Report on the Social Dimension of *Ezoneplus*

Of reshaping policies, social conflicts and political consequences

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The Eastward Enlargement of the Eurozone

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Abstract

This report discusses both the reshaping of certain policy areas and the socio-political repercussions an Eastward enlargement of the euro-zone may have. The focus lies on the potential for social conflict enhanced by the enlargement process and their consequences for national policy-making. The paper first surveys some of the major socio-economic changes to be expected in the course of enlarging the euro-zone. This allows to isolate the sensitive segments and areas in which enlargement will arguably lead to costs of adjustment. Next the paper discusses the political economy of major issues concerning national welfare states. It is shown that, whereas capital and goods markets are already in the process of reshaping, there is substantive political resistance against the flexibilisation of labour markets and social policies. This has implications for both national wage bargaining systems and national net contributions to the EU public budget. Two most significant projections are that the Stability and Growth Pact will be put under increasing pressure, since politicians will fear the negative consequences of fiscal retrenchment, and that CEEC will manage to double their share of EU transfers once they join EU and EMU. Finally, the report addresses 'soft issues' such as public opinion on the adoption of the Euro. The analysis of micro-data shows that although support is primarily driven by national legacies, welfare state institutions may well play a role in cushioning the short-term costs of *Ezoneplus*.

JEL–Classification: D6, H0, J0, F4, E6

Keywords : Labour Market, Social Policies, Welfare Economics, EU-enlargement, EU-budget costs

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Report on the Social Dimension of *Ezoneplus*

Of reshaping policies, social conflicts and political consequences

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1. INITIAL REMARKS: THE SECOND STAGE OF *EZONEPLUS*

Within *Ezoneplus*[1] the *Social Dimension* is a hybrid in the sense that it discusses both the reshaping of certain policy areas and the socio-political repercussions an Eastward enlargement of the euro-zone may have. Correspondingly, key questions to be addressed can be grouped under two headings: Firstly, what kind of shocks does EU enlargement, and more specifically, the enlargement of EMU produce on national and EU policies? Secondly, how do national societies and political systems respond to these new constraints? This implies both potential social conflicts enhanced by the enlargement process, as well as their implications for national policy-making. In order to combine both topics, we propose an analysis using insights of modern

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[1] Ezoneplus is a research project funded by the EU commission to investigate the prospective enlargement of the European Monetary Union (EMU). For details see www.ezoneplus.org.

political economy (Kemmerling '02b). In brief, this is to say that rational political actors act in response to *Ezoneplus* in a way predictable once the socio-economic outcomes of the enlargement process have been analysed.

This introduction sketches a basic motivation for analysing the Social Dimension of *Ezoneplus*. The next section goes on by interpreting some of the major findings of previous steps of *Ezoneplus* in the light of such a motivation. In particular, it briefly assesses the evolution of major socio-economic trends in employment and income. The third section deals with the degree by which relevant policy areas have already been reshaped by an anticipated adoption of the Euro in Eastern Europe. The policy areas to be inspected here are labour market regulation, wage bargaining, social security systems and EU transfer policies. Together the build the backbone of welfare states which are still national in nature, but are increasingly dependent on policy-making on the EU level. The analysis will show why some political issues are more sensitive than others and why reshaping takes place in some areas, but not in others. The fourth section deals with some aspects of the socio-political process of *Ezoneplus*. It shows what role public support plays for the shaping of an enlarged currency union. It goes on by exemplifying the transmission mechanisms of political protest in the political system, and concludes with some remarks on so-called soft issues that may be related to the process of enlargement. The last section concludes.

Why is it important to talk about a Social Dimension of *Ezoneplus*? Most studies aiming at the proliferation of policy recommendations rely on arguments about economic efficiency. Scholars analyse the effects of a policy measure on economic welfare and compare this to alternative instruments. Without doubt this is an academic practice with merits of its own, at times, however there is a considerable lack of implementation of such recommendations. This prompts the question why policy-makers choose to adopt some policies, but not other ones. In recent years, theories of policy-making that explicitly model the behaviour of decision-makers have seen a remarkable revival (for excellent surveys cf. Grossman and Helpman '01; Persson and Tabellini '02). Moreover, social scientists have broadened the scope of analysis by analysing the impact of the 'social fabric' underlying policy-making processes (e.g. Schimmelfennig and Sedelmeier '02). According to such approaches, market outcomes are not determined by economic processes only, but are also a result of political and social institutions that, at times, 'adhere' to other logics than **market efficiency** and competitiveness.

It is for this reason that the Social Dimension of *Ezoneplus* will add two further 'benchmarks' to the evaluation of enlarging the Euro-zone. First, what do market outcomes imply for the **political stability** within and between countries. For example, which political actors do favour which kind of policies in the verge of *Ezoneplus*, and how do actors with different preferences come to a common policy? This requires an analysis how different political conflicts on the enlargement process are mediated in the political system. Second, what are the implications for society as a whole? Rather than addressing explicitly normative goals such as reducing poverty or inequality, the *Social Dimension* will focus on the issue of **social acceptance** of the enlargement process. Of course, all three dimensions mutually condition each other. By their analytical decomposition, however, this report wants to shed some light into the delicate search for potential social conflicts arising from *Ezoneplus* and how these conflicts become manifest in political disputes.

The importance of looking for potential social conflicts becomes obvious if one poses another fundamental question for *Ezoneplus*. Why, in general, do countries integrate, i.e. form a political union? The question has recently been re-stated in a series of papers (Alesina and Spolaore '97; Bolton and Roland '97; for an overview cf. Persson and Tabellini '02). One major conclusion of this analysis states that political integration is contingent on the degree of world market integration and the degree of heterogeneity, be it cultural or social, of a region. As a consequence, European integration remains a puzzle under such conditions, since the liberalisation of international goods and factor markets has profoundly increased for the last decades. With international liberalisation proceeding, there is no need for specific regional integration schemes any longer, and heterogeneity will lead to disintegration rather than integration. Rather straightforward, the authors conclude that the European integration process is hallmarked by its tendency towards a 'Europe of Regions' rather than towards a political union (Alesina and Spolaore '97: 1042).

Although there is clearly some empirically discernible truth to this claim, one might easily turn the authors' argument upside down: With increasing world market pressure, a political integration has to offer more than a mere abolition of traditional trade barriers to national product markets. In such a perspective, the enlargement of the euro-zone is a necessary prerequisite to integrate candidate countries into the EU as a whole (Kemmerling '03a). For both sides, old and new member states, enlargement itself might become contingent on the enlargement of the euro-zone! This is to say that given an international environment marked by a high degree of trade liberalisation, the enlargement of the currency is a necessary prerequisite to guarantee the mutually beneficial enlargement of EU. Obviously, there are limits to a political union in terms of scope and depth, since regional and national preferences in an enlarging Europe will be more diverse than ever. So part of the policy conclusions, on very general terms, is how reduce this diversity in preferences. Or more to the point: how to find stable institutional solutions that enable the mediation and harmonisation of diverse preferences. Finding a political structure that guarantees political stability is the prime motivation of this report. A contribution to such a task consists in giving a preliminary idea of the potential risks involved in such an integration project.

2. Taking Stock: The Major Socio-Economic Outcomes of *Ezoneplus*

As a first step of analysing the potential for social conflicts, this part most briefly reviews the state-of-the-art as regards the major socio-economic changes to be expected by an enlargement of the Euro-zone. Since the *Social Dimension* is a very broad topic, some basic findings derived from previous stages of the project may be helpful in defining the key channels by which Eastward enlargement will affect national societies.

<u>Impact of Trade and FDI:</u> The integration of goods markets has already been accomplished to a considerable extent. Nevertheless, there is an ongoing discussion whether an enlarged currency union will bolster trade between member countries (for opposing opinions cf. Kiander et al. '02; Rose '00) even further. According to Caetano et al. (2002), the trade effects may be relatively small for Western Europe, but there is still quite some potential for candidate countries, mainly driven by the abolition of the exchange-rate risk. FDI-inflows, to the contrary, have dramatically picked up speed in previous enlargement rounds, and the abolition of exchange-rates is usually considered to be of paramount importance for this trend (ibid.). Some border regions and economic sectors (e.g. Quaisser 2000), however, may be challenged by an increase of trade and FDI. Although the common currency is usually found to be a source of trade and FDI creation, instead of diversion, at least the case of Portugal poses an exception (Baldwin et al. '97; Caetano et al. '02: 42) to this rule: it is the only Western European country where diversion effects dominate creation effects in most simulation studies. Equally, although the better part of FDI-flows are enhancing market efficiency and are less of a problem in terms of 'locational' competition between countries, this topic remains high on the political agenda and leads to prominent and very controversial cases that rank high in terms of public opinion (Falkner '93; Kittel '01a).

<u>Impact of Capital Markets and Macroeconomic Policies:</u> Integrating FDI in the broader perspective of enlarging financial markets, capital flows may imply new sources of risk for both candidate and member countries. Joining a single currency will largely add to the reduction of country specific risks, and hence, will lead to strong increases in capital inflows (Meyer '02). Despite the overall gain in welfare, integrating capital markets will also lead to higher divergence in regional growth and, therefore, might constitute a potential source of social and political discontent in terms of inequality. The analysis of Monetary, Fiscal and Exchange-Rate Policy suggests that candidate countries in particular, might (have to) follow a strategy of a hard 'over-

commitment' (cf. contributions of Orsi and Fahrholz in Bolle '02) to the EMU-integration process. In order to assure a smooth transit to EMU, governments and central banks in Eastern Europe could face incentives to follow strict macroeconomic policies. This, in turn, implies some serious policy constraints for social security systems and labour markets. But the adoption of a new currency may also imply serious political quarrels between old and new member countries. Since switches in exchange-rate regimes always lead to some kind of redistribution and external effects, bargaining between EU-27 countries on adjustment costs seem all the more likely (Fahrholz in Bolle '02).

Impact of Labour Markets: By its very size, the impact of labour markets could dwarf the other effects for Western Europe. This is due to the fact that Eastern European economies are small in terms of purchasing power, but constitute a huge pool of migrating labour force (Sinn '99). The problems of negative shocks or initial structural adjustment processes candidate countries face by joining the currency union may be 'resolved' by an outflow of workers to adjacent member states. But since migration remains at very low levels, labour market issues embody one of the true sources of predicament for the enlargement process. Moreover, the unequal distribution of labour flows elicits underlying political conflicts. This is particularly the case for the two countries most affected, namely Austria and Germany. More than 80 percent of the current CEEC-10 population residing in Western Europe is situated in these two countries (cf. Figure 1). It has to be added, however, that even in these two countries the overall impact of migration on the risk of job loss and on wages has been estimated to be very small (Boeri and Brücker '01).

[Insert Figure 1 about here]

In addition, the devastating performance of Eastern German labour markets and its consequences for the public budget, may serve as a reminder that East-West integration processes may be extremely costly both in social and monetary terms (Sinn '99). Correspondingly, there are good reasons to believe that the reshaping of labour markets is of prime importance when assessing the Social Dimension of *Ezoneplus*. It is also fundamental in taxing the evolution of three key socio-economic problems that have an extremely high political salience in any country. These three problems are unemployment, the degree of intranational inequality and the incidence of poverty.

The evolution of unemployment & employment: As regards public opinion, unemployment is still considered to be the most serious predicament in EU member states (Baxandall '01). Yet, standard unemployment rates are well-known to be very heterogeneous across EU-15 member states, ranging from countries such as Austria with very low rates to those with levels close to 20 percent like in Spain (Commission '02). In some candidate countries, unemployment levels have clearly surpassed the EU-15 average of around eight percent (EBRD '00). At least in the short run, unemployment could rise due to *Ezoneplus*. Simulation results (Kiander, Vaittinen, and Paas '02) show that enlargement of EU and EMU will have typical adjustment costs for both regions: accession to EU and EMU will temporarily increase the number of unemployed people. However, the level of these costs is markedly lower for Western Europe due to the aforementioned asymmetries in terms of economic size.

More importantly, unemployment is concentrated in specific regions and in sensitive groups, predominantly those of the low-skilled, foreigners and young people (e.g. Galego et al. '03; Kemmerling '03c). Sensitive segments in CEEC are predominantly found to be among young people as well as in economic sectors that show a low level of international competitiveness (Boeri and Terrell '02; EBRD '00). All else equal, these sectors are also those most likely to be affected by *Ezoneplus*. Once again this is corroborated by the findings of simulation studies. Figure 2 and Figure 3 show the expected cross-sectoral net gains in employment for both country groups. In the CEEC-10, the food and light industries will be most negatively affected by a full integration of these countries. The job loss in EU-15 countries will be much smaller and in most sectors be compensated rather quickly.

