EFFECT OF EU ENLARGEMENT ON GROWTH AND EMPLOYMENT IN GERMANY AND SELECTED EU MEMBER STATES

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EXPERIENCES TO DATE AND FUTURE DEVELOPMENTS TAKING INTO PARTICULAR CONSIDERATION THE EU ACCESSION OF BULGARIA AND ROMANIA

Summary and conclusions

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In the fifth round of EU enlargement on 1 May 2004 ten new member states were admitted to the European Union. With the exception of Cyprus and Malta, these new member states are countries in Central and Eastern Europe (Latvia, Lithuania, Estonia, Poland, Slovakia, the Czech Republic, Hungary and Slovenia, referred to below as NMS-8) which share not only their socialist past but also the far-reaching economic and social transformation into functioning market economies. On 1 January 2007 the fifth round of enlargement was then completed with the accession to the European Union of two more transformation countries, Bulgaria and Romania, which have a clearly lower income level even compared with the new member states which joined in 2004. In addition to the significant political effect of European integration on European cohesion, enlargement reduces other barriers to trade, foreign investment and in particular to labour migration. Various mechanisms will lead to effects on the development of growth and employment and their prospects in both the old and the new EU member states. Especially in the run-up to the EU enlargement in 2004 there were fears that the large income and wage differentials could result in increased competition in labour-intensive products and that the transfer of capital and the immigration of workers from the new member states could lead to decreasing wages and rising unemployment.

More than two years after the enlargement and shortly after the accession of Bulgaria and Romania, an appraisal and evaluation of what has been achieved so far is now being conducted for the first time, in particular with regard to the effects that the EU enlargement to incorporate the NMS-10 (the new member states of the fifth round of enlargement without Malta and Cyprus) is having on Germany. In addition to appraising the expectations that existed in the run-up to the enlargement, the actual development of economic integration since 2004 is described. Furthermore, besides the macroeconomic point of view and the aggregate effects, the report also goes into regional and sectoral concerns in Germany. In addition to this, in the context of a country comparison, the integration effects for Austria and Great Britain compared with Germany are examined and evaluated. Finally, conclusions regarding economic policy are drawn for Germany.

Macroeconomic development in the new member states

The macroeconomic dynamics in the new EU member states are significantly stronger than those in the countries of the old EU-15 and especially Germany. In the past decade the average growth rate of gross domestic product (GDP) in the new accession countries stood at just under 4%, whilst it averaged just over 2% in the EU-15 and only 1.3% in Germany. Macroeconomic projections for the new member states up to 2008 expect similarly high growth rates, so that also in the coming years stronger macroeconomic dynamics are to be expected in these countries. The process of convergence that has been observed since the mid-1990s will therefore continue.

According to EUROSTAT the GDP of the NMS-8 corresponds to approx. 24% and that of Romania and Bulgaria to approx. 4.5% of German GDP at market prices amounting to € 2,245 billion in 2005. Whereas the GDP of the NMS-8 roughly equals the GDP of the Netherlands, the GDP of Romania and Bulgaria together is roughly equivalent to that of the German Federal State of Rhineland-Palatinate. Clearly different relations arise when this is seen with reference to the population. In 2006 72.91 million people lived in the NMS-8 and 29.3 million in Romania and Bulgaria. This is equivalent to 88% of the population of Germany for the NMS-8 and 36% for Bulgaria and Romania. The EU enlargement of 1 January 2007 therefore resulted in a considerable increase in the population of the EU but in only a small increase in the GDP of the European Union.

GDP per capita is significantly lower in the NMS-8 than in the old EU member states, with the result that the income differentials in the European Union increased considerably with the enlargements of 2004 and 2007. In 2005 GDP per capita measured in purchasing power parities (PPP) ranged between 48.6% of the EU-25 average in Latvia and 251% in Luxembourg. Germany's GDP per capita, at 110%, was above the average of the EU-25. Significant differences also exist, however, between the new member states: the Czech Republic and Slovenia have clearly higher incomes than the rest of the new member states, with 73% and 82% respectively of the average GDP per capita in the EU-25. Their income level is similar to that of the countries with the lowest GDP per capita in the "old" EU-15 (Portugal and Greece). The accession countries Romania and Bulgaria show by far the lowest income level, with just over 32% of the EU-25 average.

In the past decade employment decreased on average in the new member states. Only recently has an improvement in the employment situation become visible and unemployment has also fallen significantly, so that an improvement on the labour market is also emerging in the new member states.

Continuation of the dynamic trade development since the 2004 enlargement

Immediately before and after the political and economic opening of the former Central and Eastern European state-trading countries, the EU already took far-reaching steps towards liberalising east-west trade by including some of the Central and Eastern European countries into its Generalised System of Preferences (GSP). In the course of the "pre-accession strategy" leading to a full free-trade zone between the EU and the Central and Eastern European countries, Germany's external economic relations with these countries had already intensified considerably before eastern EU enlargement. German foreign trade with the NMS-8 and Bulgaria and Romania has already been developing more dynamically since the early 1990s than German foreign trade overall or with the old EU member states.

These dynamics also continued after enlargement: exports to the NMS-8 increased from a good € 56 billion in 2003 to € 83 billion in 2006 and imports grew from € 55.3 billion to a good € 70 billion. Romania and Bulgaria have developed in a similar way, exports rose from € 4.6 billion (2003) to € 9.3 billion (2006) and imports increased from a good € 3.2 billion to € 5.8 billion. On the whole since enlargement Germany has recorded high trade and current account surpluses with the NMS-8 and with Bulgaria and Romania, i.e. the value added of the goods and services exported to the NMS-8 clearly exceeds the value added of the imported goods and services.

Against the background of the liberalisation process that had already taken place, EU accession could have been expected not to cause any substantial change in the external trade regime for industrial goods. Consequently a further intensification of trade relations with the eastern neighbouring states, exceeding the development of the 1990s, would be unlikely. Many observers therefore did not expect any clear increase in trade relations after enlargement. There are two arguments against this, however: firstly the "actual" EU enlargement in May 2004 lowered the costs of transactions with industrial goods that are not related to foreign trade policy. Also the integration of the Central and Eastern European countries into the Community customs union reduces trading costs compared with the free-trade area that existed before enlargement. Secondly, in view of the extent to which the Central and Eastern European countries lag behind the rest of the EU in economic terms, it is likely that these countries will grow more rapidly than the previous EU countries in the future too. Because the income level of the trading partners is a key determinant for explaining trade volume, this convergence process is likely to continue to lead to an accelerated growth of trade with the new member states compared with the “wealthy” countries of the previous EU. In addition to this there is the fact that the new EU members will receive considerable resources from the European Structural Funds and will as a result have an increased demand for imports.

