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**THE EUROPEAN ECONOMY:
BASIC TRENDS AND CHALLENGES**

99 - 01

Spyros Vliamos

DISCUSSION PAPER SERIES



UNIVERSITY OF THESSALY
DEPARTMENT OF PLANNING AND REGIONAL DEVELOPMENT

Two Lectures on the evolution of the European Economy

By

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(A) European Union Economy:

Trends, Opportunities and Challenges

**(B) Policies of Integration and Development in the European
Union: Agenda 2000**

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European Union Economy: Trends, Opportunities and Challenges

(A) European Monetary Union : Process and Benefits

1. The process to European Monetary Union (EMU)

Monetary Union has had a long history which goes back almost thirty years starting with the early plans on economic union. As expected there has been a long list of pros and cons of this, as well as of the necessary preconditions to be fulfilled before the adoption of a single currency. After all, monetary union is a fact that brings together some of the oldest and most advanced industrialized economies of the world and this is something which challenges both economists as well as economic theories. However, an EMU must not be treated as being simply a narrow economic issue but rather a major political one, as it touches the very heart of national sovereignty. Money must rather be seen as an instrument of wider political objectives and application of high politics, than as a mean through which markets and other economic variables operate and produce wealth, prosperity and happiness.

EMU constitutes *the most important and concrete part* of the Maastricht treaty. It should be noted from the outset that this treaty was accepted with skepticism and little applause from European societies and international markets alike. And that was due to the turmoil in the exchange markets prevailing at that time (early 90's) caused by a slowing down of rates of

growth of the European economies which, in turn, led to the withdrawal of currencies from the European Monetary System (EMS) and the widening of the margins of fluctuations to 15% for those remaining in the system. In that way a paradox emerged: instead of having a system of irrevocable fix exchange rates which would lead to a single currency, a more flexible exchange rate mechanism (ERM) was created, a not at all promising situation. That is why the whole process to the EMU has been characterized by many as being **a long and bumpy road leading to narrow gates.**

The return to higher rates of growth of the European economies and the subsequent exchange rate stability, coupled with the creation of the European Monetary Institute (EMI) in 1994, brought the monetary integration back to the agenda. So, a number of important decisions were taken at the European Council meeting in Madrid in December 1995, which reassured the real willingness of the EU to proceed with the monetary integration and the changeover to the single currency (Euro). According to this decision, the Euro and those national currencies participating to the final stage of EMU will coexist, with conversion rates established by law, until July 2002 when the Euro is planned to become the only legal tender. *Banknotes and coins in Euro will begin to circulate at the latest by 1 January 2002. In the meantime, private economic agents will be able to use the Euro in their financial transactions, while public authorities will gradually shift from national currencies to the new European currency in the issuing of new public debt.*

2. European Monetary Union: Pros and Cons.

There has been a long literature concerning the economics of EMU and especially the merits and demerits of the system. More specifically, the relevant arguments can be summed up as following:

(A) Elimination of risks in currency conversion and savings in other transaction costs.

For the first time real price transparency across borders will exist. Consumers will be able to source their purchases from anywhere in the Community free from the uncertainties, costs and complexities of exchange rate fluctuations. This can only bring benefits to consumers. Firms will also benefit from greater certainty in the costs of raw materials bought within the Union. Investment decisions will no longer be clouded by

the vagaries of exchange rates. The elimination of such exchange rate risks should lead to a general increase in economic activity.¹ This is to say nothing of the wider macro-economic benefits to the Community of the lower interest rates and greater stability that should accompany the Euro as a strong international reserve currency.

- (B) Achievements in price stability. That depends on the policy exercised by and the credibility of the European Central Bank. Countries with high inflation rates like Italy and Greece will be benefited from the irrevocable fixity of the exchange rates. Further, a strong single new currency could become an international means of payment and that would secure a relative price stability.

However the above benefits of the single currency must be weighted against the loss of two policy instruments: an independent monetary policy and the option of changing the exchange rate. Losing these is especially grave if a country or region is likely to suffer from «**asymmetric demand shocks**» that affects it differently from the rest of the single-currency area, because it will no longer be able to respond by loosening its national monetary policy or devaluing its currency.

But on the other hand, are countries able to conduct independent monetary policies in an increasingly interdependent world economy? Key advances made in telecommunication technologies, financial market innovation and deregulation, along with the diversification of currency portfolios have all weakened the old grasp of national authorities on domestic monetary control. Indeed, this trend would appear to make a case for greater degree of international control to be applied.

The last issue to be discussed is whether or not the EU could be considered as being an optimum currency area, i.e. an area where other economic aggregates (variables) and especially capital and labour mobility, could act as near substitutes for changes in the exchange rates. The answer is negative as the structure of the economies of the member-states differs from country to country. For example, today the German economy experiences a recession, while the British economy is in the stage of a recovery, meaning that the EU economy is not a homogeneous one, in the sense that different countries and regions are subject to asymmetric external shocks. . In such a situation a common monetary

¹ For the EU the European Commission has put these gains at 0.5% of GDP.

policy exercised by the European Central Bank cannot be applied, since a common monetary instrument (e.g. interest rates) does not fit both situations simultaneously.

(B) European Union Economy : Challenges and Opportunities

I. INTERNAL POLICIES

The successful passage to EMU and the full exploitation of the potential of the single market will enhance Europe as an economic entity, contributing to sustainable growth. Its competitiveness depends on **dynamic enterprises** and the **skills and knowledge** of its people. In order to turn growth into jobs, employment systems should be modernized. Beyond these economic goals, Europeans also want **a cohesive and inclusive society based on solidarity, as well as a high quality of life, sound environment, freedom, security and justice**. The internal policies of the Union should be more resolutely oriented towards meeting these objectives.

1. SETTING THE CONDITIONS FOR SUSTAINABLE GROWTH AND EMPLOYMENT

The process leading towards *Economic and Monetary Union* continues to be a major driving force for the European Union. All the technical preparations are now in place. The move towards the **euro** will not only provide an anchor of stability, improve market efficiency and encourage investment. It will also open new possibilities for more effective *macroeconomic management* in Europe. **The Amsterdam Resolution on Growth and Employment** as well as the **Stability and Growth Pact** provide a favourable framework for economic growth and new job opportunities.

The *Single Market* can play a central role in furthering growth and employment, provided its potential is fully exploited. To this end, the Action Plan endorsed by the European

Council of Amsterdam must be implemented in all its components. Making the rules more effective and removing all market distortions and sectoral obstacles will turn Europe into a dynamic and attractive market place. Moreover the Single Market must be there for the benefit of all citizens. The assets of the Single Market must be used to promote the Union's interests and presence internationally.

With further integration, the strict application by the Commission of *competition rules*, including close surveillance of state aids, becomes ever more important for the market operators and will enhance the overall economic performance of the Union. Rules will be made simpler and surveillance and enforcement structures will be modernized in partnership with Member States, with a view to decentralization where possible. The Union should also press for more international cooperation in competition policy.

Given their proven potential for job creation, improving the operating conditions for **small and medium-sized enterprises (SMEs)** in the Single Market remains a high priority. This must be done by reducing administrative and regulatory red tape, stimulating new forms of cooperation between small and large companies and improving (SMEs) access to finance and capital. The projected new European Investment Bank (EIB) lending facility will be of particular importance. Moreover, the Union should continue to fund actions aimed at improving the operating conditions of SMEs.

Following the inclusion of sustainable development as one of the Union's objectives into the Amsterdam treaty, progress must be made towards environmentally sustainable production and consumption patterns. The incorporation of the latest technological evolutions into the environmental policy and the use of new instruments like market based incentives can actually enhance the competitiveness of European industry and services.

The continued development of the *Trans-european networks* (TENs) will serve to enhance both sustainable development and the internal cohesion of the Union by tying regions closer together. This will need to be accompanied by a move towards sounder transport systems, drawing fully on new technology, to address the problems of congestion, pollution and climate change. **TENs also have a particularly important role to play in creating new links with the Central and Eastern European candidate countries.** It is precisely the trans-European nature of the benefits from these projects which justifies continued substantial contributions at the Union level towards their realization. Community funds can

play a crucial role in getting TEN projects in transport, energy and telecommunications off the ground.

The next financial period will see the main construction phase on many of the priority projects, involving higher overall spending than in the period 1994-99 during which the Community essentially financed preparatory works. Enlargement will extend the geographical coverage of the TENs, and consequently the financing needs. There is a range of sources of finance for TENs, including the Cohesion Fund, the European Regional Development Fund (ERDF) and the European Investment Bank/European Investment Fund (EIB/EIF). Effective coordination of these instruments, including development of public/private financing, is essential, but will not be sufficient to cover the identified needs in this sector. Additional funding must therefore be identified beyond present appropriations.