[Insert Figure 2 and Figure 3 about here][2]

A last aspect of employment performance is the evolution of employment rates. Particularly among women in CEEC-10, a secular, falling trend shows an increase of hidden unemployment, and rising numbers of illegal or shadow-market jobs (EBRD '00; for similar problems in Western Europe cf. Schneider '02). Since up to 50 percent of migration between West and East occurs in this black market (cf. literature quoted in Kemmerling et al. '02), illegal forms of employment pose another serious issue for the evolution of *Ezoneplus*. Figure 4 shows how high unemployment, immigration from CEEC-10 and the size of the shadow economy are empirically correlated. Official migration is low in countries in which both unemployment and the shadow economy are high. The flip-side of this graph is that illegal forms of migration prevail under such circumstances and inflate the number of people employed in the shadow economy (ibid.).

[Insert Figure 4 about here]

<u>The evolution of income differentials:</u> Reducing inequality is one of the self-declared aims of many European welfare states and, according to some scholars, a basic 'ingredient' of the

[2] Special thanks to Risto Vaittinnen of VATT/ Helsinki who kindly let me share his charts.

European social model (Ferrera et al. quoted in Kittel '01: p. 3). It is also frequently mentioned as a potential source for social conflicts across different social strata (Castronova '01; Harms and Zink '02). Both ideas address different aspects of the same phenomenon. For the formation of a (however defined) European Social Model, the catching-up of CEEC levels in wealth is a fundamental prerequisite. Fears are prominent among laymen, policy-makers and academics alike that high and sustaining levels of cross-national inequality results in major political and social disturbances. In addition, intra-national inequality of income, on the other hand, is usually assumed to be an important indicator for assessing the level of social conflict within societies. This could be even more relevant for countries with a post-communist legacy, where income inequality is a fairly new phenomenon (Suhrcke '01). It remains to be seen how Eastern European peoples respond to income disparities generated by regionally concentrated capital flows and resulting growth differentials.

Figure 5 shows that there has been some convergence in levels of incomes between Western and Eastern Europe. A clearly discernible catching-up of CEEC-10, however, has so far not taken place (Nuntzinger '02). In the short run, cross-national convergence of GDP per capita in the verge of enlargement will be mainly driven by factor movements (Kiander, Vaittinen, and Paas '02). Since migration flows could be markedly lower than initially expected (Boeri and Brücker '01), convergence will be rather sluggish. Studies modelling the impact of enlargement effects, such as increased intra-industry trade between EU-15 and CEEC-10, corroborate the view that cross national differences in income levels are likely to persist (Gabrisch and Segnana '02). But also within countries regional and occupational mobility is low across the whole of an EU-27 (Eurostat '02). This is one of the reasons why intra-national income inequality has increased in most CEEC (Hölscher '01), although the level of this inequality is still more akin to the German or Danish level than to that of the UK (Eurostat '02).

[Figure 5 to be included about here]

<u>The Evolution of Poverty Rates:</u> A last key socio-economic problem is that of poverty. Closely related to inequality in terms of measurement, the analysis of poverty frequently focuses much more on sensitive segments of the population (Szelenyi '02). According to recent surveys, poverty in transition societies is heavily concentrated among ethnic minorities, women, in particular lone mothers, and among the low-skilled (ibid.: Tab. 4.4). Being unemployed or living in rural areas is only of secondary importance in explaining individual differences in these countries. Finally, the urban poor and those of ethnic minorities are the most depending on social assistance and other instruments of social policy. It comes as little surprise that the incidence of absolute poverty is much higher than in Western Europe. But also the incidence of relative

poverty – measured against median income – is clearly on the rise in the CEEC and approaches the levels of Portugal and Greece, the two countries with highest poverty rates in EU-15 countries (Eurostat '02). Contrary to Eastern Europe unemployment is frequently found to be a major source of poverty in EU-15 countries, even once the effect is controlled for different levels of education (Martínez et al. 2001). Comparing the well-being effects of poverty between Western and Eastern Europe, insufficient market income seems to be much more drastic in the latter most likely due to a lack of provision in social security (Gallie et al. '01). Contrary to Southern Europe, where family and local community ties play a much stronger role in reducing the negative impacts of poverty (Esping-Andersen '99), such kind of alternatives of the welfare state seem to be less prominent in CEECs. Limiting the scope of welfare state policies, an enlargement of the currency union and its implications for national fiscal policy will likely increase the incidence of poverty in CEECs, whereas its impact on Western Europe will be marginal in most cases (Kemmerling '03c).

3. The Reshaping of Policy Areas Related to the Welfare State

One of the fundamental insights of *Ezoneplus* is the idea that markets and policy areas have already started to adapt to a future enlargement of the EU and EMU (Bolle '02; for an early discussion of this idea cf. Frankel and Rose '96). A common currency will exert considerable pressure on markets and policy-makers and will bring about the socio-economic criteria relevant for the formation of an optimal currency area. The previous stages of the project have begun to show that indeed markets have already started to adjust to an adoption of the Euro. This is plainly visible for the case of capital markets (Meyer '02), but – to a lesser extent – this is also true for labour markets (Burda '99). This section wants to apply the same logic to those policy areas most closely related to the Social Dimension of *Ezoneplus*. On the national level these areas are labour market policies and institutions, including the way wage bargaining is performed, and the most relevant parts of the social security systems. On the EU level, the policy area most similar to national social policies is Structural Funds (SFs), and the Common Agricultural Policy (CAP). Obviously, these two transfer mechanisms are not the only forms of social policy on the EU level, but they are arguably the most influential in terms of unemployment, income disparities and poverty (Geyer '00).

In analogy to the reshaping of markets, reshaping of policies implies that incentives of national policy-makers have changed because of the likely advent of *Ezoneplus*. Hence, the aim of this section is less to assess the performance of policies and institutions and derive a lack of accommodation in terms of efficient policy-making. Rather, the aim is to show why and under what conditions reshaping takes place. Political institutions and interactions between relevant actors are assumed to be of primordial importance for such an analysis.

3.1. The Reshaping of Labour Market Policies and Institutions

An enlargement of the Euro-zone provokes the discussion of three aspects of labour market regulation. First, the overall amount of geographic labour mobility is a decisive factor for balancing the costs of structural adjustment across countries (cf. section 2). This section will therefore start with an analysis of the policies regulating East-West migration. The second issue of relevance is what role an enlarged EMU will play for determining the necessity to introduce structural reforms in national labour markets. The motivation for such reasoning is straightforward: even if migration is legally allowed for, high unemployment rates in Western Europe will significantly reduce inflows of workers (Kemmerling '03c). Assessing the incidence of structural reforms helps judging whether asymmetric shocks across an enlarged currency union will become more easily absorbed across time. Most closely related to EMU is, thirdly, the reshaping of national income and wage policies. The changes of wage-bargaining systems an enlarged EMU will hold in store are fundamental concerns for coordinated macroeconomic policy-making.

Reshaping of Migration Policies: The need for assessing the Social Dimension not only in terms of economic efficiency but also in terms of social acceptance and political stability (cf. Introduction) becomes obvious when the problem of free mobility of the workforce is analysed. The issue of migration is most crucial for the two countries sharing extended borders with Eastern Europe: Austria and Germany (cf. section 2). A first best solution to the problems of *Ezoneplus* is to enhance migration to both countries. But the high levels of unemployment in Germany may be interpreted as a stable, national political equilibrium that significantly reduces labour mobility. So far, the situation seems to be locked into this equilibrium, thereby limiting migration flows. However, there is also a social equilibrium in Germany affected by higher inflows of illegal migration (cf. Figure 4). Eastern European workers form a major part of the German and Austrian shadow economy. Hence, it seems only 'natural' that the German government tries to limit the inflow of migration to Germany from Poland and other countries. In Austria the situation is different on similar grounds. Unemployment is less of a problem there, but this only suggests that higher labour inflows will form part of a wage risk for the low-skilled sector.

During the negotiations on accession, Austria and Germany managed to achieve substantial temporary exemptions from the principle of free movement of labour (Kemmerling '03a). Up to seven years, the free movement of labour will be delayed, thereby reducing what was perceived to be a significant political pressure on national governments. The European Commission admits that these exemptions were important for gaining social acceptance in the two member states most seriously affected (Erler in OBS '03). To explain this outcome of political bargaining between Western and Eastern countries, one could either rely on one of the two cardinal channels of political economy: politicians maximising votes and therefore being responsive to public opinion, or politicians being susceptive to lobbying from special interest groups. We assume that for the analysing the concrete policy outcome it is much more insightful to look at interest group lobbying than at the public. However, we will come to analysis of public support in the next section of this report (cf. section 4). For the moment, the analysis sticks to the role of relevant special interest groups during the bilateral bargaining rounds between the EU and, in particular, Poland. This bargaining was essentially two-dimensional in nature (Kemmerling '03a; c): on the one hand, Poland had to agree on the adoption of the social *acquis*, entailing all the pieces of EU legislation relevant for labour market and social security regulation. Germany and Austria, on the other hand, had to allow for the freedom of settlement affecting their national labour markets. This, necessarily, provoked lobbying from the side of Western European trade unions and employers' associations. It is reasonable to assume that the consent of both lobbies was necessary for the Austrian and German government to achieve a politically satisfying result in the negotiations. According to the structure of the lobbies' preferences, the only achievable outcome was to negotiate for an immediate adoption of the social *acquis* in Eastern Europe and a postponement of the freedom of settlements (Kemmerling '03c: p. 7). The trade unions' position proved to be the pivotal stance, and gave them the power of a de-facto veto player – at least for the short run up to seven years. In nuce, the Polish government had too much to gain from the negotiation to block the result. It nevertheless achieved to get some compensation in form of postponing the access to Polish real estate markets (Kemmerling '03a: p. 15/16).

The case study on the trade unions' influence during the accession negotiations fits perfectly to the more general findings of political economy approaches. Brou and Ruta ('02), for example, argue that rich countries, which are usually assumed to expect very little benefits from political integration with poorer neighbours (cf. Persson and Tabellini '02: p. 136), in fact may gain quite a lot, if highly organised lobby groups manage to affect national policy-making even in countries in which they are not situated. In the following it is shown, that a similar reasoning can be applied to the case of labour market regulation.

<u>Incidence of Labour Market Reform:</u> The Regional Input on Labour Markets (Kemmerling, Pogodda, and Spannbauer '02) sketched the discussion on the question whether 'real rigidities' are reduced by eastward enlargement. In short, the argument goes as follows: an enlarged currency union will increase competition between countries, and will therefore induce structural reforms to accommodate this pressure. A preliminary conclusion was that – so far – little impact could be seen in terms of making Western European labour markets more flexible (ibid.: 15). In the following these lines of reasoning are expelled in more detail. For that reason the theoretical discussions surrounding the flexibility debate are put into the context of *Ezoneplus*. However, it starts with a detour, since most of the relevant literature deals with the question whether EMU has generated more flexibility in European labour markets.

Michael Burda (Burda '01) argues that the Euro will put trade unions and national labour market regulation under pressure. For him, the Euro is a 'Trojan horse' (2001: 23) with which politicians introduce deregulation to rigid European labour markets. He bases his claims on the observation that under a unified currency regime the pressure on national collective bargain systems has significantly increased (2001: 17). Though there is some evidence that wage restraint and flexible adjustment paths are more frequent in the last few years (Kasten et al. '99; Kemmerling, Pogodda, and Spannbauer '02), there is also evidence that these forms of new flexibility have been traded-off against new forms of rigidities such as increasing wage compression. In the meantime, more and more scholars doubt that EMU has indeed a disciplinary effect on national policy-makers and trade unions. For instance, Sibert and Sutherland (Sibert and Sutherland '00) have shown that a monetary union does not automatically induce a higher level of structural reforms in labour markets. To the contrary, the inflation bias of a monetary union may, in fact, be higher than under the previous regime, as policy reform becomes more painful for rational policy-makers. They condition their claims on the extent and frequency with which asymmetric output shocks occur in a unified Europe. If such occurrence is high, the inflation bias may be higher than in a world before the arrival of a currency union.

Other theoretical approaches back such a 'pessimistic' view on the role of EMU for structural reforms in labour markets. Neugart (forthcoming), for instance, shows that political lobbies preferring high level of labour market regulation may in fact gain from a monetary union, since this makes lobbying more efficient. The reason is that policy-makers such as national governments may have less incentive to reduce structural unemployment in a currency union. In such a perspective, enlargement and the lobbying behaviour of those in favour of the current status quo are complementarities and mutually reinforcing (ibid.: p. 1). This finding is also related to a more general microeconomic theory of labour market regulation. Saint-Paul, for instance, explains hystheresis of unemployment with the help of a politico-economic bias towards the status quo in labour market institutions (Saint-Paul 2000).

The debate shows that – so far – the channels from monetary union to labour market reform are difficult to anticipate. This is all the more the case for the eastward enlargement of the euro-zone, since estimates of labour market and output shocks stemming from the enlargement differ considerably. Since theoretical arguments contradict each other, in remains to be seen on empirical grounds who is going to be right. Tentative results show that the EMU has, so far, not been a driving force for reform (Van Poeck and Borghijs '01). But if it is not EMU what else determines whether political systems respond to high rates of unemployment? Of course, there are many approaches to this problem (for a survey cf. Saint-Paul '00 Ch. 1). Rather than to review all major theoretical approaches we restrict the analysis to one particular concept that summarises institutional constraints to policy-making: the concept of 'veto-players' (Tsebelis '02). Veto-players subsume all kinds of actors and countervailing institutions that increase the status-quo bias in political systems. Examples of veto-players are second chambers in bicameral parliaments or coalition partners in multiparty governments. A simple hypothesis is that institutional checks and balances in a political system decrease the likelihood of drastic changes in policies such as structural reforms, since potential losers can use these institutions to veto the reform.

