Europe: the 1990s and beyond

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Abstract

The paper raises geographic and political issues of Europe, analyses integration processes that will take place when Central and Eastern European countries join the European Union. The author arrives at conclusion that new country-members will gain advantages after implementation of reforms, forecasts political and economic consequences of Europe's enlargement. The model of successful reforms has been worked out provided revenues and losses of oligarchs, their accomplices, civil servants, new market participants, and application of a new tax system. Done calculations prove that European enlargement brings significant economic advantages to new entrants and minor ones to others.

Key words:

Borders, criteria for accession, economic implications, Europe, European identity, judicial system, enlargement, the European Union, state sector, legal sector of economy, oligarchs, private property right, reforms, Russian-speaking population of the EU, shadow sector of the economy, taxes, tax burden, paradox of partial reforms, to seize the state power, transformation, U-curve of income.

1. What is Europe?

It is quite common to talk about Europe, the European Union, Western Europe, and Central and Eastern Europe. It is not quite clear, however, what most of these terms mean. Geography is a matter of social construction. The European Union is not a geographical notion, but a well-defined political concept because of its

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membership of 15 countries. The other terms just mentioned are geographic rather than political in character. They are less clear than they seem at first sight. For example, Israeli and Turkish football clubs participate in European soccer competitions. The Eurovision Song Contest also includes participants from Israel and Turkey. This suggests that Israel and Turkey are European countries. It seems likely, however, that many people would not consider these countries part of Europe. Yet, Turkey is a candidate-member country of the European Union, even though nearly all its territory is located on the Asian continent.

European borders seem subject to ebb and flow (WRR, 2001). This pertains in particular to the eastern borders, of course. In the Middle Ages Europe was generally described as extending to the river Don. In the early 18th century the border shifted eastwards, on the grounds that the Urals were a more «natural» border. Analytical geographers employing other environmental criteria again subsequently criticized the resultant conclusion that Russia forms part of Europe. The lack of consensus concerning the geographical borders is undeniably related to the fact that geography remains a matter of social construction.

Definitions of Europe on the basis of historic-cultural criteria provide no less elastic borders. Generally, the shared experience of Christianity and the common culture to which this has given rise played a prominent role in drawing cultural boundaries. Various authors add divergent combinations of building blocks from European cultural identity, including the Renaissance, the Reformation, the Enlightenment, and the French Revolution (Hoggart and Johnson, 1987). Countries that have not shared this series of experiences do not qualify for the hallmark «European». Again, subjectivity results in a variety of lists and the contours of Europe depend on the country in which these are drawn up. The post-communist governments proved optimistic in assuming that their cultural definition of Europe – to which they considered to belong and to which in the words of Vaclav Havel they 'wished to return' – was shared by West Europeans (Wallace, 2000, p. 479). A further complication to a cultural approach towards the accession problem is that the European culture is certainly not monolithic. There are major differences between the various regions.

Thus, Europe's borders cannot be determined on the basis of geographical or historic-cultural considerations. At the same time it cannot be denied that the European Union functions by the grace of member states that consider themselves to be part of the European family and in which the welfare of all is an important consideration for each individual member state. The shared European identity – however mythical this may be given the pronounced diversity within the European Union – contributes to what Weber termed *Gemeinsamkeitsglaube* and also feeds mutual confidence and solidarity. In the context of globalization and proliferation of multilateral and interregional organizations, the European Union fulfils a specific regional function, which no other organization fulfils or is capable of serving.

In view of these considerations it is not surprising that the European Union so far refrained from coming up with an official geographical and/or historic-cultural definition of the concept of the «European State». In 1992, the European

Commission argued that the term Europe refers to geographical, historical and cultural elements all contributing towards the European identity. However, it rejects a static definition, as evidenced by the comment that the common European experience of proximity, ideas, values, and historical interaction cannot be condensed into a simple formula and that each new generation must redefine this anew (European Commission, 1992, p. 11). In doing so, the Commission also accepts a certain geographical flexibility of the EU – its contours will only become clear after many years, and it is neither possible nor opportune to finalize the borders at the present time.

