MONITORING EUROPEAN INTEGRATION 3

Is Bigger Better? The Economics of EC Enlargement

Is Bigger Better?

The Economics of EC Enlargement

Monitoring European Integration 3
A CEPR Annual Report, 1992

Centre for Economic Policy Research

The Centre for Economic Policy Research is a network of 170 Research Fellows, based primarily in European universities. The Centre coordinates its Fellows' research activities and communicates their results to the public and private sectors. CEPR is an entrepreneur, developing research initiatives with the producers, consumers and sponsors of research. Established in 1983, CEPR is already a European economics research organization with uniquely wide-ranging scope and activities.

CEPR is a registered educational charity. Grants from the Leverhulme Trust, the Esmée Fairbairn Charitable Trust, the Baring Foundation, the Bank of England and Citibank provide institutional finance. The ESRC supports the Centre's dissemination programme and, with the Nuffield Foundation, its programme of research workshops. None of these organizations gives prior review to the Centre's publications nor necessarily endorses the views expressed therein.

The Centre is pluralist and non-partisan, bringing economic research to bear on the analysis of medium- and long-run policy questions. CEPR research may include views on policy, but the Executive Committee of the Centre does not give prior review to its publications and the Centre takes no institutional policy positions. The opinions expressed in this volume are those of the authors and not those of the Centre for Economic Policy Research.

30 September 1992

List of Contributors

Richard Baldwin, *Institut Universitaire des Hautes Etudes Internationales, Genève*
David Begg, *Birkbeck College, University of London*
Jean-Pierre Danthine, *Université de Lausanne*
Vittorio Grilli, *Birkbeck College, University of London*
Jan I Haaland, *Norwegian School of Economics and Business Administration, Bergen*
Manfred J M Neumann, *Universität Bonn*
Victor Norman, *Norwegian School of Economics and Business Administration, Bergen*
Anthony J Venables, *London School of Economics*
L Alan Winters, *University of Birmingham*

Contents

Tables

Figures

Preface

We go to press at a time of great uncertainty over the Exchange Rate Mechanism of the European Monetary System and the fate of the treaty agreed at Maastricht in December 1991. Whatever the resolution of these uncertainties, I believe that the long-run process of economic and political integration in Europe will continue. And regardless of the pace of 'deepening', the 'widening' of the European Community will remain high on the policy agenda. European integration in both directions will continue to be a major focus for a wide range of economic analysis, and hence for many of the activities of the Centre for Economic Policy Research.

CEPR is a network of 170 economists based in over 100 different institutions, primarily in Europe. Much of the research in the Centre's various programmes relates more or less directly to short- and long-run issues of economic policy in Europe. CEPR puts extremely high priority on effective dissemination of both policy research and the fundamental research underlying it. Although this is only the third annual CEPR Report, these Reports have already become an important component of this effort.

Informed discussion of European integration should be based on economic analysis which is rigorous, yet presented in a readable and non-technical manner accessible to public and private sector policy-makers, their advisers and the wider economic policy community. These are the objectives and the intended readership of the CEPR Report.

Monitoring European Integration assesses the progress of and obstacles encountered by economic integration in Europe. A rotating panel of CEPR Research Fellows meets periodically to select relevant issues, analyse them in detail, and highlight the policy implications of the analysis. The output of the panel's work is a short annual Report, for which they take joint responsibility. This is the third in this series.

Each year's Report is devoted to a particular theme or issue. The 1990 Report examined the impact of developments in Eastern Europe on the economies of Western Europe and on the process of economic integration among them. It dealt with the restructuring of production and trade as well as the short- and medium-run macroeconomic effects on the West of the economic transformation of the East. This was the first such analysis of these issues: comprehensive though not excessively detailed, comprehensible though based on careful economic reasoning. It achieved wide public notice and significantly influenced the policy debate, while laying out the analytical framework that has been used by several subsequent studies. Some of its key insights went against conventional (and even new) wisdom, yet have proved correct and prophetic – e.g. the conclusion that German unification would entail a real appreciation of the DM in the short run.

The 1991 Report dealt with Economic and Monetary Union in the European Community, in particular the macroeconomic and microeconomic issues arising from

the process leading to a single currency and a European Central Bank. It considered the monetary constitution, convergence conditions, fiscal rules and debt bail-outs, financial regulation, and the specific problems of the transition period. The Report served as an input into the discussions and the negotiations leading to the Maastricht EC summit of December 1991; as a guide to evaluating the treaty that emerged from Maastricht; and as a text for subsequent progress towards EMU. Again, the analysis in that Report has proved far-sighted and robust.

The 1992 Report analyses the economics – more broadly, the political economy – of enlargement of the European Community. It considers the economic benefits and costs of membership for potential new entrants and for the existing member countries. The focus is on EFTA and the Central and East European Countries (CEECs). Within those groups, as within the EC, individual countries present different balances of costs and benefits.

The Report finds that the EFTA countries' interest in the new European Economic Area (EEA) is mainly economic, and the wish of several to extend it into full EC membership is primarily political; whereas for the current EC members, the motivation is reversed – the EEA was mainly a political gesture, but there are significant economic incentives for bringing the EFTAns into the Community. The picture for the CEECs is quite different: on economic grounds, EC membership is not realistic for a long time to come, but radically improved access to EC markets (including agriculture) is essential for the economic progress necessary to make membership feasible, and a commitment by the Community to ultimate membership would provide an important anchor for economic expectations in the CEECs and their political development.

To implement these proposals and to adapt the EC's institutional framework to an enlarged Community, an issue that is also explored in the Report, will require political vision. That must rest, however, on sound economic foundations, such as are provided by the analysis in this Report.

The German Marshall Fund of the United States provided generous financial assistance essential to the completion of the Report. We are also grateful to the UK Department of Trade and Industry; to the Commission of the European Communities, whose Stimulation Plan for Economic Science financed the Centre's research network on 'Financial and Monetary Integration in Europe'; and to the Ford Foundation, which has supported much of the Centre's research in international economics. This Report includes new research, but since it is written and published quickly so as to be relevant to ongoing policy processes, it must rest on a solid base of past fundamental and policy-oriented research. The authors and CEPR express their continuing thanks for the support of such research which has come from these bodies and all others that contribute to the Centre's funding.

The authors and CEPR are also grateful to officials in several countries and in the European Commission who were generous with their time and cooperation in discussing the issues treated here. For the production of the Report they thank David Guthrie and

Kate Millward in particular, as well as other staff at CEPR whose patience and professionalism have been most helpful.

None of these institutions or individuals is in any way associated with the content of the Report. The opinions expressed are those of the authors alone, and not of these institutions nor of CEPR, which takes no institutional policy positions. The Centre is extremely pleased, however, to offer to an outstanding group of European economists this forum for economic policy analysis.

Richard Portes

17 September 1992

1 Introduction

It is conceivable that shortly after the turn of the century the EC(6) of 1958 will have grown into the largest and most powerful political and economic entity on the planet. The dream of a European Community encompassing most of the countries of the continent could turn into a reality. This Report looks at the facts underlying this dream. It assesses the opportunities an initial enlargement to the EFTA countries would present and the challenges a further enlargement to the countries of Eastern Europe would raise. It analyses the budgetary, institutional and political implications of these projects; discusses related issues of timing and sequencing; and considers alternatives to full membership for the different countries.

Actual or potential applicants to the EC fall into two distinct groups that we shall treat separately in this Report. The first is made up of the EFTA countries, of which Austria, Finland, Sweden and Switzerland have submitted formal applications for membership. Norway is likely to follow, while Iceland appears less eager to join and for that reason will be set aside for much of the following. The second group includes the CEECs ('Central and East European Countries': Czechoslovakia, Hungary, Poland; Albania, Bulgaria, Romania; the states emerging from the break-up of Yugoslavia; and the Baltic states); and the Mediterranean applicants (Cyprus, Malta and Turkey). Only the last three have handed in formal applications, but several of the CEECs have probably not done so only because they have been discouraged by the knowledge that their applications could not be considered for a (long) while. In what follows, we make no distinction between declared and potential applicants.

EFTAns and CEECs are widely different beings. The former are small, developed economies with long democratic traditions. They are already very close to the EC through trade relations and through bilateral and multilateral trade agreements. Their institutional ties with the Community will be furthered by the implementation of the European Economic Area Agreement, which will place them on the threshold of full membership. Were they to join, they would be net contributors to the Community budget. Their tradition of neutrality (except for Norway), however, although undergoing redefinition, could still present an obstacle to their full participation in future EC policies.

In contrast, the CEECs are at an early stage in their development as industrialized, free market economies, and they have little or no democratic tradition. Their full participation in Community institutions cannot be envisaged for many years. Their trade relations with EC countries are an order of magnitude smaller, and their institutional ties are non-existent or only at their beginning (the 'Europe Agreements' with Czechoslovakia, Hungary and Poland). At the moment and for a long time to come, they would be net recipients of the EC structural and regional funds. Including the CEECs in

the EC would constitute the largest and most demanding – in terms of budgetary transfers – enlargement of the Community to date.

The strains of potential membership become greater as one moves south-eastwards through the CEECs. Hence Czechoslovakia and Hungary have taken some steps towards eventual accession, but their poorer neighbours – Albania, Bulgaria and Romania – are only just beginning their transitions and are potentially large drains on EC funds and sources of potential immigration. These problems become even more formidable as one moves further south east to Turkey. Despite applying for membership five years ago and having undertaken a major programme of modernization and Westernization, Turkey remains as far as ever from Community membership. Politically, its antagonism with Greece and its patchy record on human rights, and economically, its poverty, huge agricultural labour force and high rate of population growth all preclude an early reconsideration of its 1989 rejection. There seems little virtue in our rehearsing for Turkey the difficulties that we find in admitting the more advanced CEECs to full membership, so in view of the political barriers it faces we leave Turkey's potential accession aside. We treat the other Mediterranean applicants – Cyprus and Malta – in the same fashion. They are small enough to admit even with their low incomes, but the precedents their accession would create for other Mediterranean aspirants and the practical difficulties of combining very small with very large states in the intergovernmental institutions of the EC both suggest that they will not be admitted in the near future.[1]

In order to discuss the widening options available to new entrants in the Community, we first single out the (economic) ingredients of membership in the Community as it stands today and as the Maastricht Treaty makes it possible to envision. By 1993, the EC will have become a truly common market, in which all barriers to the free mobility of goods, services, capital and people will (should) have been eliminated. There will be a common external trade policy, competition and company laws will have been harmonized, and rules for consumer and environmental protection and some elements of social policy will be added as part of a design for fair competition among EC producers. Agricultural products have been a special case since the advent of the EC. While fairly freely traded within the Community, they have been subject to production controls and have been fiercely protected from external competition by the CAP. EC membership today also entails participation in the European Monetary System (EMS) for those countries that are willing and able. Maastricht spells out the way to economic and monetary union (EMU), with irrevocably fixed exchange rates and the creation of a single currency managed by a federal system of central banks. The final stage will be some form of political union (EPU), which still needs to be designed and agreed, but which will certainly contain elements of common foreign and defence policies.

These ingredients have been progressively added in a temporal sequence that does not appear immutable. Freedom to trade goods came first, preceding free trade in capital, services and labour, which are not to be achieved until at least the end of 1992. The EMS is a relatively recent construct (1979), and EMU is still to be realized. Exceptions,

opt-out clauses and transition periods also form part of the evolving constitution of the Community.

The relationship between EC and EFTA countries has generated a different sequencing. From existing current bilateral or multilateral agreements will spring the establishment of a free trade zone under the name of the European Economic Area (EEA). The EEA includes elements of the single-market programme, but it simultaneously excludes some parts of the Treaty of Rome: thus the EEA has no common external trade policy and excludes agricultural products; but free trade in services and both labour and capital mobility form part of the agreement along with free trade in manufactured products. In addition, EFTA countries agree to recognize the actual and future competition rules and company laws of the Community.

While we concentrate on the economic dimension of the Community, the political dimension is an essential ingredient of, and the main force behind, the constitution of the EC. Maastricht has reinforced this fact, and the insistence on the need for prospective members to accept the *finalité politique* is unambiguous. This provides the rationale for a policy of transfers among members to reduce income differences and increase the chances for the poorer countries to catch up with the richer. These transfers go under various names: structural fund, regional fund or cohesion fund. While membership implies full participation in these funds, the EEA agreement also creates a fund, although on a much smaller scale, to benefit the poorer members of the Community.

EFTA countries are already far along the road to integration; a timetable has now been proposed that could see them as members by 1996, but how many of them would seize this opportunity is not clear. This enlargement would not raise major difficulties for the applicants or for the current members. We find, however, that the distribution of the political and economic incentives for closer integration is strongly *asymmetrical*: EFTA members get most of the economic benefits of EEA, but EC incumbents would register little economic gain at this stage of integration, and the main benefit of EEA to EC members appears to be political. In this light, the ratification of Maastricht, and thus the outcome of the French referendum, will have little impact on the implementation of the EEA. In contrast, the step from the EEA to full EC membership entails relatively small economic benefits for the EFTAns, whose main motivation appears on the political side, while for EC incumbents EFTA membership represents a substantial financial interest. We conclude that this line-up of benefits makes this enlargement less predictable, and the possibility of a two-track Europe is very much on the cards despite the political imbalance of the EEA treaty. Chapter 2 details these arguments, discussing in turn trade in manufactured goods, services and agricultural products, and analysing the growth effects of the EEA and the EFTA countries' participation in EMU. It concludes with a discussion of the policy issues that sheds light on the EFTA countries' prospects of full membership and the effects on the Community of its enlargement to include them.

The CEECs, on the other hand, are at the very beginning of the road that could conceivably lead them to EC membership. Whether they get there eventually or not, the

sequencing of their association with the Community need not replicate any observed in the past. In fact their situation is very different, and it is plausible that the priorities and the opportunities will differ. Let us recall that while the most tangible benefits of the EC over time may have been economic in nature, the main driving force behind the constitution of the common market and the institutions that have preceded it has been political – be it the political desire to anchor Germany firmly to the Western part of the European continent, or the desire of Spain, Greece and Portugal to stabilize their young democracies in a credible and definitive way. The changes of the late 1980s in Eastern Europe are certainly just as significant political events as those that have marked the recent history of the Southern European countries; they confront the EC with a challenge that it cannot avoid.

Chapter 3 analyses the terms of this challenge. It first assesses the current situation and future prospects for the CEECs and then evaluates the budgetary implications of their membership of the EC. We conclude that the budgetary burden is likely to be unacceptable to incumbents for a long time to come. We then conduct a careful analysis of current and potential trade relations between the Community (and EFTA) and the East, and we evaluate the benefits that both would draw from letting the potential for mutual trade be exploited to the full. We then assess migratory pressures, which we find may prove less threatening than is often feared, provided that the CEECs embark on a satisfactory development path. The Community's responsibility on this latter point is inescapable: given our pessimistic conclusion about early membership, and the implications of the existing migratory forces, we conclude that a much more open trade policy, encompassing agriculture, is the only policy alternative. We suggest that this should be made concrete by the EC providing the CEECs early access to something, which might be called the European Economic Space (EES), with agricultural markets and capital mobility, but without labour mobility. This would be a promising institutional arrangement, offering the CEECs the markets and the credibility they need to set out on a favourable development path.

With the prospect of some EFTA countries joining soon, and many more countries from Eastern Europe joining later, the future is one of a significantly larger and more diverse Community. We believe that in (re)designing Community institutions, this perspective must be taken into account in near-term as well as long-term planning. Chapter 4 analyses some of the consequences of enlargement for the working of EC institutions. We observe that there is a threshold level in terms of the number of Community members and that this threshold appears to have been reached. Further widening therefore cannot proceed without further institutional deepening in the form of a 'denationalization' of the policy bodies at executive levels. We explore three models of such deepening, taking the ECB Board and the European Commission as examples.

Chapter 5 provides a summary and concluding comments.

Notes

[1] In general our assessment of the timing of potential accessions parallels the European Commission's, as stated in 'Europe and the Challenge of Enlargement', the Commission paper prepared for the Lisbon meeting of the European Council in June 1992. We are somewhat more cautious on Malta and the CEECs, however.

2 The Countries of EFTA

Political agreements – be they national constitutions, international treaties or simple laws – are largely shaped by predictable and fundamental factors such as demographic, military and economic forces. But short-term and idiosyncratic factors also matter, especially for the details of such agreements. For instance, British colonial policy in the eighteenth century led the framers of the US Constitution to include a provision that forbids the housing of soldiers in civilian homes. In this light, it is important to distinguish between the economics of closer economic integration in Europe and the economics of an enlarged EC. There is deep and enduring economic logic to the further integration of the European economies, but the precise institutional arrangements necessary to effect it will be determined by factors that have little to do with economics. The prospective closer integration of the EFTA countries and the EC consists of two well-defined and distinct steps: first, from the current bilateral free trade agreements linking EFTA and the EC to the European Economic Area (EEA) Agreement; second, from the EEA to full EC membership.

This chapter argues that there are strong and well-documented economic forces behind the EFTA countries' wish to join the EC's single market via the European Economic Area (EEA) Agreement. The economic gain to the EC from the EEA, on the other hand, is positive but small, because EC exports to EFTA amount to only 2% of EC output; the driving force behind the EC's interest in the EEA therefore seems to be political.

This balance between economic versus political motivation, however, is exactly reversed for the step from EEA to EC membership. From the point of view of the EFTA countries, the additional economic gains from EC membership are relatively small, residing mainly in agriculture, competition policy, monetary union and a sense of irreversibility, while the financial costs are greater. The major gain to the EFTAns is that while the EEA essentially obliges them to accept future EC directives without any formal input into their formulation, full EC membership would give them full political representation. From the point of view of the current EC members, on the other hand, EFTA membership presents a substantial financial interest since the rich EFTAns would expand the EC tax base by roughly 14%.

One conclusion to draw from all this is that in one form or another the EFTA nations will join the single market. For instance, even if Swiss voters reject the EEA in the referendum that will be held later this year, it is likely that the other EFTAns will find a way to proceed without Switzerland. The case for the EFTA countries becoming EC members, however, hangs to a great extent on the vagaries of the balance between the political gains and autonomy losses of membership. The Danish rejection of the Maastricht Treaty – to say nothing of the 1989 events in Eastern Europe – reminds us how precarious it is to predict the political climate in the EFTA and EC nations by the mid-1990s (the most likely decision date for the first wave of new EC members).

Our second conclusion concerns the possibility that the EEA may be a model for a two-track Europe. The EEA is unbalanced in terms of input into the drafting of, and the obligation to accept, future EC legislation. Nevertheless, the preponderance of the mutual economic gains from closer integration can be had with the EEA alone – actual membership will add little extra. Thus an EEA-like arrangement might be a stable and mutually beneficial alternative to full membership that some non-EC members may actually prefer.

As befits an economic report, the bulk of this chapter looks at the economic components of the EFTA and EC decisions about future integration. We keep separate the two steps alluded to above: the single market (EEA) and the deeper institutional integration of EC membership. We organize the discussion by economic topic while defining the economic components of membership (beyond the EEA) as:

(a) adoption of the EC's common external tariff;
(b) adoption of the EC's Common Agricultural Policy;
(c) further application of EC competition policy to EFTA;
(d) a relatively ill-defined sense of commitment and irreversibility;
(e) participation in the EMS and the future monetary union; and
(f) cash payments and receipts.

Accordingly, the next three sections consider the effects of EEA membership and full accession to the EC on manufacturing industry, services and agriculture. Section 2.4 then asks how integration is likely to affect the rate and location of economic growth. We follow with a discussion of the prospects and impact of the EFTAns' participation in European monetary union and then discuss the likely levels of fiscal commitment associated with both EEA and accession. Finally, we consider the policy dimensions of the two levels of integration, concluding with a discussion of the ultimate step of full political union.

2.1 Integration and Manufacturing Industry

This section considers the effects of deeper EC-EFTA integration on industry. After nearly two decades of industrial free trade, the EC and EFTA have substantial trade flows and a significant level of industrial integration already: indeed, EFTA countries are as dependent on EC trade as the EC countries themselves. Their mutual trade, however, faces significant non-tariff barriers, and as the single-market programme removes such barriers to intra-EC trade, EFTA producers will be severely disadvantaged if they are not part of that process. They will not only face higher real costs than their EC-based competitors, but will also miss out on the stimulus to competition that completing the internal market entails. Since most EC-EFTA trade derives from imperfectly competitive industries, the latter is potentially very important.

2.1.1 The EFTA Economies and EFTA-EC Trade

Before looking at the economics of the EEA and accession, we look briefly at the EFTA economies and their relationship with the EC and each other. Table 2.1.1 shows that EFTA's population is about one-tenth of the EC's, and its nominal GDP about one-seventh; in nominal terms per capita income is about 40% higher in the EFTA countries, although this gap is substantially narrowed (to 15%) when a purchasing power correction is applied to the nominal incomes.[1] Real growth in the two areas has been quite close over the 1980s, at roughly 2.2%. Only Finland had a growth rate significantly above this. The EFTAns are on average slightly more open than the EC states, but some EFTAns (Austria and Norway) are much more open while others (Finland) are much more closed.

Turning to the patterns of international trade, on both the export and import side all the EFTAns are more dependent on the EC than they are on each other. Indeed, their export patterns fall within the range of those of the EC countries, with some 45-75% of exports destined for EC markets. On the import side, the Nordic EFTAns are less EC-dependent than the EC average, but they still import twice as much from the EC as from other EFTA states. Such differences as do exist between countries' EC-dependence appear to depend more on physical proximity to major EC economies than on degrees of integration *per se*. The shares of manufactures in EFTA countries' total exports to the EC are very high, ranging from 79% for Iceland to 91% for Austria and Finland. We therefore start our discussion with manufactures.

2.1.2 EFTA and the European Economic Area

The traditional tools for analysing international economic integration are Viner's (1950) 'trade diversion' – the displacement of imports from non-partner countries by those from partner countries with preferential market access – and 'trade creation' – the displacement of protected local production by imports from partner countries. Roughly speaking, the former is harmful because the importing country pays more for its imports (domestic consumers pay less, but less tariff revenue is collected by the domestic government), while the latter is beneficial because it provides supplies more cheaply (thus releasing domestic factors of production for more productive tasks).

This type of analysis, however, misses the most important effects of the EEA Agreement on the EFTA countries. First, the scope for trade diversion is fairly small. Both the EC and the EFTA countries already receive the vast majority (about 67% for the EC and 73% for EFTA) of their imports from other EEA countries, so the scope for diverting imports from third countries is modest. Moreover, the existing EC and EFTA tariffs on imports from non-EEA countries are fairly low: the EC's average tariff on manufactures is about 4.2%, while EFTA's is about 3.0% (Herin (1986)), so the lost tariff revenue per dollar of diverted trade will be low. Nor is the traditional analysis of trade creation appropriate to the case of the EEA. EFTA-EC trade in manufactures is already duty free, so joining the single market primarily involves the removal of

Table 2.1.1: Key Economic Indicators for EFTA Member Countries and EC.

Country	*Population (millions)*	*Distribution of Employment (%)*			*GDP*			*Average GDP Growth 1980-90*	*Exports/ GDP(%)*
		Industry	*Agriculture*	*Services*	*$billions total*	*$thousands per capita (ppp)*	*$thousands per capita (nominal)*		
Austria	8	37	9	54	159	14	21	2.2	41
Finland	5	31	10	59	137	16	28	3.2	23
Iceland	0.3	37	10	53	6	16	22	2.1	39
Norway	4	27	7	66	105	17	25	2.4	45
Sweden	9	30	4	66	227	16	26	1.9	30
Switzerland	7	38	6	56	228	19	34	2.1	37
EFTA	33	33	7	60	862	16	26	2.2	35
EC	328	39	8	53	6,010	14	18	2.3	33

Sources: EFTA (1991);
World Development Indicators, World Bank, 1991;
OECD *Labour Force Statistics*.

resource-wasting trade barriers. Removing such barriers tends to increase welfare more than removing tariffs since there is no tariff revenue loss to offset the gains to consumers. Given the current trade pattern, the dominant aspect of EFTA joining the single market is the removal of these cost-increasing administrative, fiscal and physical barriers to the flow of goods, services, capital and people. While this may not sound like an important step, we shall see below that a confluence of factors implies that the EFTA countries have a strong economic interest in the removal of such barriers – given that the '1992' programme will remove them from intra-EC trade.

Although the EC and EFTA already constitute a free trade area in manufactured goods, firms cannot treat the EC and EFTA as a unified market. It is clear to even the most casual observer that EFTA-EC trade is shackled by a list of trade-inhibiting barriers such as differing technical standards and regulations, preferential public procurement, administrative and frontier formalities, differences in VAT and excise duties, transport regulations, capital market controls and the implementation of EC law. A survey of 20,000 EC firms (Nerb (1988)) suggested that technical standards and regulations have the largest negative impact on trade across sectors. Surveys of EFTA-based firms, cited in EFTA (1992), confirm this result for EFTA-EC trade. Nerb's survey of EC firms found that the cost-raising effect of these diverse barriers was of the order of 2% of total costs. Pelkmans and Winters (1988) estimate that the aspects of the '1992' programme affecting intra-EC trade would reduce real trade costs by 1-3% of the value of trade.

Since formal trade barriers on EFTA-EC trade are quite low already, and the trade cost reduction involved in adopting the '1992' reforms would be modest, it would be easy – but incorrect – to conclude that the EFTAns' economic rationale for joining the EEA is rather weak. Even calculating the direct resource saving at the existing levels of trade generates significant benefits. For example, since EFTA exports about $170 billion, (one-fifth of its output) to the EEA countries, the economic benefits from eliminating a 1-3% cost on all of this trade is between $1.7 and $5.0 billion. Although this is only 0.2-0.6% of EFTA's GDP, it is still a sizeable amount.

Much more important, however, is the pro-competitive aspect of joining the European single market. For industries characterized by imperfect competition (and we argue below that most European industries involved in trade are), Venables and Smith (1988) have shown that lowering even modest barriers leads to a substantial rise in the degree of competition. The resulting reduction in the monopoly pricing power of firms leads to lower prices and a more efficient allocation of resources. The logic of this effect is simple. When firms treat the various national markets as segmented, i.e. they feel that the quantity they sell in one market does not affect the price they receive in another, the local firm tends to take a dominant position. This type of dominance typically leads to higher prices, lower economies of scale and therefore lower welfare. For example, a market in which four firms have equal market shares tends to be more competitive (i.e. yields lower profit margins) than one with four firms where one has the lion's share of the sales. On completion of the internal market, the myriad of legal and informal arrangements that support market segmentation should disappear, leading to lower profit margins and more efficient pricing and allocation of resources (see Haaland and

Table 2.1.2: Percentages of EC, EFTA and CEEC Countries' Intra-industry Trade with the EC. 1988–90.

EC Members			
France	82	Spain	73
Netherlands	77	Ireland	59
UK	77	Portugal	42
Belgium-Luxembourg	76	Greece	29
Germany	75		
Italy	63		
Denmark	63		
EFTA		***CEECs***	
Switzerland	77	Hungary	50
Sweden	70	Czechoslovakia	46
Austria	68	Poland	42
Finland	39	Bulgaria	41
Norway	36	Romania	34
Iceland	4		

Sources: Buigues and Ilzkovitz (1992);
EFTA (1991).

Wooton (1991) for a detailed analysis). Although the firms themselves are not usually happy about extra competition, the nation as a whole gains from the curbs on monopoly pricing. Lowering trade barriers may also lead to further gains by permitting firms to operate at a more efficient scale, while highly fragmented markets may lead firms to produce too little output.

The importance of this pro-competitive effect for EFTA depends upon how prevalent imperfect competition is in EFTA's trade. We argue that most EFTA-EC trade in fact occurs in situations where imperfect competition and increasing returns to scale are important. A good way to measure the importance of imperfect competition in European trade is to look at the extent of two-way trade in similar products. The widespread occurrence of trade in similar products between similar countries is best explained by economies of scale. For instance, within a single country, firms usually find it profitable to concentrate production in a few factories even when their customers are widely dispersed. Likewise, even if two countries are identical, economies of scale imply that the production of some goods will be concentrated in each country despite the fact that consumers are in both countries. Table 2.1.2 reports indices of such intra-industry trade

Table 2.1.3: Impact of EFTA Participation in '1992' Programme, with and without EEA Agreement. Percentage Changes from 1985 Base.

	EFTA		*EC*		*US*		*Japan*	
	With	*Without*	*With*	*Without*	*With*	*Without*	*With*	*Without*
Real Income Change as % of Expenditure on Tradables	2.90	–0.40	2.00	1.90	–0.05	–0.04	–0.06	–0.08
as % of GDP	–0.69	–0.10	0.50	0.48	–0.00	–0.00	–0.00	–0.00
Return to Capital	1.01	–0.04	0.61	0.57	–0.01	–0.01	–0.01	–0.01
Return to Skilled Labour	1.25	–0.18	0.63	0.62	–0.01	–0.01	–0.02	–0.02

Source: Haaland and Norman (1992).

with EC countries for the EFTA countries, the CEECs and the EC countries themselves. An index number equal to 100 indicates that all trade is composed of two-way trade in similar products; a value of zero indicates that all trade is in dissimilar products. Three points are worth noting. First, for the three largest EFTA countries (which have already applied for EC membership) more than two-thirds of all trade with the EC is intra-industry trade. Second, in terms of this measure the average EFTA country is no less integrated into EC trade than the EC members themselves. Third, the special position of Iceland, which relies heavily on exports of raw-material intensive goods, is evident.

Since much of EFTA-EC trade is driven by scale economies, it is inevitable that many of the markets for traded goods will be imperfectly competitive. Both in theory and in practice, firms whose production is subject to increasing returns to scale must have some degree of market power. In such markets, firms do not take prices as given; the behaviour of one's rivals has an impact on one's own actions and performance. Table 2.1.3 gives some estimates by Haaland and Norman (1992) of the effects of forming the EEA. They are based on a computable model in which firms in the traded goods sectors interact oligopolistically, and yet takes account of sectors' effects on each other through factor markets and the allocation of demand. Haaland and Norman consider two scenarios. In the first, the EC creates the single market ('1992') but EFTA is left outside. In the second, the EFTA countries join with the EC in the single market, and therefore reduce their costs of trading with the EC, and EC and EFTA markets are no longer segmented. The model considers integration only in tradable manufactures

sectors, so the estimated benefits of integration are proportionately quite significant in terms of the output of those sectors (2.9%), but they are not massive in terms of GDP. None the less, generalizing to the whole economy, there are clearly important amounts at stake, even if the figures are less enthusiastic than the European Commission's estimates of the benefits of '1992' (Commission of the European Communities (1988)).

There is another way of seeing that this pro-competitive effect is likely to be especially important in the EFTA countries. Casual empiricism suggests that prices in many EFTA countries exceed those in the EC. A more formal indication of this is provided by the difference between nominal EFTA income and EFTA income evaluated at purchasing power parity exchange rates, as shown in Table 2.1.1. In 1990, EFTA per capita nominal income was $26,500, which was 44% higher than the EC's. Correcting for the EC-EFTA price differences indicates, however, that EFTA per capita income is only 15% higher than the EC's. It is impossible to draw precise conclusions from this type of evidence, but it does in part reflect the importance of monopoly-pricing distortions.

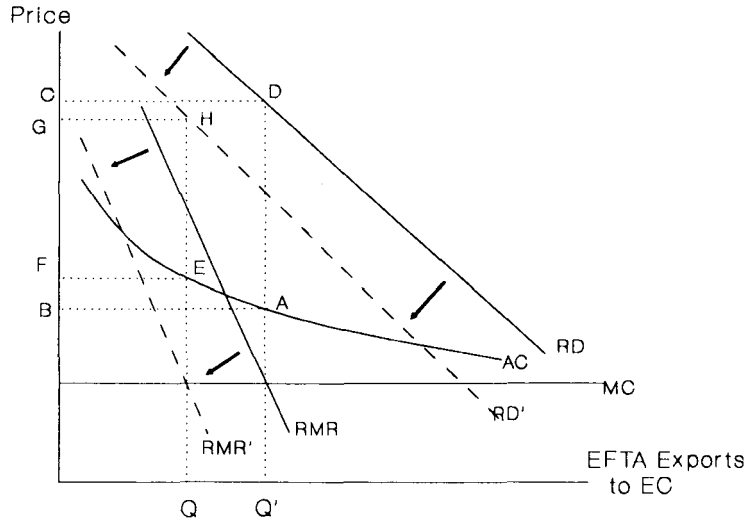
2.1.3 The Losses from not Joining the EEA

The economic rationale for EFTA countries to join the EEA is not only positive. Indeed, it is possible to argue that their initial interest in the arrangement stemmed less from the benefits just described than from the desire to avoid the losses they would suffer if the single market were created without them. Briefly stated, these losses arise from the strategic disadvantage that the '1992' programme will impose on EFTA-based firms if EFTA does not participate in the single European market. '1992' will reduce EC firms' trade costs whether EFTA countries join the EEA or not. This will provide EC manufacturing firms with a cost advantage over their EFTA-based competitors, and hence reduce the latters' relative competitiveness. The result would be a drop in EFTA's sales and profits in their most important export market and a reduction in economic welfare.

