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Jože Mencinger

Two Years after Accession

Contact: office@ipe.or.at

TWO YEARS AFTER ACCESSION*

Jože Mencinger,

EIPF and University of Ljubljana

1. General Economic Outlook

On May 1, 2004, eight former socialist countries joined EU, and three small among them: Estonia, Lithuania and Slovenia, immediately afterwards entered European Exchange Rate Mechanism 2 (ERM2) while the rest have delayed the entry because they consider that they need more time to reduce budget deficits, and, in some cases, inflation. Only Slovenia succeeded entering Euro-zone on January 1, 2007.

Table 1
 General Economic Indicators in 2005 or 2004

	GDP growth in % 2005	annual average of HICP % 2005	Current account balance, % GDP	general budget balance %GDP 2005	unempl. rate % 2005	FDI inflows %GDP 2005	GDP per capita PPS* 2005	hourly labour costs in € 2004
Czech R.	6.1	1.6	-5.2	-2.6	7.9	8.2	73.8	5.54
Estonia	10.5	4.1	-14.0	1.6	7.9	16.6	60.1	4.24
Hungary	4.1	3.5	-8.6	-6.1	7.2	4.7	60.8	4.91
Latvia	10.2	6.9	-9.6	0.2	8.9	3.5	47.2	2.37
Lithuania	7.6	2.7	-6.7	-0.5	8.3	2.6	52.0	3.22
Poland	3.2	2.2	-1.5	-2.5	17.7	2.2	49.8	4.74
Slovakia	6.1	2.8	-3.0	-2.9	16.3	4.2	55.0	4.41
Slovenia	4.0	2.5	0.2	-1.8	6.5	-0.2	80.6	10.54
EU-15	1.5	2.1		-2.3	7.9	-0.9	108.3	24.02

* EU-25 = 100

Source: Transition report update, EBRD May 2005, Eurostat, online support

In 2005 (and in 2004), the new members from Central Europe and Baltic (CEB) fared well in comparison to 2003 and to old member countries. Stimulated by domestic demand and exports GDP growth considerably outpaced the GDP growth in old countries. Average annual inflation rate which increased from 2.9 percent in 2003 to 4.3 percent in 2004, slackened again. Relatively high double deficits prevailed in most countries with exception of Estonia with enormous current account deficit accompanied by general government budget surplus, and Slovenia, with small current account surplus and not too large budget deficit. Unemployment rates exceeded double digit figures in two countries with Poland leading with 17.7 percent, while unemployment in Hungary and Slovenia was below EU-15 average. FDI net inflows calmed down as the “family silver” was more or less sold during hasty privatisations, with Slovenia being an exception. Indeed, Slovenia outward FDI (mainly to former Yugoslav republics) over-passed inward FDI. After accession, the EU-25 level of development (measured by GDP/capita in PPS) dropped for approximately 10 percent compared to EU-15, and the gap between the most developed and the least developed members widened considerably.

2. The Right to be Less Developed

The rejection of the Constitution Treaty in France and Netherlands created far less concern in CEB countries than the stalemate related to the EU budget (financial perspectives) for the 2007-2013 period. As the new EU members lag behind EU average much more than the countries, which had joined EU during previous enlargements, they expected to be assisted in their catching up process. Particularly, because illusions of large amounts of money from Brussels were created during the whole accession period. However, the newcomers were from the very beginning in a much worse position than old cohesion countries (Greece, Spain, Portugal, Ireland). Big bang enlargement in 2004 based on political rather than economic considerations and much worse economic situation in EU in 2004 than during previous enlargements can be blamed.

