

# **Lessons from Financing the 'Silent' Enlargement of the European Union in 1990**

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## 1. INTRODUCTION

On 3 October 1990, the unification of Germany produced the first eastern enlargement of the European Union.<sup>1</sup> In contrast to all other enlargements, this round was almost managed without protracted negotiations. On the very day of unification, the Treaties of the European Community (EC) and the entire Community law entered into force for the *Neue Länder*<sup>2</sup>, soothened by some short transitional periods in the fields of agricultural, structural or environmental policies. Moreover, the Southern member states did not express any concerns about losing payments from the Structural Funds.

The experiences of East Germany's reconstruction may help to formulate advice on how to finance further eastern enlargements without ruining the budget of the EU nor the budgets of the Central and East European candidate countries (CEECs) and without causing resistance within the 'old' EU member states against any contributions for the 'new' EU members. After all, uniting the whole of Europe should not fail due to money matters.

## 2. QUESTION AND METHOD

In this paper I will show that lessons from financing Eastern Germany are always neglected when thinking about the problems of financing next enlargements. This paper does not aim at an evaluation of the financial aid to East Germany nor at an evaluation of the EU's structural policy. This is done elsewhere.<sup>3</sup> Moreover, it should be noted that this paper does in no way glorify the measures and programmes implemented in East Germany. The shortcomings of the 'East-German-strategy' will be shown clearly in the following sections. This paper's central question is: What are the lessons both the European Union and the Central and East European applicant countries can draw from the EU's 'silent' eastern enlargement in 1990 ?

To answer this question, I proceed in three steps:

1. Description and analysis in detail the financing of the programmes for the transformation process of Eastern Germany; development of general principles from this analysis (chapter 3).

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<sup>1</sup> For documents see European Commission 1990.

<sup>2</sup> See Treaty on the Unification of Germany (*Einigungsvertrag*), Art. 10.

<sup>3</sup> See for example Hödl/Weida 1997; Holtzmann 1996; Roeger 1996; Beutel 1993.

2. Examination if and how these principles are applicable to the ten CEECs<sup>4</sup> that applied for EU accession (chapter 4).
3. Formulation of policy recommendations with regard to future eastern enlargements (chapter 5).

Since this paper is based on an empirical analysis and comparative in its methodology, it does not rely on any specific theoretical framework. Instead I will generate principles, or 'lessons', on financing future eastern enlargements.

At this stage, the question arises why and to what extent the experiences of Eastern Germany are comparable to the applicant countries of Central Europe. It could be argued that there were critical differences between the East German case and the CEECs: a *D-Mark*-monetary union overnight, with no exchange rate or monetary policy sovereignty; the integration overnight into the Western trading system, and the immediate application of the social market economy meant that the conditions for adjustment were more pressing in East Germany. The CEECs can operate an independent macroeconomic policy and can restructure with more deliberation than was the case in East Germany.

Nevertheless, the 'silent' enlargement of the EU is an excellent model for a comparison with further enlargements as in both cases a two-fold transformation, political and economic, had to occur. All former socialist countries suffered for example from a non-competitive economy, low productivity, hidden unemployment and an antiquated infrastructure. Such problems were common to East Germany as well as to the CEECs. Hence, it is valuable to develop general principles on the use of financial aid that are applicable to all transition countries.

Regarding the southern enlargements, Spain, Portugal and Greece at least showed structures of a market economy when they entered the Community in the 1980s. Moreover, the southern enlargements are inappropriate for a comparison because the European Union underwent a lot of changes during the last decade: the implementation of the Single European Act, the Internal Market Programme, the Maastricht Treaty and the Treaty of Amsterdam. Last but not least, the structural and cohesion policy has become a central

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<sup>4</sup> Bulgaria, the Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, Slovakia, Slovenia.

common policy of the EU only since its enlargement to the south.<sup>5</sup> The accession of Spain and Portugal in 1986 widened regional disparities in the EU. In conjunction with the Single Market Programme, these developments pushed forward a revision of the structural (and cohesion) policies.<sup>6</sup> Consequently, in February 1988 the Brussels European Council agreed upon a doubling of structural fund allocation by 1993 from ECU 6.3 billions to ECU 14.1 billions.<sup>7</sup> Between 1994 and 1999 the budget for structural and cohesion measures was again doubled up to ECU 27.4 billions by 1999, accounting for 35% of the total EU budget. Between 1994 and 1999, some 67% of total structural expenditures are reserved for Objective 1 regions, of which East Germany is part.<sup>8</sup>

Financing the eastern enlargement will be a central issue in European Union affairs. The Berlin European Council in March 1999, that mainly has to be seen in the light of the enlargement process, finally decided upon the EU budget for the years 2000 to 2006. The Council intended to push the reform<sup>9</sup> of the EU's expenditure policies forward since estimates suggest that transfers to the CEECs will reach an amount between ECU 10 billions and ECU 32 billions per year, depending on economic factors in the accessions countries and the scope of EU reforms.<sup>10</sup> The conclusions of the Berlin Council suggest expenditures of EURO 213 billions in the period 2000 to 2006, including the Structural Funds (EURO 195 billions) and the Cohesion Fund (EURO 18 billions).<sup>11</sup> Almost 70% of structural expenditures will be disbursed into Objective 1 regions. With regard to future eastern enlargements, it is also note-worthy that the Berlin Council decided on a limitation of structural and cohesion transfers. A member state will not be eligible for transfers that exceed 4% of its GDP.<sup>12</sup>

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<sup>5</sup> It is not the intention of this paper to analyse the rationale behind structural policies; see for example Michie/Fitzgerald 1997; Hödl/Weida 1997; Pollack 1995.

<sup>6</sup> Bache 1998, p. 67.

<sup>7</sup> Michie/Fitzgerald, p. 22.

<sup>8</sup> European Commission 1997b, p. 30.

<sup>9</sup> Within the academic circle and the Commission there are many proposals aiming at the reform of the EU's financial system; see for example Dickertmann 1999; Nicolaidis 1999; Begg/Grimwade 1998; European Commission 1998a; Heinemann 1998; Begg 1997; Stehn 1997; Weise 1996.

