EU Membership for Central Europe: Commitments, Speed, and Conditionality

Alain de Crombrugghe, Zanny Minton-Beddoes, and Jeffrey D. Sachs

ABSTRACT

This paper gives a motivation and a method for a fast integration of the reforming countries of central Europe into the European Union. The motivation is based on the idea of self-fulfilling prophecies where the expectation of the entry can trigger the coordination of expectations towards a fast-growth, catch-up equilibrium, and help central Europe avoid the stagnation equilibrium. The method is a target data which enhances the credibility of the integration and a set of conditions and modalities which stimulates the reforms in the applicant countries and ensures that they will contribute to its development.

Keywords: multiple equilibria, conditionality, European Union, Central Europe.

JEL # F15, O19, D72, D84

Alain de Crombrugghe is associate professor of international economics at the University of Namur in Belgium. He teaches international trade and finance and issues in transition to the market economy at the intermediate and graduate level. He obtained his Ph.D. in Economics from Harvard University in 1991 after having studied law and economics in Belgium. In 1991-92, while residing in Warsaw, Poland, he worked as a post-doctoral researcher for the World Institute for Development Economics Research (WIDER) of the United Nations, under the supervision of Prof. Jeffrey Sachs.

Zanny Minton-Beddoes writes on international economics for The Economist. She was an economist at the International Monetary Fund from 1992 to 1994 and prior to that worked as advisor to the Polish government.

Jeffrey Sachs is the Director of the Harvard Institute for International Development and the Galen L. Stone Professor of International Trade at Harvard University. Sachs serves as an economic advisor to several governments in Latin America, Eastern Europe, the former Soviet Union and Asia. He has also been a consultant to the IMF, the World Bank, the OECD, and the UNDP.

EU MEMBERSHIP FOR CENTRAL EUROPE: COMMITMENTS, SPEED AND CONDITIONALITY

Alain de Crombrugghe, Zanny Minton-Beddoes, and Jeffrey D. Sachs

INTRODUCTION

Eastward enlargement is the single biggest challenge facing the European Union today. The broad goal of integrating the newly democratic countries of Central Europe[1] into the European Union is widely shared. In its Copenhagen declaration of June 1993 the European Union offered membership of the Union to those former communist European countries that wished to join and that fulfilled certain, ill defined, political and economic criteria. With the conclusion of Association Agreements and, in some cases, with the presentation of membership applications, the Central Europeans have signaled their desire for membership of the Union. The question is no longer one of if, but of when and how.

This paper is a contribution towards that end. Its basic theme is that rapid membership is both desirable and possible. Achieving it will require greater clarity and greater commitment from both sides than is currently present. It is no longer enough to regard eastward enlargement as a vague, if desirable, goal. The road map of how to get there urgently needs to be designed.

In the first part of the paper we refer to recent developments in economic theory to show the importance of a clearer commitment to enlargement. A transparent commitment would accelerate a cumulative process of investment and growth in Central Europe; it would attract more foreign investors into the region and would support the reform process. The experience of Spain and Portugal in the 1980s provides evidence of such a process.

The second section of the paper reviews current issues and the avenues already explored in the preparation for accession. We acknowledge that there are sensitive issues involved (for instance, in agriculture) but suggest that they need not, and should not, provide an excuse for prevarication. We explain the inadequacies of the EU's current approach and warn against a "pre-accession strategy" that lacks enforcement and commitment procedures.

In the third part of the paper we explain the basic premises of our approach to enlargement. We discuss the importance of a target date as a commitment mechanism. We show how the conditionality that is opaquely implied in the Copenhagen Declaration could be translated into practice. As part of our design of conditionality we include transitional modalities of entry in

---

[1]This paper covers all countries former communist countries in Europe that have association agreements with the European Union and are thus eligible for EU membership under the terms of the Copenhagen Declaration. They are often grouped under various, ugly acronyms such as CEECs (countries of central and eastern Europe). The geographical division of Europe into central and eastern is imprecise at best. For ease of exposition, therefore, we shall refer to the group of 10 countries where association agreements are signed or being negotiated (Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Bulgaria, Romania, Latvia , Lithuania and Estonia) as Central Europe.

some sensitive areas (as was the case with other accessions). We focus on the importance of conditionality to promote economic reform and to attract countries that would be able to fulfill the obligations of membership and contribute to the development of the Union. Section four presents a modest proposal for the steps policy makers should undertake now.

1. The case for rapid enlargement

Economic theory and recent experiences within the European Union suggest that enlargement should be **rapid** and subject to **clear conditions**. Such a scenario is not only explicitly requested by the most advanced countries of Central Europe, it is also the one that maximizes the chances of success of the enlargement goal announced at the Copenhagen Summit. (Note that we are only considering the economic aspects of enlargement here; the geopolitical and security motivations for rapid enlargement under clear conditions are no doubt as large, or even larger, than the purely economic considerations).

Economic reforms are pursued to promote economic growth. The growth-promoting actions of private economic agents (in the form of investments, sectoral reallocation, political support for reforms) will tend to be stronger if reforms are credible, that is, if they are expected to be permanent, and if each agent believes that other agents will also expect them to be permanent. In many cases, economic choices depend largely on an agent's belief of how **other** agents will behave, and only to a limited extent upon the initial conditions inherited from history. In these circumstances, economic success or failure is, in large part, based on the public's expectations about the future. A "good" equilibrium will be characterized by optimism, high investment and growth; a "bad" equilibrium by pessimism, low investment and stagnation. Examples of this kind of multiple equilibrium include models of industrialization (Matsuyama 1991), of geographical concentration of economic activity (Krugman 1991), of migration (Baldwin and Venables 1994), and of fiscal balance or collapse (Sachs 1995).