An increase in Germany’s volume of trade with the NMS-10 can therefore be expected in the long term, exceeding that with the older EU member states. Even if EU enlargement and the expansion of the single market are no longer the great stimulus for further intensification in view of the elimination of customs duties and other barriers to trade, the increase in the volume of trade will be supported by the convergence of the new member states, including Bulgaria and Romania, towards the income level of the old EU-15 members.

Convergence in the structure of goods in foreign trade

The structure of goods in Germany’s foreign trade with the NMS-8 is subject to clear changes over time, though it is not always easy to interpret the pattern of the comparative advantages and disadvantages via the branches of industry in Germany’s foreign trade. Whereas obvious explanations can be found for some results, other results are not in line with expectations at first. For instance the observation that of the 20 industries with the largest comparative advantages, 5 branches of industry are from the chemical industry and another 4 from the manufacture of machinery and equipment, is in line with expectations. The same can be said for other very technology-intensive industries such as the manufacture of electronic components, the manufacture of pharmaceuticals, medicinal chemicals and botanical products or the manufacture of instruments and appliances for measuring, checking, testing and navigating.

What is unexpected, on the other hand, is the finding that rather labour-intensive branches of industry such as the ‘other textiles or food trade’ are among the branches of industry with the comparative advantages, and technology-intensive branches of industry such as the manufacture of television and radio transmitters and apparatus for line telephony and line telegraphy, the manufacture of electrical equipment, the manufacture of railway and tramway locomotives and rolling stock, or the manufacture of television and radio receivers, sound or video recording or reproducing apparatus and associated goods show comparative disadvantages. In line with expectations, branches of industry in the food trade, the wood industry, the textiles, clothing and leather industries or the manufacture of furniture show comparative disadvantages. What is remarkable is the low competition values of branches of the motor vehicle industry and fields which include their immediate suppliers (manufacture of bodies (coachwork) for motor vehicles, manufacture of trailers and semi-trailers; manufacture of parts and accessories for motor vehicles and their engines; manufacture of structural metal products; manufacture of rubber products; manufacture of electric motors, generators and transformers).

A look at the sectoral structure of German trade with Bulgaria and Romania shows (somewhat more markedly than in the case of the NMS-8) that the branches of industry with the largest comparative advantages principally include branches of the chemical industry, the manufacture of machinery and equipment or other technology-intensive fields. Conversely the branches of industry with comparative disadvantages are primarily in labour-intensive fields such as the food trade, the wood industry, the textiles, clothing and leather industries or the manufacture of metals. However, there are also some findings that are difficult to interpret in the case of trade with Bulgaria and Romania. This applies firstly to the high comparative advantages of branches of the textiles industry (manufacture of knitted and crocheted fabrics, manufacture of other textiles, textile weaving). Secondly the comparative disadvantages for branches of the manufacture of electrical machinery and apparatus (manufacture of electric motors, generators and transformers; manufacture of electrical equipment) come as a surprise.

On the whole therefore, analysing the course of the comparative advantages and disadvantages provides an ambivalent picture. The branches of industry with high comparative advantages as well as those with low values include both technology-intensive and wage-intensive branches. A comparison of the comparative advantages and disadvantages for the period 1992-1994 and the period 2003-2005 shows that the sectoral adjustment pressure has changed considerably for the NMS-8, whilst this can not be observed to the same extent for Bulgaria and Romania. On the whole it can be noted that Germany's comparative advantages in technology-intensive and human-capital-intensive product groups as well as the comparative disadvantages in labour-intensive product groups have melted away over time; at the same time, shares of intra-industry trade, in other words trade within one and the same product group, have increased clearly over time. The findings suggest that in the industrial sector the new member states are increasingly manufacturing with similar technologies to Germany.

Trade in services

In addition to the free movement of goods and capital and the free movement of labour, the free movement of services is one of the four so-called basic freedoms within the European Union. Although when the European single market was created, the free movement of services was also put into effect *de jure*, there are still numerous obstacles regarding the movement of services across the borders within the EU. Only recently, after lengthy negotiations, was it possible, with the agreement on the EU services directive in December 2006, to reach a compromise between the EU member states which should lead to concessions in the EU-wide provision of services. Accordingly it is no surprise that the trade in services between the EU and the NMS-8 in the course of the 1990s was not characterised by a similar EU liberalisation strategy and a corresponding opening up of markets to the case with the trade in goods. Nonetheless the NMS-8 have managed to increase their share of the German trade in services from 1.5% to currently almost 5%. In 1991 Bulgaria and Romania had a share of 0.21%, which rose to 0.36% in 2005, but the importance of these two states for Germany's trade in services as a whole is low. A comparison of the volume of trade in Germany's service transactions with the EU-15 and with the NMS-8 shows, however, that the volume of trade in services differs by a factor of ten and that there is still considerable potential in the trade in services with the NMS.

With regard to the structure of the international division of labour, no fundamental difference is to be expected between the cross-border provision of services and the movement of goods. Germany should export technologically sophisticated services which are provided using a relatively high level of human capital (provided it is possible to trade in these services) and conversely should import services which are produced using a large amount of low-skilled labour. Unfortunately the statistics about trade in services do not include suitable data to be able to conduct statistical analyses in the necessary depth.

If, in spite of the unsatisfactory data situation, the results on trade in services are summarised, it can be ascertained that the trade in services with the NMS-8, starting out from a low basis, has increased more rapidly since the early 1990s than the trade in services with the EU-15. The share of the NMS-8 in the entire volume of trade in services is, at around 5%, considerably smaller than the share in the movement of goods (10%). Secondly German expenditures clearly exceed the receipts, which is essentially caused by the negative balance in tourist travel. What is remarkable is that trade in technological services has increased considerably. In the meantime this sector achieves the proportionately highest receipts and a surplus in the trade in services with the NMS-8. In this respect the trade pattern is in line with the theoretical expectations according to which the international division of labour is determined by comparative cost advantages in both the movement of goods and the movement of services. On the whole, however, it has to be conceded that neither the amount nor the statistical recording of the cross-border provision of services provides much substance for further analyses. Accordingly trade in services with the countries of Central and Eastern Europe has received little attention in economic literature to date compared with trade in goods.

