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Economic and Political Reintegration in an Enlarged EU: Implications for Regional Stability

EPRIEE

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Economic and Political Reintegration in an Enlarged EU: Implications for Regional Stability

EPRIEE

Final report

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Coordinator of project:
Economics Department,University of Newcastle upon Tyne
Newcastle upon Tyne, United Kingdom
David Barlow
www.epriee.ncl.ac.uk

Partners:
Centre for European Policy Studies, Brussels, BE, Andreas Schneider
Centre for Study of Globalisation and Regionalisation, Warwick University,Warwick, UK, Huw Edwards
Estonian Institute of Economics, Tallinn, EE, Urve Venesaar
Malopolska School of Economics, Tarnow, PL, Marek Dziura
Universita degli Studi di Bari, Bari, IT, Giovanni Ferri

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Preface

Within the Fifth Community RTD Framework Programme of the European Union (1998–2002), the Key Action 'Improving the Socio-economic Knowledge Base' had broad and ambitious objectives, namely: to improve our understanding of the structural changes taking place in European society, to identify ways of managing these changes and to promote the active involvement of European citizens in shaping their own futures. A further important aim was to mobilise the research communities in the social sciences and humanities at the European level and to provide scientific support to policies at various levels, with particular attention to EU policy fields.

This Key Action had a total budget of EUR 155 million and was implemented through three Calls for proposals. As a result, 185 projects involving more than 1 600 research teams from 38 countries have been selected for funding and have started their research between 1999 and 2002.

Most of these projects are now finalised and results are systematically published in the form of a Final Report.

The calls have addressed different but interrelated research themes which have contributed to the objectives outlined above. These themes can be grouped under a certain number of areas of policy relevance, each of which are addressed by a significant number of projects from a variety of perspectives.

These areas are the following:

- ***Societal trends and structural change***

16 projects, total investment of EUR 14.6 million, 164 teams

- ***Quality of life of European citizens***

5 projects, total investment of EUR 6.4 million, 36 teams

- ***European socio-economic models and challenges***

9 projects, total investment of EUR 9.3 million, 91 teams

- ***Social cohesion, migration and welfare***

30 projects, total investment of EUR 28 million, 249 teams

- ***Employment and changes in work***

18 projects, total investment of EUR 17.5 million, 149 teams

- ***Gender, participation and quality of life***

13 projects, total investment of EUR 12.3 million, 97 teams

- ***Dynamics of knowledge, generation and use***

8 projects, total investment of EUR 6.1 million, 77 teams

- ***Education, training and new forms of learning***

14 projects, total investment of EUR 12.9 million, 105 teams

- ***Economic development and dynamics***

22 projects, total investment of EUR 15.3 million, 134 teams

- ***Governance, democracy and citizenship***

28 projects; total investment of EUR 25.5 million, 233 teams

- ***Challenges from European enlargement***

13 projects, total investment of EUR 12.8 million, 116 teams

- ***Infrastructures to build the European research area***

9 projects, total investment of EUR 15.4 million, 74 teams

This publication contains the final report of the project 'Economic and Political Reintegration in an Enlarged EU: Implications for Regional Stability', whose work has primarily contributed to the area 'The challenge of EU enlargement'.

The report contains information about the main scientific findings of EPRIEE and their policy implications. The research was carried out by six teams over a period of three years, starting in June 2001

The abstract and executive summary presented in this edition offer the reader an overview of the main scientific and policy conclusions, before the main body of the research provided in the other chapters of this report.

As the results of the projects financed under the Key Action become available to the scientific and policy communities, Priority 7 'Citizens and Governance in a knowledge based society' of the Sixth Framework Programme is building on the progress already made and aims at making a further contribution to the development of a European Research Area in the social sciences and the humanities.

I hope readers find the information in this publication both interesting and useful as well as clear evidence of the importance attached by the European Union to fostering research in the field of social sciences and the humanities.

J.-M. BAER,

Director

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Abstract

1) Accession to the Single Market is expected to generate large gains in trade (up to 100%), GDP (up to 20%) and real wages (up to 15%) for the new members at little cost to the incumbents.

2) Trade expansion is likely to be driven by outsourcing of unskilled-labour intensive production from incumbent members.

3) The pre-accession strategy enabled the candidates to take trade liberalisation further than could non-candidates by increasing the level of reform that is best for GDP growth.

4) Preparations for negotiating EU membership and the negotiations themselves do not appear to have caused reform to have significantly deviated from the pattern generated by sequencing, with the exceptions of bank reform and competition policy.

5) Small-scale privatisation is the key reform required for other reforms to progress.

6) Prior to the Europe Agreements, export growth of the candidates appears to have been a consequence of factors that are either not sustainable in the long run or are parts of processes that are almost complete; export growth in the future will depend upon how well countries adapt to the Single Market.

7) Policies to encourage greater integration in SEE (South Eastern Europe), such as a Free Trade Area, are warranted by the economic fragmentation of the region and to overcome political conflict.

8) One benefit of reduced economic fragmentation of SEE should be increased FDI due to the increased size of the local market.

9) FDI to SEE could be increased by raising the flexibility of the labour market and by improving the mechanisms for wage bargaining.

10) Crises in the country of origin are major causes of migration to the EU. These results have clear (international) policy implications: the costs of intervening to alleviate severe crises in the countries of origin should be weighed according to their ability to limit socially undesirable mass migrations towards the European Union.

11) CAP reform is anticipated as being more difficult to achieve in an enlarged EU. In contrast, the new member states might give the EU a greater mandate to further trade liberalisation in WTO talks.

12) The level of border effects is partly due to policy-related constraints; thus there is an important role for policy makers to remove these barriers.

13) Analysis of the disintegration of the communist systems suggests that disintegration is most likely when the economy is weak. Thus we should expect any pressure to leave the EU to occur in a time of recession.

14) Disagreement over transfers through the EU budget might be limited by the small-scale of these transfers. Given the low level of international labour mobility within the EU, asymmetric shocks should be met by fiscal accommodation. The EU budget is insufficient to accommodate such shocks.

16) The reorientation of exports has been most successful when driven by outsourcing of production and accompanied by high inward FDI.

List of Abbreviations

CAP: Common Agricultural Policy

CEE: Central and Eastern Europe

CEECs: Central and Eastern European Countries

CEFTA: Central Eastern Free Trade Area

CET: Common External Tariff

CIS: Commonwealth of Independent States

CMEA: Council for Mutual Economic Assistance

EBRD: European Bank for Reconstruction and Development

EP: European Partnership

EU: European Union

EU-15: EU members before 2004

FDI: Foreign Direct Investment

FSU: Former Soviet Union

IFI: International Financial Institutions

SAA: Stability and Association Agreement

SEE: South Eastern Europe

SEECs: South Eastern European Countries

SGP: Stability and Growth Pact

SIMI: Survey on Illegal Immigration into Italy

SME: Small- and Medium-sized Enterprise

WBs: Western Balkans

WTO: World Trade Organisation

EBRD Transition Indices

BNK: Banking Reform and Enterprise Restructuring

COM: Competition Policy

LSP: Large-Scale Privatisation

PL: Price Liberalisation

RES: Governance and Enterprise Restructuring

SSP: Small-Scale Privatisation

TRA: Trade and Foreign Payments

SEC: Securities Markets and Non-bank Financial Institutions

I. EXECUTIVE SUMMARY

1. The Main Challenges for the New Members

1.1. The Economic Effects of the Accession of CEECs to the Single Market

From a trade perspective, much of the integration process has already taken place. The Europe Agreements of 1997 were very important in this regard, removing tariffs and quotas on all areas of trade between the European Union (EU) and Central and Eastern European Countries (CEECs), with the exception of agriculture. The tariff reform that remains to be done for accession countries is therefore: 1) removal of agricultural tariffs and 2) adoption of the Common External Tariff for trade with third countries outside the region of Central and Eastern Europe (CEE).

Arguably more important, however, is the general accession of the CEECs to the EU's Single Market. This is a complicated series of agreements dealing with the huge raft of regulations and standards that countries impose on industry for means of health, safety and consumer protection. One school of thought suggests that regulations and standards may in practice be imposing significant costs on companies engaging in trade, by forcing them to alter the specifications of the goods they produce in order to enter new markets. Membership of the Single Market is potentially of particular value to the CEECs, as these are mostly small economies which have inherited relatively monopolistic industrial structures and can potentially gain greatly from integration into a far more competitive single European market. Edwards (2004a/EPRIEE-09) uses a computable general equilibrium model to simulate the impact of accession on the CEECs and the EU-15.

1) Aggregate trade volumes between the EU and accession states could potentially increase by 50-100%, with Poland experiencing the largest increases. These trade-volume increases go in both directions; however, given the relatively small-scale of the CEECs compared to the existing EU, the significance is far greater for the former group.

2) Output changes: light manufacturing grows by over 20% following accession in Poland, Hungary and the Other CEEC region, while Hungarian heavy manufacturing also grows by over 20%.

3) GDP is likely to increase in all regions of the CEECs and the EU following accession, with the main effects coming from entry to the Single Market rather than harmonisation of tariffs. Polish GDP could gain by 20% in this simulation, while Hungary and the Other CEECs gain somewhat less.

4) Accession is likely to lead to substantial upward pressure on prices in the CEECs (reflecting higher factor demand), while there is a small downward pressure on prices in the existing EU-15. All factor prices rise sharply in the accession countries, while they fall slightly in the existing EU. The net result is a rise of perhaps 10-15% in real wages in the accession countries, with little net change in the existing EU.

5) The overall picture painted by these simulations is a highly optimistic one for the accession countries, indicating large potential gains in trade and real incomes, at virtually no cost to the existing EU members. However, it is worth remembering that this model has been based upon an assumption that there are high regulatory barriers to trade before accession, and that these are reflected in real trading costs. These assumptions may not be accurate, and consequently the figures in this paper may be regarded as painting a relatively optimistic picture of the potential gains from enlargement. A good deal of further work is required to examine in detail the real qualitative and quantitative nature of regulatory barriers to trade and the effects of the Single Market initiative.

1.2. Sub-Regional Integration: The Importance of Networks and Clusters

Trade Blocs and the Development of Estonia's Foreign Trade

The three Baltic states, and Estonia in particular, have seen since 1992 one of the most dramatic realignments of trade ever witnessed. Between 1991 and 1994 the volume of exports from Estonia increased by a factor of almost 8, and the volume of exports from Lithuania and Latvia increased by around 2.5. The nature of the realignment can be shown as follows. In 1991, Russia, the Ukraine, Belarus and Kazakhstan accounted for 76% of Estonia's export market. When the other two Baltic states and the smaller Soviet republics were added, over 90% of Estonia's exports were to other parts of the Soviet Union. The change in that pattern reflects partly the effects of liberalisation of trade between Estonia and the West, but also the disintegration of the once tightly-integrated, planned Soviet economy, and the resulting disorganisation of the former economic network, as well as the effect of a trade war between Russia and the breakaway republics. By 1995 Finland had already overtaken Russia as Estonia's main export market, and that pattern has remained. Rajasulu (2003/EPRIEE-18) examines the re-orientation of Estonia using a gravity model.

1) In 1991 Estonia's trade was indeed severely distorted as the country was trading hugely more with the Soviet Union and less with everybody else than GDP and distance would suggest.

2) Estonia's imports now appear to be fairly evenly distributed from around the world, once account is taken of size of exporting economy and distance from Estonia.

3) By contrast, Estonia's exports are remarkably concentrated geographically. EU membership is as yet not a particularly large influence on whether a country is an export market for Estonian produce: what particularly matters is membership of the Baltic region (especially Finland and Sweden). These countries took a proportion of Estonia's exports more than 7 times greater than would be predicted from size and proximity alone. While some additional effects would be expected in the case of Finland (due to close cultural and linguistic ties), much the same applies to Sweden, where the language is not close to Estonian.

4) It seems that different forces have driven the increases in Estonia's exports compared to its imports since 1992. Estonia's imports may well be variety-driven, with Estonian customers appreciating the new availability of a selection of goods from Europe and around the world. By contrast, Estonia had to seek export markets very quickly, and it seems its economic and export recovery was driven by the very rapid growth of outsourcing for Swedish and Finnish firms. Recent economic literature on outsourcing in trade suggests strongly that matching between partners is crucial, and that network effects tend to dominate such a trade. In that sense, speculatively, the rapid export growth of Estonian trade is due largely to its discovery as a potential outsourcing centre by Swedish and Finnish manufacturers, which then passed on their learning about Estonian producers and the Estonian economy to other Swedish and Finnish firms. While geography, transport connections, tourism and language may have helped trigger this effect, it is the rapid spread of specialist information on doing business in Estonia through Swedish and Finnish business networks that led to the growth of exports to those two markets in particular (although Estonian outsourced goods would be resold from Sweden and Finland across Europe). This geographical concentration may well be a key feature of outsourcing trade. It is also interesting that Sweden and Finland dominated inward investment into Estonia in the 1990s.

5) The study indicates little observable effect of European Union membership on a country's status as exporter or importer of goods to/from Estonia. This is despite Estonia's entry into the Europe Agreements in the late 1990s, which effectively removed all non-agricultural tariff and non-tariff barriers. Full entry to the EU will lead to removal of barriers to Estonia's agricultural exports: as the

country was a major exporter of food products in its Soviet days, it will be interesting to see whether the decline of that sector since 1991 is reversed by EU entry. On the negative side, the common external tariff may well lead to more geographical concentration in Estonia's imports than at present, while some of the EU social legislation may affect its attractiveness as a destination for outsourcing. On the other hand, infrastructural investment from the EU is likely to help all the Baltic states considerably, and may well help spread the benefits of the inward investment/outsourcing boom from Tallinn to other parts of the Estonian economy.

Firms' Clustering and Polish Export Performance: Lessons from the Italian Experience

Like all transition economies, Poland stands to gain most from export-led growth. Unfortunately, though, the productive structure in this country is largely made up of small- and medium-sized enterprises (SMEs), which, due to their limited size, may face obstacles to gain access to international markets. A possible way out of the conundrum is for SMEs to cluster together and, by sharing the costs of internationalization, jointly tap foreign markets. De Arcangelis, Ferri & Padoan (2004/EPRIEE-16) simulate the benefits of firms clustering on export performance. They show:

1) Firms' clustering seems to have both a static and a dynamic effect on exports. On the static side, firms' clustering can significantly boost exports, but only in conjunction with other factors: firms' clustering strengthens the domestic model of specialisation by affecting more intensely those sectors that already experience higher export growth. On the dynamic side, they show that firms' clustering has a positive marginal impact on export growth.

2) Using different scenarios the additional impact of firms' clustering on the (projected) benchmark export growth was estimated. The simulation results showed that the gain in terms of export growth ranges between 1 and 5% over a five-year period.

3) This evidence indicates that Poland stands to reap substantial benefits by favouring SME clustering. Our results suggest that Poland will substantially gain if it is able to accelerate this process. Indeed, it appears in the interest of Poland to introduce specific incentives to effectively boost the dissemination of SME clusters in order to take full advantage of its trade integration with the EU.

1.3. Economic Integration and the Transition from Communism

Growth in Transition Economies: A Trade Integration Perspective

Did the process of EU accession influence GDP growth in the transition economies? Various agreements between the EU and the accession candidates would have improved the candidates' access to the largest market in the world. The Europe Agreements gave the transition economies the opportunity to adapt to the pressure of competition from EU firms by opening the Single Market to accession candidates faster than the candidates removed restrictions on EU imports. Before the Europe Agreements the integration of the candidates into the European economy was already being assisted by other accords with the EU and EFTA. Finally, the expectation of acceding to the EU and the stability that would imply could have stimulated investment, particularly from abroad. On the basis of an econometric analysis of a panel data set, Barlow (2004a/EPRIEE-01) finds:

1) Trade liberalisation is found to raise GDP growth. But the optimal extent of trade liberalisation is less than full liberalisation. The optimum is higher for the 10 EU candidates, but not for other western transition economies (Albania, Croatia and Macedonia). The most likely explanation for this is that the phased asymmetric opening of markets incorporated in the Europe Agreements, with the EU opening its market to an accession country faster than the partner opened to the EU, permitted a gradual adaptation to competitive pressures. Though this accession effect is stronger in the period in which the accession negotiations took place, there is also a statistically significant effect prior to negotiations. That is, the asymmetric opening is only a part of the story. The weaker pre-negotiation effect might be due to other agreements made between the eventual candidates, or due to the expectation of EU membership encouraging investment, particularly from abroad.

2) The effect of internal reform was found to not be significantly different to zero. The internal reform index was replaced by each individual element in turn. Only small-scale privatisation (SSP) was found to be statistically significant. SSP appears to increase growth. It is possible that the effect of SSP on growth is partly due to the expectation that reform will be advanced or at least not be reversed when the small-scale private sector is stronger. This is in line with the conclusion reached by some literature on the political economy of privatisation in transition economies: quicker de facto privatisation (which may be signalled by SSP) breeds middle-class type interests in the economy which will then make reversion less likely.

3) Although other reforms did not have a statistically significant effect on growth, this should not be equated with other reforms not being economically significant. As it is difficult to maintain an open economy in the face of market distortions, internal reforms are essential to be able to liberalise trade. The statistical insignificance of internal reform might follow from the co-linearity of internal and trade reform.

4) The empirical evidence offers some support for an optimistic assessment of the effect of accession to the Single Market on the GDP of the candidates.

Did the accession process influence reform in transition economies?

The accession process could have had an indirect effect on economic performance through its influence on policy. It is likely that, over the transition, policy has been sequenced. The sequence would reflect the practical issues of policy-making, such as administrative capacity and constitutional formalities; political constraints; fiscal constraints and linkages in the reform programme. Therefore, progress on any single aspect of transition could depend on the progress previously made on other reforms. An econometric analysis of the determinants of the probability of reform advanced by Barlow & Radulescu (2004a/EPRIEE-04) shows:

1) Small-scale privatisation (SSP) appears to have been the key element of the transition; countries that progressed furthest with creating small and medium-sized private businesses were those most likely to progress furthest with other reforms. The importance of SSP is most likely because it creates the broad-based participation that is central to the development process by providing political competition and strengthening civil society. Furthermore, SSP may provide an effective way to boost competition and, thus, reduce rent-seeking through the economy. The results are robust to splitting the sample into subsets of former Soviet countries and others. However, the importance of SSP is highlighted by its greater importance in the former Soviet sub-sample, a sub-sample characterised by much weaker civil institutions at the start of transition.

2) Large-scale privatisation (LSP) does not appear to have stimulated other reforms. LSP in contrast to SSP has often either concentrated wealth and influence or created weak governance. It might be significant that the most successful transition economies, such as Hungary, Poland and Slovenia, did not progress as quickly with LSP as Russia, for example. In this latter case power had become concentrated in a wealthy elite before much progress had been made on institutional reforms; these 'oligarchs' were then able to obstruct and

manipulate policy to their advantage, which sometimes was not favourable to general welfare.

3) Restructuring is enhanced by greater progress in the banking sector. The most likely explanation is that when the banks start to provide credit to industry, it is easier for the government to withdraw from the provision of credit. So, to successfully restructure enterprises, it is essential that bank regulation is of advanced market-economy standards, for example with regard to deposit insurance and capital adequacy, to increase funds available for lending. More difficult to achieve though is increasing the supply of loans to industry. The further withdrawal of the state from allocation and reductions in rents earned by speculation (for example in financing trade) should assist this, particularly now that inflation has stabilised. Advances on competition policy (COM) appear to require progress on restructuring, so that improving the performance of banks should also have the indirect benefit of easing progress on COM.

4) Liberalising the trade and exchange rate regime (TRA) enhanced the transition in banking. This could be explained either by reduced rents from funding trade as the regime is liberalised, forcing banks to change their behaviour, and/or competition from foreign banks who first enter the market to support trade. Progress on TRA also enhances SSP, most likely because diminished rents in trade enables small businesses to enter into foreign trade.

5) Relaxing the fiscal constraint appears to stimulate trade reform and large-scale privatisation as the government has less need for revenue from trade or state-owned enterprises. This effect is more pronounced in the former Soviet sub-set in which tax collection is notoriously poor so that the governments rely more on revenue from trade and from state-owned enterprises.

6) The accession negotiations advanced reforms of banking and competition policy. This is largely because, with the exceptions of Romania and Bulgaria, other reforms were almost complete by the time accession negotiations began. The candidates were more likely than non-candidates to advance restructuring and securities in advance of the negotiations. This could have been to show commitment to EU policies. The relatively small economic size and proximity to developed markets may have encouraged the candidates to reform their trade regimes regardless of any desire to accede to the EU.

7) The desire to accede to the EU appears to have anchored the transition as policy reversals have been rare and slight, in contrast to other transition countries.

8) It also appears that the delay to the accession of Bulgaria and Romania has encouraged them to deepen their reforms, starting with enhancing their efforts on small-scale privatisation. Finally, the poor assessment of Slovak democracy in 1997 seemed to encourage changes that enabled Slovakia to qualify for accession.

Did the accession process influence the growth of exports over the transition?

In the communist era the states of Central Europe, the Baltics and the Balkans generally traded less than would have been expected for economies of their size; this was even more evident in trade between the communist economies and developed countries. With the opening up of trade there should have been a catch-up process of export growth as the trade-to-GDP ratio converged to more typical values. Following the demise of the Council for Mutual Economic Assistance (CMEA), which had coordinated trade between communist countries, the rate of catch up would depend upon reforms over the transition, such as of the trade regime; and other reforms required to permit greater openness (such as price liberalisation) and to encourage and enable firms to successfully enter markets with which they had until recently engaged very little (such as privatisation, restructuring and bank reform). In addition, in the communist era there had been a tendency to overvalue the domestic currency relative to the currencies of more developed countries. Generally, the countries started transition by devaluing the currency, often excessively, which exacerbated inflation in the early years of the transition. Barlow (2004b/EPRIEE-02) econometrically examines the growth of exports from the CEECs, Balkan and Baltic states. He finds:

1) The preferred equation has little explanatory power in the later transition period, implying that the model generally applies to the early transition (points 2-6 refer to this period).

2) Export growth is negatively correlated to the lag of the ratio of exports to GDP. This is taken to be a catch-up effect as it indicates faster export growth for the countries that were under-exporting the most.

3) A significant effect of trade reform could not be established; in part this could be due to the lack of variation in this variable within the set of countries studied, which, due to their small economic size, generally liberalised trade and exchange soon after the start of transition.

4) Significant positive roles were detected for large-scale privatisation, restructuring and bank reform, all of which combine to indicate the importance of the hardening of budget constraints to encourage successful export performance.

5) The accession process appears to have generally raised the growth rate of exports for the candidates. It is curious that the accession effect is not significant in the period that includes the Europe Agreements. One possibility is that the export catch-up process was in the later period raising the growth rate of the exports of the three non-accession countries to similar levels to those predicted for the accession countries. For these three countries, catch-up export growth could have been stronger in the later period than it was in the accession countries because conflict had delayed reform and the gaining of improved access to the EU market.

6) Export growth is positively related to inflation (price level measured in dollars). This could be due to export growth coinciding with improvements in quality. However, in the light of conclusion 7 below, it is more likely indicative of the importance of undervaluation of the currencies for kick-starting exports. If export growth and inflation are positively correlated with undervaluation, then export growth and inflation could be positively associated but this will not be a causal relationship. Alternatively, there could have been a causal positive relationship if inflation, by eroding the protection of the domestic market provided by undervaluation, encouraged the movement into exporting.

7) From 1998 the correlation between export growth and inflation was negative, implying that the under-valuation of the currencies had been eroded by inflation so that exports were now demand-constrained.

8) The absence of any evidence that reform significantly influenced exports in the later period is most likely due to the lack of variation in the reform indices in this period, mainly due to reforms in many countries being close to completion.

2. Economic Integration and Reforms in South East Europe

2.1. The Case for a Free Trade Area in South East Europe

The literature review by Barlow (2004c/EPRIEE-03) suggests the following benefits would arise from a regional free trade area.

1) By promoting intra-Balkan trade, the economic fragmentation of the region should be reduced, which will enact regional multipliers and stimulate FDI. The

latter effect is important because the small size of the individual national markets could be a major obstacle to inward investment to the region.

2) Such an agreement should reduce conflict by raising interdependence.

3) The agreement must encourage the active participation of Greece, a country which already has a key role in the area, and seek a range of agreements with the EU to accommodate the varying relationships between the EU and the countries of the region.

4) A major advantage of stimulating Balkan integration more than integration into the EU is that the change to the new regime should be less stressful in terms of economic adjustment and political accommodation. In a region in which economic crises have been manipulated by nationalistic leaders (for example, former Yugoslavia) this might be an important issue. However, it is important to recognise that future prosperity depends upon changing the existing structures and so the agreements implemented with the EU must not offer the prospect of long-term protection.

5) The EU and other international organisations must rationalise their programmes in the region not only to target financial support but also to make clear that regional economic integration must proceed alongside integration into EU structures.

6) A major constraint on the region is the gap between the legal system and legal order, in other words the failure to achieve the rule of law. In addition there appears to be gaps between written law and actual law.

2.2. The Need for Reforms and the Role of State Capture in Transition Economies

What can be done to move captured economies out of their under-reform trap?

Overall the picture gives a fundamental message: in order to boost integration, both with the EU and within the region, and reap its fruits in terms of prosperity and economic growth, reforms need to be accelerated in the area. This is the major medium-term challenge for the governments of these countries together with the EU and the international financial institutions (IFIs). But why have reforms been so slow? According to the latest Annual Report on the Stabilisation and Association Process for South East Europe (European Commission, 2004a) the main reason is attributable to the continuing prevalence of organised crime and corruption in the region, which has the effects of

delaying political reform, holding back economic development and putting into question the rule of law. Along the same line of reasoning, Barlow & Buckley (2004/EPRIEE-06) empirically investigate the relationship between state capture and the progress of reforms in SEE and other transition economies. They find:

1) Reform should progress comprehensively, even while being sequenced, to avoid state capture, as once corruption or state capture takes place this can become a stable equilibrium and economies can fall into an '*under reform trap*'. Where this occurs, it is *crucial that reform momentum is re-initiated*. Failure to do so would lead to further corruption and a growing underground economy, inequality and poor economic performance, such that economies may find themselves in a worse situation than when transition began. The challenge is then to design a reform package that will not only kick-start reform, but also ensure that a strong reform momentum is established.

2) Reducing the services that the captured state can provide to the captors is clearly a part of the strategy. This includes not only advancing restructuring and *bank reform*, but also it might be necessary to take *price liberalisation* further than less-captured economies have so far. Achieving these in the presence of state capture is unlikely to be easy as captors and the captured are likely to put up strong resistance. Conversely, the beneficiaries are spread thinly and the individual gains might not be sufficient for them to be motivated to support sufficiently strong action.

3) An alternative strategy of co-opting some captors and captured into cooperating with change might give rise to future problems, and is a far from ideal strategy in immature democracies.

4) The origins of state capture might be related to the conditions at the start of transition and the *nature of the new democracies* and the *political elites* that emerged following the downfall of communism. It follows that it might be necessary to review the nature of the political elite, and electoral and judicial procedures.

5) The EU has enlarged to include two significantly captive states (i.e. Latvia and Slovakia) and will add at least two more in 2007 (i.e. Bulgaria and Romania). It is not clear that the accession process has impacted upon state capture. It is also not clear what the implications of state capture are for the performance of these states within the EU or for the performance of the single market. One concern could be the emergence of capture of the institutions required for the

application of mutual recognition of product standards and for the regulation of the markets in financial services.

2.3. Creating a Strong Export-Base: The Role of Firms' Clustering

SEE countries stand to gain most from an export-led growth in view of their increasing integration with the EU. However, the export ability of SEE countries could be jeopardised by their productive structure that is largely based on SMEs, which, due to their limited size, may face obstacles to gain access to international markets. The historical experience of SMEs in Italy suggests that by forming industrial clusters the export performance of SEE could be improved. De Arcangelis, Ferri & Padoan (2004/EPRIEE-16) simulate the potential improvement in the exports of Bulgaria, Romania and Slovenia from a similar pattern of clustering to that of Italy. They find:

1) The results show that the gain in terms of export growth ranges between 2-3% and 9-11% over a five-year period.

2) In our view, this evidence indicates that SEE countries stand to reap substantial benefits by favouring SME clustering. To be sure, as noticed, such an evolution is already in progress, as SME industrial clusters from the EU (and particularly from Italy) are outsourcing their high labour-intensive stages of production to relatively low cost-of-labour SEE. The results suggest that SEE countries will substantially gain if they will be able to accelerate this process. Indeed, it appears in the interest of SEE countries to introduce specific incentives to effectively boost the dissemination of SME clusters in order to take full advantage of their trade integration with the EU.

2.4. Creating an FDI-Friendly Environment

The importance of FDI for SEE economies is amplified by rather low domestic capital accumulation. This is mostly due to a low level of domestic savings associated with *a weak banking sector*. This is a further area where public policy intervention is warranted. Due to weak regulation and supervision, banks operate a very inefficient form of banking relationship limiting competition in the sector. The problem is not lack of financial laws and regulations but their enforcement. Furthermore the risky investment grade has restricted access to international financial markets, especially for some former Yugoslav states. As in most growing economies around the globe, the SEE countries offer many opportunities to profitable investments. However, these countries need to tackle the persistent barriers and problems that actual and potential enterprises face in conducting

their business. In this part of the chapter we stressed the importance of flexible labour market institutions for investment attraction.

Does strict employment protection deter FDI?

Radulescu & Robson (2004b/EPRIEE-08) econometrically investigate the relationship between strict employment protection and FDI inflows for a sample of OECD countries. They find:

1) Strict employment protection legislation has a strong negative effect on inflows of foreign direct investment. The study also finds significant effects for the level and growth of real GDP and real exchange rate depreciation. Insignificant effects are found for the corporate tax burden, openness, the productivity-adjusted real wage and the host country unemployment rate.

2) An additional message of considerable interest for the SEE area is given by the finding that market size (measured by the level of GDP) has an important influence on the attractiveness of a country as a location for FDI. If the aim of governments in the SEE region is to benefit from the potential effects of sustained and large FDI inflows, more economic integration between neighbouring SEE countries is a necessary pre-condition.

The Role of Trade Union Strength and Wage Bargaining Arrangements in FDI Attraction

The second paper by Radulescu and Robson (2004a/EPRIEE-07) represents an important addition to the scarce empirical evidence on the effects of trade unions and wage bargaining structures on the location of foreign direct investment. To investigate this issue, the authors undertake an econometric analysis of foreign direct investment flows using panel data on 20 OECD countries. The study finds:

1) Negative effects of trade union density and the degree of wage bargaining co-ordination on the level of inflows of foreign direct investment into an economy. These results are therefore supportive of the conventional wisdom on the effects of trade unions on foreign direct investment. The effects indicate that a 10 % decline in the level of trade union density may be expected to lead to an increase in real inflows of FDI of around 3.4 %; slightly more than the impact of a 10 % increase in real per capita GDP.

2) Another relevant finding of the study is the fact that the presence of more pervasive extension practices helps to dilute the negative effect of trade union density on inflows of FDI. The authors argue that in the presence of pervasive

extension practices, trade unions may take greater cognisance of the employment effects of their actions and thus be more inclined to moderate their wage claims, thereby presenting less of a deterrent to potential multinational investment.

3) The current situation in the SEE countries with respect to labour market flexibility is rather mixed. Although the group seems to have on average a more rigid labour market with respect to CEECs according to a set of indexes calculated each year by the World Bank, striking differences emerge when looking at single countries in the area. Romania seems to have the most rigid labour market, in particular for what concerns the difficulty of hiring and firing. Also Croatia and Bosnia-Herzegovina show a similar pattern although on a smaller scale. Rather low values of the indexes, corresponding to more flexible labour market regulations, are observed in other SEE countries, particularly in Serbia and Montenegro. While in 2003, Croatia together with other new EU members (Hungary, Latvia, Poland and Slovakia) introduced more flexible employment regulation, Albania and Romania passed more restrictive ones. In Albania the flexibility of working hours was reduced, payment for work during weekends doubled and fixed-term contracts were allowed only for temporary jobs. In Romania the premium for overtime work was increased from 50 to 75% and term contracts can now be used only for exceptional needs, making their use unlikely.

4) The challenge ahead for the SEE countries will be that of improving the flexibility of the employment law while guaranteeing fundamental workers' rights. Given the high unemployment rates in the area, reforms and deregulation aimed at increasing the flexibility of the labour market will bring a substantial pay-off in terms of job creation.

5) In all, while it may be true that much of the fragmentation of production outsourcing from the EU to Eastern Europe may have been attracted there by low labour costs, the situation might change in the future. If they want to maintain one of their chief FDI attracting factors, SEE governments should avoid allowing excessive employment protection.

