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THE ECONOMIC IMPACT OF ENLARGEMENT ON THE EUROPEAN ECONOMY:
PROBLEMS AND PERSPECTIVES

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Abstract

Much of the attention on the economic aspects of the forthcoming enlargement of the EU have concentrated upon the high-profile issues which are linked to the level of relative economic development in the acceding countries; the perceived threat of large-scale migration and the budgetary costs arising from implementation of EU agricultural and regional policies. This paper briefly discusses that these are not insurmountable problems and stresses that the main difficulties from the next enlargement may arise from the effective inclusion of the acceding countries into the Single Market, the microeconomic hub of the EU. We discuss that the process of regulatory harmonisation will become more difficult in an EU of 25 or more members, which entails greater emphasis on the principle of mutual recognition as the main tool for ensuring freedom of movement of goods and services. However, mutual recognition has its limits and is likely to be less effective the more diverse the countries involved.

* Paul Brenton is a Senior Research Fellow at CEPS. He expresses his gratitude to Jacques Pelkmans for helpful comments.

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Introduction

The European Union is on the eve of a new enterprise. After the launch of the Euro, it is now time for shifting the Union's border to the East. The challenge facing the Union with the start of the eastern enlargement, the first wave of which should be decided at the end of 2002 and implemented during 2004-2006, cannot be underestimated. A region of about 100 million inhabitants will be integrated into the EU, but, given the existing income gap between the two halves of Europe, the Union's GDP will increase by only 5% after enlargement. Populations deeply rooted in European history will become again part of the continental *polis*, yet these same populations emerged from almost half a century of Soviet domination and planned economy only just over ten years ago. A complex net of similarities and differences make the eastern enlargement something quite different compared to previous episodes of EU expansion.

There are four key differences between this and previous enlargements that have an important bearing upon the way in which the economic impact of the next enlargement should be analysed:

The level of income in many of the applicant countries is considerably lower than that of existing members.

The applicants are in the process of transition from a centrally planned to a market economy. Much of the analysis of the impact of enlargement depends upon assessments (and assumptions) of the extent to which this process has been completed.

The volume of EU legislation that the new members are having to adopt is far more extensive than in previous enlargements primarily due to the creation and enhancement of the Single Market.

The extent of pre-accession integration is already substantial due to the provisions of the Europe Agreements which have not only led to the removal of tariffs and other border policies on industrial products but have provided for the adoption of a large number of EU regulations prior to enlargement. This entails that many of the benefits of enlargement are already being enjoyed (and that many of the economic costs arising from adjustment to the enlargement situation have already been borne).

The first point relates to the relative level of economic development in the applicant countries. The second point is a reflection of the particular historical circumstances of these countries. The second, third and fourth features are very much linked to the necessary conditions for successful integration into the EU and the steps that have been taken to meet those requirements. The Copenhagen criteria stipulated by the European Council encapsulates the importance of the transition process by requiring that new members must have:

- A functioning market economy;
- The capacity to cope with competitive pressure and market forces within the EU;
- The ability to take on all the obligations of membership.

These requirements all relate to the issue of the transition to a market economy and are not related to the level of income in the applicant countries. The EU does not place any conditions on applicants concerning the level of economic development. However, the level of economic development lies at the heart of the high profile enlargement issues which have received most attention from policy makers and the media; migration, agriculture, the structural funds and budgetary issues. We will briefly review existing studies of these issues and analyse the extent, and the ways in which, these will cause problems in the enlarged EU. Careful analytical work shows that all of these issues are more than manageable in an enlarged EU and should not cause substantial *economic* problems to the Union as a whole. Difficulties arise because impacts are concentrated on particular members, creating *political* problems.

Our attention in this paper then turns to a more detailed consideration of the issue of the transition and enlargement. Given their different levels of income do the applicant countries have economic and institutional structures, which will allow them to effectively participate in the European Union and contribute to the policies and objectives of the Union? The criterion of a functioning market economy and the ability to withstand competition are amenable to relatively objective assessment, which indeed has been the aim of the Commission's regular opinions on the applicant countries. The third criteria, the ability to take on the obligations of membership, is however, more difficult to define and assess. This reflects in part that, although the pre-accession period has seen a tremendous effort by the applicant countries to adopt EU legislation, there are a number of key policies the nature of whose implementation will only become apparent *after* enlargement. Nevertheless, it is opportune now to consider potential problems that may arise and the implications of these for the enlarged Union.

