Effects of eastward enlargement of the EU on the German economy

On 1 May 2004, ten new members were accepted into the European Union (EU). This so-called eastward enlargement of the EU represents a considerable challenge for all the countries concerned and for the Community institutions. Never before have so many countries joined the EU at the same time and never before have the economic differences within the group of countries joining the EU and between these and the existing member states been so great.

Although the EU's pre-accession strategy had already provided the new member states with a "priveleged" position in relation to the EU helping them catch up with the existing member states, economic integration will be additionally stimulated by further institutional and economic involvement. The effects will be felt mostly in the new member states but are also likely to result in a variety of changes in Germany owing to its geographical proximity and close economic relations with those economies. The following article examines the potential effects of EU enlargement on Germany. It comes to the conclusion that Germany can take advantage of the chances of an increasing division of labour in Europe if its economic policy continues to focus on reforms.

Eastward enlargement of the EU: characteristics and special features

Eastward enlargement of the EU unprecedented

The accession of Cyprus (the Greek part), the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia to the EU on 1 May 2004 brought the number of EU states up to 25. At the same time, the EU population increased by approximately 74 million or almost one-fifth. Looking at it from a purely quantitative dimension, the so-called eastward enlargement of the EU is unprecedented. However, the bigger challenge is probably the integration of states that are significantly different from the existing EU members in their history, their economic development and their economic structure. Despite the generally rapid catching-up process, there are still large discrepancies, particularly in respect of the standard of living and economic strength. The per capita income of the new member states – measured in purchasing power parities – amounts to less than 50% of the average of the "old" EU.

Major differences between the new members

In addition, the new members themselves represent a very heterogeneous group. Whereas Cyprus and Malta can already look back at a long market-based tradition, the other eight states completed a fundamental transformation from socialist planned economies to open market economies during the 1990s. Considerable differences can also be identified within the group of countries in respect of the per capita income. In the case of Slovenia and Cyprus, this amounts to 70% and almost 80% respectively of the average level of the EU 15 member states in terms of purchasing power parity; thus, they already exceed Greece and Portugal. By contrast, the per capita income of Latvia is only around 37% of the level of the EU 15 member states.

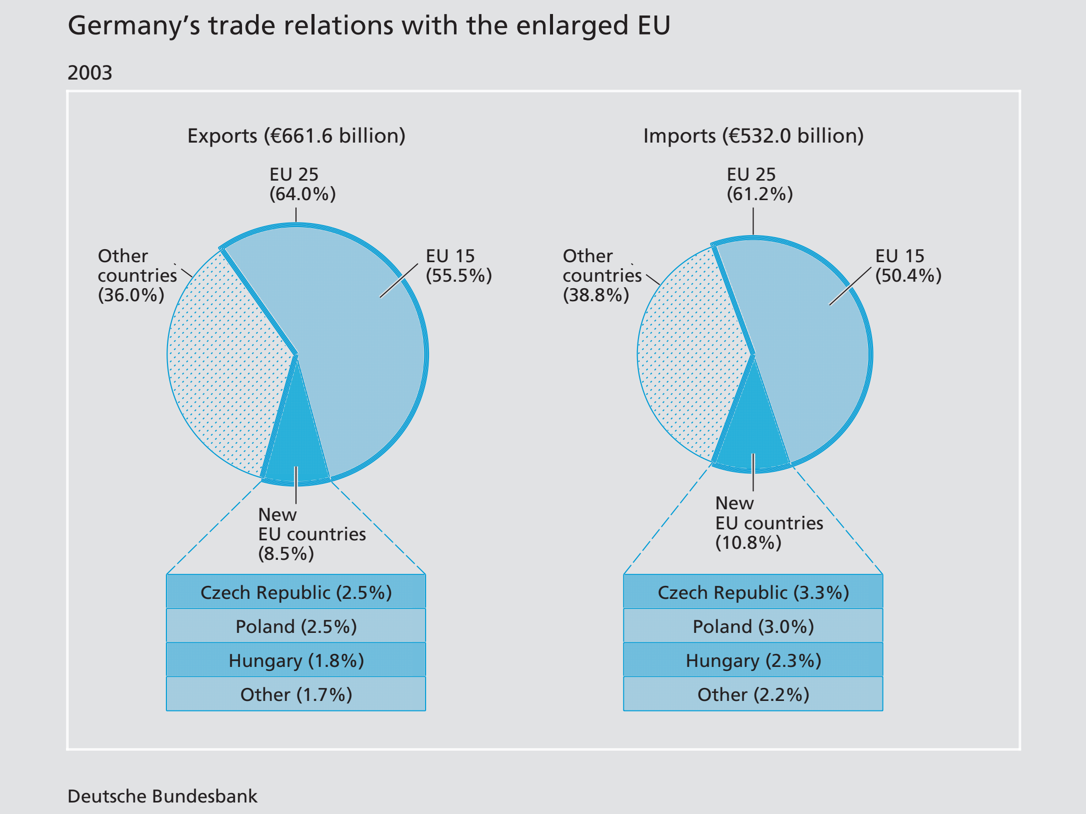
The next step

The following section will look at the current status of Germany's economic relations with the new EU states in more detail. In particular, it will examine the possible effects of eastward enlargement of the EU on the domestic economy. Significant implications of the enlarged single market can already be perceived as the states had already had a preferential status in relation to the EU since the start of the 1990s. EU enlargement is likely to strengthen further the tendencies already in evidence. Furthermore, the influences on the German tax and social security systems are of interest in this context. Finally, some conclusions for economic policy are drawn from the analysis.

