3.7 Workpackage 7

PRE-ACCESSION, STRUCTURAL AND COHESION POLICIES IN LIGHT OF THE ACQUIS COMMUNAUTAIRE AND THE DETERMINANTS OF THE PRODUCTIVITY GAP

The research in this workpackage was conducted by Peter Holmes, Xavier Lopez-Gonzalez, Johannes Stephan, and Cordula Stolberg. The objectives of research in **workpackages 7** include firstly an assessment of pre-accession policies and the terms of EU accession with a view on their effects on (productivity) catch-up. Those include in particular:

i pre-accession policies (Europe agreements, PHARE, ISPA, SAPARD)

ii the terms of EU accession (acquis communautaire in a selection of negotiation chapters, accession treaty)

In a second step, analysis is focussed upon:

iii the installation of ‘institutional framework conditions’ in CEECs

iv on the design of EU industrial and enterprise policy in light of the particular economic situations pertaining in the new member states, and finally

v the compatibility of EU competition policy with the conditions of economic development in CEECs.

Policy-frameworks before and after accession are assessed against the background of the results generated in other workpackages, *i.e.* against their likely effects on the (potentials for) productivity determinants. This analysis hence yields possibilities for sound alterations and extensions to policies on both sides (EU and CEECs) as well as to structural fund and cohesion policy to thereby provide the necessary sound basis for policy making geared towards meeting the conditions of swift economic catch-up development in CEECs in general and the closure of the productivity gap in particular. This workpackage is therefore the focal point of one of the two main objectives of the whole research project, in particular to assist the formulation of an efficient and effective management of the enlargement and integration process in respect to economic policy. The implicit objective of this workpackage as an economic policy extract of the whole research project is to provide the necessary knowledge base for a more pronounced consideration of factors of technological convergence as necessary supplement to the contemporary bias of enlargement agenda on institutional convergence.

Pre-accession policies were focussed only on ESM...

The “Europe Agreements”, concluded between the EU and new member states, as well as the white paper of the EU Commission on the “Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the EU” from May 1995 spelled out the institutional conditions that had to be met by new member states prior to their joining the ESM. Those conditions were less than those required of full members in the acquis communautaire to the extent that they are focussed on what the Commission considers to be relevant for the internal market only. Yet, those conditions were at the same time more than was required of full members in as much as new member states were asked for full legislative implementation whereas contemporary full members can still get away in some cases with at least temporary derogations and selective postponement of implementation of legislation.

...yet stricter than for full members (no derogations

It is to be expected not least from the East German example that integration into the ESM of transition economies does not *per se* guarantee swift and automatic convergence of per capita income levels, and hence the closure of the productivity gap. Where this automatism does not set in, some well targeted economic policy could accelerate or even prove to be necessary to foster economic catch-up. Supportive political measures could improve the conditions for the weaker new member states to close the productivity gap. The German experience also tells that vast financial transfers targeted at mainly social welfare systems but also used for infrastructural investment cannot induce a process of self-sustained economic growth, let alone catch up development.

German experience: integration not sufficient for catching up...

...nor are vast financial transfers targeted at social cohesion

The EU has endorsed the objective to assist the whole of the EU economy to improve industrial competitiveness with a particular focus on knowledge, innovation, and entrepreneurship. The instruments targeted at these objectives include mainly competition policy and enterprise policy.

In the framework of EU structural and cohesion policy, the EU has set itself the objective to assist a swift process of real economy catching up in less advanced regions of the Union. With the integration of CEECs, the main focus for EU cohesion policy will rest with its new member states.

Focussing on the conditions for real economy catch-up in the new member states in CEE, the aim is to assess the current design of EU policy intervention. To verify the efficiency and effectiveness of policies for our focus, a clear picture of the reasons for lower levels of real economy competitiveness in CEE is needed. In this respect, we can make use of the results generated in the research project on the determinants of productivity gaps between West Europe and a selection of candidate countries in CEE.

WP 7.1 The Europe-Agreements and trade liberalisation

The Europe-Agreements were concluded between the EU and new member states in the early 1990s. With a view on improving the conditions for a process of swift catch-up development in the new member states, the agreements in particular offered some budgetary means for structural policy, the SAPARD and ISPA funds.

In addition, the Europe Agreements stipulated the terms of respective trade liberalisation between the EU and individual new member states. Amongst the most prominent features, the agreements aimed at an asymmetric speed of reduction of tariffs and quota: the EU would open its borders faster than would the new member states be required to do. The main idea behind this was of course to offer the new member states the possibility to establish themselves on the new markets in the West following the demise of the CMEA-market. In macro-economic terms, export surpluses would provide the needed supply of foreign (and hard) currency (without constant devaluation of national currencies and increasing foreign indebtedness), and help to meet obligations arising from foreign debts (or even help reducing them). Hence, export surpluses could help much needed macroeconomic stabilisation which, at the time, was approached by way of currency overvaluation (by pegging exchange rates in a framework of positive inflation differentials) and high real interest rates.

EA stipulate asymmetric reduction of trade barriers...

In reality, however, significant deficits in foreign trade with the EU emerged right from the outset of transition (see chart WP 7.1). This, however, is not what constitutes improving conditions for catching up. But: with the demise of CMEA-trade and with

...yet trade deficits still largely prevailed

the opening of borders to the West, all transition economies experienced vastly increasing imports from all possible western origins. In particular, trade deficits *vis-à-vis* the EU turned out to be smaller than total deficits, indicating some of the positive effects of asymmetric trade liberalisation with the EU. So, if negative trade balances are a typical particularity for transition economies (large development gaps, demise of CMEA-trade and redirection of trade towards the West), then preferential trade agreements with the EU did result in lower deficits with the EU.

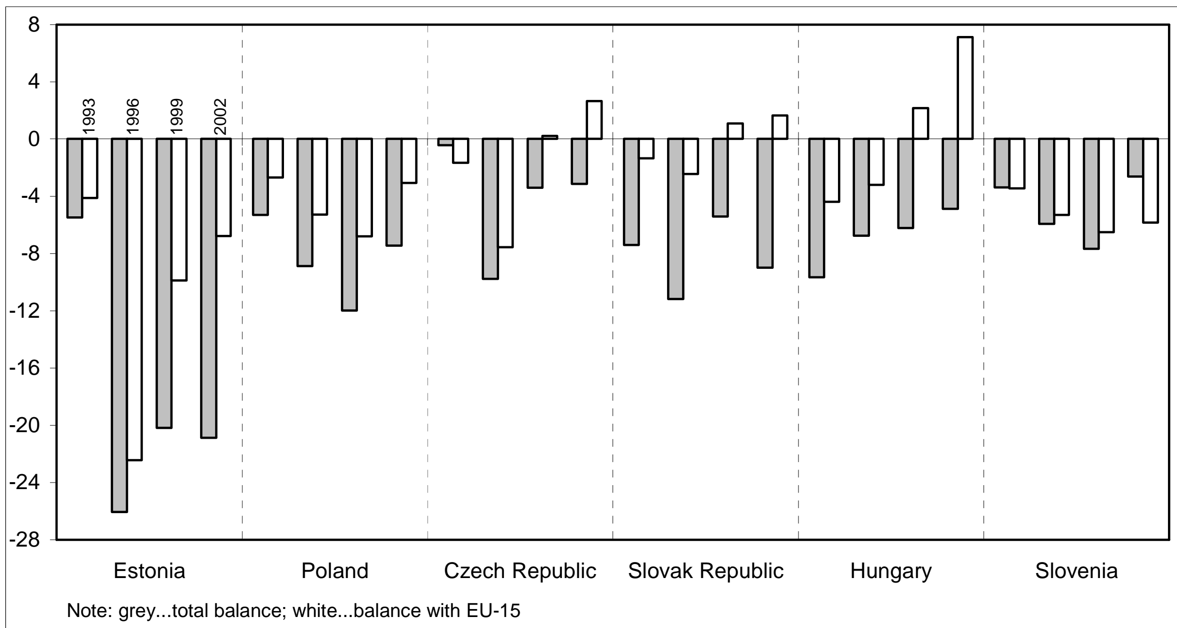

Chart WP7.1 Trade balances of transition countries with the EU-15 and total balances

Source: WIIW, National Statistical Offices, own calculations.

WP 7.2 Theoretical foundations of economic policy interventions

The aim of this part is to briefly assess the theoretical foundations that underlie EU's concept for policy interventions. To provide sound economic policy recommendations it is necessary to determine the political goals and to assess -from the point of view of market mechanisms- what policies are efficient to promote the designated political goal.

Conflicting policy goals...

The overriding aim of EU policy intervention can be characterised by the so-called 'Lisbon strategy' which entails that the Union become 'the most dynamic and competitive knowledge economy'. More precisely, today's EU policy interventions include two sub-aims: enterprise growth and innovation in all Europe on the one hand and reduction of economic disparities between economic regions on the other. From an economic point of view, we are prompted to question whether those two sub-aims are in fact compatible in terms of policy-instruments or whether achieving one aim is likely to compromise the other aim.

...and two schools of thought

In general, we can distinguish between two schools of thought with respect to the overriding aim of the Lisbon strategy. Differing predictions on the effects of economic integration follow from different theoretical concepts:

i one group assumes that technology, being exogenous, is freely available across the integrated economic area. Hence, less advanced regions either catch up with higher growth rates by using freely available and more advanced foreign

technology (absolute convergence), or are able to catch up conditional on the ability to absorb and implement the foreign technology in their own production (weak convergence). While the supply of technology is exogenous, differences in development levels are endogenous, and depend on the respective endowments of regions with immobile factors. European integration itself (*i.e.* the deepening and enlargement of the European single market as well as the introduction of a common currency) is sufficient to secure both convergence of levels of economic development within the common market via trade and competition and a higher level of economic development for the whole region via a more efficient allocation of scarce resources.

The implications for economic policy in this convergence hypothesis involve the promotion of unrestricted trade and mobility of factors. With a view on less developed regions this concept would suggest reducing the barriers to the exploitation of more advanced and foreign technology but no specific intervention into market mechanisms.

