

European Union enlargement

Effects on the Spanish
economy

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TABLE OF CONTENTS

	<u>PAGE</u>
FOREWORD	5
<hr/>	
INTRODUCTION	7
<hr/>	
I. SUMMARY AND CONCLUSIONS	11
<hr/>	
II. THE MAP AND EFFECTS OF ENLARGEMENT	21
2.1. The sequence of negotiations with candidates	21
2.2. Economic situation and evolution of candidate countries	28
2.3. The effects of enlargement: risks and opportunities	35
<hr/>	
III. STRUCTURAL AND COHESION FUND ADJUSTMENT AND REGIONAL REPERCUSSIONS	38
3.1. The Community budget and structural funds	41
3.2. Agenda 2000 and financial preparation for enlargement	52
3.3. The scenario for enlargement and its budgetary and regional repercussions	54
<hr/>	
IV. THE REPERCUSSIONS OF TRADE ADJUSTMENT	64
4.1. The evolution of Spanish and EU trade with the CEEC	64
4.2. The structure of Spain's comparative advantages vis-à-vis the CEEC	69
4.3. The impact of enlargement on Spain's trade	80

	<u>PAGE</u>
V. THE REPERCUSSIONS VIA DIRECT INVESTMENT	82
5.1. Economic integration and international direct investment	82
5.2. Spanish and EU flows of investment with the candidate countries	86
5.3. What is the risk that Spain will be displaced by the CEEC as a destination for direct investment?	93
VI. THE CHARACTER AND EFFECTS OF POTENTIAL MIGRATORY FLOWS	101
6.1. The extent and the nature of migration	101
6.2. The main economic effects of immigration from the CEEC	113
VII. MACROECONOMIC EFFECTS	121
7.1. Methodology	121
7.2. Effects of trade adjustment	125
7.3. Effects of enlargement and liberalisation of the single market	130
7.4. Effects of the adjustment of foreign direct investment (FDI)	132
7.5. Effects of the adjustment of European structural funds	134
7.6. Overview of the main macroeconomic effects of EU enlargement	139
VIII. LIMITING RISKS, SEIZING OPPORTUNITIES	142
BIBLIOGRAPHY	146

Foreword

Negotiations for a new enlargement of the European Union may be completed in 2002. Thirteen countries have already requested that they be admitted to the current group of fifteen. On the one hand, there are the ex-communist states of Central and Eastern Europe – Bulgaria, Slovenia, Estonia, Hungary, Latvia, Lithuania, Poland, Czech Republic, Slovakia and Romania – on the other, the southern Mediterranean states: Cyprus, Malta and Turkey. At the December 2000 Nice European Council meeting, the Council set the objective of completing negotiations by the end of this year for countries that are considered ready for admission.

There are a number of reasons why this round of EU enlargement will have greater and more complex consequences than were associated with the last enlargement, which saw the admission of Austria, Finland and Sweden: the number of candidates is higher, as is their weight in terms of population, territory and GDP; they are also further from the EU in terms of income, development, productive structure and labour costs, and due to their socio-political peculiarities. The effects of this enlargement will be felt in the political, institutional and economic spheres. They will be noted in the Union as a whole, and in a distinct manner in each of the member countries. In this context, the question arises of what the impact on the Spanish economy will be, and it is to this question that this volume seeks to provide an answer. The authors are Carmela Martín, professor of Economics at the Universidad Complutense de Madrid, José A. Herce, Executive Director of the Foundation

for Applied Economics Studies, Simón Sosvilla, lecturer in Economic Analysis at the Universidad Complutense de Madrid and Francisco J. Velázquez, lecturer in Economics at the same university. The authors have received assistance from Encarnación Cereijo and Jaime Turrión.

Throughout this work, the foreseeable consequences of European Union enlargement for the Spanish economy are thoroughly and clearly presented. The authors examine the effects on trade adjustment, the flow of direct investment, migratory movements, macroeconomic balances and the allocation of structural funds to the various autonomous regions.

The outlook in terms of relative costs and benefits is not very encouraging. For the Spanish economy, it is not likely that enlargement will have a positive impact in practically any of the areas analysed, particularly if effects in Spain are compared with those likely to be experienced by the majority of the fifteen EU states. In this light, the effort of the authors to suggest various means of minimising costs and taking advantage of opportunities is especially relevant.

La Caixa's Economic Research Department has published six works in this collection of economic studies. These cover different aspects of the European Union, and their number reflects the importance we attribute to the process of European construction. We hope that this work, which we believe is particularly timely, provides information and a basis for reflection, and that in so doing it helps make it possible to minimise the risks and take advantage of the opportunities of enlargement.

Josep M. Carrau

Chief Economist

Barcelona, March, 2002

Introduction

A few decades ago, the precursor to the European Union consisted of a homogenous group of half a dozen developed countries. In creating a customs union, this group took the first step on a journey that has led to the solid economic union we now know: fifteen countries with diversified economies, a monetary union that encompasses twelve of these, and a series of political, legal and economic institutions capable of sustaining and driving developments in all the areas of activity that now characterise a grand-scale community in the global context. Though this process may have temporarily slowed down or been interrupted at times, there has been no step back. In fact, there have been periods of intense development on all fronts, even in relatively unfavourable circumstances. The simultaneous unfolding of some of these developments has put to the test the capacity of member countries to conceive ambitious goals and then to achieve them, but this test has been passed. The single currency is a case in point: its implementation is a watershed event that has opened the way to the kind of political and institutional developments that characterise the finest stages in a process of integration. The European Union has experienced a *deepening* in many respects, and this has occurred in the context of a constant *widening*. Viewed from a historical context, the recurring debate about the incompatibility of these two strategies becomes irrelevant: it has been demonstrated that, in the long term, they are mutually consistent.

As the twenty-first century begins, Europe continues to pursue the type of achievements that have characterised it up until now, but it is also fully

mobilised to undertake expansion on a continental scale. In little more than a decade, this expansion will lead to a Europe with nearly thirty members – twice the current number. This process represents a challenge on a scale without precedent, and how it is met will determine the role that Europe is to play on a global level in the coming decades.

At this point, thirteen countries have applied for accession: the ten Central and Eastern European countries (CEEC), which were formerly members of the communist block, as well as Turkey, Cyprus and Malta. All are official candidates for accession, and negotiations have been opened with all of them except Turkey; for ten of these countries, negotiations will be concluded in 2002. The last EU enlargement took place in 1995, when Austria, Finland and Sweden, former members of EFTA, were admitted. However, given the high number of candidates, the special economic and political circumstances of the potential members and the challenge of governability associated with a Union with nearly thirty members strongly oriented toward continental integration, the present round of enlargement is unlike those that have preceded it.

Citizens of the Union will note the consequences of this development in numerous areas of collective and individual life. On a political level, the design of new rules for representation and decision-making will strengthen the democratic foundations of the Union. The main challenge to be faced in this context is nationalism in the forms that it currently takes in Europe. In terms of freedoms, human rights and the defence of minorities, Europe can, for the first time, grasp the real opportunity that exists to establish such principles on a continental scale. By doing so, the EU will create a mark of identity and a global point of reference, which will in turn sustain the increased diversity that enlargement will entail. In economic terms, the consequences will at last be noted in every corner of Europe.

The intensification and diversification of the flow of goods, services, capital and labour, together with the broadening and full liberalisation of the internal market will lead to a structural change in specific sectors and regions. Such developments will also contribute to an increase in the potential growth rate of the European economy, which will be of particular benefit to new member countries. There will, however, still be risks for the economies of the

current members of the European Union, the kind of risks that are always present when there is an increase in the degree to which an economy is exposed to relations with the rest of the world. In order to minimise these risks, some Community policies with economic implications, such as the agricultural and cohesion policies, will require significant modifications.

In addition to the general consequences of this new phase of European Union enlargement, distinct repercussions will be felt in each of the current EU member countries, including Spain. For Spain, as for other member countries, the question of how the flow of trade, workers and direct investment will be oriented is an important one. The implications of enlargement for the total amount and the distribution of structural funds must also be analysed: there are significant reasons why Spain is one of the main recipients of these funds. In turn, the macroeconomic balances of the Spanish economy will also be affected, particularly growth, employment and price behaviour. All of these areas will be examined in this study.

Faced with the magnitude of the change that the EU and the Spanish economy are to undergo, and the diverse nature of the effects that will accompany this change, we have focused on what we believe is a relevant set of these effects. First, we present a detailed analysis of the process of negotiation for candidate countries and an outline of their economic situation, as well as a first qualitative balance of the effects of enlargement (chapter II). The main repercussions are discussed and, to the extent that it is possible, an attempt is made to estimate their dimension. In chapter III, we turn our attention to regional repercussions. These are attributed to the adjustment of structural and cohesion funds, but the discussion is also framed in the context of the Community budget and the main characteristics of the way that it has been formulated from 1989 until the end of the current planning period in 2006. In order to speak with precision of the effects of enlargement at this level, however, we must (and do) undertake an analysis of the problematic budgetary outlook for the 2007-2013 period.

In chapter IV, we focus on the repercussions of trade adjustment, which is another source of effects that merit particular attention (and are generally problematic). The CEEC benefit from a competitive differential based on labour costs, and the effect of this differential is being exacerbated by large

transnational companies who are pursuing an aggressive policy of setting up production facilities in these countries. This has implications for the flow of direct foreign investment, and the impact on the Spanish economy is analysed in chapter V. Such an analysis is essential given that Spain competes with all of the CEEC for foreign investment, both from within the EU and from other countries. At present the amount of investment of this type in Spain and in the CEEC as a whole is at a similar level. Spain has had a certain degree of success in competing with these countries, but much uncertainty remains.

In chapter VI, we examine the effects of enlargement on migratory flows from the CEEC. Immigration is a pressing issue and the subject of a great deal of concern in Spain. Given that this immigration will be from Central and Eastern Europe, however, and within the EU context in which it must be seen, it is not likely that there will be major developments in this area. This is not the first time since the fall of the iron curtain that the prospect of migration from Eastern Europe has been viewed with alarm in Europe, but the reality of this phenomenon has never fulfilled the rather alarmist expectations. Furthermore, the perspective of the immediate incorporation of these countries in the EU will, in itself, reduce migratory flows. Neither, is it likely that Spain will be the country most affected by migration, given its geographical location and other factors.

In chapter VII, we attempt to transfer these effects (in regional, trade and direct investment terms) to the macroeconomic framework. This is done by using a series of hypotheses to express these alterations in terms of changes in the exogenous parameters or variables of an econometric model of the Spanish economy. We seek to quantify these effects for the main macroeconomic balances (GDP, employment, prices and salaries, etc.).

Each chapter includes concluding reflections, and two entire sections are dedicated to presenting these systematically. In chapter I, we present an extensive summary of the content of chapters II to VII, highlighting the main conclusions of our study. This chapter is, in effect, an executive summary. In addition, chapter VIII contains an extensive strategic analysis based on the main findings of the study. Particular emphasis is placed on ways in which Spain can limit the risks that come with enlargement while making the most of the opportunities it generates.

I. Summary and conclusions

The road map and effects of enlargement

Before the end of this decade, as many as twelve countries will have joined the European Union as full members. The candidates that may be admitted in this time frame are ten Central and Eastern European countries (Bulgaria, Slovenia, Estonia, Hungary, Latvia, Lithuania, Poland, Czech Republic, Slovakia and Romania), along with Cyprus and Malta – twelve states in total. For the first time in its history, the EU is on the verge of reaching the continental scale, and the coming change is bound to bring with it a wide range of consequences.

Taken together, these twelve countries, which we will refer to as the CEEC throughout this study, currently occupy a land area that is equivalent to 33.5% of that of the Union and have a combined population of more than 105 million (28% of that of the EU); their GDP is 12% of that of the EU, and per capita income, adjusted for purchasing power parity, is 44% of the EU average. These countries present a different pattern of specialisation and competitive advantages than the majority of the fifteen current EU members; they are clearly moving in the direction of macroeconomic stability and are experiencing high growth rates. They also have a highly qualified workforce, which, given their imminent incorporation in the EU, makes them particularly attractive for direct foreign investment, both from the EU and from other sources.

Given these characteristics of the CEEC (and without taking special institutional and regulatory factors into account), a wide range of consequences can be deduced for the current members of the Union, including Spain. The first phase of formal enlargement is likely to occur in 2004, with the accession of all of the countries except Bulgaria and Romania (which will be admitted later). To a certain degree, the consequences of this are already being noted as each member or candidate country prepares for the changes ahead. The purpose of this study is to examine in detail and quantify the consequences for the Spanish economy of enlarging the EU to include the CEEC.

All of the countries that are candidates for admission must go through a thorough process of preparation, which requires them to fulfil a series of general conditions in over thirty open chapters (as was required of Spain in the years preceding its admission to the CE). Fast-paced preparation for enlargement began just a few years after the fall of the Berlin Wall. General requirements concern the adoption of democratic principles, market economies and the *acquis communautaire* of Community rights and obligations covering all areas of EU competence. Particularly important are those aspects of the *acquis communautaire* that are of a political, economic or monetary nature. The negotiation chapters cover all of the major sectoral matters for which the Union has defined policies and precise competences, and negotiation in these areas is aimed at establishing terms for accession that are acceptable to all parties, while at the same time adopting the *acquis communautaire* and establishing transitory periods, etc.

In just one decade, significant progress has been made in negotiations, and, with the exception of Bulgaria and Romania, the candidate countries have done their homework in terms of macroeconomic stability. In spite of the fact that many set out from low initial levels, they have also initiated a process of growth that has put them on track for real convergence with the EU. Consequently, enlargement is imminent, and now is the time to undertake a detailed analysis of its consequences for the Spanish economy.

Various types of consequences can be delineated: sectoral (agriculture, manufacturing, etc.), trade (competitiveness and relative costs; extension and liberalisation of the Community market), financial (flows of investment) and

demographic (migration). A major reorientation of Community policies will result, affecting policies such as the CAP and, especially in the case of Spain, regional policy. All of the consequences of enlargement will in turn be reflected in the main macroeconomic balances of Spain's economy.

The adjustment of structural and cohesion funds and regional impacts

If current eligibility criteria for Objective 1 Structural Funds are maintained, only three of the ten Spanish O-1 regions that now receive support will continue to do so in 2007: Andalusia, Extremadura and (barely) Galicia. Spain would also lose the assistance received from Cohesion Funds. The three regions mentioned would maintain their eligibility because per capita incomes would remain below 75% of the new EU average, which would be 12% lower than the current figure. For Spain as a whole, per capita income would be approximately 94% of the average for the twenty-seven EU members. This statistical effect reflects a reality that goes beyond statistics and points to the need to reorient Community policies. Clearly, possible reformulation of financial perspectives for the 2007-2013 period will affect discussion of the impact of enlargement, and analysis of how policies will have to be adjusted. Budgetary figures for the 2000-2006 period were adopted in Agenda 2000 and cannot be altered, regardless of the fact that the first substantive stage of enlargement will take place in this period. It is not an easy task to map out a course in the budgetary terrain of the EU, but, given the evidence of the recent past, it is reasonable to expect that while spending allocations for specific items may experience substantial adjustments over time, overall credits for spending are only slightly higher than 1.1% of Community GNP while overall resources do not exceed 1.27%. Within these limits, however, nothing can be ruled out when it comes to the tough negotiating process that will soon have to be undertaken in preparation for the next period. Community power politics will come into play in full force, and the focus will be on the need to make major adjustments in spending on the agricultural guarantee, while at the same time reforming the CAP to create a margin to respond to new needs, be they structural or otherwise.

The budgetary scenarios we have established suggest that within the twenty-seven-member EU significant resources will still be available for structural actions and for those intended to promote cohesion. It is less clear, however, that Spain will manage to maintain the same level of support as in the previous period. The quantitative dimensions of the Spanish economy are of a somewhat smaller scale than those of the CEEC as a whole: in 2000, Spain's GDP was 65% of the CEEC average. Spain must therefore compete in many areas – not only for structural support. The regional panorama that emerges from our analysis is problematic, and, apart from examining the best way to confront the challenges ahead (chapter VIII), we have estimated the order of magnitude of the changes that are to be expected in different scenarios. These estimates will be discussed at a later point in this analysis. These effects are bound to be negative, but, in this context, it should be pointed out that Spain will not cease to receive structural support, as an Objective 1 region or on some other basis.

The net contributions to the EU budget are distributed to the countries with the lowest levels of income in a manner that is reasonably proportional. This same rule of proportionality has been applied in the distribution of structural and cohesion support within Spain, with less developed regions receiving greater assistance. It could be argued that the declaration of Objective 1 has simply created one particular channel for the flow of support to the regions. In the context of an active regional policy, this support would otherwise have reached the regions through some other channel. From this perspective we can discern an alternative to the drastic reduction of structural support – a scenario in which there are trade-offs between agricultural subsidies and structural support. These two types of assistance are quite distinct in nature, and it is likely that the latter provides a much greater boost to regional economies than the former.

The repercussions of trade adjustment

The likely impact of EU enlargement and the resulting trade adjustment on the Spanish economy can be inferred from the predictions of the theory of international economic integration: bilateral trade with new

members will expand, and it is possible that some Spanish exports to the rest of the current members of the Union will be substituted by those of new members. The intensity of these effects will depend on the degree of similarity between Spain's trade flows and those of the CEEC, as well as on how relative competitiveness evolves.

Our analysis of the risks associated with trade adjustment begins by showing that trade relations between the Spanish economy and the CEEC lag far behind those of major economies within the Union. Spain occupies the sixteenth position, with a meagre 1.8% of total exports to the CEEC and 1.4% of total imports. Germany (25% of exports and 33% of imports) is by far the main client and supplier for the candidate countries, followed by Italy, Russia (exports), Austria and France. Furthermore, the relationship between Spain and the CEEC is increasingly one in which they compete for the rest of the Community market, in terms of trade flows and as a result of the similarity of the trade goods and services they offer. In this context, our analysis of the respective indices of specialisation for Spanish and CEEC exports indicates a gradual decline in Spain's relative exports, not only in conventional sectors but also in dynamic and high-tech areas.

The Central and Eastern European countries are gaining this progressive advantage as the result of two factors whose growing significance cannot be doubted: direct foreign investment, which raises the level of technology in CEEC economic sectors, and the global strategies of multinationals, which give the countries in this region a privileged place in supply networks for manufactures and semi-manufactures. Spain's trade with these countries is, moreover, more inter-industry (82% of the total) than intra-industry, whereas with the rest of the EU, 43% of Spain's trade is of the latter type. It should be observed that two key sectors, equipment goods and automobiles, are exceptions to this pattern. In general, in its intra-industrial trade with the CEEC, Spain exports higher quality goods than it imports. This difference is, however, diminishing over time.

Contrary to what might be expected, agriculture is an area in which Spain has increasing specialisation in trade with these countries, in spite of the fact that this sector carries a great deal of weight in the CEEC economies.

This is due to the greater productivity of Spain's agricultural sectors and the protection that still exists in exchanges of this type. Given the uncertainty surrounding the future of the CAP after enlargement, however, there is no clear basis on which to predict how trade in this area will develop in the future.

The analysis of these matters presented in chapter IV leads us to expect a progressive increase in trade flows between Spain and the CEEC. It is quite likely, however, that Spain's imports will increase more than its exports, resulting in a deterioration of the balance of trade with the CEEC, which, at present, is positive but decreasing. We also see clear indications that Spain's role as a supplier to the European market may be adversely affected by enlargement. This is the case not only in low-demand, low-tech sectors, but also in more dynamic and technologically advanced sectors, where the CEEC are increasingly active as a result of actions taken by investors and large foreign multinationals.

The impact via direct investment

The effects of direct investment are even more significant than trade effects. In fact, direct investment acts to stimulate trade by means of two powerful levers: technology and the investment strategies of large multinational companies. Free trade between the EU and the CEEC is gradually increasing and will make a great leap forward when enlargement takes place, between 2004 and 2007; in contrast, free movement of flows of direct investment has been a reality since the signing of the Europe Agreements, and its consequences are now increasingly clear: the CEEC region has shown a remarkable dynamism in this area, and over the last decade, the countries in the region have accumulated an appreciable stock of direct investment in relation to their GDP – substantially greater than that of the EU as a whole. EU companies hold almost 70% of this stock, with the largest proportion in the hands of German and Dutch companies (19% and 14% of the total respectively). Spanish companies occupy an alarmingly low position in this ranking, with a token 0.5% of total stock. A complete lack of strategy in the approach taken by Spanish companies seems to be the only

explanation to be found for this state of affairs. The free movement of flows of direct investment means that the CEEC can compete from an advantageous position to attract future flows of direct investment. Although this has not occurred in recent years, it constitutes a risk for Spain, which has benefited a great deal from direct investment in recent five-year periods.

Direct investment reaches an economy in search of competitive advantages and an advantageous geographical location: the CEEC offer a range of benefits of this type. Its «central» geographical location – in close proximity to the axis comprised of the Nordic countries, Germany and Northern Italy – is the first advantage it offers. Of course, the importance of distance must not be exaggerated in the context of a dematerialised economy where unit costs for transport are rapidly decreasing. More crucially, these countries still offer substantial advantages in terms of labour costs, which are 16% (less than one sixth) of those in Spain, and 11.5% of the EU's. Moreover, the CEEC can offer human capital of a quality similar to that available in Spain, though it should be acknowledged that this element is difficult to measure and compare in a precise manner. CEEC institutions (economic, political, regulatory, etc), still in the transformation stage at present, will be fully adapted to meet Community standards when accession takes place, if not before.

In analysing the impact of possible shifts in direct investment, as in the case of trade adjustment, we must conclude by recognising the difficulty of making predictions concerning the risk that the CEEC may compete successfully with Spain for foreign investment. Nevertheless, in our view, this is a very real danger if Spain does not maintain and renew its locational advantages. It is particularly important to ensure that both transport and communications networks are fully modernised, and that human and technological capital are brought up-to-date. As we have mentioned, Spain's economic dimensions, though slightly smaller, are similar to those of the CEEC as a whole. Another similarity is that both Spain and the CEEC allocate the same percentages of GDP to R&D (0.89%) and to information technology (2.1%).

The characteristics and effects of potential migratory flows

Citizens of the Central and Eastern European countries that are candidates for accession to the EU are already present, to one degree or another, in all of the current member states. The free movement of persons within the enlarged Union will be subject to transitional periods varying in length and to certain restrictions. Currently, however, residents who are from these countries are protected from discrimination by the pertinent provisions of the Europe Agreements, which Spain has ratified. In any case, CEEC immigrants make up only 0.02% of the total population of Spain; the figure for the EU as a whole is ten times higher. Somewhat more than half of the CEEC immigrants residing in Spain are of Polish origin.

Various estimates set potential migration from the CEEC to the EU-15 states at slightly over one million persons by 2010, just after full integration, or slightly more than two hundred thousand persons per year. It is considered unlikely that immigrants from these countries will reach 0.1% of the total Spanish population by 2015. In part, the fact that expected migration is so low reflects the view that development in the CEEC will be boosted by EU membership. In fact, countries such as the Czech Republic, Slovakia and Slovenia currently receive a net inflow of migrants.

This phenomenon does not appear to be of major significance for Spain or for the majority of current EU members. In contrast, as a result of their cultural and geographical proximity to the region, Germany, Austria and Italy have been, at least up until now, the chosen destinations for CEEC emigration. In general, when migratory flows reach a certain level, the consequences are particularly noted in the labour market, where there is an increase the labour supply and, in theory, a decrease in wages. In such circumstances, national income increases and is redistributed in favour of immigrants themselves and the owners of productive factors. Clearly, the degree to which this redistribution occurs depends on a number of variables, including the imperfections of the labour market and the relative skill level of the immigrants. Observation of these effects in countries with significant levels of immigration indicates that wages of skilled workers increase while

those of unskilled workers decrease, though these variations are, for the most part, moderate.

Macroeconomic effects

Many of the ways in which the Spanish economy will be affected by EU enlargement are problematic (with the exception of the effects of the extension and liberalisation of the single market). Our estimates of the macroeconomic consequences indicate that, in the context of the scenarios considered, trade adjustment and the partial redirection of foreign investment are likely to result in a fall in employment and in aggregate production, particularly in manufacturing. An additional factor that will subsequently come into play is the reduction of EU structural assistance. In the context of the scenario contemplated for structural fund assistance in the 2007-2013 period, we estimate that output for 2007 will be nearly 2% lower than would have been the case in the absence of the effects described; for 2013, the reduction is estimated at 1%. According to our analysis, this reduction in output is likely to be accompanied by a significant reduction in prices and wages, and an increase in the unemployment rate of approximately one percentage point with respect to its level in the baseline model simulation used for the analysis.

The greater fall in real production is the result of the considerable structural adjustment that will need to occur in the manufacturing sector: in the framework of enlargement and liberalisation of the internal EU market, it will not be possible for Spanish industry to gain ground in foreign markets without losing market share domestically. According to our simulations, the fall in real production will be more marked if the flows of FDI are even less than those contemplated.

Only the extension of the internal market has a markedly positive effect on the main macroeconomic balances in the medium and long term. In all of the scenarios analysed, the adjustment of structural funds leads to falls in production and employment, and in none of the analyses is there any indication of a recovery of 2000-2006 levels. Structural funds received in the

2007-2013 period will, nevertheless, continue to have a stimulating effect on the Spanish economy, albeit on a more limited scale. It is difficult to imagine a scenario in which EU structural and cohesion policy remain unaltered, and it is precisely the downward adjustment of structural funds with respect to such a scenario that leads to the negative consequences anticipated.

We do not see our results as particularly negative, bearing in mind the scope of the change that is to occur in the EU economy as a result of enlargement. In any case, they constitute our best approximation of a complex process that is unfolding before our eyes. The distance between Spain and the candidate countries is considerable, but the economic, financial and budgetary relations that EU membership implies play a greater role than we tend to think –in terms of both transmitting problems and creating opportunities. Although the prevalence of negative effects warrants concern, many of our results indicate consequences that may be positive *or* negative. This suggests that impacts related to trade, the single market, shifts in foreign investment or modifications to EU support can be counteracted by using the very resources that EU membership gives Spain access to. This approach will remain an option after enlargement becomes a reality.

II. The map and effects of enlargement

2.1. The sequence of negotiations with candidates

At the beginning of the nineties, after the collapse of the communist regime, ten Central and Eastern European countries (CEEC) – Poland, the Czech Republic, Slovakia, Hungary, Estonia, Latvia, Lithuania, Bulgaria, Romania and Slovenia – gradually began to move closer to the EU as they sought to distance themselves from the former Soviet Union. At the same time, they undertook a clear process of transition toward democratic government and market economies.

The approximation of these countries to the EU was not only in their interest: from the perspective of the Union, such a development presented the possibility of gaining significant political and economic benefits as a result of the fall of the Berlin Wall. As a result of this mutual interest, a series of diplomatic relations were established, and, in the first half of the nineties, these led to the Europe Agreements.

These Agreements were the first instruments for bilateral cooperation: they have served to promote economic relations between the EU and each of the CEEC, and to stimulate the CEEC to gradually assume the *acquis communautaire*. In order to facilitate these changes, the Agreements also included provisions for financial assistance through the PHARE programme. In this manner, a foundation was laid that recognised the intention of the

CEEC to join the Union. Since that time, progress has been made toward this goal, as can be observed in Table 2.1, which outlines the chronology of the process of negotiations that are to lead to enlargement.

Table 2.1

A CHRONOLOGY OF THE INTEGRATION OF CENTRAL AND EASTERN EUROPEAN COUNTRIES IN THE EU

1988	The European Economic Community (EEC) and Hungary sign a Trade and Cooperation Agreement.
1989	After the fall of the Berlin Wall on 12 November, a set of common interests emerges between the EEC and some Central and Eastern European countries. These interests are the motivation behind the eventual association of these countries with the EEC. The PHARE programme is set up to provide financial assistance to Central and Eastern European countries.
1990	In July, Cyprus and Malta apply for accession to the EU.
1991	In December, the European Economic Community (EEC) signs the first Europe Agreements with Poland and Hungary. These agreements cover trade, political dialogue, legal approximation and other areas of cooperation such as industry, the environment, transport and customs. On 25 June, Slovenia gains its independence from the Federal Republic of Yugoslavia. Two months later, Estonia and Lithuania declare independence from the USSR. They are followed by Lithuania in September.
1993	On 1 January, the Czech Republic and the Slovak Republic are created after the dissolution of the Czechoslovak Federation. In February and March, Romania and Bulgaria sign the Europe Agreements; they are followed in October by the Czech Republic and Slovakia. In June, the Copenhagen European Council is held, and criteria for accession are established.
1994	On 1 February, the Europe Agreements signed with Hungary and Poland enter into force. The two countries apply for accession to the EU, in March and April respectively. In December, the Essen European Council puts into effect a pre-accession strategy aimed at greater approximation of the CEEC and the Union.
1995	Renewal of the PHARE programme and publication of the White Paper on «Preparation of the Associated Countries of Central and Eastern Europe». The PHARE programme and the White Paper are formulated as essential instruments within the pre-accession strategy. In June, Latvia, Lithuania and Estonia sign the Europe Agreements with the EU. The agreements signed with the Czech Republic, Slovakia, Romania and Bulgaria enter into force in February. In June, Romania and Slovakia apply for accession to the EU. Between October and December, Estonia, Latvia, Lithuania and Bulgaria also apply. In December, the Madrid European Council is held and Agenda 2000 is commissioned. Agenda 2000 defines the stages that candidate countries must pass through for accession to the EU.