The message of recent theories of growth and cumulative processes is that *underdevelopment traps* can exist, but can be avoided in three ways. The first two are traditional policy responses: governments should attempt to change the initial, adverse, conditions or attempt to improve the flexibility of the economy. The third method, however, is to orient expectations in the direction of future growth. Underlying this third approach is the aforementioned principle that the investment decisions of an individual agent depend upon his expectations of the investment decisions of other agents, so that multiple outcomes are therefore possible from the same initial conditions: low investment and low growth if agents' expectations are pessimistic; high investments and high growth outcome if they are optimistic. Expectations, whether positive or negative, can therefore be self-fulfilling.

A small model of self-fulfilling rational expectations in the spirit of Krugman (1991) attached in appendix A formalizes this process in a manner relevant for the issue of EU enlargement. Policies to increase the flexibility of an economy or improve the initial conditions (e.g. through an exogenous boom in foreign direct investment) can boost growth, but we show that a crucial factor in putting an economy on a virtuous growth path is a policy that co-ordinates the positive expectations of investors.

A quick and guaranteed accession to the European Union represents, by far, the most effective way to stabilize expectations in Central Europe and so ensure that this region remains on the path of growth. Participation in the EU market offers indispensable long-term development opportunities for Central European businesses. More importantly, the discipline of the EU's legal framework and enforcement institutions offer guarantees of a reliable economic environment. By offering a credible time-table for membership, the European Union can co-ordinate the expectations of agents in Central Europe, and of potential foreign investors, towards a high-investment, high-growth equilibrium. The time horizon over which accession is expected to occur will affect the credibility of the commitment. A vague commitment to membership that does not envisage accession for a decade or more will be perceived as less credible than one which foresees rapid accession. Thus the goal of coordinating positive expectations requires a clear delineation of the conditions and modalities of entry together with a credible (and preferably) short time-table.[2]

Various commentators within the Commission, in key EU national governments and in the academic community, assert that membership should "certainly" occur, but only after the Central and Eastern European countries have substantially converged to Western European income levels. One widely cited benchmark is that living standards among the new entrants should be equal to at least 75 percent of the EU average. Such a standard would virtually invite a self-fulfilling, pessimistic outcome. Suppose that rapid convergence is *in fact* achievable, but only if there are widespread expectations among investors that enlargement will actually occur. In those circumstances, a low-level trap is possible, in which "informed opinion" among investors fears that enlargement will be long delayed, with the result that investment in fact remains low and enlargement is, in fact, long delayed. This kind of vicious circle, or self-fulfilling prophecy, would obviously be overcome by a clear commitment to a time-table on enlargement, even one conditional on the applicant undertaking the economic reform measures necessary to underpin rapid economic growth.

Of course, this argument is predicated on the view that Central European economies will have a tendency towards convergence (i.e. economic growth more rapid than the EU) assuming that they can be nudged to the "optimistic" equilibrium. There is very strong reason to believe that membership in the EU will, in fact, underpin very rapid economic growth on a sustained basis. Economic theory (cf. Barro and Sala-I-Martin, 1995) and empirical evidence (Dowrick and Nguyen, 1989; Barro and Sala-I-Martin, 1995; Sachs and Warner, 1995) teach that poorer economies have a **strong** tendency to converge in living standards with richer trading partners, **if** the poorer economies have guaranteed market access to the richer partners, and **if** the poorer countries pursue reasonable economic policies, especially in the areas of open trade and macroeconomic stability. This suggests that the necessary combination for rapid growth is assured and rapid accession, backed up by EU conditionality on the applicant country regarding the conduct of key domestic policies in the run-up to membership.

---

[2] A commitment to rapid accession does not, however, preclude there being long transition periods for sensitive sectors.

The domestic and foreign investment boom experienced by Portugal and Spain after entry into the European Community in 1986 is a good example of the type of growth spurt accession can trigger. In those particular cases the timing of accession may also have played an important role, since accession coincided with the launch of the Single Market programme in 1985, which spurred important reforms throughout Europe. (The dismal growth and investment performance of Spain and Portugal in the first decade of their democratic reforms also coincided with the oil crises).

The urgency of bolstering investor confidence in Central and Eastern Europe is real. The rates of foreign direct investment (FDI) into the region remain very low -- surprisingly low -- especially in comparison with the FDI flowing into East Asian economies that are at approximately the same level of development. Amazingly, Singapore (with 2 million population) absorbs more FDI each year than the combined total of Central and Eastern Europe (with 150 million population). Most CEOs of multinational firms still do not view Central Europe as export platforms for their sales in the European Union. Corporate planning of production for the EU market typically neglects the opportunities for sourcing some of the European-based production in Central Europe.

The establishment of a link between rapid EU entry and faster growth has several implications. First, it suggests that new EU members, even relatively poor ones, need not long be a burden on the EU budget. This will, of course, depend on the practical deals that are struck within the EU institutions on the extension of EU transfers (the so-called structural funds) to new members, which we discuss below. Nevertheless, the big picture is clear: poor countries could soon be relatively rich. Portugal entered the EC in 1986 with a GDP per capita equal to 32 percent of the EU average. By 1992 Portugal has improved its position relative to every other member, and stood at 53 percent of the average. Moreover, the desire of Portugal and Ireland and, to a lesser extent of Spain and Italy, not to get left behind in the further process of European integration has boosted their general modernization and growth performance. These same incentives are already working in Poland and the Czech Republic. A clearer commitment would greatly reinforce these incentives and extend them to other, more laggardly, potential entrants.

Second, the possibility of a negative equilibrium, an underdevelopment trap of low investment and low growth is also a warning that failing to give a clear chance to Central Europe could have serious implications. At best it would be a missed opportunity for growth in Western as well as Central Europe. Martin (1994) has shown how Central Europe could try to compete with the European Union in protectionism. At worst, a failure in Central Europe could seriously endanger peace and security in Western Europe not only through illegal migration or new military threats, but through political unrest, illegal trades in arms and drugs and other acts of desperation.