2. PUTTING KNOWLEDGE AT THE FOREFRONT

The key feature of today's world economy is a rapid shift towards globalization and information and communication technologies. These technologies determine the global competitiveness of all economic sectors and foster the emergence of new non-material goods. In order to derive the maximum benefit from this process in terms of growth, competitiveness and employment, special attention must be paid to the development, dissemination and use of these non-material goods. *Knowledge policies* - research, innovation, education and training - are therefore of decisive importance for the future of the Union. In response to the challenges of technological development and innovation coming at a time when Europe's competitors are stepping up their efforts significantly, it is vital that the Community *research and technological development* effort be given new impetus. Community RTD policy must provide real added value in relation to national programs. This is the main objective of the 5th framework program, which will need to see its financial allocation increased above the level of the present program. The Union must focus research activities on improving the competitiveness of the European economy, thereby promoting the creation of new jobs. It is particularly important that Europe should be able to transform scientific and technological breakthroughs into industrial and

commercial successes. In this connection, innovation by small and medium-sized enterprises is a particularly important factor on which to build. The creation of innovative high-tech companies in Europe must be encouraged. The Union also has to improve on the dissemination of technology and the system of intellectual property rights for its discoveries. Like research, *education and training* represent essential non-material investments. The Union will go on giving priority to concrete initiatives to promote exchanges of young people, scientists and teachers along the lines of the Socrates, Leonardo da Vinci and Youth for Europe programs. The success of schemes like the Erasmus program should lead to new initiatives to promote transnational mobility for European citizens. An exchange program for young apprentices should be developed rapidly. At the same time the European youth volunteer program should be developed. The new generation of programs would seek to encourage life-long training through innovative transnational projects and the exchange of good practice.

The *information society* holds major opportunities for Europe's competitiveness and its development must be promoted in areas such as electronic commerce and the audiovisual sector. But it has also become a formidable medium for education, training and culture. Familiarity with these new technologies must therefore be improved, in particular in schools.

3. MODERNIZING EMPLOYMENT SYSTEMS

In order to draw the maximum benefit from growth and competitiveness for employment, *labour market and employment* policies must be modernised. Whereas the responsibility for these policies is largely national, the Union has provided a reference framework building on the process started in Essen and amplified in Amsterdam. It should fully exploit all the possibilities offered by the new employment title of the treaty such as pilot projects, exchange of best practices, benchmarking exercises and specific recommendations to Member States. In this way, a true coordination of national employment policies will take place involving all relevant actors and stimulating social dialogue. The aim must be maximum flexibility for the enterprises and maximum security for the individuals.

The Community and its Member States will have to rethink a number of policies in order to achieve these aims: how to invest permanently in the skills of the existing work force; how to increase the participation rate by providing new forms of work organisation; how to encourage mobility; and how to anticipate and respond to restructuring by appropriately informing and consulting workers, improving their reintegration and stimulating entrepreneurship. The present social protection systems should be made more employment-friendly, unemployment schemes should be geared towards greater employability in the context of a move towards life-long learning. Furthermore, tax regimes should also provide the appropriate incentives towards job creation.

The *reform of pensions and health care systems* against the background of an ageing population presents the Member States and the Union with a particular challenge. It must be reconciled with the need for budgetary rectitude. Modernisation of protection systems must build on common analysis, coordination of policies and joint dialogue with the social partners. The Union will continue to serve as a forum for promoting better mutual understanding of long-term perspectives and for identifying common challenges. Where necessary, regulatory initiatives can provide a new common framework, in particular for pension funds in the euro financial area.

4. IMPROVING LIVING CONDITIONS

The overall growth and employment prospects in the coming decade are encouraging. At the same time, there could still be very different patterns of employment and social development within the Union, or within individual Member States. Special efforts will be required to ensure that the benefits of growth can be used to promote a more *cohesive and inclusive society*. Beyond the targeted use of structural funds and other Community instruments, the Union can play a supporting role by encouraging best practices and facilitating cooperation in the fight against social exclusion and all forms of discrimination. Recent events have increased the sensitivity of Europeans as regard *public health*. There is an urgent need to draw the lessons from this situation, notably for improving food safety. As a matter of priority, a reflection is needed on the system of authorisations for the production and distribution of products with an impact on public health. In this context,

Article 129 as complemented by the Amsterdam Treaty should be fully exploited. The Union should also defend its approach and high standards in this field at the international level in accordance with multilateral rules.

In order to be able to respond to *the environmental challenges* in an enlarged Union, a better implementation and enforcement of the environmental *acquis* must be ensured. Further efforts will have to be made towards integrating environmental considerations into the design and implementation of all relevant Community policies, thus responding to public demand for creating a higher level in «quality of life».

Globalization and increased economic integration imply that cost-effectiveness becomes a crucial determinant of sound environmental policy and so does an extended cooperation with the stake-holders, as successfully practised in the Auto/Oil Program. This not only preserves and improves the situation within the Union, but also presents a way to achieve the objectives the Union is committed to in the follow-up of the Special Session of the United Nations General Assembly on the environment and sustainable development.

The *right to move and settle freely* is fundamental to the European citizen. The free movement of persons must however be accompanied by an *adequate level of security and justice* if it is to be seen as a genuine advantage by all. In Amsterdam, this twin requirement was written into the Treaty in the form of a progressive establishment of an area of freedom, security and justice. The integration of the Schengen cooperation into the Treaty amplifies the *acquis* in this area.

Migratory pressures on Europe will remain strong in the coming years and will, as in the past, have a strong impact on economic and social development. Europe will continue to attract people in need of international protection. Crime, fraud, corruption, trafficking in human beings or smuggling of drugs and other illicit goods, all call for clear common responses. With the new Treaty there is now scope for developing a comprehensive Union policy covering border control, immigration, asylum, the fight against crime in all its forms as well as judicial cooperation in civil and criminal matters. The Action Plan against Organised Crime agreed in Amsterdam bears witness as to the political determination to move forward immediately in this area of great interest to the European Citizen.

II. ECONOMIC AND SOCIAL COHESION

1. CONTINUING TO STRIVE FOR COHESION

Maintaining the political priority

Economic and social cohesion was introduced in the Single European Act, paving the way for the 1988 reform of the Structural Funds. **The Treaty on European Union turned cohesion into one of the three pillars of the European construction alongside economic and monetary union and the Single Market.** Finally, the Amsterdam Resolution on growth and employment enshrines the priority to be given to fighting unemployment.

There is no doubt that economic and social cohesion must remain a political priority.

In fact, the prospect of enlargement to new countries with widely differing levels of development makes it still more essential. *European solidarity* will become more important than ever in achieving the major goal of reducing disparities in levels of development explicitly set by Article 130a. It makes a vital contribution to the stability of the Union and the promotion of a high level of employment. There is still a need to address the unequal abilities of the regions to generate sustainable development and their problems in adapting to new labour market conditions, which require a more forward-looking adaptation of the skills of working men and women. The Structural Funds should aim at fostering competitive development and sustainable and job-creating growth throughout the Union and the promotion of a skilled, trained and adaptable workforce.

Assuring financial solidarity

The European Council in Edinburgh decided that this solidarity should reach a significant proportion of the Union's GNP (0.46%) at the end of the current financial perspective. The priority given to economic and social cohesion has been translated into comprehensive programs implemented in partnership with Member States and regions, both for regions where development is lagging behind (Objectives 1 and 6), and for declining industrial areas (Objective 2) and rural areas (Objective 5(b)). A substantial effort is also being devoted to employment and industrial change (Objectives 3 and 4). The first Cohesion Report drawn up under Article 130 b of the Treaty showed the need for and relevance of the Community's structural support system and allowed for lessons to be learnt for the

future. It also demonstrated that the Member States and regions which lag behind and are eligible under Objective 1 have made progress towards real convergence, not least as a result of assistance from the Structural Funds and the Cohesion Fund. However, despite significant successes, there is still much left to be done, particularly as regards employment: unemployment has not fallen significantly and is growing not only in many less-developed regions where disparities are widening but also in the more prosperous parts of the Union. The effort to support both the balanced development of the Union and the development of human resources throughout it will therefore have to continue over the next period of the financial perspective.

However, budgetary constraints will make it impossible to go beyond the effort made in terms of Union GNP in 1999 (0.46%). Nevertheless, with the extra resources generated by growth and a more efficient use of the resources available, it should be possible to finance both the development of structural policies in the Union of 15 and the gradual integration of new Member States from the moment of their accession. Category 2 of the Community budget, covering structural operations, will therefore have to retain a privileged place in the budget. However, automatic and systematic re-budgeting in the framework of multi-annual programming is to be avoided. An amount of ECU 275 billion (at 1997 prices) will be available for Structural operations (under both the Structural Funds and the Cohesion Fund) as compared with ECU 200 billion for 1993-99. On the basis of the assumptions made in Part Three of this communication, ECU 45 billion will be earmarked for the new Member States, including ECU 7 billion by way of pre-accession aid. The increase in transfers to the acceding countries will be gradual in line with their absorption capacity. At all events, total transfers from the Structural Funds and the Cohesion Fund to a present or future Member State should not exceed 4% of its GDP.