Integration of trade and production

Liberalisation of foreign trade as an impetus for worldwide economic integration

As a result of the opening-up of the markets in central and eastern Europe at the start of the 1990s, the German trade relations with the new EU states have already considerably intensified. In these economies, there arose, on the one hand, a major need for imports of "western" products, above all, capital goods, which were required for the transformation of the former socialist planned economies into market economies. On the other hand, they offered cost advantages in production, particularly for inputs. As a result, they be-



came attractive new locations within value-added chains of German enterprises.

Germany the most important trading partner

Germany is the new member states' most important trading partner within the (old) EU. On an average of the period from 1993 to 2003, German exports made up around 40% of total EU exports to the new member states. German imports from the ten partner countries had regularly been just as high as the total amount of imports of all the other "old" EU members put together.

Increasing significance of the new members for German foreign trade

German trade with the new EU member states more than quadrupled between 1993 and 2003. This means that last year Germany was already obtaining over 10% of its imports from these economies (1993: 4%). These states are also playing an increasingly important role for German exports. Almost 9% of German exports now go to those states, with the result that the new partners quantitatively import approximately as much from Germany as the United States does. The three largest economies, the Czech Republic, Hungary and Poland, account for four-fifths of German trade with these states.

A large part of the trade integration of the new member states had therefore already taken place in the run-up to joining the EU. In some sectors, imports from central and eastern Europe have doubled. At least one-fifth of imports of wood products, printed matter, metal products, electrical machinery and apparatus, motor vehicles (including parts) and furniture now comes from the new EU member states.

Imports from the new EU countries by sector

In %

Item	Change from 1997 to 2002	Share of overall imports 1997	Share of overall imports 2002	Share of domestic supply [1] 1997	Share of domestic supply [1] 2002
Textiles	62	7	12	4	7
Clothing	– 10	15	13	10	9
Wood and wood products	14	23	29	6	8
Paper	170	3	6	1	3
Printed matter	260	6	19	0	1
Chemicals	39	3	3	1	1
Rubber and plastic products	175	7	14	2	4
Basic metals	43	8	10	3	4
Metal products	81	15	22	2	4
Machinery and equipment	137	8	14	2	5
Office machinery and computers	529	2	8	1	6
Electrical machinery and apparatus	110	15	21	4	8
Radio receivers and components	273	3	6	2	4
Controllers, optics	151	3	6	1	3
Motor vehicles and motor vehicle parts	240	9	21	3	8
Furniture, jewellery and toys	97	16	25	5	10

1 Domestic supply = domestic sales + imports.

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The relative importance of imports from the new EU states for the German economy can also be seen in the proportion of goods imported from these countries in the overall supply of goods to the German economy (sum of domestic turnover and imports from all countries).[1] In the case of clothing and furniture, whose manufacture requires a comparatively large application of simple functions and can therefore generally take place in the new member states more cheaply, the proportion amounts to one-tenth. Apart from that, it is mostly no greater than 5%. If the size of the new member states' economies continues to increase, though, their market share in Germany could continuously rise.

Ambivalent employment effects

The increasing integration has so far not had any direct effect on employment developments in Germany on balance, even though those employed in industries whose exports are increasing seem to be gaining and those in industries whose imports are increasing losing out.[2] Although the fall in employment that had begun in numerous industries after the end of the unification boom also continued after 1997, it has noticeably weakened for the most part since then. In some industrial sectors, there have even been in-

1 Please note that such turnover as imports does not refer only to finished products but also includes semi-finished products and parts. The import content of exports should also be considered. On the other hand, a loss in domestic value added as a result of higher exports by the new member states to third countries is likewise not included.
2 Econometric studies have not found any substantial effects of foreign trade on wages and employment in Germany either. See, for example, T Boeri and H Brücker (2001), The impact of eastern enlargement on employment and labour markets in the EU member states, Report for the European Commission.

creases in staffing again. Remarkably, this also particularly applies to those industries in which the level of imports from the new EU states has risen sharply. In the car industry, for instance, the proportion of goods imported from those countries for domestic use increased between 1997 and 2002 from 3% to 8%; at the same time, employment in Germany went up by 2.6% per year. In this connection, besides the cyclical factor, the import of vehicle parts from central and eastern Europe is likely to have played a part. This has strengthened the price competitiveness of the German car industry. It is also becoming clear that a purely import-oriented view of the consequences of opening up the market is not sufficient. In the case of furniture, however, rising imports were accompanied by a sharp fall in employment. This suggests that there is likely to be a crowding-out of domestic value added in this sector.

Positive price developments

The rapid progress made in opening up the markets of central and eastern Europe has probably had a positive effect on price developments in Germany with regard to goods whose production requires a comparatively large amount of low-skilled work. Furniture is certainly one such good, as is clothing. In the case of textiles, however, the price-dampening effect from third countries is likely to have been more significant than from the new member states. In the short term, the accession of these countries in itself is not expected to have any substantial additional effects on the general price level in Germany. Although the consumer prices for goods and, above all, services are still considerably lower in the new member states, in particular, than in Germany, this is mainly a reflection of the low wage costs of providing non-tradable services. Price adjustments will therefore take place primarily in the new member states themselves after joining the EU. Substantial pressure on prices for certain services would not be expected in Germany until wages, especially those for more basic activities, had been appropriately adjusted following larger-scale immigration. Although this should be delayed by interim arrangements, increased international trade may raise the pressure to create a stronger upward spread of the qualification-based wage structure and, in that way, influence the prices of more basic services.

Favourable export prospects

The so-called "gravitation approach" can be used to assess the further development of trade between Germany and the new member states. Besides per capita income, distance is taken into particular consideration (as an approximation of transaction costs) as a determinant of trade flows. A relevant study by the Bundesbank came to the conclusion that, from the new EU member states' point of view, imports from Germany were far above the value that would be expected according to the gravitation model.[3] This is explained by the leading role played by German direct investment and the high level of conformity between the German export goods structure and the demand for imports in the countries concerned. These factors could also provide Germany with a future competitive advantage over other EU countries, bringing

3 See Deutsche Bundesbank, Germany's relative position in the central and east European countries in transition, *Monthly Report*, October 1999, p 15 ff.

with it a sustained above-average share of foreign trade with the new member states.

