

THE 2004 ENLARGEMENT: KEY ECONOMIC ISSUES

1. Introduction

At their meeting in Copenhagen in December 2002 the EU heads of state decided to accept ten new countries as members of the European Union (EU) in May 2004. This enlargement is a very significant event in the history of the EU. The number of accession countries is large, as ten new members will join (the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia). The earlier enlargements in 1995 and in 1981–86 involved only three countries each. The 2004 enlargement will raise the EU population to about 480 million people from the current 375 million in the EU-15 countries.

The 2004 enlargement will have major economic implications, and this chapter aims to provide a primer on key economic issues, including economic growth, the public sector, labour markets and social policies, as well as factor mobility and sectoral changes. Our discussion will review what different studies say about economic consequences of the enlargement.

The expansion of the EU has created, on the one hand, high hopes for fast economic growth and rising living standards among the new members and, on the other, has led to worries about the loss of jobs and higher unemployment in the EU-15 countries. Two simple indicators about differences in living standards and labour costs between EU-15 and new member states serve to illustrate the emerging economic pressures. These differences imply major challenges to economic policies.

Data on PPP-adjusted GDP per capita as a measure of living standards in Table 5.1 indicate that many of the new member countries are poor in comparison to the existing members. Latvia has currently the

Table 5.1
GDP per capita, PPP 2001
(in thousands of current international \$)

Latvia	7.73
Lithuania	8.47
Poland	9.45
Estonia	10.17
Slovak Republic	11.96
Hungary	12.34
Malta	13.16
Czech Republic	14.72
Slovenia	17.13
Cyprus	21.19
EMU	23.94

Note: PPP GDP is gross domestic product converted to international dollars using purchasing power parity rates. An international dollar has the same purchasing power over GDP as the US dollar has in the United States.

Source: WDI, World Bank.

lowest GDP per capita among the accession countries (the ratio to the EMU average is 32.3 percent) while Cyprus has the highest GDP per capita (the ratio to the EMU average is 88.5 percent). The big differences in living standards can, for example, trigger significant migration from new members to EU-15 countries. Speeding up economic growth in the accession countries is obviously a major policy objective.

As a second indicator of economic policy issues we briefly look at labour costs among the accession and present EU countries, measured at going exchange rates. Table 5.2 shows that hourly labour costs in the new member countries are only a small fraction of the corresponding costs in the present EU countries.¹ The wage gap is particularly large for those present EU countries that happen to neighbour on the accession countries, such as Austria, Finland, Sweden and, in particular, Germany. In West Germany, the hourly labour cost was about 26 euro in 2000,² which is nearly six times the Polish wage.

¹ Data on Malta is not available.

² IdW, "Deutschland in Zahlen", 2002.

Table 5.2
Hourly costs in the EU and in the accession countries
(in EUR), 2000

Czech Republic	3.90
Cyprus	10.47
Estonia	3.03
Hungary	3.83
Latvia	2.42
Lithuania	2.71
Poland	4.48
Slovak Republic	3.06
Slovenia	8.98
EU-14	21.19

Note: EU-14 includes all present EU members except Belgium.

Source: Eurostat (2003a).

The wide gap in labour costs suggests that there are incentives for western firms to move the labour intensive parts of their production activities to the new member states, and in fact, there has already been a significant movement of western firms to the east. While the 1980s and 1990s have shown significant outsourcing activities of big European companies to east Asia, at present an increasing outsourcing activity of middle-sized and even smaller firms to Eastern Europe can be observed. For example, in a survey carried out by the Cologne Institute for Business Research, about 60 percent of the German firms with less than 5,000 employees had already established plants outside the EU, most of them in Eastern Europe.³

Besides growth, labour markets, and sectoral changes, the accession to the EU will have major implications for the public sector of the new member states. On the one hand, the new member countries will receive significant transfers from the EU budget. On the other hand, they will need to co-finance project-based transfers and pay their membership dues to the EU from the beginning. Moreover, compliance with the EU regulations, the *Acquis Communautaire*, will lead to additional public expenditure. The levels of public debt in the new member countries are currently low, but

many of these countries have sizeable public deficits.

2. Economic growth

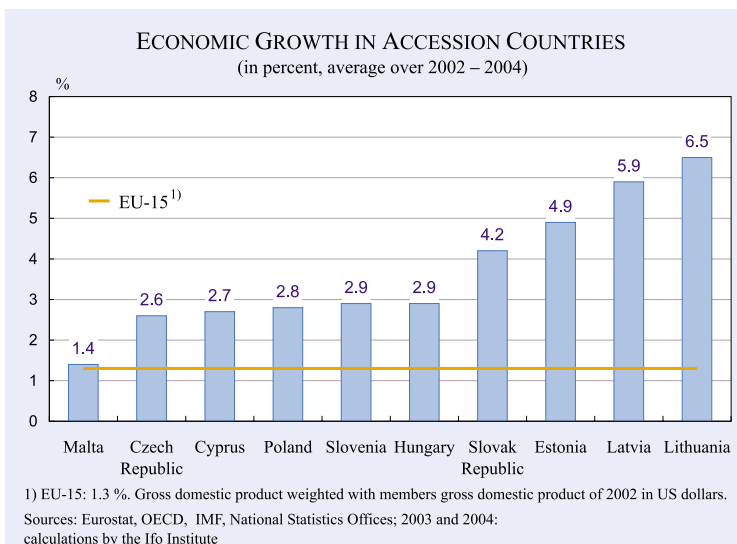
Following the difficult early 1990s, many of the new member countries have achieved relatively fast growth in recent years (see Table 5.3). For most accession countries, growth rates reached high levels as early as the second half of 1990s, but in the Czech Republic the difficulties with transition from a socialist system appear to have lasted longer, as growth became significantly positive only after 1999.⁴ Most recently, as a result of the recession in the Western world, there has been a little bit of a slowdown in growth in some accession countries, whereas economic growth has continued at a largely unchanged pace in others.⁵

On the whole, the new member countries have been growing faster than most of the EU-15 countries. The relatively high growth rates in Figure 5.1 suggest that these countries have already been reaping some gains from closer integration with Western Europe. EU Eastern enlargement will trigger some further changes in growth and welfare in the accession countries and also small growth effects in the EU-15 countries, though these changes have already partly been taking place in recent years in the pre-accession process.

⁴ It should be kept in mind that GDP per capita in the former socialist countries fell significantly in the early years of transition from socialism, so that for several countries the level of real GDP in 2001 was still lower than in 1989.

⁵ Table A.1 in the Appendix gives key economic indicators for the new member countries.

Figure 5.1



³ IdW, *IW-Trends*, Dokumentation 4, 2002.

There are two basic mechanisms whereby full EU membership contributes to improved economic growth in the accession countries. First, traditional trade effects of economic integration will occur through trade creation and trade diversion, of which the former is beneficial and the latter is harmful. Trade creation refers to increased trade generating new economic activity, whereas trade diversion refers to the redirection of existing trade as a result of changes in tariffs and other barriers due to the regional customs union.

Increased international trade will, in principle, also benefit current member countries, but this effect is much less certain, at least in the short and medium term, since it relies on the ability of the current member countries to react quickly to the changes in relative goods and factor prices that come with opening trade. (Moreover, the effect on the EU-15 will be small, given that the combined GDP of the entrants is only a small fraction of EU-15 GDP.) As Eastern Europe is capital-poor but labour-abundant, trade will require the relative prices of labour-intensive goods along with real wages to decline in the West and labour to move out of these sectors to more capital-intensive ones. If unions or social replacement incomes offered by the welfare state impede the necessary wage adjustments, unemployment may result instead of gains from trade. Among the current members, those bordering the entering countries will potentially receive the largest benefits in the long run, but they may also incur the largest adjustment costs in the short run.

Second, economic growth in the new member countries can receive a boost through movements of factors of production and other dynamic effects such as capital accumulation, technology transfer, increased competition and possible economies of scale. Movements of factors of production can lead diverse effects on growth, as they depend on the nature and direction of the factor movements. These movements have already been taking place in recent years, for example in the form of increased foreign direct investment in the new member countries.

Next, we shall discuss the effects on trade and growth more closely, after which scenarios for growth and convergence of the new member countries toward EU-15 average levels of GDP will be presented. We note that fiscal transfers to new mem-

ber countries can also alter the picture of pure growth effects as they represent a benefit to entrants. The fiscal transfers are to a significant degree a consequence of full membership, though some transfers have taken place even before membership as pre-accession aid.

2.1 Growth and trade

Changes in international trade between countries are a major part of the effects of economic integration on GDP and welfare; see Frankel and Romer (1999) and references therein. The fall of the Iron Curtain led to major changes in trade. EU imports from the Central Eastern European countries doubled within the first five years of the transition from socialism. The EU-15 countries are by far the largest trading partner of the accession countries. For example, in 2001 about 61 percent of exports of the new member countries went to the EU (see Table A.1 in the Appendix). In contrast, the share of imports from the accession countries in total imports of the EU-15 is still relatively low, approximately 10 percent in 2001.

The trade effects of EU enlargement are likely to be different from those in the 1990s because significant reductions in trade barriers have already taken place before actual enlargement. The effects of the abolition of tariffs and the reduction in trade costs between EU-15 countries and the new member states are likely to be small for the EU-15, amounting perhaps to 0.05-0.1 percentage points cumulative changes in levels of GDP in a five-year period, according to Breuss (2001). This is because the entering countries are economically small in relation to the current EU-15.

