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EU ENLARGEMENT IMPACTS – THEORY AND EVIDENCE

Key words: EU enlargement, integration impacts indicators, economic integration theory, integration impacts in Slovenia

Abstract of the paper: The past EU enlargements open different questions. Why EU has performed five enlargements in the past and why it is at present even envisaging future integration enlargements? The next question is “How the theory and practical integration evidences could explain and support the past and future integration enlargements”? According to “j-curve” logic each reform of the integration – including enlargements – could create, after its initial drop, a substantially higher GDP growth rate in comparison to long term growth rate possible when no change in the structure or functioning of economic integration happens.

Dilemmas of such nature are intensified with the EU enlargements of 2004 and 2007. The paper show some possible ways of searching the answers to the above questions. In the first part it deals with development of the theoretical background of economic integration issues starting with the dilemmas about the theory of the second best solution. Paper shows that the theory and actual international trade environment have changed substantially after initial ideas of customs union creation in Europe. Changes are giving new possibilities of explaining the rational for economic integration efforts and as well new ways of presenting the integration effects on EU member countries.

Following the idea of economic rational linked to EU integration and to its enlargement the paper presents and comments selected economic indicators related on integration effects specifics for Slovenia - recorded after the EU enlargement 2004.

1. INTRODUCTION

The theory of economic integration is not really old. Mostly starts its development after the Second World War, with its background in the neo-classical trade theory (Viner, 1950). Until the mid-1970s theoreticians had a quite sceptical opinion about the economic value of economic integrations economic functions and effects. Even more in 1950s and 1960s today's concept of general term “economic integration” was often limited only to a very specific forms of integration. In fact that time different forms of integration among states

were not strongly diversified. So in the practice of GATT they started to use term Regional Trade Agreements (RTAs) to define the relation between general GATT principles of non-discrimination and specific trade preferences which were introduced among some regional GATT members. They among themselves concluded integration agreement, at that time in reality most often of the Free Trade Area (FTA) Agreement form. Following GATT today WTO still uses the term RTA for all forms of integration which nowadays in numerous cases exceed simple classical trade preferences (WTO, Regional...). Beside that many economists defined integration agreements as “discriminatory”, or as “trading blocks” agreement (El-Agra, 2004, p.1). Economic integration theory and terminology, due to their relative short period of development and due to strong practical differentiation in their structure and objectives, are still not yet converging to the use of the same terms and to the analysing of their economic effects by the use of the same indicators measuring actual economic impacts.

At the beginning theory considered economic integration agreements among states as a second best solution compared to the theoretically appreciated absolutely free trade environment. Then it developed through different stages (Krauss, 1972), focusing on production, consumption (Meade 1955, Lipsey 1957) and trade. Actual changes in the structure and nature of international trade especially from 1970s onwards, characterized by increasing part of trade in highly differentiated product, combined by growing part of intra-industry trade, helped to develop new interest and reasoning about economic integrations specifics and economic impacts. New interest in forms and effects of economic integration was additionally accelerated by the impacts of non-tariff barriers (NTBs) developed after GATT's efforts to reduce and control the use of tariffs.

New theoretical and practical analytical efforts, showing the wider range of economic integration impacts, are specifically important to understand past EU developments which were characterised by two general developments; deepening of integration and enlargement of integration. Today in the EU case is not possible any more to contribute the real reasons for integration among states only to some political or some second best economic reasons. Theory and practice realise and show that once so called “discriminatory trading arrangements” in fact tend to be welfare-increasing for their members. It is generally appreciated that in fact they are not the second best solution, provided they are regionally-based and fairly open to new membership. By regionally-bases concept the welfare success of the integration is related to the assumption that (expectedly) similarly developed states from the region with cultural and other similarities are better suited to utilise open access to the partners' markets. Openness to new membership could bring additional positive results based on economics of scale impacts related to intra-industry trade growth. Both this concepts are incorporated in the EU enlargement and deepening development policy. By overview of selected EU integration achievement indicators and with similar indicators for Slovenia, we will try to see how much the modern theory and practices of economic integration converge.