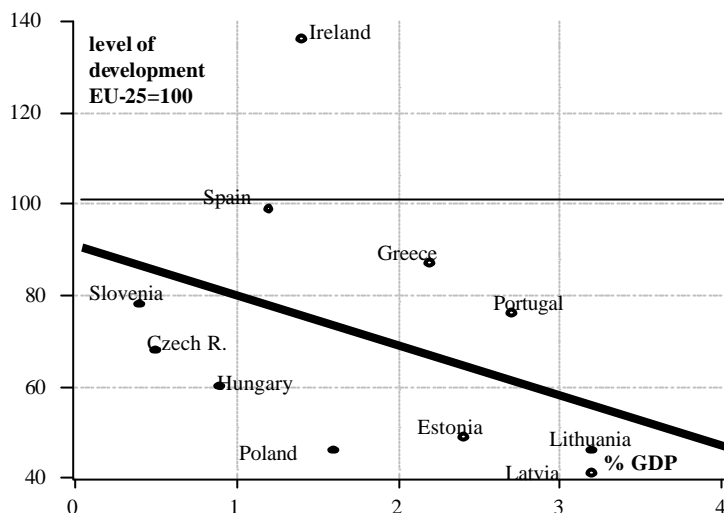
The new members are to respect the Stability and Growth Pact, to contribute to the EU budget in well known forms (traditional own resources, part of VAT receipts, a share of GNP, and a share for UK rebate) and to introduce many costly “acquis” requested by EU membership. This increases their budget expenditures. Furthermore, while the flows from national budgets to the EU budget are certain, the flows in the opposite direction are conditional and uncertain; they in most cases request co-financing and fulfilment of administrative rules determined by EU. Because of that, accession might lead to actual deterioration of CEB budgetary stance.

The estimates of net effects of accession on public finance differ considerably, depending also on the place from where they come. Thus, Hallet and Keermean (2005) from EU directorates estimate that new countries could, due to the Copenhagen package related appropriations for commitments, reckon on total budgetary envelope of 40.9 billions € in the 2004-2006 period. They however admit that amount actually paid could be much lower and that it will together with the running out pre-accession assistance amount to 31.4 billions € or 2 percent of GDP per year. Including 14.6 billions € contributions to EU budget, net inflows amount to 16.9 billions €. This implies that in the 2004-2006 period the new member countries would be as a group a net beneficiary receiving 1.1 percent of their GDP. Slovenia (with GDP per capita at 78 (in 2004) percent of EU 25) would receive 0.4 percent of GDP, Czech Republic (68) 0.5, Hungary (60) 0.9, Estonia (49) 2.4, Poland (46) 1.6, Latvia (41) 3.2, and Lithuania (46) 3.2 percent. This is far less than what was given to Ireland, Spain, Portugal and Greece in 2003, taking into account their relative levels of development. In 2003, Spain (with GDP per capita at 98.9 percent of EU-25, or 90 of EU-15) received 1.2 percent, Greece (80.6 or 74) 2.2 percent, and Portugal (76.2 or 67) 2.7 percent of their GDP. Even Ireland (135.7 or 124) received 1.4 percent of its GDP.

These estimates do not include changes in the expenditure side of the budget. Namely, most EU transfers are “additional” rather than substitutes of domestic expenditures. With adding pre-accession aid and estimating additional expenditures the authors calculated that net budgetary effects will amount to 0.5 percent of GDP: 0.1 percent in Czech Republic, 0.25 in Hungary, 0.3 in Slovenia, 0.4 in Slovakia, 0.6 in Poland, 1.4 in Estonia, 1.7 in Latvia and 1.8 in Lithuania. The authors also estimated that actual absorption will be (due to administrative inability to manage the flows) at the level of 62 percent which would bring net effect from 0.5

percent to zero. According to their views, the inclusion of accession related expenditures (costs associated with implementation of the *acquis communautaire*, co-financing, absorption capacities or need for advance payments to farmers) is however misleading.