Table 1 gives a stylised empirical model of the political determinants of labour market reform. Similar to Van Poeck and Borghijs (Van Poeck and Borghijs '01), we have chosen a synthesised indicator of labour market reform: the average follow-through rate of recommendations spelled out in the light of the OECD jobs strategy. The two regressions of the table suggest that EMU membership is not a good predictor of this follow-through rate for 18 OECD countries. Obviously, the unemployment rate in 1990 as a proxy for the need for reform is significantly inducing reform, but the statistical impact is far from perfect. Model I also shows that the number of veto players in a country does not explain the amount of reform, but if one adds total tax revenues in 1990 (model II), veto-players become decisive. Though the results are very limited in terms of robustness, an explanation for this finding is akin to veto-player theory. Total tax revenues may proxy different political preference for stronger regulation of social security systems and labour markets. In welfare states where preferences for regulation are higher, veto-players form an important institutional barrier to reform. Tsebelis (2002: ch. 7) shows similar, though more robust findings for the interaction of political preferences with the institutional setting.

[Insert Table 1 about here]

These caveats notwithstanding, the results show that *Ezoneplus* may – at most – exert a long-term disciplinary effect on labour market regulation. In the short run, substantive political costs make policy-makers very sensitive toward reform. Political institutions that impose super-majoritarian thresholds on the policy process, will likely reduce the amount and timing of reform. It is plausible to assume, of course, that the pressure on candidate countries may be much higher than for EU-15 countries. But the benefits of reform may also be lower, since labour market institutions are much weaker in Eastern Europe (Orenstein and Wilkens '01).

This leads directly to the normative problem how to evaluate labour market institutions. In general, the jury is still out on the question whether and which institutions are bad for economic performance. Whereas some scholars find a significant and rather strong negative impact of institutions on rates of unemployment and labour market performance in general (Nickell and Layard '99), others are much more cautious since they believe that institutions may have beneficial effects. One important issue in that respect is that institutions give individuals insurance against the risks of job or income losses (Agell '02). A second issue is specifically relevant for Eastern Europe. Since institutions such as non-employment benefits put a wage floor on labour markets, those countries with more extensive systems have, in general, been more successful as regards the speed of industrial restructuring (Aghion and Blanchard '94; Boeri and Terrell '02). Hence, the overall effects of labour market institutions on social welfare depend very much on country-specific circumstances.

No matter what the normative evaluation of institutions results in, the prime result of this part is that the costs of structural adjustment entailed by *Ezoneplus* – most likely due to problems of political stability – will not easily be reduced by intra- and international flows of labour.

Changes in Wage-Bargaining Systems: The discussion on how to bring structural unemployment down with the help of structural reforms is directly linked to the issue of national wage bargaining in an enlarged currency union. Specifically, the costs of wage bargaining, i.e. a potential inflation bias, should be lower than with nationally separated monetary policies (Burda '01). The reason is that exposure to world markets is smaller than for national economies and that nominal wage flexibility is larger than before. Moreover, higher competition among member states will impose wage ceilings on the bargaining system and therefore also reduces 'real rigidities'. As stated above, however, an endogenous lack of structural reform may, in fact, even increase the inflation bias. Once again, theory keeps ambiguous results in store when analysing this problem. On the one hand, increased price transparency and general market competition, may exert disciplinary pressure on national wage bargaining. Moreover, national trade unions cannot count on their governments any more to accommodate their wage policies (Soskice and Iversen '98). On the other hand, the external effect of each wage policy on the EU-15 or EU-27 price level is markedly smaller. This may lead to higher inflation than before (for an interesting survey cf. Calmfors '98).

The problem with assessing these rival claims is that the institutional variety of wage bargaining systems across Europe is very large and that economic and political effects are contingent on these institutional differences (Iversen '99). One of the first contributions to this neo-institutional approach comes from Calmfors and Driffils ('88). They argue that intermediate levels of centralisation of wage bargaining lead to most unfavourable outcomes in terms of unemployment. A naïve conclusion from this so-called hump-shape hypothesis is that the EMU implies an automatic shift towards such an intermediate level of bargaining, since a central monetary policy confronts a variety national wage policies. With more wage bargaining systems in Eastern Europe to join EMU, this could be seen as bad news for macroeconomic policy making in an enlarged currency union. However, the hump-shape hypothesis has been frequently criticised and modified (Kittel '01b). For instance, the degree of economic openness may substitute the disciplinary nature of extremely high or low degrees of centralisation. A part of the debate has focussed on the linkages between different types of monetary policy and the system of wage bargaining (Iversen '99; Scharpf '87). A central bank credibly adhering to price stability, will reduce most of the incentives to increase wage (Hall and Franzese '98).

Since institutional differences feature prominently in all these models, tracking recent changes in wage-bargaining institutions across both EU members and accession candidates should yield important insights. In previous steps of *Ezoneplus* it has already been noted that the empirical picture for Western Europe is somewhat mixed (Kemmerling, Pogodda, and Spannbauer '02). On the one hand, union density, the backbone of political clout for trade unions, has substantively declined in the last decades (Ebbinghaus and Visser '00; Wallerstein et al. '97). On the other hand, increasing coverage rates of wage bargaining and the concentration and amalgamation of unions have counterbalanced this effect significantly. Moreover, social security systems, putting an additional floor on wages and wage dispersion, have filled the gap as a substitute for declining bargaining power. Finally, no clear trend is visible as far as the level of bargaining is concerned. Most systems have remained fairly stable, but some countries have moved in opposite direction (Carly '02; Wallerstein, Golden, and Lange '97).

In candidate countries, however, the situation is fundamentally different. Trade unions are still struggling hard to find their role in post-communist societies because of the political legacy they share with the ancient regime (Greskovits '98). With the notable exception of Slovenia, union density has shown a conspicuous downward trend in Eastern Europe (Paas and Rööm '03). The differences between Western and Eastern European coverage rates are even more telling. In none of the CEEC-10 coverage rates are above 40 percent, a fact that shows the low political impact trade unions have on national political systems (Carly '02: 5). Public employment is still high in some of the CEEC-10, but since these countries have now experienced one decade of privatisation and transition, the insider power of these employees is much smaller than in Western Europe. Finally, the institutional links between trade unions and some of the most important political parties are much weaker than in tripartiste systems in Western Europe (Greskovits '98).

So far there is little reason to believe that west-east differences in bargaining systems will reduce in the next couple of years. EU-wide coordination will thus be seriously hampered since preferences of national trade unions are antagonistic, especially in the case of West- East-coordination. Skaksen and Sørensen ('01), for instance, show that the political response of trade unions to FDI largely depends on the degree of complementarity between national and FDI production (cf. also Facchini and Willmann '01). Once again, it is difficult to interpret these tendencies normatively. The strength of trade unions has both positive and negative effects. Nevertheless, the changes suggest that an enlarged EU and EMU will contain wage bargaining systems that are much more heterogeneous than before with all that entails for economic performance, political stability and social acceptance. In particular, this means that the extent and form of a EU-wide social dialogue will be markedly different in an enlarged currency union.

Summing Up: The quintessential conclusions of this part may be summarised as follows: Due to the politically generated status-quo bias, labour mobility will not become a major mechanism of adjusting markets to asymmetric shocks. Hence, whereas goods and capital markets are on their way to establishing an optimal currency area, labour markets are clearly not. Given the considerations of politico-economic approaches, structural unemployment may even rise in the short to medium term. The reasons are that Western trade unions will fortify their efforts to influence national policy-makers and that the positive impact of such lobbying will more and more be concentrated on less people. Although Western trade unions will manage to raise social and labour standards in Eastern Europe, differences will remain too high to speak of a genuine European social model. In fact, Eastern European trade unions will not want to buy easily into such a logic of harmonising standards across Europe. Both the idea of OCA and the linkages between wage and fiscal policy suggest that an encompassing picture of the consequences of *Ezoneplus* is only possible, once the social aspects of fiscal policy are included in the discussion. This is the task of the next section, which deals with the effects of *Ezoneplus* on national social policy-making.

3.2. THE RESHAPING OF SOCIAL POLICIES AND INSTITUTIONS

In the following, three major issue areas in the context of reshaping social policies are discussed. First and foremost, an accession to the EMU implies that candidate countries have to adjust not only their monetary, but also their fiscal policies. This, in turn, entails serious constraints for building and reforming national social security systems. Budget cuts prescribed by the criteria of Maastricht and the 'Stability and Growth Pact' (SGP) will affect national social policy-making. Once more, the question remains how policy-makers will respond to this kind of 'supply shock'. Secondly, and of equal significance, *Ezoneplus* entails costs of adjustment. Therefore, social policy may also be indirectly affected, as additional social hardships may generate the political demand for compensation. It will be argued that an increasing demand for social policies hinges upon the type of political system and its political room to manoeuvre for redistributive policies. Thirdly, divergent social policies may also give way to problems of collective action and externalities. Such problems come under various headings ranging from 'Social Dumping' to the 'Competition of Tax and Transfer Systems'. Though this phenomenon is surely not new for the EU-15, the stark differences between member and candidate countries will arguably sharpen this kind of social conflict and are hence addressed in the last part of this section.

Budget Cuts and Welfare State Retrenchment: To guarantee both the internal and external stability of the Euro, ECOFIN ministers agreed on the imposition of self-restraint in the wake of EMU. Among the famous Maastricht criteria, the restriction to annual budget deficits of less than three percent proved to be politically most sensitive in the following years. In 1998 this rule was cast into stone by adopting the Stability and Growth Pact (SGP), only to be seriously put into question once even the strongest adherents to fiscal discipline suffered from economic hardships. Such policy reversals show the delicate nature of the SGP striking a balance between the need to assure holders of financial assets in an enlarged currency union and the potential escalation of social conflicts in national societies (Kemmerling '03c). As a matter of fact, the attempt to delegate the issue of fiscal rectitude to Brussels might itself be seen as an attempt of policy-makers to achieve both aims at a time: economic efficiency and social acceptance.

Correspondingly, among the choice list of policy-makers, trying to cope with fiscal discipline, is the abolition of these constraints. The recent discussion on the SGP is very illuminating in that respect.[3] Loosening external restraints is, arguably, more likely for the SGP than for the Maastricht criteria for accession countries. The problems of political bargaining and speculative attacks loom too large into the formation of a common currency to allow for a reversal of the criteria. This part of the section, therefore, reviews other political strategies to deal with the major consequence of Maastricht: budget cuts and its social implications. As the recent mass strikes in countries so diverse as France and Austria show, the social consequence of fiscal rectitude have surpassed labour disputes as the major manifest social conflicts (Scharpf '00). Apart from questioning the criteria themselves, policy-makers have two other strategies to deal with the social implications of welfare state retrenchment. One is to introduce structural reforms in social security systems, clearly the most efficient way to deal with the problem from an economic perspective. Some small and open economies such as Sweden and the Netherlands have managed to do so even before EMU became an important issue (Scharpf '00; Steinmo '03).

A second strategy is to cut budget items in public households that are the least sensitive in terms of political sensitive (Easterly '99). Such shifts in public expenditure may yield seriously negative consequences in the long run, as the example of some African countries and their efforts to comply with Structural Adjustment Programs of the IMF show. The question remains,

[3] Cf. recent interviews of Romano Prodi, president of the EU-commission: 'Prodi disowns 'stupid' stability pact' (The Guardian October 18, 2002).

however, whether EMU-induced cuts in public budget share similar deficiencies as Easterly argues.

From a perspective of political economy, there are indeed good reasons to believe that some items of the public budget are more easily retrenched than others. Cutting public wages or social transfers to households reduce the policy-makers' probability of being re-elected directly, since they imply serious losses in net welfare for (organised) workers in the public sector and the huge segment of people depending on welfare state transfers. These ideas also have serious welfare effects as Alesina et al. show in a series of papers (Alesina and Ardagna '98; Alesina et al. '98). There main findings are that 1) budget cuts that focussed on reducing transfers and government wages have a positive (anti-keynesian) impact on growth in the years following major fiscal adjustments, and that 2) budget cuts only rarely led to electoral losses of incumbent governments. While the first point is in line with Easterly's findings the second point seems to be contradictory: if governments fear electoral losses they only will reduce budget positions that are less sensitive for the electorate. We subject both claims to a simple empirical model that explores the determinants of both the size of annual primary balances of the public sector and an indicator of the structural composition of the budget: Government Investments divided by the sum of Government Wages and Transfers to Households.[4] Table 2 shows the results for a sample of 18 OECD countries and twenty years (1977 – 1997).