Table 2.1 (continued)

A CHRONOLOGY OF THE INTEGRATION OF CENTRAL AND EASTERN EUROPEAN COUNTRIES IN THE EU

1996	<p>On 17 January, the Czech Republic applies for accession to the EU.</p> <p>On June 10, Slovenia signs the Europe Agreement with the Union, which replaces the existing Cooperation Agreement. On the same date, Slovenia applies for accession.</p> <p>Malta is excluded from the enlargement process after withdrawing its candidature.</p>
1997	<p>On July 17, Agenda 2000 is published.</p> <p>The Luxembourg European Council, held in December, accepts the candidatures of the ten countries. The Council is requested to prepare regular reports on the progress of the candidate countries. Measures are also adopted to reinforce the existing pre-accession strategy.</p>
1998	<p>In February, the Europe Agreements signed by Estonia, Latvia and Lithuania enter into force.</p> <p>On 12 March, the first European Conference is held.</p> <p>On 30 March, negotiations begin with the countries that are candidates for accession (Poland, Hungary, the Czech Republic, Slovenia, Estonia and Cyprus).</p> <p>In June, the European Council meets in Cardiff and a request is made that reports also refer to Cyprus and Turkey.</p> <p>In October, Malta again presents its candidature for accession.</p>
1999	<p>On 1 February, the Europe Agreement signed by Slovenia enters into force.</p> <p>Meeting of the European Council in Berlin (24 and 25 June): new financial perspectives are determined for the Community budget and a message of reassurance is sent to the countries negotiating for accession.</p> <p>The European Council meets in Helsinki on 10 and 11 December and modifies the focus of enlargement negotiations, switching from an approach by groups to an individual negotiating strategy.</p>
2000	<p>SAPARD and ISPA are incorporated as new instruments for financial assistance that complement PHARE.</p> <p>On 15 February, bilateral intergovernmental conferences are held to initiate formal negotiations with Romania, Slovakia, Latvia, Lithuania, Bulgaria and Malta.</p> <p>The Nice European Council (7-11 December) introduces modifications to existing treaties to create a new Treaty that reforms power structures and decision-making mechanisms in the framework of the enlarged EU.</p>
2001	<p>On 26 February, EU member countries sign the Treaty of Nice.</p> <p>On 15 and 16 June, the Göteborg European Council is held. A working framework is agreed to successfully culminate the enlargement process and a statement is made that the process of integration is irreversible.</p> <p>The Laeken European Council sets the guidelines for the preparation of the 2004 Intergovernmental Conference.</p>

Sources: European Commission (1999 and 2000b) and European Parliament (1998 and 1999).

The Copenhagen European Council (held on 21 and 22 June 1993) was the fundamental starting point for this process. It was there that the decision was made to integrate those countries of Central and Eastern Europe who sought this goal. Their accession to the EU would depend on the fulfilment of a series of economic and political conditions necessary for integration. These conditions, which are the guiding principles for all actions taken by the candidate countries, fall under three broad criteria:

a) A political criterion, which requires of candidate countries a stable institutional framework that guarantees democracy, the rule of law, human rights, and respect for and protection of minorities.

b) An economic criterion, which requires the existence of a functioning market economy, as well as the capacity to face competitive pressure and market forces within the Union.

c) A final criterion requiring assimilation of the *acquis communautaire*, which specifies that the candidate country must possess the capacity to assume the obligations of accession, and, specifically, to comply with the political, economic and monetary goals of the Union.

Another important step in the process of accession was taken at the Madrid European Council, which was held on 15 and 16 December 1995. At this Council, the Commission was invited to carry out various tasks related to enlargement, such as preparing official reports on the candidatures for accession, evaluating the effects of enlargement on Community policies, creating a joint document on enlargement, and, finally, presenting a communication on the future financial framework for the Union after 31 December 1999. In response to all these requests, on 16 July 1997, the Commission presented Agenda 2000 to the European Parliament.

Agenda 2000 recommended that the existing pre-accession strategy be strengthened to guarantee that the CEEC would adopt the *acquis communautaire*. This was to be accomplished by means of two new instruments that would consolidate the preparation of candidates as they moved toward accession: the Accession Partnerships and participation in Community programmes.

The first essential part of this strategy, the Accession Partnerships, is intended to regroup all the CEEC assistance initiatives in preparation for the subsequent implementation of the National Programmes for the Adoption of the Acquis, which set out in detail how each country will fulfil the short- and middle-term priorities necessary to prepare for their integration into the EU (established in the Accession Partnerships). The Accession Partnerships are reviewed annually by the Commission in order to assess the degree to which objectives have been achieved. Fulfilment of these objectives constitutes the basis for negotiations with the candidate countries. The other essential part of the accession strategy involves the participation of candidate countries in Community programmes, which is intended to provide them with an opportunity to become familiar with the policies and instruments of the Union.

In accordance with the Agenda 2000 recommendations, which included the suggestion that for accession to be successful a reinforced pre-accession strategy should be combined with negotiations based on the principle of application of the *acquis communautaire*, the Luxembourg European Council decided to initiate negotiations with a first group of six countries (Poland, the Czech Republic, Hungary, Slovenia, Estonia and Cyprus). The other candidate countries were allowed more time for preparation: for them, negotiations would be initiated as soon as they made the necessary advances. In this manner, candidate countries were segmented into two groups.

Faced with a great deal of strongly-voiced criticism in response to this decision, the Helsinki European Council (10-11 December 1999) agreed to start negotiations one year later with the second group of countries – Romania, Slovakia, Latvia, Lithuania, Bulgaria and Malta. From this point on, negotiations have been determined by the progress made by each of the twelve candidates in terms of their capacity to apply and assimilate the *acquis communautaire*. In accordance with a principle of differentiation, each state is judged on its own individual merits.

Prior to the initiation of negotiations, a systematic analysis, known as «acquis screening», is carried out to determine the extent to which the laws, regulations and institutions of the candidate state comply with the *acquis*

communautaire. The process is intended to assess the difficulties facing each country and identify the steps that need to be taken to bring the areas examined sufficiently in line with the *acquis*.

Negotiations, which are based on thirty-one chapters covering all the areas of the *acquis*, take place in bilateral conferences between Member States and candidate countries. The Union determines the nature and the number of the negotiation chapters to be opened with each candidate country, based on the stage they are at in the process of preparation. Similarly, provisional closure of chapters for candidates is decided according to their level of fulfilment of the accession progress objectives to which they have committed themselves, and in view of the results of negotiations.

In theory, it is possible for a candidate from the second group, which initiated negotiations later, to reach the same point in the accession process as a country in the first group; in fact, significant differences remain in the degree of progress made by candidate countries in the two groups. The six countries with which negotiations were started in 1998 have closed approximately half of the thirty-one chapters, and the rest are under negotiation. In contrast, for the second group of countries, many chapters have yet to be opened. Specifically, Hungary, Cyprus, Slovenia and the Czech Republic have made the most progress in accession negotiations, while Bulgaria and Romania lag furthest behind in the process.

The chapters that have been closed are those whose content involves a lower level of commitment (Statistics, Industrial Policy, Small and Medium-Sized Undertakings, Science and Research, External Relations, Consumers and Health Protection, and Common Foreign and Security Policy); the chapters for which negotiations remain open are those which have greater budgetary implications (Regional Policy and Structural Instruments, and Financial Provisions), and those which concern the internal market (Free Movement of Goods, Free Movement of Persons, Taxation, Energy, and Justice and Home Affairs).

A final key event that merits inclusion in this chronological overview of enlargement is the undertaking of the process of reform necessary to overcome institutional and political barriers within the Union. No calendar

has been set for these reforms, so it is impossible to accurately predict the dynamic of the process or its final outcome. The goal, however, is to ensure that the Union is prepared to admit new members from 2004 on. The process was initiated at the Nice European Council (December 7-9 2000) where modifications were made to key European institutions, including the Council, the Commission and the European Parliament.

One of the most significant reforms up to this point is the establishment of a new system to determine the distribution of votes in the most important European institution, the European Council. The new system will take effect for current member countries on 1 January 2005, and will apply to each of the candidate countries when they are admitted to the Union. Many areas that previously required unanimity for a decision to be made will, from 2005 on, require only a qualified majority; the weighting of votes for the various countries will be more closely tied to population; and the system of reinforced cooperation is definitively established. The effect of the new system is to shift decision-making power, and, consequently, the power to block, to the four EU countries with the largest populations – France, the United Kingdom, Italy and Germany. With the largest population in the Union, Germany is particularly favoured by this reform.

One of the results of the Nice Council is a significant alteration of the number of seats in the European Parliament: in the enlarged EU, the number of seats may not exceed 732 (which compares to the 626 seats in the current parliament). The distribution of seats is also modified, and the number of MEPs for future Member States is established. The modifications mean that all member countries will experience a loss of representation, with the exception of Germany, which will hold greater sway in the European Parliament.

As for the European Commission, the most important development to be noted is the limitation of its composition to one Commissioner per Member State from 2005 on. When the EU includes all of the candidate countries, a decision will have to be unanimously reached to set the exact number of Commissioners (no more than 27), who will be appointed on the basis of a rotation system. Under the terms of the agreement reached at the

Nice European Council, Germany, France, the United Kingdom, Italy and Spain will each lose one Commissioner in 2005.

In view of these outcomes, it can be argued that the Nice Summit has placed Germany in a privileged position, both in the Council and in the European Parliament. Spain has improved its relative position in the Council, though it has not achieved the same number of votes as the four largest EU states – Germany, the United Kingdom, France and Italy. In addition, Spain has experienced a considerable loss of representation in the Parliament and, in 2005, will also lose one Commissioner. The results of the Nice Summit will be reviewed at the International Summit to be held in 2004.

Finally, it should be noted that the Göteborg European Council set the end of 2002 as a target date for the conclusion of negotiations with those countries that are prepared for accession at that point. If this objective is met, new Member States will be able to take part in elections for the European Parliament to be held in 2004. Under the terms of the agreements reached at Laeken, an Intergovernmental Conference will also be held in 2004, and one of its key objectives will be to define a new institutional and political framework for the enlarged EU.

2.2. Economic situation and evolution of candidate countries

Having briefly reviewed the chronology of the process of accession negotiations, we may now turn our attention to the particular characteristics of the economies of the future member countries. In order to assess the possible repercussions of the integration of these countries on the Spanish economy, it is necessary to understand the nature of these economies and how they have developed in the progression toward accession.

Demographically, the candidate countries represent 28% of the population of the enlarged EU. The populations of the future members, however, differ widely: Poland and Romania have particularly high populations relative to other candidate countries. Recently, the candidate countries have experienced a generalised fall in population, which has

effected all except Slovakia, Poland, Cyprus and Malta. This is essentially due to the considerable volume of emigration registered after the fall of communism, and to a decline in fertility rates.

The main factors determining the economic situation of these countries are the profound transformations that have occurred in the system of production, and the substantial changes that have taken place in the institutional and legal framework as they move toward democratic market economies. Their economic development has also been influenced by the gradual adoption of the EU's *acquis communautaire*.

After the fall of the Berlin Wall, the CEEC experienced the kind of difficulties inevitably associated with the transition from a system of central planning to a market economy. In the early nineties, this costly economic restructuring process resulted in a significant contraction of GDP levels for associated countries. After 1993, however, the efforts made by the majority of these countries led to the beginning of a process of recuperation, which reached a peak in 1995 when overall growth for the CEEC reached 5.5% (up from a previous level of 1.1%). This vigorous growth rate, higher than that experienced by Spain and the Union, has generally been sustained since then, and has allowed for real convergence to the income levels of member countries.

It should be pointed out, however, that the degree of convergence has varied considerably among the candidate countries: the countries belonging to the «Luxembourg group» (Poland, the Czech Republic, Hungary, Slovenia and Estonia), the first to begin negotiations with the EU, have registered growth rates that have remained above 3%; in contrast, the «Helsinki group» (Bulgaria, Slovakia, Latvia, Lithuania and Romania), which began negotiations later, has experienced significantly lower growth. In fact, some of the countries in the latter group have had negative growth in recent years. The other two candidate countries, Cyprus and Malta, stand out for their high growth rates, generally higher than those for the other candidate countries.

As a group, in the period 1992-1999, the future member countries registered a cumulative annual GDP growth rate of 3.9%, outpacing Spain by one percentage point and the Union by nearly two points. This rapid overall

growth was possible because six countries – Poland, Malta, Slovenia, Cyprus, Slovakia and Hungary – sustained sufficiently high growth rates to counteract the lower rates observed in the rest of the candidate countries.

This rapid growth, greater than that in Spain and than the EU average, has allowed the CEEC to achieve income levels closer to those of their future EU partners. In spite of this convergence, however, levels of per capita GDP in all of these countries – in terms of purchasing power parity (PPP) for a standard basket of goods and services – are still well below the average for member countries (as can be clearly observed in Graph 2.1). The only exceptions are Cyprus and Slovenia, whose income levels are closer to the EU-15 average.

The reasons behind the differences observed in the process of real convergence can, in large part, be traced to the differences in the initial situations in which candidate countries found themselves when they undertook this process. It should be pointed out that before the fall of the Berlin Wall, only Hungary, Poland and Slovenia had benefited from a certain degree of economic and political liberalisation.

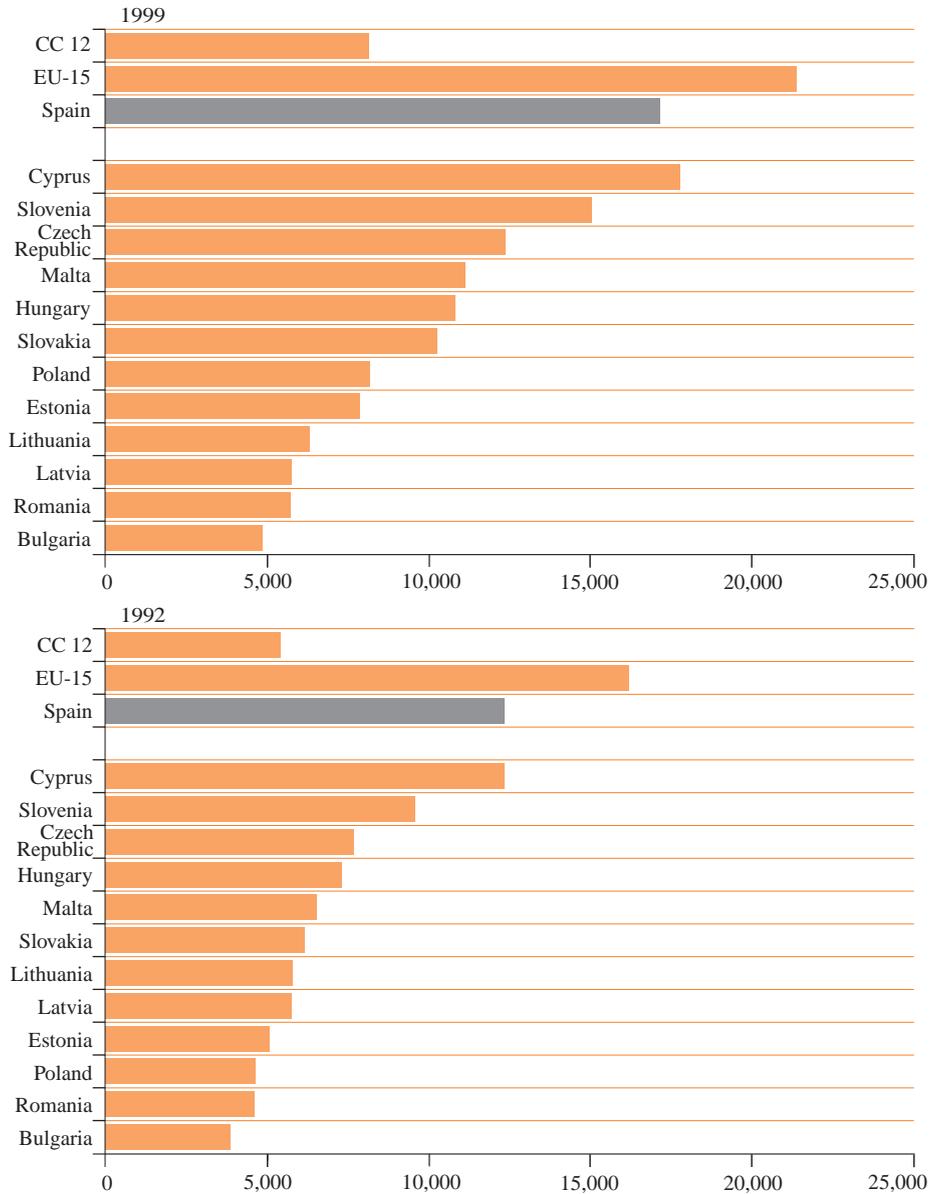
The capacity for economic liberalisation and the rate at which it can be accomplished are also factors that contribute to explaining the differences in growth. In this respect, the transition indicators calculated by the EBRD (European Bank for Reconstruction and Development) – which quantify the progress made by each country in terms of elimination of price controls and liberalisation of trade and of exchange rates – show that the countries that have gone farthest with reforms are the ones that have registered the highest growth rates. These turn out to be the same countries included in the «Luxembourg group».

Similarly, a correlation can be observed between growth and the intensity of the legal reforms carried out by the various candidates. Romania, Bulgaria and Latvia, for instance – which have only undertaken partial reforms of competition policy, property rights, bankruptcy procedures and other aspects of the legal framework for business – have a markedly lower level of growth than other candidate countries.

Graph 2.1

PER CAPITA GDP

In euros adjusted for purchasing power parity



Sources: Eurostat, IMF and UNECE.

Another essential factor to consider in attempting to explain the disparities observed in growth rates among the ten CEEC countries is the degree of restructuring of GDP composition that has taken place. At the outset of the period of transition, the sectoral structure of production for these countries reflected the focus on production that existed within their centrally planned economies. This translated into relatively high participation in agriculture and industry, and an underdeveloped services sector. In 1992, agricultural production reached levels above 5% of GDP; Romania, Bulgaria and the Baltic states were the candidates with the highest values for agricultural production. The industrial sector represented between 30% and 40% of total production for the candidate countries. The transition to the market-driven system and opening to trade have, however, to varying degrees, changed the composition of production in all of the candidate countries.

Between 1992 and 1999, the privatisation of farms and the elimination of subsidies that had been provided under the old system led to a general reduction in the weight of the primary sector in total production, which affected all of the candidate countries except Bulgaria. In spite of this relative shift away from agriculture, for these countries, this sector still represents more than 2% of GDP (the overall figure for the current members of the EU). Similarly, the weight of what was the main activity in these countries – the manufacturing industry – was reduced in all of the candidate countries, though this sector remains quite significant in Slovenia, Romania and the Czech Republic, accounting for more than 30% of GDP.

Clearly, since the beginning of the process of transition to market systems, these economies have experienced a clear shift away from agriculture and industry, while the service sector has taken on increasing importance. The result of these changes is an approximation to the productive structures of the current Member States. It should be noted that two factors – the extent and focus of privatisations, and direct foreign investment – have played a key role in the restructuring and modernisation of systems of production in these countries. In fact, the countries that still need to put a considerable effort into shifting their economies toward the tertiary sector – Bulgaria, Romania, Latvia and Lithuania – are also those which lag furthest behind in the process of privatisation.

Not surprisingly, these changes in the sectoral composition of production have had a corresponding impact on employment: high levels of unemployment were experienced during the first years of transition as a consequence of the dismantling of numerous inefficient industries and the restructuring of productive processes in agriculture and other activities that were suffering from significant problems of underemployment. Since 1993, however, unemployment has fallen in successive years to reach levels close to those for the EU: the average rate of unemployment for the 1992-1999 period was 12.3% – two points higher than the EU average.

Finally, the majority of these countries have achieved a certain degree of macroeconomic stability, which, by facilitating liberalisation and opening of markets, and the rest of the structural reforms undertaken by the candidates, has been another important factor in determining economic growth.

Macroeconomic stabilisation policies implemented by the candidate countries focused on inflation control as an initial priority. During the first years of the transition period, the economic reforms undertaken were accompanied by high inflation, which reached double-digit levels for the CEEC as a whole. From 1993 on, however, reforms began to take effect and inflation rates began to fall. By 1999, the average rate of inflation for the twelve candidate countries had fallen to a more reasonable 9.8%, although Slovakia and particularly Romania continued to experience double-digit levels.

In terms of public finance, until recently the candidate countries were characterised by annual public sector deficits lower, as a percentage of GDP, than those of EU member countries, with an average overall value for the period of 3%. In recent years, however, public sector deficits for candidates have risen and reached levels considerably higher than the EU-15 average.

At the same time, the CEEC have managed to maintain relatively moderate levels of national debt: over the last seven years the average level has been around 50% of GDP, which compares favourably with levels of 64% and 68% registered in the EU and Spain, respectively. Among the candidate countries, only Bulgaria is facing a serious problem, with a level of debt that is close to 96% of GDP.

In light of these results, it is reasonable to conclude that during this transition period the candidate countries have made significant progress toward nominal convergence with Community levels in terms of both prices and public finance. This has been largely due to the restrictive fiscal policies implemented, which have contributed to maintaining the stability of candidate-country currencies.

It should be noted, though, that these countries have chosen different exchange systems, and the parities of their various currencies in relation to the euro have followed radically different courses.

This brief analysis of the economic evolution and situation of the candidate countries cannot be concluded without mentioning the changes that have occurred in their external balance. During the first years of the period being examined, the candidate countries experienced moderate deficits in balance of trade, with figures very similar to those for Spain. From the mid-nineties on, however, trade deficits began to increase as a result of a strong expansion of imports, triggered by the advances made in trade liberalisation. The average trade deficit for the 1992-1999 period was 5.7% of GDP, while in the same period the EU member countries experienced an average overall surplus of 1.3%.

Logically, these results are reflected in current account balances: the overall current account deficit for the twelve candidate countries was much higher than that for Spain, and the difference in relation to the EU as a whole was even more pronounced. With the exception of the Czech Republic, all of the candidates had an equivalent deficit above 3.5% of GDP; Latvia and Poland had particularly high levels (over 6%), and the figure for Lithuania was above 10%.

Fortunately, however, it has been possible to finance this high external imbalance to a significant degree through the entry of considerable volumes of foreign capital. Clearly, during the transition period the candidate countries became a major focus for investors – primarily EU companies. Even in 1995 and 1996, they attracted more foreign direct investment (as a proportion of GDP) than Spain. In 1992, direct investment was 1.5% of GDP; by 1999, it

had risen to 5%. Malta, Estonia, Latvia and, above all, Hungary have captured particularly high levels of direct foreign investment in relation to GDP.

In conclusion, all of the candidates, and particularly the ten CEEC, have undergone a profound economic transformation. The countries that have made the greatest effort to adapt their institutional and legal frameworks to that of the EU and to maintain macroeconomic stability have had the greatest success in guaranteeing a high level of growth; in countries that have delayed reforms, recovery has been slower. In general, the CEEC that make up the «Luxembourg group» have achieved more dynamic economic growth than those countries belonging to the «Helsinki group». Only Bulgaria and Romania have lagged significantly behind the rest, and according to the assessment of the European Commission, only these two countries have failed to create market economies.

2.3. The effects of enlargement: risks and opportunities

The opportunities and challenges posed by eastward enlargement go far beyond those associated with previous enlargements. The accession of the new members implies transformations and changes on a grand scale, not only for the candidate countries, but also for the Union as a whole, and for each of its Member States. The accession of the twelve candidate countries will mean an expansion of more than 100 million in the population of the Union: it will thus become one of the most populated areas in the world. Similarly, in terms of production, accession will lead to an increase in Community GDP that will make it one of the most important economic areas in the world. In spite of the increase in overall GDP, however, average per capita GDP will fall due to the significantly lower income levels in the candidate countries in relation to those of current members.

The scope of these transformations makes the incorporation of the twelve candidates a major political and economic challenge for member countries. On a political level, the need to adapt all Community institutions has already been made evident; and, in economic terms, this round of

enlargement will clearly put an unprecedented degree of pressure on the Community budget, primarily via the two main budget items: the Common Agricultural Policy (CAP) and the Economic and Social Cohesion Policy.

The important role of agriculture in the economies of the candidate countries means that they are bound to become applicants for CAP resources. This will further aggravate the problems that result from the excessive level of Community budget expenditure required to sustain this policy. Furthermore, if the current system of assistance is maintained, the candidate countries, with per capita income below 40% of the average for current EU members, will have preference as recipients of structural and cohesion funds.

In this context, it is not surprising that the question of eastward enlargement has given rise to considerable tension among EU countries: in addition to requiring the expenditure of significant financial resources, enlargement highlights some of the main weaknesses in the process of European construction, such as the shortcomings of the CAP.

There are further concerns, at least from the perspective of Spain and other less-advanced members of the Union. Integration will lead to greater factor mobility (capital and labour) and the elimination of trade barriers. This, in turn, could result in an increase in imports, displacing internal production in current member countries. Direct foreign investment may also be redirected to the candidate countries: low labour costs, a highly-skilled workforce and an excellent geographical position all contribute to making these countries attractive locations for international investment projects.

Foreign investors may use the candidate countries as centres for production and bases for export to the enlarged EU. If this occurs, for Southern European countries, the costs associated with enlargement may be even greater as their exports suffer.

A final challenge facing current members is the possible intensification of migratory flows to Community states. Given existing wage differentials, it is quite possible that freer movement of labour will result in an increase in flows of this type, particularly to countries that are geographically and culturally close to the candidates.

Clearly, many challenges will continue to arise as a result of the accession process; the potential benefits of this major undertaking are, however, enormous. For EU-15 companies, integration presents an extraordinary opportunity to create new export markets and direct investment projects: many of the candidate countries are currently emerging markets experiencing high growth rates, which means there is a huge potential for efficiency gains and increased economic well-being. Apart from the economic benefits, enlargement is clearly advantageous as a means of consolidating peace in Europe.

In short, this unprecedented enlargement requires a great effort on the part of all EU member countries, including Spain. The goal is to take full advantage of the opportunities presented and to take the least costly approach to meeting the challenges that arise.

III. Structural and cohesion fund adjustment and regional repercussions

In 1986, the incorporation of Spain and Portugal in the European Community brought to the fore the question of regional differences within the Union, and that development has done much to shape Community regional policy over the last fifteen years. The enlargement that is expected to take place over the next decade will involve a similar change of direction for a policy that, with the passage of time, has acquired a high profile in its own right. In 1986, enlargement led to the reinforcement of structural funds, and, therefore, to the generalised allocation of assistance to disadvantaged regions (all the regions of Ireland, Greece and Portugal, as well as more than half of the Spanish Autonomous Communities). At that time, Community regional policy was oriented in a manner that benefited both regions within the new member countries (Spain and Portugal) and those in the other EC countries, to the extent that they satisfied the established eligibility requirements.

The doubling of resources allocated to structural funds was possible thanks to the acceptance of this measure by countries that were net contributors. This acceptance was, in turn, the result of the widely held view that the participation of all the members of the Union was necessary to reap all the expected benefits of the internal market. These benefits would flow mainly to the countries that were more developed and better situated in the trade context of the Union; for the less developed member countries, the reinforcement of structural funds was a form of *ex ante* compensation and a

stimulus to participate despite the fact that the internal market's playing field was not a particularly level one. The Cohesion Fund was created in 1994, shortly before the 1995 round of enlargement that saw the accession of the ex-EFTA countries, and was based to a large degree on the same principles underlying the structural funds.

The enlargement of the EU to include the countries of Central and Eastern Europe, however, will take place in a different context and under a different set of conditions. First, given the considerable economic distance that separates these countries from current EU members (as detailed in the preceding chapter), structural and cohesion funds will be subject to a reorientation, the direction of which, despite the Agenda 2000 framework, is yet to be precisely defined. Second, the internal market has now been a reality for one decade, and new members will have to accept all the Community regulations and practices associated with it: there is no need to establish additional incentives in order to gain this acceptance. At the same time, the beneficial effects of enlargement will be felt mainly by the candidate countries themselves (Baldwin *et al.*, 1997; Lejour *et al.*, 2001), which means that current EU members will be reluctant to increase their contribution to the funds. Finally, the application of current eligibility conditions, based on relative levels of per capita GDP, will lead to a significant alteration of the current map of regional assistance. Each of these circumstances will contribute to reorienting Community regional policy, particularly with regard to the resources available and the manner in which those resources are redistributed among a larger number of countries.

As we shall see later in this analysis, Community budget constraints have become stricter since the 1985/86 enlargement, while resources allocated to structural and cohesion funds have quadrupled in the same period. This suggests that the only way to substantially increase the resources available for Community regional policy is to reduce the allocation to other budget items, particularly agriculture. This strategy is not one that can be pursued without producing conflict, but it must be borne in mind that global pressures to reduce agricultural subsidies are mounting and that the development potential of such subsidies is less than that of structural assistance.

Any substantial increase in the resources allocated to regional support within the Community budget is likely to be the outcome of two factors: the pressure from current Objective 1 countries and regions to maintain their current status in spite of the flow of resources to new members, and the reticence of the main net contributors (Germany, France, Sweden, Austria and the United Kingdom) to increase their contributions. This reluctance is particularly marked as there is no evident need for a special incentive to induce new members to join the single market and the monetary union, which they must in any case accept as part of the *acquis communautaire*. Furthermore, though the candidate countries can exert little pressure in this regard, their mere presence within the Union substantially disrupts the current distribution of structural and cohesion funds.