Here we focus on whether the accession of the Central and Eastern European countries will have an important impact on the coherence of the Single Market and whether it will undermine or contribute to the objective defined by the Lisbon council of making the EU the most competitive and cohesive place in the world to live and to do business. We concentrate especially on the difficulties that may arise with regard to product regulations and technical barriers to trade, a key element of the Single Market. Finally, having discussed the potential economic problems that may arise from the next enlargement over the next 10 years or so we then briefly discuss what comes next. Is there scope for further integration in Europe and an intensification of economic ties between perhaps 25 EU members and to what extent will enlargement constrain or facilitate any further deepening of integration in Europe.

Enlargement and the Level of Income in the Applicant Countries

The last two enlargements were, first, to the South, and then, to the North. The accession of Greece, Portugal and Spain in the 1980s brought relatively low-income partners in the Union, and this changed the economic geography and the budgetary structure of the EU. However, both the population dimension and the average income gap of the countries then involved in the southern enlargement were about half those relating to the current candidate countries. The Northern Enlargement of the 1990s actually raised the average per capita income of the

EU, and the accession of Austria, Finland and Sweden brought a net positive contribution to the Union's budget.

This time the picture is completely different. The incoming members of the EU are, and will be for quite a few years, significantly poorer than the existing members. Their average wages are lower than in the incumbents; hence there could be an incentive for workers to move westward, and for capital to go eastward. Their core inflation rates will be higher due to structural transformation and their net contribution to the EU budget will be persistently negative. Of course, all this will impact on a number of EU policies and institutions, in the fields of migration and border flows, financial and budgetary provisions, monetary policy and the working of the ECB and trade and investment flows. Here we consider the key microeconomic policies relating to agriculture, migration and structural funds expenditures and bring the analysis together to consider implications for the EU budget.

Migration

This is perhaps the most widely discussed of the perceived problems of enlargement but which in practice is likely to be of minor significance for the Union as a whole. Migration is seen to be an important problem because the very large income gap and the relative proximity of the applicant countries appear to convinced many of the scope for substantial flows of workers from the east to the west of Europe. Nevertheless, the consensus from economic studies, which take a more considered view of the factors leading to migration, is that enlargement is unlikely to have a serious impact upon jobs and wages in the EU as a whole. CEC (2001) estimate that the cumulative net inflow of migrants from the east will amount to less than one per cent of the working population of the EU 15 in 2009, such flows cannot be expected to have a major impact on the EU as a whole. It is worth noting that as economic integration between the EU and the CEECs intensified during the 1990s the number of migrants from the east declined. According to the University of Kent, while 330,000 moved to the EU in 1990, by 1997 the total was less than 14,000.[1]

Although, the aggregate effects will be small they will be concentrated on particular countries and regions, especially, Germany and Austria. Thus, for example, in 1998 for the EU as a whole, (legal) immigrant workers from the CEECs accounted for 0.2% of total EU employment. However, around 80% of such migrants reside in Germany and Austria, accounting for 0.5% and 1.1% respectively of national labour forces, with even higher concentrations in particular regions (CEC (2001)). This is the problem that is faced by the EU, how to adjust to regionally concentrated problems to maintain general support for the enlargement. This is politically difficult but feasible to solve and has so far been addressed in terms of transition periods during which the completely free movement of labour will remain suspended to allow the receiving regions time to adjust.

Agriculture, Structural Funds and the Budget

The other issue that has received much attention is the financing of the next enlargement. Agriculture raises its head as a prominent issue, not only because it is one of the main policies of the EU in budgetary terms, accounting for around 40% of EU expenditures, but also because in many of the applicant countries, reflecting low levels of income, agriculture remains a major sector, at least in terms of employment. Similarly, transfers under the

[1] http://news.bbc.co.uk/1/hi/world/europe/1912956.stm

structural funds will be an important element in promoting cohesion with the new members states but imply substantial transfers given the low levels of income in the East.

A major concern is whether the enlargement will place undue budgetary pressures on the existing members who will have to finance transfers to the East via the CAP and the structural funds. Numerous estimates exist of the cost of extending to the new member states these two EU policies. A number of recent studies converge on figures of around €10 billion annually for the cost of extending the CAP to the first wave of eight candidates from Central and Eastern Europe. The Berlin Council decided that the absorption capacity of the structural funds should be 4% of GDP for the Central and Eastern European members. Allowing for their contributions to the EU budget, the net transfers that the new member states can expect under the current rules would be about 3% of their GDP, which entails a transfer under the structural funds of below 10 billion Euro.

