32 billion Euros at constant 1999 prices. It is interesting to compare the difference between the simulation of net positions of current members in a no-enlargement scenario. Two main facts stand out. First, the two poorest countries of the EU-15, Greece and Portugal, will bear a significant cost. In contrast with the no-enlargement case, they will see a sharp worsening of their net transfers. This is a rather unwelcome outcome, as enlargement should not cause a significant worsening of the position of the poorest countries of the EU. It is a clear inefficiency of the current system of the EU budget, dominated by policies, especially in agriculture, that imply a transfer of funds to rich countries. As shown below, a similar inefficiency is present, although to a lesser degree, in the allocation of structural funds. A reform of the EU budget is of paramount importance after enlargement, which should allow for a transparent redistribution from the richest to the poorer countries of the EU.

Another fact that stands out is the sharp deterioration of the Italian position. Net payments from Italy will be of a comparable magnitude to those of Germany, which will draw most of the benefits from the Enlargement. The net contribution of Italy in 2013 is likely to be twice as large as that of France under the status quo scenario. Italy has, therefore, a vested interest in pursuing a reform of agricultural and structural policies of the EU. We discuss below which reforms are warranted.

2.2. Reforming Agricultural Policies

The key aspect of the negotiations has been the decision to extend direct payments to the NMS. The rationale for this decision is unclear. In principle, direct payments were introduced to compensate farmers for the loss in income associated with the reform of the CAP in 1992. It is estimated that, after entering the European Union, income of the farmers in the candidate countries will increase. Yet, the request of an equal treatment by farmers of the NMS is justified. Indeed, direct payments are not de-coupled from production and thus they work as subsidies to production. Excluding candidate countries from these transfers would be inconsistent with the principle of the Single Market, as it would put farmers in the NMS in a disadvantaged position. Furthermore, the failure to "de-couple" properly also means that in the EU-15 we do not fully obtain the savings that the 1992 reform was supposed to generate through the weakening of farmers' incentives to overproduce.

The final agreement solves this problem only partially, as during the transition period farmers in candidate countries will receive only partial support and will thus be discriminated with compared to farmers of current members. Indeed, direct payments to NMS will be phased in, starting with 25% of the entitlement, increasing gradually to reach 100% by 2013. This problem could be by-passed by a reform of the system of direct payments. The proposal of the Commission to fully de-couple payments from production goes in the right direction.

It would be very important to implement such a reform as soon as possible, preferably before enlargement. After enlargement it will indeed be politically more difficult to pass this reform. NMS are indeed characterised by a much larger share of population employed in agriculture. In the largest candidate country, Poland, agriculture absorbs almost 19% of civilian population, against 4.3% in the EU. With the forthcoming accession of Romania in 2007, the problem will become even worse, as Romania has almost 40% of its population employed in agriculture. The weight of the agrarian lobbies in the Enlarged European Union will be much higher than today. Hence, the likelihood of implementing significant reforms of the CAP is going to decline after accession.

Overall, we propose to de-couple direct payments from production, including agricultural transfers within an overall transparent policy of re-distribution at the EU level, consistent with the objective of cohesion and convergence of the poorer countries.

2.3. Reforming Structural Funds

The criteria for allocating structural funds have not been revised. Given that the allocation of structural funds is based mainly on the income per capita of regions (with a ceiling of 75% of EU average), enlargement implies significant changes, due to a statistical effect. With entry of countries with a GDP per capita much lower than the EU average, several regions of the EU-15 will have their income per capita surpassing 75% of the new average of the enlarged EU. Most Italian regions will likely be in such a situation, perhaps with the only exception of Calabria. With current policies, there will be a significant shift of funds to NMS. As the limit on the overall budget is one of the cornerstones of EU policy, it is unclear how the situation would evolve. This carries several risks. If a compromise is achieved, maintaining transfers to the regions of current members at least until 2013, new resources will have to be allocated, with pressure on the budget. Alternatively, if new rules are introduced to avoid allocating new resources, there would be a conflict between old and NMS. This would be rather unfortunate, as structural funds could be a fundamental engine to foster growth in NMS, supporting the process of catching up which is deemed to be a key objective of the EU.