In light of the arguments expounded above, it appears unlikely that there will be a substantial increase in the Community budget. In this context, pressure from the countries that are currently the main beneficiaries of structural and cohesion fund support (Spain, Portugal, Greece and, to a much lesser degree, Ireland) is likely to focus on changing eligibility criteria. These countries will seek to limit the damage that would be incurred by a strict application of current criteria, and will want to see a tradeoff between the reduction of budgetary allocations related to agriculture (which would also be against Spain's interests) and an increase in resources allocated to the regional support items that are not tied to Objective 1. It is highly likely that the consensus that is bound to be reached will involve a modest increase in resources and a slight modification of the eligibility criteria for structural assistance. Another likely outcome is some kind of transition process, which, in a timeframe acceptable to all parties, will eventually lead to a system in which the only countries to benefit from these funds will be those which really lag well behind average economic standards and lack the capacity to reach them. In any case, resources available for assistance of this type will never be sufficient for conventional redistribution on the scale of a Union with almost thirty members.

3.1. The Community budget and structural funds

The structure of the budget and the stages of Community enlargement

Before examining the distribution of structural and cohesion funds that the Community budget applies to different member countries, it is worth briefly analysing how the budget is distributed under its main headings. This analysis covers an extended period of time and the years selected are those that immediately preceded different rounds of enlargement. It is thus possible to observe not only the evolution over time of the structure and quantitative dimension of the Community budget, but also the impact on the indicators considered that may be attributable to each round of enlargement. Political analysts tend to take the view that each enlargement has brought with it a certain change in the Union budget, and that the budget has eventually accommodated the associated demands put on the table (Baldwin, 1997). In fact, this is only true up to a point: the size of the Community budget (as a percentage of Community GDP) has not varied significantly since the increase that preceded the incorporation of Spain and Portugal (see Table 3.1).

Table 3.1

	1972	1980	1985	1994	2000
PERCENTAGE STRUCTURE OF THE COMMUNITY BUDGET (PAYMENTS MADE) BEFORE EACH ROUND OF ENLARGEMENT AND IN 2000					
CAP (only guarantee since 1994)	81.9	68.6	68.4	53.6	45.8
Structural and cohesion funds	4.5	11.0	12.8	25.8	36.5
Administration	5.7	5.0	4.5	5.8	5.3
Other	7.9	15.3	14.2	14.8	12.4
Total	100	100	100	100	100
Total (in millions of eua/ecu/euros)	3,034.8	16,454.8	28,833.2	61,478.7	91,322.0
Total (in % of Community GDP)	0.50	0.80	0.92	1.04	1.05

Sources: EC (2000), EC (2001a) and own calculations.

It must be borne in mind that the evolution of the Community budget reflects factors other than the incorporation of new countries with different cohesion needs. The manner in which the budget has developed has indeed been affected by the various rounds of enlargement, but associated expenditures have largely been covered by the maintenance of the GDP ratio. At the same time, though, the EU has, over time, acquired new competences and designed new policies, and these have required the allocation of additional resources. Naturally, the transitions from Customs Union to Single Market, from the European Monetary System to Monetary Union, or from the current European Union to a more evolved political union in the years ahead all imply the allocation of a progressively higher level of resources to the Community budget. The budget must provide the resources needed to carry out distributive and cohesion policies, as well as those needed for the operation and foreign projection of an increasingly sophisticated union. Demands for increased resources are frequent in certain areas (Pelkmans *et al.*, 2000), but it is difficult to imagine the Community budget increasing much beyond 1.27% of the Union's GNP. In fact, the financial perspectives for the 2000-2006 period do not anticipate an increase beyond this level, despite enlargement, and there is no reason to believe that this will change much in the following period.

Analysis of the data in Table 3.1 shows that over the last thirty years spending on Community administration, for example, has doubled as a percentage of GDP, but has remained constant as a percentage of the total budget. Agricultural spending (from which the guidance section was separated at the end of the eighties) has remained constant as a percentage of Community GDP, but its weighting within the structure of budgetary expenditures has diminished considerably: at the beginning of the seventies, this area accounted for three quarters of total spending; now that proportion has been reduced to less than half. In contrast, structural and cohesion funds have been the subject of tough negotiations at each new stage of enlargement, and in this area the dynamic of power politics has come fully into play within the Union. It should be noted, though, that the result of these negotiations has not precisely been an *increase* in the budget, but rather a *redistribution* in favour of the cohesion countries (Spain, Ireland, Portugal and Greece). The

relative weight of the corresponding budget item (Table 3.1) has steadily increased from an insignificant 3% of total spending at the beginning of the seventies to its current level of more than one third.

Pressures on the Community budget have been well contained up until now: rather than leading to increases in overall spending in proportion to GDP, these pressures have been resolved by shifting resources between the different budget items. There are two corollaries that can be drawn from this observation. First, the substitution of one budget item by another is quite possible, and this represents a margin that must be taken into account in orienting Community regional policy in response to the enlargement to the CEEC. Second, the absolute limitation that at present applies to the EU budget (in terms of Community GDP) does not entirely correspond with the political ambitions of the European Union, particularly, once again, in light of the approaching enlargement.

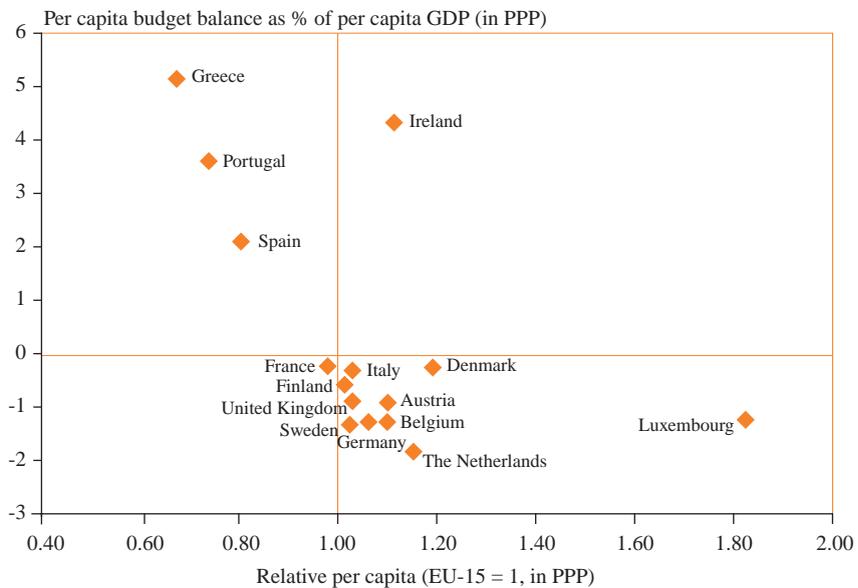
Contributors and beneficiaries

The Community budget, which in general has remained balanced, presents wide disparities when an analysis of the contributions made and funds received by each country is carried out. Given the existence of Community policies aimed at achieving cohesion and convergence, and the principle of proportionality that is applied in determining contributions, it is not surprising that the richer countries are net contributors and the poorer countries net recipients. The sum of all these balances coincides with the overall budget balance for the Union. In spite of the limited scale of the Community budget in relation to total GDP, the redistribution of common resources among member countries is very important. Apart from administrative expenses, horizontal programmes (research) and foreign aid, almost 85% of the resources captured by the Union are returned to member countries. This redistributive effect is based on «north-south» transfers, i.e., from more developed countries to less developed ones, although peculiarities such as the «British cheque» and the weight of French agriculture in the CAP result in unequal treatment among the net contributors to the Community budget (de la Fuente and Domenech, 2000).

Analyses of the redistribution carried out through the Community budget are often critical of the weight that must be borne by the main net contributors (Germany, the United Kingdom and the Netherlands). Given the existence of a Community redistribution scheme, it is indeed the case that those with lower per capita incomes are on the receiving end and those with higher per capita incomes pay (with some exceptions, as mentioned above). This can be observed (for the year 1999) by means of a simple diagram widely circulated in the literature on this question. As can be observed in Graph 3.1, the poorer countries in terms of per capita GDP relative to the Community average (adjusted for purchasing power parity) receive net payments from the Community budget that are greater the lower their relative per capita GDP. A notable exception to this pattern is Ireland, which, as a consequence of agreements reached for the 1994-1999 period (negotiated at the beginning of the last decade), received substantial Community assistance

Graph 3.1

BUDGET BALANCES AND PER CAPITA GDP IN THE EU – 1999



Source: EC (2001b) and own calculations.

while at the same time registering extremely high growth. As we shall later see, Ireland will receive substantially less Community assistance for the 2000-2006 period.

It is also evident from Graph 3.1 that richer countries contribute more, with net positive payments to the Community budget. Again, some exceptions stand out. Luxembourg is a particularly significant one: its high PPP-adjusted per capita income puts it well to the right of the lower half of the diagram. Other less striking exceptions to the general pattern are Denmark, which is comparatively favoured, and Sweden, which is a comparatively high net contributor in relation to relative per capita GDP. In absolute terms, though, Spain is by far the country that benefited most from redistribution, in 1999 and throughout the 1994-1999 period, and Germany is the main contributor by a wide margin.

Throughout the 1994-1999 period, the payments Spain received from the EU exceeded its contributions by very significant amounts, which, overall, represented 1.14% of GDP for the period. These net flows, which are registered in the current account as income transfers (agricultural assistance) or capital transfers (structural assistance), have helped to stabilise Spain's current account and finance infrastructure development. They have also supported aggregate demand and permanently raised Spain's productive capacity and the productivity of private production factors. It should be borne in mind that, in terms of percentage of GDP, these flows represent major supply and demand shocks for the Spanish economy. Their effects have been highly positive in terms of growth and employment (Herce and Sosvilla-Rivero, 1994), and have more than compensated for the negative shock associated with the sectoral adjustment that followed the creation of the internal market in 1993 (Sosvilla-Rivero and Herce, 1998).

Among the resources that Spain contributes to the EU, those based on VAT are particularly significant, although those based on GNP are increasingly important. Structural fund assistance, particularly from the European Regional Development Fund (ERDF), represents a significant proportion of payments received from the EU. Agricultural guarantee funds

are also quite important, though these are moving toward stabilisation. Agenda 2000, which will be examined in section 3.2, involved a significant commitment on the part of the European Council to undertake the reform of the Common Agricultural Policy (CAP) and progressively reduce direct support for production.

The distribution of structural and cohesion funds and the regional dimension

As has been shown in the preceding sections, the Common Agricultural Policy continues to dominate the Community budget, but emphasis is gradually shifting toward structural and cohesion programmes. Structural interventions have become highly significant in the Community budget since the incorporation of Spain and Portugal in 1986. Such measures are largely oriented toward well-defined territories characterised by specific socio-economic conditions. This is the case for the so-called «Objective 1» regions, whose main defining characteristic is per capita income below 75% of the Community average. This is a highly relevant criterion given that between 1986 and 2006 63% of the European Union's total structural and cohesion resources will have been directed to these regions. During the same period, Spain will have directed 71% of assistance received to actions in Objective 1 regions. These figures are a clear indication of the significance of the regional dimension of the Community budget.

EU structural interventions are carried out through a number of instruments: the European Regional Development Fund (ERDF, created in 1975), the European Social Fund (ESF, created in 1960), the Guidance section of the European Agriculture Guidance and Guarantee Fund (EAGGF, created in 1962), the Cohesion Fund (CF, created in 1993), the Community Initiatives (CI) and the Financial Instrument for Fisheries Guidance (FIFG, created in 1994). The first of the funds referred to clearly has a regional focus; the rest provide assistance according to criteria which, while not necessarily defined in regional terms, often affect very specific territorial areas or economic or sectoral conditions. The Cohesion Fund is used to finance infrastructure-related and environmental actions. Only member

countries that have per capita incomes below 90% of the Community average are eligible for assistance of this type.

Given the specific character of each fund, not all member countries receive the same level of resources. Table 3.2 shows the distribution for the structural and cohesion chapter of the Community budget for the periods 1989-1993 (Delors I), 1994-1999 (Delors II) and 2000-2006 (Agenda 2000). The disparities in the distribution of these funds are immediately evident, though all member countries do receive some degree of assistance. In the three programming periods shown, Spain is the EU country that receives most structural assistance in absolute terms, followed by Italy and, in the last two periods, Germany. Greece, Portugal, France and Ireland have also been allocated a significant level of total resources, although, in the case of Ireland, rapid growth in recent years means that the perspectives for 2000-2006 include a substantial reduction in its share of structural support funds.

Regional assistance is concentrated in the Objective 1 regions of Spain, the whole of Greece, Portugal and Ireland, and, since reunification, in the five new German *Länder*. Overall, these areas receive more than 60% of structural fund assistance (more than 70% in the case of Spain). The Cohesion Fund is applied exclusively in Spain, Greece, Portugal and Ireland. Greece was the country that benefited most in the 1994-1999 period, and Spain will occupy this position in the 2000-2006 period.

Clearly, if eligibility criteria for regionally oriented structural fund assistance are applied mechanically (regional per capita income below 75% of the Community average), the main beneficiaries of these funds, particularly Spain, can expect to see considerable changes. Enlargement to take in twelve new countries by 2010 will lead to a 12% fall in the average EU per capita income (see section 3.3). Consequently, most of the current Spanish Objective 1 regions will lose that status. The same applies to Cohesion Fund support. These aspects of enlargement will have a major impact, and are thoroughly analysed in the following sections.

In Spain, the regional dimension is crucial in relation to structural assistance: Objective 1 support accounts for more than 70% of total assistance received. Since the beginning of multiannual programming under

Table 3.2

STRUCTURAL FUND DISTRIBUTION BY COUNTRIES ALL PROGRAMMING PERIODS

In millions of ecu/euro

	1989-1993		
	Total	Obj. 1 regions	Cohesion Fund
Belgium	864		
Denmark	430		
Germany	6,431	2,955	
Greece	8,240	7,528	280
Spain	14,229	10,171	859
France	6,473	957	
Ireland	4,755	4,460	142
Italy	11,420	8,504	
Luxembourg	77		
The Netherlands	814		
Austria			
Portugal	9,174	8,450	284
Finland			
Sweden			
United Kingdom	5,329	793	
Total	68,236	43,818	1,565
Share	100	64.2%	2.3%

Sources: First and Second Reports on Economic and Social Cohesion (1996 and 2001).

the terms of the Community Support Frameworks (CSFs), Objective 1 regions, those which are less developed within the EU, have been the focus of special attention. The key condition for the selection of these regions, as mentioned above, has been per capita GDP below 75% of the Community average for the three-year period preceding the CSF in question. In addition, regions are required to be defined as such, as specified in the NUTS II category of international territorial nomenclature. If a region exceeds the critical per capita GDP level in the period in which a particular CSF is in effect, this does not affect its eligibility during that period. The situation of each region is, however, subject to review prior to the start of the next programming period. In Spain's case, in the three programming periods that

1994-1999			2000-2006 (1999 prices)		
Total	Obj. 1 regions	Cohesion Fund	Total	Obj. 1 regions	Cohesion Fund
2,096	730		2,038	625	
843			828	0	
21,730	13,640		29,764	19,958	
15,134	13,980	7,950	24,883	20,961	3,060
34,449	26,300	2,602	56,205	38,096	11,160
14,939	2,190		15,666	3,805	
6,104	5,620	1,301	3,974	3,088	720
21,649	14,860		29,656	22,122	
102			91	0	
2,616	150		3,286	123	
1,576	162		1,831	261	
15,041	13,980	2,601	22,760	19,029	3,060
1,654			2,090	913	
1,304			2,186	722	
12,982	2,360		16,596	6,251	
152,219	93,972	14,454	211,854	135,954	18,000
100	61.7%	9.5%	100	64.2%	8.5%

have been developed up until now, there has been only one change in the regions classified as Objective 1: the inclusion of Cantabria in the transition from CSF I to CSF II. Table 3.3 shows the Spanish Objective 1 regions for the various programming periods, including the results of the decisions that have been adopted in Agenda 2000.

The last row of the table is particularly striking, indicating the only three Spanish regions that will fulfil the current per capita GDP eligibility criterion for the 2007-2013 period. This is the worst scenario within the financial perspectives for that period and one of the most negative consequences of enlargement. This point will be dealt with in-depth in section 3.3.

Table 3.3

SPANISH OBJECTIVE 1 REGIONS – 1989-2006	
CSF I (1989-1993)	Andalusia, Asturias, Canary Islands, Castile and Leon, Castile-La Mancha, Autonomous Community of Valencia, Galicia, Extremadura, Murcia, Ceuta and Melilla
CSF II (1994-1999)	Andalusia, Asturias, Canary Islands, Cantabria, Castile and Leon, Castile-La Mancha, Autonomous Community of Valencia, Galicia, Extremadura, Murcia, Ceuta and Melilla <i>Note: Cantabria is incorporated</i>
Agenda 2000 (2000-2006)	Andalusia, Asturias, Canary Islands, Cantabria, Castile and Leon, Castile-La Mancha, Autonomous Community of Valencia, Galicia, Extremadura, Murcia, Ceuta and Melilla <i>Note: the same regions as in the preceding CSF.</i>
Perspectives 2007-2013 ^(*)	Andalusia, Extremadura and Galicia

(*) This scenario is explained in detail in section 3.3 and illustrated in Table 3.7.

Table 3.4 shows how total structural fund and Objective 1 assistance was distributed among the less-developed regions and in the rest of Spain in the 1989-1999 period. Although the data on which the table is based were obtained from different sources, we have attempted to offer the best regional breakdown available so that readers can observe how regional distribution of Community structural assistance has evolved over time.⁽¹⁾ The 1994-1999 period accurately represents the current regional distribution of structural assistance in Spain: the table shows how Objective 1 regions have received the most of this support. These regions depend on this assistance to develop their infrastructure and their productive capacity in general, and, by so doing, achieve real convergence with the more advanced regions and with the rest of the EU. It can also be observed that the resources allocated to these regions have gradually increased in each new programming period, though the amounts negotiated in Agenda 2000 suggest that the rate of increase is beginning to slow.

(1) There is no single source where this information can be obtained or confirmed without making a major effort on a scale that we have not been able to undertake in this study. Many authors have established partial views of this situation, which has been the subject of intense study in recent years, but it seems that the regional distribution of some assistance is «sensitive information» that not even the autonomous communities themselves seem to possess. Neither does the central administration have available any public report that brings together in a detailed manner regionalised breakdowns of total assistance by funds, objectives and years, by amounts programmed and paid, or by financing administration, including multiregional totals and the regional allocation of these.

Table 3.4

TOTAL STRUCTURAL AND COHESION ASSISTANCE AND OBJECTIVE 1 ASSISTANCE RECEIVED BY THE SPANISH REGIONS IN THE 1989-2006 PERIOD

In millions of ecu/euro

	1989-1993 (1989 ecus)		1994-1999 (1994 ecus)		2000-2006 (2000 euros)		Assistance and per capita GDP	
	Obj. 1 (*)	Total (**)	Obj. 1 (*)	Total (**)	Obj. 1 (*) (***)	Total (*)	Assistance (1994-99)	GDP (1999)
Andalusia	1,047	2,639	2,421	4,564	8,387	n.a.	1,006	10,216
Asturias	155	504	358	930	1,418	n.a.	1,395	12,854
Canary Islands	279	762	660	1,432	2,025	n.a.	1,378	13,265
Cantabria	n/a	n/a	176	544	362	n.a.	1,635	13,518
Castile and Leon	507	1,166	1,164	2,329	3,561	n.a.	1,490	13,200
Castile-La Mancha	371	1,072	766	1,586	2,310	n.a.	1,475	11,812
A.C. of Valencia	343	876	1,040	1,912	2,954	n.a.	760	13,504
Galicia	537	906	1,225	2,967	4,071	n.a.	1,737	11,407
Extremadura	306	666	731	1,200	2,278	n.a.	1,775	8,974
Murcia	133	329	300	438	1,237	n.a.	624	11,762
Ceuta and Melilla	22	116	38	113	136	n.a.	1,293	11,464
Multiregional Objetive 1	6,471	n/a	17,421	n/a	9,357	n.a.	n/a	n/a
Total Objective 1 regions	10,171	9,035	26,300	18,015	38,096	n.a.	1,209	11,764
Aragon	n/a	226	n/a	538	n/a	n.a.	728	15,654
Cantabria	n/a	105	n/a	n/a	n/a	n.a.	n/a	n/a
Baleares	n/a	24	n/a	104	n/a	n.a.	215	17,049
Catalonia	n/a	584	n/a	1,470	n/a	n.a.	380	17,551
Madrid	n/a	138	n/a	462	n/a	n.a.	144	19,263
Navarre	n/a	65	n/a	224	n/a	n.a.	663	18,515
Basque Country	n/a	393	n/a	839	n/a	n.a.	645	17,442
La Rioja	n/a	32	n/a	93	n/a	n.a.	558	16,370
Total rest of Spain	n/a	1,566	n/a	3,729	n/a	n.a.	369	17,931
Multiregional Total	n/a	3,628	n/a	12,704	n/a	n.a.	n/a	n/a
National total	10,171	14,229	26,300	34,449	38,096	56,205	869	14,256

n.a. - not available; n/a - not applicable.

(*) Programmed.

(**) Paid.

(***) Orientative distribution based on Ministry of Finance information (2001).

Sources: Ministry of Finance (2001), Nieto and Utrilla (1996), European Commission and own calculations.

For the 2000-2006 period, despite the reduction in their share in comparison to previous periods, Objective 1 regions will still receive 68% of the total Community structural and cohesion assistance that has been committed. These commitments will be maintained regardless of the course of CEEC incorporation over the period. The adjustment of structural funds will take place from 2007 on, for the seven-year period to 2013. Over this period, twelve new countries will become full members of the Union. The distribution anticipated in financial perspectives for the years ahead fits the expected pattern, in terms of which regions with lower average incomes in relation to Spain as a whole receive more relative per capita resources.

Clearly, Community structural and cohesion assistance has a strong regional dimension,⁽²⁾ and this focus certainly applies in the case of Spain. Given the structural nature assistance of this type, it can continue to act as a powerful lever in coming years and contribute a great deal to the achievement of real convergence. It is understandable, then, that the perspectives after 2006 are a source of constant concern, though no one should be surprised if assistance gradually diminishes as the Spanish economy progresses toward real convergence and new countries with lower per capita incomes are incorporated in the Union. We will not go so far as to present a detailed proposal concerning how this question should be approached, but we shall tentatively explore the issue in section 3.3, after analysing the financial perspectives for the European Union for the 2000-2006 period.

3.2. Agenda 2000 and financial preparation for enlargement

At the Berlin summit (24-25 March 1999), the European Union approved a package of reforms and financial perspectives known as Agenda 2000. Together with the perspectives for enlargement, important guidelines were adopted for the reform of agricultural policy, the reinforcement of regional convergence and the containment of the Community budget. These

(2) See Correa *et al* (1998) for a detailed analysis of the regionalisation of the Community budget in Spain.

measures were aimed at creating a margin for manoeuvre to ensure that the process of enlargement to the CEEC, which would have to make crucial advances in the next seven-year period, could be undertaken without any particular difficulties. The scope of the measures adopted means that Agenda 2000 will have a major impact, both economically and institutionally. One area that was the focus of much attention was the need for budgetary containment and the establishment of programmed multiannual financial perspectives within strict spending limits, but, as we saw in the previous section, this was not the first time that the Union had faced budgetary scenarios of containment. Such containment is a very healthy aspect of Community economic policy that will continue to be a priority, even as a margin is created for enlargement.

We have also seen how, in the 2000-2006 period, structural and cohesion fund assistance, including Objective 1 support, will be maintained along similar lines as in the 1994-1999 period, in which these interventions registered a considerable increase with respect to previous periods. This reflects a certain degree of consolidation within the EU-15 with a view to enlargement to the CEEC. What, though, is the detailed budgetary panorama? And to what extent has enlargement been taken into account in that panorama? In any case, within the Community budget, the own resources ceiling is set at 1.27% of the EU's GNP, and the even stricter ceiling for expenditures is set at 1.12% of Community GNP. Table 3.5 provides details concerning broad areas of expenditure and resources allocated to preparation for enlargement.

These financial perspectives allocate approximately 23,000 million euros over the budget period for preparation for accession; outside of the EU-15 budget, major agricultural and structural expenditures are anticipated – more than 47,000 million euros – to accommodate the full accession of a certain number of candidates. As indicated above, in no case do the total sums exceed the established limits for payments as a percentage of GNP. Resources are strictly limited in the same manner (see Table 3.5).

Table 3.5

FINANCIAL PERSPECTIVES 2000-2006. AGENDA 2000

Millions of euros at 2000 prices

	2000	2001	2002	2003	2004	2005	2006
Agriculture	41,738	44,530	45,352	45,538	44,488	43,624	43,344
CAP	37,352	40,035	40,847	41,023	39,962	39,088	38,797
Rural development	4,386	4,495	4,505	4,515	4,526	4,536	4,547
Structural and cohesion funds	32,678	32,720	32,106	31,503	30,785	30,785	30,343
Structural funds	30,019	30,005	29,391	28,788	28,174	28,174	27,737
Cohesion funds	2,659	2,715	2,715	2,715	2,611	2,611	2,606
Pre-accession structural inst.	3,174	3,240	3,240	3,240	3,240	3,240	3,240
Other	13,732	14,240	17,277	18,390	17,068	16,110	16,270
Payments credits	91,322	94,730	97,975	98,671	95,581	93,759	93,197
Available accession			4,306	6,979	9,247	11,899	14,792
Agriculture			1,665	2,112	2,549	3,048	3,537
Other expenditures			2,641	4,867	6,698	8,851	11,255
Total	91,322	94,730	102,281	105,650	104,828	105,658	107,989
As % of GNP	1.13	1.11	1.17	1.18	1.14	1.12	1.12
Own resources	1.27	1.27	1.27	1.27	1.27	1.27	1.27

Source: European Commission. General Budget of the EU for the Financial Year 2001. Jan. 2001 (p. 13).

3.3. The scenario for enlargement and its budgetary and regional repercussions

The budgetary scenario of the 27-member Union

The financial perspectives discussed in the preceding section do not make any prejudgments concerning exactly when the various candidates will be incorporated in the Union. Since the adoption of Agenda 2000 in 1999, however, enough time has passed to see more clearly the developments to be expected. The European Commission, in its strategy report on the progress of the enlargement process (13 November 2001, EC 2001c) established a list of the first ten CEEC that could join the EU in 2004: Cyprus, Slovenia, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Czech Republic and Slovakia. Bulgaria and Romania could be incorporated in 2007, and Turkey is not

expected to join before 2013. At the same time, the financial perspectives for the 2000-2006 period are maintained in the terms agreed in 1999. The more precise estimates of when accession will take place for the various countries are necessary to consolidate the EU budget for the 2000-2006 period and to establish some basic hypotheses for the 2007-2013 period, by the end of which all of the current candidates except Turkey will have been incorporated in the Union.

Once the items in Table 3.5 have been consolidated, the financial perspectives for a 25-member Union for the 2000-2006 period are quite similar to those shown in the table. It must be assumed that the agricultural and structural aid includes all of the resources allocated to enlargement that have been referred to above, as well as additional payment credits, within the set limits, drawn from the additional resources resulting from the increase in the Union's GNP that will occur after the accessions that will take place during the period.⁽³⁾ In spite of the declarations made in Agenda 2000, we have not taken into account the perspectives of a substantial reform of the CAP in this period. The total amount of payments would not, in any case, be significantly altered given the existing budgetary ceilings. On the basis of these assumptions, payment credits in 2006, for example, would reach 114 billion euros, compared to 108 billion in the financial perspectives without enlargement. The various budgetary expenditure items would also increase by the same modest proportion.

As enlargement proceeds, the estimated budgetary structure will progressively change. In 2000, the CAP still accounts for 46% of the total budget, but this is expected to decrease to 40% in 2013; structural and cohesion spending increases from 35% in 2000 to 48% of the total in 2013. Although these figures are hypothetical, they give a good indication of the budgetary consequences of enlargement over the next decade.

(3) We assume that the GNP of the EU-15 will grow at an annual rate of 2.3% during the 2000-2013 period; that the 10 CEEC to join in 2004 will grow at 4.3% annually between 2000 and 2004 and at 4.7% annually after that; and that the two CEEC to join in 2007 will experience growth of 3.3% until 2007 and 4% from 2007 on.

Objective 1 regions after enlargement (2007-2013)

The overall financial perspectives analysed above present only a moderate degree of uncertainty. In the case of the CAP, however, the degree of uncertainty is greater, and, consequently, the same uncertainty applies to the resources allocated to structural and cohesion policy. Resources allocated to the CAP may decrease significantly in response to internal and international trade developments: structural and cohesion funds would, in this case, increase correspondingly. It is even more difficult to say how the distribution of structural resources between the members of the Union may change as enlargement progresses. The 2007-2013 period is extraordinarily complicated given the fact that the new members, as discussed in chapter II, satisfy perfectly the criteria required of recipients of structural and cohesion assistance. The twelve countries that are likely to have joined the Union by 2007 currently (year 2000) have a PPP-adjusted per capita income of 44% of the EU-15 average, as can be observed in Table 3.6 (2001 estimates). Among them there are significant differences, from Bulgaria at 24% or Romania at 27%, to Slovenia at 71% or Cyprus at 82%.