A better division of responsibilities

Making the Structural Funds more effective will require simplification of management and greater flexibility and decentralisation in implementation, in line with modern management principles and future staffing restrictions. In return, the Commission will require greater

selectivity and rigour when priorities are defined at the outset. This is where the concept of partnership between the Commission and the Member States will have to be given a real meaning. The monitoring and evaluation systems will also have to be improved and checks made more efficient and rigorous.

2. GREATER CONCENTRATION

The Commission proposes to consolidate the budget effort of the Structural Funds over the period 2000-2006 at a level of ECU 210 billion for the 15 existing Member States. This means that over the new period average annual funding for the EU-15 will fall slightly from the 1999 level. For reasons of visibility and efficiency, the present seven Objectives should be reduced to three: two regional Objectives and a horizontal Objective for human resources. The percentage of the population of the Union of 15 covered by Objectives 1 and 2 should be reduced from 51% to 35%-40%. This figure will be smaller than the population covered by Article 92(3)(a) and (c), which should also be reduced from 1 January 2000. Furthermore, measures for the regions which will benefit from transitional (phasing out) support from the Structural Funds will have to comply with the competition rules on state aids.

A continuing high priority for Objective 1 (Greece, Spain, Portugal)

The regions lagging behind in development which are eligible under Objective 1 and which face the most serious difficulties in terms of income, employment, the productive system and infrastructure, should enjoy the same priority as at present. It should be noted that their average level of unemployment is 60% higher than the Community average. In some regions, over one quarter of the labour force is unemployed. That is why the total amount of the Structural Funds to be allocated to the Objective 1 regions should cover about two thirds of the Structural Funds available for the 15 Member States, a share comparable to the average for the current programming period.

In future, the threshold of a *per capita* GDP of 75% of the Community average should be applied strictly. Care should also be taken that there is complete congruence with the regions assisted by the Member States under Article 92(3)(a) of the Treaty. The efforts

made following the 1993 revision of the Structural Funds regulations to achieve indicative financial allocations which are more objective, transparent and equitable should be continued. Using objective criteria broadly similar to those for the current period, only the eligible population, the gap between regional prosperity and the Community average, and national prosperity should be taken into account. Additional support would be granted to regions with a high level of unemployment. For those regions currently eligible under Objective 1 but which will have passed the 75% threshold, phasing out of the relevant transfers over a transitional period will be required. The precise ways of achieving this will be defined at a later date. In view of their particular situation, the outermost regions covered by a new Treaty Article and Protocol will be treated as Objective 1 regions on an *ad hoc* basis. Similarly, the most northern regions with an extremely low population density which do not qualify for Objective 1 but which are at present eligible under Objective 6 should enjoy special arrangements.

As is presently the case, an integrated approach should be applied to the development of structurally backward regions. The success of efforts undertaken in partnership with the Member States depends on appropriate coordination of all the components of structural assistance, whether from the Regional Fund, the European Agriculture Guidance Fund (EAGGF - Guidance Section), the Social Fund or the Financial Instrument for Fisheries Guidance (FIFG). Each region will have to be looked at in terms both of specific needs and Community priorities. Programs will be drawn up taking account as much as possible of the priorities voiced by the regions concerned. There will be special emphasis on improving competitiveness, which is vital if jobs are to be created and maintained. This will require support for measures to assist infrastructure, innovation, SMEs and human resources.

Redefining Objective 2 - economic and social restructuring

A new Objective 2 devoted to economic and social restructuring will bring together measures for other regions suffering from structural problems. These are areas undergoing economic change (in industry or services), declining rural areas, crisis-hit areas dependent on the fishing industry or urban areas in difficulty. All these areas are facing structural problems which take the form of economic restructuring problems, a high rate of

unemployment or depopulation. A limited number of significant areas should be identified in order to facilitate an integrated strategy for economic diversification.

Almost one fifth of the population of the Union outside the Objective 1 regions lives in areas where the unemployment rate is above the Community average. Youth unemployment is still over 30%. In some urban areas, unemployment ranges from 30% to 50%. Vigorous structural measures are required to foster diversification, restore economic dynamism and promote an active business culture. Such measures should help exploit the very high economic development potential of such areas, accompany restructuring and encourage the adjustments required. Particular attention will have to be paid to education and training and to access to new technologies to the extent that skills do not meet the requirements of a modern economy.

The new programs to support the Objective 2 areas will favour economic diversification, including in regions heavily dependent on a single declining economic sector. This will require increased support for small and medium-sized enterprises and innovation as well as a greater emphasis on vocational training, local development potential, the protection of the environment and combating social exclusion, particularly in urban areas in difficulties. Investment in human resources, based on anticipation and on activating the labour market and on permanent training, should be increased in these areas undergoing changes. The development of rural areas should build better links between the countryside and local towns. This should facilitate the diversification of industrial, craft, cultural and service activities. The Commission would like to see simpler, transparent and specific eligibility criteria developed for the various types of areas covered by the new Objective 2. Account will have to be taken of relevant socio-economic criteria, and in particular of the rate of unemployment, the levels of industrial employment, the level and development of activity in agriculture and in the fishing industry, and of the degree of social exclusion. In the interest of simplification, the different funds (ERDF, Social Fund, EAGGF Guidance Section, FIFG) will be involved through a single program per region. The use of Community criteria in the context of partnership with the Member States, and with due regard for their regional priorities, should result in geographical concentration on the areas most affected at Community level. This will lead to a zoning which is less scattered and as consistent as possible with the areas assisted by the Member States under

Article 92(3)(c) of the Treaty. The areas currently eligible under Objectives 2 and 5(b) which would no longer be eligible under the future selection criteria should enjoy limited financial support for a transitional period. In addition to the aid provided under Objectives 1 and 2 of the structural policies for changes taking place in the fisheries sector, the FIFG could support restructuring on the Union's coastline from category 1 of the financial perspective.

Developing a strategy for human resources: a new Objective 3

The development of human resources will be a key element both in the Objective 1 and 2 regions and elsewhere in the Union and should be implemented in a consistent way. A determined effort should be made to modernise labour markets in a way consonant with the multi-annual plans for employment and the new Title on employment introduced in the Treaty of Amsterdam. Priority should be given to access to employment, the development of life-long learning and the promotion of local employment initiatives, including territorial employment pacts.

A new Objective 3 will be introduced for regions not covered by Objectives 1 and 2. It will help the Member States to adapt and modernise their systems of education, training and employment. This is required both to make their economies competitive and for reasons related to safeguarding the European model of society. Education is, in fact, a powerful tool for social equity and inclusion.

The new Objective 3 will be based on a common European framework, but with sufficient flexibility so as to reflect a variety of systems, approaches and levels of development in the Member States. Strategy and funding should therefore be sufficiently flexible so as to be modulated as a function of Member State and the scale of intervention foreseen. The policy dialogue with Member States should ensure that Objective 3 programmes provide concentration within a realistic and effective range of measures and that monies are used in a way which both ensures consistency with the mainstream of national policies and also guarantees visibility of the Union contribution. Objective 3 will promote activity in four areas which will complement the guidelines developed as part of the European Employment Strategy:

- accompanying economic and social changes;

- lifelong education and training systems;
- active labour market policies to fight unemployment;
- combating social exclusion.

Reducing the number of Community Initiatives

There are at present 13 Community Initiatives, which have resulted in 400 programmes, as many as all the other structural measures put together. This is clearly excessive, particularly since the Initiatives often deal with the same topics as the main programmes. Reform is obviously required to bring out more clearly the Community interest of the Initiatives and their innovative character. The Commission is therefore proposing to restrict them to three fields where the value added by the Community is most obvious:

- cross-border, trans-national and inter-regional cooperation to promote harmonious and balanced spatial planning;
- rural development;
- human resources, paying special attention to equal opportunities.

The schemes covered by other Initiatives will be incorporated in the programmes financed under the various Objectives. This will enable the share of the resources of the Structural Funds allocated to the Community Initiatives to be reduced to 5%.

Finally, innovative measures and pilot projects, which currently absorb 1% of the Structural Funds must be improved. Such an arrangement will make it possible to test innovative measures, to provide an interesting financial lever and to develop stronger partnerships. However, a scattering of means and the proliferation of mini-projects which are difficult to manage effectively and to monitor should be avoided at all costs. Consideration should therefore be given to concentrating on significant projects and making implementation simpler and more transparent.

3. STRUCTURAL SUPPORT FOR THE NEW MEMBER STATES

As soon as the next enlargement of the Union takes place, support from the Structural Funds and the Cohesion Fund should in theory apply to all the countries which join. There is ample reason for Community solidarity towards these new democracies, which have

enormous development needs, particularly as regards infrastructure, including in the environmental field, the productive sectors and human resources. To avoid major problems with regard to absorption, the level of annual aid should increase gradually, subject to the general limit of 4% of national GDP, which would apply to the Structural Funds and the Cohesion Fund together. As a result, the resources under category 2 of the Community budget available for the new member states would be about ECU 45 billion for the Structural Funds and the Cohesion Fund. At the end of that period, the level of structural transfers to the new member states would represent approximately 30% of the total for category 2. Pre-accession aid, to be drawn from the ECU 45 billion allocation for the new Member States, would be made available from the year 2000. This assistance, to be granted at a constant rate of ECU 1 billion per year, would initially be granted to all the applicant countries and would subsequently be focused on countries due to join the Union at a later stage. It would be primarily intended to help bring the applicant countries' infrastructures up to Community standards, particularly in the transport and environment fields, along the lines of existing Cohesion Fund transfers. It would also enable the countries concerned to become familiar with the procedures concerning structural operations.