Furthermore, since all the new EU states are in a process of catching up economically, the results of the gravitation approach are, on the basis of previous years, more likely to underestimate the potential long-term extent of bilateral trade.[4] According to our own calculations, real exports by German enterprises to the new EU states increase by ⅔% with each percentage point of real economic growth in the region. Germany's trade relations with this region are therefore likely to experience a further impetus despite the new member states having already successfully integrated to a greater than average extent.

Free movement of capital and locational competition

The liberalisation of financial transactions, the increased legal certainty as a result of joining the EU, the greater economic freedom after incorporating the internal market regulations and the efforts to improve the infrastructure in the new member states will continue to intensify locational competition in Europe. In addition to this, many new EU states have shaped their tax legislation in a very investment-friendly way and are therefore able to counter other locational disadvantages such as their peripheral position in some cases.

German capital exports support catching-up process

The economic catching-up process, above all, of the central and east European countries was accompanied by large capital exports from Germany to these states. At the end of June 2003 – the most recent data available at present – the German assets position vis-à-vis the ten new EU states amounted to €68 billion compared with €31 billion at the end of 1997, the first year for which a reliable assets position could be drawn up. Direct investment dominated the assets position at €31 billion and a share of just under 46%; it is also particularly important in terms of real economics, owing not least to its interactions with trade flows.

Vital importance of direct investment

Following the fall of the Iron Curtain, German direct investment increased especially rapidly in neighbouring countries to the east. German firms invested significantly in this region year by year, particularly at the end of the 1990s. Participating interests in privatised enterprises, the build-up of trade and distribution facilities as well as the building of manufacturing plants played an important part in this respect.[5] In recent years, however, German direct investment has noticeably fallen (see the chart on page 11).

4 See also B Alecke, T Mitze and G Untiedt (2003), Das Handelsvolumen der ostdeutschen Bundesländer mit Polen und Tschechien im Zuge der EU-Osterweiterung: Ergebnisse auf Basis eines Gravitationsmodells, DIW-Vierteljahreshefte für Wirtschaftsforschung, Vol 72, pp 565-578. Furthermore, the study finds an uneven distribution of trade profits between the *Länder*. Bavaria and, some way behind, the new *Länder* bordering Poland or the Czech Republic, recorded particularly high rates of growth.

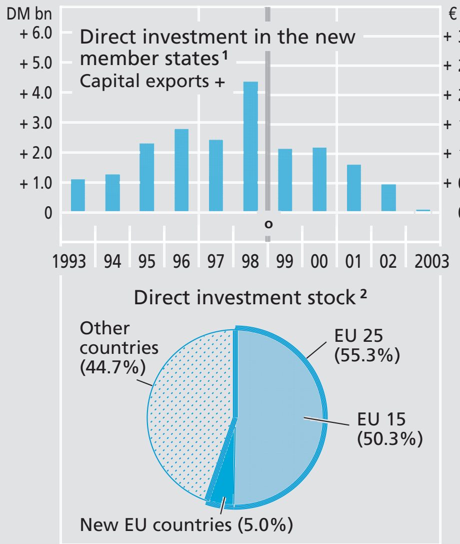
5 For more on the determinants of German direct investment in eastern Europe, see: C M Buch and F Toubal (2003), Economic integration and FDI in transition economies: What can we learn from German data? Vierteljahreshefte zur Wirtschaftsforschung, Vol 72, pp 594-610. See also: DIHK (2003), Produktionsverlagerung als der Globalisierungsstrategie von Unternehmen, Ergebnisse einer Unternehmensbefragung, Berlin, and DIHK (2000), Investitionen im Ausland, Investitionsabsichten deutscher Industrieunternehmen im Herbst 2000 für 2001, Ergebnisse einer DIHK-Umfrage bei den Industrie- und Handelskammern vom Herbst 2000, Berlin.

Weight of the individual sectors varies

The structure of the direct investment stocks shows that the investment of German enterprises in the new member states goes beyond the (cost-related) shift of production. This certainly plays an important role in the manufacture of transport equipment, which, at 18½% at the end of 2002, had the largest share of German direct investment in the new member states. However, trade as well as electricity, gas and water supply constitute other major targets for foreign investment; in these areas, cost aspects are less important than other motives such as the supply of the local markets. Around 12½% of German direct investment stock in the new member states was invested in the wholesale or retail trade, especially in the Czech Republic and Poland. Electricity, gas and water supply accounted for approximately 13%; the Czech Republic, Hungary and Poland are the most important target countries in this sector. Together with the fields of transport and communication, these sectors – with outdated capital stock in some cases – attracted the lion's share of German purchases of participating interests from mergers and acquisitions (85%). By contrast, the car sector accounted for only just under 10% of the M&A volume. However, German car manufacturers and their suppliers have often not purchased existing production plants in the new EU states but, instead, have built new premises on greenfield sites. Investment in these is not included in the aforementioned figures.

German banks are less heavily represented in terms of direct investment in the central and east European EU countries. Only around 8½% of total spending on M&A flowing into the banking sector of the new EU countries stemmed from German firms. Across all economic sectors, however, Germany had a 19% share of corporate acquisitions in the new EU countries.

German direct investment in the enlarged EU



1 Direct investment flows. — 2 According to the international investment position as of end-June 2003. — o From 1999, all figures in euro.