Krugman (1988) lays out the argument quite succinctly. The relative cost advantage, together with the reduced segmentation of the EC markets, will induce EC firms to sell more to each others' markets. The normal effect will be that EC firms lose some of their domestic sales but gain additional exports. From the economy-wide perspective, this process is a net gain since it has the effect of reining in the monopoly power of firms, resulting in lower prices and greater efficiency. If the EFTA countries do not join in the process, firms based in these countries will not experience the same cost reduction. Consequently, the relative competitiveness of EFTA firms will fall *vis-à-vis* that of their EC-based rivals. As intra-EC exports increase, some sales by firms from EFTA countries will be displaced, and EFTA firms' profits will suffer along with sales, since prices in the EC will also be lower. The loss of export sales may even be magnified by a loss of domestic sales if '1992' boosts EC firms' export competitiveness. In cases of imperfect competition, such a loss in sales and profits would be expected to reduce welfare in the EFTA countries. Box 2.1.1 gives more details on this argument.

Box 2.1.1: The Strategic Disadvantage of not Joining the Single Market.

To see a little more formally why '1992' would harm EFTA countries if they do not join the EC, consider a simple duopoly between an EC firm and an EFTA firm where the two sell in both the EC and EFTA markets. The figure below shows the impact on the EFTA firm's sales and profits in the EC market. The EFTA firm's cost curves (MC is marginal costs; AC is average costs) and its residual demand (EC market demand minus the EC firm's sales) and residual marginal revenue curves are drawn in the figure. The initial operating profit (profit gross of fixed costs) equals the area ABCD. Now suppose the EC firm's costs of doing business in the EC market (not shown) fall due to '1992', but the EFTA firm's costs do not. For the moment, assume that the cost reduction is limited to the EC market so nothing changes in the EFTA market. A reduction of the EC firm's marginal costs relative to the EFTA firm's will surely lead to higher sales by the EC firm and therefore a shifting inwards of the residual demand facing the EFTA firm. This is depicted as a shift of the residual demand curve to RD' and a corresponding shift of residual marginal revenue curve to RMR'. The EFTA firm's sales and profits drop: sales fall to Q and profit is reduced to EFGH. If '1992' also improves the EC firm's export competitiveness, the EFTA firm's sales and profits in its own EFTA market will be harmed in a similar manner. If the loss is great enough, the EFTA firm may relocate to the EC.



The strategic disadvantage that '1992' imposes on non-EC-based firms is worrisome to all countries, but for countries outside EFTA the losses are estimated to be virtually negligible (see Table 2.1.3). They matter to EFTA, however, for two reasons: EFTA countries are heavily dependent on the EC market for exports, and their economies are heavily dependent on exports (the average export/GDP ratio was 35% in 1990). The Haaland–Norman estimates suggest that this effect is significant. The loss to the EFTA countries from not joining the EC would be 0.4% of tradable goods output (0.1% of their GDP); the corresponding gains to EFTA of joining would be 2.9% (0.7% of their GDP), so the total of the potential gain plus the avoided loss is 3.3% of tradables or 0.8% of GDP.

The effects of integration on GDP and incomes presented here are already quite important, but for two reasons they are only part of the story. First, tradable manufactures account for less than one-quarter of EFTA countries' economic activity; we must look in addition at services and agriculture, which we consider in the next two sections. Second, the analysis so far has concerned only the *static*, one-off gains from the EEA. Economists have long held that *dynamic* factors are likely to be quantitatively more important than static factors, but they have not yet been as successful in measuring them. We return to this issue in Section 2.4.

2.1.4 From EEA to EC Membership

The most significant effect on EFTA's manufacturing trade of becoming full EC members will be the adoption of the EC's trade policy. Moving to the common external tariff will have only a minor impact even though the effect on specific sectors could be significant. Hamilton (1991) states that adjustment of the Nordic countries' tariff rates to those of the Community would be 'almost painless', since the EC average tariff on manufactured goods is about 4.2% while that of Finland, Norway and Sweden is 2-3%. The average tariff rate for EFTA as a whole is about 3.0% (Herin (1986)), so the overall impact would be fairly small. On the liberalization side, the new members would have to lower their tariffs in line with the Community's preferential trade agreements with Cyprus, Malta and Turkey, Czechoslovakia, Hungary and Poland, the Lomé Convention countries and Israel.

More importantly than tariffs, the EFTA nations would have to adopt the extensive and much-criticized network of anti-dumping duties that the Community currently has in place. These tend to raise the prices of many products within the Community, especially consumer electronics goods. EFTA countries would also be forced to adopt all future Community-wide restrictions arising from applications of the Community's anti-dumping and countervailing duty procedures. Finally, the EC has traditionally been one of the biggest users of 'grey area' measures to limit trade. These consist mostly of bilateral quantitative restrictions on exports to the Community. Joining the Community involves agreeing to adopt all current and future EC grey area measures.

One significant grey area measure is the restriction of imports of iron and steel and the imposition of minimum prices. This impinges on EFTA quite significantly as the EC's largest external supplier, so getting inside the Community might be expected to have a moderately liberalizing effect on EFTAn trade. The EC manages its domestic iron and steel producers so tightly – at least as soon as there is any market pressure – that evading the import controls might not allow EFTA producers to expand their sales significantly, however.

As far as the Community's competition policy is concerned, full membership would be a liberalizing influence in several EFTA countries, especially Switzerland (which has very weak domestic antitrust laws). The EEA stipulates that EC competition policy is to be applied to any activity which 'may affect trade among Contracting Parties', namely any intra-EEA trade in manufactured goods. As full members, the EFTA nations would find EC competition policy, including limits on state aid to industries, applied to a much wider range of activities. Although there is a good deal of heterogeneity among the prospective EFTA members, it is fair to say that adopting the EC's current competition policy would lead to a general increase in competitive forces in the EFTA nations. Rules governing state aid, mergers and acquisitions (especially by foreign entities), and restrictive business practices, such as price fixing and exclusive marketing arrangements, are by and large less permissive in the EC. It is hard to quantify the importance of this effect, but we can refer back to the point made above – that the prices of goods are typically higher in the EFTA countries – as suggestive evidence that domestic competition is typically less intense in EFTA states.

2.2 Services

The EFTA countries' service sectors account for a large and growing share of employment and output – see Table 2.1.1 – so the impact of the EEA Agreement and eventual EC membership on them is an important issue. As discussed above, one of the most important effects of the closer integration of goods markets is the increased import competition and corresponding reduced ability of firms to keep their various national markets segmented. Since many services in Europe are currently dominated by local firms that exercise substantial market power, increased cross-border competition and reduced segmentation of services markets could produce similarly large benefits. After a brief discussion of the general principles, we consider two case-studies: air travel and financial services.

2.2.1 Services Trade is Different

The lack of competition in service sectors has frequently been fostered by national regulation. For example, national regulation prevented widespread competition within countries and across countries in banking, insurance and telecommunications. However, even if these regulations were initially justified by considerations of natural monopolies,

technology has in many cases altered the need for a single dominant firm or group of firms. Telecommunications is one clear example where technological developments are transforming the economic rationale for a natural monopoly.

In fact, the current trend in much of Europe – and especially in the EC – is to deregulate service sectors and introduce additional competition. Here the single market's promotion of international competition in services is likely to multiply the benefits of deregulation. The point is that foreign firms can quickly boost the degree of competition faced by the local dominant firm. Trade in services obviates the need to establish new firms or to break up the old dominant firms. Indeed in the case of the small EFTA nations, import competition is probably the only realistic means of boosting competition.

Trade in services differs from trade in goods in a number of important aspects. Perhaps the most important is that the provision of many types of services requires a local presence. This commonly requires the establishment of branches in the foreign market and thus requires firms to make large, up-front investments. Establishing a local presence may also entail cross-border movement of capital and labour. For these reasons, assurances of long-term market access are especially important to encourage entry by foreign firms. Since the freedom of movement of services and the rights of establishment are firmly embedded in the Single European Act, firms contemplating engaging in intra-EC service trade can take long-term market access as assured. The EEA Agreement likewise provides these assurances and should therefore boost international service sector competition. However, in so far as it is less irreversible than full EC membership, it may provide fewer incentives for establishment and hence have a less marked impact on competition and growth.

It is important to note that the mere possibility of competition from foreign service providers will increase the competitive pressures on national firms. Thus it is perfectly possible that local firms will improve their service and lower prices in order to prevent the entry of foreign competitors: as usual, potential trade, as much as actual trade, can discipline monopolists. Given that there are real costs to many firms establishing a presence in a single market, we might observe improved behaviour by local service providers with very little increase in actual service trade.

2.2.2 Case-Study: Air Travel

Unfortunately, there are few studies formally quantifying the likely gains from increased competition in the service sectors. One, however, by Norman and Strandenes (1990), analyses the potential gains from augmented competition on the Oslo–Stockholm air route. Their analysis shows that going from the initial monopoly on this route to a situation with two, three or four firms would yield very substantial gains to the consumers and to the economy as a whole. The shift from one to two firms could yield price reductions of almost 30%, while moving to a market with three or four firms could induce price reductions of approximately 40% compared with the monopoly

outcome. In welfare terms, consumers gain substantially, by between 45% and 73% of their initial expenditures, and although the monopoly loses revenues from the increased competition, the overall gains to Norway and Sweden are estimated to be in the range of 16-31% of initial consumer expenditure, even assuming that the new carriers are not from Scandinavia. The total world gains, including revenues to the new carriers, lie in the range of 36-50%. Although the initial situation with the SAS monopoly is extreme, there is no reason to assume that similar results could not be obtained for a number of other services in many countries.

2.2.3 Case-Study: Financial Services

The Cecchini Report (Commission of the European Communities (1988)) suggests that the integration of the markets for financial services under the '1992' programme will be of great importance to the EC. The sector accounts for 6.4% of GDP and employs approximately 3% of the labour force, and Cecchini estimates the potential gains from fuller integration to be as high as 0.7% of GDP.

Gardener and Teppett (1992) have applied the same methodology to study the potential effects of the EEA for financial services. On average financial services are of approximately the same importance in EFTA as in the EC, but there is significant variation between countries. For the Nordic EFTA countries, the value added share of GDP is much lower, while the opposite is true for Switzerland.

Gardener and Teppett find that gains of the same order of magnitude as for the EC can be expected for the Nordic EFTA countries, while the Alpine EFTAns could gain significantly more. They also find that including EFTA in the integration of financial services could increase the gains for the EC substantially (from 0.7% to 1.3% of GDP in the most optimistic scenario). Although the methodology applied in this study and in the Cecchini Report is very simple and has a number of weaknesses, there is no particular reason to believe that the results for EFTA are less reliable than those for the EC. Hence, we should expect liberalization and integration of financial markets to have significant positive effects for the EFTAns as well as for the EC.

The importance of foreign supplies in increasing competition in EFTA's small services markets is evident from Norman's (1991) study of the Norwegian banking sector. The deregulation that took place during the 1980s led initially to increased competition, but it was followed by severe losses and a wave of mergers and acquisitions; the result was that the degree of concentration in the domestic financial sector is at least as high now as it was before deregulation. Larger markets and international competition seem to be the only reliable way to ensure efficiency in such markets. Norman concludes that the EFTA countries should expect clear but moderate gains in most manufacturing industries from participating in the EC internal market, but the potential benefits from increased international competition in services are much larger.

2.3 Agricultural Policy in EFTA and the EC

Although agriculture accounts for only a small proportion of GDP in the EFTA countries, it will be among the most sensitive of issues in the enlargement debate. Indeed, it is already so sensitive as to be excluded from the existing EC-EFTA free trade agreements and for the most part from the EEA. Hence the issue here is very much one of full accession. This section notes the very high levels of agricultural protection in the EFTA countries and considers their rather different objectives from those espoused for agricultural protection in the EC. It then explores the plausible effects of membership on EFTAn agriculture – trade creation and diversion, lost tariff revenue and reduced output – and briefly argues that while adopting the CAP will reduce actual levels of protection, and hence boost welfare, it might reduce the chances of getting a genuinely rational agricultural policy in the future.

2.3.1 Levels of Protection

Most EFTA countries have more highly protected agricultural sectors than the EC and in that respect stand to gain significantly in welfare terms from the *liberalizing* effects of adopting its Common Agricultural Policy (CAP)! On the other hand, reaping these gains will involve a degree of economic adjustment as resources are channelled out of agriculture and into more productive activities, and it will antagonize a powerful and articulate sectional interest – the farmers. Moreover, wider arguments about the role of agriculture in national security and in populating rural areas will make it more difficult to reduce this inflated sector to size. On a national level, the adoption of the CAP, with its strong element of EC preference, will cause trade diversion that will at least partly offset the benefits of lower levels of protection.

The high levels of agricultural protection in EFTA are shown in Table 2.3.1. The producers' subsidy equivalent (PSE) summarizes the extent to which agricultural policy raises farm incomes: EC farmers' incomes are therefore 49% higher than they would be if they produced the same level of output but had to sell it at world prices. The remaining columns report the transfers to the farm sector in absolute and per capita terms. Of course a successful conclusion to the Uruguay Round would reduce these figures independently of accession to the EC, so some adjustment in agriculture looks likely anyway.

2.3.2 Policies and their Objectives

Not only are protection levels higher in EFTA than in the EC, but, at least to some extent, they arise from a different set of objectives and policies.

Austria's accession to the CAP is not likely to cause adjustment problems, since its system of agricultural support is fairly similar to that of the EC both quantitatively (PSE

Table 2.3.1: EC and EFTA Countries' Support to Agriculture. 1991.

	Total $ billions	*$ per capita*			*Producers' Subsidy Equivalent (%)*
		Taxpayers	*Consumers*	*Total*	
EC	142.0	168	241	409	49
Austria	4.1	143	381	524	52
Sweden	3.6	100	316	416	59
Finland	5.9	460	677	1,137	71
Norway	4.2	493	494	987	77
Switzerland	6.4	236	689	925	80

Source: OECD, *Agricultural Policies, Markets and Trends.*

52% against the EC's 49%) and qualitatively. It makes use of direct price supports, export subsidies and input controls; production quotas govern milk, sugar and wheat; 'alternative' crops such as oil seeds receive production subsidies; and most prices are controlled. Austria is, however, more heavily dependent than the EC on direct payments to farmers – with regional subventions for many farmers and high direct payments to mountain farmers forming part of its population policy.

Switzerland operates a similar system to Austria's, but, with an overall PSE of 80%, on a much more protected level. Unlike most countries, Switzerland increased the producer prices of cereals over the 1980s and as a result experienced expanding production. Dairy output, on the other hand, has had to be firmly controlled by quotas and taxes on excess production – not unlike the EC's policy. Direct payments to farmers in mountainous and disadvantaged regions are high and are explicitly recognized as having a social dimension.

Sweden has undertaken its own agricultural reform in the last few years, with the result that farmers see accession to the EC as a potential bastion for their privileges. The pattern of trade policies is similar to the EC's, coupled with set-asides and dairy production restraints to control domestic output. Of the overall PSE of 59%, around three-quarters comes to farmers directly from consumers, the highest percentage in Table 2.3.1.

Finland has a very protective agricultural policy, aimed at maintaining a high degree of self-sufficiency for strategic reasons and at populating its extended eastern border. Its PSE, which has declined slightly to 71% in 1991, is generated by a combination of high

guaranteed prices supported by import controls, set-asides, production and export subsidies, and direct payments. The last are directed at the northern and eastern parts of the country, but they have not stemmed the decline of the farm population. Although adopting the CAP will cut farm support significantly, the Finns appear to have accepted that adjustment is inevitable: the farm population, which has a high average age, is expected to halve by the year 2000 quite independently of EC membership, and the obvious importance of industry to Finland's future westward-looking development means that the need for policy change is widely perceived. The Finnish farmers' organization has estimated that accession to the CAP will halve Finnish agricultural output.

Norway also operates an extensive system of administered prices, with export subsidies and deficiency payments for farmers. The latter have stimulated output, with the result that production limits are necessary. A half of total assistance (PSE 77%) comes from price support and prices have been increased quite strongly recently. Thus Norway faces considerable adjustment on accession. It also offers extensive direct payments to small farmers and disadvantaged regions. Finally, fisheries provide a potential difficulty for the Norwegians, since accession would open their fishing grounds at least partly to EC fleets.

For Iceland, fishing is almost the only issue, and one which has led it to declare that it will not seek full membership immediately. Iceland lost some of its EC market with the accession of Spain and Portugal and now fears that '1992' might further discriminate against it; but it is sufficiently nervous about fishing rights, rather than markets, to stand aside from the current scramble for membership.

2.3.3 The Effects of Membership

Applying the CAP will reduce the producer prices of most EFTAn agricultural outputs. This will raise EFTAn incomes overall, by allowing factors of production to concentrate on more productive activities and by encouraging consumption to expand. Against this, however, it must be noted that the EFTAns will lose tariff and variable levy revenue. At present, tariffs accrue to the national governments, but after accession dutiable imports will fall, as tariff-free EC sources displace other suppliers. This is known as trade diversion and is likely to be costly since unlike manufactures trade, tariffs on agricultural trade can be quite high.

But there are two further aspects to be considered. First, as is the case for all EC members, the revenue that is raised on any remaining imports from third countries will accrue not to Oslo or Stockholm, but to Brussels, as so-called EC 'own resources'. EC membership therefore entails effects that differ from those considered in traditional analyses of accession to a customs union, since the joining countries lose not just tariff revenue on diverted trade but all tariff revenue. Second, much of the revenue EFTA currently collects on agricultural imports is actually paid by Brussels, through the large export subsidies it offers EC farmers to export to EFTA; current policy thus entails a

Table 2.3.2: EFTA's Imports of Wheat. 1990. Quantities in Thousand Tonnes, Prices in Dollars per Tonne.

	North America	*EC*	*EFTA*	*Total*	*Average Import Price*	*Internal Producer Price (1989)*
Austria	–	0.4	–	0.4	650	318
Finland	13.2	0.5	–	13.7	219	574
Norway	87.6	32.9	83.0	203.5	171	415
Switzerland	168.5	48.1	4.1	221.5	231	724
Sweden	48.8	0.6	0.6	50.2	185	223
Total	318.1	82.5	87.7	489.3		
Implicit Tariff Revenue ($ millions)[a]	111	32	22	165		

Sources: Trade data: UN, *Commodity Trade Statistics*, Series D;
Prices: OECD, *Agricultural Policies, Markets and Trade.*

Note: (a) Sum across markets of (internal price – import price) × imports.

transfer from the EC to EFTA that will stop on the latter's accession. This is of little consequence to the EFTAns, since they will no longer receive the revenue anyway, but it is one of the attractions the EC finds in EFTAn accession. The EFTAns' accession offers budgetary relief, not only through their direct contributions to EC coffers – see below – but also through reductions of expenditure on agricultural export subsidies.

Table 2.3.2 illustrates these points with regard to wheat. It gives the breakdown of EFTA countries' imports of wheat, along with their average import prices and internal producer prices. If tariffs and levies accounted for all of the difference between the internal and c.i.f. import prices, these imports would generate revenues of around $165 million per year, all of which would be lost to the EFTA countries. In fact, however, some of the difference is absorbed by private rents – e.g. traders' margins – some of which will survive accession, albeit at lower levels because internal prices will fall. Hence the actual loss is somewhat below $165 million.

Table 2.3.2 also highlights the USA's potential loss of wheat export sales to EFTA. It is difficult to estimate the degree of trade diversion that will occur, but given the EC's grain surpluses it is easy to imagine North American exports falling by three-quarters.

Table 2.3.3: Effects on EFTA of Adopting the CAP, with and without the MacSharry Reforms. Percentage Changes from 1987 Base Data.

	Production		*Consumption*		*Producer Prices*	
	With	*Without*	*With*	*Without*	*With*	*Without*
Wheat	−11.0	−10.6	6.9	12.7	−15.2	−27.8
Coarse grains	2.4	−6.6	−9.4	−8.1	−1.7	−16.3
Dairy	−16.1	−17.5	6.9	7.7	−30.2	−33.0
Beef	−9.6	−15.6	4.6	13.3	−18.4	−26.5
Pork	−1.3	7.8	16.1	14.0	−12.2	−12.3

The reduction in maize sales caused by Iberian accession in 1986 caused considerable US-EC friction; given the excessive US expectations built up in the Uruguay Round and their inevitable frustration in any eventual settlement, it is bound to be worse this time round.

Table 2.3.2 does not reveal the full extent of export subsidies saved by Brussels, however, for two reasons. First, these are related to the difference between EC internal prices and world export prices – perhaps $110 per tonne. Second, wheat accounts for only a small fraction of EC cereals exports to EFTA. Total exports were $572 million in 1990 and comprised mostly processed rather than crude cereals. Since only the cereals content of processed goods attracts subsidies and such data are not available to us, we can not calculate the gross subsidy.[2] One may assume, however, that it is substantial.

In animal products, both the EFTAns and the EC are more or less self-sufficient, and trade volumes are relatively small. Hence accession implies large proportionate changes, but the absolute trade reorientation is small. The EC already exports some animal products to EFTA and will therefore save some export subsidies relative to the present situation, and its exports will also grow somewhat as EFTAn output falls. Moreover, in future one should expect continuing EC efforts to control surpluses, especially of dairy products, which will probably further cut EFTAn output relative to the position under the EEA. Overall, accession will therefore entail a degree of downsizing in EFTAn agriculture, but it will also probably consolidate the protection that remains. As the Swedish farmers feared, once a small country has decided to reform agricultural policy, it can probably proceed further along that road than the EC with its tradition of committee bargaining and politically brokered decision-taking.

Table 2.3.3 provides very rough numerical estimates of the effects of integrating EFTAn agricultural policy into the CAP. It is based on a model that represents agricultural protection in terms of the differences between regions' internal prices and world prices, and assesses what happens if the differences in EFTA countries are reduced to EC levels. Adopting the CAP broadly as it stands today entails reductions in all producer prices, ranging from 30% for milk to 2% for coarse grains. Taking the cross-price effects into account, EFTAn wheat output falls by 11%, dairy produce by 16% and beef by 10%. The opposite movements in consumption indicate higher imports, most of which come from the EC. In the 'post-MacSharry' position EC – and hence EFTAn – protection on cereals is assumed to be lower by 15%, beef by 10%, and dairy produce by 4%;[3] the additional price shocks reduce production further, but they affect the mix more than the aggregate level. Overall agricultural output declines by 10-15%, while consumption and welfare increase correspondingly. These figures should certainly not be taken literally, but their basic suggestion of significant but not intolerable agricultural adjustment in the EFTA countries is probably robust.

The major agricultural issue between EFTA and the EC(12) will be the EFTAns' direct support payments to farmers in inhospitable areas. Although the CAP is supposed to address the rural population problem in the EC, it does so by technical advice – to raise productivity to viable levels – and gradual adjustment where that is impossible. Even putting aside the CAP's disappointing results in this regard, it is plain that its approach is fundamentally different from that of the EFTAns, whose objective appears to be to maintain populations in inhospitable regions regardless of their agricultural viability. The comprehensive regional subsidies in the EFTA countries are quite different from the payments suggested by the MacSharry Plan for the CAP, which explicitly compensate farmers for the cut in cereals prices according to their past yields and acreage. MacSharry's concession to the Germans, allowing them to pay additional compensation nationally, offers a precedent for the EFTAns to continue their regional payments, but only on a much smaller scale than they currently do.

Two 'solutions' look possible. First, it may be possible to define a new class of disadvantaged region for inhospitable areas, using existing hill-farm subsidies as a precedent. However, given the strain on the CAP budget, it seems unlikely that other member states will be willing to transfer significant amounts to these relatively rich regions under its rubrics. More likely, a new form of regional policy will have to be devised, allowing members to transfer their own funds to certain regions subject to the condition that this does not distort the common market or entail the EC policies in additional expenditure.

Fisheries also present problems to the present institutional structure. However, as Gylfason (1991) has argued convincingly, if fishing rights were auctioned, and if the licence fees for Icelandic and Norwegian fishing grounds accrued to those countries (just as they do for North Sea oil and land-based resources such as coal), their incomes would be protected. There is a danger that employment in the local fishing industries would contract, but as Gylfason observes, Iceland and to a lesser extent Norway maintain highly efficient fishing fleets, so that they are likely to be able to outbid other

EC firms for the rights to fish northern waters. In fact, however, access to Norwegian waters could probably be limited in any final agreement in the name of conservation, an issue of increasing importance in EC policy-making.

2.3.4 The Prospects for Agricultural Reform

Agriculture illustrates the political dimension of fuller European integration. It is a tiny sector economically, and yet has so great a weight politically that it has had to be kept right outside the existing EC-EFTA free trade agreements and plays only a minor role in the EEA Agreement. Indeed, strong feelings about agriculture could prevent the accession of certain potential members – e.g. Norway – and will certainly lead to a huge expenditure of energy and goodwill in negotiations with the others.

EC membership will take agricultural policy outside the competence of national governments and will for that reason be welcomed in some EFTA capitals, provided that the terms of entry are not too draconian. Indeed, at least some parts of some EFTA administrations see membership as a way of controlling, and making credible commitments to control, their agricultural lobbies. There is, however, a strongly second-best flavour to such arguments. The CAP may currently provide lower protection than local policies, but it appears to be more or less immune to fundamental reform. While the recent (MacSharry) reform has taken steps in the right direction of decoupling farm support from agricultural production, it has not gone far enough to address the fundamental disequilibria in EC agriculture. It was extremely arduous to negotiate; and it ended up substantially weaker than the Commission had originally wished (see *Agra Europe* (22 May, 1992)). The MacSharry reform illustrates well the problems of the EC's current method of policy-making (see Scharpf (1988)): with no exit mechanism for dissenters and the need for near unanimity among member states, the *status quo* is a very likely outcome of any negotiation. When that is impossible, each of the various interests at the table has to be given something in the final solution, and since these interests are national administrations rather than the legislatures or the voters directly, bureaucratic convenience gets a much higher weight than is desirable. As a result, reform tends to proceed in a series of minimal steps hedged about by caveats that create precedents for future interventions. Overall, it seems likely that there is less chance of a genuinely liberal and economically rational agricultural policy emerging from the EC than from a unitary and smaller state acting in isolation. Thus, for example, until the prospect of EC membership suggested that there would always be a high degree of agricultural protection, the recent Swedish agricultural reform looked much more likely to achieve major change than has any EC round.

This section has shown that agriculture is more highly protected in EFTA than in the EC and thus that accession will generate economic benefits in terms of consumption gains and releasing factors of production for more useful tasks elsewhere. The latter, of course, will entail a contraction of EFTA's agricultural output. Accession will also entail losses of EFTA's tariff revenue and trade diversion. The EC will probably agree to the EFTA governments continuing their subsidies to farmers in inhospitable areas,

but by bringing these into the framework of the CAP may make them more difficult to reform in future. EFTAn accession will increase EC agricultural exports slightly and reduce export subsidies, and will for that reason be welcomed in Brussels.

2.4 Growth Effects of the EEA

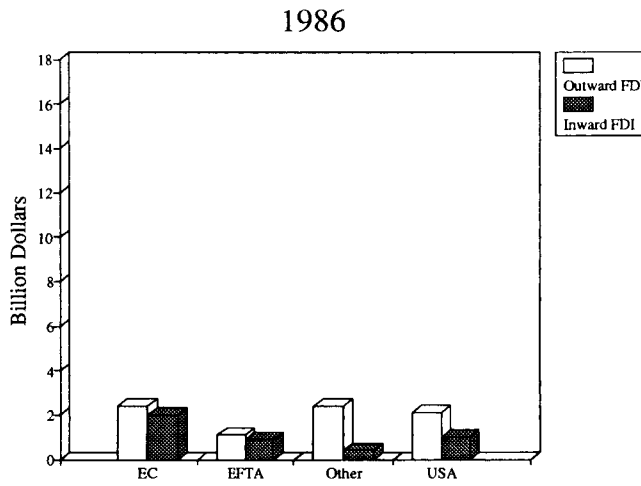
The small size of the aggregate effects of the EEA Agreement calculated by Haaland and Norman (1992) – Table 2.1.3 – is quite typical of studies that focus only on static, i.e. one-off, effects. Despite this, economists have long held that free trade matters because in addition to its static effects it has a growth effect. Until recently, this view had to be qualified by the proviso that growth effects were poorly understood and impossible to measure. Since the late 1980s, however, our understanding of these growth effects has begun to expand, through the endogenous growth literature introduced by Paul Romer (e.g. 1986) and refined by many. Moreover, although the development of techniques for evaluating the empirical impact of dynamic gains from trade lagged behind the theory, it is at last beginning to make some headway (see for example Baldwin (1989) and (1992)).

Of the many possible dynamic effects that have been examined in the theoretical advances, the best understood is that of endogenous physical capital formation. It rests on the observation that a nation's stock of physical capital and technology are not like land or natural resources; rather, they are the endogenous outcome of economic decisions. Other approaches – such as those relying on human capital – are still in the experimental stage. This section illustrates the potential benefits of stimulating EFTA's investment – perhaps up to 2% of GDP – and discusses other growth effects in principle. Finally, it notes the importance of the irreversibility of policy changes in stimulating growth and observes the advantages of EC membership over the EEA in this regard.

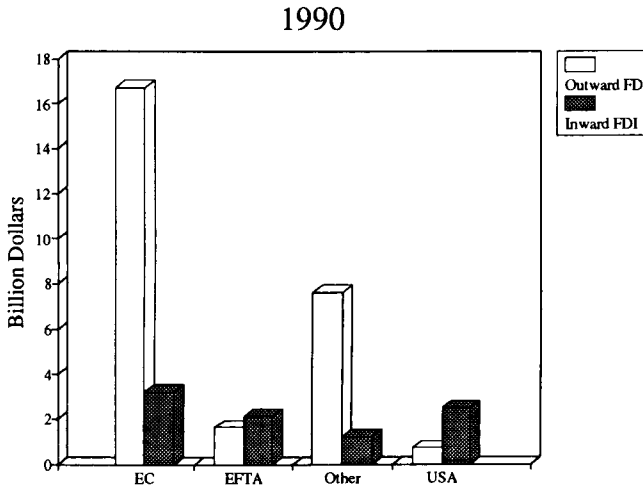
2.4.1 Investment Diversion

The basic approach to measuring the growth effects of EEA due to endogenous capital formation is straightforward. A change in policy large enough to have a noticeable economy-wide impact is likely to alter the productivity of the nation's capital thereby inducing a change in the nation's equilibrium capital stock. In the short term, this shows up as a change in the return to new investment. Haaland and Norman (1992) estimate that if the '1992' single-market programme is successful but EFTA does not join the EEA, the return to EFTAn capital will drop by 0.04% (not percentage points, i.e. the initial return to capital, say, 4%, will fall to 3.96%), while the return to EC capital will rise by 0.57% (see Table 2.1.3). In contrast, if EFTA does participate in the EEA, the return to EFTAn capital rises by more than the return to EC capital (1.01% versus 0.61%). These results strongly suggest that EFTA would experience a reduced rate of investment without membership of the EEA, while it would benefit from a moderate

Figure 2.4.1: EFTA Countries' Foreign Direct Investment Flows to and from Rest of EFTA, EC, US and Rest of World. 1986 and 1990.



Source: EFTA (1991)



Source: EFTA (1991)

stimulation of investment with it. The growth implications of this are clear. If EFTA did not join the single market, it would experience slower output growth until the new lower equilibrium level of the capital stock were reached. If EFTA did join, on the other hand, its growth would be stimulated by the extra investment until the higher equilibrium capital stock were reached.

There is in fact some suggestive evidence that this investment diversion is already occurring between the EC and EFTA. Figure 2.4.1 shows how EFTA's inward and outward foreign direct investment flows have changed between 1986 and 1990. The top panel shows the nominal values of EFTA's outward and inward direct investment in 1986 (the year in which the '1992' programme formally started). The second panel shows the corresponding figures for 1990. The EC has become a much less important source of foreign investment flowing into EFTA, with the EC share dropping from 47% to 36% between 1986 and 1990. Over the same period, the EC has become twice as important as a destination for EFTA's outward foreign direct investment, with its share rising from 30% to 63%. The change in the levels of these flows has been even more impressive. EFTA's flow of direct investment into the EC rose almost sevenfold in nominal terms, while the flow of EC direct investment into EFTA rose only 1.6 times. Clearly this evidence is only suggestive, since many factors affect flows of direct investment, but it is nevertheless striking.