A new perspective is needed. *Structural policy should switch from the financing of regions to the financing of countries.* There are two main reasons justifying such a switch: equity and efficiency. Regarding equity, as national states are still the main actors in the European Union and most of the redistribution is carried out by national states, channelling funds to regions, irrespective of their nationality is inequitable. Poor regions in rich countries should be supported by their national government. Regarding efficiency, transfers to regions suffer from an excessive dispersion which does not allow to exploit economies of scale in regional development. Infrastructural investment usually requires a critical mass of investment that cannot be achieved if funds are diluted over a large number of territories. As regional economics points out, there are significant benefits from agglomeration. Investing in infrastructure in regions that are richer but can exploit agglomeration effects (like large cities) leads to higher returns than investing in poor regions with no economic prospects. Creating jobs where they can be sustained, and fostering mobility from poorer regions is often the best policy option to improve welfare of the poor. The current approach to transfer at the regional levels has also created large inefficiencies in the management of such funds. There are high bureaucratic costs, induced by the large red tape associated with the allocation of structural funds. This implies that regions that spend more on creating a bureaucracy dealing specifically with EU projects have a higher chance to obtain funds, irrespective of the real need for them. The system seems to re-create the well-known problem of input-input production characterizing planned economies. The incentives of current policies are wrong as they stimulate a costly behaviour of maximizing the potential funds to be obtained rather than evaluating the projects with the higher social returns.

In summary, we believe that the whole system should be modified. Rules have to be made more transparent and consistent with the objective of fostering convergence. At the EU level, priorities for investments should be established, the amount of the transfers agreed and linked to the GDP per capita of recipient country. National governments will thus manage the resources and transfer them to the most productive projects.

Overall, we propose to agree at the EU level the amount to be transferred to each country on the basis of the GDP gap criterion (the deviation of each country from the EU average). Evaluation of the projects to be financed should be made at the EU level, based on similar methodologies and defining a ranking based on the expected rates of returns of the different projects. The choice of specific projects would be however determined by each national state.

The investments agreed upon in this context could also be used in the monitoring of budgetary positions within the Stability and Growth Pact. The Commission proposals on the modifications to the SGP considers taking into account public investments and structural reforms when assessing the budgetary position of each country. The incentives of the proposed scheme will move in the right direction while being also consistent with the goal of transferring EU resources from richer to poorer countries.

3. The issue of the "Euro"

NMS eventually will have to adopt the Euro, as no opt-out solution is allowed. However, there is an important issue regarding the timing as well as the possible paths for the entry in the EMU. According to the European Central Bank and the European Commission, the NMS should follow the traditional route of entry in the ERM-II before accession to EMU. As NMS belong to the category of emerging market economies, they tend to be vulnerable to currency and financial crises. Several NMS have opted for currency board arrangements, while others have manifested their willingness to enter EMU as soon as possible. Although the issue of optimal exchange rate arrangements is a complex one and often implies different regimes for different countries, a less restrictive approach by the European institutions is advisable, as currency instability may cause large negative effects on the economies of the new members.

It is often argued that early EMU participation by the NMS should be discouraged on the grounds that i) they would loose the use of the exchange rate and interest rates as absorbers of asymmetric shocks, ii) the economies of the NMS are too "weak" to be subject to the supposed rigours of the single currency, and of the Stability and Growth Pact (SGP), and iii) that nominal convergence within the EMU would delay real convergence.