Dynamic development of direct investment, little indication of shifts

The temporal development of the direct investment stocks in the NMS-8 and in particular the “bilateral” investment relations with Germany show that the integration of the Central and Eastern European countries into the European economy is progressing rapidly and that German firms show a considerable proportion of the direct investment stocks in the new member states. Furthermore the development in the period 1995-2004 shows that German investors have expanded their investment activities considerably in all of the NMS-8 and also in Bulgaria and Romania. The development of German direct investment in the NMS-8 has progressed far more dynamically than the development of German investment activity in the EU-15. The course of direct investment in the NMS-8 overall fits in with the worldwide globalisation of production and production facilities, it shows no particular development compared with German direct investment worldwide.

The stock of direct investment in the NMS-10 is, however, still relatively small, at about 6% of German stocks of direct investment worldwide in 2004, which totalled approx. € 700 billion. Bulgaria and Romania receive 0.08% and 0.19% of the direct investment stocks respectively with the result that in particular the newest EU member states have very low stocks of German direct investment. In Poland, the Czech Republic and Hungary, the larger of the new member states, Germany is one of the most important investors with a share of 20 to 25 percent of the entire stock of direct investment there.

In public debate the worry prevails that German direct investment in the new member states is primarily associated with a displacement of jobs. In order to examine whether these worries about huge displacements to low-wage countries are legitimate, it is worth taking a look at the determinants of direct investment. Economic literature identifies two main reasons for foreign investment: first the decision for direct investment can be made in order to open up new markets (horizontal engagement) or second, it can be made with the intention of utilising comparative cost advantages (vertical engagement).

Depending on which of the motives is uppermost when firms choose their location, there can be completely different effects on the development of domestic employment. Especially investment decisions which are based on comparative advantages can lead – though not inevitably so – to a direct adjustment pressure on the national labour market. The empirical literature on the motives for direct investment generally finds that motives to do with opening up new markets are the main reason for investment in the new member states. This applies on the whole to Germany too. With respect to the countries of Eastern Europe, however, there are also empirical results which identify the differences in wage costs as being significant for the direct investment of German firms in Eastern European countries. Although negative effects on employment in the old EU member states can be identified from this, they are not very large.

All in all on the basis of the available empirical evidence on direct investment, the conclusion can be drawn that the effects on growth and employment in Germany are rather marginal. Even if there are individual cases of firms moving their production facilities to the new member states, it is not possible to derive from this a general trend towards the reduction of employment in Germany as a result of EU enlargement. In macroeconomic terms the volume of direct investment in the NMS-10 is too small for that. In 2004 the volume of direct investment in the new member states amounted to approximately 0.3% of Germany's gross domestic product.

Diversion of migration flows as a result of the transitional arrangements

Of the four basic freedoms, the introduction of the free movement of labour for the new member states is likely to have especially far-reaching economic consequences. One of the reasons for this is that the free movement of goods and capital had already been liberalised to a large extent and the trade in services in part before enlargement, whereas the member states of the European Union restricted access to the labour market considerably for citizens from the accession countries.

The restrictions on migration come up against strong economic incentives to migrate. The income gap between the EU-15, the NMS-8 and Bulgaria and Romania is large. In 2005 GDP per capita measured in purchasing power parities was around 50% and measured in current exchange rates about 25% of the level in the EU-15. In view of these large income differentials, there is a great deal of uncertainty about the extent of potential migration from the new member states and Bulgaria and Romania.

In the run-up to enlargement attempts were made to reduce the uncertainty about the consequences of the free movement of labour and to examine it systematically. Most of the studies expect an inflow of 3-4% of the population of the accession countries into the EU-15 in the long term, even if individual studies reveal considerably higher or clearly lower forecasts. With a population of 73 million in the NMS-8, this would be equivalent to a migration of 2.2-3 million people. If Romania and Bulgaria are also taken into account, the predicted immigration rises to a total of some 3-4 million people. In the short run, i.e. in the first years following enlargement, most of the studies expect an annual net immigration into the EU-15 from the ten accession countries (including Bulgaria and Romania) of 250,000 to 400,000 people, but this rate is expected to fall quickly. If the free movement of labour had been introduced at the same time in all of the EU member states, network effects and other arguments would have suggested that the regional distribution of the immigrants from the new member states across the individual countries of the EU-15 would have remained largely constant. Germany would then have received a share of some 60% of the immigration from the new member states into the EU-15.

The different application of the transitional arrangements since 1 May 2004 has led to a re-orientation of the regional migration structure. Following enlargement in 2004 the labour markets in some of the countries were not opened up at all, in others they were partly opened up and in some countries they were opened up completely. All in all immigration from the NMS-8 into the EU-15 in the two years since enlargement can be estimated at 200,000 to 220,000 persons per year. This is equivalent to a good two thirds of the potential predicted by many studies for the case of full freedom of movement for labour. Although this can be interpreted as confirmation of the estimates in view of the existing restrictions on migration, immigration to Great Britain and Ireland has been clearly higher than in the estimates whilst net immigration to Germany, at 36,000 persons (2004) and 63,000 persons (2005), has fallen far behind the potential estimated for the case of free movement of labour.

Above-average labour market risks with controlled immigration

Even after enlargement, the immigration of labour into Germany is still regulated to a large extent by bilateral agreements or by bilateral placement agreements between the labour administrations (called “scheme workers” here). These agreements open up access to certain branches of the economy and activities. In agriculture or in hotels and restaurants the demand for workers from the NMS-8 has increased in the past decade. By far the majority of the workers who immigrated in this context were seasonal workers. Most of them (90%) work in agriculture, they are predominantly from Poland (almost 90%) and 90% of them work in western Germany. After enlargement the number of seasonal workers remained stable to begin with at a high level and stood at 330,000 in 2005.

In addition to the scheme workers, the freedom of establishment has provided another possibility of access to the German labour market since enlargement. Although the number of self-employed people from the NMS-8 in Germany is not recorded, it is possible to draw conclusions regarding the use of the freedom of establishment from the registration of self-employed people with the Chambers of Handicrafts. Since 1 May 2004, approx. 14,000 citizens from the NMS-8 have registered a business with the Chambers of Handicrafts. In 2005 alone almost 11,000 craft businesses were registered by owners from the NMS-8. The share of craft businesses as a percentage of the total in Germany in 2005, at 1.6%, was considerably higher than the share of NMS-8 citizens as a percentage of the German population of working age (0.6%). From a regional point of view, registrations of businesses are concentrated in the agglomerations and in the regions in Germany that have a high GDP per capita. In the rural regions and in the *Länder* of eastern Germany the number of registrations is generally small.