<sup>10</sup> This is an estimation (three scenarios) of the German Institute for Economic Research (DIW) for the CEFTA-5 countries; see Weise 1996. For further estimates see Baldwin et al. 1997; Eser/Hallet 1993.

<sup>11</sup> Agence Europe, 2 April 1999, p. 6.

<sup>12</sup> European Council 1999 (Agence Europe, 27 March 1999, p. 9).

Though in the following sections I will divide between national German and EU contributions to the *Neue Länder*, this division is not always easy as some regional measures are co-financed between the European Union and the German Federal State.<sup>13</sup>

### 3. THE 'SILENT' EU-ENLARGEMENT IN 1990: FINANCING EAST GERMANY'S RECONSTRUCTION

*Introduction.* In this first step, I provide an analysis of EU and German national contributions to the *Neue Länder* based on various criteria. What are the respective aims of the national and the EU contributions? To what extent were contributions made until now? Who are the actors on the EU level and the national German level regarding structural policy measures? What tools do they use? What mechanisms and criteria have been developed to implement those measures? This part of the study will conclude with general principles concerning the financing of an enlargement by transition countries.

#### 3.1 National Distribution from West to East: Figures and Measures

*Economic Developments in Brief.* The integration of East Germany into the EU and the world economy required a wide-ranging restructuring of markets.<sup>14</sup> After the breakdown of the COMECON, East Germany, like all of the former "Soviet satellite states", suffered from a massive decline in industrial production. This was a result of a lack of competitiveness and the breakdown of export markets.

The economic situation in East Germany recovered between 1991 and 1994 significantly with a rise in the Gross Domestic Product (GDP) of nearly 10% in 1994. GDP growth lowered in the following years down to 2.5% in 1998.<sup>15</sup> This is even lower than the estimated rate for West Germany (2.8%) or other Objective 1 regions in the EU such as Greece (2.8%) and Portugal (3.2%).<sup>16</sup> Nevertheless, East Germany's GDP per capita

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<sup>13</sup> Especially the 'Joint Task for the Improvement of Regional Structures' (*Gemeinschaftsaufgabe zur Verbesserung der regionalen Wirtschaftsstruktur*).

<sup>14</sup> On a very early view on the problems of integrating East Germany into the world market see for example Hölzer 1991; Werner 1991.

<sup>15</sup> Riedl/Scharr 1998a, p. 7; Bedau 1998.

<sup>16</sup> Riedl/Scharr 1998a, p. 7.

approximated the EU level rather quickly. While in 1991 it was only at a rate of about 37% of the EU average, it raised up to almost 65% in 1996.<sup>17</sup>

Furthermore, the economic situation in East Germany was characterized by a very high level of unemployment. Between 1991 and 1997 the unemployment rate in the *Neue Länder* doubled. In Saxony for example the rate rose from 8.8% up to 16.7%, in Berlin from 7.7% to 15.8% and in Sachsen-Anhalt from 9.3% to 19.8%.<sup>18</sup> It should be noted that the tendency of rising unemployment was to a certain extent a European-wide development and not only restricted to former socialist countries.

After more than eight years of unification, transformation in East Germany is still proceeding. The narrowing of GDP between East Germany and the European Union's average level and the growth of productivity was paid with high unemployment. In 1998 the reconstruction of East Germany has slowed down. German research institutes expect a GDP growth of only 2% in 1998 (West Germany: 2.8%) and of 2.3% in 1999 (West Germany: 2.3%). Unemployment rate will stick at about 18% in East Germany and 9% in West Germany in 1999.<sup>19</sup>

Regardless of all difficulties, East Germany's economy seems to be on a very promising way.<sup>20</sup> In the meantime, many competitive enterprises have been established in the Eastern part of Germany and their number is still growing. Nevertheless, it should not be concealed that it still will take more time to reach an economic level comparable to that of West Germany or other EU member states.

*Transfers.* So far, the German Federal State (*Bund*), the German *Länder* and the EU have transferred a high amount of funds to support East Germany's transformation process. During the period 1991 to 1998, the contributions from the German Federal budget sum up to over DM 900 billions.<sup>21</sup> Further contributions have been disbursed from the West German *Länder* and other sources such as the Unemployment Insurance or the 'German

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<sup>17</sup> Ibid., p. 8.

<sup>18</sup> Ibid., p. 13; Kreditanstalt für Wiederaufbau 1998, p. 3.; Federal Ministry of Economics 1998e.

<sup>19</sup> DIW et al. 1998. The problem of long-term unemployment grew significantly in recent years; see Schultz 1998.

<sup>20</sup> DIW/IfW/IWH 1998a.

<sup>21</sup> Federal Government 1998, p. 70; Boss 1998, p. 17.

Unity Fund' (*Fonds 'Deutsche Einheit'*).<sup>22</sup> This aid sums up to an additional amount of almost DM 500 billions. All in all, on the national level about DM 1.400 billions have been transferred from West to East Germany between 1991 and 1998, while only DM 300 billions flew back from East to West.<sup>23</sup> In 1996 the transfers amounted to 4.5% of West Germany's GDP and 34% of East Germany's GDP<sup>24</sup>, whereas the support to West Germany given by the Marshall plan in the period 1948 to 1951 was about 3% of Germany's Gross National Product (GNP).<sup>25</sup>

The motivations for transfers to the East can be seen in political as well as economic reasons. After unification, the industrial collapse led to a loss of employment that forced the Federal Government to play a strong part in the restructuring of East Germany. The engagement of the state was necessary for social reasons. Under economic aspects, theories suggest that interventions by the State make sense if they lead to more market efficiency, a better distribution of income and the removal of extreme economic imbalances.<sup>26</sup> It seems to be obvious that these conditions are fulfilled in East Germany.

*Programmes and Instruments.* The following section gives a brief overview of the programmes and instruments implemented by the German Federal Government to facilitate economic recovery in East Germany. Economic promotion in East Germany focuses mainly on four areas:<sup>27</sup>

- (1) investment in manufacturing business (especially small- and medium-sized enterprises),
- (2) investment in infrastructure,
- (3) investment in so-called 'soft' location factors (protection of the environment, energy, research and development, etc.),
- (4) regional policy.

