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THE EASTWARD ENLARGEMENT OF THE EUROPEAN UNION

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Abstract.

In this paper I will try to show that the EU enlargement from 2004 is not a good economic move for eight newcomers from Central and Eastern Europe (CEECs). It is unlikely that newcomers will get larger FDI, speed up their economic growth and catch up with richer EU countries, although this was broadly advertised both academically and by the EU "propaganda for happiness." The EU subsidies, intended to offset accession costs, turn out to be useless if not damaging for acceding economies, because they change the structure of incentives. So, instead of being rewarded for accession, accession countries are going to be punished twice. Firstly, by lower FDI and a persisting GDP gap. Secondly, by getting subsidies which worsen the situation. CEECs would be better off staying outside the EU and continuing to improve economic freedom and the rule of law. But even after they have acceded, there is still some space for reasonable objectives of the CEECs, due to unintended consequences of the socialist enlargement design.

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THE EASTWARD ENLARGEMENT OF THE EUROPEAN UNION

After more than 10 years of transition from communism to constitutional market democracy, eight countries from the Central and East Europe (CEECs) became members of the European Union (EU) on May 1, 2004.[1] Even before transition countries joined the Union, the main bulk of academic production in the field recommended integration by saying it was a good thing both for the Union and for these countries - in political, economic and any other sense.[2] One group of academic writers conceptualized full membership as a panacea for all CEEC problems – like Alice's trip to Wonderland. This probably had to do with the prevailing mentality in the CEECs and the rational constructivism of the European official academia. The EU bodies contributed to such a picture with their own "propaganda for happiness", which ignored or diminished problems and glorified the allegedly positive aspects of accession – a practice well known from the communist past. Strongly interested people cannot produce a balanced view. Intellectuals from acceding transition countries and the EU profit due to a higher demand for their services before, during and after accession. Eurocrats from Brussels profit from being paid well, for extending their rule to ten additional countries and running the game of EU25, which is less accountable than ever before. And some interest groups get subsidies.

The main finding of this paper is that for economically successful transition countries it would have been better to stay outside the EU, and to continue to improve the rule of law and economic freedom. This would be "first best" for the CEECs. But even after some CEECs have joined the Union they need not be delivered at the mercy of Eurocrats, since there is some space inside the Union for pursuing the above-mentioned reasonable objectives, either due to the nature of integration or due to some unintended consequences of the "fifth enlargement" from 2004. Acceding to the EU and

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[1] By working on this study I have enjoyed the generous hospitality of the ICER. I would like to thank Enrico Colombatto (ICER & Turin university), Svetozar Pejovich (Professor emeritus at the Texas A & M University), Slavisa Tasic (Free market center), Simon Teitel (Simon Teitel and Associates) and several participants at the EACES 2004-conference for helpful comments. Usual caveat applies.

[2] "It is commonly accepted view that further integration with the European structures will be beneficial to the CEECs in a political and economic sense." Maliszewska 2004, p. 6.

fighting from inside for more economic freedom emerges as “second best”. Inferior to “second best” is to accept heavy regulation and rent-seeking policies in exchange for subsidies and to join the over-regulated economies of the EU15.

In what follows, I will first consider the main economic reasons in favor of the CEECs joining the Union.[3] So, the advocates of the eastward enlargement pointed out that the CEE entrants would profit in economic terms for a number of reasons by:

i) getting larger investment and especially FDI;[4]

ii) increasing their growth rates and bridging the gap with the rest of the Union;[5]

iii) getting subsidies in order to offset accession costs.

None of that is true as we are going to show below (in the same order).

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[3] “The enlargement of the European Union will have a positive impact on the economy of acceding countries. (…) EU enlargement is expected to provide a significant further boost to economic growth and prosperity in acceding countries.” European Commission 2003, p. 5-6.
This view is strongly dominated the field and supported by larger think-tanks (Tinbergen institute, EUI, CESifo, WIIW, Jean Monet Center, ZEI, Robert Schuman Foundation, British CPS), the most frequently used textbooks on the EU (see books by D. Dinan, A. M. El-Agraa, Feldman & Watson, N. Nugent, Schneider & Aspinwall, D. Swann, W. & H. Wallace), by stuff at the university departments for European studies and by the most important non-market funds like IMF, WB, EBRD.

[4] “…it is obvious that integration does have a positive effect on trade and foreign direct investment (FDI) flows”. Kaitila 2004, p. 26. Breus (2000) estimated that, with full EU membership, FDI into CEECs could increase by up to 1.5 percentage points per year.

[5] “Full membership /of the CEECs/ is expected to accelerate economic growth via increased foreign direct investment (FDI), new trade within the enlarged EU, and aid from the EU budget, and other channels.” CESifo, 2004, p. 96. Wagner & Hloushova (2002) expect that even poorer members of EU25 will catch up in three or four decades. Lajour & oth. (2001) predict 9% and 5.8% rise of GDP for Hungary and Poland after accession, while Maliszewska (2004, p. 42) predicts a rise of GDP for two countries of 7% and 3.4% respectively. CESifo (2004, p. 99) cites even higher growth figures after accession that were stated by the EU Commission and some other studies.

I. Higher FDI

Let us first consider the question of FDI. This will be divided into two steps. In step one I will consider what happens with FDI[6] for selected newcomers until shortly before accession, since the post-accession data are not available now. Step two draws an analogy with the flow of FDI in some EU15 countries that were similar (i.e., less developed than other EU countries) to transition countries when they acceded some decades ago.

