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Socio-economic Discrepancies in the Enlarged EU

Rapporteur
JUDY BATT

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Report of the Reflection Group on the "Long-Term Implications of EU Enlargement: the Nature of the New Border"

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Members of the Reflection Group on "Long-term Implications of EU Enlargement: The Nature of the New Border"

Chairman: **Giuliano Amato**, Robert Schuman Centre and Department of Law EUI, Florence

Judy Batt, University of Birmingham, Rapporteur

Maarten Brands, University of Amsterdam

Lord Dahrendorf, Bank Gesellschaft Berlin (UK)

Jean Marie Guéhenno, National Audit Office, Paris

Elemér Hankiss, University of Budapest

Christopher Hill, London School of Economics and Political Science

José Maria Maravall, Juan March Institute, Madrid

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Jacques Rupnik, Centre d'Etudes et de Recherches Internationales, Paris

Aleksander Smolar, Batory Foundation, Warsaw

Rüdiger Stephan, European Cultural Foundation, Amsterdam

Renate Weber, Helsinki Committee on Human Rights, Bucharest

Jan Zielonka, Robert Schuman Centre and Department of Political Science EUI, Florence

Summary

- The socio-economic gap between West and East Europe is wide, and certainly wider than was the case in previous enlargements of the EU. After a deep recession in the early 1990s, growth has now resumed in several countries and the gap between these and the West has begun to narrow.

-Some CEE economies have clearly done better than others, so differentiation among the applicants to the EU is essential. The sustainability of high rates of growth is, however, open to question, and the gap will certainly not have disappeared before the accession of the first wave of CEE states.

- The decision to enlarge the EU eastwards has now been taken, on political and geo-strategic grounds. Nevertheless, economics remains the key determinant of the pace and methods by which integration of the new members can be achieved.

- While enlargement can be shown to bring many benefits not only to the new but also to existing member-states, public opinion on both sides is ambivalent. In the West, there are fears of increased competition from low-wage labour and the relocation of production to the east. In the East, there are concerns about the capacity of wide sectors of industry and agriculture to withstand the competitive pressures of full integration into the single market.

- A strategy of phased transitional arrangements is necessary to allow new member-states to adjust and develop before taking on the full acquis especially in such fields as labour regulation and the environment, which would pose a heavy burden on the CEE's capacity to catch up, and thus increase the costs of integration to both existing and new member-states.

- An increase in the EU budget to ease the integration of new members seems to be ruled out politically, but budgetary reform is essential. Budgetary transfers will retain an important role in managing adjustment in both new and existing member-states.

- The challenge we face is to avert not only the development of a 'two-tier' EU, but also deepening the divide between the first and second wave accession states. The latter should be included as far as possible in all preparations for enlargement. Sub-state regional cross-border cooperation can also make a vital contribution here.

- New costs are unavoidable in adjusting to the challenges of the new Europe and the new global economic context, whether the EU enlarges or not. But enlargement represents the most promising strategy available for all concerned.

I. Assessing the Socio-Economic Gap

There is no doubt that there is a large socio-economic gap between the existing member-states of the EU and the prospective new entrants from Central and Eastern Europe. It is, moreover, larger than that which existed between member-states and new entrants at the time of previous enlargements which brought in Ireland (1973), Greece (1981) and Spain and Portugal (1986). But exactly how large that gap is, and whether it has narrowed or become wider and deeper as a result of the policies of post-communist economic transformation pursued over the past ten years, are questions of intense current controversy among economists.

Comparative data using official market exchange rates against the US dollar present a very bleak picture. Per capita GDP of the ten CEE associates in 1997 ranged from the lowest at \$1,198 in Bulgaria and \$1,532 in Romania to the highest at \$5,167 in the Czech Republic and \$9,039 in Slovenia. This can be compared with the EU average of \$21,640. Only one of the five current front-runners for early EU accession, Slovenia, has a per capita GDP approaching that of the poorest existing member-state, Portugal (\$10,167). The others (Poland, Hungary, the Czech Republic and Estonia) are all about half, or well below half that.

However, a more encouraging picture is provided by comparative date based on purchasing power parities, which give a more realistic impression of the differences in the standard of living between countries. This is the basis for the data used by the European Commission in its *Agenda 2000* report (see table 2). The socio-economic gap remains formidable, however, and still wider than has been the case in any previous enlargement. And while growth has resumed in most countries, reaching quite rapid rates in some countries (notably Poland and the Baltic Republics), the estimated level of real GDP is still below, even well below, its 1989 level in all countries except Poland and Hungary. In other words, in quantitative terms, the socio-economic gap appears to be wider today than it was ten years ago. Moreover, the sustainability of current growth rates is open to question in some countries. The Czech Republic seems set for at least a year or two of stagnation following its early apparent success in weathering the shock of transition, while Romania's economy has suffered a sharp downturn since 1996.