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Large differential in wage costs

Differences in wage costs are an important motive for direct investment by German enterprises. Despite a sharp rise in recent years, the average income in the new central and east European member states has so far reached only a fraction of the German value. In terms of the labour costs per hour worked, it stands at between 13% and 22% of the German level in the three largest countries, namely the Czech Republic, Hungary and Poland.

Labour costs in selected new member states *

As a percentage of the German figures

Country/indicator	1999	2000	2001	2002
Poland				
Compensation of employees	10.1	11.3	13.7	13.3
Labour productivity	27.5	29.1	29.8	30.8
Unit labour costs	36.7	38.8	46.0	43.2
Czech Republic				
Compensation of employees	12.7	13.3	15.2	17.5
Labour productivity	39.3	39.4	39.5	41.7
Unit labour costs	32.3	33.7	38.4	41.9
Hungary				
Compensation of employees	14.7	15.8	18.5	21.6
Labour productivity	46.3	45.7	45.7	47.3
Unit labour costs	31.7	34.5	40.4	45.6

Sources: Eurostat, Groningen Growth and Development Centre, Bundesbank calculations. — * Figures on an hourly basis. Converted on the basis of current exchange rates.

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However, such wage gaps do not necessarily induce shifts in capital. Wage gaps that result, for example, from different quality profiles of the economically active population or from differences in the underlying conditions (such as the infrastructure set-up) do not trigger any capital flows. It is difficult with the existing data, though, to determine the differences in productivity that are relevant for direct investment. However, labour productivity can serve as a rough indicator of the differential between Germany and the new member states. On that basis, the productivity shortfall of the largest three new member states amounts to between 60% and 70% compared with Germany; in recent years, it has declined only slightly.[6] According to these data, unit labour costs in the largest three new member states have so far not reached even half of the German level, despite a sharp rise in recent years. This suggests that there is still considerable potential not just for additional trade but also for further relocations.

Increased domestic rate of return requirements

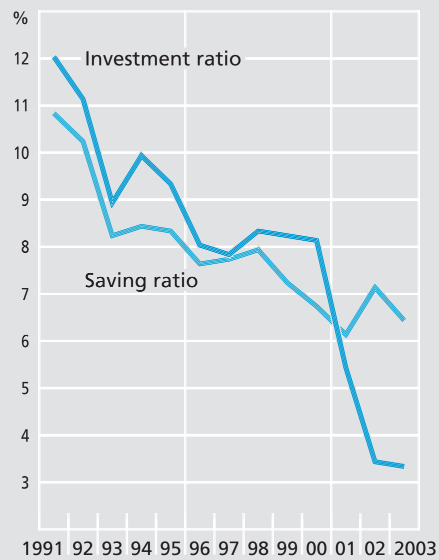
In principle, the creation of new investment opportunities abroad increases the minimum yield demanded for domestic investment when the supply of capital is unchanged, affecting not just new investment but also replacement investment. This is certainly welcomed by domestic investors owing to the higher rates of return but for the domestic real economy this means that fixed capital investment is falling (relatively). Capital mobility leads to a part of domestic savings being in-

6 In view of the problems in comparing the data on hours worked and production, these data are to be regarded only as indications.

vested not in Germany but abroad, ie in the new EU countries, for example. The capital intensity of production in Germany then increases more slowly or possibly even goes down somewhat, with the result that the real wages that are consistent with a constant employment ratio are lower than in a reference scenario without capital mobility.

Over the past few years, there has indeed been a broad slump in investment in Germany where the national saving ratio has, in any case, been low.[7] The overall net investment ratio, which, in addition to investment in industrial assets, also comprises investment in housing and public infrastructure, has fallen to slightly above 3½% of the disposable income of the domestic sectors. This meant that the level of German (net) investment abroad (equivalent to the difference between domestic savings and domestic fixed capital formation) was recently similar to that of domestic investment. Fixed capital formation in Germany has evidently become considerably less attractive than foreign investment (including German financial investment abroad). However, this is due to only a minor extent to the opening up of the markets in central and eastern Europe. Most capital exports go to the advanced economies.

Saving and investment in Germany*



* Overall ratio (excluding depreciation allowances) as a percentage in each case of the disposable income of the domestic sectors.

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Freedom of establishment, migration and the labour market

The EC Treaty guarantees not only the free movement of goods and capital but also freedom of movement for workers, freedom of establishment for the self-employed and free trade in services even if this means work being carried out in the beneficiary's country of domicile. Furthermore, it follows from the general ban on discrimination that citizens of other EU countries working in EU member states are to be treated on an equal basis to residents.

Transition rules

In the Accession Treaty, however, transition periods were agreed according to the so-called "2+3+2" model for all new member states except Cyprus and Malta. According to this arrangement, during the first two years after enlargement, the original 15 member states can apply national measures or measures arising from bilateral agreements to re-

7 As a result of the long running period of stagnation, the trend decline in the net investment ratio is possibly overstated – especially compared with 1991 and 1992, which were marked by the unification boom.

strict the access of employees from the new member states to their labour markets without further justification. An initial extension of these regulations is possible at the request of the "old" member states. After a further period of three years freedom of movement will, in principle, come into force. A member state can, however, demand a further two-year extension of the transition regime on the grounds of serious existing or foreseeable disruptions to its labour market. After seven years, the restrictions no longer apply. Apart from the United Kingdom and Ireland, the original EU countries intend to make use of the transitional arrangements. Furthermore, Germany and Austria have been granted the right to limit free movement of services in some sectors for a maximum of seven years where such freedom would entail the cross-border deployment of labour. In Germany, this applies to construction and a number of other economic sectors. Freedom of establishment for the self-employed is not subject to any particular restrictions during the transition period or subsequently.