However, the NMS are already so highly integrated in terms of trade and investment flows with the present EMU that asymmetric shocks are no more likely to affect them than current EMU participants (see Table 2). Trade with other members of a proposed currency area as a share of GDP provides a good measure of the degree of a country's economic integration with the area, and of the extent to which it is protected by this integration from asymmetric domestic shocks. All of the NMS in central and eastern Europe trade a higher share of their GDP with EMU countries than did six of the current 12 EMU members (including the four largest Germany, France, Italy and Spain) at the establishment of EMU in 1999. Trade with the currency area as a share of total trade provides a good measure of the extent to which a country is protected from asymmetric shocks originating from its trade with third parties outside the proposed currency area. All of the NMS traded a higher share of their total trade with EMU countries than two EMU members, and six of the NMS traded a higher share of total trade with EMU than ten current EMU members. Thus, NMS are probably no more likely to need to use monetary policy or the exchange rate to respond to asymmetric shocks than are current EMU participants.

Furthermore, recent empirical research has shown that for the NMS, possession of an independent currency can be more of a shock generator than a shock absorber. Thus, Habib [2002] found that emerging market risk premia had a significant impact on exchange rates in the Czech Republic, Hungary and Poland during the period mid-1997 – mid-2001, and on interest rates in the Czech Republic and Hungary, while Csermely and Vonnak [2002] show that in Hungary the main reason for exchange rate and real interest rate movements has been changes in the risk premium Hungary has had to pay. These changes were due to world capital market increases in the premium required of emerging markets, an effect which would very largely disappear after EMU accession.

Most economists agree that, given a stable and low inflation macroeconomic environment, NMS can be expected to generate labour productivity improvements much faster than current EU members. EMU participation would provide such an environment. This makes it hard to understand claims that NMS economies are "too weak" too meet EMU or SGP requirements, or that the nominal convergence required for EMU participation would occur at the cost of real convergence.[5]

Thus, EMU participation eliminates the risk of "emerging market contagion", making a higher level of capital inflow into NMS safe, while at the same time providing a strong, externally guaranteed anti-inflationary framework. This can increase the long-term rate of growth of the NMS, rather than reduce it, and accelerate real convergence rather than delay it. As a result, current EMU participants will benefit (slightly) from faster EU growth, and from the elimination of the possibility of competitive devaluations by NMS.

Careful economic analysis suggests that the fear that early participation by fast growing NMS in EMU will increase inflationary pressure in the eurozone is mistaken. Thus, it is not the case that such participation will require *either* the accommodation of higher inflation *or* higher ECB interest rates, which would depress growth in Germany even further [Rostowski 2003]. There has been a strong deceleration in inflation in the NMS. Nevertheless, it is the case that unbalanced growth within EMU, whether as a result of participation by new fast growing States, or growth-enhancing reforms by existing participants, is likely to put competitive pressure on those tradeable goods sectors in those countries in which labour productivity growth lags. However, because of the very small size of NMS economies, this effect will be quite small in the case of their participation in EMU, much smaller than if some large current EMU participants reformed and others did not.

3.1 *Adjustments to the EMU admission process.*

The underlying economic logic of the Treaties on which this process is based was developed at a time when the euro did not exist. The euro is now a fact and a success, and this has created an "economic regime change", which implies that additional routes to EMU admission can and should be opened. The requirement for the development of such routes is that they should improve the welfare of new EMU participants without reducing that of current participants.[6] The principle put forward by the Commission [EC 2000] that current and future EMU participants must be

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[5] This highlights the absurdity of suggestions from within the EU that NMS should not participate in EMU because meeting the Maastricht Treaty's fiscal criterion is unsuitable for countries which would benefit from high government investment even if it were financed by borrowing. First, all Member States are obliged to avoid deficits in excess of 3% of GDP, whether they participate in EMU or not (an obligation which is not obviated by non-participating Member States not being subject to financial penalties in the case of non-compliance). Second, the 3% limit leaves ample room for borrowing to finance investment. Third, if it was they case that borrowing for investment in the special case of the NMS justified a higher deficit, if is surely the 3% limit on deficits which should be changed in their case, rather than NMS' ability to benefit from EMU participation. Perhaps more importantly, payments by government into private pension schemes should not be included in government expenditure for the purpose of the Maastricht criteria or the SGP, as they merely makes explicit a part of government's implicit pension debt. Otherwise governments will have a disincentive to tackle their pensions overhangs. Such a reclassification would be important for a number of NMS, which either have implemented or are preparing important pensions reforms. Such a reclassification must, of course, apply to all Member States, including the UK and Holland, which have large private pension provisions.