After the collapse of communism CEECs entered transition and started market reforms. Private investors reacted very positively to this change, especially where it was fast and deep. Since transition countries had not had enough accumulated capital they were directed to import it. FDI is a fast way of transferring know-how, organizational and managerial practices and creating products for the world market, but above all it is a crucial indicator of a country's integration into the global division of labor. In order to attract private FDI, countries needed to develop a good business environment, and how good they were at doing that is to be seen from the table below. As expected, FDI was generally on the rise in the CEECs throughout the 1990-ies, but it started to decline in 2002-2003. FDI peaked in CEECs in 2000 or 2001, while Hungary had two peaks in 1993 and 2001.[7] The peak for CEECs as a group was in 2002.

Table 1: FDI in 5 transition countries, 1989-2003, in million of dollars.

State	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Czech r.	-	-	-	983	563	749	2526	1276	1275	1275	3591	4477	5600	9300	3500
Estonia	-	-	-	80	156	212	199	111	130	574	222	241	307	307	800
Hungary	187	311	1459	1471	2328	1097	4410	1987	1653	1453	1414	1650	2730	1281	-85
Poland	-	0	117	284	580	542	1134	2741	3041	4966	6348	9299	6377	4335	3500
Slovakia	10	24	82	100	107	236	194	199	84	374	701	1500	1763	4620	700
Total	197	335	1658	2918	3734	2836	8463	6314	6183	8642	12276	17167	16777	19843	8415

Source: EBRD, Transition report, 2002; Global development finance 2004 (World Bank) for 2002 and 2003. Own calculation.

[6] One has to bear in mind that a small fraction of FDI may stem from foreign governments and non-market funds like the WB and EBRD, while the majority of FDI is a private investment.

[7] FDI in Hungary was negative in 2003, since the data do not include reinvested profit. FDI does include inter-company loans.

By designing policies to attract FDI in the 1990-ies some countries used subsidies[8] that were not legal according to EU law.[9] Even before accession, accession-candidates started to change their legislation in order to adjust it to the EU regulations.[10] Some investors anticipated a loss of subsidies and decided to leave candidate countries or not to go there in the first place. For that reason Hungary, Czech republic, Poland and Slovakia had lower FDI in 2003, compared to 2002. Total FDI in five countries fell from $ 19.8bn in 2002 to $ 8.4bn in 2003. FDI was only on the rise in Estonia in 2003 compared with 2002. By putting aside the question of opacity in defining and using subsidies in the EU, it needs to be added that the provision of subsidies to firms is also a transfer from some government or non-market funds to firms partially to cover differential costs. It turned out to be a transfer to largely foreign owners. All subsidies, including those to attract FDI, are the activity of considerable losses, some of them deadweight. It was a positive step of CEECs to remove part of subsidies, even if this happened because of an enforcement of EU law rather than on their own initiative. However, the fact that it is good to remove subsidies for FDI does not make true the expectation that FDI is going to rise due to accession. All those that accepted such a view acted on all other considerations rather than factual ones. In 2004 and thereafter FDI in eight new members will be significantly lower from the peak in 2002.

The loss of subsidies was just one important factor for lower FDI in CEECs. Another may be the heavier regulation that was expected to be imposed on CEECs before and after accession. Some of the accession costs originating in regulation will be discussed later on. For now it suffices to say that the loss of subsidies and higher operation costs after accession were the main factors for more than halving FDI in CEECs in 2003 compared to 2002.

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[8] A large majority of CEECs has used different subsidies (tax relief, financial assistance, property grants, provision of utilities, training, etc.) in order to attract more investment and especially FDI. For example, the Czech government approved in 1998. a package of incentives including corporate tax relief for 10 years (newly established firms) or partial tax relief (established companies), job creation grants, training grants, the provision of industrial property at low prices and infrastructure support.

[9] Beyond Common Agricultural Policy (CAP) and structural funds, the EU in general does not allow so called direct subsidies, but it tolerates so called horizontal subsidies, i.e. those that benefit many (all) firms, and not just those that otherwise get some subsidy. It also allows subsidies for extremely underdeveloped regions (like ex-German Democratic Republic) or for depopulated regions, like northern parts of Sweden or Finland.

[10] For example, special Slovak incentives for foreign investors or 10-year tax holidays were abolished in 2002.

One may just partly accept my view and still say that FDI declined in the whole world after 2000, and that this trend explains the deterioration in FDI in newcomers more strongly than EU membership and the loss of subsidies do.

Table 2: FDI in the world, in billion of dollars

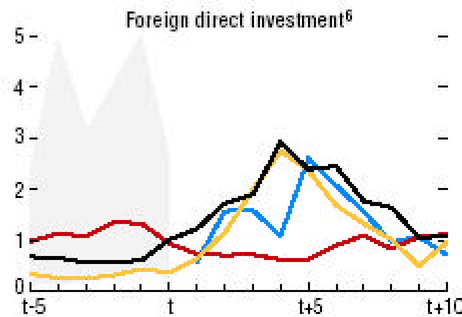
1990-94	1995	1996	1997	1998	1999	2000	2001	2002	2003
197.7	327.9	372.9	461.4	690.4	1076.6	1498.8	823	654	575

Source: IMF 2003, p. 10. For years 1990-94 an average is counted; for years 2001-03, see EIU 2004, p 9.