2. EU INTEGRATION EFFECTS - EXPECTED

Studies on EU growth and welfare enlargement effects for individual member states in general are not really too numerous or extensive. More often there are studies available on expected effects of deepening of integration, like well known Cecchini Report (Cecchini, 1988), or for the 2004 enlargement a study by Richard Baldwin, Joseph F Francois and Richard Portes (Baldwin, 1997). They examined the economics of EU Enlargement as a solution to potential increasing instability of the Central and East European region and a means of ensuring its future prosperity. They concentrate on the benefits for both East and West. They find eastern enlargement to be an excellent bargain for all the incumbent EU15 and enormously beneficial to the Central and East European economies in the long run.

The authors estimate the long-run economic benefits and budgetary costs of eastern enlargement. The benefits were calculated using a computable equilibrium model, with two scenarios envisaged. The first 'conservative' scenario views membership for the region as entailing only the standard elements (Single Market access and the common external tariff). The second additionally takes on the argument, that membership promotes regional investment by stabilizing the economic and political climate, which in turn lowers country-risk premium. Under both scenarios, *the EU15 are projected to gain about ten billion Euros (ECU) in real income*. This gain was likely to be very unevenly distributed: rough calculations suggested that Germany, France and the UK would together get 70% of the total (Germany alone accounts for about 40% of the total gain). Under the conservative scenario, the CEE countries gain three billion Euros (ECU) (1.5% of their GDP): including the stimulus to investment multiples this amount tenfold: CEE would gain 30 billion Euros (ECU), somewhat over 15% of their base year GDP.

The authors estimated EU budget costs using two different approaches. The first was based on a survey of the literature estimating likely CAP and structural fund receipts and an approximation to the region's contributions to the EU budget. They arrived at a consensus estimate of the net budgetary cost for a Visegrád 5 enlargement only in 2000 at 17 billion Euros (ECU). The second approach estimated a new power-politics model of the EU budget (members' receipts are related to their voting power in the Council of Ministers and per capita national contributions are related to per capita income) and uses this to project the net budgetary cost of a Visegrád group countries enlargement. The figure arrived at – 15 billion ECU.

Putting together the expected economic gains and budgetary costs, the authors saw eastern enlargement as a phenomenally good bargain for the incumbent EU15. Setting aside questions about the timing of the benefits and budget costs, and the list of countries in the first enlargement, the budgetary transfers less the economic benefits should be no more than between five and seven billion Euros, which is on the order of one-tenth of one percent of the EU15's GDP. This could be valued as extraordinarily favorable result considering the historical nature of the political and economic opportunities in Central Europe. At the same

time, the three authors estimate that EU membership would be enormously beneficial in the long-run to the new EU members from Central and East European economies.

As in the case of introducing the Internal EU market as well the 2004 enlargement was assessed basically on the bases of expected increases in the level of EU GDP. The bases for the additional growth were different to some extent. In first case focused more on cost reduction and increased competition and in the second case more on investment flows and traditional effects of internal market. It is interesting that after two such important transformations of the EU in fact studies which would test the relevance of both integration results prognoses are not really available – or author of the didn't find them.

For instance estimates of integration impacts on new 2004 EU members or for the entire EU are available only in different fragments. They are mostly showing just changes in selected growth and welfare indicators. In the EU document "Enlargement, 3 years after" (Enlargement, 2007) one can find predominantly data on freedom of Workers Movement from central and Eastern Europe Freedom of Movement for Workers from Central and Eastern Europe, on trade and social cohesion and some other. According to indicators calculated in documents and studies envisaging the integration effects whether related to EU deepening or enlarging, such situation is rather surprising.

As known from theory "j-curve" effect both integration developments are vital for faster economic growth of the integration members. The problem is how to select between "normal" rate of economic growth and additional growth rate which was induced by the integration effects. Evidently from the above mentioned studies it is possible to calculate in advance, but ex post testing of results accuracy really is not very popular. Results of different past and 2004 EU enlargements are so presented by partial data and often with "soft" data provided by Euro barometer.