Altered Generosity of EU



Source of data: Hallet, Keermaen (2005)

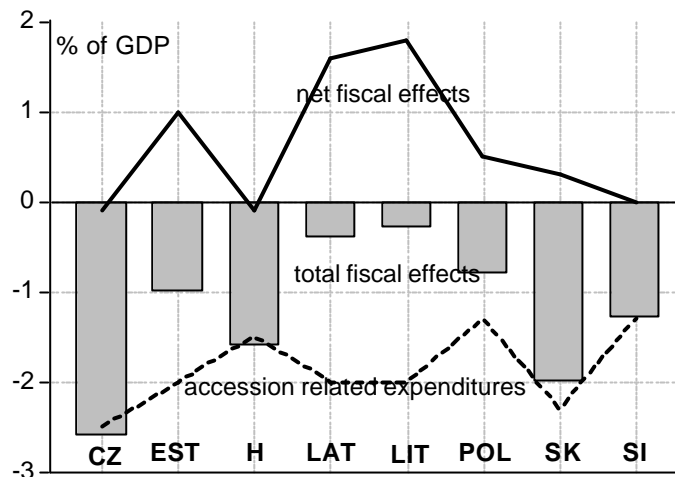
The estimates coming from the new member countries are much more pessimistic. Kopits and Szekely (2002) estimate that negative budgetary effects for Czech Republic, Estonia, Hungary, Poland and Slovenia will range between 3 and 4.75 percent of GDP. Antczak (2003) estimates deterioration of up to 3 percent, Mrak (2003) calculates the overall fiscal effect for Slovenia to be negative around 1 percent, while Backe (2002) claims that in the short run, membership in EU will increase fiscal strain which will become neutral in the medium run. The estimates of total fiscal effects by Dabrowski, Antczak and Gorzelak (2004) are presented in Table 2 and Graph 3.

Table 2
Fiscal Effects of EU membership

	CZ	EE	HU	LT	LV	PO	SK	SL
Net fiscal effects	-0.1	1.0	-0.1	1.6	1.8	0.5	0.3	-0.0
From national to EU budget	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
From EU to national budget	+1.0	+2.1	+1.0	+2.7	+2.9	+1.6	+1.4	+1.1
accession related expenditures	-2.5	-2.0	-1.5	-2.0	-2.0	-1.3	-2.3	-1.3
total net fiscal effects	-2.6	-1.0	-1.6	-0.4	-0.3	-0.8	-2.0	-1.3

Source: Dabrowski, Antczak and Gorzelak

Fiscal Effects of EU membership



Source: Table 2

When one discusses EU structural and cohesion funds one cannot but compare EU to former CMEA countries though flows of wealth were non-transparent (they were conducted by relative prices) or to Yugoslavia¹ in which fiscal flows were, particularly in the last decade of its existence, relatively transparent. Less developed republics and regions in former Yugoslavia insisted on a right to be less developed and therefore assisted by wealthier republics, while the latter claimed to be exploited. In reality, it was impossible to estimate what were actual flows of wealth. The same appears to be the case in EU. Modest (less than 0.1 percent of EU-15 GDP) pre-accession assistance was very much advertised while the effects of the opening and liberalization of CEB countries on the flows of wealth (by cheap acquisitions of companies in the hasty privatisation process, and FDI being often supported by different types of subsidies (tax vacations, property grants, provision of utilities, direct financial support)) were wholly neglected.

Contrary to the contradicting views on benefits and costs of joining EU, the author of the paper believes that joining EU was (at least for his country) a kind of emergency exit with unclear costs and benefits, resulting also from very different positions of newcomers and incumbents. While enthusiasm for accession on the part of CEB was founded both on assumed (not wholly realized) political and economic grounds, enthusiasm for enlargement on the EU-15 side was based predominantly on political grounds². Namely, assumed costs and benefits which enlargement would bring to incumbents differed very much from those of newcomers. For

¹ The comparison of EU with former Yugoslavia might seem far too pretentious, pessimistic or even unfair. Some similarities are however striking. It is true that disintegration of Yugoslavia was a side effect of the end of socialism, which might imply that any comparison of EU and Yugoslavia is beside the point. However, is the European identity any stronger than the Yugoslav identity was a decade ago? Is EU also not composed of distributional coalitions, strong enough to prevent urgent changes but too weak to implement them? Is democratic deficit (of different form) really so much smaller than it was in former Yugoslavia? Are the people in EU convinced that cooperative game pays off? Would they not in a case of a prolonged recession begin to believe that they are exploited by everybody else?