[Insert Table 2 about here]

The results show that, in the long run, there is little strategic room to manoeuvre for national governments in the sense spelled out by Easterly. Otherwise, increases in the primary budgetary balance would significantly reduce the amount of public investments relative to public transfers and wages (cf. last column of Table 2). Analogously to Table 1, the EMU does not, so far, exert a visible pressure on adjusting the primary balances of governments. Rather counter-intuitively, EMU does have an impact on the structure of the public budget, but not as expected by Easterly. Governments of the euro-area have improved the budget structure more than other governments. The general picture of Table 2 amounts to the idea that primary balances are predominantly determined by economic pressures (unemployment and growth), whereas the structure of the budget is due to political preferences (number of left vs. secular right party seats in national parliaments). The later finding seems to be robust to alternative specifications (Tsebelis '02: Ch. 8.2).

[4] For both equations we have decided to use first differences of all variables of 5-years-averaged data in order to confront their time-series characteristics (Kemmerling '02).

The results may lead to some tentative conclusions: 1) EMU apparently helps governments to overcome political gridlocks, but only to a limited extent. So far, budget positions are much more likely to be subjected to economic prosperity than anything else. 2) Political preferences may play a role in leading to more or less success in the aftermath of budgetary retrenchments. Rather than to opt for any political party, the results may imply that the politicisation of the issue is extremely high, and could lead to future divergence in the social and macroeconomic performance of these welfare states. 3) It is hard to extend these findings to new accession countries. It is not guaranteed that the Euro plays a similar role in lending credibility to reform processes in Eastern Europe. To the contrary, one may argue that joining the currency union, Eastern European governments will face problems with implementing reform in such important but sensitive areas as privatising public pension systems.

Social Policy and the Demand for Redistribution: The previous part modelled supply-side considerations for social policy. The prime question was how politicians react to external constraints for policy-making. So far, it was merely assumed that the demand side for social policy also has consequences for policy-making. Section 2, however, has already shown that an EMU enlargement will have serious consequences for national societies in terms of unemployment, inequality and poverty. At least in the short run, *Ezoneplus* could trigger an expansion of social policies as a means of compensating those who are bound to loose in the enlargement process. The probability of being compensated, in turn, depends very much on the ability of social actors to influence national policy-makers, i.e. on their political clout. These considerations suggest a more detailed introspection into the causes of social expenditure expansion. It is useful to note that the politics of retrenchment as previously discussed and the politics of welfare state expansion are not always the same (Pierson '94). One reason is that the politico-economic process of welfare state expansion generates new classes of dependent people that will block any attempts to reduce their net income. On more general terms, the inherent status quo bias in social security regulation drives a wedge between creating and abolishing the provision of social security (Saint-Paul '00).

In the context of EMU, potential labour market shocks stemming from Eastward enlargement will be more difficult to handle than without the restrictions on monetary and fiscal policies. In the short run, this may lead social security systems to face the double challenges of increasing expenditures vs. declining revenues. A higher inflow of (younger) workers from CEECs could mitigate these consequences, but hinges upon the capacity of western European labour markets to integrate the additional work force. Prima facie, a naïve prediction of the socio-economic consequences (cf. section 2) says that the demand for social policy should rise, in particular, in candidate countries.

There is an extremely large literature on the determinants of social policy (Iversen and Cusack '00; for an overview cf. Schmidt '98). Since we focus on political economy we do not touch issues such as demographic and sectoral change as well as 'modernisation' – the 'usual suspects' in this literature –, but look at different political approaches to explain rises in redistributive transfers. A prime avenue to be taken here is the median-voter theorem (Meltzer and Richard '91). Simply stated, it argues that the demand for redistributive social policy depends on the relative income of the median voter. Ceteris paribus, inequality should therefore raise the demand for social expenditure, since it strengthens the political clout of rent-seekers and it increases the uncertainty of voters.[5] In addition, rising inequality may be viewed as the flip side of rising unemployment, since the sources of unemployment, arguably, are based on some aspects of redistribution caused by modern welfare states (Freeman '95; Hölscher '01).

The empirical evidence for this thesis is mixed, at best (Gradstein and Milanovic '00; Milanovic '99). If pensions are excluded from an analysis of the median-voter model, Eastern Europe does not produce much evidence that increasing inequality leads to a higher demand for social policy (ibid.: 38). This is all the more astonishing, since inequality is a fairly new phenomenon in post-communist societies and its social acceptability should therefore be quite low.

There are several rival theories to explain the expansion of social security in modern political systems (Persson and Tabellini '02). Apart from older approaches that focussed on the role of insider-outsider problems, interest groups and/ or the bureaucracy, critiques of this thesis argue that a theory based on pure special-interest politics underestimates the insurance character of social policy (Iversen and Soskice '00). The argument is similar to the debate about labour market regulation (Agell '02). This is to say that specific 'social policies' such as unemployment benefits may be explained either along the lines of the rent-seeking or the insurance-seeking literature (Saint-Paul 2000).

Whatever the approach to be taken, some consequences remain markedly stable across paradigms. For example, an increase in unemployment, rather unsurprisingly, should lead to a higher demand for social policy as a means of compensation (Greskovits '98). An alternative foundation for this result is delivered by approaches modelling the 'optimal speed of transition' (Aghion and Blanchard '94). In this literature, unemployment is a key variable for government behaviour, namely to initiate and steer privatisation. The argument may not be restricted to an analysis of CEEC exclusively, but could be also applied to notions of structural change in western

[5] This argument is contested in the literature. Whether inequality determines the level of material insecurity in a society depends on additional factors such as socio-economic mobility (Alesina, et al. '01).

European labour markets. The true question of this approach boils down to the idea of explaining policy reform. In our context, it could determine the level of unemployment benefits as well as the amount of general social transfers. A number of scholars have resorted to such models. Fidrmuc, for example, extends Aghion's and Blanchard's reasoning, and provide some empirical evidence that is backing their claims (cf. also section 4.1).

In short, theoretical accounts suggest that the demand for social policy responds positively to increasing inequality and unemployment. However, this does not automatically imply that levels of social spending will rise in Eastern European countries. So far the evidence for such a convergence between Western and Eastern levels of social expenditure is mixed. Advanced Eastern European countries have already surpassed southern countries as far as gross social expenditure levels are concerned (cf. Figure 6). But there is no clear-cut convergence discernible, since the region contains fast growing welfare states such as Poland and more or less stagnant ones such as the Czech Republic. Moreover, as with the case of the median-voter theorem, a rise of unemployment does not automatically lead to an increase in social expenditures. The elasticity of social expenditures to unemployment is typically about half a percentage point in OECD countries.[6] This compares to an elasticity of 0.2 percentage points p.a. for the case of all accession candidates. Such elasticities are not very likely to hold in future, but they show that there is no clear convergence to a single (Eastern) European level visible so far.

The expansion of social security has important consequences for a common currency as well, since higher levels of social redistribution usually lead to higher inflation thereby fuelling the Balassa-Samuelson effect (Kemmerling/ Fahrholz; (for a similar argument on wage drift cf. Golinelli and Orsi '02). But the impact is not necessarily restricted to the relative price effect between tradables and non-tradables, since the law of one price rarely applies to tradables in reality (Cihák and Holub '01). It is highly problematic to estimate the quantitative impact of social security systems on inflationary pressures across Europe. Since institutional characteristics of these systems vary widely across countries the causal channels will differ correspondingly. The following results are therefore tentative. We use the levels of gross social expenditure ratios (as shown in Figure 6) as an explanation for differences in price levels across Europe. More specifically, we use a two step procedure. First, we regress price levels in 2001 (prilev) for each country on its gross domestic product per capital adjusted for purchasing power parities (gdpppp) of the same year. Although the fit is fairly high, it is not quite perfect:

[6] We used a sample of all OECD countries displaying data for the years 1970 to 2000. The average elasticity was 0.40 percentage points, the its standard deviation about 0.70.

$$\begin{array}{lll} \text{Priclev} = & 17.07 + & 0.81\text{*gdpppp} \\ & (8.54)^{*} & (0.09)^{***} \\ & \multicolumn{2}{l}{R^2 = 0.82, N = 19, F = 84{,}16^{***}} \end{array}$$

The second step of the procedure consists in explaining the residuals of this equation by the level of gross public social expenditure relative to the GDP. The result is shown in Figure 7. As expected, higher welfare state spending indeed causes higher levels of cumulated inflation across countries. The overall effect is, however, only one of the sources that drive price differences. Only one fifth of the variation is explained by GSER. If one were to add the impact of different wage-bargaining systems on the evolution of price levels, the impact would be markedly higher. But all things considered, the welfare state impact on inflationary pressures may not be exaggerated.

<u>Competition between Tax and Social Security Systems:</u> The con- or divergence of welfare states is necessarily linked to the issue of 'locational competition' (Standortwettbewerb) and the claim of wage dumping. Given the political sensitivity of the issue, any normative point of view in this discussion is necessarily provocative, but simply stated such a claim cannot be entirely rejected on an empirical basis. Caetano et al. (2002: 40), for instance, find that differentials in labour costs do play a role in determining the extent of bilateral FDI-flows between Western and Eastern Europe. Of course, these results are of the partial equilibrium type and, hence, have to be treated with outmost delicacy. Brown et al. (Brown et al. '96) build a general equilibrium model showing that under particular circumstances, overall welfare effects may indeed be negative. In a similar vein, Casella (Casella '96) claims that a necessary condition for an efficient solution of the problem of different standards is the convergence of income levels across countries.

There is, however, more to say on this issue once it is put into the broader perspective of social dumping in general. Sinn (Sinn '00; Sinn '01) for example, strongly argues that even with factor price convergence in the long run, the externalities produced by different standards of social security across Europe, will have detrimental effects on the welfare of Western European economies. Moreover, in the public debate the empirical validity of these claims may matter less than their sheer, 'apparent' cogency. Rational political actors may take up these arguments to pursue their own interest-maximising strategies. Such tendencies are clearly visible in the debates about the socio-economic consequences of eastward enlargement for border regions. Under such circumstances, locational competition and the problems of FDI are extremely transparent and already provide societal disturbances (cf. Zwickel in OBS '03).

In general, the issue of international tax competition contains more aspects than differences in the size and structure of European welfare states. Nevertheless, tax competition is an important consideration for the *Social Dimension* as well. In fact, if Sinn is right in his assumption that differences in the level of social security provision shows the typical problems of collective action and external effects, tax competition may be a serious issue for the Eastward enlargement of the euro-zone (for a recent contributions cf. Baldwin and Krugman '00; Kanbur and Keen '01). Ireland is a major case in point, since this country has managed to attract sizeable amounts of FDI by offering competitive tax rates and by limiting its commitment to providing social safety nets for its own citizens. This prompts two questions: 1) Are the CEEC likely candidates for using tax policies strategically? 2) How will old member states respond to this problem?

Recent evolutions in the tax systems of CEEC indeed imply that these countries set tax levels for competitive reasons. Above all, corporate income tax rates have and will be consecutively lowered in most of the accession candidates. Tax competition, however, seems to be driven by pressures between the new members rather than between old and new member states (Scharpf '97). Nevertheless, tax competition will also be an issue for the whole of an EU-27 in the long run. This is not least due to EU's commitment to generate a certain level of convergence between old and new member states. Hence, the tax issue will come up in future because of problems that are similar to the competition between OECD countries (Ganghof '00; Genschel and Plümper '97). Most of the literature on both positive and normative aspects of international coordination of tax policies does not suggest, however, that the old member states will exert successful pressure on the accession candidates to raise their standards or levels. It rather seems to be the case that transition economies need to strengthen their own tax bases by non-competitive measures, such as improving tax levying procedures, in order to manage structural adjustment successfully (Schaffer and Turley '00).

<u>Summing Up:</u> The major policy lessons to be drawn from this section are the following: First, the discussion of budget cuts and the retrenchment of social policies has shown – similar to the debate on structural reforms of labour markets – that national political systems deeply influence the nature of budget cuts. Political stability considerations at times lead to the outcome that less efficient budget items survive, whereas productive government policies are reduced. Reforming the financial viability of social security systems has arguably replaced the hot conflicts on wage policies of the 1970s as the major form of societal and political discontent.

Second, a convergence between western and eastern social security systems is unlikely in the short run. Though the demand for social policy in Eastern Europe has increased, the political channels of redistribution differ markedly from well-established welfare state such as Germany or France. Hence, the size of compensation will be much smaller than with traditional institutional structures of welfare states.

Third, given the increasing competitiveness of some Eastern European economies, claims of social and wage dumping cannot be entirely discarded. Some candidate countries are about to imitate the growth miracles of Western Europe, i.e. Spain and Ireland. This prompts the question whether the 'benevolence' of Western European countries will be overstretched, since the macroeconomic context is much less favourable than in previous enlargement rounds.