Therefore, following Gros (2001) a rough rule of thumb would be that enlargement could imply a net transfer to the East (from the current EU-15) of about €20 billion. This represents about 0.3% of the GDP of the EU-15, or less than one per cent of total public expenditure in the EU-15. Enlargement will thus not bankrupt any government. Nor will enlargement blow the ceiling on the EU budget, which has been set at 1.27% of GDP (equivalent to about €100 billion given a GDP of the EU-15 of around €8000 billion). As the EU is currently spending only around €80 billion it would be possible to accommodate an increase of about €20 billion without breaching this ceiling. All in all it thus appears that enlargement should not put an unbearable strain on the EU budget. The problem will be who will pay for the enlargement. At present this has not been resolved and remains the real issue with regard to the budgetary cost of enlargement.

The main problem with regard to agriculture is that enlargement makes an ill-designed policy even more unsustainable in the light of global trade commitments and the desire to conclude a new trade round, following increasing demands from consumers for a change in the nature of agricultural production and the increasing emphasis on environmental sustainability and rural development. Enlargement has not created any of these issues but does add to them and increases the imperative to reform and redesign the CAP to effectively meet modern and achievable targets for the agricultural sector in conjunction with other European and global policy objectives.

To conclude, the next enlargement requires the inclusion of a large number of relatively low-income countries into the Union. Since the two key policies of the Union involve transfers which are either directly or indirectly linked to the level of income and economic development this entails a substantial increase in demands upon the EU budget. However, under plausible scenarios it does not appear that these demands will undermine the EU budget. The difficult issue is upon whom will the burden of funding enlargement fall. Similarly, with regard to migration, the impact for the EU as a whole is unlikely to cause substantial problems. However, the impact will be concentrated upon particular countries and regions. So, these income-related problems related to enlargement are not insurmountable. However, the pre-occupation with the financial costs of enlargement and the ill-perceived threat of mass-migration has led to other potential problems related to the next enlargement being overlooked. We now proceed to suggest that paramount among these is consideration of how the new members will affect the day to day operation of key elements of the Union, and in particular, the Single Market.

Enlargement and the Cohesion of the Single Market

Many of the direct economic benefits of EU membership, in terms of enhanced trade and investment relations, have already been reaped. This reflects that a range of barriers to trade and investment between the EU and applicant countries has already been removed in the context of the free trade (Europe) agreements that were signed in the early and mid-1990s. Formal trade barriers (tariffs and quantitative restrictions) in the EU to imports of industrial products from the CEECs have now been completely dismantled. A similar situation exists in all the applicant countries in Central and Eastern Europe. Agriculture, as always, is a notable exception, where trade restrictions will remain until the date of enlargement. As Brenton and Manzocchi (2002) argue to all intents and purposes the transition with regard to trade and investment is over in those countries that will shortly join the EU. If one examines the trade and foreign investment features of these countries in ignorance of history then there is nothing that identifies them as being different from market economies.

With trade between the EU and the applicants largely free of formal trade barriers and adjustment to this policy environment already completed the economic impact of the next enlargement of the EU revolves around participation in the Single Market of the EU. The key feature of the Single Market is its attention to non-border regulatory policies which, although not necessarily their primary intent, may act as a substantial impediment to trade. For trade in goods the principal issue, and the main remaining obstacles to trade, are technical barriers, which arise from the implementation of regulatory policies by governments, concerning for example, safety and health issues and from voluntary standards adopted by domestic industries. Similarly for services the key issues relate to differences in regulatory regimes across countries which constrain the ability of firms to effectively operate on a European-wide basis.

In this section we examine the possible impact of the accession of the Central and Eastern European Countries on the operation of the Single Market. Since the implementation of regulatory policies lie at the heart of the Single Market effective participation requires a certain level of suitable infrastructure and administrative and legal capacity to implement the range of regulatory instruments that are necessary to support markets for goods and services. In terms of the next enlargement and the effective operation of the Single Market, this is the key dimension of the transition that needs to be addressed. To what extent will the application of regulatory policies in the enlarged Union act to segment markets and constrain and compromise the level of economic integration that has been achieved between the current members?

The Single Market is the microeconomic core of the Union, if the enlargement were to seriously undermine or weaken the Single Market then this would constitute a substantial, but unquantifiable, cost of enlargement. At the same time the EU is placing greater emphasis on enhancing the Single Market and increasing further the degree of integration in Europe. A completely integrated market is seen as essential in enhancing the competitiveness of the EU relative to the US. We now proceed to describe the key mechanisms by which the EU has sought to create a Single Market and then briefly examine why there is a belief that the Single Market programme can be more effectively implemented. In the next section we consider some of the broad implications of enlargement for the Single Market and then assess to what extent the objective of achieving perfectly integrated markets for goods, services and capital in Europe can actually be met.