2.5. The Challenges of Migration

The importance of the SEE countries for EU immigration policy does not stem only from their role as sending countries but is also due to the importance of the area as a 'bridge to Europe' for other nationals, in particular Slovenia and Albania. A closer cooperation in border controls is under way with these countries. Chiuri, De Arcangelis, Chiuri & Ferri (2004/EPRIEE-15) investigate illegal migrants to Italy by surveys; they find:

1) On average the illegal migrant is about 27 years old and the distribution is highly concentrated in the first class, 18-30 years (for three quarters of the sample) and another 15 % of them are between 31 and 35 years old. As for the total sample, these individuals are mainly male (70%) but the share of female for SEE countries is substantially larger that the rest of the sample (30 against 11%).

2) The average monthly income in the country of origin is slightly below $200. Most of the interviewees stated to be literate (96.9 %), and the authors also find a relatively high level of schooling: almost 39% of the sample interviewed spent more than 9 years at school, some achieving high school and in few cases (3 %) a first degree.

3) With respect to the full sample, migrants from SEE countries seem to have a lower educational level. This result is not surprising: the act of migration implies a great deal of both human (i.e. ability to gather and elaborate information) and financial resources. Therefore, as abundant literature has demonstrated, migration is usually selective towards the individuals with higher abilities. Other things being equal, migration from a closer country is less costly and therefore feasible also for individuals with low levels of ability. Most of the individuals were expecting to get a job in relatively low-skills occupations (carpenter 27.1%; cleaner 23.3%; mechanic 8.5%; farmer 6.2%) and earn a monthly income between $500 and $1,000 (72% of the interviewed).

4) The importance of migration for development in these countries is evident when considering the propensity to remit part of the expected earnings: approximately 80% of the interviewees claim that sending remittances back home is really important. One third of the migrants expected to send between the 40 and 60% of the earned income and for another 20% of the respondents, the percentage is even higher. It is important to underline that individuals

whose country/city/village of origin experienced a social, political or economic crises have a substantially lower propensity to remit.

5) The majority of the illegal migrants from SEE countries expect to return home (64.5%, a share slightly higher than that of the whole sample which is 58.4%). The percentage is higher for Croatia, Bulgaria and Serbia (100%) and Albania (72%); it is below the average for all the other SEE countries.

6) Lack of finance seems to be the major motivation for potential migrants to shelve migration, while 20% of the respondents said that potential migrants will migrate in the future. This finding suggests that we should probably expect increasing migration as income in SEE countries increase. The establishment of migration networks and remittance flows might be an important channel for financing further migration in the near future. As a country grows, migration flows usually show an inverse U-shaped behaviour: i) at the initial stage the country is too poor to finance migration; ii) once financial constraints are eased and migration takes place, the process is self-reinforcing and out-migration flows increase; and iii) this process continues up to a point where growth and economic prospects in the country of origin offset the initial push and pull factors that triggered migration and then migration outflows start to decline. While out-migration flows are still considerable in most SEE countries, it is likely that, for some of them, the peak has already been reached. Further progress in the EU-SEE economic and institutional integration may contribute to speed up the decline of these flows.

Crisis in the Country of Origin and Illegal Immigration into Europe via Italy

The contribution by Chiuri, De Arcangelis & Ferri (2004/EPRIEE-15) analyses the hypothesis that economic, financial and political crises hitting the countries of origin may generate impulses augmenting migratory inflows into the European Union. Obviously, originating from the crisis momentum, the inflows mostly consist of illegal aliens rather than regular migrants. To this end, data on apprehensions of illegal migrants in Italy (the main country of entry for illegal aliens to the EU) are used to show econometric support for the outlined hypothesis. The paper examines illegal immigrants rather than legal ones for two reasons: firstly, because the majority of immigrants entering Italy are only in transit towards destinations in other EU countries; secondly, because consideration of illegal rather than legal immigrants purges the analysis of the distortions that would otherwise arise from the amnesties granted in the past decade. Analysis is conducted of the period 1990-2000, which comprises various crises that have erupted in the

Mediterranean basin (e.g. in the area inhabited by the Kurdish people) and in the Balkans (e.g. the conflicts in the former Yugoslavia or the crises in Albania).

1) Crises in home countries significantly amplify illegal immigration into (or through) Italy. For example, when a country moves from what the ICRG Risk Rating System calls a situation of 'moderate risk' to one of 'very high risk', as Albania did in 1990-92, its share of illegal immigrants entering Italy increases by around one percentage point. In other words, a crisis of the type experienced by Albania would increase the number of clandestine Albanians by around 1,000 units per year, implying a much larger impact on the 'true' number of illegal immigrants from Albania, given that the proxy used to measure illegal inflows (expulsion orders vis-à-vis apprehended clandestines) underestimates the phenomenon (only a small fraction of the clandestines are effectively apprehended).

2) These results have clear (international) policy implications: the costs of intervening to alleviate severe crises in the countries of origin should be weighed according to their ability to limit socially undesirable mass migrations towards the European Union.

3) In a Union more and more concerned about controlling its borders, these side-effects of a politically stable and economically solid SEE area are of considerable importance.

3. Economic Impact of CEEC Enlargement on EU

3.1. Quality Standards

There is a widespread belief among economists and policy-makers that, while formal trade barriers may have been reduced greatly in recent years, there may be growing barriers – whether intentional or unintentional – resulting from the imposition by nation states and by international blocs of technical regulations on product safety, labelling, environmental emissions, hygiene and the like. It is increasingly suggested that these barriers may be being manipulated by national authorities as an alternative, and potentially costly, way of discriminating against import suppliers in favour of their domestic industries, and that trade rules need tightening to reduce such protectionism.

Looking at this from an economic angle, the case appears that there may be much hidden protection embodied in national standards and regulations. There have also been strong arguments in support of the idea that the simplest way to reduce such 'regulatory protection' barriers is by introducing mutual recognition accords, where a group of

countries agree that, if goods are judged satisfactory for sale by the authorities in their country of origin, all countries would treat them as acceptable. This mutual recognition principle effectively underlies much of the legislation underpinning the European Union's Single Market and the Asia Pacific Economic Community.

Edwards (EPRIEE-12) looks at what happens when different countries have technological differences. In this case, it has often been argued that since there is imperfect competition suppliers can make profits on all goods sold, governments have a strong incentive to introduce regulations which increase their home firms' share of the local market at the expense of foreigners. This is called 'profit-shifting', and can lead to protectionism. While there is some validity in this argument, this paper makes some contrary points ignored in the existing literature:

1) There is little incentive to use regulatory protection, if other, less costly methods of protection like tariffs are available to policy-makers.

2) The analysis shows that in the absence of a mutual recognition agreement, policy-makers have a strong incentive to force up producers' quality standards, benefiting consumers at the expense of producers. This may well leave profit margins much lower than previous studies have estimated, and as a result the incentives to introduce protectionist barriers for profit-shifting motives are greatly reduced, or even totally eliminated.

3) Therefore, while there is indeed a problem of policy biases in setting quality standards on traded goods, this may well not take the form of protectionism. To assume that such policies may interfere with trade, to the extent that they should be dictated by international trade bodies (rather than by other forms of international negotiation), may result in excessive interference in countries' internal policies. Even the current consensus in favour of mutual recognition agreements may be misplaced in some circumstances.

4) With regard to the impact of the accession of the new member states to the EU-15, one assumes that the setting of quality standards inhibits new member states from delivering products into the common market. Therefore, these measures are being seen as barriers to trade and have a positive effect on the EU-15. By receiving little competition from the new member states, their exports to the new member states remain intact.

3.2. Voting Decisions in the Agricultural Sector

Agriculture still plays an important role in both set of countries, the EU-15 and the CEEC-10. Changes in the political arena in all East European countries and the globalisation and liberalisation of international markets have all contributed to the creation of a new framework for reforming the CAP. The proposed reforms and their structures have been introduced through the Agenda 2000, which aimed simultaneously to reform the CAP, the EU budget and regional policy. The reformed package has been based upon two major requirements: first of all the preparation of the EU for the accession of new members from East and Central European countries and second the need to facilitate the EU negotiating position in the ongoing round of the WTO. All this is envisaged to lead to an ever more liberal CAP and it would induce major developments concerning issues like competitiveness of agricultural production, income and finance.

Of particular interest with regard to the impact of an enlarged Union on the EU-15 agricultural sector is how the new member states would vote on both a future CAP reform as well as within the EU's single voice in WTO negotiations. Both of these scenarios may have significant consequences for the EU-15, because it could potentially slow or block future CAP reform progress and/or make the EU less progressive in the WTO negotiations on reforms. But then again, the opposite effect could emerge. Schneider (EPRIEE-23) argues:

1) As for the CAP, it is anticipated that the new member states would show a tendency to veto any radical reform changes. This would be purely out of self-interest and to gain some benefits from the currently enjoyed payments into their sector. A similar behaviour was observed in the case of Finland, because despite being a pro-reform country, it vetoed the Agenda 2000 in order to benefit longer from the CAP and to reach out to the largely rural population.

2) Because none of the new member states has a well-functioning and supportive agricultural policy, this may also add to the case that they will become anti-reformer. This means that their farming constituency for the first time receives farm support payments, which are likely to be welcomed and hence it may be difficult to vote against them. Even though the CAP budget for the new member states is smaller than that of the EU-15, it will be aligned by 2013, the net inflow of payments and in particular for the second pillar, will certainly act as an anti-reformer element.

3) The picture regarding the new member states' influence on the EU-15 towards WTO negotiations is seen as completely different. Because many of these

countries did not have a supported agricultural sector, it is anticipated that most countries would vote for greater agricultural trade liberalisation. This is further explained by the fact, that, for instance, Hungary used to be a member of the Cairns Group of countries promoting freer trade with no or very limited support.

4) Therefore we may conclude that the impact of the enlargement will affect the agricultural sector. As for the domestic issues, a future CAP reform is anticipated to be more difficult to achieve. Countries will act on self-interest and try to optimise their gains from the CAP. In contrast, the new member states might give the EU a greater mandate to further trade liberalisation in WTO talks.

3.3. Mutual Recognition and Home Bias

This looks at barriers to trade and the level of integration between the EU and the Central and Eastern European countries. More specifically, it analyses the issue of border effects in the enlarged EU. The objective of the chapter is to examine whether technical barriers to trade influence border effects and to estimate the magnitude of the border effects in CEECs' trade with the EU.

In their paper, Manchin & Pinna (EPRIEE-25) look at the issue of border effects by investigating imports of five accession countries differing in size and other characteristics (Hungary, Poland, Romania, Latvia and Cyprus). The paper examined whether border effects are related to technical barriers to trade. Products were grouped into different categories, according to the approach applied by the EU to remove technical barriers to trade which provided us with a proxy for the magnitude of technical barriers by products. To avoid inflated border effects, a weighted measure of distance was used both for cross-countries and internal distances in the gravity model.

1) All accession countries included in our estimation trade with themselves more than with other countries in manufacturing products, and the home bias is higher than in the case of EU countries.

2) Products were grouped into three categories regarding the approach to technical barriers: old approach, new approach (including mutual recognition, new approach), and mixed approach (which includes products where old approach and another approach is applicable). The results suggest that the border effects are the largest for old approach products, where we expect to have the most important technical barriers due to complicated harmonisation procedures. The 'new approach' category has the smallest border effects, while the 'mixed approach' products are in between the two previous categories.

3) When considering country-specific border effects, Hungary had the highest border effects, followed by Bulgaria, Poland and Latvia. Border effects are somewhat mitigated for EU partner countries, but not for other accession countries. This might be also the result of the foreign direct investment by EU firms in accession countries which was significant during this period in sectors where technical barriers to trade were important. Much of this investment probably led to production consistent with EU standards.

4) The magnitude of the estimated border effects seems to be too large to be consistent only with the presence of trade barriers. In this paper we did not aim to explain fully what causes this high estimate for border effects; rather we tried to see whether we could observe some difference in the importance of border effects in trade in products with different magnitude of technical barriers. Thus what we could conclude from our results is that there are larger and more persistent border effects for sectors where technical regulations constitute major barriers to trade. However, border effects, although to a lesser extent, are also significant for products where technical regulations are less cumbersome.

5) Interestingly, this result is different from other findings which found higher levels of border effects for sectors where technical regulations did not constitute major barriers to trade. These different results might indicate that in the EU's imports to the CEECs technical barriers matter more than in the intra-EU trade, where there are other, more important factors contributing to the border effects. Furthermore, the presence of border effects in sectors where technical regulations are less important can also be explained by other factors, such as rules of origin, spatial distribution of production, the presence of social and business networks, consumer or firm preferences and for our estimation also by tariffs. Although tariffs were gradually dismantled during the period, we did not find a significant reduction of border effects over time.

6) Our results suggest that the estimated level of border effects is partly due to policy-related constraints; thus there is an important role for policy-makers to remove these barriers. The level of trade of accession countries is substantially lower than what would arise in the absence of border effects, which is much more pronounced in trade with other accession countries than in the trade of accession countries with the EU. Certainly the border effects are present not only due to policy-related constraints, but the larger border effects for products with higher technical barriers to trade suggest that an important part of the

border effects in the case of the accession countries could be eliminated by removal of such barriers.

4. Disintegration, Restructuring and Reorientation

4.1. Lessons from the Disintegration/Fragmentation Experiences

Barlow & Radulescu (EPRIEE-05) examine the disintegration of the Soviet economic bloc in the context of the strand of literature that views economic unions as sharing public goods. They argue that:

1) There is a huge disparity in the effects of disintegration and economic reform upon the various countries concerned, so generalisations regarding the transition process need to be treated with a good deal of caution.

2) EU institutions are generally supportive of further integration. Crucially the Single European Market places limits on the ability of countries to restrict trade, and for 12 of the 15 members, the single currency supplements this. The biggest threat to the integrity of the Single Market could be a consequence of enlargement. Whilst acceptance of the *acquis communautaire* should help restrict the behaviour of the new members, it might turn out that the poorer countries of Eastern Europe are unable to uphold the rules of the single market, particularly with regard to standards and the regulation of services. A further issue in a bigger more heterogeneous Union, particularly one with many more small members, will be voting rules. The smaller members may be able to form an effective coalition to influence the development of the union in their favour. The voting rules must be amended to prevent small states gaining a disproportionate influence.

3) Enlargement could place huge stress on the EU. It is possible that some members might feel that the larger EU is not to their advantage. There are a number of means by which dissatisfied members could exert pressure on the Union. They could refuse to make contributions to the budget, or refuse to abide by the Stability and Growth Pact (SGP), or fail to obey the rules of the single market. Infringements of any of these could result in retaliation and provoke a spiral of disintegration akin to that observed in the USSR. The EU requires a means to resolve such disputes.

4) The CAP could prove to be a most divisive issue, given the cost of the policy and that there can be little justification for the way in which the CAP redistributes wealth.

5) The Stability and Growth Pact might yet prove to be the biggest source of conflict. The budget deficit limit might prove onerous for countries struggling with recession. If significant deviations from the rules are repeatedly tolerated, then the whole pact could become difficult to maintain, with a consequent rise in eurozone interest rates.

6) Analysis of the disintegration of the communist systems suggests that disintegration is most likely when the economy is weak. Thus, we should expect any pressure to leave the EU to occur in a time of recession. Due to both size and location, a crucial issue is likely to be the strength of the German economy. Whilst it does not economically dominate the EU in the way, the USSR dominated the CMEA; after enlargement the significance of the German economy will increase. The greatest strains on the EU might be via Germany. In a struggling Germany pressure might build up to restrict imports from the former communist states, particularly if interest rate decisions and the Stability and Growth Pact appear to be hindering a German recovery.

7) Disagreement over transfers through the EU budget might be limited by the small-scale of these transfers, though similarly small transfers proved to be an issue in Yugoslavia and the UK remains very defensive over the rebate it receives from the EU. However, the small-scale of the transfers presents a problem within the eurozone. Given the low level of international labour mobility within the EU, asymmetric shocks should be met by fiscal accommodation. But the Stability and Growth Pact limits the extent of fiscal expansion. The EU budget is insufficient to accommodate such shocks in the way that the Federal authorities in the US can. The demise of budgetary transfers is part of the reason why a single currency was not desirable for the former Soviet Union (FSU), but the issue of such transfers was also part of the reason for the break-up of Czechoslavakia and the USSR. A problem in both cases appears to have been poor institutional design. Any system of transfers should have clear objectives and should be transparent. The current system of transfers within the EU meets these criteria and should be applied to any additional system of transfers. Finally, it is important to remember that the systems of transfers became an issue either in times of economic hardship (USSR and Yugoslavia) or at a time of radical change. Whilst such extensive radical change is unlikely to apply to the current EU members, it might yet apply to some of the candidates, but since they are unlikely to join the eurozone for some time, this issue should not influence any debate about extending the EU budget. With regard to times

of hardship, it is important to remember that the purpose of such transfers would be to prevent such problems.

4.2. Lessons from the Analysis of the Restructuring Process

Edwards (EPRIEE-11) argues:

1) Labour mobility has generally been good across the former Soviet economies, and structural unemployment has been less than might have been expected given the very severe post-Soviet recessions.

2) Official estimates of GDP declines following the Soviet break-up are probably misleading as regards overall income. A high proportion of Soviet-era industry was highly inefficient, and indeed its products were often of little or no value. Scrapping of wasteful capacity (or at least the decision not to renew it when it falls down) means lower costs in terms of depreciation. Capital invested abroad may yield an income. Other measures of national income may well have risen even where GDP has fallen.

3) Against this, however, workers' income may be more closely correlated to GDP, since this is a measure of domestic economic activity. Where GDP has fallen but the inheritors of privatised industry (e.g. the Soviet oligarchs) have invested heavily abroad, the results are likely to be huge increases in inequality, with important social consequences.

4) The adverse effects of restructuring for wage-earners will be reversed where:

   The decline is concentrated in capital-intensive industries only. The privatisation programme is highly equitable. There are high rates of firm start-up and/or inward investment.

5) Adverse effects on wage-earners are worse where several of the following simultaneously occur:

   There is poor labour mobility between industries or regions. There is a high degree of monopoly in existing industries. Import competition to monopolists is limited. The business climate does not favour new firm start-ups. The gains from privatisation are highly concentrated. AND it is easy to export capital.

This is practically a description of the economic conditions of Yeltsin and Putin-era Russia. In these circumstances, rapid outflows of capital (reflected in large trade surpluses) contributed greatly to the impoverishment of wage-earners. European neighbours should

not be surprised if political pressures lead to interventionist policies to claw back privatisation gains and halt capital outflows.

4.3. Lessons from Analysis of the Reorientation Process

Edwards (EPRIEE-13) argues:

1) Where exports have grown fastest (notably the Baltic states) they have been driven by outsourcing and inward investment, and highly concentrated by industry and destination country. This reflects the importance of informational capital in developing exports.

2) There are likely strong gains from exporting which are external to the firm, in that the development of one set of export ties helps establish more such ties.

3) The development of trade in differentiated goods involves investment in informational capital by both exporters and importers.

4) Where a country seeks to find new export markets, it may need to accept a temporary fall in its terms of trade. The highly competitive exchange rates of the Baltic states following the Soviet break-up illustrate this. In general, one would expect the relative price level in accession states to the EU to rise gradually as their export relationships mature. This could well produce a source of instability in the case of early accession to the eurozone.

5) As countries' trade ties mature, one would expect trade price elasticities to fall. Applying this to optimal tariff theory may well suggest that longstanding members of a trade bloc will be more protectionist in their instincts than newer members.

II. BACKGROUND AND OBJECTIVES OF THE PROJECT

The overall theme was how to maintain a viable and stable Union, while incorporating into the EU a number of new members greatly different to the incumbents in terms of recent history, political relations and economic development. To this end the research was broken down into four core themes.

1) Economic effects of enlargement upon the new entrants using simulation modelling, data analysis, econometrics and case studies. The analysis takes account of the diversity of the entrants, their trade, size and reform efforts. How would the phasing of enlargement affect reform in these countries?

2) Effect of enlargement on the remaining countries of South East Europe (SEE), through foreign direct investment, trade and migration. Is greater integration within the region desirable as a stepping stone towards integration into the EU?

3) Effect of enlargement upon the relationship between the incumbents, and the institutional adjustments required to maintain a stable union.

4) The causes and costs of instability, fragmentation and institutional paralysis of economic blocs. Data, institutional analysis of historic bloc fragmentation, particularly the USSR and Yugoslavia, will be used to shed light on the appropriate reforms required for the wider EU to be stable and to avoid institutional paralysis or even fragmentation of the Union.

III. SCIENTIFIC DESCRIPTION OF PROJECT RESULTS AND METHODOLOGY

1. Objective 1: Impact of Enlargement on New Members

1.1. An Economic Assessment of the Accession of the CEECs to the EU Single Market

This section draws upon a numerical investigation, by Edwards (EPRIEE-09), assessing the possible benefits to the Central and Eastern European Countries (CEECs), and to existing EU members of enlargement of the European Union. For data reason, the enlargement considered is accession of Poland, Hungary and an Other CEEC region (Czech Republic, Slovakia, Slovenia, Romania, Bulgaria). The latter two were not included in the current accession round, but head the list of candidates for future enlargement.

From a trade perspective, much of the integration process has already taken place. The Europe Agreements of 1997 were very important in this regard, removing tariffs and quotas on all areas of trade between the EU and CEECs, excepting agriculture. The tariff reform that remains to be done for accession countries is therefore 1) removal of agricultural tariffs and 2) adoption of the Common External Tariff (CET) for trade with third countries outside the CEEC region.

Arguably more important, however, is the general accession of the CEECs to the EU's Single Market. This is a complicated series of agreements dealing with the huge raft of regulations and standards that countries impose on industry for means of health, safety and consumer protection. There is considerable disagreement as to the real significance of such regulations as barriers to trade. On the one hand, certain costs to importers, such as testing, certification and relabelling of goods, are fairly easy to establish: on average these probably account for an addition of between 1 and 2 per cent to the cost of imported goods into the European Union. However, a substantial school of thought suggests that regulations and standards may in practice be imposing far higher costs than this on companies engaging in trade by forcing them to alter the specifications of the goods they produce in order to enter new markets. Some economists, such as Wallner (1998) carry this argument further, and suggest that domestic health, safety, environmental and other regulations may be systematically distorted by countries for protectionist purposes. This is, however, controversial.

If we accept for the moment, however, the line that national regulations are impinging seriously upon international trade – whether or not this is being done for protectionist motives – then this suggests that international agreements on product standards are

central towards opening markets for trade and competition. This certainly was a motive for the institution of the Single Market by the European Union, which relies primarily upon mutual recognition agreement to remove perceived barriers to trade among EU member states.[1] Membership of the Single Market is potentially of particular value to the CEECs, as these are mostly small economies that have inherited relatively monopolistic industrial structures and that can potentially gain greatly from integration into a far more competitive single European market.

The issue addressed in this section is to quantify such potential benefits to the accession states, as well as the effect of entry upon existing EU members. This is done by means of a multi-country, multi-industry computable general equilibrium (CGE) simulation model. In this regard, Edwards follows in the footsteps of earlier studies by Baldwin, Francois and Portes (1997) and LeJour et al. (2001). However, the current model differs from the previous studies in a couple of respects. Firstly, unlike LeJour et al., the current study utilises an imperfectly competitive economic model, which potentially takes account of the role of trade in enhancing competition within the hitherto sheltered CEEC economies. Secondly, there is the issue of how the current regulatory barriers are estimated. As has already been explained, such barriers are not easy to quantify. Baldwin et al. simply applied an ad hoc assumption that an additional resource cost of 10 per cent was added to all goods traded between EU member and non-member countries, due to the need to comply with different regulatory standards. By contrast, LeJour et al. inferred the size of regulatory barriers by comparing actual trade with predicted trade using a gravity model. This is an ad hoc economic model that predicts how much two countries will trade with one another from the size of their economies and the distance between them (with a few other adjustments for tariffs or common membership of economic blocs). To the extent that trade between the EU and the CEECs in 1997 fell short of what the gravity model would predict, this was assumed to be 'explained' by unquantified regulatory barriers.

The approach in this paper is based on similar assumptions to LeJour et al. However, the general equilibrium model used here is somewhat more sophisticated, being based upon the variety goods approach of Dixit & Stiglitz (1978). It is assumed that a larger economy will be producing a greater variety of goods, and since consumers in all countries like variety it will, consequently, capture a larger share of export markets, other things being equal, than a smaller economy. This produces a very similar basic model to the gravity model, but which is directly derived on theory and can be calibrated

[1] Mutual recognition is an agreement by which country A agrees to accept without further testing any goods from country B which meet country B's domestic standards, in return for country B accepting all goods from country A which meet A's own regulatory standards. For the basic economic arguments underlying this, see Baldwin & Venables (1995).

directly from the same data set used for the general equilibrium simulations, once data for tariffs and transport costs and a few assumptions about production costs have been incorporated (see Appendix I of Edwards' paper). Like LeJour et al., Edwards finds that there is a considerable shortfall in trade at present between the EU and the accession states, and then he assumes that 1) this trade shortfall represents the effects of a real resource cost of regulatory differences and 2) this will be rectified once the countries join the Single Market. On these assumptions, the model simulations in this paper uphold the results of the two earlier studies: namely that accession to the Single Market could greatly boost trade between the EU and the CEECs, that this will lead to greater trade in both directions in many industries and that the effects of increased competition, as well as of better utilisation of comparative advantage, lead to sizeable welfare gains for the accession states, while having no measurable detrimental effect on existing EU economies.

The results of these simulations are summarised in Tables 7 to 11 of Edwards' paper. Aggregate trade volumes between the EU and accession states could potentially increase by 50-100 per cent, with Poland experiencing the largest increases. These trade volume increases are in both directions, although given the relatively small-scale of the CEECs compared to the existing EU, the significance is far greater for the former group. Table 9 shows output changes: light manufacturing grows by over 20 per cent following accession in Poland, Hungary and the Other CEEC region, while Hungarian heavy manufacturing also grows by over 20 per cent. Table 7 indicates that GDP is likely to increase in all regions of the CEECs and EU following accession, with the main effects coming from entry to the Single Market rather than harmonisation of tariffs. Polish GDP could gain by 20 per cent in this simulation, while Hungary and the Other CEECs gain somewhat less.

Table 10 indicates that CEEC accession is likely to lead to substantial upward pressure in prices in those regions (reflecting higher factor demand), while there is a small downward pressure on prices in the existing EU regions. All factor prices rise sharply in the accession countries (Table 11), while they fall slightly in the existing EU. The net result is a rise of perhaps 10-15 per cent in real wages in the accession countries, with little net change in the existing EU.

The overall picture painted by these simulations is a highly optimistic one for the accession countries, indicating large potential gains in trade and real incomes, at virtually no cost to the existing EU members. However, it is worth remembering that this model has been based upon an assumption that there are high regulatory barriers to trade before accession, and that these are reflected in real trading costs. These assumptions

may not be accurate, and consequently the figures in this paper may be regarded as painting a relatively optimistic picture of the potential gains from enlargement. A good deal of further work is required to examine in detail the real qualitative and quantitative nature of regulatory barriers to trade and the effects of the Single Market initiative: this is a subject to which economists have been slow to turn attention.

1.2. Sub-Regional Integration: The Importance of Networks and Clusters

1.2.1. Trade Blocs and the Development of Estonia's Foreign Trade

The three Baltic states, and Estonia in particular, have seen since 1992 one of the most dramatic realignments of trade ever witnessed. From being an integrated part of the Soviet Union as recently as 1992, in 2004 the Baltic states entered the European Union as the members with perhaps the lowest per capita incomes but by far the highest economic growth rates. At the same time the expansion of exports has been just as dramatic. Between 1991 and 1994, the volume of exports from Estonia increased by a factor of almost 8, and the volume of exports from Lithuania and Latvia increased by around 2.5. Rajasulu (EPRIEE-18) examines the nature of the expansion of Estonian trade.

Table 1 of Rajasalu's paper underlines the nature of this change. In 1991, Russia, Ukraine, Belarus and Kazakhstan accounted for 76 per cent of Estonia's export market. When the other two Baltic states and the smaller Soviet republics were added, over 90 per cent of Estonia's exports were to other parts of the Soviet Union. The change in that pattern reflects partly the effects of liberalisation of trade between Estonia and the West, but also the disintegration of the once tightly-integrated, planned Soviet economy, and the resulting disorganisation of former economic networks (Blanchard, 1997), as well as the effect of a trade war between Russia and the breakaway republics. By 1995 Finland had already overtaken Russia as Estonia's main export market, and that pattern has remained.

What the paper does not perhaps bring out is two linked effects. Firstly, the geographical shift in trade is paralleled by a huge shift in the industrial bias of Estonian production. In Soviet days, Estonia was specialised in food processing: today, wood products and telecommunications are growing rapidly in Estonian trade. Table 14 in the annex to Objective 1 comes from another paper by Rajasalu & Venesaar (EPRIEE-19). The second linked feature is that the growth of these industries is highly driven by outsourcing by Swedish and Finnish firms.

Economists' analysis of the geographical alignment of trade requires comparison with a counterfactual model of trade as it might be expected to be without the presence of political and other 'distortions'. This is the rationale behind the gravity model approach Rajasalu uses in this paper. Trade between two countries is expected to be larger the larger the two economies are in terms of GDP and the closer they are geographically. The latter effect reflects not just transport costs but also the ease of making and maintaining business connections. It is therefore sensible to start by estimating such a relationship econometrically. The issue then is which countries in reality appear to be trading more, and which countries appear to be trading less than the pure gravity model would suggest, and what factors are driving that. These differences are estimated by inserting dummy variables for countries or trade blocs into the equation estimated. Economists often assume that if a country's trade patterns differ greatly from what the pure gravity model would imply (i.e. the dummy variables are significant and large) then its trade is 'distorted' and it is likely to be suffering economic costs. However, this may be a simplistic assumption.

Rajasalu's article shows that in 1991 Estonia's trade was indeed very distorted compared to what a gravity model would indicate: effectively it was trading hugely more with the Soviet Union and less with everybody else than GDP and distance would suggest. However, this pattern changed extremely rapidly, with a rapid decline in the CIS dummy, and rapid growth in trade with the Baltic region (Sweden, Finland, Denmark, Poland, the other Baltics and Russia) and the European Union. It is worth noting that for Sweden, Finland and Denmark, both the EU and Baltic dummies apply, so if they are positive, there will be a joint effect leading to even bigger trade increases.

Perhaps the most interesting aspect of Estonia's trade since 1992, apart from the amazing speed of its reorientation, is the difference between the pattern of imports and exports. Estonia's imports now appear to be fairly evenly distributed from around the world, once account is taken of size of exporting economy and distance from Estonia. By contrast, its exports are remarkably concentrated geographically. EU membership is as yet not a particularly large influence on whether a country is an export market for Estonian produce: what particularly matters is membership of the Baltic region (especially Finland and Sweden). These countries took a proportion of Estonia's exports more than 7 times greater than would be predicted from size and proximity alone. While some additional effects would be expected in the case of Finland (due to close cultural and linguistic ties), much the same applies to Sweden, where the language is not close to Estonian.

It seems that different forces have driven the increases in Estonia's exports compared to its imports since 1992. Estonia's imports may well be variety driven, with Estonian customers appreciating the new availability of a selection of goods from Europe and around the world. By contrast, Estonia had to seek export markets very quickly, and it seems its economic and export recovery was driven by the very rapid growth of outsourcing for Swedish and Finnish firms.[2] Recent economic literature on outsourcing in trade suggests strongly that matching between partners is crucial, and that network effects tend to dominate such a trade (see e.g. the Journal of International Economics Symposium, June 1999). In that sense, speculatively, the rapid export growth of Estonian trade is due largely to its discovery as a potential outsourcing centre by Swedish and Finnish manufacturers, which then passed on their learning about Estonian producers and the Estonian economy to other Swedish and Finnish firms. While geography, transport connections, tourism and language may have helped trigger this effect, it is the rapid spread of specialist information on doing business in Estonia through Swedish and Finnish business networks which led to the growth of exports to those two markets in particular (though Estonian outsourced goods would be resold from Sweden and Finland across Europe). This geographical concentration may well be a key feature of outsourcing trade. It is also interesting that Sweden and Finland dominated inward investment into Estonia in the 1990s, as Figure 1 in Rajasalu & Venesaar indicates.

The study to date indicates little observable effect of European Union membership on a country's status as exporter or importer of goods to/from Estonia. This is despite Estonia's entry into the Europe Agreements in the late 1990s, which effectively removed all non-agricultural tariff and non-tariff barriers. Full entry to the EU will lead to removal of barriers to Estonia's agricultural exports: as the country was a major exporter of food products in its Soviet days, it will be interesting to see whether the decline of that sector since 1991 is reversed by EU entry. On the negative side, the common external tariff may well lead to more geographical concentration in Estonia's imports than at present, while some of the EU social legislation may affect its attractiveness as a destination for outsourcing. On the other hand, infrastructural investment from the EU is likely to help all the Baltic states considerably, and may well help spread the benefits of the inward investment/outsourcing boom from Tallinn to other parts of the Estonian economy.

