IMPLICATIONS FOR THE ACCESSION COUNTRIES OF THE REJECTION OF THE EU CONSTITUTION[*]

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The rejection of the EU Constitutional Treaty by the French and Dutch electorates has profound implications for the European Union, its existing members and its accession candidates. The two referenda indicate that public opinion in Western Europe is more wary of deeper European integration and more anxious about enlargement than had seemed the case in the euphoria of May, 2004. The leaders of the existing Union are, therefore, likely to proceed more cautiously on both fronts. In some cases, accession will be postponed, in many the doors to immigrant workers will be partially closed, in all, structural funds in support of accession risk being reduced.

This paper will address two implications of the May/June 2005 referenda for the accession countries which are the closest to entering the Union. These countries have no alternative but to continue to pursue accession as an over-riding priority. First, I shall argue that what the changed circumstances call for in these countries is a renewed commitment to policies of market opening and structural reform. Whether the objective is to catch up with a missed deadline, or to ensure successful integration, the aggressive pursuit of enhanced competitiveness is an even higher priority than it was before May/June 2005. My second point will be that the Union will be an unfinished project when these countries enter, and that they should prepare to engage actively in the cooperative effort to complete the construction.

1. The importance of pro-market reforms

In Romania and elsewhere, analysts of accession frequently weigh the benefits versus the costs of integration into the Union[1]. A moment of economic reflection suffices to demonstrate that the potential, long-term benefits for the accession country are at least of the order of magnitude of the current level of GDP. When a country in which the average monthly wage is 150-200 Euros integrates a region in which the average monthly wage is 2000 Euros or more, the forces of convergence are such that, not instantly, but in a limited number of decades, the real wage in the acceding country has the potential to catch up with the real wage in the larger region. That means, by itself, a potential for the labor share of GDP roughly half of the total in most accession countries to increase ten-fold, over time. Even if one discounts for the decades the convergence will take, this implies that the present discounted value of the benefit of integration is roughly equal to current GDP[2].

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[1] *See, for example, Ciupagea et al. (2004). They compare the benefits of accession in 2007 with accession in 2009/2010, and find earlier accession preferable.*

[2] *If the average duration of convergence is 30 years, and the discount rate is 5%, a five fold multiplication of real GDP i.e. a 400% increase – is roughly a 100% increase in present discounted value.*

How does this potential benefit compare with the cost? The costs of integration into the European Union are of two different kinds: direct, budgetary costs, on the one hand, and transitional, structural adjustment costs, on the other. The budgetary costs include contributions to the EU budget, and the costs of catching up to EU standards, as regards infrastructure and the environment. It is reasonable to assume that, during most of the convergence period, accession countries will be net recipients rather than net contributors to the EU budget. (Their direct contributions will be compensated for by subsidies from the EU's structural funds and from the Common Agricultural Policy.) Investments in infrastructure presumably pay for themselves over time. The costs of catching up to environmental norms are, however, a net burden to the economy. The World Bank has estimated that these environmental clean-up costs may reach 2% of the GDP of the accession countries for a number of years. If they are 2% for ten years, the present discounted value of the total environmental clean-up cost will be 16% of each accession country's initial GDP[3].

There remain the transitional costs of structural adjustments principally the time spent in unemployment by workers and managers laid off in inefficient plants and uncompetitive industries. The magnitude of these costs is difficult to estimate. They are likely to be concentrated at the beginning of accession, and to be born by the public at large, rather than by the owners of the new and expanding firms. They are therefore a legitimate matter for public concern. But they are bound to be a fraction of the present discounted value of the potential gains. If unemployment were 10% higher than it otherwise would have been for five years, the loss in the present discounted value of labor income would be less than 25% of GDP[4]. Adding these transitional costs to the costs of environmental clean up, one obtains an upper estimate of 40% of GDP for the present discounted value of the total cost of integration into the EU. These illustrative calculations suggest that the ratio of potential, long-term benefit to cost could be two or three to one.

However, in order to realize this net benefit, the accession country must be competitive. If its leaders view integration into the EU as an opportunity to receive subsidies that will allow them to postpone painful adjustments, the country is more likely to stagnate than to experience rapid growth. This is all the more true in the likely present context of tighter EU budgets.