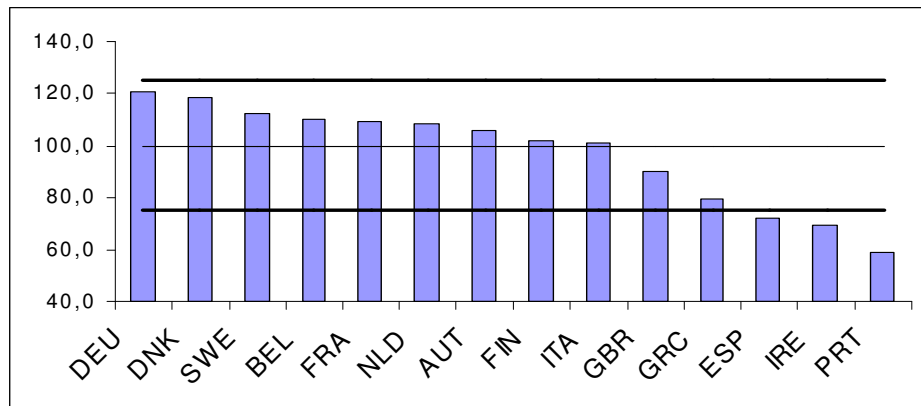
3. WHAT IS THE INTEGRATION REALITY?

As in the case of internal market effects, after 2004 no similar calculation of actual enlargement effects was made yet. There are, as motioned already, only different partial evidences available. Further we present just a few of possible indicators presenting the new understanding - enhanced over the classical trade integration issues.

Regional EU cohesion is one of initial integration priorities. "The Community **shall aim at reducing disparities between the levels of development** of the various **regions** and the backwardness of the least favored **regions...**" (*Article 158 of the Treaty*). The main objective of the EU cohesion policy is to accelerate the process of reducing the gap between the poor and the rich regions of the EU (in other words to reduce economic and territorial disparity). The second objective is to enhance employment and social inclusion (and reduce social disparities). To that end considerable amounts of money are spent on programs that are supposed to contribute to the attainment of these policy objectives. On

the other side the integration positive impacts per se have to contribute to higher level of regional and by that as well between member countries cohesion levels. According to a past OECD study, δ -convergence of EU member countries, after internal market introduction, was improved.

Figure 1 The EU countries position in 1980 measured by “ σ -converged”



Source: Are the New Member States Ready to Catch-Up in the Wider EU?" Patrick Lenain, OECD, 2003

In 1980 GDP per capita (PPP) for EU =100. Borders are set on +/- 25% of EU average. In 1980 standard deviation from the EU average was 19.6. On the low end – below 75% EU average were three countries, Spain, Ireland and Portugal. According to theoretical and expected impacts of integration, economic cohesion of the countries, especially by the effects of additional help provided by EU structural and cohesion funds, would have to be improved. The figures for 2002, with the impacts of internal market, prove that the cohesion level of integrated EU members was in fact improved. Standard deviation from EU GDP average level was reduced to 17.2. If we don't go in to specific details the result could be contributed to positive effects of integration deepening and specific financial supports given to less developed regions from the EU funds.

Figure 2 EU members 2002 GDP per capita (PPP) and standard deviation of member states from the average (standard deviation=17,2)



Source: Are the New Member States Ready to Catch-Up in the Wider EU?" Patrick Lenain, OECD, 2003.