In summary: Estonia and the other Baltic states suffered a huge jolt when they left the Soviet Union at the end of 1991, but have recovered remarkably quickly, with network

[2] The share of subcontracting is more visible in exports where the contribution of goods re-exported after processing in Estonia reached 42.8% of the total value of commodity exports in 2000 (Eesti Pank –Bank of Estonia – Bulletin No. 3, 2001).

effects precipitating their development as outsourcing sources for companies from the wealthier countries in the Baltic region. This has been linked to high rates of inward investment. There are strong parallels with the pattern of development Feenstra & Rauch (1999) and others have observed in some of the dynamic Far Eastern economies, whose growth rates the Baltic states have come close to matching in recent years. It will be interesting to see how the development of these countries spreads to other sectors, and whether other accession states in Central and Eastern Europe can achieve similar growth as outsourcing sources in the years to come.

1.2.2. Firms' Clustering and Polish Export Performance: Lessons from the Italian Experience

Like all transition economies, Poland stands to gain most from export-led growth. Unfortunately, though, the productive structure in this country is largely made up of small and medium enterprises (SMEs), which, due to their limited size, may face obstacles to gain access to international markets. A possible way out of the conundrum is for SMEs to cluster together and, by sharing the costs of internationalisation, jointly tap foreign markets. This approach has been at the heart of the successful export performance of SMEs clustered within Italy's industrial districts. De Arcangelis, Ferri & Padoan (EPRIEE-16) apply the methodology used in objective 2 to quantify the boosting effect due to firms' clustering on Polish export performance.

The results show that firms' clustering seems to have both a static and a dynamic effect on exports. On the static side, firms' clustering can significantly boost exports, but only in conjunction with other factors: they found that firms' clustering strengthens the domestic model of specialisation by affecting more intensely those sectors that already experience higher export growth. On the dynamic side, they show that firms' clustering has a positive marginal impact on export growth, equal approximately to 0.009% (per year) for each percentage point of sectoral workers employed in sectoral firms' clusters.

The authors designed different scenarios taking the Italian experience as a benchmark and obtained the estimated additional impact of firms' clustering on the (projected) benchmark export growth. The simulation results showed that the gain in terms of export growth ranges between 1% and 5% over a five-year period. In the authors' view, this evidence indicates that Poland stands to reap substantial benefits by favouring SME clustering. The results suggest that Poland will substantially gain if it is able to accelerate this process. Indeed, it appears in the interest of Poland to introduce specific incentives to effectively boost the dissemination of SME clusters in order to take full advantage of their trade integration with the EU.

1.3. Economic Integration and the Transition from Communism

1.3.1. Growth in Transition Economies: A Trade Integration Perspective

The economic transition from central planning to market economies involves large-scale economic reform simultaneously with (re-)integration into the world economy. In the Communist era not only was the market suppressed, trade was also, particularly with developed economies. Furthermore other cross-border economic activities were even more restricted. Reform should change the way the domestic economy functions and open up the economy to the outside world. With the collapse of both demand at home and trade links between the former communist states, integration into the world economy became essential.

Opening up trade to developed economies was seen as a way to rapidly remove the price distortions of the communist era. However, for an 'imported' price structure to have an effect on domestic production, domestic producers have to engage with competition. This goes further than simply reforming the trade regime. If domestic firms are protected by subsidies, price controls and soft credit, then even if the trade regime is relatively liberal domestic firms need not engage in competition with foreign producers. Thus external and internal reform must both be implemented if trade reform is to stimulate the economy.

In addition, significant economic distortions can be major obstacles to integration into the world economy. If the prices of goods and commodities are sufficiently below world prices, then export controls will be required to prevent goods from leaving the domestic market. To maintain prices significantly above world levels imports must be restricted. The alternative to maintaining prices that differ from world levels is to subsidise production. But such subsidies are costly and can create problems when negotiating trade deals. In the communist era price distortions and subsidies could be maintained because trade with market economies was suppressed whilst trade between the communist countries was organised by the Council for Mutual Economic Assistance (CMEA). Once the former communist countries undertook market reform there was little point in the CMEA continuing to exist, and it was officially dismantled in 1991.

The main focus of Barlow (EPRIEE-01) is upon trade reform because integration into the world economy is a critical aspect of transition. A survey by Berg & Krueger (2002) presents evidence that trade reform has enhanced growth in developing countries. Is this also true of the transition economies? Furthermore to what extent do other reforms enhance or counter the impact of trade reform on growth? This paper empirically analyses these issues.

This paper uses the EBRD's transition indicators to explore the relationship between GDP growth and the trade and exchange regime.[3] Other elements of the transition are regarded as internal reforms required to support the trade regime. For example, price liberalisation is required for exports to be liberalised. Initially the internal reforms – Small-Scale Privatisation (SSP); Large-Scale Privatisation (LSP); Restructuring (RES); Banking (BNK) and Price Liberalisation (PL)) – are aggregated into an overall index of internal reform. As the reform indices are highly collinear this aggregation should improve estimation. The index of foreign exchange and trade liberalisation index is preferred to an outcome-based measure such as ratio of trade to GDP to focus on the role of policy. The simplification of the transition into 2 indices allows for greater experimentation on the form of the relationship between growth and policy. In this case, it allows us to incorporate the possibility of non-linear relationships between growth and reform.

The scores for the foreign exchange and trade liberalisation index for the full set of transition economies are presented for 1995, 1997 and 2002 in Table 15 of the annex to objective 1. The table clearly shows that Belarus, Turkmenistan, Uzbekistan and until recently Serbia and Montenegro have barely engaged with integration/transition; for this reason Barlow excludes them from the analysis. The only countries to have achieved the maximum score in both 1997 and 2002 are all amongst the new EU members. But by 2002 the majority of countries had achieved the maximum. By 2002 Romania was the only EU candidate not to have achieved the maximum, yet other potential candidates (Albania, Croatia and FYR Macedonia) had achieved the maximum. The only reversals of trade liberalisation over this period are for Kazakhstan and Russia; in addition the score for Ukraine also fell temporarily between these periods. All of these appear to have been related to the Russian crisis of 1998.

For estimation Barlow controls for country-fixed effect, but these are replaced by region dummies for sub-sample estimation. Each estimated equation's robustness was tested in sub-sets of western (Central Europe, Baltic plus Balkan countries) and eastern transition economies and for the early and late transition (pre-1997 and post-1996). Growth of GDP at constant prices is regressed on inflation, a dummy variable for periods of conflict, one lag of internal and external reform, one lag of small-scale privatisation and a liberalisation shock variable.

Internal reform is not found to influence growth but small-scale privatisation does positively influence growth. When the sample is divided into early and late transition

[3] See Box 1 of the annex to objective 1 for descriptions of the indicators.

periods the effect of external reform greatly decreases. One possible explanation for this is that as external reform progresses its effect on growth declines. To allow for this the lag of external reform squared is added to the equation. The point estimates of the parameter on the square of external reform behaves in a way consistent with declining benefits from extra trade reform as the level of trade reform rises. These results, see Table 15 of the paper, imply that the benefits to growth from more trade reform are diminishing as reform increases. The impact of trade reform on growth reaches a maximum when external reform equals 3.2. According to the *Transition Report*, a trade and foreign exchange system score of 3 corresponds to "removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility." A score of 4 is achieved when all restrictions are removed and state involvement in trade is insignificant. Barlow's finding suggests that complete liberalisation of the trade regime is not (yet) desirable, which probably reflects some remaining inefficient industries and an inefficient agricultural sector that struggle to adapt to foreign competition.

The variable that accounts for the liberalisation shock follows from the work of Radulescu & Barlow (2002) who reported a negative effect on growth from increased price liberalisation. Such a variable probably picks up the shock as price distortions were removed. It is likely that such a shock was greatest when prices were most distorted, so the shock variable employed is the change in price liberalisation divided by the first lag of price liberalisation, denoted RELDLIPL. This variable was also found to only be significantly different from zero in the Eastern subset. In the western group we found the variable to have significant effect on the Baltic countries only. This suggests that in the estimation period price liberation was only disruptive to growth in the former USSR. For this reason we construct the variable $\mathbf{Shock}_{i,t}$ which equals RELDLIPL for the former USSR countries and zero otherwise. This variable performs well in both the Eastern and Western sub samples. The absence of a negative effect of price liberalisation in the non-FSU countries is probably due to a number of things. Firstly, much of the price liberalisation in these countries had taken place by the time our sample begins; in contrast price liberalisation in the Soviet Union was somewhat later. Secondly, in contrast to the non-FSU countries price liberalisation in the USSR was very chaotic. The Soviet republics used their right to choose the 'modalities of reform' to proceed with price liberalisation at different speeds (Bahry, 1991). Since they then shared a common economic space the result was that barriers were erected to prevent the flow of goods from the less liberalised republics to the more liberalised. This would have persisted until the collapse of the rouble zone effectively brought to an end the common economic space.

Other than small-scale liberalisation, Barlow found no direct influence of the level of internal reform on the rate of growth. There are a number of reasons why small-scale privatisation might dominate other internal reforms. Firstly, other authors report a strong role for newly established firms.[4] Secondly, a more extensive small-scale private sector by creating pro-reform constituencies might generate expectations of further reform and that reform will not be reversed.[5] The absence of any other internal reform should not be interpreted as evidence that internal reform is generally unimportant because internal reforms are required to be able to liberalise the trade regime. The price liberalisation shock can then be viewed as an unavoidable first step towards integration.

1.3.2. EU Candidacy Effect

So far no distinction has been made between the EU candidates and the non-candidates. However, it is possible that there have been growth benefits to the candidates (or possibly growth losses) that have not been received by the non-candidates. The only significant accession effect is found to occur on the square of external liberalisation, the revised preferred equation is reported in Table 2 of the paper.

The estimates suggest that the optimal extent of trade reform is greater for the accession candidates than for the non-candidates. For the candidates the influence of trade reform on growth reaches a peak at 3.66, but for the non-candidates the peak is at 2.67. This effect is most likely due to the EU strategy that reduced trade barriers in industrial products between the candidates and the EU initially through Association Agreements, and then enhanced by the Europe Agreements through an asymmetric process in which the EU lifted protection faster than the candidates were required to lift protection against the EU. This procedure allowed domestic industries in the candidate countries time in which to adapt to competitive pressure. Furthermore the accession partnerships by providing assistance with adapting to EU laws and regulations offered a clear path for the latter period of reform. Prior to the accession process the EU also engaged more deeply with the countries that became candidates than with the other transition economies via various Europe partnerships and many of these had formed trade agreements with the European Free Trade Area, and many were members of the European Free Trade Area.

[4] For example, Gomulka (2000) states "the early conventional view…failed to appreciate strongly enough the key role that a completely new private sector would play in the recovery and growth." Most new firms would of course be classed as small-scale private firms.

[5] See for example Barlow & Radulescu, "The Sequencing of Reform in Transition Economies" (EPRIEE-04).

Split sample estimates on the basis of early (pre-1997) and late transition sub-samples, and on the basis of Geography (East and West sub-samples) reveal a robust relationship (see Table 3 of the paper). The main changes are: Firstly, the effect of the price liberalisation shock becomes positive in the late transition period, but is not statistically different to zero. This is simply due to the shock being over by the later period. Secondly, the slope shift on the square of external reform is significant even when the sample is restricted to the Western sub-set. This confirms that this is an accession effect and not simply due to a 'western' location. Thirdly, the slope shift effect is also significantly positive in the early and later periods, but is larger in the post-1996 period. This confirms that the benefits occurred before the formal launch of the accession process, and that the Europe Agreements enhanced the effect.

To summarise, evidence is found that trade reform stimulates growth, but the optimal extent of reform is less than full. The asymmetric reduction of trade barriers incorporated in the Europe Agreements meant that the optimum extent of reform is greater in the accession candidates than in non-candidates. Of internal reforms a role was found for small-scale privatisation only, but the absence of any other internal reforms is most likely due to these reforms being undertaken to permit trade reform. As in many other studies inflation is found to reduce growth.

Did the accession process influence reform in transition economies?

The transition from communism to capitalism required a scale of reform greater than that previously undertaken anywhere. Key elements have been changes in ownership, the development of market mechanisms to replace the plan and restricting the macroeconomic imbalances inherited from the command economy. Given the extensive transformation that was necessary full market reform became impossible to implement at once and therefore it became a staged process. At the same time as these economic challenges were undertaken, the one-party state was abandoned, in many cases to be replaced by multi-party democracy. In this new political environment it was vital for reformers to build and maintain pro-reform constituencies in order to maintain the momentum for reform.

'Big bang' reform was proposed as a means to achieve significant amounts of reform before effective opposition could be established. In practice, however, a pure big bang strategy was never feasible because some reforms would take time to implement, for example privatisation and legal reforms. Consequently economic reform in the former communist states has been in stages. But when reform moves in stages, opposition to further reform might come from the ex-post winners who expect to lose their gains if

reform progresses further (Hellman, 1998). The transition indices produced annually by the European Bank for Reconstruction and Development are used by Barlow & Radulescu (EPRIEE-04) to examine whether progress on some elements of reform has a stimulatory effect on advancing other elements of reform. This should give some evidence on the dynamics of transition.

Estimation is a logit model of the probability of advancing a reform (Small-Scale Privatisation (SSP); Large-Scale Privatisation (LSP); Restructuring (RES); Banking (BNK), Trade and Exchange (TRA), Competition Policy (CO) and Securities (SEC)). The explanatory variables are the lagged levels of each reform, budget surplus and inflation. The empirical model was augmented to take into account country fixed effects.

The most striking finding is the broad role that appears to be played by small-scale privatisation to enhance other policies (see Table 1 of the paper of the paper). In contrast large-scale privatisation only seems to be associated with progress in one other reform – that is, in securities. The importance of small-scale privatisation for further reforms is consistent with papers that argue for small-scale privatisation as a means to build support for reform, such as Roland (2000). The strength of small-scale privatisation relative to large-scale privatisation in promoting reform also supports the findings reported by Hellman et al. (2003) that new firms have been a "major constituency for further structural reforms". Barlow and Radulescu argue that the significance of small-scale privatisation is because it creates lobbies for further reforms. The importance of small-scale privatisation is consistent with results in the broader development literature. For example, Acemoglu et al. (2002) argue that economic progress requires "a cluster of institutions ensuring secure property rights for a broad cross section of society".

Small-scale privatisation is significant in the regressions for large-scale privatisation, restructuring, trade, banking and competition policy. The coefficients vary from 1.24 in the restructuring regression to 1.86 in the competition policy regression. Assuming that all reforms are at level 1, inflation is zero and the budget is balanced, the estimated probability of not progressing with reform (1-p) is 22 to 25 times higher than the probability of further reform (p) for large-scale privatisation, banking and competition policy, while the same ratio rises to 83 for restructuring. The only reform that is more likely to happen than not is trade reform with a probability of further reform twice as high as 1-p. With other reforms at the minimum level of 1, zero inflation and balanced budget, small-scale privatisation needs to reach a level of 3 to 3.3 in order to get large-

scale privatisation, banking reform and competition policy started.[6] For progress on restructuring, small-scale privatisation is not enough; banking reform is also needed.

One of the reasons for large-scale privatisation having a weak role in enhancing other reforms could be the varying ways in which large enterprises were privatised. Voucher privatisations and give-aways had the putative advantage of speed. However, speed might in practice have been a considerable disadvantage. If mass privatisation results in large income inequalities this could become a major obstacle to reform. Reform in Poland, Hungary and Slovenia might have been enhanced by lags in their large-scale privatisation programmes. UNECE (2003) states that "mass privatisation – implemented for the sake of speed and ideological reasons – might backfire and induce counterproductive results". However, the roles of small- and large-scale privatisation are reversed for securities. In this case it is large-scale privatisation that advances the transition, as in the more advanced stages of transition securities are issued by private enterprises. For reasons such as economies of scale in transactions costs this is an activity more suited to large businesses.

A budget surplus is found to make large-scale privatisation and trade reform more likely. This is consistent with the relaxing of fiscal constraints permitting governments to undertake reforms that reduce their revenues. As expected, the probability of further reform is lower once reform has reached higher levels. Moreover, the coefficients on the lagged level of reform are quite large. The coefficients vary between -2.61 for small-scale privatisation and trade to -10.76 for competition policy. The size of these coefficients suggests that it is easy for reforms to get stuck at a certain level. The higher the coefficient the lower is this level. In order to get reforms restarted progress is required in other reforms. There are a number of plausible linkages in the reform programmes. Bank reform appears to be required for advances in restructuring, which is consistent with the view that a functioning banking system is essential for the process of transformation as it provides financing for restructuring industries. Trade reform appears to lead to advances in banking reform. There are two possible reasons for this. First, as the economy opens up, foreign-owned firms encourage change in the banking sector. Second, once reform reduces the short-term profits available by financing trade, the banking sector is more willing to accept reform. Trade reform also advances small-scale privatisation, as the reduction in rent-seeking activity in trade permits the entry of small businesses into trading activities. Progress on competition policy is more likely the greater has restructuring been. This could be due to competition policy being delayed until firms are

[6] It is assumed that reform is likely to progress when the probability of further reform exceeds the probability of stagnation or reversal.

more able to withstand competition and also because restructured firms might act as a lobby for competition policy. Finally, competition policy appears to enhance trade reforms.

In order to obtain a deeper understanding of the interaction between reforms, Barlow & Radulescu ran the regressions on separate sub-samples for FSU and non-FSU countries (table 2 of the paper).[7] Small-scale privatisation appears to have the same effect on large-scale privatisation in the two sub-samples. However, small-scale privatisation stimulates restructuring and trade reform only in the FSU countries. Here the effect is quite dramatic, the coefficients being much higher than the ones obtained for the whole sample. Small-scale privatisation has an effect on banking in both regions but the effect is much stronger in the FSU. Although the FSU countries have achieved less than the non-FSU countries in terms of small-scale privatisation and generally started later with reform, small-scale privatisation appears to have a much stronger impact on FSU countries. This stresses the importance of small-scale privatisation in countries that are laggards in reform. In the absence of institutions that strengthen the workings of the market creating grass-roots support for reform becomes crucial.

The effect of trade reform, while practically non-existent in the FSU, appears to be very strong in the non-FSU countries, especially on small-scale privatisation, restructuring and banking. This difference might be due to the differing compositions of trade. Exports from the FSU are in many cases dominated by fuels, raw materials and other primary products. The production and trade in these products have tended to be heavily concentrated, in contrast to the broader range of traded products in the non-FSU countries. In addition, geography and poor infrastructure hinder the external trade of many FSU countries, and might be an alternative source of rents from trade. Consequently, trade reforms in the FSU have not promoted support for reform. This point also helps to explain the greater importance of small-scale privatisation in the FSU.

The effect of fiscal constraints is also somewhat different between the sub-samples, especially in the way that fiscal constraints affect trade. An improvement in the fiscal position appears to increase slightly the probability of advancing trade reform only in the FSU countries. With notoriously poor tax collection systems, the reliance of the government on import/export tariffs would be higher in the FSU countries and therefore the state might be more reluctant to let go of trade and exchange rate controls. By comparison, trade reform in most non-FSU countries was driven by the desire for greater

[7] The three Baltic states, Estonia, Latvia and Lithuania, are counted as non-FSU for this purpose.

openness and for joining the EU and therefore is less likely to have been influenced by the fiscal stance.

1.3.3. The Effects of the EU Accession Process on Reform

Barlow & Radulescu use two dummy variables to test the effect of EU candidature on the reform effort. The dummy *AFTERACC* takes the value one after the country has been invited to negotiate EU membership and zero otherwise. For the first wave of countries (Poland, Hungary, Slovenia, Estonia and the Czech Republic) this dummy takes the value one from 1998. For the other five candidate countries (Slovakia, Romania, Bulgaria, Lithuania and Latvia) the dummy takes the value one only from 2000. The dummy variable *B4ACC* which takes the value one for the candidates in the period before their accession negotiations began and zero otherwise. For estimation the fixed effects are replaced by initial conditions.

The results are presented in Table 3 of the paper. The dummy *AFTERACC* is only significant in the regression for banking reform. Otherwise, it appears that reform efforts have not been significantly intensified after the country was accepted as an EU candidate. The results imply that being accepted as a candidate had little effect on the reform effort. For most reforms the results suggest that once candidate status was granted the reform effort in the candidates was no greater than in the non-candidates. This could happen for a number of reasons, though the most likely explanation is that candidate countries have slowed down their efforts after being accepted as candidates. In the case of trade liberalisation and small-scale privatisation, the slowdown was most likely due to the fact that these reforms were completed before the countries were accepted as EU candidates. For other reforms the slowing down would be mainly due to the complex issues regarding institution-building.

The dummy variable *B4ACC* is significant in the regressions for advances in restructuring, securities, competition policy and small-scale privatisation (but only weakly in the latter two). This suggests that in general the high level of reform achieved by the time that accession negotiations began was more due to the momentum of reform than preparations for the accession negotiations. It is surprising that B4ACC was not significant in trade reform as it could be expected that countries desiring to join the EU would be more willing to reduce trade barriers. However, the split sample estimates show that SSP stimulates trade only in the former Soviet sub-set of countries. In the non-former Soviet group only restructuring makes trade reform more likely. Restructuring has proven a difficult reform to make progress with and is unlikely to account for the rapid progress of trade reform in the candidates. This suggests that this issue needs some

reconsideration: it might be that small size, proximity to markets and better infrastructure encouraged the non-former Soviet countries in general, rather than solely the accession candidates, to liberalise their trade

Small-scale privatisation stands out as the key element of the transition that permits progress on many other aspects of transition. However, it must be complemented by bank reforms for restructuring to progress, in turn progress on restructuring is required for progress to be made on competition policy. The relaxing of fiscal constraints appears to be important when advancing the transition requires that the government gives up sources of revenue. There is little evidence that the accession process had a significant influence on the progress of transition. However, Bulgaria and Romania, the only former communist countries negotiating EU membership that failed to accede in May 2004, consistently lagged other Central European countries in reform. By the time that the EU started negotiating EU accession with the first five candidates in 1998, the largest differences in reform between Bulgaria and Romania on one hand and all the other candidates on the other hand were in small-scale privatisation.[8] The opening up of negotiations in 1998 appears to have encouraged both Romania and Bulgaria to step up their reforms; significantly Romania started its renewed efforts by further small-scale privatisation (EBRD, 1999). There might be similar evidence for a demonstration effect in the reforms undertaken in other potential EU members, such as Croatia and even Albania and FYR Macedonia. In 2004 the greatest progress recorded in the aggregate transition scores was in Croatia, Bulgaria and Romania (and also Kyrgyz Republic) and the second greatest was in Albania and FYR Macedonia (and no other countries). While we cannot discount the possibility that this was generally due to the sequencing of reforms in lagging reformers, it is also not inconsistent with a demonstration effect following the decision to admit all of the candidates except Bulgaria and Romania.

Did the accession process influence the growth of exports from transition economies?

During the latter half of the 1980s, trade between the members of the CMEA underwent a deep contraction. Though countries such as Hungary and Poland expanded their trade with developed countries faster than intra-CMEA trade declined, in general there was a significant fall in exports by the former communist countries. The CMEA itself had not been as successful as the EU at expanding intra-community trade. Thus at the start of the transition these countries exported a much smaller proportion of their GDP than would be considered normal for open countries of similar sizes. The growth of exports

[8] The difference in transition score from the average of the other eight accession countries for small-scale privatisation was 0.92 and 1.22 for Romania and Bulgaria respectively. The next biggest difference was 0.88 on restructuring for Romania.

over the transition would in part to be to correct this imbalance. However, a correcting expansion of exports would not be automatic and would reflect a number of policy choices, as shown by the poor export performance in the socialist era.

Of major importance was reform of the trading system. Trade within the CMEA relied upon non-market measures that frequently discouraged trade. The system evolved into a hub-and-spoke pattern in which the other members traded manufactured goods with the Soviet hub in exchange for natural resources; there was little trade between the spoke countries. In trade with developed countries the CMEA exported less sophisticated products than they exported to the USSR. This trade was hindered by the overvaluation of the communist currencies. Reform would involve the removal of barriers to importing and exporting, easing access to foreign currency and permitting the market to influence the exchange rate.

To be able to remove obstacles to exporting, domestic reforms were required. For example, prices significantly distorted from world prices are incompatible with unrestricted exports. Furthermore, to stimulate exporting it is important that there should be incentives to respond appropriately to price signals, so issues of ownership and restructuring are also relevant.

A further issue in the transition to consider is the impact of inflation. The relationship between exports and inflation is not straightforward. If inflation resulted in an appreciation of the real exchange rate, export growth would be expected to fall, which could also be reinforced by uncertainty associated with inflation. However, this is the case for an economy at or near the equilibrium exchange rate. There is a strong argument that the devaluations at the start of transition were excessive. Such devaluation both stimulates exports but also raises inflation by increasing the domestic price of imports. If both the inflation rate and growth of exports are increasing with the extent of the devaluation, we would find a positive association of inflation with export growth.

Following extreme devaluations there is also the possibility of a positive causal relationship between inflation and export growth. Extreme devaluation offers protection to the domestic market from imports. In this case producers find sales in the domestic market easier than sales to the more competitive export market. If domestic inflation is not fully countered by further devaluation, by reducing the effective protection of the domestic market, inflation might encourage producers to enter export markets. In addition, if the exchange rate is pegged and if transition produces the Balassa-Samuelson

effect,[9] then the only channel through which this can operate is inflation. If rising productivity raises exports then this too would result in a positive association between inflation and export growth. Given the inferior quality of communist-era exports, then if transition leads to a switch to higher quality goods there is also the possibility that actual inflation is less than recorded inflation implies.

For these countries the EU provides the most important market for their exports. Ten of the 13 countries in the data set had Europe Agreements which gave tariff-free access to the EU for manufactured products, excluding for a while some sensitive products. Prior to the Europe Agreements there were various agreements that had improved access to the EU market. The EU has granted similar favourable access to the three non-candidates in this data set (Albania, Croatia and FYR Macedonia). Finally, the ability to export for some countries has been constrained by conflict.

Barlow (EPRIEE-02) examines export growth for a subset of the transition economies that excludes all of the states created as the USSR broke up except for the three Baltic republics. The focus is on this subset because the process driving exports in the rest of the former USSR is likely to be significantly different to that behind export performance elsewhere. One reason for this is that the exports of a number of these states are dominated by fuels and raw materials. A second reason is that many of the remaining former Soviet states are much more isolated, particularly from developed markets, and are further hampered by notoriously poor transport infrastructures.[10] Furthermore access to other markets involves crossing less open borders. In contrast the geographic advantages of the remaining transition economies, such as better transport networks and proximity to major markets, are complemented by various agreements with the EU.

The policy reform variables were obtained from the EBRD. Barlow starts by using an aggregate measure of internal reform which is calculated as the mean of five reforms: price liberalisation; small-scale privatisation; large-scale privatisation; restructuring and banking reform.[11] External reform is represented by the transition scores for trade and foreign exchange. The dependent variable is the % growth in exports valued in current dollars. The explanatory variables include the capacity for export expansion, incorporated by the first lag of the ratio of exports to GDP. This is an imperfect measure as larger economies are expected to be less open. Inflation is measured by the annual growth rate

[9] The Balassa-Samuelson effect postulates that productivity gains in the internationally traded goods sector can cause a real appreciation of the currency. The evidence for this occurring over the transition is presently unclear, see for example.
[10] See for example the Transition Report for 2003 and 2004.
[11] The EBRD provides indices also of competition policy and non-bank financial reforms. However, progress on these reforms has until recently been slight and is unlikely to have significantly contributed to export growth.

of the consumer price index converted to a common currency (the US dollar). The current level and first lags of the reform variables and inflation are included. In addition, dummy variables are included for the EU candidates and for periods of conflict. Estimation initially incorporates country fixed effects, which are later excluded with no significant qualitative changes, corrections for heteroskedasticity and serial correlation.

Column 1 of Table 1 of the paper shows the results for the whole sample. The ratio of exports to GDP is significantly negative, so that there is evidence of a catch-up effect. Reforms are not found to stimulate export growth. Surprisingly inflation is found to be positively correlated with growth. This result confirms the importance of the large devaluations that the transition economies started the transition with. Export growth appears to have been higher for the accession countries and periods of conflict reduced export growth.

Have the forces driving export growth changed over the transition as the market-type economy became more established. A division of the sample into early and later transition periods would cast some light on the issue. The division is set for the pre-1997 and post-1996 periods to achieve sub-samples of almost equal size. Columns 2 and 3 of Table 1 of the paper suggest that the equation works best in the early transition period. In the latter period (column 3) the parameter on the ratio of exports to GDP becomes positive but is not significant from zero. This suggests that the opportunity for catch-up growth in exports has generally passed. The effect of inflation becomes negative, which suggests that in the early period the undervaluation was a significant cause of export growth and that once the undervaluation had been eroded by inflation, the negative price elasticity of demand began to bite.

The accession effect is only significant in the early period. In other words after controlling for the other variables export growth was only greater in the accession candidates before the Europe Agreements were made. Given the improved access to the EU market created by these agreements, this result is surprising. There are though good reasons for this apparent weakening of the accession effect. The EU has made trade agreements with the three non-accession countries in the data set. The transition and re-integration of these three countries, however, was delayed by conflict. According to the EBRD's 2003 Transition Report the effective protection of the EU against South East Europe was lower than that against the countries that joined the EU in 2004. The net effect of these could be that the 'catch-up' growth of exports was still going on in these three countries in the later period, even though the catch-up process appears to have been completed in the new members, so that there was no systematic differences in the behaviour of export

growth between the accession candidates and the remaining countries in the latter period.

The overall reform index was replaced by the variables that constitute it. Price liberalisation and small-scale privatisation were both statistically insignificant from zero. The results for the other three variables are reported in Table 2 of the paper. Large-scale privatisation, restructuring and bank reform are all significant, suggesting the importance of the withdrawal of the state to make the economies able to respond to the challenges of international markets. All of the variables play important roles in the early period, but in the latter period the only significant variable is inflation, which has become negative. Again the accession effect is only significant in the early period.

A combination of currency undervaluation and catch up appears to have significantly contributed to export growth. In the early years of the transition undervaluation of the currency seems to have put the economies onto the export supply curve. But it now appears that the exports are demand constrained. Expansion of exports will now depend upon conventional factors such as product quality, cost and so on. However, entry into the Single Market could lead to a new process of catch up.

2.- Objective 2: Economic Integration and reforms in South East Europe

2.1. The Case for a Regional Free Trade Area

A number of authors argue for a regional free trade area in South Eastern Europe (SEEFTA). By promoting intra-Balkan trade the economic fragmentation of the region should be reduced, which will enact regional multipliers and stimulate FDI (Petrakos & Totev, 2000). Such an agreement should reduce conflict by raising interdependence (Bartlett & Samardžija, 2000). The agreement must encourage the active participation of Greece, a country that already has a key role in the area, argue Petrakos & Chritodoulakis (1997), and encompass a range of agreements with the EU (Welfens, 2001) to accommodate the varying relationships between the EU and the countries of the region. Christie (2002) claims that success of an agreement to promote trade between Macedonia, Slovenia and Croatia indicates the potential for success.

A major advantage of stimulating Balkan integration more than integration into the EU is that the change to the new regime should be less stressful in terms of economic adjustment and political accommodation. In a region in which economic crises have been manipulated by nationalistic leaders (for example, in the former Yugoslavia) this might be an important issue. However, it is important to recognise that future prosperity depends upon changing the existing structures and so the agreements implemented with

the EU must not offer the prospect of long-term protection. The EU wished to promote a SEEFTA through the Stabilisation and Association process, though it has replaced the FTA with a policy to encourage regional cooperation. Furthermore, as argued by Gligorov (2004 a and b), van Meurs (2003) and von Brabant (2001), the EU and other international organisations must rationalise their programmes in the region not only to target financial support but also to make clear that regional economic integration must proceed alongside integration into EU structures. Given that the challenges of integrating the region into the European economy are greater than the challenges of the 2004 enlargement, it is essential that moves must be made to promote integration within the region.

The gains that should come from regional integration are of a strongly dynamic nature – such as the acceleration of the reform effort, rationalisation of economic structures and on increase in intra-industry trade – which make the static nature of general equilibrium modelling, with its focus on trade creation and diversion, a far from ideal tool to analyse the benefits of a regional free trade area. Most importantly of all, we should remember that the biggest gains from economic integration are political – such as the reduction in conflict and greater stability, all of which bring large economic benefits.

The failure of the Central European Free Trade Area, however, starting with more favourable conditions vis-à-vis South Eastern Europe, hardly raises hopes for the success of a South East Europe Free Trade Area. The EU may have to take an even more active role to promote a SEEFTA. However, the failure of CEFTA, and the failure of the CMEA to achieve anything more than limited trade integration raises the question of what determines the depth of integration. Lewis & Šević (2000) argue that a major constraint on the region is the gap between the legal system and legal order, in other words the failure to achieve the rule of law – alongside the gap between written law and actual law.