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<sup>22</sup> On the role of the Social Insurance in financing Germany's unification see Boss 1998, pp. 8-13.

<sup>23</sup> Mainly tax revenues; see Federal Government 1998, p. 70.

<sup>24</sup> In 1991 resource transfers to East Germany even amounted to 60% of national income in the former GDR; see Welfens 1993, p. 165.

<sup>25</sup> Boss 1998, p. 16f.

<sup>26</sup> Musgrave 1959.

<sup>27</sup> Federal Ministry of Economics 1998d.

In order to achieve success in these areas, a wide range of measures have been implemented to restructure the East German economy and to stabilize its labour market by improving the acting conditions for enterprises. A special tax called the 'solidarity tax' (*Solidaritätszuschlag*) has provided the financial basis for this patchwork of measures in Germany.<sup>28</sup> However, this tax did not prevent the Federal budget from an increasing deficit.<sup>29</sup>

(1) Instruments to attract business activities in East Germany consist of (a) measures based on taxation, (b) the promotion of investment through loans at reduced interest rates, (c) bails (*Bürgschaften*) and (d) special funds such as the 'Participation Fund East' (*Beteiligungsfonds Ost*) and the 'Consolidation Fund' (*Konsolidierungsfonds*).<sup>30</sup>

(a) Measures based on taxation can be defined as investment allowances (*Investitionszulage*), special depreciations (*Sonderabschreibungen*) or the total exemption of taxation. The scope and aim of investment allowances is laid down in two Investment Allowance Laws. The latest law of Summer 1997 guarantees investment allowances during the period 1999 to 2004. Since January 1999 special depreciations are ceased. Investment allowances are granted for the purchase and production of mobile goods if they are more expensive than DM 800, if they are not automobiles or aircrafts, if they remain at least three years within the enterprise and if their use for private purposes does not exceed 10% of total use. Before 1999 the investment allowance amounted 5% of the purchase value in general and 10% for small- and medium-sized enterprises (SMEs) with not more than 250 employees. Since January 1999 these figures have been fixed at 10%, respectively 20%.<sup>31</sup> Additionally, the investment volume was not allowed to exceed DM 5 million. Between 1991 and 1997 DM 22 billions were spent in investment allowances.<sup>32</sup> This instrument shall foster a rapid and broad investment dynamic in order to favour structural changes and economic modernisation as well as to promote the foundation of SMEs.

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<sup>28</sup> This special tax (7.5% income tax surcharge) was first limited to a one year period between July 1991 and June 1992, but was later re-introduced.

<sup>29</sup> Only in the years 1991 and 1992 the budget deficit increased by 40%; see Kitterer, p. 51.

<sup>30</sup> For a detailed description of all instruments see Federal Ministry of Economics 1998b.

<sup>31</sup> Federal Ministry of Economics 1998b, pp. 11-13.

<sup>32</sup> Federal Ministry of Economics 1998d, p. 7.



The second measure based on lower taxation is the use of special depreciations. In the period 1991 to 1997 DM 47 billions were spent in this field. Special depreciations of 40% were granted for the purchase and production of mobile and immobile goods as well as for the expansion of enterprise buildings.<sup>33</sup>

Finally, profits of SMEs that have been realized by the sale of shares will be exempted from taxation if this profit is invested in the *Neue Länder* immediately. This is to improve the capital basis of East German firms.

(b) The promotion of investment through loans at reduced interest rates is provided through different programmes. The aim of this measure is the establishment of new ('young') firms. The so-called 'ERP-Programme for the Formation of Capital' (ERP-*Eigenkapitalhilfe-Programm*) provides loans at reduced interest rates (at an interest rate of zero in the first two years) to someone who wishes to establish or consolidate an industrial or self-employed existence. Similar ERP-loans pursue the same intentions. All loans are characterized by a low interest rate, long periods to run, no redemption up to five years, and the possibility to repay the loan at any time. This financial aid amounted to DM 72 billions until 1997.<sup>34</sup>

(c) Bails are guaranteed through three channels: special banks dealing just with bails (*Bürgschaftsbanken*), the *Deutsche Ausgleichsbank (DtA; German Bank for Settlement)*, and the *Bund/the Länder*. Bails are intended to secure loans, especially for people wishing to establish new firms if no other securities are existing. A single bail of the special bailing banks must not exceed DM 1.5 million. The *DtA* is responsible for bails between DM 1.5 million and DM 20 million. Bails by the *Bund* and the *Länder* are available starting with an amount of DM 20 millions with a 15 year period to run. Investments with a sum of DM 35 billions have been realized by this instrument.<sup>35</sup>

(d) Since 1996 the 'Participation Fund East' is a special fund to raise risk capital for enterprises in the new *Länder* which need capital to finance their expansion, want to enter

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<sup>33</sup> Federal Ministry of Economics 1998b, pp. 13ff.

<sup>34</sup> Federal Ministry of Economics 1998d, p. 7. Further loans at reduced interest rates are available through the *Kreditanstalt für Wiederaufbau* (German Bank for Reconstruction) and the *Deutsche Ausgleichsbank* (German Bank for Settlement).

<sup>35</sup> Federal Ministry of Economics 1998d, p. 7.

new markets or are in the process of developing new products.<sup>36</sup> The fund with a total budget of DM 1.5 billions is administered by the *Kreditanstalt für Wiederaufbau (KfW)* and the *DtA*. Eligible for financing are SMEs with an annual turnover of not more than DM 250 millions in the case of *DtA*-funds and DM 500 millions in the case of *KfW*-funds. The 'Consolidation Fund' has a volume of DM 1 billion and is a special instrument to help SMEs with an annual turnover of not more than DM 40 million that suffer from temporary liquidity problems.

(2) The second area of massive investment is the infrastructure sector. Between 1990 and 1997 almost DM 162 billions have been invested into traffic and telecommunication infrastructure as well as into projects that are connected to business activities such as manufacture areas or tourist institutions. The 'Traffic Project German Unity' (*Verkehrsprojekt Deutsche Einheit*) is the most important pillar concerning traffic infrastructure in East Germany. Nearly one-third of the transfers provided for infrastructure projects have been disbursed for telecommunication. Another DM 36 billions have been invested into business-near infrastructure projects.