Large income differential

Owing to the transitional arrangements that will apply for a maximum of seven years, there will be no immediate influx of labour into Germany. At the same time, freedom of establishment for the self-employed and free movement of services (subject to considerable limitations only in some sectors) will foster the integration of the markets. The question often raised in this connection is whether the transitional arrangements are necessary at all in view of there being little identifiable mobility of labour between the original member states and even within the countries themselves. The first thing that can be established here is that the differences in income between the original EU countries and the new EU members are very much greater than in the old EU or within individual countries. For example, the average monthly pay of an employee in Poland amounted to approximately €835 in 2002 whereas the figure was €2,725 in Germany. Even in Greece and Portugal, EU countries with low incomes, wages were around 107% and 70% higher respectively than in Poland. Although the average cost of living in Poland is almost half what it is in Germany, the mathematical difference in real income from a Polish point of view amounts to approximately 75% if this factor is taken into consideration. There are therefore definite material incentives for emigrating to the old "rich" member states. However, there are also obstacles standing in the way of economic success in a foreign country that need to be overcome first, eg language barriers. Furthermore, most people feel better in their familiar surroundings than in a foreign country. For that reason alone the economic differential is by no means the only determinant of migration flows even if it is an important one.

Reasons for migration

In recent years, a series of studies has been undertaken on the size of possible migration flows between eastern and western Europe when free movement is permitted.[8] All these

8 See *inter alia* T Boeri and H Brücker *et al* (2001), The impact of eastern enlargement on employment and labour markets in the EU member states, Report for the European Commission; H-W Sinn *et al* (2001), EU-Erweiterung und Arbeitskräftemigration, ifo Beiträge zur Wirtschaftsforschung, Vol 2, Munich; P Alvarez-Plata, H Brücker, B Siliverstovs (2003), Potential migration from central and eastern Europe into the EU-15 – an update, DIW, Berlin.

estimations face the problem that there has not been any freedom of movement between the countries concerned for several decades and empirical evidence from other regions therefore has to be applied to eastern Europe. Consequently, these studies have largely fallen back on Germany's experience of migration in the growing EU as well as in a number of third countries since the beginning of the 1960s. Certain factors that can change over time, most notably differences in income and labour market opportunities, regularly prove to be determinants of migration decisions in such estimations as are demographic variables in some cases. This is important in that it is typically young people who migrate. Irrespective of the size of the income gap, an ageing population does not exert any major migration pressure.[9] In addition, there are undoubtedly significant timeless influences on migration behaviour such as the geographical proximity and cultural affinity of two countries.

Migration scenarios

Differences in various migration scenarios result, on the one hand, from assumptions about the future economic development in the new EU countries. The more quickly progress is made on the convergence of real income and the better the employment opportunities develop compared to Germany, the less immigration there will be. On the other hand, a large real income gap will remain for a long time even if the economy develops very favourably in the new member states. The low starting level in those states is reason enough for this. According to the econometric estimates, some of which are modelled very differently, between 100,000 and 200,000 immigrants can be expected annually in the first few years after the opening of the borders.

A more recent study based on surveys of migration behaviour and conducted on behalf of the European Commission[10] supports the hypothesis of a somewhat weaker influx. Although there is a relatively strong general inclination among many people in the new member states to work in other EU countries at some point, only a small proportion of those questioned actually pursue the matter further. Moreover, these people are typically well-educated and young. Taking into consideration all the arguments, there is therefore a lot to be said for expecting a maximum net influx of one million people from the new EU states in the first five years of free movement.

The labour market effects of increased immigration crucially depend on which people emigrate under which conditions and how flexibly the labour market of the recipient country reacts to the influx. Owing to the postponement of the starting date of free movement, emigration to Germany will occur at a time when the economically active population is declining, and so the effects are likely to be different from those derived in a scen-

9 See M Fertig, C M Schmidt (2000), Aggregate-level migration studies as a tool for forecasting future migration streams, IZA Discussion Paper No 183. Microeconometric studies also show that age plays a very important role when deciding to migrate. For an overview of this, see T Bauer and K Zimmermann (1999), Assessment of possible migration pressure and its labour market impact following EU enlargement to central and eastern Europe, IZA Research Report No 3.
10 See H Krieger (2004), Migration trends in an enlarged Europe, European Foundation for the Improvement of Living and Working Conditions, Draft, 26.

ario where the economically active population is growing or at least not shrinking (or from those observed in the past).

The labour market success of migrants is essentially determined by two factors. The human capital specific to the country of origin tends to diminish as a result of the emigration from the home country. At the same time, it is often difficult for migrants to exploit the full capacity of their career-specific human capital, especially as they need to acquire complementary country-specific human capital, notably knowledge of the local language. Migrants therefore frequently look for work in fields that do not place any great demands for country-specific or career-specific human capital. However, one advantage of migrants is their geographical mobility. Those who move to a foreign country to work go where the work is.

Effects of migration

Immigration increases employment in the adopted country if wages are sufficiently flexible and residents do not withdraw from the labour market. Although additional employment is possible only in the case of fairly low-paid jobs with a given capital stock, real wage reduction will be lower in the medium term following an adjustment of the capital stock. Moreover, since the transition arrangements come to an end at the same time as the economically active domestic population will start shrinking, there is unlikely to be any lasting downward wage pressure from the immigration expected at that time. However, increased immigration might at least force an adjustment to the qualification-based wage structure. Owing to their lack of country-specific human capital, migrants are frequently in competition with less qualified domestic workers and may push down their wages. The wages of better-educated residents could even tend to rise more quickly if there is more immigration. If a disproportionately high number of low-qualified workers immigrate and wages at the lower end of the wage scale are more rigid than at the higher end, additional immigration will add to domestic unemployment.[11]

Migration and movement of capital

Given the likely demographic development in Germany, it is important that capital flows and migration can at least be partly seen as substitutes. The more vigorously immigration is constrained, the stronger direct investment in the new member states will be and the weaker fixed capital formation in Germany will be. In view of the ageing population, however, Germany must have an interest in ensuring that the basis for taxes and social security contributions does not shrink but, if possible, continues to grow. From this point of view, the immigration of workers must be allowed.