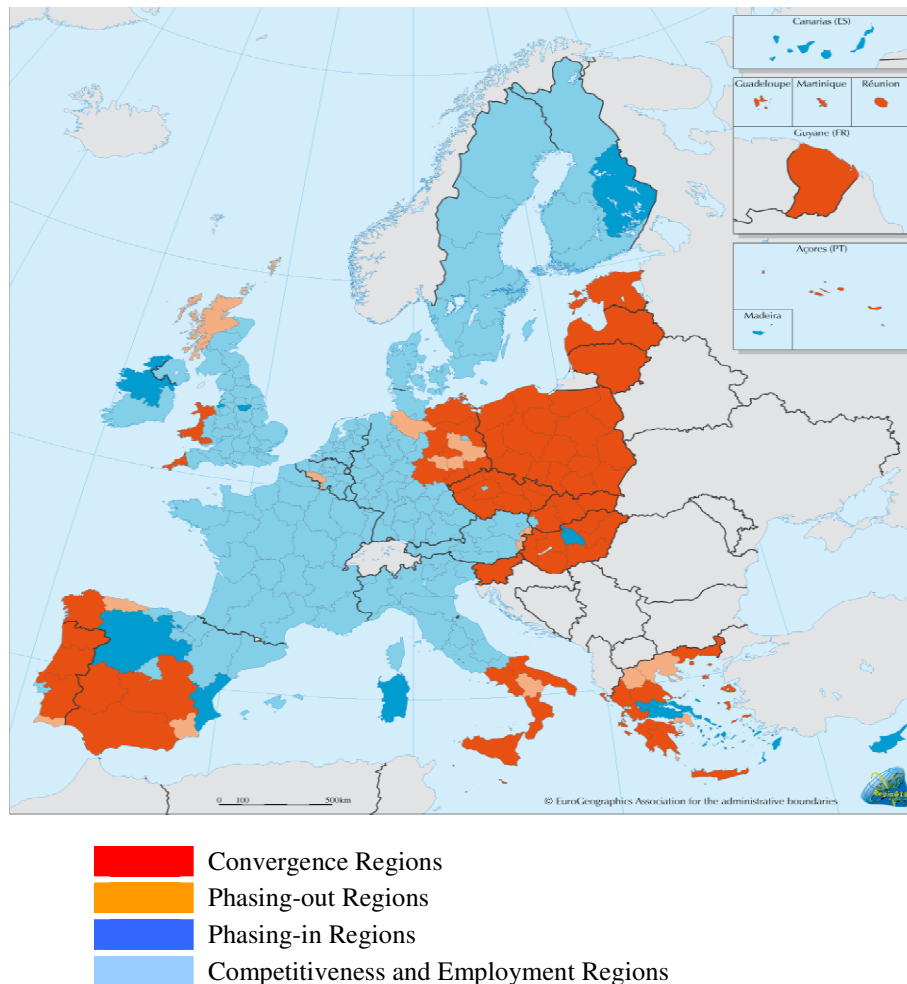
Data suggest that EU Members in reality gradually converged. As usually just the all over convergence does not tell the whole story. Among the countries below the 75% level of EU GDP average remained Portugal, who was joined by Greece, and close to them was Spain, although, had slightly improved its position. Integration impact and budget supports from EU could help to improve convergence/real cohesion but some other facts had to matter too. Ireland for instance had shown a tremendous development moving from last to first place in GDP/capita. While others were not so successful for Ireland, beside integration impact and utilization of financial supports from the EU, obviously some other economic (political) factors had to be relevant. The same probably had to be true for the other end of the countries list– for those who remained or dropped below the EU average.

Ireland probably utilized dynamic effect of integration connected to high level of FDI inflows. Getting that demanded as well relevant domestic FDI stimulating policy and creation of advantageous investment environment – enough skilled and educated labour, stable and transparent state governance, creative project development to absorb high level of financial sources potentially available from the EU budget. All such elements were probably missing or were not so well implemented in the case of the countries who remained at the rare end of the of GDP /capita level. To prove that as well less successful countries still have advanced due to positive economic integration effects, the cited study made comparison of EU countries growth rats and sample countries that were fastest growing Asian countries. “Cohesion” EU countries had higher growth GDP rat as sample Asian countries during the period 1986-2002. Integration helps member states as theory predicts to have higher that normal GDP growth, but such help is not evenly distributed among members. Most of it is related to the EU members who are organized and able to

use integration benefit at a larger scale. So they better utilize and attract more, capital inflows, utilize positive effects of economics of scale developed by large open internal market of EU. Market structure is getting more competitive and utilization of classical comparative advantages is improved.