2. Current "pre-accession" issues and alternative proposals

A generous interpretation of the current "pre-accession" strategy proposed by the European Union is that it is pragmatic. A more realistic description would be to call it ill-defined. While numerous initiatives to draw in the Central Europeans have been undertaken in uncontroversial areas, there is a noticeable lack of commitment and specificity regarding membership The absence of a target date or of pre-announced modalities of entry is largely due to unresolved difficulties inside the Union. The Union has begun to define and examine the implications of eastward enlargement, but has gone little further than that. The three main developments so far are the structured dialogue ("dialogue structural" (COM (94) 361); the White Paper on the single market (COM (95)163); and studies of sensitive issues like agriculture. All these steps are useful but they are characterized by an absence of binding power. Under the guise of an organized postponement they have the potential to delay actual accession.

The structured dialogue was instigated after the Corfu Summit of June 1994. It recognized the need for a closer process of political consultation between the European Union and the Central European countries, both to monitor the Europe Agreements and to make progress on issues of mutual political concern (security, drug trafficking etc). It acts as a useful learning process for Central European countries to understand the operations of the EU. It can provide a helpful forum in which to discuss economic progress. The invitations extended to Central European countries to attend part of the EU summits since the December 1994 (Essen) summit, has also given enhanced visibility to the integration process. A more organized format for political dialogue, which is essentially what the structured dialogue boils down to, is important, but it cannot substitute for participation in common institutions and for abiding by common rules. It does not go over the line that separates OECD-type co-operation from EU-style policy integration.

The White Paper on the Single Market (COM (95) 163 & annex) provides guidelines for potential Central European applicants on the regulation of the single market. In essence it is a legal shopping list, a description of the legal and regulatory apparatus that is required for participation in the EU's single market. But, crucially, it has no binding force and provides no guarantee of future benefits. The associated countries can adopt the contents of the White Paper without being sure that they will be closer to being considered for accession. The EU does not offer single market treatment, or indeed any improved trade access, for countries or sectors that implement the rules. Contingent protection, especially recourse to anti-dumping measures, is not abandoned.

In addition to these legal limitations, the White Paper lacks any sense of economic priorities. Its contents are rooted in legal rather than economic logic. Within the rules of the single market, two steps are distinguished, according to a legal logic that goes from general to particular rules. The chapters are not prioritized and the possible accumulation of distortions from old and new rules is not discussed. Moreover, there is no indication of measurable economic indicators that could complement the regulations as indices of integration. The White Paper provides no information on how progress towards a "market economy" should be measured. The fact that the White Paper on the Single Market remains the sole concrete part of a "roadmap" towards accession and that it is so uncompromisingly legalistic is instructive. Preparing for accession, as far as the EU is concerned, appears to mean the pro forma adoption of the rules of the "acquis communautaire" and, so far, nothing more.

That an eastward enlargement means much more than simply ensuring that applicant countries fulfill the regulatory and legal requirements of the “acquis communautaire” is beyond doubt. In three areas, in particular, it will have profound implications: first, on the internal organization and structure of EU institutions. A Union of 25 cannot function with a decision-making and organizational structure designed originally for 6 members. Second, on the Common Agricultural Policy (CAP): the integration of the more agricultural economies of Central Europe will, eventually, have a huge impact on the financial viability of the CAP’s system of market intervention and price support. Third, on the financial transfers within the Union. With the accession of several, poorer economies, the criteria of the EU’s structural funds will need redesign.

A number of scholars have begun to analyze the political economy of these shifts (Baldwin 1994, Widgren 1994). The Union has not ignored them either. The Intergovernmental Conference (IGC) of 1996 will address the issue of the design of institutions, both to fulfil the extended objectives of the Union as set out in the Treaty of Maastricht (deepening) and to ensure that they can function with more members (widening). Discussions of the future division of power between common institutions and national governments, of “variable geometry” or a European “hard core” are widespread within the Union. However, without a clear consensus of the time frame of enlargement they lack a crucial ingredient.

On agricultural policy, the EU (DGV1) has undertaken an evaluation of the situation in the associated countries and on the possible implications of accession on the CAP, as well as an assessment of the efforts undertaken by the EU to fulfill its GATT obligations. It appears the EU recognizes that the accession of Central European countries will reinforce the existing internal trend to move away from production-related support to direct financial support for farmers themselves; there is a conviction that the CAP’s share of the EU budget (around 35 billion ECU or 50% in 1993) should remain capped; and that a long transition period for agriculture will be required. But, crucially, no clear signals have been sent to the associated countries. They may well face the wrong short-term incentives (for instance, to increase agricultural trade protection or to set up support mechanisms that will eventually need to be reversed).

The structural funds (worth around 20 billion ECU in 1993) are up for review in 1999. Their purpose is to promote European integration through a redistributive process; their level was raised in 1992 at the request of the EU’s poorest members in compensation for the implementation of the Single Market. Eligibility for most of the structural funds is currently based on per capita income: any region of the EU with an income per head below 75% of the Union’s average is eligible for such support. On this basis all the new Central European members would be eligible. If support were extended in the same way that it is now, this would enormously increase the burden structural fund payments placed on the EU’s budget; if would also result in a level of financial transfer that Central European countries would have difficulty in absorbing. For both reasons a new approach is required. The EU, as yet, has made little progress in defining it.

Other, complex issues remain less studied. The suitability of much of the EU's organization of a social market economy to the poorer countries of Central Europe is unresolved. Does it make sense, for instance, for Central European countries to adopt the Social Chapter? Even in the richest countries of Western Europe the purpose and sustainability of some regulations, social provisions and sectoral subsidies is debated. It would be unfortunate if Central European countries adapted regulations of the EU that were either to change soon, or were unsuited to their situation. Of course, Central European countries have already inherited many unsustainable social provisions of their own (unbearable pensions burdens, for instance). These would not disappear with entry to the Union. But a major gain of rapid, and conditional, accession, would be that the current policies would have a clear goal to aim for, and that upon accession, common solutions could be sought that will maximize fuller integration and faster growth for the wider Europe.