2.2. The Need for Reforms and the Role of State Capture in Transition Economies

While, in recent years, the SEE countries have made important progress in the transition process to an open market-oriented economy, the pace of reforms has been slower and more problematic compared with the CEECs. The European Bank for Reconstruction and Development (EBRD) provides – in the yearly *EBRD Transition Report* – a measure that attempts to capture the progress of reforms in different areas (small-scale privatisation, large-scale privatisation, competition policy, development of the banking sector, infrastructure reform, trade and foreign exchange liberalisation, etc.). Croatia and Bulgaria seem to have made substantial progress in their transition process and their

EBRD Transition scores are comparable to most accession countries. Albania, Bosnia and Herzegovina and Serbia and Montenegro lag behind.

Overall the picture gives a fundamental message: in order to boost integration, both with the EU and within the region, and reap its fruits in terms of prosperity and economic growth, reforms need to be accelerated in the area. This is the major medium-term challenge for the governments of these countries together with the EU and international financial institutions (IFIs). But why have reforms been so slow? According to the latest Annual Report on the Stabilisation and Association Process for South East Europe (European Commission, 2004a) the main reason is attributable to the continuing prevalence of *organised crime and corruption* in the region which has the effects of delaying political reform, holding back economic development and putting into question the rule of law.

Along the same line of reasoning, in this part of the report we discuss the findings of a recent study by Barlow & Buckley (2004/EPRIEE-06), which empirically investigates the relationship between state capture[12] and the progress of reforms in SEE and other transition economies.

2.2.1. State capture and reform progress in transition economies

The transition from communism required the state to take on a new role. The state had to give up central planning and control over allocation to become the enforcer of contracts and provider of public goods. Reform required action on many fronts to reduce state control and influence over production. First of all, prices were liberalised so that the price mechanism could convey information. Secondly, to provide incentives to respond appropriately to price signals budget constraints needed to be hardened through privatisation and the withdrawal of subsidies. Thirdly, banks had to take on the role of channelling funds from savers to investors. Fourthly, economies that had been relatively autarchic had to change their trade regimes.

In their contribution Barlow and Buckley show that state capture is a consequence of reform not progressing in a comprehensive manner, particularly in the early years of reform, so that opportunities arise to those with influence that makes state capture a worthwhile strategy? Why is state capture a profitable strategy? State capture brings together two major anti-reform groups: potential captors – the oligarchs – and corrupt government officials. These groups seek to gain from the lingering communist distortions

[12] State capture is defined as the efforts of firms to manipulate policy formation to their own advantage through the illicit provision of private gains to public officials.

and the weak governance of transitional states; oligarchs via their manipulation of policy and rule, state officials through the private payoffs they receive for such manipulation.

Captor firms are primarily new SMEs (small- and medium-sized enterprises), or '*de novo*' firms, trying to compete in a market where there are large incumbent firms, and state governance and provision is weak. In such environments, new firms suffer from weaker property rights and lack access to the public goods necessary to function independently of the state. This situation arose from inconsistencies in reform, encouraging private sector activity, yet not providing the market institutions and tools necessary for them to perform autonomously in the market. Creating a private sector without first preparing the market 'rules' breeds a culture of corruption as clandestine activities such as state capture become viable business strategies for firms seeking a competitive advantage.

Firms adopting a 'capture strategy' reap large benefits in terms of additional sales, investment and employment. Hellman et al. (2003) finds that the captor firm premium is around 10, 12 and 13.2% for sales, investment and employment respectively. This highlights one of the dangers of state capture: once it has a grip on a country new entrants to the market are forced to partake in capture to compete in the market. In other words, when state capture arises, the adverse consequences of gaps in reform persist, so that there appears to be path dependency in the relationship between growth and reform.

Barlow and Buckley utilise the capture index as in Hellman et al. (2000) for 22 transition countries[13] (see Figure 1 in the annex to objective 4). The countries are categorized into *high- and low-capture economies*. High-capture countries are those with a capture index above 18%.[14] Reform progress in these countries is often slow and partial. Low-capture economies, those whose index is less than 18%, consist of two sub-groups; *low capture-low reform* and *low capture–high reform*. The former describes countries such as Belarus and Uzbekistan, countries that remain, to all intents and purposes, dictatorships, whose reforms are minimal and to which the concept of state capture has little relevance, as effectively there is no private sector to act as captors. As the *low capture-low reform* group have barely engaged in the transition, they are excluded from the analysis. The

[13] Romania, Bulgaria, Hungary, Poland, Slovakia, Czech Republic, Albania, Armenia, Azerbaijan, Belarus, Croatia, Estonia, Georgia, Kazakstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Russia, Slovenia, Ukraine and Uzbekistan.

[14] Romania, Bulgaria, Slovakia, Azerbaijan, Croatia, Georgia, Kyrgyzstan, Latvia, Moldova, Russia and Ukraine.

low capture-high reform group is composed mainly of EU accession countries,[15] which have achieved high levels of reform across the board.

The authors find that low-capture countries are characterised by strong, comprehensive reform, particularly in early transition, as opposed to high-capture economies which have often progressed in a protracted, listless manner. Figures 3 – 8 of the paper provide a clear picture of the difference in the pace of reform progress between these two groups of countries. Partiality in reform, either in terms of the level or spread gives rise to capture as firms seek to fill the subsequent reform gaps with 'a la carte' purchases of the legal and institutional services that are unavailable without private procurement. They identify the early years of transition to be the most important time for an aggregated reform effort, especially progress in banking and privatisation reforms.

What can be done to move captured economies out of their under-reform trap?

Reform should progress comprehensively even while being sequenced to avoid state capture. The authors show that once corruption or state capture takes place this can become a stable equilibrium and economies can fall into an '*under reform trap'*. Where this occurs, it is *crucial that reform momentum is re-initiated*. Failure to do so would lead to further corruption and a growing underground economy, inequality and poor economic performance, such that economies may find themselves in a worse situation than when transition began. The challenge then is to design a reform package that will not only kick-start reform, but also ensure that a strong reform momentum is established.

Reducing the services that the captured state can provide to the captors is clearly a part of the strategy. This includes not only advancing restructuring and *bank reform*, but it also might be necessary to take *price liberalisation* further than less-captured economies have so far. Achieving these in the presence of state capture is unlikely to be easy as captors and the captured are likely to put up strong resistance; in contrast, the beneficiaries are spread thinly and the individual gains might not be great enough to motivate them to support sufficiently strong action.

An alternative strategy could be to co-opt some captors and captured into cooperating with change. However, this might only give rise to future problems and is a far from ideal strategy in immature democracies. The problem might lie deeper than this analysis has gone. Why did certain countries move their transition forward in a comprehensive manner and so avoid significant state capture, when others became trapped due to partial reform?

[15] Poland, Hungary, Czech Republic, Estonia, Lithuania and Slovenia; plus Albania, Armenia and Kazakhstan.

The origins of state capture might be related to the conditions at the start of transition. But then why did countries that emerged from now-defunct federations end up with significantly different levels of state capture, for example, the contrasts between Estonia and Latvia; the Czech and Slovak Republics; Armenia and Georgia; or Slovenia and Croatia? This suggests that the story also concerns the *nature of the new democracies* and the *political elites* that emerged following the downfall of communism. It follows that it might be necessary to review the nature of the political elites and the electoral and judicial procedures.

The EU has enlarged to include two significantly captive states (i.e. Latvia and Slovakia) and will add at least two more in 2007 (i.e. Bulgaria and Romania). It is not clear that the accession process has impacted upon state capture. It is also not clear what the implications of state capture are for the performance of these states within the EU or for the performance of the single market. One concern could be the emergence of capture of the institutions required for the application of mutual recognition of product standards and for the regulation of the markets in financial services.

2.3. Creating a strong export-base: The role of firms' clustering

Like all transition economies, the countries of South Eastern Europe (SEE) stand to gain most from an export-led growth. Unfortunately, however, the productive structure in these countries is largely made up of small- and medium-sized enterprises (SMEs) which, due to their limited size, may face obstacles to gain access to international markets. This part of the report is based on a recent paper by De Arcangelis, Ferri & Padoan (2004/EPRIEE-16) which proposes a possible way out to overcome the limits to internationalisation associated with firms' size: policies aimed at promoting the clustering of SMEs.

Their analysis is based on the widely-acknowledged success story of SMEs clustering within Italy's industrial districts, which lies at the heart of the spectacular export and growth performance of this country during the past decades. The authors use historical data on Italian exports (in 1971 and 1961) in order to quantify the boosting effect due to firms' clustering. In particular, they use detailed data on exports classified by sector and by destination country to estimate a panel gravity model on which the firms' clustering effect is computed. Building on the Italian experience, the authors design four scenarios for firms' clustering in three SEE economies (Bulgaria, Romania and Slovenia). By means of these scenarios and applying the estimated coefficient for firms' clustering in Italy, they simulate the firms' clustering effect for the three SEE economies and obtain the gain in export growth over the benchmark case.

2.3.1. The role of SME's clustering as a way of overcoming size-constraint: Learning from the Italian experience

During the 1960s, the Italian economy experienced its so-called 'economic miracle' with a growth rate at or above 5% for a protracted number of years. The growth boom was largely export-led with increasing market shares in the newly created European Common Market. What is more important, both large firms and small- and medium-sized enterprises participated in the export boom. As was later ascertained (e.g. by Pyke et al., 1990), SMEs clustered in industrial districts were mostly responsible for the success story.

The main idea behind the positive effects arising from clustering is simple: firms can enhance their competitiveness and regions and countries can improve their growth potential through agglomeration effects as clusters of firms exploit increasing returns generated by location proximity. Such effects result from several factors, including the availability of a pool of skilled workers and concentration of demand – referred to as 'pecuniary externalities' (Krugman, 1991) – or innovation spillovers – named as 'technological externalities' (Belleflamme et al. 2000). Others (e.g. Bagella et al., 1998) have stressed the role of interactions among firms participating in clusters. So it is not just proximity that allows firms to benefit from shared costs, but also, and more importantly, it is the exchange of information between firms that allows exploiting knowledge externalities.

Can such experiences be important also for emerging and transition economies, such as SEE countries? De Arcangelis et al. (2004) believe the answer is yes for one main reason. Small enterprises are production units that are most likely to develop in transition and emerging economies, as opposed to large firms, given lower organisational costs,[16] and offering better opportunities to young entrepreneurs.[17] As is evident from Table 16. in the annex to objective 2, small enterprises (defined as enterprises with less than 250 employees), and in particular micro enterprises (less than 10 employees), already play a vital role in SEE countries where they represent a large share of the total number of firms. In Albania, Croatia and Romania, SMEs account for more than 50 % of GDP (UN ECE, 2003).

[16] However, financial constraints may be more stringent. International organisations (like the World Bank and the EBRD) have recently tried to lessen those constraints with different types of intervention.

[17] Two further benefits may be associated with an SME-based type of development. First, SMEs increase competition and more competitive market structure has been shown to increase efficiency and firm performance in transition economies (Angelucci et al., 2001; Carlin at al., 2001). Second, given their limited ability to collude among themselves and with the state bureaucracy, SMEs may be an antidote to corruption, often plaguing restructuring in transition economies (Kaufmann et al., 2000).

The probability of success of small firms could be greatly enhanced by clustering so as to indirectly exploit economies of scale. Clustering phenomena in SEE at the initial stage of their integration process in a wider European economic space are a concrete possibility and could closely resemble the features and patterns of the evolution of clusters in the Italian economy in the early 1960s when Italy was beginning to exploit the benefits of integration in Europe and in the world markets.

2.3.2. Simulation exercises for SEE countries[18]

As we discussed in the previous section, SEE economies are at an early stage of firms' clustering formation that is not comparable with the current one in Italy or elsewhere in industrialised economies. Hence, De Arcangelis et al. focus their attention on historical data of Italian exports for the year 1971 – and, alternatively, on the export performance of Italian sectors between 1961 and 1971. At that time, in fact, Italy's 'economic miracle' had only begun to take place. The economic boom for Italy crucially rested on the possibility to take full advantage of the low cost of labour and quickly expand its export share in the European Community. In these two respects (low labour costs and the beginning of an integration phase), the Italian case in 1971 could be said to resemble that in which the SEE countries will find themselves in a few years from now.

The empirical exercise conducted by De Arcangelis et al. consists of two steps:

1) estimation of the effect of firms' clustering on both the level and the dynamics of Italian exports;

and

2) use of the results to infer the impact of the formation of sectoral clusters on SEE exports.

In the first part of the analysis, the authors find that firms' clustering seems to have had both a static and a dynamic effect on exports. On the static side, firms' clustering can significantly boost exports, but only in conjunction with other factors: firms' clustering strengthens the domestic model of specialisation by affecting more intensely those sectors that already experience higher export growth. On the dynamic side, firms' clustering has a relevant marginal impact on export growth, equal approximately to 0.009% (per year) for each percentage point of sectoral workers employed in sectoral firms' clusters.

[18] We refer the reader interested in the methodological details of the analysis to De Arcangelis et al. (2004/EPRIEE Working Paper No. 16).

The coefficients estimated for the Italian experience represent a useful measure of the marginal impact of clustering on export performance which is subsequently used to quantify the potential effect of sectoral clustering in SEE countries on their export performance. Due to lack of data on sectoral firms' clusters in the SEE economies, the authors consider four different scenarios:

- *First scenario (benchmark):* the formation of clusters in SEE occurs with the same sectoral pattern and intensity observed in Italy in 1971;

- *Second scenario:* clusters in SEE take place only in a few sectors and, more precisely, only in sectors where firms' clustering was particularly intense in Italy in 1971; and

- *Third and fourth scenarios:* the authors assume that the distribution of the (original) 1971 Italian firms' clustering is the result of a general pattern. This pattern is 'identified' (estimated) and applied to the SEE economies.[19]

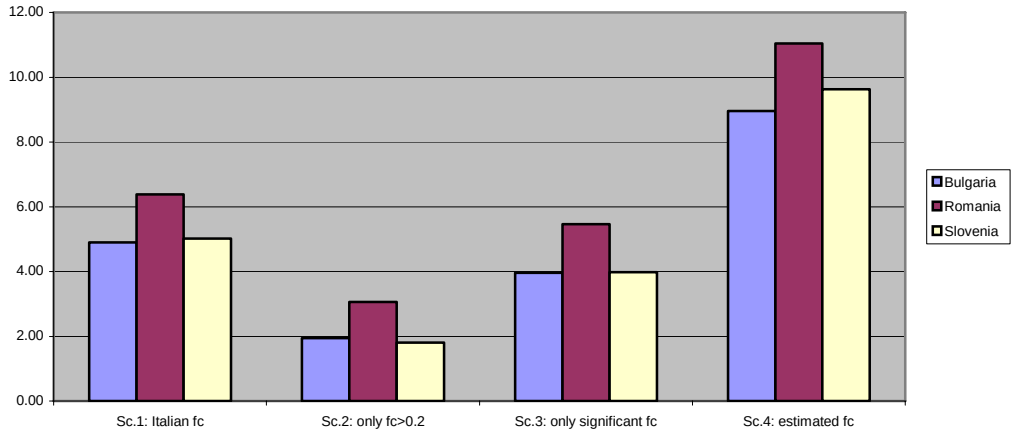
The simulation exercise is conducted using three of the major SEE countries: Bulgaria, Romania and Slovenia. The choice of the countries has been limited by data availability (1993-98 data were used). Figure 1 reports the result of the simulations describing for each country and for each scenario the additional five-year growth rate of the potential exports over the benchmark projection, based on the previous five-year growth rate. The figure shows that the gain from firms' clustering on total export growth ranges between 2-3% and 9-11% over a five-year period, but with a different impact on the three economies.

The highest gain occurs for Romania, which also presents the highest benchmark growth (equal to 292.4% on a five-year period, not reported in the graph), given it had the best performance in 1993-98. The fact that Romania shows the largest impact implies that the sectors with the highest potential of firms' clustering formation are also the sectors that already present a good export performance in the country. Whereas the gap in the gains remains constant between Romania and Slovenia in the different scenarios, the gap increases in the comparison between Romania and Bulgaria when moving from the

[19] As a first step, they fitted the (ordered) distribution of the firms' clustering variable (*fc*) with a potential function and obtained both the fitted values ($\hat{fc}$) and the standard error of the estimates. By constructing a confidence interval around the fitted values equal to twice the standard deviation (both up and down), some small values of $\hat{fc}$ turned out not to be significantly different from zero (at the 5% level). Hence, in the third scenario all the non-significant $\hat{fc}$ values were set to zero and the others were allowed to be equal to the original Italian values. In the fourth scenario the fitted values $\hat{fc}$ were substituted for the original ones. For additional details we refer the reader to the full paper.

scenarios with a narrow firms' clustering value to the estimated scenario 4. This result suggests that Romania may gain most from a firms' clustering formation similar to the Italian pattern in 1971 and is not in contrast with what one might have expected, given that Romania, over the 1990s, has hosted an increasing number of industrial localisations originating from Italian firms and Italian firms' clusters.

Fig. 1. Simulated Firms' Clustering Additional Effect on Export over Benchmark Growth
for Bulgaria, Romania and Slovenia
(per cent for 5 years)



Slovenia and Bulgaria show similar impacts of firms' clustering in the first three scenarios, with Bulgaria slightly prevailing for the more restrictive cases 2 and 3. However, when considering the estimated scenario 4, Slovenia performs better. This evidence highlights that the Slovenian export performance is more equally distributed among the sectors and gains more from a generalised formation of clusters in all sectors. On the other hand, in Bulgaria the concentration of firms' clusters in sectors with the highest potential of firms' clustering formation (as especially in scenario 2) provides an advantage over Slovenia. However, all three countries benefit from a more even diffusion of firms' clustering.

2.3.4. Policy implications

SEE countries stand to gain most from an export-led growth in view of their increasing integration with the EU. However, as highlighted above, the export ability of SEE countries could be jeopardised by their productive structure largely based on SMEs that, due to their limited size, may face obstacles to gain access to international markets.

As highlighted by the study of De Arcangelis et al., the export potential of SMEs could be boosted through their clustering. The authors obtain an estimate of the boosting effect

that sectoral firms' clustering may have had on sectoral and total exports in the case of Italy in the 1960s and early 1970s, the phase of Italy's export-led growth most reminiscent of the current prospects for closer integration between SEE and the EU. Then, they propose a plausible way to apply such estimated effects to the SEE economies and quantify the gain in terms of export performance these economies could reap through sectoral firms' clustering. The simulation results show that the gain in terms of export growth ranges between 2-3% and 9-11% over a five-year period.

In our view, this evidence indicates that SEE countries stand to reap substantial benefits by favouring SME clustering. To be sure, as noticed, such an evolution is already in progress, as SME industrial clusters from the EU (and particularly from Italy) are outsourcing their high-labour-intensive stages of production to relatively low-cost-of-labour SEE. The results suggest that SEE countries will substantially gain if they will be able to accelerate this process. Indeed, it appears in the interest of SEE countries to introduce specific incentives to effectively boost the dissemination of SME clusters in order to take full advantage of their trade integration with the EU.

2.4. Creating an FDI-friendly environment

Increasing recognition of the benefits that may accrue to nations from the attraction of foreign direct investment (FDI)[20] has led to a resurgence of interest in the factors that help to make a country a more or less attractive location for investment by multinational enterprises. Although the inflows of FDI in the South Eastern European countries have considerably increased since 1997, the area continues to attract, on average per year, a lower amount of FDI per capita compared with eight of the new accession countries ($129.30 and $157, respectively).[21]

In terms of country performance in attracting FDI, the area is substantially heterogeneous (Table 1). In 2003 Croatia, Bulgaria and Serbia-Montenegro experienced a higher per capita inflow compared to other SEE countries. Inward FDI represents in these countries an important share of gross fixed capital formation, which ranges from 12.2% for Romania to 81.1% for Serbia and Montenegro. In the table we also report the ranking of SEEs and CEECs on the basis of UNCTAD's Inward FDI Performance Index (2001-2003), calculated as the ratio of a country's share in global FDI inflows to its share

[20] At the microeconomic level several empirical studies have shown that these benefits accrue through direct technological transfer and knowledge diffusion which improve productivity and efficiency of local firms, and hence increase growth. FDI inflows have strong effect also at the macroeconomic level, increasing domestic investment, employment and usually improving the balance of payment.

[21] For a recent survey on FDI in the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, Macedonia FYR and Serbia and Montenegro), see European Commission (2004b).

in global GDP; a value greater than one indicates that the country attracts a more than proportional share of FDI relative to its economic size. Croatia is the leading country of the region in attracting FDI and ranks 19. The other SEE countries, for which data on the considered index are available, rank within the first 50 positions with the exclusion of Romania.

The proximity of the area to the EU and the prospects of a regionally integrated trade area have the potential to attract a substantially higher share of foreign investors in the near future. However much progress is needed in order to create a friendly business environment and unlock this potential.

Table 1. FDI in SEEs and CEEs countries: Inward flows per capita, stocks and ranking by UNCTAD Inward FDI Performance Index

	FDI inflow per capita ($, 2003)	FDI inward stock, 2003 ($ millions)	UNCTAD FDI perform-ance index (ranking)*	Inward FDI as a % of gross fixed capital formation (2003)	Population (millions, 2003)
Albania	56.8	1091	44	22.7	3.2
Bosnia and Herzegovina	92.0	1153	*na*	37.4	4.1
Bulgaria	181.4	5082	21	36.5	7.8
Croatia	384.4	11351	19	21.8	4.5
Macedonia, FYR	46.4	1024	31	16.5	2.0
Romania	70.5	12693	62	12.2	22.2
Serbia and Montenegro	167.8	3319	*na*	81.1	8.1
SEE	**129.3**	**35713**		**23.4**	**51.9**
Czech Republic	253.2	41033	13	11.6	10.2
Estonia	660.0	6511	10	35.2	1.4
Hungary	244.1	42915	33	13.5	10.1
Latvia	155.1	3320	41	13.7	2.3
Lithuania	51.8	4960	55	4.7	3.5
Poland	110.6	52125	68	11.1	38.2
Slovak Republic	106.1	10248	12	6.8	5.4
Slovenia	92.2	4290	53	2.9	2.0
CEE	**157.0**	**165402**		**28.0**	**73.1**

Source: World Bank, UNCTAD (World Investment Report 2004).

* Country ranking on a total of 140 nations; *na* = not available.

Which policy should be adopted in order to maximise FDI inflow and its beneficial effect? While some factors behind the FDI performance of a country or region are behind

governments control (i.e. geographical position, market size, availability of natural resources), other relevant factors might be influenced by policy actions. Political stability and security, a sound and stable macroeconomic environment, reduced impediments to trade, FDI legislation and a well-functioning regulatory framework are essential features of a business-friendly environment attractive to FDI.

In what follows we investigate the importance of domestic labour market institutions for FDI attraction, an issue that has received increasing attention by policy-makers and economists. The analysis is based on two recent empirical studies by Radulescu & Robson (2004a&b/EPRIEE-07 & 08) from which we highlight the main results and draw policy implications for the SEE countries.

2.4.1. The role of labour market institutions: Lessons from OECD countries

What are the factors that help to make a country a more – or less – attractive location for foreign direct investment (FDI)? Among the several determinants and obstacles to this important source of external capital,[22] the features of domestic labour market institutions – in particular employment protection legislation, the strength of trade unions and the nature of trade union bargaining arrangements – have recently attracted considerable attention by economists and policy-makers.

In two related studies, Radulescu and Robson, using panel data for a sample of OECD countries,[23] set out to examine the effects of key features of domestic labour market institutions on the attractiveness of a country as a location for FDI. The view that institutional arrangements that make the labour market less flexible hinders FDI inflows seems to have gained popularity with policy-makers and other commentators and has received theoretical and empirical support in recent papers (Haaland & Wooton, 2002; Haaland, et al., 2003; Cooke, 1997; Dewit et al., 2003a; Naylor & Santoni, 2003; Leahy & Montagna, 2000).

The findings of these studies are particularly important for South Eastern European countries for two main reasons:

a) they provide specific indications aimed at designing policies and at promoting the inflows of FDI, a key component of future economic development in the area;

[22] For a recent survey on the issue see Moosa (2002).
[23] The countries included in the data sample used for the panel data regressions are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, New Zealand, Spain, Sweden, Switzerland, the UK and the US.

and

b) they give further support to the need of labour market reforms aimed at creating a more business-friendly environment.

Hereafter, we provide more details concerning the two studies conducted.

Does strict employment protection deter FDI?

In the first paper the authors investigate the relationship between strict employment protection and FDI inflows. The main idea is driven by the fact that in an environment of uncertainty multinational enterprises will take account of future exit costs when deciding on the location of a new investment. Employment protection legislation – e.g. in the form of statutory redundancy payments – will tend to add to the scale of future exit costs. As such, countries with relatively strict employment protection legislation will therefore tend to be less attractive locations for multinational investment, other things being equal, than countries with relatively weak employment protection regimes.[24]

The authors made use of a summary indicator of the strictness of employment protection legislation in a number of OECD countries constructed by Blanchard & Wolfers (2000). This measure embraces a wide range of restrictions on the use of labour, including regulations governing the use of fixed-term contracts and the activities of temporary work agencies. The indicator is scaled to lie between a minimum value of 0 (corresponding to very weak employment protection) and a maximum of 6 (corresponding to very strict protection). Table 17. in the annex to objective 2 shows selected values of the Blanchard-Wolfers indicator of the strictness of employment legislation for the countries in the data sample.[25]

What are the main results of the empirical exercise? Strict employment protection legislation has a strong negative effect on inflows of foreign direct investment. The study found significant effects also for the level and growth of real GDP and real exchange rate depreciation. Insignificant effects are found for the corporate tax burden, openness, the productivity-adjusted real wage and the host country unemployment rate.

[24] Theoretical analysis does not present unambiguous predictions. In a recent contribution to the debate, Dewit et al. (2003a; 2003b) show that if firms act strategically there may be circumstances in which firms may find it in their best interests to locate in countries with relatively strict employment protection. We refer the reader to the cited papers for further details.

[25] A detailed discussion of recent developments in employment protection legislation in OECD countries is contained in OECD (1999a).

An additional message of considerable interest for the SEE area is given by the finding that market size (measured as the level of GDP) is an important influence on the attractiveness of a country as a location for FDI. If the aim of governments in the SEE region is to benefit from the potential effects of sustained and large FDI inflows, more economic integration between neighbouring South Eastern European countries is a necessary pre-condition.

An important contribution of the study by Radulescu & Robson (2004b/EPRIEE-08) is the extension of the analysis to FDI data disaggregated by sector in order to examine the possibility that the effects of employment protection legislation may differ across industry sectors. While the key finding that strict employment legislation discourages FDI inflows is confirmed, the authors find that the effect does indeed differ between sectors. Quantitatively, the strongest effects are found in petroleum, chemicals, rubber and plastic; financial intermediation; and trade and repairs. In these markets, therefore, the negative effect that a strict regime of employment protection legislation has in restricting the ability of a firm to respond flexibly to shocks strongly dominates any beneficial effects that may be conferred by strategic considerations.

2.4.2. The role of trade union strength and wage bargaining arrangements on FDI attraction

The conventional wisdom on this issue is that a strong trade union presence will tend to make a country a less attractive location for investment by multinational enterprises, as they will be concerned that the rent-extraction activities of trade unions will tend to limit the profitability of their investments. Following on from this, it is argued that multinational enterprises will prefer to locate in countries with decentralised or uncoordinated bargaining arrangements, as these will tend to restrict the degree of trade union power and leave the firm relatively free to determine the wage and employment conditions in its own plants.

The second paper by Radulescu & Robson (2004a/EPRIEE-07) represents an important addition to the scarce empirical evidence on the effects of trade unions and wage-bargaining structures on the location of foreign direct investment.[26] To investigate this issue, the authors undertake an econometric analysis of foreign direct investment flows using panel data on 20 OECD countries. The data cover the period from the early to mid

[26] A recent study by Cooke (1997) finds that foreign direct investment by US multinational companies is attracted to countries with decentralised wage bargaining systems and deterred by high levels of trade union density, thus supporting the conventional wisdom in this area. The limitations of this study are that it is based on the decisions of multinational enterprises based in only one country – albeit that the US is the largest contributor to global foreign direct investment flows – and that it focuses only on a single year, 1992.

1970s (the precise date varies between countries) to 1997. The start date is dictated by the availability of data on FDI flows, while the end date is dictated by the measures of trade union density and bargaining coordination.[27]

Table 18 in the annex to objective 2 presents selected data on trade union density, the incidence of coordinated bargaining and real inflows of foreign direct investment for the countries in the sample. The measure of wage bargaining coordination is an index with a range 1-3, compiled by Ochel (2000), and based on data reported in OECD (1997) and other sources. It is increasing in the degree of coordination in the bargaining process, both on the employers' side and between trade unions. From this data it appears that the level of wage bargaining coordination has tended to be relatively high in the Scandinavian economies (though less so in Finland), but notably also in Austria, Germany, Ireland and Japan. In contrast, the US has been characterised by uncoordinated bargaining.

The study finds negative effects of trade union density and the degree of wage bargaining coordination on the level of inflows of foreign direct investment into an economy. These results are therefore supportive of the conventional wisdom on the effects of trade unions on foreign direct investment. The effects that we have identified in the empirical analysis are quantitatively as well as statistically significant. In their most conservative estimates the authors find that a 10% decline in the level of trade union density may be expected to lead to an increase in real inflows of FDI of around 3.4%; slightly more than the impact of a 10% increase in real per capita GDP.

Another relevant finding of the study is the fact that the presence of more pervasive extension practices helps to dilute the negative effect of trade union density on inflows of FDI. The authors argue that in the presence of pervasive extension practices trade unions may take greater cognisance of the employment effects of their actions and thus be more inclined to moderate their wage claims, thereby presenting less of a deterrent to potential multinational investment.

What are the main policy implications?

As in most growing economies around the globe, SEE offers many opportunities to profitable investments. However these countries need to tackle the persistent barriers and problems that actual and potential enterprises face in conducting their business. In

[27] The data on trade union density are taken from the Labour Market Institutions database of the Centre for Economic Performance – as described in Nickell & Nunziata (2001) – updated with information from Ebbinghaus & Visser (2000). The measure of wage bargaining coordination that we use is taken from Nickell (2003). We refer the interested reader to the article for additional details.

this part of the report, we stress the importance of flexible labour market institutions for investment attraction.

The current situation in the SEE countries with respect to labour market flexibility is rather mixed. Although the group seems to have on average a more rigid labour market with respect to CEECs countries according to a set of indexes calculated each year by the World Bank (see Table 2), striking differences emerge when looking at single countries in the area. Romania seems to have the most rigid labour market, in particular for what concerns the difficulty of hiring and firing. Also Croatia and Bosnia-Herzegovina show a similar pattern although on a smaller scale. Rather low values of the indexes, corresponding to more flexible labour market regulations, are observed in other SEE countries, particularly in Serbia and Montenegro. While in 2003, Croatia together with other new EU members (Hungary, Latvia, Poland and Slovakia) introduced more flexible employment regulation, Albania and Romania passed more restrictive regulations. In Albania the flexibility of working hours was reduced, payment for work during weekends doubled and fixed-term contracts were allowed only for temporary jobs. In Romania the premium for overtime work was increased from 50 to 75% and term contracts can be used only for exceptional needs, making their use unlikely.

Table 2. Labour market flexibility in SEECs and CEECs: Some evidence

	Difficulty of hiring index[a] (0 - 100)	Rigidity of hours index[b] (0 - 100)	Difficulty of firing index[c] (0 - 100)	Rigidity of employment index[d] (0 - 100)	Firing costs[e] (weeks)
Albania	11	60	20	30	55
Bosnia and Herzegovina	78	40	30	49	33
Bulgaria	33	40	10	28	30
Croatia	61	60	50	57	55
Macedonia, FYR	33	40	40	38	38
Romania	78	60	50	63	98
Serbia and Montenegro	28	0	40	23	21
SEECs	*46*	*43*	*34*	*41*	*47*
Czech Republic	44	20	20	28	22
Estonia	11	80	40	44	33
Hungary	11	80	30	40	34
Latvia	78	20	50	49	42
Lithuania	33	60	30	41	34
Poland	11	60	30	34	25
Slovak Republic	0	20	10	10	17
Slovenia	28	80	50	53	47
CEECs	*27*	*53*	*33*	*37*	*32*

(a) The **Difficulty of Hiring index** measures whether term contracts can be used only for temporary tasks; the maximum duration of term contracts; and the ratio of the mandated minimum wage (or apprentice wage, if available) to the average value added per working population.

(b)The **Difficulty of Firing index** has 8 parts: whether redundancy is a fair ground for dismissal; whether the employer needs to notify the labor union or the labor ministry for firing one redundant worker; and the same for group dismissals; whether the employer needs approval from the labor union or the labor ministry for firing one redundant worker; and the same for group dismissals; whether the law mandates training or

replacement prior to dismissal; if priority rules apply for dismissals; and if priority rules apply for re-employment.