Appraisal of key projections made before EU enlargement

a) Large integration gains for the NMS and moderate welfare gains for Germany

Before the 2004 enlargement, numerous studies dealt with the macroeconomic effects of the integration of the Central and Eastern European countries into the European Union. Although there are considerable differences in the form of the individual studies, three key results can be drawn from virtually all of the studies. Firstly, the effects of EU enlargement are stronger for the Central and Eastern European accession countries than for the “old” EU member states and reveal on the whole clear welfare gains for the new member states. Secondly on the whole EU enlargement brings welfare gains for the old member states, too, though they are generally only small gains. Thirdly, the welfare gains in the old EU member countries vary strongly from a regional and a sectoral point of view. As a rule it can be seen that the welfare gains are likely to be greater the larger the shares of trade of the countries or regions with the new member states are. These shares are, on the other hand, a function of spatial proximity, so in particular Germany and Austria may expect positive effects. The macroeconomic integration gains for Germany and Austria are estimated as a change in the GDP level of about 0.5%.

In summary, the studies conducted in the run-up to enlargement come to the conclusion that the fifth round of the EU enlargement to include NMS leads to positive net economic benefits for the old member states whose order of magnitude is sufficient to compensate for the fiscal burdens of the EU budget resulting from the net transfers to the accession countries. It must be taken into account, however, that EU enlargement covers all the positive welfare effects here and also includes the effects that were already achieved as a result of the far-reaching liberalisation of trade via the Europe agreement.

b) Labour market effects: On the whole small effects on wages, employment and unemployment

The studies that deal with the effects that foreign trade and migration have on wages, employment and unemployment in the old EU member states tend to find small effects, but emphasise the consequences of economic integration for distributional policy. Perhaps the most surprising result obtained is that immigration need not have negative consequences for all the groups on the labour market. Especially for groups that are in a complementary relationship to low-skilled foreign workers, which is the case for highly skilled workers, these studies also find that immigration has positive effects on wages and employment prospects. However, these effects are stronger in Austria than in Germany. For low-skilled and immobile workers some studies find negative effects of trade and migration on wages and employment prospects, whilst other studies obtain neutral results.

One critical objection to these studies is the fact that they are hardly suitable for forecast purposes owing to their partial-analysis approach and the often very specific groups that they deal with, and also that they do not permit statements about the welfare effects of migration and foreign trade. For this purpose methods which are orientated more towards a general equilibrium are to be preferred. The strength of the empirical view of the labour market lies above all in supplementing such model-based studies, which are often forced to be quite sweeping, with additional information about distribution effects.

Germany benefits more from EU enlargement than previously assumed

For this reason in the present study the effects of EU enlargement on the economy as a whole were simulated in an applied equilibrium model for Germany. The enlargement of the EU influences the national economies of the European Union in three ways in particular: through the integration of the goods markets, the capital markets and the labour markets.

The equilibrium model makes it possible to simulate the effects of enlargement on all three markets simultaneously. The simulations are based on a model that explicitly models the wage and employment structures of employees covered by social security. It takes wage rigidities into consideration, thus making it possible to analyse the effects of immigration on unemployment and employment. Furthermore the specific employment structure of workers from the new member states compared with German workers and other nationalities is included in the study. In this way conclusions can also be drawn concerning the effects that immigration from the new member states has on sectoral wages and employment.

The simulations reach the result that in Germany the liberalisation of trade and the capital transactions with the NMS-8 lead to an increase in overall production, higher wages and, if wage rigidities are taken into account, even to a reduction of unemployment. If the status quo continues, i.e. if the transitional arrangements regarding the free movement of labour are maintained, Germany's gross domestic product rises by 1% compared with the baseline scenario, wages rise by 0.8% and employment by 1.1%, whilst the unemployment rate falls by 0.6%. If free movement of labour is introduced for the NMS-8 the gross domestic product rises by 1.3% and employment by 1.6%. However, the growth of wages and the decrease in unemployment are somewhat smaller than if the status quo continues, at 0.6% and 0.5% respectively. If free movement of labour were also introduced for Bulgaria and Romania, employment and overall production would grow somewhat more strongly whilst wage growth and the decrease in unemployment would be slowed down further. On the whole the introduction of the free movement of labour could raise the enlargement-related increase in GDP in Germany by roughly one third.

In the simulations carried out here, the increase in overall production and employment is somewhat stronger than in similar calculations with similar model approaches. The reason for this, in addition to smaller methodical differences and the use of a more recent data basis, is probably that in the course of the eastern enlargement of the EU trade grew more strongly than earlier studies had expected.

The macroeconomic results of the simulations for the case of free movement of labour depend strongly on the assumptions made about immigration. Here projections of the migration potential that were made before eastern enlargement were used. Actual immigration to Germany could be lower, however, because owing to the diversion of the migration flows to Great Britain and Ireland, the number of people prepared to emigrate from the NMS-8 and Bulgaria and Romania falls after the transitional arrangements end. This can scarcely be quantified, however. On the whole, the migration scenarios and thus also the macroeconomic simulations of the effects of enlargement when free movement of labour is introduced are subject to considerable uncertainty.

Assuming the existence of a negative wage curve, i.e. falling wages with rising unemployment, the effects that immigration and the integration of the goods and capital markets have on wages are quite moderate. Nonetheless considerable distribution effects arise as a result of the sectoral effects of integration. Thus, for instance, immigration puts pressure primarily on agriculture and, as a result of the quota regulations being abolished, also on the construction sector. In these sectors either wages have to fall considerably or there will be a reduction in employment. In contrast to this, industry benefits from immigration. In this economic sector the effects of EU enlargement can only be fully utilised when the free movement of labour is introduced or labour market flexibility created. Therefore industry can be seen as the engine of enlargement for Germany, which, if there is an adequate supply of labour, changes positively the balance of payments on current account both as regards trade with the rest of Europe and regarding trade with the rest of the world.