² The growing internal pressures over CAP and other issues seem to be covered by issues of enlargement, EU. Thus, **the fear of implosion of the existing EU** can be considered one of the pillars of enlargement. Not less important is the so called **democratic deficit**; if people in all existing member countries were asked whether they are in favour of enlargement there would be no enlargement whatsoever.

incumbents, potential benefits of enlargement would be scanty as they could already under arrangements which prevailed in CEB after dissolution of socialism reap the benefits of transition.

3. The Stability and Growth Pact and Lisbon Strategy in the new members

The belief that price stability and growth can be assured by elimination of budget deficit and reduction of public expenditures has acquired the status of conventional fact and appears to be undisputable truth for official economic policy of EU if this policy is implied by **The Stability and Growth Pact** signed in 1997³. Though fiscal policies, together with wage policies, formally belong to member countries, in reality, this is not entirely true. It was not only compulsory for the members to adopt VAT, the minimum tax rate of 15 percent as a standard rate and 5 percent as a reduced rate were also set⁴. The Stability and Growth Pact also created mechanisms for interventions, by which fiscal policies should support monetary policy of ECB⁵.

Budget deficits of the EMU member countries, between 1993 and 2000, indeed declined and some of the countries had budget surpluses, while reported budget deficit in 2000 was in no country higher than 3 percent and public debt in 2001 was lower than in 1993. The decline of budget deficits and public debts is however not surprising, taking into account high economic growth in the period. It is simply part of the economic mechanism of a normally functioning European market economy. Pact was functioning well (it was not harmful) in the period of high economic growth when the restrictions imposed by it were anyhow irrelevant. It became troublesome when growth dropped. Consequently, budget deficits began to rise in 2000 and soon also officially exceeded the “magic” 3 percent Maastricht level in Germany and France. Until 2005, other countries followed. Indeed,, one could expect that budget deficits will start increasing with declining growth. Formal insistence on the Stability and Growth Pact can thus be looked at as an attempt to modify the existing macro economic mechanism of the European social market model.

EU does not apply sanctions which are supposed to be applied against member countries or does not dissolve the Growth and Stability Pact which would be the reasonable thing to do. Instead, EU is nervously looking for excuses for higher deficits and for new definitions, which would lower budget deficit below the magic 3 percent and public debt below 60 percent level. The measures for the implementation of the Pact however add to lower economic growth and employment in EU, destabilize economy, and also threaten the implementation of the new Lisbon strategy. Indeed, the two strategies appear to exclude each other; it is most likely that both will end as political rhetoric which will have not much to do with economic reality.

³ Pact on Stability and Growth passed in June 1997 in Amsterdam insists that fiscal position is balanced or in surplus in normal times and urges stronger surveillance of medium-term fiscal position with the deficit of 3 percent being considered risky. The EMU participants are therefore allowed to exceed 3 percent ceiling automatically and temporary only if their GDP declines by 2 percent or more, while those with a decline between 0.75% and 2% need concurrence of the Council of Ministers. A country with deficit higher than 3 percent and milder recession or no recession would be obliged to make mandatory deposit of 0.5 percent of its GDP which is transformed into a fine if fiscal excess is not eliminated within two years.

⁴ 6th Directive on the harmonisation of the laws of member states relating to turnover taxes, Dir 77/388, paragraph 12

⁵ Mechanism has three pillars – medium term notifying mechanism, mechanism for shortterm control of the programs for stability and procedures which would start at too high deficit, and institutions responsible for the the implementation of the Program. These are European Commission (EC), Economic and financial committee (EFC) and Council of ministries for economy and finance (ECOFIN).