(c) The **Rigidity of Hours** index is a simple average of 5 indicators: whether night work is allowed; whether weekend work is allowed; whether the workweek consists of 51/2 days or more; whether the workday can extend to 12 hours or more (including overtime); and whether the annual paid vacation days are 21 or less.

(d) The **Rigidity of Employment index** is a simple average of the Difficulty of Hiring, Rigidity of Hours and Difficulty of Firing indices, varying between 0 and 100, with higher values for more rigid regulation.

(e) **Cost of firing** is expressed in months of salary equivalent to the severance package.

Source: Doing Business 2005, World Bank (2004).

The results presented above may be seen as lending support to the position of those governments and commentators who have advocated the merits of flexible labour markets as a means of attracting internationally mobile FDI. For governments that aim to attract greater inflows of foreign direct investment into their economies, measures designed either to reduce the level of trade union membership density (for example, legislation to curb the existence of union 'closed shops') or to encourage greater plant-level flexibility in wage bargaining and less strict employment protection may be effective. However, the results also indicate that for economies in which political constraints or concern for wider social and economic objectives inhibit the scope for reductions in the level of trade union density, an alternative means of stimulating inflows of FDI may be to encourage greater – rather than less – coordination in wage bargaining.

The findings may add substance to the fears of those who have expressed concern that competition between governments to attract internationally mobile capital investment could lead them into a 'race to the bottom' in labour standards relating to employment protection.

The challenge ahead for the South Eastern European countries will be that of improving the flexibility of employment law while guaranteeing fundamental workers' rights. Given the high unemployment rates in the area, reforms and deregulation aimed at increasing the flexibility of the labour market will bring a substantial pay-off in terms of job creation.

In all, while it may be true that much of the production outsourcing from the EU to Eastern Europe may have been attracted there by low labour costs, the situation might

change in the future. If they want to maintain one of their chief FDI attracting factors, the SEECs' government should avoid allowing excessive employment protection.

2.5. The challenges of migration

Migration is one of the major issues on the political agenda across Europe. Although discussion around immigration, asylum and border-control policies started in the mid-1980s, when some EU members initiated removing barriers among them and facilitating the movement of workers, these policy areas still represent an unfinished business. Most member states find it hard to reach an agreement on this sensitive issue and see every step in this direction as a weakening of sovereignty.

Managing migration, and in particular moving towards common policies in an enlarged Europe is proving even more difficult. The fear of the old EU members that the large economic disparities between them and the new member States would provoke large migration inflows has given rise to restrictions imposed on potential migrants from the new 10 members. As a consequence, the concept of EU citizenship (right to freely move, reside and take employment in a member state) is not widely applicable anymore across the Union: the new member states entered on May 1, 2004 as 'second-class EU citizens' with the right of freely moving and residing in any other member states but with limits on their rights to take up employment.

The question is even more sensitive when looking at potential migration into the EU from neighbouring SEE countries, given the large economic disparities and their proximity. In addition recent crises in the area have generated considerable flows of refugees and asylum-seekers from the area.

In general, the recent evolution of immigration and asylum policy is the result of mounting anti-immigration sentiment, weak economic growth and high unemployment rates in the major EU economies. But what is the result of stricter immigration policy towards new members and other countries such as SEE countries? As we have learned from many past experiences (US-Mexico being the most emblematic), making laws more restrictive does not stop people from crossing the borders, but it directly translates into more and more illegal migration. From a policy point of view, it becomes imperatives to enhance our knowledge about this phenomenon.

In this section, our contribution to the debate is twofold:

1) We present the results of a recent survey on illegal migration in Italy (Chiuri et al., 2004/EPRIEE-14), a country that has become the main gateway into the

European Union (EU) for illegal immigrants. In particular, our attention will be focused on the characteristics of illegal migrants coming from SEE countries.

2) We present empirical evidence on the effects that crises in the country of origin have on the inflow of illegal migration into Europe (Chiuri et al., 2004/EPRIEE-15).

The findings of these studies shed light on a phenomenon where information is scanty and suggest important policy directions for the EU. In particular, by comparing the economic consequences of intervention (preventing mass immigration before it begins) and non-intervention, the analysis highlights the implicit effects of the various policy choices the EU will need to take should further crises occur in neighbouring countries.

2.5.1. Illegal immigrants into Italy and Europe: Results from a field survey

As is well known, illegal migrants (or clandestines) are those who unlawfully enter a country or overstay the expiration date of their visa or asylum-seekers who remain despite not having been granted political refugee status. It is quite difficult to exactly measure the scale of the phenomenon of illegal migration in a country. As a matter of fact, although national and international statistical institutions usually provide accurate statistics concerning the legal migrant populations, they only produce estimates of the illegal ones.

From January to September 2003, a team of researchers at the Department of Economics, University of Bari[28] designed and conducted a data collection regarding the phenomenon of illegal migration in Italy, one of the main gates for migrants into the EU. The product of this joint effort is the Survey on Illegal Migration in Italy (SIMI henceforth), aiming to contribute to the scant knowledge currently available on the phenomenon of irregular migration in Italy. It collects information concerning the main demographic and socio-economic characteristics of a representative sample of 920 clandestines, as well as disentangling their motivations and future expectations. As will be clarified later on, the sample unit is a clandestine, 18 years old or older and staying in Italy for a period no longer than 6 months.[29].

[28] See Chiuri et al. (2004a/EPRIEE Working Paper No. 14).
[29] The statistical reliability of the information collected is based on a precise definition of the sampling unit, that allows us to delimit the reference population. Interviewing a sufficient number of non-representative sampling units would bias the quality of the results.

The composition by nationality of the migrants interviewed is reported in Table 19. of the annex to objective 2. Citizens of Balkans[30] countries represent a consistent share of the sample (14%), well above the share of those illegal migrants coming from CEECs (3%). There might be different reasons for such divergence between the two areas, for instance the higher proximity to Italy of the Balkans and the generally lower level of development in SEECs compared to CEECS. But it might also be the case that EU accession by enhancing the growth prospects in the country of origin reduces the push factors of migration. The fact that migration from East Germany was substantially lower than was feared before reunification could be partly explained by a similar mechanism working through potential migrants' future expectations about their countries. Further research is needed to validate this potentially important effect.

A close inspection of Table 19. of the annexe highlights an important issue that will be discussed in more detail in the next section: social and political conflict and economic and financial crises are one of the most important factors explaining illegal migration. Individuals coming from countries that have experienced such episodes represent a large share of the total (Iraq, 9.6%; Liberia, 9%; Sudan, 5.4%; Kosovo, 3.2%; etc.). Policy intervention aimed at preventing crises has a potential for reducing illegal migration at least as important as stricter border control.

Who are the illegal migrants coming from the SEE countries?

[30] Albania, Kosovo, Romania, Bulgaria, Croatia, Serbia and Montenegro, Bosnia and Herzegovina and Macedonia.

Table 3. From which nation did illegal migrants in the survey reach Italy?

	number	%
Albania	44	4.78
Algeria	29	3.15
Austria	48	5.22
Bosnia	2	0.22
France	59	6.41
Greece	55	5.98
Germany	14	1.52
Israel	3	0.33
Libya	190	20.65
Macedonia	4	0.43
Morocco	11	1.20
Slovenia	111	12.07
Switzerland	6	0.65
Turkey	197	21.41
Tunisia	41	4.46
Other	84	9.13
na	22	2.39
Total	920	100.00

Source: Chiuri et al. (2004/EPRIEE-14).

The importance of the SEE countries for EU immigration policy stems not only from their role as sending countries but is also due to the importance of the area as a 'bridge to Europe' for other nationals (see Table 3); in particular Slovenia and Albania. A closer cooperation in border controls is under way with these countries.

On average the illegal migrant is about 27 years old and the distribution is highly concentrated in the first class, 18-30 years (for three-quarters of the sample) and another 15% of them are between 31 and 35 years old. As for the total sample, these individuals are mainly male (70%) but the share of female for SEE countries is substantially larger than for the rest of the sample (30% against 11%).

The average monthly income in the country of origin is slightly below $200. Most of the interviewees stated to be literate (96.9%), and the authors also find a discrete level of schooling: almost 39% of the sample interviewed spent more than nine years at school, some achieving high school and in few cases (3%) a first degree. With respect to the full sample, migrants from SEE countries seem to have a lower educational level. This result is not surprising: the act of migration implies a great deal of both human (i.e. ability to gather and elaborate information) and financial resources; therefore, as abundant literature has demonstrated, migration is usually selective toward the individuals with higher abilities. Other things being equal, migration from a closer country is less costly and therefore feasible also for individuals with a lower level of abilities.

What are their expectations?

In terms of their intended final destination, almost 83% of SEE illegal migrants in the sample had Italy as the final destination country, followed by Germany (13.2%).

Most of the individuals where expecting to get a job in relatively low-skill occupations (carpenter 27.1%; cleaner 23.3%; mechanic 8.5%; farmer 6.2%) and earn a monthly income between $500 and $1000 (72% of the interviewed).

The importance of migration for development in these countries is evident when considering the propensity to remit part of the expected earnings: approximately the 80% of those interviewed claim that sending remittances back home is really important. One-third of the migrants expected to send between the 40 and 60% of the earned income and for another 20% of the respondents the percentage is even higher.[31] It is important to underline that individuals whose country/city/village of origin experienced a social, political or economic crisis have a substantially lower propensity to remit.

The majority of the illegal migrants from SEE countries expect to return home (64.5%, a share slightly higher than that of the whole sample, which is 58.4%). These percentages are higher in Croatia, Bulgaria and Serbia (100%) and in Albania (72%); below the average in all other SEE countries.

Should we expect more illegal and legal migrants from these countries?

The survey provides some interesting hints into this crucial issue. The author have asked to the illegal migrant interviewed: *"Why do you think that friends and relatives of your*

[31] Aggregate remittances in most SEE countries represent a considerable share of the GDP (for instance, 17% in Albania, 12.8% in Macedonia) and substantially increase the consumption and investment potential, injecting in these economies a stable and increasing source of financing.

age remained in the country of origin?" The answers to this question for each SEE country and for the entire sample are reported in Table 4.

Table 4. Why friends and relatives of the illegal migrants interviewed remained in the country of origin (percentage of total answers)

	Lack of finance	They are more attached to the family and the job	They are satisfied of the job	They are less risky	They will migrate in the future	Other reason
SEECs	25.8	9.4	5.4	9.3	20.3	29.7
Full sample	31	8.8	4.1	9.9	16.6	28.3

Source: Chiuri et al. (2004/EPRIEE-14).

Lack of finance seems to be the major motivation for potential migrants to not migrate while 20% of the respondents said that they will migrate in the future. This finding suggests that we should probably expect increasing migration as income in SEE countries increases. The establishment of migration networks and remittance flows might be an important channel for financing further migration in the near future. As a country grows, migration flows usually show an inverse U-shaped behaviour: i) at the initial stage the country is too poor to finance migration; ii) once financial constraints are eased and migration takes place, the process is self-reinforcing and out-migration flows increases; iii) this process continues up to a point where growth and economic prospects in the country of origin offset the initial push and pull factors which triggered migration, and migration outflows start to decline. While out-migration flows are still considerable in most SEE countries, it is likely for some of them that the peak has already been reached. Further progress in the EU-SEE economic and institutional integration may contribute to speeding up the decline of these flows.[32]

2.5.2. Crisis in the country of origin and illegal immigration into Europe via Italy

Since the 1990s, Italy, once the 'land of voyagers, saints and emigrants', thanks to its geographical position and the extensive length of its coastline, has become the principal gateway to illegal migration into Europe.

[32] Most of the EU countries (for instance Italy and Germany) have experienced a similar migration pattern in the past.

The literature generally divides the factors determining immigration into two main groups: 'pull' (or demand-side) factors and 'push' (or supply-side) factors. Among the former, the recent literature has stressed institutional features and policies implemented in the host country as well as other factors which determine the costs and expected benefits of immigration. These include the presence of social networks, transport costs, language and religion contiguities and the regulation of the labour market, which if too rigid may foster the growth of the black-market economy. Among push factors, since its early stages, the literature has emphasised wage differentials between the host country and the home country. However, in the specific case of illegal immigration into Europe, political and financial crises, social conflict and famine in the countries of origin may be of major importance.

So far, empirical research on these aspects has concentrated on immigration into the United States (especially illegal immigration from Mexico). This is probably because the United States has historically been the main receiver of immigrants, attracted to that country by high wages. Yet European immigration differs from that of the US for various reasons: net flows into the EU grew during the 1980s, peaking in the 1990s owing to wars and ethnic conflicts. These specific historical events, together with tighter controls at European borders, have reduced the flow of legal immigrants and increased the flow of illegal ones. Therefore, for historical and geo-political reasons, immigrants into the EU have demographic characteristics and expectations that differ substantially from those of immigrants into the United States. Moreover, to a certain extent, European immigration may be temporary in nature.

The contribution by Chiuri, De Arcangelis & Ferri (2004/EPRIEE-15) analyse the hypothesis that economic, financial and political crises hitting the countries of origin may generate impulses augmenting migratory inflows into the European Union. Obviously, originating from the crisis momentum, the inflows mostly consist of illegal aliens rather than regular migrants. To this end, data on apprehensions of illegal migrants in Italy (the main country of entry for illegal aliens to the EU) are used to show econometric support for the outlined hypothesis. The paper examines illegal immigrants rather than legal ones for two reasons: firstly because the majority of immigrants entering Italy are only in transit towards destinations in other EU countries; secondly because consideration of illegal rather than legal immigrants purges the analysis of the distortions that would otherwise arise from the amnesties granted in the past decade. Analysis is conducted of the period 1990-2000, which comprises various crises that have erupted in the Mediterranean basin (e.g. in the area inhabited by the Kurdish people) and in the Balkans (e.g. the conflicts in the former Yugoslavia or the crises in Albania).

This study analyses the trend over time and by country of origin of illegal immigration as approximated by the number of expulsion orders issued by the Italian authorities – that boomed from some 10,000 in 1990 to almost 150,000 in 2002 – certainly providing an underestimation of the phenomenon given that only a tiny fraction of the illegal immigrants entering Italy are apprehended.

The data on immigration are supplemented with variables relating to the main features of the countries of origin, including: i) a proxy for expected future earnings based on net per capita national income; ii) an exponential function of geographical distance from Italy as a proxy for the costs of migration; iii) the legal (male) immigrants resident in Italy at the beginning of the period by country of origin, as an approximation of the pre-existence of social networks and iv) two dichotomous variables indicating religious and language contiguities with those prevailing in Western Europe. The paper uses the numerical composite indicator of political, financial and economic risk as classified by the ICRG Risk Rating system that allows country risk comparability for a large number of countries. After introducing the control variables for push and pull factors, the empirical analysis assesses whether and to what extent crises in the country of origin associate with an increase in the number of expulsion orders issued –and, as a consequence, in the migratory flows– pertaining to that specific country.

What is the effect of crises on illegal immigration?

Empirical results obtained by the authors confirm that crises in home countries significantly amplify illegal immigration into (or through) Italy. For example, when a country moves from what the ICRG risk rating system calls a situation of 'moderate risk' to one of 'very high risk', as Albania did in 1990-92, its share of illegal immigrants entering Italy increases by around one percentage point. In other words, a crisis of the kind experienced in Albania would increase the number of expulsion orders vis-à-vis Albanians by around 1,000 units per year, implying a much larger impact on the 'true' number of illegal immigrants from Albania, given the mentioned under-estimation intrinsic in the used proxy.

These results have clear (international) policy implications: the costs of intervening to alleviate severe crises in the countries of origin should be weighed according to their ability to limit socially undesirable mass migrations towards the European Union.

In a Union more and more concerned about controlling its borders, these side-effects of a politically stable and economically solid SEE area are of considerable importance.

3. Objective 3: Economic Impact of CEEC Enlargement on the EU-15

3.1. Quality Standards

There is a widespread belief among economists and policy-makers that, while formal trade barriers may have been reduced greatly in recent years, there may be growing barriers –whether intentional or unintentional – resulting from the imposition by nation states and by international blocs of technical regulations on product safety, labelling, environmental emissions, hygiene and the like. It is increasingly suggested that these barriers may be manipulated by national authorities as an alternative, and potentially costly, way of discriminating against import suppliers in favour of their domestic industries, and that trade rules need tightening to reduce such protectionism.

Such a sentiment underlies the Annexes on Technical Barriers to Trade (TBTs) and Sanitary and Phytosanitary Standards (SPSs) to the World Trade Organisation Agreement from the Uruguay Round. The WTO Agreement Annex on TBTs recognises that countries have legitimate reasons for introducing product regulations, but that such regulations must not "be more trade-restrictive than necessary to fulfil a legitimate objective, taking account of the risks non-fulfilment would create". Attempts to reduce perceived TBTs also underlie the European Union's Single Market initiative and several recent trade agreements. Nevertheless, there is still considerable disagreement between those (particularly developing country lobbyists) who argue that regulations are still highly obstructive to trade and those who feel countries' sovereignty and the environment and quality of life of their citizens would be at risk from loosening regulations.

Looking at this from an economic angle, the case that there may be much hidden protection embodied in national standards and regulations has been argued forthrightly by Richard Baldwin and others involved in a current World Bank study. There have also been strong arguments in support of the idea that the simplest way to reduce such 'regulatory protection' barriers is by introducing mutual recognition agreements, where a group of countries agree that if goods are judged satisfactory for sale by the authorities in their country of origin, all countries would treat them as acceptable. This mutual recognition principle effectively underlies much of the legislation underpinning the European Union's Single Market and the Asia Pacific Economic Community.

The problem is that economic arguments to back up this increasingly popular policy prescription have little formal theoretical basis at present. What work has been done has often been either i) rather narrow case studies of technology within individual industries, ii) ad hoc studies based upon the assumption that if two countries trade less than simple

econometric models would indicate, this must be because of 'regulatory protection' or iii) a few very complicated models of product choice.

There are strong reasons to be sceptical about the current literature on 'regulatory protection'. For a start, minimum standard regulations are rarely introduced primarily for protectionist reasons. Rather they serve important purposes in protecting consumers in cases where there are product compatibility problems ('network externalities' such as the different technical standards for TV or telecoms equipment), informational problems (so that 'bad' suppliers may drive out 'good' ones), safety and disease control issues or issues of monopolistic supply. We cannot always be sure when such standards are really being distorted in order to benefit one country at the expense of its trading partners. Nor can we always conclude that such distortions will be trade-reducing – quite the contrary, it is conceivable that a country may be tempted to use legislation in such a way that its neighbours are induced to sell it more goods at lower price. The assumptions that such regulations necessarily form large trade barriers in practice and that trade fora such as the WTO are the appropriate place to determine national quality regulations are not really supported by much theoretical analysis.

Against this background, Edwards (EPRIEE-12) sets out to examine in a more rigorous theoretical way the issue of quality regulations, particularly minimum quality standards (e.g. for safety or reliability) for goods in an open economy, where the motive is to correct an under-provision of quality by a monopolistic or oligopolistic industry. He shows that, on reasonable assumptions, a monopoly or duopoly will tend to produce goods of less-than-optimal quality (selling substandard goods is really just another way a monopoly raises its profit margins). This provides a justification for governments to set minimum quality standards by regulation benefiting consumers.

The issue then becomes one of how regulators' choice of standard is affected when an economy is open to trade. It is shown that when a monopoly supplier is foreign, the importing country's government has an incentive to set higher-than-optimal standards, which induce the foreign company to sell it more goods at a lower price, benefiting consumers at the expense of profits. This same strategic policy distortion happens when two countries with one firm in each engage in trade: regulators set higher-than-optimal product standards, in order to benefit their own consumers at the expense of foreigners' profits.

However, an important point arises: these strategic distortions in policy-makers' choice of standards actually increase, rather than reduce, international trade, and do not

necessarily favour one country's producers over another's. It follows that, while policy may not be optimal, it is not protectionist in the sense that it is an obstacle to trade.

Further, mutual recognition agreements can themselves introduce policy distortions. If a monopolistic producer in one country can raise its profits by selling sub-standard goods to foreigners, then it may benefit its home country to allow it to do so, even if this also reduces the quality of goods sold at home. It follows that when countries agree to enter a mutual recognition agreement, regulatory standards, which are set too high under non-cooperation, will become too low.

The paper then looks at what happens when different countries have technological differences. In this case, it has often been argued that, since when there is imperfect competition suppliers can make profits on all goods sold, governments have a strong incentive to introduce regulations which increase their home firms' share of the local market at the expense of foreigners. This is called 'profit-shifting', and can lead to protectionism.

While there is some validity in this argument, this paper makes some contrary points ignored in the existing literature:

1) There is little incentive to use regulatory protection if other, less-costly methods of protection like tariffs are available to policy-makers.

2) The analysis in the first part of the paper shows that, in the absence of a mutual recognition agreement, policy-makers have a strong incentive to force up producers' quality standards, benefiting consumers at the expense of producers. This may well leave profit margins much lower than previous studies have estimated, and as a result the incentives to introduce protectionist barriers for profit-shifting motives are greatly reduced, or even totally eliminated.

Therefore, while there is indeed a problem of policy biases in setting quality standards on traded goods, this may well not take the form of protectionism. To assume that such policies may interfere with trade to the extent that they should be dictated by international trade bodies (rather than by other forms of international negotiation) may result in excessive interference in countries' internal policies. Even the current consensus in favour of mutual recognition agreements may be misplaced in some circumstances.

With regards to the impact of the accession of the new member states to the EU-15, one assumes that the setting of quality standards inhibits new member states from delivering products into the common market. Therefore, these measures are being seen as barriers

for trade and have a positive effect on the EU-15. By receiving little competition from the new member states, their exports to the new member states remain intact.

3.2. Voting decisions in the agricultural sector

Agriculture still plays an important role in both set of countries, the EU-15 and the CEEC-10. Changes in the political arena in all East European countries and the globalisation and liberalisation of international markets have all contributed to the creation of a new framework for reforming the CAP. The proposed reforms and their structures have been introduced through the Agenda 2000, which aimed simultaneously to reform the CAP, the EU budget and regional policy. The reformed package has been based upon two major requirements: first of all the preparation of the EU for the accession of new members from East and Central Europe, and second the need to facilitate the EU negotiating position in the ongoing round of the WTO. All this is envisaged to lead to an ever more liberal CAP and it would induce major developments concerning issues like competitiveness of agricultural production, income and finance.

With the agreement and ratification of the Agenda 2000 CAP reform, the EU set the scene for an agricultural policy for an enlarged Union. The Berlin summit did not change the CAP fundamentally, but it had its impact on two major fronts. The first was to reach an agreement on a ceiling for the CAP budget for the 2000-13 period, deemed necessary to control spending after the forthcoming enlargement. Secondly, since only little progress was made to trim the CAP for imminent WTO negotiations, a mid-term review (MTR) of the Agenda 2000 was agreed. The ratification of the mid-term review in June 2003 made significant progress in making the CAP 'fit' for the WTO, by reducing domestic support as well as re-addressing support to the extent that it is less trade-distorting, extending market access and give greater emphasis to developing countries. Both of these points are of great importance to the enlargement and its impact on the EU-15.

Of particular interest with regard to the impact of an enlarged Union on the EU-15 agricultural sector is how the new member states would vote on both a future CAP reform as well as within the EU's single voice in WTO negotiations. Both of these scenarios may have significant consequences for the EU-15, because it could potentially slow or block future CAP reform progress and/or make the EU in the WTO negotiations less progressive on reforms. But then again, the opposite effects could emerge.

So far, only a few attempts have been made to analyse the initially-stated preferences of the EU member states, since only the final preferences by the Council are published. Schneider's study (EPRIEE-23) is based on positions adopted by member states on the initial proposals to the Agenda 2000 and it tries to identify the elements that helped in

achieving the final compromise. It also examines the formation of coalitions between member states, which is further explored in relation to the degree to which these coalitions acted as supporters of or opponents to the proposed reforms.

However, to make a more timely assessment of the national interests of the EU-15 member states as well as their intentional voting, it has been decided to take the position of the EU-15 member states towards the Mid-Term Review (MTR) of the Agenda 2000 as a benchmark for the purpose of this study. The initial positions are laid out in Table 5, where the position of each EU-15 member state and their preferences towards policy options on the MTR agenda have been set out (Agra Europe, 1999). It can also be observed from Table 5. that some countries changed their position in relation to the Agenda 2000 negotiations in 1999. In particular, Germany turned from an anti-reformer to a pro-reformer largely due to internal budgetary constraints and the new emphasis of the agricultural minister who is directing the policy further towards a freer market.

3.2.1. Voting models for agricultural policies

A look at the literature reveals that two basic models (Swinnen & van der Zee, 1993) have been frequently being used for the rationalisation of agricultural policy. These are the lobbying model (Gardner 1987; Miller, 1991) and the so-called voting model (de Gorter & Tsur, 1991; Swinnen & de Gorter, 1993). The lobbying model is based on the theoretical background developed by Olson (1965) concerning the importance of the production costs in the creation of coalitions and groups of interests that have as a common goal the approval of policies favourable to their interests. From this point comes the position regarding the ability of small groups to obtain protection. Also the size of the benefits to be secured is a basic motivation in the creation of groups, since between two groups that face the same organisational cost, the one that will expect the higher benefit will be the one most actively seeking protection (Olson, 1985*).*

The voting model is based on the assumption that political decision-making is influenced by two groups. On the one side are the politicians, who due to their position of common interests can (or are willing to) offer protection. On the other are the voters, who ask for protection by offering in exchange their voting support to politicians who satisfy and serve better their interests. There are politicians who for their own interest can use income redistribution to the advantage of low-income groups (Baldwin, 1989) or more specifically towards the imposition of measures of agricultural policy protectionism (de Gorter & Tsur, 1991). This is explained by the increase in political support that results from a strong redistribution policy and greater economic support, whose size corresponds to the decrease in support due to the reduction in the number of farmers. Under this

approach, agricultural protectionism increases as agricultural income decreases in relation to the incomes per capita realised in the non-agricultural sectors of the economy (Swinnen & de Gorter, 1993). They pointed out that the CAP currently benefits a small but well organised minority of farmers at the expense of the vast majority of consumers who remain fairly unorganised and under-represented in the context of CAP reform discussions. Farmers interests prefer CAP control to be central rather than local, as this permits decisions to be taken further away from electorates that eventually bear the costs of the agricultural policy, thus also leading to resistance to ideas promoting the co-financing or else the re-nationalisation of agricultural policies.

Table 5. Member states' positions on the mid-term review (July 2002); numbers in brackets show votes in Council

	France (10)	Germany (10)	UK (10)	Italy (10)	Spain (8)	Belgium (5)	Greece (5)	Netherlands (5)
Decoupling	No. No change to form or level of payment	Yes. Minister claims it was her idea	Yes. Pro-reform and bold	No. Full decoupling is seen as CAP breakdown; partial maybe	Reference period would create tension between farmers	No. Full decoupling not acceptable, partial maybe	No. Decoupling a threat to rural employment	Yes. Courageous and visionary
Dynamic modulation	See above, 2nd pillar reinforcement through other means	Yes. Degressivity instead. No ceiling on payments	No. Degressivity instead. No ceiling on payments	No. No money diverted from 1st pillar. Not apply to wine or olive oil	No. 20% cut excessively large	No. Raise money for RD through export subsidy savings	No. 1st pillar serves social function should not be diminished for RD	Yes. To be limited by overall budget savings
Cross-compliance			Yes. Sensible		No. Rules too rigid			
Cereals	No. No price cut				No. Too early to consider price cut	No. No price cut		
Others			Want to see proposals to abolish milk quotas	Durum wheat proposal hurt marginal farmers; Tobacco,	Durum wheat unacceptable	Maintaining dairy regime beyond 2006 more advantageous	Durum wheat, rice, olive oil all unacceptable	

				olive oil should not be in MTR				
General comments	Ready to negotiate but hard to see what is ready to negotiate over. Less aggressive than predecessor	CAP reformist but unwilling to penalise Eastern German farms. Modulation negotiating tactics	Same position as Germany. Compromise based on Commission agreeable. Unrealistic with milk	Anti-reform. Agenda 2000 not being altered until it expires in 2006.	Reform neither pressing nor essential. Anti-reform tactic, but rules nothing out, could be swayed	No financial reasons for reform, re Berlin, but pressures to do something now	Traditionalist defender of status quo and Med products subsidies	Seeking budget savings to pay for enlargement and could support Fischler going further

Table 5. cont. Member states' positions on the mid-term review (July 2002); numbers in brackets show votes in Council

	Portugal (5)	Austria (4)	Sweden (4)	Denmark (3)	Finland (3)	Ireland (3)	Luxembourg (2)	Comments
Decoupling	No. Not enough redistributio n	No. Very critical, breaks links with production	Yes. In principle	Yes. Needs further study	No. In its proposed form does not rectify inequities	No. Will reduce economic activity, damaging RD	No. Would reduce farmers income	55 votes against, 32 in favour. P & Fin could be swayed; F & SP did not rule it out
Dynamic modulation	No. As above	No. Unworkable as proposed but preferable to degressivity	No. Uncertain effect. Transfer to RD based on real need	Yes. Would pay for measures like quality standards and animal welfare	Yes. Cohesion effect welcome	No. Reduction s in aids to smaller holdings not tolerable	No. Direct support cannot be reduced without compensation	76 votes against only 11 in favour. D & UK back degressivity but could accept modulation, P & SP maybe
Cross-compliance		No. Unworkable as proposed	No. Uneven effect		Needs to take into account difficult climate north	YES.	No. Bureaucratic and unnecessary	16 in favour with Fin, 18 against, others did not comment
Cereals			Abolish intervention , make compensatio n uniform		No. Price cuts must be fully compensate d			30 against, none voiced support, maybe easy bargaining chip for Fischler
Others								23 against durum wheat proposal

General comments	Not in favour but open to the idea	Anti-reform, back RD with benefits to environment, but not decoupling or modulation	Pro-reformer, but only lukewarm to big idea	Environmentally pro-reformer	New member state still trying a bigger slice of CAP, little subsidies so far	Ambiguous anti-reformer against major changes until 2006	Minnow in anti-reform, could accept cap on direct aid, simplified payment scheme	Every member state showed willingness to negotiate. F & SP did not rule out decoupling and modulation, prefer no change until 2006, D, UK, NL and SW have 29 votes enough to sink agreement, counter argument that there is no need for reform is popular and convincing

Source: Agra Europe

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Endogenising the decision-making on a supra-national policy, such as the CAP, invariably poses certain difficulties. First of all because the interventions of the interest groups take place at the national level and are transferred to the EU level mainly through the national governments. Secondly, because the approach of the voters can only be interpreted with great difficulty regarding decisions at the EU level, since the attitude of the voters is formed basically at a national level and the decision-makers are controlled in an indirect manner by the body of voters.

According to Tracy (1997), two major groups have been created in terms of agricultural policy; the first group consists of countries characterised by significant differences between them, but with a relatively clear and predictable overall political position. This first group includes a subgroup of countries with a liberal orientation and a tradition of large and efficient agricultural enterprises like the United Kingdom, and of countries whose agricultural sector has strong structural advantages, like the Netherlands and Denmark, which are countries with an export orientation. This first group includes a subgroup of countries with an agricultural sector of considerable size, which is characterised by structural problems of a different magnitude, like Spain, Greece, Portugal, Ireland, Finland and Austria. The second group, according to Tracy, is limited to two countries: Germany and France. These two countries are characterised by a tremendous agricultural heterogeneity. In the case of Germany, heterogeneity derives from the different policy objectives set by the individual *länder* and the differences between the eastern and the western parts of the country (former DDR and Federal Republic of Germany, respectively). This has often left Germany unable to present an integrated political position despite a stated preference toward the continuation of the status quo. The French positions aim at satisfying heterogeneous and frequently contrasting interests within the country. The history of CAP reforms shows that no decision has ever been taken over the opposition of both France and Germany.

But even between countries with common positions and interests, differences can be observed in relation to their political willingness, particularly where policies on specific products are concerned. A good example of this is the bloc of the Mediterranean countries of the EU. While Greece and Spain both demand an increase of the Maximum Guaranteed Quantity for cotton, they take very different positions in regard to the existence of a national quota for cotton, where Greece is in favour of its abolition, while Spain wishes its continuation. The opposite applies to the case of olive oil, with Greece supporting the introduction of a national quota, while Spain is opposed to this option. Thus, the importance of each product is the determining factor in the formulation of national positions with regard to CMO discussions.

Generally speaking, the basic factor that determined the national positions on previous CAP reforms was the net benefits derived by the member states from the Community Budget (Tracy, 1997). The countries leading the calls for the current CAP reform are the UK and Sweden followed by Denmark, while Germany opposed the proposals driven mainly by budget considerations, supported by Ireland and Spain which opposed reforms for reasons related to budgetary allocation to Structural Funds. But the reasons for the exerted opposition of support were not unique or simple. For instance, although the UK was in favour of cost cuts, it was against the introduction of ceilings on the subsidies given to agricultural enterprises, which were expected to help in the reduction of CAP costs. This simple example identifies the difficulties to reach an agreement, since the Agenda 2000 proposals reformed not only market policies, but also imposed budgetary constraints and changed the way that agricultural policy interacted with regional policy. It is here, that it is expected that the new member states will be holding the key to the outcome of future voting decisions, because self-interest is believed to be put first.