The Single Market and Trade in Goods

The awareness that differences in national regulations and their application could be an important barrier to economic integration has been an important part of EU policy since the inception of the EEC in the 1950s with even greater emphasis having been given to this issue under the Single Market programme. The Treaty of Rome prohibited 'quantitative restrictions on imports and all measures having equivalent effect' (Art. 30 (28)), although, and this is very important, this was qualified to allow exemptions from this obligation for a range of public policy and security issues. We discuss these exemptions in a little more detail below. In practice one of the key areas of regulation that has affected trade between members states has been rules governing the placing of products on the market, often for health and safety reasons, and the testing of products for conformity with those regulations. Barriers to trade can arise when countries regulate for the same risks but in different ways and when products must be tested for conformity with each differing set of national rules.

The basic EU approach to this issue of differences in national regulations is the principle of mutual recognition, which was developed on the basis of European Court of Justice case law, specifically, the Cassis de Dijon and Dassonville judgements. The mutual recognition approach is based on the idea that products manufactured and tested in accordance with a partner country's regulations can offer equivalent levels of protection to those provided by corresponding domestic rules and procedures. Thus, products produced in partner countries can be accepted without the need for further agreement with the presumption that they will not undermine basic regulatory objectives concerning health and safety and so on. Governments maintain substantial freedom to apply their own rules to domestically produced products but have to accept products produced to rules stipulated elsewhere. Hence, the application of the mutual recognition principle requires a degree of trust between different countries and regulatory authorities that another countries regulations can offer equivalent levels protection and that such regulations are effectively implemented ensuring that products actually conform to the requirements of the regulations. The principle of mutual recognition is the hub of the Single Market since it provides for the free movement of goods (and services, as we shall discuss later) without the general necessity for regulatory harmonisation.

Despite the basic principles of non-discrimination and free circulation of goods, services people and capital the EU has always permitted what are deemed as legitimate restrictions on trade. Article 36 of the Treaty of Rome provides for restrictions on imports for reasons of 'public policy or public security' and protection of health as long as such restrictions are not a disguised restriction on trade. In such cases the onus is on the importing country to demonstrate that lack of equivalence of regulations is undermining public policies towards, for example, human health. In practice the European Court of Justice has accepted lack of equivalence on many occasions and, significantly, has not required conclusive proof of a threat to human health or other public policies for the refusal to accept a product legally available elsewhere in the community, accepting in effect that the precautionary principle is sufficient (Holmes and Young (2001)).

A key element in the application of the principle of mutual recognition has been the development of mechanisms at the EU level for disciplining national regulations and interventions into product markets. There are three means by which the EU can affect national regulations (Pelkmans et al (2000)):

- Infringement procedures whereby the Commission acts to enforce Community law. These are important provisions whose existence can have important disciplinary effects and where case law can establish clear interpretations of relevant statutes. Nevertheless, such procedures are very time consuming and costly, have an impact only after the event and are ad hoc in nature. As such they are insufficient to prevent the creation of barriers to free movement of goods (Pelkmans et al (2000)).

- Notification procedures whereby member states are required to notify all draft technical regulations for scrutiny by the 94/34 Committee, whose objective is to prevent new regulatory barriers to trade. In practice all new national regulations of EU members states have to pass an EU test regarding their impact on the free movement of goods.
- Notification of derogation procedures that require member states to notify cases in which they wish to prevent the sale of goods lawfully produced or marketed in another Member State on the grounds of non-conformity and non-equivalence with domestic requirements. This seeks to ensure that any derogation from the principle of mutual recognition is transparent and subject to scrutiny.

Where it is clear that ‘equivalence’ between levels of regulatory protection embodied in national regulations cannot be assumed, the EU approach to removing technical barriers to trade is for the member states to reach agreement on a common set of legally binding requirements. Subsequently, no further legal impediments can prevent market access of complying products anywhere in the EU market. EU legislation harmonising technical specifications has involved two distinct approaches, the ‘old approach’ and the ‘new approach’.

The old approach mainly applies to products (chemicals, motor vehicles, pharmaceuticals and foodstuffs) by which the nature of the risk requires extensive product-by-product or even component-by-component legislation and was carried out by means of detailed directives. In the main achieving this type of harmonisation was slow for two reasons. First, the process of harmonisation became highly technical, with attention being given to very detailed product categories including components. This resulted in extensive and drawn-out consultations. Secondly, the adoption of old approach directives required unanimity in the Council, which meant that the issuing of directives was a slow process. The limitations of this approach as a broad tool for tackling technical barriers to trade become clearly apparent in the 1970s and early 1980s when new national regulations were proliferating at a much faster rate than the production of European directives harmonising regulations (Pelkmans (1987)).