The key to gauging the importance of this effect in the long run is to determine how much the capital stock must rise in order to restore the equality between the costs and benefits of further investment. This can be accomplished using the following condition:

Marginal Return to Investment = Discount Rate + Depreciation Rate

This states that in the long run, the capital stock in each country must be sufficiently large that the real marginal product of capital just equals the discount rate plus the rate of depreciation of capital. This assumes diminishing marginal returns to capital. Given the changes in the return to EFTA and EC capital indicated by Haaland and Norman's estimates, the capital stock in both EFTA and the EC should rise if the EFTA countries join the EEA, whereas only that of the EC will do so if EFTA does not join. In fact, if we are willing to assume a simple but standard form for the relationship between output and capital, we can make a back-of-the-envelope calculation directly. This suggests that induced capital formation will increase EFTA's gains from the EEA by 1.3-2.0% of GDP. The details of the calculations are explained in Box 2.4.1.

2.4.2 Long-run Growth Effects

In addition to the effects discussed above, there are a number of plausible dynamic effects which economists have so far been unable to quantify. We briefly address two of them: permanent growth effects and the 'offshoring' of EFTA industry to the EC. The fact that they cannot be expressed in numbers does not, of course, mean that they do not exist. Indeed, it may be precisely these unquantified dynamic effects that are the

Box 2.4.1: Growth Effects from Induced Capital Formation.

If we assume a standard functional form for the relationship between capital, labour and GDP, namely, GDP equals AK^aL^b, we can perform a back-of-the-envelope calculation of growth effects of EFTA's membership and non-membership based on the Haaland–Norman estimates listed in Table 2.1.3. Assuming that the initial capital stock is approximately in long-run equilibrium and that the labour force is approximately constant (as it has been in Western Europe for the past decade), the long-run change in the capital stock is related to the initial change in the return to capital as follows:

(percentage change in K) = $[1 - a]^{-1}$(percentage change in return to capital).

The long-run increase in output implied by the increase in the capital stock is:

(percentage change in GDP) = $[(1/a) - 1]^{-1}$(percentage change return to capital).

It is clear that this long-run effect on output will be a multiple of the initial change in the return to capital.

The next step requires estimates of a, which is just the capital output elasticity. This is difficult to estimate accurately: estimates range from 0.23 to 0.48 (Baldwin (1992)). Using this range of estimates gives us a range of output effects between 1.30 and 1.92 times the initial change in the return to capital (estimated to be 1.01% by Haaland and Norman (1992)).

Of course the full adjustment of the capital stock to its new levels may take decades. As a result, this dynamic effect will look like an small increase in the growth rate for a long period of time.

primary motive driving the EFTA industrialists and governments to seek closer integration with the EC. We discuss them in terms of the negative effects of EFTA's failing to join the EEA, but the arguments apply *pari passu* to the positive effects of joining.

Haaland and Norman estimate that if EFTA does not join the EEA the return to human, as well as to physical, capital in EFTA will fall (see Table 2.1.3). Moreover, any such

fall in the return to skilled EFTA labour would probably be amplified by the induced capital formation effects just discussed. Since the productivity of EFTA workers depends in part upon the amount of capital per worker, a long-run decline in the capital stock will most likely harm the productivity and wages of EFTA workers, and to the extent that highly-trained workers are internationally mobile, this suggests that the EFTA countries would experience a brain drain if they did not join the EEA.

A fall in the return to skilled labour may also permanently reduce EFTA's growth rate of output. In an endogenous growth model the rate of growth depends upon the rate of accumulation of factors that do not experience diminishing returns. Lucas (1988), for example, supposes that it is the accumulation of human capital that drives output growth: each generation is more highly educated, and therefore more productive, than its predecessor, but because knowledge accumulates through time, the fraction of primary resources that must be devoted to educating them does not rise. In this framework, it is likely that any depression in the demand for human capital in the EFTA countries will slow the rate of human capital formation permanently and thereby permanently reduce the growth rate in the EFTA countries. The systematic migration of a fraction of skilled EFTA labour would have a similar effect.

2.4.3 Economic Geography

A further source of economic effects comes from the emerging literature on economic geography (Krugman (1991)). This literature, which can be thought of as the 'new' location theory, studies the geographic clustering of economic activity. Since land prices and the cost of non-traded goods tend to be much higher in areas of economic concentration (London, Milan, Paris, etc.), there must be some type of economic benefit from locating physically near other firms that offsets the extra costs. An explanation for this is that physical closeness provides some form of common benefit that escapes the market mechanism in the sense that it is shared by many firms and is not the 'property' of any firm or individual. The sources of this benefit range from technology and informational spillovers, through the depth of the pool of human resources available to firms, to the hard-to-define amenities of living in population concentrations.

Whatever the explanation, the implications for EFTA countries are clear. Staying outside the single market will reduce EFTA countries' industrial output via the direct, one-off, investment diversion and long-run growth effects. This may then be exacerbated by an additional 'offshoring' of EFTA plants to the EC, as the reduced attractiveness of EFTA locations leads some EFTA-based firms to move to the EC. Such a response seems especially likely among large EFTA multinationals that depend heavily on the EC market. Thus, if the external economies of industrial agglomeration are important, then a reduction of output, for whatever reason, will reduce the competitiveness of the remaining EFTA industry, and loss of EFTA output due to the direct effects could be magnified by locational factors.

Unfortunately, economists are presently unable to quantify such geographical effects, because the current generation of computer models does not allow for the spillovers that explain economic concentrations. Consequently they cannot capture the full impact of EFTA firms moving to the EC. Nevertheless, the latter may be very important.

2.4.4 Commitment and Irreversibility

If the single market is to lead to greater efficiency and competition, European firms must change their behaviour. In many cases, adapting to the new integrated Europe will involve substantial up-front costs. For instance, embarking upon a campaign to expand market share in EC countries or relocating production facilities can be quite expensive. Faced with up-front costs and the promise of future rewards, European firms would be irresponsible not to question the permanence of the single-market reforms. After all, history shows that governments often change their minds and reverse policies that were announced as permanent.

The evidence on restructuring activity within the EC suggests that EC businesses are convinced that the single-market reforms are here to stay. Jacquemin (1992) presents data that show the value of EC mergers and acquisitions has increased steadily since the mid-1980s, increasing roughly one-and-a-half times between 1985/6 and 1989/90. It appears that EC membership and the adoption of the Single European Act furnish sufficient assurances that the policy changes are irreversible. It is less clear, however, that the signing of the EEA Agreement provides EFTA firms with equal assurance. In particular, suppose an EFTA-based firm with extensive exports to the EC is considering building a new factory or service facility. If its home country does not join the EC, the safe bet is to set up in an EC country rather than at home, since this locks in the reduced trade costs of the '1992' programme. This sort of haemorrhaging of industries could cost the EFTA countries dearly in the long run. In contrast, if the EFTA country becomes a full EC member, there is no artificial reason for the EFTA-based firm to relocate. Unfortunately, this sort of effect is extremely difficult to quantify, but it may be the most important aspect of moving from the EEA to EC membership.

2.5 EFTA and EMU

A key feature of EC membership is participation in the European Monetary System for those countries that are ready and willing. Greece does not yet participate in the Exchange Rate Mechanism of the EMS, and the UK negotiated at Maastricht a specific opt-out clause in respect of EMU. Thus although there is a presumption that new EC members will join in EMU, participation in EMU is not part and parcel of membership. In the still uncertain future, the EMS is to evolve into a full monetary union. In this section we deal with two main issues. First we examine the extent to which potential participation of EFTA countries in EMU alters the prospects of a European monetary union. In Section 2.5.1, we assess the readiness of EFTA countries to join the future

monetary union. We first summarize the set of economic preconditions contained in the Maastricht Treaty that will determine the eligibility of a country to participate in EMU. Next, we compare these criteria with the current economic conditions of the various EFTA countries to determine which ones already satisfy them.

Section 2.5.2 then discusses the implications of the enlargement to EFTA for the timetable of EMU. First, we compare the positions of the current EC members with those of the EFTA countries with respect to EMU preconditions. We conclude that the presence of EFTA in the EC increases the number of countries that will be eligible for an early start for EMU. Next, we discuss a few scenarios in which this could permit an early start for EMU.

The discussion in these two sub-sections makes clear that some EFTAns will welcome the monetary credibility associated with the EMS. In addition, the benefits of a single currency, in terms of reduced transactions costs and uncertainties about future parities, will be shared by both EC and EFTA members. The main cost of monetary union is the loss of monetary independence, hence of the ability to smooth an occasional large idiosyncratic shock through exchange rate adjustment. The nature of economic shocks affecting both EC and EFTA economies could be such that the membership of EFTAns in EMU significantly changes the magnitude of this cost for EC incumbents. It could also make it economically unviable for some EFTAns to join EMU.

Sections 2.5.3 and 2.5.4 deal with these questions. First, we argue that in a monetary union, the ability of monetary policy to stabilize output is limited to the common component of fluctuations. Next we try to disentangle idiosyncratic and common components of output shocks in the EC and EFTA countries. Finally, we rank countries according to the cyclical characteristics of their output in order to determine which ones will be most affected by joining EMU. Section 2.5.4 concentrates on fiscal policies. We review the argument in favour of centralizing fiscal policies in a monetary union and discuss recent related studies based on US and Canadian experience. Next, we distinguish between the stabilization and redistributive roles of fiscal policies. We conclude by arguing that stabilization can be achieved without centralizing fiscal policies. Section 2.5.5 summarizes our findings.

2.5.1 EFTA Entry into EMU

The Maastricht Treaty defines a set of conditions that a country has to fulfil before it qualifies to participate in EMU. Table 2.5.1 summarizes these prerequisites. These are conditions on the public debt, public deficit, inflation rate and interest rates.[4] Taken as a whole, they specify a criterion of fiscal and monetary convergence among potential EMU members. The wording of the Treaty is sufficiently vague, however, to allow for a certain degree of flexibility in the application of these criteria. For example, in the case of fiscal convergence, the Treaty seems to suggest that attaining a level of national debt below 60% of GDP may not be necessary, as long as the debt is diminishing and approaching this target at a 'satisfactory pace'. Similarly, the Treaty seems to allow for

Table 2.5.1: Maastricht Convergence Conditions.

	Target Variable	*Condition*
Public Debt	General (Central and Local) Total Gross Debt Outstanding	Not exceeding 60% of GDP
Public Deficit	General Government (Central and Local) Net Lending	Not exceeding 3% of GDP
Inflation Rate	Growth Rate of Consumer Price Index	Not exceeding by more than 1.5% the third-lowest in the EC
Interest Rate	Interest Rate on Long-term Government Securities	Not exceeding by more than 2% the highest interest rate among the three countries with lowest inflation rates in the EC

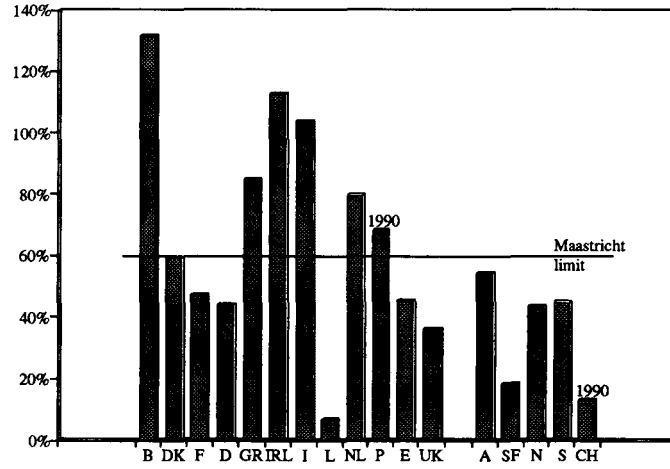
levels of public deficit above 3% of GDP, as long as they are of an 'exceptional and temporary' nature. Moreover, the reference values cited above are not in the Treaty itself. They are contained in an attached protocol and thus subject to future alterations. Political considerations will determine how strictly these criteria are applied. None the less, in evaluating the suitability of the EFTA countries for entry into EMU, it is convenient and instructive to use as bench-marks the reference values mentioned in these protocols.

Figure 2.5.1 (first panel) deals with the precondition on public debt. The Maastricht Treaty sets an upper bound to debt accumulation by the national fiscal authorities. Accordingly, the total outstanding gross debt of the general government (i.e. central plus local governments) should not exceed 60% of GDP. Figure 2.5.1 reveals that all five EFTA countries satisfy this condition. Data for Iceland is excluded since it has been announced that they will not apply for EC membership. It also shows that their situation is quite different from that of the current EC members, half of which fail this requirement.

Similar indications are provided by the second panel of Figure 2.5.1, which shows the behaviour of public deficits. The Maastricht Treaty sets a limit of 3% of GDP for general government net lending. If the Maastricht criteria were applied today then all EFTA countries would comply with this constraint. Again, however, the situation is different for EC members, five of which overshot this target in 1991.

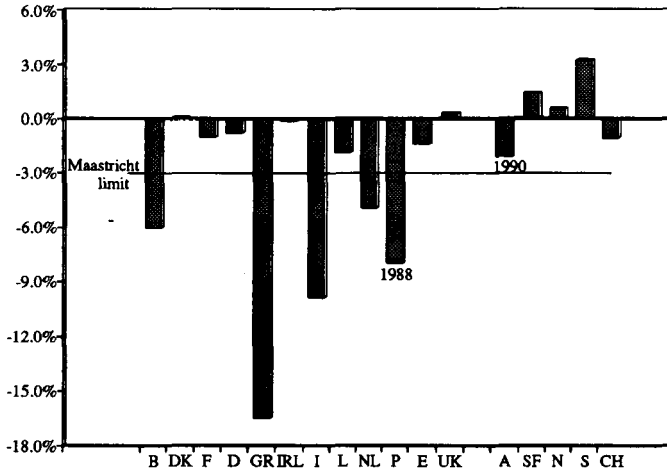
Figure 2.5.1: Fiscal Preconditions.

Gross Debt/GNP. 1991.



Source: OECD, *Economic Outlook*

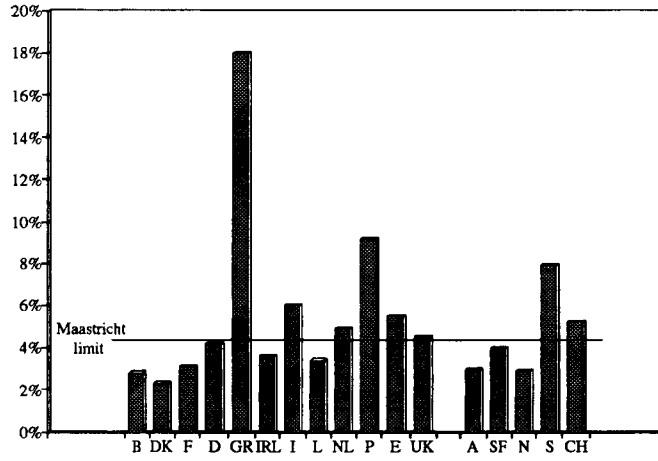
Net Lending/GNP. 1991.



Source: OECD, *Economic Outlook*

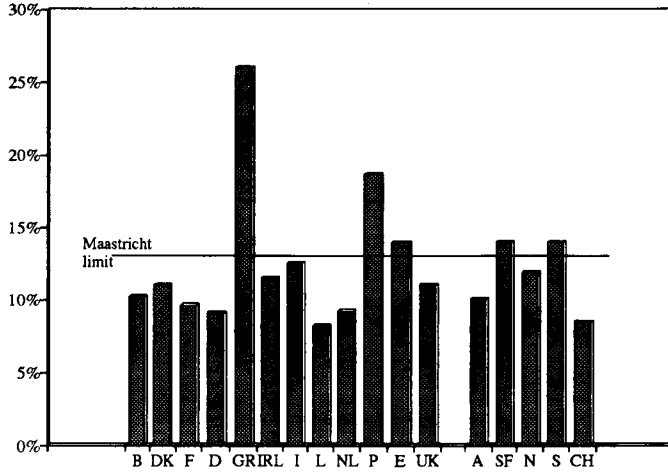
Figure 2.5.2: Monetary Preconditions.

Inflation Rate. 1991.



Source: OECD, *Economic Outlook*

Long-term Interest Rates. 1991.



Source: OECD, *Economic Outlook*

This evidence of fiscal discipline in the EFTA countries contrasts with their performance in terms of monetary convergence. From Figure 2.5.2 we learn that, in 1991, two of them (Sweden and Switzerland) exceeded the ceiling set in Maastricht for inflation. This limit is set at 1.5 percentage points above the third-lowest inflation rate (in terms of the consumer price index) among Community members. In 1991, the third-lowest level of inflation was in France at 3.1%. Figure 2.5.2 also shows that Finland and Sweden did not meet the convergence criterion in terms of interest rates. The relevant interest rate is the interest rate on long-term government bonds. The limit is set at two percentage points above the highest interest rate among the three lowest-inflation countries in the EC. In 1991, this was Denmark, with a long-term interest rate of 11%.

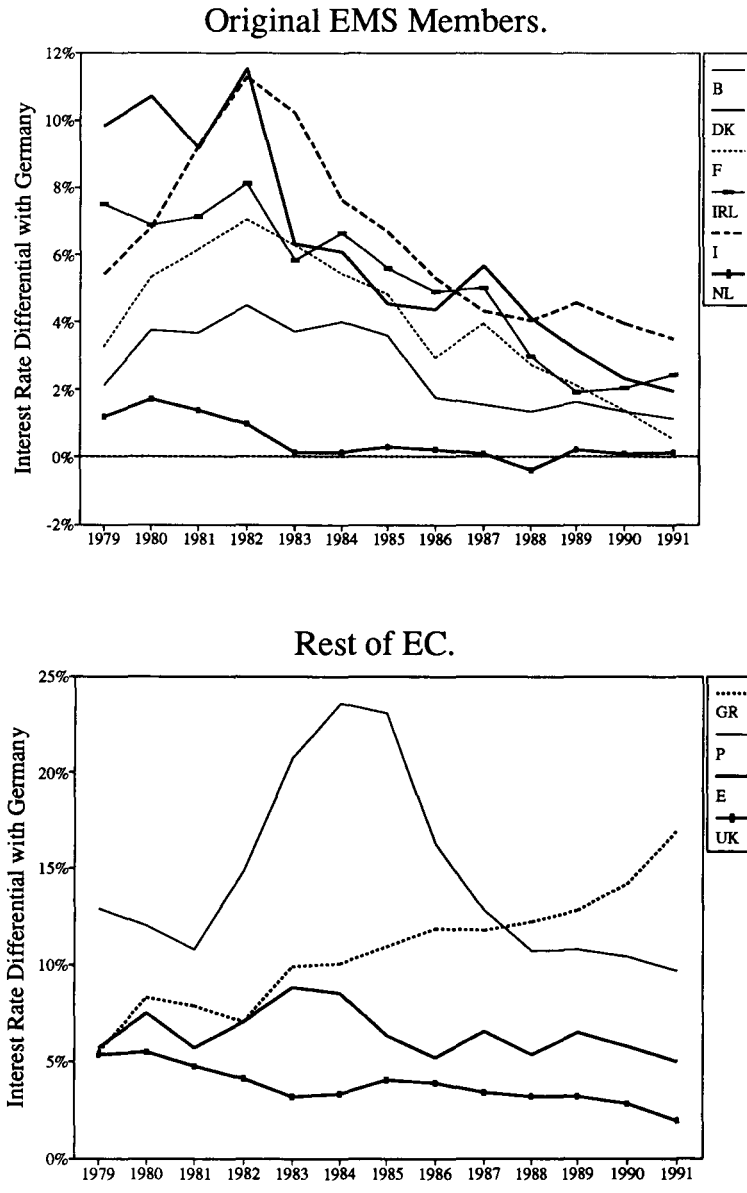
Summing up, of the five EFTA countries only two (Austria and Norway) currently satisfy the Maastricht convergence criteria. The failures of the other three to meet these conditions are due to excessive levels of inflation and interest rates. This may be further evidence of the benefit of the ERM for monetary convergence. The EFTA countries, not being part of the EMS, have not been able to achieve the same gains in terms of inflation reduction and interest rate convergence as the participants in the System. This point is made in Figure 2.5.3, which plots the behaviour of the interest rate differential (in terms of long-term rates) between each country and Germany. For clarity, we divide the countries in three groups. In the first panel of the figure, referring to the original seven participants in the EMS, the converging pattern of nominal interest rates towards German levels emerges clearly. This contrasts with the second panel, which plots the behaviour of the interest rate differentials of the remaining countries in the EC, and the third panel, which plots the differentials with respect to the EFTA countries. No clear evidence of convergence can be detected in either case.

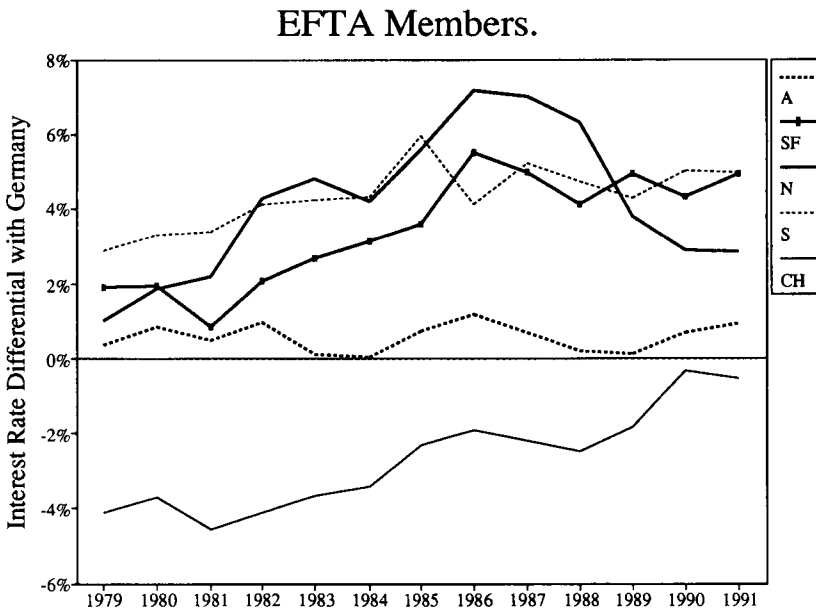
2.5.2 Political Economy Impact on the Timing of EMU

After the result of the referendum in Denmark, the future of the Maastricht Treaty is unclear. Renegotiations of the Treaty may take place that could change the aim or the timetable of EMU. The factors that will influence these developments most strongly are mainly political and largely beyond the scope of this report. Here we address a more confined set of questions. Assuming that the main goals agreed in Maastricht are not going to be abandoned, what are the possible implications of the enlargement to the EFTA countries for the timing and depth of EMU?

We have argued that, from the point of view of the feasibility of a European monetary union, the potential enlargement of the Community to EFTA does not raise new issues or problems. The general macroeconomic conditions of the EFTA countries are similar to those of the current EC members. We have seen that progress will still have to be made in terms of inflation and interest rate reduction in some EFTA countries to fulfil the Maastricht requirements. These adjustments, however, are certainly not unique to EFTA countries. Figure 2.5.2 indicates that Greece, Italy, the Netherlands, Portugal and Spain also face similar problems of monetary adjustment.

Figure 2.5.3: Interest Rate Convergence. 1979–91.





In our view, therefore, the question of the economic feasibility of the enlargement to EFTA is largely independent of considerations of EMU. But while EMU requirements do not influence the feasibility of EFTA membership in the EC, the enlargement to EFTA may affect the economic viability of EMU. There are two main channels through which this effect could materialize: the first is political, the second economic.

The referendum in Denmark has shown that the popular support for EMU is not as widespread as was previously assumed. Further difficulties in the ratification process, now under way at the national level, may make it necessary to reopen intergovernmental negotiations and modify the Maastricht Treaty. The bargaining process may become more complicated if, in addition to the original twelve members, the EFTA countries also participate. This is not simply because an increase in the number of players will make the solution to the process of give-and-take more difficult. It is also because a positive attitude in these countries towards the deepening of the Community may not be as well established as in the current EC members. This prospect could induce the current EC members to delay the admission of the EFTA countries until EMU and the transition to a single currency are politically secured.

If these political considerations lead to a delay in the monetary unification process, other economic factors could have the opposite effect. The Maastricht Treaty clearly

Table 2.5.2: EC and EFTA Members' Fulfilment of Maastricht Preconditions. 1991.

	Debt	*Deficit*	*Inflation Rate*	*Interest Rate*	*Conditions Fulfilled*	*Eligible*
Belgium			YES	YES	2	
Denmark	YES	YES	YES	YES	4	YES
France	YES	YES	YES	YES	4	YES
Germany	YES	YES	YES	YES	4	YES
Greece					0	
Ireland		YES	YES	YES	3	
Italy				YES	1	
Luxembourg	YES	YES	YES	YES	4	YES
Netherlands				YES	1	
Portugal					0	
Spain	YES	YES			2	
UK	YES	YES	YES	YES	4	YES
Austria	YES	YES	YES	YES	4	YES
Finland	YES	YES	YES		3	
Norway	YES	YES	YES	YES	4	YES
Sweden	YES	YES			2	
Switzerland	YES	YES		YES	3	

defines the conditions that must be met before the transition to Stage III (i.e. the introduction of a single currency and the delegation of monetary policies to the European Central Bank) can be made. Specifically, the earliest possible date to enter Stage III is 1997. A necessary condition for this to happen is that a majority of member states will, by 1996, satisfy the convergence criteria discussed above. In the event that in 1996 an inadequate number of countries qualify for the monetary union, the beginning of Stage III will be postponed until 1999. At this later date, a majority of member states will no longer be required to fulfil the convergence criteria. Any country fulfilling the Maastricht conditions will be able to move to Stage III. In the light of these considerations, how likely is an early launch of Stage III? Will the enlargement to EFTA alter the timetable for EMU? Our answer is that the enlargement to EFTA will make an early start of Stage III more likely.

Table 2.5.2 summarizes each country's current situation with respect to the Maastricht preconditions. Of the present members of the Community, five (Denmark, France, Germany, Luxembourg and the UK) satisfy all four conditions. This falls short of the

Table 2.5.3: Numbers of EC and EFTA Members Fulfilling Maastricht Preconditions under Alternative Scenarios. 1991 Data.

	Countries Fulfilling Condition				*Minimum Required*	*Actual*
	Debt	*Deficit*	*Inflation Rate*	*Interest Rate*		
Present Situation						
EC	6	7	7	9	7	5
EFTA	5	5	3	3		2
EC + EFTA	11	12	10	12	9	7
'Softer' Scenario for EC						
EC	–	9	8	9	7	8
EFTA	–	5	3	3		2
EC + EFTA	–	14	11	12	9	10
Optimistic Scenario for EFTA						
EC	6	7	7	9	7	5
EFTA	5	5	5	5		5
EC + EFTA	11	12	12	14	9	10
Without Denmark and UK						
EC	–	5	5	7	6	3
EFTA	–	5	5	5		5
EC + EFTA	–	10	10	12	8	8

majority of seven, implicitly required by the Treaty for entry into Stage III in 1997. Table 2.5.3 shows that, if the situation remains unchanged, the enlargement to EFTA will have no consequence for the start of EMU. In an enlarged EC of 17 members, the minimum number of countries for the early start of Stage III would be nine. Only two EFTA countries qualify, bringing the total to seven. Stage III could not start in 1997 under this scenario.

From now to 1997, however, substantial changes may take place and the prospects for EMU may improve dramatically. There are still four years before the countries are expected to meet these requirements, and it is thus possible that other current members will succeed in doing so. This may be particularly difficult for Greece, Italy and

Portugal, given their acute fiscal imbalances. On the other hand, adjustments in Belgium, Ireland and the Netherlands may be more likely. The eligibility of some countries might be facilitated if the condition on the national debt is not strictly enforced and, instead, the milder requirement of 'approaching the reference value at a satisfactory pace' is applied. Table 2.5.3 also assesses this 'softer' scenario, assuming the requirement on debt not to be binding. If either Belgium or the Netherlands were to achieve monetary and fiscal convergence, the necessary quorum of countries would be attained, and Stage III could begin in 1997. Notice that, in the above scenario, the enlargement to EFTA does not jeopardize an early start for EMU, even if no additional EFTA country satisfies the convergence criteria.

In the above scenarios, the issue of EC membership for the EFTA countries is largely irrelevant to the timetable for EMU. But the enlargement to EFTA could make a positive difference in other, perhaps more plausible, circumstances. As described above, the current failures of Finland, Sweden and Switzerland to satisfy the criteria are due to their lack of monetary convergence. But the necessary reductions of inflation and interest rates in these three countries are quite possible; and this is certainly more likely than the achievement of fiscal convergence conditions by some current EC members. Moreover, the monetary convergence of EFTA countries could be eased if their entry into the ERM were arranged prior to their formal membership of the Community. Alternatively, as in the cases of Austria and more recently Sweden, similar reputational benefits could be achieved if they signalled a clear commitment to follow the rules and constraints of the EMS as external members. In the optimistic, but not unrealistic, scenario of all five EFTA countries achieving monetary convergence and thus meeting the Maastricht preconditions, an early start of Stage III would be quite likely. As described in Table 2.5.3, the EC membership of the EFTA countries will permit the transition to a single currency even if none of the currently diverging EC countries can fulfil the Maastricht requirements.

The importance of the entrance of the EFTA countries for an early start of EMU is also increased by the uncertain attitude of Denmark and the UK. If they remained outside the monetary unification process, they would not be included in the definition of the majority necessary for the move to EMU, which would reduce by one the quorum (from seven to six countries), while the number of qualifying countries also declined by two. Under this scenario, the chances of an early transition to Stage III in the Community of 12 would be very slight. On the other hand, even if Denmark and the UK were to opt out of the monetary union, its early start would still be possible if the enlargement to EFTA took place before 1997. France, Germany, Luxembourg and the five EFTAns would suffice to reach the quorum of eight required in this case. Such a scenario, with the common monetary institutions and policies dominated by new EC members, may be unlikely, however, for political reasons.[5]

To summarize, on the one hand, the future transition towards a European monetary union does not raise additional concerns about the feasibility of the enlargement to EFTA countries. On the other hand, the timing of the EFTA countries' entry into the EC could alter the timetable for monetary union. In particular, we have argued that the entry

of the EFTA countries could enhance the feasibility of an early movement towards a single currency. The recognition of this effect could, in turn, influence the political decision about the calendar for the enlargement to EFTA by generating support or opposition to a rapid enlargement, depending on the attitude of the current EC members towards EMU. We will return to this point in Section 2.7.

2.5.3 The Impact on Stabilization within the Enlarged EC Area

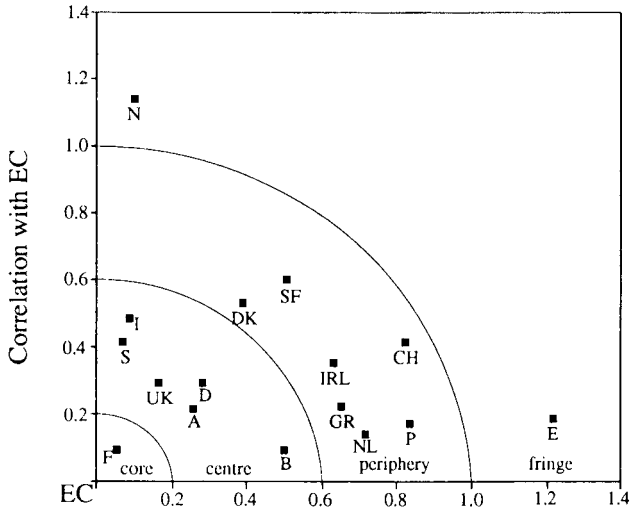
The movement towards more rigid exchange rates in Europe and, eventually, the future creation of a single currency will impose greater constraints on the use of monetary policies. In particular, it will reduce the extent to which national outputs can be stabilized through countercyclical monetary policies. In fact, the transition to a monetary union will make it impossible to offset those elements of economic 'shocks' that are particular to individual economies (the 'idiosyncratic' component of national shocks) with monetary policy. Common monetary policies can be used effectively only against the component of shocks that is common across member states. The European Central Bank, in fact, will not be able to target national outputs separately. It will have to monitor their combined behaviour, i.e. the total Community GDP. Therefore, the stabilization role of monetary policies in a monetary union depends on the degree of synchronization of the cycles of the individual members' outputs.