The results of this analysis have to be interpreted with caution, however. As is also the case with other applied equilibrium models, the analysis conducted here is subject to a number of restrictions: first, the effects of EU enlargement are only examined for the case that the global trade conditions remain constant. Second, this is an examination of two points in time when the economy is in a state of equilibrium, i.e. the effects are compared with each other in fictive long-term equilibrium conditions. Nonetheless the constancy of the prognosis, which leads to similar results when using the data basis of 1996 and when using that of 2001, indicates that the present results are quite robust with regard to different assumptions.

Regional and sectoral effects of EU enlargement

In addition to the effects on the economy as a whole, the study also went into the question as to what effects EU enlargement has had and will continue to have on the competitiveness of Germany's regions, in particular the border regions. The competitiveness of a region is defined here as a region's ability to secure for the population a high factor income in the long run, and is measured, as is usual internationally, in terms of gross domestic product (GDP) per capita. Standard statistical regions are used as regional analysis units.

As many of the effects of EU enlargement actually already occurred in the course of the 1990s, it is assumed that regions which revealed a high (low) level of competitiveness in the past under the conditions of global economic integration will also do so under the conditions of an (even) stronger integration of the Central and Eastern European markets into the EU. In the light of this, the spatial distribution of GDP per capita within Germany is analysed. Here both a clear east-west differential and a north-south differential is found, though the latter is far smaller. In addition it can be noted that higher GDP per capita is reached in the urban agglomerations than in the rural peripheral regions. Another finding of the study, besides these well-known "stylised facts", is that there is no strict relationship between spatial proximity to the former eastern external border of the EU and GDP per capita. Instead, some border regions show higher GDP per capita than comparable non-border regions and others lower GDP per capita.

In addition to the development of GDP per capita, the analysis also focuses on the sectoral structure of the economy as a key determinant of the competitiveness of the regions. However, it is not possible to derive any clear statements about the influence of a given sectoral economic structure on *long-term* region-specific economic developments. It is possible, though, make *short- to medium-term* forecasts if one takes into account the impact of EU enlargement on the future development of the comparative cost advantages of foreign trade and the locational advantage for sectors with increasing returns to scale. With regard to the degree to which regions are affected by the implied structural change as a result of EU enlargement, the following statements can be made for the short- to medium term:

- The regions that benefit from EU enlargement are first and foremost those regions within Germany in which many branches of the economy that have specialised in (human-) capital-intensive production methods and the manufacture of technologically sophisticated goods are represented.

- EU enlargement has increased the opportunities to organise production along the supply chain internationally by means of direct investment and cooperations. The resulting displacement risks tend to be concentrated in the regions with a large share of sectors specialising in labour-intensive manufacturing processes and inferior product segments.

The enlargement of the EU has increased the pressure to secure and expand existing competitive advantages by means of innovations. Consequently regions within Germany that have a high level of research and development activities and specialise in the manufacture of products that are in an early stage of the product life cycle benefit to an above-average extent. Regions in which the existence of comparative cost advantages are intensified by agglomeration advantages outside the firms (e.g. knowledge spillovers in research and development) benefit in particular.

What is of particular interest when evaluating EU enlargement is the question regarding the change in employment in the manufacturing sector and the services sector which could be observed in Germany's regions immediately after the accession of the NMS-8. For this purpose the increase in the number of employees covered by social security between June 2004 and June 2006 was examined. The pattern of regional employment growth in the individual industry and service groups proves to be very heterogeneous. Spatial proximity to the new member states does not play a systematic role, however. On the whole the employment growth rates thus provide no indication of a special effect in the border regions which could plausibly be explained by EU enlargement.

In a final step, in order to supplement the macroeconomic study in Chapter 3, the determinants of the regional distribution of the new craft enterprises owned by people from the NMS-8 are analysed with the aid of a regression model at the level of the districts covered by the Chambers of Handicrafts. The results show that start-ups of craft enterprises by people from the NMS-8 are first and foremost determined by the prosperity of the region and the density of economic activity. Hardly any particularities can be observed for eastern Germany, so the relatively small share of new craft enterprises set up there can essentially be put down to the lower economic efficiency. In summary the econometric findings thus confirm the results derived intuitively in Chapter 3, but explain at the same time that the dependence of the business start-ups is determined by economic factors.

All in all the analysis shows that no coherent regional pattern and no special role of spatial proximity to the NMS can be recognised with regard to the sectoral structure of the economy in the regions. Instead, it can be ascertained that the expected positive macroeconomic effects will be distributed very differently within Germany from a spatial point of view and will be most noticeable in the regions which have sectoral structures that have proved to be strong in international competition on the whole and therefore also in the course of the integration of the Central and Eastern European countries. Regions that have a large stock of labour-intensive segments with a low level of human capital, on the other hand, are increasedly exposed to adjustment pressure. It must be pointed out, however, that this adjustment pressure was not originally triggered by EU enlargement, but that enlargement is simply a special European component of the general trend towards the global liberalisation of the markets.

International comparisons

a) Great Britain

In the observation period 1991 to 2006 the British economy experienced a positive economic development compared with that in Germany and also that in the EU-15 as a whole. This positive growth stimulus also shows effects on the relative level of prosperity of Great Britain within the EU: whilst in the early 1990s British GDP per capita still lagged clearly behind the EU-wide and German income levels, by the end of the period under observation it had been possible to convert this deficit into a clear plus.

Britain’s most important trade partners include the countries of the EU-15. In contrast, the share of exports to the NMS-10 is still relatively small, even though slight increases can be recorded over time. Imports from the NMS, on the other hand, are growing relatively clearly. Quantitative studies on the potential of trade between Great Britain and the NMS also see further scope in this respect. British foreign direct investment is dominated by the EU-15 and the USA, which together account for more than two thirds of the total of FDI stocks. Direct investment in the new EU states is very small, direct investment from the NMS in Great Britain virtually does not exist.

From the 1990s until the end of the period under observation the British labour market also showed a clearly positive performance. This manifests itself in particular in the combination of a high employment rate and a low unemployment rate. In this respect Great Britain is well ahead of the EU and the German levels. Although Germany shows a similarly high employment rate, its unemployment rate is considerably higher.