These weaknesses have been addressed through the adoption of the ‘new approach’ whereby EU directives only indicate the ‘essential requirements’ that must be satisfied which leaves greater freedom to manufacturers as to how to satisfy those requirements, dispensing with the ‘old’ type of exhaustively detailed directives. The new approach directives also provide for more flexibility than the detailed harmonisation directives of the old approach by using the support of the established standardisation bodies, CEN, CENELEC and the national standard bodies. New approach directives are adopted by a qualified majority in the Council.

The Single Market and Trade in Services

Application of the principle of mutual recognition also lies at the heart of attempts to integrate the markets for services in the EU. For certain sectors, such as financial services, negotiated mutual recognition is a better description since integration is based upon a degree of regulatory approximation of national prudential requirements together with mutual recognition of regulatory authority, normally referred to as home country control. The essence of the system is that the operations of a financial institution throughout the EU, whether provided across borders or through establishment overseas, is regulated by the government of the state in which it has its headquarters. In principle such a system should avoid financial institutions having to satisfy different regulatory requirements in each of the countries in which they operate.

However, as in the case of goods, exceptions are permitted to the general requirement of mutual recognition of services. For example, in the case of financial services the Second Banking Directive defines that 'Member States must ensure that there are no obstacles to carrying on activities receiving mutual recognition in the same manner as in the home member state, as long as the latter do not conflict with legal provisions protecting the general good in the host member state' (see CEC (1997)). The Second Banking Directive does not, however, provide a definition of the 'general good' or stipulate limits or conditions under which member states can impose 'general good' rules on community financial institutions.

Hence in areas without explicit harmonisation at the EU level the definition of the general good varies between member states and is influenced by national traditions and national policy objectives. The Court of Justice, through its case law, has specified areas that can be considered to be in the public good. This open ended list currently comprises: protection of the recipient of services; protection of workers, including social protection; consumer protection; preservation of the good reputation of the national financial sector; prevention of fraud; social order; protection of intellectual property; cultural policy; preservation of national historical and artistic heritage; cohesion of the tax system; road safety; protection of creditors; protection of the proper administration of justice (CEC (1997)). National rules adopted in these areas can be enforced upon a community company based in another member state provided that the area has not been harmonised at the EU level, that such rules are applied in a non-discriminatory way, that there is an overriding requirement for them in the general interest, that they are relevant for attaining the objective for which they are imposed and do not go beyond what is necessary to attain that objective.

It is important to note that financial services do not appear to be subject to the same notification requirements as goods, where, as noted above all, new technical regulations and derogations from free movement have to be notified to the Commission. There is no counterpart to the 98/34 committee for services. Thus, the disciplining effect of notification and EU level scrutiny of new regulations is absent for services. In addition, for financial services, companies are often wary of bringing a problem to the attention of the Commission for fear of undermining their relationship with the regulatory authorities of the country that is constraining trade. This entails that mutual recognition is likely to be less effective in removing barriers to trade in services in the EU.

The Single Market in Practice

How effectively is the Single Market working in the current EU of 15 member states? The European Council has identified the Single Market as being a key element in economic reform and in achieving the Lisbon objectives. In this context substantial problems remain. Again, it is useful to examine the goods and services sectors separately. For goods, the New Approach to harmonised standards at the European level has been undermined by the slow development and adoption of European standards implementing the agreed minimum standards under New Approach directives. CEC (2001) reports that CEN (one of the European Standards Organisations) takes around 8 years to draft and obtain consensus on a European standard. As a result between April 1998 and May 1999 the European standards bodies ratified only 40% of the mandated standards and nearly five times as many national standards were adopted (Holmes and Young (2001)).

The Commission also recognises that there are problems with the application of the principle of mutual recognition (CEC (2000)) and that these difficulties appear particularly in the new technology sectors and for complex products. Evidence from businesses suggests that many firms will still adapt their products to satisfy different technical specifications in other markets rather than seeking the application of mutual recognition. This reflects, in part, uncertainty about the effectiveness of the available measures in enforcing mutual recognition and expectations about the time taken to change the actions of national administrations either through persuasion or through judicial process. Weak administration and uncertainty by national administrators leads to a very cautious application of the principle of mutual recognition. CEC (1999) reports an average length of procedure for cases of infringement of mutual recognition of 15.5 months for cases initiated between 1996 and 1998. During this period 228 cases were initiated. According to a survey of industry in 1998 some 80% of businesses reported that there were still obstacles preventing the full benefits of the Single Market from being exploited, with differences in standards and technical regulations being mentioned by 41% of respondents and problems with testing, certification and authorisation procedures being identified by 34% of the sample (CEC (1999)).