Given the selection criteria for Objective 1 regions, there are two relevant factors for the new scenario. First, the fact that the average Community income in the 27-member EU will decline relative to the level it would have reached with only the current fifteen members. Second, both the CEEC and the Spanish regions currently (and until 2006) classified as Objective 1 will register a certain degree of real convergence. Though it is not easy to combine these considerations to create an accurate scenario, we have attempted to explore how the current situation may have altered by the year 2005. 2005 has been selected for this exercise because it is the year which, according to the criteria governing the allocation of structural funds, is the mid-point (2004-2006) for the assessment of Objective 1 eligibility for the 2007-2013 period. The results are presented in Table 3.6, in the last two columns. We have assumed that the population in the candidate countries included here will grow by 2.53% and that of the EU-15 by 1.47% in the 2000-2015 period, and that GDP will increase as anticipated in the financial perspectives analysed in the preceding section. On the basis of these

Table 3.6

CEEC PER CAPITA GDP IN RELATION TO EU-15 AND EU-27 IN 2000 AND 2005

	Per capita GDP in 2000		Per capita GDP in 2005(*)	
	In PPP	% of EU average	In PPP(**)	% of EU average
Bulgaria	5,392	24	6,190	28
Cyprus	18,421	82	22,369	102
Slovenia	15,950	71	19,368	88
Estonia	8,537	38	10,366	47
Hungary	11,682	52	14,185	65
Latvia	6,515	29	7,911	36
Lithuania	6,515	29	7,911	36
Malta	11,906	53	14,458	66
Poland	8,761	39	10,639	49
Czech Republic	13,479	60	16,368	75
Slovakia	10,783	48	13,094	60
Romania	6,066	27	6,964	32
CEEC	9,885	44	10,898	50
UE-15	22,465	100	24,876	114
UE-27			21,904	100

(*) See the main text for discussion of hypotheses concerning population and GDP.

(**) Without assuming changes in relative prices (PPP for 2000).

Sources: Own calculations, and the EU Commission.

assumptions, in the 27-member EU of 2005,⁽⁴⁾ the per capita income for the CEEC would be 50% of the Community average, while that for the fifteen current members would 114% of the Community average. All of the countries in Table 3.6 (their regions), except Slovenia and Cyprus, would qualify for Objective 1 assistance.

This is the nature of the «competition» that Spanish Objective 1 regions are facing, and the difficulty of their position is further aggravated by the fact that many of them are already at the limit of eligibility: in 2005, when average income declines significantly in the EU-27, they will be clearly above

(4) Bulgaria and Romania will join the Union in 2007, but their per capita income levels in 2005 will determine their share of structural funds from 2007 on.

the new limit. In order to explore this effect for the Spanish regions, we have designed a scenario in which Spain continues to converge in real terms, and per capita income (without distinguishing between the different regions) rises from 80.6% of the Community average in 1999 to 82.2% in 2005.⁽⁵⁾ Table 3.7

Table 3.7

PER CAPITA GDP IN THE SPANISH REGIONS^(*) COMPARED TO THE NATIONAL, EU-15 AND EU-27 AVERAGES IN 2000 AND 2005

	Per capita GDP in 1999		Per capita GDP in 2005(**)	
	Spain = 100	EU-15 = 100	EU-15 = 100	EU-27 = 100
Andalusia	71.7	57.8	58.9	67.2
Aragon	109.8	88.5	90.3	102.9
Asturias	90.2	72.7	74.1	84.5
Baleares	119.6	96.4	98.3	112.1
A.C. of Valencia	94.7	76.3	77.9	88.8
Canary Islands	93.1	75.0	76.5	87.2
Cantabria	94.8	76.4	77.9	88.9
Castile-Leon	92.6	74.6	76.1	86.8
Castile-La Mancha	82.9	66.8	68.1	77.6
Catalonia	123.1	99.2	101.2	115.4
Ceuta and Melilla	80.4	64.8	66.1	75.4
Extremadura	62.9	50.7	51.7	59.0
Galicia	80.0	64.5	65.8	75.0
La Rioja	114.8	92.6	94.4	107.6
Madrid	135.1	108.9	111.1	126.6
Murcia	82.5	66.5	67.8	77.3
Navarre	129.9	104.7	106.8	121.7
Basque Country	122.3	98.6	100.6	114.7
Total Objective 1 regions	82.5	66.5		
Total other regions	125.8	101.4		
Spain	100	80.6	82.2	93.7
EU-15		100	100	114.0
EU-27				100

(*) The figures shown in colour in the second column indicate the current Objective 1 regions; those in the fourth column indicate the regions that would be classified as Objective 1 in 2005 if current eligibility criteria are maintained.

(**) See the hypothesis on population and GDP in the main text.

Sources: Own calculations, and the EU Commission.

(5) We take 1999 as a starting point because this is the most recent year for which data on regional income is available.

shows how, under the terms of this hypothesis, Spain's per capita GDP would be 93.7% of the EU-27 average, exceeding even the current ceiling for the concession of Cohesion Fund assistance.

However, the point that most requires our attention in this table is the effect on per capita GDP in the Spanish regions. The figures shown in colour indicate the regions that are currently classified as Objective 1 and those that would be classified as such in 2005, applying the 75% of EU-27 average criterion. In 2005, only Andalusia, Extremadura and Galicia would fulfil this condition. Galicia could easily fail to meet the criterion if the real convergence of the Spanish economy and of its less-advanced regions turns out to be greater than we have estimated. There is no denying that for Spain this scenario is very negative, but, in our view, it must be accepted as an unavoidable starting point for the design of the necessary alternative policies, which may involve demands for compensation for the assistance lost, or a broader approach. Although the results can largely be attributed to a statistical effect, the situation they portray is clearly conceivable in the context of the type of enlargement that the EU has undertaken. Alternative responses to this situation will be discussed later in this analysis.

Clearly, this dramatic change in the Spanish regional panorama in relation to Objective 1 structural funds is bound to have an impact on the assistance received by Spain after 2006, when the current programming period for structural and cohesion funds has been concluded. Moreover, this is an extremely complex matter: the manner in which it is resolved depends on the set of strategies adopted by EU member countries, including Spain. As we argued at the beginning of this chapter, there is little reason to believe that budgetary ceilings (1.27% of Community GNP for resources and 1.12% for payments) will be altered significantly. This is the assumption we have made in developing the scenario concerning the financial perspectives for 2007-2013 for the Community budget, including its structural chapter (discussed in the preceding section). Readers will recall that the overall allocation for payment credits increases slightly, simply as a consequence of taking into account the growth in real Community GDP that results from the inclusion of the new members. At the same time, the structural chapter of the budget

comes to represent a progressively more significant proportion of total payments, increasing from 44% in 2007 to 50% in 2013. This dynamic is obtained simply by extending the trends established in the 2000-2006 period for agricultural expenditures (assuming moderation but not substantial reform) and making a similar extrapolation for other expenditures: given the limit for spending (1.12% of Community GNP), the resources available for the structural chapter rise as indicated in the previous section. To what extent these perspectives accurately reflect the situation that is likely to emerge in the 2007-2013 period is highly uncertain, but it is on the basis of this scenario that we have attempted to draw conclusions concerning Spain's participation in structural funds from 2007 on.

We have assumed that only Andalusia, Extremadura and Galicia will be classified as Objective 1 regions from 2007 on, and that the rest of the current Objective 1 regions will cease to receive assistance of this type. Within this scenario, Andalusia, Extremadura and Galicia receive the same assistance, adjusted according to the levels in effect at the time, and the country as a whole continues to receive the same non-Objective 1 assistance, also adjusted to levels in effect at the time. We have not formulated any specific hypothesis concerning the Cohesion Fund: it is possible that this fund may cease to exist, and the resources which it is to be allocated up until 2006 would, in that case, be reassigned to other funds. Adjustment of the level of assistance to Objective 1 regions in the new period involves a 93.3% decrease in funding of this type, given that in the 2000-2006 period, Andalusia, Extremadura and Galicia will absorb 51.72% of such assistance. The result of this exercise implies a major adjustment in the structural assistance that Spain receives, the level of which would be reduced from 56.2 billion euros in the 2000-2006 period to 38 billion euros in the 2007-2013 period. Within these overall figures, Objective 1 assistance would represent 18 billion euros in the latter period compared to 38 billion for 2000-2006. The relevant figures are shown in Table 3.8, in the following section. The effects of this adjustment will be noted on a multitude of different fronts. In chapter VII we will turn our attention to its macroeconomic consequences.

A scenario of substantial CAP reform (2007-2013)

Substantial reform of the Common Agricultural Policy, although one of the declared objectives of Agenda 2000, has not yet taken place and seems unlikely to be undertaken in the near future. In any case, the financial perspectives for the 2000-2006 period are already closed for the agricultural guarantee expenditures chapter. Nevertheless, it is likely that from 2006 on the EU will make a significant move in this direction, and that this will be reflected in the organisation of the budget for the following years. There are various reasons why this is so, from the declarations made by Community partners and the reform programme announced in Agenda 2000, to the relevant obligations that will arise from the new round of trade liberalisation to be undertaken by the WTO. In this light, we believe it is worth considering the possibility of an alternative scenario based on a substantial reform of the CAP in the coming years, with budgetary consequences to be noted from 2006 on. This would clearly alter the 2007-2013 financial perspectives previously projected.

In order to examine the effects of this possible change on financial perspectives and extrapolate the implications for Spain, we have formulated an alternative to the scenario outlined in the previous section. In this scenario, in addition to the previously described adjustment of Objective 1 regional assistance, there is a major transformation in the agricultural guarantee assistance received by Spain as non-Objective 1 structural support. Moreover, Spain recovers general structural fund assistance in an amount equivalent to an arbitrary proportion (50%) of the assistance lost as a result of the adjustment of Objective 1 regional funding. The increase in this category of assistance is possible because of the freeing up of Community resources that results from an overall reform of the CAP. Spain must contribute to this reform, and this is reflected in the reduction of agricultural guarantee assistance. This reduction, however, is more than compensated by new structural assistance, which makes it possible to reach almost the same level of assistance in this area as in the 2000-2006 period.

There are two key assumptions implicit in this scenario. First, that in exchange for this new structural assistance Spain would accept a reduction of agricultural guarantee assistance and support a substantial reform of the CAP. Second, that structural assistance is inherently more productive and leads to greater growth than does agricultural guarantee assistance, which means that even a one-to-one tradeoff between the two would be in Spain's interest. In our view, this argument is particularly significant when it comes to dealing with the situation that emerges at the end of the 2000-2006 period: it offers a possible basis for an ambitious strategy that goes beyond mere demands for Community assistance. The quantitative aspects of this alternative scenario are presented in Table 3.8. As expected, the level of structural assistance is similar to that for the current period; agricultural guarantee assistance is somewhat reduced, and, overall, Community assistance received by Spain is almost 14% higher than in the previous scenario described.

As in the previous case, this scenario has consequences for the economy as a whole, and these will clearly be more positive than those which would result from a mere adjustment of the level of assistance to Objective 1 regions. These consequences will also be explored in chapter VII.

One of the most hotly-debated questions concerning the new European Union to emerge after enlargement concerns its possible assumption of a broader political role – either of a federal nature or along the lines followed since the reform of the Treaty of Rome through the Single European Act in 1987. Such an evolution, whatever its precise nature, would need to be associated with a corresponding increase in budgetary ceilings in relation to Community GNP. Given the current level of these ceilings (below 1.3%) such an increase should represent less than half of the current 1.3%, bringing the level of the ceilings to approximately 2%. An increase in the Community budget, even on this limited scale, is only conceivable in the context of a process that has barely been initiated in the relevant areas. Such a change would imply only moderate absolute adjustments. Nevertheless, from the income perspective, for each member it would involve resources that would represent country oscillations comparable to those associated with a slight slowdown in tax receipts. On the other hand, from the expenditures perspective, it would represent a doubling of the EU resources allocated to the

Table 3.8

STRUCTURAL ASSISTANCE TO SPAIN FOLLOWING THE ADJUSTMENT OF OBJECTIVE 1^(*) REGIONS AND THE REFORM OF THE CAP SCENARIO B

Millions of euros at 2000 prices

	2000-2006 period (Agenda 2000)	2007-2013 period (Scenario A)	2007-2013 period (Scenario B)
CAP – Guarantee assistance		44,100	38,122
Structural funds	56,205	37,910	55,258
For Objective 1	38,096	19,754	19,754
Other	18,109	18,156	35,503
Total structural and CAP – Guarantee assistance		82,010	93,379

(*) Andalusia, Extremadura and Galicia (see Table 3.7).

Sources: Own calculations, and European Commission (2000-2006 period).

budget's structural and cohesion chapter. The relevant question in this highly hypothetical context is whether these additional resources should be dedicated to conventional policies (CAP, cohesion, etc.) or to financing the new competences of a genuinely European agent in the new global context. This question in itself warrants a separate study with a focus quite different from this one, which is intended to focus on the economic aspects of enlargement and the repercussions for Spain. We will, however, make some reference to this issue in the discussion in chapter VIII.

IV. The repercussions of trade adjustment

4.1. The evolution of Spanish and EU trade with the CEEC

In attempting to assess the impact on the Spanish economy of the accession of the CEEC to the EU, the theory of international economic integration is a useful starting point. The theory's analysis of the most advanced stages of integration is particularly relevant to the case that we are concerned with. In effect, the future members of the Union must meet all the requirements that were applied to the EU-15 countries in the process of creating a single market, and must create a framework that permits the free movement of goods, services and productive factors.

According to the theory, the elimination of trade barriers and restrictions on the movement of labour and capital between the member countries of an integrated area triggers an adjustment of trade and factor flows. The process of adjustment applies within the integrated area as well as to exchanges with third countries, and usually leads to an increase in the weight of relations with member countries to the detriment of those with the rest of the world.

All things being equal, the mutual elimination of trade and non-trade barriers that comes with integration (in this case, the incorporation of the CEEC) leads to a lowering of import prices for products from member countries. In terms of trade, the reorientation toward the integrated area (in

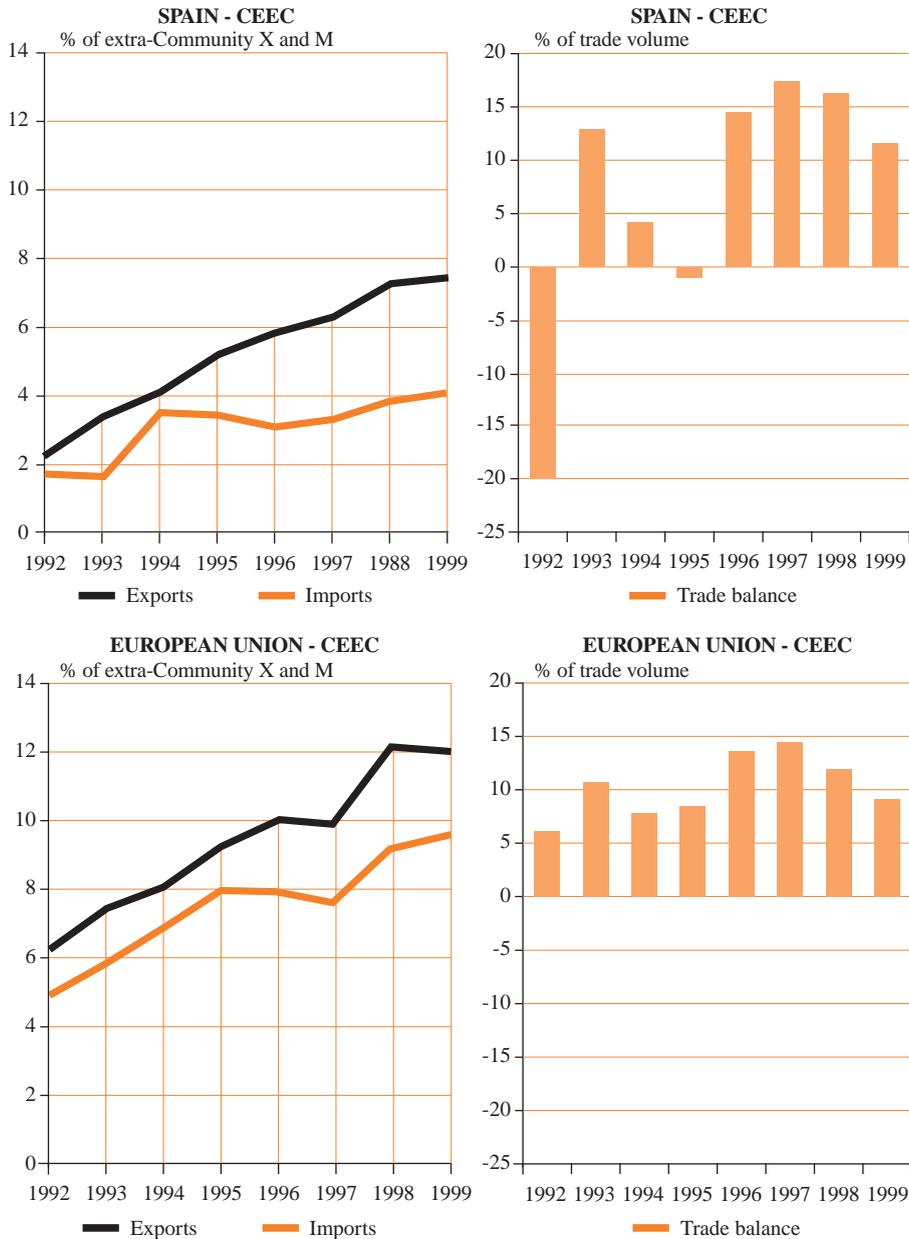
this case, of CEEC exchanges toward the EU area) is a logical response to this development, and applies both in the case of products produced internally in member countries and those imported from third countries. For Spain, the logical consequence of enlargement is an increase in bilateral trade with the new EU members. Given the higher levels of protection in place in the CEEC, it is likely that exports will increase more than imports, which will have a positive effect on Spain's bilateral trade balance with these countries. At the same time, however, it is quite possible that the expected increase in exchanges between the other EU members and the CEEC may lead to the substitution of Spanish exports to the EU market by products exported from the CEEC. Unlike the previous effect, this one would have a negative impact on Spain's trade balance. Fortunately, this effect is more uncertain: it is likely to apply only to the goods for which Spain is less competitive than the CEEC.

In order to determine the likelihood that Spain's exports to the EU may be substituted by those of the CEEC, it is necessary to examine the extent to which the structure of comparative advantages and disadvantages of Spain's exchanges with EU members is similar to that for the CEEC. The degree of similarity represents an approximation of the degree to which Spain and the CEEC will be competitors for the EU market.

We will now turn our attention to an analysis of the evolution and structure of Spanish and EU trade with the candidate countries. Such an analysis will provide a better basis on which to assess the threat to Spain's exports. The first point to be made in this regard is that trade exchanges between the CEEC and Spain and the CEEC and the EU have increased in a spectacular manner since these countries began their transition to the market system; as can be observed in Graph 4.1, the candidate countries have come to represent a much more significant proportion of extra-Community imports and, particularly, exports, for both Spain and the EU. In the graph it is also evident that Spain began to develop trade with the candidates more recently than the EU as a whole. This explains to some extent the fact that, in spite of the dynamism of trade flows in recent years, the CEEC's share of Spain's extra-Community trade (about 8%) is still lower than the average for the EU (12%). In any case, as the theoretical models would lead us to expect, it appears that the accession agreements and the expectation that integration

Graph 4.1

IMPORTANCE OF THE CEEC IN EXTRA-COMMUNITY TRADE FLOWS FOR SPAIN AND THE EU



Sources: OECD, IMF and European Economy Group (EEG).

will take place in the near future have been a driving force behind trade relations, and that, for the moment, these have resulted in an improvement in bilateral trade balances for Spain and the EU.

Nevertheless, it is important to highlight the fact that the level of trade integration with the CEEC that Spain has achieved is, regrettably, much lower than that for other EU members, particularly Germany, the United Kingdom, Italy, France and Austria – the countries that have been most successful in recognising and taking advantage of these emerging markets. When CEEC trade suppliers and clients are ranked, it is clear that Spain lags far behind these countries, particularly Germany (see Table 4.1). In fact, Germany's relative trade position is quite impressive: it is the point of origin for 25% of CEEC imports and the destination for almost 33% of their exports.

The extent of Spain's trade relations with the different CEEC varies. Geography appears to be one of the factors that influences the intensity of trade between current and future members. Specifically, in line with the propositions of a series of recent geography and trade models, the data suggest that geographical proximity favours trade.

Bearing in mind this variable, it could be predicted that Spain will continue to be one of the EU members with lowest trade volume with the CEEC. Such a forecast, however, should not be made without taking other variables into account: as indicated in specialised publications in this area, distance is only one of many factors that determine the flow of international trade. In this respect, since David Ricardo we know that countries trade in function of their comparative advantages, which, in general, are defined as advantages in terms of the relative prices of different goods. There are numerous hypotheses that attempt to explain the structure of comparative advantages for different countries. Among these, one which stands out is that formulated in the Heckscher-Ohlin-Samuelson (H-O-S) model, which attributes comparative advantages to differences in relative endowments of productive factors (capital and labour). According to this model, the elimination of trade barriers associated with the accession of the CEEC is likely to lead to specialisation by the different countries in the production and export of goods that utilise intensively the productive factor for which their relative endowment

Table 4.1

MAIN CEEC SUPPLIERS AND CLIENTS. 1999

Main suppliers (exports to CEEC)		Main clients (imports from CEEC)	
	% of total		% of total
Germany	24.8	Germany	32.6
Italy	8.9	Italy	7.6
Russia	6.8	Austria	5.4
France	6.1	France	4.7
Austria	4.4	United Kingdom	4.0
United Kingdom	4.0	The Netherlands	3.8
United States	3.8	United States	3.6
Czech Republic	2.8	Czech Republic	2.9
The Netherlands	2.7	Poland	2.5
Japan	2.4	Belgium and Luxembourg	2.5
Belgium and Luxembourg	2.3	Slovakia	2.4
Sweden	2.2	Russia	2.1
China	2.2	Sweden	1.9
Finland	1.9	Hungary	1.6
Slovakia	1.9	Spain	1.4
Spain	1.8	Denmark	1.4
Poland	1.7	Ukraine	1.2
Switzerland	1.5	Switzerland	1.1
Korea	1.4	Finland	1.0
Hungary	1.4	Croatia	0.9
European Union	61.8	European Union	67.9
OECD	78.6	OECD	82.1
Spain (millions of dollars)	2,841	Spain	1,732
Total (millions of dollars)	156,566	Total	120,624

Sources: IMF and European Economy Group (EEG).

is greatest. Consequently, enlargement will give rise to an increase in inter-industry trade (i.e., the exchange of products from different sectors).

The H-O-S model is the most accepted theory as far as inter-industry trade exchanges are concerned, but it has serious limitations when it comes to

explaining intra-industry trade. Such trade involves the exchange of products similar enough to be classified within the same sector in customs statistics; the sector, in this case, represents the greatest degree of sectoral disaggregation. Other variables must be taken into account to understand trade of this type, which plays a major role in exchanges between more-developed countries. Two key factors in the majority of models developed during the eighties are the existence of economies of scale and differentiation of products. These models remain adequate for explaining *horizontal* intra-industry trade – that which involves the exchange of varieties of products that do not present qualitative differences. Recent contributions, however, have emphasised differences in the technological capacity of different countries, at least in intra-industry trade based on *vertical* product differentiation strategies, or, in other words, on different levels of product quality.

In view of these theoretical considerations, a reasonable approach to clarifying the nature of the impact of eastward EU enlargement on Spain is to explore how inter-industry and intra-industry trade have developed, and, within intra-industry flows, to examine the relative weight of horizontal intra-industry trade and that based on vertical (qualitative) product differentiation.

In addition, if the analysis of past trade includes not only bilateral exchanges between Spain and the CEEC, but also those that take place between each of these economies and the EU, it will be possible to obtain information that will be highly useful when it comes to assessing the likelihood that enlargement will have a negative effect on Spain's exports to other members of the EU. These are the areas that will be analysed in the next section.

4.2. The structure of Spain's comparative advantages vis-à-vis the CEEC

We shall first examine the structure of comparative advantages and disadvantages of the trade exchanges of Spain and the CEEC with the EU. To make this comparison, we have calculated the Indices of Revealed Comparative Advantages (IRCA) for each of the 15 branches of goods defined in the NACE-CLIO R25 classification system. These indices are defined in the following manner:

$$IRCA_{it} = \frac{X_i - M_i}{X_i + M_i} \cdot 100$$

From an examination of the IRCA values for 1992 and 1998 (see Table 4.2), it can be observed that the sectors where Spain registers favourable trade balances with the rest of the EU countries are, to a large extent, the same sectors where the CEEC have achieved their best trade results in exchanges with this area. Moreover, over time the structure of

Table 4.2

INDICES OF REVEALED COMPARATIVE ADVANTAGE^(*) IN TRADE BETWEEN SPAIN, EU-14 AND THE CEEC

	Spain - CEEC	
	1992	1998
1. Agriculture	-23.4	68.6
Industry (2 to 15)	-14.2	13.9
2. Energy	-75.3	-91.8
Manufacturing (3 to 15)	-12.0	15.0
High-demand, technology-intensive sectors (5+8+9)	-21.8	-6.9
5. Chemical products	-15.1	1.4
8. Office machinery and other	-32.6	1.6
9. Electrical goods	-30.1	-11.7
Medium-demand and technology sectors (7+10+14+15)	44.8	33.5
7. Agricultural and industrial machinery	46.8	32.8
10. Transport equipment	70.4	44.6
14. Rubber and plastic products	10.7	-15.7
15. Wood, cork and other manufactured products	-2.7	4.8
Low-demand and technology sectors (3+4+6+11+12+13)	-34.5	8.0
3. Ferrous and non-ferrous metals	-43.0	-57.1
4. Non-metallic minerals and mineral products	-57.6	26.9
6. Metal products	-15.7	14.8
11. Food, beverages and tobacco	-7.7	55.7
12. Textiles and footwear	-42.6	10.9
13. Paper and derived products	46.3	-32.0
Total	-15.8	18.6

(*) $IRCA_i = \frac{X_i - M_i}{X_i + M_i} \cdot 100$

Sources: OECD and the European Economy Group (EEG).

comparative advantages and disadvantages of Spain and the candidate countries has become progressively more similar. These observations suggest that enlargement may well affect Spain's export opportunities with respect to current EU members.

Comparison of the sectoral structure of Spanish and CEEC exports to the Union constitutes a complementary means of analysing the relationship between Spain and the CEEC as EU suppliers. Consequently, it provides further information to assess the risk that Spanish intra-Community exports

Spain - EU		CEEC - EU	
1992	1998	1992	1998
24.7	36.2	25.8	0.9
-17.6	-9.7	-5.5	-12.9
-6.0	-17.5	27.9	35.4
-17.9	-9.6	-7.6	-14.0
-38.7	-32.4	-35.5	-28.7
-43.6	-36.1	-34.8	-54.3
-41.3	-37.7	-70.8	-23.5
-32.1	-26.2	-27.2	-17.6
-7.6	-2.9	-26.6	-16.5
-48.7	-39.7	-60.0	-49.0
7.5	6.7	-42.6	-8.7
-20.4	-12.7	-13.4	-31.0
-16.9	4.8	40.6	37.7
-17.6	-2.6	14.9	-1.8
-17.8	-15.9	53.2	10.1
11.0	23.9	19.4	4.4
-26.4	-11.6	15.2	0.0
-17.2	2.2	-8.3	-36.4
-16.6	7.8	15.8	9.0
-33.4	-24.0	-46.2	-46.8
-14.6	-6.6	-3.9	-12.6

may be displaced to some degree by those from the new members. This comparison can be made on the basis of a simple indicator: the index of specialisation, with reference to Spanish and CEEC exports to the EU market, may be defined as:

$$\frac{(X_{it} / \sum M_{it})^{SPAIN}}{(X_{it} / \sum M_{it})^{CEEC}} \cdot 100$$

The values of this indicator, shown in Table 4.3, indicate that at the beginning of this period Spain was in a dominant position with respect to the

Table 4.3

INDICES OF EXPORT SPECIALISATION^(*) FOR SPAIN WITH RESPECT TO THE CEEC IN TRADE WITH THE EU		
NACE - CLIO R-25	1992	1998
1. Agriculture	130.1	420.0
Industry (2 to 15)	97.4	92.3
2. Energy	31.6	30.8
Manufacturing (3 to 15)	103.1	94.4
High-demand, technology-intensive sectors (5+8+9)	126.4	76.8
5. Chemical products	102.8	163.8
8. Office machinery and other	399.5	60.3
9. Electrical goods	115.9	54.5
Medium-demand and technology sectors (7+10+14+15)	220.7	135.5
7. Agricultural and industrial machinery	127.5	77.7
10. Transport equipment	660.6	205.6
14. Rubber and plastic products	125.5	126.1
15. Wood, cork and other manufactured products	30.5	39.1
Low-demand and technology sectors (3+4+6+11+12+13)	52.7	69.8
3. Ferrous and non-ferrous metals	45.5	74.3
4. Non-metallic minerals and mineral products	94.3	84.3
6. Metal products	51.8	44.9
11. Food, beverages and tobacco	92.5	291.4
12. Textiles and footwear	28.7	39.0
13. Paper and derived products	174.8	139.5
Total	100.0	100.0

(*) See definition on page 71.

Sources: OECD and the European Economy Group (EEG).

export of goods associated with the highest level of technology and the most dynamic demand; CEEC exports were concentrated mainly in low demand sectors associated with a lower level of technological intensity. The evolution of the indices, however, highlights the fact that Spain's export specialisation has deteriorated as exports from the candidate countries in some sectors have experienced vigorous growth, as in the case, for example, of office machinery, electrical goods or transport equipment. The gains made by the CEEC in these sectors appear to be the consequence of strategies pursued by multinationals that have been highly active in setting up production facilities in these countries.