The lessons of earlier enlargement experiences are informative, in this regard. The most interesting examples for Romania are those of the accession of Greece (1981), and Portugal and Spain (1986)[5].

There are common threads with some similarity to the histories of the formerly Soviet countries in political developments in the three countries prior to accession. The collapse or overthrow of authoritarian regimes the generals in Greece, Salazar in Portugal and Franco in Spain opened the way to membership in the EEC. But the domestic economic policies implemented by the leadership of these countries after accession were markedly different.

In Portugal and Spain, new democratic governments, freed prices,

[3] *This assumes, again, a real discount rate of 5%.*

[4] *By reducing labor income, the additional unemployment mechanically reduces GDP by roughly 5% each year. Discounted at 5%, the present discounted value of that reduction is 22.5% of GDP.*

[5] *Ireland has made a remarkable success of accession, but its size and its language advantage make the example less informative for Romania than the other three.*

opened trade, and denationalized and deregulated industry[6]. In Greece, the new democratic government pursued a populist program, imposed price controls, nationalized industrial firms, increased social spending and incurred large budgetary deficits, new taxes on capital notwithstanding. In the eyes of one analyst, Greece, rather than seize the opportunity presented by accession to increase competitiveness, used the structural funds it received to postpone needed adjustments.[7]

The result was that the Portuguese and Spanish economies boomed in anticipation of and after accession, whereas Greece's economy entered a twenty-year period of stagnation, which was not reversed until policies changed, and budgetary consolidation, fiscal cuts, and regulatory reforms were implemented in the lead-up to Greece's entry into the European Monetary Union in 2000.

One number which captures the difference in the economic climates of these countries is the ratio of total fixed investment to GDP. In both Portugal and Spain, fixed investment grew at double-digit rates during the accession year and the two following years. As a result, the ratio of investment to GDP climbed in both countries, even though GDP was also accelerating. By contrast, in Greece, the ratio of investment to GDP, which had temporarily risen after the fall of the Generals, was stagnating at the time of accession.

Graph 1 tells the story[8]. One sees there that, in Portugal and Spain, the ratio of fixed investment to GDP, rose 20% above its accession level in two years, and then remained high. By contrast, in Greece, this ratio was at its highest-level two years before accession, and fell steadily thereafter.

The consequences for GDP of the differences in business climate, and the differences in investment intensity just described, are more dramatic. Graph 2 shows that, whereas GDP rose steadily in Portugal and Spain before and after accession, in Greece, it stagnated for years. The consequence was that, by the time the European Monetary Union was launched in 1999, Portugal, initially the poorest of the three, had erased half of the gap between its GDP per capita and the EU average. Spain, better off in 1986, had also eliminated close to half of its smaller gap. Greece, in almost twenty years, had not significantly changed its relative position. See Table 1[9].

What are the lessons of these three examples for Romania? The reforms which the Portuguese and Spanish governments implemented in the 1980s have already been implemented in Romania. Foreign exchange was decontrolled, prices were liberalized, directed credits were essentially discontinued, and large scale, industrial and financial privatization was launched during the period of the Coalition governments of 1996 2000. What Romania needs now is a second wave of reforms, with an emphasis on the liberalization of business regulations, the liberalization of the labor code, and the development of financial markets, notably

[6] *For details on Spain, see Blanchard and Bentolila (1990); on Portugal, OECD Portugal country reports; on Greece, Alogoskoufis (1995). Some observers deem domestic policies in Portugal to have been more market friendly at the time of accession than domestic policies in Spain. See Bean et al. (1998), pp. 64-67, who emphasize the costs for Spain of its rigid labor-market regulations. But the difference between policies overall in those two countries in 1986, and policies in Greece in 1981 is like night and day.*

[7] *See Aologoskoufis,op. cit.*

[8] *The data are taken from World Bank (2005). By normalizing the ratio with respect to its value in the accession year, one eliminates much of the effect of the structural differences between these economies.*

[9] *The numbers in Table 1 are also taken from World Bank Development Indicators.*

through the enactment of private pension reform.