The conditionality and modalities that we discuss below are a step in this direction. Our proposal differs from the EU's approach so far as discussed above in that we explicitly address the issue of conditionality. Conditionality on the Central Europeans (in terms of broad, defined criteria that must be fulfilled) and conditionality on the Union (in the form of an explicit ex ante commitment to admit countries that fulfill these criteria after a specified target date). Our proposals also differs from other accession proposals, of which the most explicit is for a near-permanent "pre-accession structure" (Baldwin 1994). He suggests an association of the association agreements (AAA) followed by an Organization of European Integration (OEI). The main benefits would be to get out of the "hub and spoke" mentality of the current association agreements, where each associated country has a legal relationship with the European Union, but there is no cumulative benefit amongst associated members. The goal of an OEI would be to drop contingent protection rules amongst its members and exploit the possibility of increased integration wherever it is "unsensitive" and budget-neutral. It would, in effect, be like an improved European Economic Area. While we subscribe to much of Baldwin's analysis, his proposals fails to avoid the trap of self-fulfilling expectations of constant postponement of actual integration.

3. An improved accession strategy

Addressing the weaknesses of the current "pre-accession" strategy means progress in three areas. We argue that there needs to be a commitment to a target date for entry; that there must be transparent and verifiable conditions for entry, and that the modalities for entry need to be clearly spelt out now.

3.a. Commitment to a target date

The previous sections have emphasized the importance of a stronger commitment to enlargement than has been the case so far. A specific target date appears as one of the clearest ways to signal this stronger commitment, and so play an important incentive role. It sets clear responsibilities upon incumbents and applicants, and it creates a window of opportunity for a group of potential applicants at a given point in the EU's process of deepening and widening.

(I) *Commitments of the incumbents*:
By setting a target date, the EU recognizes that it has no reasons to keep out countries that satisfy pre-set conditions for membership. This means that if the EU has to reform itself to make enlarged membership workable, it commits itself to doing so by a given date, or to accept the consequences of working with new members under old rules. As discussed in section 2, the EU has already recognized that internal reform is necessary. A commitment to a target date would place much needed credibility on this realization. Strictly speaking, maximum credibility requires two target dates: a target date for the commencement of negotiations and a maximum period for negotiations, provided, of course, that the applicant countries fulfill the relevant conditions.

(ii) *Responsibilities of the applicant*
The target date for accession should indicate that , in the view of the current EU members, the applicant could effectively be able to enter if all conditional reforms are made. A failure to fulfill the conditions by the target date would be the clear responsibility of the applicant. It is thus important to frame the conditions realistically, so that they can indeed be met assuming that reforms remain on course. The conditions must not be perceived as simply a more formalized “barrier to entry” by being set impossibly high. The time-lag between the target date for the commencement of negotiations and that of accession will be largely the responsibility of the applicant.

(iii) If the target date for accession is perceived by applicants as a window of opportunity, during which present members commit themselves not to undertake any further “deepening” projects other than those currently existing, it will have an added incentive effect. Applicants that are able to enter during this period will have a guarantee that they **do not face a moving target** and will be able to participate in all further legislative work of the EU. The ability to participate in law-making is on of the strongest differences between any form of association and full membership, and is therefore an important benefit of entry. Applicants who are not ready for entry by the target date face the risk that the EU will launch new projects for further integration, that could make entry harder at a later date.

3.b. <u>Motivation for membership criteria.</u>

The conditionality of admission should be in the spirit of the Copenhagen Declaration which implied that EU membership would be conditional on economic and political progress, albeit ill-defined. In addition, explicit and verifiable conditionality, linked with a target date for entry, holds clear benefits for both parties.

There are several reasons why clear conditionality is in the interests of the EU. It should ensure that the candidates share the same objective as the EU, that they have similar democratic and market-oriented institutions that make co-operation within the EU possible. It should ensure that the principle of market unity is not threatened by perceptions of “free-riding” or complicated by the need for new attempts at harmonization. Explicit and verifiable conditions help the EU solve the “who gets in” problem in a way that is not perceived as arbitrary. The applicant countries will be forced to take a greater share of responsibility for ensuring their entry upon themselves.

Conditionality is also in the best interests of the candidate countries. It gives guidelines for reform to governments. It can help the electorate - which is presently quite confused about what is and what is not market-oriented reform - to evaluate the programmes of different parties. Supposing that EU membership is a widely shared objective, it can introduce some healthy competition between parties on how best to satisfy the conditions. This powerful incentive to reform can only work with a clear commitment on the part of the EU to reward reforms with membership. Hence the need for a target date to work in conjunction with explicit conditionality.

An objection often raised against a more precise definition of the conditions suggested in the Copenhagen declaration is that a functioning market economy cannot be defined in a set of legal rules and quantitative achievements. Such conditions, it is argued, would even resemble central planning. Former socialist countries would be expert at meeting the letter of the conditions without reaching the broader economic objectives behind them; there would be an incentive to obfuscate and cheat. Real as this risk is, it does not take away from the usefulness of guidelines. There are many understandable complaints about the Maastricht criteria, but there is little doubt that the programme of monetary union could not go forwards without some clear criteria, however imperfect. Moreover, a country takes the sovereign decision to join the EU knowing that it has to adjust to the Union more than the Union will adjust to any new member. When the modalities of entry are well-defined (see below), the sovereign decision to join makes possible a political cost-benefit analysis by the applicant country; indirectly in the course of national elections and, perhaps, finally in the form of a national referendum.

3.c. <u>Structure and design of the conditions</u>

The design of such accession conditions should ensure that they have four characteristics: that they are within the control of the applicants, that they are relevant for integration, that they are verifiable and that they are broad enough to be good indicators of the development of a market economy, not merely subject to political or statistical manipulations. Broadly, they can be divided into three types. The list that follows is illustrative and designed to introduce the subsequent discussion.

1. Institutional or legal conditions:
    * Adoption of the “acquis communautaire” except in specific opt-out areas (e.g. Social Charter, labor mobility).
    * Commitment to no other regional integration mechanisms other than those that are compatible with the EU.