[6] Or improve the welfare of current participants without reducing that of potential new ones (although it is harder to think of examples of this).

treated equally is unjustified.[7] Just as the SGP has to be developed and improved, so does the EMU admission process. Nevertheless, it is vital that any new routes to EMU admission should not be in any way "softer" than the existing one. Rather, they should merely be more appropriate to the new conditions (arrival of the euro, enlargement), just as the EC's proposals [EC 2002] for the development of the SGP are more appropriate rather than softer. A further guiding principle of any new route to EMU participation should be that it put more stress on the fundamental conditions for nominal convergence (i.e. the fiscal and public debt positions of the Member State) than has been the case hitherto.

The main changes we propose are as follows:

(1) The acceptance of *unilateral euroization* as a valid route to EMU participation, both for EU Member States, for countries which are still applicants, and for countries which may become applicants. Why unilateral euroization can be beneficial has been extensively discussed in the literature [Bratkowski and Rostowski 2001, Coricelli 2002, Gros 2002, Rostowski 2002, Sulling 2002]. Member States wishing to adopt the euro unilaterally before EMU participation could usefully be required to become subject to Article 104, paragraphs 9 and 11 of the Treaty of Maastricht, making them subject to the same financial penalties when in breach of the excessive deficit requirement as EMU participants.

(2) Waving the need to meet the Maastricht Treaty's reference value for the inflation criterion in the case of those Member States which have in place a well-established currency board arrangement pegged to the euro [Estonia, Bulgaria, Lithuania], or which have unilaterally adopted the euro as a path to EMU participation. In the latter case, countries could be required to have adopted the euro for at least three years before the reports of the Council on their admission to EMU participation.

Overall, *the Commission and the Council should encourage the NMS to participate in the Economic and Monetary Union as soon as they can meet the required nominal convergence criteria and themselves consider that they will benefit from doing so.*

This is because the adoption of the euro will eliminate currency risks for the NMS, allowing them attract more foreign direct investment, will remove the threat of sharp currency fluctuations, and will provide a guarantee of a stable, low inflation environment, which will contribute to growth in the NMS, to the overall benefit of current EMU participating states.

[7] The Commission should not be concerned that this may provide a benefit for those countries which have delayed entry into EMU. In most other areas of integration those who pioneer the integration benefit most, because they are able to define the rules on which it is based. The creation of monetary union is an exception because of its special nature, but it is likely to remain an exception, so the general principle that "late joiners" should not benefit from joining late will not be undermined. Second, the NMS were unable to join EMU in 1998 because they were not EU members. So they cannot be held to benefit from a decision to delay participation. This cannot, of course, be said of the UK, which is widely expected to be allowed to join the EMU without a period of ERM2 membership.

Table 1. Net transfers in 2013 (millions of Euro, at 1999 prices)

	No enlargement	Enlargement	Difference
Belgium	-659	-1250	-591
Denmark	16	-425	-441
Germany	-6421	-12828	-6407
Greece	3261	2143	-1118
Spain	6308	1151	-5157
France	444	-3609	-4053
Ireland	1377	1201	-176
Italy	-242	-6121	-5879
Luxembourg	-83	-125	-42
The Netherlands	-908	-1757	-849
Austria	-165	-736	-571
Portugal	2172	353	-1819
Finland	-13	-356	-343
Sweden	-724	-1299	-575
UK	-4366	-8398	-4032
Accession countries			
Czech Republic		3231	
Hungary		3976	
Poland		12413	
Slovak Republic		1411	
Slovenia		-7	
Estonia		401	
Latvia		691	
Lithuania		1264	
Cyprus		-53	
Malta		-28	
Romania		2059	
Bulgaria		6696	
EU-15		-32055	
12 accession countries		32055	