In order to evaluate the cost of the loss of monetary independence that a country incurs by joining EMU, we compare the cyclical behaviour of its output with that of the aggregate output of the Community. We measure a country's cyclical proximity with the rest of the EC along two dimensions. The first is the correlation between the cyclical component of its GDP and that of the EC total GDP. The second is the volatility of the cyclical component of its GDP compared with that of the EC.

The first measure captures whether and to what extent a country's cycle is synchronized with that of the rest of the Community. A large positive correlation coefficient suggests that a country's output is moving together with the output of the rest of the Community most of the time. Therefore, the timing of the country's recessions and booms will largely coincide with EC aggregate recessions and booms. Common monetary policies carried out to offset these aggregate swings will also have countercyclical effects for this particular member country. Conversely, a negative correlation coefficient indicates that the country's cycle is opposite to that of the Community as a whole. Aggregate booms in the EC will then tend to occur during recessions in this particular country, while European recessions will coincide with this country's expansions. In this case, common monetary policies will have an undesirable procyclical impact on the country.

The second measure evaluates the relative size of business cycles. When the standard deviation of the cyclical component of a country's GDP is larger than that of the aggregate Community, recessions and booms are on average more intense in this country than in the rest of the EC. Monetary policies tailored to Europe-wide economic movements will tend to be insufficient to offset the national disturbances.

Figure 2.5.4: EC and EFTA Members' Cyclical Distance from EC. 1960–90.



Summarizing, a member country's cyclical closeness to the rest of the Community increases with: (a) the correlation coefficient between the temporary component of its GDP and that of the Community; and (b) the closeness of the standard deviation of the temporary component of its GDP and that of the Community. The smaller is this 'cyclical distance' from the EC, the larger is the extent to which a common monetary policy will stabilize the national economy.[6] In Figure 2.5.4 we plot, for each of the current EC members and for the EFTA countries, this measure of 'cyclical distance' from the EC. The vertical axis measures the difference between the correlation coefficient and its optimal theoretical level of one. Similarly, the horizontal axis measures the difference between the ratio of the standard deviation of a country's cyclical output and that of the Community and its theoretically optimal level of one. The graph is therefore constructed so that its origin coincides with the EC.

For clarity of exposition we divide the graph into the EC core, centre, periphery and fringe. Only France is at the core of the system. The cyclical behaviour of its output, crudely measured by our indicators, practically coincides with that of the Community. Of the current members of the EC, four are at the centre of the system: Belgium, Germany, Italy and the UK. At a greater distance, in the periphery, are Denmark,

Greece, Ireland, the Netherlands and Portugal. Finally, Spain is the furthest away from the Community core.

The location of the EFTA countries is not homogeneous. We find two (Austria and Sweden) in the centre, two in the periphery (Finland and Switzerland) and one in the fringe (Norway).[7] From the viewpoint of EC incumbents this means that the presence of EFTA countries in a European monetary union would not significantly alter the outlook for monetary policy as a stabilization device. From the viewpoint of EFTAns, this suggests that the cost of joining the monetary union, measured by the reduction in the stabilization role of monetary policies, is likely to be small for Austria and Sweden, somewhat larger for Finland and Switzerland, and probably significant for Norway. The latter case is particularly striking. Norway is the only country whose output cycle is negatively correlated with that of the rest of the Community, i.e. displays a negative correlation coefficient. Therefore, common European monetary policies will tend to have destabilizing effects on the Norwegian economy. Moreover, given Norway's low inflation, the potential gains in terms of monetary credibility that are usually associated with EMU may not be too important. The reasons for Norway to participate in EMU thus do not seem very strong.

2.5.4 Implications for Fiscal Policies

Monetary policies are not an effective stabilization tool in a monetary union, given their inability to cope with idiosyncratic components of national shocks, so stabilization must be achieved by other means. From a macroeconomic perspective, fiscal policies are the obvious candidate. The recent debate on the costs and benefits of EMU has focused on whether stabilization through fiscal policies should be pursued at the national level or, instead, coordinated at the Community level. Again, because of the similarity between the economic structure of EFTA and that of most other EC members, their future entry in the Community does not raise new questions on this issue. It is none the less useful to review the main points of the argument and draw some simple conclusions.

The main issue of contention is whether a transition to a monetary union requires a similar transition to a fiscal union, or at least a shift towards a stronger involvement of the Community in fiscal policies. The main argument in favour of an increased centralization of fiscal policies is the automatic stabilizer characteristic of a federal fiscal system. Support for this argument is found in empirical studies of the fiscal systems of the US and Canada. Work by Sala-i-Martin and Sachs (1992) and by Bayoumi and Masson (1992) shows that in these two large monetary unions, the federal fiscal system has indeed an automatic stabilization function. For example, Sala-i-Martin and Sachs (1992) estimated that a $1 reduction in a US region's per capita income triggers a decrease in federal taxes of about 34 cents and an increase in transfers by 6 cents. Therefore, almost 40% of output shocks are buffered through fiscal policies. Similar results are reported by Bayoumi and Masson, who found stabilization effects of 31 cents in the dollar in the US and 17 cents in the dollar in Canada.

We do not find the argument in favour of a centralized fiscal policies a compelling one. Stabilization can be achieved, equally effectively, with independent fiscal policies, through the use of international borrowing and lending. This mechanism is not an automatic one, but it is fairly straightforward to implement. Perhaps more importantly, it does not have some of the undesirable features of a centralized fiscal system. In particular, most federal fiscal systems have not only an automatic stabilizer function but also an automatic redistributive function, i.e. funds are not only transferred on a temporary basis from areas in expansion to areas in recession but also transferred on a permanent basis from fast-growing to slow-growing areas. Bayoumi and Masson (1992) estimate, for example, the long-term cross-regional redistribution effects embedded in the federal fiscal system in US and Canada. They calculate a long-run redistributive flow of 22 cents in the dollar in the US and of 39 cents in the dollar in Canada.

Because of the difficulty of isolating short-term stabilization flows from long-term redistributive ones, a federal fiscal system is ill-suited for stabilization purposes. Besides, truly temporary shocks can be buffered by public debt, without resorting to changes in taxes or transfers. For example, a country experiencing a temporary reduction in output could borrow on the international capital market. The extent to which it is feasible to use capital markets to offset temporary output shocks depends on how country-specific these shocks really are. While highly idiosyncratic shocks are difficult to stabilize with common monetary policies, they are the easiest ones for national fiscal policies to handle. If a recession is 'global', affecting several countries, it is unlikely that all of them will be able to borrow sufficient funds to offset the negative shock. The most likely effect will be an increase in international interest rates large enough to discourage large amounts of borrowing. On the other hand, if a country shock is truly idiosyncratic, then competition for international borrowing is low, and the shock can be handled effectively.

This brings us back to the previous discussion about the stabilization role of common monetary policies. There we argued that for countries like Denmark, Finland or Norway, whose cyclical output has a low or even negative correlation with EC aggregate output, common monetary policies will not have beneficial countercyclical effects. But the lack of correlation of their cycles with that of the rest of Europe countries increases their ability to use public deficits effectively to smooth business fluctuations. Furthermore, the presence in the Community of countries with low cyclical correlation with the rest of the members is beneficial to everyone since it will increase the scope for intertemporal smoothing of shocks.

2.5.5 Summing-up

In the light of the discussion in the previous four sections, we conclude that EMU supporters in the EC should welcome the EFTAns into the European monetary union. First, with the EFTAns a part of EMU, the area over which a single money would prevail will be significantly enlarged to the benefit of economic agents in both EFTA and the EC. Second, the participation of EFTA makes an early start of EMU more

likely. Third, if using monetary policy for stabilization appears wise to EC incumbents, it will also appear so for the EFTAns with only one exception. Fourth, the prospects for smoothing idiosyncratic shocks through national fiscal policies are rather improved by the enlargement of EMU to EFTA. On this score as well, it therefore seems that EFTA membership is a good idea for EC incumbents.

From the viewpoint of the EFTAns, participation in EMU also has some benefits. Some EFTA members can use the credibility they will gain by joining the EMS and later EMU, as evidenced by explicit behaviour in the cases of Austria and Sweden. Other EFTAns may have less to gain, but even if the benefits are modest the costs appear small as well: the loss of their monetary independence is unlikely to be economically significant for any of the EFTAns, with the possible exception of Norway, for which EMU in itself may be a liability.

2.6 Transfer Payments

2.6.1 EFTA's Financial Contributions under the EEA

One of the items that was always on the EC's agenda during the negotiations leading up to the EEA Agreement was financial contributions by the EFTA countries to the EC's budget. This sort of 'side-payment' between participants in trade liberalizations is quite uncommon even between rich and poor countries. For instance, the agenda for the US–Mexico free trade talks never included direct payments of this type. Although the arguments of the negotiators were never made public, informal reports suggest that the EEA side-payment was primarily intended to compensate the Spanish fishing industry for the fact that the Agreement does not provide open access to the fishing grounds of certain EFTA members.

The EEA Agreement stipulates that the EFTA nations will make three types of financial contribution to the EC's budget. The first involves paying for the EFTA countries' participation in the EC's Stimulation Programmes such as Human Capital and Mobility, Biotechnology and the Environment (although the nuclear energy programmes are explicitly excluded). EFTA countries will contribute according to the shares of their GDPs in EC GDP, which in 1993 implies about 270 million ecu in commitments and about 100 million ecu in payments. Spending in these programmes is not explicitly intended to be concessionary, in the sense that there is no presumption that the poorer EC members would benefit more than proportionately from these funds. Since EFTA researchers will be able to compete for funding from these programmes on an equal footing with EC researchers, it seems reasonable to assume that EFTA receipts will approximately balance EFTA contributions.

The second and third types of contribution provide assistance to the development and structural adjustment of the EC's poor regions. Since none of the eligible regions are in

Table 2.6.1: Switzerland's Projected Contributions and Receipts as an EC Member. Based on 1990 Data. Billion SFr.

Customs Duties	0.6
Agricultural Levy	0.1
Reimbursement of Customs Expenses	0.07
VAT Contribution	2.5
GDP Contribution	0.7
Agriculture Fund	–0.4
Regional Development Fund	0.1
Social Fund	–0.03
Total Net Contribution	3.5

Source: Swiss Federal Council (1992).

EFTA, these two contributions are clearly net contributions. The second contribution entails that EFTA lend 1.5 billion ecu to the poor regions for five years at an interest rate three percentage points below the market. The flow cost of this is 45 million ecu per annum. The third contribution is a straight grant of 100 million ecu per annum for five years.

Altogether we estimate that the annual net contribution by EFTA under the EEA will be 145 million ecu, which amounts to less than 0.02% of EFTA income.

2.6.2 Why the EC Wants the EFTA Countries to Join

If transfers are a minor component of the EEA Agreement, the situation is quite different in EC membership. On this score, the accession of EFTA would be significant as it would imply a sizeable expansion of the EC tax base.

The EC's total revenue today adds up to about 1.1% of total EC GDP. The explicit ceiling for the Community budget is currently set at 1.2% of EC GDP. EC revenues come mainly from value added taxes, tariffs and levies collected on external trade, and a variable contribution (based on GDP) that member states are occasionally asked to make by the Commission. The value added tax is by far the most important, accounting for about 54% of the total budget in 1991 and 1992.[8]

The nature of the EC's financing makes it fairly simple to calculate how much the new members would contribute. Since the GDP of the EFTA countries that are likely to join

(including Norway) amounts to about 14% of the current EC's GDP, the EC's revenue from the value added tax should rise by about 14%. The EFTA countries as a whole import approximately the same share of their GDPs from non-EEA nations, so the EC revenue that would be generated from EFTA border taxes should also expand by roughly 14% (ignoring compositional effects). The extent to which the EFTAns would contribute to the last component, the variable contribution, is very difficult to assess. One reasonable guess is that again the contribution would match the new members' share in Community GDP. The clear implication then is that the EC's budget receipts would rise by roughly 14%.

To arrive at the net contribution that the EFTAns would make as new members is a much more difficult task. Adding new members will inevitably increase the expenditures by the EC, but it is a safe bet that the rich EFTA countries will be net contributors to the EC's coffers. The average per capita EFTA income is about 40% higher than the EC average (in nominal terms), and none of the regions within the EFTA countries would qualify for 'cohesion' assistance under the EC's current rules. The four EFTAns that have already applied for membership have presented official estimates of their annual net contributions. It is reasonable to suspect that the governments in power in the applicant countries have an incentive to understate the tax burden of membership and that the official estimates are systematically too low.[9]

Be that as it may, for Austria, Finland and Sweden the total net contribution is estimated to be 3 billion ecu.[10] The Swiss estimate that their annual gross contribution will be around SFr 4 billion and their receipts (mostly for agriculture) around SFr 400 million (see Table 2.6.1 for details). At the current exchange rate this amounts to a net contribution of 1.9 billion ecu. Adding the net contributions of these four potential members yields a net increase in the EC's budget of almost 5 billion ecu per annum.

An alternative estimate of the budgetary implications of EFTAs accession comes from the Commission's opinions on Austrian and Swedish membership. The former envisages a net increase in EC revenue of about 1.1 billion ecu: a gross increase of 1.8 billion ecu coupled with reduced revenues on agricultural imports from Austria of 700 million ecu. For expenditure the Commission predicts an increase of about 1 billion ecu, leaving Austria's net budgetary contribution at only about 100 million ecu. For Sweden gross revenues of 2 billion ecu and expenditure of 1 billion are predicted with, apparently, much smaller losses on agricultural levies.

To get an idea of the importance of these potential budget contributions, note that the lengthy and difficult debate over the 'Delors II' budget was sparked by the Commission's proposal to expand revenue by 20.9 billion ecu. The entry of the four EFTAns would take care of about a quarter of this expansion. If the EFTAns' projected net contributions make up a significant amount for the Community, *a fortiori* this is a non-negligible sum for the applicants. In their move from EEA to full membership, transfers thus clearly enter on the liability side.

2.7 The Political Economy of Enlargement to EFTA

The thrust of this chapter has been to suggest that economic arguments can explain the desire of EFTA countries to participate in the EEA but less readily explain their apparent desire to join the EC. Conversely, we saw little economic benefit to the EC from expanding the single market to include the EFTAns under the EEA Agreement, but we identified clear reasons for inviting them to join the Community as full (and paying) members. Economics is not the whole story, however, and we review in this section the political considerations that may explain the observed behaviour and stated intentions of EC and EFTA member states. At a second stage, we discuss how the political economy of the Community might be altered were the EFTA countries to join the EC.

2.7.1 EEA vs Membership: The Politics

The EEA Agreement obliges the EFTA countries to adopt most future EC legislation as it comes into force, and one can be quite sure that there will be plenty of it. To name but a few issues, the EC is likely to reform its ground, sea and air transportation, its banking sector and its energy and environmental polices. All of these reforms are likely to have a major impact on the corresponding EFTA sectors. The formal influence of EFTA states on the formulation of future EC legislation under the EEA is very limited,[11] however, so a crucial issue for this stage of integration is how much informal influence they will get.

The EEA Agreement stipulates that as soon as new legislation affecting the Agreement is considered by the EC Commission, EFTA experts are to be widely but informally consulted; but it explicitly reserves the task of drafting the legislation to the Commission. It could well be that new EC laws and directives will be formulated with the best interests of all EEA countries in mind; but the fact that EC firms often compete head-on-head with firms from the EFTA countries, taken together with the fact that the EFTAns have no formal standing in the legislative process, suggests substantial potential for future EC legislation to harm the interests of EFTA-based firms.

EC legislation that affects the EEA Agreement is not truly subject to direct approval by EFTA states on a measure-by-measure basis. The agreement states that the EEA 'Joint Committee' consisting of representatives of EFTA and EC states shall amend the EEA Agreement to permit the simultaneous application of the new EC legislation to all EEA trade. If the Joint Committee decides not to amend the EEA Agreement in accordance with new EC legislation, the affected part of the EEA Agreement may be suspended. Thus, although the EFTAns do have the right to approve each new measure, they never have the choice between the *status quo* and accepting the new law. The choice is between accepting the new law and having the whole relevant part of the EEA Agreement suspended.

Although it is not entirely clear how this 'suspension' would be implemented, the thrust of it is that if EFTA countries do not accept new EC legislation on, for example, rights of establishment in the banking sector, the EC could suspend all rights of establishment of new EFTA firms in the EC market. There is, however, a 'grandfather' clause that guarantees that rights extended to existing EFTA and EC firms will not be revoked by such a suspension.

Even before the EEA Agreement has been ratified, Austria, Finland, Sweden and Switzerland have put in applications for EC membership, and Norway may apply before the end of 1992. Thus it seems that the EEA is currently viewed only as a transitory agreement. Since we have argued that the additional step to membership confers relatively little direct economic gain on the EFTA countries, we conclude that their motives for continuing to full accession must be largely political: the desire to have a say in future policy formation is without a doubt the driving force behind the EFTA countries' membership bids. Unlike the EEA, EC membership would provide the EFTA countries with full representation in the EC's decision-making processes. Of course, given the small size of the EFTA countries, one could argue that they will have a negligible influence on EC policy even as full members. This, however, misses the point that although the EFTA economies are small, several are important players in particular industries. Thus for example, membership might allow Switzerland to have a significant say in EC policy affecting banking and pharmaceuticals, Norway to have an impact on EC fishing and petroleum policies, Sweden to have a say in EC automobile and capital goods policies, and Finland to have a say in forestry product policies.

The economic rationale behind the EC's desire to create the EEA with the EFTA countries is quite different from EFTA's motivation. Freeing up trade between a large region and a small region almost always leads to larger benefits (in proportion to GDP) for the smaller region, because although it opens up opportunities in both regions, the relative increase is greater for the smaller region. Thus we have suggested above that the EC(12)'s GDP might be increased by just 0.02% as a result of admitting EFTA to the single market! Similarly, EFTA's financial contributions under the EEA are quite insufficient to explain the EC's interest.

In contrast to the economics, however, a number of significant political motives for the EEA may be inferred. First, several commentators viewed Jacques Delors's January 1989 proposal for the EEA as a delaying action. That is, the EEA provided time to implement the Single European Act (the '1992' programme) without being distracted by applications for membership from the EFTAns (Wijkman (1991)). Second, the desire to treat its EFTAn neighbours fairly can constrain the vigour with which the EC can treat other countries if there is a presumption that all partners have to be treated equally. Such is the case, for example, with emergency trade protection under the GATT where non-discrimination is a formal requirement.

2.7.2 The Political Economy of an Enlarged EC

Despite their small individual size, the EFTA countries would also collectively carry a non-negligible weight inside an enlarged Community. This is true not only because of their share in the aggregate Community income but mostly because of their (relative) homogeneity. Their accession is thus likely to alter the balance of forces inside the EC and this fact in turn may affect the terms and the timing of their entry. There are at least three areas where this might be significant: transfers, EMU and EPU. We deal with each of these in turn.

Transfers. We have seen in the previous section that, with average incomes per head well above the current EC average, EFTA countries would be net contributors to the Community budget. This has two likely implications. First, abstracting from the CEECs, the total budget available for redistribution to the poorer regions of the Community would grow. In fact, this upward revision of the average Community income may make new regions eligible for structural or regional funds. One would of course expect the net recipients of transfers to favour such a change.

But there is another side to this same coin. The EFTAns' interests on most issues are likely to be closer to those of the richer incumbents. At a general level, this means that the political weight, inside the EC, of the poorer South would be decreased by an enlargement to EFTA. In particular, the latter are likely to side with the richer incumbents and resist further increases in transfers.

The issue is not *whether* EFTA countries will be allowed to join but *when*. Incumbents are expected to adopt different positions on this issue, with the Southern members more anxious to wait until Maastricht and Delors II are out of the way, while Northern members may well seize the opportunities offered by the ratification of the Maastricht Treaty to enlist the help of new entrants and to try altering the priorities.

The Timing of EMU. Section 2.5 has made it clear that the accession of EFTA countries would make EMU both more likely and feasible at an earlier date. With an enlarged Community there is little doubt that, on economic grounds, the realization of monetary union by 1997 would be feasible. This is because a majority of the members of an enlarged Community are likely to satisfy strictly all the convergence criteria, while it is doubtful that this would be the case without EFTA.

Of course, the Maastricht Treaty is sufficiently ambiguous regarding the status of the key debt criterion to leave open the possibility of a 'soft' enforcement. But is it imaginable that EMU could start at the earlier date with a majority of exceptions to the set criteria? With EFTA countries this would not be the case, so the likelihood of the establishment of the monetary union by 1997 would be increased.

A strict enforcement of the convergence criteria might then enable EMU to start only with a majority of new members, which might well be politically unpalatable. However, with a majority of EMU participants satisfying the criteria, it would be easier to grant

Table 2.7.1: EC and EFTA Countries Affected by EPU.

	'Rich' or Influential	*'Less Wealthy'*
Large	France Germany Italy UK	Spain
Small	Benelux Denmark Portugal	Greece Ireland
	EFTAns	

exceptions on the grounds of a satisfactory performance over, say, the previous two or three years. Belgium and the Netherlands would be plausible candidates for such exceptions.

All this tends to isolate those members who clearly will need more time to qualify: Greece, Italy and Portugal. And it goes against the wishes of those who oppose, at least for now, the objective of monetary union. On these grounds alone, one would expect these countries to favour a slower rather than a faster enlargement.

Towards EPU. We believe that the most interesting political economy issues relate to political union.[12] This is because the matter there is not only one of timing but also one of substance. Indeed EPU has been given only a loose content so far and the Danish vote casts further doubt on the Maastricht design on this front. Although the insistence on new members' acceptance of the *finalité politique* suggests that there may not be much to bargain over once EFTA countries have joined, it is clear that not all incumbents are likely to benefit equally from deeper political integration.

We surmise, taking the Danish vote on Maastricht as evidence, that the smaller a country is, the less interest it has in diluting itself into a larger political entity over which it will exercise very little control and inside which it will find it hard successfully to promote its idea. A larger country, on the other hand, may be more willing to sacrifice its own sovereignty over foreign affairs for the benefit of becoming a significant and influential part in a larger entity that is to become one of the two or three dominant players on the planet.

At another level, the more influential a country is individually in world affairs (which is often but not always synonymous with being rich), the more significant, and probably

painful, will be the loss of sovereignty implied by EPU. Thus, on this ground, small Portugal will suffer less than the influential UK. We summarize these observations in Table 2.7.1.

This simple characterization must now be modified: the abstract principle that France and Germany would have less to gain than Spain from EPU is swamped by the political realities resulting from twentieth-century history, since France and Germany are in fact the main movers behind EPU. Other idiosyncrasies may alter the simple-minded ordering of Table 2.7.1. In its search for political stability and credibility, Italy may be much more favourable to political union, seeing specific gains from merging into a bigger, inherently more stable entity. Similarly, the Benelux countries may see EPU from another angle, either because the externality from permanently stabilized Franco-German relations is large for them or because their central geographical and institutional location confers upon them additional benefits from a further deepening of the integration process, or both.

This notwithstanding, our main point is made by now taking EFTA countries into account and observing that all EFTA countries join Denmark (and the Benelux countries) in the one category in which we predict a lukewarm attitude towards EPU: all EFTA countries are small and individually they will carry little weight inside the Community; all are arguably relatively more influential in world affairs than their size would lead one to expect. Now searching for special circumstances, we can find only an aggravating one: the neutrality of Austria, Finland, Sweden and Switzerland. Neutrality is undergoing a redefinition in all these countries. While this evolution naturally implies that it will be much less of an obstacle than it would have been in the past, under no circumstances can it be expected to facilitate for political union.

The conclusion is clear: the entry of EFTA countries into the EC can only weaken the support for EPU or, alternatively, strengthen the position of those who oppose further deepening along political lines. This plausibly underlies the 'Maastricht first' motto of some incumbents, an attitude that may become untenable, however, if others join the Danes in expressing their doubts about the Treaty. One can also imagine a course of events where an *à la carte* approach on the political front would become inevitable, with the UK, Denmark and some of the EFTAns opting out of some of the ingredients of a political union.

We thus conclude that the EFTAns will contribute to deepening the Community up to EMU, but they are likely to slow down its further deepening to EPU. The precise implications of these twin observations will depend on the consequences of the Danish vote on Maastricht, themselves a function of the French referendum and the evolution of the mood of the Germans on the same issue. Under the most favourable circumstances, the Danish vote will remain unique. With that exception, Maastricht will be approved by the end of 1992 and the EFTAns will not make much of a difference to EPU. In that case, their help on EMU will be gratefully enlisted. Under all other scenarios, one may hope to proceed to EMU, possibly on schedule thanks to the EFTA countries, but the price may be to allow the latter to help redefine the future of a European political union.

Notes

[1] Throughout this chapter, data for Switzerland include Liechtenstein.

[2] Total data from OECD *Commodity Trade Statistics*, Series C, SITC(3R) 04. In many cases the cereals content is calculated from the manufacturers' secret recipes, which they show to the Commission confidentially.

[3] These estimates are based on a reduced version of Tyers and Anderson's (1992) model of world agricultural trade and production, as used in Hamilton and Winters (1992). We are grateful to Per Lundsjo for the calculations. The 'MacSharry' reductions are by less than the 'nominal' amounts announced by MacSharry because his package undid previous reform commitments and introduced substantially greater Community preference margins. See *Agra Europe* (22 May, 1992).

[4] In addition, the protocol on convergence criteria requires a country to participate in the Exchange Rate Mechanism of the European Monetary System for two years before examination, without having devalued (on its own initiative) against any other member state's currency. Unfortunately, there is no way of measuring the likelihood that the EFTA countries will satisfy this requirement. We believe, however, that a country satisfying all the other criteria will find it relatively easy to satisfy this exchange rate criterion as well.

[5] We cannot formulate and discuss all the possible scenarios that may arise in 1996 or 1999. In particular, we have not allowed for any of the EFTA countries to remain outside the monetary union, once they satisfy the Maastricht criteria. It is not difficult, however, to imagine a scenario in which one, or maybe two, of the EFTA countries will remain outside the Community. The willingness of Switzerland and Norway to pursue economic integration any further is far from certain. The enlargement to a reduced number of EFTA countries, however, will still be beneficial for EMU. From Table 2.5.3 we see that, under the 'optimistic scenario', the necessary quorum will be reached even if only three EFTAns acquire membership. In this case, the required minimum number of countries would be eight, the same as the eligible number of countries.

[6] In order to compute the cyclical component of national and EC GDP we have used the standard methodology of applying to the data the Hodrick–Prescott filter.

[7] Notice that the graph may overestimate the cyclical distance of the EFTA countries, because the GDP of the current members is included in the definition of EC GDP used in the computations, but the GDP of the EFTA countries is not.

[8] 1991 total revenue: 56.1 (billion ecu); VAT receipts: 30.3. 1992 total revenue: 62.8; VAT receipts: 34.2. See Table 3.2.1 for more detailed 1990 figures showing VAT accounting for 60% of total revenue for that year. Source: EC Commission.

[9] For instance, the Swiss government based its calculations on 1990 as a base year. The choice of 1990 instead of 1992 or 1996 (the earliest date for entrance) makes the nominal amount of the net contribution smaller than it will actually be. The point is that contributions (which far outstrip receipts) are basically 1.2% of GDP. Using the smaller 1990 GDP makes the net contribution look smaller.

[10] See *Financial Times*, July 1 1992, Special Section, 'Europe: State of the Union'.

[11] Part VII, Chapter 2 of the EEA Agreement lays out the relevant decision-making procedures.

[12] Admittedly, EMU is part and parcel of EPU. Indeed, from the Werner Report onwards, EMU has been seen by many architects of the Community as a means of proceeding further towards political union. Excessive as it may seem, the distinction between EMU and EPU drawn in this section is useful, however, given the uncertainties surrounding the final form and content of the European political union.

3 Central and Eastern Europe

In this chapter, we focus on possible EC enlargement to include the Central and East European Countries (CEECs). The CEECs are at an entirely different stage of development from the EFTA countries, and their economic prospects are far from clear. Is it conceivable and desirable that they be admitted as Community members in the near future? What role should the EC play in helping them grow?

To answer these questions, we start by observing that trade, factor migration and growth interact with each other in a number of important ways. It is most unlikely that current income differentials between the EC and neighbouring East European countries can persist indefinitely, but the way in which adjustment is achieved will depend on the relationship between the East European countries and their potential trading partners. For example, per capita income differentials could be eroded by an increase in demand for labour in these economies, and an important way of achieving this will be through trade and capital inflows. Alternatively, wage differences might be narrowed by a reduction in Eastern Europe's labour supply due to emigration. Which of these occurs will depend on, among other things, the openness of international trade and the relative speeds of adjustment of capital and labour to international profit and wage differences.

Furthermore, there are strong positive feedbacks which create the possibility that the long-run outcome is sensitive to short-run developments and the expectations they create. For example, if workers expect capital inflows and an associated increase in demand for labour, incentives to emigrate are reduced; less emigration means greater availability of human capital, wages lower than they otherwise would be, and hence greater incentives to capital inflows. Conversely, pessimistic expectations about capital inflows can be self-fulfilling, as they will raise emigration, thus denuding the economies of human capital and making investment less attractive.

It is sometimes argued that if agents form their expectations in a sufficiently well-informed and consistent way then this indeterminacy of expectations and long-run equilibrium will not occur: everyone will understand the processes involved and hence converge onto a single consistent set of expectations. This may not be so in the present context. If there is some linkage between migration and investment decisions that is not fully captured by the market, then individuals' expectations and behaviour will be governed by what they believe others expect. In this way many outcomes are possible, each entirely consistent with the set of expectations that gives rise to it; that is, there may be multiple equilibria, even with rational expectations. An example of this linkage would be if the efficiency of new plants depended not just on the skills of labour employed in the plant, but also on skill levels elsewhere in the economy (in the public sector for example). A linkage of this type means that both the low- and high-emigration paths may be consistent with rational expectations, as in each case expectations are self-fulfilling.

The possibility of multiple equilibria and the sensitivity of the long-run outcome to short-run developments and expectations mean that short-run policy actions can have a major effect in preparing candidate countries for EC membership, even if this membership is several decades away. We shall argue that decisive action committing the EC to integrate the CEECs into the internal market is required. This will create labour demand and encourage capital inflows. It may also encourage positive expectations and hence lead to a 'good' long-run outcome in which there is less pressure for out-migration than might be feared. The alternative could well be much larger pressure to emigrate.

This chapter starts with some key evidence to set the scene. First, we examine previous EC enlargements, establishing the degree of disparity between EC members and successful applicants. Second, we document the existing gap between the rich West and the poor East of Europe. Third, to define a bench-mark against which to judge the pressures for EC enlargement to the East, we review the likely prospects for CEECs if they remain outside the European Community, keeping in mind the uncertainties involved in such assessment.

Section 3.2 discusses possible CEEC admission to the EC from the viewpoint of the incumbent EC members. We assess the burden that the CEECs' admission would place on the incumbents and conclude that budgetary reasons make it very unlikely that any CEEC will be admitted in the foreseeable future.

Section 3.3 considers international trade. It argues that the EC and EFTA – which we shall generally consider together as the prospective EC(17) – are the CEECs' natural trading partners. It notes that CEEC-EC(17) trade could expand by four to six times relative to pre-revolutionary levels – to the benefit of both parties – and observes that for the stronger CEECs – Czechoslovakia, Hungary and Poland – such expansion is already under way. It shows that such trade is not as threatening to the producers of Southern Europe as is sometimes thought, but that it could pose a serious – and welcome – threat to the CAP if it were extended to agriculture. Free trade will, of course, impose adjustment strains on the CEECs, both in terms of raising average productivity and restructuring their economies. We believe that with sound domestic policy CEEC industry can cope with these pressures, but this is not to say that it could cope with immediate full membership of the EC. The latter entails additional pressures and constraints – evident in East German adjustment problems – which may initiate a downward spiral if encountered too early in the transition.

In Section 3.4, we consider whether the possibility of massive migration from the East stands as another impediment to admitting the CEECs into an economic area where labour would be free to move. We conclude that, in the absence of political chaos or economic collapse, this will not be the case: although current income disparities are high, the experience of migration from Southern Europe suggests that as long as their countries' futures are sufficiently promising most East Europeans will be content to remain at home. There is, however, some danger of a brain drain, which would be harmful to the CEECs.

