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REINTEGRATING THE REFORM COUNTRIES INTO THE WORLD ECONOMY

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1. In the nineties, the world economy is experiencing a dramatic change. Communication costs and transport costs are falling, market segmentations are being reduced, markets are globalized and become more contestable, competition is getting more intensive, value added chains are sliced up, production is being fragmented and is reallocated on a world-wide scale. This is one line of change in the world economy. The other line of change is that major regions of the world economy, China and Central and Eastern Europe, which up to the late eighties were more or less secluded from the international division of labor, now are being reintegrated in the world economy, a quarter of the world population. This second aspect is our topic, looking at the reform countries, the new market economies of Central and Eastern Europe.

2. Talking in terms of an economic model, the opening up of the post-communist-reform countries can be understood as an exogenous shock to the world economy which requires an adjustment to find a new equilibrium. It is a <u>supply shock</u> in the sense that the factor endowment of the international community of nations changes; more people, i.e. more labor, more space, and to some extent more capital, mostly obsolete physical capital, is added. It is a <u>market shock</u> in the sense that new markets are opened up. This change in relative factor endowments and in additional "demand" potential is occurring simultaneously with the melting away of market segmentation.

3. In my paper I address four different points:

— How quickly can we expect the reform countries to catch up?
— Which trade flows are likely to develop in the years to come?
— How relevant are factor movements?
— To what extent can institutional arrangements foster re-integration?

Of course, all four issues are interrelated, for instance the rate of economic growth will depend on trade and on the institutional arrangements, and, in turn, economic growth will influence trade.

* I appreciate comments from the participants of the symposium, especially Ulrich Koester and Stefan Tangermann as well as from Ralph Heinrich and Jürgen Stehn.

4. Our topic is in a flux, in a process of development. This can best be seen from the phenomenon that even the names for the new region of Europe are still shifting: We talk of the reform countries, the new market economies, the Visegrad-4 and the Visegrad-5, the CEFTA members (i.e. the members of the Central European Free Trade Association) — there are five —, the CEECs, the Central and Eastern European Countries — there are ten —, the EEC's, the Europe Agreement Countries — again ten —, Central and Eastern Europe including Russia and the former Soviet bloc, and the 30 post-communist countries of the world economy which are all in the process of transformation.

I. Catching Up

5. Where do the reform countries stand? The new market economies of central Europe, the Visegrad-5, have passed the valley in the J-curve of transformation, with Poland surpassing the pre-reform level of 1989-GDP and the other most progressed countries reaching 90 percent of the initial level. A different story holds for the CIS-countries with Russia at fifty percent of the starting position and for the Baltic states with a similar pattern except Estonia. Note, however, that these intertemporal comparisons have to be interpreted with great caution because the statistical basis of comparison, the year 1989, is likely to be distorted.[1]

The most progressed countries, the Visegrad-5 (Czech Republic, Hungary, Poland, Slovak Republic and Slovenia), have reached roughly 40 percent of the EU-15 level in per capita GDP, 30 percent of the West German level.

6. From the literature on catching-up processes, we know that catching up takes time, a lot of time. In a simplified notion, the catching-up country is walking down the marginal productivity curve of capital. With more capital per worker accumulated, the marginal productivity of capital falls and the growth rate is reduced. Eventually, if absolute convergence can be applied, it will reach the same steady state as a country in Western Europe. According to the Barro rule, GDP-differences in per capita between regions of the Unites States have been leveled in at a rate of 2 percent per year over one hundred years, in the period 1880-1988 (Barro and Sala-i-Martin 1991). Among the OECD countries this rate is only 1 percent in the post war period. In Western Europe, the rate of convergence is somewhere between 1 and 2 percent. Can we apply these results to the reform countries?