III. THE COMMON AGRICULTURAL POLICY

In December 1995, the Commission presented its Agricultural Strategy Paper to the Madrid European Council. This stressed the importance of improving the competitiveness of the European agricultural and agri-food sectors on internal and world markets, in the context of trade liberalisation and an expected growing world food demand. It highlighted the need for a further evolution of the CAP, by developing the approach successfully started by the 1992 reform. The Paper also outlined the need for an integrated rural policy which would accompany the reform process. Moreover, it called for a radical simplification of legislation at Union level and for a substantial decentralisation of policy implementation.

Later on, in November 1996, the First Cohesion Report argued in particular in favour of a more rational development of agricultural production, through a greater market orientation of prices and continuing structural adjustment. The Union should make a parallel effort to enhance the economic potential and the environmental value of rural areas and their capacity to provide sustainable jobs. Building on these ideas, it is now time to formulate concrete proposals to reshape the common agricultural policy and prepare it for the next century.

1. THE ASSESSMENT OF THE REFORM PROCESS

Agricultural market policy

After the 1992 reform, there has been a considerable improvement of *market balances* and a decrease of public stocks in most of the reformed sectors. In the case of cereals, set-aside has helped to keep production under control, while the increased price competitiveness has allowed significant additional quantities to be used on the domestic market, mainly for animal feed. In the beef sector, the market situation evolved favourably and intervention stocks were diminishing rapidly. The general evolution of *agricultural income* per capita has been positive since the reform was implemented growing by + 4.5 % on yearly average between 1992 and 1996, with a diversity of situations according to Member States and farm orientations. The improvement of the market situation, the strong adaptation capacity of farmers, the agri-monetary context and, last but not least, the continuing decline in agricultural employment have contributed to this result. In the case of cereals the market prices improved much more than originally expected. This has led to an over-compensation of producers in the last few years. In the case of oilseeds, too, the observed market prices have been most of the time significantly higher than the reference price so that producers have benefited from the franchise in four years out of five. The reform effects on the *environment* are mixed. Some positive elements can be identified: the more rational use of fertilisers and pesticides resulting from price decreases, the possible environmental benefits of set-aside (if well managed), incentives for a long-term improvement in the territorial distribution of livestock rearing. But there are also negative elements, mainly the encouragement given to irrigated crops through the regionalisation of direct payments to

cereals, oilseeds and protein crops, as well as the relative advantage given to intensive livestock farming through lower feed prices and subsidising silage.

The reduction of price support and the introduction of direct payments have benefited *consumers* as part of the burden of agricultural support has shifted away from them. *Budgetary expenditure* is therefore significantly higher in the sectors concerned. It is also under better control since factors of uncertainty (world prices, dollar exchange rate, level of intervention stocks) that strongly affected its past evolution have become less determining. At the same time the shift to direct payments has made the support for farmers more transparent.

Rural development policy

Since almost two decades, attempts have been made to integrate agricultural structural policy into the wider economic and social context of rural areas. Experience gained shows how rural diversification can be exploited in a flexible way as a necessary complement to farming. Activities which had hitherto been marginal - the development and marketing of high-quality produce, rural tourism, investment projects linked with the environment or the region's culture, small and medium-sized enterprises - have been developed and opened up new perspectives. The 1992 CAP reform stressed the environmental dimension of agriculture as the largest land user. Among the accompanying measures of the reform, the agri-environmental measures are of key importance and have in general been welcomed by the public and well received by farmers.

However, the scale of support still provided through prices and crop specific payments (e.g. silage maize and flax) may discourage farmers from committing themselves to more extensive practices or dedicating land to environmental purposes. On the whole, as a result of these different developments, rural policy in the Union still appears as a juxtaposition of agricultural market policy, structural policy and environmental policy with rather complex instruments and lacking overall coherence.

2. LONG-TERM OUTLOOK

According to the major forecasting institutes world-wide, the long term outlook for the main agricultural markets is favourable for exporting countries. Prospects for increased food consumption, mainly in developing countries, combined with the limited possibility of a proportionate growth in domestic production, are expected to boost world trade and sustain world prices over the next decade. Two key factors influence food demand: population growth and rising incomes. The world population is expected to increase by more than 85 million people a year between 1995 and 2005. Moreover, growing urbanisation will influence the pattern of food consumption. The second factor determining increasing food demand is the favourable prospect for world incomes and economic growth, particularly in developing countries. An increase in world agricultural production is expected over the next decade, but at a lower rate than in the past. In particular in many developing countries, the increase will be less than the growth in demand. This is firstly due to the limited availability of land, because of urbanisation and environmental constraints and, secondly, to a slowdown in the growth of yields. The development of genetic engineering, if well controlled, could enhance production but may raise questions of acceptability to consumers. Almost all analysts expect generally strong prices for agricultural commodities up to 2006 and even beyond. Prices are projected to strengthen or remain strong for cereals, oilseeds, beef, poultrymeat, cheese, milk powder, but may weaken for pigmeat. However, price variability could increase in the future, as world stocks are expected to be relatively low compared to in the past.

Despite this favourable world context, the *agricultural commodities outlook* is not very promising at European level. Supposing that present policies continue, over the coming years a gap between Union and world prices will remain for many sectors. Taking into account current commitments under the Uruguay Round Agreement, in particular on export subsidies, non-exportable surpluses are likely to emerge after 2000, for the existing Union. A structural surplus was already projected for beef before it was made worse by the BSE crisis. Increasing problems may also appear for cereals, sugar, wine, olive oil, skimmed milk powder and some other dairy products, and the Union risks losing more and more of its share in expanding world markets.

New *multilateral trade negotiations* will start in 1999 as a follow-up to the Uruguay Round. Cutting border protection, reducing export subsidies and reshaping internal support

towards more «decoupled» instruments will enhance the Union's negotiating stance in the new Round. Another, increasingly sensitive, issue is the need to introduce environmental and social standards at international level and to take into account consumer concerns. *Eastward enlargement* will add over a 100 million consumers, whose average purchasing power would however be only roughly one third of that of the current consumers in the Union. Agricultural area would be expanded by half and the agricultural labour force would at least double. The Central and Eastern European Countries have a serious need for structural improvement in their agriculture and up- and downstream sectors. Restructuring can be expected to reduce the labour absorption capacity of agriculture, implying a need for diversification of their rural economies. If the CAP instruments, mainly support prices and direct payments, were applied at their present level by the Central and Eastern European Countries, particular problems would arise. Inordinate cash injections through direct payments would risk creating income disparities and social distortions in the rural areas of these countries. In addition, surpluses would increase, in particular for sugar, milk and meat, reinforcing the growing market imbalances predicted after 2000. *Consumer requirements* from agriculture and the food industry are also evolving. Health, notably food safety, is the main one. Convenience (fast-food, ready-made meals and snacks) is becoming more and more important in the context of changing life-styles. But at the same time, typical, well-identified products, linked to specific areas or cultural values (traditional production methods, animal welfare, etc.) are increasingly sought after. Rural trends in the Union show a sharp decline in the number of farms and in the number of people employed in agriculture. In terms of regional income and employment, agriculture (and forestry) no longer forms the main basis of the rural economy. It represents only 5.5 % of total employment on average, and in very few regions is its share higher than 20 %. The long term trend is a further drop in the number of farmers, at a rate of 2- 3 % per year. New activities and new sources of income are emerging on-farm and off-farm. Among those, the production of *renewable raw materials*, for non-food purposes in niche markets or the energy sector, can represent a new opportunity for agriculture and forestry and contribute to job creation in rural areas.

Society is increasingly conscious of the importance of the *natural environment* and of the environmental effects - both positive and negative - of human activity. Rural areas are in a

unique position to respond to these concerns by maintaining and creating environmentally attractive living, working and recreational spaces. In this context, the concept of public payment for the protection of natural resources and the enhancement of the countryside is increasingly gaining acceptance and offers agriculture and forestry, as the main land users, both new challenges and fresh opportunities. While the successive reforms have improved transparency and effectiveness, a number of inconsistencies and overlaps between different policies have developed. Too many programmes and measures can apply simultaneously in the same area under different policy headings, affecting consistency. There is an urgent need for a radical *simplification* of rules and a greater *decentralisation* of policy implementation, with more margin being left to Member States and regions. More decentralisation should not, however, lead to any renationalization of policies. The CAP absorbs around 0.6 % of the Community's GDP. Considering both the declining share of agriculture in the economy and the increasing *budgetary constraints* many Member States are facing, this public support has to be fully justified. This means that the crucial role that agriculture plays, in producing high quality food, in maintaining a living countryside, in protecting landscapes and preserving cultural values, has to be clearly demonstrated. While the generalisation of direct payments to farmers after the 1992 CAP reform made financial support for agriculture more transparent, it also increased the need for it to be economically sound and socially acceptable.