FDI was halved in 2001 compared to 2000, but the same move cannot be observed in the CEECs. On the contrary, FDI rose in four out of five observed CEECs in 2001 compared to 2000, and fell in just one. The total FDI in five CEECs was significantly higher in 2002 than in 2001 – again contrary to the world trend. FDI started to decline in accession countries in 2003 – with the exception of Estonia – and this was precisely due to their anticipation of EU-membership and non-allowed subsidies. From that it seems obvious that accession rather than a worldwide decline in FDI caused a decline in FDI in transition newcomers, and this goes contrary to what was stated both in academic productions and the political "propaganda for happiness".

Let us now go to the second step. As the cases of less developed new entrants in the EU once upon time, like Greece, Ireland, Portugal and Spain, clearly show, FDI rose just temporarily due to the accession, and went back to the pre-accession level after some 8-10 years, so that accession did not matter in the long run. In Greece FDI even halved when the country became an EU-member in 1981. On the vertical axis in the next figure FDI is represented as a percentage of the GDP, while on the horizontal axis is represented the time of accession (t), with periods of 5 years prior (t-5) and 5 and 10 years after accession (t+5, t+10).

____ Greece ____ Spain ____ Portugal ____ Ireland



Source: **World economic outlook**, IMF 2001, ch.4, p. 150.

The above figure shows that FDI in Greece dropped, while that of Ireland, Portugal and Spain grew temporarily for some 8 years between t and t+10, and thereafter went down to pre-accession levels.[11] However, in Greece, Ireland, Portugal and Spain there was no deterioration in FDI prior to accession such as had happened in the transition newcomers mentioned earlier. Two factors explain this observation. The EU regulation was not as extensive (expensive) at the time when Ireland, Greece, Portugal and Spain acceded as it is now. Secondly, the EU policy toward the FDI-subsidies was not restrictive before, as it is now. Subsidies for FDI were broadly used two or three decades ago among the EU-members and in the 1990-ies they were outlawed due to the establishment of the common market.

The conclusion from both steps above is straightforward. Advance in economic freedom and the rule of law is the main factor in attracting FDI rather than accession to the EU. The reason for this is very simple. Private investors are interested in a good business environment rather than in accession that brings about more regulation, costly adjustments and more power of bureaucracy over the economy.[12]

Without larger changes in design of economic institutions CEECs are

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[11] Although temporary rise cannot prove the case for higher FDI, it represents a gain for the economy in question as long as it lasts.

[12] This is clear not just to pro-market economists but also to objective euro-optimists: "The preferential access to EU markets, coupled with the liberalization of Central and East European countries' domestic markets, has promoted changes of specialization patterns in these countries. However, national options in terms of economic policy have constrained the rhythm and intensity of those changes. Those who adopted more radical liberalizing reforms, and applied wider programs of privatization and macroeconomic stabilization have attracted higher amounts of FDI and have progressed more in economic terms." Caetano et alii, 2002, p. 5.

unlikely to attract more FDI. A survey among international business people, conducted by ***The Economist Intelligence Unit***, cooled off high expectations related to FDI in CEECs. "The survey offers little support for the theory that EU enlargement will lead to a new surge of FDI inflows into the new entrants".[13] CEECs have already achieved the main benefits of integration for investment and "further positive changes to business environments associated with EU membership will be small".[14] Stagnation in the size of FDI on a world level, and increasingly tough competition from Asia in particular, are the main external factors.

[13] EIU 2004, p. 14.
[14] EIU 2004, p. 13.

II. Bridging the GDP gap

Considerations relating to what is going to happen with the GDP gap of acceding countries from the CEE are also divided in two steps. Firstly, I will present the evidence related to GDP-development in EU newcomers from the CEE. Secondly, I will consider what happened with the GDP gap in Greece, Ireland, Portugal and Spain when these countries became the EU members.

GDP fell sharply in transition countries during 1991-3, due to costly market reforms, and 1994 was the first year of GDP growth in a majority of the eight acceding transition countries. Post-reform recession in the Baltic countries lasted until 1993-4, since they entered transition later on. Taking into account the period 1994-2003, the champions of growth are Latvia, Poland, Slovak republic and Estonia, followed by Slovenia and Hungary, with Lithuania and Czech republic at the end.

Table 3: GDP growth in transition newcomers to the EU, in %.

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	1994-2003[1]
Czech r	-	-	0.1	2.2	5.9	4.3	-0.8	-1.0	0.5	3.3	3.1	2.0	1.7	2.12
Estonia	-7.9	-21.6	-8.2	-1.8	4.3	3.9	9.8	4.6	-0.6	7.1	5.0	5.8	5.0	4.12
Lithuan.	-5.7	-21.3	-16.2	-9.8	3.3	4.7	7.0	7.3	-1.8	4.0	6.5	6.7	5.8	3.37
Latvia	-11.1	-35.2	-14.9	0.6	-0.8	3.7	8.4	4.8	2.8	6.8	7.9	6.1	5.5	4.58
Poland	-7.0	2.6	4.3	5.2	6.8	6.0	6.8	4.8	4.1	4.0	1.0	1.4	2.9	4.30
Hungary	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.8	3.3	3.0	3.47
Slovakia	-	-	-3.7	4.9	6.5	5.8	5.6	4.0	1.3	2.2	3.3	4.4	4.0	4.20
Slovenia	-	-	2.8	5.3	4.9	3.5	4.6	3.8	5.2	4.6	2.9	3.2	2.2	4.03
Average	-8.72	-16.24	-4.55	1.19	4.05	4.15	5.75	4.15	1.96	4.65	4.19	4.11	3.76	3.77

Source: **The World Bank files** (Internet) for years 1991-1994; **IMF World economic outlook 2003. Statistical appendix**, p. 183, for years 1995-2003. Note: 1 = average; estimates for 2003; Own calculations.