For the accession countries, the trade effects are likely to be much bigger than for the EU-15, amounting perhaps to 1.2 to 4.3 percentage points of changes in GDP; see e.g. Breuss (2001) for a study using the OEF world macroeconomic model and for references to other studies.⁶ The asymmetry is explained by the fact that, as noted above, the current EU countries are the largest trading partner of the new member countries, whereas the new member countries are a small trading partner for EU-15.

⁶ Some estimates of the effects from trade diversion have also been made. Overall, the effects of Eastern enlargement on the rest of the world are small, but the effects from trade diversion can be significant in specific sectors, notably in textiles and agriculture; see Francois and Rombout (2001) for further discussion.

2.2 Estimated growth effects

Full membership is expected to accelerate economic growth via increased foreign direct investment (FDI), new trade within the enlarged EU, the aid from the EU budget, and other channels. However, it is not straightforward to disentangle the effects of full membership from the effects of increased integration that has already taken place at the pre-membership stage.

The empirical studies considering full integration of the accession countries into the Single Market of the EU employ either global computational general equilibrium models or global macroeconomic models for computing the growth effects; see e.g. Baldwin et al. (1997), Breuss (2001), Lejour et al. (2001), Fidrmuc et al. (2002) and the references therein. These studies suggest that the level of GDP in the accession countries will be significantly raised by the 2004 enlargement. For example, simulation results from a world macroeconomic model reported in Breuss (2001) suggest an up to 8 or 9 percent higher GDP over a ten-year period for some accession countries, with lower estimates for other entering countries. These estimates of GDP effects on the entrants translate into an increase in their growth rates by nearly one percent per year.

Even higher estimates of the effect of EU enlargement on growth in the Central Eastern European countries have been suggested in studies using the methodology of growth accounting. The growth effect might be as high as 1 to 2 percent per year; see European Commission (2001a) and Doyle et al. (2001).⁷ Possible membership of the accession countries in EMU in the longer term could stimulate GDP per capita further through improved opportunities for trade and capital movements as a result of reduced exchange rate risks, increased competition and lower transaction costs.⁸

The effect on the GDP of current members is, at best, of the order of one tenth of the corresponding effect on the accession countries. Moreover, there are likely to be differences among the current member countries. The largest benefits will be received by

countries having geographic proximity to and extensive trade links with the new members. Germany and Austria are examples of higher than average impacts.⁹ However, as mentioned above, it is unclear when such benefits will occur. The available empirical results are based on general equilibrium models with instantaneous market clearing and flexible wages that are unable to capture the particular difficulties facing economies whose labour markets are restricted by large welfare states and powerful unions. By their very nature these models are unable to foresee the transitional difficulties such economies might have before they are able to reap textbook gains from trade.

More generally, the growth benefits from joining the Single Market will not be uniform across countries and regions. There will probably be significant differences between countries, with the Central Eastern European countries having possibly the largest growth benefits. In addition, experiences from the transition period, during which there has already been significant partial integration of Eastern European countries into the Western world, suggest that close-to-border regions and regions around national capitals are likely to be the greatest beneficiaries in the process of further integration. Not only geography but also foreign direct investment and a high level of education are apparently the keys to regional and country success; see Tondl and Vuksic (2003).

2.3 Growth scenarios for new member countries

The slowness of the growth and catching-up processes is an important point that is often forgotten in popular discussions of the benefits from the 2004 enlargement. We illustrate the long period of time needed in the catching-up towards the EU-15 average by two simple simulations of per capita GDP levels and labour costs of the new member countries.¹⁰

The computations assume that the income per capita difference between the EU-15 and the respective acceding country will shrink by two percent every year. This is in accordance with the estimates in Chapters 11 and 12 of Barro and Sala-i-Martin (1995), although the actual convergence rate was

⁷ More generally, panel-structured growth accounting estimates suggest that membership in the EU has positive effects on economic growth through closer integration and possibly institutional change; see Crespo-Cuaresma et al (2002) for estimates and discussion.

⁸ The estimates of the growth effects of a common currency are subject to disagreements due to different measurement methodologies; see for example Persson (2001), Rose (2000, 2001) and Micco et al. (2003).

⁹ Keuschnigg et al. (2001) point out that Germany is likely to have gains from the enlargement even after accounting for the increased budgetary costs via contributions to the EU budget. See Fidrmuc et al. (2002) for results on Austria.

¹⁰ See for example Sarajevs (2001) and European Commission (2003b) for other scenarios.

even lower in the period 1963 to 2000, which was only 1.1 percent; see Sinn and Ochel (2003).

Table 5.3 gives the relative levels of per capita income and labour cost for the years 2010, 2020 and 2030. We emphasize that the quantitative results must be viewed with extreme caution since they are based on strong assumptions and a mechanistic projection. Despite their limitations, the scenarios convey the important lesson that catching up with EU-15 will take several decades for most accession countries even under the optimistic assumption that EU membership is consistent with a two percent annual convergence rate, which is above the rate so far observed.

Cyprus and Slovenia have the shortest catching-up periods, but even for them it will take, respectively,

10 and 30 years to reach 90 percent of the EU-15 level of per capita GDP. Under the more realistic present convergence rate, it would take even longer. At the other extreme, several countries, including Poland, and the Baltic countries, will need 10 to 20 years to reach even 50 percent of the EU per capita income level. Achievement of fast economic growth must therefore be a major item on the economic policy agendas of the new member countries.

3. Fiscal aspects of enlargement

3.1 Sustainability of public finances

We start by considering the public finances in the accession countries. Figures 5.2 and 5.3 show the development of public sector deficits and debt for the period 2001–2003.

Table 5.3 a

Convergence in per capita income (PPP)

	2001	2010	2020	2030
Latvia	32.2	43.5	53.8	62.3
Lithuania	35.3	46.1	55.9	64.0
Poland	39.4	49.5	58.7	66.3
Estonia	42.4	52.0	60.8	67.9
Slovak Republic	49.9	58.2	65.9	72.1
Hungary	51.5	59.6	66.9	73.0
Malta	54.9	62.4	69.3	74.9
Czech Republic	61.4	67.8	73.7	78.5
Slovenia	71.5	76.2	80.6	84.1
Cyprus	88.5	90.4	92.1	93.6
EMU	100	100	100	100

Table 5.3 b

Convergence in labour cost (% of EU average)

	2001	2010	2020	2030
Latvia	10.9	25.7	39.3	50.4
Lithuania	12.2	26.8	40.2	51.1
Estonia	13.6	28.0	41.1	51.9
Slovak Republic	13.7	28.1	41.2	52.0
Hungary	17.2	31.0	43.6	53.9
Czech Republic	17.5	31.2	43.8	54.1
Poland	20.1	33.4	45.6	55.5
Slovenia	40.4	50.3	59.4	66.8
Cyprus	48.4	56.9	64.8	71.2
EU	100	100	100	100

Note: The assumption underlying these simulations is that the difference in the levels of per capita income and labour cost will shrink by two percent every year.

Source: World Bank, WDI, Cologne Institute for Business Research and own calculations.

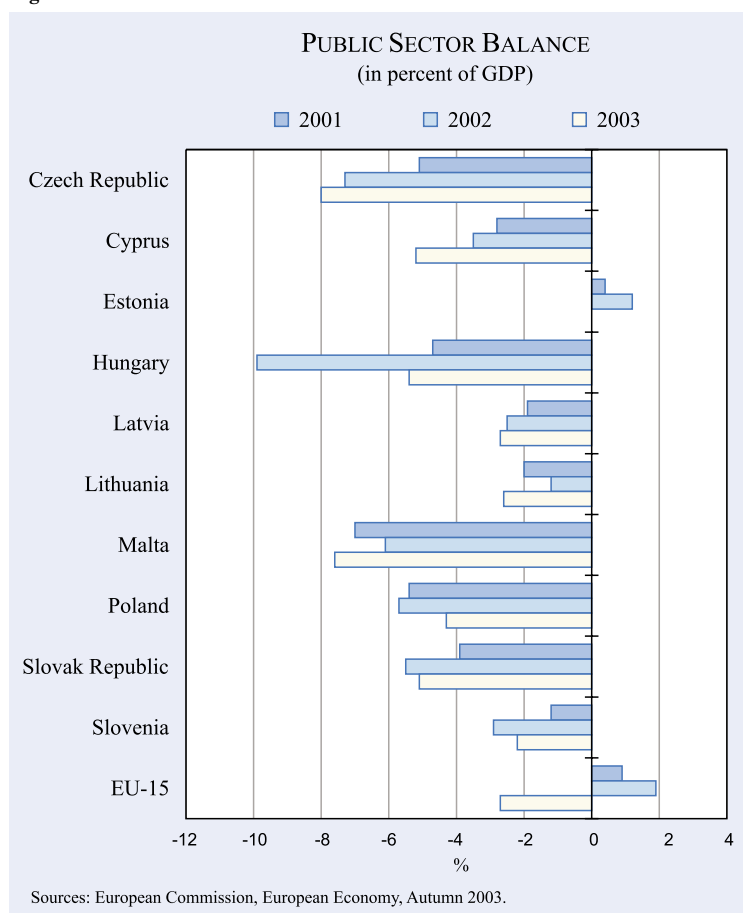
Table 5.4 indicates that interest rates for long-term bonds have been relatively high for most entering countries.