The policy implications to be derived from the other school of though are quite distinct from this:

ii a second group assumes increasing returns to scale in the aggregate (decreasing long-term cost curves) and beneficial externalities at the micro level, technology is endogenous and localised. With deepening integration, the most productive factors will tend to flow toward the more favourable regions which offer higher returns and hence improve the allocation of scarce resources; agglomerations will benefit from integration whereas disadvantaged peripheries might well fall further behind. In the strong case of this non-convergence story, the existence of a sufficiently large development gap causes divergence, whereas in the weaker version, convergence can only set in if a minimum regional-specific threshold level of economic development has been achieved (below which private investment cannot yield the rate of return required by the market). Hence European integration secures the higher level of economic development via reallocation of scarce resources to their most efficient use, but benefits are not necessarily distributed equally across regions.

In terms of economic policy, regional concentration by liberalisation of trade and movement of factors within the integration area is the optimal policy (efficiency-argument). However, more regional concentration might violate the second objective of the Lisbon agenda, if deepening integration results in an uneven distribution of agglomerations between European regions. With reduction of economic disparities between economic regions being an explicit European goal, the non-convergence concepts might justify policy intervention.

This is essentially a political decision...

This, however, raises two questions: first, a political decision has to be taken on the character of the reduction of economic disparities, *i.e.* whether convergence of per capital GDP via relatively higher growth in lagging regions is the aim, or whether the establishment of equal economic welfare is to be achieved. Whereas the former case would justify policy intervention to reduce the gap or to achieve the minimum required level in regions with insufficient agglomerations, the optimal policy for an equalisation of welfare between regions could best be served by allowing the maximum level of efficiency via concentrations and a surrogate redistribution of generated income to lagging regions in the form of transfers. In the case of the EU, we can assume that for regional policy the former character of convergence is preferred.

The second question pertains to the definition of regions for which the aim of convergence is postulated: if the sizes of regions are too divergent, if population densities are very heterogeneous between regions, if endowments with natural resources are too different, and if the territorial size of a region is too small to assume a meaningful relationship between the activities taking place in the region and what is reported by statistics (take *e.g.* larger agglomerations with central functions), then expecting economic convergence is implausible. In the context of EU regional policy, the so-called NUTS2 regions have been defined as the geographical level at which inequalities should be measured, yet some of the regions are too divergent in their underlying potentials to serve as meaningful regions for economic convergence (see *e.g.* Boldrin / Canova, 2001).

...with the EU tending towards a less interventionist philosophy

From the design of EU cohesion policy and from public statements in support of policy interventions, we may derive that the theoretical foundation is deducted from the concept of possible non-convergence and that regional policy does take the form of compromising overall economic efficiency for inter-regional equality. However, empirical analysis of effects of regional policy alone on economic convergence (in particular income levels) are rather sceptical (*ibid.*). Some of the evidence suggests that interaction between economic integration (foremost trade liberalisation), macro policy, micro policy and institutional reform, and EU policy intervention may be important (Pischke, 2001).[1] Moreover, cohesion policy has lately received a 'Lisbon agenda makeover' (see the speech of Commissioner Barnier to the enlarged presidency of the Parliament on 18 February 2004): the proposed re-nationalisation of large parts of cohesion policy to some degree dilutes the potential conflict between the two sub-aims. This allows us to assess EU structural and cohesion policy in the broader framework of policy interventions in general.[2]

EU cohesion policy under the umbrella of EU industrial policy

WP 7.3 The implications of policies aimed at 'institutional framework conditions'

Institutional framework conditions are necessary...

During the phase of membership preparation, the EU placed particular weight on installing the institutional framework in CEE economies. The pre-accession phase was clearly dominated by the installation of community law from the acquis communautaire into the national laws of the new members. However, the German experience shows that institution-building can possibly be considered a necessary condition for catching up but is by far not sufficient for improving the conditions for real economy convergence. Rather, in post-socialist economies, we observe particular conditions which suggest the need for likewise particular policies. The analysis below, especially chapter WP 7.4, suggests that EU policies as planned have the potential to meet those particular needs. Maybe, however, a different weight of policies aimed at increasing skills and know-how, production networks and inter-firm interaction, R&D and innovation, entrepreneurship, infrastructure, *etc.* would promise to be more effective.

...yet insufficient

This, however, does not mean that setting framework conditions right for fast economic growth and recovery is less important. Rather, next to fulfilling the pre-

[1] Clearly, EU assistance in establishing infrastructure remains undoubtedly a positive-effect story.

[2] None-the-less, this trade-off still persists at the level of member states. With a view on this trade-off, a recent competitiveness report suggests that European regional policy should embrace a stronger focus on promoting knowledge and innovations in the weaker regions. Otherwise, the gap between the most and least competitive regions in Europe threatens to grow even wider (European Competitiveness Index 2004).

condition for economic activity under uncertainty, it can play an important role in the particular situation of post-socialist transition economies, and our analysis will focus competition policy as one of such institutional framework. The intuition is that intensifying competition will lead to both, a more efficient allocation of resources, and second to economic activity to be more innovative. In fact, analysis in other workpackages (in particular WP 6) could indicate that one important reason for aggregate productivity gaps lies in the existence of a 'long tail' of less and least efficient firms. Their exiting the market and thereby freeing resources so far still bound in inefficient use, could free the way to a more efficient allocation of these resources. In reality, freed resources can either be soaked up by growing efficient firms, could engage into own entrepreneurial activity (Schumpeter), or might also in the worst of cases remain unemployed and eventually become obsolete. With respect to economic policy, there are possibilities to prevent such a worst case scenario, and we will frequently return to such policies, if from different points of departure.

Competition policy an insightful case in point

WP 7.4 The design of EU industrial policy in light of the particular conditions pertaining in CEE economies

Industrial policy is essentially under the competence of the member states. The role of the EU in EU industrial policy is therefore confined to the 'open method of co-ordination', in which the Commission serves as something like a conductor of discussions, policy developments and improvements. In the framework of the Lisbon agenda, the discussion pertaining to EU industrial policy centres around industrial competitiveness: knowledge, innovation and entrepreneurship are held to be the three key factors (see COM(2002) 714). The overarching 'philosophy' for EU policies can be summarised as:

> "...the Lisbon goal calls for policies that establish an environment conducive to enterprise growth and innovation while ensuring that the market players are subject to uniform rules. Enterprise policy focuses on the first objective, while competition policy emphasises the second. But both policies contribute to high and sustainable productivity growth" (COM(2002) 262, p. 14).

More specific, the assessment of individual instruments of EU industrial policies suggests the predominance of three important characteristic features:

- i policy intervention can only compensate (where necessary) for market failure (enterprise policy) or protect/safeguard the market (competition policy);
- ii enterprise policy and competition policy are to work complementary (COM(2002) 262). Potential areas of conflict, as *e.g.* cooperation in R&D and innovation are dealt with specifically in the EU competition policy, in our example in the form of technology transfer block exemptions;
- iii industrial policy is strictly confined to a horizontal approach. Hence the *leitmotiv* of 'framework conditions'. This concept originates from the definition of the broad principles of EU industrial policy in 1990 (see COM(90) 556) and resurfaces throughout the latest publications outlining future EU policy, including policies for CEE economies (*e.g.* COM(2002) 714). Specific interventions aimed at

supporting particular firms or sectors of the economy are either ruled out explicitly or embraced only if aimed at reducing over-capacity (*e.g.* the steel sector).[3]

Conceptualisation of EU industrial policy well adapt to help CEECs

This conceptualisation of industrial policy appears to offer all possibilities to devise a coherent and effective policy-mix in the new CEE members to thereby assist swift real economy convergence. Of particular importance for the new member states is that none of the instruments in EU industrial policy serve to restrict flexibility: none appear to change market scarcities, prices, and hence send distorted signals to market agents, in particular investors.[4]

For the post-socialist economies, flexibility in the reallocation of resources is a particularly important condition of real economy catch-up (Stephan 2003): because of the historically rooted distortions both in sectoral structures and within industrial firms of post-socialist economies, profound restructuring is a necessary pre-condition for a dynamic process of catch-up development. The contemporary patterns of comparative advantages of those economies are hence also subject to change and it is impossible to determine which comparative advantages will in fact lead the new members into real economy convergence: today, those economies feature lower unit labour costs in industrial production, yet some CEE industries appear to develop particular strengths in capital-intensive and knowledge-driven manufacturing industries. Any policy in support of *e.g.* more standard labour-intensive production would hence intervene unduly into the market and can be expected to be non-sustainable in the medium to long term, or non-economically in the short terms as costs exceed societal benefits.

WP 7.5 Additional EU industrial policy specifically targeted at new members

Some additional policy instruments of EU industrial policy are targeted to the particular needs of new members. Those mainly focus upon improving infrastructure, know-how and skills, and local institutions.

Infrastructure and training programmes can be very efficient policies

Clearly, investment in infrastructure is well targeted at the specific deficiencies in the region. In fact, the accessibility and quality of transport infrastructure proved to be amongst the firm-specific sources of lower levels of productivity in a comparison of firms from West and East (workpackage 6). Policies aimed at improving know-how and skills of entrepreneurs and workers alike also correspond well to the specific needs of the new members' economies (again workpackage 6). Of course, the level of formal education is comparably high in the new member states, but management deficiencies and a weakness in entrepreneurship are amongst the most important competitive disadvantages in CEE. The EU plans to focus policy in this field on "creating an environment conducive to entrepreneurship, skills upgrading and SME development" (COM 2002) 714, p. 28). Further measures include "supporting the development of business services, promoting the culture of inter-firm cooperation and enhancing the development of innovative clusters" (*ibid.* p. 28). In fact, the above cited analysis on firm-specific determinants of productivity gaps /workpackage 6)

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[3] One prominent exception to this rule, however, is the EU Common Agricultural Policy. We will later stress that in particular this policy can in fact be potentially harmful for the goal of real economy catch-up in some of the CEE member economies.

[4] A possible exception are instruments targeted at improving the access to finance by way of "a wider availability of guarantees" (COM(2000) 771, p. 7). Such policy intervention can easily give rise to adverse motivational effects as moral hazard. Apart from this, however, provision of seed and early stage financing as well as micro-loans have the potential to increase flexibility by assisting the emergence of new firms.

holds that amongst the most important sources of gaps between comparable firms in East and West pertain to marketing and management deficiencies like low intensities of use of communication technologies (email, internet, e-business) for inter-firm networking, and a general lack of networking between the firms and their customers, suppliers and other stake-holders as such. Here, management training programmes can be very efficient.