Enlargement after 2004 offers similar conditions for better cohesion of new members. The financial EU supports are already planned to 2013. The absorption capacities of new members are becoming of vital importance.

Figure 3 EUCohesion-Geographical Eligibility for Structural Funds Support 2007-2013

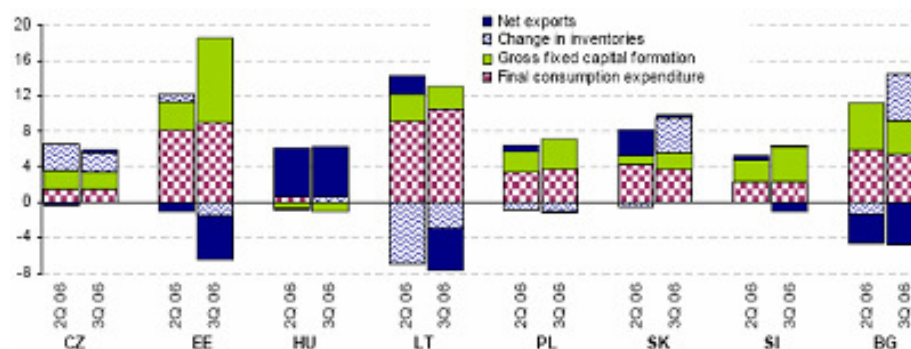


As well for higher cohesion of the new EU members their ability to utilize trade and other integration positive impacts is of vital importance. Ireland although most successful cohesion country of the past in acquiring the EU financial supports was growing fast as well due to utilizing other “general” integration advantages and impacts like; large open “internal” market of EU, positive effects of trade creation, production restructuring towards products with higher value added. Let us look what were the growth drivers in 2004 EU members.

4. INTEGRATION IMPACTS AND EVIDENCES AFTER 2004

Contribution to the GDP growth from of 2004 members expectedly (first –early stage of integration) should be relate to above effects among them trade growth, growing export of products with higher added value, etc.

Figure 4 Contributions to GDP Growth (%points of GDP)