The picture of transition champions is very different if we consider the number of years for which some countries had above average growth rate in eight CEECs after 1994. In that case, Estonia and Latvia are at the top with 7 such years each, followed by Lithuania (6), Poland (5), Slovakia (4), Hungary (3), Slovenia (2) and Czech republic (1). Poland had all good years in 1995-1999, while all three Baltic countries grow faster than the CEE-8 group in 2001, 2002 and 2003. Slovakia is the only one of the remaining five countries, except for the Baltic states, that had grown

above average in 2002 and 2003. This means that the Baltic states – as least those that are considered to be less developed among 8 CEE newcomers – bridged the gap faster than other transition countries and even the EU15.[15]

The growth rate in eight EU newcomers has been significantly higher than growth rate in EU15 or the Eurozone from 1995 onwards. With the exception of Ireland, no other EU15-country has grown faster than the eight CEE countries. This means that selected CEECs started to bridge the gap with the EU15 before they became EU members. However, as can be seen from Table 3, growth rate in eight EU newcomers has been in decline from 2000 to the present – it was 4.65%, 4.19%, 4.11% and 3.76% in 2000, 2001, 2002 and 2003 respectively. Eight newcomers were obliged to accept costly EU-regulation progressively, well ahead of accession, and this had a deteriorating effect on economic freedom, economic activity and consequently on GDP growth. Some tentative estimates stated that these costs of adjustment might go up to 10-12% of country's GDP. The topic, however, was never researched exhaustively and precisely, so that we will never find out what the real total cost of accession of eight newcomers was. There are, however, some more or less complete estimates, and some of them are cited in this paper. Anyway, if transition newcomers continue to bridge the gap after accession, this is going to happen despite membership rather than because of membership.

In order to find out what is going to happen to the GDP gap in transition countries after accession, let us consider what happened with the GDP gap in less developed countries that joined the Union a long time ago - like Greece, Ireland, Portugal and Spain.[16]

Since its first enlargement in 1973, the EU bodies have stated that accession helps less developed countries to overcome backwardness, to narrow the gap and finally to catch up with more developed members. It seems that membership as such induces convergence in GDP and the standard of living. If this had happened before with less developed countries like Greece, Ireland, Portugal and Spain, this might be expected to

[15] A country growing at 2% needs 35 years to double its GDP. Growth rate of 4% requires 17.5 years while growth rate of 7% requires 10.3 years to double GDP.

[16] The investigation of the effects of trade creation and trade diversion is omitted, since it is related to the question whether actual EU-candidates were eventually close to the level of market protection or even above. See, Gross & Gonciarz 1996.

happen to transition countries as well.[17] Table 4 summarizes evidence related to the GDP gap. Spain and Portugal narrowed the gap moderately; Ireland did the same explosively, while only Greece stagnated.

Table 4. Convergence in the EU15, selected countries and years, (GDP *per capita*, EU15=100)

Country	1975	1985	1995	2001
Greece	62	64	66	65
Ireland	66	69	93	118
Portugal	56	57	70	69
Spain	82	74	78	84

Source: Barysch 2003, p. 5, according to the *OECD* and *Eurostat* data.

The level of the Greek GDP *per capita* compared to the EU average stagnated throughout the observed period, both before and after the country acceded the Union. This happened despite the fact that Greece received significant subsidies from Brussels of between 2% and 5% of GDP *per annum*. When left-wing forces got rid of the dictatorship in the early 1970-ies, and when Greece became a democracy, the government designed policies to reward the main liberators' interest groups, which required very high state expenditures, and redistribution policies that deteriorated growth and allowed only modest growth rates. By entering the EU Greece even worsened its economic policies – in exchange for costly adjustments in regulation Greece got subsidies from the EU. As a result, the country's distance in terms of GDP pc remained the same both before and after accession.[18]

Ireland has passed two phases while being in the EU. First, it stagnated for more than a decade, again despite accession and a lot of EU subsidies. Second, Ireland prospered after the mid-1980ies and soon surpassed the EU average income.

[17] Ireland has acceded in 1973, together with UK and Denmark, Greece joined in 1981, while Portugal and Spain joined in 1986.

[18] Ironically, the fastest tempo of development after IIWW Greece experienced under dictatorship 1954-1974. with average growth rate of 7%, when it conducted sound economic policies. Cf. Prokopijevic 2002, p. 17-18.

This happened due to a huge improvement in economic freedom rather than accession. As a result, after larger economic reforms were conducted in Ireland from the mid-1980ies on, Ireland's GDP increased at an average rate of 5.14% from 1990 to 1995, and it increased at an average rate of 9.66% from 1996 to 2000. Empirical evidence clearly suggests that subsidies from Brussels have not been the major cause of Ireland's economic success.[19]

To sum up, all four considered cases show that membership in the EU *per se* does not mean solid growth rates and "catch up" policies. Growth rates result from liberalization policies rather than from the EU membership. The regulation required by membership makes business transactions more costly and deteriorates growth. Without larger advances in economic freedom countries remain stagnant despite EU membership. Subsidies from Brussels cannot induce sustainable growth, if any. Governments benefit more from granting subsidies to their political supporters than by directing them to the most profitable projects. We are going to see later on that subsidies have a negative impact on a subsidized economy because they change the structure of incentives and retard growth. For now we may conclude that the expected large rise of GDP after accession was a myth in the past and that it is not likely to be very different with CEECs in the near future. Membership alone and subsidies from Brussels cannot help the eight transition countries in developing "catch-up" policies. If they have such an objective, they need to introduce policies to improve economic freedom and the rule of law. EU membership is not an obstacle for such policies *per se*, as the cases of more liberal EU members show, like UK, Ireland or Luxembourg. Provided governments are committed to reform and ready to pay for its cost, advances in economic freedom and the rule of law are possible. It is questionable, however, whether governments may resist rent-seeking policies strengthened by a flow of Brussels' subsidies that change the structure of incentives.