Finally, there is the question how to link the issue of social and labour market policies. In an currency union with limited geographical mobility and high structural unemployment, a second best option would be to use wage restraint and/ or adjustments of payroll taxes to imitate the flexibility of real exchange rates (Calmfors '98). Given the structural rigidities of tax structures the latter option is not very likely leaving the major burden of adjustment to moderate wage policies (Soskice '99). But as the previous part has shown the temptation to increase nominal wages may have even increased due to the currency union. A likely outcome is that national governments, and the German in particular, are tempted to negotiate for wage restraint by offering 'fiscal activism' to trade unions (Soskice and Iversen '98). According to our findings this may relieve the level of societal conflict generated by adjustment costs, but the long-term perspective is more pessimistic. Governments may be tempted to cut 'the wrong' budget items and avoid the implementation of structural reforms. Moreover, since Eastern European trade unions are much weaker, social contracts trading off fiscal rectitude for wage restraint are less likely. In nuce, such an analysis suggests that neither labour market nor social policies of CEEC will be able to fully absorb the costs of adjustment of *Ezoneplus*. Correspondingly, an interesting question is whether candidate countries will manage to get compensated by EU-15 via EU transfer policies.

3.3. EU Transfer Policies and the EU Budget

To discuss the likelihood of compensation on a European level, we use politico-economic models of fiscal federalism. A first point of entry to this literature is by simply anticipating which regions, countries and individuals of current member states will loose transfers, and how they will react to this problem. Departing from efficiency considerations of the optimal transfer debate in fiscal federalism (Oates '99), 'pork-barrel politics' is a convenient way how to conceive this process (Dixit and Londregan '98). Regions within a country lobby their national governments for support, while these governments determine the absolute level of transfers on the EU-level. By this means, the demand for SFs and CAP is primarily explained by concerns within a country. A point of further complication in these models is the problem of multi-level governance, typical for fiscal federalism. Regions may lobby sub-governments in federal states which, in turn, voice their demand to their national governments (Kemmerling and Stephan '02).

A second point of entry focuses on the set of policy alternatives a national government has to respond to enlargement. As, for example, Casella (Casella '02) has shown, the question of coordinating redistributive policies between countries hinges upon the capacity of national governments to impose barriers to migration. To be sure, these barriers may consist of other tools than simply regulating work permits of foreign workers. An important example is the discretion of government to grant social assistance and other forms of 'non-tariff' migration barriers. A more mundane, but not totally implausible, way of conceiving this issue is to say that governments try to set national rates of unemployment high enough in order to prevent migration. According to Casella such behaviour has profound consequences for the need of a common fiscal transfer policy across Europe. In fact, the optimal size of international redistribution may be higher than without such politico-economic considerations.

A third important theoretical approach deals with the political economy approach to anticipate reforms of the EU budget (König '01; Weise '01; '02). Since net contributors in the EU such as Germany and the Netherlands, fear substantive additional costs once new countries are accepted, they try to reform the EU household before the enlargement. These attempts experience fierce opposition by countries that benefit from the status quo, namely France and Spain.

We start evaluating the latter problem with the help of Figure 8. It shows a simulation of future budget positions of current EU member states. We compare the current status quo in 2001 with a one-to-one extension of the budgetary rules to CEECs. This is not realistic since, for instance, CEEC farmers will receive much less immediately after the accession than their Western counterparts. The thought experiment is nevertheless revealing: Measured in percentage of GDP the Baltic countries will gain most from accession, but also bigger countries such as Poland would gain annual net inflows up to three percent of GDP. The only accession country that is likely to be a net contributor is Cyprus. On relative terms, Greece and Spain could loose up to one percent of annual inflows. It goes without saying that on absolute terms, Germany, France and Italy are those countries that pay most of the 'bill' (Weise '01). Accepting 10 new member countries would imply, for instance, that Germany's net position would deteriorate by some five billion Euros (Weise '01).

[Insert. Figure 8 about here]

But worse a budget position is not only due to increasing contributions. EU regional transfers (SFs) will be redistributed, since many regions of current member countries will be pushed above certain thresholds, namely the 75-percent level in relative income that is aligned to the so-called Objective 1 (Weise '02). For Germany this implies that six out of seven regions won't be entitled to get SFs in an enlarged Europe.[7] In France three regions, and in Belgium and Austria one region will also be dropped. According to Weise, 90 percent of the Objective 1 population will maintain their entitlements in 2007 with no enlargement. With enlargement, the share is reduced to around five percent. He shows that next to Germany the southern European countries are most affected by the diversion of SFs to CEECs (cf. also Galego, Caetano, and Costa '03: 13).

The problem of CAP is similar in nature, only that Belgium and France are the main beneficiaries of the current situation. However, on first sight, the logic of reform is inverted. Whereas the major criteria for SFs are relative in nature such as the 75-percent threshold of EU GDP per capita, thus holding absolute levels of SFs constant, CAP hinges mainly upon absolute levels of production. In other words, shifting the status quo of EU-15 to EU-25 is mainly a zero-sum game, whereas CAP directly affects the absolute size of the EU budget. For SFs a reform would be interesting for Germany in order to maintain their population within the criteria of entitlement. A reform of CAP would mean the opposite, i.e. down-sizing the entire budget. Given the fierce opposition of farmers in most countries (Imig '02), reforming CAP is politically dangerous. The compromise currently emerging out of EU negotiations on CAP is thus biased against the future members. At least for a grace period, new members will not be entitled to the same proportion of CAP-cash the old members are.

The structure of the EU-budget and its main two components, CAP and SF policies, however, is not very likely to remain stable, once enlargement will have taken place. In that respect, the problem of time inconsistency looms large into the recent past of institutional reforms of EU decision-making procedures. Most simply stated, the problem amounts to the simple fact that CEEC can tilt the current status quo towards their ideal position, once they are member of the EU. Previous rounds of enlargement have indeed shown that the EU budget, and the amount of SFs in particular, have substantively increased once new (poorer than the median)

[7] It comes with little surprise that the EU Commission has recently guaranteed that Eastern Germany will continue to receive SFs in the near future.

countries were accepted (Baldwin, Francois, and Portes '97). The Cohesion Fund is the most visible example in that respect and its existence is directly linked to the creation of EMU. Many authors have related this problem to the recent attempts of current EU members to fix the status quo by adopting higher thresholds (König '01; Tsebelis and Yatagans 2002).

We have constructed a simple empirical model to corroborate such claims. We assume that the receipts of current member states from Brussels are a function of the bargaining mechanism of the EU Council. In the council, several bargaining principles are working at a time. First, each country has a certain amount of votes loosely connected to the size of its population. Such differences in bargaining power are most easily related to coalition theory by the concept of a power index such as the Shapley-Shubik Index (Aleskerov et al. '02; Schröder '98). Moreover, the Nice Treaty has lead to a number of thresholds a qualified majority has to pass in order to be accepted as a common political output. This leads to a modified Shapley-Shubik Index that takes such thresholds into account (Aleskerov, Avci, Iakouba, and Türem '02: p. 385). Next, the SSI is commonly divided by the size of population to measure the average voting power of an inhabitant in a given country (Baldwin, Francois, and Portes '97: p. 162/3). The theoretical justification for such a proceeding is that the European Union tries to follow the at times formal, at times informal principle of unanimity. Hence, big coalitions between many countries are usually preferred to smaller ones. This gives small countries with few inhabitants a relative increase in bargaining power. Finally, poor countries manage to receive more funds from the EU than richer ones. This is related to the classical median voter idea in majority voting systems, though the argument differs slightly: poor countries have homogenous preferences as far as the overall budget is concerned and build coalitions to increase their political leverage.

Table 3 shows the results of our model. The dependent variable is receipts per capita for a given country in the year of 2000. We first show that the old rules can explain the cross-national structure of the EU budget reasonably well. The SSI95 is positively related to per capita receipts. Moreover, cohesion countries manage to get substantially larger funds than the rest of EU-15. Model II shows that the Nice rules have indeed reduced the leverage effect of a modified SSI01. But it is nevertheless an important predictor of budget shares across countries. If we take this coefficient of 0.08 and count CEEC-10 as cohesion countries, a projection of their common budget share would amount to roughly 32 billion Euros. This estimate seems to be reliable since the overall amount of the estimated budget is around 101 billion Euros for the year 2006. The Commission's financial outlook states a figure of 107 billion Euros, which is well within the statistical range of Model II projections. The only difference is that the Commission counts with 16 billion Euros to be dispatched to the new member states, whereas Model II shows that the bargaining power of CEEC-10 would lead us to predict an amount more than twice as much – roughly 32 billion Euros. Correspondingly, a politico-economic analysis suggests that important re-negotiations will take place in the near future and that the new member states will manage to increase their share by a considerable amount. This could imply that transfers to Eastern Europe will be increased soon after enlargement has taken place. Given that we believe that the pressure on CEEC governments to compensate for costs of structural adjustment will increase with an EMU accession, the likelihood of exerting voting power should all the more increase. Previous estimations came to very similar conclusions (Baldwin, Francois, and Portes '97; Kandogan '00). In addition, evidence from previous enlargement rounds also shows that indeed countries such as the UK have managed to change their positions once they were in the EU.

[Insert Table 3 about here]

All things considered, the outcome of pork-barrelling on EU-transfers is yet to be seen. Most likely, the EU budget will expand in the nearer future though only to a limited extend – up to a maximum of some 20 percent, according to our estimations. The expansion seems to be plausible as at least some EU-15 countries such as Germany will have an interest in a compensation deal: they will be allowed to loosen the SGP (cf. previous section), and transfer larger sums to Brussels. EU-15 countries with smaller structural problems in labour markets and social security systems such as the Netherlands will oppose such a tendency, since they have less to fear from their national societies. In nuce, the national willingness to pay or renounce of transfers will depend, as in the previous cases of policy reform, on internal political processes. It is these to which the report now proceeds.

4. Politics of Ezoneplus: Support, Opposition and Alienation

So far, we have merely assumed that societies are reluctant to policy changes in the realms of social security and employment. This sort of societal unrest and its political manifestations have been treated as unobservable variables. This is quite natural since hard empirical evidence is difficult to attain and evaluate. Nevertheless, this part of the report tries to nail down some of the strategies individuals and interest groups have to make this unrest visible.

Talking about both the winners and losers of the enlargement process generates a major question: What kinds of strategies do individuals and corporate actors have to complain about their losses or promote their benefits in a politically meaningful way? Two distinctions may help to organise the argument. First, there is the distinction between 'voice' and 'exit' strategies (Hirschman '70). Political actors can either choose to make their complaints observable within the political institutions, or they stop their cooperation within these institutions and look for alternatives outside. A second distinction deals with the capability of organising the voice strategy. Some segments within the population are more apt to form a (unified) political platform and to coordinate strategies than others. Hence this difference is best captured by the notion of 'organised groups vs. dispersed individuals'.

Some of these strategies have already been mentioned in previous parts. This is true for the case of special interest groups. This time, however, we will look more closely at the empirical evidence for the politics of *Ezoneplus*. The section contains two parts: The first entails a set of issues and indicators dealing with the question how general interest in the form of public opinion is affected by enlargement of EU and EMU. We will analyse whether support is driven by politico-economic considerations or depends on more general historic and cultural situations in these countries. The next part will shed light into the question whether and how these anti-enlargement attitudes may be transformed into a political position (usually in the form of Euro sceptic parties). In addition, other 'soft issues' that may be linked to the enlargement process are discussed.

4.1. Public Support for Ezoneplus: Voice or Alienation?

The major issue of this part is the question how people respond to the process of eastward enlargement. Although government officials and most economists duly stress the overall social benefit derived by the accession of Eastern European economies, it is common knowledge that any integration process generates winners and losers. For instance, sectors in both Western and Eastern Europe that have lived through times of relative protection against foreign competition are likely to meet considerable adjustment pressure once integration takes place (cf.. Figure 2). This necessarily prompts the fear that those suffering from integration will use any possibility to endanger the enlargement process or, at least, will demand compensation for anticipated losses.

Before we assess these claims Figure 9 shows the overall amount of support for EMU, using recent data of the Eurobarometer. It illustrates that almost all CEEC-10 are rather enthusiastic about the Euro. Only the Czech and Estonian people have smaller shares of the population that actively support the Euro than the members of EMU itself. This may be compared to a country well known for its scepticism towards the Euro: the UK. Only about 30 percent of the UK inhabitants are for the Euro, and about 20 percent are against it. This ratio is only 'beaten' by that one of the Turkish people where a majority of the inhabitants is actually against an adoption of the Euro.

[Insert Figure 9 about here]

These figures underestimate a decisive problem of support. For instance, when the national referenda have been held on the question whether CEEC-10 should join the EU, it was beyond doubt that the overwhelming majority of those who vote are in favour of accession. The crucial question was whether sufficient people turn up at the ballots (Kemmerling '03b). It is not only for ratification that public support matters. To quote political scientist Seymour Martin Lipset "a society in which a large proportion of the population is outside of the political arena is potentially more explosive than one in which most citizens are *regularly* [his emphasis] involved in activities which give them some sense of participation in decisions which affect their lives." (quoted in Hahn and Kamieniecki '87: 6). The normative nature of this statement is clearly disputable, as wealthy countries such as Switzerland live with comfortable, low rates of political inclusion. From an analytical point of view, political alienation is, nevertheless, an important aspect when talking about the evolution and convergence of European Union member countries. First, the question remains whether a continual, low participation rate is a symptom of latent social conflicts in an enlarged EU. Second, low participations rates may have consequences for the kind of social model evolving in Eastern Europe and its convergence or divergence to Western European welfare states.