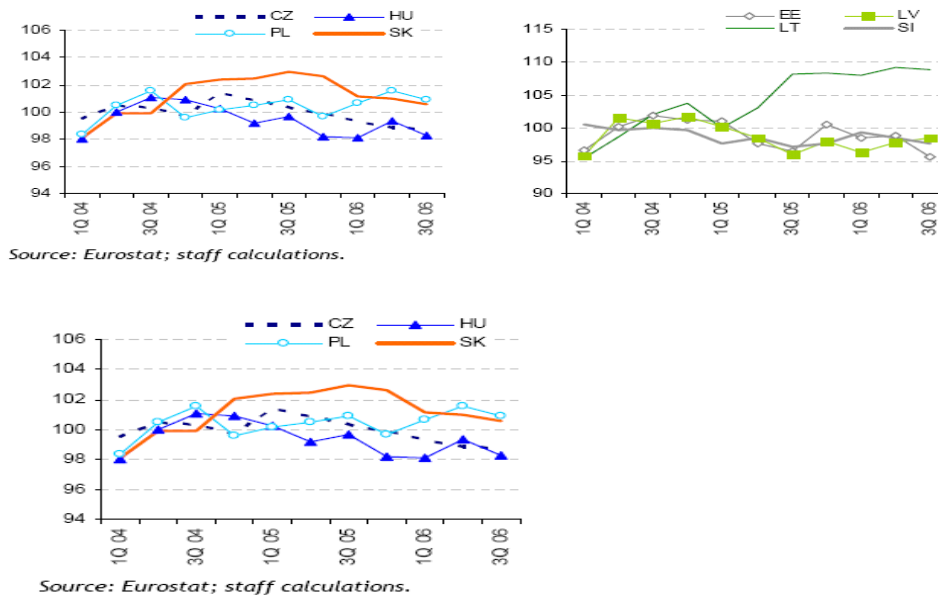


Source: CSOs; staff calculations

Major contribution to the GDP growth was in most cases based on domestic final consumption expenditure. In most cases inflation is controlled or reducing so large importance of domestic consumption could be related to use of previous savings or to growing indebtedness of the population. Net exports are often negatively related to GDP growth showing probably that restructuring of production in is not yet implemented in full. That is evident especially for Bulgaria, Lithuania and Estonia. To a smaller extend for Slovenia, but where we will see later that this is eventually more problematic for successful future integration based growth. Non growing exports, in an internal market environment, are not too good sign for future improvement in convergence. Restructuring would be necessary, perhaps helped by improved FDI inflows. Hungary with relative largest part of FDI is showing as well relative highest export's contribution to the GDP growth.

Among the integration impacts are as well changes in countries terms of trade.

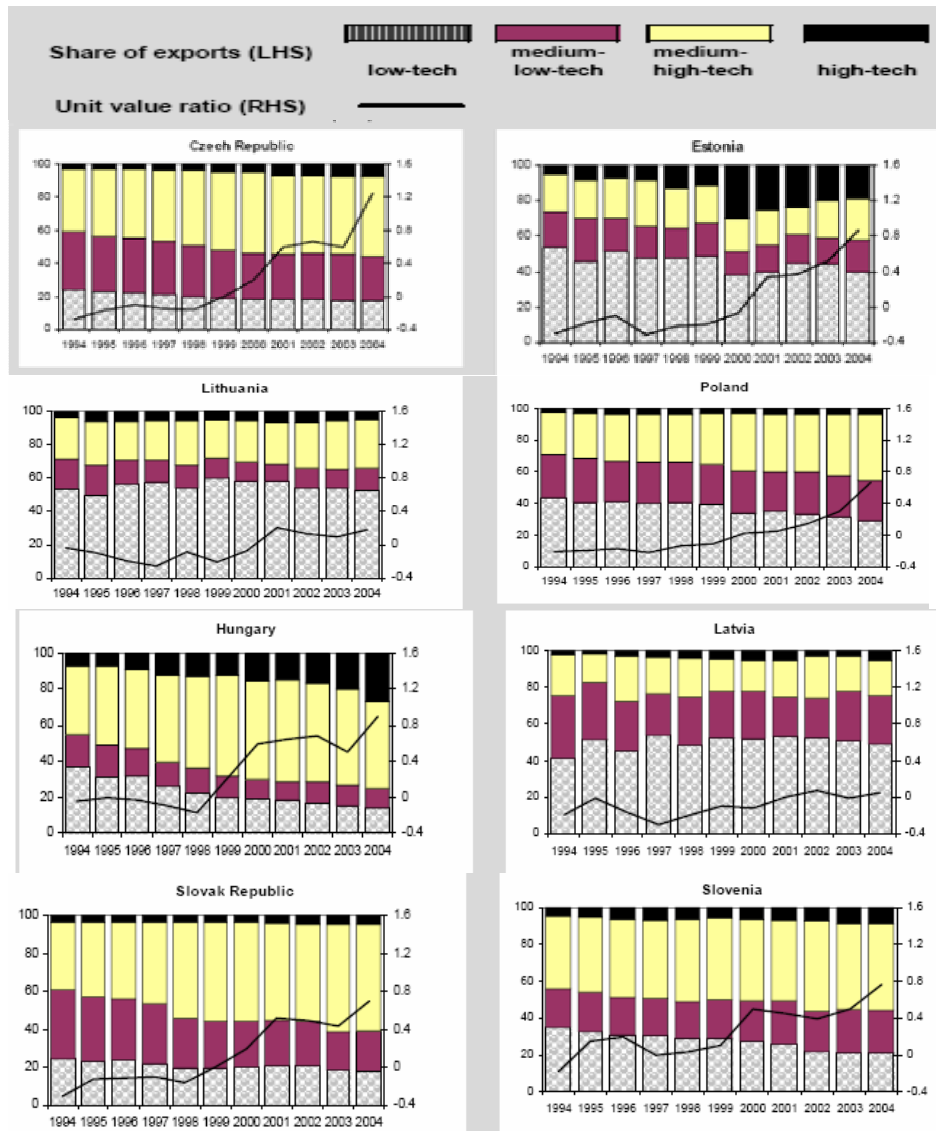
Figure 5 Terms of trade changes for (new) 2004 EU members after 2004