7. Estimates on growth rates for the reform countries of Central Europe differ widely. Let us look at the Visegrad-5. According to Baldwin et al. (1997) "most ... ... predict growth rates that are two or three times those of Western Europe" (p. 129). This would be a growth rate of 5–7 percent or even more. Others are less optimistic. Sachs and Warner (1996) point out that the new market economies of Eastern Europe differ significantly from the four or six tigers in South-East Asia with real growth rates for two decades of 6–7 percent, namely in two decisive points:

— First, the savings and investment ratio to GDP is much lower in central Europe with 23,5 percent in the nineties (Czech Republic, Poland, Slovak Republic,

[1] For measurement issues in centrally planned economies in the older literature see the discussion on the Gerschenkron effect (1955).

Slovenia) to 35-36 percent in the quickly expanding countries in South East Asia (Indonesia, Korea, Malaysia, Singapore, Thailand).
— Second, the share of government in GDP with 60 percent in the reform countries is much higher than in South East Asia.

Consequently, a lower growth rate, let us say of 3.5 percent, may be expected. Note that the share of government in GDP is not to be confounded with the share of production that has been privatized which is roughly 70 percent.

8. Of course, the growth rate will be crucial for convergence. If we assume that the Visegrad-5 have a growth rate of 5 percent and the EU-15 of 2.5 and if we evaluate their initial position at 40 percent of GDP per capita relative to Western Europe, it will take 37 years to reach the same level in per capita output and a quarter century — 22 years — to halve the distance. This presumes a permanent growth difference of 2.5 percentage points. If the growth rate in Eastern Europe would only reach 3.5 percent and if the permanent growth differential were only 1 percentage point, it would take nearly a century — 92 years — to reach the same level and more than half a century — 56 years — to halve the distance.

Note that much more time is needed for the convergence of other countries like Bulgaria, Romania and Russia all of which start at a much lower level.

II. Trade Flows

9. In order to answer the question of which trade flows will develop, we can look to trade theory. Which story would theory tell us?

— Gravity Models allow predictions on the volume of trade, suggesting that geographical distance is an important factor; trade occurs between countries that are geographically close. This type of interregional trade can be expected to be relevant for the reform countries vis-à-vis Western Europe. Also market size as a mass factor is relevant. Gravity models, however, do not allow predictions on the product mix (Winters and Wang 1994, Baldwin et al. 1997).
— Early in the transformation process when the international exchange was still minimal, historical patterns were studied in order to find clues for the product mix of trade flows (Collins and Rodrick 1991). Pre-World War II trade patterns served as an indicator for future trade patterns. Thus, it was stressed that Czechoslovakia was one of the leading industrialized regions in Europe in the 30s.
— Relative endowments as predictors of trade flows would indicate that the reform countries specialize in the production and export of products which require their relatively abundant factors of production, i.e. land and labor. Although labor is less skilled relative to Western Europe, it is generally agreed that labor in some Eastern European countries predisposes of relatively high qualifications. Therefore, we can expect that labor-rich countries will export labor-intensive products, but also human-skill-intensive products. At the moment, and for some time, however, Eastern Europe would be expected to embody less human capital in its exports than Western Europe. Some countries, for instance the Visegrad-5, can be expected to export more skill-intensive products than the other CEECs.
— Intra-industry trade postulates that trade takes place in similar products, due to economies of scale and due to a preference for differentiated products, i.e. to a

love for variety. With income per capita approaching each other, with preferences being or becoming similar due to cultural nearness and with similar production technologies being applied, intra-industry trade is likely to play a greater role in the future.

— Finally, networks in the value added chain, i.e. a hub and spoke system between Western and Central Europe, including a fragmentation of production, can be expected. This would also include intra-firm trade.

10. So much for theory. Seven years into the transformation process, the empirical picture of the international division of labor already tells us quite a lot. As a matter of fact, it tells exactly what theory would predict. I must admit that I was quite surprised when I saw the data. And I had to correct quite a few prejudices.

— Exports of the reform countries amount to roughly 27 percent of their GDP (for the Visegrad-5 countries in 1996). They have reached degrees of openness comparable to Western European Countries (Gros and Gonciarz 1996). This means that these countries are quite outward oriented.

— The share of exports going to the EU relative to total exports is roughly 66 percent so that the reform countries are integrated into the EU with a similar percentage as the EU-members; in terms of trade, they are de facto already EU members. The EU-market is critical for the reform countries (Baldwin et al. 1997).