Romania's first wave of reforms was implemented under extremely difficult external circumstances. The East Asian crisis in 1997 and the Russian default in 1998 dried up incipient global demand for investment in transition countries, and caused the IMF to retrench and insist on difficult, if not unrealistic, conditions for Stand By renewal[10]. The following year, the war in Kosovo reduced exports and put a further damper on FDI. In spite of these negative external conditions, and of the burden of internal political conflicts, the first wave of reforms was successful. After a sharp, initial transition recession, output began to turn around in 2000. The liberalizing reforms of 1997-2000 laid the foundations for the steady growth of the subsequent four years.

Circumstances would be otherwise supportive if accession into the EU was preceded and accompanied by a second wave of reforms. By improving Romania's competitiveness, these reforms would allow Romania to take full advantage of its enhanced access to the Single Market. The combination of expanded access and liberalizing reforms could be a potent recipe for increased growth.

2. Preparing to participate in the construction of Europe

When Romania accedes to the European Union, the Union will still be a work in progress. The key problems of governance in a Union of 27, which the Constitution was intended to solve, are unlikely to have been solved by then. Two stand out.

• The European Council must be able to act. Under current operating rules, established in the Treaty of Nice, decisions which require a qualified majority vote (QMV), can only be passed if three conditions are simultaneously met: The decision must be supported by more than half of the Member States, with 72% of the weighted country votes, and 62% of the EU population. Experts estimate that the conjunction of these conditions means that, in a Union of 27, only 2% of all proposals are likely to be passed[11]. This is tantamount to gridlock. The European Council will be almost incapable of taking a decision on any subject. The EU Constitution would have simplified this procedure and radically improved the capacity of the Council to take decisions. If the Member States want to avoid gridlock, they will have to find another simplified procedure with a lower threshold. Reducing the threshold does not necessarily require changing the allocation of weighted votes. A revival of the rule proposed in the Constitution (55% of the countries and 65% of the population) would require changing the relative positions of Poland, Spain, France, Germany, and others. In the present context of caution which the rejection of the Constitution has created, that may not be possible. Lowering the threshold without changing the relative weights may be a feasible compromise.

• Opinion polls suggest that the electorates of France and the Netherlands are not the only ones to chafe at what they perceive to be the democratic deficit of Union institutions. If they ignore these frustrations which, technically, they can, since citizens do not yet have a major formal voice in Union decisions the leaders of

[10] *On the "bail-in" conditions the IMF wanted initially to impose on Romania in 1999, see Stiglitz (2002), chapter 7.*
[11] *See Baldwin and Wyplosz (2004), Chapter 3, and the references cited there.*

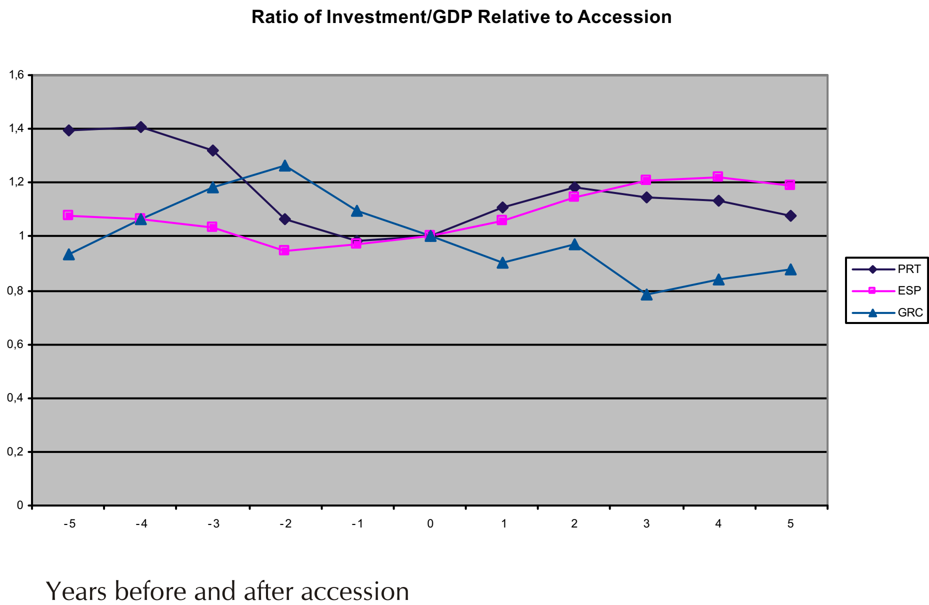
Europe risk precipitating a popular crisis of legitimacy, which could, in fact, paralyze Union actions in the future. Addressing the demand for democratic accountability is therefore necessary and urgent. The Commission is the brunt of the greatest criticism in this regard, and the Parliament is the only institution inherently capable of channeling the desire for more democracy. Logic suggests that making the Commission more answerable to Parliament (than it is under the Nice Treaty), and increasing the codetermination powers of Parliament are feasible ways of endowing the institutions of the Union with more democratic legitimacy.