The general view seems to be that obstacles to cross-border trade in services in the EU are much more substantial than those to trade in goods. Traditional measures of integration, such as the share of intra-EU trade relative to GDP, provide little clear evidence of an increase in the intensity of cross-border trade and competition in services in recent years (CEC (2000)). Trade in financial services in Europe takes place primarily through physical establishment in another Member State. Mergers and take-overs, rather than cross-border supply, have tended to be the main vehicle for change in European financial markets.

EU financial markets are undergoing a period of substantial change following the introduction of the Euro, substantial technological change and regulatory initiatives. Whether these will combine to generate a genuine single market in financial services and a large European investment area remains a key issue. A number of important developments have taken place (Danthine et al (2000), CEC (2001)). A corporate Eurobond market has emerged of comparable size to that of the dollar market. European firms are increasingly turning to stock markets for funding via equity issues. EU companies newly admitted to European stock markets raised twice as much capital in 2000 than in 1999.

Some researchers detect a fundamental change in the nature of European investment portfolios with an increasing share of foreign equities (Danthine et al (2000)) whilst others find little evidence that country specific factors have declined in importance in defining European portfolios (Rouwenhorst (1998)). Heinemann (2002) notes that whilst the market for investment funds in the EU has been growing strongly, national markets remain dominated by domestic fund companies. Wojcik (2001) looks at the extent and nature of cross-border corporate ownership in Europe and concludes that the level of capital market integration in Europe remains low and that 'the contours of national borders on the map of the European capital markets are still very sharp'. These border effects reflect that the conditions of foreign ownership differ between countries with particular emphasis being placed on the role of corporate governance.

Enlargement and the Single Market in Europe

Thus, there remain substantial problems within the EU, where there is an extensive infrastructure, in completing the Single Market. Removing remaining constraints upon the free movement of goods, services, capital and labour have been put at the heart of the policy drive to achieve the Lisbon objectives of substantially raising productivity in the EU. Clearly, the efforts of the existing members to effectively implement the Single Market must increase in the context of enlargement since the accession of between 8 and 10 new members will substantially increase the pressures on the Single Market and stretch the abilities of the Commission to monitor and ensure compliance with harmonised directives and the principle of mutual recognition.

The Europe Agreements between the EU and each of the candidate countries in Central and Eastern Europe provide for the widespread approximation of relevant laws in the CEECs with EU internal market legislation. These provisions have become of particular importance given the subsequent drive towards membership of the EU and the requirement that the applicant countries adopt the legal and institutional framework of the EU, *the acquis*. Thus, the implementation of EU directives relating to technical regulations has become an essential element of the accession process.

As part of this process the EU has accepted that the CEECs should be granted sectoral access to the Single Market prior to accession if the necessary changes to their domestic legislative systems have been made and implementation of regulations and the EU system of testing and conformity assessment is deemed to be satisfactory. Even when the relevant EU laws relating to technical regulations have been adopted in the CEECs, technical barriers will remain if duplication of conformity assessment procedures persists.

The process of achieving access to the Single Market prior to accession is governed by mutual recognition agreements called the Protocols on European Conformity Assessment (PECAs). Following the satisfactory alignment of laws, individual CEECs can negotiate sectoral access to the Single Market, subject to the technical competence of conformity assessment bodies being of a level equivalent to that in the EU and the acceptance by both parties of the results from notified conformity assessment bodies.

The European Commission has concluded agreements with Hungary and the Czech Republic both of which cover machinery, electrical safety, electromagnetic compatibility, gas appliances, hot water boilers and good manufacturing practice for medicinal products. The Hungarian agreement covers in addition good laboratory practice for medicinal products and medical devices whilst the agreement with the Czech Republic also includes personal protective equipment and equipment for use in potentially explosive atmospheres. Products from these sectors that satisfy conformity assessment by any notified body in the EU or the CEECs will have freedom of movement in the EU and the country concerned. The EU has also signed a framework agreement, which covers general principles, with Latvia and is negotiating PECAs with Estonia, Lithuania, Slovenia and Slovakia.

The PECAs have primarily been concerned with those sectors where technical regulations have been harmonised in the EU and have concentrated on New Approach sectors. Thus, the pre-accession commitments of the CEECs have involved the adoption of EU New Approach directives and the standards issued by CEN, CENELEC and ETSI. Little or no progress has been attempted on non-harmonised sectors where the principle of mutual recognition operates in the EU (CEC (1998)). Hence, for certain products access to the Single Market will only be delivered, at the earliest, with accession. The basic principle underlying the operation of the Single Market, that of mutual recognition, will not be applied until after accession, and so there is no clear means of assessing now how effectively mutual recognition will operate after enlargement.