— Meanwhile, the market of the reform countries is becoming important for the European Union with 8.4 percent of EU's exports (extra EU-exports); for some countries, Central and Eastern Europe is an especially interesting market. Germany accounts for 53.6 percent of the EU-exports to the reform countries (Visegrad-5). Germany exports 7 percent of its total (i.e. both intra-and extra-EU) exports to Central and Eastern Europe.

11. This basically confirms gravity models. What is the empirical picture on the product mix? In trade between the EU and the CEECs-10, in two product categories, namely in "chemicals and rubber and plastic goods" and in "other machines and equipment", the EU is a net exporter (Baldwin et al. 1997). There is only a slight net surplus in transport equipment whereas the CEECs have a net surplus in "other manufactures". This suggests that the EU has a comparative advantage in capital- or technology-intensive products (and the CEECs-10 in labor-intensive "other manufactures"). It is quite surprising, however, that all the other product groups, trade between the EU and the reform countries is more or less balanced, namely in food and agricultural products, other primary goods, textiles, clothing and footwear, iron and steel and semi-processed goods. This means that in there is already quite a lot of intra-industry trade.

III. Factor Movements

12. When, in 1989, the countries of Central and Eastern Europe opened up, segmentations of factor markets were reduced considerably. This implies that a reallocation of factors of production is likely to take place.

The opening up of new regions means new investment opportunities. If uncertainties for investors can be kept low, the new regions will attract capital. The Visegrad-4 have attracted an accumulated stock of foreign direct investment of 33 bill. US-$ as of July 1996 (UN Economic Commission for Europe 1996) which translates into roughly 500 US $ per capita or 13 percent of GDP. For Hungary and Slovenia, this ratio is much higher, for instance 31 percent of GDP for Hungary.

Hungary, Slovenia and the Czech Republic have reached FDI levels comparable to those of emerging markets in Latin America and in Asia. Foreign direct investment accounted for roughly 10 percent of total investment in 1993/94 in the Czech Republic and in Poland, and reached 33.6 (1993) and 18.4 (1994) for Hungary. These levels, not in line with the findings in the Feldstein-Horioka[2] (1980) tradition, are of course corrections of the isolation in the last 50 years from the world capital market. It can be expected that capital inflows will not, however, continue at the current level. An important condition for capital inflows is that political uncertainty is further reduced. Of course, integration with the EU would be a major event in reducing uncertainty.[3]

13. We cannot exclude that in the future capital inflows may temporarily die down or even reverse, and balance-of-payments crises may ensue. Witness the Czech Republic in 1997 (Buch and Heinrich 1997). Countries may get into a credibility crisis due to an unconvincing stability policy. High absorption relative to domestic production, wage increases surpassing productivity growth, short-termism of economic policy, social policies, budget deficits and government debt, distributional targets and populist policies all may be a cause for instability implying a depreciation of the home currency, lower capital inflows and a lower growth rate of production potential.

14. Differences in net wages between Poland and the Czech Republic on the one hand and Germany on the other hand are now (1996) estimated to be 1 : 5 at market rates; they were 1 : 10 at some interval in the transformation process. In purchasing power parity, net wages in Poland and the Czech Republic are put at 40 or even 45 percent of the German level. For other countries such as Romania or Russia, wages at market rates reach only 10 or 8 percent of the German level, respectively (and 15 percent at purchasing power parity).

Income differences are under normal conditions a factor that leads to the movement of people. We know, however, that it is not only income differences in the Harris-Todaro tradition (1970) that can explain migration. The decision to migrate must be understood as an intertemporal maximization problem where the potential migrant searches for a maximum life time income, i.e. he maximizes the expected present value of his income during his life (Siebert 1993). Migration is to be compared to an investment decision. As a matter of fact, it is an investment relating to human capital. Consequently, expectations on how a migrant's future income will develop both abroad and at home come into play. If it can be expected that the economic situation at home will improve, the incentive to migrate is reduced. In that case there is a positive option value of waiting because, over time, differences in income per capita will become smaller.