Based on the political behaviour of member states at the Council of Ministers, there have been in the past groupings of countries on several issues. Despite the frequent changes of government, it has been observed that the positions of the national representatives remain relatively constant. Thus, assigning countries to groups is a logical exercise, even if it sometimes entails certain risks. The grouping of the EU-12 countries according to their attitude towards free trade carried out by Hamilton (1991), placed the United Kingdom, Germany, Denmark and the Benelux in the free market group, while France, Italy and the Iberian countries were considered as primarily protectionist. Greece and Ireland occupied the middle ground. When Hamilton examined the positions of EU countries on environmental issues he concluded that the countries of the Southern Europe (i.e. Greece, Spain and Portugal) would not support countries like Denmark, Belgium, Luxembourg and the Netherlands, which are more environmentally minded. This thinking supports the idea that there is a permanent character to the inequality that appears between the developed countries of the North and the less developed South.

Table 6. Distribution of votes in the EU Council of Ministers

Member state	Votes pre-Nice	Votes post-Nice
Austria	4	10
Belgium	5	12
Denmark	3	7
Finland	3	7
France	10	29
Germany	10	29
Greece	5	12
Ireland	3	7
Italy	10	29
Luxembourg	2	4
The Netherlands	5	13
Portugal	5	12
Spain	8	27
Sweden	4	10
United Kingdom	10	29
Czech Republic	5	12
Poland	8	27
Hungary	5	12
Slovenia	3	4
Estonia	3	4
Cyprus	2	4
Malta	2	3
Bulgaria	4	10
Romania	7	14
Slovak Republic	3	7
Latvia	3	4
Lithuania	3	7
Total	135	345
Qualified Majority	96	258

Source: Own calculations.

Since the beginning of the 1980s, most decisions taken in relation to the CAP are the result of majority voting. Only rarely have member states claimed reasons of national interest (the Luxembourg compromise) or reached unanimous decisions (Teasdale, 1993). This means, that in the EU-15, 62 votes are needed for a decision to be taken, while 26 votes are enough for the expression of a blocking minority (Table 6.). Majority voting is especially important for the CAP, since it applies to the most important of the bodies that would decide on any reform: the Council of Ministers.

However, the different weight given to each country does not accurately represent its power to determine an outcome. This is determined by the minimum limit of votes required in obtaining a decision and the predetermined attitude of certain members to any attempt to form coalitions. Even if the resort to the ballot represents a rare situation today, the possibility of using the tool of majority voting has influenced the negotiation behaviour of the member states. Obviously, decisions are taken more effectively when member states have homogeneous views or, in the presence of heterogeneity, by linking national preferences into package deals. The more heterogeneous member states are, the more they can gain by linking decisions and the less likely it is that a single compromise solution will pass (Kirman & Widgren, 1995).

3.2.2. Coalitions of countries in the context of the Nice Treaty summit – an approach

With the ratification of the Nice Treaty in 2003, the proposed new voting weight came in force from the beginning of January 2004. It is in that light that groups of countries have to be identified with common positions towards the proposals for CAP reform under the framework of Agenda 2000, in particular the MTR, thus identifying possible coalitions of member states and their potential voting decisions taken on that matter. In addition, this study also aims of analysing the combined EU member states' voting and decision-making processes as a single unit towards WTO negotiations. This is of particular relevance to this project, because as many researchers argue that CAP reforms had always been achieved only when the EU has been faced with a crisis situation, e.g. related to budgetary issues or, in the case of the 1992 reform, to GATT/WTO conditions.

The two main aims of this study differ significantly, because the first aim, country individual voting and decision-making towards reforming the CAP, will be governed by country-specific issues, whereas the second aim, the EU as a single unit vote in WTO negotiations, will require a single vote decision based on the best interest of the EU as a trading partner. However, it cannot be discounted that the latter will strongly influence and possible be influenced by the first aim (Swinbank, 1989; Tangermann, 1996).

The institutional arrangements of the EU determine decision-making for CAP reforms, but little empirical research has been done on this issue. Game theory appears to be suitable for analysing CAP decision-making. Voting game models have been used in the past to produce estimates for vote calculation in different EU enlargement scenarios (Widgren, 1994) and to explore the distribution of power in the decision-making process under different information integration assumptions (Widgren, 1999). Further Baldwin et al. (2000) undertook a more complex game analysis related to questions concerning decision power in the European Central Bank under various scenarios of enlargement and in the light of changes in the EU voting system discussed in the Nice Summit. Their analysis demonstrates the need to identify possibilities of groups with homogeneous positions in order to continue from a pre-fixed basis with voting game models. Also work by Kandogan (2001), and Nunez-Ferrar & Balcombe (2000) applied various models to try to estimate voting patterns towards CAP or other decision-making processes.

The existing work in this field demonstrates how difficult it is to use voting game theory when a considerable number of players (15 member states and the Commission) is involved and the decision-making process displays the characteristics of a repeated game (several compromising attempts). In addition to these conditions, in the case of Agenda 2000 negotiations, information had been altered during the progress of the game (due to counter proposals that have appeared during the negotiation phase). This study aims to have a simple approach to analyse the impact of enlargement and voting rules on the CAP and the relationship between the process at the EU level and the behaviour of the EU in world agricultural trade negotiations.

Table 7. Proxies for member states voting decisions (1= Pro-reformer; 2= Swinging vote or easily swayed; 3= Anti-reformer)

Old MS	MacSharry	Agenda 2000	MTR (July 2002)	MTR (Jan 2003)	New MS	MTR (Jan 2003)
France	3	3	3	3	Poland	3
Germany	3	1	1	1	Hungary	2
UK	1	1	1	1	Estonia	3
Italy	3	3	3	3	Latvia	3
Spain	2	2	2	3	Lithuania	2
Belgium	2	2	2	2	Slovak Republic	2
Greece	3	3	3	3	Czech Republic	2
Netherlands	1	1	1	1	Slovenia	1
Portugal	2	2	3	3	Malta	1
Austria	N/A	3	2	2	Cyprus	1
Sweden	N/A	1	1	1		
Denmark	1	1	1	1		
Finland	N/A	3	3	2		
Ireland	3	3	3	3		
Luxembourg	3	3	2	2		

Source: Own calculations.

By taking the theoretical aspect as discussed earlier as well as the qualitative elements of political voting, the EU-25 (EU-15 and AC-10) were initially given proxies for their voting decisions based upon Table 6., where the countries were given a 'Pro-reformer', a 'swinging vote' or an 'anti-reformer' indicator. This is shown in Table 7. Tables 6 and 7 devide the EU-15 countries as well as the candidate countries into three groups according to their national interests. By projecting these two tables into the pre-Nice agreement, one can easily see which way CAP reform decisions were taken. Because under the Qualified Majority Voting (QMV) rule prior to the Nice agreement, 62 votes were needed to pass any reform with a blocking minority of 26 votes. Therefore, a reform against the will of two larger countries was almost impossible.

The situation changed significantly with the Nice Treaty, where individual member state votes were re-distributed. This is also shown in Table 6, which also includes the votes for the candidate countries, including Bulgaria and Romania. A short distribution analysis was carried out, whereby the proxies of Table 7 were used to estimate the weighted average among those proxies and changed with respect to the Agenda 2000, the July 2002 MTR and the January 2003 MTR. The results are shown in Table 10 and it can be seen that there is a similar pattern amongst the three reforms for the weighted averages. Both the pre-Nice and post-Nice weighted averages decline slightly from the Agenda 2000 reform towards the July 2002 MTR, but then increase for the January 2003 MTR.

The initial benchmark shown in Table 8. shows the total number of all proxies for voting calculated. As can be seen, there is only a slight change amongst the reforms, although Table 7 shows changes in the voting preference amongst the individual countries.

Table 8. Development of weighted average of voting indicators

Indicators	Agenda 2000	MTR July 2002	MTR Jan 2003
Benchmark	32	31	31
Benchmark < 3	11	13	13
Benchmark + Pre-Nice	50	51	46
Benchmark + Post-Nice	139	141	121
weighted ave Pre-Nice	2.057	2.045	2.103
weighted ave Post-Nice	2.042	2.033	2.118

Source: Own calculations.

That change is not translated into an overall change, however. The benchmark < 3 shows the accumulated voting preference for all 'pro-reformer' and potential swinging votes. The benchmark pre- and post-Nice indicates the actual votes for a reform by calculating the pre- and post-Nice votes, respectively, and this shows, compared with the QMV rules, shown in Table 9, that with the pre-Nice voting a qualified majority would not have been achieved, but it would have with the post-Nice voting rules. So far, only the EU-15 member states are included in this calculation.

The second step in analysing the voting pattern among the EU-25 and candidate countries, was to try to explain why and whether the respective countries are either a 'pro-reformer', a 'swinging voter' or an 'anti-reformer'. The robustness of the proxies has to be tested and verified in order to see whether countries are categorised correctly in accordance with their voting patterns. Therefore, various variables were reported that seem to indicate a significance within a country of influencing the voting pattern (Tables 9. and 10.).

To analyse the variables, a multiple choices regression was initially thought to be employed, as suggested by Greene (1993), because the nature of the data in the study has more than one dependent variable (1-3, depending on the voting indicator estimated in Table 7.) which does not allow the use of binary regressions. Regression analysis for the EU-15 finds that none of the variables are significant in explaining the voting pattern of any individual country. The closes to be significant is the variable x_2 (No. of farms). Also interesting is that the coefficient for average farm size is negative, indicating that the larger the average farm size the more likely the country will be a 'pro-reformer'.

Table 9. Variables affecting the voting pattern of individual EU-15 countries

Country	Share of ag in GDP	% of Employ-ment	Average farm size ha	CAP/VAG %	CAP/GDP %
Variable	X_1	X3	X_5	X_6	X_8
France (10) 29	2.2	4.9	42.0	19.6	0.43
Germany (10) 29	0.9	3.2	36.3	20.3	0.18
UK (10) 29	0.6	2.1	67.7	39.5	0.24
Italy (10) 29	2.4	7.5	6.1	10.7	0.26
Spain (8) 27	3.6	9.3	20.3	17.0	0.61
Belgium (5) 12	1.1	2.7	22.6	9.7	0.11
Greece (5) 12	6.7	3.2	4.4	0	0.0
Netherlands (5) 13	2.2	3.8	20.0	2.0	0.04
Portugal (5) 12	2.4	11.5	9.3	14.8	0.36
Austria (4) 10	1.3	7.3	17.0	8.8	0.11
Sweden (4) 10	0.6	3.3	37.7	37.2	0.22
Denmark (3) 7	2.3	4.4	45.7	17.4	0.40
Finland (3) 7	0.9	7.8	27.3	24.4	0.22
Ireland (3) 7	2.5	12	31.4	35.1	0.88
Luxembourg (2) 4	0.6	3.9	45.4	14.5	0.09

Table 10. Variables affecting the voting pattern of individual candidate countries

Country	Share of ag in GDP	No of farms x 1000	% of employ-ment	% of total gross Value-added	Average farm size ha
Poland (8) 27	3.1	1880.9	26.9	7.6	7.2
Hungary (5) 12	3.8	966.9	8.0	6.2	6.7
Estonia (3) 4	3.2	1714.6	13.1	8.1	20.1
Latvia (3) 4	3.0	124.9	18.5	9.9	18.0
Lithuania (3) 7	3.1	537.0	23.8	9.3	6.1
Slovak Republic (3) 7	1.9	6.7	9.7	6.3	306.0
Czech Republic (5) 12	1.7	53.3	6.3	5.2	12.0
Slovenia (3) 4	2.0	90.6	7.1	5.0	5.1
Malta (2) 3	2.2				1.0
Cyprus (2) 4	3.9	52.0			3.6
Romania (7) 14	12.9	3946.6	34.4	20.5	2.6
Bulgaria (4) 10	11.5	760.7	23.2	13.9	4.7

The numerous calculations revealed that no combination applied resulted in any significance of a variable. This gave us reason to conclude that variables, albeit being of greatest importance on their own, taken together make it virtually impossible to single out one or a set of variables being more important than others. The strong correlation effect, which was proven with this step in the analysis, showed that the interplay of the variables is too great to be able to separate them.

The results from the calculations lead to the final step of the analysis. As suggested by many researchers, decisions cannot be accurately examined quantitatively and hence a qualitative approach is often needed. The examination and reasoning given in the earlier part of this chapter hinted already that decisions relating to a policy vote may be based on self-interest. There is of course no doubt that the above-mentioned variables play a crucial part in the outcome of the decision of a member state. But this is not quantifiable.

Numerous examples might be given as to why member states voted as they did. For example, Germany's change from being an anti-reformer to a pro-reformer was largely stimulated by a set of incidents. The change to a left-wing agricultural minister, the ongoing budget crisis as well as the increased emphasis on consumer protection was largely seen as the catalyst for the change and that against the backdrop of a very powerful and well-established farm lobby. Therefore, variables such as farm size, number of people employed in agriculture, etc., did not influence the debate as much as anticipated.

Therefore it is safe to assume that the new member states will show the following voting pattern for future CAP or WTO negotiations: As for the CAP, it is anticipated that the new member state would show a tendency to veto any radical reform changes. This would be purely out of self-interest and to gain some benefits from the currently enjoyed payments into its sector. A similar behaviour was observed in Finland, because despite being a pro-reform country, it vetoed the Agenda 2000 in order to benefit longer from the CAP and to reach out to the largely rural population.

The reason that almost none of the new member states had a well-functioning and supportive agricultural policy may also add to the case that they will become anti-reformers. This means that their farming constituency for the first time receives farm support payments, which are likely to be welcomed and hence it may be difficult to vote against them. Even though the CAP budget for the new member states is smaller than that of the EU-15, it will be aligned by 2013, the net inflow of payments and in particular for the second pillar, will certainly act as an anti-reformer element.

The picture regarding the new member states' influence on the EU-15 towards WTO negotiations is seen as completely different. Because many of these countries did not have a supported agricultural sector, it is anticipated that most countries would vote for greater agricultural trade liberalisation. This is further explained by the fact that for instance, Hungary used to be a former member of the Cairns Group of countries promoting freer trade with no or very limited support.

Therefore, one must conclude that the enlargement will affect the agricultural sector. As for the domestic issues, a future CAP reform is anticipated to be more difficult to achieve. Countries will act on self-interest and try to optimise their gains from the CAP. In contrast, the new member states might give the EU a greater mandate to further trade liberalisation in WTO talks.

3.3. Mutual recognition and home bias

This part of the report looks at barriers to trade and the level of integration between the EU and Central and Eastern European Countries. Evidence of border effects in the exchanges of Central and Eastern European countries is still an undeveloped issue in the literature. Only Sousa & Disdier (2002) have assessed the effect of a legal framework on bilateral trade flows of Hungary, Romania and Slovenia with EU and CEFTA countries using the 'border effects' approach. Referring to the period 1995-98, they find more significant border effects towards CEFTA countries than towards EU countries. In this paper we consider accession countries of different sizes and other characteristics, i.e. Hungary, Poland, Czech Republic, Romania, Latvia and Cyprus, and measure the extent

to which internal trade exceeds international trade in a set-up where controls for other economic determinants of commerce are considered.

Until now the issue of border effects has been investigated along different dimensions. A central point of recent discussions has been the definition of the geographical entities that are actually separated by relevant borders. First, evidence in the literature concentrated on borders between countries (McCallum, 1995; Wei, 1996; Nitsch 2000; Head & Mayer, 2000). These papers show surprisingly large and time-enduring border effects comparing intra-national and international exchanges of Canada, US and Europe. McCallum (1995) found that trade flows between Canadian provinces were about 22 times as large as their trade with US states of the same size and distances. Several studies arrived at similar results looking at trade in North America, OECD and Europe.[33] Head & Mayer (2000) estimated the size of border effects in the European Union by using the gravity approach on sectoral data. Compared to McCallum's results, the paper finds lower border effects: on average Europeans purchased 14 times more from domestic producers than from foreign ones. The paper finds no correlation between non-tariff barriers and the border effect, and the authors conclude that the cause of the border effects lies in the bias of consumer preferences towards domestically-produced goods. Starting from Wolf (1997, 2000) border effects have been investigated also at the intra-national level. Referring to the US, Wolf (1997, 2000) finds intra-state trade excessive relative to inter-state trade, such evidence suggesting a degree of market fragmentation also at the national level. Similar intra-national evidence for an EU country has been recently provided by Head & Mayer (2002. Administrative borders in France have been shown to have a negative impact on trade. Examining the question of whether, other things being constant, nations or intra-national geographical entities, such as regions, express non-linearities in the propensity to exchange goods aims directly at the black box, i.e. the 'nature' of border effects. If border effects are a direct consequence of protection, or barriers to trade, then they should disappear at the intra-national level. Their presence in country level analysis cannot just be linked to barriers to trade, but may reflect other factors, such as the spatial distribution of production (Wolf, 2000), the presence of social and business networks (Head & Mayer, 2002) and also a pure 'home bias' in consumer or firm preferences.

A gravity model was applied to European sectoral data by Brenton & Vancauteren (2001) also in order to estimate the importance of border effects and to look at the impact of

[33] See, among others, Anderson (2001), Anderson and van Wincoop (2003), Chen (2004), Evans (2003, 2001), Head & Mayer (2000), Helliwell (1995, 1997, 1998, 2000), Helliwell & Verdier (2000), Hillberry (1999, 2001), Hillberry & Hummels (2002), Nitsch (2000), Wei (1996), and Wolf (1997, 2000).

technical barriers on imports of the EU countries. The paper grouped sectors by the approach the EU adopted to removing technical barriers (old approach, mutual recognition, new approach and sectors where technical barriers are not important). The paper finds that border effects are significant for all groups of sectors except for those subject to mutual recognition. Border effects are high for sectors where technical barriers are not important, which suggests that factors other than policy-induced barriers play an important role.

Chen (2004) examines the border effects for a set of European countries for the year 1996. The paper finds important differences in border effects between industries. The estimates for border effects range from negative border effects to extremely high positive border effects (exp(19.17)) at industry specific-level. The paper also seeks to find an explanation for the causes of border effects by taking into consideration transportability of products, multilateral trade resistance, information costs,[34] spatial clustering, and technical and non-tariff barriers to trade. The paper finds that technical barriers to trade and product-specific information costs increase border effects, while on the other hand non-tariff barriers are not significant.

Manchin & Pinna (EPRIEE-25) does not aim to address directly the issue of defining the elements that contribute to create a border but instead look at border effects at the country level with the aim of evaluating whether market fragmentation and technical barriers to trade in the CEEC area, particularly when referring to imports from EU countries, is more relevant than existing evidence for trade within the EU-15. Such concern is mainly motivated by the fact that barriers in movements of goods between the EU and the CEECs have started to be dismantled relatively recently, mainly through mutual recognition agreements and the adoption of the *acquis communautaire* by the applicant countries. With the exception of Chen (2004), other empirical works have not been able to confirm that technical barriers to trade increase border effects and we therefore provide new evidence on the impact of technical barriers on border effects and the magnitude of border effects in the CEECs.

They investigate the border effects at the country level with two important points in mind. First, to avoid the possibility of inflated border effects due to the mismeasurement of distances (Head & Mayer, 2000), information at the regional level both for CEECs and EU countries has been used in order to construct a weighted measure of distance both for between countries and internal distances. Both arithmetic and harmonic means have

[34] Information costs captured partly by average firm size calculated for each sector and by using three dummies for industries according to whether search costs are assumed to be either lower or higher.

been tested in order to check for differences in results when using a formula of aggregation more coherent with suggestions from previous gravity exercises. Second, we isolate border effects from impediments to trade due to technical barriers. A comparison between internal and international movements of goods requires a proper control for protection measure which can still operate in a liberalised trade area. As in Brenton & Vancauteren (2000), we consider this issue in the context of the impact of regulatory policies on international trade flows. We look at the extent of border effects for sectors grouped according to the approach adopted by the EU to remove technical barriers to intra-EU trade. The gravity model is applied to data that identifies separately sectors subject to the different approaches to the removal of technical barriers in the EU.

3.3.1. The data

Our data set consists of trade flows for the period 1992-98 between a sample of accession countries (Cyprus, Bulgaria, Hungary, Latvia, and Poland) and EU countries and other accession countries.[35] Both trade and production data originate from the World Bank Trade and Production Database and the data is in International Standard Industrial Classification (ISIC) Rev. 2. The World Bank database is constructed from the COMTRADE database for trade data and the production data originating from UINIDO and OECD sources. Trade data was originally in SITC rev. 2 classification, but it was then transformed to ISIC rev.2 by the World Bank. Both production and trade data are in thousands of US dollars and cover 28 manufacturing sectors. Trade and production data was transformed into NACE 70 classification in order to identify products for which new approach and mutual recognition, old approach, or mixed approach applies. In order to identify these three different categories we use the data from the detailed study undertaken for the Commission's review of the impact of the Single Market in the EU (European Commission, 1998). This study provides information, at the 3-digit level of the NACE classification, of the dominant approach used by the Commission for the removal of technical barriers in the EU. To measure internal trade we use the approach proposed by Wei (1996) who showed how the gravity equation could be used to estimate border effects when data on trade flows by sub-national units are not available. The idea is that internal trade can be represented by the value of production minus exports to other countries. The coefficient of a dummy taking the value of 1 for the observations related to internal trade can then be interpreted as the border effect.

[35] EU-15 member states, with Belgium and Luxembourg aggregated as one country, while the number of accession countries varies by reporting countries and years depending on the data availability.

3.3.2. Technical Barriers to Trade and the EU Instruments to their Removal

Technical barriers to trade result from differences in product requirements and in the approval and control procedures (testing, certification, etc.) for evaluating compliance with such requirements between countries. These differences in national technical regulations and standards can have important adverse effects on the bilateral trade flows, by increasing costs, distorting production processes and discouraging business co-operation. On the other hand, the full harmonisation of all product-related technical regulations can result in slow and ineffective procedures. In the EU before the 1980s harmonisation of all product categories was achieved by the so-called 'old approach', where harmonisation was very technical requiring in-depth consultations. Moreover, the adoption of the old approach directives required unanimity in the Council of Ministers. These long delays resulted in ineffectiveness since national regulations were produced at a much faster rate than the production of harmonised EU directives (Pelkmans, 1987). Nevertheless, a number of old approach directives still remain in force covering a wide range of product groups such as pharmaceuticals, foodstuffs and motor vehicles.

In order to minimise technical barriers to trade in the EU and to reduce the costly procedure of product by product, or component by component, harmonisation of technical regulations, the EU initiated a 'new approach' in the 1980s which combines both harmonisation of different regulations and mutual recognition. Harmonisation under the New Approach is required when the different national regulations differ significantly for similar products and mutual recognition cannot be achieved. One of the key elements which allow harmonisation under the New Approach to be more effective than the Old Approach is that the directives can be adopted by majority voting. Furthermore, only essential requirements are indicated for the producers or service providers, thus giving greater flexibility.

The principle of mutual recognition was applied in cases where the harmonisation of regulations and standards is not considered essential from either a health/safety or an industrial point of view. It means that in any sectors that have not been subject to harmonisation measures, or that are covered by minimal or optional harmonisation measures, every country is obliged to accept into its territory products that are legally produced and marketed in another country. In other words, a producer or service provider who has fulfilled the requirements of his country of origin can sell his products or provide his services in the partner country. However, it often requires accreditation of testing and certification of bodies, and a mutual recognition arrangement between

bodies, because countries often regulate risks in slightly different ways for the same product (Brenton et al., 2001).

As part of the pre-accession strategy a special type of mutual recognition agreement (Protocols to the Europe Agreement on Conformity assessment and Acceptance of industrial products (PECAs)) was recently concluded with several accession countries. According to these agreements mutual recognition operates on the basis of the *acquis communautaire*. PECAs treat all mandatory approval procedures in the sectors that they cover. They are made up of a framework establishing general principles and procedures for the mutual recognition of results of conformity assessment and mutual acceptance of industrial products. The EU expects the applicant countries to apply the transposition of harmonised European product legislation at the latest by the date of accession. The application of the complex EU legislation on goods requires reform of both product legislation and administrative traditions based on national preferences and controls. Thus it requires a transitional period for the accession countries to be able to transpose the legislation. Several countries had applied the *acquis communautaire* in the field by 1999, while some other countries are still working on the transposition of EU regulations. One should note though that our data covers the period 1992-98 when mutual recognition agreements were not yet implemented. We expect that most of the countries have started to align their approach to products already before the mutual recognition agreements.

We group the products into three broad categories according to the approach applied by the EU. The first group includes products for which harmonisation under the Old Approach applies. The second group consists of products for which the new approach applies either in the form of the mutual recognition principle or by setting the minimum requirements. The final 'mixed approach' group includes products where both old and new approach applies to the products.[36] The grouping of the products to these three categories provides a proxy for the different level of technical barriers applying to the products not only for trade within the EU but also with other regions. Old Approach products include products with important health and safety requirements, such as pharmaceuticals, foodstuffs, etc., which are also expected to meet relatively more severe technical regulations in CEECs than products for which safety and health concerns are not so important, such as products under the New Approach in the EU.

[36] Products under the mixed approach could not be separated into the old and new approach, partly due to the conversion from ISIC to NACE70 and partly because for certain products both approaches apply. Details on the industries covered by our data are provided in Annex II.

3.3.3. The Issue of Distance Measurement

Point to point measures (great circle distance between country centres) have normally been used in the gravity literature for obtaining between-country distances. The selection of which city to consider as the economic centre of a country is a potential source of bias if countries are not small, trade partners are not far from each other, and when the economic activity is not concentrated in the chosen city (Head & Mayer 2001). Exchanges between European countries easily fall into one of the previous categories. Large countries tend to share borders and these tends to be more than one economic centre, which are geographically dispersed rather than concentrated in the main or capital city. Data on GDP shares for NUTS1 European regions provide some clear evidence of the European geography of production and of its evolution in time.

With respect to internal distances, several methods have been used in the literature. Portions of the distance between a country to its neighbours, (Wei, 1996; Wolf, 1997, 2000) or distances between the two major cities of a country have been replaced by area based measures (Nitsch, 2000; Redding and Venables, 2000; Head & Mayer 2000; Helliwell & Verdier, 2000) due to the risk of possible geographical inconsistencies (Nitsch 2000). In our empirical analysis we use the approach proposed by Head & Mayer (2002).

The Model: We estimate specifications from the following gravity equation:

$$\ln X_{ij} = \alpha + \beta_1 \ln R_{ij} + \beta_2 \ln D_{ij} + \beta_3 A_{ij} + \sum_{ijk} \gamma_{ijk} DUM_{ijk}$$

where:

X_{ij} is the value of imports by country *i* from country *j*;

D_{ij} is the distance between the trading centres of the two countries.

R_{ij} is the remoteness of country *i* in relation to all trading partners with the exception of country *j*. The remoteness of importing country *i* in relation to trading partner *j* is given as the weighted average distance between country *i* and all trading partners other than *j*, where the weights are given by the GDP of the trading partners.

The more remote country *i* is from other partners rather than *j*, the greater the amount of trade is expected with country *j*. A_{ij} indicates adjacency between *i* and *j*, if *i* and *j* have common borders.

Adjacency dummy in the gravity equations tends to be highly significant. This can be partly due to the fact that neighbouring countries can be expected to have an additional stimulus to trade because of similarity of tastes, an awareness of common interests, some personal and business linkages especially when the border regions are highly populated or when in the past the border was somewhere else (for example in the case of some Central and Eastern European countries). Aitken also argues that neighbouring countries are likely to experience significant additional amounts of international trade in mainly locally traded goods, especially where border regions are densely populated, as in much of Europe. Therefore we include a dummy for countries which share common borders and expect to obtain positive coefficients.

DUM_{ijk} are a set of *k* dummy variables. Separate dummy variables are included to reflect the effects if there is a free trade agreement between *i* and *j*, to reflect the size of the border effect ($j = i$). To capture the effects of different preferential trade agreements of the reporting countries, we included three dummies: a dummy for Europe Agreements, a dummy for CEFTA, and a dummy for other bilateral trade agreements concluded between the reporting and partner country. In all cases we choose the date of entering into force of the agreement instead of the signing date. Furthermore three dummies were included for the three different groups of product categories; for old approach, new approach and mixed approach products.

Anderson & Wincoop (2003) argue that bilateral trade flows depend on the destination and origin price levels, which are themselves related to the existence of trade barriers, which they call 'multilateral resistance'. They propose a method which consistently and efficiently estimates gravity equations. To avoid inflated border effects and inconsistent results we control for price effects in both of the destination and origin markets (and for other regional specificities which would be omitted) by including origin and destination fixed effects in all our equations.

What plays a crucial role for estimating non-biased gravity parameters are proper controls for the heterogeneity in trade flows across countries and controls for business cycle effects (Mátyás 1997, 1998a and 1998b)). Panel data analysis allows such controls to be implemented. Business cycle effects can be controlled as time fixed effects, i.e., treated as time dummies and estimated. Therefore we also include time fixed effects in all estimations.

3.3.4. Econometric Results

Table 2 of the paper presents results from the tobit estimation. The equations include controls for reporting, partner country and time fixed effects. Equation (1) and (2) include three dummy variables for the different product categories. While equation (1) has distance and remoteness measures calculated with the 'average' methodology, in equation (2) we used the harmonic distances. All home dummies are smaller when the latter approach is used which are in line with the results and propositions of Head & Mayer (2002).

The dummies capturing border effects are significant and high for all three categories. Old approach products display the highest border effects implying that technical barriers to trade can increase substantially the magnitude of border effects. The coefficient for new approach products is the smallest, while for mixed approach products the border effect is in between the two other categories' coefficient (which is in line what one would expect since the mixed approach contains products for which both old and new approach apply). When measuring distance with the harmonic method we find the home coefficient to be equal to 7.09 in old approach, while being 4.75 in new approach products. The coefficients are somewhat higher than those measured by Brenton & Vancauteren (2001) for EU countries, who found that in new approach products (excluding mutual recognition products) in 1994 the home coefficient was 4.81, in mutual recognition products it was 2.4 and for old approach products the coefficient was 5.32.[37] Although these coefficients are smaller than what we found, the reporting countries in our sample are likely to have higher technical barriers on imports originating from EU countries than what would be the case for trade within the EU.

Distance and remoteness take the expected sign for all different specifications and are significant in all cases. Import elasticity to distance ranges between 1.5 and 1.8 which is broadly in line with previous results in the literature (Venables, 2001). Adjacency is always significant and positive implying that the reporting countries in our sample trade more with neighbouring countries than with countries with similar characteristics which are not geographically situated next to them.

The dummy which stands for the Europe Agreement is significant and positive implying that the implementation of the Europe Agreements had a positive impact on accession countries' bilateral trade flows during 1992-98. Europe Agreements helped reduce border

[37] For the year 1997 they found slightly smaller border effects for both old and new approach products, while for mutual recognition products the border effects were not significant.

effects between EU partner countries and signatories of the Europe Agreements. For example, in the case of new approach products internal trade within our reporting countries is 114 times more than trade with other countries (using the results of equation (2)), while internal trade is only 34 times higher than trade with EU member countries (when the reporting countries signed the Europe Agreement). This implies that the Europe Agreements substantially mitigated border effects for trade with partner countries, although border effects still remain important. The coefficient of CEFTA, the variable measuring the effects of the Central Eastern European Free Trade agreement, is significant and takes a negative sign. This indicates that the reporting countries in our sample trade more with the EU than with other countries in the region and that the CEFTA did not deliver increased trade between its members.

Table 3 shows the border effects in the different industries. The coefficients of the explanatory variables are close to those obtained from equation (1) and (2) (in Table 2). The importance of border effects is high for almost all industries, but there is a wide variation in its magnitude between different industries. The highest border effect coefficient (value of 7.37) is found for food products, while the lowest (2.9) is found for footwear products.

Table 4 presents the developments of border effects in the three different categories over time. There does not seem to be a reduction in border effects over time during 1992-98. In order to better understand differences between countries we run the same regression including country-specific dummies for home trade (results are presented in Table 4). There are important differences between countries. Hungary has the highest border effects followed by Bulgaria, Poland and Latvia, while on the other hand Cyprus has negative border effects in all product categories. For all countries old approach products have the highest border effects, new approach the lowest and mixed approach products lie in between. This confirms our previous findings that high technical barriers to trade increase border effects.

3.3.5. Conclusions

In this paper we have looked at the issue of border effects by investigating imports of 5 accession countries differing in size and other characteristics (Hungary, Poland, Romania, Latvia and Cyprus). The paper examined whether border effects are related to technical barriers to trade. We grouped products into different categories, according to the approach applied by the EU to remove technical barriers to trade which provided us with a proxy for the magnitude of technical barriers by products. To avoid inflated border

effects, a weighted measure of distance was used both for cross-countries and internal distances.