It is evident that public finances are fairly delicate for many of the entering countries. It is anticipated that problems of fiscal balance will continue in the future; see for instance European Commission (2003b) for such forecasts. The new member countries are in quite different situations with respect to current public sector balances. Some countries face severe problems, while public deficits are moderate for other countries, with Estonia even running a surplus.

The levels of public debt are relatively low (Figures 5.2 and 5.3). In terms of the level of public indebtedness, the entering countries are generally in better shape than most of the EU-15 countries.¹¹ Only Cyprus and Malta are above the Maastricht limit of 60 percent and even

¹¹ See also Chapter 2 of the 2003 EEAG report for data and discussion of public debts and deficits of the EU-15 countries as well as of the accession countries.

Figure 5.2



European Commission (2003b) forecasts that public sector deficits will continue to be a problem in coming years for several of the new member countries. Unless public sector deficits are brought under control, the sustainability of public debt can become a major problem for some of the new member states in the longer term.

3.2 Enlargement and the EU budget

The EU-15 member countries have to finance the additional expenditures in the EU budget that are not covered by the contributions of the new members. The latter contributions will, however, be small in the aggregate, though not so small in terms of the GDPs of the entrants, which is of the order of 1.2 percent of their GDP; see Backe (2002) and Richter (2003b).

their debts are not very far above the limit. The currently low levels of public debt are, however, not that convincing as several entering countries are running large public sector deficits, though there are also countries with a much better fiscal situation (Figures 5.2 and 5.3). The highest forecasted figures for 2003 are 8.0 and 7.6 percent deficits in the Czech Republic and Malta, respectively. Moreover, the entering countries will greatly need to increase their public spending, e.g. to improve their public infrastructure.

On the whole, the accession countries have not been successful in improving their public finances. In the period 2000 to 2002 the deficit levels have been constant or slightly increasing for many of the entrants as a result of the economic slowdown, though a few countries, notably the Baltic countries, have succeeded in improving their public sector balances despite the slowdown. The

The burden of the enlargement on the EU budget for the EU-15 members has been estimated to be small, perhaps of the order of 0.2 percent of GDP, though for the southern European countries the costs (relative to GDP) are likely to be higher due to a reformulation of the structural funds programme; see Breuss (2001).

After enlargement, over 14 percent of the EU budget will go to the ten accession countries. Table A.2

Table 5.4

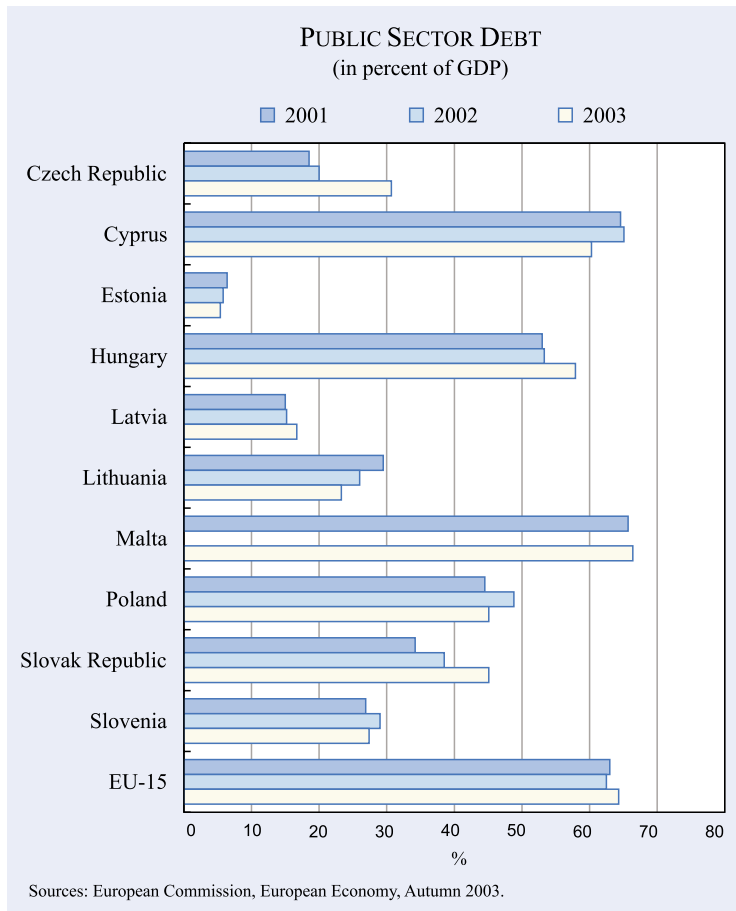
Long-term interest rates in percent

	2000	2001	2002
Czech Republic	6.9	6.3	4.6
Cyprus	7.6	7.7	5.4
Estonia	3.8	4.0	2.7
Hungary	8.6	7.9	7.1
Latvia	7.8	7.5	5.3
Lithuania	11.5	7.3	6.0
Malta	5.8	6.1	5.7
Poland	11.8	10.7	7.3
Slovak Republic	8.3	8.1	6.9
Slovenia	4.7	4.6	3.4
Euro area	5.4	5.0	4.9

Note: long-term or medium-term government bonds. Estonia: Commercial bank deposit rates; EU: weighted average using GDP; Euro area: From January 1999, weighted by the nominal stock of government bonds.

Source: Eurostat, "Money, Finance and the Euro," European Commission, Luxembourg.

Figure 5.3



in the Appendix provides the data on the amounts of the EU budget that are appropriated to the new member countries for the years 2004 to 2006. (In EU jargon “appropriations for commitments” refer to maximal allocations in the EU budget. The *ex post* amounts will usually be smaller than the appropriations since, for example, some of the items require a project.) The appropriated amounts for the new member countries range from 6.9 to 1.7 percent of the GDP of each recipient country. Table A.3 shows the appropriations to the new members as part of the EU budget, expressed as fractions of the total EU budget.

3.3 Effects on the new member countries

The new members will be recipients of significant funds from the EU budget, as indicated by Table A.2 in the Appendix. Total receipts as a percentage of the GDP of recipient countries vary inversely with the level of GDP. Structural assistance to public infrastructure, transport, the business sector and education are a major item in the EU support, with, for example, Latvia receiving 4.4 percent of its GDP as

support for structural actions. Agriculture is another major item of support from the EU budget to the new member countries: entering countries will receive from 1.7 percent (Lithuania) to 0.3 percent (Cyprus and Malta) of their GDP as support for agriculture. We will discuss agriculture further in Section 5.

Several further considerations are pertinent in assessing the data in Tables A.2 and A.3. First, a significant part of the appropriations will be project-related, and it is probable that some projects will not go through. Thus, in reality net transfers are going to be smaller than the appropriations, though precise estimates are not easy to obtain. By making specific assumptions about “success rates,” Richter (2003b) estimates that the actual transfers might be around 60 percent of the appropriations. He suggests that the net transfers from

the EU to the new member states might be just a little over one third of the gross figures in Tables A.2 and A.3.

Second, the entering countries will have to co-finance the EU-funded structural operations to a significant extent. This will be a burden on government budgets in these countries unless there is substitution between the co-financing and existing national public spending. On the other hand, the additional infrastructure investments are likely to stimulate growth in the entering countries. Estimates of these two effects vary a great deal. Moreover, differences in opinion exist about the adequacy of public infrastructure in terms of both quantity and quality (see Funck 2002 and Backe 2002 for further discussions).

The reform of public administration and *acquis* implementation is another source of costs and benefits to the government budgets in the entering countries.¹² In particular, the costs of environmental pro-

¹² Funck (2002) provides a detailed discussion and estimates of costs and benefits. Young and Wallace (2000) assess the enlargement and the politics of EU regulatory policies.

tection have been viewed as a major expenditure item. The European Commission (2001b) provides information on the relevant aspects of environmental financing and the state of the environmental infrastructure in the accession countries. A variety of estimates have been made of the budgetary implications in adopting EU environmental regulations, with the initial high estimates becoming more moderate in recent times. In individual cases the costs of regulatory compliance can be high. An example is Estonia, for which the annual compliance costs have been estimated to be of the order of 4 to 5 percent of GDP, mostly resulting from meeting environmental regulations. This estimate for Estonia is in marked contrast to general estimates that are in the range of 0.5 to 1.9 percent; see Backe (2002). Transport is another item of public infrastructure,¹³ for which the compliance costs are likely to be significant; see Kopits and Szekely (2002) and Funck (2002).

The recent Comprehensive Monitoring Report by the European Commission (2003c) points out numerous difficulties in the progress towards implementing EU regulations in the new member countries. The failures of fulfilment can even risk reductions in EU aid to some entering countries. Another concern is the continued existence of corruption in several entering countries even if progress has been made in reducing it; see European Commission (2003c) for further discussion.

Additional budgetary costs or savings to the entering countries arise from realignment of customs duties, tax harmonization and phasing out of production subsidies. Most entering countries have higher customs duties than EU-15 members and the loss in this revenue item can be up to 0.5 percent of GDP for some entering countries. However, for Estonia there is an estimated revenue increase of the order of 0.2 percent of GDP, since customs duties there will have to be raised after EU entry. With respect to tax harmonization it is estimated that there will be a small positive revenue effect, perhaps 0.5 percent of GDP of the new member states. Similarly, the elimination of production subsidies will have a positive budgetary effect, as they will be phased out gradually. A case in point is the banking sector. Some of the accession countries are still struggling with reducing the subsidies to the banking system that are a legacy of the banking crises in the early years of transition (see Backe 2002, Römisch 2003, Funck 2002, and Kopits and Szekely 2002 for further discussion).