In most cases of 2004 EU members' terms of trade have slightly decreasing tendency. Lithuania makes an exception in these developments. Cost structure and competitiveness of most of the 2004 EU members is still rigid and competitiveness too slowly improving. Two above selected sets of development indicators are for 2004 EU members are not too positive. On the other side all new members due to in the past already proven fact enjoy relative high GDP growth rates, which according to experiences could be contributed to short term positive integration impacts on economies; actual decrease of costs in trade across internal borders, effects of financial supports from EU sources, increase of lower priced goods and services inflow from EU 15 and among new members, generally optimistic attitude of consumers – evidence above, and other. The question is how long such positive effects from integration can last, and what could be important in long run to keep positive (relative high) growth rates.

Long term successful growth by theory and according to Lisbon objectives could be achieved based on innovation growth. A measure to it is related to structure of high, medium and low tech products in GDB or export structure. More of higher tech products more positive effects could be developed from growth whether on large EU internal market or on the third markets. Slovenia is often supposed to be among more successful 2004 EU members. Looking to long term ability of keeping such at least relative position of Slovenia asks growing share of higher tech products in production and export.

Figure 6 Moving up the Technology and Quality Ladder (share in % of country export; 1994-2004) -2004 EU members



Source: Comtrade; IMF

Hungary and Estonia were most successful in increasing the high tech share in their exports. According to integration theory impacts and based on known facts, eventually such growth could be related to high level of FDI in both countries, helping to change the structure of production and export in the direction which could secure positive integration results long term. On the other side some indications especially in Hungary might suggest that such conclusion could be problematic. In any case reasons for growth of high tech exports in this two countries and on the other side relative stagnancy of same type of export for example in Slovenia – most successful new entrant – show as well different attitudes of national policies to integration opportunities especially to FDI flows. Case of Ireland and other above mentioned “old” EU countries suggest that beside opportunities offered by integration effects for faster economic growth, proper policy and business activities have to be developed and implemented so as to be successful in the process of EU cohesion.

5. ENLARGEMENT TRADE IMPACTS FOR SLOVENIA

Slovenia Export to EU25 and EU15 has a downfall trend caused by increases to EFTA, ex-YU (B&H in SCG), Bulgaria, and Romania. The turning point happened in 2005, so after entering the EU. Result is surprising from the integration theory aspect. Entering the internal market, with lower transaction costs should improve sales to the EU market. But that did not happen in case of Slovenia. An explanation could be based on reasoning that Slovenia had utilized EU market potential already before accession, and have received better “image” on EFTA or Western Balkan countries’ markets due to its EU status. On such ground growing exports to these markets could be explained at least to some extent. However import from EU25 has a growing tendency, which corresponds to the idea of trade creation after entering or changing the level of integration relationship. Share of trade with new EU members is growing throughout entire observation period.

Table 1 Slovenia trade with the EU and non-EU countries before and after EU accession

Export	Average share % 1996-2003	Average share % 1994-2006
Intra EU25	69,97	67,70
Intra EU15	62,94	58,81
Intra EU New members	7,04	8,89
Extra EU25	30,03	32,30
Extra EU15	37,06	41,19
Import	1996-2003	1994-2006
Intra EU25	75,70	81,14
Intra EU15	58,94	53,68
Intra 2004 New members	7,72	9,06
Extra-EU25	24,30	18,86
Extra EU15	41,06	46,32

Source: Calculation based on National Trade Statistics

Assessing the reasons for the above market structure of exports and imports of Slovenia is important especially to see if long term integration results could be expected positive too. Integration in long term is improving the competitive environment, so the companies improving their competitiveness could in long term enjoy the benefits of integration – of large and open internal EU market. One of indicators helping to see the long term “quality” of Slovenian sales on the EU market and of its exports to third countries is related to intra industry trade indicators. General growth of intra-industry trade (ITT) shows indirectly success and competitiveness of companies on global markets, including often their ownership or strategic alliance relationships.