We recur to the theoretical approaches of previous parts of report and put them into the broader perspective of modelling support for EMU. Traditional political-economy approaches to integration and transition (Aghion and Blanchard '94; Roland '02) usually claim that liberalisation leads to some form of (organised) political pressure and, hence, to government policies that compensate potential losers. Job loss is arguably the most important 'ingredient' for most political economy models of transition (ibid.). Hence, as in previous sections structural adjustment costs imply a higher demand for social policy in ways similar to the results of standard median-voter theories on redistributive politics. With democratisation and international openness, the size of redistribution should expand, as (relatively) poorer voters become both more decisive and more exposed to shocks (Franzese '00). However, in the context of *Ezoneplus* these arguments have to be qualified. First, international openness may add to volatility, but not necessarily to relative losses in incomes or employment. To the contrary, the low-skilled in less developed economies, should, as argued above, favour economic integration (Fernández Albertos '02). Second, as argued before the median voter theorem is empirically not very meaningful, especially in the context of Eastern Europe (Milanovic '99). As for the latter, a potential exit out of this problem lies in the fact that voter turnout is an important intervening variable in the median-voter and size-of-redistribution model (Franzese '00). In many countries richer people are more likely to vote than poorer. Hence, political abstention or alienation is a way of explaining the general lack of redistribution in CEEC.

This does not mean that CEEC completely refrain from any means of redistribution or regulation in labour markets. As shown before, accession countries differ considerably in their labour market institutions (cf. section 3.1). Extensive non-employment benefits (NEB) and employment protection legislation (EPL) may act as a substitute for high levels of unemployment benefits (UB). Hence, the second major point of modification to political economy approaches should lie in a more detailed account of alternative compensation and protection strategies.

We try to substantiate these claims with a set of empirical regressions that explain the voting behaviour of people in different countries with the help of individual and national characteristics. Unfortunately we cannot make use of the data presented in Figure 9 since no information on Euro-specific question is available so far. To test these hypotheses, we use data coming from the Eurobarometer for Central and Eastern Europe No. 8/ 1997. More specifically, the analysis concentrates on question no. 9 stating the following: *"If there were to be a referendum tomorrow on the question of (OUR COUNTRY'S) membership of the European Union, would you personally vote for or against membership?"* The question has been recoded into dummy variables for 'vote for', vote against', 'not vote', and 'undecided'. Table 4 summarises our findings.

[Insert Table 4 about here]

The following key results are informative for our purposes: (1) People are more positively responding to enlargement, the more educated they are. This effect dominants the income effect which does not prove to be a significant predictor of voting behaviour.[8] (2) The size of community is significantly related to voting behaviour. People in rural areas are less likely to be pro-EU than others. (3) A similar effect is also visible for two 'occupational groups': agriculture and housewives. Whereas the former result keeps in line with the idea that rural sectors may be losers of enlargement, the gender pattern may be explained by the issue of job loss which is concentrated among women (cf. section 2). Indeed, to be unemployed is significantly related to voting against enlargement. (4) The lack of enthusiasm for the EU (2nd column) has also an interesting cross-country pattern. The fixed effects for the Baltic countries are all significant and negative. This implies that, on average, the model overestimates the share of people in a society that is likely to vote for enlargement. A similar finding also holds for the Czech Republic, whereas Romania is an example of an opposite case.

So far the analysis suggests that voting behaviour may indeed be explained by individual characteristics such as working in agriculture. The fixed country effects, however, have shown that national characteristics play a decisive role. The cross-country pattern fits to the previous findings on the attitude towards the Euro and, therefore, seems to be reliable. The question, however, remains whether these differences are based on diffuse notions of culture or whether institutions of the welfare state may intervene in the relationship between individual characteristics and the voting behaviour.

The evidence for the latter thesis is fairly weak, but nevertheless visible (cf. Figure 10). For reasons explained above, we focus on the role of non-employment benefits relative to GDP (Boeri and Terrell '02). We find that cross-country differences in voting for the EU are related to the size of the social minimum assistance guaranteed by Eastern European countries. Of course, there are important outliers such as Romania, and the evidence needs further corroboration. But the preliminary conclusion arising from this figure is that enlargement of both the EU and EMU works smoother were, at least, a minimum welfare state exists. We think the results to be more general in nature. Politico-economic considerations have, for example, also been shown to drive part of the public support for EU parliament elections (Mattila '01).

[Insert Figure 10 about here]

In Kemmerling ('03b) we have performed an analysis similar to that one of Table 4 for the current member countries of the EU. We found that there is some, though weak evidence for the hypothesis that low-skilled workers in the EU fear competition from accession countries (p.7). The fixed country effects show that those countries closest to Eastern Europe are all more

[8] A minor exception is column three (Vote Against). We are cautious about the results however, since the reported figures on income levels contains significant measurement errors.

pessimistic about enlargement than the rest of EU-15. This finding corroborates the idea that the political salience of enlargement is highest in Austria, Germany and Finland. Finally, while welfare state institutions play a role in the diversity of support, 'soft issues' with a cultural and historical background are nevertheless important considerations in these countries as the following part shows.

4.2. 'SOFT' AND 'HARD' EUROSCEPTICISM AND RELATED TOPICS

To evaluate the risk of lacking political support we need to know how euroscepticism is transformed into (party) politics. Unfortunately, so far there has little research been done on the direct impact enlargement may have.[9] Figure 11 shows information of a recent study about the extent of general euroscepticism in both national public opinion and national party systems. According to the authors (Taggart and Szczerbiak '02), parties may be classified into three groups: hard euroscepticism, soft euroscepticism and no (open) euroscepticism.[10] They maintain that there is no perfect fit between the level of euroscepticism in the public opinion and the size of anti-European parties in national parliaments. Country studies show that the reasons for the success or failure of anti-European parties differ profoundly from country to country (ibid.).

[Insert Figure 11 about here]

Hardliners, in particular, are not members of any government in Western Europe (ibid.: 16). The political clout of anti-enlargement parties is therefore clearly limited. Most interestingly, Germany has shown a marked resilience against euroscepticism and anti-enlargement parties, a fact that has been related to its federalist political system (Lees '02). The two exceptions, where hard euroscepticism features prominently in the political system, are France and Denmark. However, enlargement has, so far, never been made to a major issue during recent election campaigns.[11] Soft euroscepticism, frequently related to the enlargement of EMU, is strong in Austria and the Netherlands. In both countries, parties with an outspoken, but not extremist scepticism towards enlargement are or have been in national governments.

All things considered, party politics does not seem to be a major 'avenue' for societal discontent against enlargement. However, for some parties it seems to be a handy 'tool' for mobilising critical and, at times, extremist voters as the following box suggests. Historical legacies

[9] For western Europe, at least, enlargement has, so far, not featured as a significant political issue along which party systems could be arranged (Gabel '98; Gabel and Anderson '02; Sitter '02).
[10] The distinction between 'hard' and 'soft' notions of euroscepticism is drawn on the question whether European integration is generally rejected or only some aspects of it such as the monetary union.
[11] Cf. RIIA/OERN Election Briefing No. 4
http://www.sussex.ac.uk/Units/SEI/oern/ElectionBriefings/index.html, 10.11.02).

play a crucial role here. In the Czech Republic, the issue of how to deal with the expulsion of Germans after World War II is an important example. But also populist movements against enlargement in Austria illustrate this problem (Kemmerling '03c). Especially because of issues concerning labour markets and social security systems, the political discussion on enlargement is, now and then fused with explicitly nationalistic positions.

To be sure, data on public opinion, Euroscepticism or voter turnout is prone to well-known critique. One could try to find complementary measures for societal discontent with enlargement. One of the alternatives to polls is to look at the evidence for manifest political protests. The politics of Brussels is haunted by frequently occurring manifestations and blockades. But not only Brussels is a place to express dissatisfaction, national protests and manifestations may also have a linkage to the EU and enlargement. Empirical data on the incidence of genuinely European protests (i.e. protests about EU-related issues) shows an ascending trend in the nineties (Imig '02). On the national level, strike is still the most common form of political protest, compared to other forms of public protest. For the case of Brussels politics the 'tone of the discourse' seems to be markedly more confrontational (ibid.: 926). Moreover, EU policies may play a role in causing national political predicaments (see above). Hence national waves of protests such as general strikes are indirectly related to EU issues. Anecdotal evidence suggests that the occurrence of general and mass strikes is related to the attempts of national governments to retrench and reform their welfare states, labour markets included.[12] Most manifest and regularly occurring forms of political protest presuppose political agents endowed with the necessary capabilities and resources to organise these protests. Two likely candidates that potentially provide political agency of euroscepticism are trade unions and sectoral interest groups, namely farmers' associations.

All things considered, the way societal reactions are transformed into political concerns depends on the specific policy area, but also on nationally idiosyncratic facts. Labour market regulation and CAP will affect major national veto players, i.e. special interest groups. Social security systems are rather a problem of 'general interest politics' (Persson and Tabellini '02). No matter what transmission channel is argued for, societies will react towards enlargement and lead to a reshaping of policy areas that is different from one predicted by pure market forces.

[12] Note, for instance, the recent general strikes in Italy and Portugal, the latter being directly related to attempts of the government to obey to the EMU-rules for fiscal policy.

5. Conclusions: Of reshaping policies, social conflicts and political consequences

Perhaps the most important general finding of this report is that in none of the areas inspected the social dimension implies the likelihood of catastrophic scenarios sometimes attached to the prospects of enlargement. To give but one example, early migration studies forecasted an inflow of up to one million people p.a. to EU-15 countries (Friis and Murphy '99). Currently, estimates are much more modest and the societal consequences of reduced inflows should be manageable from a political point of view.

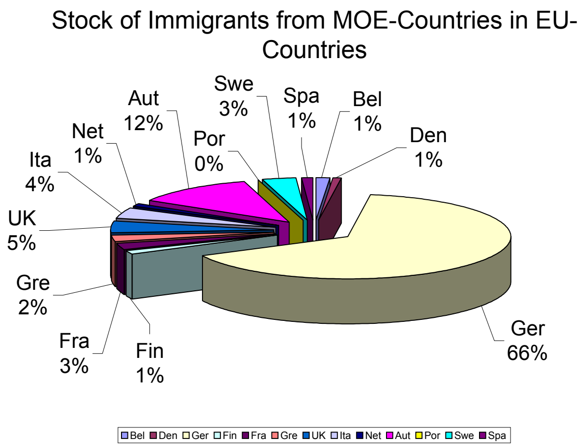
In fact, labour inflows may be too small to absorb the negative consequences of an enlarged currency union. Hence, although, EMU enlargement seems to be feasible, it will not be processed efficiently from an economic perspective. The report gave some evidence of the reasons that are predominantly situated in the political and social system of both member and accession countries. An easy absorption of asymmetric shocks, for instance, would demand smoothly working labour market and social policies. Since these policies are formed by other logics than plain economic necessities, powerful interest groups and political institutions were shown to play a major role in determining the amount and direction of reform across Europe.

This holds for both labour market and social policies. From a macroeconomic point of view, the largest risk lies in the possibility that enlargement will increase the inflation bias in the monetary union and could possibly lead to a 'retaliatory' behaviour of the European Central Bank. Since a major part of inflationary pressure is directly or indirectly produced by social security systems, the true source of predicament lies in the interaction of fiscal and social policies. In addition, the political conflicts are highly manifest in the area of regulating social security, and will arguably continue to exist in the near future. Given this prediction, some of the Western European governments will try to loosen fiscal restrictions in the short run and, simultaneously, allow for more EU transfers to be directed to the new member states.

Structural asymmetries in an enlarged currency union will guarantee that a convergence of welfare states across EU-25 will proceed slowly. This will increase the demand for coordination of these policies on an EU level. We assume this to be good news for the whole of Europe. Although competition among tax and transfer systems is clearly a source of social conflict in some cases, the opposite strategy, a rush to higher labour and social security standards, would be clearly less desirable. Once again the prime example for this predicament is Eastern Germany. From a sociological point of view, there is little reason to believe that the German example may serve the case of negative role model for Eastward enlargement. In nuce, the immediate adoption of social standards in Eastern Germany was due to unique historic and cultural circumstances. The social acceptability of different standards for West and East was very low. We do not expect this to happen between Western and Eastern Europe, since national diversities are in general much higher than within Germany. In that respect, sustaining national heterogeneity is more a benefit than a curse to the whole of Europe.