The role of local governments in developing business-services

Where business services do not yet exist to a sufficient extent (and workpackage 1 identified rather small shares of this sector in all CEECs), local government institutions can help businesses in tasks like *e.g.* the application for assistance from EU structural funds, the channelling of potential investors to profitable locations and potential local partners, the institutionalisation of networking in general and with respect to technology transfer, *etc.* For CEE's local government institutions, these tasks are complete novelties. Hence, EU support in the development of local governmental institutions and the training of their employees can have an indirect albeit very important effect on the competitiveness of CEE industry.

WP 7.6 EU enterprise policy in light of CEE development conditions

In particular, the instruments of EU enterprise policy focus on the three objectives of entrepreneurship, innovation, and access to markets (see SEC(2000) 771). The instruments promoting entrepreneurial activity include predominantly institutional framework reforms (in the field of bankruptcy legislation, a simplifying of administrative and regulatory procedures for start-ups, and by promoting new legal forms of entrepreneurship), but also more direct measures as *e.g.* improved access to finance for seed and early stage financing and micro-loans, knowledge and skills-related activities (education schemes at all levels, vocational training in firms), as well as business support activities (events laying out the possibilities of inter-firm cooperation and networking, supply-chain management, e-commerce, *etc.*).

The instruments targeted at supporting innovation and change focus on a removal of obstacles for the dynamic and market-oriented development of research and technology (including issues such as intellectual property rights and patenting, as well as the removal of obstacles to the introduction of new products), on an encouragement of support mechanisms and exchange of good practices (both at a regional level in the 'Regional Innovation Policy Network' and 'Network of Regions of Excellence', and at the firm level with a view on innovation finance and technology transfer), and on promoting business services in general. The instruments related to ensuring access for goods and services to markets are mainly concerned with improving the efficiency of the single market project: elimination of remaining barriers, liberalisation in the fields of utilities, improvements in public procurement, competition and state-aid rules and other single market legislation. In addition, the policy-mix envisages some strategies to help small and medium enterprises using the whole potential of the Single Market.

Most of those instruments are not only conducive to dynamic economic development in European industries, but in particular in the new member states: here, entrepreneurship and innovative activity are particularly less developed, existing and potential entrepreneurs are at the lower end of the learning curve in terms of management and market know-how and experience.

Important focus on entrepreneurial concerns...

In this respect, promoting a bankruptcy framework that allows entrepreneurs a fresh start after failure is necessary to account for the risky character of entrepreneurship

and helps to disentangle inefficient allocations of scarce resources in the Schumpeterian sense. Due to the high intensity of enterprise restructuring in the formally state-governed economies, such a dynamic approach to restructuring is particularly important. This can be further promoted by facilitating the administrative and regulatory procedures which are all new to the agents in CEE: here, know-how on how best to operate in a highly regulated environment is particularly scarce. The experience with the promotion of new forms of entrepreneurship, however, seems to suggest only limited effects in the case of Germany if not paralleled with the training of potential entrepreneurs: the introduction of the so-called 'Ich-AG' was targeted at simplifying access of individuals to start an own one-person company.[5] It remains hence doubtful whether the introduction of such additional forms of entrepreneurship are actually needed.

...but not on new forms of entrepreneurship

Without doubt, access to finance for (in particular small) entrepreneurs (whether for start-up, restructuring, or innovation) is not only a particular European problem (in comparison to the US), but especially grave in CEE: here, incumbent banks are often over-burdened with a poor loan-portfolio from larger client enterprises, and hence unable to provide more risky seed and micro-loans. Additionally, knowledge and skills-related activities in the form of education schemes and vocational training in firms, as well as business support activities by use of events laying out the possibilities of inter-firm cooperation and networking, supply-chain management, e-commerce, *etc.* can help entrepreneurs in CEE to bridge the experience gap *vis-à-vis* their Western competitors. In fact, firm-specific investment-intensities proved to be the one most important determinant of productivity gaps at the firm-level, regardless of size, industry, and country (workpackage 6). Hence finance for investment becomes an important focus in an efficient policy-mix for CEECs. Also, even amongst foreign investment subsidiaries, domestic financial institutions play a less important role for finance. Only in the case of Hungary were domestic sources of finance more important than the foreign owner indicating an already more developed capital market in Hungary (workpackage 4).

Finance for entrepreneurial investment

In particular the policies geared towards R&D and S&T appear to be well formulated to suit the particularities in CEECs. This can be read from the results generated in workpackage 3, where the main deficiencies in National Innovation Systems were identifies in the 'broad' macro-institutional context of innovation. With firms in CEE only gradually integrating into Western markets and East-West firm networks, Western technology in the East is often new, hence innovative activity is generally lower (see Cserháti/Takács, 2002, for an analysis of factors driving innovation in CEE firms). The production of new knowledge or the combination of existing knowledge in new ways can result in marketable new methods of production (process innovations) and/or in newly developed products. Innovations are typically held to be amongst the most important sources of productivity growth and are subsequently an essential factor for the new member economies to become internationally competitive. Hence, policies aimed at dynamic development of research and technology are of particular importance in CEE economies. In particular, the region- and network-related instruments for the exchange of 'good practices' can help CEE firms to leapfrog on the learning curve.

Framework conditions to improve National Innovation capacities

[5] Whilst the time period since the reform is too short to warrant a meaningful assessment of this vehicle, the IAB diagnoses an unexpected high rate of failures.

WP 7.7 EU competition policy in view of CEE development conditions

We now look at the EU's principal policy towards industry, namely competition policy and will devote most space at this point to this theme. Here, the candidates have been obliged to adopt rules compatible with the Rome Treaty since the Europe agreements were signed. It might therefore be tempting to conclude that the effects of accession have already occurred. On the contrary however there are likely to be quite subtle changes. In fact the Europe Agreements did not impose any requirements on candidates with respect to domestic competition laws, but only with respect to matters covered within the EU by Articles 81 (on restrictions of competition) and 82 (on abuses of dominant position) for private actions, which affect cross border trade, and the corresponding state aids rules. Paradoxically the functions of the newly created competition agencies that had to be carried out under the EA's will most likely have disappeared in most of the new member states on accession, which would have left them with only internal tasks had accession not been the occasion for a major re-think of the way the EU deals with competition issues, namely the creation of a network of national competition agencies to complement DG Competition.

Table WP 7.1 Shifting Policy responsibilities after accession

	Pre accession		Post accession		
	National	EU	National	EU	
				Network	DG Comp
Competition	Must ensure 81/82 & state aids equivalence where effect on trade Can treat local cases as it wishes. Monitor & approves aids	No formal powers	National markets only EA related tasks *end*	Regional markets	EU-25 cases Pre-amble & SME policies of EU apply in full Control of state aids
Trade	National rules apply	FTA rules only NTBs as they affect product norms	Must apply CET incl. AD; National transition measures?	CEECs lose voice at WTO 2003; gain vote in EU 2004	
Industry	Give state aids; must accept *acquis*	Sets technical norms	Norms? Scope for national derogations?	EU technology etc policies apply in full to CEECS	

Note: AD...anti-dumping; CET... common external tariffs; EA...Europe agreements; FTA...free trade area; NTBs...non-tariff barriers.

Trade policy will now become an EU matter for the candidates. Interestingly the pre-accession phase (like the European Economic Area) was not a customs union but a form of free trade area. The new member states have now joined the EU customs union. For most countries the tariff structures have anticipated membership and a smooth transition is expected. The major impact is likely to be on anti-dumping (AD) where it can be expected that all EU measures applied against candidates will be dropped (barring use of the new transition mechanism). But the new member countries will have to take on the EU's AD measures instead of their own. The loss of the remaining pre-accession trade policy autonomy raises the question of whether the CEECs had been able to use their residual trade instruments as a policy to affect location of investment and more problematically if so whether the loss of this instrument is likely to be bad for catch up. Table WP 7.1 highlights the main changes in competition, trade, and industrial policy.

WP 7.7.1 Competition Law Reform

The EU accession of the CEECs coincides with a major reform of competition law enforcement across the EU. The overall objectives of the Competition Law Reform are a more transparent and more directly applicable competition law enforcement with simpler procedures, a decrease in bureaucracy, and closer co-operation between national competition authorities (NCAs) and the Commission as well as amongst NCAs.

Enlargement made competition policy reform highly opportune...

The CEEC accession made a reform of competition law highly opportune. The CEEC competition authorities were set up with the Europe agreement rules in mind. These required that the CEECs, then as associates, should put in place some form of competition regime which would replicate the impact on trade between member states of the articles 81 and 82 (ex 85, 86) of the Rome Treaty. These articles are directly effective within the EU (being enforceable by DG Competition and if necessary by action in the courts). But the clauses of the EA's could not be directly effective in the same way unless implemented by legislation in the partner countries. The partners chose to set up competition laws and competition agencies. The new competition policies went beyond the literal requirement of the EAs, which only necessitated controls on restrictive business practices, which might affect cross border trade between the EU and partners.

...so far CEE competition policy was geared towards external EU trade only

It is interesting to note that many existing member states (*e.g.* Italy) did not have a competition authority until recently: the Commission was empowered to tackle cross border cases and the Rome Treaty is silent on purely domestic matters. And member states with competition policies were free to use principles different from Treaty rules for purely domestic matters (the UK for example has only just removed a blanket public interest provision from its domestic competition rules). Hence the new CEEC competition agencies were primarily established to carry out a function that would cease to exist once they became member states. The new agencies would have found that their sole tasks would be to concentrate on the purely domestic cases; indeed it would have been possible for new member states to abolish their agencies had they wished to do so on the grounds that they could rely on the pro-competitive effect of regional free trade on a small open economy, an option that could have appealed to Baltic states.

However a decision was taken at the overall EU level that will radically transform the potential role of the fledgling agencies. The new plan gives operational effect to the jurisprudence of the European Court of Justice that EU competition law is directly effective within member states and can therefore be invoked by parties other than the Commission (though the scope for actors other than the Commission to apply article 81(3) (governing the rules for exemptions from Article 81) is more complex). As we noted above of course, the new arrangements only apply to the application of Community law: matters with no possible effect on trade remain in domestic hands.