(3) Third, investment in so-called 'soft' location factors has been promoted very strongly by the German Government. The total investment volume in housing and urban projects amounted to DM 225 billions. Measures to improve the environmental situation (for example reorganisation of the brown coal industry, removal of radiological waste) were subsidised with ca. DM 50 billions since 1990. Again lower taxation and loans at reduced interest rates served as important instruments. Last but not least, research and development was supported with a sum of almost DM 10 billions between 1990 and 1997.<sup>37</sup>

(4) Finally, a West German instrument for economic promotion, the 'Joint Task for the Improvement of Regional Structures' (*Gemeinschaftsaufgabe 'Verbesserung der regionalen Wirtschaftsstruktur'*), was activated in the Eastern part of Germany as well. This happened because the Treaty on the Unification of Germany (*Einigungsvertrag*) states that in both parts of Germany the same rules for economic promotion shall be applied (article 28 of the Treaty). The aim of the Joint Task is to induce the creation of durable and qualified jobs. The *Bund* and the *Länder* co-finance the budget for this instrument.

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<sup>36</sup> Federal Government 1998, p. 65.

<sup>37</sup> Federal Ministry of Economics 1998d, pp. 9-13.

Furthermore, the financial aid of the European Regional Development Fund (ERDF) is channeled through this programme by the East German *Länder*, with the exception of Berlin East, Mecklenburg-Vorpommern and Saxony.<sup>38</sup>

*Actors.* The patchwork of actors in this 'distribution game' is in some way confusing. While for most programmes the *Bund* or the *Länder* are the donors of financial aid<sup>39</sup>, the distribution of the capital is provided by a bulk of different actors. The *KfW* and the *DtA* are the most important actors entrusted with distributional affairs. They are responsible for granting special loans at reduced interest rates for the promotion of investment and they administer the 'Participation Fund East'. The administration of the 'Consolidation Fund' differs among the new *Länder*. While for example in Berlin a special investment bank assumes this task, in Mecklenburg-Vorpommern a so-called *Landesförderinstitut*, or 'Land Promotion Institute', and in Saxony a *Beteiligungsgesellschaft*, or 'Participation Company', is responsible for passing on financial aid. Additionally, with regard to bails, there are special banks in each East German *Land* to which applications have to be filed. With regard to regional policies and the Joint Task, responsibilities are shared by the Federal Government and the *Land* governments, while prime responsibilities lies with the *Länder*.<sup>40</sup>

This was just a very brief summary of national programmes, measures and actors implemented to speed-up the transformation process in East Germany. It would be absurd to believe that any of the CEECs or the European Union is able (or willing) to raise a similar amount of money in the transition countries. Therefore, it seems even more important to draw lessons from a decade of financing the reconstruction of a former socialist country. After looking at EU's aid to East Germany a critical view on the programmes will help to develop principles for future eastern enlargements.

### 3.2 EU's Aid: Structural Policy in East Germany

*General Remarks.* In 1994 the EU designed the *Neue Länder* as 'Objective 1 regions in structural policy matters, since Eastern Germany belongs to the poorest EU regions measured in terms of GDP per capita. Furthermore, East Germany suffers a rather high rate

<sup>38</sup> Riedel/Scharr 1998b, p. 18. Concerning EU programmes and aid see chapter 3.2.

<sup>39</sup> With the exception of the Consolidation Fund where together the *Treuhandanstalt*, the political parties and the *Länder* build the group of donors.

<sup>40</sup> Drerup 1997, p. 337.

of unemployment, as mentioned above. Before 1994 EU assistance was provided by a Special Regulation.<sup>41</sup> The Structural Funds of the EU are coordinated by the so-called 'Joint Assistance Concept (JAC)' (*Gemeinschaftliches Förderkonzept*) which was negotiated between the *Bund*, the *Länder* and the European Commission in July 1994. This system co-ordinates the structural policies of the EU for East Germany. It lays down the aims of support, describes the financial framework of transfers and represents the base on which the operational programmes work. In total, the EU spent about DM 48 billions during the period 1991 to 1998.

*Structural Transfers.* Between 1994 and 1999 financial assistance from the four Structural Funds<sup>42</sup> ERDF, ESF, EAGGF and FIGF for Germany will reach approximately DM 39 billions.<sup>43</sup> This is 14.3% of the total Structural Funds budget. Nearly two-thirds of the EU's structural transfers for Germany, that is DM 26.7 billions, are reserved for the *Neue Länder*. Of this, DM 13.3 billions (50.2%) will be provided by the ERDF, DM 7.9 billions (29.8%) by the ESF, and DM 5.5 billions (20.8%) by the EAGGF and the FIGF.<sup>44</sup> Further DM 2 billions will be disposed through Community Initiatives such as ADAPT<sup>45</sup> or INTERREG II<sup>46</sup>.

Divided by *Länder*, Saxony will receive 24.7% of the transfers followed by Sachsen-Anhalt with 17.4%, Brandenburg with 15.9%, Thuringia with 14.7%, Mecklenburg-Vorpommern with 13.4%, and finally East Berlin with 5.5%. 8.4% of structural funding is not regionalized.<sup>47</sup>

*The Joint Assistance Concept.* The Joint Assistance Concept provides a total budget of approximately DM 100 billions for the years 1994 to 1999. It formulates several global aims with regard to the application of Structural Funds in East Germany: the reconstruction of the economy, the creation of durable jobs, to raise income, to improve location factors,

<sup>41</sup> Council Regulation No. 3575/90, 4.12.1990.

<sup>42</sup> ERDF: European Regional Development Fund; ESF: European Social Fund; EAGGF: European Agricultural Guarantee and Guidance Fund; FIGF: Fishery Guidance Fund.

<sup>43</sup> European Commission 1997b, p. 30. 1 ECU = 1 EURO = 1.95 DM.

<sup>44</sup> Drerup 1997, p. 345.

<sup>45</sup> Programme for the qualification of employees; see Federal Government 1995.