Indeed, as we shall see in greater detail in the next chapter, foreign investment has made it possible for the candidate countries to transform the structure of their comparative advantages and disadvantages over a very short period. Studies suggest that the preferred strategy of multinationals that set up operations in the CEEC is to take full benefit of the advantages of locating there – low-cost, relatively skilled labour and geographical proximity to the most important EU markets – in order to use these countries as production and export centres. Automobiles are a paradigmatic example of this strategy (though by no means the only one). The pursuit of this strategy by foreign investors is allowing some of the CEEC to specialise in the export of medium- and high-technology products. Consequently, there are good grounds to think that over time the CEEC with the greatest presence of multinationals will continue to develop specialisation along these lines, and, as a result, will increasingly compete with Spain to supply the enlarged EU market.

Clearly, the fact that EU and other multinationals use the CEEC, or more accurately some of the CEEC, as production centres and export platforms does not mean that they do not at the same time intend to create distribution channels to consolidate and effectively supply CEEC internal markets. On the contrary, there is evidence that this is part of their strategy, particularly in countries with large markets, such as Poland. It has been demonstrated that the countries that have achieved the highest degree of penetration in the CEEC in terms of direct investment are also those which, in general, supply the greatest share of their imports (documented in chapter V). Evidence of the positive influence of direct investment on sales in the international markets of the

countries receiving that investment extends beyond the case of the CEEC: such evidence derives from a broad geographical frame of reference and is, in fact, better documented in other cases.

Before drawing to a conclusion these considerations concerning the export specialisation of the CEEC in the EU-15 market, it is worth drawing attention to what is happening in trade in agricultural products. The fact that Spain shows an increasing specialisation vis-à-vis the candidates for these products may initially come as a surprise, given that the agricultural sector plays a far greater role in the economies of these countries than is the case in Spain. It seems that this is primarily the result of the significant productivity gap that exists in this sector within the candidate countries, and of the fact that such products were considered sensitive within the Europe Agreements and, therefore, are subject to a stricter and more long-term protection regime within the context of the CAP. Consequently, and particularly in light of the fact that the CAP may be the object of substantial reform, any attempt to forecast the impact that enlargement may have on trade in this area is purely conjectural.

Finally, it is worth examining trade flows at a maximum level of disaggregation in order to obtain further evidence concerning the degree to which the trade pattern of the CEEC in the EU area approximates that of Spain. This will also provide an indication of to what extent competition between Spain and the future members to supply the EU market is likely to intensify. The most appropriate means to carry out such an analysis is to determine the extent and the nature of intra-industry trade (IIT), i.e., exchanges of products that are so similar that they fall within the same category at the maximum level of disaggregation that can be determined by trade statistics. Intra-industry trade can be broken down into two types: horizontal intra-industry trade (HIIT) arises from the capacity and interest of companies in following product differentiation strategies based on attributes (such as colour, size or brand) that do not imply a qualitative difference; vertical intra-industry trade (VIIT) involves product differentiation based on the quality of the product imported or exported, and takes advantage of consumer preferences for a variety of products.

To measure the proportion of IIT in bilateral trade between Spain and the CEEC, we have used the Grubel and Lloyd index (the generally accepted means of making this determination). This index is defined as:

$$IIT_i = \left[1 - \frac{|X_i - M_i|}{X_i + M_i} \right] \cdot 100$$

Possible values for the index fall between 0, when there is no IIT, and 100, in which case all bilateral trade is intra-industry. To determine the proportion of intra-industry trade based on qualitative or vertical product differentiation, we have considered the variation in the unit value of the products imported and exported as an approximation of prices: intra-industry trade is regarded as vertical if the unit value of exported products differs from that of imported products by more than 15%, and as horizontal if the values differ by less than 15%. By following an analogous approach, it is also possible to determine what proportion of vertical IIT corresponds to exchanges in which Spanish exports to a determinate group of countries have a higher level of quality than its imports from the same area. In other words, intra-industry trade is horizontal (HIIT) if:

$$0.85 \leq \frac{UVI^{EXP}}{UVI^{IMP}} \leq 1.15$$

and, analogously, vertical intra-industry trade is defined by:

$$\frac{UVI^{EXP}}{UVI^{IMP}} < 0.85 \quad \text{or} \quad > 1.15$$

where

UVI^{EXP} is the unit value index for exports, and

UVI^{IMP} is the unit value index for imports.

Finally, in the case of vertical intra-industry trade (VIIT) in which Spain specialises in higher-quality product ranges,

$$\frac{UVI^{EXP}}{UVI^{IMP}} > 1.15$$

on the other hand, in cases of VIIT in which Spain exports lower-quality product varieties,

$$\frac{UVI^{EXP}}{UVI^{IMP}} < 0.85$$

Table 4.4 shows the values for intra-industry trade between Spain and the CEEC, Spain and the EU, and the candidate countries and the EU. Various interesting observations can be made on the basis of these values. First, it is evident that the exchanges between Spain and the CEEC are primarily inter-

Table 4.4

INTRA-INDUSTRY TRADE BETWEEN SPAIN, EU-14 AND THE CEEC

	Spain - CEEC	
	1992	1998
1. Agriculture	0.1	1.4
Industry (2 to 15)	4.8	20.0
2. Energy	0.0	0.1
Manufacturing (3 to 15)	4.9	20.2
High-demand, technology-intensive sectors (5+8+9)	5.2	23.9
5. Chemical products	2.9	6.5
8. Office machinery and other	16.7	38.0
9. Electrical goods	7.4	30.5
Medium-demand and technology sectors (7+10+14+15)	6.1	26.4
7. Agricultural and industrial machinery	3.7	16.9
10. Transport equipment	7.7	31.2
14. Rubber and plastic products	12.6	19.2
15. Wood, cork and other manufactured products	5.5	14.7
Low-demand and technology sectors (3+4+6+11+12+13)	4.3	7.7
3. Ferrous and non-ferrous metals	1.7	2.5
4. Non-metallic minerals and mineral products	4.1	5.9
6. Metal products	7.1	21.1
11. Food, beverages and tobacco	3.7	2.7
12. Textiles and footwear	9.1	6.9
13. Paper and derived products	6.7	5.7
Total	3.9	18.4

(*) See definition of the index on page 76.

Sources: OECD and the European Economy Group (EEG).

industry: IIT represents only 18% of trade with the candidate countries, much less than the proportion of trade of this type with the EU (43%). It should be noted, however, that Spain's intra-industry trade exchanges with the CEEC are substantial for some product types, particularly equipment goods and transport equipment (in this case due to trade in automobiles). This is not surprising given that many multinationals operate in both markets.

It should also be noted that the proportion of intra-industry trade is higher for trade between the candidates and the rest of the current EU members (28%) than it is in trade with Spain. It would appear, therefore, that in EU-

Spain - EU		CEEC - EU	
1992	1998	1992	1998
11.6	15.5	4.3	9.3
42.2	45.0	19.0	28.7
21.2	26.2	4.7	9.0
42.6	45.2	19.9	29.1
39.7	40.8	19.1	29.6
29.7	41.1	8.9	11.2
45.6	30.7	17.9	35.1
47.7	44.4	30.9	38.1
52.5	53.7	21.5	30.8
34.0	34.1	20.3	28.1
59.2	59.0	22.5	33.0
55.9	60.6	25.8	35.5
33.5	33.6	19.2	24.7
30.6	35.2	19.3	27.3
31.3	32.3	10.9	19.8
35.7	39.3	27.1	40.8
50.4	53.2	34.8	41.1
14.4	21.5	6.3	8.9
31.3	40.6	21.6	24.8
26.4	30.2	12.7	18.5
40.0	43.0	18.1	28.3

CEEC exchanges competitive strategies based on product differentiation play a greater role.

When unit values of imports and exports are compared in order to determine the nature of intra-industry trade (as explained above), other interesting observations can be made. For instance, it becomes clear that in trade between Spain and the CEEC, the vertical intra-industry type, based on qualitative differences between the varieties of products exchanged, is predominant (see Table 4.5).

Table 4.5

INTRA-INDUSTRY TRADE^(*) BETWEEN SPAIN AND THE CEEC

	Horizontal IIT	
	1992	1998
1. Agriculture	0.0	0.2
Industry (2 to 15)	0.4	6.6
2. Energy	0.0	0.0
Manufacturing (3 to 15)	0.5	6.7
High-demand, technology-intensive sectors (5+8+9)	0.5	3.0
5. Chemical products	0.2	0.6
8. Office machinery and other	8.6	1.4
9. Electrical goods	0.2	4.3
Medium-demand and technology sectors (7+10+14+15)	1.3	12.6
7. Agricultural and industrial machinery	0.5	1.8
10. Transport equipment	0.1	17.7
14. Rubber and plastic products	10.0	5.1
15. Wood, cork and other manufactured products	0.2	1.0
Low-demand and technology sectors (3+4+6+11+12+13)	0.1	1.4
3. Ferrous and non-ferrous metals	0.0	0.4
4. Non-metallic minerals and mineral products	0.1	0.8
6. Metal products	0.0	3.1
11. Food, beverages and tobacco	0.0	0.8
12. Textiles and footwear	0.3	1.9
13. Paper and derived products	0.4	1.3
Total	0.4	6.1

(*) See definition of the index on page 77.

Sources: OECD and the European Economy Group (EEG).

The breakdown of vertical intra-industry trade, in turn, highlights that the majority of Spain's exports to the CEEC involve product varieties with a higher level of quality than that of products imported from these countries. This observation should, however, be qualified in two respects. First, this circumstance is changing over time, which suggests that the candidates are improving the quality of their products more rapidly than Spain is. Second, in some product classifications, such as office machinery and transport equipment, it is the CEEC that are more specialised in higher-quality product

Vertical IIT					
Total vertical IIT		Low-quality		High-quality	
1992	1998	1992	1998	1992	1998
0.1	1.2	0.1	0.9	0.1	0.3
4.3	13.4	1.4	5.8	2.9	7.6
0.0	0.1	0.0	0.0	0.0	0.0
4.5	13.5	1.5	5.9	3.0	7.7
4.7	20.9	1.6	5.6	3.1	15.3
2.7	5.9	0.7	2.3	2.0	3.7
8.0	36.6	0.7	31.9	7.2	4.6
7.3	26.1	3.0	4.2	4.3	21.9
4.8	13.9	0.8	8.9	4.0	5.0
3.2	15.1	1.1	4.2	2.2	10.9
7.5	13.5	0.2	11.7	7.3	1.9
2.6	14.1	1.3	1.7	1.3	12.5
5.3	13.7	1.4	4.9	3.9	8.8
4.2	6.3	1.8	1.6	2.4	4.6
1.7	2.2	0.0	0.5	1.7	1.6
4.0	5.1	2.5	2.2	1.6	2.8
7.1	18.0	1.4	2.7	5.7	15.3
3.7	1.9	2.9	0.9	0.8	1.0
8.8	4.9	4.9	1.3	3.9	3.7
6.2	4.5	0.6	1.9	5.7	2.6
3.6	12.4	1.2	5.4	2.4	7.0

ranges. These are two important considerations that justify concern about the growing competitive pressures that the candidates may exert on Spain's exports.

4.3. The impact of enlargement on Spain's trade

In light of the preceding analysis of how trade between Spain and the CEEC has evolved, it can be argued that Spain appears to be capable of increasing its share of exports to Eastern European countries. Although Spain got a late start and its export growth has been less intense than that of the rest of the EU-15 countries, exports to these emerging markets have, in fact, been growing, particularly in recent years. Nevertheless, it should be stressed that Spain is far below the EU average as a supplier to the candidate countries.

Based on the experience of the EU members who have had the greatest success in supplying these markets, it can be inferred that direct investment projects are an important factor behind export growth. Consequently, the future evolution of Spanish exports to the CEEC will depend to a large extent on the capacity of Spanish companies to open and consolidate commercialisation channels by setting up affiliates in these countries, either financed entirely by Spanish capital, or in the form of joint ventures.

In terms of Spain's imports, based on past trends, it appears likely that CEEC products will continue to gain ground in this area, quite possibly at a faster rate than they have up until now. The significant degree of international investment penetration in the CEEC is playing an important role in this regard by allowing the candidates to reinforce their competitiveness.

In summary, it is likely that in the coming years, particularly after the integration of the candidates, Spain will intensify bilateral trade flows with these countries. Moreover, unless Spanish companies pursue a more active and effective policy, it is possible that the growth of Spain's exports to the CEEC will be less than the growth of its imports, resulting in a deterioration of the trade balance with these countries. Though, at the moment, this balance is still in Spain's favour, the difference represents an increasingly lower volume of trade.

As for the composition of trade exchanges between Spain and the CEEC, the fact that multinationals operating in these emerging markets have produced major changes in the structure of comparative advantages over recent years makes it highly difficult to make well-founded forecasts. It should also be borne in mind that many of the affiliates of multinational companies that have established production centres in the CEEC also have such facilities in Spain: the automotive industry is again a perfect example of this. The changes that take place in the sectoral composition of bilateral trade exchanges will, to a great extent, depend on the future strategies adopted by these multinational companies concerning the location of their facilities within the new scenario of an enlarged EU.

Up to this point, we have concerned ourselves with the possible impact of enlargement on trade between Spain and the new EU members. However, the anticipated repercussions of CEEC integration on bilateral transactions are not the only consequences that enlargement may have for Spanish trade. In fact, in our opinion, the effect on Spain's role as a supplier to the European market is likely to be more significant. As we have attempted to argue throughout this chapter, there is good support for the view that this role may be negatively affected, not only in the low demand and technology sectors that traditionally constituted the nucleus of candidate country exports, but also in areas associated with more complex technologies and more dynamic demand. The limited productive and export capacity of the CEEC in these areas is improving notably as a result of the actions of foreign investors.

V. The repercussions via direct investment

5.1. Economic integration and international direct investment

Having analysed the possible effects of enlargement on Spanish trade, we will now turn our attention to the implications of the changes that are very likely to occur in flows of direct investment. In fact, in attempting to forecast investment behaviour a significant body of evidence is available for analysis: within the framework of the Europe Agreements, direct investment has in recent years flowed freely in much the same way that it will after the accession of the CEEC. Moreover, the governments of these countries have seen the entry of foreign capital as an essential factor to successfully complete their respective transitions to the market system and to advance toward convergence with the levels of economic well-being of Western Europe. As a result, all of them have provided incentives to attract foreign investment.

Before examining what has happened to flows of direct investment since the CEEC initiated their transition to the market system and established the basis for their eventual integration in the EU, it is worth briefly reviewing the main ideas concerning the influence of processes of integration on movements of capital in the form of direct investment between the countries involved. In order to determine how flows of direct investment (or

multinational strategies, which are essentially equivalent) are influenced by international integration agreements, it is first necessary to establish what the factors determining such investment are.

According to the conventional model developed in Mundell (1957), international movements of capital (without distinguishing between possible variants) are determined by differences between countries in terms of relative factor endowments (of capital and labour). According to this model, in the context of perfect competition and other assumed conditions, relative factor endowment determines marginal productivity as well as return on capital (and labour). Consequently, when a process of integration eliminates barriers to the free movement of capital, the expected response is clear: capital will flow from countries that have a relatively abundant endowment of this factor to other members where it is relatively more limited.

Since the pioneering work of Hymer (1960), however, we know that the assumptions on which these predictions are based often do not fit reality, and that neither do the predictions made. Hymer was correct in suggesting that movements of capital, at least when they take the form of direct investment, occur in response to a broader set of causes. One of the most important of these is the desire of the investor to exercise control over the foreign company in which he holds shares. The study of direct investment has focused on further developing the ideas put forth by Hymer, and this has led to what is known as the Eclectic Theory or the OLI paradigm. In spite of its limitations, the OLI paradigm is the best and most comprehensive explanation available of direct investment, and, by extension, of the behaviour of multinational companies. Dunning (1974, 1980 and 1993) systematised the various causal factors behind direct investment that had been proposed in different studies, and this led to his classification of relevant variables in three groups: the advantages of *ownership*, those of *location* and those of *internalisation*, thus the acronym «OLI», which has served as a name for the overall set of variables.

According to the OLI paradigm, there must be a concurrence of the three types of variables in order for direct investment projects in other countries to be carried out successfully. First, the investor must possess some ownership advantage, usually a non-material asset, such as a technological

improvement or a commercial brand with a good reputation among customers. Undoubtedly, the current members of the EU have advantages of this kind with respect to the CEEC, which will allow them to carry out international investment projects in these emerging markets. Second, direct investment also depends on the desire to benefit from the advantages the recipient countries offer in terms of location. In this regard, the majority of the CEEC offer relatively low-cost skilled labour, markets that are increasingly dynamic as transition is consolidated, and geographical proximity to the most prosperous areas within the Union. These are some of the characteristics that make them an attractive location for direct investment. Finally, the OLI paradigm points to advantages of internalisation as the third type of causal factors for direct international investment: the various kinds of imperfections that are associated with transactions carried out through the market can be avoided by internalising them within companies that maintain affiliates in various countries, and such internalisation has a positive effect on profits.

Predictions concerning the possible consequences of integration agreements between countries that are made on the basis of this model (the most widely accepted one at present) are, logically, more complex and uncertain than those made in accordance with the simpler but less realistic Mundell model (1957).

If the OLI framework is accepted, as it is in most studies, an attempt can be made to predict how the accession of the CEEC may affect flows of direct investment to both candidate countries and current EU members. Integration of the candidates in the EU implies the free movement of capital and labour, as well as free trade in goods and services. These developments will affect the three groups of variables that influence the international direct investment strategies of companies.

Clearly, the accession of the CEEC will result in a substantial enlargement of the size of the EU market, which will increase opportunities to exploit advantages of ownership (better product and process technologies, more efficient forms of organisation and management, commercial brands, etc.). Integration will also make it easier to benefit from the location

advantages offered by the candidate countries. Likewise, it facilitates the geographical positioning of affiliates in such a way as to profit from advantages of internalisation. Such advantages are increasingly significant as advances in information and communication technologies make possible the reduction of management costs for activities carried out in different countries. After the accession of the CEEC, it will be possible, for example, to carry out intra-firm trade without the cost generated by the tariff barriers between multinational affiliates that are located in the current members and those that are located in the candidate countries.

In light of these considerations, it can be inferred that accession involves a significant stimulus for companies based in current member countries to set up operations in the candidate countries. In fact, as mentioned above, this has taken place even before accession: the liberalisation measures contained in the Europe Agreements were enough of an incentive for EU-15 multinationals to begin establishing affiliates in the majority of the CEEC. Spanish companies have also adopted the strategy of setting up production centres in candidate country markets, though, as we shall later document, their response has been both late and on a modest scale.

The ideas formulated in the OLI paradigm have been incorporated in recent «geography and trade» models. Together these constitute a theoretical framework that provides a basis for another type of predictions concerning the effects of CEEC accession on flows of direct investment. On this basis it can be predicted that the accession may lead to a shift to the CEEC of the investments received by Southern European EU members, including Spain. There are two considerations that support such a forecast, at least as regards those activities where significant economies of scales can be achieved and unit transport costs are relatively high (as is the case, for example, in the production of automobiles). First, both regions offer advantages in terms of labour costs, though the CEEC have the edge in this regard. Second, some of the candidate countries also offer a better geographical position.

5.2. Spanish and EU flows of investment with the candidate countries

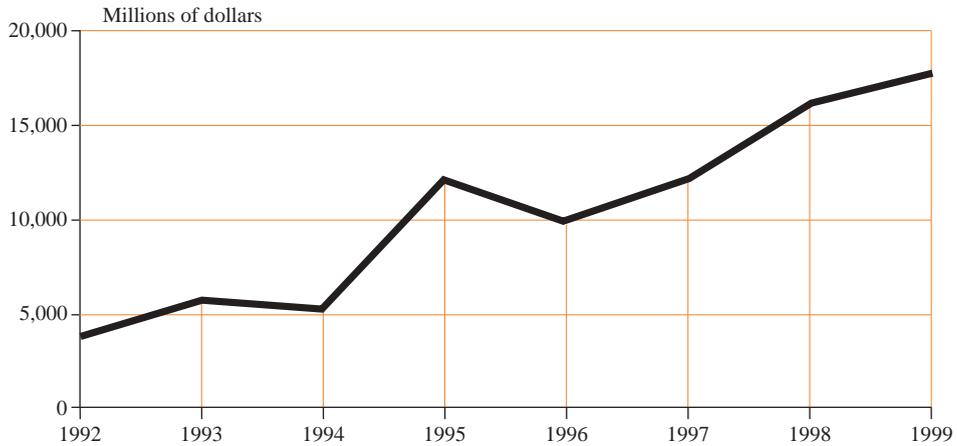
As mentioned above, in order to determine the perspectives and effects of flows of direct investment within an enlarged Europe, it is useful to examine the response to the liberalisation that has occurred within the framework of the Europe Agreements. On the basis of this evidence, it seems likely that in the coming years direct investment will continue to flow from current EU members to the CEEC. In this regard, it is important to highlight again the significant advantages of location these countries possess: the availability of low-cost and relatively skilled labour, geographical proximity to the EU's nucleus of economic activity, policies that promote and support foreign investment, and good prospects for growth. As part of a study commissioned by the European Bank for Reconstruction and Development (see Lankes and Venables, 1997), companies established in the region were surveyed to find out the reasons why they had decided to invest there. According to the responses obtained, the availability of low-cost skilled labour was the main consideration. The study also confirms investor preference for the CEEC as «production and export platforms» to supply the European market – a preference based on their low labour costs and good geographical position.

It is not surprising then that once the CEEC had undertaken the process of transition to the market system, they began to be the focus of major direct investment projects. In addition to pursuing the advantages already outlined, these projects sought to exploit the acquisition opportunities that were generated by the intense process of privatisation. As shown in Diagram 5.1, since the beginning of the nineties, the candidate countries have been the destination for significant and increasing flows of direct investment. Initially, investment flowed mainly to the first group of candidates (PECO I), particularly Hungary, Poland, the Czech Republic and Slovenia. Subsequently, however, nearly all of the other countries also became major focal points for direct investment.

In this manner, over time, most of the CEEC have accumulated a stock of foreign investment. Table 5.1 shows how this represents an increasing

Diagram 5.1

EVOLUTION OF DIRECT INVESTMENT RECEIVED BY THE CEEC. 1992-1999



Sources: UNCTD and the European Economy Group (EEG).

Table 5.1

PENETRATION OF FOREIGN CAPITAL IN THE CEEC

Stock of foreign capital / GDP (%)

	1990	1995	1998
Bulgaria	–	2.6	12.3
Slovakia	0.6	7.2	12.1
Slovenia	3.8	9.4	14.5
Estonia	–	20.2	35.6
Hungary	1.7	22.4	33.2
Latvia	–	13.8	25.2
Lithuania	4.4	5.8	15.2
Poland	0.2	6.6	15.1
Czech Republic	4.3	14.5	26.1
Romania	2.0	3.2	10.4
European Union	10.7	12.4	17.3
Spain	13.4	19.1	21.5

Source: UNCTD.

proportion of GDP for these countries, and, in the case of Estonia, Hungary, Latvia and the Czech Republic a proportion that is higher than the EU average.

It should be stressed that differences in the flows of direct investment reaching the various candidate countries can largely be attributed to significant variations in the approaches taken to the privatisation process and the rhythm of privatisations. Countries such as Hungary – which undertook this process sooner and provided greater opportunities for foreign investors to purchase company shares – have also been the main recipients of foreign capital. Table 5.2 shows this relationship: with the exception of only Slovenia and Estonia, the countries that have earned the most revenue from privatisations are the countries with the highest degree of foreign capital penetration.

Spanish companies, unlike those in the majority of EU member countries, took little advantage of the opportunities that the first privatisations presented to purchase companies at a low cost.

As for flows of investment from the CEEC to current EU members, there is little that warrants attention, apart from their virtual inexistence.

Table 5.2

INCOME GENERATED BY PRIVATISATIONS (FROM 1989 TO THE INDICATED YEAR)

As % of GDP

	1995	1999
Bulgaria	0.7	8.7
Slovakia	8.4	11.0
Slovenia	0.4	2.5
Estonia	9.4	14.8
Hungary	5.9	13.0
Latvia	0.7	3.5
Lithuania	1.4	8.0
Poland	2.6	7.7
Czech Republic	4.3	9.1
Romania	1.2	7.7

Source: EBRD.

In terms of the geographical and sectoral pattern of investment flows, analysis of the origin of foreign capital (Table 5.3) reveals certain aspects common to the candidate countries. The European Union, for instance, is the

Table 5.3

GEOGRAPHICAL ORIGIN OF THE STOCK OF FOREIGN CAPITAL RECEIVED BY CANDIDATE COUNTRIES

Data as of December 31 1999

	Percentage of the total stock of foreign capital received
1. Germany	19.4
2. The Netherlands	13.9
3. United States	10.7
4. Austria	7.1
5. France	7.0
6. United Kingdom	5.5
7. Italy	4.8
8. Sweden	2.9
9. Belgium	2.4
10. Switzerland	2.2
11. Korea	2.1
12. Russia	1.6
13. Finland	1.5
14. Denmark	1.4
15. Ireland	1.1
16. Norway	0.9
17. Cyprus	0.9
18. Liechtenstein	0.9
19. Luxembourg	0.5
20. Spain	0.5
European Union	68.4
OECD	86.9
Total received	95.776 billion dollars
From Spain	453.2 million dollars
Spain's share	0.5%

Sources: Bulgarian Foreign Investment Agency (BFIA), National Bank of Slovakia, Bank of Slovenia, Bank of Estonia, National Bank of Hungary, Bank of Latvia, Bank of Lithuania, Lithuanian Department of Statistics, Polish Agency for Foreign Investment (PAIZ), Czech National Bank, Regional Development National Agency of Romania, IMF, UNCTD and the European Economy Group (EEG).

main source of investment capital: 68.4% of the total stock of CEEC foreign capital originates in the EU – a much higher percentage than that accounted for by US investment (10.7%). Within the EU, Germany is the leading investor in the region (19.4% of the stock of foreign capital), followed by the Netherlands (13.9%) and Austria (7.1%). It is also worth noting the key role investment from the Nordic countries plays in the Baltic republics: the Nordic countries are the source of 78.7% of the stock of foreign investment in Estonia, 41.6% in Lithuania, and 31.7% in Latvia. In addition to Germany's clear dominance, it is evident that the geographical distribution of investors is associated with proximity to the countries to which investment is directed.

The importance of geographical proximity explains to some extent the fact that Spain is one of the EU members that have invested least in the region, but the insignificance of Spain's share, just 0.5% of total foreign capital in the CEEC, remains surprising: Ireland – a country quite a bit smaller than Spain and farther from the CEEC – has more than double Spain's share.

Spain's limited presence is not uniformly distributed among the candidates: more than half of investment has gone to Poland (259 million dollars), though this still represents only 0.7% of the foreign capital received by that country. The only candidate country where Spain has a relatively significant position as an investor is Bulgaria, where 3.9% of investment capital received is of Spanish origin (still just a modest 110 million dollars). Spain has achieved only a token level of investment in Slovakia and Slovenia. Overall, this data clearly indicates that Spanish companies have for the most part ignored this region as a destination for international investment projects. In fact, in the last three-year period for which information is available (1998-2000), these countries were the destination for only 0.8% of Spanish investment abroad.

In terms of the sectoral pattern (see Table 5.4), the first aspect that stands out is that foreign capital investment is very evenly distributed between the industrial sector and the services sector. Within the industrial sector, food industries, transport equipment, and non-metallic minerals and mineral products are the areas that account for the largest proportion of investment. In

the services sector, preferred areas for multinational investment are services related to the generation of distribution networks (commercial sector), financial intermediation, and business services in general.

Table 5.4

SECTORAL DISTRIBUTION OF THE STOCK OF FOREIGN CAPITAL RECEIVED BY THE CEEC

Data as of 31 December 1999

	Percentage of the total stock of foreign capital received
<i>Agriculture</i>	0.5
<i>Industry</i>	47.7
<i>Energy</i>	6.2
<i>Manufacturing</i>	41.5
Metallic minerals and mineral products	2.0
Non-metallic minerals and mineral products	4.8
Chemical products	2.3
Rubber and plastics	3.1
Agricultural and industrial machinery	2.6
Office and data processing machinery	1.2
Electrical goods and equipment	2.3
Transport equipment	7.8
Food, beverages and tobacco	10.0
Textiles, leather goods and clothing	1.2
Paper and printing	3.0
Other manufactured products and wood	1.0
<i>Construction</i>	3.0
<i>Services</i>	45.9
Commerce, recovery and repair	12.5
Accommodation and restaurant industry	1.2
Transport and related services	4.8
Communications	2.9
Credit and insurance institutions	17.4
Other sales-related services	7.1
<i>Unclassified</i>	2.9
Total received	95.776 billion dollars

Sources: Bulgarian Foreign Investment Agency (BFIA), National Bank of Slovakia, Bank of Slovenia, Bank of Estonia, National Bank of Hungary, Bank of Latvia, Bank of Lithuania, Lithuanian Department of Statistics, Polish Agency for Foreign Investment (PAIZ), Czech National Agency, IMF, UNCTD and the European Economy Group (EEG).

Investment in the food and agriculture industry is directly related to the high weighting of this sector in the economies of many of the CEEC. A similar explanation applies to the presence of multinationals in the non-metallic products sector (ceramics and glass-related products). The high proportion of foreign investment in the transport equipment sector in Slovenia, Hungary, Poland and the Czech Republic indicates that multinationals are betting heavily on this area. This focus has led to the purchase of local automotive companies (such as that of Skoda by Volkswagen) and, above all, to the setting up of new affiliates by the main multinationals (Suzuki, Renault, Fiat and others). It appears that the multinationals have two objectives: to supply the domestic market and to take advantage of low labour costs by setting up the most work-intensive stages of production in these countries and exporting the end product.