2. Transition in Central and Eastern Europe

After the fall of communism a debate started about enlarging the European Union towards the East. Obviously, the Central and Eastern European countries were in serious economic trouble after the fall of communism. The transitional recession in Central and Eastern Europe – whatever the region is defined – has been long and diverse. The common heritage of communism implied that all countries in the region began their transition with a productive system adapted to the requirements of a command economy, not to a competitive environment. Price signals were generally wrong. Given this environment, many sectors and enterprises were not viable after price liberalization. Two challenges had to be faced (World Bank, 2002):

1. The imposition of market discipline on inherited enterprises, so that they would face the incentive to restructure and, in doing so, become more productive and able to compete at the new prices. Failure to do so should lead to closure.
2. Encouragement to create new enterprises willing and able to compete in the marketplace without seeking special favors from the state.

The fall in GDP in the early 1990s was dominated by the drag of old enterprises. Initial conditions were significant factors during the initial period of output decline. Policy reforms, however, have also been significant factors in differences among countries in the speed of economic recovery.

The first impression of what happened in the 1990s gives Table 1 displaying the change of GDP between 1989 and 2002. It should be noted that given the notorious allocative inefficiency of the centrally planned economies a fall of real GDP is not identical to a decline in the standard of living. A decrease of the production of weapons and barbed wire, for example, does not necessarily reduce the welfare of individuals. Nonetheless, the transition from centrally planned to market economies has proved to be painful. Initially, GDP decreased considerably in Central and Eastern Europe, but grew from the mid-1990s. In 2002, GDP exceeded its 1989 level in a number of countries, in some cases considerably (Poland and Slovenia). The picture is less favorable in Southeastern Europe. In Bulgaria and Romania GDP is still below its 1989 level. The same holds true for the Baltic countries, though Estonia has come close to the 1989 level. The slowest development can be observed in the Commonwealth of Independent States (CIS). The lack of structural reforms seems the most obvious cause of the slow recovery in Southeastern Europe and the CIS. Developments are very diverse, however, in the CIS countries. The recovery has hardly begun in Moldova and Georgia, while Ukraine is the third slowest recovering country in the CIS. Turkmenistan and Uzbekistan are the only CIS countries where GDP seems to have exceeded the 1989 level. They are curious exceptions, since reforms – if any – are very slow in both countries. I would not be amazed if the statistics appear to be flawed and erroneous. This caveat pertains to all CIS countries, although to a varying extent.

Table 1.

Estimated level of real GDP in 2002 (1989=100)

Czech Republic	109
Slovakia	114
Hungary	116
Slovenia	124
Poland	130
Bulgaria	83
Romania	87
Lithuania	76
Latvia	78
Estonia	94
CIS	67
* Moldova	38
* Ukraine	48
* Turkmenistan	109

Source: EBRD (2002).

Ten years of economic reform underline the fact that the elementary institutional reforms of the transitional phase need to be taken further in order to guarantee the persistence of the recovery. The level of flexibility and uncertainty is high. Old, inflexible but predictable institutions of the formal planning system have largely been dismantled, while new, stabilizing market institutions are still in their infancy. Institutional deepening is thus needed. This would mean that new, formal rules and institutions of the market economy and democratic system will function more effectively and that the social actors will gear their behavior and standards increasingly to that system. Fighting corruption and crime is also important. A substantial portion of corruption may be traced back to discretionary government intervention and regulation, including subsidies and licenses. Natural government monopolies and public tendering provide classical examples of situations in which large-scale corruption is commonplace at higher levels of government (Mauro, 1997). In general, inadequate institutions and undue economic intervention by an inefficient government lacking public confidence enhance the risk of excessive corruption. Reduction of all kinds of protectionism and strengthening of the democratic, legal and administrative capacity may help in fighting corruption. One thing is certain: the transition will take more time.

3. The political economy of reform

The political economy of reform can be expressed graphically by tracing the paths of winners and losers from the transition (World Bank, 2002). Figure 1 depicts the gains and losses in income accruing to three different constituencies at different stages of reform in a typical transition economy:

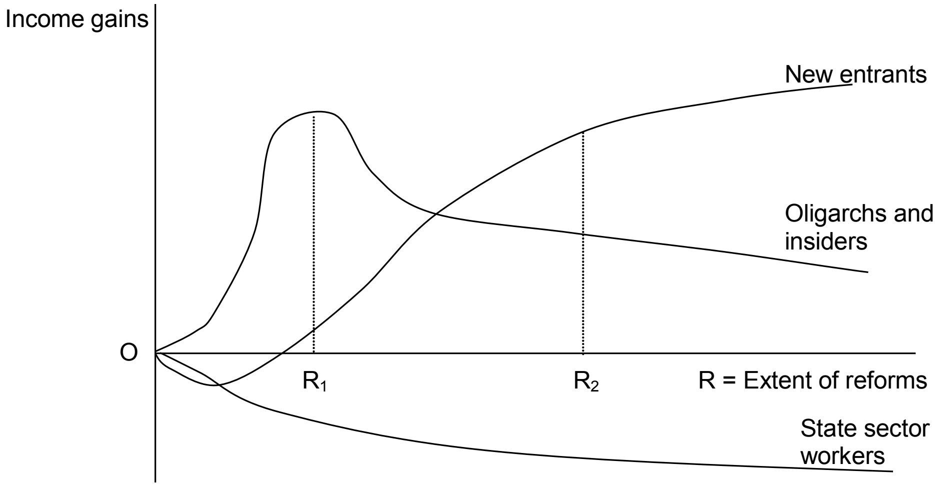
1. State sector workers, employed in state enterprises and lacking the skills to become new entrants in the competitive market. They face a sharp drop in income as market discipline on inherited enterprises calls for downsizing the sector, with little hope of any substantial recovery with the intensification of reform.

2. Potential new entrants, workers in state enterprises and new entrepreneurs with skills to become new entrants in the competitive market. They have a classic J-curve pattern of income. They face significant adjustment costs at low levels of reform as they exit the state sector. In addition, they realize gains only when enough progress has been made with policy and institutional reforms to promote and support new entry into the competitive market.

3. Oligarchs and insiders. They begin the transition with substantial de facto control rights over state assets, while they have close ties with the political elite inherited from the previous command system. However, because of limited skills to compete in the market economy, they face an inverted U-curve of income gains. They are the immediate beneficiaries of liberalization and privatization, as de facto control rights over state assets can be converted into de jure control and cash flow rights. They reap concentrated gains in the early stages of reform from the opportunities for arbitrage and rent seeking that arise if liberalization and privatization are not combined with market discipline and encouragement. But these gains dissipate as further reforms lead to increasing competition and market entry.

Figure 1.

Winners and Losers from Reform



R_1 = point at which income gains of oligarchs and insiders are maximized
R_2 = level of reforms that allows the winners of reforms beyond R_1 (new entrants) to compensate for or exercise enough political pressure to neutralize the resistance of oligarchs, insiders, and state workers.

Source: World Bank, 2002, p. 93.

Given these patterns of gains and losses, each constituency prefers a different combination of reforms. For potential new entrants, the reform process offers only sacrifices at the beginning of the reform process, but gains when the reforms are further advanced. State sector workers prefer the status quo (point *O*), so they reject all reforms. Oligarchs and insiders prefer a partial reform and sustain the reform process through R_1, the point where their gains are maximized. Beyond this point further implementation of policy of market discipline and encouragement threaten to undermine gains from rent seeking. It is precisely such partial reforms – liberalization without market discipline and with selective encouragement – that make capture of the state by oligarchs and insiders a self-fulfilling prophecy. This has led to a so-called partial reform paradox in many transition economies in which governments lack credibility and are highly susceptible to state capture. If potential new entrants believe at the outset of transition that oligarchs and insiders will be able to block anything more than partial reforms, they will discount substantially the potential gains from any proposed radical reforms. Therefore, they will support partial reforms that offer lower costs early in the reform process, even though they are more likely to lead to barriers to entry. Public support for radical reforms thus depends on perceptions of government credibility in its commitment to follow through with such reforms.

This analysis leads to the conclusion that there is a high risk of getting stuck at a low level of reform (R_1) characterized by liberalization without market discipline and limited encouragement of new entry. As both insiders and state sector workers face declining incomes after R_1, these groups have a strong incentive to join forces to oppose further economic reforms. It is only when reforms reach a critical threshold (for example R_2) that the added gains to new entrants are enough to allow these winners to either compensate the losses of the other groups or to generate enough political pressure to neutralize opposition to continued reform.

By recognizing that different combinations of reforms produce different configurations of winners and losers, the framework of market discipline and encouragement suggests two political challenges in promoting economic reform:

1. Securing the support of potential new entrants for comprehensive reforms until wider efficiency gains from discipline and encouragement are realized.

2. Preventing the early winners from liberalization and privatization from undermining further reforms that would impose discipline and encourage new entry and competition and thus reduce their rents.