<sup>46</sup> Programme for cross-border cooperation; see Brandenburg Ministry for Economics, Business and Technology 1998, pp. 16ff.

<sup>47</sup> Schuster 1996, p. 185.

and to implement qualification measures.<sup>48</sup> Some of the aims are specified by quantitative allegations, for example overall employment shall rise by 0.5% per year, and GDP per capita shall increase from ECU 9.000 in 1993 up to ECU 14.800 in 1998.<sup>49</sup> In general, the JAC is preceded by the Joint Task (*Gemeinschaftsaufgabe*).<sup>50</sup> Nevertheless, the JAC includes a clause that authorizes the *Länder* to spend money outside the Joint Task. This flexibility allows for recognizing regional differentiations.

The prime principle of the Joint Assistance Concept is the co-financing of projects (so-called 'additionality'). This means that ERDF-funding has to be co-financed with a 50%-share by public or private investors, ESF-funding with a 35%-share, and EAGGF-funding with a 25%-share. In other words, while only 23.6% of the transfers indicated in the JAC originate from the European Union's structural assistance, 58% come from private investors and 18.5% from public budgets. While private investors and investments by the ERDF concentrate more on infrastructure, immaterial investments (e.g. research and development, consultation of management) and the establishment of new enterprises (SMEs), public sector investments focus on the development of human capital and employment promotion.<sup>51</sup>

*Actors.* The 'Fund Administrators' (*Fondsverwalter*) play a vital role in distributing EU money in the five *Neue Länder* on all levels, i.e. the EU level, state level, and *Land* level.<sup>52</sup> They have an executive function and decision-making competence. Together with the economic and social partners, they build a 'partnership'. On the EU level, a variety of Committees assist the Commission in the process of Structural Funds implementation. In the context of Objective 1 measures, the 'Committee on the Development and Transposition of the Regions' is concerned with all matters of Structural Funds implementation. This Committee consists of experts from all implementation levels. It is again assisted by regional Committees that arrange the meetings of the main Committee.

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<sup>48</sup> Riedel/Scharr 1998b, p. 17.

<sup>49</sup> Ibid.

<sup>50</sup> It must be recognized that the national Joint Task and the Joint Assistance Concept of the Community are two independent concepts of regional policy. In the light of German Unification the national concept had to be brought in line with the Community concept; see Schrupf 1997, p. 249; Voelzkow/Hoppe 1996, pp. 119-125.

<sup>51</sup> Riedel/Scharr 1998b, p. 18 (tab.1 ).

<sup>52</sup> A very detailed analysis of actors in EU structural policies gives Pollack (1995).

Table 1: The structure of financing East Germany

Financed Area	Instruments	Programmes	Actors
1 Manufacturing	<ul style="list-style-type: none"> <li>• investment allowances</li> <li>• special depreciations</li> <li>• no taxation</li> <li>• loans at reduced interest rates</li>   <li>• bails</li> </ul>	<ul style="list-style-type: none"> <li>• ERP-Programmes</li> <li>• Participation Fund East</li> <li>• Consolidation Fund</li> </ul>	<ul style="list-style-type: none"> <li>• KfW</li> <li>• KfW/DtA</li> <li>• Landesförderinstitute/Beteiligungsgesellschaften</li> <li>• Bürgschaftsbanken</li> </ul>
2 Infrastructure		<ul style="list-style-type: none"> <li>• Traffic Project 'German Unity'</li> <li>• telecommunication</li> <li>• manufacturing areas</li> <li>• tourist institutions</li> </ul>	<ul style="list-style-type: none"> <li>• Bund/Länder</li> </ul>
3 'Soft' Location Factors	<ul style="list-style-type: none"> <li>• lower taxation</li> <li>• loans at reduced interest rates</li> </ul>	<ul style="list-style-type: none"> <li>• housing</li> <li>• urban projects</li> <li>• environmental projects</li> <li>• R &amp; D</li> </ul>	<ul style="list-style-type: none"> <li>• Bund/Länder</li> <li>• KfW</li> </ul>
4 Regional Policy	<ul style="list-style-type: none"> <li>• 'Joint Assistance Concept': <ul style="list-style-type: none"> <li>• ERDF</li> <li>• ESF</li> <li>• EAGGF</li> <li>• FIGF</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• 'Joint Task for the Improvement of Regional Structures'</li> </ul>	<ul style="list-style-type: none"> <li>• Bund/Länder</li> <li>• Fund Administrators</li> <li>• EU</li> </ul>

### 3.3 Developing Principles from Financing East Germany's Reconstruction

As indicated, the effects of structural measures and economic promotion are not always obvious or even positive. *Schrumpf*<sup>53</sup> points out three fundamental problems in context with the evaluation performed to date: First, "when a massive amount of funds are provided by the national government in addition to the programme co-financed by the Community for the expansion of infrastructure, housing, the tertiary sector and the establishment of general administration, the effects of promotion can no longer be clearly assigned to any particular programme." Second, *Schrumpf* continues, "the same problem occurs when joint initiatives are carried out in addition to the aid programmes of the Community in the same area. If the evaluation is only intended to be related to the programmes or to the joint initiatives, the results must necessarily be distorted". Finally, he mentions the classic problem of identifying the 'counterfactual': What would have been the

<sup>53</sup> Schrumpf 1997, p. 253.

effects without the promotion? Lessons for future enlargements have to be seen in the light of these evaluation problems.