Britain’s positive labour market performance is seen as a key factor for a comparatively high level of immigration from the NMS-8 to Great Britain – in addition to a multitude of other motives such as institutional factors, low language barriers etc. One subject which is heavily discussed in public debate and academic research is the economic effects of the migration especially in the light of the EU enlargement to include Bulgaria and Romania which came into force on 1 January 2007. The debate focuses on the effects on key macroeconomic aggregates such as employment, unemployment, production and productivity. Several macro simulations have been conducted for the British economy which are largely consistent in their fundamental statements (adjusted for different model assumptions). A relationship between immigration and a high unemployment rate is seen at most as temporary. Barrell et al. (2006) estimate that if the number of immigrants increases by a total of 500,000 (spread over 5 years), the unemployment rate in Great Britain increases by up to half a percentage point in the first five years. In the long term, however, the effect is more likely to be replaced by falling wages and increasing employment, which brings the unemployment rate back down to its original level. Only in labour market segments which are characterised by wage rigidities (such as the low-wage sector with a minimum wage as the lower limit) can an increase in unemployment arise, since it is not possible for price mechanisms (wage cuts) to have an effect here. Owing to employment increasing as a result of immigration, the majority of macro studies see a positive output effect that is driven by domestic demand, which stands at about 1% of the British national product. In addition to aggregate effects, immigration from the NMS also triggers sectoral and spatial effects, which could be cushioned by suitable policy measures (e.g. modifications in the inter-regional transfer system). From a sectoral viewpoint, the labour market equilibrium in the services sector in particular is affected by the additional labour force potential from the new member states. This can be expected to further encourage trends towards tertiarisation.

On the whole the results show that Great Britain benefits from the increase in migration from the NMS-8. The production potential and GDP are increasing as a result of the larger supply of labour, whilst labour costs, prices and the pension burden are falling due to the younger age structure of the new immigrants. What is also significant is the fact that the migrants' activities are making the regional labour markets more flexible, and that the entire economy is becoming more dynamic and less sensitive to disturbances. Although from an economic point of view, there is little indication that immigration from the NMS to Great Britain is causing permanent negative effects, Great Britain has refused the immediate granting of the free movement of labour for Romania and Bulgaria. The reason given for this was first and foremost the strong focus of immigration on employment in agriculture and thus a change in the regional distribution of immigration, the consequences of which, in particular language and educational problems, have not yet been overcome in social terms.

b) Austria

For Austria, too, the macroeconomic, sectoral and regional developments do not indicate any dramatic shifts in growth dynamics or the labour market situation as a result of EU enlargement. Already before enlargement, only slight macroeconomic effects were expected from the further reduction of the barriers to trade and the movement of capital. The areas in which EU enlargement was expected to have the most serious effects were especially protected by the transitional arrangements concerning the free movement of labour as well as the free movement of services and the freedom of establishment.

The most important impulses of economic development in 2004 and 2005 thus came from an improvement of the foreign trade position as regards non-European countries and from immigration originating mainly from the old EU countries. Also with regard to regional aspects, no dramatic shifts in economic development can be observed at present. However, on the Austrian labour market signs are emerging of increasing competition between different groups of immigrants and a partial use of the possibilities to circumvent the transitional arrangements, which are laid down in the accession agreement. In general, however, these developments have not led to any considerable problems on the labour market, and the transitional arrangements seem to have stemmed migration at least in relation to the ex-ante forecasts of immigration without transitional arrangements. From a short-term point of view therefore, EU enlargement has had hardly any effects on the development of Austria's economy as a whole.

From a medium-term point of view, the opening of the economies of Central and Eastern Europe in the 1990s was a driving force in the internationalisation of Austrian firms, but in recent years especially direct investment in the former candidate countries has been increasing whilst that in the new member states actually fell in 2004 and 2005. In this respect Austria has benefited above all from an improvement in the locational advantages for the headquarters of international firms, from falling costs for domestic firms, which boosted the international competitiveness of Austrian firms, and a high profitability of investment made in the new member states. The displacement of jobs abroad, on the other hand, has probably played only a minor role.

The sectoral and regional effects ascertained so far, which have been discussed particularly intensively especially in Austria, hardly point to considerable regional or sectoral changes. In particular with regard to the sectoral developments, no dramatic changes in the locational advantage have arisen. Some of the border regions have developed better than regions in the centre of the country and others have developed more poorly, so no clear general relationships result between sectoral and regional development and EU enlargement. Although 2004 and 2005 were characterised on the whole by a more rapid change in the sectoral structure of the economy (in particular in the production of physical goods), this is likely to have been a result of the good level of export activity. Moreover, our studies also show that, since enlargement, employment in the border regions of Austria and the NMS has grown significantly more slowly than in non-border regions compared with the two previous years. However, this effect can be put down exclusively to the development of employment in Vienna.

Bulgaria and Romania:
large population, low GDP and high growth dynamics

With the accession of Bulgaria and Romania to the EU on 1 January 2007, the fifth round of EU enlargement was concluded. In the process the European Union grew by just under 30 million inhabitants. However, the national product of the European Union, measured as GDP at market prices in €, only increases by just under 1%. In relation to Germany, the production of Bulgaria and Romania is equivalent to just over 4% of German GDP. Consequently two economies which are relatively populous but have low economic efficiency have been adopted. The present growth forecasts show dynamic development prospects for Romania and Bulgaria, albeit starting out from a very low level. Our analyses have shown that foreign trade with both of the economies has expanded significantly, but that Germany's direct investment stocks in the two countries are also still relatively small. On the whole it can be assumed that there will be no significant sectoral shifts for Germany resulting from foreign trade after the accession. At most there could be significant effects resulting from migratory movements. However, Germany does not plan to grant the free movement of labour, so hardly any effects on the German economy are to be expected from that side, either.

Conclusions regarding economic policy

The enlargement of the EU to include ten new member states in 2004 and the accession of Bulgaria and Romania at the beginning of 2007 have reinforced economic integration in Europe. The integration of these countries into the single market is likely to lead to a dynamic growth of trade, direct investment and an increased intensity of competition on the single market. Furthermore the opportunities for choice of location have grown. In contrast to trade and the movement of capital, the free movement of people is still subject to considerable restrictions, especially in Germany and Austria, whilst other EU countries either opened up their labour markets immediately to immigrants from the NMS-8 which joined the EU in 2004 (Great Britain, Ireland, Sweden and partly also Denmark) or opened them up after the first phase of the transitional arrangements expired in 2006 (Italy, Finland, Portugal, Spain). In contrast, all of the member states of the old EU-15 (apart from Finland and Sweden) have retained their restrictions on immigration from Bulgaria and Romania for the time being even after their accession.