We explore the policy consequences of this analysis in Section 3.5. Full and immediate EC membership for CEECs is neither feasible nor desirable: it would entail large transfers eastwards and put great strain on the CEECs' economies and institutions. It would also run the risk of a brain drain, which could cripple the prospects for economic development in the East. Yet too little access to the EC is also inappropriate for both parties, because it would stifle growth in the East, encourage protectionism and possibly set the CEECs on an unfavourable, self-fulfilling course towards a low-growth equilibrium. Moreover, it could also generate strong migration pressures. Thus the only real alternative is a deliberate free trade policy that includes agricultural products. The current Europe Agreements between the EC and Czechoslovakia, Hungary and Poland are not adequate. We argue that the EC should act immediately to provide the CEECs with early access to what we call the European Economic Space, which would be similar to the EEA but would include free trade in all goods and services and exclude labour mobility. Furthermore, this should be preceded by enhanced EC financial transfers to the CEECs. We do not, however, advocate early access to the EMS.

3.1 Defining the Baseline

3.1.1 Evidence from Previous EC Enlargements

To place the analysis of the CEECs' accession to the EC in perspective we start with some observations from previous enlargements. Previous EC enlargements clearly establish that successful candidates for membership must satisfy both political and economic criteria. Politically, they must exhibit stable democracy and respect for human rights, and they must have objectives compatible with existing EC ambitions. For example, in 1963 France vetoed the UK's application, arguing that its ties to the US took precedence over its commitment to Continental Europe. Economically, candidates must be established market economies, and, when subject to standard Community allocation rules for CAP and the structural funds, they cannot threaten the prospect of receiving more transfers than the richer incumbents can reasonably be expected to finance. We unravel these allocation rules later, but in essence an applicant that is (a) large in population, (b) low in per capita income and (c) unduly specialized in agriculture is likely to be eligible for more EC transfers than incumbents are prepared to finance; nor in such circumstances are incumbents likely to wish to legalize the possibly massive migration from the EC's new entrant to its much richer partners.[1]

Table 3.1.1 indicates some of the relevant evidence about previous EC enlargements. Two features are of particular relevance to an assessment of the prospects of any CEEC candidacy. First, new democracies have typically had to prove their political stability over about a decade before gaining admission to the EC. Second, the only successful applicants whose per capita income was less than 80% of the poorest incumbent, Ireland and Portugal, were both so small that the total transfer burden imposed on richer incumbents was relatively small.

Table 3.1.1: Previous EC Enlargements.

	UK	*Ireland*	*Denmark*	*Greece*	*Spain*	*Portugal*
Democracy restored				1974	1977	1974
EC accession	1973	1973	1973	1981	1986	1986
Per capita income at accession:						
% of EC average	82	50	122	41	49	23
% of poorest EC member	114	71	170	80	132	62
Population at accession:						
% of EC total	29	2	3	4	14	4

Source: World Bank, *World Tables*, 1991.

3.1.2 Measuring the CEECs' Initial Position

Table 3.1.2 provides some basic economic indicators for the CEECs, and compares them with the three poorest (and newest) EC members – Spain, Greece and Portugal – and with a representative of the rich inner core, the former West Germany.[2] Several points emerge immediately. First, at the start of their transition to the market, the CEECs exhibited considerable disparity of living standards, economic development and monetary control. Second, the richest of the CEECs had attained productivity levels comparable with Portugal, but most CEECs fell a long way behind such levels. Third, in only a very few countries has inflation been brought effectively under control. This reflects more than the inevitable price increases once controls are removed: as yet most CEECs have an inadequate tax base, inexperience in tax collection and rudimentary financial markets (so it is difficult for them to fund budget deficits by borrowing rather than printing money).

Table 3.1.2 gives too optimistic an account of the CEECs' current position. Since 1989 there have been big falls in output as Table 3.1.3 documents.[3] This reflected the collapse of CMEA trade as the former Soviet Union broke up[4] and the adverse terms-of-trade shock (as moving to world prices ended massive Soviet subsidies of CMEA exports to the USSR), but some causes were domestic – stabilization and demand restraint coupled with a feeble supply response. Thus, in judging the current position of CEECs, one should recognize that output has fallen substantially below the levels indicated in Table 3.1.2 and will fall further before starting to recover. We shall assume the CEECs will begin expansion from output levels about 25% below those shown in Table 3.1.2. Even

Table 3.1.2: Key Economic Indicators for the CEECs and Selected EC Comparators.

	Population (millions)	*GDP per capita ($)*	*Inflation (%)*		*Unem-ployment*	*Cars per thousand people*	*Life expect-ancy*
			1990	*1991*			
Albania	3.3	500	500	60			72
Bulgaria	9.0	2,300	500	75	10	122	71
Croatia	4.7	2,900	350		19		
Czechoslovakia	15.6	3,400	60	10	6	175	72
Estonia	1.6	2,600		260		136	71
Hungary	10.4	2,600	37	23	9	157	69
Latvia	2.7	2,800		317		95	71
Lithuania	3.7	2,400		350		119	72
Poland	38.2	1,900	89	42	12	106	70
Romania	23.2	1,400	53	264	5	11	70
Slovenia	2.0	5,200		303	11	288	
Spain	38.8	9,300	6	6	15		77
Greece	10.0	5,300	20	18	9		77
Portugal	10.3	3,800	13	11	4		75
West Germany	62.0	20,400	3	3	5		75

Sources: European Commission DG II; World Bank, *World Development Indicators*; OECD *Economic Outlook*; PlanEcon.

Notes: Population in 1990 or 1991. 1990 inflation is for March 1990–March 1991, and 1991 inflation for March 1991–March 1992, except: Estonia, Latvia, Lithuania, and EC are for calendar year. Unemployment is at April 1992, except for Albania and Bulgaria (December 1991), Croatia (March 1992) and Poland (February 1992).

the most developed of the CEECs are thus some way behind even the poorest existing member of the EC.

3.1.2 CEECs: The Short-run Outlook

How soon can we expect the CEECs to start growing again? This will depend on at least four factors. First, the more exposed a country was to CMEA trade, the more difficult its

Table 3.1.3: The Depth of Recession in the CEECs. % Annual Fall in GDP. 1990 and 1991.

	1990	*1991*
Albania	10	21
Bulgaria	12	23
Croatia	10	23
Czechoslovakia	3	16
Estonia	4	11
Hungary	4	12
Latvia	0	8
Lithuania	5	10
Poland	12	7
Romania	8	13
Slovenia	8	12

Source: EC Commission, DG II.

Note: Falls in Net Material Product have typically been much larger than those in GDP: reforms tend to contract old heavy industries and promote services, which were previously underrepresented.

adjustment will be. Second, *ceteris paribus*, the earlier a country embarked on serious reform the sooner it may expect the upturn to begin, as it now has in the former GDR. A third factor of significance will be the credibility of the government and its ability to maintain political support for the reform programme. Each of these will differ from country to country. For the CEECs pioneering reform – Czechoslovakia, Hungary and Poland – it may be reasonable to anticipate a resumption of output growth in 1993; in some other CEECs it may take considerably longer.[5]

3.1.3 Growth in the Longer Run

One important theme of the recent growth literature we put to use in Section 2.4 is convergence, and this has an immediate bearing on the issue of what the CEECs may expect in the longer run. Convergence refers not to eventual growth rates but to behaviour while economies are making the transition to that long-run behaviour. Barro and Sala-i-Martin (1992) show that, for a wide range of countries, poor countries tend to

Table 3.1.4: Various Countries' Actual and Forecast Convergence Relative to US. 1950-87.

	GDP/Hour (USA = 100)		*Equipment Investment*	*Lawyers per Doctor*
	Actual	*Forecast*	*(% of GDP)*	
Austria	74	43	9.9	0.12
Belgium	86	60	6.8	0.50
Denmark	68	61	6.9	0.28
Finland	67	48	12.1	0.97
France	94	58	8.8	0.30
Germany	80	47	8.9	0.32
Italy	79	48	6.8	0.28
Netherlands	92	64	7.8	0.15
Norway	90	61	7.1	0.27
UK	80	73	6.9	0.62
Argentina	28	50	2.1	0.78
Chile	33	53	1.5	2.14
India	4	8	2.8	1.23

Sources: Actual GDP/hour worked: OECD countries for 1987, Maddison (1991); developing countries for 1986, Maddison (1989). Equipment investment 1960-85, De Long and Summers (1991). Lawyers/Doctors, Brock (1989).

Note: Forecast GDP/hour worked is based on the following equation: $(1/T)\log(y_{it}/y_{it-T}) = x^*_t + \log(y^*_i/y_{it-T})(1 - e^{bT})/T + u_{it}$ as in Barro and Sala-i-Martin (1991), taking b=2% per annum.

close the gap with rich countries at about 2% per year. Thus, countries that are initially poor tend to grow more quickly. In itself this suggests the CEECs can look forward to more rapid growth once the initial disruption of reform is over. Cohen (1991) uses this framework to suggest that most CEECs can look forward to annual growth of up to 4% in the medium run.

Crafts (1992) cautions against assuming inexorable catch-up of the poor to the rich, however. Using data for 1950-87, he shows that some countries spectacularly outstripped 'expected convergence', while others fell woefully short of it, as Table 3.1.4 indicates. Convergence is not an iron law, but a behavioural regularity itself dependent

Table 3.1.5: Average Annual GDP Growth of Recent EC Entrants. Percentage. 1971–92.

	Portugal	*Spain*	*Greece*	*EC Average*
1971-3	8.2	6.8	7.8	4.5
1974-9	3.0	2.3	3.8	2.6
1980-5	1.5	1.4	1.4	1.5
1986-90	4.6	4.6	1.7	3.1
1991-2	2.7	2.7	1.2	2.2

Source: OECD *Economic Outlook.*

on other forces. Crafts provides evidence that higher levels of capital investment can accelerate convergence, and that rent-seeking and other forms of institutional or political sclerosis can impede it dramatically. Table 3.1.4 takes the GDP gap between a country and the US in 1950 and forecasts what GDP should have been by 1987 if convergence had occurred at 2% per year as in Barro and Sala-i-Martin (1992). Countries with high investment in equipment and with few lawyers compared with doctors (a controversial but ingenious indicator of the degree of rent-seeking fostered by a country's institutions) seem to have grown faster than anticipated.[6]

What does all this imply for the likely growth rates of the CEECs? It suggests that to realize rates of growth significantly higher than those found in Western Europe, the CEECs may have to solve three problems: how to finance and organize investment (given scarce financial and managerial resources), how to limit rent-seeking and institutional sclerosis (which might otherwise be a severe brake on change and innovation), and how to increase access to protected export markets, most notably to the EC itself. On the other hand, it is hard to maintain that central planning has been responsible for a supply-side catastrophe in the CEECs without simultaneously endorsing the view that their medium-run potential for growth must be substantial. Table 3.1.5 documents the above-average growth of Spain, Greece and Portugal as they emerged from years of stagnation and isolation. Note that, whereas Spanish and Portuguese growth rates have gradually moved towards the EC average as our earlier discussion of convergence suggested, the increasing vulnerability of the Greek economy to supply-side problems reinforces our discussion around Table 3.1.4: without adequate institutions, a poor country cannot rely on automatic convergence on its richer trading partners.

Since the arithmetic of compounding growth rates is tedious, we have regrouped in Box 3.1.1 some illustrative calculations about possible catch-up by the CEECs to EC income levels. These calculations show, for example, that if the CEECs can sustain 4% annual

Box 3.1.1: Catch-up under Different Scenarios. (CEEC GDP as Percentage of Portugal's GDP)

Initial CEEC GDP as % of that in Portugal	*Assumed Annual Growth (%)*		*Years Elapsed*			
	CEEC	*Portugal*	*5*	*10*	*15*	*20*
80	3	2	84	88	93	96
60	3	2	62	66	69	73
40	3	2	42	**44**	46	49
80	4	2	88	97	**107**	**118**
60	4	2	66	73	80	97
40	4	2	44	48	53	58
80	5	2	92	**107**	**124**	**143**
60	5	2	69	80	93	**107**
40	5	2	46	54	62	72
80	6	2	97	**118**	**142**	**173**
60	6	2	73	88	**107**	**130**
40	6	2	48	59	71	86

Note: Entries in bold show scenarios in which CEECs catch up EC country. CEEC growth is unlikely to begin before 1993.

Suppose per capita real incomes in Portugal (or any other EC comparator) grow on average at 2% a year. The above table shows at five-year intervals the ratio of CEEC to Portuguese per capita income given two assumptions: the annual growth rate of the CEEC, and its baseline per capita income relative to Portugal.

growth in per capita output after their initial recession, a CEEC beginning at 80% of, say, Portuguese living standards will take just over ten years to match the living standard Portugal has then reached; but a CEEC which initially has only 60% of Portuguese living standards will not have caught up even after twenty years.

Growth calculations such as these help us think about the circumstances in which the CEECs might catch up either to the income levels of the EC as a whole or those of its poorer members. The latter are themselves a moving target, however, as they continue

to grow. As a result, the message emerging from these calculations is not how easy it is for the CEECs to catch up, but rather how difficult it will prove. There may be short periods in which CEEC growth will be dramatic, but it will be difficult to sustain growth several percentage points in excess of the EC (and *a fortiori* to sustain growth at that level above the poorer EC regions).

3.2 The Budgetary Cost of Admitting the CEECs

Thus far, we have been focusing on how the economies of the CEECs may evolve. Now we consider things from the viewpoint of incumbent EC members. Specifically, we examine the cost to incumbents of admitting new members. This requires us to estimate the likely budgetary contributions of new members in comparison to their entitlements to transfer receipts. We conclude that under present EC budgetary rules admission of the CEECs, either now or in the foreseeable future, would impose a burden on incumbents that they are unlikely to accept. Given the absence of relevant data, we start by developing a model of EC transfers that we shall apply to the economies of potential members. This is the object of Sections 3.2.1 to 3.2.4. We validate our model by estimating the net contributions of incumbents in Section 3.2.5, and then use it to derive the budgetary implications of enlargement in Section 3.2.6.

3.2.1 Budgetary Contributions

The EC's sources of revenue include customs duties on external imports, various agricultural levies, a proportion of VAT revenue, and a contribution from member states based on their GNP. With such a complex formula, different member states contribute a similar but not identical share of GNP to the EC budget. We can obtain a rough idea of contribution obligations by assuming that each country's contribution depends only on its GNP. Indeed, since the 1988 reform of the budget procedure, this has increasingly been the case. Regressing each state's 1989 budget contribution[7] (in logs) on a constant and its 1989 GNP (also in logs), we obtain (t-statistics in parenthesis):

$$\begin{array}{lcccccc} \text{National} & & & & & \text{National} & \\ \text{Contribution} & = & 2.9 & + & 0.91 & \text{GNP in} & R^2 = 0.99 \\ \text{in mn ecu} & & (21.2) & & (36.1) & \text{mn ecu} & \end{array} \qquad (1)$$

Equation (1) shows that GNP is a very good predictor of contributions. In 1989 the EC took almost exactly 1% of each member state's GNP as its budget contribution. As a result of the 1988 budget reforms, it was agreed that the ceiling for the Community budget should rise to 1.2% of EC GNP by 1992. Subsequently, the European Commission has been pressing for further budget enlargement to 1.37% of GNP by 1997. One reason for such pressure is existing commitments on the pattern of EC expenditure. Table 3.2.1 shows the EC budget for 1990, at which date roughly 60% of EC expenditure was incurred for price supports under the CAP, 25% went to the

Table 3.2.1: EC Budget. 1990. Billlion ecu.

Revenue		***Expenditure***	
VAT	28.4	CAP price support	28.0
Customs duties	11.3	Structural funds: regional	6.0
Sugar and		social	4.4
agricultural levies	2.3	agricultural	2.1
GNP based	0.9	Energy and industry	2.0
Other	3.9	Administration	2.4
		Foreign aid	1.9
	46.8		46.8

Source: Commission of the European Communities (1991).

structural funds, and the remainder went primarily to external aid and administrative costs of running the EC. However, the Brussels summit of 1988 agreed to double expenditure on the structural funds by 1992 (partly in response to the admission of Spain and Portugal in 1986) and this commitment to reinforcing the cohesion of the Community was further strengthened at Maastricht. Whereas it was originally foreseen that additional money for the structural funds could be obtained by reforming (cutting back) the CAP, in practice some addition to contributions (above the current 1.2% of GNP) is likely to be necessary if commitments to the structural funds are to be met. Although we shall use equation (1) as the basis for forecasting contributions by potential new EC members, the above discussion reminds us that policy continues to evolve and indicates the possible changes in budgetary rules that may ensue. Having discussed contributions by member states to the EC budget, we now examine budget expenditure on transfers to individual member states. These arise primarily through the structural funds and the CAP.

3.2.3 Eligibility for Structural Funds

The structural funds aim to finance investment in physical and human capital in the poorer regions of the EC. Most member states have some poor regions eligible for structural funds, and in some of the poorest member states the entire country is eligible. Since our object is to discuss EC enlargement, and since we have only national data for such poor entrants, we base our analysis of existing transfers on data at national levels. Table 3.2.2 shows 1990 data on allocations of structural funds by member state. It also shows per capita income, unemployment and the percentage of GDP in agriculture. The

Table 3.2.2: Allocations of Structural Funds in the EC. 1990.

Country	*Structural funds (ecu/person)*	*Per capita 1989 Income (thousand ecu)*	*Agriculture as % of 1989 GDP*	*Unemployment %*
Belgium	15	14.7	2	8.0
Denmark	15	18.7	4	7.9
France	22	16.0	3	9.4
Germany	12	18.6	2	5.6
Greece	116	5.0	6	7.4
Italy	28	3.7	4	10.9
Ireland	209	8.0	11	15.6
Netherlands	10	14.5	4	8.3
Portugal	103	4.0	9	5.0
Spain	73	8.5	5	16.9
UK	19	13.3	2	7.1

Sources: World Bank, *World Development Indicators*; EC Commission, *Second Annual Report on the Implementation of Reform of the Structural Funds*, 1992; OECD *Economic Outlook.*

Notes: West Germany prior to unification; Luxembourg omitted (incomplete data).

simple message of Table 3.2.2 is that the poorer a country is, the larger is its allocation of structural funds. The cross-sectional data of Table 3.2.2 may be used to investigate whether high unemployment and a rural structure (a high share of agriculture) increase entitlement to structural funds. The regression of 1990 structural funds by country on the mentioned variables produces (t-statistics in parentheses):

Structural funds by country (ecu per person) =

$$\underset{(4.17)}{84.31} - \underset{(4.37)}{4.87}\ \text{per capita income (thousand ecu)} + \underset{(2.74)}{3.66}\ \text{share of agriculture (\% of GDP)} + \underset{(10.1)}{122.90}\ \text{dummy (Ireland)} \quad (2)$$

$R^2 = 0.98$

Table 3.2.3: EAGGF Guaranteed Receipts and GDP of the Agricultural Sector. 1989. Billion ecu.

	Receipts	*Value Added in Agriculture*
Belgium	0.546	2.82
Denmark	0.977	3.55
Germany	3.700	16.66
Greece	1.700	5.82
Spain	1.850	16.57
France	4.606	28.25
Ireland	1.071	3.00
Italy	4.506	27.82
Netherlands	3.469	8.36
Portugal	0.175	3.74
UK	1.797	13.09

Sources: World Bank, *World Development Report*; *Official Journal of the European Communities*, 13 December 1991.

Equation (2) reveals that the allocation of structural funds favours Ireland to a significantly greater extent than other countries; otherwise per capita income and the share of agriculture essentially explain allocations under the structural funds.[8] We shall use equation (2) as the basis for our discussion of entitlements to structural funds within an enlarged Community.

3.2.3 Price Supports under the CAP

We now proceed in a similar manner to derive an implicit entitlement rule for national receipts from the European Agricultural Guidance and Guarantee Fund (EAGGF), the price support mechanism of the CAP that currently accounts for the lion's share of the total EC budget. Different commodities attract different degrees of subsidy. For example, dairy produce has typically been rather heavily subsidized (the famous butter mountain), but without a commodity breakdown for EC members and potential entrants we confine our analysis to agriculture as a whole. To what extent does the scale of agricultural production determine national transfers receipts under the CAP? Table 3.2.3 displays the key data: crudely, CAP receipts rise with agricultural output. A simple cross-section regression using the data of Table 3.2.3 yields (with t-statistics in parentheses):

Table 3.2.4: Estimated Contributions and Funds Received. Million ecu. 1989.

Country	*Contribution*	*Receipts*		*Net Contribution*
		Structural Funds	*CAP*	
Belgium	1,657	95	446	1,116
Denmark	991	105	544	342
Germany	10,477	1,335	4,219	4,923
Greece	477	1,080	893	–1,496
Spain	3,704	3,135	2,539	–1,970
France	8,589	1,470	4,436	2,683
Ireland	363	700	460	–797
Italy	7,848	1,305	4,269	2,274
Netherlands	2,272	0	2,950	–678
Portugal	531	1,060	558	–1,087
UK	6,619	595	2,009	4,015

Note: Given the simple linear specification, any country whose estimated receipts are negative is recorded as a zero entry.

EAGGF funds received (mn ecu)	=	0.153 (13.5)	agricultural output (mn ecu)	+	1666.4 (4.2)	dummy for Netherlands and Germany	(3)

Equation (3) implies that each extra ecu of agricultural output was accompanied by a subsidy of 0.15 ecus from the EC. This is the estimate we use in later calculations. One final remark on agriculture. Controlling for agricultural output, the highest subsidies were earned by Northern producers, the Netherlands and Germany, that specialized in the most heavily subsidized commodities, and the lowest subsidies were earned by Southern producers. The trend of more recent reforms has been to switch the balance somewhat, towards commodities produced in Southern countries. If anything, this will tend to improve the fit of our simple statistical model of CAP allocations.

3.2.4 Completing a Model of Receipts and Expenditures

In the previous sections we discussed (a) the basis of budgetary contributions, (b) the implicit formula for entitlement to structural funds and (c) the implicit formula for entitlement to CAP transfers. Together, (b) and (c) currently make up the vast bulk of receipts in the EC(12). We shall estimate receipts of potential EC members by first

estimating (b) and (c), and then scaling up the total by a factor. This factor reflects the share that (b) and (c) currently make up in total EC payments to member states.

Armed with these estimates, we then discuss the budgetary implications of enlargement and assess what would happen if current rules continued to apply.. Thus, for each applicant or group of applicants, we calculate its hypothetical net contribution to the EC budget. If this is positive, new entrants make life easier for incumbents. The EC will then be in the happy position of deciding whether to increase expenditure at given tax rates or to reduce the burden of EC fiscal contributions. However, if the net contributions of new entrants are likely to be negative, incumbents will be aware that allowing their entry will lead either to higher contributions for all or a dilution of existing entitlements to EC expenditure. Rich incumbents are likely to oppose the former, and poorer incumbents may feel especially threatened by the latter.

3.2.5 The Net Contributions of Incumbents

Before discussing enlargement, Table 3.2.4 presents the baseline result of our methodology applied to existing EC members. We view the EC at 1989, the last date for which we have a complete breakdown of all relevant data. All estimates follow directly from our previous discussion, except that we reduce national estimates of structural funds by 4% to convert our 1990 estimates from Table 3.2.2 to comparable 1989 estimates.

Table 3.2.4 shows estimated national contributions and transfers received under the CAP and structural funds. We neglect the national composition of remaining EC expenditures on Development Cooperation (Foreign Aid), Administration, and Energy and Industry.

3.2.6 Budgetary Implications of EC Enlargement

Table 3.2.5 displays estimated budgetary contributions and receipts for three groups of countries. The first is the EFTA countries: Austria, Finland, Norway, Sweden and Switzerland. The second are the CEECs: Bulgaria, Czechoslovakia, Hungary, Poland, and Romania. Finally, for comparison, we show our estimates for Turkey, confirming our earlier assertion that it is economic as well as geographical and cultural reasons that make Turkey's early entry to the EC problematic.

Regarding EFTA countries we arrive, with a very different methodology, at the conclusion reached earlier (Section 2.6): EFTA countries may reasonably be expected to be net contributors to the EC budget, although our estimates of their net contribution are somewhat smaller than those we had obtained from EFTA sources.[9] While this appears to be due mainly to differences in estimating what EFTA countries would receive under the CAP, we have no indication at this stage that a similar bias would arise for our CEEC estimates. On the contrary, our estimates of potential transfers to CEEC farmers

Table 3.2.5: Estimated Contributions and Receipts of Potential Entrants. Million ecu.

Country	*Contribution*	*Receipts*		*Net Contribution*
		Structural Funds	*CAP*	
Switzerland	1832	0	977	855
Norway	1059	0	391	668
Finland	1110	40	809	261
Sweden	1751	0	684	1067
Austria	1364	145	558	661
Total				3512
At central estimates of 1989 output levels				
Poland	817	4600	1409	–5192
Hungary	341	1255	544	–1458
Czechoslovakia	617	1360	446	–1189
Bulgaria	263	1205	516	–1458
Romania	396	3190	809	–3603
Total				–12900
At 75% of central 1989 estimates[a]				
Poland	628	4675	1062	–5109
Hungary	253	1285	418	–1450
Czechoslovakia	478	1415	335	–1272
Bulgaria	202	1225	391	–1414
Romania	304	3225	613	–3534
Total				–12779
At double the central 1989 estimates[a]				
Poland	1534	4500	2818	–5784
Hungary	641	1195	1088	–1642
Czechoslovakia	1161	1190	893	– 922
Bulgaria	493	1170	1032	–1709
Romania	743	3195	1618	–4070
Total				–14127
For comparison				
Turkey	812	7520	1660	–8368

Note: (a) In these sensitivity calculations we assume that agricultural output remains a constant share of GDP.

due to grain production only (see Section 3.3.8 below) suggest that total transfers due to the CAP may even be higher than our regression results imply. We conclude this section with the observation that, even taking account of a possible underestimation, EFTA's net contributions would only be a fraction of the net transfers to which the CEECs would be entitled to as members.

Table 3.2.5 shows that all the CEECs for which we have data would be large net recipients of EC funds were they admitted to the EC under its existing rule. The CEECs are poor enough to get substantial transfers under the structural funds and sufficiently concentrated in agriculture also to enjoy the prospect of substantial CAP subsidies. Notice that, whereas for Western Europe CAP flows are much larger than flows through the structural funds, the converse is true for the CEECs. While our methodology is rather crude, we note with comfort that our estimates are close to the only other data we are aware of, cited in House of Lords (1992): Poland: –6,300; Hungary: –2,000; Czechoslovakia –1,600; Turkey: –12,000.

We also examine the sensitivity of our results to estimates of initial output in the CEECs. Whereas our first set of CEEC estimates uses income data from Table 3.1.2, the middle set of CEEC data reduces by 25% both estimated GNP (reducing the budget contribution but increasing the entitlement to structural funds) and agricultural output (reducing CAP subsidy entitlements). Table 3.2.5 suggests that these effects largely cancel out. For the same reason, we obtain a striking result in the bottom panel of CEEC estimates. *Even if the CEECs' incomes and agricultural output double relative to their 1989 levels, their net receipts do not diminish; indeed, they increase.* This strongly suggests that it will take a long time before CEECs grow to a position where, under existing EC rules, they would be acceptable candidates for entry.[10] This result stems from two things: CEECs would be entitled to large transfers per capita; and countries such as Poland and Romania have sizeable populations, accentuating the burden they would then place on their richer EC counterparts. We therefore conclude that the EC faces a stark dilemma: either it must abandon for the foreseeable future any ambition to admit the indisputably European CEECs, or their admission must be accompanied by a change in the budgetary rules. Even though the EFTA countries will be net contributors, their contribution will go only a small way to finance EC enlargement even to a small number of CEECs.

3.3 Trade

In the previous section we noted the large uncertainty attached to forecasts of economic growth and concluded that even after doubling their income levels, the CEECs would still be a substantial burden for the richer EC countries. Membership is therefore unlikely for a long time to come. There are, however, powerful reasons for the EC to provide assistance to the CEECs – reasons that extend well beyond charitable concern for fellow Europeans or ambitions to consolidate European power. Helping the CEECs is in the EC's self-interest because it would help to prepare them for future membership,

it would offer potentially profitable investment opportunities, it would minimize the danger of political and military upheaval on the Community's eastern frontier and it would reduce the risk that economic despair will prompt mass migration to the West. This means that, while it may be difficult for the EC to admit substantial numbers of CEECs as full members within the next two decades, the 'do-nothing' strategy is also an economically unattractive option for the EC.

In this section, we analyse the present and future trade relations between EC and EFTA on the one hand and the CEECs on the other. Because of their better data, higher levels of development and greater progress in transition we concentrate in places on Czechoslovakia, Hungary and Poland (CHP). Throughout the section, we assume that the trade of Czechoslovakia will be unaffected by the upcoming 'divorce' of the Czech and Slovak republics. We first assess the extent of current trade, and we note in particular the promising developments for CHP in recent years. We analyse the composition of CEEC exports to the EC and evaluate the prospects for EC-CEEC trade in the medium and long run. Finally, we close with a discussion of agriculture in the transition and the implications for the CAP of the CEECs joining the Community. We argue that a substantial expansion of EC-CEEC trade is essential for the CEECs and highly advantageous to the EC; that it is unlikely to generate intolerable adjustment pressures in the currently poorer members of the EC; that growing agricultural trade should be part of the package; and that this will place burdens on the CAP. In Section 3.4 we shall also argue that the expansion of CEEC-EC trade along the lines described here could substantially reduce the pressures for emigration from the CEECs. In short, we shall argue that expanding trade is just about the only option for EC-CEEC relations over the next two decades or so.

The successful development of the CEECs will depend critically on their economic relations with the EC, through both trade and factor mobility. Moreover, as emphasized in the introduction to this chapter, there are feedback effects between trade, capital flows and migration that give expectations an important role in determining the future evolution of the CEECs. These points create a presumption not just for liberal trade, but also for commitment to ultimate full membership of the EC, creating the expectation that firms and workers in these countries will eventually operate within the EC internal market.

3.3.1 Trade in Goods and Services

International trade and trade policy are key issues in the CEECs' successful transition. Rapid economic growth requires the rapid expansion of trade. Since the EC and EFTA are, and will continue to be, the most important trading partners for the CEECs, the latters' rapid development will require the EEA countries to refrain from erecting systematic barriers against their exports. It would be easy simply to take it on faith that rapid income growth in the CEECs requires rapid trade expansion – this is certainly the received wisdom. Nevertheless it is worth recalling that almost every instance of rapid economic growth in the modern world has been accompanied by rapid trade growth.

Examples in the past two decades include South Korea, Taiwan and Singapore. The economic explanations for this nexus are simple, but they bear repetition.

Poor countries are poor primarily due to low productivity. The key to quick development is to drive productivity up to the average of the industrialized nations. There are no 'magic bullets' that allow a country to accomplish this, and the paths adopted by different nations have differed widely. Nevertheless, it is clear that the implantation of foreign technology is essential. This requires international trade for a number of reasons. If firms are to find investment in productivity-boosting technology worth while, they must be assured that they will find markets for their products. Given the scale economies involved in many modern technologies, this often requires exports. Moreover, international competition is often essential to keep the firms (and domestic government policy) on their toes. Finally, improving productivity generally involves importing foreign technology embodied in foreign capital goods. For all of these reasons, and many more, trade growth goes hand in hand with income growth.

The integration of the CEECs into the world trade system will be accompanied by unprecedented increases in their imports and exports, especially with the EC and EFTA. But the transition to this state of affairs and the attendant trade expansion is not a foregone conclusion. It could be stifled by trade barriers erected either by the CEECs or (more likely) by their trading partners. Since the EC(17) (the current twelve plus five EFTAn accedants) are predicted to account for the lion's share of the trade expansion, the EC's trade policy will be a key determinant of the CEECs' trade and therefore their economic growth. Of course one cannot turn this around: a liberal EC trade policy is only a necessary, not a sufficient, condition for income catch-up by the CEECs. Catch-up also requires vigorous action by the CEECs themselves.

Trade expansion of the magnitudes predicted will make both groups of countries better off in the long run. In the short run, however, the EC cannot avoid considering the cost of adjustment that may fall to a number of politically powerful import-competing sectors. For this reason, it is interesting and important to form judgements about which sectors the expanding CEEC exports will affect. There are two aspects which we will consider below in forming our judgement on the sectoral pattern of the CEECs' incipient trade expansion. The first concerns their long-run pattern of comparative advantage, since their actual exports should tend to converge to this as the shadow of central planning recedes. The second concerns their actual pattern of trade. While the future pattern of trade with the CEECs is likely to change substantially, the gestation lags involved in the transition lead us to believe that their current trade pattern is the best predictor of their trade patterns over the next 5-10 years.