A further point to note is that Vissi (1998) argues that whereas under the pre-accession regime cross border competition cases in the CEECs had to be judged according to the wording of articles 81 and 82 alone, the application of the full Rome Treaty to these cases implies that the early general articles of the Treaty, regarding cohesion *etc.* will become relevant to the interpretation of the competition provisions. Frazer (1999) argues that this has been problematic even within the EU, but it is a particularly delicate burden to add to new competition authorities.

The modernisation of Regulation 17 (1962), which governs the restriction of competition (Article 81) and abuses of a dominant position (Article 82), forms the core of the Competition Law Reform. A new European Competition Network serves as a key-player within the new enforcement system. At the same time, more responsibility is shifted to companies, as they will have to ensure that their actions either do not restrict competition or qualify under the provisions of Article 81(3) without being able to rely on “comfort letters” from the Commission.

The European Competition Network will operate on the principle of best-placed authority. The provisions of Article 81(3) will become directly applicable in the candidate countries as well as in the EU, and based on this there will be joint enforcement of the rules governing restrictive practices by the Commission, the NCAs, and national courts. This represents a major change to the present enforcement system. Whereas prior to the reform only the Commission was able to apply Article 81(3), NCAs and national courts are now able to and expected to apply the provisions of Article 81(3) when the Competition Law Reform comes into power. National courts thus play an important role in the enforcement of competition law and complement the role of NCAs. Equally important is the change to the handling of block exemptions granted by the Commission. If the Commission has granted such a block exemption, by which Article 81(1) (governing restriction of competition) is declared inapplicable to certain agreements, decisions, or practices, and if these agreements, decisions or practises cause effects that are incompatible with Article 81(3), the Commission as well as NCAs have the power to withdraw the block exemption from a particular case.

With regard to the relations among the members of the network and their competences, the Commission maintains a leading function. National competition law has to act within the boundaries of EU competition law. NCAs cannot apply national competition law to agreements or practices within the provisions of Article 81(1) that would prohibit such agreements or practices if the same is not also prohibited under EU competition law. Member states are, however, free to apply stricter national competition laws that prohibit unilateral conduct by companies, *e.g.* abusive behaviour toward economically dependent undertakings.

Moreover, NCAs are obliged to inform the Commission before or without delay after commencing a formal investigation under the provisions of Articles 81 / 82. This information about proceedings has also to be made available to the other member states. The Commission can also directly intervene in the proceedings of NCAs or national courts: if the Commission initiates proceedings under the provisions of Articles 81 / 82, NCAs and / or national courts are relieved of their competencies for those cases. Furthermore, if the Commission has reached a decision in cases under the provisions of Articles 81 / 82, NCAs and / or national courts must not reach decisions that counteract the ruling of the Commission.

In proceedings under Articles 81 / 82 that might affect trade between member states, the application of national competition law must not lead to the prohibition of agreements / practices that affect trade between member states, but are allowed under Article 81(1) or fulfil the conditions of / are covered by Article 81 (3).

According to the principle of best-placed authority, each case should only be dealt with by one (namely the best-suited) authority. Hence, competition authorities are able to suspend or close a case on the ground that another competition authority has dealt or is dealing with the case. In practice, this requires the exchange of –even

confidential- information between the different authorities. The Competition Law Reform provides for an exchange of information conditional on the sole use of such information for the application of Articles 81 or 82 or for the application of national competition law if it refers to same case.

New EU competition policy puts more responsibility to national institutions...

The Competition Law Reform and the concept of the European Competition Network in principle provide ground for a more direct approach to the enforcement of competition policy. At the same time, it puts more responsibilities to the NCAs and national courts, in terms of applying and enforcing competition law. This could potentially prove difficult for some NCAs in CEE, as competition authorities are relatively new in those countries and are not as experienced in the enforcement of competition law as NCAs in other member states.

...which could prove to be problematic in CEECs

The European Competition Network aims at a more direct approach to the enforcement of competition policy. The new system leaves, however, some questions open with regard to responsibilities and competencies within the network as well as with regard to the relationships between the members of the network. These issues become particularly interesting in cases with cross-border implications.

The principle of best-placed authority and the handling of each case by a single authority should make competition law enforcement more transparent (both for competition authorities and firms) and offer a more direct application. Nevertheless, it is not always clear which authority should initiate proceedings in cases with cross-border implications or should have the competency to deal with such cases.

It is ambiguous if NCAs can take decisions that affect other member states too in cases with cross-border implications or whether such decisions are legally binding only within national boundaries.[6] If decisions by NCAs are only legally binding within national boundaries, it might well come to multiple and contradictory enforcement (which the competition law reform actually aims to avoid). It is worth noting that the jurisdictional overlap issue arises in the EU in a very different one from that of the US, where both the Federal Trade Commission and the Anti Trust Division of the Department of Justice enforce federal law. In this case they normally act as prosecutors only and coherence is assured by the fact the initial decisions, and not simply appeal decisions are made by the courts. In fact anyone with standing can bring a case to a US court, notably aggrieved competitors, consumer groups and individual states. The direct effect of EC competition law actually opens up the prospect of additional private enforcement of EC competition law as has occurred occasionally in the UK. We note below the issues raised by the private enforcement of the state aid element of competition law.

The issue of market definition is an important one, too. The outline of the Competition Law Reform does not state which authority should define the relevant market in cases with cross-border implications. The market definition is however highly relevant in such cases, as the decision on whether a firm conducts anticompetitive behaviour can change with the definition of the relevant market.

Also some institutional ambiguities remain in the new EU-system

In their paper on the European Competition Network, Mavroidis and Neven (2000) point out some further potential problems that the implementation of the Competition Law Reform might bring about: they refer to a potential 'disintegrating effect' of the reform, as the NCAs have different incentives in exercising their power and have

[6] See also Mavroidis, Petros C. and Neven, Damien J. (2000) on this issue. They interpret the White Paper, as that decisions by NCAs are only binding within national boundaries.

probably no incentive to consider effects outside their national boundaries but will in their own interest.

The balancing between positive and negative net benefits might become difficult under multiple enforcement. If one country experiences a negative effect from a decision (although the net effect over all countries affected might be positive) it will bloc the implementation of the decision. Some hypothetical scenarios and their likely outcomes[7] can help to highlight the potential problems and questions the new system of competition law enforcement raises:

- In case two firms from two different countries that have an agreement which would impose vertical restraints, which NCA would have the competency to deal with the case / initiate proceedings? Or is this otherwise a case that the Commission would deal with?

No set rules exist for such a scenario. Two or more NCAs might deal with one case. NCAs might continue to deal with cases that are already dealt with by other authorities or might indeed initiate proceedings although another NCA / the Commission is already dealing with the case. Generally, the member state / NCA that is better placed to deal with the case should take on the case.

- Considering the same case as above, one of the two countries now has granted an exemption for that agreement. Would such an exemption only be binding within national boundaries or would it also be applicable across borders, *i.e.* in the second country? What would happen if the second country disagrees with the granting of the exemption? Would the Commission intervene and, more importantly, would the Commission undertake a cost-benefit analysis for the case in light of its effect on both countries / all member states? Alternatively, would one of the two countries have to undertake such an analysis?

If the Commission has issued a decision concerning an agreement, NCAs and national courts cannot –in cases with cross-border implications- issue a divergent decision (as mentioned above, this does not –under the provisions outlined above- apply to purely domestic agreements under block exemptions). If however a NCAs or national court grants such an exemption, another Member State is free to assess the matter without considering previous rulings. The outcome of such a process is nevertheless entirely unforeseeable at the moment, as the issue of the reach of jurisdiction of a state in itself is not clarified. Complicated by the issue of an exemption, there are neither formal nor informal guidelines as how to deal with such a case.

- How is the question of defining the relevant market in any potential case handled? Which authority defines the relevant market and which criteria are used to do so? What happens if there is disagreement about the definition of the relevant market among NCAs or between NCAs and the Commission?

Apart from the general criteria of the homogenous conditions of competition and the substitutability of the concerned products which NCAs will use in a similar fashion when applying EC law, there are no further guidelines as how the relevant market should be determined. Therefore, different and contradicting market definitions might

[7] The scenarios were presented to Adam Zolnowski from the Polish Competition Office who kindly outlined the operations of the European Competition Network with regard to the cases and highlighted where such operational procedures have yet to be put in place. The results above represent a summary of the answers.

emerge which could considerably hamper the identification of cases. The issue of market definition may be subject to discussion on the forum of the European Competition Network (discussions of this issue between the US and the EC for example have proven to be successful).

- How big is the potential for “forum shopping”, *i.e.* NCAs only taking up cases that are of national interest? Will there be a mechanism in place to prevent such behaviour?

It should not be possible to bring complaints before an authority with little interest in the matter. Cases should be dealt with by the best-suited authority which also has an interest in the case and where the outcome of the case (especially if unresolved) has a potential impact on the economy. There exists however the risk that in some circumstances no authority wants to deal or cannot afford to deal with a case.

- How will the principle of best-placed authority operate in practice? Assuming there is a horizontal agreement between two firms in two countries, which authority will deal with the case? What happens if an NCA of a third country has an interest to intervene because some of its industries / its consumers would be affected by the agreement, too?

The future functioning of the European Competition Network is still very much unresolved. Generally, cases should be dealt with by the authority that has the biggest interest / is most affected by the case and has the best resources to deal with it. How does this affect CEECs?

WP 7.7.2 State aid

The state aid regime in the CEECs changed completely with EU accession, although the economic impact may turn out to be modest. During the transition period, the CEECs have already established national authorities managing the state aid system in accordance with the EU rules. With accession, however, those national authorities still have a monitoring function but final decisions are taken in Brussels. All new state aid and all plans to alter existing aid (including aid under Article 87(2), ex Article 92)) have to be notified to the Commission. The proposed measures cannot be put into effect until the Commission has approved of them. Moreover, under Article 88(3) (ex Article 93(3)), the Commission has the power to prevent the distribution of aid or stop an ongoing payment. The only exception forms new aid that is classified as being too small to affect trade between member states.

Under the EAs, all CEECs were eligible to apply the regional exception rule in the distribution of state aid, provided under Article 87(3). The Article lists three additional conditions under which state aid can be granted:

i for regions where the standard of living is low,

ii to promote the execution of an important project of common European interest, and

iii to facilitate the development of certain economic areas.