To advance reforms, governments should focus on smoothing the curves of winners and losers at the initial stages of reform as shown in Figure 1. This means lowering the adjustment costs for potential new entrants and reducing the high concentration of gains to oligarchs and insiders. One way to do this is by strengthening the provision of basic public goods, such as secure property rights and a legal and judicial system. This stresses the significance of institutional and legal transformation. Another way is by reducing excessively high marginal tax rates and broadening the tax base that promotes entry of enterprises from the unofficial to the official economy. This can break the vicious circle of informalization, lower tax revenue, and further intensification of tax rates on a shrinking base. It goes without saying that developing a rule-based tax administration to enforce efficient taxation of the new private sector is also important. The more successful transition countries are in advancing reforms by smoothing the curves of winners and losers at the initial stages of reform, the more successful their accession to the European Union will prove to be.

4. Enlarging the European Union

Apparently, the European Union is attractive to most European non-member countries. It is tempting to state that Norway has been very smart by not joining the EU. It is a member of European Free Trade Association (EFTA), while EFTA and the European Union have formed the European Economic Area. This implies that EFTA members have free access to the European Union market and thus enjoy the benefits of a larger market, while they retain some independence in areas such as monetary and foreign security policy. Moreover, they do not have to bear the financial burden in the form of contributions into the European Union budget. Why, then, did most of the EFTA states join the European Union in 1995? First, as EFTA members they did not participate in the process whereby internal market rules were set. As a result, they had to accept them as they had been enacted without the possibility to influence the drafting of the rules. Second, political neutrality lost much of its significance after the collapse of the Soviet Union. To countries such as Finland, Sweden, and Austria neutrality was not a meaningful issue anymore and, thus, no obstacle to their admission to the European Union in 1995. On the contrary, Finnish voters probably voted for the European Union accession primarily because of political concern about Russia's intentions. Participation in the European Union's Common Foreign and Security Policy was no challenge to any of these countries after the ending of the Cold War.

The next European Union enlargement mainly pertains to Central and Eastern European Countries. Eight countries in the region – Estonia, Latvia, Lithuania, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia – and two mini-states in the Mediterranean – Malta and (the Greek part of) Cyprus – will join the European Union in May 2004. The acceding countries will need to apply to join the European Economic Area, while this accession should take effect at the same time as the accession to the European Union. The enlarged European Union will have direct frontiers with Russia as well as borders with Ukraine, Belarus, and Moldova. It will also enjoy direct access to the Black Sea, which will lead to intensified contacts with countries of the Caucasus and Central Asia. The enlarged European Union will also surround the Kaliningrad oblast, which is part of Russia. After the enlargement the European Union will have several hundreds of thousands of Russian speaking citizens, living mainly in Estonia and Latvia. Thus, it will be important for the enlarged European Union to deepen its relationship with Russia, Ukraine and other CIS countries. Accession of Ukraine and other CIS countries is another story, however, and seems highly unlikely in the foreseeable future.

The European Union assesses the preparedness for membership of the 10 applicant countries from Central and Eastern Europe[1] on the basis of the three Copenhagen criteria (from June 1993): a political criterion, an economic criterion, and the ability to take on the *acquis*[2]. As the applicant countries progressively adopt the *acquis communeautaire* in preparation for membership, they are given an opportunity to participate in European Union programs. This is

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[1] In addition to the countries that will join the European Union in 2004 Bulgaria and Romania applied for membership, but their indicative date for accession has been set at 2007.

[2] These criteria are:

1. The stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities.
2. The existence of a functioning market economy, as well as the ability to cope with competitive pressures and market forces within the European Union.
3. The acquis: the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

provided for in the Europe Agreements. The gradual integration of the Central and Eastern Europe countries into different programs enables their representatives to become more familiar with European Union legislation and proceedings and to take advantage of member states' experience in areas such as public procurement, the right of residence and VAT. Nevertheless, this does not imply giving decision-making power to countries that are not yet members of the European Union.

Never before has the European Union envisaged an enlargement of such dimensions. The enlargement of 2004 will add 75 million people to the European Union's population of 370 million. The number of applicant countries and the differences between them are also greater than ever before. Their average GDP per capita is nearly 40% of the European Union average in 2001 and total GDP of the European Union would rise by nearly 5% (European Commission, 2002). The combined GDP of the eight new members in Central and Eastern Europe with their population of 75 million is lower (approximately 82%) compared to that of the Netherlands alone (with its population of 16 million). After accession all new member states will be net recipients of European Union funds.