This discussion of the EU approach to technical regulations, which is an essential element in the working of the Single Market, raises a number of issues regarding the post-enlargement situation and, in particular, the impact that enlargement will have on the Single Market. Most of the applicant countries have made enormous progress in adopting the relevant EU regulations regarding the placing of products on the market and in upgrading testing and conformity procedures to similar standards in the EU (precise details for four of the applicant countries are available in Brenton and Manzocchi (2002)). This is a key element of the pre-accession process. However, as stressed by Pelkmans et al (2000) the durability of the Single Market turns on implementation and compliance with Single Market provisions and the effectiveness of remedies that can be applied in cases of non-compliance.

With regard to the enlargement, we first of all note that the harmonisation process will become more difficult and probably slower since discussions of minimum technical requirements will take place amongst 23 to 25 members rather than just 15 with a much greater variance in incomes, traditions and national policy objectives. Thus, whilst there may be greater emphasis on the need for new approach directives for a broader range of products and issues, the ability of the harmonisation procedure and then the standardisation process to effectively and quickly deliver the necessary standards is at best uncertain. We still do not have a precise idea of the extent to which the new approach is working to actually remove technical barriers and stimulate trade between existing member states. Evidence from surveys of businesses suggest that even in the current EU of 15 substantial barriers to cross-border trade remain due to the presence of national technical requirements and their application.

Standardisation remains a slow process and cumbersome process which together with the commitment to reduce the regulatory burden on businesses suggest that increasing emphasis will have to placed upon application of mutual recognition. On the other hand, the enlargement of the Union to 25 members and the increase in diversity that this implies is likely to make general application of the principle of mutual recognition more difficult and more contested. Administrative capacity is a key element in the application of the principle of mutual recognition. Although it is important to note that mutual recognition is a principle and not something that can be directly legislated. CEC (2000) states that ‘Member States must ensure that appropriate administrative and judicial means exist to enforce Single Market rules properly, including adequately staffed and trained market surveillance and enforcement authorities and that adequate means of redress and appropriate sanctions are available and sufficiently known to economic operators’.

Members require a system that can recognise that equivalent levels of protection are being offered by the regulatory systems of fellow members. How long it takes to establish such a system and the preconditions for its effective operation are unclear. What can be said is that the effective operation of the principle of mutual recognition requires a degree of trust between regulatory authorities and in the testing systems whose role is to ensure conformity with the relevant technical requirements. How long it takes to engender such trust is not clear. Thus, it is very difficult to objectively assess to what extent the applicant countries will be ready to effectively implement the principle of mutual recognition.

Enlargement and Deeper Integration in Europe

The EU is one of the most integrated groupings of countries in the World. From the outset, and recently enhanced by the completion of the Single Market, the EU has gone beyond the simple removal of commercial policy instruments that constrain trade at the border, such as tariffs and quotas, to address behind the border barriers to trade resulting from the application of regulatory policies, such as product regulations, environmental regulations, sanitary and phytosanitary standards, state aids, the protection of intellectual property, and so on. Nevertheless, the EU is far from a perfectly integrated economic area. For both goods and services, and financial flows, trade between European countries is quantitatively small relative to similar exchanges within national boundaries. In highly integrated markets we should not be able to detect any impact from national borders, the propensity to trade internationally with citizens of other countries should be the same as that to trade internally with citizens of the same country of residence. This is the benchmark of perfect integration. However, in practice it appears that borders still loom very large (Brenton (2002)).

The crucial issue emanating from this empirical finding is to identify the factors that lie behind this border effect. In particular, are there impediments which can be broken down, suggesting that there is considerably more, and much more than we have already experienced, globalisation to come? Or, can we discern whether there are factors that will always constrain and limit the extent of global integration? A second issue is whether the removal of such barriers, if feasible, will lead to the sort of productivity gains that have been achieved from dismantling formal trade barriers or have the principal gains from trade already been reaped. In the context of the future of the EU this debate revolves around the issue of whether efforts towards further integration can contribute to the Lisbon strategy of raising productivity and competitiveness in Europe.

So what factors could be constraining cross-border integration in Europe. In general, one of the main reasons for the economic impact of the border is that movement across a national frontier, even those in the EU where, with the Single Market, there are no border formalities and only empty border posts, entails movement into a different legal, regulatory, social and cultural jurisdiction. These borders ‘proscribe, adjudicate and enforce a wide range of norms, rules, habits, networks and the like’ (Thompson (2000), p4), which differentiate one geographical area from another, in terms of both consumers preferences but also the legal and institutional environment for doing business.