Multinationals have a significant presence in the commercial sector in all of the candidate countries, though the level of investment in this area varies from 9.7% of foreign capital received in Poland to 24.5% in Lithuania. This highlights the interest that multinationals have in supplying these markets and the special attention they give to creating distribution channels for their export products, while consolidating and defending their position against the entry of other potential foreign competitors.

Another of the sectors where there has been a significant penetration of foreign capital is credit and insurance institutions. In fact, some of the most recent and significant privatisations have been of state banks. In this sector, Western financial institutions enjoy clear ownership advantages in relation to local institutions, which, before the transition, had been operating in a much less competitive financial market that was cut off from the international system. There has also been a significant entry of foreign capital in the telecommunications sector, in many cases as a result of privatisation processes for state monopolies. The vast majority of companies in this sector are wholly or partially backed by foreign capital.

5.3. What is the risk that Spain will be displaced by the CEEC as a destination for direct investment?

The expansion of investment projects carried out in the CEEC by EU members and other countries – an extension of past trends – is not the only foreseeable effect of EU enlargement on flows of direct investment. Another phenomenon that is at least as significant and, without doubt, more of a threat to Spain is the possible redirection to the new EU members of flows of direct investment received by Southern European countries.

The aim of this section is to analyse the likelihood of this scenario (a rather grim one for Spain) becoming a reality. A relevant starting point is the examination of the evolution of flows of direct investment received by Spain and the CEEC in recent years from current EU members and other countries.

Diagram 5.2 shows the magnitudes of these flows of investment. Flows received by Spain fell during the years that the entry of direct investment capital in the CEEC was increasing rapidly. This seems to bear out the hypothesis that investment in the candidate countries will be at Spain's expense. In recent years, however, the data do not fit this hypothesis so well: as can be observed in the same diagram, the evolution of direct investment over this period is quite similar in the two areas, though somewhat more dynamic in the CEEC.

Another useful means of exploring the likelihood of the proposed hypothesis is to assess the location advantages of the CEEC vis-à-vis Spain as a destination for international direct investment projects. Along the same lines, it is also worth reviewing the evidence that is available concerning the reasons why foreign companies invest in the CEEC.

Diagram 5.2

DIRECT FOREIGN INVESTMENT RECEIVED BY SPAIN AND THE CEEC. 1992-1999



Sources: UNCTD, Eurostat and the European Economy Group (EEG).

As mentioned above, the Eclectic Theory or OLI paradigm, which seeks to explain the development and expansion of multinational companies, maintains that the location advantages a country offers in relation to other possible destination points are crucial to decisions made about where to establish affiliates. The list of these advantages is long and varied. Dunning, the developer of the OLI paradigm, made various attempts to catalogue these advantages, which include the economic, social and political characteristics of a country that may affect the overall income statement of multinational companies (i.e., that for the parent company *and* its affiliates).

The catalogue of location advantages includes variables ranging from those which affect the set-up cost (land prices, legal steps required for the creation or purchase of companies by foreign investors, etc.) to those which have an impact on profits (e.g., capital taxes and regulations regarding the repatriation of profits earned by companies with foreign capital), as well as a seemingly endless list of other factors affecting the productive and commercial activity of foreign investors (e.g., wages, labour regulations, infrastructure, geographical location, trade barriers, etc.).

Clearly, comparing these variables as they apply to different countries (in our case each of the CEEC and Spain) in order to determine their relative capacity to attract international investment projects is a highly complex task, if not an impossible one. It is even more difficult to assign an appropriate weighting to each of the variables: the most that can be done is to take into account the relative importance of each location variable in accordance with the activity type (or within activities, according to the stage in the production process). For instance, if we consider labour costs, it is evident that this variable will play a more important role in determining the geographical location strategies of multinationals in activities for which the production process is more labour-intensive, as is the case, for example, in the textile industry. This logic also applies to any other activities (such as the production of computers) for which there are stages in the production process that are relatively labour-intensive. In such activities, labour costs have a greater impact on overall production costs.

In addition to these difficulties, the availability of statistics that can provide a basis for comparison is still limited in the CEEC. Not surprisingly, then, it is difficult to accurately assess the risk that Spain may be displaced as a destination for direct investment by the candidate countries. It is possible, however, to provide a comparative analysis of some of the possible location variables in order to clarify this point to some extent.

We will begin by considering geographical location, a variable that recent literature in the area known as «new economic geography» stresses as one of the factors that determines location strategies for company production units and, consequently, also orients international direct investment decisions and foreign trade policies. In the context of these models (see Ottaviano and Puga, 1998, and Schmutzler, 1999), the existence of economies of scale and of agglomeration, together with consideration of transport costs means that the geographical location of a country (particularly, its distance from main centres of production and consumption) constitutes a significant element in the assessment of its capacity to attract investment. In this regard, there can be little doubt that Spain is at a disadvantage compared to those CEEC, such as the Czech Republic, Hungary or Poland, that have a more central geographical location, closer to the area where the greatest economic wealth of the EU is concentrated (for more details, see the Second Cohesion Report, prepared by the European Commission).

Nevertheless, the importance of geographical location should not be exaggerated. This factor is not linked to substantial advantages in most services, where, thanks to spectacular growth in communications technology, barriers of distance are less and less relevant. This is also the case for manufacturing, where transports costs represent a very small proportion of the unit price for goods produced. Moreover, the disadvantages of a peripheral geographical location can be more than compensated by other location advantages. A good example of this is Ireland, which, in spite of its clearly peripheral position, has attracted a great deal of interest from international investors both within and outside of Europe. Finally, the disadvantages of distance can also be largely outweighed by a good endowment of transport and communications infrastructure.

In fact, in light of the evidence available, transport and communications infrastructure is considered one of the most significant variables affecting the choice of destinations for direct investment. Data concerning transport infrastructure in the CEEC is limited, but that which is available indicates clear shortcomings, even in the candidate countries with the highest levels of economic development. This is the diagnosis reached in studies carried out by the European Commission (Inforegio, 1999) and by the European Bank for Research and Development (EBRD, 2000). The EBRD study also indicates a quantitative deficiency in road networks due to the age of construction and limited investment in maintenance and upgrading.

As for communications, when data are compared for the indicators generally used to assess the degree of development in this area, it is evident that the CEEC lag behind Spain. The figures in Table 5.5 reflect the fact that the level of penetration for the new technologies that have revolutionised the

Table 5.5

DEGREE OF PENETRATION OF INFORMATION TECHNOLOGIES IN THE CEEC

	Personal computers per 100 population (2000)	Internet host per 100 population (2001)	Internet users per 100 population (2000)	Spending on information technologies (% GDP) (2000)	Mobile phones per 100 population (2000)
Bulgaria	4.4	0.3	5.2	1.7	9.0
Czech Republic	13.1	1.8	9.7	3.9	42.3
Estonia	16.6	3.1	25.4	–	38.7
Hungary	8.7	1.4	7.1	3.3	29.9
Latvia	10.1	0.9	6.2	–	16.6
Lithuania	7.3	0.8	4.1	–	14.2
Poland	6.9	1.4	7.2	2.2	17.5
Romania	3.2	0.2	3.6	1.0	11.1
Slovakia	9.1	1.2	12.0	2.9	24.0
Slovenia	27.6	1.4	15.1	2.1	54.6
CEEC	6.4	0.7	5.5	2.2	21.8
European Union	28.6	3.3	24.2	2.7	62.6
Spain	13.7	1.6	12.6	2.1	61.3

Sources: Eurostat, ISPO, ITU, EITO and the European Economy Group (EEG).

area of information and communication is significantly lower than in Spain, even though Spain, in turn, is quite far from Community levels.

The advantages of the CEEC are, however, enormous in terms of labour costs. According to the latest data available, the average per-hour labour cost for the ten CEEC was just 16% of that for the Spanish economy (see Table 5.6). Although this difference is somewhat lessened when the lower productivity of the candidates is taken into account, their advantages in this area remain substantial. Two important points, however, need to be made with regard to this location advantage for the candidates. First, it must be stressed that the availability of reduced labour costs is only an essential factor when it comes to attracting company investment operations whose objective is total or partial production of goods that require the intensive use of labour. This is a particularly important element, for example, in assembly processes of the type usually associated with less-developed economies. Such activities better fit the profile of the CEEC economies than those, like Spain's, that have reached relatively high income levels. The second important point to bear in

Table 5.6

AVERAGE WAGES PER WORKER IN THE MANUFACTURING SECTOR^(*) IN THE CEEC

EU = 100

	Year 2000
Bulgaria	4.16
Czech Republic	12.39
Estonia	11.13
Hungary	12.37
Latvia	9.17
Lithuania	10.07
Poland	17.15
Romania	4.55
Slovakia	10.04
Slovenia	28.58
CEEC	11.55
European Union	100
Spain	73.73

(*) In euros. Naturally, if corrected for purchasing power parity, the disparities would be substantially reduced.
Sources: ILO, Eurostat and the European Economy Group (EEG).

mind is that, in any case, what is most relevant is not labour costs but productive human capital.

Indeed, given that human capital is a key determinant of productivity, its availability is a fundamental factor in the geographical diversification strategies of companies. It is highly difficult to compare the endowments of human capital for different countries, as there are no appropriate measures of this variable. Nevertheless, the average number of years of schooling for the working-age population is a fairly simple indicator that can provide a certain amount of information concerning Spain's situation relative to the CEEC. In fact, a comparison based on this indicator (see Table 5.7) shows that in the majority of the CEEC the human capital that makes up the potential workforce is comparable to that in Spain. Though this indicator may be limited by the fact that it does not take into account the profound differences that exist between educational systems and content in Spain and the CEEC, it is difficult to question that, at least in conjunction with the difference in labour costs, the level of workforce education and training in the CEEC is a point in their favour when it comes to attracting direct foreign investment.

Table 5.7

AVERAGE NUMBER OF YEARS OF SCHOOLING FOR THE CEEC WORKING-AGE POPULATION	
	Year 1999
Bulgaria	9.5
Czech Republic	10.7
Estonia	9.7
Hungary	9.5
Latvia	9.9
Lithuania	9.3
Poland	10.5
Romania	9.3
Slovakia	8.5
Slovenia	10.9
CEEC	9.8
European Union	9.5
Spain	8.1

Sources: OECD, Eurostat and the European Economy Group (EEG).

Despite the advantages outlined above, the CEEC do suffer from certain handicaps when it comes to gaining the trust of foreign investors. These stem from the relative fragility of their political systems, and the fact that the establishment of the institutions, legislation and practices that underlie a functioning market system is incomplete, or at least not yet consolidated. There are clear signs, however, that these limitations – largely the result of the relatively short time that has passed since the transition process began – are being overcome and that they will cease to be a consideration by the time these countries join the EU.

To sum up, the evolution of investments received by Spain and the CEEC and the assessment of their relative location advantages do not provide a sufficient basis on which to make precise forecasts concerning the extent to which foreign direct investment received by Spain may be redirected to the future EU members. Nevertheless, the evidence available is enough to at least suggest that the risk of displacement of this kind is high if the right measures are not taken to reinforce the location advantages associated with the Spanish economy. There are several areas where action is needed in order to compensate for a geographical location that will become more peripheral in the context of an enlarged EU: transport and communication infrastructure clearly require improvement, and efficient investment in the development of human and technological capital must be intensified.

VI. The character and effects of potential migratory flows

6.1. The extent and the nature of migration

One of the affects of the accession of the CEEC to the EU will be to establish a framework for the free movement within the enlarged Union of goods, services and productive factors. At the moment, trade barriers with these countries have been eliminated and movements of capital have been almost completely liberalised, but restrictions still apply to the free circulation of workers.

After the fall of the Berlin Wall, a clear confluence of interests between the EU countries and the ex-communist states made the signing of a set of bilateral agreements possible. These were known as the Europe Agreements, and were intended to facilitate closer economic ties and establish the basis for the future incorporation of these countries in the EU. The agreements established a series of conditions that favoured trade and factor mobility, focusing primarily on the free movement of capital. In contrast, only minimal concessions were made with regard to the free movement of labour: the agreements reached only went so far as to ensure the right of workers from the CEEC already residing in the Union not to be subjected to discrimination. Accordingly, at present, such immigrants must conform to the requirements contained in the immigration law of each Member State as they apply to non-Community foreign nationals, or to the stipulations of any specific agreement that may be in effect.

This restriction on labour mobility was a response to the fear of high levels of immigration from the CEEC, a fear that was intensified by the entry of significant numbers of immigrants in some Community states during the early nineties: when the transition process began, net annual immigration to the EU from these countries was approximately 200,000 persons. Faced with this volume, from 1993 on, the current Member States tightened migratory policies. Consequently, it is not surprising that the current EU stock of immigrants from the candidate countries is quite low.

According to the latest data available (1999, see Graph 6.1), the population of EU residents originating in the CEEC represents only 0.2% of the total Community population, equivalent to 0.5% of the population of the ten candidates. Poland, Estonia and Hungary are the countries with the most emigrants. Countries bordering the CEEC are the main destination for migration: 60% of immigrants reside in Austria and Germany.

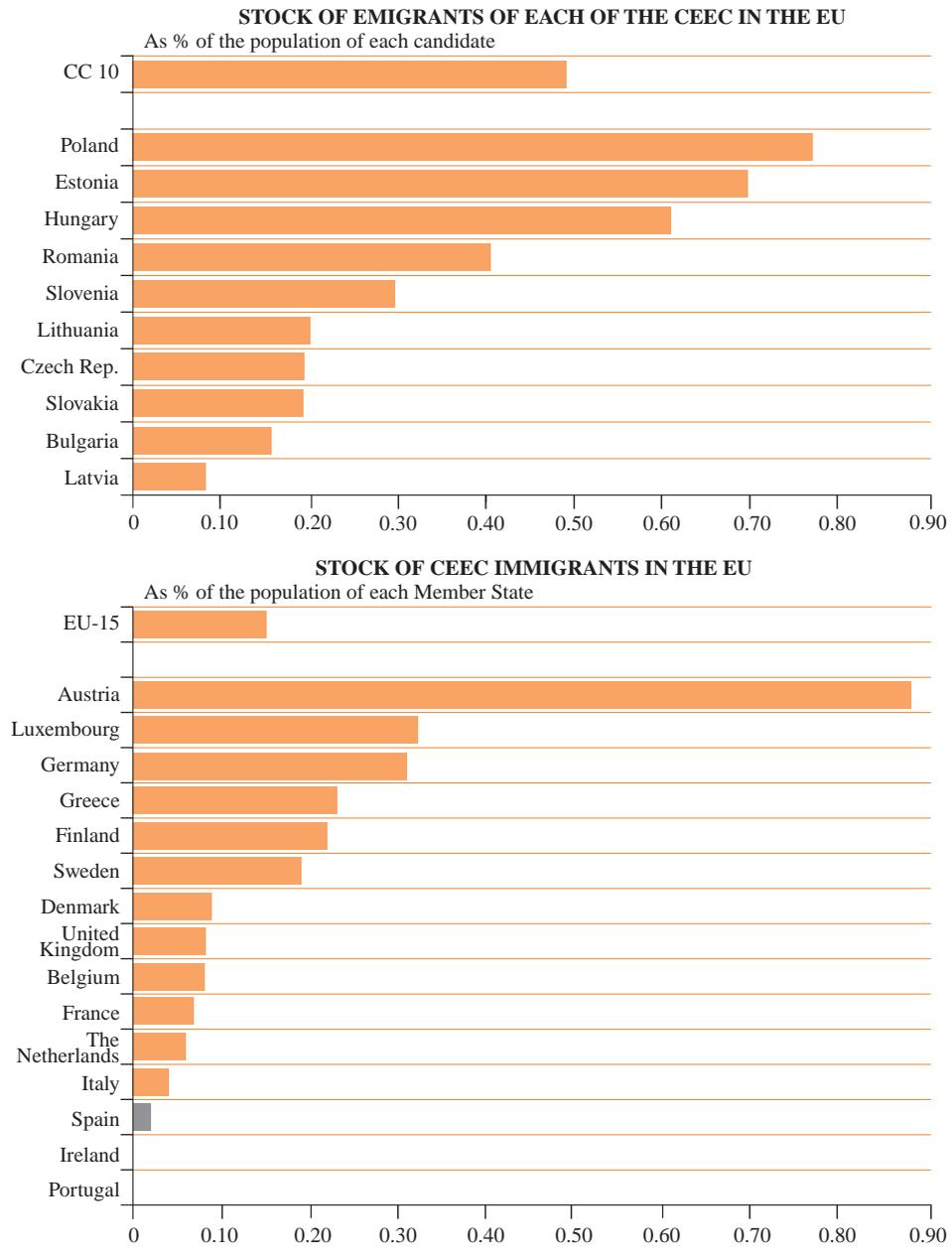
Generally, emigrants choose destinations countries that are geographically close to their countries of origin, but other preferences also seem to come into play. Specifically, immigrants from Slovenia, the Czech Republic and Slovakia choose Austria as a destination, whereas Germany is the first choice for emigrants from Hungary, Poland and Romania. Emigrants from Latvia and Lithuania have concentrated in the United Kingdom, and those from Bulgaria in Greece. Finally, Estonians have emigrated almost exclusively to Finland.

Overall, as a consequence of the size of its population, Poland is the most common country of origin for CEEC immigrants residing in EU-15 countries. Finland is one exception, where there are more immigrants from Estonia, and Italy is another with more Romanian immigrants.

In this context, Spain is one of the Member States with the lowest proportion of immigrants from the candidate countries (only Portugal and Ireland have lower proportions). Specifically, immigrants from the CEEC represent only 0.02% of the total population of Spain. The main countries of origin for these immigrants are Poland (53%), Romania (18.1%) and Bulgaria (14.2%).

Graph 6.1

STOCK OF EU IMMIGRANT POPULATION ORIGINATING IN THE CEEC. 1999



As a result of strict controls put in place by recipient countries, the presence in the EU of immigrants from the candidate countries is limited, and stays are usually of short duration. OECD reports (2001) indicate that east-west migratory movements are generally short-term stays, limited to border regions, and, in most cases, regulated by bilateral agreements.

A more detailed examination of the geographical pattern of migrations from the CEEC to current members of the EU reveals certain characteristics that are useful when it comes to anticipating future migratory behaviour. Before making such an examination, however, it is worth reviewing some of the ideas offered in theoretical models concerning the possible determinants of migratory movements. According to Mundell's conventional theory (1957), such movements can be explained by differences in factor endowments, and, consequently, in accordance with the assumptions made in this model, by relative wage levels in different countries.

From a microeconomic point of view, a worker will migrate if the net earnings he expects in the destination country are higher than those expected in the country of origin (Sjaastad, 1962). Wage expectations for the destination country are, of course, conditioned by the opportunities for finding work in that country's labour market.

In the process of making a decision to migrate, workers take into account travel costs, which depend primarily on the geographical distance (given that the information cost appears to be linked to this variable), and the existence of «ethnic networks» or previous concentrations of immigrants, which reduce the costs and risks of emigration. There is evidence that first-wave immigrants provide assistance to family members and friends who later decide to emigrate. This assistance is in the form of information about job offers, as well as provision of accommodation or transport: support of this kind leads to the creation of a social and information network.

To sum up, from a microeconomic perspective, the main causes underlying migrations are differences in economic conditions between the country of origin and the destination country (measured essentially in terms of income levels and unemployment rates), geographical distance and the presence of previous immigrants. Given the significant per capita income

differentials that exist between current EU members and the candidates, the high levels of unemployment in the latter, and the historical and cultural ties that exist with member countries in some cases, it is quite reasonable to think that integration could lead to a considerable increase in migratory flows from the CEEC.

Several studies have been carried out in recent years in order to estimate the number of immigrants that will reach the EU after accession. A selection of these is shown in Table 6.1.

In general, these studies use two different methods to arrive at their estimates: surveys and quantitative models. Surveys are directed either at a sample of individuals and households in the candidate countries, who are asked directly about their intention to emigrate, or at particular specialised groups that can provide useful data from which to estimate the extent of emigration after accession. There are two main drawbacks to this method: the sample chosen may not be representative of the population as a whole, and, given that the intention to emigrate does not always translate into action, the results may overestimate the number of potential immigrants. In a study of households in Hungary, Poland, Slovakia and the Czech Republic, Fassmann and Hintermann (1997) sought to maximise the validity of their results by differentiating different degrees of intention to emigrate. According to their results, the total potential flow that is regarded as most likely to take place – that associated with individuals who are already preparing to emigrate by looking for a place to live or applying for work – was estimated at approximately 700,000 persons at the time of the survey.

Studies based on quantitative methods generally extrapolate their results on the basis of migratory flows that occurred after past rounds of EU enlargement, or other migratory experiences. For example, Bauer and Zimmermann (1999), whose results are inferred from the migratory experience in the EU that was associated with the most recent accession, estimate that over the next fifteen years between 2% and 3% of the population of the ten CEEC will emigrate to the Union. This would correspond to slightly more than 200,000 immigrants per year. Applying the same method, Hille and Straubhaar (2001) raised the forecast to between 270,000 and

Table 6.1

SOME ESTIMATES OF POTENTIAL MIGRATORY FLOWS FROM THE CANDIDATE COUNTRIES TO THE EU

Study	Year	Method of analysis	Initial assumptions
European Commission	2001b	<ol style="list-style-type: none"> 1. Estimation of net annual emigration rates for candidate countries based on income and unemployment differentials with the EU. 2. Application of these rates to the future populations of these countries in order to quantify the number of emigrants. 	<p>Free movement after the accession of the eight CEEC in 2005.</p> <p>Accumulated CEEC net emigration rate of 2.5% of the population in the 15-year period after integration.</p> <p>Annual emigration rates that increase gradually over the first three or four years and then fall off.</p>
Boeri and Brücker (DIW)	2000	<ol style="list-style-type: none"> 1. Forecast of immigration from the CEEC to Germany based on an estimate taking into account per capita income and employment rate differentials, the stock of CEEC immigrants, institutional variables (e.g. bilateral agreements) and country-specific effects such as culture, language and geographical distance. 2. Extrapolation of this result to all member countries based on the number of CEEC immigrants already received (1998) in proportion to national population. 	<p>Accession of all of the CEEC in the year 2002.</p> <p>Per capita incomes in the EU and the CEEC converge at an annual rate of 2%.</p> <p>Unemployment rates in Germany and the CEEC remain constant.</p> <p>The proportion of CEEC immigrants in member countries remains constant over time.</p>
Hille and Straubhaar	2001	<ol style="list-style-type: none"> 1. Estimation of emigration determinants (per capita income and unemployment rate differentials, stock of immigrants, and distance) affecting migration from Spain, Greece and Portugal to the EU after their integration. 2. Extrapolation of these results to the candidate countries to simulate potential emigration rates. 	<p>10.5% unemployment rate for the EU and 15% for the CEEC.</p> <p>Stock of CEEC immigrants in the EU of 1,000,000.</p> <p>Per capita income differential between the CEEC and the EU of 50% and 60%.</p> <p>Average geographical distance between the CEEC and the EU of 1,500 km.</p> <p>Free movement after accession.</p>
Bauer and Zimmermann (IZA)	1999	<ol style="list-style-type: none"> 1. Estimation of emigration determinants (per capita income and unemployment rate differentials) affecting migration from Spain, Greece and Portugal to the EU after their integration. 2. Extrapolation of these results to the candidate countries to simulate potential emigration rates. 	<p>Income differentials and unemployment rate differentials between the EU and the CEEC from 1985 to 1997.</p>

Geographical coverage	Time horizon of the analysis	Potential flow of immigrants per year	Potential accumulated flow of immigrants
Poland, Czech Republic, Slovakia, Hungary, Slovenia, Lithuania, Latvia, Estonia.	5 years.	120,000 immigrants per year initially following integration, increasing to 215,000 per year over two or three years and then falling off.	In 5 years, 900,000 (1.2% of the expected CEEC population).
All of the CEEC.	30 years.	335,000 immigrants per year initially following integration, decreasing over ten years to 150,000 per year.	In 5 years, 1,000,000 (1.93% of the expected CEEC population). In 15 years, 3,000,000 (3.37% of the expected CEEC population).
All of the CEEC.	Not considered.	Between 270,000 and 340,000 annually.	
Poland, Czech Republic, Hungary, Slovenia, Romania and Bulgaria.	Not considered.	200,000 immigrants annually.	In 15 years, between 2% and 3% of the population of the candidate countries.

Table 6.1 (continued)

SOME ESTIMATES OF POTENTIAL MIGRATORY FLOWS FROM THE CANDIDATE COUNTRIES TO THE EU

Study	Year	Method of analysis	Initial assumptions
Franzmeyer and Brücker	1997	1. Application to the CEEC of the coefficients estimated by Barro and Sala-i-Martin (1995) for past migrations between EU regions as a function of income differentials.	Constant GDP growth rate (PPS) of 2%. Income differential of 10% between the CEEC and the EU.
Fassmann and Hintermann	1997	1. Surveys of CEEC households concerning the intention to emigrate.	Differentiation between «general migratory flow» (those who intend to emigrate), «probable migratory flow» (those who have information on the destination country) and «real migratory flow» (those who have already taken the first steps toward emigrating).

340,000 immigrants each year. Similar results were obtained by Boeri and Brücker (2000), who, extrapolating from expected flows for Germany, calculate that the number of immigrants to reach member countries over the next fifteen years will be approximately 3% of the population of the ten candidates.

Some studies, however, obtain much higher estimates. For example, Franzmeyer and Brücker (1997), utilising the income elasticity observed in migrations between European regions (based on a previous study by Barro and Sala-i-Martin, 1995), estimated annual migratory flows at between 340,000 and 680,000 immigrants from Poland, Hungary, the Czech Republic, Slovakia and Slovenia. It appears, however, that this study overestimates the volume of immigration: per capita GDP differences between countries are taken into account as the main determinant of immigration, but other factors are not considered, including unemployment rates, information costs derived from the previous presence of immigrants in the destination country, or distance as an indicator of transport costs or cultural differences.

Geographical coverage	Time horizon of the analysis	Potential flow of immigrants per year	Potential accumulated flow of immigrants
Poland, Czech Republic, Hungary, Slovakia and Slovenia.	30 years.	Between 340,000 and 680,000 immigrants per year.	
Poland, Czech Republic, Hungary and Slovakia			<p>General migratory flow: 9,500,000 immigrants (30% of the population of the candidates).</p> <p>Probable migratory flow: 4,000,000 immigrants (18% of the population of the candidates).</p> <p>Real migratory flow: 700,000 immigrants (between 1% and 2% of the population of the candidates).</p>

There are two important points to bear in mind in assessing these results. First, estimates arrived at by means of surveys have greater interest from a qualitative point of view than in quantitative terms, given that they provide information primarily on the type and characteristics of immigrants. Second, the studies that are based on migrations between regions present methodological problems as indicated above. Consequently, the most plausible results concerning potential migratory flows (which also yield similar figures) are those provided by quantitative examinations based on past enlargements or on extrapolations from the number of immigrants that arrived in a particular country. On this basis, it can be inferred that, during the period of migratory flow expected from the ten candidate countries, between 200,000 and 340,000 immigrants will arrive annually for the first five years following accession, and that this figure will gradually diminish as the result of convergence of per capita income levels. It does not appear likely, therefore, that the accession of the CEEC will lead to a substantial increase in the number of immigrants entering the EU.

As far as Spain is concerned, Boeri and Brücker (2000) indicate that it will only be the destination for 1.24% of the total number of immigrants: over a fifteen-year period the resulting number of CEEC immigrants would reach only 0.1% of the total Spanish population.

It should be stressed that all of the forecasts discussed above are subject to a considerable degree of uncertainty. This uncertainty arises from the fact that they are based on restrictive assumptions, such as specific long-term growth and convergence perspectives, that can vary over time and that have a direct effect on emigration rates. CEEC growth rates may increase rapidly as a result of policies that foment integration in the EU and convergence to the standards of living found in Member States. Moreover, the estimates do not take into account the fact that if the candidate countries can achieve an income level that makes reasonable living conditions possible for the majority of their population, this will significantly reduce the motivation to emigrate, even though significant income differentials may remain vis-à-vis the EU. In fact, in previous enlargements involving the accession of the Southern European countries, free movement of labour did not lead to a significant increase in migratory flows, but rather to strong economic growth that discouraged emigration. Some immigrant workers even saw improved conditions as a stimulus to return to their countries of origin. In this manner, free trade and capital mobility may be enough to counteract potential emigration of CEEC workers. Indeed, it should be noted that some of the candidate countries (the Czech Republic, Slovakia and Slovenia) are now experiencing net positive migration rates as a result of the return of emigrants (Hönekopp, 1999).

Another question to consider is how potential migratory flows are likely to be distributed after enlargement. It is reasonable to expect that flows will continue to follow the same geographical tendencies that have been observed up until now. In order to examine more closely how the various factors determining emigration (according to formulated theories) have influenced the distribution of CEEC immigrants in Member States, we will first analyse the relationship between some of these factors and the presence of CEEC immigrants in each of the EU states (measured as the quotient

between the number of CEEC immigrants in a country and its total population). The determinants considered for this analysis were per capita income levels (GDP in purchasing power parity), unemployment rates in member countries, and the average distance of each from the CEEC.

The results obtained from this analysis are consistent with the predictions of the theoretical models for each of the three determinants considered. First, a positive relationship is evident between the choice of a member country as destination and the income level in that country: all values are concentrated around the EU average, except those corresponding to Austria, Luxembourg, Greece, Portugal and Spain. In the case of Spain, the percentage of CEEC immigrants is lower than the expected value of 0.1%. Second, the higher the unemployment rate in a destination country, the lower the proportion of CEEC immigrants. Austria is an exception to this pattern: despite a level of unemployment similar to other member countries, it attracts a relatively high proportion of immigrants from the CEEC. For Spain, in contrast, the percentage of immigrants from the candidate countries remains below the level that would be expected given its unemployment rate.