2. Microeconomic management conditions:
    * Subsidy levels that are close to the EU average
    * Share of private sector in value added that is close to the EU average

* Effective protection and trade of property rights; effective competition policy; functioning financial sector

3. Macroeconomic management conditions:
    * A softer form of the Maastricht convergence criteria (on budget deficits; inflation rates, etc.)

The first type of conditions - institutional and legal - are necessary but not sufficient. They are most clearly within the control of applicant countries, relatively easy for the EU to stipulate, are clearly relevant for integration. The White Paper (COM (95) 163) is a good example of this type of legal and institutional conditionality. The question of verifiability, however, is more difficult. Adopting a legal framework without the support of effectively functioning institutions could result in an empty shell. For this reason, these conditions need to be supplemented with further types of conditions, that provide evidence of an applicant country's commitment to reform and ability to adhere to newly established laws and guidelines.

The management conditions (microeconomic and macroeconomic) are not sufficient alone either. Some countries could reach them without adopting EU-compatible institutions. However, they are necessary to facilitate the working of the single market and they provide direct evidence on the progress of economic reforms. In both cases, macroeconomic and microeconomic, management conditions are largely within the control of national authorities, despite claims to the contrary. In neither case should an excessively high standard be set. For instance, it makes little sense to expect Central European countries to fulfill criteria for monetary union before they become members of the EU.

A fourth type of conditionality could include explicitly measurable performance conditions like per capita GDP, export growth or employment creation. In some instances, such performance-based criteria could play a useful role in supplementing the other, more immediate policy conditions. A country that felt its microeconomic achievements were being unfairly judged, would, for instance, have more of a case if its growth performance and net employment creation were booming. But the fact that such conditions would be partly beyond the control of policy makers in an applicant country, makes them dangerous and subject to the kind of self-fulfilling failures that we discussed earlier. For this reason, we do not advocate explicit "economic performance criteria" but would add a more general stipulation that the Commission would need to be convinced that an applicant country would be able to sustain economic growth under the conditions of membership. Preceding high rates of economic growth, export growth etc could be useful as supporting evidence, but would not be dispositive.

3.d. <u>Modalities of accession</u>

The modalities of entry need to be agreed before accession. These should cover, in particular, the adjustments that are required in sensitive areas. In agriculture, for instance, a long transition period will clearly be required. Its length and the necessary adjustments required by both sides in the interim need to be made clear. Regarding structural funds, it is clear that it is in the interest of the EU budget to limit them. Moreover, we suggest that it is not in the long-term interest of applicant countries to regard financial assistance levels as a key benefit of accession. Such transfers will promote rent seeking behavior, and the magnitudes of assistance are likely to be too small to influence long-term economic growth markedly. **We would therefore suggest a more radical proposal: that applicant countries should renounce their eligibility for structural funds in return for a commitment to rapid accession**. In return the EU should accept a near-term date for accession of the leading reform economies.

One of the key modalities of accession will be the renunciation by EU members of the resort to "safeguard measures" from the moment of accession onwards. This is crucial for trade integration and for augmenting the confidence of Western enterprises that an investment in Central Europe is indeed an investment in production within the single European Union market. Similarly, the applicant countries should be allowed an opt-out on the social charter (a luxury their low productivity and income levels do not afford). In return they should renounce the immediate freedom of labor flows, to allay West European fears of mass migration. Finally, while full voting rights should come immediately upon membership, new members should not be allowed to use their voting rights to change the modalities of their transition phase. These modalities should be "grandfathered" before entry. In essence, these modalities will ensure that while there is a long transition phase in certain sectors and policies, while there is in some sense a lengthy transitional phase of a two-class EU membership, the long-term is locked in place ex ante. It is this certainty that will prove essential for stabilizing positive expectations and promoting growth.

4. A modest proposal

We outline here a modest proposal for discussion. It shows how our analysis can be the basis of a concrete proposal. The specific contents of conditions and modalities should, of course, be discussed by the applicants and the EU Commission and members. We distinguish 7 conditions and 10 modalities.

4.a. Milestones before accession.

1. The EU will commit itself to start negotiating accession in 1998 and will indicate that it sees the year 2000 as the year of enlargement for the countries that meet the criteria.

2. The EU will review the fulfillment of the criteria before the accession of a first group of countries and will indicate a new target date for meeting the criteria to the remaining countries.

3. The applicants will refrain from entering into commercial, military or political alliances with non-members of the EU, and will agree with the EU on the contents of all such existing or intended international agreements.

4. The applicants will adopt the "*acquis communautaire*" except in the areas of the opt-out of the transition period (agriculture, social charter, structural funds - see modalities below). They will also ensure the proper functioning of commercial and civil law, including the protection of property rights, the enforcement of contracts, competition policy, bankruptcy, freedom of enterprise creation and development...These institutional developments will be reviewed annually with the Commission and all applicants.

5. Microeconomic management: not more than the highest of 20 percent or one standard deviation above EU average on subsidies as a percent of GDP (so if average subsidies in the EU are 3 percent of GDP and the standard deviation is 1 percent, the maximum would be 4 percent). The private sector share in employment should not be less than 60 percent. These milestones should also be reviewed annually, and a qualitative review of gross private enterprise creation and net employment creation in the private sector should complement them. Given the low starting point of the applicants, these indicators should in no case be below the EU average.

6. Macroeconomic management: Inflation below 15% per year or below the average of the non-ERM members provided there are no less than three (currently these are Britain, Finland, Greece, Italy and Sweden), whichever is highest. Budget deficit under 5 percent of GDP. Public debt as a percent of GDP stabilized or declining. These performances should be maintained over a period of 3 years or steadily converging to the target over a period of 3 years, and they should be monitored annually by the Commission and the applicants. The inflation target could be limited to tradable goods inflation (and then made more stringent) if it is demonstrated that faster productivity growth in tradable than non tradables is a key factor in the overall inflation rate.