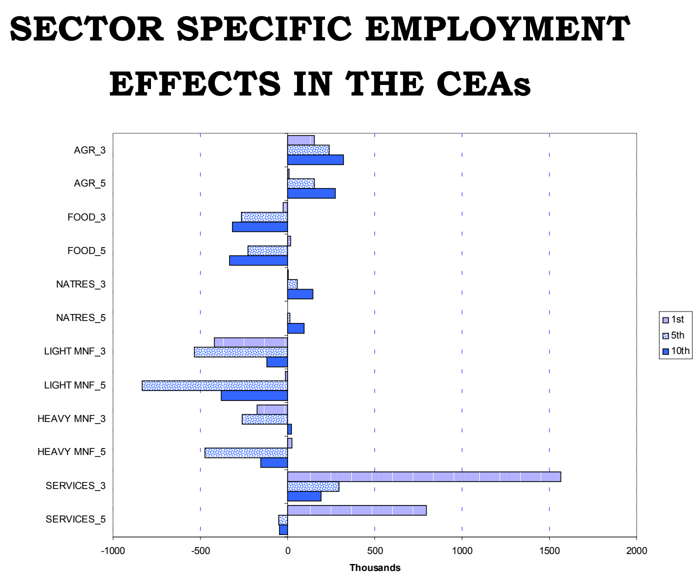
FIGURES AND TABLES:

Figure 1 The Distribution of EU-15 Immigrants Stemming from CEEC-10



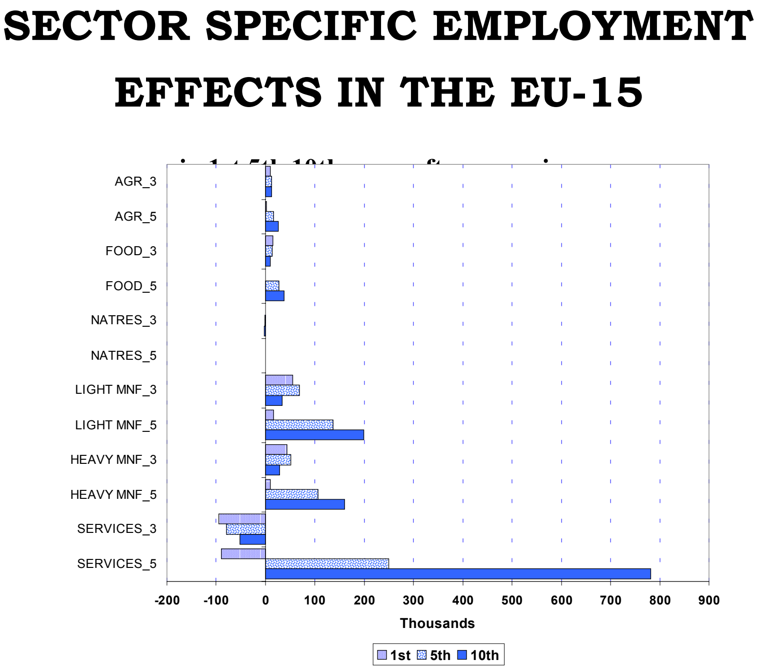
Source: own graph on basis of Kemmerling, Pogodda, Spannbauer (2002). 'MOE' countries are all 10 CEE accession candidates.

Figure 2 Sector Specific Employment Effects in CEEC-10 (Simulation)



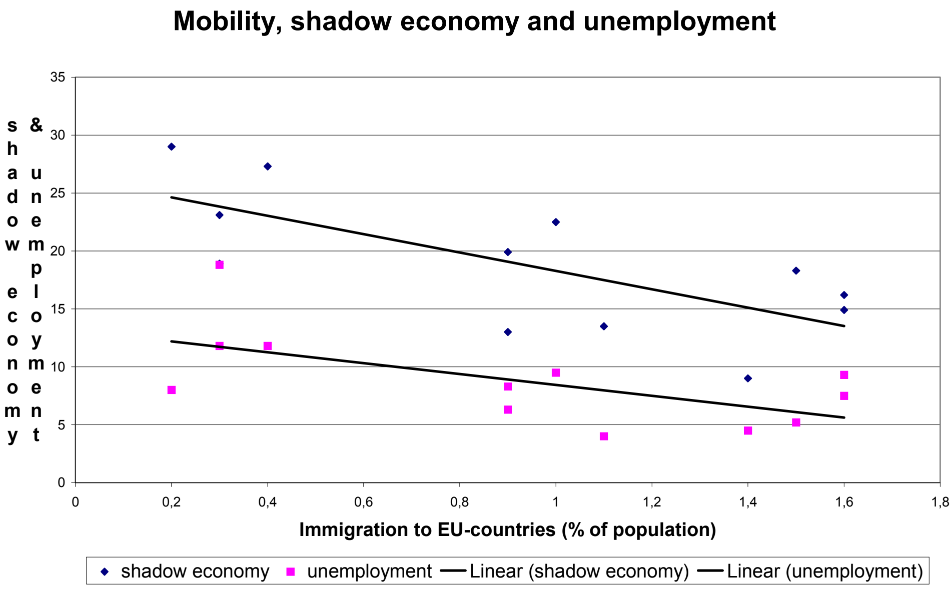
Source: Figures provided by Vaittinnen (available on request). Bars represent changes in thousands of employed people after the 1st, 5th and 10th year of enlargement respectively.

Figure 3 Sector Specific Employment Effects in EU-15 (Simulation)



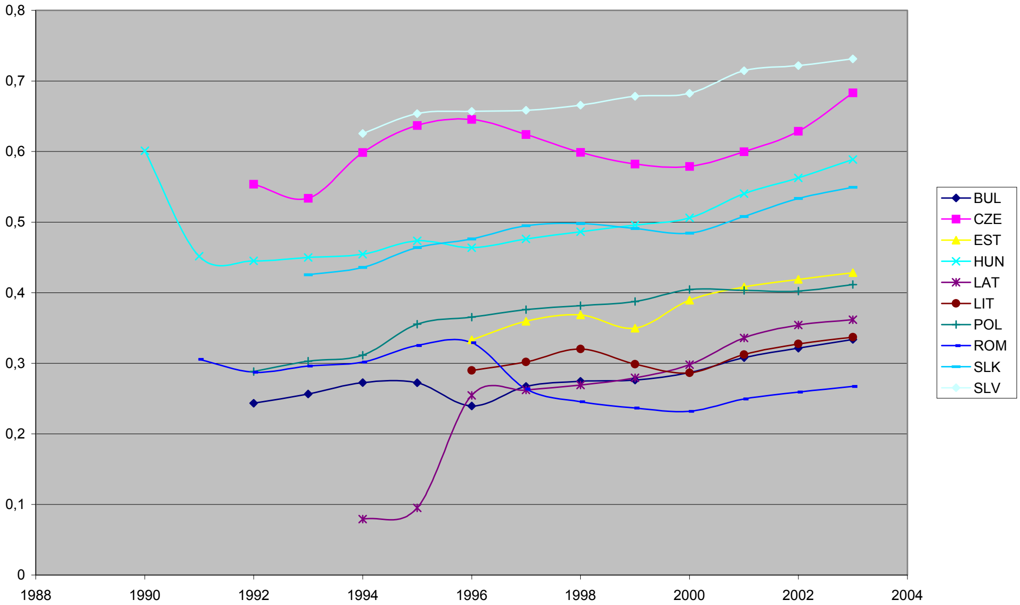
Source: Figures provided by Vaittinnen (available on request). Bars represent changes in thousands of employed people after the 1st, 5th and 10th year of enlargement respectively.

Figure 4 Migration, Unemployment and the Shadow Economy



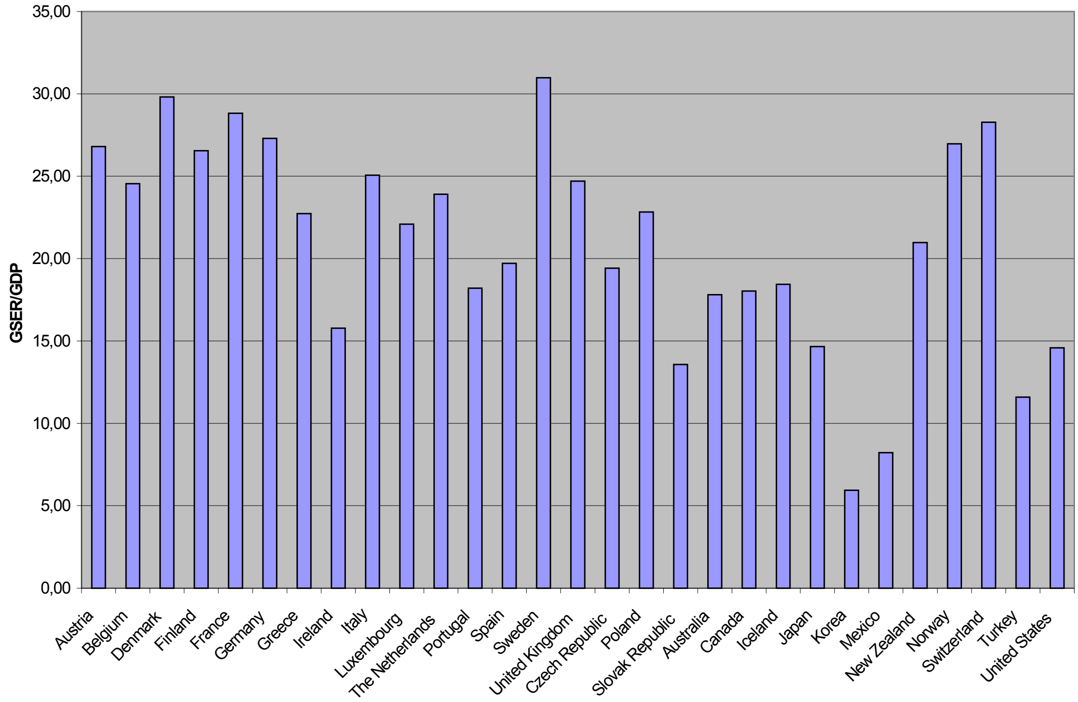
Source: own graph on basis of Kemmerling, Pogodda, Spannbauer (2002) and Schneider (2002)

Figure 5 Convergence of GDP p.c. in PPP (EU-15 = 1)



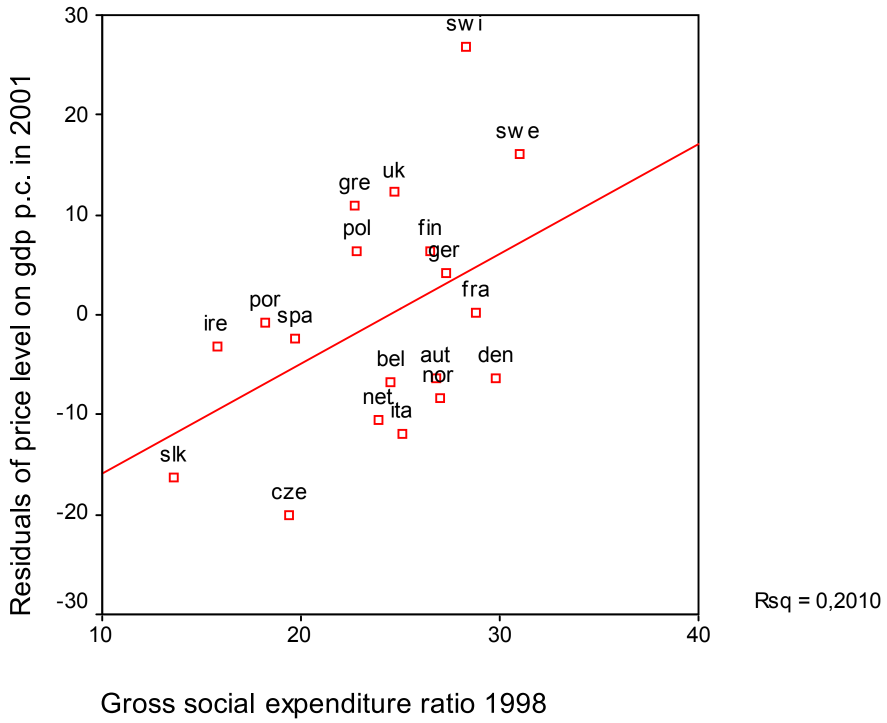
Source: own graph on basis of Eurostat.

Figure 6 International Comparison of Welfare State Expenditures in 2002 ?