[19] Cf. Powell 2003, p. 431.

III. Subsidies to offset accession costs

In contrast to apparent disadvantages for transition newcomers flowing from the accession, which are kept far away from publicity, transfers from the EU to newcomers are highly publicized. They are the basic element of the "propaganda for happiness" that is systematically conducted from Brussels. Let us for now accept official EU propaganda that subsidies are useful. Transfers are limited to 4% of countries' GDP, and it is said that newcomers will profit more from the EU single market. However, newcomers profited from the common market long before they acceded, after they had contracted "Europe agreements" in the 1990s, which allowed free trade between them and EU15.

What is concerning about the subsidy of up to 4% of GDP, is that it is highly unlikely that newcomers will get it, since the CEE countries by entering the EU will contribute 1.20% of their GDP to the EU budget, which reduces the net subsidy from 4% to 2.80% of their respective GDP. It is also questionable what part of the 2.80% subsidy new entrants will get, especially in the first years after accession, since their "absorption capacity" is low, according to the EU bodies, due to poorly prepared institutions for that operation. But even if newcomers get subsidies of up to 2.80%, this is bad news for their economies due to a number of adverse effects.

By entering the EU, firms from newcomers undergo quotas intended to reduce the production of some goods and services, which causes a net loss to newcomers' economies. Quotas do restrain firms in some areas (agriculture, textile, steel, fishery) to accede to the EU market, and these restrictions are negotiated before accession. For example, Poland and Czech Republic should reduce steel production for 1.2 m/t and 0.6 m/t respectively in the period 1996-2007.[20] Similar restrictions hold for other members. The EU Commission will monitor the implementation of reduction. Actually, wherever subsidies exist, overproduction is encouraged, and restraints like quotas are needed. During negotiations, Slovakia asked to produce 1.2bn litres of subsidized milk, but the EU set the limit at 950m litres per year. Slovakia wished to raise 400,000 sheep, but the EU set the limit at 218,000. According to Hungarian party

[20] Cf. Perlitz 2003, p. 13, 14. Poland should reduce the number of employees in the steel sector from 23,000 to 16,000 from 1996 to 2007. Ibid, p. 13-14.

Fidesz, Hungarian agriculture alone may lose up to $ 6bn over the next ten years due to trade restraints.[21] Accession related trade restrictions will have especially bad effects on the economically most liberal transition country. "Estonia will have to erect a vast wall of common external tariffs against non-EU countries, starting this year /2000/, jumping from last year's baseline of zero to a total of 10,794 different tariffs. This will result in serious distortions, and will particularly increase the cost of food. (…) /Also/ upon accession Estonia will have to introduce a panoply of EU non-tariff barriers (e.g., subsidies, quotas, and antidumping duties) that will divert imports form low cost locations outside the EU to high-cost locations within it. In particular, imports of coal and steel will become more expensive."[22] Before starting accession adjustment, Estonia had a 0% customs rate and no non-tariff barriers. In addition, and contrary to other CEECs facing an annual financial burden of 2-3% for meeting environmental regulations, Estonia's environmental costs are estimated to be of the order of 4 to 5 percent of GDP.[23]

Probably, the most damaging effect of accession consists in imposing very tight regulation over incoming economies, which is unnecessary and is merely intended to offset their comparative advantage, basically consisting of a cheaper labor force, less regulation, and lower taxes. The most costly are the regulations related to the labor market, environmental protection, consumer protection, administrative and judicial standards. For example, environmental regulations will impose a cost of up €120bn on eight CEECs until 2015. This means that CEECs will have to cover environmental expenditures at around € 10bn per year, which again is equal to annual net transfers from the EU15 to newcomers. The cost of confronting Poland just with the EU environmental standards is estimated at € 40bn over the transitional period that ends in 2015.[24] It is an amount equal to the whole Polish budget. The EU Commission estimates[25] that costs of the environmental regulation alone will consume between 2% and 3% of the CEECs' annual GDP during transition period of 7 years.

Eventual application of the European regulations to newcomers' labor

[21] Cf. Tupy 2003, p. 11.
[22] Razeen Sally, cited according Tupy 2003, p. 15.
[23] Cf. CESifo 2004, p. 103.
[24] Cf. Walsh, 39.
[25] Environment, EU Commission, at the site: http://europa.eu.int/comm/enlargement/negotiations/chapters/chap22/index.html

markets will cause a larger jump in labor costs, which is going to affect adversely the demand for labor. Firms are going to be affected by costly regulations and in combination with higher labor and environmental costs this will raise both start-up and operational costs and impair the country's competitiveness. Less demand for labor will lead to larger unemployment, higher start-up and labor costs will lead to fewer new firms than would otherwise have been the case, and lower business formation will inhibit the economy, slow down growth rates, and degenerate the business environment. Lower competitiveness will reduce market return and continue to have a negative dynamic impact on the economy.[26] This clearly contradicts bridge-the-gap-policies.