This section first discusses the conclusions regarding economic policy which result from the integration of the goods and capital markets in general and the regional and sectoral developments, and then examines the question of the opening up of the German labour market to immigration from the new member states.

Promoting the integration of the markets for goods, capital and services

The integration of the goods and capital markets is raising the gross domestic product of the enlarged EU perceptibly. As one of the most important trade partners of the new member states, Germany benefits from enlargement more considerably than was previously assumed. At macroeconomic level, production, wages and employment are increasing, whilst the unemployment rate is declining. This development does not constitute a shock but a dynamic trend which is very likely to continue in the future.

The most important cause of the positive macroeconomic effects for Germany is trade with the new member states. The often feared, systematic relocation of firms due to comparative disadvantages in Germany are hardly justified. On the contrary, the development of direct investment stocks serves primarily to open up new markets, there is no indication of production being relocated on a large scale. Germany's constantly high current account surpluses in trade with the new member states, too, demonstrate that on balance no value added is being shifted from Germany to the NMS-8 or the NMS-10. Our findings do not confirm the assumption that the Central and Eastern European countries will put especially labour-intensive production in Germany under competitive and adjustment pressure due to their comparative advantages as regards their endowment with the factor of labour. At first the new member states did have visible comparative advantages in the manufacture of labour-intensive goods compared with Germany and the EU-15, whilst conversely Germany and the EU-15 had comparative advantages over the new member states as regards human-capital-intensive, real-capital-intensive and technology-intensive goods. However, these comparative advantages have melted away over time. Conversely, the shares of intra-industry trade, i.e. trade within the same product groups, between Germany and the new member states are reaching roughly the same values as in trade between Germany and the rest of the EU. In other words, the new member states are in the meantime producing goods with similar technologies and similar factor input relationships as the EU-15. Bulgaria and Romania are exceptions in this respect. However, these countries are too small to cause price changes on the goods and factor markets in the EU-15 or in Germany. Consequently there is no, or at most only marginal, adjustment pressure on the factor markets, i.e. in sectoral terms, too, no negative wage or employment effects resulting from trade and the movement of capital can be determined. Similar applies to the regional level. The adjustment pressure on the border regions that many observers expected has failed to materialise. The border regions are affected neither particularly positively nor particularly negatively by enlargement; many regions, such as the German-Polish border regions, are even affected to a clearly disproportionately low degree. In Germany the agglomerations are the regions that are likely to benefit most from EU enlargement.

In view of these findings – positive macroeconomic effects with no, or at most only slight, adjustment frictions at sectoral or regional level – the most important policy conclusion is that Germany and the EU should work together on further reducing the remaining barriers to trade in goods and services and the movement of capital. Although the NMS have accepted the "acquis communautaire", the legal framework of the Community, there continue to be numerous barriers to the integration of the markets, for instance in the area of transport infrastructure, the number of border crossings, the carrying through of Community law etc., which lead to high transaction costs and hinder further integration. Further integration steps, such as the new member states joining the European Monetary Union can be expected to bring additional macroeconomic gains for the new member states and the EU-15. Economic theory postulates that monetary integration also drives forward the integration of the real economies by means of greater transparency in cross-border transactions and easier access to the capital market for the Central and Eastern European countries. Consequently the participation of the Central and Eastern European countries in the European Economic and Monetary Union can be expected to bring additional impulses for trade. Following the experiences made with the previous stages of integration, this is likely to reinforce further the positive macroeconomic effects of EU enlargement on Germany.

The largest development potential is in the services trade. Owing to the underdeveloped transport structure but also to the lack of depth of the capital markets, the level of trade in services lags behind that of comparable countries and regions. Clear increases can be expected in this respect with the further integration and adjustment of the new member states, which can be supported politically by the harmonisation of regulations and the promotion of investment in infrastructure.

Strengthening competitiveness

An increasing level of integration can be accompanied by changes in the possibilities for choosing the location of a firm. In order to utilise the comparative advantages of the individual countries, firms will rethink their location decisions. In this respect even marginal differences between individual countries can be a decisive factor for a concrete location decision. Our studies found no indication of firms relocating their production facilities to the new member states on a large scale, however. Thus the direct investment made by German firms in Central and Eastern Europe is relatively low, is in accord with the global development of German direct investment and has served to a considerable extent to open up new markets. In view of the rather large wage differentials, this finding comes as quite a surprise.

From the viewpoint of the firms, the relocation of production capacities is associated in the short term with costs, but due to the exploitation of comparative advantages, agglomeration advantages and the harmonisation of budgeting, returns are yielded in the medium to long term which can exceed the costs by far. The employment effects, too, can be positive on balance in the medium to long term, although in the short term the workers suffer the loss of their jobs. From an economic point of view, the relocation of industries is associated with a strengthening of competitiveness via the exploitation of advantages. The strong German direct investment in industrial countries also points in this direction. However, in specific industries and regions job losses may occur and in others employment gains may arise. The effects of direct investment are consequently ambivalent for a sending country such as Germany. It is therefore quite justified to support regions in the short run if they are confronted by specific problems caused for instance by the relocation of a large plant. Such support should aim to accelerate the adjustment process, i.e. should begin with Germany’s comparative advantages in human-capital-intensive and technology-intensive goods, and not support the preservation of existing structures. This could be done, for example, by supporting scientific establishments or the economic infrastructure. In the case of EU enlargement, however, there is no immediate need for action due to the marginal effects.

Besides the continued integration and liberalisation of the markets, improving competitiveness within Germany will depend on strengthening those factors which can yield higher incomes as the integration of the international goods and factor markets gains increasing strength. This means above all strengthening regional competitiveness, understood as a region's ability to secure the production factors of labour and capital and thus a high factor income for the population in the long term. Two aspects are of importance here: firstly the current sectoral structure of the economy can provide a picture of where fast-growing or rapidly declining sectors are located and where there are competitive advantages or disadvantages in the short to medium term. Secondly, a region's endowment with (immobile) potential factors of production is decisive for its long-term development prospects, however. Incidentally, this can change as a result of the increasing trade and the increasing mobility of production factors between the German regions and the new member states and therefore lead to repercussions on the development of the regional economy.