11 See H Brücker (2003), Die Arbeitsmarkteffekte der Ost-West-Migration: Theoretische Überlegungen, Simulationen und empirische Befunde, DIW Vierteljahreshefte zur Wirtschaftsforschung, Vol 72, pp 579-593. In his model calculations, Brücker comes to the conclusion that, under plausible assumptions, the unemployment rate of the lower qualified could be 0.2 to 0.3 percentage point higher than in the reference scenario. In other variations of his model calculations, the unemployment rate of the low qualified economically active population rises by more than 0.6 percentage point. The vast majority of other empirical studies come to the conclusion for Germany that, on the one hand, the labour market effects of immigration are less pronounced than in Brücker's model calculations but, on the other hand, the assumption that the field of lower-skilled activities is more adversely affected is confirmed.

The freedom of migration and establishment is of particular importance for the east German border region. It is already possible to switch to cheaper providers in the Czech Republic or Poland for services such as hairdressing, dentures and motor vehicle repairs. The restriction of freedom of migration can therefore have only a very limited effect on "protecting" the regional labour market. The disadvantages of restricting freedom of establishment and migration will therefore be particularly noticeable here. In these regions, industrial estates have been built and residential areas maintained at considerable expense. These currently stand empty, firstly, because investors are investing some kilometres further to the east owing to the low wage level there and, secondly, because some of the east German population are emigrating to the west owing to the economic problems. Unless the economies in the regions either side of the border integrate quickly, there is a threat of wastelands being created on the German side.

Effects of EU enlargement on general government in Germany

Risiks and opportunities for German public finances

EU enlargement affects public finances in Germany in several respects. For example, the German fiscal system is exposed to heightened international tax competition. Depending on the extent and structure of the migration induced by the accession of the new member states, additional spending may be incurred, especially for social benefits. There are also likely to be additional fiscal burdens emanating from the EU budget since most of the new member states will be net beneficiaries at first. On the other hand, tax competition might raise the pressure to create a more transparent, simpler tax system and, above all, one that promotes performance incentives. The same goes for the organisation of the social security systems.

Heightened tax competition

Enlargement will considerably further heighten tax competition within the EU as the new member states offer considerably more attractive tax conditions for enterprises than Germany does. They are planning even further tax cuts in some cases. This will increase the pressure on the "old" countries – such as Germany – to further improve their tax conditions for enterprises.

New member states with attractive tax rates ...

The tax burden on corporate profits is far lower in the new member states than in Germany (see the table on page 18). This applies above all to corporations which are exposed to international competitive pressures. Whereas their profits in Germany, despite the relief provided by the tax reform, are still subject to a marginal tax burden of almost 39% in all, the maximum business tax rate in the new member states is 28% (Czech Republic). In most cases it is still below 20%. Particularly attractive are conditions in the Baltic states, which have tax rates of 15% (Latvia and Lithuania) or in some cases do not tax corporate profit at all (such as Estonia). Furthermore, of the other countries, the Czech Republic and Hungary are planning a further cut in their corporation tax rate for the coming years.

Selected indicators on the tax burden in the new member states *

%

Country	Marginal tax rate on profits of corporations		Average tax burden at the corporate level in the case of ... Investments by corporations resident in the countries concerned		Investments by German corporations in the countries concerned		Top rate of income tax		Average overall tax wedge on the factor labour [1]	Stand rate of value added tax
	2003	2004	2003	2004	2003	2004	2003	2004	2002	2003
Estonia	[2] 0/26	[2] 0/26	22.5	22.5	24.6	24.6	26	26	.	18
Latvia	19	15	17.8	14.3	23.4	20.1	25	25	.	18
Lithuania	15	15	13.1	13.1	15.4	15.4	33	33	.	18
Poland	27	19	24.7	17.5	29.8	23.1	40	40	42.7	22
Slovak Republic	25	19	22.1	16.8	27.4	22.5	38	19	41.4	20
Slovenia	25	25	21.6	21.6	33.4	33.4	50	50	.	20
Czech Republic	31	28 (2006: 24)	24.2	(2006: 17.1)	31.9	(2006: 25.7)	32	32	43.5	22
Hungary	18-20	16 (ultimate aim: 12)	19.4	[3] 14	24.9	[3] 19.8	40	38	46.3	25
By comparison										
Germany	[4] 40	[4] 38.7	37.2	36.0			[5] 51.2	[5] 47.5	51.3	16

Source: German Federal Ministry of Finance, Centre for European Economic Research, OECD, ECB. — * Excluding Malta and Cyprus (Greek part). — **1** Wage tax and social security contributions of an average unmarried wage or salary earner in relation to gross earnings plus the employer's share of social security contributions. — **2** In the case of profit retention/profit distribution. — **3** Assuming a planned subsequent corporation tax rate of 12%. — **4** Corporation tax, trade tax and solidarity surcharge. — **5** Including solidarity surcharge.

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... and low effective tax rates for enterprises ...

Besides tax rates, regulations governing the determination of profit are also of great importance for the choice of location and the investment decisions of enterprises. In most of the new member states, however, these are likewise designed very generously, especially in respect of the depreciation rules.[12] Because of this, the effective tax burden on corporate profits is mostly far lower than in Germany. A detailed analysis by the Centre for European Economic Research[13] found it to range from 13% (Lithuania) to around 25% (Poland) compared with just over 37% in Germany for investments by corporations domiciled in these countries.[14] Moreover, the effective tax burden on corporate profits has continued to fall in some of the new member states during 2004.