Relatively high double deficits prevail in CEB countries, with exception of Estonia with enormous current account deficit accompanied by substantial budget surplus, and Slovenia, with small current account surplus and not too large budget deficit⁶. However, while it is unimaginable that a large old EU member would be fined for ignoring Pact, the position of a small CEB country wishing to enter EMU is very different. Indeed, they do expect to be discriminated if compared to incumbents or to countries which entered EMU with public debt much higher than allowed (Italy, Belgium).

The **Lisbon strategy** signed in March 2000 should ensure Europe to become the most efficient knowledge based economy with of full employment. After some years of mantras on the importance of the strategy, actual development and the report of the Wim Kok committee at the end of 2004 brought soberness and admittance that EU was not only far from the Lisbon goals for 2010, but also heading in the opposite direction. European Commission reluctantly admitted that Lisbon strategy failed and the old strategy was in February 2005 replaced by “Partnership for Growth and Jobs – New Beginning of the Lisbon Strategy”. In it, the ending year 2010 was abandoned, number of goals was reduced, and responsibilities were turned to the governments of member states. The new strategy, ready for the spring 2005 meeting of the Council of Europe, was said to be simple, pragmatic, and tangible⁷. It should be based on the partnership between the Commission and member states, which should create their own “Lisbons” and become responsible for efficiency, increase of productivity, and employment attained by assistance of healthy macroeconomic policy supporting structural reforms. While the goals of the “Partnership” (growth, jobs, and social security) are not questionable the new strategy does not assure that low economic growth accompanied by budget deficits, high unemployment, and moderate inflation will not continue. There are no provisions for the turning point. Instead, the new strategy surprises with the abundance of words, empty talks, newly invented phraseology and concepts, action plans and programs, priorities, mobilizations, new institutions and similar claptraps⁸. In short, if economic growth in EU depended on rhetoric, it would be high. Because it does not, it is most likely that the new Lisbon strategy will soon turn into a worthless political document. In CEB, the strategy was met with similar enthusiasm by politicians but much less so by common people accustomed to many similar empty talks during the former regimes.

By joining EU, some of the globalization challenges of the member countries were shifted from the national to the EU level. It seems however that also EU is not able to successfully compete in the globalization contest and to preserve European social model, existing standard of living, and economic growth⁹. A

⁶ Strangely enough, while budget balances are considered important performance indicators, current account balances are not.

⁷ Communication to the Spring European Council, **Working together for Growth and Jobs**, A new start for the Lisbon Strategy, COM (2005) 24, Brussels, 02.02.2005;

⁸ See for example: **Delivering on Growth and Jobs: A New and Integrated Economic and Employment Co-ordination Cycle in the EU**, Companion document to the Communication to the Spring European Council (COM (2005) 24) Brussels, February 3.,2005;

⁹ Globalization occurred when American model of capitalism prevailed not only over socialism but also over other models of capitalism which led to the globalization of market fundamentalism.

decrease of costs by further liberalization of labor market, reduction of social benefits, and disregard of environmental externalities large enough for the competition with much more ruthless societies, China in particular, would imply total abandoning the social market model. This is politically impossible and socially unacceptable.

CEB countries could easily compete with old members if labor costs and productivity would be the only determinants of the costs of production. Namely, average hourly labor costs (defined as total labor costs divided by the corresponding number of hours worked) in CEB compared to average hourly labor costs in EU-15, remain much lower than labor productivity compared labor productivity in EU-15. Multinational corporations were therefore relocating production into accession, but have begun leaving them and relocating production to new candidates and much more to China. Indeed, some domestic companies in rich Slovenia have shifted their production into countries with lower labor costs. It is not only production of many traditional industries with low value added jobs (textiles) which has been shifted but also industries with presently high value added jobs. By their relocation to the countries with miserable wages, nil social security, and disregard of externalities (which all contribute to high initial profits) these industries also swiftly turn to industries with low value added jobs. The relocation of production, thus, also diminishes the ability of EU countries for creating more jobs in services. While it is true that by higher economic growth and increase in the standard of living in the rest of the world, new markets will emerge, their emergence will lag behind the disappearance of jobs in EU due to production being shifted from EU.