The commodity composition of the CEECs' exports raises a question that is of secondary importance to EC enlargement, but very relevant to whether the EC will pursue a liberal trade policy towards the CEECs: will short-term adjustment costs due to escalation of Eastern trade fall unduly harshly on the poorer EC members? If EC trade with the CEECs proves a boon to EC growth as a whole and does not particularly disfavour the poorer members, we expect little resistance to CEEC trade expansion. If,

Table 3.3.1: Export/GNP Ratios, Percentage Shares of OECD Regions in Export and of Labour Force Employed in Agriculture for the CEECs.

	Bulgaria	*Czecho-slovakia*	*Hungary*	*Poland*	*Romania*
Trade Ratios					
Exports/GNP[a]	34	19	15	7	13
Exports/GNP[b]	31	11	31	17	16
Exports/GNP[c]	31	35	33	19	21
Destination of Exports to OECD (% shares)					
EC	66	65	60	67	63
EFTA	10	24	24	19	6
US	7	3	8	7	20
Other	16	8	7	7	12
% of Total Labour Force in Agriculture[d]	20	12	19	27	28

(a) Source: Collins and Rodrik (1991), Table 1.4, 1988 data;
(b) Source: CIA (1990), Table 3, 1989 data;
(c) Source: OECD, cited in Buigues and Ilzkovitz (1992), Table 1, 1989 data;
(d) Source: *Agricultural Outlook*, February 1992, US Department of Agriculture.

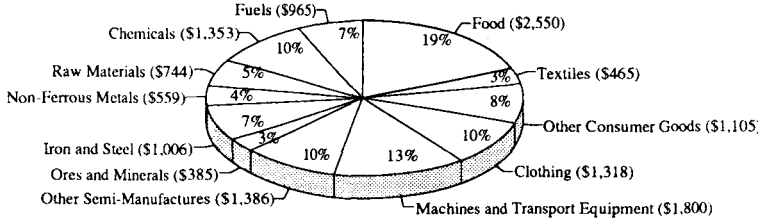
on the other hand, the new trade fails to be an engine of growth and if competition from the new Eastern exports systematically worsens the terms of trade, and thus lowers the incomes, of the poorer EC members, then the pressures for protection will swell.

To analyse these questions properly requires some facts about the current level and recent trends of East-West trade in Europe. This we do in the next section. The subsequent section examines various predictions of the CEECs' future trade pattern, focusing on East-West trade.

3.3.2 EC and EFTA Trade with the CEECs

Measures of the CEECs' current openness vary widely since estimates of both the numerator (exports including East-East trade) and the denominator (GNP) are subject to numerous data problems (see UNECE (1992)). Estimates range from Collins and Rodrik's (1991) 7% for Poland to the OECD's 35% for Czechoslovakia (see Table 3.3.1). The EC is clearly the most important trading partner for both imports and

Figure 3.3.1: Czechoslovak, Hungarian and Polish Exports to EC. 1990. Million Dollars.

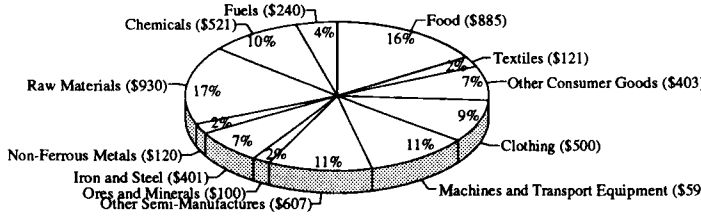


Source: GATT (1992), Tab. III.42

exports. The EFTA states come next, with about one-quarter as much trade as the EC, followed a long way behind by the US and Japan.

The growth of the CEECs' total merchandise trade with both the EC and EFTA is striking. The EC's exports and imports grew on average at double-digit rates over the past four years. Exports by EFTA to the CEECs have also grown rapidly since 1988, but EFTA's imports from the CEECs grew at more modest rates. CEEC exports to the US and Japan either stagnated or declined. Figures for trade performance in 1991 are still incomplete, but according to the UN Economic Commission for Europe (UNECE (1992)), the export boom continued for CHP. Czechoslovakia's exports to the West rose by 24% over the first three quarters of the year, and Hungarian and Polish exports by 18% and 12% respectively over the first half. Their imports grew even faster: 27%, 79% and 23% respectively. Meanwhile the data for the southern CEECs showed a continued decline in exports, with Bulgaria's exports dropping by 12% in 1990 and 32% in 1991 and Romania's by 38% and 27% respectively. Germany alone accounted for more than one-third of all of the CEECs' trade with the OECD, followed by France and Italy with around 6-9% each. EFTA as a whole imported about 13% of the CEECs' total exports to the OECD. Preliminary data indicate that the EC (especially Germany) and EFTA continued to dominate the CEECs' Western trade in 1991.

Figure 3.3.2: Growth of Czechoslovak, Hungarian and Polish Exports to the EC. 1988–90. Million Dollars and Share of Total Growth.



Source: GATT (1992), Tab. III.42

3.3.3 The Composition of CEEC Exports to the EC

Figure 3.3.1 dispels the misconception the CEECs can export only simple products to the West, and that these consist mainly of products that face a great deal of resistance from the EC's import-competing sectors. The figure presents the composition of CHP's exports to the EC by product in 1990. 'Sensitive' products (from the point of view of the EC) – food, iron and steel, and textiles and clothing – account for only one-third of their total exports to the EC. More detailed data show that food and agriculture were the most important export categories for Hungary and second most important for Poland, but of only modest importance for Czechoslovakia. The rest of their exports are spread fairly evenly across the range of goods. Particularly noteworthy are the large shares of chemicals, machinery and transport equipment, and other semi-manufactures.

Figure 3.3.2, which looks at the growth of exports, reinforces this message. Sensitive goods accounted for only 27% of the total growth in CHP's merchandise exports during 1988-90, with the remainder spread fairly evenly across the range. Of course, the growth of sensitive products has been the most severely constrained by trade policy, so these data do not reflect the growth that would have occurred under free trade, but they certainly dispel the notion that all, or even most, CEEC export growth must be conflictual.

3.3.4 The CEECs' Intra-Industry Trade with the EC

The degree of intra-industry trade is an important determinant of the adjustment cost involved in trade expansion. Intra-industry trade – the two-way flow of similar goods – generally entails trade in differentiated products, so imports do not compete head-on-head with domestic production. Moreover, whatever resource reallocations are implied by the adjustment often involve resources shifting between firms within an industry or between various production lines within firms. Consequently, there is a presumption that the higher is the index of intra-industry trade, the lower will be the adjustment costs.

Table 2.1.2 above shows that the CEECs engaged in substantially more intra-industry trade with the EC than Greece and, for CHP, somewhat more than Portugal. Moreover, this applied not only for the EC as a whole, as shown, but also for trade with the EC-North, which is a more demanding comparator for CEEC exports and takes most of their EC exports. The fact that CHPs' indices are higher than those of Greece or Portugal suggests that their exports to the EC-North are unlikely to compete directly with those countries' production.

3.3.5 Potential EC-CEEC Trade in the Medium and Long Run

The potential for expanded trade between the CEECs on one hand and the EC(17) – EC and EFTA – on the other holds out the promise of decades of export-led growth for Europe as a whole. This is vital to the CEECs and may also prove to be an engine of growth for the EC itself. Wang and Winters (1991) and Collins and Rodrik (1991) have investigated this potential trade. They use very different methods, but come up with fairly similar results. Absent any unforeseen increase in trade barriers, trade between the CEECs and the EC could expand nearly sixfold in the long run, and CEEC-EFTA trade by a factor of three to four.

Wang and Winters (1991) – see also Hamilton and Winters (1992) – take the most direct approach using the so-called 'gravity' model, which explains bilateral trade flows in terms of the partners' incomes, populations, distance apart and preferential trade agreements. The estimated model fits the data on trade between 76 market economies very well, and it is then used to predict CEECs' trade if they conformed to the same patterns – basically, if they were integrated into the world economy on the same sort of terms as apply at present between market economies. The results for the base year 1985 are listed in Table 3.3.2.

The numbers in Table 3.3.2 are striking. First, the EC(17)'s exports amounted to $753 billion in 1985, so the extra exports shown as CEEC imports are important to the EC even from a macroeconomic point of view: an extra $44 billion – 6% of total exports and around 17% of extra-EC exports – when adjustment is complete. Germany will account for about 25% of that increase. Second, the percentage increases for imports and exports are smaller for EFTA than for the EC, because the neutral members of

Table 3.3.2: CEECs' Potential Trade with EC(17). Change from 1985 Base. Billion Dollars (% Change).

Imports

	Bulgaria	*Czecho-slovakia*	*Hungary*	*Poland*	*Romania*	*Total*
EC(12)	1.3 (95)	14.0 (855)	5.1 (293)	11.9 (572)	5.0 (599)	37.4 (486)
EFTA	0.3 (81)	1.9 (357)	0.2 (26)	2.5 (447)	1.4 (810)	6.3 (253)

Exports

EC(12)	2.1 (527)	13.7 (894)	5.2 (391)	10.2 (406)	2.7 (102)	33.8 (404)
EFTA	0.5 (887)	1.6 (269)	0.2 (23)	1.9 (282)	1.0 (325)	5.2 (219)

Source: Wang and Winters (1991), Tables 3 and 4.

EFTA were more integrated with the East than the EC member countries prior to the revolutions. Third, the CEECs will increase their exports to the EC(17) fivefold, from $10 billion to $49 billion. Fourth, these massive increases in trade imply that the CEECs' economies will become substantially more open. On the basis of the nominal data used by Wang and Winters, Czechoslovakia's exports/GDP ratio increases from 14% to 28%, Hungary's from 14% to 31%, and Poland's from 7% to 19%; and their imports/GDP ratios increase similarly. Moreover, the actual 1985 shares quoted here contain a huge component of intra-CMEA trade, which had largely disappeared by 1992. Thus the increase in openness to 'regular' trading influences is actually expected to grow by much more than these figures suggest. Finally, we observe that if the GDP data from Table 3.1.2 were used to calculate the trade ratios, they would be substantially higher both before and after transition, but the estimated increases would be just as dramatic.

The policy implication of Table 3.3.2 is that Western export gains of this magnitude must be paid for by the CEECs, and their only means of doing so is increased exports to the West. Increasing their debt could not remotely support trade flows of this size.

The evidence cited above suggests that part of the adjustment predicted by Wang and Winters is already taking place, especially for Germany. EC imports from CHP have risen 149% in value between 1985 and 1990, compared with 22% for imports from other regions. Exports to CHP have also grown slightly faster than those elsewhere – 87% compared with 84%.

Collins and Rodrik (1991) make separate estimates of these same predicted values using a quite different methodology. They update a trade matrix from 1928 using six West European economies as indicators of what the CEECs' trade behaviour would have been had they not fallen under Communist influence. They predict that EC exports to CHP will increase by 297% in the medium term and 872% in the long run. Again Germany accounts for a large portion of these changes. On the import side, the EC is predicted to increase imports by 266% in the medium run and 804% in the long run.

The bottom line of these studies is that the opening of the East could provide export market opportunities to Western economies on a scale and speed unprecedented in modern history. The bulk of the benefits will fall to the EC(17) as the natural trading partners for Eastern Europe. Again, it is important to stress that if either side is to realize the gains, the West must open its markets to Eastern products.

3.3.6 Predicting the Product Composition of EC-CEEC Trade

Unfortunately, no systematic studies have been made of the likely long-run product composition of East-West trade. In fact, the data on the CEECs are so rough and their economies in such a state of flux that such an exercise is almost impossible at this stage, beyond observing that their capital endowments are so small that their comparative advantage is almost bound to reside in labour of some sort. Hamilton and Winters (1992) make two observations. They argue, first, that East European agriculture has a great potential to expand output and, second, that the CEECs will not specialize indefinitely in simple labour-intensive goods: CHP, in particular, appear to be relatively well endowed with educated workers, so their true comparative advantage will lie in more sophisticated manufactured goods. If this turns out to be the case, their penetration of Western markets is unlikely to put disproportionate pressure on the industries of poorer EC members.

While the long-run pattern of trade remains obscure, the short-run pattern will evolve from the pattern of the past few years. Exports of any good are, as a matter of accounting, the difference between domestic production and domestic absorption of that good. Consequently, changing the commodity composition of trade requires a change in the domestic consumption pattern and/or a change in the domestic production pattern. Since prices have been substantially free in the main CEECs since 1991, most of the change in the consumption patterns should already have taken place. Changing the pattern of production takes time, however, as new facilities need to be built and skills acquired. Hence the legacy of central planning will cast a shadow over production patterns for several years, and the patterns shown in Figures 3.3.1 and 3.3.2 above are as

good an indication as we are likely to get of the nature of CEECs medium-term trade pattern.

3.3.7 Agriculture in the CEECs: Now and Later

Agriculture is a major sector in the CEEC economies, if not in terms of its contribution to GDP then in terms of employment – see Table 3.3.1. It is central to the issue of their EC membership in two ways: first in terms of the transition, and second in terms of the final destination – the adoption of the CAP. In the former case the issue is one of net exports – the ability to generate or economize on foreign exchange resources – which, in turn, hangs mostly on access to EC markets under the Europe Agreements. In the latter case, the East European economies have undertaken fundamental reforms of their agricultural support systems since 1989, and they will be made more restrictive by adoption of the CAP. Thus, with their present trade patterns they would suffer both domestic inefficiency as excessive resources are drawn into agriculture (or their speed of departure from it reduces below its optimal level) and trade diversion (as high-cost EC supplies displace imports at world prices). The important issue for the future, however, is the extent to which the CEECs are likely to increase output between now and their accession. We estimate below that they are likely to become net agricultural exporters by the year 2000, and that their accession will add to the strain on the CAP and generate net resource inflows to them.

The Europe Agreements between the EC and CHP offer rather limited concessions in agriculture. Over the next five years, tariffs and variable levies will be reduced, but not generally eliminated, and quotas increased by up to 50% (see Winters (1992)). This will increase CHP earnings somewhat, but do nothing to address their need to develop substantial export trade. For Czechoslovakia this is not a major problem, but for Hungary, with its large and relatively efficient agricultural sector, and for Poland, with its abundant land and large unskilled rural labour force, it is a major constraint. It both reduces their chances of successful transition in general, by eliminating a macroeconomic stimulus, and places great strain on their agricultural sectors directly, by preventing the efficient use of resources. This could well lead to irresistible pressure for agricultural protection. Indeed, Poland's decision in 1991 to moderate its very liberal trading stance owed much to pressure from farmers. An unsympathetic observer might conclude that such pressure was part of the EC's policy. A Polish/EC/World Bank Task Force on agriculture (World Bank (1990)) contained the following advice in a section written mainly by an EC staff member:

> 'Political costs of an export-oriented agricultural sector in terms of strained relations with the EC and in terms of creating a barrier to Poland's eventual political integration with the rest of western Europe should be one concern for the Polish government.
>
> 'The government should allow itself all types of border measures, including quantitative restrictions, to ... set the price of cereals ... where, for political reasons, it would like it to be.

> 'The domestic prices for [cereals, meat and dairy products]... should be stabilised by a system of variable export taxes/subsidies and a corresponding system of import taxes-subsidies.
>
> 'The Polish government should aim deliberately for an agricultural production somewhat below self-sufficiency, if necessary by providing financial assistance to reduce excess agricultural capacity in a socially acceptable way.'

The EC could usefully deny, by word and deed, such sentiments. Indeed from all participants' viewpoints, it is to be hoped that more liberal counsels prevail.

3.3.8 Farming and Full Membership

Turning to accession proper, the situation in Eastern Europe is very different from that in EFTA. The CEECs are still relatively liberal and, although they currently import small amounts of agricultural goods, this is likely to change. Many commentators – e.g. Begg *et al.* (1990), *Agra Europe* (1991), and Hamilton and Winters (1992) – argue that they will become potential net exporters following increases of 40% or more in output as ownership patterns and infrastructure are put on a proper basis. This means that by the year 2000, say, the CEECs will be net exporters of wheat, and possibly also of feed grains and/or livestock products. Hamilton and Winters (1992) estimate that opening the East European economies to international trade, coupled with a conservative 15% increase in their agricultural productivity and a 10% increase in their GDP, will reduce world prices of wheat by 5% and those of beef and pork by 1% and 5% respectively. Only in dairy products does Eastern Europe's transition raise world prices, but this sector is so distorted globally that the world price means very little.

More pertinently, Hamilton and Winters also estimate the effects of bringing Eastern Europe into the CAP. They do this on the assumption that the combined net exports of Eastern Europe and the EC remain at pre-integration levels – i.e. suppressing the world trade effects of the integration. The CAP raises prices in the East and, because of the latter assumption, forces them down in the EC(12) – see Table 3.3.3. It encourages increases of around 50% in Eastern output, and although the higher prices penalize local consumers, the net effect is a strong income transfer towards the East. Their increase in wheat exports alone, for example, would attract export subsidies of around 1.7 billion ecu at today's rates (a subsidy of 80 ecu per ton), and while much of this would be wasted in excessive production costs (the penalty of the CAP), at least some would represent pure economic rent.

The existing EC(12) farmers would suffer from integration on these terms, and would of course lobby very hard to change the terms so that the burden fell on consumers and the budget. The MacSharry reforms suggest that such a shift would not be entirely feasible, but those reforms are not sufficient to eliminate the surpluses generated in the EC(12), let alone cope with Eastern Europe's new surpluses.

Table 3.3.3: Effects on EC and CEEC Agriculture of Integrating a Growing Eastern Europe into the CAP. Percentage Change from 1987 Base.

	Price to Farmers	*Production*	*Consumption*	*Net Exports*
CEECs				
Wheat	41	47	–2	450
Dairy	16	26	0	370
Beef	85	78	–23	1,030
Pork	32	54	–13	570
EC				
Wheat	–26	–21	11	–103
Dairy	–10	– 5	6	–101
Beef	–19	–18	14	–528
Pork	–17	–17	17	–453

Note: Beef includes beef and veal; pork includes pork, poultry, lamb and mutton; dairy figures are measured in milk equivalent.

Source: Hamilton and Winters (1992), Table 8.

As we have noted above, it is difficult to estimate the transfers to member states implicit in the CAP, but two further calculations confirm that they would be high. One approach is to combine the contributions from EC consumers and taxpayers and look at the excess payments for EC agricultural output over and above world prices. Table 3.3.4 makes this calculation for grains in the CEECs, suggesting transfers of 5.6 billion ecu. This is based on 1990 data, which probably overestimate the difference in prices that will apply when the CEECs accede, but certainly underestimate their output. The second approach is to consider East Germany. The European Commission estimated that German unification would increase agricultural support expenditures by 1.0-1.2 billion ecu in 1992 (Commission of the European Communities (1990), p. 110). To our knowledge, these figures have not subsequently been revised.

The MacSharry reforms will clearly reduce the benefits that East European farmers can expect from accession to the CAP below those reported above, but will not eliminate them entirely. EC prices are destined to remain well above world prices for the foreseeable future. MacSharry's notional 29% reduction in intervention prices for grains reduces the benefits per unit of production. For existing farmers in the EC(12) this is fully compensated by direct transfers (implicitly for ever), provided that they set aside

Table 3.3.4: Grain Output in Eastern Europe and Potential Transfers to Farmers. 1990. Thousand Metric Tonnes.

	Wheat	*Maize*	*Barley*	*Rye*	*Oats*
Bulgaria	5,095	1,241	1,345	48	62
Czechoslovakia	6,707	468	4071	736	421
Hungary	6,159	4,500	1,359	226	158
Poland	9,026	290	4,217	6,044	2,119
Romania	7,320	6,810	2,680	59	234
Total	34,307	13,309	13,672	7,113	2,994
Transfer million ecu	2,691	1,099	1,000	557	240
Memorandum EC output	85,074	21,865	50,831	5,297	4,786
Prices per metric ton (ecus)					
World (Rotterdam)	90	86	87	82	80
EC intervention	169	169	160	160	160

Sources: FAO, *Production Statistics Yearbook;*
EC, *The Agricultural Situation in the Community.*

15% of their land, with the set-aside and compensation based on historical areas and yields (1989-91). The EC is most unlikely to offer better conditions to new partners and will probably insist on worse. Hence farmers will, at the most, be eligible for income payments on the basis of their (lower) 1991 yields than their (higher) ones at the time of accession. More likely, after decades of sales to the EC being tightly constrained by the Europe Agreements, the East Europeans will be asked to restrict output to the levels implied by these restrictions as a condition for accession. In terms of income transfers, if not overall economic efficiency, these conditions will be among the most important parts of any accession negotiation.

Agriculture represents a potential growth point for CEEC exports, but one which, to date, has not been much encouraged by EC policy. Under full membership on current terms, the CEECs would qualify for extensive export subsidies and support payments, which could considerably enhance their benefits from accession. There is some danger,

however, that the EC would try to avoid such transfers by seeking to restrain CEEC output in the accession negotiations.

3.4 Migration

Full membership of the Community would involve the free mobility of labour. This raises the possibility of large-scale East-West migration and, for that reason, could be another impediment to the admission of the CEECs into the EC within a reasonable time-period. We examine this issue in the present section in the light of the (paltry) evidence on migration and conclude that, while large migration flows from the East are possible, they are unlikely, particularly if appropriate policy actions are followed by the West. Provided the EC encourages the economic prospects of the region, for example through liberal trading policies and credible promises of eventual membership, the current income differences between East and West will remain tolerable to the vast majority of Eastern residents.

3.4.1 Incomes and Migration

Table 3.1.2 above recorded some figures on income differences between EC countries and the CEECs. They can be summarized by saying that per capita incomes in the poorest countries of the EC (Greece and Portugal) are around 25% of those in West Germany, and in turn, income levels in the Baltics, Poland, Hungary and Czechoslovakia are around 60-80% of those in the poorer regions of the EC. Bulgaria and Romania drop to 30-50% of the level of the poorer regions of the EC. If we adjust for differences in the cost of living in various countries, the differentials narrow to put Greek and Portuguese incomes at around 40% of Germany's and the CEECs' at around 80% of theirs (*World Development Indicators*, Table 30).

The migration pressures that income differences of this magnitude are likely to create are impossible to estimate with any accuracy. The determinants of international migration involve social, cultural, environmental and legal factors, as well as economic ones, and all on a forward-looking rather than a historical basis. Even within countries, wide variations in willingness to migrate are observed. Nevertheless, the historical record gives some indication of what might be expected.

Consider first the experience of international migration within the EC, for which the income disparities between the Northern and Southern members during the 1960s to 1980s were around the same as today's East-West disparities. Table 3.4.1 gives the percentage of nationals of each EC country resident elsewhere in the EC in 1985. The figure is higher for lower-income countries, with Ireland an outlier presumably for historical reasons. The table suggests that – over a long enough time-period – around 5-10% of a given population may be prepared to migrate in response to wages differences of around 3 to 1. Taking flows from Southern to Northern Europe as a

Table 3.4.1: Percentage Shares of EC Member States' Nationals in Other EC Member States. 1985.

Belgium	1.2	Italy	2.2
Denmark	0.7	Netherlands	1.5
France	0.5	Portugal	9.5
Germany	0.4	Spain	1.4
Greece	4.1	UK	0.6
Ireland	15.1		

Source: *Population and Migrants*, Eurostat, 1991.

whole, around 3% of the population of the South moved North during 1950-70. Similar figures apply in North America, where, during 1970-90 around 4% of the population of Mexico emigrated to the US; in this case the pull of a very large income gap was offset by the illegality of much of the migration.

Considering the European experience in more detail, it is possible to identify some of the factors that might influence migration patterns. For example, high unemployment – and expectations of it – appears to be a major factor in internal and international migration in Europe. In particular, youth unemployment appears to stimulate outflows, because younger workers have fewer ties and hence face lower adjustment costs. This suggests that rapid population growth – which increases the proportion of young in a population – may increase rates of outflow, as will any policies that tend to protect older workers, such as Yugoslavia practised in the 1960s (UNECE (1992)). All of the CEECs are likely to experience substantial unemployment, but their population growth rates are all moderate or low: only Poland's, at 0.7% per annum, exceeds the OECD average.

The presence of a large and underemployed agricultural labour force also raises the pressure for outward migration, not so much directly through emigrating agricultural workers, as by exerting pressure on low-skill labour markets in general. The migratory pressure generated by CEEC agriculture will depend on the extent to which output can expand to provide employment for the existing labour force, which in turn depends partly on EC trade policy. The timing of the pressure also depends on the progress of land reforms. UNECE (1992) argues that where agriculture is being decollectivized, the new peasant farmers will tend to remain in the sector for at least a few years more, savouring their independence and trying to make a go of their private farms. Eventually, however, a large shake-out will be required to achieve adequate productivity levels. This pattern is predicted in particular for Bulgaria and Romania. On the other hand, where peasant farming already exists, as in Poland, the need to boost productivity will lead to a stronger immediate exodus.

Expectations are important in migration decisions. In recent years the Southern members of the EC have experienced relatively little continuing emigration. This is arguably because of their membership of the EC, which not only relieves factor market pressures by encouraging goods trade, but also lends credibility to their political and economic reform processes. That is, low current incomes are tolerable if political freedoms are secure and the future looks rosier. This experience suggests that – in the absence of mass unemployment or major political upheaval – migration flows from East to West might be restricted to a few per cent of the population. An extensive survey of the literature undertaken by Blanchard, Dornbusch, Krugman and Layard (1992) estimates that around 3% of the population of Eastern Europe might want to move West in the next fifteen years. UNECE (1992) suggests rather less, particularly if the EC can make firm commitments to trade with and eventual membership for these countries. It notes in particular that among the central and northern CEECs, only Poland seems likely to generate large flows, and then only in the short run. The larger potential flows seem likely to emanate from the Balkan states and also, incidentally, from Turkey.

To put the magnitude of these flows in context, suppose that 5% of the population of the CEECs shown in Table 3.1.2 were to emigrate westwards. This is an improbably large share under present circumstances, given the estimated low migration propensities in the larger Central European countries; nevertheless, it would generate an inflow of only 5.7 million people, about 1.5% of the population of the EC plus EFTA, over a number of years. This figure is small compared with post-war immigration into West Germany (8 million in 1945-50 plus 4 million in 1950-61), Algerian returnees to France (0.9 million in 1962) or the current flow of immigrants into the US (around 0.5 million or 0.2% of population per annum). The immigrants would not be evenly spread through the EC, so difficulties could arise for particular regions. But these orders of magnitude do not suggest that migration flows would be an insurmountable problem. Furthermore, much of this migration is liable to occur whether or not the countries concerned are members of the EC, and whether or not the migration is legal. Membership would, however, remove the national controls that currently allow member states to select among potential (legal) immigrants. This would probably increase the flow of unskilled workers.

A potential difficulty for the CEECs is the nature of migration. Much of the available evidence suggests that it is the relatively highly educated who are most mobile. This raises the spectre of a brain drain, which could undermine many of the positive externalities that foster economic take-off. Indeed, the Europe Agreements already appear to be more relaxed about such migration than that of unskilled workers. Two policy issues arise in this context. First, if the highly skilled produce tradable goods and services, they will be much more likely to stay behind if their output is freely traded. They will, however, require high rewards by local standards, and that entails a steeper income distribution profile than the CEECs have traditionally had. Second, short-term migration is an important mechanism for technology transfer in the skilled service sector. It will be important to make it easy for such workers to return after periods abroad, for example by encouraging things such as flexible career paths and accessible high-quality housing.

3.4.2 Trade and Migration

It was suggested in the introduction to this chapter that short-run EC policies could be of great importance in influencing expectations and determining the future development of the CEECs' economies. Positive expectations may be self-fulfilling by causing relatively little labour outflow and hence raising the return on capital, raising capital inflows and justifying the expectations; negative expectations could create the reverse effects.

These considerations give EC trade policy a particularly important role. The real income gains from liberal trade regimes have already been discussed, both in Section 3.3 and in Chapter 2. A further beneficial effect of trade is its effect on the demand for labour and hence on the incentives to migrate. We suggested in Section 3.3 that the CEECs' comparative advantage lies with products that are labour-intensive (skilled as well as unskilled); following comparative advantage therefore raises labour demand and tends to promote convergence of wage rates between East and West.

Some simple calculations illustrate the potential effect of trade on labour demand. The labour demand created by trade (exports and imports together) depends on the share of labour in export and import-competing industries, the share of trade in GDP and the share of labour income in GDP. It can be expressed by the following equation:

Proportion of employment due to trade = (share of labour in value added in export industry − share of labour in value added in import industry) × (share of trade in GDP)/(share of labour in GDP)

The share of labour in valued added varies quite widely across industries, but if CEEC trade is governed by comparative advantage we might expect the wage share to be 20-30 percentage points higher in export industries than in import industries, or perhaps more. The share of labour in GDP is around 50%. From the data in Tables 3.1.2 and 3.3.2, the share of trade with the EC and EFTA in the GDP of CEECs might be expected to quadruple, from 5% to 20%, with even greater increases for Czechoslovakia, Hungary and Poland. This suggests that moving from the present position to a liberal trade regime with the EC would, *ceteris paribus*, raise CEEC labour demand by 6-10%.

Confirmation of the employment effects of comparative advantage trade comes from Bowen, Leamer and Sveikauskas (1987), who compute the proportions of various countries' endowments of factors of production embodied in their exports minus those in their imports. The study was undertaken on 1967 data and indicated that some relatively labour-abundant economies (for example Greece, Ireland and Spain) exported between 2% and 15% of their endowment of different types of labour embodied in net exports.

The speed with which production can be reoriented towards comparative advantage will depend on capital inflows, and it is likely that a significant part of any capital inflow to

the CEECs will be related to export production. Two observations follow. First, the volume of investment is likely to be greater the more open is access to EC markets, the more secure is this access, and the more fully the CEEC economies are integrated into the internal market of the EC. These arguments have already been made in the context of investment in the EFTA countries, and they apply *a fortiori* to the CEECs.

Second, the composition of exports and hence production determine the employment effects of a given volume of foreign investment. Different sectors have widely differing capital/labour ratios; for example, capital per worker is four or five times higher in the metalliferrous products sector (as a whole) than in manufacturing electrical goods. Ensuring that production becomes reoriented to the pattern suggested by comparative advantage will maximize the employment effects of a given scale of capital inflow.

In summary, the composition of around 10-20% of the CEECs' GDP will be directly influenced by EC trade policy, and this will have major implications for the rest of their economies, particularly through its effect on factor demands. If this trade does not develop, or if barriers to the export of labour-intensive products are imposed, there may be no effect on labour demand. But if trade between the EC and the CEECs does realize its potential, and if this is comparative advantage trade, we may expect it to increase demand for labour by up to 5-10% of the total labour force – with larger increases for some skill categories. Bearing in mind that around half of the labour force is engaged in non-tradable activities – government, retailing and so on – it is clear that liberal trade can drive a very significant increase in labour demand. But to secure this effect, the CEECs must be able to specialize according to comparative advantage; restricting their exports of labour-intensive products would evidently remove the associated labour demand. And the more secure this access is, the more likely are rapid capital inflows and the consequent growth in labour demand and slackening of incentives to migrate.

3.5 The Transition: An Economic Space for the CEECs

This section pulls together the implications of the previous analysis for EC policy in the next decade. The need is for a package that promotes only soundly-based – i.e. economically viable – productive activity, while at the same time offering significant hope of prosperity to come. The latter will encourage physical and human capital formation in the CEECs, while the former must provide the wherewithal for it.

Full membership of the EC is not a realistic objective for the CEECs for at least two decades, but, as we saw in Section 3.3, there are major and mutual benefits to Western and Eastern Europe from a rapid and substantial trade liberalization. Such a liberalization must lie at the heart of any programme to promote the CEECs' growth and allow them to evolve towards EC membership. It also implies that the Europe Agreements, signed in early 1992 between the EC and Czechoslovakia, Hungary and Poland, do not go far enough in promoting freer trade and competition. They offer too much protection for too long to groups such as EC farmers, textile manufacturers and iron and steel producers; and their anti-dumping clauses provide too ready a mechanism

for EC producers to fend off cheaper imports from the CEECs. Although EC enlargement to the CEECs would not command the unanimous support of existing EC members, we firmly believe that it is in the self-interest of the EC as a whole to promote freer trade, and specifically to dismantle the agricultural protection of the CAP.