Similar measures are for example applied to East Germany, for which Article 87(2) explicitly provides ground to grant state aid in order to promote regional development. The measures under Article 87(3) are, however, only applicable for a certain time period laid down in the EAs. The regional exception rule can be considered to be of particular relevance to CEECs: here industries are often infant, agglomerations often insufficiently large to provide cluster advantages and scale

economies (in the sense described in the chapter on theoretical foundations). Here, additional support to investment and tax incentives not least for FDI can help to improve conditions for catch up development in CEECs. Looking at the Treaty of Accession 2003 for the Candidate Countries, only Cyprus, Hungary, Poland, and Slovakia appear to have further transitional periods for competition policy and, more specifically, state aid. Those transitional rules lay down particular measures that can be applied as well as the time frame in which these measures can be applied. Poland, for example, will under the special economic zones provision be able to grant aid that does not exceed 75 *per cent* of the eligible investment cost to big companies and aid up to 30 *per cent* of the eligible investment cost to the motor vehicle sector. Furthermore, tax exemptions might grant corporate tax exemptions to SMEs until 2010. For the other CEECs listed under the transitional measures in competition policy, equally specific measures apply.

As mentioned above, the CEECs have already been adapting to the post-accession state aid system prior to accession by establishing the necessary institutional framework. The establishment of state aid monitoring authorities is thus a central task. Table WP 7.2 shows which authorities in the CEECs hold the control of state and which authorities are responsible for monitoring state aid.

Table WP 7.2 Institutional arrangement for state aid in CEECs

	Control of state aid	Monitoring of state aid
Bulgaria	Commission for the Protection of Competition	Ministry of Finance
Cyprus	Office of the Commissioner for Public aid	
Czech Republic	Office for the Protection of Economic Competition	
Estonia	Ministry of Finance	
Hungary	State aid Monitoring Office	
Latvia	State aid Surveillance Commission	
Lithuania	Competition Council	
Poland	Office of Competition and Consumer Protection	
Romania	Competition Council	Competition Office
Slovakia	State aid Office	
Slovenia	Ministry of Finance	

Source: “Anti-trust and State Aid authorities and legislation in the Candidate Countries”, http://www.europa.eu.int/comm/competition/enlargement/candidate_countries/

In the following, we take a closer look at the state aid system in practice and we discuss whether and where problems in the state aid systems of the CEECs are likely in light of EU accession. In particular, we consider the following issues:

- the new state aid regime in practice;
- the amount of granted aid and the instruments used;
- state aid to the manufacturing sector *versus* horizontal objectives;
- state aid used by firms as an strategic instrument;
- state aid and productivity.

WP 7.7.2.1 The new state aid regime in practice

As mentioned above, the main impact of EU accession on the state aid regime in the CEECs is that the CEECs have a monitoring function of state aid. Moreover, although general provisions as to the functioning of the state aid system after accession are outlined for the CEECs (see above), further provisions such as potential cooperation between the state aid monitoring authorities (similar to the cooperation within the European Competition Network) are not specified. At this point

–considering the short time span the new regime has been put into effect- it is therefore not possible to discuss the new state aid regime in practice after accession further.

WP 7.7.2.2 The amount of aid granted and the instruments used

Whilst state-aid does not appear to be a great problem in CEECs in general...

An indicator of potential problems facing the CEECs after accession could be the overall amount of state aid granted by the CEECs compared to the overall amount granted by the EU. If there existed a remarkable discrepancy between those two amounts and in particular if the amount of aid granted by the CEECs was considerably higher than that of the old EU, this might indicate that the CEECs would face pressure to reduce the amount of granted aid after accession. A comparison between the amount of state aid granted by the old EU and the CEECs in 2000 reveals that the old EU granted an average of 0.8 *per cent* of their GDP whereas the CEECs granted an average of 1.3 *per cent* of their GDP; measured in Purchasing Power Standards (PPS), the old EU on average granted 185 PPS per person and the CEECs 105 PPS per person.

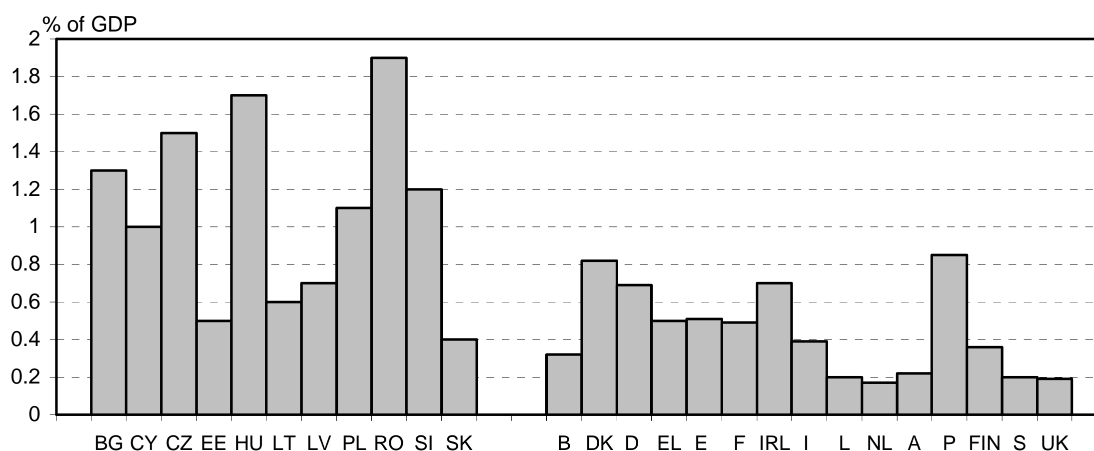

Chart WP 7.2 State aid as percentage of GDP for EU-15 and CEECs, 2000

Note: Total State aid less agriculture, fisheries, and EU funding.
Source: State Aid Scoreboard, autumn 2002 update, Special edition on the candidate countries, Statistical Tables of the Online State Aid Scoreboard.

...state aid reductions will be necessary in Romania, Hungary, and the Czech Republic

The diagrams clearly show that on average the percentage of GDP spent on state aid is higher in the CEECs (1.3 *per cent*) than in the old EU (0.8 *per cent*). It should though be noted that this percentage varies considerably across the CEECs, ranging from 0.4 *per cent* in Slovakia to 1.9 *per cent* in Romania (see chart WP 7.2). Hence, while countries at the higher end of the scale such as Romania, Hungary, and the Czech Republic might have to aim at decreasing the amount of state aid granted, the other countries do not lie considerably above the old EU average or the single amounts granted by each of the old EU member states.

More importantly, these aggregate indicators are not well suited to make predictions about potential problems for the state aid regime in the CEECs after accession. An analysis at sector-level would be much better suited to make predictions about potential problems in the state aid system, as it would reveal whether certain sectors seem to be unfoundedly ‘favoured’ by state aid and how the CEECs perform with regard to the EU objective of tackling horizontal objectives. This analysis will be carried out in the following section.

The instruments for the distribution of state aid can be divided into 4 categories:

i direct grants and tax reductions

ii capital and investment subsidies

iii 'soft credits'

iv credit guarantees

In 2000, the CEECs generally made more use of tax exemptions (51 *per cent* of all state aid was granted by using this instrument compared to 29 *per cent* in the old EU) than the EU. The intense use of this instrument may partly be explained by government budget restrictions (note that, again, the use of instruments varied across the CEECs); however, there does not appear to exist a significant discrepancy in the use of state aid instruments between the CEECs and the old EU, which could become problematic after accession

WP 7.7.2.3 State aid to the manufacturing sector versus horizontal objectives

The main objective of the distribution of state aid is to increase competitiveness. This is highly relevant for the CEECs as they lack behind most of the old member states in terms of competitiveness. At the same time, as the CEECs are gradually adapting to the EU state aid system, they also have to adopt the state objectives imposed by the EU. The EU has highlighted the need to target horizontal objectives across its member states and subsequently across the CEECs (se above). At this point it is important to stress that the targeting of horizontal objectives does not preclude aid being granted to the manufacturing sector *per se*, as this might actually facilitate the fulfilling of horizontal objectives (*e.g.* aid to increase R&D / training facilities or reducing unemployment).

Hence, a look at the general structure of state aid granted by the CEECs should help to analyse how the CEECs perform with regard to pursuing horizontal objectives. Moreover, it could reveal potential problems in terms of the amount of state aid granted in total in relation to the old EU and the amount of aid granted to the manufacturing sector in relation to the old EU. We now turn to the amounts of aid granted to the manufacturing sector and to horizontal objectives.

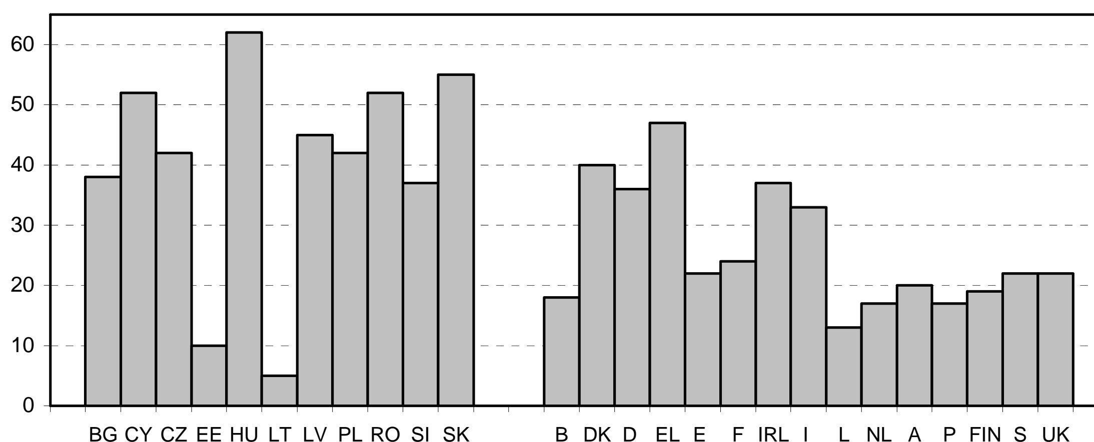

Chart WP 7.4 State aid to the manufacturing sector as percentage of total aid for EU-15 and CEECs, 2000

Source: State Aid Scoreboard, autumn 2002 update, Special edition on the candidate countries, Statistical Tables of the Online State Aid Scoreboard.