4. The Strength of Neo-Liberalism in New Member States

“Back to Europe” was a slogan of the last decade of the 19th century and the ultimate goal of all former socialist countries in Central and Eastern Europe. Indeed, full membership in EU was considered a panacea for all current and future economic and political problems. Enthusiasm for accession was founded both by political and economic considerations. Political democracy and social market model with high standards of living were understandably attractive, and EU was practically the only market left to CEB countries. They could not afford to lose it; they also expected capital in form of direct investments, well paid jobs, and fiscal transfers. The benefits were very much stressed by many studies done by influential institutes or distinguished authors, calculating the contribution of accession to growth through adaptation to a better economic system, increased FDI, and subsidies. CEB countries therefore swiftly adapted their economic policies to reach the goal.

Opposite views were rare. A few liberal economists argued that CEB countries “would be better off by staying outside the EU and continuing to improve economic freedom and the rule of law” (Prokopijevic, 2005, 6). According to these views, the benefits of staying out would outweigh the benefits of getting in. As staying out being the “first best” choice disappeared, the newcomers should within EU fight for more economic freedom as the “second best” solution.

One can say that newcomers or at least their governments¹⁰ are much more attracted by American market model and neo-liberalism than the old EU members. Indirectly, this is indicated by the flat tax being introduced in some or seriously discussed in other countries. Estonia introduced a flat tax of 26 percent in 1991, Lithuania and Latvia followed in 1994 with rates of 33 and 25 percent respectively. The tax reform in Slovakia in 2003 with a flat rate tax of 19 percent attracted much more attention. The discussion whether to follow spread to all other new member countries. In Slovenia it became part of the announced economic reform which has been, due to fierce opposition by trade unions and general public replaced by a “reform”.

The new countries also range quite high on different scales of economic liberties calculated by institutions such as Heritage Foundation or Fraser Institute¹¹, and slightly worse on the scales of competitiveness calculated by WEB or IMD. Estonia which is clearly leading on the scales of the first two institutions is supposed to be more liberal than most EU countries; it is followed by Latvia, Lithuania and Czech Republic which are close to EU-15 average while Slovenia is on the bottom not only among ten newcomers but also among all 25 EU members. The economic freedom rankings however have not much to do with the macroeconomic performances of the countries (see Table 1). The two countries on the extreme positions, very liberalistic Estonia and very conservative and gradualist Slovenia, can be considered the best performers in the catching up process.

Table 3
Economic Freedom and Competitiveness Rankings

	general govt. expenditures %GDP	Economic Heritage*	Freedom Fraser*	Index average	World Econ. Forum competitiveness index
Czech Republic	44.5	6.52 (4)	6.9 (4-6)	6.71(5)	4.55 (5)
Estonia	37.3	8.10 (1)	7.7 (1)	7.90(1)	5.08 (1)
Hungary	49.2	6.00 (6)	6.9 (4-6)	6.45(6)	4.56 (4)
Latvia	36.2	6.60 (3)	6.9 (4-6)	6.75(3)	4.43 (6-7)
Lithuania	34.7	7.02 (2)	7.3 (2)	7.16(2)	4.57 (3)
Poland	48.1	5.47 (8)	6.6 (7)	6.03(7)	3.98 (8)
Slovakia	48.0	6.39 (5)	7.0 (3)	6.69(4)	4.43 (6-)
Slovenia	47.8	5.62 (7)	6.2 (8)	5.91(8)	4.75 (2)
EU-25	45.8	6.96	7.18	7.07	

*Heritage Foundation index and Fraser Institute index are on the scale 0-10 with 0 meaning no economic freedom and 10 meaning maximum of economic freedom.

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¹⁰ This is often true for “right” and “left” governments. Indeed, classical division to left and right is in new EU members very misleading.

¹¹ Rankings of both institutions reflect their extreme neo-liberal positions.

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