Finally, a clear relationship can be observed between geographical distance and the presence of immigrants: countries attract fewer immigrants from Eastern European countries the further away from them they are situated. Geographically close countries, such as Austria, or those that are very distant, such as Spain and Portugal, present levels of immigration that deviate significantly from the average. Specifically, Austria stands out as the country where immigrants from the candidate countries have a much greater weight within the population than they do in other EU countries. Spain and Portugal, on the other hand, are among the least attractive countries for this group of immigrants.

To sum up, member countries with a level of immigration from the candidate countries that is higher than that expected for their income and unemployment levels (i.e., Germany, Greece, Finland and, in particular, Austria) are the states that border the CEEC. In contrast, the countries that are most distant from the CEEC, such as Spain and Portugal, have a lower than expected percentage of immigrants. Therefore, on the basis of our study, it

appears that geographical distance is the factor that most strongly determines choice of destination, exerting a stronger influence than income or unemployment levels.

Having attempted to establish the likely destinations for immigration from Eastern European countries, we will now turn to the question of which countries will be the points of origin for this movement after enlargement. With this objective in mind, we once again examined the associations between factors influencing the decision to emigrate and the percentage of the population that has emigrated to the EU for each country of *origin*. In this case, the results are not those that would be expected on the basis of theoretical models: no clear association emerges between the number of emigrants a country produces and its levels of income and employment or its distance from EU countries. This suggests that there must be additional factors influencing the decision to emigrate, such as historical and cultural ties. As indicated by Gosh (1998), «since 1989, the main source countries were also the same as those which, in addition to having large populations, had already experienced waves of out-migration in the past, namely, Poland Romania and Yugoslavia».

In view of the manner in which the geographical structure of migratory flows has developed, it seems likely that integration will lead to a concentration of future migratory flows in the EU states that share a border with the CEEC. The ethnic communities that are already present in some of these countries are another reason to believe that they will be the states most affected by future migratory movements. Along these lines, Boeri and Brücker (2000) conclude that Germany and Austria will be the main recipient countries for immigrants from Eastern Europe, and that in thirty years the percentage of CEEC immigrants will reach 3.5% of the population in Germany and 5.5% in Austria.

In the survey carried out by the International Organisation for Migration (IOM, 1998), the forecast made stresses the extent of the border-region immigration that these countries may receive: between 13% and 68% of those surveyed (depending on the country) indicated a preference for trans-border and temporary employment; only 7% to 26% wished to emigrate for a

long period or permanently. Therefore, all indications are that border areas are likely to receive the greatest migratory flows.

As for emigration from candidate countries after integration, Bauer and Zimmermann (1999) suggest that Romania, Bulgaria and Poland will register the highest rates (in relation to total population). They also predict that Slovenia, the Czech Republic and Slovakia will have the lowest levels of migratory flow. These forecasts are in line with those that can be inferred from the survey carried out by the Central European Opinion Research Group (CEORG, 2001) involving five candidate countries (Poland, the Czech Republic, Hungary, Romania and Bulgaria). In this survey, the populations that show most interest in working in the EU are those of Romania, Poland and Bulgaria, in that order.

In this context, estimates of potential flows and analysis of related factors indicate that Spain is among least attractive destinations for immigrants from the candidate countries. This is the result of the distance that separates Spain from these countries, as well as the lack of significant historical or cultural ties. It seems, therefore, that the flow of immigration that will reach Spain after integration will be on a limited scale and will originate in the same countries as at present – Poland, Bulgaria and Romania.

Although it does not appear likely that the volume of migratory flows to the EU will be high, the European Commission has proposed a five-year transition period for all Member States. The purpose of this measure is to allow time to adapt labour markets to the arrival of immigrants, and each state will have the option of extending the period for an additional two years. Given the concern shown by the Commission, it is worth examining the possible effects of immigration on destination countries.

6.2. The main economic effects of immigration from the CEEC

Given the unemployment problem affecting the majority of current EU members, one of the main fears raised by the expected increase in flows of immigrants from the CEEC concerns the impact on the labour market.

Conventional theory, however, predicts that production factor mobility between countries will lead to price equality, and that migratory movements will not have a negative effect on the economy of recipient countries.

According to this model, immigration leads to a general increase in production and employment in the destination country, and this, in turn, leads to a fall in the wages and income of national workers. This income, together with the net surplus value generated by migratory labour, becomes additional income for the owners of capital. Consequently, as a whole, the economy registers an increase in national income, thanks to the redistribution of the income of national workers to owners of capital.

It should be pointed out that this prediction is based on two key assumptions, namely, that wages will automatically adjust to changes in the labour market and that labour is a homogenous factor. These assumptions, however, do not entirely hold in the European context. First, given the existence of imperfections in the labour market (rigidity with respect to wage decreases), integration may lead to increased unemployment rather than lower wages. Nevertheless, the majority of the empirical studies that have explored the impact of immigrants on wages and employment in destination countries have found beneficial effects.

Second, the workforce is heterogeneous in terms of level of qualification, which means that not all workers will be affected by immigration in the same way. National workers who compete with immigrants in the labour market will experience lower wages and/or a possible increase in the level of

Table 6.2

**PERCENTAGE OF THE CEEC IMMIGRANT POPULATION IN THE EU⁽¹⁾
WITH THE INDICATED MAXIMUM LEVEL OF EDUCATION. 1999**

	Germany	Austria	Belgium	Denmark	Spain
With primary and secondary studies	24.9	21.0	47.1	2.9	17.6
With postsecondary education	39.4	58.4	35.9	69.3	13.6
With university studies	35.7	19.2	17.1	27.8	68.8
<i>Memorandum</i>					
<i>National population with university studies</i>	<i>19.6</i>	<i>8.5</i>	<i>20.4</i>	<i>31.8</i>	<i>15.6</i>

(1) Excluding Ireland and Portugal.

Source: EUROSTAT and the European Economy Group (EEG).

unemployment, but those whose role complements that of immigrant labour will benefit from the migratory phenomenon.

Consequently, the effects of CEEC migratory flows on the wage and employment levels of national workers will largely depend on the level of qualification of immigrants. Currently, as indicated in Table 6.2, levels of education for immigrants from the CEEC are high – in many cases higher than those of national workers. The percentage of immigrants with university studies, for instance, is higher than the EU average: more than one third of CEEC immigrants have received university-level instruction.

Immigrants from the candidate countries, however, are not occupying positions that match their level of qualification. In general, the highest percentages of employment correspond to activities associated with low wages and low levels of qualification, such as construction, the hotel and restaurant industry, or domestic service. It appears that there is a problem of «brain waste» – a waste of knowledge and skills that occurs when skilled immigrants are engaged in jobs that do not require the application of the knowledge and experience they have acquired.

This phenomenon is particularly pronounced in Spain, where 80% of the CEEC immigrant population is employed in activities that require only a low level of qualification. These workers are particularly concentrated in domestic and social services, even though their level of training is much higher than that required to carry out such tasks: nearly 70% have university studies.

Finland	France	Greece	The Netherlands	Italy	Luxembourg	United Kingdom	Sweden	EU
44.9	34.2	49.4	42.1	23.6	50.5	33.4	28.7	28.8
31.7	23.6	43.6	32.7	27.6	40.7	53.9	31.3	37.1
23.4	42.2	7.0	56.2	48.8	8.8	12.8	40.0	34.1
22.4	17.0	11.9	18.3	7.3	12.6	24.3	24.2	16.7

Clearly, the structure of immigrant employment in the destination country is the result of certain factors that prevent them from occupying positions that match their level of training. One significant factor in this regard is the existence of institutional restrictions that result from the alienage laws in effect in Member States. Migration policies establish authorisation to reside in a country to carry out some activity as an employed person, subject to the granting of a work permit. One of the considerations determining whether or not such a permit is granted is the situation of the national labour market. Specifically, Spain's alienage law states that in the granting of an initial work permit the national employment situation will be taken into account (art. 38). This position is reinforced by the establishment of annual immigration quotas by destination countries. The majority of work permits granted are, therefore, for positions that national workers cannot fill because they lack the necessary qualifications, or positions they do not wish to fill, or attempt to avoid by taking advantage of protection mechanisms (unemployment insurance). As a result, most immigrants are employed in temporary or cyclical positions, in areas such as construction or the hotel and restaurant industry.

Language and cultural differences also play a role in determining immigrant occupational structure. For immigrants arriving in a new country the lack of language skills and other specific knowledge of the destination country puts them at a disadvantage in the labour market with respect to national workers. Unable to compete effectively, immigrants often have no choice but to carry out tasks that require only a low level of qualification.

It should be borne in mind that after free movement of workers comes into effect CEEC immigrants will be regulated by the laws covering the entry and residence of Community workers: there will no longer be legislative barriers affecting their access to the labour market. Nevertheless, in the short term, language will continue to be a limitation, and, as a result, immigrant workers will be directed toward low-skilled jobs in the Spanish market. Clearly, the time horizon of immigration is a relevant consideration in this regard: immigrants who anticipate a long period of residence will invest in developing the specific elements of human capital corresponding to the destination country in order to find employment that matches their level of

qualification. Consequently, in the medium and long term, CEEC immigrants may reach a point where they begin to compete with more skilled Spanish workers.

The empirical evidence available for Europe (relatively limited compared to that which refers to the US experience) suggests that the effects of immigration on the national workforce are quite limited in their scope. De New and Zimmermann (1994) find that an increment of 1% of immigrant workers in Germany leads to a fall of 0.45% in the wages of national workers with a low level of qualification, and a 0.12% increase in the wages of skilled workers. For the same level of immigration, in Spain, Dolado, Jimeno and Duce (1996), find slight increments in the wages of all national workers, both skilled and unskilled. In the context of enlargement, Hille and Straubhaar (2001) suggest that the arrival of emigrant workers representing 0.5% of total EU workers would lead to a 0.8% fall in real wages for low-skilled labour in the EU and a 1.3% increase in the wages of skilled workers. Empirical studies also indicate quite moderate effects on unemployment.

It should be pointed out that immigration has other effects on the labour market. It can improve the efficiency of the destination country, helping to create a more flexible workforce by supplying workers with greater occupational and geographical mobility.

Migrations can also have a significant impact on other aspects of the economy, particularly the budget. The arrival of immigrants involves an increase in public revenue for the destination country, given that they are required to make the same tax and social security payments as the national population. Immigration, however, also involves increased spending due to the creation of budgetary programmes directed specifically at immigrants, as well as their consumption of social benefits associated with the welfare state – education, health care, housing assistance, pensions and unemployment insurance – to which they are entitled as citizens.

Given that the sustainability of the welfare state depends to a large extent on the age structure of the population, it is also worth considering the impact of immigration from a demographic perspective, and the related budgetary effects. Low fertility rates and longer life expectancies in

developed economies are resulting in a slowdown in the rate of population growth and increasingly accentuated ageing of populations. This trend has two significant effects. First, it leads to workforce deficits as a result of the shrinking working-age population. Second, it results in an increase in the numbers of recipients of social benefits, both in absolute terms and in relation to the number of contributors, which means that increased fiscal pressure is necessary to guarantee pension and social security systems. At the same time, an ageing population causes an increase in public spending, primarily due to increased demand for healthcare services.

Immigration can play a positive role in helping to sustain the welfare state. In general, immigrants, who tend to belong to younger age groups, directly increase the working-age population and reduce workforce deficits. In addition, given that immigrant populations usually have higher fertility rates than national populations, they contribute to slowing down the ageing of the population.

In terms of the effect of immigration on budgetary items, the majority of empirical studies suggest that the positive effect of immigration compensates for the negative effect (Weber and Straubhaar, 1994). When the age structure of immigrants is taken into account, some studies show that the net fiscal impact of immigration is more negative during youth than that of the national population, less positive during the working life and similar in retirement (OECD, 1997). It should be stressed that these effects can vary depending on the level of qualification of new immigrants. In the United States, for instance, some recent studies have found that the probability of an immigrant receiving payments from the social welfare system increased between the seventies and the nineties due to the lower level of human capital of more recent arrivals (Borjas, 1999).

As for the demographic impact of immigration on the welfare state, it should be noted that the arrival of immigrants has influenced overall population growth in the main OECD areas. According to Eurostat (1999), in the case of Spain, immigration accounted for 23% of population growth between 1990 and 1994. Moreover, negative growth of the Spanish population in recent years has only been avoided due to the higher fertility

rates of immigrant women. According data from the National Institute of Statistics (INE), in 1999, the average number of children per woman for the national population was 1.07; for immigrant women of African origin, the figure was 1.60, and for immigrant women from Latin America, 1.39.

Nevertheless, according to the United Nations (2000), in order for immigration to maintain the population level in the future, guarantee the pension system and maintain the current workforce in developed countries, very high levels of migratory flow would be necessary. Spain, for example, would have to accept 240,000 immigrants per year until approximately 2050 – a level of inflow that clearly could trigger social tensions. Furthermore, the majority of studies conclude that immigration in itself cannot limit the negative impact on standards of living and future tax burdens: as a means of delaying the ageing of the population, it is less effective than increases in fertility rates (Young, 1990 and Schmertmann, 1992). This is the case because immigrants become part of the elderly population sooner than additional children born as a result of increased fertility. Immigration, therefore, can only reduce and delay the scope of these problems up to a point.

We will now turn to a recapitulation of the conclusions we have reached concerning the possible impact of migrations from the CEEC after the accession of these countries to the EU. First, it has been observed that immigration from the CEEC is, at present, on quite a modest scale in the majority of the countries in the Union. It is primarily of a temporary nature, as a result of the restrictive policies implemented by the Member States. Despite this limited presence, however, significant differentials between the CEEC and the EU in terms of per capita income, together with higher CEEC unemployment rates, have led to fear that there may be a considerable increase in migratory flows from the CEEC after integration.

Existing forecasts, however, do not appear to justify this fear of a massive inflow of immigrants. If current migratory trends are maintained, it is likely that flows will originate primarily in Poland, Bulgaria and Romania (countries with an extensive migratory tradition). It has been demonstrated that historical and cultural ties have oriented east-west emigration toward the EU member countries that are geographically closest to the CEEC, so it is

likely that immigrants will concentrate in states that border the CEEC, particularly Germany and Austria. Moreover, all indications are that emigration will be a short-term phenomenon.

In spite of the fact that forecast immigration figures are not high, the EU has proposed the establishment of transition periods in order to protect labour markets before workers from the candidate countries are granted full mobility. The literature and empirical results, however, show that immigration has quite a modest impact on labour markets in destination countries. As a result of alienage laws and language barriers, immigrants occupy positions that require only a low level of qualification (far below the level that corresponds to their training), and, consequently, unskilled national workers are the most affected group within the labour market.

It has also been argued that immigrants have a positive budgetary effect – given that they contribute more to tax revenue than they consume in the form of public goods – and that they help sustain the welfare state from a demographic point of view, due to their higher fertility rates and their population age structures. The evidence examined, however, suggests that immigration alone is not the solution to future problems involving the sustainability of the current system of social welfare which is in place in the developed economies.

Finally, Spain is one of the least attractive EU countries for this group of immigrants because of its distance from the candidate countries and very limited cultural and historical ties. Therefore, if current trends are maintained, even when the CEEC immigrant population increases after enlargement, it is likely that the percentage of immigrants in relation to the total population will remain very low. Moreover, given language differences and the type of immigration, it seems likely that, at least in the short term, immigrants will continue to occupy positions that require only a low level of training.

VII. Macroeconomic effects

7.1. Methodology

In this chapter, we will assess the macroeconomic effects on the Spanish economy of EU enlargement to the CEEC. For this purpose, we have used the HERMIN-Spain model jointly developed by the Foundation for Applied Economics Studies (FEDEA) in Spain, the Economic and Social Research Institute in Ireland and the Universidade Católica Portuguesa in Portugal. This is a conventional Keynesian-type model, which in its current versions involves disaggregation into four sectors: public, agricultural, tradeable (primarily manufactures) and non-tradeable (made up of energy, construction and private services). A more detailed description of the model can be found in Bradley et al. (1995a), Herce and Sosvilla-Rivero (1995) and Sosvilla-Rivero and Herce (2001). Within the framework of this model, production in the tradeable sector is determined by external demand in conjunction with domestic demand, as well as by relative competitiveness; at the same time, its price is affected by the prevailing price at the international level and by a mark-up. Sector production that is not exposed to international competition evolves in accordance with weighted national final demand, and price in this case is determined based on a mark-up on costs.⁽¹⁾ Finally, the behaviour of the public sector accounts for the effects (mainly exogenous) of

(1) See, for example, Alogoskoufis (1990) for an analysis of the theoretical framework within which models distinguishing tradeable and non-tradeable sectors are developed.

economic policy (public debt and deficit are endogenously determined), while the magnitudes of values for the agricultural sector are exogenously determined. In the model, wages are the outcome of a process of negotiation that is influenced by the level of prices, the level of productivity and the unemployment rate. The unemployment rate, in turn, is determined based on the difference between labour supply (which depends on the working-age population and the labour force participation rate) and the demand for labour (determined in sectoral derived demand equations for factors in the respective product-supply blocks).

CES-type production functions are used for tradeable and non-tradeable sectors to relate added value to the use of labour and capital; constant returns to scale are imposed in the long term, and the rate of technical progress is estimated by means of a time trend.

Classification of macroeconomic effects

We will examine in the three economic effects which are associated with regional integration in the economic literature (see, for example, Baldwin and Venables, 1995): a) trade effects (creation and shifting of trade), b) single market effects (improvement of efficiency and increased competition) and c) movements of productive factors (primarily direct foreign investment). We will also examine the effects of expected changes in European structural fund assistance, closely following the analysis carried out in chapter III. By taking this approach in our empirical examination of the macroeconomic consequences of EU enlargement for the Spanish economy, we are working directly on the main mechanisms and can outline four shocks resulting from enlargement.

Shock (i) (trade and structural adjustment)

The incorporation of the CEEC in the EU will imply the participation of the former in the Common External Tariff and the Common Trade Policy, while, from the internal perspective, it will involve the elimination of barriers to the free movement of goods within the EU (both trade and non-trade

barriers), which will lead to a reduction in trade costs. Goods imported from the CEEC will be more economical for national consumers, and the cost of intermediate and capital goods from these countries will be reduced for national producers. Consequently, there will be greater competition in national productive sectors, which may result in a process of structural change. This shock is implemented in the model through exogenous changes in the coefficients of the behavioural equations that determine foreign trade, as well as manufacturing sector output and its price.

Shock (ii) (enlargement and liberalisation of the single market)

The enlargement of the EU to Eastern and Central Europe will extend the scope of the European Single Market (ESM), which will lead to increased competitive pressure both for new and current member countries, though to a lesser degree for the latter. Based on the experience already accumulated in the SEM, we can expect an increase in productivity (through the exploitation of economies of scale) and a decrease in price levels (through a fall in margins and intermediate prices). The combined effect of these changes will be to increase growth potential in the CEEC and the current EU (see Emerson, 1988; Catinat and Italyner, 1988; Barry et al., 1997, and Sosvilla-Rivero and Herece, 1998).

Shock (iii) (changes in flows of direct investment)

The ESM also implies the free movement of the productive factors, capital and labour. Specifically, movements of capital are expected from the current Member States to the CEEC, while workers are expected to flow in the opposite direction. Given the difficulty of formulating realistic scenarios concerning migratory flows from the candidate countries, for the purposes of this macroeconomic assessment, we will consider only the impact of capital movements. Accordingly, we will examine the consequences for productivity of a possible decrease in flows of foreign direct investment (FDI) to Spain and the possible negative effects of this decrease on the ability to mitigate the impact of structural change in the manufacturing sector.

Shock (iv) (changes in structural funds)

Finally, we will study the impact of a substantial alteration of the European funds resulting from a budgetary adjustment after enlargement. We will focus especially on the selection of Objective 1 regions after the current 2000-2006 programming period. If, after the conclusion of the current multiannual programming period, there is a significant decrease in the structural and cohesion assistance that Spain has received in the past and will continue to receive until 2006, the effect of this shock will be negative. Indeed, public opinion in Spain has focused primarily on consequences of this type. As the description of the previous shocks suggests, however, this is just one of a complex range of effects associated with enlargement.

In order to broaden the perspective on the difficult problem that will be have to be faced after 2006 in a 25-member Union, we will consider alternative scenarios, involving different structural and cohesion policies within the EU that may be initiated at this time (in line with the discussion in chapter III). Structural funds have played an important role in the past (1994-1999) in helping the less-developed economies in the Union smoothly adapt to the creation of the European Single Market (Hercé and Sosvilla-Rivero, 1994 and Bradley et al., 1995b). It is, therefore, essential that a detailed alternative analysis be carried out of the consequences of the future adjustment of these funds.

Simulations

The different effects brought about by the shocks described above will be assessed in comparison to the situation as it would have developed in the absence of enlargement. In other words, the base projection of the HERMIN-Spain model is that in which none of the relationships are modified as a result of the effects described (baseline scenario). In the simulations, 2003 has been taken as the base year, and the shock has been spread over a ten-year period extending to the year 2013. These choices reflect the assumption that 2004 will see the entry of the ten CEEC that currently meet, or are close to meeting, the criteria set by the European Council (see chapter II): Cyprus, Slovenia,

Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Czech Republic and Slovakia. We have also assumed that Bulgaria and Romania will join the Union in 2007. In our analysis, Turkey, an official candidate for accession, will not be admitted until after 2013. An advantage of the adoption of this calendar is that the conclusion of the period covered by the simulation coincides with that of the 2007-2013 period for budgetary programming of Community cohesion policy (the seven-year period that will follow the current 2000-2006 period).

The results of the simulations carried out will be presented in tables which indicate the impact of the shocks on the model's three groups of variables. The first group of variables shows effects on sectoral composition of production (tradeable, non-tradeable and real gross domestic product at factor cost). These effects will be presented in terms of percentage deviations from the baseline scenario (no enlargement), in which none of the shocks attributed to enlargement take place. The second category of variables indicates the impact on prices and wages, the gross added value (GAV) deflator of the tradeable sector, the annual wage gain in the tradeable sector, and the private consumption deflator. Again, the effects will be presented in terms of percentage deviations in relation to the baseline scenario (no enlargement). The last group of variables captures the effects on three economic balance indicators: the unemployment rate, the public sector capacity or need for financing, and the balance of trade (with the last two variables expressed as a percentage of GDP). For this set of variables, effects will be presented as simple deviations with respect to the baseline scenario (no enlargement).

7.2. Effects of trade adjustment

Hypothesis for the quantification of the shock

We have based our quantification of this shock on the information presented in chapter V concerning the sectors that are most likely to be affected by the accession of the CEEC to the EU. We will refer to these as «sensitive sectors». Specifically, we have assumed the continuation of the

trends described in chapter V concerning competitive advantages in the various sensitive sectors, projecting the changes registered in Spain's indices of export specialisation in relation to the CEEC in trade with the EU. These sectors roughly correspond to those indicated in Boeri and Brücker (2001) as sectors which, after EU enlargement, could experience changes in current member countries. These changes should be seen as complementing those which may occur in the same sectors in the candidate countries.

In order to determine whether the sectoral impact will be positive or negative and assess its quantitative significance, we will classify sectors using a code with three characters (see the first column of Table 7.1). The first character indicates whether the effect on each sector of competition from the

Table 7.1

CLASSIFICATION OF SPANISH MANUFACTURING SECTORS AFFECTED BY THE TRADE ADJUSTMENT RESULTING FROM EU ENLARGEMENT

Exports and output in millions of pesetas, 1995

Code (*)	NACE R-25	Sector	Exports (X)	Real output (Y)
G.1.1	5	Chemical products	1,056,464	3,685,298
G.1.3	11	Food, beverages and tobacco	861,978	9,475,058
G.2.2	14	Rubber and plastics	379,513	1,586,280
G.2.3	13	Paper and related products	329,843	2,839,369
Total G sectors			2,627,798	17,586,005
L.1.1	8	Office machinery and other	279,054	675,943
L.1.1	9	Electrical equipment	655,352	1,780,710
L.1.2	10	Transport equipment	3,061,281	5,413,999
L.1.2	15	Wood, cork and other manufactures	304,230	2,335,212
L.1.3	6	Metallic products	300,689	2,777,663
L.1.3	12	Textile products and footwear	681,056	3,380,209
L.2.2	7	Agricultural and industrial machinery	748,242	2,183,618
L.2.3	3	Ferrous and non-ferrous metals	675,216	2,308,229
L.2.3	4	Non-metallic minerals and mineral products	388,726	2,346,116
Total L sectors			7,093,846	23,201,699
Total manufacturing sectors			9,721,644	40,787,704

(*) This code is interpreted in the following manner: G (sector that gains) or L (sector that loses), according to whether the sector benefits or is harmed by trade adjustment; 1 or 2, after the G or L, according to whether the impact is strong or weak, and 1, 2 or 3, according to whether global demand in the sector is strong, medium or weak, respectively.

Sources: SIOT 95, chapter V, and own calculations.

CEEC is expected to be positive (which we will refer to as a sector that gains, G sector) or negative (a sector that loses, L sector). This classification is based on revealed comparative advantage, which depends to a large degree on the indices of relative specialisation for each sector in the Community market, and the evolution of these indices over time. G sectors are those with indicators that are at a high level and are rising (among other characteristics), and L sectors are those in which this indicator is predicted to fall. The second character in the code is numerical: a value of 1 is used for sectors that are strongly affected, and a value of 2 for those that are only weakly affected. The third character, also numerical, indicates whether global demand for the product of this sector is high (value of 1), moderate (value of 2) or weak (value of 3).

X/Y	H/Y	Y/YM	dX/YM (G) or dH/YM (L)
28.7	71.3	9.0	0.73
9.1	90.9	23.2	0.63
23.9	76.1	3.9	0.08
11.6	88.4	7.0	0.09
14.94	85.06	43.10	1.53
41.3	58.7	1.7	-0.16
36.8	63.2	4.4	-0.50
56.5	43.5	13.3	-0.54
13.0	87.0	5.7	-0.95
10.8	89.2	6.8	-0.87
20.1	79.9	8.3	-0.63
34.3	65.7	5.3	-0.17
29.3	70.7	5.7	-0.14
16.6	83.4	5.7	-0.26
30.57	69.43	56.90	-4.22
23.83	76.17	100.00	-2.69

Table 7.1 shows the results obtained by applying this system of classification. The table also indicates the orientation of each sector toward exports (measured by the ratio exports/output, X/Y) and toward the internal market (measured by the ratio domestic sales/output, H/Y), as well as the sector share of total manufacturing output (Y/YM).

In order to estimate the contraction or expansion of output in the various sectors, we assume that the orientation toward exports will increase as the CEEC advance in the process of integration. For sectors that adapt in a satisfactory manner to the new circumstances of the Community market («G sectors»), at a given level of internal demand, output and the exports/output ratio grow exclusively through an increase in exports without any variation in domestic sales. In sectors where production is adversely affected by trade liberalisation («L sectors»), domestic sales decline in the face of increasing penetration of imports, which forces a growing export orientation. This procedure allows us to calculate the net static gains (or losses) for the set of tradeable sectors and, thereby, to construct an exogenous shock that can be evaluated in our macroeconomic model (see Barry et al., 1997 for a detailed description of this methodology).

In Table 7.1 the estimated increase in output for G sectors is shown as a proportion of the total output in manufactures, expressed as dX/YM , along with the estimated decrease in output for L sectors ($-dH/YM$). The magnitude of these effects was obtained by assuming that maximum variation in sectoral output will be 7.5% for sectors that are strongly affected and highly dependent on global demand (G.1.1 or L.1.1 sectors). Table 7.1 also presents net static gains (dX/YM) and losses ($-dH/YM$) calculated in this way, and their net balance as a percentage of overall tradeable sector output. As can be observed, given the assumptions adopted in this scenario, net losses of 2.69% would be registered.

Another significant effect of the incorporation of the CEEC stems from the change in the composition of the economy's external trade. This is the reason why in shock (i) we modify the global and national demand coefficients in the equations for manufacturing output and output price. These modifications are also based on the classification established in Table 7.1,

and an examination of each of the sectors. If the ratio exports/output is greater than 90%, we make no change in this ratio. For sectors strongly affected by trade adjustments resulting from enlargement (G.1 or L.1), we increase the ratio to 90%; for sectors that are less affected, we increase the ratio by one quarter of the initial orientation toward the internal market.

Assessment of the effects of the shock

Table 7.2 presents the effects of this shock, in real and nominal terms, on the main macroeconomic indicators for the Spanish economy beginning in 2003 (the year before the incorporation of the first CEEC). As can be observed in this table, an initial fall is registered in manufacturing sector production (a reduction of 0.64% in relation to the baseline situation in 2004, without enlargement). Production gradually recovers, though in 2007, the level is still 0.40% below that in the baseline scenario, by 2013 it reaches a level 0.88% higher. The non-tradeable sector initially registers less significant losses (–0.15% in 2004), and undergoes a gradual improvement in relation to the

Table 7.2

MACROECONOMIC EFFECTS ON THE SPANISH ECONOMY RESULTING FROM TRADE ADJUSTMENT AND STRUCTURAL CHANGE AFTER EU ENLARGEMENT – SHOCK (i)

Macroeconomic indicator	2004	2007	2013
Real GDP (FC) ^(*)	–0.24	–0.16	0.36
Real output – tradeable sector ^(*)	–0.64	–0.43	0.88
Real output – non-tradeable sector ^(*)	–0.15	–0.10	0.22
Tradeable sector GAV deflator ^(*)	–1.78	–2.88	–0.23
Average annual wage gain in the tradeable sector ^(*)	–1.71	–2.98	–0.20
Private consumption deflator ^(*)	–1.85	–2.65	–0.17
Unemployment rate ^(*)	0.13	0.11	–0.16
Capacity or need for financing for public administrations (as % of GDP) ^(**)	0.05	–0.04	0.57
Current account balance (as % of GDP) ^(**)	–0.09	0.03	0.59

(*) Percentage difference in relation to the baseline simulation.

