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## Economics Revision Focus: 2004

# A2 Economics

# European Union Enlargement

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# Revision Focus on European Union Enlargement

**A2 Syllabus Requirements**

Students should to be able to analyse and evaluate the performance of existing members of the EU compared with applicants. The economic consequences of admitting new members should be considered including the links to further economic reforms inside the European Union

**Transition economies**

Eight of the ten new EU countries were **socialist economies** operating under a **centrally-planned system** until at least 1989. In the intervening fifteen years most have made huge strides in **transforming** their economies into ones based on **western free-market norms**. This process has involved **privatisation of state assets, liberalisation of markets** and the **establishment of financial markets** e.g. money markets and capital markets to boost savings and finance investment. Hungary is thought to be the closest to an advanced western-style market based economy followed by the Czech Republic, Estonia, Poland, Latvia, Lithuania, Slovakia and Slovenia. But there is still much to be done – not least in developing proper systems of corporate governance/reducing fraud etc.

**Openness to trade and investment**

The accession countries have become **increasingly open to international trade and investment**. The average ratios of trade (imports plus exports) to gross domestic product of the accession countries is already above 50 per cent, up from 35 per cent in 1995, compared with 65 per cent for existing members of the EU. This can be expected to increase

**Western Europe as an export market**

By 2002, the share of EU markets in the exports of the accession countries was 63 per cent. This is much the same proportion as existing EU members. The key point here is that for most of the accession countries, the adjustment to Western Europe becoming their major export market has already occurred. We will see further **trade creation** in the years ahead as these countries settle into the single market.

As the Economist noted in April 2004 – "For the latest entrants, formal membership of the EU is just the icing on a cake they have been eating for some time"

**Foreign investment flows**

Between 1989-2003, cumulative inflows of **foreign direct investment** into the accession countries of central and eastern Europe were £66 billion with the largest quantities going to Poland, the Czech Republic and Hungary. In 2003, inflows were 8.3 per cent of Estonia's GDP and the inflow into the Czech Republic was 11.9 per cent of GDP. These inflows were made in anticipation of accession – so although substantial opportunities for foreign investment remain, much of the flow of new foreign capital into these countries may already have occurred for example investment into the newly privatised industries.

**Stock market capitalisation**

| Country | Exchange | €m, end Mar 2004 |
|---|---|---|
| Greece | Athens | 87,058 |
| Poland | Warsaw | 33,346 |
| Czech Rep | Prague | 16,673 |
| Hungary | Budapest | 16,118 |
| Slovenia | Ljubljana | 6,430 |
| Cyprus | Cyprus | 4,115 |
| Estonia | Tallin | 3,577 |
| Lithuania | Lithuanian | 3,500 |
| Slovakia | Bratislava | 2,186 |
| Malta | Malta | 1,923 |
| Latvia | Riga | 1,018 |

**Labour market**

| | Hourly labour costs* (€, 2000) | labour productivity** (€'000, 2002) |
|---|---|---|
| EU15 | 22.21 | 57.6 |
| Czech Republic | 3.90 | 16.9 |
| Estonia | 3.03 | 12.0 |
| Cyprus | 10.74 | n.a. |
| Latvia | 2.42 | 12.0 |
| Lithuania | 2.71 | 10.7 |
| Hungary | 3.83 | 17.0 |
| Malta | n.a. | n.a. |
| Poland | 4.48 | 16.9 |
| Slovenia | 8.98 | 25.4 |
| Slovakia | 3.06 | 13.3 |