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[2] According to their findings, the world capital market only bridges excess demand and excess supply of individual countries, but by and large investment of a country has to be financed through national savings.

[3] An interesting point is made by Baldwin et al. (1997). Uncertainty for private investment in the reform countries still requires a high risk premium. Becoming a member of the European Union reduces these risks because the reform countries would bind their economic policy. Baldwin et al. calculate the reduction in risk premium as 45 basis points.

15. Data on East-West migration including temporary work are sketchy and anecdotal. There are several salient features (Table A1).

— First, migration generally picked up after the onset of reforms, reflecting both more open frontiers and the uncertainty of Central Europeans about the outcome of economic reforms as well as large income differentials. As a result, the share of former citizens of the CEEC-6-countries plus Russia in the foreign population of Germany was 8 percent in 1996, up from 5.7 in 1988, reaching 9 percent in 1993.
— Second, migration started to subside after 1992/93. This is probably due to Central and Eastern Europeans realizing that reforms in their countries are for real, with first successes beginning to show (hence the option value of waiting increased), but also due to tighter German regulation of inward migration.
— Third, migration from the poorest and most sluggish reformers, Bulgaria and Romania, has been highest in relative terms. The number of Bulgarian and Romanian residents in Germany rose by a factor of 9 to 12, respectively, between 1988 and 1993. The share of Polish people, of Hungarians and CSFR-nationals remained relatively stable.
— Fourth, for Russians, migration has not yet started to subside, which is consistent with the ongoing economic crisis and political instability in that country.

This seems to confirm migration theory: the larger the income difference and the less promising the option of waiting, the stronger is the incentive to migrate.

16. Of course, a completely free movement of workers between Eastern and Western Europe does not exist. We can only speculate on the amount of migration that would prevail if people could move freely. In any case, migration would become smaller over time. Forecasts of migration to be expected are highly speculative. Migration scenarios (Deutsches Institut für Wirtschaftsforschung 1997) estimate the migration potential of the Visegrad-5 until 2030 at 5 million (with an actual population of 66 million) in a low migration scenario, and the migration potential of the CEEC-10 at 10 million (with an actual population of 105 million).

17. The additional supply of labor in the new region to be integrated into the world economy will have its repercussions on the EU-15 countries. A rather simple analysis can be undertaken with the concept of the factor price frontier. The factor price frontier is the combination of factor prices (for capital and labor) that are possible with a given technology. Thus, the maximum real wage is a declining function of the real rate of return on capital. A specific point on the factor price frontier represents a factor market equilibrium with full employment of labor and capital. Consider now the factor price frontier of Western Europe. With additional labor being available in Western Europe due to migration, the equilibrium relative factor price has to change; i.e. under *ceteris paribus* conditions the real wage must come down (relative to the real interest rate). Labor in Western Europe comes under pressure. Over time, the frontier may shift outward, induced, for instance, by technological efficiency gains from trade (Siebert 1997).
18. If the movement of people is considered undesirable, it is not sufficient to erect obstacles against the mobility of workers. It is necessary to reduce the economic pressures which will imply migration. As water follows the law of gravity, people will follow economic opportunities. One important mechanism that can ease the pressure

is capital mobility. Here, it is in the own interest of the new market economies to make themselves attractive for foreign capital. As they succeed in luring capital from abroad, they improve the productivity and wages of their workers and reduce the incentive to migrate. They must also aim to raise the savings rate at home. The other mechanism is to make exports more competitive; this, in turn, can be brought about by the EU opening up its product markets. If this is done, real income in the new market economies can rise, and again, the advantage of migrating becomes smaller. Thus, there is a cascade of adjustment mechanisms. Ceteris paribus, i.e. if nothing else is done, people will have a strong incentive to move. This mechanism will become less important if capital can be attracted, and even less if product markets in the European Union are completely opened up.

IV. Institutional and Policy Aspects

19. Finally I look at some issues of institutional economics and at the political economy of enlargement. Where are major obstacles for enlargement? How important are these obstacles?