... as well as low maximum rates of income tax

The maximum rates of personal income tax in most of the new member states are also far lower than the German level (of 47.5% at present including the solidarity surcharge), a factor which is significant for enterprises' choice of location in respect of management. The Slovak Republic, which introduced a flat tax of 19% at the start of this year, is the most attractive in this respect. In particular,

12 By contrast, the intertemporal offsetting of losses is, in some cases, even more heavily restricted than in Germany.
13 See specifically: Centre for European Economic Research and Ernst & Young (2003), Company Taxation in the New EU Member States, Frankfurt am Main and Mannheim.
14 Only the "tax wedge" at enterprise level is recorded here. For investment by German corporations in the countries concerned, although the rates are somewhat higher owing to the additional consideration taken of withholding taxes on the profit distributions to the German parent company, they are mostly still far below the ratio in Germany.

the Baltic states – which likewise operate a uniform rate – moderately tax top earners. One downside of the flat tax, however, is that low incomes are subject to a higher tax rate in the countries concerned than in Germany (where the starting rate has been 16% since the beginning of this year). If social security contributions, which also need to be taken into account, are included, there are therefore fewer advantages for average earners, for example, than there are under the fiscal rules applying in Germany whereas corporate profits and top earners fare better in these countries. However, since total labour costs in the new EU countries amount to only a fraction of the German level, this is of minor importance for international locational competition.

Further cut in the direct tax burden required in Germany

The aforementioned conditions in the new member states lead to the conclusion that, in view of the need to adapt the German tax system to take account of international competition, not only income tax tariffs but also the effective burden of direct taxes on incomes should be cut further in Germany.

Social security system: increasing mobility of labour …

Firstly, the German social security system will be affected by EU enlargement in that the cross-border mobility of labour will increase. This is likely to lead initially to more people emigrating to Germany from the new member states than vice versa, a development which will influence the income and expenditure of the social security system. Secondly, the social security systems themselves represent an important factor in locational decisions, and this factor will gain greater importance owing to the increased competitive pressure resulting from enlargement. What is therefore important is not only the existing design of the social security systems but also the efforts that need to be made to reform them.

… to be welcomed in principle

Switching one's country of employment as a result of enormous differences in income is, in principle, advantageous as the loss of value added in terms of wages in the countries of origin is likely to be lower than the profit of additional value added in the countries of destination. This migration is, however, especially problematic when the tax and transfer system of the country of destination offers immediate incentives to migrate – particularly to the low-skilled.

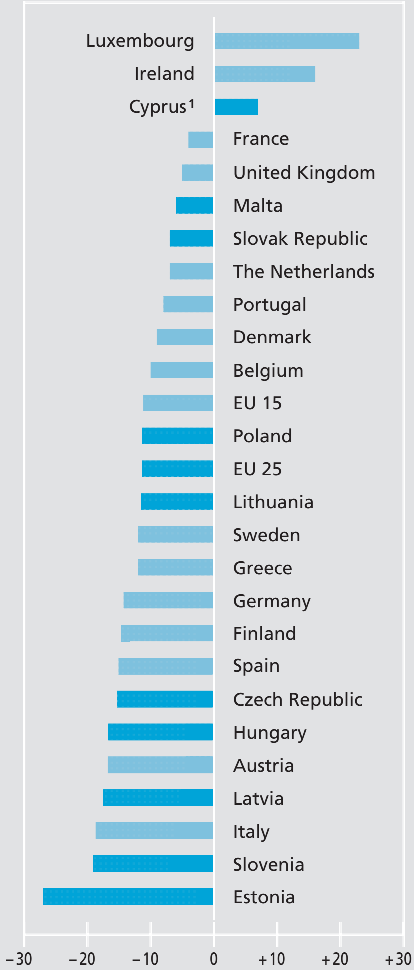
Agreements on social legislation at EU level

Article 42 of the EC Treaty stipulates coordination of the national social security systems in order to ensure the free movement of workers that will be allowed following the transition period. In practice, the existing rules at EU level mean that an unemployed immigrant must first take up an employment subject to social security insurance contributions in order to gain entitlement to social security insurance in Germany and to claim other social benefits. However, only a brief period of employment is sufficient for this if previous periods of employment in the immigrant's homeland are recognised. In respect of social assistance, foreigners must, in principle, also be eligible for this form of benefit unless this were the only reason that they had travelled to Germany.[15] A heavier burden on the German social security systems after expiry of the

15 See W Peter (2004), Sozialleistungsansprüche von EU-Ausländern in Deutschland, in iw-trends, 1/2004, p 3 f.

Growth in the population of working age* in EU 25

Percentage change between 2000 and 2025



Source: United Nations, World Population Ageing 1950-2050. — * 15 to 59 years old. — **1** Total.

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transition periods cannot therefore be ruled out.

Demographic perspectives

Where immigration is linked to additional employment in the destination country, this will lead to an increase in the persons liable to pay contributions. However, the demographic development in the central and east European countries is less favourable than in western Europe. Although the proportion of senior citizens in the population is still below the average in the "old" EU countries, a noticeable increase in this ratio can be expected if there is no dramatic rise in the birth rate, life expectancy moves closer to the EU average and individuals of working age migrate. Population projections by the United Nations show that the working population will have fallen even more sharply in the new central and east European member states than in the "old" EU states by 2025. According to these projections, Estonia, Slovenia and Lithuania are likely to be particularly affected by the fall (see adjacent chart).

Immigrants' benefit claims on existing social security system

There is, however, no certainty that even successfully broadening the base of people paying contributions in Germany as a result of immigration will make it easier to finance social security because the additional revenue from contributions will be at least partly offset by claims to benefits. All the same, temporary relief is expected. In the longer term, however, today's younger immigrants will also become net beneficiaries of the social security systems. Younger persons with below-average incomes are also net beneficiaries of the statutory health insurance system, especially when members of their family, who are exempt from contributions, are also included. Where immigration concerns lower wage groups, this will bring about immediate strains.