(**) Difference in relation to the baseline simulation.

Note: In any year, the percentage or absolute difference for any given macroeconomic indicator (in relation to the baseline scenario) accumulates the differences registered in the preceding years since the beginning of the shock.

baseline scenario. As a consequence of these sectoral developments, the initial effects on GDP are negative. GDP is reduced by 0.24% in 2004, and in 2007 a 0.15% lowering is still observed relative to the baseline scenario. By around 2010, though, the negative effects on GDP have disappeared, and in 2013 GDP is 0.36% higher than in the baseline scenario. The impact on prices is considerable (the result of the demand shock, which in fact constitutes a loss of markets to foreign competitors), and there is a significant deterioration of the current account balance and the public sector deficit. Finally, there is an initial increase in the unemployment rate, which begins to fall around 2010.

7.3. Effects of enlargement and liberalisation of the single market

Hypothesis for the quantification of the shock

The experience of the internal market suggests that productivity in the CEEC will increase by 2% to 3% in the middle term (Catinat et al., 1988), but for current members of the EU productivity growth will be on a more moderate scale. Casella (1996, p. 389) points out that «if economies of scale imply that firms located in large countries enjoy lower costs, then the gains from enlarging the bloc will fall disproportionately on small countries, because the entrance of new members diminishes the importance of the domestic market and improves the small countries' relative competitiveness». We will adopt the initial assumption that Spain's productivity will grow at a cumulative rate of 0.75%, subsequently falling off progressively. This shock is implemented in the HERMIN-Spain model as a progressive alteration of the scale parameter in the CES production function for the manufacturing sector.

Given that price competition will also be greater in future member countries than in the current members, we also assume a 3% reduction in export prices and costs (half of the expected impact for the EC indicated in the Cecchini Report; see Emerson, 1988). Given the homogeneity in the specification of wage and price equations in our model, the real effects of this aspect of the shock are on quite a modest scale: internal prices and costs are simply adjusted to this change in the external environment.

Finally, to assess the influence of greater EU growth as a result of enlargement, an increase of 0.5% in the EU's total GDP is assumed (see, for example, Breuss, 2001).

Assessment of the effects of the shock

Table 7.3 offers the results of this simulation. It can be observed that an initial fall is followed by a positive effect on total production in the medium and long term. This effect is based particularly on growth in the manufacturing component. The positive difference in relation to the baseline scenario increases over time, reaching 1.08% in the year 2013. A fall in price levels is detected as a result of the reduced margins and intermediate prices associated with increased productivity. Finally, a somewhat more favourable position is observed in the current account balance and the level of public deficit.

Table 7.3

MACROECONOMIC EFFECTS ON THE SPANISH ECONOMY RESULTING FROM THE EXTENSION AND LIBERALISATION OF THE SINGLE MARKET AFTER EU ENLARGEMENT – SHOCK (ii)

Macroeconomic indicator	2004	2007	2013
Real GDP (FC) ^(*)	-0.10	0.08	1.08
Real output – tradeable sector ^(*)	-0.33	0.20	2.87
Real output – non-tradeable sector ^(*)	-0.04	0.05	0.65
Tradeable sector GAV deflator ^(*)	-0.75	-0.31	-0.08
Average annual wage gain in the tradeable sector ^(*)	-0.79	-0.30	-0.07
Private consumption deflator ^(*)	-0.76	-0.27	-0.08
Unemployment rate ^(*)	0.06	-0.05	-0.07
Capacity or need for financing for public administrations (as % of GDP) ^(**)	0.03	-0.02	-0.25
Current account balance (as % of GDP) ^(**)	-0.04	-0.01	0.18

(*) Percentage difference in relation to the baseline simulation.

(**) Difference in relation to the baseline simulation.

Note: In any year, the percentage or absolute difference for any given macroeconomic indicator (in relation to the baseline scenario) accumulates the differences registered in the preceding years since the beginning of the shock.

7.4 Effects of the adjustment of foreign direct investment (FDI)

Hypothesis for the quantification of the shock

We will now turn our attention to an examination of the consequences for the Spanish economy of a possible reduction in flows of FDI, and the possible effects this may have in terms of delaying structural change in the manufacturing sector. Given the Spanish experience of increasing entry of FDI associated with the implementation of the European Single Market (Bajo-Rubio and Sosvilla-Rivero, 1994), the first such effect is the necessity of adjusting total factor productivity. Bearing in mind the relative weight of FDI in the sectors that will be adversely affected by trade liberalisation with the new Member States after enlargement (our L sectors), we have set the effect of productivity (due to redirection of FDI to the CEEC) at a reduction of 0.30 percentage points in the productivity increment. Accordingly, the final increment will be 0.45% rather than the 0.75% assumed in shock (ii). This shock is implemented in the model through an alteration of the scale parameter in the CES production function for the manufacturing sector.

Reduced flows of FDI may slow down structural change in the manufacturing sector. Based on the macroeconomic effects the ESM involved for Spain (Barry et al, 1997, and Sosvilla-Rivero and Herce, 1998), these effects are implemented in the HERMIN-Spain model through the alteration of the scale parameter of the CES production function for the manufacturing sector. Specifically, it is assumed that the loss of FDI flows will involve an additional net loss in manufacturing output of 0.75%, bringing the total effect to 3.44% compared to the figure of 2.69% established in the analysis of shock (i). In effect, this simulation involves a partial revision of that carried out for shock (i) and simply explores the consequences of expected adjustments in FDI flows for effects previously examined, qualifying in this manner the results obtained.

Assessment of the effects of the shock

The results of this simulation are presented in Table 7.4. As can be observed, an increasingly marked fall in the manufacturing sector is registered, and by 2013 this has resulted in a level 3.18% lower than that generated in the baseline scenario. The non-tradeable sector also experiences relative losses, though smaller than those in manufacturing: by 2013, output is 1.03% lower than it would be without the effect of this shock. This behaviour in production generates a significant fall in aggregate production (−1.68% in 2013) and a resultant increase in the unemployment rate. Finally, there is a moderate reduction in prices and wages, as well as a deterioration of the current account balance and the public deficit.

Table 7.4

MACROECONOMIC EFFECTS ON THE SPANISH ECONOMY RESULTING FROM THE ADJUSTMENT OF FOREIGN DIRECT INVESTMENT AFTER EU ENLARGEMENT – SHOCK (iii)

Macroeconomic indicator	2004	2007	2013
Real GDP (FC) ^(*)	−0.15	−0.85	−1.68
Real output – tradeable sector ^(*)	−0.40	−2.27	−3.18
Real output – non-tradeable sector ^(*)	−0.10	−0.53	−1.03
Tradeable sector GAV deflator ^(*)	−0.84	−2.14	−2.63
Average annual wage gain in the tradeable sector ^(*)	−0.85	−2.17	−2.66
Private consumption deflator ^(*)	−0.79	−2.09	−2.61
Unemployment rate ^(*)	0.08	0.59	0.99
Capacity or need for financing for public administrations (as % of GDP) ^(**)	0.03	0.21	0.60
Current account balance (as % of GDP) ^(**)	−0.04	−0.14	−0.36

(*) Percentage difference in relation to the baseline simulation.

(**) Difference in relation to the baseline simulation.

Note: In any year, the percentage or absolute difference for any given macroeconomic indicator (in relation to the baseline scenario) accumulates the differences registered in the preceding years since the beginning of the shock.

7.5. Effects of the adjustment of European structural funds

Hypothesis for the quantification of the shock

We assume that the economic benefits resulting from structural assistance take the form of externalities, and attempt to capture these by modifying the model's key equations, particularly the factor supply and demand functions. We take into account two types of externalities: the first concerns the productivity increment for private factors that results from a greater endowment of public capital (infrastructure), human capital (training) and company equipment (production assistance); the second concerns better product quality in the tradeable sector (Herce and Sosvilla-Rivero, 1994, and Bradley et al., 1995b).

The first of these externalities is implemented in the HERMIN-Spain model by endogenising the scale parameter of the CES production function for investment in public infrastructure, human capital and production assistance to the private sector. The second type of externality operates at two levels. First, it has a direct impact through the effect of each of the programmes on the improvement of the quality of industrial production (which leads to greater external demand for these goods). Second, it has an indirect effect by producing greater flows of foreign direct investment. These higher flows of FDI are the consequence of the increased availability of better-qualified scientific and technical personnel and better infrastructure (Porter, 1986), the associated modernisation of equipment and production methods in participating companies, and an increased inclination to export on the part of these companies (Alonso and Donoso, 1994). To capture this type of externality, we relate growth in the infrastructure stock, the increment in human capital and the greater endowment of sectoral private capital to the measure of external demand used in the HERMIN-Spain model.

In our empirical application, the values used for the production scale variable elasticities with respect to investment in public infrastructure, human capital and the private sector are, respectively, 0.20 (a value midway between the estimate made by Argimón et al., 1994, and that made by Bajo-Rubio and Sosvilla-Rivero, 1993); 0.07 (based on estimates made by Corugedo et al.,

1992, of the social return on investment in education and vocational training), and 0.10 (based on microeconomic information concerning the effects of the Community Support Framework 1989-93, contained in FEDEA, 1994).

Given the lack of detailed information, we have assumed that the total allocations for European structural fund assistance are distributed among large-scale actions and programmes in the same manner applied for other assistance received by Spain in previous budgetary periods.

Assessment of the effects of the shock

In contrast to the approach taken to the assessment the previous shocks, in this case the baseline scenario used is one in which EU structural and cohesion assistance continues to be received at current levels.

Table 7.5 shows the results of the simulations carried out for the two scenarios discussed in chapter III, which we refer to here as «Reduction of

Table 7.5

STRUCTURAL ASSISTANCE EFFECTS. SCENARIO A «REDUCTION OF OBJECTIVE 1 STRUCTURAL ASSISTANCE» AND SCENARIO B «CAP TO FUNDS » – SHOCK (iv A) AND (iv B)

Macroeconomic indicator	2004	Esc. A		Esc. B	
		2007	2013	2007	2013
Real GDP (FC) ^(*)	0.0	-0.98	-0.89	-0.58	-0.49
Real output – tradeable sector ^(*)	0.0	-2.61	-2.38	-1.55	-1.31
Real output – non-tradeable sector ^(*)	0.0	-0.62	-0.55	-1.37	-0.30
Tradeable sector GAV deflator ^(*)	0.0	-2.23	-1.98	-1.78	-1.08
Average annual wage gain in the tradeable sector ^(*)	0.0	-2.19	-1.95	-1.74	-1.05
Private consumption deflator ^(*)	0.0	-2.01	-1.67	-1.61	-1.07
Unemployment rate ^(*)	0.0	0.68	0.59	0.40	0.32
Capacity or need for financing for public administrations (as % of GDP) ^(**)	0.0	0.24	0.21	0.14	0.11
Current account balance (as % of GDP) ^(**)	0.0	0.46	0.40	0.29	0.22

(*) Percentage difference in relation to the baseline simulation.

(**) Difference in relation to the baseline simulation.

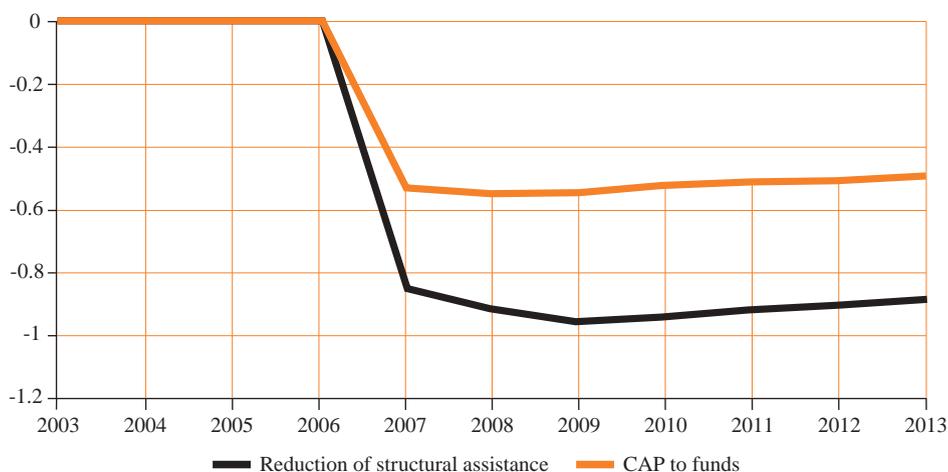
Note: In any year, the percentage or absolute difference for any given macroeconomic indicator (in relation to the baseline scenario) accumulates the differences registered in the preceding years since the beginning of the shock.

structural assistance» [shock (iv) scenario A] and «CAP to Funds» [shock (iv) scenario B, in which CAP funding is cut substantially and some of the resources freed up are allocated to general structural funds]. Although enlargement is to begin in 2004, the difference between the two alternative scenarios will start to be noted in 2007, when the current Agenda 2000 financial perspectives are concluded and the new programming period is initiated. The results presented refer to the overall effects caused by this shock, taking into account both demand and supply effects. As can be observed in Table 7.5, a fall in real production is registered in 2007 in comparison to the baseline scenario in which structural assistance is maintained. The fall is more significant in shock (iv) A (–0.91% compared to –0.55%), and is slowly reduced to –0.89% in 2013 for shock (iv) A, and to –0.49% for shock (iv) B. Graph 7.1 shows the evolution of the effect on real GDP for both scenarios over the period analysed. The difference in the behaviour of real GDP is essentially the result of the unequal impact on the tradeable sector in the two

Graph 7.1

EFFECTS OF THE REDUCTION OF STRUCTURAL ASSISTANCE. 2007-2013

Percentage deviation of real GDP with respect to the baseline simulation
(continuation of structural assistance)



scenarios. Inflation is lowered relative to that registered in the baseline scenario; the lowering is greater in the case of reduction of structural assistance (−1.99% in 2007 compared to −1.67%). Unemployment increases in both cases, but, logically, the increase is greater in the case in which budgetary programming is changed [shock (iv) A]. Finally, it can be observed that the ratio current account balance/GDP deteriorates, and the public deficit as a proportion of GDP also deteriorates progressively. Both of these trends are more pronounced in the case of shock (iv) A.

Structural assistance will continue to have positive effects

In spite of the outlook that emerges from the analysis in the preceding section (i.e., the negative effects of the reduction of structural assistance), structural assistance will continue to have a positive effect on the Spanish economy. In the scenarios that we have formulated, assistance of this type is still received, albeit at a lower level; the positive effects on the Spanish economy will be less, but they will not cease to be noted. The preceding analysis focused on the presentation of the negative differential within the context of the classification of shocks that are likely to affect the Spanish economy after EU enlargement to the CEEC. We must, however, insist that the Spanish economy will continue to register a positive effect based on the Community structural assistance, just as it has since Spain joined the Union. What will the extent of the associated macroeconomic effects be? Graph 7.2 gives some indication of this in relation to GDP.

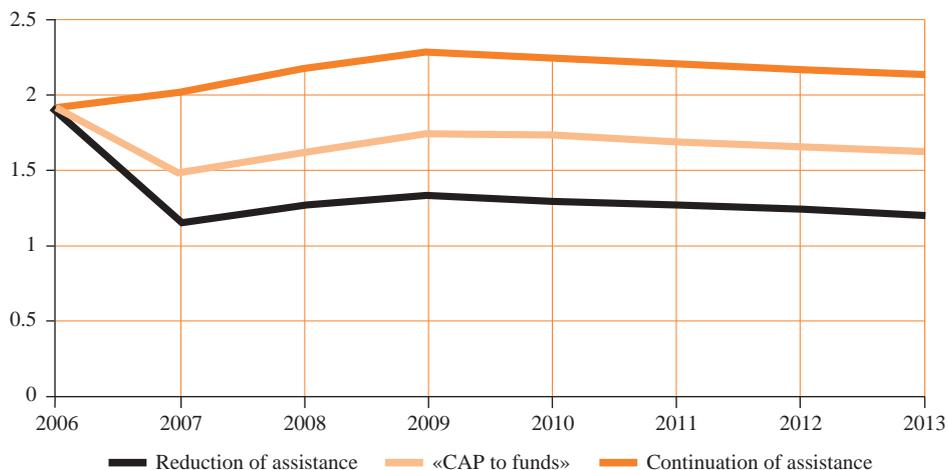
As argued in section 3.3, it is highly unlikely that the scenario in which the level of structural fund assistance is maintained will become a reality: we present this scenario only as a basis for comparison.⁽²⁾ It can be observed that with the continuation of assistance, GDP growth is naturally greater than that which occurs in the two alternative scenarios involving different degrees of reduction in the short and medium term. Nevertheless, in both of the alternative scenarios such assistance continues to produce a

(2) See Sosvilla-Rivero and Herce (2000) for an assessment of the macroeconomic effects of Agenda 2000.

EFFECTS ON GDP OF STRUCTURAL ASSISTANCE IN THE SCENARIOS «REDUCTION OF OBJECTIVE 1 ASSISTANCE» (A) AND «CAP TO FUNDS» (B) FOR 2007-2013

Compared to the effects of a continuation of the 2000-2006 perspectives

Percentage deviation of real GDP from the baseline (no assistance)



significant amount of extra growth. A similar reduced effect would continue to be noted in the other macroeconomic balances, including effects on output in the tradeable and non-tradeable sectors. It should be pointed out that the tradeable sector is particularly susceptible to shocks associated with the reduction of structural assistance (and to the other shocks related to enlargement). The effect on wages and prices would be moderated when assistance is reduced, as would the reduction of the unemployment rate that such assistance contributes to achieving. A significant effect would be noted on the unemployment rate due to the fact that a lower level of assistance stimulates a lower level of growth in labour productivity. The extent of the reduction of the public deficit would be less when assistance is reduced, but public accounts would not cease to improve given that assistance also boosts aggregate demand, tax receipts and social security payments, while at the same time reducing expenditure on payment of unemployment insurance benefits. Finally, the stimulus to economic activity that occurs in any of the

scenarios would lead to a deterioration of the economy's current account balance. The greater the reduction of structural assistance, the less the extent of this deterioration would be.

In Graph 7.2, it is evident that were structural assistance to be maintained along the same lines established in the 2000-2006 perspectives, Spain's real GDP would remain permanently at a level 2% above the level it would be at if such assistance had not existed. Nonetheless, in scenarios A and B, both of which involve some degree of reduction in structural assistance, Spain's real GDP remains above the level it would be at in the absence of any type of Community assistance (by approximately 1.2% in the case of scenario A and 1.7% in scenario B). The analysis that focuses on the effects of enlargement and the associated reduction of structural funds as a negative shock represents a valid point of view. This alternative way of looking at the effects, however, illustrates the fact that Spain's economy will continue to benefit from the effects of structural assistance during the process of enlargement and beyond, and that such assistance will go on contributing to Spain's real convergence with the most advanced countries in the Union.

7.6. Overview of the main macroeconomic effects of EU enlargement

Though quantitatively the effects of enlargement are on a limited scale, the analysis presented in the preceding sections shows that the majority of such effects are negative. (The positive effects of the enlargement and liberalisation of the Community market and of long-term trade adjustment are the exception.) It is, however, important to consider the overall order of magnitude of the macroeconomic effects of enlargement for the Spanish economy. In this sense, it should be stressed that it is the manufacturing sector, given its exposure to external competition, that will be the focal point for much of the necessary adjustment.

As we have seen in the preceding sections, output and employment fall in the short term (2004). This is due to trade and structural adjustment, and, to a lesser degree, to ESM effects and the partial exit of FDI. As we have also seen, however, this shock is mitigated to some degree by improved

efficiency and an increment in competition that results from the creation of a larger market. The growth of Community GDP associated with the accession of the new members also plays a mitigating role. Nevertheless, in 2007 the negative effects of the reduction of Community structural assistance begin to be noted. This is the year in which the greatest deviation of real GDP is registered in relation to the baseline scenario (no enlargement and structural assistance at a level similar to that currently received) (see Graph 7.3).

The greatest fall in real production will be that attributable to structural adjustment in the manufacturing sector. The very significant extent of this fall will be a reflection of the incapacity of Spanish industry, in the context of internal EU enlargement and liberalisation, to gain ground in the external market without giving up domestic market share. In the framework of our simulations, this situation would be further aggravated if flows of FDI entering Spain were even lower than the levels assumed: in the past, flows of FDI appear to have counteracted certain shortcomings of Spanish manufacturing sectors by driving some of them to enter the overall Community market.

The non-tradeable sector (basically services) will initially register losses on a more reduced scale. However, given that this sector is the main beneficiary of the demand effects associated with structural fund assistance, when such assistance is reduced in 2007, production in this sector will experience a significant setback, which then will gradually be mitigated by ESM effects.

In parallel with the effects on production, there will be a gradual increase in the unemployment rate. At the beginning of 2013, the percentage of the working population unemployed will be 1.35 points higher than in the baseline scenario. As for the impact on wages and prices, it should be pointed out that a considerable fall will be registered in all of the indicators in relation to levels in the «no enlargement» scenario. Finally, a deterioration is observed in the current account balance and the public deficit.

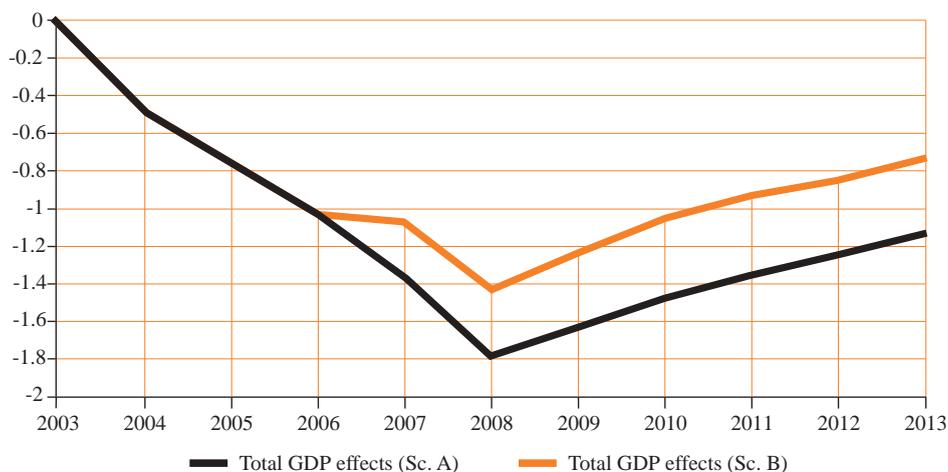
To sum up, our simulations (notwithstanding their highly hypothetical nature) demonstrate that some of the consequences of enlargement must be taken very seriously, particularly as regards the exposure of manufacturing sectors. They also point to the need to take maximum advantage of the allocated

Graph 7.3

TOTAL EFFECTS OF ENLARGEMENT ON SPANISH GDP.

2003-2013

Percentage deviation of real GDP from the baseline scenario
(continuation of structural assistance)



structural assistance that is yet to reach Spain's less-developed regions. It is also important to note that many of the effects we have discussed are closely linked to the dynamics of the Spanish economy, concerning which no prejudgments are made in our analysis: the simulations presented occur in the context of a macroeconomic base, the level of which may be as high as can be sustained by the many circumstances that will determine Spain's economic future during the period analysed. Faced with these results, the reaction required of economic agents is clear: they must continue to do their homework in those areas of the economy that they can control (training, capitalisation, long-term saving, R&D, efficient regulation of labour and product markets, efficiency in the public sector, etc.). Such efforts will help compensate for the inevitable risks associated with a process of supranational construction. In any case, it must be borne in mind that, overall, this process has been a highly positive one for the Spanish economy, and, if the opportunities presented are grasped, this will continue to be the case in the future.

VIII. Limiting risks, seizing opportunities

Throughout the preceding analysis, the nature of a new and unique stage in the enlargement of the Union has been described, and the main opportunities and challenges of this event have been assessed, particularly as they relate to the Spanish economy. Inevitably, this assessment has been based on developments that have taken place since, within the framework of the Europe Agreements, the foundations were established for the process of accession negotiations with the CEEC countries.

We have carried out a detailed examination of the profound changes that the production and trade structures of the great majority of the CEEC have undergone. We have also seen the ever greater ties of economic integration between the CEEC and current members – ties based on trade, direct investment, and, to a much lesser degree, on migratory movements. Based on all of these considerations, we have attempted to formulate a scenario that traces the economic impact of accession on the EU-15 as a whole and on Spain in particular. Naturally, the effects of enlargement on the Community budget have also been taken into account in this scenario, particularly those that impact on the two chapters where spending is highest: financing of the CAP and Structural Actions.

For Spain, the balance of enlargement costs and benefits that emerges from the extrapolation of past trends is not a positive one, particularly when it is assessed in comparison to the impact on the majority of the EU-15

countries. The effort made within the Spanish economy to take advantage of the export and direct investment opportunities associated with the opening of CEEC emerging markets has come late and has been quite limited compared to the average for current EU members. As a result, expected future opportunities in these areas are also on a relatively modest scale.

In addition to the fact that limited mutual flows of trade and investment translate into limited gains for the Spanish economy, there is an added threat that Spanish exports and the flows of investment received by the economy will experience diminished growth as the result of competition with the future member countries. Some analysts take the view that the impact of enlargement on Spanish trade will be insignificant given the very limited weight of the CEEC in Spain's total trade. The position taken in this study is that this view is mistaken: we believe that the error of this forecast lies in its failure to consider the negative trade repercussions that the accession of these countries may indirectly have for Spain's export capacity. In this study, we have presented evidence that the preferred strategy of multinational companies established in the candidate countries is to use them as production centres and export platforms to supply the enlarged European Union. If this evidence is borne out, it is likely that the negative impact on Spain's export capacity will be noted.

Furthermore, the accession of a group of countries with an income level that is still well below the current EU-15 average places a great deal of pressure on expenditure items in the Community budget, in relation to both the CAP and the financing of Structural Actions. Such additional pressure on expenditures, which, given the most realistic financing outlook for the next budget period (2007-2013) seems likely to occur, may well be associated with a substantial reduction in the assistance that Spain receives.

It should, of course, be stressed that the forecast effects of EU enlargement (and the meagre benefits predicted for Spain) are not as inevitable as they may appear. In light of the unexpected and convulsive changes currently occurring at an international level, it is particularly important to bear in mind that any trend determined by a particular set of causal factors is subject to modification. We cannot, for instance, rule out the

possibility that the relative passivity with which Spanish economic partners are reacting to the opportunities associated with enlargement may give way to a more determined and efficient approach. Indeed, in our view, such an approach is desirable, and necessary if Spain is to take advantage of these opportunities in the same way that most current member countries have been doing. In spite of added difficulties due to a late start, it is still possible for Spanish companies to increase their export shares in the market of the future members. It is also desirable that Spanish companies carry out investment projects aimed at benefiting from the location advantages these countries offer – particularly the availability of relatively skilled, low-cost labour – in order to supply from the CEEC not only demand in these countries, but also within the enlarged European Union.

In fact, the examination of Spanish exports to the CEEC in recent years reveals a dynamism that reflects the growing interest of Spanish companies in their emerging markets. Though on a much more modest scale, the same increased interest and activity can be observed in terms of direct investment in the region.

In spite of these bright spots, though, there remains much to be done when it comes to grasping the opportunities of enlargement and, no less importantly, limiting the associated risks for the Spanish economy. The achievement of this objective depends on the efforts made by all economic and social partners, not least companies, but economic policy must also play a key role, particularly in reinforcing Spain's strong points as a location for international investment projects and thereby limiting the risk that these projects shift to the CEEC. This means improving transport and communication infrastructure in order to compensate for the disadvantages of a more peripheral post-enlargement geographical location. The factors on which the productivity and competitiveness of Spanish companies are based, including employment training and R&D activities, must also be reinforced.

The clear labour-cost advantages of the candidate countries, together with the skills and technologies provided by the many multinationals that have set up there, have made possible the achievement of widely recognised advances in efficiency and competitiveness. The accession of these countries

to the EU represents a significant challenge for Spain's economy, and all of the measures outlined above appear to be essential if this challenge is to be successfully overcome.

Equally important is government action to minimise the costs associated with the likely reduction of income that Spain receives from the Community budget under the terms of the CAP and Structural Actions. The first priority for the government should be to pursue an effective strategy in the negotiation of future Union budgets for the 2007-2013 period. Rather than merely focusing on Spain's individual claims, such a strategy could involve a legitimate defence of the need to ensure that the financial requirements associated with enlargement are distributed in accordance with the principle of cohesion, a recognised element of the Treaty of the Union. A defence of this principle may be the most effective approach open to Spain, given its limited negotiating strength in comparison to Germany and other net contributors.

It must be recognised that, unless the current Community budget ceiling of 1.27% of GNP is raised, the incorporation of candidate countries will lead to a loss of resources for current EU members. In this context, the most sensible response would seem to be to maintain the resources allocated to Structural Actions and other Union policies, even though this will inevitably involve reducing the funds allocated to financing the CAP. In any case, it is increasingly difficult to find an economic rationale for this policy, which, at least from this perspective, is clearly susceptible to criticism based on efficiency and equity arguments.

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