Evaluations of financing East Germany's reconstruction show that positive effects had been reached by the promotion of capital formation in patterns of investment allowances or other instruments. On behalf of EU financing in the *Neue Länder*, the European Commission's Ninth Annual Report on the Structural Funds in 1997 pointed out that since 1994 22.000 projects have been supported in East Germany. Moreover, 107.000 jobs have been created and 230.000 jobs have been secured.<sup>54</sup> Of course, this is a balance of success offered by the European Commission. Other studies suggest that private investment and the creation of jobs lag behind of what was expected in the Joint Assistance Concept.<sup>55</sup> Additionally, the reduction of unemployment was less successful in comparison to other Objective 1 regions.<sup>56</sup> Though some scepticism arises about economic promotion in East Germany, a study by the IFO Institute for Economic Research admits that ERDF-funding has led to an investment per job of DM 105.000, compared to DM 181.000 that have been invested because of national promotion.<sup>57</sup> Through ERDF-funding 270.000 jobs have been secured or created.<sup>58</sup>

On the other hand, an evaluation study of ERDF-funding in Saxony by the German Institute for Economic Research (*DIW*) is cautious about job market success when it admits that "ERDF-promotion in Saxony comprises many different types of projects that are hardly comparable to each other".<sup>59</sup> Furthermore, it is questionable if the financing of the so-called 'second' job market is desirable. This 'second' market has become an important employment factor in East Germany. Subsidisation of non-competitive jobs leads to market distortions if salaries paid by subsidised enterprises are higher than that paid by not-subsidised ones. In the long run, subsidisation of the 'second' job market

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<sup>54</sup> European Commission 1997b, p. 58.

<sup>55</sup> Riedel/Scharr 1998b, pp. 19, 22.

<sup>56</sup> *Ibid.*, p. 22.

<sup>57</sup> Riedel/Scharr 1998b, p. 23.

<sup>58</sup> *Ibid.*, tab. 3.

<sup>59</sup> Hagen/Toepel 1997, p. 802.

endangers the recovery of the regular job market.<sup>60</sup> Hence, statements about job market effects have to be qualified.

Furthermore, subsidies always lead to a mentality of 'rent-seeking'. This means that enterprises are promoted that also would have invested without subsidies. These enterprises see economic promotion not as a means of reducing locational disadvantages but as a means of regular income.

Infrastructure is another area to which attention has to be paid. Modern infrastructure is a precondition for investment activities of enterprises. New communication systems and acceptable traffic infrastructure decrease the cost of firms and increase the attractiveness of locations.

There is no doubt that locational disadvantages in East Germany require the use of special instruments to facilitate the establishment of new firms and the creation of jobs. Nevertheless, economic promotion also helped to produce structures that are not capable of living without financial aid. For example: attractive special depreciations led to investment into business real estate instead of investment into industry equipment, and investment allowances considered only insufficiently that not each sector of the economy suffered from locational disadvantages.<sup>61</sup> A poll among investors in Saxony discovered that one-third of the projects would have been realized even without promotion by the ERDF.<sup>62</sup>

Weighing pros and cons of economic promotion in the five *Neue Länder*, four principles can be distilled:

(1) *Regional Differentiation*: Studies prove that financial aid is best set up in areas where spill-over-effects can be expected. Industrial agglomerations are such areas which foremost profit from transaction cost advantages. Growth effects in the centre, i.e. the agglomeration, will have an effect on the periphery ('centre-periphery-effect').

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<sup>60</sup> The three German Research Institutes DIW, IfW and IWH show the dangers of job subsidization in detail; see DIW/IfW/IWH 1997b.

<sup>61</sup> DIW/IfW/IWH 1997b.

<sup>62</sup> Hagen/Toepel 1997, p. 803.



- (2) *Focusing*: From the experiences of East Germany it seems important to focus financial funds.<sup>63</sup> To avoid the durable establishment of a 'second' job market, assistance has to be concentrated on the regular job market, for example by qualification measures for employees, the advice of management staff, promotion of technology and marketing, and measures to establish new and innovative SMEs<sup>64</sup> as well as to increase the number of self-employed persons. These activities have to be accompanied by the promotion of capital formation and infrastructure measures.
- (3) *Subsidiarity*: The experience of actors in East Germany has elucidated that greatest success has been achieved in regions "that developed their own initiatives and mobilised available potential".<sup>65</sup> *Drerup* calls this "support for indigenous development".<sup>66</sup> People and actors in the regions know best what is needed in their respective region. This principle of subsidiarity is limited in cases where regional actors do not have such a strong influence with regard to decision-making as in the German *Länder*.<sup>67</sup> This may be the case in the Central and East European candidate countries with a less developed federal structure.
- (4) *Conditionality*: Conditionality aims at the improvement of efficiency. This principle should include the frequent use of repayable loans instead of grants and the temporal limitation of measures. The latter is especially applicable with national financing and EU pre-accession financing as it is hardly imaginable that this principle will be welcomed in the context with EU structural policies. Nevertheless, repayable loans guarantee that the recipient calculates more carefully because the loan must be amortised. Moreover, the problem of 'rent-seeking', described above, can be restricted. The temporal limitation of measures avoids the effect of 'habit' and a 'subsidisation mentality'. A joint study by the German Institute for Economic Research and two other research institutes admits that in East Germany the danger of taking subsidies as a 'normal' income factor is clearly rising.<sup>68</sup>

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<sup>63</sup> On the need to focus structural aid see Piehl 1996, pp. 329ff.

<sup>64</sup> The promotion of SMEs is essential. Since 1990 four-fifth of newly established enterprises have been SME's which are independent of bigger enterprises or trusts; see DIW/IfW/IWH 1998a.

<sup>65</sup> Drerup 1997, p. 344.

<sup>66</sup> Ibid.

<sup>67</sup> During the process of planning the *Länder* only can get officially in contact with the Commission through the Federal Government. This has led to a growing number of informal contacts between the *Länder* and the Commission. Nevertheless, the potential of the *Länder* to influence the Commission is rather note-worthy; see Staeck 1996b, p. 100.

<sup>68</sup> DIW/IfW/IWH 1997b.

In the following section, these principles, drawn from the experiences in East Germany, are applied to the EU programmes for the CEECs. After short general remarks on the enlargement process, the next chapter will point out the characteristics of the EU programmes for the candidate countries. The core question than will be how far the principles developed above can already be found in the assistance for Central and Eastern Europe.