Principle of equal treatment

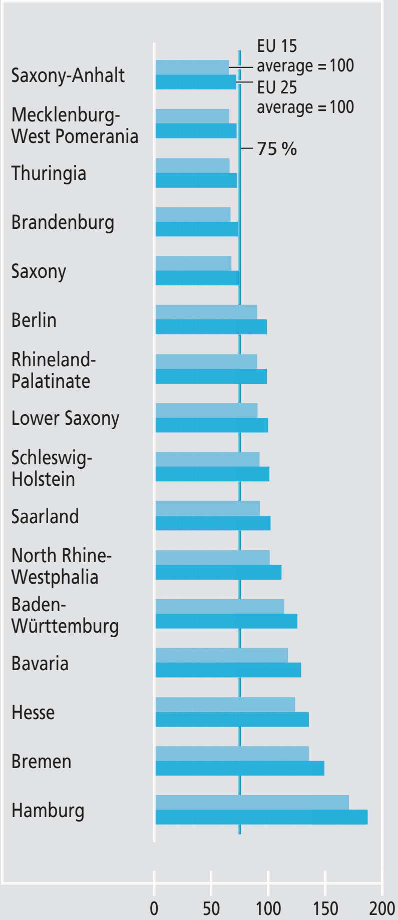
In the end, the effects of EU enlargement on the social security systems in Germany cannot be reliably predicted. EU law and, in particular, the principle of treating immigrants and the domestic population as equals (from which the country of employment principle is derived[16] are at odds with proposals for a restriction of social benefits.[17] This is why labour market and social security reforms in Germany are all the more indispensable.

Germany's net contribution to the EU budget

EU enlargement will have an effect on Germany's net contribution to the EU budget. According to the European Commission's initial proposals for the new financial perspective for the period from 2007 to 2013, the upper expenditure limits, which are currently 1.06% of gross national income, should be increased to 1.14%. Compared with the actual budget estimates for 2003 and 2004 of 0.98% in each case, this would represent a considerable expansion of the budget. If Germany's share of the financing is approximately one-fifth, as things now stand, this could result in an additional burden on the German budget of up to €3 billion per year. In addition, refunds from the EU budget are likely to decrease if promoting the east German regions in particular is a lower priority. According to the European Commission's most recent "cohesion report", although the east German promotional areas could remain under the 75% threshold following EU enlargement and the associated decline in average income in the EU, individual regions (south-west Brandenburg and Leipzig) are likely to have already exceeded this promotional criterion owing to the enlargement (see adjacent chart).

Economic power* of individual German federal states compared with EU average

2001



Source: European Commission, Cohesion Report, February 2004. — * Per capita GDP expressed in purchasing power standards as a percentage of the respective EU average.

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16 See C Nowak (2003), EU-Osterweiterung, Personenfreizügigkeit und staatliche Schutzpflichten im Bereich der sozialen Sicherheit, in Europäische Zeitschrift für Wirtschaftsrecht, Heft 4, p 102.
17 For example, establishing a "country of origin principle" for certain social benefits has been proposed. According to this, immigrants would obtain social benefits of a redistributive nature only in accordance with a notional claim in their country of origin. See H-W Sinn (2001), *inter alia*, EU-Erweiterung und Arbeitskräftemigration – Wege zu einer schrittweisen Annäherung der Arbeitsmärkte, ifo Beiträge zur Wirtschaftsforschung, Munich.

Consequences for economic policy

Important integration step

In enlarging to the east, an important step has been taken in the economic and especially political integration of Europe. This was preceded by the accession of the new member states to the EU 15, in the form of the European Agreements, for example, which had already been associated with a widespread opening-up of the markets, above all for industrial goods. This was reflected in Germany's close trade and financial integration with this economic area as well as intensive competition with the suppliers domiciled there.

Making use of wealth potential by ...

This study comes to the conclusion that further adjustments can also be expected after the formal accession to the EU in respect of improved factor allocation, whose quantitative effects are, however, difficult to estimate. It is often argued that, macroeconomically, prosperity gains will be relatively minor in the old member states – and therefore in Germany, too – as a result of the current round of enlargement because some of the effects have already been realised through including the new member states in the international division of labour, the economic weight of the countries is small and transition arrangements are in place.

However, EU enlargement also creates potential for growth going beyond the immediate advantages brought about by integration because in addition to the purely level effect dynamic aspects must also be taken into account. The tax and regulation systems in the new member states put the relevant conditions in Germany to the test and the pressure on the labour market to reform will remain high. In particular, the tax systems in some central and east European countries are noticeably more growth-friendly than in Germany.

... avoiding defensive answers and ...

It would be wrong to react defensively to a gap in tax, labour costs and regulation by maintaining the status quo or demanding that other things be adjusted by harmonising standards. To do so would be to throw away opportunities for growth and development in the new member states, something in which Germany can participate via close trade links. Acting defensively would conceal the need for action that already exists in Germany anyway.

... strengthening adaptability

Besides tax policy, not least labour market and wage policy are also under pressure to adapt and become more flexible. And this needs to happen before the end of the transition periods for the free movement of workers from the new EU countries. Although these transition periods protect parts of the domestic labour market, at the same time, they also present an incentive for increased German direct investment in low-cost neighbouring countries. The labour market will depend more than ever on giving appropriate answers in order to keep sustained profitable employment in Germany and bring about new employment opportunities during the structural change. Germany can take the chances of an increasing division of labour as a result of EU enlargement to the east if its economic policy continues to focus on reforms.