¹³ For example, road improvement for heavy trucks will need to be done.

3.4 Further indirect effects

The 2004 enlargement will induce indirect effects on the economies of the entering countries, which will in turn have implications for the government budgets. As discussed in Section 2, full EU membership is likely to stimulate economic growth in the entering countries. The projected increases in growth will lead to some improvements in the government budgetary balances of these countries. The magnitude of these budget effects depends on the size of the positive growth effect. The budgetary improvement could be significant, of the order of 0.4 percent of GDP; see Backe (2002).

In addition to growth effects, structural reforms as a result of EU membership can yield some improvements in government budgetary balances, but these effects are difficult to separate from the growth effects. EU membership will also bring benefits in the form of reduced interest rate risk premia and increased FDI, though these have to some extent been anticipated before the entry itself. Finally, with EU membership, the entering ten countries will face some tax competition, for example in the taxation of capital. This can, in principle, exert a negative effect on their government budgets. However, since the relevant effective taxes in the entering countries are usually lower than in the current EU-15 members, the downward pressure on the tax rates of the entrants is likely to be small if not non-existent.

The following table summarizes the estimated medium-term fiscal effects of EU membership on the entering countries; the estimates are from Backe (2002).

Table 5.5 suggests that the fiscal effects from EU membership are likely to be somewhat positive in the medium term. In the short run, there will most likely be fiscal strains on the entering countries, as the positive indirect effects will emerge only gradually. Moreover, the magnitude of the indirect effects will depend on the size of the positive growth effects of EU membership.

3.5 Other pressures in the public sector

Recent data on the new member countries indicate that, on the whole, the countries have not cut their public expenditures. In addition to expenditure needs that arise from joining the EU, the new member states will need to reform the structure of their

Table 5.5
Fiscal effects of EU membership
 (medium-term annual effects on the fiscal balance of entering countries)

	% of GDP
Direct effects	
Contributions to EU budget	-1.0 to -1.2
EU structural operations	-0.9 to +1.3
Infrastructure expenditure	?
Admin. reform and <i>acquis</i> implementation	+/- 0
Realignment of customs duties	+0.2 to -0.5
Tax harmonization	+0.5
Phase-out of production subsidies	+0.2 to 2
Indirect effects	
Positive growth effects	0 to +1
Structural reforms	+ (minor)
Tax competition	- (minor)
Reduced risk premia	+ (anticipated)

Source: Backe (2002).

public finances to achieve rapid growth. In comparison to the EU-15 countries, the entering countries have relatively high rates of consumption taxes, similar levels of labour taxation and relatively low taxes on capital and corporations; see Römisch (2003) for a description and estimates of statutory and average effective rates.

Pension reforms have been undertaken in some but not all of these countries. In particular, the Czech Republic, the Slovak Republic and Slovenia have not undertaken major reforms and are facing sustainability pressures, whereas concerns about the sustainability of the pension system are gradually subsiding in other countries (Estonia, Latvia, Hungary and Poland); see Funck (2002, 71–83) for a detailed discussion.

A more universal issue is the need for reform of the education systems in the accession countries. School age populations and to some extent school enrolment in the accession countries (excluding Cyprus and Malta) have fallen and are projected to fall further. Performance in terms of recent international comparisons does not seem to be very good. For example, the PISA results for some accession countries were below the OECD average in 2000 and there is some evidence of a fall in the test scores over time; see Funck (2002, 37–39) for a discussion of the indicators. Improving the ability of the education system to match the changing structure of skill needs is a central element in the challenge of economic

growth in the future; Landesmann (2003) provides some evidence on changing skills.

Some other areas of public spending also face major needs for reorientation and restructuring. Transport industries, for example railways and utilities, are such areas. Cost-benefit analyses of transport infrastructure investments would be important, as there can be a tendency to favour new big projects such as new motorways at the

expense of road maintenance and improvement that may in fact yield higher rates of return. Improvement also appears possible in the social services sector, which appears to have too much manpower. Here improvements in the productivity and efficiency of health care are a significant issue given that health care is a major item of social spending. The modernization of social services and education can also lead to demands for increased wages, which can create another pressure on public finances unless reductions in manpower are carried out in conjunction with reforms in these sectors.

4. Labour markets and social policies

4.1 Employment and unemployment

Figure 5.4 indicates that there are wide disparities in the unemployment rates among the entrants. For

Figure 5.4

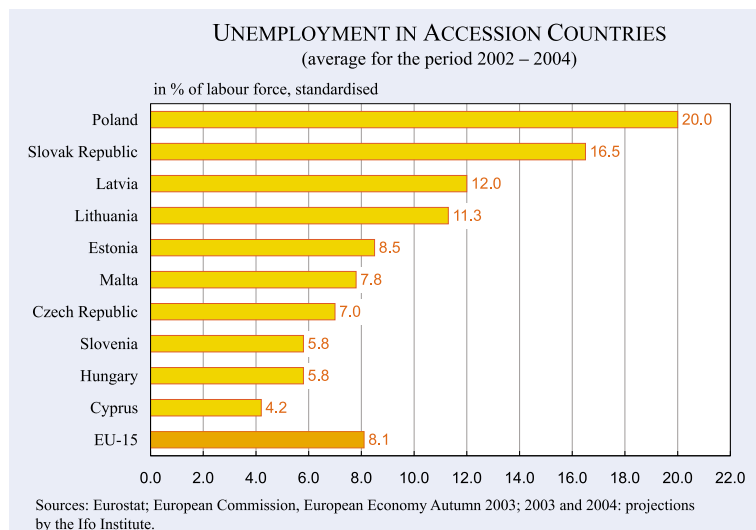


Table 5.6
Employment rate in accession countries
 (employment in percent of population, 15 to 65 years)

Age limits 15 to 65	
Czech Republic	71.4
Cyprus	69.7
Estonia	70.8
Hungary	60.2
Latvia	67.6
Lithuania	71.0
Malta	n.a.
Poland	65.8
Slovak Republic	69.7
Slovenia	68.0
EU	63.2

Source: Eurostat (2003d), German Statistical Office (2003).

some countries unemployment is, in fact, lower than the EU-15 average, whereas other entering countries have quite high unemployment. The 2003 unemployment rates range from the high 20 percent for Poland to the low figure of 4.2 percent in Cyprus.

The relatively high unemployment rates indicate that there is potential for higher output in the accession countries. Employment rates in the accession countries are relatively high, though there is quite a lot of variation among countries. Growth of employment in the new member countries has been fluctuating and it

has not been very high on average. Hungary and Slovenia are to some extent exceptions.

Labour markets in both the entering and the EU-15 countries are likely to face major challenges as a result of the 2004 EU enlargement even if transition periods will make the effects more gradual than would an immediate liberalization. Box 5.1 outlines the transition agreements.

The movement of labour and capital among countries can enhance economic efficiency when it corresponds to comparative advantages of the different economies. These efficiency gains may not be realized if the functioning of labour and product markets in EU-15 and entering countries is not sufficiently smooth.¹⁴ In any case, the efficiency gains will take a long time to realise and different sectors may well experience different patterns and speeds of adjustment. Some results suggest that convergence takes place mostly in services whereas traditional manufacturing will experience only very slow change; see Stehrer et al. (1999). If possible gains do not accrue equally to different parts of the labour force, political and social opposition to these impacts of the 2004 enlargement can be induced.

¹⁴ The establishment of NAFTA, especially the increased prosperity of the US-Mexican border areas, indicates that increased integration need not lead to unemployment and other adverse effects when the labour markets are flexible; see e.g. Hanson (2001).

Box 5.1

Transition periods in labour mobility and social policies

The enlargement treaties give individual countries a possibility to introduce transition periods during which mobility of people from the new member countries to Western EU countries can be limited. Each country can decide whether it adopts the transition arrangements. The general rules for transition periods are:

Free movement of people

The following measures apply to all acceding countries except Cyprus and Malta.

- During a period of two years, national policies will be applied by current members to new member states; they may result in full labour market access depending on how liberal the measures are.
- Before the end of the second year after accession an automatic review by the Commission will be held and upon request by a new member state a further one. The decision whether to apply the *acquis* is left to the current member state.
- After five years the transitional arrangement should in principle end; nevertheless it may be extended by two more years in the member states in case of serious labour market disruptions.
- Up to the end of the seventh year safeguards may be applied by member states.

Austria and Germany are allowed to apply specific national measures in certain critical service sectors. There is also a safeguard clause for Malta.

EU-15 countries are currently deciding on the application of the transition periods. Austria, Finland, France and Germany have decided to adopt them, while Sweden has not yet made a decision. Some other countries, including the UK, that are not bordering the entrants, have decided against transition periods.

Further information: European Commission: Report on the results of negotiations on the accession of Cyprus, Malta, Hungary, Poland, the Slovak Republic, Latvia, Estonia, Lithuania, the Czech Republic and Slovenia to the European Union.

http://europa.eu.int/comm/enlargement/negotiations/pdf/negotiations_report_to_ep.pdf

The wage determination process is also likely to change with tighter product market integration, leading to some wage moderation in the current EU countries and possibly higher average levels of employment.