7. The criteria for monetary union need not be met for membership, but are part of the modalities applicable after accession. A commitment to the modalities of monetary union (modality 9, below) in the accession treaty is nevertheless a condition for membership.

4.b. Modalities after accession

1. Ten year transition period commencing upon membership.

2. The new members will participate in voting within the Council and the Parliament and be represented or eligible as all other members in all common institutions. The new members will have no right to alter the modalities of their transition period (financial and others), without a special majority vote (as determined by the IGC for the modification of the treaties) of the pre-existing members of the European Union.

3. Both the EU and the new members will renounce immediately the right to apply safeguard measures (anti-dumping duties, countervailing duties, contingent protection). Trade, except in agriculture, will be governed by the adoption of EU competition policy upon the start of membership, including Commission review of subsidy policies.

4. Agriculture will remain protected, with border controls, and a gradual and preferential reduction of the existing quotas and tariffs scheduled to reach full integration of agricultural policies and free trade in agricultural goods within the 10 year transition period. The new members will not join the Common Agricultural Policy during the first five years.

5. The new members will renounce unilaterally the claims to all structural funds during the transition period.

6. The new members will participate fully in Community-wide infrastructure projects, and all initiatives with a Community-wide character (including the energy grid, transport systems, communication systems, community-based science initiatives, community-based education initiatives, assistance to foreign or developing countries)

7. The new members contribution to the EU budget will be scaled downward in proportion to their non-participation in the structural funds programmes, and in the CAP.

8. During the ten-year transition, the new members will waive the freedom of movement of labor (into Western Europe), and will also opt out of the Social Charter. The ultimate disposition of the Social Charter will be determined jointly in the course of the ten year period.

9. The new members will meet the criteria for monetary union within 5 years of membership, or within 3 years of the introduction of the common currency, whichever comes latest. After two years of "grace period", they will be subject to macroeconomic management by the Commission in order to enable them to enter the monetary union by the end of the transition period.

10. The new members will participate in all discussions of issues of current or future interest to the Union, and in the drafting and signing of all new treaties and constitutional articles. They will participate in the reform of all policies, but their votes will not be counted in the areas to which they do not participate fully until the end of the 10-year transition period (agriculture, structural funds, social charter).

5. <u>Conclusions</u>

Neither the European Commission nor member governments in the European Union have yet put forwards practical suggestions for speeding the accession of reforming countries in Central Europe. To many participants in European politics, there is a hope that controversial issues linked to enlargement - such as the CAP, voting rights and structural funds - can simply be avoided if the subject of enlargement is pushed under the rug for a few years. This would be fine, perhaps, if the costs of uncertainty about enlargement were not so high. In fact, the current ambiguities over EU enlargement court disaster in Europe, by upsetting the process of economic and political reforms in the post communist economies, and by undermining the crucial confidence of investors in the region.

The obstacles to enlargement are far from insurmountable, and could be addressed through a range of clear and practical compromises. The Central European applicants need the economic and geopolitical security of membership; they do not need huge budgetary transfers nor immediate membership of the CAP. Nor does the EU have to guarantee immediate rights to labor mobility at the time of accession. Even with rapid accession, it will be necessary to stipulate an extended adjustment period for both sides, as has been done in earlier cases of enlargement.

We offer a set of practical guidelines for quick accession. In our view, the EU should commit to open negotiations with the applicant countries in 1998. Accession should be possible by 2000, assuming that the applicant meets various conditionalities for membership. These conditionalities should guarantee an accelerated pace for legal and economic reforms, both on the microeconomic and macroeconomic levels.

The modalities of accession should include a 10-year transition period, during which agricultural trade and mobility of labor will be gradually liberalized. The applicant countries should renounce their claims on EU structural funds, both because they do not need them, and because the fears amongst some EU countries (Spain, Portugal, Greece, Ireland) about the diversion of structural funds, now represent a large hurdle to quick accession. In fact, reliance on structural funds would probably worsen the political culture in the new members, by encouraging rent-seeking and an overly large role of government in investment spending. However, accession should lead to an immediate cessation of resort to safeguard measures in trade; to the full adoption of the *acquis communautaire*, with a few stipulated exceptions; and to the full involvement of the new members in regional infrastructure projects and in the governance of the EU itself. In this way, both existing EU members and applicant countries can maximize the benefits of EU enlargement, while minimizing the costs.

APPENDIX A

To show the importance of a commitment to a rapid enlargement of the EU, we use a small model of self-fulfilling rational expectations in the spirit of Krugman (1991). The model is characterized by three equilibria. There are two stable equilibria: full development (catch-up) and complete stagnation. There is an unstable equilibrium in-between, where firms are indifferent between modernization and their traditional activities.

We assume that the returns to a diversification or modernization investment in a given period t are a function of the number of enterprises already diversifying. This captures the idea of increasing returns at the country level, which can be due to the diffusion of knowledge (Grossman & Helpman 1991), trading externalities, or the concentration of demand in a region (Krugman 1991). In the present context we prefer the first two interpretations. The net present value of such an investment is written q:

$$q_t = \int_t^{\infty} [\Pi(n)-n^A]\, e^{-r(s-t)}\, ds. \qquad (1)$$

where $\Pi(n)$ is the value of the investment and n^A is the value of the status quo. We have kept the notation of Krugman (1991) wherever possible to show that our model is not conceptually different from his, but simply adapted to a different situation.

Integrating q to infinity, or simply requiring equal returns in the alternative investment at the world interest rate, gives an equality between the world interest rate and the sum of the instantaneous profit ($\Pi(n)-n^A$) and of the expected capital gain (dq/dt which stems from the expected future profits)

$$r = (dq/dt + [\Pi(n)-n^A]) / q. \qquad (2)$$

which can then be solved for dq/dt to give the law of motion of q.