IV. THE UNION IN THE WORLD

It is imperative that Europe steps up its activities in the external relations field. The European project will remain credible only if it responds to the growing calls from its citizens for greater unity and more effective ways of building and defending peace, stability and prosperity on the European continent and throughout the world. The Member States of the Union have many *common interests*. The Union must increase its influence in world affairs, promote values such as peace and security, democracy and human rights, provide aid for the least developed countries, defend its social model, and establish its presence on the world markets. In addition to maintaining the territorial integrity of the Union, Member States must combine their forces to combat organized crime, terrorism and the proliferation

of nuclear, bacteriological and chemical weapons, prevent major damage to the environment and ensure sustainable growth with an optimum use of world resources. Collective action by the European Union is an ever increasing necessity if these interests are to be defended, if full advantage is to be taken of the benefits of globalization and if the constraints it imposes are to be faced successfully. Europe's partners, beginning with the applicant countries, expect it to carry out fully its responsibilities. The enlargement of the European Union will affect not only the destiny of the Europeans, the Member States and the applicant countries. Through its international implications, enlargement will have an impact far beyond the new frontiers of an enlarged Europe because it will increase Europe's weight in the world, give Europe new neighbours and form Europe into an area of unity and stability. The geopolitical impact of the enlargement process was already underlined in the Madrid European Council conclusions concerning «The Political Agenda for Europe».

1. A STABLE EUROPE THAT IS OPEN TO THE WORLD

Over the last four decades and in line with the basic intentions of Europe's founders, the Member States have developed between them a real Community of security within which it is inconceivable that there would be the slightest threat of recourse to force as a means of settling disputes. The challenge is now to extend that basic achievement of the European project to new Member States. The enlargement of the European Union must therefore aim to make an additional stabilizing impact complementary to that made by the enlargement of NATO. This stability should facilitate the gradual definition of a common defence policy that could lead to a common defence, in accordance with Article J.7 of the Amsterdam Treaty. An enlarged Union will have more direct frontiers with Russia as well as frontiers with Ukraine, Belarus and Moldova. It will enjoy direct access to the Black Sea which will lead to intensified contacts with the countries of the Caucasus and Central Asia. An enlarged Union will also surround the Kaliningrad oblast, which is part of Russia, and will contain several hundred thousand ethnic Russians, living mainly in Estonia and Latvia. It

will be important for the enlarged Union to deepen its relationship with Russia, Ukraine and the other NIS on the basis of the Partnership and Cooperation Agreements (PCAs). Among the Union's new neighbouring countries will be those of the Balkan region. Stability through cooperation in this region will be all the more important for the enlarged Union. The Union will have to continue and step up its policy of providing support for democracy, and assisting the reform process and the transition to the market-economy system, which constitute long-term guarantees of security and stability. There is likely to be an increase in trade flows, a rise in energy and raw material imports from CIS countries, an expansion of transport networks and increased cooperation on environmental protection. Moreover, these developments could lead to changes in the content and geographical organization of Community programmes such as Tacis in order to take account of new geopolitical circumstances.

Active measures will have to be taken to reinforce links between the Union and its Mediterranean partners. The stable development of the southern Mediterranean rim is a challenge of ever increasing proportions. The potential of the Barcelona process will have to be fully exploited to that end. The Union will also have to maintain an increased presence in the Middle East as one of the main promoters of peace in that region. Enlargement should therefore lead to an intensification of economic and commercial relations between the European Union and its southern partners, based on the pursuit of reciprocal interests.

Development cooperation constitutes the third major element of the Union's external action. The Union's development assistance and its efforts to reduce poverty and inequalities around the world are closely linked to the search for peace and stability, the need for better management of global risks and interdependence, and the promotion of a sound development path. As part of the new partnership arrangements which will have to be established between the European Union and the ACP countries, whose political and economic situations differ, the question of the inclusion of development cooperation in the Community budget will have to be examined.

The Union should also intensify its relations with the United States, with the implementation of the New Transatlantic Agenda agreed in Madrid in December 1995.

Asia and Latin America are also among the regions which should be given particular attention.

2. A STRONG AND COHERENT EUROPE

The enlarged Europe will have richer but inevitably more complex relations with the rest of the world. In order to be more effective and more present, in order to prepare as much as possible to exercise wider responsibilities and in order to assume its role on the international scene, Europe will have to reinforce its political decision-making capacity and ensure consistency in all of its actions.

Making the European Union a global actor

It is in the interests of the European Union to exercise political responsibility commensurate with its economic power. The interdependence of modern economies and the increased importance of transnational factors mean that an active and effective foreign policy cannot be limited to the more traditional aspects of international relations. This applies in particular to the Union, characterized by its strong economic dimension. Ultimately, a common foreign and security policy can become reality only if the Member States accept, in terms of working methods and in substance, that progressively an *integrated approach to external relations* must be built. This integrated approach will make it possible to support a common political will with the instruments of the CFSP, those of commercial policy, development aid or other common policies and the operational capacity of the Western European Union to carry out tasks recently included in the Treaty. It should also strengthen the complementarity, which is currently inadequate, between the activities of the Union and those of the Member States. The provisions of the new Treaty for designing and implementing the common foreign and security policy will make it possible to strengthen the overall cohesion and continuity of external action. The Council and the Commission will have to cooperate closely to that end. It will of course be essential to resort more frequently to a qualified majority for the Union to be able to take rapid, specific action.

The European Union will increasingly have to acquire the capacity to take foreign-policy decisions involving the use of military resources. This is essential if the Union's external action is to be credible. It will therefore be necessary to strengthen the operational resources of the WEU, both in order to carry out the new tasks laid down in the Treaty of Amsterdam and with a view to the WEU becoming increasingly integrated in the development of the European Union itself.

Maintaining the commercial power of the Union

The international environment must not be seen as a threat to the Union, but rather as a positive challenge and development factor. The EU, the biggest trader on the world stage, has a strong interest in consolidating the new WTO structures and in *promoting further international trade liberalisation* beyond that which is already programmed. The alternative to a multilateral approach is likely to be a risk of less advantageous conditions of access and competition. It is also essential that the dismantling of trade barriers be accompanied by the development of competition policy principles within the WTO framework. Taking account of the new forms of international trade, it will be necessary to make full use of the new opportunities offered by Article 113, as amended by the Treaty of Amsterdam, for conducting *international commercial negotiations* in the field of services and intellectual property. In this way, the enlarged Union will be able to act more decisively and more cohesively in international organizations such as the WTO or the OECD.

Ensuring complementarity between internal and external policies

The *advent of the euro* will give Europe a key role to play in economic and monetary matters. During the next eighteen months, it will therefore be necessary to define the relationship with international financial institutions and the arrangements for external representation in this field. The *external potential of the Single Market* should be developed. Both the strength and the experience of the Internal Market can be used to promote the Union's interests and presence internationally, for example in the area of aeronautics and satellites. Another example is greater European assertiveness in

international standard-setting, but the potential extends into many other areas, including financial services, intellectual property and competition policy.

Greater care will have to be taken to ensure coherence and complementarity between the internal and external dimensions in Union policy. *Energy policy* provides a good example of such a consolidated approach, where the achievement of market integration will provide the essential basis for the diversification and flexibility of energy supplies as well as reinforcing the competitiveness of European enterprises in this field. A careful coordination of external energy policy will also contribute simultaneously to enhanced supply security and the achievement of international environmental objectives. Better integration is equally necessary for other internal policies of the Union, for example in the field of research, in order to promote the Union's international interests.

Handling transnational issues which are at stake

The process of globalization, from which the Union has benefited so much, also exposes it to both economic and political risks in the international arena, such as the consequences of demographic imbalances, failures in governance and environmental mismanagement. These must be handled resolutely with the Union's international partners in multilateral fora. The increasing importance of threats to the environment, like global climate change, is already high on the international agenda. The Union has, on various occasions, confirmed its leading role in this field, where it is particularly well placed for taking the leadership in international negotiations in order to reconcile conflicting interests. The proliferation of drug trafficking and organised crime also requires coherent and concerted action at the international level. This should be developed in close cooperation with the Union's main partners and with the countries most afflicted by these phenomena, focusing on preventive action in a multilateral framework as well as on measures aimed at eliminating the social and economic sources of these scourges of society.