The 2004 enlargement will affect the structure of labour demand as well as industrial location in both current and new member countries. Low-skilled manufacturing jobs and industry will probably relocate to some extent to the accession countries. In addition, there will be both low and high-skill labour migration from the accession countries to the current members.

Both developments will incur substantial difficulties for a number of the existing EU countries, and they will challenge the flexibility of their political systems. Currently, the wages of low-skilled workers are rather high in the West, as they are supported, among other things, by high replacement incomes provided by the welfare state. If these replacement incomes remain as high as they are, the speed at which manufacturing industries in the West will have to give way may be excessive, and the risk that too few jobs in the service sectors will be created will be substantial. Unemployment could increase. To prevent such a development, it is desirable that the West European welfare states overhaul their welfare systems to allow for the necessary flexibility of wages for low-skilled workers.¹⁵

4.2 Income inequality

Table 5.7 presents data on income inequality (measured by the Gini coefficient).¹⁶ Two characteristics stand out. First, overall the degree of income inequality in the entering countries is similar to that in the EU-15 countries. Second, there is significant variation in inequality among countries. Among the new member states, the Slovak Republic and Slovenia have the most egalitarian income distributions.

¹⁵ In our first report, EEAG (2002), we designed a system of employment tax credits as activating social aid that provides for such flexibility and that allows the western countries to capture the potential gains from trade in an enlarged Europe.

¹⁶ See for example Deaton and Muellbauer (1980, 232-237) for a definition and discussion of the Gini coefficient and other related measures of inequality.

Table 5.7

Gini coefficients for EU and acceding countries

Country	Survey year	Gini coefficient
Czech Republic	1996	24
Cyprus	1997	29
Estonia	2000	36
Hungary	1998 ^{a,b}	24.4
Latvia	1999	31
Lithuania	1999	31
Malta	2000	30
Poland	1999	28
Slovak Republic	1992 ^{c,d}	19.5
Slovenia	1999	22
EU-15 ^e	1999	29
EU range		23-34

Notes: a. Refers to expenditure shares by percentiles of population, b. Ranked by per capita expenditure, c. Refers to income shares by percentiles of population, d. Ranked by per capita income, e: The EU average is calculated as a weighted average of national results (where each country receives a weight that equals its total population).

Source: World Bank: *World Development Indicators 2002*; Eurostat (2003b) and (2003c).

Following the well-known Kuznetz Curve hypothesis, it is often suggested that over time income inequality follows a hump-shaped curve, so that it initially tends to increase and then decrease as countries grow rich.¹⁷ If this hypothesis is true, some increase in income inequality in the new member states is likely to occur. This is all the more probable in the Eastern European and Baltic countries, as trade unions there are weak and collective bargaining is of limited importance and takes place at the firm level if it occurs. However, at this stage of development this increase in income inequality may be beneficial for employment growth in these countries.

4.3 Migration of labour to EU-15 countries

It has been estimated that opening of borders as a result of the enlargement will lead to increased migration of labour from the new member states to the EU-15 countries. This migration process is likely to have very differential impacts on different EU-15 countries, with countries close to new member states, like Austria and Germany receiving the biggest impacts. Belgium, Denmark, Finland, Greece and Sweden may also be affected to a significant degree. It is anticipated that the time pattern of the migration of labour will be hump-shaped with increasing magnitudes in the early years due to learning effects and tapering off late in the current decade.

¹⁷ See Aghion and Williamson (1998) for a discussion and critique of the Kuznetz curve hypothesis.

According to the estimates provided by the European Commission (2001a), the cumulative migration potential in the five-year period 2005 to 2009 could amount to 1.2 percent of the population in the acceding countries and 0.35 percent of the working population in the EU-15 countries. These estimates are based on the study by Boeri and Brücker (2000), but that study filters out the cross country information on economic migration stimuli and infers its long-run migration estimates from observing migrants' previous responses to business cycle variations.¹⁸ Another study by Sinn et al. (2001) comes up with higher estimates for the migration potential in the order of 4 to 5 percent of the population in the acceding countries over a period of 15 years, which corresponds to a migration of roughly 1.5 to 2 percent of the population of the acceding countries within the first five years.¹⁹ Whatever the true migration potential, actual migration will, in all likelihood, be smaller than these estimates of migration potentials simply because the EU has already envisaged administrative constraints on the possible number of migrants (see Box 5.1). There is no study we know of that dares to predict the volume of migration under these constraints.

The structure of migration is an additional issue even if it is difficult to obtain quantitative estimates of it. A first distinction is between short-term and permanent migration. It is anticipated that there will be significant temporary migration – even commuting – into EU-15 countries bordering some of the new member states. Cross-border provision of services is likely to increase as a result of free mobility of labour once any transition restrictions are abolished.

A second distinction concerns the skill level of the migrants. The old impression that migrants move from relatively high positions may be true, but in many cases the jobs taken in the receiving countries will have a lower qualification level than the jobs the migrants left behind. Using different studies, the European Commission (2001a) quotes the estimate that 12 to 14 percent of westbound migration after 1989 has been highly skilled, comprising managers, scientists and students. If these estimates are of any guidance about the future, it seems that the new member countries will face some brain drain.²⁰

The migration scenarios just discussed can perhaps be summarized as indicating that the 2004 enlargement will induce a non-trivial amount of labour migration, which will lead to downward pressures and possible unemployment of blue-collar manufacturing workers and of unskilled labour in services in the EU-15 countries. Moreover, it is likely that a relatively high proportion of the migration from the new member countries will go to Germany and some other countries that are geographically close to the entrants. Thus far, two thirds of east European migrants into the EU have moved to Germany, and one third has spread over all other EU countries.²¹ Unemployment in the latter countries can increase as a result of the migration, which will put pressure on their welfare systems.

Referring to experiences from the 1980s' EU Southern enlargement, which did not lead to very large migration flows, Boeri et al. (2002) suggest that, while migration after the 2004 enlargement will be significant, the impact on the labour markets of the EU-15 countries will nevertheless be fairly moderate. One should note, however, that Eastern enlargement differs substantially from Southern enlargement. First, while Portuguese and Spanish wages averaged about one half of west German wages at the time of accession, the average wage of the Eastern countries is about one sixth of German wages, both measured at going exchange rates. Second, while the Iron Curtain and subsequent legal migration constraints by Western EU countries have prevented mass migration before accession, the Iberian countries had experienced mass emigration before accession. From 1960 to 1974, the time when the Iberian dictatorships ended, and EU membership was applied for (1975), net cumulated emigration from Portugal and Spain had been 5.5 percent of the joint population of these countries despite a simultaneous re-migration from overseas territories. This crucial difference should not be overlooked when forecasts about migration from Eastern Europe are made.

4.4 Social policies towards labour

As was already noted, the functioning of the EU-15 labour markets is a key issue in dealing with the labour market impacts of the 2004 enlargement. It is often argued that, in the EU-15 countries, labour markets are relatively rigid due to fairly high levels

¹⁸ See Sinn and Werding (2001).

¹⁹ Sinn et al. (2001).

²⁰ According to the EEAG (2003, Ch. 5), the issue of a brain drain from Western Europe to North America is currently a concern. A similar brain drain to Western Europe can become a concern for the new member states.

²¹ See Ochel (2001).

of employment protection. Measures to increase labour mobility and wage flexibility would facilitate the adjustments that are needed in EU-15 countries in response to the 2004 enlargement. The major policy objective will be the enhancement of labour mobility between different sectors and types of jobs in the economy.

The challenges will be partly different for the new member states. They are in general likely to benefit from enhanced economic opportunities and faster economic growth. However, the question of labour mobility is also a concern for the new member states since their economies are likely to face major structural change as a result of EU membership. The current high unemployment in several accession countries suggests that labour markets in these countries are not functioning well even though wages are determined in a decentralized manner.

Labour market policies that increase employment protection reduce labour mobility; see Chapters 2 and 3 and also Chapter 6 in EEAG (2002). Similarly, mobility can be decreased by social replacement income schemes. Such schemes play a valuable role in providing insurance against adversity, in particular the incidence of unemployment, but the design of these schemes implies a trade-off between the insurance rationale and the negative effects on labour mobility. The EU-15 and the accession countries face very different pressures as regards these labour market policies. The former will need to restructure employment protection arrangements. In contrast, the latter countries will probably face pressures to introduce some policies of employment protection, at least when these countries grow richer and begin to build up their welfare states. Premature introduction of labour market policies can be dangerous for the accession countries as it can slow down the required labour mobility and structural change.²²

Different measures of labour market regulation for income protection are to an extent substitutable: a lower level of employment protection could be compensated by more generous temporary unemployment insurance and in-work benefits. Retraining schemes and better incentives for life-long learning to educate people in the middle of their working life are another set of measures that improve labour mobility. These kinds of measures will be important

in the current EU-15 countries since the low-skilled workers are likely to be hit hardest by the 2004 enlargement even if transition periods will smoothen the effect of labour competition from the entering countries. Chapters 2 and 3 in this report provide more complete discussions of appropriate policies to enhance the functioning of EU labour markets.