Table 1. Per capita GDP in EU and CEE countries (US$, 1997)

EU Member States	
Austria	25,666
Belgium	23,843
Denmark	32,173
Finland	23,319
France	23,319
Germany	25,632
Greece	11,474
Ireland	20,021
Italy	19,919
Netherlands	23,094
Portugal	10,167
Spain	13,522
Sweden	25,720
UK	21,848
EU (15)	21,640
CEE Group 1	
Czech Republic	5,167
Estonia	3,127
Hungary	4,398
Poland	3,502
Slovenia	9,039
CEE Group 2	
Bulgaria	1,198
Latvia	2,238
Lithuania	2,574
Romania	1,532
Slovakia	3,656

Source: D.Vaughan-Whitehead

Table 2 Per capita GDP on Purchasing Power Parity basis (1995)

	% EU average	ECU per capita
EU average	100	17,260
<u>EU member states</u>		
Luxembourg	169	29,140
Denmark	116	19,960
Germany	110	19,070
France	107	18,520
Italy	103	17,770
UK	96	16,580
Spain	77	13,230
Portugal	67	11,620
Greece	66	11,320
<u>CEE Group 1</u>		
Slovenia	59	10,110
Czech Republic	55	9,410
Hungary	37	6,310
Poland	31	5,320
Estonia	23	3,920
<u>CEE Group 2</u>		
Slovakia	41	7,120
Lithuania	24	4,130
Bulgaria	24	4,210
Romania	23	4,060
Latvia	18	3,160

Source: *Agenda 2000*

Average monthly wages at market exchange rates are very low indeed by comparison with those of existing member-states, for example, US$102 in Bulgaria, US$282 in Hungary, US$383 in Poland, and US$897 in Slovenia, at the end of 1997. Unemployment has risen in all countries from virtually zero at the end of the communist period to levels approaching, and in some cases exceeding, the current EU average. Official figures almost certainly understate the extent of the problem. As also applies to unemployment figures in the West, the introduction of restrictions on eligibility to register as unemployed, and extensive use of early retirement provisions may deflate the real picture. Recent trends in some CEE countries to a halt or modest reduction in unemployment may not be sustained, given doubts about the sustainability of current growth rates; widespread evidence of continued over-employment in some sectors of industry and, especially, agriculture; the underdevelopment of active labour market policies and mechanisms; and the ever-increasing challenge posed by exposure to international competition.

The extent of officially-defined poverty in CEE is quite alarming: for example, in Poland, 36 per cent of all employees were found to be below the poverty line in 1994. According to household surveys, the number of people living below the subsistence minimum in Hungary reached 3 million in 1995, over one-third of the total population. A similar proportion was found in Romania in 1996, while in Bulgaria, over 70 per cent were living below the poverty line in 1998. The low levels of economic development in general, and the specific problem of poverty, are undoubtedly factors influencing the wide discrepancies between East and West Europe in key social indicators such as life expectancy. For example, in 1993, male life expectancy was behind the EU average by 8 years in Hungary, 6 years in Romania, 4.6 years in Poland, and 4.3 years in Bulgaria.

What figures such as these actually imply for our assessment of the socio-economic gap in an enlarged of the EU, however, is open to debate. They have to be set in context by taking into account firstly, the extent of unregistered economic activity and the impact of informal social practices; and secondly, by assessing the underlying dynamics of socio-economic change in the post-communist transformation. To what extent do official figures really give us an accurate picture of the extent of the socio-economic gap as it stands today? And how quickly can we expect the gap to close?

The existence of a sizeable unrecorded "second economy" in CEE long pre-dates the transition to the market. Under communist central planning, endemic shortages and unreliable supplies of even the most basic goods and services drove consumers onto the black market. Low wages in official employment usually had to be supplemented by moonlighting, or outright theft of materials, components etc from the state employer, in order to buy or barter for goods unavailable in state shops and pay the bribes necessary to obtain services (e.g. housing allocation, health care) provided by state authorities. Throughout the region, urban households' food supplies depended vitally on family connections in the countryside, or on the cultivation of allotments on the edge of the city. Subsistence farming has been a vital factor in poorer economies such as Bulgaria and Romania.