#### 4. FUTURE ENLARGEMENTS AND THE DEMAND FOR EU REFORMS

##### 4.1 General Remarks

Enlargement negotiations with five Central and East European countries (Estonia, Hungary, the Czech Republic, Poland, Slovenia) and Cyprus started in November 1998. Since April 1998, the 'screening' of the *acquis communautaire* is in progress with each of the ten CEE candidate countries. In general, there is no doubt that the EU has to undergo substantial reforms in its structural, agricultural and budgetary policies before taking new member states in. Otherwise, the financing of further enlargements will be difficult or even impossible as the EU's policy of structural assistance for regions experiencing economic difficulties will also be adopted in the new member states. *Martin* points out that "since all potential member states will still be relatively poor at the time of accession, they will all be eligible for the most intensive form of structural assistance which in turn increases EU expenditures significantly".<sup>69</sup> Therefore, he continues, "the Union's regional policy is [...] one of the key obstacles to enlargement".<sup>70</sup>

The European Commission addressed the necessary reforms in its document AGENDA 2000.<sup>71</sup> Concerning the financing of the future eastern enlargements, the AGENDA 2000 highlights a new instrument of direct funding by the Structural Funds in the applicant countries, by way of pre-accession aid, from the year 2000 - the so-called Instrument for Structural Policies for Pre-Accession (ISPA). This assistance, to be granted at a constant rate of DM 2.03 billions per year, would initially be offered to all the applicant countries

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<sup>69</sup> Martin 1998, p. 1.

<sup>70</sup> Ibid.

<sup>71</sup> European Commission 1997c; 1997d.

and would subsequently be focused on countries joining the Union at a later stage.<sup>72</sup> This instrument, the PHARE<sup>73</sup> Programme and the new agricultural funds are brought together and coordinated within the Accession Partnerships.<sup>74</sup> All in all, Commission plans suggest that pre-accession aid will amount to DM 42.6 billions between 2000 and 2006 (agricultural aid, structural aid, PHARE). Assuming that in 2002 five Central and East European candidate countries - Poland, Hungary, Czech Republic, Slovenia, Estonia - join the EU, each of the new member states will benefit from an average amount of DM 4.0 billions per year until 2006, first in the frame of pre-accession aid, later through the Structural Funds. The 'remaining-five' - the Slovak Republic, Bulgaria, Romania, Latvia, Lithuania - will receive in the same period DM 1.2 billions per year as pre-accession aid. Notably, this is a much smaller contribution compared to the DM 48 billions the *Neue Länder* received from the EU during a similar time period.

#### 4.2 Reflecting EU Initiatives in the CEECs so far

The second part of this chapter continues with a very brief description and analysis of the EU programme for the Central Europeans so far, i.e. the PHARE-programme, and the new pre-accession instrument in the field of structural measures, the ISPA.<sup>75</sup> The same criteria (aims, tools, financial volume, etc.) shall be applied as in the first step, i.e. in the case of East Germany, to make the two cases comparable.

*PHARE.* PHARE has been initiated in 1989<sup>76</sup> first to support just Poland and Hungary but soon 14 East European countries participated. PHARE shall contribute to the transformation of the economic and political systems in Eastern Europe by financing projects in the areas of qualification of employees, industrial restructuring, infrastructure, privatisation and environment. The implementation of projects under the PHARE programme follows the principles of subsidiarity and focusing of transfers. PHARE only provides grants that are not repayable, hence, there is no conditionality. While in the first

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<sup>72</sup> European Council 1999 (Agence Europe, 27 March 1999, p. 14).

<sup>73</sup> PHARE: Poland, Hungary Aid for the Reconstruction of the Economy.

<sup>74</sup> European Commission 1998h.

<sup>75</sup> Financial aid from development banks such as the EBRD and the EIB are not considered.

<sup>76</sup> Council Regulation No. 3906/89.

years an emphasis was put on privatisation and the establishment of SMEs, since 1995 a special focus has been put on infrastructure projects.<sup>77</sup>

Subsidiarity shall be reached by a so-called 'demand-driven-approach' in which the partner countries decide how and where they use the financial aid. Nevertheless, in the planing phase the Commission has to agree to an indicative programme which lays down the framework for projects to be supported.<sup>78</sup> During the implementation phase, a PHARE Coordinator is responsible for implementing the programme on the national level. On the EU level, an Administrative Board, composed of representatives of the member states and of the Commission, and the Commission's DG I.A finally decide upon the proposed projects.

Between 1990 and 1999, the European Union has provided more than DM 20 billions under the PHARE programme. The Berlin Council granted the same sum for the period until 2006 as pre-accession aid.

*ISPA*. ISPA is the new pre-accession instrument of the EU in the field of structural policies. The financial volume for the ten CEE candidate countries amounts to DM 14.2 billions between 2000 and 2006.<sup>79</sup> Articles 1 and 2 of the Commission's proposal for a Council Regulation on the ISPA<sup>80</sup> determines that funds will be granted for measures that help to transpose the necessities concerning the environmental *acquis* of the EU and that improve the traffic infrastructure. Consequently, this aid serves to align the rules of the CEECs to Community rules. The concentration on environment and infrastructure complies with the principle of focusing financial aid on selected sectors.

In contrast to PHARE, ISPA not only provides aid by non-repayable grants but also through repayable loans, interest-reduced payments, participation in risk capital, or through other instruments.<sup>81</sup> The principle of conditionality is further strengthened by the regulation that a project or a group of projects must have a volume of more than DM 10

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<sup>77</sup> At the Essen European Council in 1994 the CEECs were included in the Trans European Networks; see European Commission 1998g, p. 12.

<sup>78</sup> Harsay 1994.

<sup>79</sup> European Council 1999 (Agence Europe, 27 March 1999, p. 14).

<sup>80</sup> European Commission 1998f.

<sup>81</sup> *Ibid.* (article 6).

millions.<sup>82</sup> The rationale behind this idea is that a project should be big enough to be sustainable.

Similar to the PHARE contributions, proposals for ISPA financial measures are under review of the Commission. The Commission has to agree to a proposal that has been delivered by the country that benefits.