Enlargement of the Internal Market

20. Except for agricultural and sensitive products, regional integration is already taking place due to the Europe agreements with ten reform countries, that is the individual members of the Visegrad-5 (and not the CEFTA, their free trade association), the Baltic States, Romania and Bulgaria. The agreements more or less establish a free trade zone with the EU in which tariff obstacles and quantitative restrictions are largely abolished. In addition, the Visegrad-5 have established their own free trade area, the CEFTA.

21. One major remaining problem for Europe Agreement Countries is that country of origin procedures still hamper trade; this is especially relevant since the reform countries continue to have a higher external tariff than the EU with 6 percent for the Visegrad-4 against 3.6 of the EU. Moreover, external tariffs rates differ (Poland 9, Hungary 6.9, Czech and Slovak Republic 3.8). In addition, the Europe treaties do not rule out that the European Union may use escape clauses and anti-dumping procedures if imports from Middle and Eastern Europe are large and if economic positions in the EU come under pressure. Thus, there remains a protectionist risk.

22. With respect to commodity trade, except agriculture, however, enlargement should not represent major problems. Opposition in the European Union should be small and even negligible for a number of reasons. Enlargement has already been prepared by the Europe treaties. Since trade is to a considerable part intra-industry trade, trade liberalization (and regional integration with the European Union) can lead to increased production in the same sector in both the EU and the reform countries; this means that opposition to liberalization should not be too strong. Moreover, with foreign direct investment coming from Western Europe, it is partly west European capital that exports to Western Europe.

23. Another issue is whether the "*acquis communautaire*" is appropriate for the reform countries and to what extent it will hinder economic growth and reduce employment. Moreover, from the point of view of the reform countries, the European Union is somewhat closed to the world market in some product lines using anti-

dumping measures as a protectionist device. These may be areas in which the CEECs have (or will have) a comparative advantage on a global scale. Their infant industry would thus not be exposed to international competition; viewed from the CEECs, the EU follows more the Latin American pattern than the Asian road of export orientation in these product lines. Therefore, there can be no doubt that the reform countries must be interested in a multilateral integration as well. Regional integration with the EU should not go against multilateral integration.

24. With respect to benefits from an intensified division of labor, simulation studies indicate that all countries, i.e. the EU and the reform countries, will benefit from integration. Theory would tell us that the small countries gain more because they experience the larger relative price changes. Indeed, simulation studies indicate that the CEECs gain relatively more (Baldwin et al. 1997).

25. Whereas trade and the movement of capital do not seem to create major problems in the case of enlargement, four problem areas exist: the free movement of labor, common agricultural policy, cohesion policy and the voting rules.

An Exemption for the free movement of labor

26. A first stumbling block is migration. Even though migration pressure seems to be smaller than feared initially, with the existing wage differences between Western and the most progressed Middle and Eastern European countries enlargement cannot immediately include the free movement of labor. This important freedom has to be phased in over time. Keeping in mind that convergence is a very slow process and that income per capita can be expected to differ for quite some time, the transitional period cannot be short, i.e. it should be in the range of 10–15 years. Possibly, quotas defining the right of entry to a national labor market in Western Europe have to be used; these quotas, which can be auctioned off in the new EU-member countries, should increase over time.

It must be pointed out that it will be difficult to delineate the (permitted) exchange of commodities from the (not permitted) movement of workers. The dividing line between these forms of interaction is blurred, and people will use their imagination to find forms of trade flows which are close substitutes to the mobility of people. Subcontracting in the construction industry is a well known example.

Common Agricultural Policy

27. The second major stumbling block for EU-enlargement is the common agricultural policy. It is true that since 1992 an attempt has been made with the MacSharry reform in the European Union to bring price floors somewhat more in line with world market prices-paying compensations per unit of land and also per head of cattle or sheep (as a means of income). These compensation payments are, however, not yet uncoupled from production. Moreover, compensation should have been conditioned to the development of world market prices. Possibly, the EU will come under greater pressure in the WTO negotiations starting in 1999 to further reduce production-stimulating compensations, especially after the US has abolished its deficiency payments in 1996.