The concrete implication of our analysis is to provide the CEECs speedy access to a form of European Economic Space. This new or adapted institutional framework should *not* include labour mobility, which would be premature from the point of view of skill levels in the East, but it *should* include agricultural products. This is probably not feasible without substantial reform of the CAP. The level of agricultural distortion in the EC is so high that reform will yield sufficient overall social profit that the losers could easily be compensated by the winners. Moreover, in our judgement, any additional funding that the EC can raise should be spent to finance a liberalization of the CAP by buying off, for a generation though not in perpetuity, the EC farmers who would lose out and whose opposition has been vociferous. Not only would this directly benefit EC consumers; it would also provide market access for any CEECs that concluded an Association Agreement with the EC, and hence encourage them to meet whatever reform conditions Association implied. Moreover, with subsidies to EC agriculture reduced, existing members would have less incentive to veto EC enlargement to countries whose agricultural sectors remain substantial. Short of such a credible institutional commitment, there is a danger that interest groups in the EC will continue to push for so many trade restrictions that the potential outlined earlier in this chapter will never be exploited. The damage that this would do to the developing economies of Eastern Europe would be significant and lasting, and it would spill over in a costly fashion to the West.

The CEECs' path towards enlargement is seriously blighted by their currently low levels of productivity and exacerbated by their recent difficulties. If the transition to the market can be successfully accomplished, there is then the prospect of growth, perhaps at quite substantial rates, thereafter. But first of all the short term must be endured, and because most of the pain is up front, the greatest pay-off to any financial inflow the CEECs receive will be in the short run. A substantial part of the CEECs' current fragility arises because capital market imperfections prevent them from borrowing to provide tolerable consumption and adequate investment during the period in which the burden of adjustment is greatest. Previous attempts by CEECs to borrow their way out of trouble ended in disaster, but that does not make a repeat outcome inevitable. While we note the current extent of the EC contribution to the CEECs through the EBRD and other channels, we believe that EC self-interest would justify an increase in such efforts. Even if the institutional reforms we have just proposed take a long time to implement, it is important that the CEECs get immediate assistance through other channels, whether access to loans at reasonable interest rates or outright transfers. It would be the greatest misfortune, for the EC as well as the CEECs, if the current reforms were abandoned because the patient could not survive the operation. Current policies limiting their access to EC markets and being over-cautious about aid and lending may be seen in future to have been inadequate and short-sighted.

A seductive idea is that, unlike the countries of Western Europe, the CEECs could be admitted to the EMS before they become full members of the EC. This might allow the EC to lend reputation and respectability to the CEECs at little cost to itself. Although appealing at first sight, this is almost certainly a bad idea. First, although countries like Italy originally joined the EMS with inflation rates of nearly 20%, significantly higher inflation rates are not compatible with fixed nominal exchange rates, even for periods of only months at a time. In many of the CEECs, high inflation today is a symptom of very deep-seated problems: a rudimentary tax structure, shrinking tax base, and the absence of a history of successful tax collection; pressing demands for public expenditure; and infant financial markets in which to fund budget deficits. Such structural problems need structural solutions, and until they are in place excessive commitments will merely be constraints to be smashed. Not only would EMS membership offer only limited help on inflation reduction, but it might also have direct costs both for the CEECs and for the EC. The cost for the CEECs is the surrender of seigniorage before an adequate fiscal system is in place. Spain, Greece and Portugal all retained the inflation tax for several years after becoming full EC members, and for over a decade from the date of their first application for EC membership.

Hyperinflation is to be avoided, to be sure, but it is far from evident that squeezing inflation all the way down to single figures should be a priority for the CEECs at this stage in their transition. Nor in practice are EC countries likely to be happy to guarantee the unlimited foreign exchange market intervention to which EMS enlargement would commit them. Western Europe will not wish to monetize Eastern Europe's deficits: that would indeed be an unhappy honeymoon for monetary union. Thus we conclude that, to the extent the CEECs wish to bring inflation under control, they will primarily have to do so without special assistance from the EC. This does not mean they will be entirely alone. The IMF and other international agencies will still perform a useful role in imposing external conditionality. With such a structure already in place, any additional measures by the EC would be of second-order importance.

Notes

[1] A good example of such a country is Turkey, whose application in 1987 for EC membership was scarcely greeted with enthusiasm. Quite apart from any doubts about Turkey's geographical, religious or cultural identity with Europe, it is also a country of 56 million people with a per capita income only half that of Portugal, the poorest incumbent EC member.

[2] PlanEcon is the original source of the GDP estimates. These estimates, at purchasing power equivalent, give a broad coverage of CEECs, but they are often thought to be too high (confirmed by recent experience in the ex-GDR). Thus, in Table 3.1.2 we have scaled down the per capita estimates until the mean for Bulgaria, Czechoslovakia, Hungary and Poland coincides with the mean for those countries in the *World Development Indicators*. This procedure inevitably is arbitrary, not least because World Bank estimates are based on current exchange rates, not purchasing power parity. Because of the continuing uncertainty about initial living standards of CEECs, we later conduct a sensitivity analysis of our results to assumptions about these initial levels.

[3] In reality, GDP has fallen by less than the data suggest. As yet, much of the new private activity is neither recorded in official statistics nor taxed. For a discussion of measurement problems in Poland, see Berg and Sachs (1992).

[4] For an attempt to decompose the domestic and external causes of lower output in the CEECs, see Rodrik (1992).

[5] The OECD forecasts the following percentage output growth figures for 1992 and 1993 respectively: Bulgaria: –8, –2; Czechoslovakia: –5, 0; Hungary: 0, 3; Poland: –2, 1; Romania: –8, –2. Source: OECD *Economic Outlook*, June 1992.

[6] Table 3.1.4 yields the cross-section regression (*t*-statistics in parentheses):

Actual output gap with US	=	5.16	+	0.91 Forecast 1987 GDP	+	3.65 Investment/ GDP	–	15.77 Lawyers/ doctors
		(0.31)		(4.19)		(2.77)		(2.16)

Crafts (1992) obtains similar results for a larger sample of countries.

[7] Source as in Table 3.2.1.

[8] Note in particular that we found no extra role for unemployment once the share of GDP in agriculture was included.

[9] In the case of Switzerland, we may compare our results with the figures in Table 2.6.1. The key difference appears to be our estimate of what the Swiss would collect under the

CAP. Indeed we know that Table 3.2.5 overestimates payments to EFTA countries because their commodity composition of agricultural production does not necessarily attract the highest rates of CAP subsidy, while we have assumed their composition to be the same as the EC average. It remains that the EFTAns have substantial (and substantially supported) agricultural sectors and that payments under the CAP should not be neglected. The Swiss authorities may well have been too conservative on that score. Relative to Commission calculations we appear to overestimate contributions slightly.

[10] There is a mitigating factor, however: CEEC growth is likely to be accompanied by changes in economic structure, with a larger share in services and smaller shares of industry and agriculture. The share of agriculture is rather important: not only does it directly drive CAP receipts, we also found it to be correlated with entitlements to structural funds. Thus CEEC growth, by eventually reducing dependence on agriculture, is likely to reduce their potential net receipts from the EC. In that sense, the results of Table 3.2.5, striking as they are, should be interpreted with caution.

4 Institutional Implications of Enlargement

Enlargement of the EC will take place on a case-by-case basis, with EFTA countries first and CEEC countries later. Eventually, when all potential entrants are admitted, the Community will be a union of more than 30 countries. The question arises whether the current design of major EC institutions is capable of coping with such large membership. While this might be considered to be a long-run issue whose solution can be postponed to the next century, it is foreseeable that the first round of enlargement to EFTA countries will already have undesirable institutional consequences. Since membership in EC policy bodies is basically determined by the principle of member state representation, enlargement will inflate the membership of these bodies beyond an efficient size.

This chapter discusses the implications of enlargement for institutional reform. In Section 4.1 we point out the nature of the efficiency loss from too large committee size. We argue on efficiency grounds that in an enlarged EC the principle of national representation should not be applied to policy committees, such as the Council of the European System of Central Banks or the Commission, whose task is to decide common policies independently of the specific interests of selected regions or member states.

Sections 4.2 and 4.3 present alternative approaches to limiting the size of the ECB Council to an efficient level. One approach is districting: member states are organized into a smaller number of central bank districts, each of which is served by a joint district central bank whose governor sits on the ECB Council. The other approach is alternation of voting membership in the ECB Council, which retains the structure based on national central banks by denying national governors a permanent seat on the Council. Finally, in Section 4.4 we propose to apply the organization principle of 'denationalization' of appointed agents in order to achieve an efficient size for the Commission. Section 4.5 concludes this chapter.

4.1 Rising Committee Size

Membership of European policy bodies has hitherto been basically determined by the principle of member state representation. Consequently, any enlargement of the EC by n countries implies increasing the number of members in existing EC policy bodies by at least n. In some committees, notably the Commission, membership may have to increase by even more than n if the current practice of providing large countries with two seats is continued. For example, when Greece, Portugal and Spain became members, the number of EC Commissioners rose by four, providing Spain with two

Table 4.1: Size of Boards in the Largest German Firms. 1991.

	Number of Firms	*Board Size*	*Average*	*Standard Deviation*
Industry	30	3-18	7.3	3.0
Insurance	5	5-13	6.8	3.2
Banks	5	10-12	10.8	0.7

Source: Saling Aktienführer (1992). Own computations.

Note: Size is measured by sales, insurance receipts or bank assets.

Commissioners because it was considered a large country, like France, Germany, Italy and the UK. If the Maastricht Treaty is put into effect, the minimum number of Commissioners will equal the number of member countries, because Article 126 of the Treaty reinforces the principle of member state representation. The same applies to the number of central bank governors in the policy body of the European System of Central Banks (ESCB), the ECB Council.

Increasing the number of members of a committee raises the costs of its organization and, in particular, the minimum duration of meetings. The theory of organization suggests that the efficiency of decision-making is reduced by rising committee size whenever each member holds the same rights to propose motions. More importantly, the effectiveness of the committee work, i.e. the quality of accepted policies, is likely to suffer markedly if committee size extends beyond a certain level.

The larger a committee becomes, the lower is group cohesiveness and the less transparent the process of decision-making becomes, because face-to-face communication is increasingly replaced by aggregate communication among opinion leaders. The probability that factions emerge rises with committee size, and the process of negotiation tends to be shifted to meetings of sub-groups outside official committee meetings. As a result, the emergence of a consensus view becomes less likely, and non-cooperative majority voting replaces the search for cooperative solutions.

These considerations no doubt explain why the governing bodies of central banks, company boards, parliamentary committees or university committees rarely exceed 15 members. Table 4.1 provides illustrative evidence on the size of company boards. The 30 largest German industrial enterprises are directed by boards of seven members on average. The same applies to the five largest insurance companies, while the boards of the five largest commercial banks are somewhat larger with 10-12 members.

With unchanged organization rules, the expected enlargement of the EC by five EFTA countries will increase the size of the European Council from 12 to 17 members, the size of the Commission from 17 to 22 members and the size of the ECB Council from 18 to 23. Thus, from an efficiency point of view, this first round of future enlargement already gives cause for concern, since it entails an efficiency loss by driving the size of the policy bodies further away from an optimal level. Matters will certainly become unbearable in the more distant future when the CEEC countries are admitted.

If these inefficiencies are to be prevented, the Community will have to consider abandoning the uniform application of the basic principle of member state representation. While national representation is indispensable in genuine political institutions designed to resolve conflicts among member states – examples are the European Parliament and the European Council – it hinders efficient decision-making in those bodies that are supposed to execute a common policy for the Community as a whole without undue regard to the specific conditions or interests of selected regions or member states. A clear example is the ECB Council.

We discuss three approaches of coping with the problem of rising committee size. These are: (a) districting; (b) alternation of voting membership; and (c) 'denationalization' of the appointed agents. While the first two approaches provide alternative solutions to limiting the number of voting governors in the ECB Council, the third approach lends itself to holding the size of the Commission at an efficient level.

4.2 Districting

Districting is an established method of organization. In the US, for example, it successfully serves to organize efficiently the regional distribution of central bank services and to limit the number of central bank governors. This is achieved by organizing the 50 states in 12 central bank districts, each of which is served by one Federal Reserve Bank. Apart from exploiting economies of scale, districting permits limiting the size of the Federal Reserve System's monetary policy body. Therefore, it is worth considering whether districting could be used in the European context to limit the size of the ECB Council to an efficient level.

A new example of districting is provided by the future reorganization of the Deutsche Bundesbank, which is intended to cope with the enlargement of Germany resulting from unification. The policy body of the Bundesbank, the Central Bank Council, consists of six board members and the Presidents of the Bundesbank's subsidiaries in the German states, the Landeszentralbanken (LZBs). Before unification, each of the 11 West German states was served by a LZB headed by a President with a seat in the Central Bank Council. The unification of 1990 increased the number of states from 11 to 16. With unchanged organization rules, this enlargement would have led to the creation of 5 additional LZBs and an extension of the Central Bank Council from its current 17 to 22 members.

Table 4.2: Planned Reorganization of the Deutsche Bundesbank.

Current State LZBs	*% of West German population*	*Future District LZBs*	*% of Total German population*
1. Nordrhein-Westfalen	27.4	1. Nordrhein-Westfalen	21.5
2. Bayern	18.0	2. Bayern	14.1
3. Baden-Württemberg	15.4	3. Baden-Württemberg	12.1
4. Niedersachsen	11.7	4. Niedersachsen, Bremen, Sachsen-Anhalt	13.8
5. Hessen	9.1	5. Hessen, Thüringen	10.6
6. Rheinland-Pfalz	5.9	6. Rheinland-Pfalz, Saarland	6.0
7. Schleswig-Holstein	4.2	7. Schleswig-Holstein, Hamburg, Mecklenburg -Vorpommern	7.8
8. Berlin (West)	3.0	8. Berlin, Brandenburg	7.7
9. Hamburg	2.6	9. Sachsen	6.3
10. Saarland	1.7		
11. Bremen	1.1		

Source: Deutscher Bundestag (1991) and own calculations.

For reasons of efficiency, not just with respect to committee work but also with respect to the provision of domestic payments and credit systems, the Bundesbank designed a reorganization based on the principle of districting. Table 4.2 provides the details. The planned reorganization reduces the number of LZBs to 9 instead of 16 (11 West plus 5 East German LZBs). Consequently, only 9 LZB Presidents will remain. Adding the six members of the Bundesbank Board, the reform will reduce the size of the Central Bank Council to 15. To achieve this, the German central bank system will be organized in nine districts by merging the LZBs of the smaller states. The districts will differ in size; but the smallest district will contain 6.0% of the total population as compared with 1.1% before the reform.

Applied to the case of the EC, districting would require asking the smaller EC member countries to join together in European Central Bank districts, each of which would be served by a joint district central bank. The district's governor would be a member of the ECB Council and be selected by the national governments of the countries forming the district.

Table 4.3 presents the current state of affairs in the EC(12) and two conceivable applications of districting for the enlarged EC. The first version includes the EFTA

Table 4.3: Districting in an Enlarged Community: An Illustration.

Current Central Banks		*Future District Central Banks*			
		EC of 17		*EC(17) + CEECs*	
State	*% of EC(12) population*	*District*	*% of EC(17) population*	*District*	*% of total population*
1. Germany	22.9	1. Germany	21.0	1. Germany	15.6
2. Italy	16.8	2. Italy, Greece	18.1	2. Italy, Greece	13.4
3. UK	16.7	3. UK, Ireland	16.2	3. UK, Ireland	12.0
4. France	16.3	4. France	14.9	4. France	11.1
5. Spain	11.4	5. Spain, Portugal	13.2	5. Spain, Portugal	9.8
6. Netherlands	4.3	6. Netherlands, Belgium, Luxembourg	6.7	6. Benelux	5.0
7. Portugal	3.0	7. Denmark, Sweden, Finland, Norway	6.1	7. Denmark, Sweden, Finland, Norway, Latvia, Lithuania, Estonia	5.7
8. Greece	2.9	8. Austria, Switzerland	3.8	8. Austria, Switzerland, Hungary, Slovenia, Croatia	6.3
9. Belgium	2.9			9. Poland, Czechoslovakia	10.6.
10. Denmark	1.5			10. Romania, Bulgaria, Serbia, Albania, Bosnia, Macedonia	10.5
11. Ireland	1.1				
12. Luxembourg	0.1				

Source: Own calculations.

countries; the second version adds the CEEC countries. We emphasize that this is only a theoretical exercise aiming to show concretely how the districting principle could be applied in the European context. In no way do we mean the sketched solutions to be taken as definite proposals for reform. The illustrations are based on measuring country size by the share of population. An alternative or supplementary measure would be real GNP. Also note that we assume throughout that Denmark and the UK will participate in the monetary union.

Consider first the district solution for the EC(17) (the current EC members plus the EFTA countries: Austria, Finland, Norway, Sweden and Switzerland). The sketched solution organizes the 17 states in eight central bank districts of different size. The largest district (Germany) would comprise 21% of the population, the smallest district (Austria and Switzerland) 4%. This solution limits the size of the ECB Council to 14 members (8 governors plus 6 board members), to be compared with 23 under the Maastricht Treaty. Note that the even number does not create an impasse, because the ECB President holds the casting vote (Article 10 of the Maastricht Treaty).

While districting permits avoiding the inefficiency of inflating committee membership, it also provides a flexible framework for further enlargement beyond the EFTA countries. Since the CEECs joining as a group at some specified date is not a realistic option, it would be very advantageous for each of them to be admitted, when it is ready, without the need for a reorganization of the ESCB; any reorganization is a potential source of political conflict.

The right-hand side of Table 4.3 shows how a one-time reform could be achieved by the adoption of districting. There we have illustrated the form that a 'final' district solution could take under the assumption that over time up to 14 CEECs might become eligible, raising the union's membership from 17 to 31.

Given the small size of most CEECs, it would be possible to allow for no more than ten districts altogether. One of the many possibilities of assigning countries to districts is as follows. First, two districts of the EC(17) framework could be extended by adding the three Baltic states to the Nordic district 7 and Croatia, Hungary and Slovenia to district 8. Second, the remaining eight CEEC countries could be organized in districts 9 and 10. As a result, the largest district would comprise 16% of the total population, the smallest district 5%.

It is important to note the flexibility of this structure. For example, if the first CEEC to enter is Hungary, it could join the already existing district 8. Alternatively, if Czechoslovakia is admitted, district 9 could start functioning, and this district would be extended automatically once Poland enters the union. To repeat, the assignment of countries to districts as sketched in Table 4.3 is only one of several possibilities. It is presented as an illustration, not a proposal of any sort.

Summing up, districting is a proven method of organization which prevents the efficiency loss of inflated committee membership. Organizing the ESCB from the start

of monetary union as a set-up of ten European Central Bank districts would limit the size of the ECB Council to 16 members. Another advantage of this solution is that it provides a sufficiently flexible framework to cope with future enlargements, even if this process extends to a large number of countries and stretches over decades. The advantage comes at a potential political cost as smaller countries are asked to share one district central bank and the right to appoint the governor. It is conceivable that the final assignment of countries to districts will become a politically sensitive matter, should districting be adopted by the EC. The solution we have used in Table 4.3 as an illustration of the principle is based on relative population size and geographical distance, but it abstracts from national idiosyncrasies and related political considerations which may suggest a different solution of the assignment problem.

4.3 Alternation of Voting Membership

It is conceivable that the organizational solution of districting will be rejected by the smaller countries, because national pride or prejudice might rule out cooperating with other nations in a joint district, even though the districting solution is applied only with respect to central banking. In this case, a streamlining of the ECB Council could be achieved by adopting the solution of alternating voting membership.

An example is again provided by the organization of the US Federal Reserve System (FRS). The FRS consists of the Board of Governors and of twelve Federal Reserve Banks (FRBs) of different size. Each FRB is headed by a President, and the Board of Governors consists of six board members. The ultimate policy guidelines are set by the Federal Open Market Committee (FOMC), which corresponds to the ECB Council, consisting of the six board members and no more than five of the twelve FRB Presidents. Thus, not every FRB President is a permanent member in the FOMC. Instead, the five seats for FRB Presidents are determined annually by an alternation rule that does not treat all FRB Presidents equally:

(a) the President of the New York FRB is a permanent member, because this Bank implements the FOMC's policy guidelines in the domestic open market and in foreign exchange markets;
(b) the Presidents of the FRBs of Chicago and Cleveland become members every other year;
(c) the Presidents of the remaining nine FRBs become members every third year.

Table 4.4 illustrates the principle of alternating membership applied to the example of the EC enlarged by EFTA countries. It is presented in the same spirit as Table 4.3: the goal is to provide a concrete illustration of a principle of organization, not to make a formal proposal. Here we work under the assumption that in each year, nine of the seventeen national central bank governors would be voting members in the ECB Council. The differences in country size, as measured by population shares, suggest forming four groups.

Table 4.4: Annual Alternation of Voting Governors in the EC(17) with 9 Seats for National Governors in ECB Council.

State	*% of EC(17) population*	*State*	*% of EC(17) population*
Group 1 Permanent voting: 5 seats			
1. Germany	21.0	4. France	14.9
2. Italy	15.4	5. Spain	10.4
3. UK	15.3		
Group 2 Voting every other year: 2 seats			
1. Netherlands	3.9	3. Greece	2.7
2. Belgium	2.7	4. Portugal	2.7
Group 3 Voting every third year: 1 seat			
1. Sweden	2.3	3. Switzerland	1.7
2. Austria	2.0		
Group 4 Voting every fifth year: 1 seat			
1. Denmark	1.4	4. Ireland	1.0
2. Finland	1.3	5. Luxembourg	0.1
3. Norway	1.1		

The first group could consist of the five largest countries with shares in total EC(17) population of more than 10%: Germany, Italy, the UK, France and Spain. Their governors would be appointed permanent members. A second group of four smaller countries with relative population size between 2.7% and 4% could be provided with two seats. Thus, each of the governors of the Netherlands, Belgium, Greece and Portugal would become members of the ECB Council every other year. The governors of the three countries forming the third group (with population size between 1.7% and 2.3%) would become members every third year. This holds for Sweden, Austria and

Switzerland. The final group could consist of the five smallest countries, with population shares of less than 1.5%, whose respective governors would be members every fifth year.

In this example, the number of voting governors in the ECB Council would be limited to nine for an enlarged Community of 17. Adding the six members of the ECB Board, the Council would consist of 15 members. Thus, as in the case with districting, the method of alternating membership would prevent an enlargement-induced inflation of voting governors in the ECB Council.

Comparing the alternative methods of organization, an alternation of membership has the advantage that it does not require any major change in the existing national organization of central bank services. This might make it politically attractive. However, it needs to be emphasized that the scheme of alternating membership depends critically on the number and relative size of the countries forming the monetary union. Any time another country wishes to join the union, the scheme must be redesigned and hence renegotiated if the chosen limit to the Council size is to be retained. This is an invitation to potential conflict. We conclude that the need for repeated redesign puts alternation of Council membership at a clear disadvantage relative to districting. Under districting, the maximum number of central bank districts as well as potential district membership could be decided once-and-for-all by the current Community before the start of the ESCB and monetary union.

4.4 'Denationalization' of the Appointed Agents

With unchanged organizational rules, the enlargement of the EC will not only blow up the size of the ECB Council to an inefficient level but the size of the Commission as well. The question then is whether the organizational principle of 'denationalizing' committee membership could be applied to limit the Commission's size to an efficient level. Denationalization implies that a person is appointed on the basis of his or her professionalism rather than nationality. By contrast, denationalization in the private sector is not an issue but a fact driven by companies' dominant interest in efficiency.

Denationalization can be viewed as a deepening of European decision-making in the sense that the appointed persons are expected to evaluate alternative European policies on purely professional and European grounds and not to respond to the specific national interests of their countries of origin. A major advantage of denationalization is that the size of committee membership can be kept in line with the number of functions or departments that are to be controlled by the committee. Denationalization is not applicable to all European policy bodies but only to those that are supposed to solve common policy problems affecting all member states in a similar way. The ECB Board is an example. In fact, the Maastricht Treaty has implicitly introduced denationalization by limiting the size of the Board to six members.

The Commission provides another example of an EC committee whose size needs to be limited on efficiency grounds. As a result of the principle of national representation, the current size of the Commission is already out of proportion with its functions. A casual inspection of the current distribution of competences among the 17 commissioners in office indicates that basic functions have been split arbitrarily among commissioners. For example, according to the Commission's 1991 directory, foreign affairs are handled by F Andriessen (NL) and A Matutes (E), regional policies by H Christophersen (DK) and B Millan (UK), and translation services by J Delors (F) and A Cardoso E Cunha (P). Moreover, Commissioners are in charge of EC activities such as the Security Office, the Statistical Office, the Office for Official Publications or the 'People's Europe'. It is not evident that such activities should be handled at this level of responsibility.

An efficient organization of the Commission would probably require fewer than 10 commissioners instead of the current 17 or future 22 if and when the EFTA countries join. The organization of governments suggests that the various responsibilities of the Commission might be concentrated. For instance, one could think of the following functional distribution: (1) President's Secretariat-General; (2) foreign affairs; (3) EC budget and finance, EC taxation and customs affairs; (4) competition, regional and trade policies, consumer protection, monetary affairs; (5) labour markets and social issues; (6) agriculture and fisheries; (7) EC law and other legal issues; (8) relations with other EC institutions; (9) organization and human resources.

Applying the principle of denationalization would enable the Commission to be streamlined to a more efficient size. Such denationalization requires providing committee members with a status that permits personal independence from the political authorities of the country of origin. But this is an already accepted provision.

While there is no compelling argument pointing to the infeasibility of denationalization with respect to membership of the Commission – much to the contrary, this would be in line with accepted principles governing the composition of the executive in parliamentary democracies – the proposal is likely to meet with strong opposition from member governments for several reasons, not the least of which will probably be that the number of appointments to European posts prepared or decided by national governments is thereby reduced. However, if denationalization is rejected, the *status quo* of national representation would imply increasing the size of the Commission to 22 with EC enlargement by the mid-1990s and more than 30 later on, when the CEECs join.

4.5 Conclusions

Enlargement of the EC beyond its current 12 members will require a reorganization of existing policy bodies as well as of future policy committees implied by the treaty revision of Maastricht in order to assure efficient decision-making by limiting

committee size. The three approaches towards organizational reform presented above restrict the application of the general principle of member state representation in different ways. They are not uniformly applicable to any EC policy body.

In order to limit the size of the ECB Council to an efficient level of about 15 members, it is advisable to introduce either the organizational principle of districting or of alternating voting membership for regional central bank governors. Both approaches alter the current principle of member state representation and take into account the vast differences in country size.

Under districting, smaller countries would form a central bank district with a joint district central bank, headed by one governor. The countries belonging to a district would jointly decide which person to appoint district governor with a seat in the ECB Council. The approach of alternating voting membership is less demanding as it keeps the inherited structure, and hence does not reduce the number of national central banks or national governors.

The major advantage of districting over alternating membership is that it needs only one reform to establish an efficient and flexible structure for the ESCB, which can accommodate future enlargements. Concerning the provision of central bank services, districting may provide the additional advantage of permitting a more efficient organization of the central bank structure within regions.

Districting as well as alternation of voting membership might be interpreted to imply reducing the influence of the many small countries on joint monetary policy-making. Since it is the declared will of all EC countries that the ECB shall be independent from national governments, however, the argument does not appear to have much force.

As regards limiting the size of the Commission to an efficient level, it is advisable to replace the principle of member state representation by the principle of denationalization. Since it is the Commission's task to take decisions for the Community as a whole without regard for the specific national interests of member governments, denationalization is the appropriate organizing principle.

The major advantage of denationalization is that it permits limiting committee size by equating the number of members with the number of departments to be administered. As has been pointed out above, applying the principle to the Commission would permit reducing its size to a more efficient body of fewer than ten members. Another advantage of denationalization is that it permits longer terms of office. This method of organization thus avoids the waste of human capital implied by frequent rotation that is dictated by a rigid application of member state representation.

Widening provides the Community with a real challenge. This chapter has made the case that this challenge can only be met through institutional deepening.

5 Conclusions

On the Maastricht model full membership of the EC would eventually entail: the entirely free movement of goods, labour, services and capital; common policies such as for trade and competition; European monetary union (EMU); and European political union (EPU). Members, both actual and aspiring, will have to decide how far along this road they wish to travel and in which sequence. The Community started in 1958 with goods and trade policy, followed by labour (but not for non-working persons), capital and services. These four freedoms are not yet fully achieved, but there is reasonable confidence that they will be by the end of the single-market programme. In addition, EMU has been agreed conditionally and commitments made to work towards EPU, although, as the UK government and the Danish voters have shown, there is still considerable uncertainty. But the pressures for enlargement will continue regardless of how that uncertainty is resolved.

Turning to the potential members, a slightly different sequence appears. The free trade agreements between the EFTA countries and the EC have, since the mid-1970s, allowed fairly free trade in industrial goods, with the result that their industrial sectors are already partially integrated. The EC's '1992' programme, however, has offered EC firms a substantial competitive boost, from which the EFTA countries, still on the wrong side of various non-tariff barriers to trade, are excluded. For this reason they have sought to join the single market by means of the European Economic Area (EEA) Agreement, which enhances the free movement of goods, by promising to reduce many of the non-tariff barriers, and institutes the free movement of capital, labour and services. The EEA delivers most of the gains that '1992' offers the EC members and promises significant increases in EFTAn GDP – perhaps up to 5%. Indeed it offers most of the economic benefits of '1992' with almost none of the political baggage of Maastricht, and so could well represent an attractive long-term form of integration for some EFTA countries. For two reasons, however, most of them have decided to apply for full membership and thus apparently seem prepared to accept the complete set of Maastricht conditions. First and most importantly, full membership offers them a political role in the development of EC policy that is almost wholly absent from the EEA. Second, membership offers some further economic gains: it would bring the CAP, EMU and the full EC competition policy to EFTA and also, by being an apparently more binding commitment to integration, it is more likely to prevent investment and skilled labour from draining away into the EC.

The EFTA countries' interest in the EEA is almost wholly economic, but their wish to extend it into full membership reflects mainly political motives. For the existing members of the EC, however, these motivations are reversed. The EC has relatively little to gain from deeper economic integration with a group one-tenth of its size, and it offered the EEA largely as a political gesture towards its neighbours. Considering full accession, on the other hand, there are slight political worries about diluting the will for

complete political integration, but strong economic incentives in the form of the EFTAns' substantial net budgetary contributions and their likely ability to meet the conditions for EMU. The Commission's recent opinions on Austrian and Swedish membership are generally positive. The condition that Sweden commit itself to a currently undeveloped common defence policy – a condition which not all existing members would be able to accept – looks like sabre-rattling, and it can almost certainly be finessed by negotiation. Our judgement is that, with more to gain, the EC will actually be more conciliatory over membership conditions than it was over EEA terms.

Overall, then, both sides are well disposed towards an EFTAn enlargement. Since there are likely to be relatively few contentious issues in the accession negotiations, and given the desire in some quarters to get the EFTAns in before the next round of intergovernmental discussions in 1996, we would expect a fairly speedy resolution of this issue. The two greatest threats to rapid EFTAn accession are: first, a political backlash from public opinion in one or more EFTA country; and second, the failure of the current twelve to ratify Maastricht and to agree on the budget this year – preconditions they have set themselves for opening accession negotiations.

Austria, Finland, Sweden and Switzerland will be party to any accession negotiations. Although public opinion, especially in the last, does not guarantee that a positive outcome would be ratified, there are none the less advantages to them in negotiating, such as the ability to influence the terms of eventual accession and possibly to influence EC policy during the negotiations. Because of its different cyclical pattern and less integrated trade, Norway appears to have less to gain from proceeding from EEA to full membership, so it might still hang back. However, the threat of being the only significant non-EC country in Continental Western Europe is a considerable counterweight to doing so. Iceland, which is different both geographically and economically, will probably stick to its decision not to apply. Hence the most probable outcome is an EC of 17 by 1996.

The second set of potential entrants are the countries of Central and Eastern Europe – the CEECs – which are in an entirely different position from the EFTA countries. While the latters' accession has close parallels with the EC's first enlargement (to the UK, Ireland and Denmark), the CEECs' is parallel to the second or Southern enlargement (Greece, Portugal and Spain). Like the CEECs, these countries wished to reinforce their new market democratic systems and to underpin their economic reforms. They had, however, to wait about a decade between political liberalization and accession, and, while poor relative to the rest of the EC, they were not as far behind the EC average as the CEECs currently are. Moreover the poorest entrants – Greece and Portugal – were relatively small and hence could be incorporated with relatively small gross transfers. The Southern enlargement also illustrates the fact that accession is not sufficient to guarantee convergence towards average EC income levels. Despite significant transfers from Brussels, economic policy in Greece has been so weak that the country has grown poorer relative to other EC members.