Investors create new firms responding to a positive expected profit $q>0$ at a rate γ, which can be interpreted as derived from a quadratic cost function. The continuous rate of firm creation, which is also the law of motion of n, is thus

$$dn/dt = \gamma q. \qquad (3)$$

To explain the dynamics of the model, we have to be more explicit about the profit function. The relevant range of n is between n^A (the status quo or autarky number of firms) and N (the EU integration number of firms). The diversification is thus a "catch-up" growth, i.e. the convergence process referred to in the text, which comes on top of any underlying trend. The economy is sure to get the profits from n^A, but this fall-back option corresponds to an underdevelopment trap. For a given number of firms n^*, firms are indifferent between investing in diversification and staying in a status quo: below n^*, the profits are lower than n^A ($\Pi n<n^*)<n^A$); above n^*, we have $\Pi(n>n^*)>n^A$. The profit function can be written

$$\Pi(n_t) = n^A + \beta\, [(n_t/N) - (n^*/N)]\, . \qquad (4)$$

There is thus an externality from each firm's diversification investment: it improves the returns from other firms' diversification investments. Diversification, in turn, improves the chances of entry into the EU, if only because a country with less agriculture, less backward regions or less declining industries is less of a burden for the EU budget, and less of a competitor for the declining sectors of the EU. Entry into the EU improves the expected return from investment.

Putting the specification (4) of $\Pi(n)$ into equation (2) and solving for dq/dt gives, together with (3), the full dynamics of the model. The roots ρ of the dynamic system are:

$$\rho = [r \pm (r^2 - 4\beta\gamma/N)^{1/2}]/2. \qquad (5)$$

Real positive roots occur when $\beta\gamma/N$ is small, the intermediate equilibrium n^* is then unstable, and the stable endpoint that will be reached (n^A or N) is fully determined by the historical position of n relative to n^*. The dynamics are presented in figure 1. Complex roots occur when r is small and $\beta\gamma/N$ is big; then, for a range of values of n around n^*, the system can spiral towards one of the two stable equilibria at N or n^A, as in figure 2. The expectations of the agents about the equilibrium that will be reached determine the path that is chosen: expectations are self-fulfilling.

A policy of boosting the expectations of entry into the EU can coordinate the expectations of the agents and put the economy on a virtuous growth path. This is the most important policy message from this model, it applies if the system has complex roots, thus when flexibility is high.

The reference to the flexibility of the economy in the text corresponds to high values of the parameters of adjustment, β and γ. They make past history less relevant and make adjustment according to optimistic (or pessimistic) expectations faster and more likely. A low value of N has the same effect as a high value of β. Such a low value of N could be interpreted as a short distance between the level of development of the applicant country and the EU. A low opportunity cost of capital r helps to catch up too. Entry into the EU could contribute to this too by raising the time horizon and lowering the risk premium.

The initial conditions referred to in the text are represented by the exogenous value n^* at which the instantaneous profits from diversifying or not are equal. Improvements in infrastructure or education could lower the cost of diversifying and so lower n^*. Indeed, the externality coming from the number of diversifying firms is equivalent to a public good. A boom in foreign direct investment could lower the domestic value of n^*, showing the importance of foreign direct investment in a model of diversification externalities.

Once the economy reaches the level of diversification of the EU, further growth is still possible, but governed by the dynamics of a different model than the catch-up model presented here.

QUOTED REFERENCES

Baldwin, Richard E. (1994) Towards an Integrated Europe London: Centre for Economic Policy Research (CEPR) 234 pp.

Baldwin, Richard E. & Venables, A (1994) "International Migration, Capital Mobility and Transitional Dynamics" Economica 61, 243 (August) 285-300.

Barro, Robert J. and Sala-I-Martin, Xavier (1995) Economic Growth New York: MacGraw-Hill.

Dowrick, S. and Nguyen, D.T. (1989) "OECD Comparative Economic Growth 1950-85: Catch-Up and Convergence" American Economic Review 79, 5, 1010-1030.

Krugman, Paul (1991) "History versus Expectations" Quarterly Journal of Economics 106, 2 (May) 651-667.

Grossman, G. & Helpman E. (1991) Innovation and Growth in the Global Economy MIT Press.

Martin, Carmela & Gual, Jordi (1994) "Trade and Foreign Direct Investment with Central and Eastern Europe: Its Impact on Spain" CEPR Discussion Paper 1006.

Martin, Philippe (1994) "A sequential approach to regional integration: the European Union and Central and Eastern Europe" CEPR Discussion Paper 1070.

Matsuyama, Kiminori (1991) "Increasing Returns, Industrialization and Indeterminacy of Equilibrium" Quarterly Journal of Economics 106, 2 (May) 617-650.

Sachs, Jeffrey (1995) "Russia's Struggle with Stabilization: Conceptual Issues and Evidence" World Bank Economic Review (ABCDE Conference).

Sachs, Jeffrey and Warner, Andrew (1995) "Economic Reform and the Process of Global Integration" Brookings Papers on Economic Activity 1, 1-118.

Summers, Robert and Heston, Alan (1991) " The Penn World Table (Mark 5): An Expanded Set of International Comparisons, 1950-1988" Quarterly Journal of Economics 106, 2 (May) 327-369.

Widgren, Mikka (1994) "Voting Power in the EC Decision-Making and the Consequences of Two Different Enlargements" European Economic Review 38, 5 (May) 1153-1170.

EXTENDED LIST OF REFERENCES

Akerlof, G., Rose, A.K., Yellen, J. & Hessenius, H (1991) "East Germany in from the Cold: The Economic Aftermath of Currency Union" Brookings Papers on Economic Activity 1, 1-106.

Anderson, Kym & Tyers, Rod (1993) "Implications of EC Expansion for European Agricultural Policies, Trade and Welfare" CEPR DP 829.

Baldwin, Richard E. (1989) The Growth Effects of 1992 Economic Policy.

Baldwin, Richard E. (1994) Towards an Integrated Europe London: Centre for Economic Policy Research (CEPR) 234 pp.

Baldwin, Richard E. & Venables, A (1994) "International Migration, Capital Mobility and Transitional Dynamics" Economica 61, 243 (August) 285-300.