Bureaucrats from the EU15 worry about a flood of workers from the newcomers. The best way to keep workers at home is to allow them to get a good job in their home country. However, costly regulation that is going to be imposed on newcomers will not just reduce the number of jobs available; it will also keep workers from newcomers relatively poor for longer than necessary, by slowing down economic growth, and thus increase worker flight to higher-wage countries. As it is well known, doors to higher-wage countries for workers from newcomers will be closed for 7 years, so that newcomers will have to bear the cost of higher unemployment.[27] Ex East Germany provides a very good example of what happens when a country gets high salaries and unnecessary but costly labor and other regulation. In 2004, despite a transfer of €1.2 trillion from West Germany following reunification of the country, the unemployment rate in the Eastern part is more than twice as high as it is in the Western part. Something similar awaits the CEE newcomers if they accept business regulation at the French-German level.

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[26] In addition, transition newcomers will get economic policies on which they have no influence. For example, the CAP (Common agricultural policy) was defined for the period 2006-2013. before new entrants have arrived. It is unlikely that the CAP is going to be essentially changed from now, although it is well known for being ecologically harmful, economically inefficient and legally unjust, since it favors the largest farms.

[27] Unemployment rate in CEECs moved on average for 2002-2004. between 5.8% in Slovenia and Hungary, and 16.5% and 20% in Slovakia and Poland respectively. Cf. CESifo 2004, p. 104. Unemployment figures are likely to raise in CEECs, not just because of more expensive regulation. Agricultural sector in CEECs employs 7-25% total working force. Since this sector will shrink to the 3-5% EU-level in the next years, surplus labor will join those that are already unemployed.

In exchange for losing comparative advantages through regulation and quotas, newcomers will get subsidies of up to 2.80% of GDP, which are unlikely to offset their losses, and which are going to change their economic environment over time, by providing incentives for more subsidies[28], regulation, rent seeking and arbitration over economy. This will result in lower competitiveness and productivity, and in a decline of risk-taking and innovation, the driving forces of modern economies. If a firm can earn more income from Brussels than from the market, it will invest less in becoming more efficient (competitive) and it will prefer to invest in lobbying and bribing bureaucrats controlling and distributing the EU money.

Both managers (owners) and bureaucrats will be engaged in non-productive activity. Subsidies from Brussels will decrease incentives of the government to conduct reforms. National and international bureaucrats will spend others' money and they both are well known for being ignorant where to invest.[29] Otherwise, they would be rich by being successful entrepreneurs and would not be bureaucrats at all.

The use of subsidies requires regulation (tariff, non-tariff barriers, export subsidy, protective price, etc.), which suspends market forces by implementing restrictions, prohibitions, non-necessary procedures, bureaucratic arbitration, government policies. This hinders whole sectors from developing and raises the cost of business operation.[30] It requires a larger increase of bureaucrats on all levels – from municipality to Brussels. Enlarged echelon of clerks will require further enlargement in monitoring, auditing, anti-fraud and similar agencies. Instead of doing something productive all these people will live at the expense of taxpayers. Due to the "democratic deficit", the bureaucratic echelon will develop as an uncontrollable machine extracting money. But instead of being controlled, Eurocrats plan to hire 5161 new bureaucrats in the CEE to monitor newcomers' compliance with the *acquis*. Instead of being more controlled, bureaucrats will extend their own control over the economy and the electorate.

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[28] Incentives undergo changes for all actors in a society – citizens, politicians, bureaucrats, firms, NGO, non-market funds, national and international organizations, interest groups, business associations, unions.
[29] Cf. Stanchev et alii, 2004.
[30] Firms and whole sectors can miss-invest in order to capture subsidies and this miss-allocation will be covered by taxpayers. The harm is doubled, first for miss-allocation, second, for the prize (subsidy) for that. Employees will be engaged in lobbying, strikes, threat of strikes, cheating and bribes instead of in productive efforts leading to innovation, efficiency and growth.

Predictably, corruption prospers in such an environment. The larger role of bureaucrats in economic life goes hand in hand with corruption opportunities. "A senior partner at *Ernst and Young* calculated that around five per cent of the Commission's budget – or almost £ 4 billion – goes missing every year, but even this may well underestimate the scale of the problem".[31] Having this in mind, anti-corruption policies and measures should be well designed and tight. However, this is not the case. Cases of corruption involving EU bodies are unlikely to be investigated, publicized and prosecuted, since the investigation is impossible without the authorities in member states, and member states are short of incentives to conduct such an investigation. If they discover corruption and find offenders, they have to compensate damage to the EU funds and to punish actors. By doing so, member states will cause losses and troubles to themselves. First, by imposing fines over themselves, their budget will face a financial loss. Second, it is not easy to punish influential bureaucrats and to avoid political clashes and unrest in the bureaucratic echelon. Third, by fighting corruption, some interest groups will face losses and will not accept that without counteraction. Having all this in mind it is clear why Eurocracy keeps a low profile on corruption, and why some action emerges only when things go too far, as happened in March 1999 with the resignation of Santer's Commission.[32]

As was already pointed out, subsidies are highly publicized, while the costs of subsidies and negotiations on imposing trade restrictions and regulations are not. The truth is that subsidies from Brussels are just a fraction of what newcomers lose due to regulation and quotas. Although total transfers from the EU15 to ten newcomers exceed €40bn for years 2004-2006, the net transfer per year over the same period is likely to be € 10-12bn.[33] As we have seen, environmental costs alone offset the amount of net transfers – not to mention other costs. But even if subsidies were larger, this would not offset the losses, since this money would flow from bureaucrats rather than from markets, making economies even more dependent on bureaucrats than on markets in the next round, and changing the structure of incentives in the economy. Bureaucrats spend money according to political objectives rather than according to economic efficiency,

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[31] Cf. Blundell & Frost, 2004, p. 27.
[32] According to the official explanation, the Commission has lost control over EU funds. The investigation found more than €3bn "misused" money.
[33] Cf. Walsh, 31.

which again enhances corruption, stealing, unfair auctions and other forms of funds' misuse.