In any case, CAP is still a mechanism producing excess supply relative to market conditions. If this mechanism is extended to the reform countries we can expect a sizable increase in the productivity of the agricultural sector there, especially since these countries tend to produce the heavily subsidized "northern" products. It is apparent that an extension of CAP to Central and Eastern Europe in its existing form will add to the already existing inefficiency and require additional funds. Estimates of yearly additional budget costs of an enlargement by the Visegrad-4 countries range from 4 billion ECU to 37 bill. ECU (Baldwin et al. 1997, Tangermann 1997). Baldwin et al. (1997, p. 154) put the consensus estimate at 10 bill. ECU. Tangermann (1997) expects CAP expenditure for the CEEC-4 to be around 13 bill. ECU in 2005 (in 1993 prices).

28. It seems there are two options for agricultural policy in enlargement. One is that the agricultural policy of the EU is reformed before enlargement takes place. The other option is to exclude agriculture from enlargement completely or to practice a phased-in enlargement for agricultural products. The problem with such a waiver for agricultural products or a phasing in is that agricultural production would operate under different conditions in two parts of an enlarged European Union. One approach would be to have different prices using border controls. This would be a severe obstacle to a common market in the non-agricultural goods. The other option would be to practice a different approach to agricultural policy in the new member countries in applying other policy instruments there, such as quantity controls of production. It is difficult to envisage quantity controls on production in the new member countries; it is equally difficult to keep farm income in the CEECs low by other instruments (such as producer price reductions in case of oversupply). To sum up, a reform of the European Common Agricultural Policy is a precondition for enlargement; at the minimum, a reform should be credibly under way before enlargement begins.

Setting such a condition cannot mean that the agricultural lobby is put into the position of preventing the enlargement of the European Union. Care must be taken to prevent an increased threat potential of the agricultural sector in the political bargaining of enlargement.

Cohesion and Structural Funds

29. The extension of cohesion policy to the CEECs is another hard nut. The structural fund (European Fund for Regional Development, European Social Fund, European Agriculture Fund with an annual budget 1997: 24.0 bill. ECU) and the cohesion fund (annual budget 1997: 2.5 billion ECU) account for 29 percent of the EU-budget, that is 0.4 percent of GDP of the EU-15. Projecting the actual rules for transfers implies that the new potential members of the European Union would receive transfers for decades. Estimates for the Visegrad-4 countries range from 26 bill. ECU (Courchene 1993) to 13 billion per year (Baldwin et al.) for the structural fund alone. This amounts to 0.2 to 0.4 percent of EU-GDP. Other estimates are higher (33 billion ECU for the CEFTA countries, Deutsches Institut für Wirtschaftsforschung 1997).

30. The political economy of transfers suggests that enlargements have been used in the past also to extend the transfer items and the transfer budget. Before enlargement, due to unanimity, the yes-vote of those countries who are current recipients of transfers and who may lose their income per capita status is needed; thus it has been estimated that 45 million people in Western Europe would lose their objective 1 status in the structural fund due to a changed average of an enlarged union. Since these countries have to agree to an enlargement they demand compensation for future losses. If they are successful, the actual programs will be extended.

After enlargement "the poor-4 will become the poor-9" — as Baldwin et al. put it (1997, p. 165). Greece, Ireland, Portugal, Spain, the Czech Republic, Hungary, Poland, Slovakia and Slovenia will have 40 percent of the 112 Council Votes in the EU-20 and consequently have a blocking minority. Thus, there will be a strong political demand for structural and cohesion policy.

As an alternative, one could envision excluding the new members from cohesion policy (including the structural funds) for an interim period. This, however, would be difficult to justify because they then would have an artificially created locational disadvantage relative to other European regions.