In many respects, the state in "real socialism" proved an unreliable guarantor of the secure and steadily rising standard of living it promised. A well-known quip of the time was that "he who does not rob the state robs his own family". Habits of evasion of the state became at least as deeply entrenched as those of dependency on it. Learned self-reliance and individual resourcefulness are thus at least as characteristic of the peoples of post-communist Europe as "learned helplessness", and have clearly been called into play in the new conditions of transition to the market economy. Recent estimates in Hungary, for example, suggest that unregistered economic activity may account for 30-50 per cent of GDP. Whether the unregistered economy has become larger or not with the transition to the market is hard to assess. But without some reference to its mitigating impact on the socio-economic shocks of transition it is hard to explain the extraordinary resilience and stability of the societies of the region during the 1990s.

To what extent does this modify the picture given by official statistics of the socio-economic gap between East and West? This depends on whether the level of unregistered economic activity is in fact higher in CEE countries than in the EU. It almost certainly is on the average, although high levels of such activity are also estimated in some south European member-states. While unregistered activity may modify the official picture as far as the distribution of incomes is concerned, it does so in largely unknown and only hazily understood ways. There is hardly reason for rejoicing. While unemployment and poverty for some groups may be less intolerable than official data would imply, no doubt some of the poorest are still excluded from the "second economy" through lack of skills, resources and personal connections. On the other hand, the incomes of some of those in the highest income brackets may be even further augmented.

More important than the effects on the pattern of income distribution, however, is the close association between a large "second economy" and corruption in government and the state administration. States weakly embedded in societies that continue to mistrust and evade them, states captured by the interests of narrow self-serving elites, are not going to be in a position to devise or implement appropriate social policies to complement the development of functioning market economies. They are neither likely to be capable of gathering taxes effectively nor of allocating public resources efficiently and fairly. They are thus less likely either to deal adequately with the immediate needs of their societies, let alone to meet the challenges of eventual integration into the EMU. Thus while in certain respects and in the short term, the unregistered economy may act as a safety valve for CEE economies in transition, taken in a broader perspective and in the longer term, it may signal a more intractable source of divergence between East and West Europe than the statistically quantifiable gap itself.

Assessments of the prospects for closing the gap between East and West in the foreseeable future depend very much on prior assessments of what has so far been achieved in the economic transformation in CEE. Have the policies pursued since 1989 served to set the economy on a new path, opening the way for eventual convergence with the EU? To what extent do legacies from the communist past still exert a drag on progress? Has the approach to transition created new problems of its own? Some would argue that, having been executed at vast and unnecessary social cost, the policies pursued have not lessened the gap but widened it, storing up an array of explosive tensions that cannot be managed, but could even be further exacerbated, by persisting in the standard recipes of liberalisation and adaptation to the demands of the EU's *acquis*. There are at least two ways of answering these questions, presented below.

The most critical accounts of CEE developments since 1989 present the following arguments. The transition policies pursued have failed, as demonstrated by the dramatic falls in output of 20-40 per cent in all countries of the region in the first two to three years of the transition and slow recovery thereafter. The collapse in industrial output has been particularly dramatic, and recovery is hampered by lack of expertise in international markets, poorly developed commercial infrastructure, inexperienced entrepreneurs, and tight monetary policy which starves the economy of credits. Sharp falls in real wages and incomes have led to sudden and widespread social impoverishment, a vast increase in social and regional inequalities, and a surge in the crime rate. The structures of the communist state that provided, however imperfectly, the basic essentials of social protection have been dismantled in a reckless pursuit of neo-liberal dogma, and no adequate replacements have been put in their place. New private health insurance and pension schemes are likely to be less efficient than the system of publicly financed and state-managed social security and certainly more risky. They tend to privilege the already privileged. The NGOs that have sprung up in the welfare field are either low-capacity and low-quality substitutes for public services, or they favour the rich. The net result of nearly ten years of this "leap in the dark" has been a pervasive sense of social insecurity and deep disillusionment that threaten to undermine the fragile new democratic order itself. CEE is thus converging not on the "European model" but on the "Latin American" one.