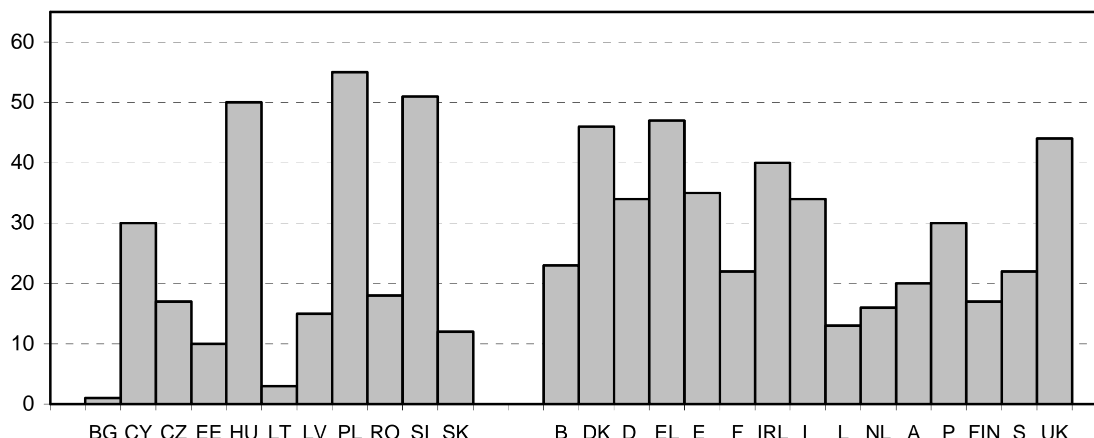

Chart WP 7.5 State aid for horizontal objectives as percentage of total aid for EU-15 and CEECs, 2000

Source: State Aid Scoreboard, autumn 2002 update, Special edition on the candidate countries, Statistical Tables of the Online State Aid Scoreboard.

The average percentage of state aid to manufacturing in 2000 was 46 *per cent* for the CEECs and 35 *per cent* for the EU. Again, it is important to consider the variations across the CEECs. Moreover, and as mentioned above, aid to the manufacturing sector *per se* is not negative as such; aid might well facilitate the creation of a level playing field (which is another state aid objective of the EU). Alternatively one has to consider that even in 2000 at least some of the CEECs still undertook some restructuring. The aid might have gone into those sectors that underwent restructuring (unfortunately, no industry-specific data is available).

Whilst Hungary, Romania, Slovak Republic, and the Czech Republic granted the highest percentages of aid to the manufacturing sector...

With regard to the manufacturing sector, Hungary, Romania, Slovak Republic, and the Czech Republic granted the highest percentages of aid to the manufacturing sector. A detailed analysis of the receiving industries could reveal whether some sector seem to be ‘favoured’ by aid. This would certainly have to be changed if it was the case. But even so, those countries might have to reconsider their state aid distribution with regard to the manufacturing sector as they grant considerably more than any old EU member state.

...Hungary’s state aid system seems to be well in line with EU requirements...

...whereas esp. Bulgaria, Latvia, and Estonia might have to reconsider their state-aid systems

The picture changes slightly when taking the horizontal objectives into account, too. Here, Hungary scores very high with 50 *per cent* of its total aid being granted to the fulfilling of horizontal objectives and lies indeed above every current member state. Thus, Hungary’s state aid system seems to be well in line with EU requirements. The Czech Republic, Romania, and the Slovak Republic (and especially Bulgaria, Latvia, and Estonia) on the other hand score much lower in terms of horizontal objectives and might therefore have to reconsider their state aid systems. Bulgaria and Latvia in particular will have to increase their share of state aid going to horizontal objectives. It should be stressed that on average, though, the CEECs in 2000 spent a higher percentage of their total aid on horizontal objectives (39 *per cent*) than the old EU (24 *per cent*). Poland, Hungary, and Slovenia stand out here with considerably higher percentages spent on horizontal objectives than any of the old EU member state. Thus, although some CEECs might have to aim for higher rates of aid directed to horizontal objectives, on average the CEECs seem to perform very well with regard to horizontal objectives and indeed better than the EU.

WP 7.7.2.4 State aid rules used as a strategic instrument

State aid granted in the form of tax-incentives to FDI is a strategic tool for CEECs...

Another issue, which is also highly relevant for the CEECs, is the one of firms using the state aid system as a strategic tool for pursuing their interests. This would be done in particular to challenge aid granted to competitors or to claim aid themselves. With regard to the situation in the CEECs, foreign investors might also 'bind' the investment decision on the granting of certain forms of state aid (*e.g.* tax exemptions). This would hit the CEECs particularly hard as they still very much seek to attract foreign investment. All of these cases are however very hard to prove and thus only represent suggestions as to the possible use of the state aid system by private firms. The Commission itself has taken up that subject in its "Report on the application of EC state aid law by the Member State courts" (1999) and notes that surprisingly little companies seem to make use of the opportunity to challenge the granting of aid legally. They suggest that a lack of knowledge about the system might be the reason.

...but might become a problem if investors 'bind' their decisions on this aid

WP 7.7.2.5 State aid and productivity

State aid can be used as an instrument to raise productivity

The issues discussed above raise the question of the relationship between state aid and productivity. The EU has established the principle of creating a level playing field: this objective does not necessarily increase a region's / industry's productivity as aid might be granted for redistributive or social purposes that does not enhance economic performance. On the other hand, with regard to the provisions of Article 87(3), the CEECs can be assumed to use the state aid system to actively promote an industry's / region's productivity and therefore to raise the country's competitiveness. This is particularly the case, if state aid aims to support R&D and training activities.

WP 7.8 Other Union policies with impact on industrial competitiveness

Not only industrial policy instruments and framework conditions such as competition and state-aid policies are orchestrated to support the aim of competitiveness: in the EU Treaty, all other policies and activities the EU pursues under the provisions of the treaty form part in today's EU industrial policy approach. Those include mainly trade policy, R&D policy, regional policy with EU structural and cohesion fund policies, vocational training policy (see COM(2002) 714, pp. 26-28).

WP 7.8.1 FDI, Trade, and Trade Policy

The relationship between FDI, trade, and trade policy is one that is also highly relevant for the CEECs in light of their integration into the EU. The CEECs are trying to attract FDI, at least partly to increase productivity and the country's competitiveness. Moreover, FDI should contribute to a country's economic growth prospects and should possibly also trigger spillover effects to domestic industries. It is therefore interesting to analyse the impact that trade policy measures seem to have on FDI. The CEECs had to adopt EU trade policies by the time of accession. Thus, it is worthwhile to see whether the current trade policies of the CEECs and their potential effects on FDI do support the EU's emphasis on horizontal trade policy. In an initial investigation of the relationship between trade and FDI we looked at a few simple relationships for the Polish case.

The one relationship that stood out was that the trade pattern of 'foreign' firms by sector seemed to match that of the rest of firms. Where foreign firms have a high share of total exports there would inevitably be a high correlation between total exports of a sector and foreign firm exports, so we plotted the relationship between

exports by foreign firms and exports by ‘domestic firms’ across sectors and find a positive correlation. The same is also true of imports. These could be spurious if all that is happening is that we are measuring the size of large and small sectors. However we also observe a strong positive correlation between the trade balance by foreign firms and that of other firms.

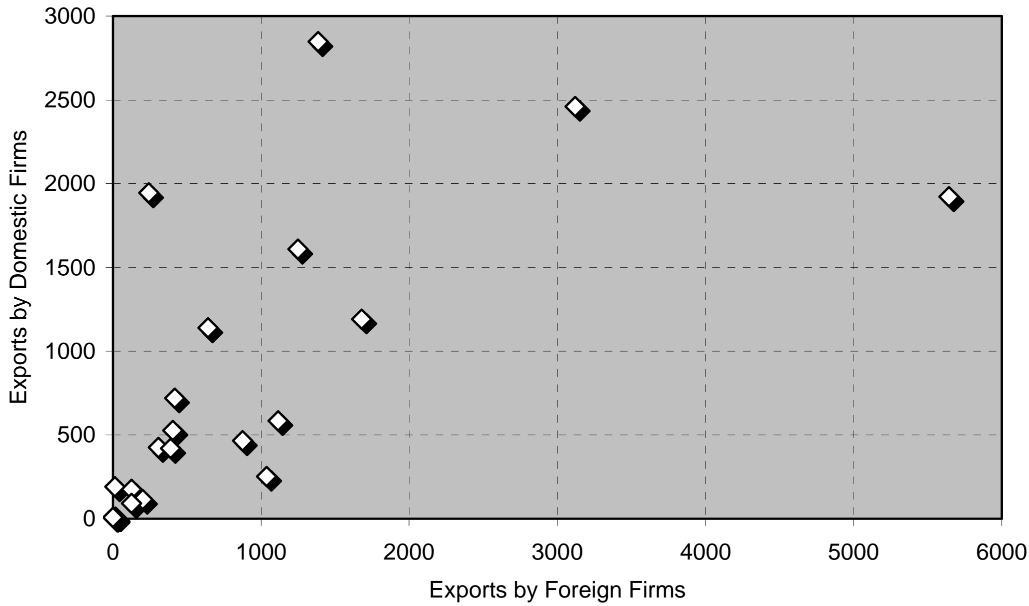

Chart WP 7.5 Exports by foreign firms against domestic firms for Poland, 2001

Source: “Foreign Investment in Poland”, Annual Report by the Foreign Trade Research Institute, 2002; Trade Policy Review for Poland 1999, WTO.