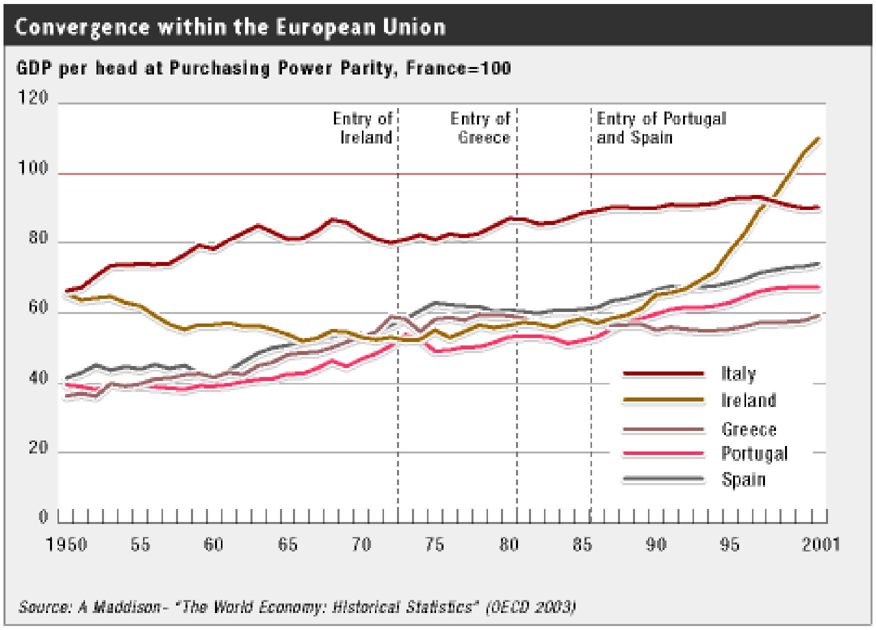
* Annual labour costs divided by hours worked
** Gross value added per person employed

Foreign investment will be encouraged by

1. **Low unit labour costs** (labour productivity is almost a third lower on average, but wage costs currently are one fifth of EU levels) – this will encourage out-sourcing. There is a large pool of reasonably well-educated, low-cost labour and previous foreign investment successes may well prompt new flows of investment
2. **Low land prices**
3. **Lower corporation taxes** - In the Czech Republic the main business tax rate has been cut by 7 percent to 24 percent. Like Poland before, Slovakia this year introduced a uniform tax rate of 19 percent for individuals and businesses. In Latvia, the poorest accession country, several special economic zones have been established in which corporations enjoy tax exemptions of over 80 percent. Estonia has completely exempted business profits from taxes. This **"tax competition"** has caused a stir in some existing EU countries.
4. **Access to relatively fast growing markets** in the accession countries and beyond - many consumer markets are under-developed (for example in services such as banking & pensions)
5. **Desire to take advantage of larger-scale infrastructural projects** – partly funded by the EU included hi-speed rail links and environmental projects
6. **Opportunity to establish business service industries in these fast-growing economies** - about 15 multinationals, including IBM, Fiat and KPMG, the accountants, have already established business service centres in Poland for example

**Income convergence**

Clearly, using **standard measures of living standards** based on **per capita national income,** purchasing power parity adjusted, the accession countries have much lower standards of living than the main western European countries. Data for 2003 show that incomes per head are half those of the current EU on the basis of purchasing power parity. Some process of income convergence is likely because the accession countries nearly all have a **higher trend rate of growth of real GDP** than existing EU states. But this process of convergence will take many years. If real GDP per head rose two percentage points a year faster in the new members than in France, it would take 21 years for Slovenia and 57 years for Lithuania to catch up. Experience of previous enlargements suggests that some degree of income convergence is likely. But it is unlikely to be anything like as spectacular as that achieved by Ireland in the thirty years since it came into the European Union. Hopefully the performance of the accession countries will be better than that of Greece.




*Source: Financial Times*

**Financial support for the new EU members**

**Transitional financial support** has been agreed between existing and new EU members – but the final support total is substantially below what the accession countries initially wanted. Between 2003-2006 the EU is allocating €40bn (£26.8bn) for the ten new members. New members will also have to make contributions to the EU's budget, which will reduce net receipts to €10bn a year, or 0.1 per cent of the aggregate GDP of the EU.

Transition funding also applies to the **Common Agricultural Policy** (CAP) – it will not be until 2013 that eastern European farmers are entitled to the same farm support levels as those of the west.