The alternative view is also critical of progress since 1989, but from the opposite perspective: while the basic policies have been correct, they have not been implemented consistently enough, and in certain respects, especially in the field of social welfare reform, the transition has been "marking time". Proponents of this view are more sanguine about the impact of the policies pursued in the transition. Some of the decline in output was unavoidable, and some is more apparent than real. Communist-era statistics were notorious for 'padding', as enterprises had strong incentives to report better results than actually achieved. Some output was in fact worthless, unsaleable on world markets, environmentally damaging, and even 'value-subtracting'. The phenomena of poverty and unemployment had their roots in the former communist system. Their recent growth thus represents at least in part merely the increased visibility of what was previously hidden.

Moreover, proponents of this line of argument point out that not all post-communist transitions have had equally deleterious socio-economic consequences. The more consistent and determined the liberalism of government economic policies, the "softer" the socio-economic impact: stabilizing the economy and restarting growth has made possible the recovery of wages and incomes, with rising social transfers and improved services. It is therefore essential to differentiate between groups of post-communist countries, and to avoid sweeping generalisations that confuse the issue.

While some bewail the collapse of the welfare states of CEE, others bewail the extent to which they have preserved intact basic features of the command economy, such as overcentralisation, waste, rationing, shortage, paternalism, rent-seeking, corruption. In this view, it is precisely because of the *lack* of thorough and effective reform that the pension system, health care and family allowances (not to mention education) have continued to be biased toward the well-to-do.

Far from seeing the citizens of new democracies as yearning to exchange their new liberties for a return to greater protection by the state, survey evidence can be put forward which demonstrates stronger popular inclinations towards individualist than collectivist values. There are thus grounds for hope that people can be liberated from their "fiscal illusions", once they are made aware that that social services are not "free" and that their taxes are being redistributed in ways that have not been negotiated with them. This suggests that reform is indeed politically feasible, insofar as the aim is not to suppress welfare spending for good but to adjust it realistically and temporarily to the overall performance of the economy, to restructure and streamline - in other words, to cut back social expenditures now in order to raise them later on. Welfare reform in CEE does not inevitably mean "Latin Americanisation", but can be designed to be compatible with similar reforms under way in west European models of the welfare state.

The reality of what has happened in CEE in transition probably lies somewhere between these two polarised, and rather ideologically-driven views. Significant change has happened, but it has not necessarily followed the trajectory anticipated by the "Grand Project" of transformation. What has taken place is a great variety of small transformations, which cumulatively do add up to significant change. A whole new range of organisations has emerged for the public management of welfare or for private/civic social provision both on central and local levels. Their interaction may result in strong institutional relations safeguarded by the rule of law as well as by new individual strategies and public awareness. At the same time, old institutions, embodied in organisations (ministries of social affairs, labour unions, hospitals) or in policies, values, habits of mind (the propensity for centralisation, corruption, forced solidarity) may show immense resistance to reform. The "communist welfare state" *is* being transformed, but its relatively tightly knit safety net has not disappeared. The welfare regimes in CEE have been instrumental in cushioning the blows of marketisation and privatisation, not to speak of the worst economic recession this century.

Piecemeal, incremental and improvised change - "muddling through" - is probably inevitable in the context of a task of such unprecedented scope and complexity as the post-communist transformation. It may even be desirable in a context of mounting uncertainty concerning the end-state of the transformation process: which model of welfare state should CEE countries choose from the ever-changing Western menu? Experimentation is no evil. We should be prepared for slow and uneven progress, trial-and-error, recognising that minor moves, creeping changes can accelerate, cumulate and become irreversible - while not forgetting that they can also get diverted and burn out prematurely. Keeping change on track is less a matter of having the right all-embracing blueprint, than of defining clear priorities which can be realised alongside the necessary political compromises.

In conclusion, we can acknowledge that the socio-economic discrepancies between East and West are large, while recognising that precise quantitative measurement is problematic. Nevertheless, some CEE states have done much better than others, so differentiation is essential. But differentiation should not lead to over-optimistic assessments of the extent and future pace of convergence between even the most advanced transition economies and the EU average. Recently, faster growth in the front-running transition economies than in the EU economy has begun to narrow the gap; but nevertheless progress will be gradual, and will certainly not be achieved before accession of the current front-runners. Catching up to the EU average by 2015 will require sustained levels of growth in the front-running states of 5-9% per annum. Whether such levels are feasible has much to do with the terms and conditions of CEE states' integration with the EU.

Economic growth is the key to closing the gap in incomes and standards of social welfare between East and West. Social reform has so far lagged behind economic transformation in CEE. This is not only, and possibly not mainly due to the alleged "neo-liberal" bias in policy. It has to do with the lack of resources in terms not only financial, but human: the lack of government time and attention, low levels of administrative competence, and uncertainty as to the appropriate "social model" to be adopted in a changing Europe.