Table 2 ITT for Slovenia based on Grubel-Lloyd indexes (3 level SITC)

	Grubel-Lloyd IIT index based on 3 level SITC				
	1996	1999	2003	2004	2005
Food live animals	42,931	42,107	38,749	39,030	46,303
Beverages and tobacco	75,213	63,896	45,470	58,458	60,109
Raw materials excluding fuels	39,135	43,96	44,009	47,251	53,425
Mineral fuels	14,631	12,506	10,849	24,391	30,526
Animals and vegetable oils, fats and waxes	39,269	40,892	37,594	30,122	33,381
Chemical products	56,577	56,547	58,008	58,352	60,072
Other semi-manufactures by material	67,714	70,073	69,932	69,272	70,626
Machinery and transport equipment	65,465	65,026	64,503	68,580	64,655
Finished manufactured products	70,640	68,302	68,499	65,722	66,427
Other products	18,348	9,791	87,724	59,638	39,791
TOTAL	61,895	62,479	61,486	62,821	62,258

Source: Calculated on the bases on Trade Statistics

The data in Table 2 show similar picture to the previous table data. Even more reasons for decrease of sales on the EU market after 2005 could be related to the developments shown by ITT indexes. Products with higher level of processing, potentially with higher value added are often showing decreasing index of ITT (finished manufactured products for example). On the other side less processed products are having increasing indexes of ITT, like food and live animals. Such situation, following the integration theory expected effects, might be contributed to better utilization of classical comparative advantages on the large EU internal market. Obviously such conclusion is problematic by the fact that natural environment and production tradition not allow assumption that Slovenia has really comparative advantage in food and animals production. In fact one can say that Slovenia has not yet concluded process of production restructuring induced by integration impact during the accession period. Is that bad or good? Restructuring will have to happen in some aspects CAP and other EU financial sources could make this restructuring faster and less problematic from the GDP growth sustainability.

Table 3 Vertical and horizontal ITT indexes for Slovenia (1995 and 2005)*

	IIT	HIIT	VIIT	VIIT1	VIIT2
1995	45,6	7,4	38,2	23,81	14,39
2005	48,58	13,3	35,28	22,42	12,86

*calculation based on 5 level SITC

Source: Calculated on the bases on Trade Statistics

Growing index for horizontally diversified products – vertical index of ITT – shows additional improvement in sales (exports) competitiveness. Unfortunately in case of Slovenia VIIT in fact is decreasing. Such development additionally at least on trade bases suggest that production restructuring in Slovenia will be needed. This will secure further successful cohesion development on the bases of broader utilization of the positive impacts on growth and welfare developed by the integration impacts.

6. CONCLUSION

Theory offers a number of expected effects supposedly created by the economic integration among national states. Different studies often predict aggregate integration results on the bases of additional GDP growth, or saving based on cost reduction and competition increases.

In practice integration impacts and results are difficult to detach from “normal” economic and welfare developments. Even measuring the integrated states convergence brings to the arena some doubts and questions. Especially how much really integration helps to higher level of cohesion and how much national policy in integration environment create and

support increased of cohesion -convergence. Obviously there is no clear answer to such question.

Some data on 2004 members of the EU show strong differences in their economic performance. Obviously different production structure, different national policies and different size and ownership in the business sector create strongly different integration impacts. Some expected results based on integration impacts for such reasons – case of Slovenia – could be delayed or not developed at all in relative short run.

Testing and exploring the real integration impacts on GDP growth and welfare in member states is still a challenge. The challenge is not smaller if we won't to check relation between envisaged integration results based on enlargement or deepening integration processes. There is practically no evidence that expected results are in reality possible to prove. Models used are giving results according to assumptions which normally strongly differ from the later developed in integration reality. However soft methods – Euro-barometer results – often shows, based on the answers in questioners, that welfare by integration is in generally improved.

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