More specifically, tastes differ across countries. Domestically located firms will tend to have better knowledge of local tastes and more generally firms will tend to locate close to markets to avoid trade costs. This effect will be magnified if intermediate goods producers co-locate with final goods producers (Hillberry and Hummels (2000)). Even if consumers in different countries have identical tastes for products they may still have different preferences for the way that these products are packaged and marketed, which will add to the costs of international trade. Engel and Rogers (1999) suggest that one of the factors behind the border effects in consumer prices that they identify in Europe will be differences in national marketing and distribution systems.

It is also suggested that both consumers and producers tend to have a preference for purchasing products produced in their own country. Indeed, there is a large literature in the context of marketing that documents the presence and importance of home bias on the basis of consumer surveys (see, for example, Knight (1999)). More generally, systematic evidence on home bias in preferences is sparse. But if home bias in preferences is a genuine phenomenon and reflects actual desires on the part of consumers then policies that seek to undermine such bias and to promote further trade are unlikely to be welfare improving.

In this context the application of the principle of mutual recognition plays an important role in Europe. CEC (1999) argues that the application of mutual recognition is ‘consonant with the idea of a dynamic approach to the application of subsidiarity; by avoiding the systematic creation of detailed rules at Community level, mutual recognition ensures greater observance of local, regional and national traditions and makes it possible to maintain the diversity of products and services which come onto the markets’. In short, mutual recognition preserves the multiformity of tastes and preferences in Europe and allows consumers to effect any bias towards locally produced products. Detailed harmonisation and, to a lesser extent, the specification of minimum standards under the new approach, act to undermine nationally disparate preferences by reducing the degree of permissible product differentiation and so suppress diversity.

Thus, although there are clearly additional gains to be had from the more effective implementation of the principle of mutual recognition in Europe there are limits to the extent to which this process will increase economic integration. Similarly, Holmes and Young (2001) argue that a key feature of the EU's regulatory approach is that progress with market integration has been possible only by allowing members to pursue their own legitimate public policy objectives such that a significant degree of variation in rules between members is permitted. In other words the EU approach of mutual recognition allows national diversity to be accommodated, to a certain degree. They argue that the EU is reaching a 'logical limitation' in that market integration is only possible if some degree of national variation is permitted but such variation constrains integration. The further that integration progresses the more intractable will be the national variations that remain. Thus, on the one hand, mutual recognition will play a crucial role in an enlarged EU allowing the accession of diverse countries to the Single Market. On the other hand, by increasing diversity in the Union and raising the number of legitimate national public policy objectives, enlargement may constrain the future level of integration in the EU. The immediate priority for the EU after enlargement will be to ensure that there is not a retrenchment from the current level of integration.

Conclusions

Most discussions of the problems that will arise from the next enlargement focus on the high profile issues that are related to the level of income in the applicant countries; migration, agriculture and the budget. However, none of these issues appears to create insurmountable problems for the current 15 members as a group. The difficulties arise because they are likely to be significant for some members and not others. Equally relevant is the extent to which enlargement will affect the ability of the EU to achieve its key objectives. Here we have briefly considered the impact of enlargement on the integrity of the Single Market and at least raised the issue of how enlargement will affect the key principle of the Single Market, that of mutual recognition. If enlargement makes the Single Market less effective through erosion of this basic principle then the achievement of the Lisbon strategy will be compromised.

In addition, mutual recognition has its limits, in terms of the level of integration that it can provide for, which in turns has implications for the future direction of the EU. On the one hand mutual recognition is a powerful tool for undermining barriers to trade in goods and services whilst avoiding the need for detailed harmonisation and extensive EU level intrusion into national policy making. On the other hand, mutual recognition preserves a degree of national differentiation and allows national governments to implement specific policies to protect 'the national good'. It is unlikely that the EU could have achieved the level of integration that it has attained today without the use of the principle of mutual recognition as the main tool for undermining national segmentation in Europe.

Now EU policy makers want to enhance the Single Market to achieve the bold objectives defined at Lisbon. Clearly, there is scope to make the Single Market work more effectively. This is particularly true for the service sectors, where enhanced integration will not only generate direct economic benefits but will also lead to gains in manufacturing and agricultural sectors where services are a vital input into modern processes. Nevertheless, there are limits to the extent that mutual recognition can integrate the markets of different countries. Whether efforts to increase the effectiveness of mutual recognition will be sufficient, particularly in the light of enlargement, to achieve the Lisbon objectives remains to be seen.

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