II. What are the Implications for EU Enlargement?

None of the ten associates is currently economically ready for accession in the immediate future. This has not, however, prevented the EU and its member-states from deciding to go ahead with enlargement, and to begin accession negotiations with the five CEE associates deemed to have reasonable prospects of meeting the economic requirements for entry early in the next century (Poland, the Czech Republic, Hungary, Estonia and Slovenia). The overriding arguments in favour of enlargement are recognised as essentially political and geo-strategic in character. That said, it remains the case that economics is at the core of EU integration. If economics has not been allowed to decide the argument for or against enlargement, nevertheless economics does determine the pace and methods by which it can be achieved.

It can be argued that the economic benefits of eastward enlargement to both the existing EU members and new entrants from CEE outweigh the costs. Enlargement provides existing EU member-states' firms with extensive new trading opportunities, and an opportunity to enhance their global competitiveness by taking advantage of low-cost, relatively high-skilled labour in the new eastern member-states. CEE economic leaders have long argued for 'trade not aid': open access to the EU market will promote quicker, more effective and sustainable adjustment on the part of their firms than any aid programme. This has now been achieved (with the exception of trade in agricultural products), with the implementation of the trade provisions of the 'Europe' Agreements. Direct investment by western firms - one of the most important sources of growth and innovation in the region - is already bringing in technology, managerial and commercial know-how. The CEE new entrants have good prospects of becoming new 'economic tigers', a significant dynamising factor in the European economy, to the overall benefit of the whole.

But the benefits will inevitably be unevenly distributed among sectors, regions and states. Among existing member-states, to judge by the experience so far, it has been primarily German and Austrian firms which have seized the new opportunities in the east. Other member-states have been slower to recognise the potential gains, and public opinion throughout the EU tends to focus far more on the costs than the benefits. Opening up to the poorer states of the east is seen as a threat especially by less-skilled labour and less dynamic economic regions in the west. These face the prospect of competition from immigrant workers prepared to work for lower wages, and from the relocation of production to the east. The charge of 'social dumping' will almost inevitably be heard, and governments will be pressed to respond. If outright protectionist measures are ruled out, the insistence that Central and East European states meet the acquis, for example, in the environmental field, in full and without transitional arrangements, could have the same effect.

Question marks remain about the capacity of large sectors of industry and agriculture in the east to withstand the competitive pressures of full integration into the European single market. Rising unemployment could well afflict the east more severely than the west. Stagnation in living standards and depressed opportunities could prompt emigration of the most valuable, highly skilled workers. Even if the socio-economic discrepancies between existing and new EU member-states diminish as a result of enlargement, regional inequalities within new member-states could well increase, as experience with past enlargements has shown.

The political economy of enlargement thus raises the real danger of widespread political disillusion in both western and eastern states of the Union. In order to head off this danger, the EU has to devise effective social and economic policies, and back them up with credible political arguments.

First of all, an appropriate transitional strategy of phased integration of the new entrants has to be devised. While existing member-states will no doubt be ready to accept this, the temptation to use this as an opportunity to exploit the possibilities of the social and environmental acquis to impose high barriers on the new entrants has to be avoided. These would only benefit the existing member-states in the short term, at the expense of delaying the essential adjustments in the new entrants, and throttling their chances of attaining a sustainable path of maximum growth. The long term costs of such an approach to the EU as a whole, and in particular to its richer members, have to be constantly reiterated in political debates.

At the same time, the new entrants have to be given a clear schedule for the phased implementation of the acquis in the course of accession and in the years immediately following it. This is necessary not only to bolster the political commitment of the governments of new entrants to press on with painful reforms and complex adjustments, but also to convince 'threatened' producers and workers in existing member-states that the temporary arrangements are finite in duration and will lead to a genuinely 'level playing-field' in the shortest possible time.

The EU is well placed to assist the new entrants in preparing themselves for enlargement, and the accumulated expertise and practical experience it possesses in education and training, the development of active employment and labour-market policies, institution-building and administrative modernisation should be deployed to the full. There may be some resistance on the part of member-states to the extension of the EU's activities into these fields, and there is the danger that as a result the EU may become more closely involved in the internal affairs of the new member-states than any of the existing member-states has been willing to allow. The spectre of a 'two-tier' Europe once again raises its head, and will have to be confronted.