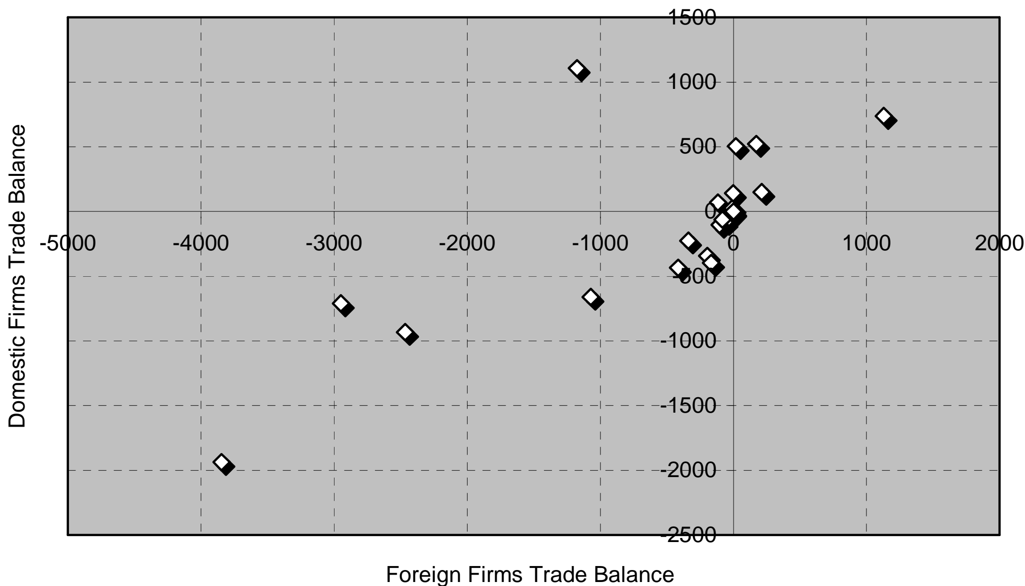

Chart WP 7.6 Trade balance of domestic firms against foreign firms for Poland, 2001

Source: “Foreign Investment in Poland”, Annual Report by the Foreign Trade Research Institute, 2002; Trade Policy Review for Poland 1999, WTO.

It is not easy to draw policy implications from such a simple analysis but it does seem to offer some reassurance about the nature of the growth and FDI process. It implies (weakly) that foreign investors are in fact investing in firms where Poland has a comparative advantage and whilst we would be hard pressed to use this simple result to argue that foreign net exports have a positive spillover effect on other firms, we can at least suggest that there is in the Polish case no sign of a crowding out effect. On the face of it the similarity of foreign and other firms supports rather than undermines the case for accepting the EU philosophy of horizontal rather than discriminatory industrial policy at least in this case.

Horizontal bias of EU-policy supported by trade analysis if viewed from the perspective of FDI

WP 7.8.2 Institutional Changes

From April 2004 the new member states cease to have a voice at the WTO; they must let EU speak and negotiate for them. This means they lose a voice and a vote at the WTO but acquire a voice in the EU in 2003 but only get a vote in the EU in 2004.

Candidates must apply EU common external tariffs and also EU Anti-dumping (AD) measures rather than their own. CEECs use AD very little but will be obliged to adopt all the EU measures after entry (though there will also be transitional possibilities of anti-dumping after accession). Most CEECs have few or no AD measures in place but where they had them main targets appear to be the former Soviet Union, China and each other. Poland however had 8 on 4 products. In fact the EU had measures against more countries for all these products and of course many others. Inside the EU the new member countries will not be able to invoke AD unilaterally but for many products they will find a ready coalition of the willing. This is however unlikely to be a plus for the economies concerned. The ability to introduce anti-dumping measures has in most cases similar effects on productivity to the ability to subsidise declining sectors. A burden is rather imposed on consumers and user industries.

The new member states will of course be relieved of AD and safeguard duties imposed by the EU on them. In fact between 1998 and end 2002, out of 202 new investigations by the EU, 31 were against candidates (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Lithuania, Poland (the top at 6), Rumania, Slovak, Slovenia). In the Swedish case, having been a victim of AD led this country to become a fierce internal opponent of AD. It is not clear if this will apply to the new member states. In the next section, we investigate the trade effects of EU accession of the CEECs with regard to AD policies and in particular the removal of EU anti-dumping measures towards the CEECs.

CEECs will be relieved of AD and safeguard duties *vis-à-vis* the EU

WP 7.8.3 Anti-Dumping law in the EU

The current definition under which an AD duty can be incurred in the EU follows the agreement on the code of practice of antidumping set out during the Uruguay Round. The antidumping agreement is formally known as the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994. It takes dominance over all other agreements under the international trade arena on AD. Article VI allows members of the WTO to apply AD measures on other contracting parties. This can be done when sufficient evidence has been brought forward demonstrating the presence of dumping and the presence of injury to the domestic industries. Dumping, as defined under the agreement, is considered as introducing a good into an export

market at a lower worth than its normal comparable value for like[8] products in the exporting country under the ordinary course of trade. An AD investigation can have the following possible outcomes.

- Provisional measures: these can take the form of a price undertaking or a duty once preliminary examination has given sufficient evidence of the existence of some form of injury caused. However they are only valid for four months. Under special circumstances they can be extended for a further two-month period.[9]
- Definite measures: these can be used once the investigation has finished and evidence shows that dumping has occurred and that injury has been caused to the domestic industry. Duties are imposed by the Council following recommendations of the Commission after consultation of the Member States[10]. A definite measure can be a price undertaking or a duty, depending on what is judged to be more suitable to undo the harm that dumping has caused.
- Termination: an AD investigation is terminated when there is insufficient evidence to prove the act of dumping or when dumping does not pose a threat to the domestic industry.

Price undertakings are described under the GATT as "a binding commitment by the foreign firm to raise export prices so that either the dumping or the injury suffered by the domestic industry is eliminated" (WTO). The size of the duty tends to be equal to that of the dumping margin, however for the EU this is not the case. The lesser duty rule takes priority indicating that the size of the penalty must be set to remove the injury caused to the domestic firm and not by the full dumping margin. In 1968 the first community wide legislation on anti-dumping was enacted, and similarly to most countries' AD law (notably the US), modified several times. However, the current legislation governing AD practices in the EU is based on the agreements reached in the international trade arena set up by the WTO[11]. It is the Agreement on the Implementation of Article VI of the General Agreement on Tariffs and Trade 1994. However, the AD laws governing practice in the EU show a couple of amendments to the laws agreed upon during the Uruguay Round. These are the Community interest test and the lesser duty rule.

- Community interest test: this measure aims at satisfying all interested parties of the community. It thus incorporates into the implementation of article VI of the GATT that measures against dumped imports will only be undertaken when the appropriate interest of domestic consumers and producers have been considered.
- Lesser duty clause: this clause seeks to reduce the magnitude of the duties imposed so that they do not have to be equal to the dumping margin, but to a margin that will remove the injury caused to the domestic industry by the dumped imports.

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[8] A like good as defined by WTO/GATT rules is "a product which is identical, *i.e.* alike in all respects to the product under consideration, or in the absence of such a product, another product which, although not alike in all respects, has characteristics closely resembling those of the product under consideration."

[9] Thirteenth Annual report from the commission to the EU parliament on the community's AD an anti-subsidy activities, 1995. p. 15.

[10] *ibid.*

[11] Seventeenth Annual report from the commission to the EU parliament on the community's anti-dumping and anti-subsidy activities. Brussels 08/09/99 COM (1999) 411 final.

Upon accession, New Member States (NMS) will have to adapt their trade policy to that of the EU thus incorporating the community interest test and the lesser duty clause into their current AD policy.

WP 7.8.4 The Trade Diversion Effects of EU Anti-Dumping Policy

The accession agreements undertaken by the EU and CEECs have conceded duty free access to 95 *per cent*[12] of CEEC imports towards the EU 15 (the remaining 5 *per cent* concerning mainly agricultural products). Thus the trade balance between the new member states and the EU-15 is not likely to change enormously upon accession. The main change that will affect trade between the two parties is the removal of all contingent protection from the EU. Antidumping and anti-subsidy activities will cease. We will analyse the possible effects of the removal of anti-dumping actions from the EU targeted at the NMS. The European Union has been a prolific user of anti dumping measures; during the 90s the EU initiated 349 proceedings of which 38 were against future accession countries. 17 (44.7 *per cent*) of these investigations ended in the imposition of definitive duties, 8 (21.05 *per cent*) were resolved by price undertakings and 13 (34.2 *per cent*) investigations were terminated with no imposed penalties. The apparent trend in AD filings from the EU to the then-Accession Countries is significantly biased towards chapter 73, this being *articles of iron or steel* with 36.8 *per cent* of all investigations. Table WP 7.3 represents the distribution of AD initiations by sector.

The EU has been a prolific user of AD against CEECs...

these activities cease with EU membership

Table WP 7.3 Incidence of AD Initiations by Sectors for the Period 1991-2000 towards New Member States.

Chapter	Product Specification	Amount of times targeted	NMS Chapter share of exports towards the EU
73	Articles of Iron or Steel	14	3.9464%
31	Fertilizers	7	0.8068%
44	Wood and Articles of Wood; Wood Charcoal	5	4.6556%
72	Iron and Steel	5	3.6990%
56	Wadding, Felt and Nonwovens: Special Yarns; Twine, Cordage, Rope and Cables	3	0.1290%
25	Salt: Sulphur; Earths and Stone; Plastering material, Lime and Cement	3	0.9464%
79	Zinc and articles thereof	1	0.1590%
Total		38	14.3422%

Note: NMS refers to Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.
Source: Authors calculations taken from the EU annual report on antidumping and anti subsidy activities.

The share of new member states targeted chapter exports in total exports towards the EU shows the possible range of trade distortion that AD will have upon trade between the two parties during the period under investigation. The results obtained show that the above seven chapters represent 14.34 *per cent* of exports from new member states to the EU. The following analysis will try to shed light on the possible distortions to the 14.34 *per cent* of trade that *may* be affected by AD. This figure by no means cast a maximum on the effects of AD on NMS, but is useful in understanding what proportions of trade we are talking about in the following section.

WP 7.8.4.1 Revealed Comparative Advantage in Targeted Chapters

In order to further understand the nature of AD targeting towards NMS, we look at the Revealed Comparative Advantage of the above mentioned chapters so as to ascertain the competitiveness of the targeted industries.

[12] According to the Revue de l'Elargissement, No. 59, English edition 9th February 2004.

Box A Calculation of Revealed Comparative Advantages (RCA)

Commonly RCA bears the name of its inventor and is known as the Balassa index. The RCA is calculated using the Balassa (1965) index. This measures the specialisation of countries in given sectors by comparison to the rest of the economy. We compare NMS trade with the EU as a benchmark and thus calculate the RCA relative to the EU.