All accession countries included in our estimation trade with themselves more than with other countries in manufacturing products, and the home bias is higher than in the case of EU countries. We grouped products into three categories: old approach, new approach (including mutual recognition, new approach) and mixed approach (which includes products where old approach and another approach is applicable). Our results suggest that the border effects are the largest for old approach products, where we expect to have the most important technical barriers due to complicated harmonisation procedures. The 'new approach' category has the smallest border effects, while the 'mixed approach' products are in between the two previous categories. When considering country-specific border effects, Hungary had the highest border effects, followed by Bulgaria, Poland and Latvia. Border effects are somewhat mitigated for EU partner countries, but not for other accession countries. This might be also the result of the FDI by EU firms in accession countries which was significant during this period in sectors where technical barriers to trade were important. Much of this investment probably led to production consistent with EU standards (Brenton & Vancauteren, 2001).

The magnitude of the estimated border effects seems to be too large to be consistent only with the presence of trade barriers. In this paper we did not aim to explain fully what causes this high estimate for border effects; rather we tried to see whether we could observe some difference in the importance of border effects in trade in products with different magnitudes of technical barriers. Thus what we could conclude from our results is that there are larger and more persistent border effects for sectors where technical regulations constitute major barriers to trade. However, border effects, although to a lesser extent, are also significant for products where technical regulations are less cumbersome. Interestingly this result is different from findings of Brenton & Vancauteren (2001), which found higher levels of border effects for sectors where technical regulations did not constitute major barriers to trade. These different results might indicate that in the EU's imports to the CEECs technical barriers matter more than in the intra-EU trade, where there are other, more important factors contributing to the border effects. Furthermore, the presence of border effects in sectors where technical regulations are less important can also be explained by other factors, such as rules of origin, spatial distribution of production, the presence of social and business networks, consumer or firm preferences and for our estimation also by tariffs. Although tariffs were gradually dismantled during the period, we did not find a significant reduction of border effects over time.

Our results suggest that the estimated level of border effects is partly due to policy-related constraints; thus there is an important role for policy-makers to remove these barriers. The level of trade of accession countries is substantially lower than what would arise in the absence of border effects, which is much more pronounced in trade with other accession countries than in the trade of accession countries with the EU. Certainly the border effects are present not only due to policy-related constraints, but the larger border effects for products with higher technical barriers to trade suggests that an important part of the border effects in the case of the accession countries could be eliminated by removal of such barriers.

4. Objective 4: Fragmentation, restructuring and Post-Soviet change

4.1. Soviet backwardness and the potential for gains from market reforms

The costs of fragmentation need to be compared with the potential gains from adopting a market system. Prior to 1989 these were judged to be huge – the Soviet bloc economies lagged well behind the West in income per head, despite fairly comparable estimated human capital levels. While greater openness and the arrival of competitive market forces after 1989 forced Western economists, if anything, to lower their estimates of the state of the Central and Eastern European economies in the late Soviet era, that should, if anything, suggest an even greater potential for improvement.

Two papers discussed here cover technological backwardness. Edwards (EPRIEE-10) looks at the effects of the isolation of the former Soviet bloc in terms of difficulty of assimilating new technology, given the relatively autarkic structure of the economy, the lack of incentives to install new technology and the Western technological boycott.

4.1.1. Technological costs of autarky

Measured in terms of trade with the West, all the Soviet bloc economies were relatively autarkic compared with their Western counterparts. Looking in particular at machine tools, which may be seen as particularly embodying technical progress, prior to the Western technological boycotts in the 1980s, the Soviet Union imported only 3-6% of its machine tools from the West (Nove & Gomulka, 1984), whereas for Eastern Europe the figure was 10-30%.

Estimates of the relative productivity of Soviet and Western capital goods vary: one study by Green & Levine (1978) concluded that one ruble's worth of imported machinery in the USSR 1961-74 was worth over 8 rubles worth of local capital. However the

methodology and reliability of the results have been severely criticised by Weitzman (1978).

The very low total factor productivity (TFP) growth rates indicated for all the Soviet bloc economies, except the German Democratic Republic, in 1980-85, indicate that the Soviet strategy of growth through high rates of capital accumulation had reached a dead end, and that there was negligible technical progress. This indicates that the problem facing the Soviet bloc was not simply one of constant static allocative inefficiencies, but more one of increasing backwardness due to a combination of protection (implying increasing protection against more advanced Western inputs which would have embodied better technology compared to competing Soviet goods) and a system of management and incentives ill-suited to the installation of better technology.

Table 11. Total factor productivity growth in the former Soviet Bloc, 1970-1985.

Implied total factor productivity		**Annual growth**	**Annual growth**
		1970/75	*1975/80*	*1980/85*
	Bulgaria	4.0%	2.6%	0.9%
	Czechslovakia	3.5%	1.5%	-0.6%
	GDR	3.3%	1.8%	2.9%
	Hungary	4.0%	1.2%	0.6%
	Poland	5.9%	-7.9%	0.2%
	Romania	6.4%	3.2%	0.8%
	Soviet Union	1.8%	0.8%	0.9%

Sources: NMP Growth – UNECE Survey of Europe 1985/86.

Contributions of fixed assets, employment and productivity:

-For 1975/1970 and 1980/1975: UNECE Survey 1986/86 Table 3.8.5.

- For 1985/1980: UNECE Survey 1987/8 Table 3.4.3.

4.1.1. Sectoral and intersectoral misallocation.

Edwards (EPRIEE-11) examines the effects of misallocation of resources within the Soviet system. This is done at a general level rather than looking at particular cross-subsidies (other studies look at specific subsidies, e.g. Gros & Jones (1991) estimated a welfare loss from energy subsidies of at least 10 % of Soviet GDP, though there might, of course, be short-run costs to any reforms). Edwards' starting point is the assumption that the

key difference between a Soviet-style planned economy and a Western market economy is assumed to be the way in which inefficient firms are handled. It is assumed that the system of soft budget constraints ensured that, under the Soviet system, inefficient firms remained open and were able to find enough subsidy to cover depreciation and interest costs (if any interest were ever charged). This would tally with the planners maximising short-run output. Meanwhile, all industrial profits would be reinvested, so that, as returns to capital in the economy as a whole dwindled, eventually a stagnant equilibrium would be reached where profits of the successful firms were entirely used up in cross-subsidising the bad firms. In this situation, even despite the high rates of investment within the Soviet system, the planned economies were reaching a stagnant equilibrium by the 1980s, where all the resources set aside for investment were being used up replacing capital in inefficient industries and firms. The economic effects of reforming such a system are discussed in section 5 below.

4.2. Costs of Economic Fragmentation

In this section, we link the process and effects of post-Soviet fragmentation to the state and nature of integration prior to 1989. Quite simply, before 1989 the degree of integration of the socialist planned economies varied hugely, and this is bound to have significant impact upon the results of breakup and the nature of the disintegration process. The former communist states experienced economic integration prior to the drive for EU accession, either as part of the CMEA and/or as a part of Yugoslavia, USSR or Czechoslavakia. Integration with the West was limited due to the nature of trading relationships and the obstacles created through planning.

4.2.1. Theoretical background on breakup and disintegration

Bolton & Roland (1997) identify three determinants to the break-up of nations. First, there are differing fiscal policy preferences. Second is the efficiency loss due to disintegration. Third, changes in the tax base. The efficiency effect turns out to be essential for holding integration together. Papers in the spirit of Bolton & Roland clearly view integration as providing common public goods. In this context the efficiency effect is firstly due to economies of scale in the provision of public goods. Second, it is related to spillovers across regions and common public goods. Fiscal federalism can be regarded as a halfway house between the full integration of the provision of public goods and complete fiscal disintegration in which regions are given some control over spending and revenue decisions to provide local public goods, but in which a central government provides common public goods.

Trade regimes have the character of public goods and the tensions over the optimal size are similar to the above issues. Spolaore & Wacziarg (1997) introduce heterogeneity as the price to pay for having a customs union, heterogeneity that increases with the size of the customs union. Once these heterogeneity costs are introduced, it is possible to determine the 'optimal' size for a customs union which can be less than the whole world.

Finally the issues regarding public goods also have a bearing on monetary integration. The public goods nature of money is that there is an inflationary bias when there is more than one body empowered to issue currency. But the main issue linking public goods and monetary integration is the requirement for some sort of insurance against asymmetric shocks when the labour market is inflexible or labour is not sufficiently mobile.

4.2.2. Fragmentation and public goods

There are two main strands of literature on the reasons for integration and unions. The first follows from standard customs union theory, and interprets the formation of trade blocs in terms of trade creation, trade diversion and terms of trade effects (to which can be added scale, competition and capital inflow effects – see Baldwin & Venables (1995)). The alternative approach is to view a union as being designed to share public goods. Barlow & Radulescu (EPRIEE-05) discuss disintegration/fragmentation within this latter framework. In doing so, they build on the pioneering work of Bolton & Roland (1997), Riviere (1997), Alesina et al. (various papers, 2001) and Persson & Tabellini (1996 a & b).

Relationship between integration pre-1989 and disintegration post-1989: region-by-region analysis (Barlow & Radulescu, 2004)			
<u>Integration in the USSR</u> The USSR was a highly integrated economic union. Up to 50% of the GDP of some of the Soviet Republics was traded with other Soviet Republics. This degree of integration was introduced by Stalin to reduce the possibility of any of the Soviet republics from breaking away. Integration involved trade links between the 15 republics, but reinforced by payments from the centre and a hugely distorted price structure compared to world prices. Trade integration was thus supported by implicit transfers from oil and gas rich Russia and Turkmenistan to the other republics. There were also implicit transfers through overpriced industrial goods. Orlowski (1993) suggests the likely impact of the loss of these transfers following the demise of the USSR (Orlowski, 1995). Williamson (1992) predicted that, in the absence of reorientation, trade disruption as the USSR disintegrated could reduce output of some republics by up to 50%. Subsequent events have to some extent conformed to this prediction, except in countries,	<u>Disintegration of the Soviet Union.</u> Disintegration of the Soviet Union preceded democratisation of the USSR; it is more accurate to say that decentralisation lead to disintegration. Contradictions in Gorbachev's reforms, such as differing speeds of price liberalisation across the republics, were inconsistent with the maintenance of a single market in goods. Direct budgetary transfers and indirect transfers through price distortions became critical issues in inter-republican relations. The demise of budgetary transfers compromised the prospects for monetary integration. The loss of credibility in all Union institutions hindered the prospects of an orderly disintegration.	<u>Integration in the CMEA</u> Despite a high level of trade between CMEA members (Pelzman, 1977), integration was limited: e.g. much less intra-industry trade than in the EU (Drabek & Greenaway (1984)). Among a number of obstacles were the following (Marer & Montias 1982): Fear of losing independence. Little incentive for exporting. Planned exports were set to pay for essential imports, rather than to achieve specialisation and economies of scale. Unofficial policies of import substitution. Arbitrary prices and exchange rates. Little incentive for factor mobility. Bilateral import agreements and non-convertibility of the transferable ruble restrict the amount of trade. The USSR transferred considerable resources to the CMEA by accepting overvalued capital goods in exchange for undervalued commodities. Estimates vary from $29bn over 1972 to 1984 (Poznanski, 1988) to $118bn (Marrese & Varous 1983). Under the CMEA GDP per head failed to catch up with that of the EU and fell increasingly further behind that of the southern EU states.	<u>Disintegration of the CMEA</u> Transport costs and economic strength dictate that Western Europe is a more natural trading partner for the countries of Central and Eastern Europe, than is trade amongst the CEECs themselves. Politics and distorted prices enabled CMEA to defy gravity, but once the communist era ended, a massive reorientation of trade would be essential. The reorientation had already begun in some countries prior to the collapse of the CMEA, but even so such a catastrophic fall in trade within Central and Eastern Europe was not foreseen. Neither was it regarded as desirable, as various attempts to maintain trade within the region despite the new economic environment, testify. However, the early attempts to maintain these links were still built upon bilateral negotiation and so failed due to being inappropriate to the new

such as Estonia, that successfully re-orientated their trade and the collapse was not so severe and recovery sooner and more robust.			economic environment

Integration in Yugoslavia Yugoslavia appears to have been a very unsuccessful attempt at economic integration. Despite some considerable transfers to the less developed regions of the federation, the ratio of real GDP per capita in the wealthiest Yugoslav region (Slovenia) to the poorest (Kosovo) was 7.9, twice the value in 1952. Reforms initiated in the mid-1970s eroded pan-Yugoslav planning, and so eroded efficiency, and contributed to the slowest growth rate in Europe in the 1980s (Pratt, 2000). Trade statistics show that generally a smaller proportion of trade was conducted between Yugoslav states than is typically conducted between European countries (Gros & Steinherr, 1995).	Disintegration of Yugoslavia Barlow & Radulescu (2004) conclude there were strong signs of economic disintegration long before 1991, reflected in the decreasing shares of intra-Yugoslav trade and the increasing nationalistic tendencies in all republics. There are many parallels with the Soviet case, and again the evidence seems to suggest that the theory fails to consider many key issues.	Integration in Czechoslovakia Before World War II the Slovak part of the federation greatly lagged behind the Czech lands. But over the Socialist period, both consumption per head and production per head in Slovakia converged toward the Czech level. The rapid development of Slovakia at this time was financed by considerable transfers from the Czech lands, of up to 14% of Slovak income to begin with, but declining to 7% by 1989 (Dedek, 1996). From the Czech point of view, development during the Czechoslovak era was far less satisfactory. As a nation that had ranked amongst the most developed in the world before World War I, it tended to lag increasingly behind the most developed nations.	Disintegration of Czechoslovakia The shock of transition put an end to convergence and sharpened the disagreement between the regional governments regarding the desired path of reform. These disagreements, combined with an increasing separation of policies, led, after only three years of transition, to economic disintegration, which culminated with the break-up. Crisis only seems to be relevant in the sense that disintegration might have helped the avoidance of crises. Institutions, though, are clearly important. Stronger federal institutions could have prevented the division. However, the institutions did permit a very orderly break up.

4.2.3.The post-1989 disintegration experiences: A summary

A number of papers argue that economic crises motivate reform. This was true of the events leading up to disintegration in Eastern Europe. There became a perception that the old system could no longer be fixed. What was less clear is what should replace it. Disagreements over the direction and speed of reform are part of the motives behind disintegration.

The demise of the old system left a void from which issues of distribution emerged. Some valid issues of reform were raised. However, some nationalistic leaders exploited heterogeneity to gain power. In some countries disintegration led to democratisation and economic reform, such as in the Baltic former Soviet Republics. But in others change has been at best hesitant and often harmful. Similar comments apply to former Yugoslavia and to a much lesser degree to former Czechoslovakia. In the latter the lower level of development of Slovakia seems to have been a lever used by Meciar to gain political influence.

In Yugoslavia social heterogeneity became more of a political issue than it appears to have been in the other federations. The evidence by Alesina et al. (2003) that Yugoslavia was the most heterogenous country other than those in sub-Saharan Africa perhaps explains this. But heterogeneity has many dimensions, such as race, nationality, religion, class, gender or even eye colour. For long historic periods these may not appear to have much significance, as in post WWII Yugoslavia, but then at other times they become serious issues. The switch can be explained by crises, but what can explain the form of heterogeneity that matters. Presumably it is related to the emerging political elite who seek to use heterogeneity as a means to gain control. In Serbia the myth of the Serbian nation enabled power to be taken from the communist state.

The crises can, generally fairly, be attributed to the institutions of communism; hence the desire to change the system. The loss of authority in the existing institutions left a vacuum that could not be readily filled. In part this accounts for the chaotic and rapid nature of disintegration. The communist system had been designed to hold the whole together, but once the momentum for reform was sufficiently strong there was little that could be done to manage the disintegration. This is why disintegration was not only faster but also deeper than intended. Here there is a very marked contrast with integration which by proceeding slowly gives time for agents to adapt. For example, the arrival of the Single Market in 1992 was flagged in 1987 and imposed in a series of well-defined steps over five years. Similar comments may be made of the single currency and the enlargement of 2004.

Case Study: Estonian-Russian trade relations

The three Baltic Republics have undergone the most dramatic economic realignment since the break-up of the former Soviet Union, having made the transition from integrated Soviet republics to member states of the EU. The change has been most marked in Estonia.

To summarise Venesaar's (EPRIEE-20), until 1991 exports to the former Soviet Union accounted for 90-95% and imports for 80-87% of the total volume of exports and imports. The principal trade partner for Estonia was Russia, which contributed 56.5% of total exports and 45.9% of imports in 1991 (Table 12., below). In 2001 the share of exports to Russia dropped to 3.8% and imports from Russia to 8.1%. Exports to Russia were small due to the trade policy implemented by Russia, and also imports from Russia declined. Trade with Russia was almost blocked in the first quarter of 1992 and led to a sharp contraction of Estonia's foreign trade volume. The declining Russian market for Estonian goods was replaced by the markets of Sweden and Finland. Because Estonia succeeded to reorient its foreign trade to Nordic markets rather fast, perhaps the impact of discriminatory trade policy of the former Soviet Union had a (less than expected) minor impact on Estonia (Rajasalu, EPRIEE-18). A gravity model was used by Teet Rajasalu to assess the impact of different trade blocs on Estonia's economic integration on the basis of foreign trade development. This assessment shows the decline of the initially (before 1991) positive impact of the CIS as well as its turning into an impediment to Estonia's exports (Rajasalu, EPRIEE-18).

Table 12. Estonia's foreign trade with Russia in selected years % of total exports and imports

Years	Exports to Russia	Imports from Russia
1991	56.5	45.9
1992	20.8	28.4
1993	22.6	17.2
1995	16.4	14.6
2000	2.4	8.5
2001	3.8	8.1

Source: Statistical Office of Estonia (www.stat.ee).

Estonian firms had difficulties adjusting themselves to a changing market situation and competing in Western markets. EU import quotas and other market protection measures

(including quality standards, etc.) restricted exports to this market for a number of firms. For that reason enterprises were more capable of exporting to the East, because demand in the Russian market existed and products sold to Russia had often lower quality than the EU market would have accepted. Certainly, it was almost impossible to sell these low-quality products elsewhere. This strategy was used by enterprises of food industry and some other activities exporting to Russia and to some former republics of the Soviet Union (based on bilateral trade agreements). However, such a deliberate strategy could not last for long. The task involved developing new technologies in production processes and developing new and/or improved products to fit the new opportunities. As far as new products were effectively sold in EU markets, it had important implications for the new Russian market as well.

Russia imposed double customs tariffs on Estonian goods in 1995, and they are still in force today. Bilateral negotiations on the agreement on trade and economic co-operation have lasted for more than seven years. On 11 April 2001, in Moscow the heads of the Estonian and Russian delegations initialled the text of bilateral agreement on trade and economic cooperation, which has been agreed at the level of experts.

Estonia, being a small country of 1.4 million people, relies on its greatest natural asset – its location at the crossroads of East and West. Estonia lies just south of Finland and across the Baltic Sea from Sweden. To the east are the huge potential markets of northwest Russia. Estonians know how to do business in Russia and in other former Soviet countries. Estonia's modern transportation and communication links provide a safe and reliable bridge for trade with former Soviet Union and Nordic countries. According to the RIPE Network Coordination Centre (www.ripe.net), Estonia has the highest Internet connected hosts/population ratio in Central and Eastern Europe and also is ahead of most of the EU countries. Latest surveys indicate that 39% of the Estonian population regard themselves as Internet users. There are a number of ICT services implemented in the everyday life of enterprises and organisations, which helps to develop business relations and direct logistical flows in most profitable ways. Thus, Estonia might have good outlooks in offering services for directing Russia’s trade flows to their destination.

4.3. Obstacles to closing the technology gap with the West

In section 4.2 we reviewed evidence that the Soviet bloc was suffering from technological deficit compared to the Western economies. One would therefore expect that a positive aspect of removing the autarkic form of integration of the Soviet bloc (or at least of countries within that bloc) would be greater exposure to Western technological methods, producing rapid total factor productivity growth. However, the evidence presented in

section 2 suggests that the growth experiences of the various states since the Soviet breakup has been remarkably diverse. Why is this?

One approach to the question of technological catch-up (or lack of it) is in Edwards (EPRIEE-10). The paper looks at various potential obstacles to the uptake of this new technology using a dynamic general equilibrium model for the post-Soviet era, in which there are two technologies available: Soviet and Western. Western technology is assumed to be twice as productive as Soviet, but to require the input of Western capital goods to start its growth. Potential obstacles to growth in this framework are the savings gap and the foreign exchange gap, and the lack of initial local availability of modern quality inputs. These are seen as dynamic obstacles to reaping the potential static gains. A number of such factors are discussed, and a simple dynamic general equilibrium model is set up which focuses in particular on a subset of these: lack of substitutability between modern and older capital goods, falls in domestic savings and a foreign exchange constraint. A simulation is carried out for a 40-year period based upon very simplified Polish starting data.

The conclusions must be rather tentative. While it does seem that there are indeed adjustment factors at work, the model simulations seem to indicate that the transition to a modern economy is not particularly sensitive to the dynamic variables investigated. Moreover, although GDP falls, utility rises – quite considerably. It therefore seems that much of the apparently disappointing performance of the transition economies may reflect a combination of poor statistics for the pre-transition period and misreading of economic data.

4.4. The Costs of Restructuring

As well as trade realignment, the Soviet break-up meant a dramatic change of economic system from a centrally planned socialist one to a market capitalist one. Edwards (EPRIEE-10) seeks to analyse this change using a series of simulations based upon a fairly simple format, but which nevertheless identifies at least some of the characteristics of the Soviet economy, and as such to explain why in some countries workers have lost out far more than in others.

Comparing the post-transition experiences of the Central and Eastern European countries with those of the Balkan states, Russia and the other CIS states, Edwards (EPRIEE-11) suggests the key observation is that wage-earners have fared best in countries where liberalisation has been combined with proximity to the EU and rapid trade liberalisation. The first wave of Central and Eastern European EU accession states also had a more recent history of advanced capitalism and higher human capital levels than the rest of

the former Soviet bloc. Where these conditions do not hold, what liberalisation there has been (and it has generally been more partial) has seemingly resulted not in prosperity but in capital flight and extreme inequality – though the alternative of minimal liberalisation, as pursued by Belarus or the Ukraine, seems even more dire.

While both neoclassical and macroeconomic models offer some understanding of the experiences of these countries, both are flawed. In part this is because the pre-transition Soviet bloc economies were so different from Western economies that traditional analysis misses many of the key features of these economies – the sheer degree of inefficiency and irrationality of economic allocation. While perhaps no modelling approach based on orthodox Western economics can fully capture this, Edwards develops an approach based on the notion of a 'batting order' of firms which may help to understand at least some of what was going on, and the effects of a sudden application of market forces.

The model depends upon the idea that firms naturally and randomly vary in efficiency. The key difference between the Western and Soviet systems is seen as being the effect of market forces in determining investment and closure decisions in the former. By contrast, it is assumed that the Soviet model involved deliberate application of large-scale investment – all profits were essentially reinvested, there being no capitalists to consume income from capital – but at the same time a total lack of discipline as to where that investment went. In particular, Edwards assumes no plant closure decisions were ever taken, so that the result was that, as capital depreciated and was renewed, investment was essentially channelled into unproductive uses. An economy that followed this path would soon end up in a stagnant equilibrium, where depreciation and replacement of misallocated capital would eat up the surplus generated, so that the economy remained poor despite high investment levels.

Edwards' paper also assumes that firms require a significant start-up cost before they can open. This means that we cannot guarantee large numbers of firm start-ups in a post-transition economy, unless either the start-up cost is low or the wage falls sufficiently far to encourage new firms to enter the market.

A third key assumption is that the privatisations carried out in the post-Soviet economies resulted in the concentration of industrial wealth in rather few hands (in the extreme case of Russia, the 'oligarchs'). Whether this was a necessary result of the privatisation process, or a fault of the particular way in which it was carried out is beyond the scope of this paper.

In the interests of telling a simple story, many of the other effects of the Soviet system pre-1989 are glossed over – the disincentivisation of management and workers, the

shortages and queues and the lack of access to Western technology. However, the paper captures at least some of the key elements. The initial situation of the Soviet bloc economies prior to 1989 was one where profits from the more efficient firms were squandered keeping open less efficient ones. The immediate effects of introducing market reforms were therefore to allow owners for the first time to close capacity, and the experience of many of these economies (certainly the EU accession states) is that much of this closure took place rapidly.

Despite this, the rise in unemployment was perhaps more modest than feared. This may be partly because many people dropped out of the labour force (though figures for this may well reflect the reclassification of workers who were almost permanently sick as people excluded from the labour force on grounds of invalidity, as the benefits system was changed), but it also suggests that labour markets were perhaps more flexible than many people assumed. Nevertheless, the economies concerned showed large falls in output.

Edwards analyses the transition in the form of some very simple counterfactual simulations, calibrated to aggregate data for Poland. Firstly, just assuming market reforms lead to a high level of closures, it is shown that, even when labour is redeployed to more productive firms, the scrapping of capacity causes a decline in labour demand and a fall in real wages. This fall closely mirrors the fall in measured GDP (around 5\% in the first simulation performed).

However, the fall in GDP and wages is not the full story. Capital depreciation is now much less than before, as capital is being allocated much more efficiently across the economy. Consequently, the new owners of industrial capacity can pocket much of the profits, which were previously squandered on maintaining poor investments. As a result, net domestic product rises – but the benefit flows to the new wave of capitalists, not to the workers.

Secondly, in the long run, the owners of capital are able to reinvest it – either at home or abroad – earning more income. Whether this reinvestment takes place at home or abroad is the next key factor in determining who benefits. If new firms can be set up costlessly, then there is likely to be a high rate of new firm start-up even if wages rise above pre-transition levels. In this case, the rapid growth of new investment will boost labour demand and ensure workers gain. This is essentially the situation in the Baltic states.

By contrast, if the set-up of new firms is difficult, then capital may well flow abroad. While this still yields plenty of income for the new capitalists, it produces little in the way

of labour demand and so wages fall sharply (unless there is unemployment). This may well be the situation in Russia in particular, which has seen regular and sizeable outflows of capital ever since the Soviet break-up.

Other factors that can moderate the effect on wages include the effects of removing sectoral subsidies. If, pre-transition, the authorities had forced labour-intensive sectors (i.e. services) to subsidise capital-intensive sectors (heavy industry), then removal of the subsidies may allow the former to expand employment, even if there are few new firms setting up. In addition, it is more likely that new firm start-up will be sufficiently profitable to tempt in newcomers in the formerly taxed sectors – again benefiting wages.

Easy access to export markets will make expansion, and particular the arrival of new firms in export sectors much more attractive, again benefiting wages. This may have helped in the case of EU accession states. By contrast, there has been little growth of non-oil exports from Russia and the CIS states.

The final factor worth considering is the role of monopoly. In many of the former Soviet states there was only one producer firm per industry, and consequently, unless there is strong possibility of either new firm entry and/or competition from foreign trade, owners will charge large profit margins. If this happens in all sectors, then wages can be driven down a long way. On the other hand, if there is at least one sector where new entrants are moving in rapidly and creating labour demand, then wages will be held up. In these circumstances, the monopolistic sectors will see a decline in output but wages will not fall. Again, this seems to be a key difference between the EU accession states and the more remote Balkan, Russian and CIS economies, where far fewer firms report either pressure from foreign competition or from newcomers in their industry (see Table 13 below).

Table 13. Importance of pressure from domestic and foreign competitors

		Privatised	State	New Entrants	Total
Domestic competition	Central Europe/Baltic	29	20	32	30
	SE Europe	32	17	33	29
	Central CIS	13	9	16	15
	CIS Periphery	17	6	17	15
	Total	22	14	25	22
Foreign Competition	Central Europe/Baltic	31	24	16	22
	SE Europe	32	20	20	23
	Central CIS	9	2	8	9
	CIS Periphery	11	6	8	9
	Total	21	13	13	16

Source: EBRD (2000), Table 7.2.

4.5 The realignment process

When countries have experienced a major trade policy shock, such as the break-up of one trade bloc and the need to seek new markets and suppliers, it is critical to understand the processes involved in developing such new ties. The case study in 3.4, which analyses Estonia's almost unprecedented trade realignment, forms an important starting point for understanding this process. In the space of three years, exports to Russia fell from 56.5% to just 16.4% of Estonia's total exports. Meanwhile (see Rajasalu, 2004) exports to Sweden and Finland grew dramatically, so that these two countries rapidly came to dominate Estonia's trade. This was driven to a large extent by Swedish and Finnish domination of inward investment into Estonia. At the same time, Estonia's industrial structure moved sharply away from its old focus on food processing towards newer industries (food processed exports initially being largely obstructed by the Russian boycott and by the Common Agricultural Policy's impact on non-EU states).

Key aspects of this trade realignment is that it was driven by inter-firm, outsourcing trade in the case of the realigning countries' exports and by the growth of large, recognisable Western brands in their imports. Both of these types of trade apply particularly to goods where different suppliers are qualitatively differentiated (see Rauch, 1999), so that the key for purchasers is to find suppliers whose products and business

practices are suitable for their individual needs. Where trade involves outsourcing, there is a two-way matching process, where both firms need to establish whether they are suitable partners – something which depends upon technology, language, culture and accounting and legal practices, as well as transport ties and the like.

The traditional trade literature, which effectively sees trade volumes in a static context as something determined by comparative costs alone. This is a relatively poor predictor of how trade develops in the early phases of establishing new trading relationships. Hence the growing awareness of the need to rethink trade literature to take account of the informational aspects of developing trade between two countries.

The Estonian case illustrates the importance of information in developing trade in a number of ways. In particular, Estonia was able to rapidly develop alternative sources of trading contact because it broke into two major outsourcing markets: Finland and Sweden. In doing so, Estonia had certain strong advantages compared to many other post-Soviet economies:

1) Geographical proximity (just 50 miles by sea from Helsinki to Tallinn).

2) Language and cultural similarities with Finland.

3) Close historical ties, albeit interrupted by the Soviet period.

4) A policy of vigorous export promotion, based upon a currency board and a very competitive exchange rate, and backed by a social consensus that Estonia, in the face of the Russian trade boycott, had no alternative but to promote exports vigorously with the West.

5) A boom in high-technology industries in Finland and Sweden (notably mobile phones), starting at just the time the Soviet Union broke up.

4.5.1.Theoretical background

There are three key theoretical aspects to the development of trade where information about one's trading partner is initially poor. These are:

a) Matching. The need to find a supplier or purchaser whose technology, business practices etc match one's own needs.

b) Search. The need to investigate potential partners, in order to distinguish between those who will form good matches and those who will not. Search inevitably involves mistakes and costs.

c) Networking. The ability of firms to pass on information about potential matches and foreign markets to other similar firms.

The matching and search processes effectively mean that developing trading ties between firms in different countries involves a kind of capital investment: namely an investment in informational capital. Networking enables firms to take advantage of other firms' existing search capital, thus reducing the costs of entering overseas markets. This has both positive and negative aspects:

NEGATIVE: Where firms can share information, there is a free-rider problem. This means that it may be difficult to persuade any company to be the first to test the water in a new market, since firms will wait for others to test the water first.

POSITIVE: If this initial barrier can be overcome, and the initial entrants into the new market find good results, then firms will enter new markets in large numbers.

The domination of investment in Estonia by Swedish and Finnish firms is strong evidence for this kind of networking: it seems that, at the very least, firms from those two countries were able to imitate one another and more likely able to share information about the new partner across the Baltic, and that ties between firms in Sweden and Finland enabled this process to occur at a rapid pace. This may well have made the key difference between Estonia's economic success and the problems faced by other breakaway Soviet republics such as Moldova or Ukraine.

In economic terminology, there is an externality (or public good) effect from one firm entering a foreign market. This may well explain why new investors tend to congregate in certain markets (in recent years, say, Thailand, China, Mexico, Ireland and Estonia but not Ghana or the Ukraine), and why numerous surveys (e.g. Winters, 2004) tend to find strong positive links between trade and economic growth. It seems that to achieve export-led growth a country may need some form of central coordination in the form of an export promotion policy, or at least a social consensus accepting export-orientated economic reforms and a competitive exchange rate.

4.5.2. The theory of match-searching.

Edwards' paper (EPRIEE-12) is a theoretical piece looking at the implications of a matching and searching process (ignoring the networking aspects) for trade patterns and policy. It builds on existing matching models of trade to incorporate search, and draws a number of propositions, many of which are new to this literature, linking trade volumes and elasticities to the parameters of the search process and to the past history of trade between countries. If economies are seen as moving from being relatively closed initially,

then contract periods and the availability of finance will greatly affect growth of trade. The behaviour of trading firms depends to a large extent on whether they are already well-matched or still searching for partners. Countries with a large initial number of well-matched firms will show relatively low price elasticities of demand for imports and exports, and in particular for trade with new partners. Apparent home bias in current trade patterns may well reflect past, rather than present, trade costs and protection.