Increasing the visibility and adapting the procedures for the Community's external assistance

External action should become more *visible*. The Community and its Member States finance half of the international development assistance effort, in particular through the

comprehensive partnership embedded in the Lomé Convention. They are responsible for well over half of the humanitarian aid distributed throughout the world. They provide one third of total aid to the Middle East, including half the assistance granted to the Palestinian Territories, nearly 60% of international aid to Russia and the republics of the former Soviet Union, and 40% of the reconstruction in Bosnia-Herzegovina. These figures, often unknown, show that the Union is the most important provider of international aid - a situation which should be consolidated by enlargement. The reality of Europe's presence will have to be explained and enhanced in order to increase the margins of manoeuvre in the common foreign policy. Strengthening decision-making capacity, and the efforts which may be required in order to increase the speed with which action can be taken, will be decisive in improving the impact of the Union's external assistance programmes. *The effectiveness of Community instruments* in the external sphere is currently limited by slow, complex internal procedures. A reflection should be undertaken on how to overcome these constraints where rapid action by the Union is required. In addition, here as elsewhere, it will be appropriate to limit as much as possible the spread of financing over too many small-scale measures. It will also be necessary to promote closer *coordination of Community programmes and national action by Member States*. Where the Union's external financial action is concerned, it will be necessary to foster the synergy between the Community instruments and those of institutions such as the EBRD or the IMF, as part of a balanced financial burden sharing. Given the prospects for economic growth, the maintenance of *financial resources* in terms of percentage of GNP will make it possible to ensure that Europe has a strong presence at world level.

V. AN EFFICIENT COMMISSION AT THE SERVICE OF EUROPEAN CITIZENS

Armed with its right of initiative, the Commission must remain a dynamic force for renewal, including in the new domains opened up by the Amsterdam Treaty. Nevertheless, the legislative activity of the Union will be less intense than in the past. Implementation and enforcement of existing legislation will need to have the highest priority. Greater decentralisation will require closer monitoring on the ground. More generally, the Commission will have an enhanced role in the promotion of cooperation, the launching of

partnership and network activities as well as an effective coordination. Managing a high level of integration will require a thorough *re-evaluation of the Commission's executive and management functions* and a change in its administrative culture. Budgetary constraints will remain tight, with an inevitable impact on spending policies and the management of human and financial resources. With increased competition for limited funds, there will be a need to *identify more clearly the core functions* on which the Commission should concentrate. The relevance of policies, structures and procedures should be examined critically in a screening process preceding decisions on funding programmes and allocating resources to their management. It is imperative to make more efficient and effective use of available resources. In this context, the quality of available human resources and use of their full potential are crucial. A European public service operating on the basis of the three principles of competence, independence and permanence must therefore be preserved; it must nevertheless be capable of adapting and modernizing in order to take up the ever-evolving challenges of European integration and of a profoundly changing world. Therefore, the Commission has already initiated a far-reaching programme of reform of its administration in the Sound and Efficient Management (SEM 2000) and Modernisation of Administration and Personnel policy (MAP 2000) initiatives. This will involve a review of its structures, modernisation of the management and a streamlining of procedures. *Decentralisation, rationalisation and simplification* are key words for such an undertaking. It will be necessary to determine for each policy area the appropriate balance between core policy and control functions, which need to be retained within the Commission, and executive functions which are more effectively administered at a level closer to the end users.

Consideration should be given to the appropriate size of programmes and projects supported financially by the Community to ensure that the programmes deliver a clear added value at European level and that the required administrative resources are not excessive. Administrative functions can sometimes be carried out by executive agencies reporting to the Commission, by administrations in Member States in partnership with the Commission or even by non-governmental organisations or other private sector organisations on a contract basis. In some areas, new network management structures involving both Community and national levels may be appropriate. In all cases, however, a

clear policy framework will have to be established. Ultimately, the Commission depends on the competence and motivation of its staff to be able to respond effectively to the demands of the integration process. More emphasis should therefore be put on the upgrading of skills and competence in order to take full advantage of synergies created in the reform of structures and to enhance flexibility in view of the new challenges ahead. In recent years the Commission has had to take on a growing number of new tasks, resulting in successive reorganisations which have often had to be carried out hastily and without adequate preparation. Now that a new phase in European unification is beginning and that the shape of Europe in the 21st century is emerging more clearly, the time has come to embark on a thorough review of the organization and operation of the Commission beyond the year 2000. It was along these lines that the Commission defined its position in its recent contribution to the IGC, in which it announced that it would be regrouping and redefining tasks, including those of its Vice-Presidents. It also announced that it would undertake a corresponding restructuring of its departments. By strengthening the status and powers of the Commission President, the Amsterdam Treaty has introduced a reform sought by the Commission which will heighten the effectiveness and profile of the Commission as a body. In a declaration annexed to the Final Act of the Amsterdam Treaty, the Member States have taken note of the Commission's intention to prepare the above mentioned reorganisation in time for the new Commission due to take office in the year 2000. The Council must also play its part, e.g. by reducing the number of different compositions in which it meets and by assigning to the General Affairs Council its true overall coordinating role.

Policies of Integration and Development in the European Union:

Agenda 2000

1. Introduction-A brief overview

The cost and the benefits of the enlargement consists of one of the greatest part of the Agenda 2000 (the other part deals with the THE POLICIES OF THE UNION).

The European Council at Copenhagen in June 1993 agreed that the associated countries in central and eastern Europe that so desire shall become members of the Union. At the same time it stated that accession will take place as soon as a country is able to assume the obligations of membership by satisfying the economic and political conditions. The Union's capacity to absorb new members, while maintaining the momentum of European integration would also be an important consideration. Since then, all ten associated countries of central and eastern Europe have applied for membership² and the Council has initiated the procedure of consulting the Commission, in accordance with Article O of the Treaty on European Union. The Essen European Council in December 1994 requested the Commission "to submit as soon as possible the detailed analysis desired by the Council on the effects of enlargement in the context of the Union's current policies and their future development". An Interim report was presented by the Commission to the Madrid European Council in December 1995³. In it the Commission announced a subsequent report which would provide a more detailed analysis of the effects. The Madrid European Council called upon the

²* Hungary, Poland, Romania, the Slovak Republic, Latvia, Estonia, Lithuania, Bulgaria, the Czech Republic, and Slovenia (in the chronological order they submitted their applications). This report does not deal with the candidature of Cyprus, for which the European Council has decided that it will be involved in this phase of enlargement.

³ "Interim Report from the Commission to the European Council on the effects on the policies of the European Union of enlargement to the associated countries of central and eastern Europe", CSE(95)605,

Commission "to take its evaluation of the effects of enlargement on Community policies further, particularly with regard to agricultural and structural policies". The present presentation is referred to this report and subsequent developments. It attempts to present a comprehensive assessment of the impact of enlargement on EU policies.

Enlargement to the associated states of Central and Eastern Europe is a great opportunity for both acceding countries and the European Union as a whole. It is expected to bring major political benefits to the Union and to peace and security in Europe. In the economic field too, important benefits are expected, but problems, related to adjustment strains from the developing integration process, will also have to be addressed, especially since acceding countries are at a lower level of economic development, while they are still undergoing transition towards market economy.

Enlargement will greatly increase the EU's heterogeneity. If properly perceived and addressed, diversity is a fundamental element of the richness of the common European heritage and identity. Enlargement will thus promote the idea of European integration, which underlies the Treaty, and which rejects divisions along cultural or religious lines.

The integration of new members will be a complex task. It will pose a major challenge to the Union, its policies and its cohesion, while it is likely to put a strain on its resources. The objective must be to ensure that the full potential of enlargement is developed to strengthen the European model, i.e. a Europe built on a set of values shared by all its societies and combining the characteristics of democracy with those of an open economy underpinned by market forces, internal solidarity and cohesion.

Assessing the impact of enlargement is an extremely complex and hazardous task. There is a great degree of uncertainty on a number of important factors which will directly determine that impact; indirect effects, which could be as important as direct ones, are even more difficult to estimate. The impact of enlargement will very much depend on the economic performance of the present EU, itself depending to a large extent

on the success of Economic and Monetary Union; on the economic performance of candidate countries; on largely exogenous factors, such as the international environment, world agricultural and energy prices; on the timely implementation of the Union's new institutional arrangements; and on the future form of the Union's policies, in particular the Common Agricultural and structural policies, but also of the Common Foreign and Security Policy and of policies in the area of Justice and Home Affairs. It will also depend on the date and possible sequence of accessions, the effort deployed during the pre-accession period, and the nature and duration of any transitional measures after accessions. Given the complexity of assessing the impact of enlargement, and the uncertainties involved, a number of working hypotheses had to be retained. It is assumed by EU that current EU policies will be applied, but also takes into account their foreseeable future development. These hypotheses are purely methodological and do not prejudice in anyway the Commission's position on these issues. It should be stressed in particular that present policies will continue to develop, and not only for reasons related to enlargement. Naturally, the impact of enlargement would be different, were the accessions of the ten candidate countries not to occur simultaneously.