The Central and Eastern European countries will need to prepare themselves for participation in the monetary union once they have joined the European Union. Table 2 summarizes both the *acquis* to be adopted by the new member states and the well-known criteria for accession to the Economic and Monetary Union (EMU). The EMU has set in train an enormous deepening of the internal market and has resulted in divergent processes of European policy coordination. The European Union member states' budgetary policy is constrained by the Stability and Growth Pact. So it limits member states' latitude to pursue their own budgetary policy. Furthermore, it compels countries to draw up multi-year convergence programs and to take part in the new exchange rate mechanism (ERM-2) some time after accession. Within this system the new member states must maintain a fixed but adjustable parity (central rate) for at least two years between the national currency and the *Euro* within a range of plus or minus 15%. This is a formal prerequisite for qualifying for joining the EMU.

Since national monetary policy is no longer possible, economic fluctuations in the EMU must be absorbed by other instruments, such as enhanced flexibility of prices and/or wages, and increased labor mobility between sectors and between regions. The obligations of Central and Eastern European countries not only pertain to their exchange rate policy and economic policy, but also to more or less regulatory dimensions. These dimensions include the existence of central bank independence, a ban on central bank direct monetary financing of budget deficits, and the prohibition of privileged government access to financial institutions.

Table 2.

Criteria for accession to the Economic and Monetary Union

Adoption of the acquis communeautaire	Maastricht convergence criteria
Central and Eastern European countries must adopt the acquis, especially: • Exchange rate policy is of common interest; take part in economic policy co-ordination • National central bank legislation cannot counter the independence of the ESCB • Capital movements must be liberalized before accession • Rules and supervisory mechanisms for a healthy banking system and effective financial system must be introduced	• Government deficit: < 3% of GDP • National debt: < 60% of GDP • Exchange rate: within normal fluctuation margins of the EMS; no unilateral devaluation or revaluation • Long-term interest rate: not more than 2%-points higher than that of no more than 3 member states that have performed best (sustainability of convergence) • Price stability: inflation cannot be more than 1.5%-points higher than that of a maximum of 3 member states that have performed best

Most of the applicant countries have already adopted a part of the necessary legislation to bring their monetary system in line with the requirements of the EMU *acquis* and the Maastricht conditions. This applies in particular to safeguarding the independence of the central bank, excluding the possibility of privileged government access to central banks, and strengthening the supervision of the financial sector. Several of the applicant countries are in fact already in compliance with a number of convergence criteria and/or have anchored their exchange rate to the *Euro* or have taken the *Euro* as the reference currency in a system of floating exchange rates.

5. Economic implications

Enlargement of the Monetary Union will most likely offer both static and dynamic prosperity benefits that are comparable to the long-term advantages of introduction of the *Euro*. For trade and investment within the region it will mean the disappearance of damaging exchange rate fluctuations as well as the transactions costs associated with the conversion of currencies. The problems and risks of enlargement can be expected to occur primarily in the short and medium term in the run-up to *Euro* participation. This should be considered against the background of the dynamics brought about by the Maastricht Treaty. This treaty aims at further broadening and deepening of economic integration and reformulation of economic objectives, including sustained non-inflationary growth, convergence in economic performance, price stability, healthy public finances, favorable monetary conditions, and balance of payment equilibrium. To this end the treaty outlined a provisional program consisting of three stages. As a result, the EMU's monetary policy has been centralized, the political independence of the European Central Bank (ECB) has been guaranteed, and the ECB is required to pursue policy giving priority to the goal of price stability over any other economic goal.

The Dutch Central Planning Bureau (CPB, 2001) has adopted a computable general equilibrium (CGE) model for the world economy (WorldScan) to explore the implications of European Union enlargement. This model makes an explicit distinction between a number of regions, including the European Union on the one hand, and Poland, Hungary and the other Central and Eastern European accession countries[3] on the other hand. In exploring the economic impact of the European Union enlargement with this model, economic variables in 2020 are compared with the results in a baseline scenario. In the baseline, the GDP growth is based on long-term projections of the World Bank. Three shocks of the European Union enlargement are:

1. A gradual removal of the remaining formal trade barriers in agriculture and food processing and the adoption of the common external tariff (CET). Accession of the Central and Eastern European countries to the European Union implies a move from an almost free-trade area towards a customs union. This means that all remaining bilateral formal trade barriers will be abolished.