Barro, Robert J. and Sala-I-Martin, Xavier (1995) Economic Growth New York: MacGraw-Hill.

Bliss, Christopher and Macedo, Jorge Braga de (Eds.) (1990) "Unity with Diversity in the European Economy: The Community's Southern Frontier" CEPR and Cambridge University Press, 368 pp.

Cadot, Olivier & De Melo, Jaime (1994) "The Europe Agreements and EC-LDC Relations" CEPR Discussion Paper 1001.

Cadot, Olivier & De Melo, Jaime (1994) "France and the CEEC's: Adjusting to another enlargement" CEPR Discussion Paper 1049.

CEPR (1992) Is Bigger Better? The Economics of EC Enlargement: Monitoring European Integration 3.

Corrado, Cristina (1994) "Textiles and Clothing Trade with Central and Eastern Europe: Impact on Members of the EC" CEPR Discussion Paper 1004 (Portugal, Outward Processing Trade).

de Crombrugghe, Alain (1995) "The Nascent Polish Labor Market: Insiders, Mobility and Concentration effects" mimeo, Namur.

De Grauwe (1994) "Towards European Monetary Union without the EMS" Economic Policy 18 (April) 147-185.

De Grauwe (1995) "Monetary Union and Convergence Economics" 10th annual congress of the European Economic Association, Prague.

De la Fuente, Angel & Vives, Xavier (1995) "Infrastructure and Education Instruments of Regional Policy: Evidence from Spain" Economic Policy 20 (April) 11-52.

Dowrick, S. and Nguyen, D.T. (1989) "OECD Comparative Economic Growth 1950-85: Catch-Up and Convergence" American Economic Review 79, 5, 1010-1030.

Fakin, Barbara & de Crombrugghe, Alain (1995) "Pattern of Taxes and Expenditures in OECD vs. Transition Countries" mimeo, LICOS Leuven.

Grossman, G. & Helpman E. (1991) Innovation and Growth in the Global Economy MIT Press.

Krugman, Paul (1990) "Macroeconomic Adjustment and Entry into the EC: A Note" in Bliss & Macedo.

Krugman, Paul (1991) "History versus Expectations" Quarterly Journal of Economics 106, 2 (May) 651-667.

Krugman, Paul (1991) "Geography and Trade" MIT Press.

Krugman, Paul & Venables Anthony (1990) "Integration and the Competitiveness of Peripheral Industry" in Bliss and Macedo.

Martin, Carmela & Gual, Jordi (1994) "Trade and Foreign Direct Investment with Central and Eastern Europe: Its Impact on Spain" CEPR Discussion Paper 1006.

Martin, Philippe (1994) "A sequential approach to regional integration: the European Union and Central and Eastern Europe" CEPR Discussion Paper 1070.

Matsuyama, Kiminori (1991) "Increasing Returns, Industrialization and Indeterminacy of Equilibrium" Quarterly Journal of Economics 106, 2 (May) 617-650.

Neven, Damien (1994) "Trade Liberalization with Eastern Nations, How Sensitive" CEPR DP 1000.

Rollo, Jim & Smith, Alasdair (1993) "The Political Economy of Central European Trade with the European Community: Why so Sensitive?" Economic Policy 16 (April) 139-182.

Sachs, Jeffrey (1993) Poland's Jump to the Market Economy LSE Lionel Robbins Lectures Series, MIT Press, 126 pp.

Sachs, Jeffrey (1995) "Russia's Struggle with Stabilization: Conceptual Issues and Evidence" World Bank Economic Review (ABCDE Conference).

Sachs, Jeffrey and Warner, Andrew (1995) "Economic Reform and the Process of Global Integration" Brookings Papers on Economic Activity 1, 1-118.

Summers, Robert and Heston, Alan (1991) " The Penn World Table (Mark 5): An Expanded Set of International Comparisons, 1950-1988" Quarterly Journal of Economics 106, 2 (May) 327-369.

Widgren, Mikka (1994) "Voting Power in the EC Decision-Making and the Consequences of Two Different Enlargements" European Economic Review 38, 5 (May) 1153-1170.

Winters, L. Alan (1994) "The Liberalization of European Steel Trade" CEPR Discussion Paper 1002.

Publications of the OECD:

OECD Economic Surveys:
Spain 1990/91 (on EC integration)
Portugal 1991/92 (on EC integration)

Publications of the European Community:

EC 1985 L1/302 Treaty of Membership of Spain and Portugal.

EC 1993a European Council at Copenhagen, June 21-22, 1993: Conclusions of the Presidency.

EC 1993b Trade and Foreign Investment in the Community's Regions: The Impact of Economic Reform in Central and Eastern Europe Regional Development Studies No.7, 157 pp. Directorate-

General for Regional Policies and National Economic Research Associates (NERA). Luxemburg: Office for Official Publications of the EC.

EC 1993c European Economy 53 (on EC budget and enlargement)

EC 1994a European Council at Corfu, June 24-25, 1994: Conclusions of the Presidency.

EC 1994b "The Europe Agreements and Beyond: A Strategy to Prepare the Countries of Central and Eastern Europe for Accession" COM(94)-320.

EC 1994c: European Economy: Supplement A March 1994: Foreign Direct Investment in Eastern Europe.

EC 1994d: European Council at Essen, December 9-10, 1994: Conclusions of the Presidency

EC 1995a: White Paper: Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union, COM (95)163 final, May 1995.

EC 1995b: European Council at Cannes, June 26-27, 1995: Conclusions of the Presidency, SI (95)500.

EC 1995c: Agricultural Situation and Prospects in the Central and Eastern European Countries, Summary Report and Country Reports, DG VI working documents.

<u>Data Sources:</u>

Eurostat

Eurostat 1991, Special Issue on Central and Eastern Europe.

GUS (Polish Central Statistical Office), Rocznik (Yearbook) various issues, and Rocznik Handlu Zagranicznego

International Monetary Fund (IMF) International Financial Statistics (IFS).

OECD National Accounts, various issues.