All this game with subsidies – unfriendly to market forces – might be tolerated provided there is some point in it. However, this is missing. Greece championed in subsidies from Brussels in *per capita* terms during the past two decades, but despite all it has remained the poorest EU15 country. Ireland, its poor companion some two decades ago, contrary to Greece, has relied on market reforms rather than on subsidies. As a result, Ireland is today the second richest country in the EU25, just behind Luxembourg. When the EU started disbursing aid through structural and cohesion funds, 44% of the EU population lived in regions that qualified for it. By 1997 that percentage increased to nearly 52%, which shows that the program not only failed to promote growth but spread stagnation and decline even beyond targeted regions.[34] Subsidies are eventually beneficial for politicians and users, but they are economically inefficient, damaging, or both. If so, CEECs are going to be punished twice for accession: first, by obtaining quotas and expensive regulation; secondly, by getting subsidies to worsen the situation.

[34] Cf. Tupy 2003, p. 17-18.

IV. Unintended consequences

The enlargement from 2004 onwards was designed similarly to previous ones, in a manner of social engineering: in order to provide a new market for the EU15 and to prevent costly changes in expensive EU15 regulation, new entrants will be allowed to join in exchange for accepting the existing rules of the game. This means that new members have to accept costly regulation, which reduces their competitiveness, and in exchange they will get subsidies to offset their adjustment costs. The amount of subsidies for the EU new members from 2004 was not generous compared to previous enlargements when compensation moved at the level of 2-5% of the GDP of new members. New members were also promised that they would get larger FDI, speeded up growth rates, and would bridge the gap with the rest of the Union. Since this is unlikely to happen as we have seen in previous parts, it may be that for the economically most successful transition countries – those having well designed economic rules – it would be better to stay outside the Union.[35] Instead of entering the EU and a nightmare of bureaucratic supra-national regulation and arbitration over economy, it would be better to stay outside and to continue to improve economic freedom and the rule of law – i.e. all those things that contribute to individual freedom and welfare.

Conditions for that already existed, since Estonia[36] was already more free in economic sense than nearly any of the EU15 countries, while Estonia, Latvia, Lithuania and the Czech Republic were on average equally free as the EU15 average country (see Table 5). These countries have improved economic freedom more in 12 years than the average EU country had for decades. Even some rare authors, whose works are to be found on the EU-official web site, now recognize this. "In some cases, the accession states demonstrate a greater adherence to liberal economies than established EU members."[37] Had CEECs opted to be out of the EU, the neighborhood of reform fatigue, over-regulated and passive giants, like the EU, would even facilitate and speed up the

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[35] "… for the EU and for the new member states, enlargement is a poor deal". Walsh 2003, p. 7. Tupy (2003) agrees with this conclusion.
[36] Estonia is ranked just after Luxembourg and Ireland according to the Heritage foundation in 2004, and after UK, Ireland and Luxembourg according to the ranking by the Fraser institute in 2002. See Table 5 in the text.
[37] Walsh, 40.

economic success of the economically open CEECs. This strategy might induce Brussels' bureaucracy to reconsider its policy and to shift to diversity, liberalization and competition. If the Wonderland changes in a positive way, Alice may consider joining one day, if that is going to be profitable for her. "First best" – to stay outside the EU and improve economic freedom and the rule of law – is however consumed through accession for at least one period of time. "Second best" – to fight for economic freedom and the rule of law inside the Union – is still available, but in no way guaranteed.

Table 5: Economic freedom in the EU25 in 2001, 2002 and 2004

		HF Index[1]				FI Index[2]	FI Index		(HF + FI)/2	
Rank	**Country**	**2004**		**Rank**	**Country**	**2001**	**2002**	**Rank[3]**	**Country**	**Index**
4	Luxemb.	8.23		5	UK	8.2	8.2	1	UK	8.11
5	Ireland	8.14		8	Ireland	8.0	7.8	2	Luxemb.	8.01
6	Estonia	8.10		10	Holland	7.8	7.7	3	Ireland	7.98
7	UK	8.02		11	Finland	7.7	7.7	4	Denmark	7.80
8	Denmark	8.00		12	Luxemb.	7.7	7.8	5	Estonia	7.80
12	Sweden	7.75		13	Austria	7.6	7.5	6	Finland	7.66
14	Cyprus	7.62		14	Denmark	7.6	7.6	7	Holland	7.55
15	Finland	7.62		16	Estonia	7.5	7.7	8	Sweden	7.52
18	Germany	7.43		18	Belgium	7.4	7.4	9	Austria	7.40
19	Holland	7.40		21	Germany	7.3	7.3	10	Germany	7.36
20	Austria	7.30		25	Portugal	7.2	7.2	11	Belgium	7.21
22	Belgium	7.02		32	Sweden	7.1	7.3	12	Cyprus	7.11
23	Lithuania	7.02		35	Hungary	7.0	7.3	13	Italy	6.95
26	Italy	6.90		36	Italy	7.0	7.0	14	Lithuania	6.91
27	Spain	6.73		38	Spain	7.0	7.1	15	Spain	6.91
30	Latvia	6.60		39	Czech rep.	6.9	6.9	16	Portugal	6.86
31	Portugal	6.52		44	France	6.7	6.8	17	Latvia	6.80
32	Czech rep.	6.52		45	Greece	6.7	6.9	18	Czech rep.	6.71
35	Slovak rep.	6.39		54	Latvia	6.6	7.0	19	Hungary	6.65
37	Malta	6.22		61	Malta	6.4	6.8	20	Malta	6.51
42	Hungary	6.00		69	Cyprus	6.2	6.6	21	Slovak rep.	6.46
45	France	5.93		70	Lithuania	6.2	6.8	22	France	6.36
52	Slovenia	5.62		76	Slovenia	6.1	6.2	23	Greece	6.20
54	Greece	5.50		79	Poland	6.0	6.4	24	Poland	5.91
57	Poland	5.47		80	Slovak rep.	6.0	6.6	25	Slovenia	5.91
	Average	**6.96**			**Average**	**7.04**	**7.18**		**Average**	**7.07**