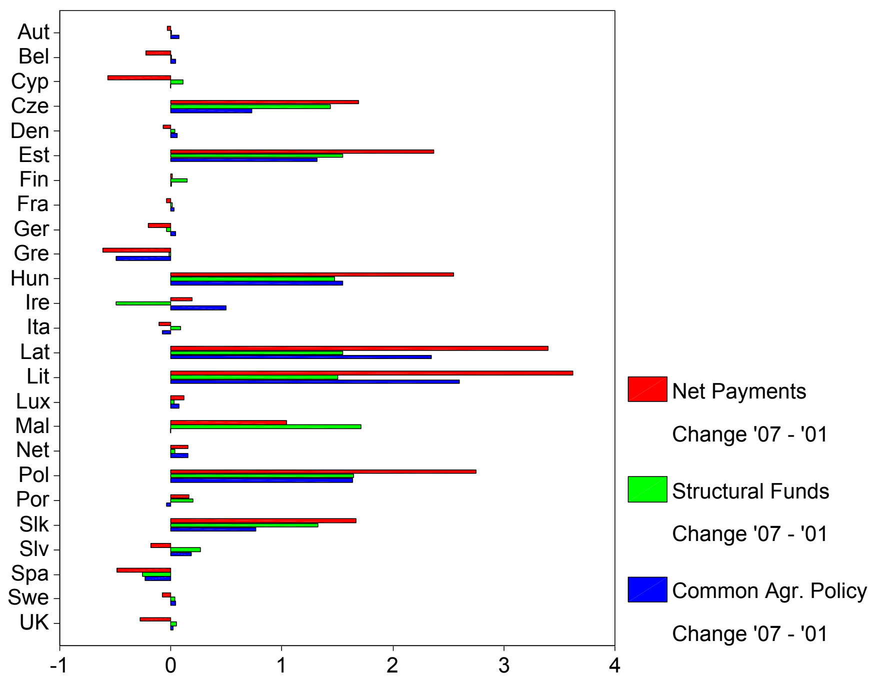
Source: own graph on basis of OECD. Statistical Compendium (2002). Bars show the percentage of GDP dedicated to social expenditures (OECD-definition).

Figure 7 Regression Plot: Levels of Social Expenditure and Adjusted Differences in Price Levels



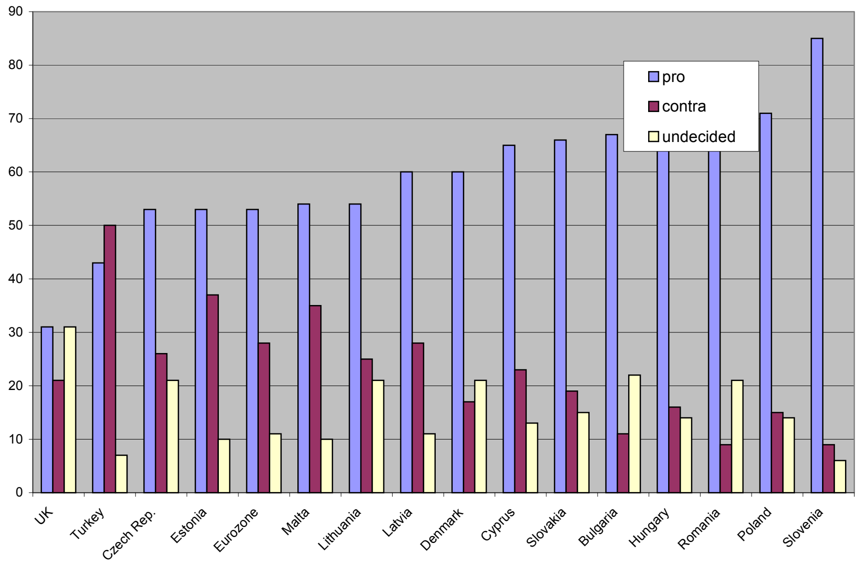
Source: own graph (cf. text body).

Figure 8 Effects of an Enlargement on the EU Budget



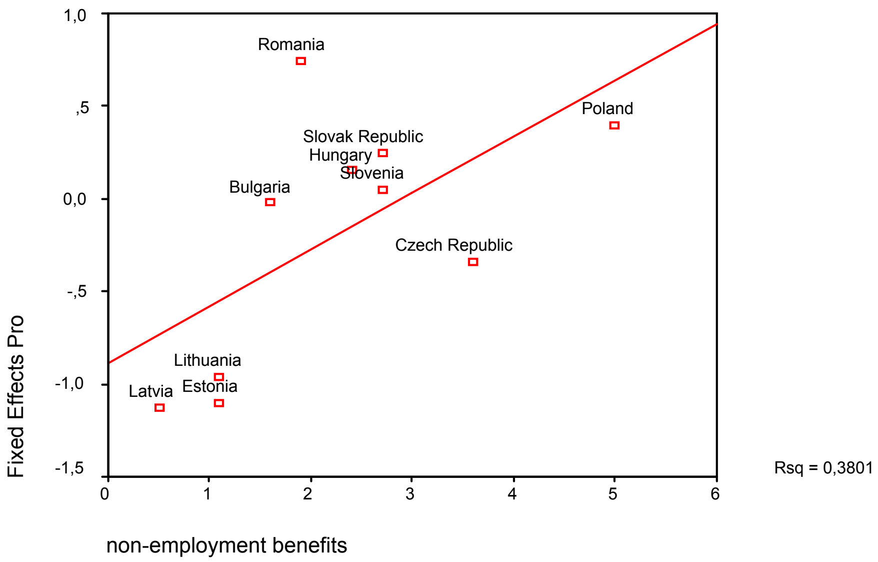
Source: own graph on basis of simulation studies (Weise 2001). The bars represent the changes the status quo as of 2001 and the direct extension of this status quo to the year 2007. Numbers are percentage of changes relative to GDP of the respective country.

Figure 9 Public Opinion on EMU Membership



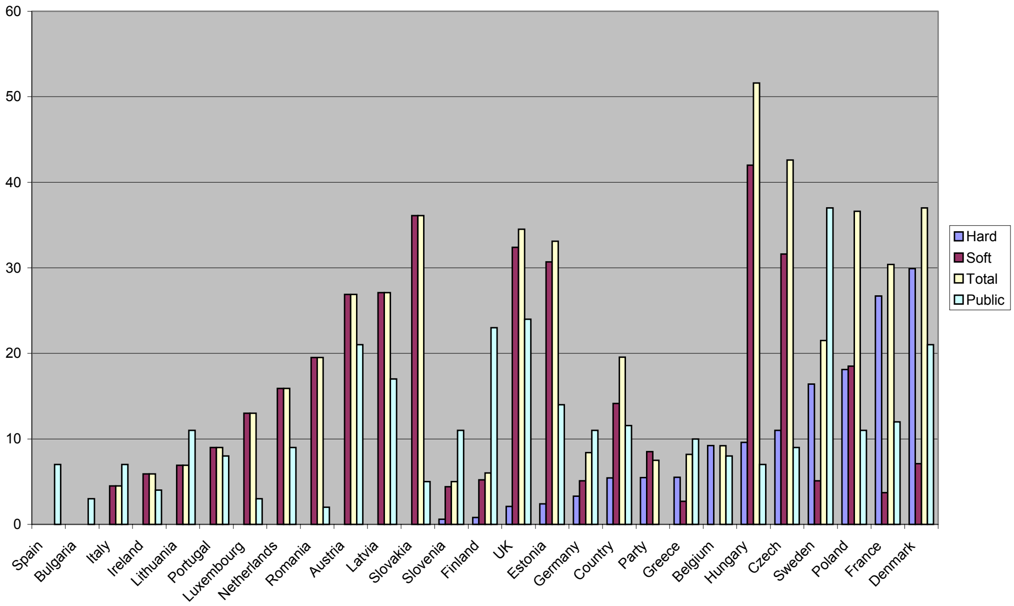
Notes: Sources EB57(2002: p. 4), EB Candidate Countries 2002.2 (p.134); bars represent share of respondents. For candidate countries question is whether they are for, against the adoption of the Euro or undecided. For EU-15 it is whether people believe that the Euro is a good, bad thing or neither good nor bad.

Figure 10 The Importance of Labour Market Institutions for EU Support



Source: own graph on basis of the Fixed Effects Regression in Table 4. The graph relates these fixed country effects to the relation between non-employment benefits and national GDP in the respective country.

Figure 11 The Extent of ‚Euroscepticism' in Europe



Source: own graph on basis of Taggart/ Szczerbiak (2002: 23). For each country, the first two bars represent the incidence of hard and soft forms of party scepticism. The figures correspond to the percentage of votes for these parties in the last elections. The third bar, 'Total', is the sum of these percentages and the fourth, 'Public' refers to the percentage of euro sceptic people reported in the latest Eurobarometer as of 1997.

Table 1 A Simple Empirical Model of Labour Market Reform in OECD Countries

	Average Follow-Through Rate of Labour Market Reforms			
	Model I		Model II	
Intercept	37.44	**	95.24	**
	(15.05)		(39.82)	
Unemployment	3.27	*	2.95	*
	(1.59)		(1.53)	
EMU-dummy	-15.32		-11.22	
	(12.68)		(12.40)	
Tax Revenues/	-		-1.33	
GDP			(0.85)	
Veto-Players	-4.38		-5.92	*
	(2.87)		(2.92)	
adj. R^2	0.18		0.25	*
Nobs.	18		18	

Source: own calculations; average follow through rate of recommendations of the OECD Jobs Strategy (Van Poeck/ Borjis 2002); Veto-Players (Huber/ Stephens 1993); see text for details. Levels of Significance: '*' < .1, '**' <.05, '***' <.01.

Table 2 Modelling the Political Economy of Budget Cuts in OECD Countries

	First Differences in			
	Primary Balance		Budget Structure	
First Differences in				
Intercept	-88.68	**	0.90	
	(35.78)		(0.63)	
Government/ Total employment	-24.94	*	0.02	
	(13.19)		(0.23)	
Age65/Total Population	-12.85		0.11	
	(21.05)		(0.35)	
Union Density in % of Total Employment	10.22	*	0.12	
	(5.81)		(0.10)	
Share of 'left vs. right seats' in national parliaments	1.04		0.17	***
	(2.57)		(0.04)	
Unemployment Ratio	19.15	***	-0.05	
	(5.60)		(0.11)	
GDP Growth	43.16	***	0.45	*
	(11.31)		(0.22)	
Public Primary Balance	-		0.01	
			(0.01)	
EMU Dummy	5.29		0.85	*
	(28.68)		(0.47)	
Adj. R^2	0.36		0.32	
F-Stat.	4.42	***	3.52	***
Nobs.	42		42	

Source: own calculations; simple OLS-SE in paranthesis; test statistics show that fixed effects were not significant and that heteroscedasticity does cause any problems. Data sources: budgetary data from OECD statistic compendium, other data cf. Kemmerling 2002. Levels of Significance: '*' < .1, '**' <.05, '***' <.01.

Table 3 Modelling the Effect of Different Bargaining Rules on the Distribution of EU Transfers

	Receipts per capita in 2000			
	Model I		Model II	
Intercept	0.046		0.049	
SSI95/ pop.	0.042	***	-	
SSI04/ pop.	-		0.082	***
Cohesion- Dummy	0.177	**	0.166	**
adj. R^2	0.965	***	0.965	***
Nobs.	15		15	

Comparison between Model II and EU Commission statement		
	EU Financial Outlook 2006	Estimated Projections for 2006
sum for CEEC-10	ca. 16 bill. Euro	ca. 32 bill. Euro
sum for EU-25	ca. 107 bill. Euro	ca. 101 bill. Euro

Source: SSI95 and SSI04 are power indices taken from Alskerov et al. (2002), receipts per capita are expenditures of the EU budget for member states (EU Commission Report 2002); notes cf. Table 1.

Table 4 Modelling Support for EU in CEEC-10

	Binary Vote for	Binary Vote Against	Binary Not Vote
Education	0,3884 ***	-0,4884 ***	-0,3588 ***
Age	-0,0021	0,0086 **	0,0069 **
Income	-0,0003	0,0022 *	-0,0021
Size of Community	-0,1266 ***	0,1126 ***	0,0422
Civil Servant	-0,1087	0,0035	-7,40E-06
State Firm	-0,0632	-0,0586	0,0317
Private Employer	0,162	-0,0353	-0,3689
Private Employee	-0,0754	0,2859	0,1052
Agriculture	-0,3272 **	0,3306	-0,3099
Pensioner	-0,1462	0,3867	0,1081
Housewife	-0,3352 **	0,5879 **	0,1022
Student	0,1223	0,5929 **	0,4856 **
Not work./ Unemployment	-0,1503	0,5043 **	0,2749
Bulgaria	-0,0223	-1,8269 ***	-2,308 ***
Czech Republic	-0,3385 *	-2,4211 ***	-1,7573 ***
Estonia	-1,1042 ***	-3,3798 ***	-1,5584 ***
Hungary	0,1525	-2,876 ***	-2,2949 ***
Latvia	-1,1234 ***	-2,1745 ***	-1,5495 ***
Lithuania	-0,9646 ***	-1,4652 ***	-2,0919 ***
Poland	0,396	-2,7454 ***	-2,3085 ***
Romania	0,7462 ***	-2,5716 ***	-3,0451 ***
Slovak Republic	0,2453	-3,4213 ***	-1,8623 ***
Slovenia	0,0483	-2,6786 ***	-2,4004 ***
-2 Log Likelihood	13097,259	5152,84	5762,29
Goodness of Fit	10416,407	850,87	10423,752
Wald statistic [df1]			
Levels of Sign.: '*' < .1; '**' <.05; '***' <.01			

Sources: own calculations; data from EB8 on candidate countries.

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