Other social policies to mitigate labour market and regional effects of enlargement will rely on more general transfers and other measures. These will be politically important since the impacts of the 2004 enlargement on different sectors and regions will differ a great deal. On the one hand, some regions and sectors in EU-15 will receive aid to combat economic decline. On the other hand, there will be pressures to provide aid to the poorest regions in the entering countries. Redistribution schemes between regions and countries are going to be the subject of debate as a result of the enlargement.²³ Building up social safety nets will probably be a policy concern in the new member countries. An important consideration for safety nets is the creation of a system of “welfare to work” in order to increase employment in the entering countries (see Chapter 6 of EEAG 2002 for a further discussion of welfare to work). The proposal relies on a system of employment tax credits to enhance work incentives.

It is often suggested that the EU structural funds play an important role in facilitating the growth and convergence processes that were discussed in Section 3 above. The efficiency of the EU structural programme has been questioned in a number of studies; see the discussion in Boeri et al. (2002). The empirical findings have given rise to a fair amount of controversy, which suggests that the structural funding programme must be implemented with great care.²⁴ Some measures are likely to be beneficial, while the effect of others is more questionable. Education is perhaps the clearest example of where EU-level aid can be helpful in promoting growth and thereby in mitigating social problems. Other items such as infrastructure investment can also be useful at least in cases where the region or country has deficiencies in its infrastructures.

²² See Sinn and Ochel (2003).

²³ See Ingham et al. (2002) for an overview of regional policies and further discussion.

²⁴ The empirical assessment of such programmes is subject to a number of econometric issues that have not been fully solved; see de la Fuente (2000).

5. Capital mobility and selected sector issues

Data on the current accounts of the new member countries are presented in Figure 5.5. Evidently, current accounts are in deficit in the new member countries. This is not surprising, given that these countries are amidst a catching-up process with Western Europe. Domestic savings have not been sufficient to finance the relatively high levels of investment required for rapid economic growth. The saving-investment gap has necessitated the financing of investment by foreign funds and, as will be discussed below, there has already been quite significant FDI into the entering countries during the transition process in the 1990s.

Current account deficits in the accession countries are a symptom of both large financing needs for enhancing economic growth as well as possible problems in domestic financial intermediation. Current account deficits can be sustainable if economic growth takes place at a rapid rate. However, if growth starts to slow, then deficit countries become vulnerable to capital inflows, which could trigger exchange rate instabilities and macroeconomic fluctuations. This is discussed at length in Chapter 6. Countering such instabilities would require flexibility in macroeconomic policies, and countries with large public deficits would need to rely on monetary and exchange rate policies.

5.1 Capital movements

Besides international trade, capital movements are another major element of the benefits from

Figure 5.5

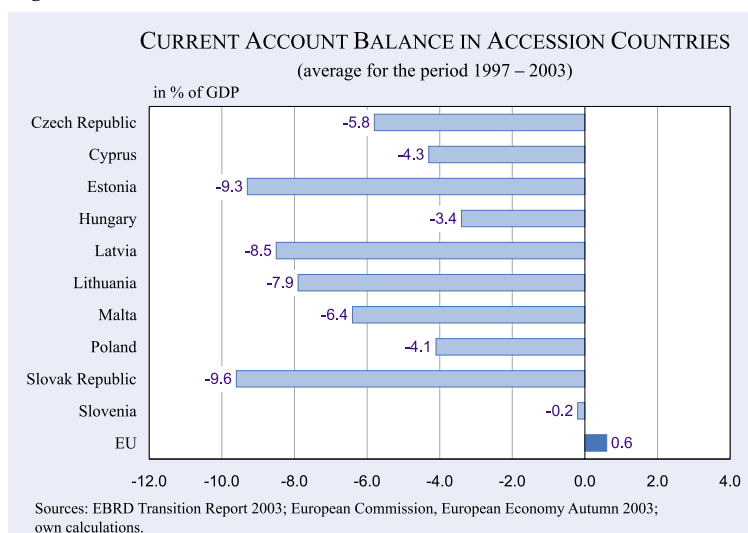


Table 5.8

Foreign direct investments in accession countries
(in percent of GDP – 1998 to 2002 average)

	1998 to 2002
Czech Republic	9.2
Cyprus	6.2
Estonia	8.1
Hungary	3.7
Latvia	4.9
Lithuania	5.1
Malta	14.0
Poland	4.0
Slovak Republic	8.0
Slovenia	3.3

Notes: For Malta the average is calculated for the period until 2001; figures used for 2002 (also 2001 for the Slovak Republic and 2002 and 2001 for Cyprus) are provisional.

Source: Regular Reports 2002 and 2003;
<http://europa.eu/enlargement/report2002/>;
<http://europa.eu/enlargement/report2003/>;

European integration. Capital movements are a potentially important source of growth for new member countries. In general, the 2004 enlargement is likely to reduce industry risk premia for FDI into the entering countries, which is likely to promote FDI. Direct investment in Eastern Europe has already taken place on a large scale.²⁵ As was mentioned above, firms from the old member countries have already moved labour intensive parts of their intermediate product chains to Eastern Europe. The process is particularly pronounced in west Germany where even many the small and medium-sized firms have sought to preserve their competitiveness by shifting activities to Eastern Europe and other parts of the world.

FDI involves the establishment of new plants as well as acquisitions of existing firms in the entering countries.²⁶ Data on FDI into the new member countries are presented in Table 5.8.

A notable feature of capital flows is that they, at least for Central Eastern European and Baltic countries, predominantly take the form of private FDI. In the early years of transition, the privatisation activities were

²⁵ See Sinn (2003).

²⁶ The studies in Alessandrini (2000) provide further details on FDI from EU-15 into Central and Eastern Europe.

apparently a key factor behind the FDI flows. However, the connection between privatization and FDI has become much less pronounced in recent years, which suggests that mergers and acquisitions might be playing an increasing role in FDI inflows; see European Bank for Reconstruction and Development (2003) for further discussion. Capital outflows from the accession countries are currently very limited, but there is some potential for increase, which might be of some importance to those EU-15 countries that border on the new member countries.

With the exception of Slovenia, the entering countries have largely liberalized their capital movements in advance of integration into the EU. There have been significant differences among the entrants in the timing of the liberalization; see Buch (1999). For example, Estonia liberalized capital account transactions as early as 1994. In general, it is difficult to separate the impact of EU membership from the effects of “announcements” and from liberalization measures that have been taking place ahead of actual membership.

Buch (1999) considers the correlation between national savings and investment and finds that, in the period 1991 to 1997, the degree of capital mobility for several of the Central Eastern European countries is of a similar order of magnitude to those of Southern European countries (Greece, Portugal and Spain).²⁷ Moreover, looking at time series, it appears that EU membership of the Southern European countries had differing effects on capital mobility. There were significant positive effects on capital inflows to Portugal and Spain, whereas the change in capital inflows to Greece was much less pronounced (with even a decline relative to GDP). Breuss (2001) estimated that, with full EU membership, FDI into Central Eastern European countries could increase by up to 1.5 percentage points of GDP per year.

5.2 Industrial change

After the downfall of socialism in the early 1990s, Central Eastern European countries came increasingly to operate under the practices and rules of market economies. In the latter, industrial structures and their changes are largely the outcome patterns of relative competitiveness among different sectors in a country and, for sectors with tradable goods, also

of the relative competitiveness of each sector in different countries. The performance of the “open” sectors, whose products are tradable internationally, depends critically on relative cost and price structures among countries. The cost and price structures are in turn determined by aspects of both comparative advantage in international trade as well as by possible scale economies and firm linkages.

Midelfart-Knarvik et al. (2000) suggest that reductions in trade costs with deepening EU integration have the potential of explaining industry location and industry structures in the EU. When the new members join the EU Single Market, the forces of comparative advantage, scale economies and firm linkages will also become increasingly important for them. Using a global computable general equilibrium model with trade costs and scale economies, Forslid et al. (2002) suggest that many industrial sectors with scale economies will be relatively concentrated in specific areas when international integration lowers trade costs. The agglomeration effects would seem to work in favour of both the present EU countries and the entering Central Eastern European countries. However, Forslid et al. (2002) also find that the relationship between trade costs and industrial concentration is not monotonic and forces of comparative advantage become relatively more important when other trade costs approach zero. Effects of comparative advantage in international trade do not favour any particular country or region, and the agglomeration effects are weakened as a high degree of integration with small trade costs is attained. The more symmetrical effects of comparative advantage would, in relative terms, favour countries in northern and southern parts of the enlarged EU. In total, it is difficult to make unambiguous predictions about future developments here.²⁸

The transition away from socialism led to major structural changes in industries of the Central and Eastern European countries. Many of these countries inherited, in terms of relative employment, very big industrial sectors, which were pronouncedly biased towards heavy base industry. The early years of transition led to both absolute and relative declines of manufacturing in these countries. In some of these countries, the second half of the 1990s saw a partial recovery as a result of restructuring,

²⁷ The correlation of national saving and investment as a measure of lack of capital mobility was initially suggested by Feldstein and Horioka (1980).