At the same time, the 'second wave' applicants must be included, in order to prevent a further 'tier' developing in Europe as the integration of 'first wave' applicants procedes. Here, the challenge is to maintain and further develop cross-border economic cooperation in the East, which brings benefits to both sides. This accelerates integration of the first wave new member-states by promoting growth, particularly in their poorer eastern regions; and contributes to averting the danger of new barriers, and therefore new political and economic tensions between the Central and East European associates, and between them and their neighbours to the East. Recent measures imposed by the EU on first wave applicants to tighten up the control of their eastern borders have proved short-sighted and damaging. A more flexible and productive approach has to be found.

Another area where both existing and prospective new member-states have much work to do is in the field of combatting corruption and increasing transparency in political and economic governance. Collaborative research and the elaboration of common policies in this field should be a matter of priority.

Unavoidably, enlargement has implications for the EU budget. To Central and East European applicants it seems obvious that enlargement cannot be successfully managed without an increased budget, but this seems far from obvious to existing member-state governments. Their reluctance to increase the budget is matched by an equally frustrating failure of political will when it comes to reforming the structure of the budget. At present there seems to be agreement only that the pattern of the previous enlargements, which absorbed poorer new entrants by doubling the size of structural and cohesion funds, will not be repeated. It is no doubt true that the world has changed, and that global economic realities no longer permit resource transfers on former scales. It can also be argued that the results of this expenditure were quite mixed - regional disparities within the EU remain wide. Budgetary reform is long overdue and is at last under way.

But EU budgetary transfers remain a crucial issue. For all their failings, budgetary transfers have played an important role in sustaining the momentum of integration after previous enlargements. They brought benefits not only to the poorer new entrants, which were compensated for the costs of adopting the acquis, but also to the richer existing members, whose problems of sectoral and regional adjustment were alleviated. The current logic of budgetary politics in the EU may throw the baby out with the bathwater. Not only enlargement but also monetary union would appear to require a substantial pool of resources for compensatory inter-regional transfers if integration is to be managed politically and economically.

An essential point which needs to come across loud and clear in political debate among EU member-states and their citizens is that the changes in Europe since the collapse of communism inevitably impose new costs, whether the EU enlarges or not, whether it takes in only some, or all of the CEE associates. The costs of not enlarging, or enlarging only slowly, are likely to be higher for all concerned.

Exclusion from the EU undoubtedly slows the pace of economic transformation in eastern Europe; while offering a reasonable prospect of accession within a specified timescale on clearly defined conditions plays an important part in sustaining the commitment of governments and public opinion to reform. The unquantifiable, but deeply influential psychological impact of being recognised as rightful and respected partners in the 'Grand Project' of constructing a united and free Europe is evident in all the CEE associates.

The political and economic risks of excluding CEE states from EU membership are high. Delayed or diverted reforms, slow growth, chronic high inflation, stagnant or falling living standards in the east mean high pressures to emigration. The fear of 'swamping' by uncontrolled flows of emigration from the east seems much more likely to be realised if CEE states are excluded from membership than if they are included. Economic migration tends to happen irrespective of the barriers governments try to erect against it. Industrial relocation and new foreign direct investment, taking advantage of low labour costs in neighbouring CEE states, will happen to a significant extent even if enlargement is delayed - indeed much already happened even before enlargement came onto the official agenda. However, integration into the EU provides a framework which will accelerate foreign investment in CEE and encourage larger and more long-term investment projects.

The EU faces the costs of coexisting with fragile new democracies and weak transitional economies all around its borders whether it enlarges or not. If it enlarges to only a few, say the first five now beginning accession negotiations, it will have to take on the costs of managing a new division in Europe which separates states whose histories and peoples are inextricably tied together (Poland with Lithuania and Ukraine, the Czech Republic with Slovakia, Hungary with its neighbours where large Hungarian minorities exist). When it later enlarges further to include all the CEE associates, it will have to develop new policies to bridge the gap with Russia, Belarus, Ukraine, Moldova, and the successor states of former Yugoslavia, now directly on its borders.

The EU member-states and their citizens would be deceiving themselves if they believe the challenge of responding to the new realities of post-Cold War Europe consists merely in their digging deeper into their pockets and being generous towards their less fortunate neighbours. The challenge is in fact to convince themselves that new costs are unavoidable, and therefore that it is in their own interests to summon the political will to make enlargement work. New expenditure is necessary - of energy and imagination in the search for new European solutions. This the best means we have of managing the new political and economic realities in the interests of the whole of Europe.

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