31. As a consequence, it is necessary to change the rules:

— First, one should clearly distinguish between the cohesion fund and the structural fund. The cohesion fund, according to article 130d, is intended to promote convergence; it provides transfers in the areas of the environment and transportation infrastructure to the four countries with a per capita-GDP of below 90 percent of the EU average, that is Greece, Ireland, Spain and Portugal (with Ireland approaching the EU-average). Since the cohesion fund is directly linked to improving the convergence conditions for monetary union, it should not be extended to the CEECs. They definitely will need the exchange rate as an instrument for adjustment in the future and they cannot possibly be included in the monetary union soon. An alternative would be to lower the required percentage to 70 percent of the EU-average. This would exclude Ireland, Spain and Portugal from the cohesion fund.
Of course, this may be the wishful thinking of an academic. I am well aware that a currency union is associated with higher transfers; thus it is likely that there is a strong political demand for cohesion finance. In any case, this does not apply to the reform countries because they will remain out of the monetary union for a long time.

— Second, the structural funds must be reformed. The structural funds now extend to 50 percent of the EU-population (the zone-1 criteria to 25 percent). This clearly shows that the structural funds have degenerated to an all-encompassing watering can, having lost their original intent. The subsidiarity principle should be used: This means that regions are helped by nations, and nations are helped by the union. The correct way to implement the subsidiarity principle is to discontinue regional support by Brussels completely. Instead, a vertical transfer systems from the EU to the countries should be intiated with the individual country helping its regions. Concomitantly, the structural transfer for zone-1 should be nationalized. Other items of structural funds (targets 2-5) should be given up.

32. This still leaves the question of what a transfer system between the EU and individual nations should look like. With an enlarged European Union of 20 or even more, we cannot possibly aim at a homogeneous space in terms of GDP per capita. It seems to me that in such a heterogenous economic space a lower floor for income per capita at 60-70 percent of the average must be accepted.
33. During the catching up process the absorption capacity of new members should be taken into account. Whereas transfers are expected to be between 2-3 percent of GDP for Greece, Ireland, Portugal and Spain in the next years, a pure extension of the structural funds would imply 6,7 percent for the CEFTA-5 (Deutsches Institut für

Wirtschaftsforschung 1997). This is likely to lead to a waste of resources; thus a cap for transfers is required, for instance a cap of 3 percent of GDP.

Decision Making in an Enlarged Union

34. The final issue is decision making. Enlargement implies that it will become more difficult to make decisions. According to Article 148, there are three different types of majority:

— If not stated otherwise, the majority of votes of the Member States is needed. This is 8 out of 15.
— For a qualified majority in a specific competence, the majority of the weighted votes of the Member States is required, i.e. 62 out of 87 if the Council acts in response to a Commission proposal (and at least the votes of 10 Members if the Council does not respond to the Commission). The allocation of votes does not correspond to population in a strict sense.
— Unanimity is required in the areas of new members, taxation and fundamental rules. Of course, the unanimity principle in the area of taxation is at the heart of national sovereignty or of political union. Besides, there seems to be a consensus, not to take votes and to continue negotiation, whenever a vital interest of a member state is involved.

35. In an enlarged European union, the veto power that each country has due to the principle of unanimity becomes a powerful hindrance eventually meaning that no decision can be taken at all. For qualified and normal majority, the EU becomes more heterogeneous. The common denominator gets smaller, and smaller eventually becoming meaningless. Therefore, the institutional framework of decision making has to be redesigned. This, however, will not be easy for a number of reasons.

— First, it is questioned whether renouncing on unanimity would ultimately consolidate the integration process (Seidel 1997). The "optimum majority rule" is intended to minimize decision costs, i.e. the costs arising from the inability to reach decisions as well as the costs of disregarding the minority interests of countries. Thus, the longstanding debate on the pros and cons of the unanimity principle reflects the dilemma of European decision-makers who are caught between the inefficiency of the consensus principle and the protection of vital national interests. A second-best solution to this dilemma may be the introduction of the "unanimity minus one rule". In this model, unanimity is deemed to exist in spite of the veto of one Member State. It reflects the idea that no single member state should be in a position to veto a unanimity-based decision (however, see below).
— Second, Europe does not have a constitution; decisions with a qualified majority of the European Council or a "unanimity minus one rule" can run into conflict with national constitutional law in areas of "vital interest". Thus, it is not possible, in the opinion of Germany's Constitutional Court, to legitimize — in a sufficiently democratic way — decisions of the Council that have been adopted against the will of Germany. This position makes the rule "unanimity minus one" impossible.