²⁸ The structure of the Forslid et al. (2002) model does not yield very specific predictions for industries and welfare in the new member states and incumbent countries after the enlargement.

privatization and FDI. Table 5.9 shows, within each country, changes in productivity among different industrial sectors for the period 1995 to 2001 in the

entering Central Eastern European countries. It can be seen that different countries have experienced somewhat different changes in relative productivity

Table 5.9
Relative productivity gains, winner and loser industries 1995-2001

(average annual change in % for total manufacturing (D) and relative gains DA to DN, in percentage points)¹

	Czech Republic	Estonia ²	Hungary	Latvia	Lithuania ³	Poland	Slovak Republic	Slovenia
D	7.2	10.6	12.7	7.5	6.4	9.6	8.2	3.6
DA	-3.9	-7.2	-8.8	-4.8	-4.3	-3.6	-4.1	-0.6
DB	-4.9	2.8	-6.5	0.5	-2.3	-1.4	-8.6	0.2
DC	-16.1	3.7	-9.1	-2.1	9.8	-2.6	0.3	-6.0
DD	-1.8	15.4	-8.0	-2.0	0.1	-1.7	-2.9	-8.6
DE	-1.7	0.8	-1.7	-0.6	-5.2	-1.2	3.6	-7.0
DF	-2.6	4.8	-7.9	-4.2	-12.2	-4.7	-4.0	2.3
DG	0.4	4.8	-9.5	4.2	11.2	-0.8	-2.2	-2.0
DH	1.4	-2.6	-7.4	10.2	0.0	-0.2	-2.9	1.6
DI	-0.4	4.6	-5.0	11.2	1.3	1.0	-2.4	2.1
DJ	-6.8	4.1	-6.1	3.3	-3.2	-1.7	-6.7	-1.5
DK	5.4	3.7	-6.9	-5.3	-2.7	4.4	2.7	3.3
DL	13.3	7.0	18.7	18.1	24.0	6.3	18.8	6.5
DM	2.8	5.6	6.7	-0.2	13.3	0.8	18.8	3.1
DN	1.2	1.2	-5.3	1.0	-4.2	-0.6	0.8	3.1

Notes: 1: Calculations of relative gains DA (1995-2001)- D(1995-2001)= relative gain DA.

2: 1995-2000

Sources: Richter ed. (2003a, 25); WIIW estimates based on national statistics.

Table 5.10

Relative changes in unit labour costs, 1995 to 2001
(average annual change in % for total manufacturing (D) and relative gains DA to DN, in percentage points)¹

	Czech Republic	Estonia ²	Hungary	Latvia	Lithuania ³	Poland	Slovak Republic	Slovenia
D	3.3	2.4	-7.8	6.0	13.8	3.0	1.5	3.6
DA	4.0	2.9	7.1	0.7	2.6	3.5	3.9	0.3
DB	4.1	-3.3	5.8	0.8	-0.3	0.5	8.5	-2.8
DC	14.9	-4.6	9.8	2.0	-11.5	0.4	-1.1	5.7
DD	1.0	-10.0	6.5	2.4	-5.3	2.3	-0.4	6.2
DE	2.9	3.8	-0.2	4.9	6.5	1.7	-1.0	9.3
DF	5.1	11.1	11.1	4.0	-9.7	2.1	2.1	1.9
DG	1.9	11.7	11.7	4.0	-9.7	2.9	1.6	1.9
DH	-1.3	0.1	9.5	-13.2	9.2	-1.7	2.2	0.0
DI	0.4	1.3	6.8	-5.4	-3.7	0.4	3.3	-0.4
DJ	4.6	-2.4	4.5	0.8	-0.6	-0.7	5.4	-0.4
DK	-4.4	-1.7	5.8	6.1	5.2	-1.0	-0.8	2.4
DL	-10.8	-1.7	-13.1	-10.2	-5.9	-3.5	-2.2	-4.7
DM	-2.6	-4.8	9.4	2.1	-10.7	-4.8	-14.4	-5.5
DN	-1.6	n.a.	4.9	-1.9	4.7	-1.1	-1.9	-1.0

Notes: 1: Calculations of relative gains DA (1995-2001)- D(1995-2001)= relative change DA. Positive values indicate weaker, negative values better competitive (cost) performance than total manufacturing (D.)

2: Data for individual industries only available from 1995 onwards. However, average annual change for total manufacturing is available for the period 1995-2000 (6.8%)

3: 1996-2001.

Sources: Richter ed. (2003a, 25); WIIW estimates based on national statistics.

changes.²⁹ The electrical and optical equipment industry has been a big gainer in several countries, notably in the Czech Republic, Hungary, Latvia and Lithuania. The transport equipment industry has been another industry that is becoming more competitive in terms of productivity. In Estonia productivity improvement in the wood industry also stands out. On the other hand, food products, textiles and leather industries have been relative losers in terms of productivity, though there are some variations between countries. Productivity changes are one key factor behind changes in competitiveness. In addition, changes in labour costs are important.

Table 5.10 shows the relative changes in unit labour costs among different domestic sectors for the Central Eastern European entering countries. Certain specific industries, such as electrical and optical equipment and transport equipment, have made gains in cost competitiveness in the entering countries (excluding Cyprus and Malta).

Relative competitiveness in domestic terms is not the only determinant of the overall competitiveness of sectors with tradable products. Changes in overall competitiveness vis-à-vis other changes are not straightforward to measure, though indicators such as sector trade balances for different countries can be used to suggest patterns of competitiveness. Examining sector trade balances, Havlik (2003) suggests that the gains in competitiveness vary a good deal among the entering countries. It appears that textiles, wood and wood products and other (non-classified) manufacturing have fairly generally been gainers in competitiveness in the period 1995 to 2001. For individual countries and sectors some clear results also emerge: Big gainers are (i) the electrical and optical equipment industry in Hungary and Estonia, (ii) transport equipment in the Czech Republic and Hungary, and (iii) coal, refined chemicals and nuclear fuel in Hungary and the Baltic countries.

The results from the indicators suggest that there will be significant diversity in the patterns of industries and their

²⁹ See Havlik (2003) for an overview of industrial change in Central Eastern European countries.

catching-up and growth processes in the entering Central and Eastern European countries. This conclusion broadly accords with studies that consider sector dynamics using models of catching-up in terms of productivity and product quality; see e.g. Stehrer et al. (1999) and Landesmann (2003). The diversity is likely to translate into fairly persistent differences in wages and living standards among countries and among regions within countries.

5.3 Agriculture

In order to assess the effects of the Common Agricultural Policy (CAP) on the new member states, we start with some basic facts about their agricultural systems. These are summarised in the following table:

In terms of total cultivated area, Poland is the most important country, followed by Hungary and the Czech Republic. If measured in terms of civilians employed in agriculture, Poland is also the country with the highest agricultural share, but by this measure agriculture is also quite important for Latvia and Lithuania. The agricultural sector contributes about 2 to 4 percent of GDP. The GDP shares of agriculture are much lower than its employment shares, which suggest that labour productivity in agriculture is quite low and there is scope for significant improvement. Agricultural and food trade between EU-15 and the entering countries increased significantly already during the transition process in the 1990s.³⁰ All of the entering Eastern European

³⁰ See Lukas and Pöschl (2003) for a more detailed discussion.

Table 5.11

Key agricultural data for accession countries – 2001

	Employment in agriculture. in % of total civilian employment	Share of agriculture in GDP (%)	External trade balance in food and agricultural products (million EUR)
CC-10	13.2	3.1	- 2,281
Czech Republic	4.9	1.7	-709
Estonia	7.1	3.2	-347
Cyprus	4.9	3.9	-556
Latvia	15.1	3.0	-361
Lithuania	16.5	3.1	-56
Hungary	6.1	3.8	1,486
Malta	2.1	2.2	-265
Poland	19.2	3.1	-604
Slovenia	9.9	2.0	-363
Slovak Republic	6.3	1.9	-506

Source: European Commission, Eurostat and Directorate General for Agriculture, **Agricultural statistics**; http://europa.eu.int/comm/agriculture/agrista/2002/table_en/2012.pdf

countries except Hungary exhibit trade deficits in food and agricultural products.

The data show that agriculture is of major political and social concern to the entering countries. Reforming their agricultural sectors as well as the integration into the EU Common Agricultural Policy will be an important task for the years to come. Agriculture is also an important policy concern as it is a huge item in the EU budget (see Section 3 above).

Considering the economic aspects, it can be noted that for the EU-15 economies and also for EU-25 as a whole the effects of the enlargement stemming from agriculture on the aggregate economies will be fairly limited. This is because the role of agriculture in GDP is relatively small even if agriculture is an important policy concern. Interestingly, the role of agriculture in the Southern European countries was of similar magnitude upon their entry in the EU in the 1980's. The southern countries provide a point of comparison for developments in agriculture: The share of agriculture in GDP and employment decreased gradually after the entry of the southern countries into the EU.

What are the likely effects of the 2004 enlargement for agriculture and food industries in the entering countries? The abolishment of tariffs and other protective measures will no doubt lead to increased trade between EU-15 and the entering countries that have major agricultural and food processing sectors.³¹ This should increase agricultural production in several new member countries. There are, however, some factors that will limit this tendency. Quota restrictions will limit increases in agricultural output and EU regulations on food quality and safety also have a restrictive effect. The latter are imposed on the new member countries from the beginning of EU membership. The tight regulations will make some of the food industry firms in the entering countries non-competitive, but the regulations are also likely to lead to improvements in food quality in the longer term. More generally, the future of agriculture and the food industry in the entering countries will significantly depend on how CAP develops in the coming years. Future changes in CAP are in turn heavily dependent on what happens to agriculture in the WTO global trade negotiations.