Economic development policy so far has the problem of identifying and supporting industries that are considered to have good prospects for the future. In addition this support must be expanded more in the direction of utilising the comparative advantages of the particular region. In border regions this should also be done together with the respective partner regions in the new member countries. Thus for example if technology-intensive production is established, the necessary regional labour market must be available. In contrast, the opposite strategy of preventing a relocation by means of subsidies – in whichever region of Germany – would only achieve short-term effects and would in the long term hinder the competitiveness of the firms and the regions affected.

The results of our study show that EU enlargement does not seem to be causing general disadvantages for specific regions. It was not possible to identify a regional pattern of disadvantaged regions. For instance the border regions are not systematically disadvantaged, which had often been feared. Most of Germany's regions are prepared for competition with the regions of the new member states. Not all regions benefit to the same extent, however. For example many eastern German regions on the border to Poland only benefit to a disproportionately small extent because there is only a low level of economic integration. Regional policy should therefore systematically promote economic integration between Germany and the new member states. This includes improving the cross-border infrastructure and a joint development of clusters which starts out from the economic strengths of the region and its potential factors of production.

Although the majority of the trade between Germany and the new member states is of intra-industrial character, there are individual sectors which have to bear adjustment burdens. From a sectoral viewpoint, agriculture has to bear the highest adjustment costs, as is shown by the results of our simulation of EU enlargement. It is therefore necessary to reconsider the present agricultural policy, the sense of which is to be questioned for other reasons, too. When the transitional arrangements cease to apply there could also be a serious decrease in seasonal labour from Central and Eastern Europe, which switches to other sectors.

Gradual opening up of the labour markets

Freedom of movement for workers is one of the most sensitive issues of EU enlargement for economic, social and political reasons. It is necessary to distinguish between the two types of use of the transitional arrangements for the NMS-8 and for Bulgaria and Romania. The selective use of the transitional arrangements for the NMS-8 led in the first two-year period to a diversion of the migratory flows (expected in the case of free movement) from Germany and Austria to Great Britain and Ireland. In the second period the majority of the EU member states had opened up their labour markets partially or fully to immigration from the NMS-8. With Germany, France and the Benelux countries, important parts of the EU are maintaining considerable barriers to the migration of labour. Are these barriers justified?

It is undisputed that migration leads to considerable macroeconomic gains, especially when the welfare of the migrants is taken into account. Depending on the migration potential, GDP could rise by 0.5 to 1% in the enlarged EU as a result of the full introduction of free movement. The greatest benefit is likely to be for the incomes of the migrants themselves. The per-capita income of the population in the emigration countries would probably rise, too, if the relief on the labour market is also considered. As the majority of migration involves workers with medium-level qualifications, the costs of a “brain drain” in the case of the new member states can probably be classified as rather low. Finally the sending countries are likely to benefit from migrants’ remittances. In view of the large share of temporary migrants, the connections to the native countries and consequently the transfers made by the migrants are likely to be comparatively large.

What is disputed on the other hand, is whether the indigenous population in the immigration countries gains anything from immigration in view of labour market rigidities and unemployment. Although immigration leads to an increase in production in the economy as a whole in the immigration countries, it remains open whether the indigenous population gains anything from immigration or whether increasing risks of unemployment lead to welfare losses. The results of simulations and econometric studies do not permit any clear conclusions in this respect. According to our own simulations, the introduction of free movement would result in a considerable increase in production in Germany’s economy as a whole, but the wage growth that is related to EU enlargement and the drop in unemployment would be dampened somewhat.

Neither the experiences made in Great Britain and Ireland nor the results of our simulations indicate that immigration leads to a discernible increase in unemployment. Finally an argument associated with the economic cycle suggests reviewing the regulations concerning the free movement of labour. In a cyclical upturn, workers can be better absorbed by the labour market and potential displacement effects are smaller. At present the situation in Germany is therefore comparatively good, whereas the conditions in the year 2011 when the transitional arrangements for the free movement of labour expire can not be predicted today. The results of our simulations show that the effects of migration on wages and unemployment are moderate as long as the future migratory flows remain within the limits of the existing forecasts. The diversion of the migratory flows to Great Britain and Ireland indicates that the actual amount of migration to Germany is likely to be below the level predicted. However, a considerable amount of uncertainty continues to remain with regard to the migration potential. It would therefore be appropriate for immigration policy to take this uncertainty into account. This could be done by means of safeguard clauses or quotas – perhaps at the level of the estimated migration potential. With such a policy the labour market could be protected against possible risks without losing the economic gains from migration. Safeguard clauses or quotas could be cancelled completely before the transitional arrangements expire if it emerges that they are not being fully utilised. In this case the risk of an unexpected mass immigration could be ruled out.

In the case of regulation by quotas one possibility would be to conduct the allocation according to human capital criteria, for instance following the Canadian example. On the whole, the gains from migration increase along with the skill level of the immigrants. However, as control of this kind is only possible during the transitional arrangements anyway, the amount of bureaucracy must be taken into account and it must be examined whether this kind of regulation makes sense. An alternative possibility is a safeguard clause which would control immigration in accordance with the “first-come-first-served” principle.

Transitional arrangements for Bulgaria and Romania

In the case of Bulgaria and Romania, all of the member states of the EU-15 apart from Finland and Sweden are taking advantage of transitional periods for the free movement of labour. In most of the countries the transitional arrangements are probably being used restrictively, i.e. effectively limiting immigration. The restrictive use of the transitional arrangements in the EU-15 reflects not only the lower incomes compared with the NMS-8 and the less favourable qualification structure of the population of Romania and Bulgaria, it is also the result of the migratory flows being diverted to Great Britain and Ireland. Many EU member states fear that if they open up their labour markets first, they will receive a far larger share of the immigration instead of countries that opt for a restrictive immigration policy. As a result all the member countries have opted for a wait-and-see policy. Without diversion effects, presumably only a moderate part of the immigration from Bulgaria and Romania to the EU-15 would be apportioned to Germany. The foreign population from these two countries in Germany has fallen by half since 1993, whilst it has grown considerably in Spain and Italy in the last few years. In addition to the role played by bilateral agreements, language, culture and climate have probably also been important in this respect. Owing to the restrictive policy in the EU, the migration effects of opening the labour markets are difficult to calculate. However, the same applies for Bulgaria and Romania as for the NMS-8, that effective restrictions on migration lead to welfare losses at least at the level of the enlarged EU. In order to realise at least some of the possible welfare gains to be had from immigration from these countries, immigration quotas could also be granted to these countries which, analogous to the NMS-8, could be controlled according to human capital criteria or by safeguard clauses.