Source:Weise, Christian, "EU Eastern Enlargement can be financed: Increased need for reform, DIW 12/2002

Table 2: Degree of trade integration of TACs with EMU compared to that of EMU countries

	EMU trade/GDP	Intra-industry EMU trade/GDP(estimated)*	EMU trade/total trade
Belgium-Lux.	81.4	59	56.8
Hungary	**73.2**	**43**	**68.7**
Czech Republic	**65.1**	**43**	**61.7**
Estonia	**62.0**	**24**	**45.1**
Slovenia	**61.8**	**37**	**67.1**
Slovakia	**58.9**	**29**	**56.8**
Netherlands	48.8	38	47.9
Ireland	44.2	22	33.2
Bulgaria	**39.3**	**13**	**54.2**
Portugal	38.5	19	67.1
Austria	37.6	26	63.2
Romania	**34.7**	**10**	**66.4**
Latvia	**30.9**	**7**	**46.8**
Poland	**27.6**	**12**	**58.5**
Lithuania	**26.5**	**6**	**36.0**
Spain	25.5	17	58.3
France	21.7	18	51.9
Germany	20.8	17	43.8
Finland	20.7	10	34.0
Italy	19.5	12	49.3
Greece	17.4	5	53.4

Source: Eurostat. Data is 1999 for accession countries and 1998 for EMU countries. The shares of intra-industry (II) trade with EMU countries in GDP were estimated by taking the 1997 shares of II trade with the EU in Fidrmuc and Schardax [2000] and applying them to columns 2 and 4.

Table 3: Inflation in the New Member States

	Estonia	**Slovenia**	**Lithuania**	**Poland**	**Czech Republic**	**Hungary**	**Slovakia**	**Latvia**
1997	11,2	8,4	8,9	14,9	8,4	16,0	6,0	7,0
1998	8,2	7,9	5,1	11,8	10,7	11,2	7,0	2,8
1999	3,3	6,1	0,8	7,3	2,1	8,0	13,6	3,2
2000	4,0	8,9	1,0	10,1	3,9	9,1	9,2	1,8
2001	5,8	8,4	1,3	5,5	4,7	8,1	6,5	3,2
2002	3,6	7,2	0,3	1,9	1,9	5,4	3,4	1,4

4. Institutional reforms: some final remarks

In this paper we developed a number of proposals which would allow the EU to cope with the Eastern enlargement, without diluting the current degree of economic integration in the EU and possibly strengthening its political integration. Some of the proposed changes will require stronger supra-national authorities, e.g., in the field of international migration. Others will have to be accompanied by improvements in decision-making procedures, as in the case of the conduct of monetary policy under a broader EMU. It is important that these necessarily institutional transformations are envisaged already at this stage and, whenever relevant, taken into account in the final steps of the EU Convention.

An incremental approach to institutional transformation may be ill-suited for an enlarged Union. *Institutional instability* is already quite a problem for a Union with 15 countries. The Treaties which currently provide the "constitutional framework" of the Union are changed quite frequently, almost every 4-5 years. Sometimes the EU constitution itself, which is being discussed at present by the Convention, is perceived as a very temporary settlement. Allied to institutional instability is the practice of *incremental institutional change*, treating important reforms (e.g., the reforms of the Stability and Growth Pact currently under the scrutiny of Ecofin) merely as technical matters, rather than as fundamental political choices.

With the increase in the number of Member States, the temptation to use this "incremental-technical" approach, so as to circumvent blocking minorities, will increase. The danger is that the result will be increased confusion between technical and political (even properly constitutional) matters, leading to a loss of legitimacy, both among old and new Member States, and thus institutional fragility.

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