³¹ Currently, the accession countries (excluding Cyprus and Malta) tend to have high import tariffs for agriculture and food processing but hardly any export tariffs. In contrast, EU-15 has both tariffs; see Lejour et al. (2001).

There will be some transition periods in the adoption of CAP by the new member countries. These imply a gradual percentage increase in the EU support in the form of direct payments and other schemes. The development of productivity in agriculture and food processing is clearly an important issue for agriculture. There appears to be much scope for narrowing the productivity gap in agriculture between the EU-15 and the entering countries. For example, small farms still dominate agriculture in Poland. For the record, it can be noted that the agricultural productivity gap between the southern European countries and the other EU countries did not close very rapidly; see European Commission (2001a).

The structural changes in agriculture in the entering countries imply a significant movement of labour from agriculture to other sectors and possibly also to other countries. This movement was already in progress in the 1990s, as employment in agriculture was falling; see European Commission (2001a) and Ingham and Ingham (2002b) for details. The movement of labour away from agriculture can be a major source of immigrants from the accession countries to EU-15 member states. It appears, however, that the across-the-border migration flows due to the structural change in agriculture are likely to be limited since much of the "released" labour will be relatively aged and low-skilled. Thus this movement is more likely to be towards other domestic sectors and retirement.

6. Conclusions

The 2004 EU enlargement will most likely yield major benefits to the new member countries in the long run. The new members will be able to capture gains from trade in goods and services and will moreover benefit from a continued inflow of financial and real capital. In fact, the capital inflow is already very substantial as revealed by the current account deficits in the order of 4 to 6 percent for the major countries. Most of the capital flows are in the form of direct investment by present EU member countries, largely driven by the attempt to profit from currently very low wages. Many firms in the existing member countries outsourced labour-intensive parts of their intermediate product chain to Eastern Europe already in the pre-accession stage and this development is likely to gain further momentum after the formal accession. Without doubt, these processes will significantly

accelerate the economic growth of Eastern Europe. However, even under optimistic assumptions, catching-up with the EU-15 countries will be a time-consuming process that will take several decades in most cases.

In principle, the existing EU member countries will also participate in the gains from trade. However, the internal adjustment processes necessary for such an outcome may involve significant costs and frictions. In particular, it will be difficult to administer the wage cuts for the low-skilled that are necessary to prevent a further increase in unemployment and an excessive dismantling of labour intensive production. EEAG (2002) suggested a system of employment tax credits as a way of activating social assistance that would generate the necessary wage flexibility without reducing the living standards of the poor. Moreover, in Chapters 2 and 3 of this report, we point to reforms of labour market institutions that would also enhance wage flexibility. As regards pay-setting practices, such reforms should entail measures to promote relative-wage flexibility among sectors, regions and occupations.

The economic consequences of EU entry will also depend on the policies adopted by the new member countries themselves. The entering countries currently have fairly fragile macroeconomic situations. Many of them have significant public sector deficits even if the levels of public debt are low or moderate. Sustainability of public finances can become a major policy concern for several of the new member countries.

Significant transfers from the EU notwithstanding, the new members will face pressures on public spending after enlargement. The countries will have to co-finance EU-funded projects, and implementation of EU regulations will entail fiscal costs. Improvement of the infrastructure, including reforms of the social sector and education, will be another major item in the public spending of several new member countries. Some other fiscal costs and savings coming from EU membership contributions and alignment with EU customs and taxes will also have to be met. In total, the fiscal effects are not straightforward and there can be small gains or losses for the different new members.

Many of the accession countries have high unemployment, so that there are significant underutilized resources. At best this can provide further impetus

for rapid economic growth. The same characteristics represent major labour migration potential from the new members to EU-15 countries. This pressure will be particularly strongly felt in countries such as Germany and Austria that are geographically close to the new members.

EU membership and fully open borders will gradually lead to changes in industrial structure as well. The 1990s decline of manufacturing in the Baltic and Central European accession countries has been reversed in most recent years. Some manufacturing sectors have seen a recovery, and it is probable that this will continue in the future. Significant amounts of fairly low-skill manufacturing industry and services may gradually shift from EU-15 to new member countries.

Agricultural productivity is evidently quite low in the new member states with significant potential for improvement. This can lead to increased agricultural and food production in some of these countries, though food safety and CAP regulations imply limitations in this respect. The future of international WTO negotiations will also play an important role for the development of agriculture and the food processing industry in the new member countries.

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Appendix: Basic data on accession countries

Table A.1
Key economic indicators of EU 15 and accession countries (A10) in the year 2001

	EU 15	A 10	Poland	Czech Republic	Hungary	Slovak Republic	Slovenia	Lithuania	Cyprus	Latvia	Estonia	Malta
Area ³⁾	3191.1	738.5	312.7	78.9	93.0	49.0	20.3	65.2	9.3	64.6	45.2	0.3
Population	377.1	74.8	38.6	10.3	10.2	5.4	2.0	3.5	0.8	2.3	1.3	0.4
GDP (bill.)	8843.1	411.7	204.1	63.3	57.8	23.3	20.9	13.4	10.2	8.5	6.2	4.0
GDP per capita (PPP) ¹⁾	100.0	47.7	40.5	59.0	52.8	48.2	69.8	39.6	74.0	33.4	39.8	55.0
Share of agriculture in gross value added (in %)	2.1	4.1	3.8	4.2	4.3	4.6	3.1	7.1	4.0	4.7	5.8	2.4
Export share in GDP (in %)	35.9	48.5	28.1	71.3	74.3	75.9	57.8	50.9	46.8	44.4	89.4	87.4
Import share in GDP (in %)	34.7	52.4	31.8	75.8	75.8	84.6	58.2	56.4	51.5	55.6	93.1	92.2
Unemployment rate (in %) ⁵⁾	7.7	14.4	19.9	7.3	5.6	18.6	6.0	13.1	3.9	12.8	9.1	7.4
Share of exports ³⁾ of EU 15 to (in %)	-	11.3	3.6	2.8	2.4	0.8	0.7	0.3	0.1	0.2	0.3	0.1
Share of imports ³⁾ of EU 15 from (in %)	-	10.3	2.5	2.4	2.4	0.8	0.9	0.3	0.3	0.2	0.3	0.2
Share of exports ⁴⁾ to EU 15 from (in %)	-	61.2	69.2	68.9	74.3	59.8	62.2	50.2	52.3	61.2	69.5	44.6
Share of imports ⁴⁾ from EU 15 to (in %)	-	56.6	61.4	61.8	57.8	49.7	67.6	44.4	50.8	52.6	56.5	63.0

Notes: 1) In purchasing power parities (as a percent of EU average)

2) 2002

3) Share of exports to (imports from) EU 15 in total exports (imports) of EU 15 in the definition of foreign trade statistics.

4) Share of exports to (imports from) EU 15 in total exports (imports) of accession countries (A 10) in the definition of foreign trade statistics.

Source: Ifo Institute (2003).

Table A.2

Financial framework for enlargement 2004-2006
Indicative allocation of Commitment appropriations - in % of the respective country's GDP for 2003

	Cyprus	Czech Republic	Estonia	Hungary	Lithuania	Latvia	Poland	Slovenia	Slovak Republic	Malta
1. Agriculture	0.3	0.5	1.3	0.8	1.7	1.6	0.9	0.6	0.8	0.3
1a Common Agricultural Policy	0.1	0.3	0.6	0.5	0.6	0.4	0.4	0.2	0.3	0.03
1b Rural development	0.2	0.2	0.7	0.3	1.1	1.2	0.5	0.4	0.5	0.27
2. Structural Actions after capping	0.3	1.2	3.2	1.6	3.3	4.4	2.3	0.6	2.1	0.7
3. Internal Policies	0.1	0.2	0.8	0.3	1.3	0.8	0.4	0.4	0.5	0.2
10. Compensations	1.0	0.4	0.7	0.1	0.1	0.1	0.3	0.4	0.1	2.1
Total Appropriations for Commitments (Heading 1,2 and 3)	1.7	2.3	5.3	2.8	6.5	6.9	3.9	2.0	3.5	3.3

Note: The calculations for Malta are per GDP of 2002

Source: EU: http://europa.eu.int/comm/budget/pdf/financialfrwk/copenhagen_package/webtablesEN.pdf.

EBRD Transition Report update 2003; own calculations.

Table A.3

**Financial framework for enlargement 2004-2006
Indicative allocation of Commitment appropriations
in % of total Commission budget for 2004**

	Total 10 Acc. Countr.	EU-15	EU-25
1. Agriculture	3.3	38.3	41.6
2. Structural Actions	7.5	26.8	34.3
3. Internal Policies	1.5	5.9	7.4
4. External Actions		4.2	4.2
5. Administration	0.6	4.5	5.1
6. Reserves		0.4	0.4
7. Pre-Accession Aid		2.8	2.8
8. Compensation	1.2		1.2
Total Appropriations for Commitments (Heading 1, 2 and 3)	14.1	82.9	97

Source: EU.

http://europa.eu.int/comm/budget/pdf/financialfrwk/perspfin/tbl20002006eur15_en.pdf.

http://europa.eu.int/comm/budget/pdf/financialfrwk/ip03217/ip03217_en.pdf.

http://europa.eu.int/comm/budget/pdf/financialfrwk/copenhagen_package/webtablesEN.pdf.

http://www.europarl.eu.int/committees/budg/budg2003/preparation_inter_en.htm

Calculations by the EEAG.