Source: **The 2004 index of economic freedom**, ch. *Executive summary*, p. 9-10; Gwartney, J. (Ed)(2003), p. 13-15.

Note: 1= Index of the Heritage foundation for 2004 (HF), recounted on the scale 0-10; 2 = Index of the Fraser institute on the scale 0-10 (FI); In both ratings 0 means no economic freedom while 10 means maximum of economic freedom; 3 = Ranking of the EU25-countries is based on the arithmetic mean of HF and FI indexes.

What is going to happen to the economic freedom and GDP of eight EU-newcomers from the CEE in forthcoming years basically depends on how they are going to behave after accession. Countries that will rely on heavy regulation, rent-seeking and the heavy hand of the state will become similar to the less liberal EU15 members,[38] and as a result, they will face stagnation both in investment and GDP rates. They even will miss the "second best".

Although accession was not the best choice for "success stories" among CEECs, it is not the end of the world after they have once mistakenly acceded. Their position now is weaker, but the adherents of individual freedom in these countries do not need to be altogether desperate. The EU25 is rather more a diverse than a homogeneous unit, and the EU15 will undergo a larger shock caused by the accession of ten new countries.

The diversity of the EU is going to be larger after accession of ten countries than before. There are situations where nearly all newcomers adhere to quite different rules compared to the EU15. For example, all eight CEECs have lower corporate tax rates than the EU – on average 10pp, and lower top rates for income tax of 11pp.[39] The total tax burden – taxes plus social contributions – in the EU25 is highest in Sweden (50.6% of GDP), Denmark (48.9%) and Belgium (46.6%) and the lowest in Ireland (28.6%), Latvia (28.8%) and Lithuania (31.3%). The former group has an average rate of 48.7%, the later one of 29.6% while the CEECs average is 35.2%.[40] Having such larger differences in mind, it is important to follow what is going to happen after accession. Are high-tax EU nations going to suppress low-tax members, say, by enforcing tax harmonization[41] at the higher tax rates? This has not happened in the EU15. For example, the tax burden in Sweden was larger by 22pp than that in Ireland, and there were no larger signals of tax competition. But this may happen if high tax nations offer subsidies to low tax nations in exchange for their acceptance of higher tax rates. In order for this to happen all EU15 members should accept this extra-

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[38] The four economically most illiberal EU15-countries, according to the Heritage foundation index in 2004. are Greece (ranked 54th with index 5.50), France (45th, 5.93), Portugal (31st, 6.52) and Spain (27th, 6.73). The same four are the most illiberal according to the HF/FI average.
[39] Cf. European Commission 2004, p. 8. The VAT rates in the EU15 ran between 15% and 25%, while the CEECs' average is 19%.
[40] Cf. European Commission 2004, p. 239. Own calculation.
[41] First attempt to harmonize direct taxes in EU25 failed in September 2004. It has been proposed by the ECOFIN and backed up by the EU Commission.

expenditure; although this is unlikely for now, it can not be excluded in principle. If high-tax nations for any reason succeed in imposing high taxes over low-tax nations, they themselves may postpone necessary changes in their over-regulated and expensive economic systems. In this case the EU25 will resemble an even more rigid, centrally harmonized "nirvana" that misses incentives for change, innovation and competition among jurisdictions.[42]

If high tax nations do not succeed in imposing heavy regulation on newcomers, they will be forced to change their own tax systems with high rates and excessive regulation, which is extremely politically costly, and for that reason, the high-tax nations will do everything before remaining with this option.

It seems obvious that the EU after "historical enlargement" is going to be much more diverse than ever before. This means, that this enlargement may have some unintended consequences. Instead of being a large homogenous and harmonized bloc, the EU may become divided into groups of comparatively diverse countries, which tend to move at two or more different speeds. Continued political integration and harmonization may appear to be impossible tasks in the light of greater diversity among country members. Instead of leading to a stronger and politically more integrated Union, the fifth enlargement may provoke a stoppage or even a set back to integration as conducted up to now. Enlarged diversity might lead to stalled political integration and division of countries into several clubs rather than to a further push toward unification and closer political integration. But this is good news. By siding with more liberal "old members" of the Union, liberal newcomers may be a decisive factor in preventing a dangerous political integration and over-regulation and so inspire a comeback to the liberal economic dimension of the Union. It is surprising that a dirigiste, socialist design, due to unintended consequences, may lead to a liberal outcome, but this is not unlikely to happen. In behaving this way liberal newcomers will face some "aggravated circumstances". One would be their weaker internal position, due to a changed structure of incentives in their internal policies and economies. The other may be pressure from the EU institutions and some larger countries from the Union, who may share other plans and objectives. Nevertheless, Alice's battle is not lost either way.

[42] Cf. Colombatto, 2000.

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