The CEECs are currently very poor – with per capita incomes perhaps two-thirds of Portugal's in the late 1980s and very deep recessions thereafter. This suggests that they would have great difficulties in coping with full integration with the EC – consider the strains on the former East Germany, probably the most advanced of the former-CMEA economies – and also that current EC policies on cohesion would exact substantial transfers from other members. For example, we estimate that Czechoslovakia, Hungary and Poland would require a combined annual net inflow of about 8 billion ecu and Bulgaria and Romania, with only about 32 million people between them, a further 5 billion. Since the EC will not reduce its commitment to cohesion – indeed, it is trying to increase it – these figures alone suggest that the CEECs will have to stabilize their economies, rationalize their institutions and achieve several decades of above-average economic growth before it is realistic to think in terms of full accession to the EC.

How is this to be done, and how, if accession is ruled out, can the EC help? Here sequencing is important again. Economic growth will be stimulated by high levels of demand for their output; since the poor CEEC economies cannot provide this sufficiently for themselves they must look abroad, and by virtue of both geography and culture that effectively means to the EC and EFTA – the potential EC(17). CEEC-EC(17) trade has a huge potential for expansion – perhaps fourfold relative to pre-revolution levels – to the advantage of both parties. For the Central European countries – Czechoslovakia, Hungary and Poland – that expansion appears to be under way already. Moreover, a significant fraction of it appears to be in relatively sophisticated goods, so that it will not all be at the expense of the poorer members of the EC. Having noted that, however, it is plain that if CEEC exports are to have the maximum impact on their economies, and if the EC is to reap maximum benefit from trade with its new partners, then trade must also be allowed to expand in traditional sectors. This is particularly true of agricultural goods, for the CEECs appear to have substantial capacity to increase output in that sector. In our view, if free agricultural trade were to break the EC's Common Agricultural Policy, that would be so much the better.

A major consideration in EC deliberations on enlargement and association with neighbouring countries is migration. Fears have been expressed that the accession of the CEECs would cause a flood of unskilled workers onto Western labour markets. The experience of migration from Southern Europe suggests, however, that these fears are exaggerated. Income disparities, even of the current degree let alone of the degree likely on accession, seem unlikely to generate flows in excess of 5% of CEEC population over a couple of decades, although severe political disruption could change this – *vide* the recent Albanian flow to Italy. Moreover, sensible policy could reduce migratory pressures even before accession: liberal trade is required to raise the demand for CEEC labour and to provide income and investible funds, while commitments to eventual EC membership are necessary to encourage an optimistic view of the future. Indeed, if the CEECs are to take off onto a path of economic growth, confidence in the future will be an essential ingredient in fostering investment in human and physical capital.

The necessary sequence for both the CEECs and the EC to benefit appears, then, to be immediate free trade in goods and services including agriculture, coupled with high capital mobility. The mobility of labour is not necessary, however, and would indeed run two risks. First, it might scare EC politicians into slowing down integration, and second, if it permitted a westward brain drain, it could undermine rather than enhance development in the East. These policies could be institutionalized by building up the Europe Agreements between (certain of) the CEECs and the EC from their current state of delayed and somewhat qualified access to Western markets to full free trade agreements immediately. In addition more generous capital flows should be provided.

The improved access that we envisage for the CEECs should be formalized in a new form of European Economic Space (EES), which might encompass not only the CEECs and the current EC(12), but also the EFTA countries. It would not be identical to the current EC-EFTA European Economic Area, for it would include agriculture (and probably all competition policy) and exclude labour mobility, but it would be strengthened by its institutional parallels to that agreement and by spreading the trade and integration it induced over the whole European mainland. The political objections to Europe *á la carte* are strong – endless negotiation and the undermining of governments' abilities to impose the tough short-term adjustments and restructuring that successful integration entails – but a Europe comprising the EC, EEA and EES in overlapping sets would offer nations some choice over the degree and nature of the integration they sought.

It is difficult to predict when enlargement to the CEECs will be feasible. At present the most plausible candidates appear to be Hungary and Czechoslovakia, or more precisely the Czech Republic, its more Western and Westernized part. These countries have the highest incomes among the CEECs, the most favourable location, the fewest agricultural problems, booming trade with the EC, the best records of transition and the least threatening migratory pressures. Poland comes next, its deep commitment to reform and accession hindered by its poverty, its poor and overcrowded agriculture, and its political difficulties. Bulgaria and Romania are further behind both economically and politically. They are more likely to generate heavy migration flows and are further from the EC's geographical heart. It is impossible to judge the future for the Yugoslav states or for those of the CIS, although the Baltic states may be ready for accession as soon as Poland.

Enlargement to 17 members, let alone to more than 20, will have severe consequences for the EC's institutions. Many committees are already over-large and cumbersome, and extending them to allow for the national representation of new members would be the last straw. The opportunity of enlargement should be taken to rationalize EC decision-making bodies, and although it is plainly premature to consider specifics, we illustrate several ways of thinking about the problem. It will be a sign of EC political maturity that, while still recognizing the primacy of national representation in the EC's senior fora, it can relax such rules in the name of efficiency at bureaucratic levels.

Our policy conclusions are stark and simple, and appear to involve no conflicts of interest. What is good for the EC is also good for its partners.

- ☐ Neither EFTA nor the EC should ignore the opportunities afforded by further integration. The EFTAns will benefit from the stimulus of competition and trade and the confidence that EEA and EC membership provide, while the EC could use EFTA's money and, if it is aiming for it, EFTA's ability to reach EMU.

- ☐ Neither the CEECs nor the EC can afford full enlargement for some decades yet. The CEECs' economies are not strong enough and the EC's pockets not deep enough.

- ☐ The CEECs and the EC are natural trading partners and must exploit that fact to stimulate growth in the CEECs. They must have free trade in all goods and services, coupled with strong capital flows from West to East. Labour market integration is not required yet, but a commitment to full membership when the CEECs have achieved some catch-up is.

References

Agra Europe (1992), *Enlargement of the European Community: Agricultural Implications*, Special Report No. 58.

Baldwin, R (1989), 'Growth Effects of 1992', *Economic Policy*, 9, pp. 247-82.

Baldwin, R (1992), 'Measurable Dynamic Gains from Trade', *Journal of Political Economy*, 100, pp. 162-74.

Barro, R and X Sala-i-Martin (1991), 'Convergence Across States and Regions', *Brookings Papers on Economic Activity.*

Barro, R and X Sala-i-Martin (1992), Journal of Political Economy, 2.

Bayoumi, T and P Masson (1992), 'Fiscal Flows in the United States and Canada: Lessons for Monetary Union in Europe', mimeo, International Monetary Fund.

Begg, D *et al.* (1990), *Monitoring European Integration: The Impact of Eastern Europe*, Centre for Economic Policy Research, November.

Berg, A and J Sachs (1992), 'Structural Adjustment and International Trade in Eastern Europe: The Case of Poland', *Economic Policy*, 14, pp. 117-73.

Blanchard, O, R Dornbusch, P Krugman and R Layard (1992), 'East-West Migration: the Alternatives', Working Paper No. 101, Centre for Economic Performance, London School of Economics.

Bowen, H P, E E Leamer and L Sveikauskas (1987), 'Multi-country, Multifactor Tests of the Factor Abundance Theory', *American Economic Review*, 77, pp. 791- 809.

Brock, W A, S P Magee and L Young (1989), *Black Hole Tariffs and Endogenous Policy Theory*, Cambridge University Press.

Buigues, P and F Ilzkovitz (1992), 'Central and Eastern European Countries, Basic Facts and Main Issues: Trade', Commission of the EC, DG-II, Doc. II/125/92-EN.

CIA (1990), *Handbook of Economic Statistics, 1990*, Central Intelligence Agency, Washington DC, September.

Cohen, D (1991), 'The Solvency of Eastern Europe', CEPR Discussion Paper No. 539, also in *European Economy* Special Edition, 2, July 1991, pp. 263-303.

Collins, S and D Rodrik (1991), *Eastern Europe and the Soviet Union in the World Economy*, Institute for International Economics Policy Analyses in International Economics, No. 32, Washington DC.

Commission of the European Communities (1988), 'The Economics of 1992', *European Economy*, No. 35; known as the Cecchini Report.

Commission of the European Communities (1990), 'The European Community and German Unification', *Bulletin of the European Communities*, Supplement 4/90.

Commission of the European Communities (1991), *The Community Budget: the Facts in Figures*, Office for Official Publications of the European Communities.

Crafts, N F R (1992), 'Productivity Growth Reconsidered', *Economic Policy*, 15, pp. 1-40.

De Long, B and L Summers (1991), 'Equipment Investment and Economic Growth', *Quarterly Journal of Economics.*

Deutscher Bundestag (1991), *Drucksache 12/1869*, Bonn.

EFTA (1991), *EFTA Trade 1990*, EFTA Secretariat, Economic Affairs Department, November.

EFTA (1992), 'Effects of 1992 on the Manufacturing Industries of the EFTA Countries', Occasional Paper No. 38, EFTA Secretariat.

Gardener, E P M and J L Teppett (1992), 'The Impact of "1992" on the Financial Services Sectors of EFTA Countries', EFTA Occasional Paper No. 33, revised.

GATT (1992), *International Trade 1990-1991*, Volume II, GATT Secretariat, Geneva.

Gylfason, T (1991), 'Iceland on the Outskirts of Europe: The Common Property Resource Problem', CEPR Discussion Paper No. 530, April, also in *EFTA Countries in a Changing Europe*, EFTA Secretariat, July.

Haaland, J and V Norman (1992), 'Global Production Effects of European Integration', CEPR Discussion Paper No. 669, forthcoming in Winters, L A (ed.) (1992).

Haaland, J and I Wooton (1991), 'Market Integration, Competition and Welfare', CEPR Discussion Paper No. 574, forthcoming in Winters, L A (ed.) (1992).

Hamilton, C B (1991), 'The Nordic EFTA Countries' Options: Seeking Community Membership or a Permanent EEA-Accord', CEPR Discussion Paper No. 524, also in *EFTA Countries in a Changing Europe*, EFTA Secretariat, July.

Hamilton, C B and L A Winters (1992), 'Opening up International Trade with Eastern Europe,', *Economic Policy*, 14, pp. 77-116.

Herin, J (1986), 'Rules of origin and differences between tariff levels in EFTA and the EC', EFTA Occasional Paper No. 13, EFTA Secretariat, Geneva.

House of Lords (1992), Report on 'Enlargement of the Community', 9 June, HMSO, London.

Jacquemin, A (1992), 'Effects of "1992" on the World Economy: An Overview', paper presented at MITI/RI Symposium, Tokyo, June.

Krugman, P (1988), 'EFTA and 1992', EFTA Occasional Paper No. 23.

Krugman, P (1991), *Economic Geography*, MIT Press, Cambridge MA.

Lucas, R (1988), 'On the Mechanics of Economic Development', *Journal of Monetary Economics*, XXII, pp. 3-42.

Maddison, A (1989), *The World Economy in the Twentieth Century*, OECD, Paris.

Maddison, A (1991), *Dynamic Forces in Capitalist Development*, Oxford University Press.

Nerb, G (1988), 'The Completion of the Internal Market: A Survey of Europe's Industry Perception of the Likely Effects', *Research on the Costs of Non-Europe, Basic Findings*, 3, Commission of the European Communities.

Norman, V (1991), '1992 and EFTA', in Winters, L A and A J Venables (eds.) (1991).

Norman, V and S Strandenes (1990), 'Deregulation of Scandinavian Airlines: A Case Study of the Oslo-Stockholm Route', CEPR Discussion Paper No. 403.

OECD, *Economic Outlook , OECD, Paris.*

OECD, *Commodity Trade Statistics* Series C, Annual, OECD, Paris.

OECD, *Agricultural Policies, Markets and Trends*, Annual, OECD, Paris.

OECD, *Labour Force Statistics*.

Pelkmans, J and L A Winters (1988), *Europe's Domestic Market*, Chatham House, London.

Rodrik, D (1992), 'Making Sense of the Soviet Trade Shock in Eastern Europe: A Framework and Some Estimates', CEPR Discussion Paper No. 705.

Romer, P (1986), 'Increasing Returns and Long Run Growth', *Journal of Political Economy*, October, 94, pp. 1002-37.

Sala-i-Martin, X and J Sachs (1992), 'Fiscal Federalism and Optimum Currency Areas: Evidence for Europe from the United States', CEPR Discussion Paper No. 632, also in Canzoneri, M, V Grilli and P Masson, *Establishing a Central Bank: Issues in Europe and Lessons from the US*, Cambridge University Press.

Saling Aktienführer (1992), Hoppenstedt & Co., Darmstadt.

Scharpf, F W (1988), 'The Joint Decision Trap: Lessons from German Federalism and European Integration', *Public Administration*, 66, pp. 239-78.

Swiss Federal Council (1992), 'Rapport sur la question d'une adhésion de la Suisse à la Communauté europeénne', Report to Parliament, May 18.

Tyers, R and K Anderson (1992), *Disarray in World Food Markets: A Quantitative Assessment*, Cambridge University Press, Sydney.

UN, *Commodity Trade Statistics*, Series D, Annual, United Nations, New York.

UNECE (1992), *Economic Survey of Europe in 1991-1992*, UN Economic Commission for Europe, New York.

Venables, A J and A Smith (1988), 'Completing the Internal Market in the European Community: Some Industry Simulations', *European Economic Review*, 32, pp. 1501-25.

Viner, J (1950), *The Customs Union Issue*, Carnegie Endowment for International Peace, New York.

Wang, Z K and L A Winters (1991), 'The Trading Potential of Eastern Europe', CEPR Discussion Paper No. 610.

Wijkman, P (1991), 'The EEA Agreement – At Long Last', in *EFTA Trade 1990*, EFTA Secretariat, Economic Affairs Department, November.

Winters L A (1992), 'The Europe Agreements: With a Little Help From Our Friends', mimeo, University of Birmingham.

Winters, L A (ed.) (1992), *Trade Flows and Trade Policies After '1992'*, Cambridge University Press.

Winters, L A and A J Venables (eds.) (1991), *European Integration: Trade and Industry*, Cambridge University Press.

World Bank (1990), *An Agricultural Strategy For Poland*, The World Bank, Washington DC.

World Bank, *World Tables*, World Bank, Washington DC.

World Bank, *World Development Indicators, World Development Report*, Annual, World Bank, Washington DC.

CEPR Research Programmes

Comparative Experience of Economic Growth in Postwar Europe: A European Research Network

Understanding why growth rates differ across countries is of central importance. Comparative economic growth has been an active area of research for CEPR especially since 1988, but we are now in a better position to understand the process of economic growth than at any time in the past twenty years. This new project will yield a deeper understanding of postwar West European growth, by bringing together economists and economic historians utilizing a variety of complementary approaches and new analytical tools. The research gives priority to careful measurement of comparative economic performance in Europe, to understanding the political economy of supply-side factors in economic growth, and to comparative analyses of the effects of institutions on productivity.

Market Structure, Industrial Organization and Competition Policy in Europe

The study of industrial organization and market structure is now one of the most lively and dynamic areas of economic research. The insights provided by this research are directly relevant to industrial, trade and competition policy in Europe. This new CEPR project brings together researchers from accross Europe to develop new analytical approaches to the study of market structure and industrial organization; to carry out empirical studies of particular sectors of European industry, such as pharmaceuticals, airlines and telecommunications; and to apply these theoretical and empirical advances to issues of European competition, trade and industrial policy.

Economic Transformation in Eastern Europe

This programme involves a set of linked projects that brings together outstanding researchers and policy-makers from West and East European countries and from international organizations. As the East European reform process accelerates, incoming governments face a number of conventional but pressing economic problems: high debt, high interest rates, fiscal imbalance, and an industrial structure that is ill suited to exporting to hard currency markets. They must also quickly create financial systems, functioning labour markets, and much more rational tax-subsidy structures. This programme therefore gives high priority to research in the areas of internal and external stabilization, industrial restructuring, trade reorientation and tax reform, within an overall framework of 'robust sequencing'. The programme is designed to exploit a wide variety of theoretical, empirical and institutional approaches to the transformation of economic systems.

Recent CEPR Books

Unity with Diversity in the European Economy: The Community's Southern Frontier, edited by Christopher Bliss and Jorge Braga de Macedo

This volume derived from CEPR's Delphi conference of October 1989 addresses the theoretical issues involved in the integration of a diverse economic region and the combined impact of accession to the European Community, financial integration and the single-market programme on Spain, Greece and Portugal. Cross-country papers assess investment and growth in the Community's poorer regions; the effects of membership on output and employment in peripheral regions; and the constraints imposed by rapid monetary and financial integration on national macroeconomic policies.
Cambridge University Press, £30.00/$59.50, August 1990.

Public Debt Management: Theory and History, edited by Rudiger Dornbusch and Mario Draghi

Fiscal convergence and the prospect of a common money lie at the centre of the macroeconomic policy debate as the European Community moves towards EMU. This volume of proceedings of a joint CEPR conference with the Italian Macroeconomic Policy Group, held at Castelgandolfo in June 1989, brings together theoretical, applied and historical research on the management of public debt and its implications for financial stability. Leading international authorities consider the European and US experience to assess the welfare economics of public debt, the dangers that inappropriate debt management will lead to funding crises, capital levies and debt consolidation, the history of the US public debt, political influences on debt accumulation, trade-offs between indexation and maturity, and confidence effects.
Cambridge University Press, £30.00/$54.50, January 1991.

European Financial Integration, edited by Alberto Giovannini and Colin Mayer

Capital markets will be at least as affected as goods markets by the European Community's continued economic integration, and plans for economic and monetary union foreshadow fundamental upheavals in financial services, central banking and monetary and fiscal policies. In this volume, based on a Rome conference held by CEPR and the Istituto Mobiliare Italiano in January 1990, leading international experts examine the implications of Europe's financial integration for the structure and regulation of capital markets and the relationship between the corporate and banking sectors. They also address possible means of overcoming the distortionary effects of member states' differing taxation policies and alternative routes to monetary union.

Cambridge University Press, hardback – £30.00/$49.50, paperback – £14.95/$27.95, April 1991.

European Integration: Trade and Industry, edited by L Alan Winters and Anthony J Venables

This volume, based on a CEPR joint conference with the Centro Interuniversitario di Studi Teorici per la Politica Economica (STEP) and Confindustria, held at Urbino in March 1990, assesses the implications of completing the European Community's single-market programme. Contributors assess the effects of '1992' on both 'internal' and 'external' economies of scale, the Community's trade with EFTA, Eastern Europe and the rest of the world, the design of technology and taxation policies, and Japanese direct investment in European manufacturing.
Cambridge University Press, £27.50/$54.50, May 1991.

External Constraints on Macroeconomic Policy: The European Experience, edited by George Alogoskoufis, Lucas Papademos and Richard Portes

This volume of papers presented at a conference held by CEPR and the Bank of Greece in Athens in May 1990 assesses the impact of the European economies' increased commitment to their exchange rates and the growth of private international capital flows on the formulation and coordination of EC member states' macroeconomic policies. They include cross-country studies of savings and investment, fiscal policy, unemployment and European macroeconomic policies in the 1930s. The volume also contains a study of the effects of the exchange-rate constraint on France and Germany, and studies of the external constraint in Denmark, Spain, Greece, the Netherlands and the UK.
Cambridge University Press, £30.00/$54.50, August 1991.

Exchange Rate Targets and Currency Bands, edited by Paul Krugman and Marcus Miller

In recent years, a new programme of research has emerged in international monetary economics, underpinned by a firm theoretical framework grounded in stochastic calculus and the increasing importance of the international arrangements under which national monetary authorities seek to keep their exchange rates within 'target zones'. This volume, largely based on the proceedings of a July 1990 joint CEPR conference with the National Bureau of Economic Research, includes contributions from most of the active participants in this new field. Papers in this volume address the stability of fixed exchange rate regimes in the face of speculative attacks, international efforts to stabilize the US dollar since 1985, the place of the European Monetary System in the international financial system, and the key issues facing a country with a floating currency when contemplating entry into a fixed rate system, such as the UK's late 1990 entry into the EMS.
Cambridge University Press, £30.00/$54.50, October 1991.

Open Economies: Structural Adjustment and Agriculture, edited by Ian Goldin and L Alan Winters

This volume of papers presented at an April 1991 CEPR joint conference with the OECD Development Centre focuses on the interrelationship between macroeconomic stabilization programmes and the agricultural sector in developing (and East European) economies that are increasingly open to foreign trade and capital flows. Liberalizing agricultural trade has major effects on these countries' income distribution and may have significant implications for the political economy of reform. The papers focus on the sequencing of reforms, the effects of structural adjustment on infrastructure and investment, the design of policy programmes to stabilize income and agricultural prices, and the implications of relaxing the 'small country assumption'.
Cambridge University Press, £35.00/$59.50, May 1992.

Establishing a Central Bank: Issues in Europe and Lessons from the US, edited by Matthew Canzoneri, Vittorio Grilli and Paul Masson

This volume of the proceedings of a joint CEPR conference with Georgetown University's Center for German and European Studies and the IMF considers the possible structure and operational procedures of a European Central Bank. Many of the papers draw on historical and contemporary US experience of federal government with a currency union. Issues considered include the role of such a bank in controlling liquidity and supervizing financial markets, the implications of proposed voting rules for the development of a currency union's monetary policy, and the likely difficulties to be encountered in the *transition* from national to Community monetary policy. Other chapters address the lessons of US 'fiscal federalism' for the smoothing of regional imbalances and the possible role of private financial markets in disciplining member states' fiscal authorities, and also the interaction of the ecu with the dollar and the yen as international reserve currencies once the transition to monetary union is complete.
Cambridge University Press, £29.95/$44.95, July 1992.

Trade Flows and Trade Policies After '1992', edited by L Alan Winters

The completion of the European Community's single-market programme will stimulate the European economy and affect the rest of the world principally through its effects on trade among EC member states and on the Community's external trade. Although there has been much discussion on the effects of '1992' on economic welfare, there has been relatively little detailed analysis of the trade issues involved. This volume, offers a major reappraisal of the effect of completing the single market on intra-EC trade and on the Community's member states. Individual chapters assess the effects of '1992' on EC and world trade and welfare and analyse its effects on competition if transport costs and taste differences remain within the unified European market. Detailed case-studies of banking and pharmaceuticals show that integration has complex effects on trade flows and prices and stress the importance of devising a satisfactory common external trade policy. Other chapters estimate the elasticities of import demand

within the Community and examine the effects of industrial policy.
Cambridge University Press, c. £30/$54.95, November 1992 forthcoming.

Hungary: An Economy in Transition, edited by István P Székely and David M G Newbery

Hungary's uniquely 'gradualist' economic transformation has now reached a critical stage. Despite recent upheavals, Hungary has succeeded in attracting foreign capital and has achieved its first current account surplus in convertible currency since 1984. It is clear that privatization will be a lengthy and difficult process, with significant repercussions for the future of the economy and profound social and welfare consequences. This book presents local arguments and perceptions informing the current debate and critical examinations of these ideas from an international panel of scholars. The individual chapters address privatization; financial, tax and legal systems; foreign trade and integration into the international financial and monetary systems; labour markets, unemployment and the social safety net; and the political economy of the current economic transformation. The analyses and results will be of major interest to economists and policy-makers concerned with transition throughout Eastern Europe.
Cambridge University Press, c. £30/$54.95, December 1992 forthcoming.

The above books cannot be obtained from CEPR, but they can be purchased from good academic bookshops or from Cambridge University Press, The Edinburgh Building, Shaftesbury Road, Cambridge, CB2 2RU *or* 40 West 20th Street, New York, NY 10011, USA.

The 1990 Report – Monitoring European Integration: The Impact of Eastern Europe

David Begg
Jean-Pierre Danthine
Francesco Giavazzi
Carl Hamilton
Damien Neven
Victor Norman
André Sapir
Alasdair Smith
L Alan Winters
Charles Wyplosz

The 1990 Report, *Monitoring European Integration: The Impact of Eastern Europe*, was the first major study of how developments in Eastern Europe would affect the economies of Western Europe and the process of economic integration among them; and its main conclusions and recommendations have been borne out by subsequent experience. The first section of the 1990 Report focused on the medium- and long-term implications of the current transformation of Eastern Europe for European production and trade, in particular whether current and historical patterns of trade shed any light on Eastern Europe's comparative advantage. It also assessed the implications of change in Eastern Europe for EC trade and industrial policy and the likely magnitude of East European trade with the West, given the current state of the capital stock and the potential for industrial restructuring. The Report analysed Eastern exports of energy and agricultural goods, the future of the CAP, and competition between Eastern and Southern Europe.

The second section of the Report assessed the medium-term macroeconomic impact of the transformation of the East European economies, focusing on issues such as the consequences of German reunification, East European spending on consumption versus investment, and the likely impact on the EMS of the flows of new investment and capital goods from the West into Eastern Europe. Here the Report assessed the implications of reform in the East for interest rates, pressures for DM realignment, and the case for accelerating EMU in response to the 'Eastern Europe shock'.

Available from CEPR, 25–28 Old Burlington Street, London W1X 1LB.
Telephone: (44 71) 734 9110 Fax: (44 71) 734 8760
£7.50 or $15.00 including p&p.

The 1991 Report – Monitoring European Integration: The Making of Monetary Union

David Begg
Pierre-André Chiappori
Francesco Giavazzi
Colin Mayer
Damien Neven
Luigi Spaventa
Xavier Vives
Charles Wyplosz

The process of economic integration is at the heart of the European policy debate. Monitoring European Integration assesses the progress and obstacles encountered by economic integration in Europe. The 1991 Report, *The Making of Monetary Union*, examines the monetary unification of Europe and the creation of a European Central Bank. The Report deals first with the macroeconomics of monetary union, and highlights four issues. What monetary constitution is required to deliver price stability, and do the draft statutes of the European Central Bank (ECB) meet these conditions? Are fiscal rules a necessary adjunct to such a constitution? Is convergence of inflation rates a precondition for embarking on monetary union? Finally, how should the transition be managed?

The second section of the Report analyses the vital but neglected question of the supervision and preservation of the stability of the financial system. It highlights the possible conflicts between the ECB's responsibility for financial stability and its commitment to stable prices. The authors argue that the ECB should be responsible for authorization of banks and the lender of last resort function. Closure of banks and administration of deposit insurance may, however, be kept separate from those of the ECB. Centralization of regulation does not require harmonization: differences in the functions of banks across countries impose different risks on depositors and therefore require different regulatory responses.

Available from CEPR, 25–28 Old Burlington Street, London W1X 1LB.
Telephone: (44 71) 734 9110 Fax: (44 71) 734 8760
£10.00 or $15.00 including p&p.

Recent Related Discussion Papers

603	J Corbett C P Mayer	Financial Reform in Eastern Europe: Progress With the Wrong Model	AM	9/91
604	P Bofinger	Options for a New Monetary Framework for the Area of the Soviet Union	IM	11/91
605	A J Venables	A Customs Union with a Continuum of Products	IT	12/91
609	D Marin	Monopoly, Tying and Reciprocity: An Application to International Trade	IT	11/91
610	Z K Wang L A Winters	The Trading Potential of Eastern Europe	IT	11/91
614	M C Burda C Wyplosz	Human Capital, Investment and Migration in an Integrated Europe	IM	12/91
615	M C Burda C Wyplosz	Labour Mobility and German Integration: Some Vignettes	IM	12/91
617	P R Masson M P Taylor	Common Currency Areas and Currency Unions: An Analysis of the Issues	IM	2/92
623	A J Hughes Hallett Y Ma	East Germany, West Germany, and their Mezzogiorno Problem: An Empirical Investigation	IM	2/92
628	G Roland	The Political Economy of Transition in the Soviet Union	IM	1/92
632	X Sala-i-Martin J Sachs	Fiscal Federalism and Optimum Currency Areas: Evidence for Europe from the United States	IM	3/92
634	J B De Long B Eichengreen	The Marshall Plan: History's Most Successful Structural Adjustment Program	IM	5/92
638	B Eichengreen M Uzan	The Marshall Plan: Economic Effects and Implications for Eastern Europe and the Former USSR	IM	3/92

639	A Brociner P Levine	Fiscal Policy Coordination and EMU: A Dynamic Game Approach	IM	5/92
640	K Mayhew P Seabright	Incentives and the Management of Enterprises in Economic Transition: Capital Markets Are Not Enough	AM	3/92
641	T Straubhaar K F Zimmermann	Towards a European Migration Policy	HR	3/92
643	T Bayoumi B Eichengreen	Shocking Aspects of European Monetary Unification	IM	5/92
646	T Bayoumi B Eichengreen	Is There a Conflict Between EC Enlargement and European Monetary Unification?	IM	5/92
650	D K Rosati	Problems of Post-CMEA Trade and Payments	IT	4/92
651	G Bertola	Models of Economic Integration and Localized Growth	IM	3/92
652	M Burda M Funke	Trade Unions, Wages and Structural Adjustment in the New German States	IM	6/92
653	G Hughes P Hare	Industrial Policy and Restructuring in Eastern Europe	IT/AM	3/92
654	P Bofinger D Gros	A Multilateral Payments Union for the Commonwealth of Independent States: Why and How?	IM	5/92
658	P De Grauwe	Inflation Convergence During the Transition to EMU	IM	6/92
660	J von Hagen M Neumann	Real Exchange Rates Within and Between Currency Areas: How Far Away is EMU?	IM	6/92
661	A Giovannini	Bretton Woods and its Precursors: Rules versus Discretion in the History of International Monetary Regimes	IM	6/92
664	D M Newbery P Kattuman	Market Concentration and Competition in Eastern Europe	AM	4/92
666	B Hoekman	Conceptual and Political Economy Issues in Liberalizing International Transactions in Services	IT	6/92

667	S Rebelo	Growth in Open Economies	IM	6/92
668	W H Buiter	Should We Worry About the Fiscal Numerology of Maastricht?	IM	6/92
669	J I Haaland V D Norman	Global Production Effects of European Integration	IT	3/92
672	M Gasiorek A Smith A J Venables	1992: Trade and Welfare; A General Equilibrium Model	IT	3/92
673	D Marin	Tying, Risk-Sharing, and 'Lock-In': An Investigation of Countertrade Contracts	IT	6/92
676	D Rodrik	Foreign Trade in Eastern Europe's Transition: Early Results	IT	6/92
677	C Ryan	The Integration of Financial Services and Economic Welfare after 1992	IT	6/92
678	L A Winters	European Trade and Welfare after '1992'	IT	6/92
679	L A Winters	Integration, Trade Policy and European Footwear Trade	IT	6/92
682	G Corsetti N Roubini	Tax Smoothing Discretion Versus Balanced Budget Rules in the Presence of Politically Motivated Fiscal Deficits: The Design of Optimal Fiscal Rules for Europe after 1992	IM	7/92
686	P Bofinger I Cernohorsky	Some Lessons from Economic Transformation in East Germany	IM	6/92
687	L T Katseli	Foreign Direct Investment and Trade Interlinkages in the 1990s: Experience and Prospects of Developing Countries	IT	6/92
691	D Cohen	Tests of 'Convergence Hypothesis': A Critical Note	IM	7/92
694	J-P Danthine J Hunt	Wage Bargaining Structure, Employment and Economic Integration	IM	7/92

695	D Begg R Portes	Enterprise Debt and Economic Transformation: Financial Restructuring of the State Sector in Central and Eastern Europe	AM	6/92
705	D Rodrik	Making Sense of the Soviet Trade Shock in Eastern Europe: A Framework and Some Estimates	IT	7/92
719	J von Hagen	Monetary Union, Money Demand, and Money Supply. A Review of the German Monetary Union	IM	10/92
722	C R Bean	Economic and Monetary Union in Europe	IM	10/92
727	A Gehrig C M Schmidt K F Zimmermann	Mass Migration, Unions, and Fiscal Migration Policy	HR	10/92

Single copies of Discussion Papers are available from CEPR for £3.00 ($5.00). CEPR can accept the following means of payment: i) Sterling cheque drawn on a UK bank; ii) Crossed UK Postal Order; iii) US dollar cheque drawn on a US bank; iv) Eurocheque, denominated in sterling, endorsed with customer's card no.; v) Sterling transfer to the Centre for Economic Policy Research (for bank details and a reference number, please contact CEPR). Orders should be sent to CEPR Discussion Papers, 25–28 Old Burlington Street, London W1X 1LB.

Centre for Economic Policy Research

25-28 OLD BURLINGTON STREET • LONDON W1X 1LB • TEL: (44 171) 878 2900 • FAX: (44 171) 878 2999