2. Accession to the internal market.

3. Free movement of labor.

Table 3 shows the long-term effect of these shocks of the European Union enlargement on GDP. To put the effects of these shocks into perspective, the effects of the Europe agreements (i.e., the removal of formal bilateral trade barriers in manufacturing) have been included in the last column. As the bottom line shows, third countries appear hardly to be affected, so we can focus on the effects on the European Union and the accession countries. The effect of elimination of bilateral tariffs and the adoption of the common external tariff on GDP is larger for Poland than for the other applicant countries. This results from the fact that the initial bilateral tariffs between the European Union and Poland are higher than those between the European Union and the other accession countries (so that more efficiency improvements can be reaped). The GDP-effects of accession to the internal market are substantially larger than the effects of moving towards a customs union. Moreover, they are for the applicant countries approximately twice the size of the effects of the Europe agreements. These large effects are due to the following reasons:

[3] The Czech Republic, Slovakia, Slovenia, Bulgaria, and Romania. The Baltic States are not included in the analysis, since the data neither distinguishes these countries as separately nor as a block.

Table 3.

Long term effect (in %) on real GDP of three shocks of the European Union enlargement and Europe agreements

	Customs union	Internal market	Free movement of labor	Europe agreements
Hungary	1.9	9.0	–1.3 (0.8)[a]	5.6
Poland	4.3	5.8	–1.4 (0.6)[a]	2.3
CEEC-5[b]	1.0	3.4	–2.3 (1.1)[a]	1.9
EU-15	0.0	0.1	0.6	0.1
Third countries	0.0	0.0	0.0	0.0

a. GDP per capita.
b. The Czech Republic, Slovakia, Slovenia, Bulgaria, Romania.

Source: CPB (2001).

1. The shock is large compared to the formal barriers to trade.

2. Accession to the internal market refers to a reduction in real trade costs, whereas formal trade barriers reflect distortions in relative prices.

3. Higher return to capital and lower production cost of investment lead to additional investment.

Finally, the migration shock (free movement of labor) results in a drop of *total* GDP in the accession countries because of the outflow of labor. GDP *per capita*, however, increases due to the reduced labor supply. Since capital is not perfectly mobile across countries, the lower labor supply leads to an increase of the capital/labor ratios in the applicant countries, which raises the marginal product of labor and thereby wages. For similar reasons, GDP per capita in the European Union decreases. The lower capital/labor ratios cause a decline in labor productivity and thus a fall in wages. The effect is small, however, because of the modest increase in the population size. *Total* GDP increases slightly in the European Union as a result of the population growth.

Overall, the economic implications for the applicant countries tend to be significant. Though the exact size of the effects depends on specification of the model and is subject to debate, it seems obvious that the economic effects of enlargement of the European Union are considerably larger for the accession countries than for the European Union. Compared to the customs union and free movement of labor, accession to the internal market yields the largest economic effects. If the impact of the three shocks of enlargement for the Central and Eastern European countries is taken together, the GDP per capita increases by more than 8% in the long run. The effects for European Union countries are generally positive, though very small. The Dutch GDP per capita, for example, rises by a mere 0.15% in the long run. Once again, this suggests that the economic benefits of the European Union enlargement mainly accrue to the accession countries rather than the current European Union member states.

From a strictly economic point of view, the European Union will hardly be affected by enlargement. It does not matter to European Union countries – or for the *Euro* area members – whether the applicant countries in Central and Eastern Europe join the European Union and/or the *Euro* area or not. Even if trade with the ten applicant countries in Central and Eastern Europe doubles over the next decade, as can be expected, it will remain small compared to intra-European Union (or intra-*Euro* area) trade and a small fraction of the *Euro*-area's external trade. It is unlikely that the applicant countries could damage the European Union because their financial systems are minuscule compared to that of the current *Euro* area and because their banking systems are increasingly dominated by institutions from the European Union. Enlargement may create institutional problems, however. The governing council of the ECB, for example, would then comprise 33 members (6 from the Executive Board of the ECB plus 27 governors from national central banks – including Malta and Cyprus). This issue is similar to the general issues raised by enlargement for the governance of the European Union of more than 25 members. The European Commission cannot function well if it would grow even larger than its current 20 members.

Thus, the enlargement process seems more important politically than economically. The European Union's main reason for existence has been and still is to create and preserve stability in Europe. Similarly, the rationale behind the currently envisioned enlargement is not the transfer of money to the Central and Eastern European countries, but the preservation of stability in the new Europe.

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