While there are many applications of this theory, the Edwards (EPRIEE-12) paper focuses particularly upon the implications for the sequencing and timing of trade liberalisation decisions. It is shown, using a fairly simple example, that match-searching theory strengthens the argument that global welfare is likely to be enhanced by liberalising trade multilaterally rather than by stepwise bilateral deals. However, individual countries may lose from this route.

The paper particularly concentrates on a 'match-searching' model. This is a very basic model of the search process, in which firms search for new partners by means of a series of sequential matches with foreign partners, which Edwards uses to derive a number of key results expounded as propositions.

4.5.3. The implications of a match-searching process

a) It is no surprise that observed trade patterns between countries do not tally easily with comparative advantage, and that considerable 'home bias' and two-way trade in the same commodity class are common. Such features may well represent, at least in part, the vestiges of past changes in alternative production efficiency, transport costs, trade protection and exchange rate movements. Many firms which developed a market foothold at a time when their home market was relatively sheltered may well be able to maintain it even when that protection is removed.

b) An implication of a) is that the strong border effects observed in today's trade patterns may reflect past, rather than present barriers to trade. Studies such as LeJour et al. (2000), which infer from observed trade patterns that EU trade barriers against non-member states must be high, may be misleading. While removing trade barriers may produce a large response in trade volumes, the effects under match-searching are harder to predict than in orthodox models.

c) Today's policy decisions are tomorrow's historical factors. Trade diversion from a preferential trading agreement may well persist as informational diversion well

after the preferential agreement has been scrapped. This is perhaps an important argument in favour of multilateral over bilateral trade liberalisation.

d) There is a key difference between import demand by firms still searching for a satisfactory partner, and demand by firms who have already found such a good partner. In the former case, their demand is very sensitive to changes in prices of relative supply sources, while in the latter demand may be much less price-sensitive. Consequences include:

- Long-standing trade blocs may well have lower import price elasticities and higher optimal tariffs than newer trade arrangements.

- Countries that are attempting to break into new export markets may find themselves needing to compete keenly on price with other new entrant countries, while established producers may not have the same price-sensitivity.

IV. CONCLUSIONS AND POLICY IMPLICATIONS

1. Impact of Accession on New Members

Assuming that trade between the CEECs and EU has been constrained by significant non-tariff barriers, accession to the Single Market is expected to generate large gains in trade (up to 100%), GDP (up to 20%) and real wages (up to 15%) for the new members at little cost to the incumbents.

Trade expansion is likely to be driven by outsourcing of unskilled-labour intensive production from incumbent members. This is also likely to generate strong sub-regional integration, such as has been observed around the Baltic Sea.

The pre-accession strategy enabled the candidates to take trade liberalisation further than could non-candidates by increasing the level of reform that is best for GDP growth.

Preparations for negotiating EU membership and the negotiations themselves do not appear to have caused reform to have significantly deviated from the pattern generated by sequencing, with the exceptions of bank reform and competition policy.

Prior to the Europe Agreements, export growth of the candidates appears to have been a consequence of the low ratio of exports to GDP. This catch-up process was a consequence of large currency devaluations, hardening of budget constraints and preferential access to the EU market. As many of these factors are either not sustainable in the long run or are parts of processes that are almost complete, export growth in the future will depend upon how well countries adapt to the Single Market.

2. Integration of South East Europe

Policies to encourage greater integration in SEE, such as a Free Trade Area, are warranted by the economic fragmentation of the region and to overcome political conflict.

Integration of the region is restricted by corruption and failings in the rule of law. The market for corruption could be reduced by renewed reform efforts, particularly of banking. The banking sector of the region performs very poorly and so constrains domestic and inward investment. A stronger banking sector should also enhance industrial restructuring by easing the withdrawal of the state from the allocation of credit.

One benefit of reduced economic fragmentation should be increased FDI due to the increased size of the local market.

FDI to the region could be increased by raising the flexibility of the labour market and by improving the mechanisms for wage bargaining.

Crises in the country of origin are major causes of migration to the EU. These results have clear (international) policy implications: the costs of intervening to alleviate severe crises in the countries of origin should be weighed according to their ability to limit socially undesirable mass migrations towards the European Union. In a Union more and more concerned about controlling its borders, these side-effects of a politically stable and economically solid SEE area are of considerable importance.

3. Effect of Accession on the Union

CAP reform is anticipated as being more difficult to achieve. Countries will act on self-interest and try to optimise their gains from the CAP. In contrast, the new member states might give the EU a greater mandate to further trade liberalisation in WTO talks.

The level of border effects is partly due to policy-related constraints; thus there is an important role for policy-makers to remove these barriers. The level of trade of accession countries is substantially lower than what would arise in the absence of border effects, which is much more pronounced in trade with other accession countries than in the trade of accession countries with the EU. Certainly, the border effects are present not only due to policy-related constraint, but the larger border effects for products with higher technical barriers to trade suggests that an important part of the border effects in the case of the accession countries could be eliminated by removal of such barriers.

4. Lessons from Experiences of Disintegration

Analysis of the disintegration of the communist systems suggests that disintegration is most likely when the economy is weak. Thus we should expect any pressure to leave the EU to occur in a time of recession.

Disagreement over transfers through the EU budget might be limited by the small scale of these transfers. However, the small scale of the transfers presents a problem within the euro-zone. Given the low level of international labour mobility within the EU, asymmetric shocks should be met by fiscal accommodation. But the growth and stability pact limits the extent of fiscal expansion. The EU budget is insufficient to accommodate such shocks in the way that the federal authorities in the US can.

The reorientation of exports has been most successful when driven by outsourcing of production and accompanied by high inward FDI. Success has also been associated with worsening terms of trade following significant currency devaluation.

5. Future Research

1) Simulations of the effects of enlargement are based upon the assumption that the access of CEECs to the Single Market had been severely constrained by regulations relating to product standards. Further research into this issue is necessary to raise confidence in the predictions of this modelling exercise.

2) Research on the economic motives, costs and benefits of product quality regulations is somewhat lacking. Further research in this area would help to clarify the benefits of the Single Market.

3) The role of networks in the economic re-orientation of former communist states should be examined further. For example, did the historic links of Hungary, Slovenia and Croatia with Austria assist post-communist development in a manner similar to that witnessed around the Baltic Sea?

4) Migration remains a major issue for the Union. Crisis in the home country appears to be a major factor but what are the appropriate policies for the EU in response to these crises? There could be a moral hazard problem here, if the EU was known to respond favourably to crises that might make crises more likely. In addition, some policies of the EU might cause crises outside the EU.

5) At a European level policies taken to promote inward investment could be contentious. If flexible labour markets are attractive to investors there could be a danger of a 'race to the bottom' as members compete for inward investment. How can the EU make social policy attractive to investors?

6) With further enlargement on the cards, it is vital to understand how the prospect of enlargement enhances reform. In addition, how can new members be encouraged to maintain reform?

6. State of the Art

1) State of the art was advanced through:

2) Simulation modelling made the more realistic assumptions of imperfect competition, or dual technologies.

3) Econometric analysis of the probability of advancing reform conditional on the reforms so far undertaken.

4) Extensive use of fixed effects panel data econometrics.

5) Utilising theoretical advances on the break-up of federations to examine the collapse of the USSR, Yugoslavia, Czechoslovakia and the CMEA.

6) Analysing survey evidence on illegal migrants.

7) Simulation of voting within the enlarged Union on agricultural reforms and on negotiations with the WTO.

8) Extensive consideration of border effects on trade and how these could be related to quality standards and regulations.

7. Importance of European Collaboration to the Research Effort

1) Collection of data that would have otherwise not been possible due to lack of familiarity with other countries' sources, language or procedures.

2) Field work performed in key countries, for example the survey of illegal migrants in Italy.

3) Range of experiences of the various researchers. Most importantly of all relating to the Estonians' experiences of the Soviet economy and the process lead to the establishment of independent Estonia. In addition, the Estonians understanding of Soviet-era statistics proved vital.

4) Working the institution based in Brussels enabled us to anticipate the evolution of EU policy and institutions.

V. DISSEMINATION AND EXPLOITATION OF RESULTS

In the first years of the project the main means of dissemination was by making abstracts of early drafts of papers available on the project website (http://www.epriee.ncl.ac.uk). Later drafts of complete papers were then made available on the website as EPRIEE Working Papers. Project deliverables were also made available on the website.

The final report will be published by the Centre for European Policy Studies. The feasibility of publishing a number of the project papers in book form is being examined.

Other

HM-Treasury sent Andrew Gurney to attend the first project meeting in 2001. Representatives of the Newcastle and CEPS teams then attended a seminar on enlargement hosted by HM-Treasury in 2002.

The 2002 project meeting in Tallinn was attended by numerous academics and policy-makers.

Attempts to get representatives of the Commission and EBRD to meetings failed.

It was planned to meet policy-makers and other stakeholders at the 2003 meeting in Poland, but this meeting had to be cancelled.

Proposal for an ESRC-sponsored research group on Wider European Integration has been put forward by Huw Edwards.

Follow Up Strategies

Result	Partners	Planned Exploitation
EPRIEE-01	Newcastle UNEW	Submitted to Econ. Of Transition
EPRIEE-02	Newcastle UNEW	Book
EPRIEE-03	Newcastle UNEW	Book
EPRIEE-04	Newcastle UNEW	Submitted to J. of Comparative Econ.
EPRIEE-05	Newcastle UNEW	Journal/book
EPRIEE-06	Newcastle UNEW	book

EPRIEE-07	Newcastle UNEW	being prepared for journal submission
EPRIEE-08	Newcastle UNEW	submitted to Manchester School
EPRIEE-09	Warwick	submitted to Weltwirtschafliches Archiv
EPRIEE-10	Warwick	being prepared for journal submission
EPRIEE-11	Warwick	being prepared for journal submission
EPRIEE-12	Warwick	submitted to European Econ. Review
EPRIEE-13	Warwick	being prepared for journal submission
EPRIEE-14	Bari	Use in policy papers
EPRIEE-15	Bari	CSGR discussion paper
EPRIEE-16	Bari	Book
EPRIEE-17	Bari	Book
EPRIEE-18	Tallinn EIE	CSGR discussion paper
EPRIEE-19	Tallinn EIE	Chapter of first deliverable
EPRIEE-20	Tallinn EIE	published by Tallinn Technical University
EPRIEE-21	Tallinn EIE	being prepared for journal submission
EPRIEE-22	CEPS	CEPS publication
EPRIEE-23	CEPS	CEPS publication
EPRIEE-24	CEPS	CEPS publication
EPRIEE-25	CEPS	CEPS publication
Migrant data set	Bari	Unrestricted access for research

The final report contains no contributions from the 6th partner, MASCEC. Their contributions to the deliverables was of generally poor quality, sometimes little more than lists of committees. In April 2004 they promised to contribute to the final report. The coordinator advised on the required format and other teams, CEPS and Warwick, advised on how to improve their work. Since then there has been no communication received from them despite numerous emails being sent by the coordinator.

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VII. ANNEXES

1. EPRIEE Working Paper Series

EPRIEE -01: D. Barlow, Growth in Transition Economies: A Trade Policy Perspective, 2004

EPRIEE-02: D. Barlow, Explaining the Growth of Exports from Central Europe, the Balkans, and Baltic States over the Transition, 2004

EPRIEE-03: D. Barlow, Economic Integration in South Eastern Europe, 2004

EPRIEE-04: D. Barlow and M-R. Radulescu, The Sequencing of Reform in Transition Economies, 2004

EPRIEE-05: D. Barlow and M-R. Radulescu, Public Goods in Economic Integration and Disintegration, 2004

EPRIEE-06: D. Barlow and D. Buckley, Reform Progress and State Capture in Transition Economies, 2004

EPRIEE-07: M-R. Radulescu and M. Robson, Trade Unions, Wage Bargaining Co-ordination and Foreign Direct Investment, 2004

EPRIEE-08: M-R. Radulescu and M. Robson, Does Strict Employment Protection Legislation Deter FDI?, 2004

EPRIEE-09: T.H. Edwards, Modelling the Accession of the central and Eastern European Countries to the EU Single Market, 2004

EPRIEE-10: T.H. Edwards, Transition and the post-Soviet technology gap: A dynamic assessment, 2004

EPRIEE-11: T.H. Edwards, Who Gains from Restructuring the Post-Soviet Transition Economies, and why?, 2004

EPRIEE-12: T.H. Edwards, Quality Standards under Imperfect Competition and Trade, 2004

EPRIEE-13: T.H. Edwards, Import Search and the Path-Dependency of Trade, 2004

EPRIEE-14: M.C. Chiuri, G. De Arcangelis, A.M. D'Uggento and G. Ferri, Illegal Immigration into Italy: Evidence from a field study, 2004

EPRIEE-15: M.C. Chiuri, G. De Arcangelis and G. Ferri, Crisis in the Countries of Origin and Illegal Immigration into Europe via Italy, 2003

EPRIEE-16: G. De Arcangelis, G. Ferri and P.C. Padoan (2004), What Role for Firms' Clustering on Eastern Europe's Export Performance: Inferring from the Italian Experience in the 1960s.

EPRIEE-17: G. Di Pietro, Trade, legal and illegal immigration, 2003

EPRIEE-18: T. Rajasalu, Trade Blocs and the Development of Estonia's Foreign Trade: A Gravity Model Approach for Assessment of Reintegration, 2003

EPRIEE-19: T. Rajasalu and U. Venesaar, Background Information on Estonia, 2001

EPRIEE-20: U. Venesaar, Trade Relations between Russia, Estonia and the EU, 2002

EPRIEE-21: U. Venesaar, Enterprise Restructuring and Capital, 2004

EPRIEE-22: P. Brenton, The Economic Impact of Enlargement on the European Economy: Problems and Perspectives, 2002

EPRIEE-23: A. Schneider, The impact of enlargement and voting rules negotiations on the CAP and the behaviour of the EU in world agricultural negotiations, July 2004

EPRIEE-24: A. Schneider, FDI and Trade in the Western Balkans, October 2004

EPRIEE-25: M. Manchin an A.M. Pinna, Border Effects in the Enlarged EU Area, Evidence from Imports to Accession Countries, July 2004

2. List of Deliverables

1) Transition and Accession – delivered month 7. Completed.

2) Nature and Measurement of Integration – delivered month 13. Completed.

3) Experiences if Integration – delivered month 19. Completed.

4) Experiences of Integration – delivered month 25. Completed.

5) Institutional Reform – delivered month 31. Completed.

3. Publications

The following four papers were made available as Warwick University Discussion Papers:

Edwards, EPRIEE-09.

Rajasulu, EPRIEE-18.

Radulescu and Robson, EPRIEE-08.

Chiuri, De Arcangelis and Ferri, EPRIEE-15.

Barlow, EPRIEE-01, has been invited for revision and resubmission to Economics of Transition.

Barlow and Radulescu, EPRIEE-04, has been invited to be revised for resubmission to Journal of Comparative Economics.

Rajasalu T. 2003. Indicators of Economic Freedom and Economic Structure as Determinants of Growth and Convergence in Enlarging EU and Priorities for Estonia. In: Ennuste Ü. & Wilder L. (Eds) Essays in Estonian Transformation Economics, Estonian Institute of Economics at Tallinn Technical University, pp. 7-32.

Venesaar U. (co-author) 2003. The State of Small and medium Sized Enterprises in Estonia on the Way to Accession. In: Ennuste Ü. & Wilder L. (Eds) Essays in Estonian Transformation Economics, Estonian Institute of Economics at Tallinn Technical University, pp. 71-92.

Venesaar (EPRIEE-20) published by the Estonian Institute of Economics at Tallinn Technical University.

4. Seminars and Conferences

January, 2002

CSGR Workshop of General Equilibrium Models of Transition and EU Enlargement on with a range of invited speakers, the following work was presented in addition to an early draft of EPRIEE-09:

Yannis Zahariadis and David Evans, Institute of Development Studies, Sussex on deep integration variables for an EU/Turkey customs union.

Helena Marques, University of Newcastle. 'A Two Peripheries Model When Trade Matters'.

Daniel Piazolo, IFW Institute for World Economics, Kiel Germany, 'An intertemporal CGE assessment of Poland's membership in the EU'.

Richard Nahuis, CPB Netherlands. 'EU Enlargement: Economic Implications for Countries and industries'.

February 2002

The Bari team organised a "migration research day", with a range of invited speakers with Prof. Laura Chies and Dario Gregori from the University of Trieste.

March 2002

Newcastle team attended a conference on the Emerging Industrial Landscape of Europe.

2003

Radulescu and Robson, EPRIEE-08 was presented at Aberdeen University, and at the Money, Macro and Finance Conference.

Radulescu went to the 'Transition and development in South-East Europe' CEPR-ESRC Workshop at the Department for International Development (DfID) in London.

Radulescu was a discussant at the 'Politica Economy of Transition: job creation and job destruction' conference at the Center for European Integration Studies (ZEI).

January 2004

Barlow and Radulescu, EPRIEE-04, was presented at Warwick University.

Study of EU candidature and reform was proposed as a special session for the 2004 Royal Economic Society conference. The proposal was rejected.

5. Annex to Objective 1

Table 14. Estonia Structure of industrial output at current prices

	1992	1993	1994	1995	1996	1997	1998	1999
Energy supply	11.0	12.7	14.7	13.5	13.3	11.5	11.0	12.2
Mining	4.3	4.7	4.6	4.5	4.9	4.4	3.8	4.0
.. mining and agglomeration of oil-shale	3.3	4.0	3.9	3.7	4.1	3.7	3.0	3.1
.. extraction of peat	0.3	0.4	0.6	0.7	0.7	0.6	0.5	0.5
Manufacturing	84.7	82.6	80.7	82.0	81.8	84.1	85.2	83.8
.. manufacture of food products, beverages and tobacco products	31.6	37.7	32.8	28.9	27.2	27.0	24.5	20.2
.. manufacture of textiles	11.8	4.6	4.6	5.9	6.9	6.4	6.3	6.0
.. manufacture of wearing apparel	3.2	3.8	3.2	3.5	3.5	3.4	3.5	4.0
.. tanning and dressing of leather and manufacture of footwear	2.1	1.5	1.4	1.2	1.1	1.1	1.2	1.4
....manufacture of footwear	1.4	1.0	0.9	0.8	0.8	0.8	0.9	1.1
.. manufacture of wood	3.7	3.5	4.6	6.7	6.5	8.3	9.1	11.2
.. manufacture of paper and paper products	1.1	0.3	0.6	1.0	1.3	1.6	1.7	1.8
.. publishing, printing and reproduction of recorded media	1.6	3.0	2.5	3.6	3.7	3.5	4.5	5.0
.. manufacture of chemicals and chemical products	7.6	7	7.6	8.1	7.2	6.1	5.2	4.2
.. manufacture of rubber and plastic products	1.2	0.9	1.0	1.2	1.3	2.2	1.9	2.0
.. manufacture of other non-metallic mineral products	3.9	3.7	4.7	3.8	3.8	3.9	4.6	4.4
.. manufacture of fabricated metal products	2.2	2.7	3.1	3.8	4.5	4.8	5.9	4.9
.. manufacture of machinery and equipment	2.2	2.3	2.5	2.0	2.2	1.9	2.1	2.2

.. manufacture of office machinery and computers	0.0	0.1	0.2	0.5	0.4	0.5	0.9	0.6
.. manufacture of electrical machinery and apparatus	2.5	1.4	1.5	1.6	1.6	1.5	1.3	1.7
.. manufacture of radio, television and communication equipment and apparatus	0.5	0.5	0.3	0.4	1.0	1.1	1.2	1.5
.. manufacture of medical, precision and optical instruments, watches and clocks	0.8	0.8	0.7	0.6	0.6	1.0	1.7	1.7
.. manufacture of motor vehicles, trailers and semi-trailers	2.3	2.4	2.1	1.8	1.6	1.7	1.3	1.6
.. manufacture of other transport equipment	1.2	1.6	2.0	1.6	1.7	1.5	1.6	1.7
.. manufacture of furniture and other manufactured goods	4.9	5.0	5.0	5.3	5.4	6.4	6.5	6.8
.. other manufacturing n.e.c.	0.3	0.1	0.3	0.3	0.3	0.2	0.2	0.9

Box 1. Description of transition indicators[38]

Large-scale privatisation

1) Little private ownership

2) Comprehensive scheme almost ready for implementation; some sales completed.

3) More than 25% of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.

4) More than 50% of state-owned enterprise and farm assets in private ownership and significant progress on corporate governance of these enterprises.

4.3) Standards and performance typical of advanced industrial ownership with effective corporate governance.

Small-scale privatisation

1) Little progress.

2) Substantial share privatised.

3) Nearly comprehensive programme implemented.

4) Complete privatisation of small companies with tradable ownership rights.

4.3) Standards and performance typical of advanced industrial economies; no state ownership of small enterprises; effective tradability of land.

Governance and enterprise restructuring

1) Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.

2) Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate

[38] Source: EBRD (1999).

governance.

3) Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g. through privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).

4) Substantial improvement in corporate governance, for example and account of an active corporate control market; significant new investment at the enterprise level.

4.3) Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.

Trade and foreign exchange system

1) Widespread import and/or export controls or very limited legitimate access to foreign exchange.

2) Some liberalisation of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent) possibly with multiple exchange rates).

3) Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.

4) Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility.

4.3) Standards and performance norms of advanced industrial economies: removal of most tariff barriers; WTO membership.

Banking reform and interest rate liberalisation

1) Little progress beyond establishment of a two-tier system.

2) Significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.

3) Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.

4) Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.

4.3) Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.

Securities markets and non-bank financial institutions

1) Little progress.

2) Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.

3) Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework.

4) Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalisation; well-functioning non-bank financial institutions and effective regulation.

4.3) Standards and performance norms of advanced industrial economies: full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation.

Competition policy

1) No competition legislation or institutions.

2) Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.

3) Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.

4) Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.

4.3) Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

Table 15. EBRD Scores for Foreign Exchange and Trade Liberalisation

	1995		1997		2002
Hungary	4.3		4.3		4.3
Albania	4		4		4.3
Bulgaria	4		4		4.3
Croatia	4		4		4.3
Czech	4		4.3		4.3
Estonia	4		4		4.3
FYROM	4		4		4.3
Kyrgyz	4		4		4.3
Latvia	4		4		4.3
Lithuania	4		4		4.3
Moldova	4		4		4.3
Poland	4		4.3		4.3
Romania	4		4		4
Slovak	4		4.3		4.3
Slovennia	4		4.3		4.3
Russia	3.7		4		3
Armenia	3		4		4
Kazakh.	3		4		3.3
Ukraine	3		3		3
Azer.	2		2.3		3.7
Belarus	2		1		2.3
Georgia	2		4		4.3
Tajik.	2		2.7		3.3
Uzbek.	2		1.7		1.7
Bosnia.	1		3		3
Serbia.	1		1		3.3
Turkmen.	1		1		1

6. Annex to Objective 2

Figure 1.

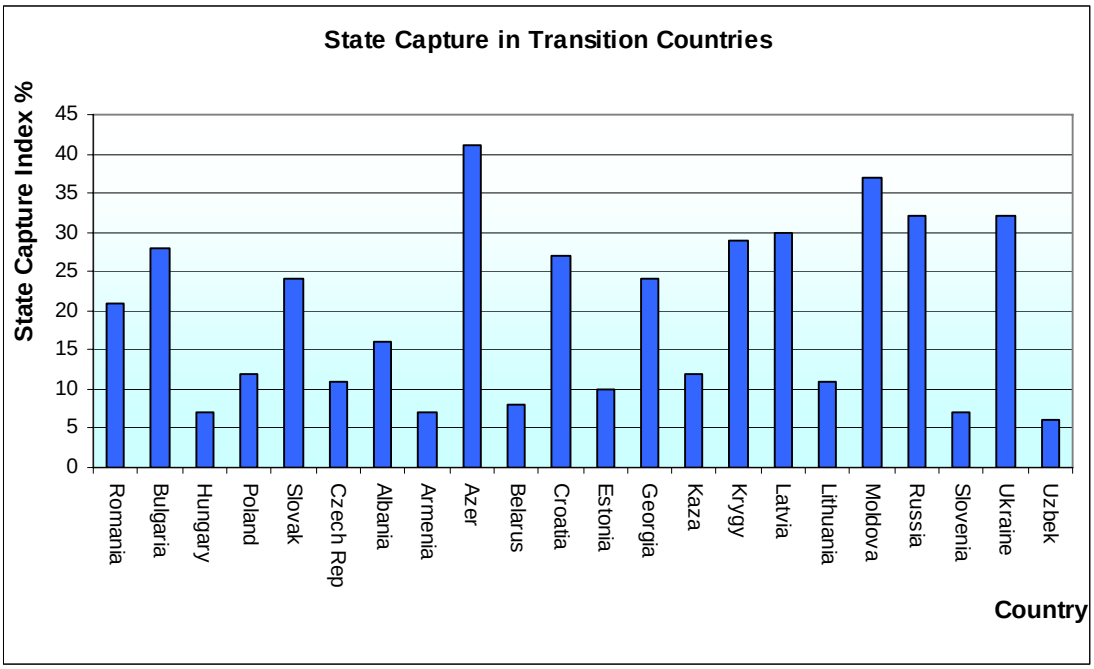

Table 16. Number and size of enterprises in SEE countries

	Number of SMEs (including micro enterprises)	% of total enterprises	Number of micro enterprises	% of total enterprises	Number of large enterprises
SEE					
Albania	56237	99,6	54145	95,8	253
Bosna and Herzegovina	30000	99,3	25600	84,8	200
Bulgaria	224211	99,7	207643	92,3	741
Croatia	63135	99,3	41988	66,1	426
Macedonia FYR	27938	99,3	25985	92,4	194
Romania	612862	99,7	311260	50,6	1955
Serbia and Montenegro	66968	98,9	64002	94,5	742
Selected CEE countries					
Czech Republic	876990	99,8	830601	94,5	1671
Hungary	858981	99,9	827806	96,3	1041
Poland	3368367	99,8	3206452	95,0	6589
Slovak Republic	365783	100,0	354373	96,8	160
Slovenia	26915	98,9	22285	81,9	308

Note: Data for Albania, Croatia, Czech Republic and Hungary are for 2002. Data for Bosnia and Herzegovina, Poland, Serbia and Montenegro, Slovak Republic and Slovenia are for 2001. Data for Bulgaria, FYR Macedonia, Romania

Source: EBRD (2004).

Table 17. Selected Values of the Blanchard-Wolfers Index of the Strictness of Employment Protection Legislation

Country	1965-9	1985-9	1995-7
Australia	1	1	1
Belgium	2.21	3.1	2.2
Canada	0.6	0.6	0.6
Denmark	1.8	2.2	1.3
Finland	2.4	2.4	2.1
France	1.02	2.6	3.1
Germany	1.44	3.3	2.7
Greece	3.7	3.7	3.7
Ireland	0.25	1	1.1
Italy	4	4	3.4
Japan	2.8	2.8	2.8
Netherlands	2.7	2.7	2.4
New Zealand	1.6	1.6	1.6
Norway	3.1	3.1	2.7
Spain	4	3.8	3.1
Sweden	0	3.6	2.4
Switzerland	1.1	1.1	1.1
United Kingdom	0.33	0.7	0.7
USA	0.2	0.2	0.2

Source: Appendix to Blanchard and Wolfers (2000) (available at http://web.mit.edu/blanchar/www/articles.html).

Table 18 Trade Union Membership Density, Bargaining Co-ordination and FDI in Selected Years

Country	Period	Union density (%)	Bargaining coordination	Real FDI Inflow ($m)
Australia	1975	49	2.36	1115.2
	1985	48	2.31	2747.0
	1995	35	1.63	12432.0
Austria	1975	53	2.5	193.6
	1985	52	2.5	230.4
	1995	41	2.42	1901.0
Belgium	1975	52	2.1	2340.7
	1985	51	2.55	1399.5
	1995	54	2	10689.0
Canada	1975	34	1.63	8299.0
	1985	37	1.08	1806.9
	1995	37	1	9319.0
Denmark	1975	69	2.96	654.4
	1985	78	2.54	147.8
	1995	77	2.42	4139.0
Finland	1975	65	2	166.7
	1985	69	2	150.5
	1995	80	2.38	1044.0
France	1975	22	2	3823.5
	1985	14	2	3462.1
	1995	10	1.92	23730.0
Germany	1975	35	2.5	1691.2
	1985	34	2.5	652.5
	1995	27	2.5	11990.0
Ireland	1975	56	2.91	387.3
	1985	56	2.08	218.4
	1995	46	2.75	1447.0
Italy	1975	48	2	1580.9
	1985	43	1.81	1427.4

	1995	39	1.95	4842.0
Japan	1975	31	2.5	-
	1985	26	2.5	852.2
	1995	24	2.5	40.0
Netherlands	1975	38	2	3019.6
	1985	28	2.38	2004.0
	1995	24	3	12104.0
Norway	1975	52	2.96	539.2
	1985	56	2.72	567.2
	1995	55	2.84	2393.0
New Zealand	1975	37	2.5	338.2
	1985	33	2.32	1685.8
	1995	24	1.25	3659.0
Portugal	1975	61	2.56	281.9
	1985	56	1.58	364.8
	1995	32	1.88	685.0
Spain	1975	09	2.64	1674.0
	1985	12	2.3	2620.5
	1995	18	2	6297.0
Sweden	1975	74	3	196.1
	1985	84	2.53	523.3
	1995	90	1.94	14939.0
Switzerland	1975	32	2	-
	1985	28	2	1687.1
	1995	24	1.63	3599.0
UK	1975	54	1.77	8137.3
	1985	51	1.08	7310.3
	1995	37	1	20320.0
USA	1975	26	1	6274.5
	1985	18	1	26644.5
	1995	15	1	59640.0

Note: The measure of wage bargaining co-ordination is an index with a range of 1-3. Higher values correspond to a greater degree of bargaining co-ordination between employers and/or trade unions. The data were compiled by Ochel (2000) and taken from Nickell (2003). See Radulescu and Robson for further information on data sources and details of the construction of the variables.

Table. 19. Nationality of illegal migrants in the survey

Nationality	n.	%	Nationality	n.	%	Nationality	n.	%
Iraq	88	9,6	Afghanistan	16	1,7	Mauritania	4	0,4
Liberia	83	9,0	Ghana	16	1,7	Bulgaria	3	0,3
Sudan	50	5,4	Nigeria	16	1,7	China	3	0,3
Morocco	47	5,1	Moldavia	13	1,4	Croatia	3	0,3
Senegal	44	4,8	Sri-Lanka	13	1,4	Russia	3	0,3
Turkey	44	4,8	Ethiopia	11	1,2	Serbia	3	0,3
Pakistan	40	4,3	Ivory Cost	10	1,1	Syria	3	0,3
Bangladesh	36	3,9	Iran	9	1,0	Libya	2	0,2
Albania	34	3,7	Congo	7	0,8	Czech Republic	2	0,2
Sierra Leone	31	3,4	Macedonia	7	0,8	Mauritius	2	0,2
Kosovo	29	3,2	Slovakia	7	0,8	Others	8	0,8
Eritrea	28	3,0	Egypt	6	0,7			
Israel - Palestine	27	2,9	Philippine	6	0,7			
Tunisia	27	2,9	India - Punjab	6	0,7			
Romania	25	2,7	Bosnia	5	0,5			
Ukraine	25	2,7	Poland	5	0,5			
Somalia	23	2,5	Cameroon	4	0,4	*SEECs*	129	14,0
Yugoslavia	20	2,2	Chad	4	0,4	*CEECs*	14	3,0
Algeria	18	2,0	Colombia	4	0,4	Total	920	100,0

Source: Chiuri et al. (2004a)

7. Annex to Objective 4

Table 20. Average annual growth performance of former Soviet bloc economies

		1980/89	1990/99	1999/2004
CEEC	Czech Rep	1.7	0.9	2.3
	Slovakia	2.0	1.9	3.2
	Hungary	1.3	1.0	3.9
	Poland	2.2	4.7	3.5
BALKANS	Bulgaria	3.4	-2.7	4.2
	Romania	0.5	-2.2	3.3
BALTICS	Estonia	2.2	-1.3	4.7
	Latvia	NA	-4.8	6.2
	Lithuania	NA	-3.9	4.3
CIS	Russia	NA	-6.1	6.7
	Armenia	NA	-3.1	9.0
	Azerbaijan	NA	-9.0	0.0
	Georgia	0.4	-10.3	4.7
	Kazakhstan	NA	-5.9	8.9
	Kyrgyz Rep	NA	-7.4	3.8
	Moldova	3.0	-11.5	3.7
	Tajikistan	NA	-9.8	8.4
	Turkmenistan	NA	-3.5	18.4
	Ukraine	NA	-10.8	5.8
	Uzbekistan	NA	-2.0	4.2

Source World Development Report, World Bank, 2000-01. World Development Indicators 2005 for final column.

European Commission

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