Without major changes in the democratic legitimization of the European decision making process relating to the role of the European parliament and a European "people" as a sovereign (Grimm 1997), the unanimity principle cannot be given up.

36. In contrast to the area of unanimity, it may be easier to find a solution in the arena of normal and of qualified majority. Assuming that in enlargement the allocation of new voting rights will follow the established pattern, Poland with a population of 40 million will have 8 votes (like Spain), the Czech Republic and Hungary 5 votes (like Belgium), the Slovak Republic 4 votes and Slovenia 3 votes. Altogether, the Visegrad-5 will have 25 votes out of 112 votes in the EU Council. Applying the same percentage for a qualified majority as in the EU-15, qualified majority would be at 80 votes with a blocking possible by 33 votes. In order to make decisions possible, the qualified majority will have to be put at a somewhat lower percentage.

37. A mere continuation of the current weighting of votes after an Eastern enlargement would mean that Council decisions can be taken by a qualified majority of member states against a minority of other member states representing a majority of the European population. Thus, the next intergovernmental conference cannot do otherwise than reweight the votes in the Council. Several models are currently discussed to this end, most importantly of all the introduction of a so-called "double majority". According to this model, for a majority decision to be valid, not only a majority of states but also a majority of the European population represented by these states would be necessary.

V. Deepening versus Enlargement

38. In a historical perspective, deepening of the EU-institutions in the EU-15 should be a vehicle to promote enlargement, to make enlargement more likely and more successful. It should not be a mechanism to block enlargement. After all, the vision for deepening was conceived in the eighties when the option of enlargement was completely unrealistic.

Enlargement of the European Union is a grand historic opportunity, a chance that should not be missed. This holds from a purely economic perspective, it also holds in political terms. Enlargement secures freedom to the peoples east of the Oder and along the Danube, enlargement is instrumental in providing economic and political stability to Central and Western Europe. A failure would perpetuate a power vacuum in Central Europe (Baldwin et al. 1997), it would have severe repercussions for Western Europe.

The enlargement of the European Union is one of these moments when history is rushing by. To this opportunity Bismarck's famous sentence can be applied: "You cannot do more than wait until you feel the step of God in history, and then jump forward and attempt to seize the tail-end of his coat".

Table A1 — Proportion of foreigners from Central and Eastern Europe in foreign population Germany, in percent

	1988	1993	1996
Poles	3.82	3.79	3.87
CSFR-Nationals	0.62	0.91	0.77
Hungarians	0.59	0.90	0.76
Rumanians	0.40	2.36	1.38
Bulgarians	0.10	0.82	0.49
CEEC-6	5.53	8.79	7.29
Russians[a]	0.19	0.26	0.75

[a]1988: Soviet Union

Source: Statistisches Bundesamt; eigene Berechnungen.

Table A2 — Allocation of Votes[a] in the EU

	Votes	Population (in million)
France	10	58,2
Germany	10	81,6
Great Britain	10	58,3
Italy	10	57,3
Spain	8	39,2
Belgium	5	10,1
Greece	5	10,2
Netherland	5	15,5
Portugal	5	9,9
Austria	4	8,1
Sweden	4	8,8
Denmark	3	5,2
Finland	3	5,1
Ireland	3	3,6
Luxembourg	2	0,4
	87	
Poland	8	38,6
Czech Republic	5	10,3
Hungary	5	10,2
Slovak Republic	3	5,4
Slovenia	3	2,0
	112	

Allocations of votes to new members according to the population size of existing members, see Baldwin et al. 1997.

Table A3 — Qualified Majority

	Votes	Qualified majority votes	in percent of votes
EU–12	76	58	76
EU–15	87	62	71
EU–20[a]	112	80	71

[a]Assuming the same percentage as in EC–15.

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