*Table 2: The structure of EU pre-accession aid to the CEECs*

	PHARE	ISPA
1 Beneficiary	• 14 CEECs	• 10 CEE candidate countries
2 Total	• DM 20 bill. (1990-99) • DM 20 bill. (2000-06)	• DM 14,2 bill. (2000-06)
3 Financed Areas	• infrastructure (mainly since 1995) • privatisation (mainly until 1995) • industrial restructuring • environment • qualification of employees	• traffic infrastructure • environment (alignment of legislation)
4 Principles	• focusing • subsidiarity (partially) (‘demand-driven-approach’)	• focusing • conditionality (partially) • subsidiarity (partially)
5 Actors	• Commission DG 1.A • PHARE Administrative Board • national PHARE Administrator	• Commission • national governments

#### 4.3 Promoting the CEECs: Already anything learned from East Germany ?

In this section I will examine how far the lessons developed under section 3.3 can already be found in the EU assistance for Central and Eastern Europe. Just to remind, the following principles have been developed under section 3.3: focusing of aid, subsidiarity, conditionality and regional differentiation.

The overview shows that only the principle of **focusing** financial measures is sufficiently fulfilled in the EU's pre-accession strategy for Central and Eastern Europe. The PHARE programme as well as the ISPA instrument concentrate their budgets on important measures such as the promotion of SMEs, qualification measures, and infrastructure projects. According to the European Court of Auditors, financial mechanisms in favour of

<sup>82</sup> Ibid. (article 2).

SME promotion led to the most positive effects of PHARE financing.<sup>83</sup> The principle of **subsidiarity** remains vague. Indeed, each instrument knows administrators at the national level but they only have limited decision-making power.<sup>84</sup> What is more, regional or local actors are hardly involved during the implementation process. It is not to be recommended that people who know the specific region best are excluded. The European Parliament directed the Commission to this point and required that in the future regional and local decision levels should be involved in managing PHARE and ISPA aid properly.<sup>85</sup>

**Conditionality** has been introduced with the new pre-accession instrument ISPA. ISPA provides the possibility to confer repayable loans whereas PHARE totally lacks this possibility. It can be assumed that the conditionality for ISPA measures together with a frequent ex-post-evaluation of the projects<sup>86</sup> should lead to a greater efficiency of disbursed financial aid.

Finally, it is not clear if the programmes pay attention to **regional differentiation**. In general, financial aid is best set up in agglomerations where spill-over-effects can be expected. The areas of Leipzig/Halle or Dresden are prominent examples for that. These facts are not considered by the programmes. PHARE makes a contribution to regional factors by the PHARE Cross-Boarder-Cooperation-Programme (CBC). But as the designation indicates, the CBC is not aimed at promoting agglomerations, but to facilitate the development of isolated boarder regions.

As this brief analysis elucidates, the principles that have been developed from the East German experience are not well integrated into the pre-accession concepts of the European Union so far. What is more, this identification is also partly true for the EU's structural policies.

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<sup>83</sup> European Court of Auditors 1998a.

<sup>84</sup> In contrast, Rupp (1999, pp. 102ff.) sees the PHARE programme as highly decentralised and the national administrators endowed with sufficient decision-making power.

<sup>85</sup> European Parliament 1999b, p. 6.

<sup>86</sup> This is envisaged in the Proposal of the Commission for a Council Regulation in Annex I, Article C.

## 5. CONCLUSIONS: POLICY RECOMMENDATIONS FOR FINANCING FUTURE ENLARGEMENTS

The final step consists of lessons - or policy recommendations - drawn from the empirical analysis beyond what the EU has done so far. What can we learn from financing the 'silent' EU enlargement in 1990 ?

Experience of financing East Germany shows again that the amount of money that is spent may not be the decisive factor for the reconstruction of transition countries. Aid in general should be 'efficient' and 'effective': these are the keywords that are often used.<sup>87</sup> On behalf of the Structural Funds, many authors have made proposals on how to reform these instruments, mainly in the light of future eastern enlargements.<sup>88</sup> These proposals often comprise the concentration of aid in terms of objectives, population, and geographically as well as the decentralisation of fund management. The analysis of financing East Germany has clearly specified the principles that may help to finance Central and Eastern Europe's reconstruction more effectively/efficiently. These principles are valid for EU measures as for national measures by the CEECs .

Proceeding from these principles the following policy recommendations can be made:

1. Favourable measures are those that promote spill-over-effects in agglomerations. Experience with East Germany shows that centre-periphery-effects account for essential economic profit.<sup>89</sup>
2. Financial aid should be focused on programmes that foster human capital formation, the establishment of SMEs and the modernisation of infrastructure.
3. Regional actors should become the most powerful decision-making bodies. The effectiveness of projects is best guaranteed if people, who are familiar with the region, can decide about the projects.
4. Financing should be made conditional. Conditionality guarantees a more careful calculation of beneficiaries and may help to avoid a 'subsidisation mentality'.

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<sup>87</sup> See for example Toepel 1998, pp. 466f; Funkschmidt 1997, p. 220; Stahl 1997, pp. 204ff.

<sup>88</sup> For example Bollen 1999; Martin 1998; Toepel 1998; Funkschmidt 1997, pp. 221f; Stehn 1997; Bachtler/Turok 1997; Samland 1997; Holtzmann 1997, pp. 660-672; Weise 1996.

<sup>89</sup> This argument was proved by Geppert (1997).

It has to be stressed that some fundamental practical problems occur in the CEECs that restrict the possibility to apply those lessons derived from the East German experience. As the Commission in their latest reports on Hungary and Poland for example points out, shortcomings in the coordination and transposition of regional policies are obvious. Both applicant countries are still underway of implementing adequate structures and institutions in order to take part in the structural funds after EU accession.<sup>90</sup>

To summarize, this paper has developed certain principles from the financing of East Germany, applied them to the EU programmes for the CEECs, and formulated some policy recommendations with regard to further eastern enlargements. This analysis concludes that lessons from financing East Germany are at least partly neglected when thinking about the problems of financing next enlargements. In the document AGENDA 2000, the Commission addresses the historical significance of the eastern enlargement and underlines that the expansion of the EU model of free nations to the whole of Europe will be a guarantor for stability.<sup>91</sup> "The more tangible the advantages of the enlargement are, the easier it will be to deal with the adjustment process and with the burdens for Community policies, including the financial dimension."<sup>92</sup> Investigating the experiences of East Germany could contribute to the mitigation of these financial problems, since Germany already underwent a revealing 10-year-process of "learning-by-doing".

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<sup>90</sup> European Commission 1999b, pp. 31f., 40f.; European Commission 1999c, pp. 31, 40.

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