The Commission strongly supports the commitment to enlargement to include the associated countries of central and eastern Europe. The enlargement process is irreversible; it reflects fundamental European interests; the cost of not implementing it would be high. Candidate countries' accession is no longer a far-off prospect. Nonetheless, enlargement must be undertaken with safeguards for the achievements of forty years of European integration. These achievements are the basis of the Union's solidarity with the acceding Member States. At he following we consider the implications of enlargement on the Union's policies with the aim of allowing for its adequate preparation and implementation. Emphasis on possible problems and strains reflects the Commission's concern to ensure that the integration of new members will evolve

smoothly and as fast as possible both before and after their accession, without creating major tensions or endangering the Union's achievements, which would adversely affect the enlargement process itself.

The Overall picture of the Enlargement is considered by the following issues:

1. The external dimension
2. Overall economic impact
3. Structural policies
4. Agriculture
5. Internal Market and EMU
6. Horizontal policies
7. Sectoral policies
8. Justice and Home Affairs

1. THE EXTERNAL DIMENSION

1.1. Political

An enlarged EU will have substantially enriched and diversified human potential and economic resources. It should be able to play an increased role and to assume greater responsibilities in world affairs, providing it demonstrates its willingness and capacity to act. Enlargement should increase the security of EU member States and of the entire continent. Enlargement will modify the Union's geopolitical situation and its proximity to critical zones in Eastern and South-eastern Europe. Bilateral disputes involving acceding members, and issues related to national and ethnic minorities, could burden the Union's cohesion and its CFSP, and would have to be effectively tackled before accession.

Exacerbation of such problems could pose security threats to the Union independently of enlargement. The process of enlargement should provide an opportunity to address and find positive solutions to issues vital to

pan-European security. The EU and its Member States, with their weight, stability and democratic traditions, could greatly contribute to this.

An enlarged EU will be substantially more heterogeneous in its foreign and security interests and perceptions. Definition of common interests and other CFSP decisions may thus prove more difficult. On the other hand, acceding countries should have no major problem in adopting the EU acquis in this field, while most of them would favour its development. A consistent and effective CFSP, comprising an enhanced preventive diplomacy capability, will be vital, if the EU is to face successfully the challenges posed by enlargement and to play its role in world affairs.

Although autonomous processes, there are important links between EU and NATO enlargement, particularly as the June 1996 NATO ministerial meeting in Berlin agreed on the establishment of an European Security and Defence Identity (ESDI) within the framework of the Atlantic Alliance. The progressive development of a common defence policy of the Union will also be affected by enlargement since the security interests and requirements of an enlarged EU will be more complex and heterogeneous. At the July 1997 summit in Madrid, NATO agreed to invite three countries to open negotiations, and also agreed new measures to deepen co-operation with other partner countries. The summit also made clear that there will be future enlargement negotiations with other partner countries. This means that the issue of congruence in membership of the EU, Western European Union (WEU) and NATO remains an open and delicate question, the outcome of which may also affect the objective of integrating the WEU into the EU.

1.2. Foreign Economic Relations

An enlarged EU will not wish to modify its open, outward perspective as regards economic and trade policy. It could, moreover, improve its competitive position in a world characterised by increasing globalisation. Direct *trade* effects from enlargement will tend to be limited, as non-

agricultural EU trade with both candidate and other third countries already is or is in the process of becoming extensively liberalised (Europe Agreements, other existing and planned free trade zones, Uruguay Round decisions). However, as with previous enlargements, further considerable trade benefits can be expected between the Union and the rest of the world from the increased dynamism of the enlarged Union's economy.

Enlargement is very likely to have a net trade-creating effect. The Common External Tariff, which will be applied by acceding countries, is on average lower than national tariffs presently applied. Developing countries, enjoying preferential access to the EU, will find new markets in the acceding countries, while the latter will also improve their access to the markets of the former (through economic and trade co-operation). Important remaining links of some candidate countries with their partners in the former Soviet Union and in certain developing countries should provide EU-based firms opportunities to channel increased trade with these countries. New trade creation effects will depend, however, on cost-price relative competitiveness. On the other hand, enlargement could also lead to some trade-diversion, and to erosion of preferential margins enjoyed by developing countries on the EU market, especially in certain agricultural goods.

On accession, new Member States will have to bring their trade regimes and other external economic policies into line with the Community common commercial and other external policies or remove inconsistencies between their regimes and the Community's.

They will have to ensure compatibility with the Community's international, multilateral and bilateral commitments, either making adjustments to their own or in some instances, adopting those of the EC in their entirety. This will imply extending preferential treatment to third countries in accordance with Community international obligations (bilateral free trade agreements, the future LOME Convention) and autonomous regimes (Generalised System of Preferences). By the date of the accessions, the

Community acquis which new Member States will have to adopt is likely to have considerably developed towards further liberalisation (implementation of old and possibly new WTO agreements, new free trade agreements, etc.).

In cases where third countries entertain special arrangements or relations with acceding states (including payment arrangements), care should be taken that the necessary adaptation will not adversely affect EU relations with the countries in question. Similarly, the EC will have to bear in mind the potential impact on third countries when the EC's remaining quantitative restrictions are adjusted to take the acceding Member States into account.

Enlargement is likely to have a strong positive effect on inward **foreign direct investment**

in the acceding countries, and the net effect on investment flows into the enlarged Union is also likely to be positive. The effect on outward flows is difficult to predict. Labour mobility from acceding members could have an impact on **immigration** to Member States from third countries, affecting thus EU relations with the latter. The Union's partners, in particular in the Mediterranean, the New Independent States and the ACP countries fear that efforts to absorb new members could limit the availability of **Community resources** for assistance to their regions. Without a commitment that this would not be the case, the Union's relations and mutual confidence with these countries would be affected, while competition for the funds both among and within the regions concerned would increase. It will be thus important to ensure that enlargement with new members facing considerable problems of transition and development will not dampen the Union's attitude of openness and responsibility towards the rest of the world, and in particular towards the developing countries.

1.3. Selected particular areas

Enlargement to the Central and East European countries will influence EU relations and policies towards third countries and regions, as well as towards international organisations. A long-term stable and close relationship with a democratic **Russia** is essential to the EU, and indeed to stability in Europe and the world. Enlargement should benefit relations and co-operation with Russia, **the Ukraine and the other New Independent States**. By consolidating democracy and enhancing stability and security in Central and Eastern Europe, enlargement will increase the security of the EU's eastern neighbours as well. Geographic proximity, important traditional economic ties, cultural and religious affinities between acceding members and New Independent States are assets to a closer relationship. Meanwhile, adverse effects could result from enlargement, were it to be perceived as raising new barriers in Eastern Europe. The Union is taking steps to minimise such risks and to create conditions for exploiting fully the opportunities created by enlargement: support for the development of trans-european networks, for NIS participation in sub-regional co-operation and for their full participation in the pan-European and global economic and political system. Due account will have to be taken of eastern neighbours' legitimate security and economic concerns, as well as of those on the situation of Russian minorities in an enlarged Union. Disputes between acceding members and their eastern neighbours could constitute potential security threats for the Union and will have to be effectively addressed. It will be important to ensure that maximum use is made of the Partnership and Co-operation Agreements, as well as of the EU Action Plans for Russia and the Ukraine, and to persist in the assistance to the transition process in the NIS.

Events in former Yugoslavia have underlined the importance of **South Eastern Europe** to the peace and security in the whole of the continent. The EU's relations with these countries are based on a regional approach, offering political and economic relations to countries which are prepared to

Union's competitiveness could be significantly increased following enlargement.

EU enlargement should have the same general positive effect on our relationship with **Asia**, and **Japan** in particular. Problems that could arise in negotiations for compensation following enlargement are not expected to be important. Capital flows from Asia and industrial co-operation between Asia and the candidate countries will help facilitate the individual candidates economic adjustment.

Enlargement will strengthen the weight and negotiating power of the Union in **international organisations**, provided that the Union is able to speak and act in a coherent manner. This will tend to attract, even more than in the past, a careful scrutiny of EU actions by its trade partners. The Union will need to reflect on implications of enlargement on its positions in the WTO and on its role and representation in organisations such as the United Nations, the Organisation for Security and Co-operation in Europe, and International Financial Institutions (IFIs). It will also have to take account of the fact that financing of candidate countries by certain IFIs will be terminated as a consequence of their accession to the EU.

2. OVERALL ECONOMIC IMPACT

The economic effects of enlargement will undoubtedly be beneficial for the Union in the longer run. Enlargement will mean the creation of a larger economic area, with up to 500 million consumers, compared to the current 370 million. Liberalised factor and goods markets, common rules of the game and, eventually, a common currency will allow for a better allocation of resources, and for exploiting economies of scale. This could trigger a higher-growth / lower-inflation scenario for the whole area, and improve the EU's competitive position in the world. However, these benefits will not all be instantaneous, or evenly spread. For a long period following enlargement substantial adjustment pressure at the sectoral and regional

level will be unavoidable. This could cause economic, social and political tensions. Yet, independently of enlargement, the Union will need to change anyway. Domestic im-balances; the globalisation of markets for goods and services; the changed world trader; the emergence of new and highly competitive producers in South-East Asia and in eastern Europe - these factors are all putting our economies under severe adjustment pressure. The Union is already committed to responding to these issues. The economic effects of enlargement should thus be regarded as a development of tendencies which are already present, rather than an imposition of new stresses on the Community economy.