Although the financial support is constrained, it doesn't fundamentally alter the rationale for these countries coming into the single market. As a recent article in the Financial Times made clear: *"The chief determinant of success (inside the EU) is not money, but how well a country exploits the wider advantages of membership"* The Economist also has a similar perspective on the importance of EU funding. "The EU's "cohesion" funds are not terribly effective. Liberal handouts of aid are at best a poor substitute for liberal movements of goods, capital and labour."

**Are the enlargement countries joining the Euro?**

The answer is **no** – although a commitment to enter the single currency at some point in the future is part of the accession process. Some countries such as Estonia - could join the single currency almost immediately if they were permitted to do so. But the reality is that the vats majority of the accession countries do not yet have the macroeconomic stability / economic convergence that is required as part of the entry process into the Euro. In particular most of the countries are running sizeable government fiscal deficits and long-term interest rates are well above Euro Zone levels.

In principle the majority of enlargement countries do want to join the Euro – particularly if it helps to provide lower inflation and (in the medium term) lower interest rates. For the moment they will operate outside, choosing their own exchange rate regime (fixed, floating etc).

**Which accession countries are likely to be most competitive inside the European Union?**

According to new research from the World Economic Forum, some of the accession countries are already ahead of some existing EU members in terms of international competitiveness.

Estonia is ranked first among accession countries. Among Estonia's specific strengths are the quality of its business enterprise environment and the level of sophistication of information society elements present in its economy, both areas in which it scores above the EU average. Estonia has one of the most highly developed ICT sectors in the EU. Slovenia is ranked second among accession countries with relative strengths in the dimensions of network industries and sustainable development.

**The labour migration issue**

The social effects of increased labour migration are important but the likely scale of migration within an enlarged European Union has been exaggerated.

In practice, few people will move, indeed **domestic geographical mobility** within their own countries is much smaller than the EU average. The consensus among economists is that economic migration is a positive sum game for those countries involved. Migrants are much more likely to be temporary e.g. after graduating from university - they may choose to work in a country for a few years to learn a second language before returning home to start a family or perhaps establish a new business. The temporary nature of migration will be a major contrast to the experience of previous generations for example the migration of people brought about by the 1939-45 World War or people escaping from communism.

**Entrepreneurship and the demographic contribution**

Enlargement will bring young people into an ageing union. Younger people often have many more economic ideas and energies with younger voters typically supporting more dynamic policies (for example policies that are more favourable to entrepreneurship and lower taxation).

| **Opportunities for UK** | **Risks for the UK** | **Advantages for Accession Countries** | **Risks / problems for the Accession Countries** |
|---|---|---|---|
| Trade opportunities in emerging consumer markets and in business services | Labour-intensive low cost producers many threaten some parts of UK manufacturing | Political stability, security and an economic framework for future growth | High levels of government borrowing (fiscal deficits) |
| Foreign investment opportunities and chance to outsource manufacturing | Some UK regions may lose eligibility for securing EU regional funding (Objective 1) | Limited EU accession funding – mainly through the CAP and regional funds | Threats to domestic industries from foreign investment – can smaller scale producers compete? |
| Attract inflows of younger, well educated and dynamic workers – e.g. to relieve shortages of key public sector workers | Social pressures created by labour migration – increased pressure on education, housing and health services etc | Access to overseas capital – promoting employment and higher living standards | Costs of meeting the requirements of the single market (e.g. health and safety legislation and environmental regulations) |
| Increased competitive pressure on the UK to raise productivity in faces of new competition | Our net contribution to the EU budget may have to rise in the medium term | Access to the single market - opportunity to exploit comparative advantage | Social unrest – already apparent e.g. in Poland, expectations may be unfulfilled – puts pressure on governments |
| Opportunities for UK farmers – e.g. in exporting high-added premium products | Tax competition from accession countries may reduce the scale of foreign investment coming into the UK | Eventual membership of the single currency brings opportunities for macro-stability | Unemployment may rise in the short term – still many economic reforms to be carried out |