Forging an intergovernmental consensus on these two important matters in a Union of 27 members will be a daunting task. If the Constitution had been ratified, serious progress would already have been made on these issues by the time Romania entered the Union. The rejection of the Constitution is a serious setback. But the positive implication for Romania is that, instead of inheriting a Union which is already constructed, it will have the opportunity and indeed be called upon to participate in the construction. If a Union of 27 is to endure, and to continue becoming a political entity which is more than a common market, Romania will have to live up to its responsibility to become, with its partners, a builder of Europe.

Conclusion

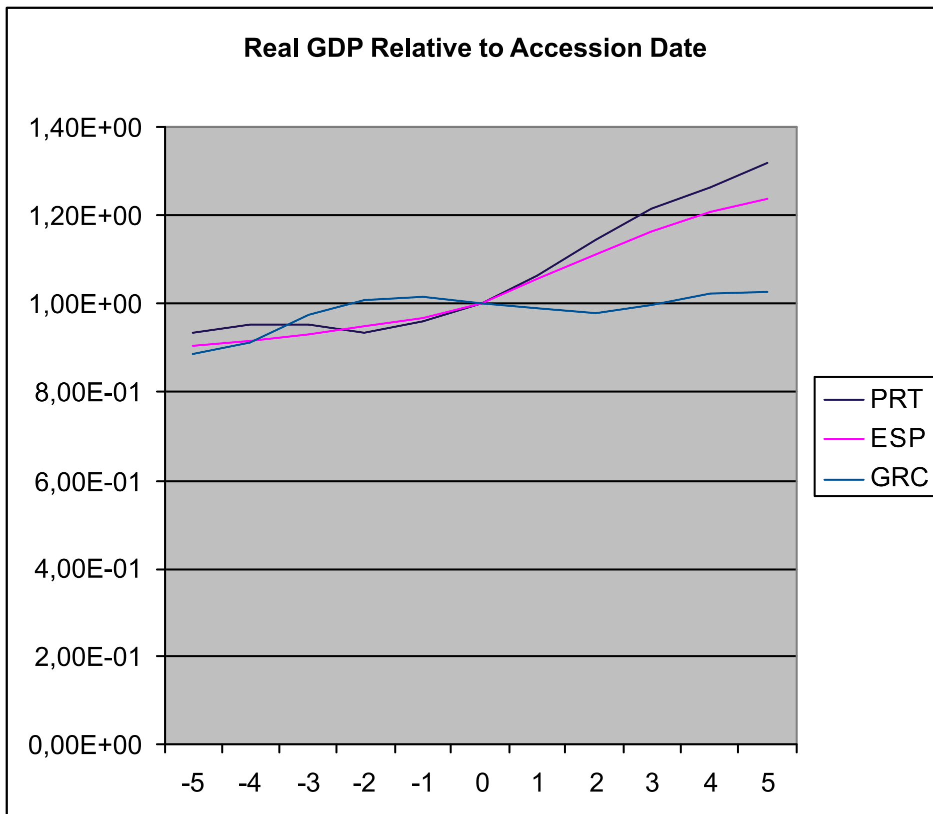
The two aspects of accession which I have emphasized the need for active, pro-market reforms, and the political responsibility of new members to contribute to the necessary deepening of the Union both highlight the fact that accession is not a road of passive entitlement, but an opportunity for constructive engagement. This was true before May-June, 2005. It has become more so, in the aftermath of popular rejection of the EU Constitution.

Graph 1



Years before and after accession

Graph 2



Years before and after accession

Table 1

GDP per capita
Ratio to average of Eu15*

	Year of Accession	1999
Portugal (1986)	0.55	0.75
Spain (1986)	0.71	0.82
Greece (1981)	0.65	0.68

* *Note: Source is World Bank Development Indicators. GDP is measured in constant US Dollars at purchasing power parities.*

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