2.1. Potential Economic Benefits

In general, the enlarged internal market should create substantial new output and employment opportunities. The opening of the candidate countries has already led to rapidly growing trade links. Indeed, the value of their trade with the Community has more than tripled over the 1989-95 period. Further integration and enlargement will help rapidly growing income in Central and East European countries translate into a continuous rapid growth of the West-European export market. The emergence of new and competitive suppliers in eastern Europe should also have a dampening effect on input prices for key industries and services, thus reducing or containing costs and improving their global competitiveness. The need for modernising the public and private capital stock in eastern Europe and to build a pan-European infrastructure should stimulate investment expenditure. More integration should intensify competition on factor (labour) and goods markets. This should contain price inflation facilitating a stability-oriented monetary policy with relatively low interest rates, which will in itself stimulate growth.

Intensified competition in the labour market (be it directly through migration or indirectly through the emergence of new competitors) would probably contribute to wage moderation in Western Europe, thereby

supporting job creation. Faster growth at moderately rising wages could also allow for further improved employment prospects, although there may continue to be a shortage of openings for unskilled workers. The potential integration of the (pan-European) labour force should alleviate constraints on growth potential.

The emergence of the East European market should continue to imply a reorientation of regional trade structures. The new division of labour resulting from enlargement should lead to a further intensification of cross-border transactions. The enlargement process should accelerate trade expansion for two reasons: closer integration will mean that a greater share of trade will be with the Union; and accession will stimulate economic growth in the applicants, and thus raise their import demand. Moreover, increasing public transfers in the context of cohesion considerations may allow these countries to import the necessary investment goods that will enable them to expand their production potential and to catch up more rapidly.

2.2. Problem Areas and Risks

This enlargement is different from the previous one because the candidate countries are catching-up countries. Therefore, major challenges related to enlargement are (i) the low per-capita income of the applicants, (ii) the heavy bias of most of their economies towards agriculture and so-called sensitive sectors, (iii) inadequacy of transport, telecommunication and energy infrastructures and networks and (iv) their weak administrative capacity. Notwithstanding the rapid growth and pace of structural adjustment in some of the applicants, these features are likely to persist over the medium-term. Furthermore, (v) high unemployment both in the EU and in most of the applicants' economies make it more difficult for potential 'losers' at the sectoral and regional level of the adjustment process to find new jobs. These problems might trigger sectoral and regional policy interventions and a conduct of fiscal and monetary policy

not favourable for reaping the above-mentioned benefits of enlargement. Indeed, given the high unemployment rates all over Europe, any adjustment that leads to a loss of jobs will be politically difficult. If the new jobs resulting from structural adjustment are created in regions and sectors different from the old ones, even a net increase in jobs may be objectionable in the eyes of policy-makers. It will therefore be all the more important to promote trade, investment and market integration - the main vehicles for growth and employment in this context.

Adjustment is likely to be quite painful in regions or industries already suffering from excess supply on the labour market or excess capacity in so-called sensitive sectors. Adjustment will be much easier whenever capacities are complementary, or not really competing, e.g., in telecommunications, energy supply, financial services or tourism. It is hard to predict exactly which sectors and regions will 'lose' or 'win' and how much, but adjustment needs will be reinforced in regions and industries already suffering from economic decline. Public support may be needed to alleviate the regional and social problems related to this structural change.

2.2.1 Sectoral and regional issues

Labour markets

A substantial West-East wage differential serves as a strong incentive to East-West migration despite high unemployment in Western Europe. On the one hand, this may accelerate the drive towards more flexible labour markets, especially in bordering countries, such as Germany, Austria, Greece or the Scandinavian countries. On the other hand, labour market imbalances might increase, as there will be little employment opportunities for those parts of the Western labour force which will be crowded out. Although adjustment pressure will be highest at the lower end of the wage scale, there might also be an inflow of highly qualified workers, which could alleviate some supply bottlenecks in this segment of the labour

market. The size of these effects is hard to gauge: the widely expected massive migration from Greece, Spain and Portugal after their accession in fact never materialised. In the case of the current applicants, the size of the wage gap may increase the likelihood of migration actually occurring, though such migratory movement may to some extent be checked by anticipated relative improvements in those countries and uncertain employment opportunities in the West.

Sectoral adjustment

Sectoral adjustment in the enlarged Union might be most marked in agriculture, coal and mining and traditional industries such as textiles. Additional employment and output opportunities will emerge in those sectors which benefit from the adjustment pressure in upstream sectors, e.g. food processing and clothing, and where the emergence of a new market in the East, and the privileged access to this market, will boost demand. Enlargement would extend the market for European agricultural products. Under the Europe agreements, agricultural goods have remained more protected than industrial goods. Removing remaining barriers to trade would thus increase trade in primary products as well as in processed food and could improve economic welfare in the Union as a whole, although adjustment pressure from exposure to competition could be considerable in acceding countries, while, to a lesser extent, problems could arise as well for some products in the present Member States. Enlargement may also improve the Union's access to the acceding countries' traditional markets in the countries of the former Soviet Union. However, extending the CAP in its present form to acceding countries would create a number of difficulties in terms of budgetary implications, the economies of acceding states, and international trade commitments of the EU (*see section II.4*).

Regional adjustment

Accession of a large number of relatively poor countries will pose a special challenge to Community policies which aim at strengthening economic and social cohesion. This challenge will be all the greater since adjustment strains as a result of increased exposure to competitive pressure could be widespread in acceding countries. The problem will be more important in regions remaining very dependent on agriculture, or on the industrial sectors which will be most affected by enlargement. In this context, it will be important to ensure that national development strategies take account of the need to avoid widening existing within-country regional disparities.

The need to build up an adequate publicly and privately financed infrastructure, and to invest in human resources, in order to improve the growth potential of the joining economies will require substantial financial resources, which will only partly come from domestic savings. With respect to public infrastructure in particular, transfers from western countries, and especially from the Community, are of considerable importance.

The experiences of Ireland, Spain and Portugal show that economies are able to catch up rather quickly once supported by adequate domestic policies and a favourable inter-national environment. Community support, in the form of the structural funds, has made an important contribution to the catching-up process, and should play a similar role in the acceding countries.

The likely medium-term impact of enlargement on the cohesion countries in the present Union is highly uncertain. Different countries and regions will be affected in different ways, according to their respective competitiveness. With respect to adjustment strains, one should be wary of accepting an unduly pessimistic outlook for the less developed regions of the current Union; similar fears expressed at the time of the enlargement to Spain and Portugal proved to be exaggerated.

The economic centre of gravity of the Community will shift eastward, which will have some implications for the locational decisions of firms, primarily as a result of access to new markets, but also in the form of

relocation due to production cost considerations. In terms of their geographic position, the candidate countries are generally in favourable situation. They may thus be well-placed to profit from their comparative advantages, such as low unit labour costs, and low transport costs due to their proximity to the main Community markets, provided the necessary transport infrastructure is available.

The new theory of location emphasises that the consequences for the periphery are not necessarily adverse: elimination of trade barriers could induce concentration in clusters of industries because of economies of scale also to the benefit of peripheral regions, if improved market access were combined with competitive advantages such as low wages. However, only industries for which the sunk cost is low and which are faced with a sufficient reduction of transport costs would be inclined to relocate from current Member States to areas in the candidate countries in which real unit labour costs are even lower.

2.2.2 Increased heterogeneity

Enlargement will make the Union much more heterogeneous. This will constitute a major challenge for one of the key tenets of European integration so far: the unitary character of the *acquis communautaire* - one set of policies that applies to all. Enlargement does not call for a change in this fundamental principle and any transitional arrangements will have to be limited both in time and in scope. However, even within this framework, the Union will be faced with unavoidable choices between faster adaptation to the *acquis* by the new entrants, which would probably entail substantial financial costs, and a more gradual adaptation. If conducted after accession, the latter option would carry certain risks, for instance of negative side-effects in the functioning of the Internal Market. Extending Economic and Monetary Union to the new Member States will not be straightforward. The increased diversity of economic positions in the enlarged Union may complicate the co-ordination of economic policies. In

addition, further fiscal reforms and experience in tax collection are necessary in the candidate countries in order to meet EU fiscal discipline on a permanent basis. Also, the catching-up that is needed in the candidate states often goes hand in hand with higher inflationary pressure, which will complicate monetary and exchange rate policies. Large movements in nominal exchange rates could threaten the operation of the Single Market.

Apart from the market related impacts on policy, enlargement will increase the heterogeneity of the agricultural, rural and environmental problems in the Union. This will call for better targeting and a broader range of policies. More local (regional or national) influence on policy may be appropriate, though this will have to integrate a concern for preserving fair competition and promoting cohesion.

Finally, enlargement may prompt changes in the Union's administrative procedures to take account of the less developed administration in the acceding countries and the need to combat fraud.

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