This is calculated using the following equation:

$$RCA = \left(\frac{X_{i,j}}{\sum_i X_{i,j}} \right) \div \left(\frac{\sum_j X_{i,j}}{\sum_i \sum_j X_{i,j}} \right)$$

with $X_{i,j}$ = exports of sector *i* from country *j.*

The numerator represents targeted chapter exports to the EU divided by overall chapter (all chapters) exports of NMS to the EU. The denominator is chapter imports of the EU divided by overall chapter imports (all chapters) of the EU. When RCA > 1 then the sector under investigation is said to have a revealed comparative advantage. Conversely when RCA < 1 then the sector does not benefit from a revealed comparative advantage.

The results of the analysis using the method as explained in Box A for the chapters under investigation reveal the following.

Table WP 7.4 Revealed Comparative Advantage for Targeted Chapters

Chapter	Product Specification	Average RCA[*)]
73	Articles of Iron or Steel	3.400
31	Fertilizers	2.986
44	Wood and Articles of Wood; Wood Charcoal	2.785
72	Iron and Steel	2.535
56	Wadding, Felt and Nonwovens: Special Yarns; Twine, Cordage, Rope and Cables	1.263
25	Salt: Sulphur; Earths and Stone; Plastering material, Lime and Cement	2.163
79	Zinc and articles thereof	2.328

Note: [*)] The value reported is the average RCA for the period 1992-2001.
Source: COMEXT-database.

As can be clearly seen all the targeted chapters show a very important positive RCA. This shows that AD targeting is mainly towards those sectors which show a revealed comparative advantage. The removal of AD measures will allow the targeted sectors to reap the benefits of their comparative advantage. Hence, accession to the EU can be expected to yield an additional benefit to CEECs in the form of discontinuation of AD measures levied against them.

The negative impact of AD can be measured by analysing the diversion of trade from countries that are named by the petition to those that are not, this is know as the *trade diversion* effect.

WP 7.8.4.2 Trade Diversion

The trade diversion effect analysed by the literature[13] discriminates between named and non-named countries. It reports the apparent trend of non-named countries *taking over* trade from named countries, thus reducing the effectiveness of AD as a tool for keeping imports out. Our concern lies on the direction of this trade diversion within NMS, the EU and the rest of the world.

[13] Studies such as Prusa (1996), Vanderbussche et al (1999), Brenton (2001) and Lasagni (2000)

By separating the non-named category into three sections we can investigate whether trade is diverted to non-named countries within the EU, in NMS or towards other world producers. We shall also discriminate between the outcomes of the investigations[14]. The results are reported below.

Box B Calculation of effects of anti dumping on trade between NMS and the EU

In order to calculate the trade effects of AD, the framework introduced by Prusa (1996) (and expanded by Lasagni (2000) for the EU) is used[15]. This consists of creating a dataset containing trade values of imports towards the EU of both named and non-named countries. However, Cross-case comparison is not always relevant when large differences in trading volumes exist, this is the case for most of the data. This called for the use of differing techniques so as to allow comparison. Time was normalised using t_0 as the year of initiation and subsequent years with the corresponding suffix depending on how many years had passed since initiation so that t_1, t_2 t_3 and t_4 represent respectively trade values 1 ,2,3 and 4 years after the investigation has been initiated, these lie between 1992 and 2001. Furthermore to allow for cross-case comparison percentage changes of trading volumes were computed using the year of initiation of the AD investigation (t_0) as the benchmark following this equation:

$$\Delta\, imports_{i,t}^{j} = \frac{\left(imports_{i,t}^{j} - imports_{i,t0}^{j}\right)}{imports_{i,t0}^{j}}$$

with i = (1, ..., 38), t = (t0, ..., t4), and j = (named, non-named EU, world and NMS).

So that the change in imports of good i at time t is equal to the imports of the product at time t minus the import of the products at time t_0 (initiation of AD investigation) divided by the value of imports at time of initiation. The j is to differentiate between named countries and non-named countries (in the EU, in NMS and in World).

When an AD investigation ended in the imposition of definite duties, the results reveal the following reaction in trading patterns.

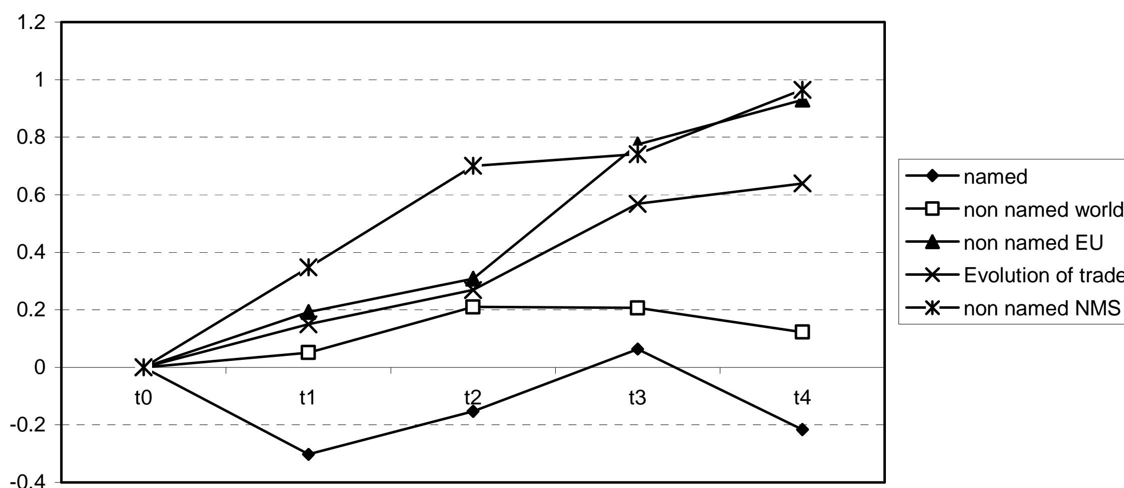

Chart WP 7.7 The Trade Effects of AD duties on named and non named countries

Source: Authors' calculations using EUROSTAT.

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[14] These can be resolved by termination of the investigation, agreement on a price undertaking or the imposition of definite duties.

[15] Other notable cases, Brenton (2001) and Vanderbussche et al (2001)

As can be seen in chart WP 7.7 there is a negative effect of AD duties on named new member states by reducing trade with the EU for the goods under investigation by over 20 *per cent* in the first year. After that, we see a recovery of trading patterns. More interestingly we also note that the share of trade of non-named new member states goes up quite significantly. We use the evolution of trade throughout time as a counterfactual showing how trade should have evolved during the period under investigation and thus note that named country trade is well under the evolution of trade line thus showing that the negative effect of AD on named new member states is of greater magnitude than 20 *per cent*. We can also see that there is a significant diversion of trade when AD is imposed towards non-named new member states. This can have many implications. It allows us to make inference on the similarity of composition of industry across new member states, and show that there appears to be a trade diversion effect. When an AD investigation ends in the imposition of duties, named country exports suffer but non-named new member states exports increase. The imposition of duties also seems to benefit EU producers but very slightly.

When an AD investigation ended in a price undertaking, the deviation of trade from its value before investigation revealed little change in trading patterns. The data showed a fall in named country exports for the goods under investigation in t_1, followed by a quick rise in the following year tending towards the evolution of trade line. Prusa (1997) indicated that there tended to be a negative effect on trade during the period of investigation, largely caused by the uncertainty of the outcome of the investigation. This he termed the investigation effect. When an investigation is terminated there appears to be no negative effects on named country exports for the goods under investigation. However, non-named NMS exports show a significant increase.

These results must be put into perspective. We must look at the trade values in order to assert the magnitude of the effects of AD on trade. Named country trade with the EU represent but a fraction of total trade both within and outside the EU for the goods under investigation. Total trade for the period under investigation between new member states and the EU amounted to an average of 53 billion EUR. The average amount of trade directly affected by AD was but 795 million EUR. This amounts to a mere 1.5 *per cent* of total trade with the EU. We thus note that although the effects of AD on new member states are quite significant individually, the amount of trade that is directly affected by these is only 1.5 *per cent* of all trade between the two parties. It must be noted that these are the direct effects of AD on the named products. There may exist the presence of other effects of AD not investigated in this study. The existence of a *trade deflection* effect needs to be inspected.

Trade deflection reflects the tendency for countries to adjust their trading patterns as a result of AD. Due to the highly specific nature of AD, countries can switch production at low costs from a highly disaggregated good which has suffered the imposition of AD duties to a *like* good[16] that does not face AD duties. Thus escaping the AD duty, this can be seen as the *trade deflection effect*. The counteracting effect is the so-called *deterrence effect*, which encompasses the probability of new AD filings on the import-deflected goods and thus causes the targeted industry to be deterred from production.

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[16] A like good in this instance can be described as a good of a parallel 8-digit category or higher digit category normally within the same 4-digit category.

The significance upon trade of the trade diversion and deterrence effects have yet to be calculated, however the magnitude of the effects are kept in the perspective of the estimated distortion of 14.34 *per cent* of trade stipulated above.

Whilst AD against CEECs produced great distortions...

...the share of trade affected is very small

We can thus conclude that the effects of AD on new member states produce great distortions in targeted industries whether these be from named or non-named producers. However the overall direct effect is very small and amounts to 1.5 *per cent* of trade being distorted. The trade deflection and deterrence effects may affect a greater share of trade and thus need more investigation. Furthermore we have identified that the trade diversion effect is present between named and non-named new member countries. This stipulates that when a named NMS suffers the imposition of duties, there is a counteracting benefit to non-named NMS industries which 'take over' named country exports. We can thus say that the identified trade diversion effect of AD shows that the trade effects upon accession are going to be of small magnitude. However the analysis of the RCA of the targeted industries reveal that the removal of AD measures will allow new member countries' targeted industries to reap the benefits of their comparative advantages and thus grow without suffering distortions to their trading patterns.

WP 7.9 Regulation

The creation of the new network of competition authorities coincides with a new phase in EU regulatory structures, the attempt to introduce a degree of subsidiarity into the rule making system. In a variety of areas such as telecoms, competition and food safety the EU is introducing a system whereby the Community authorities will act as a supervisor of national authorities rather than the final legislator in every case. The area where there is most pressure is food safety. This is of particular interest to CEECs as their food and food-processing industries may be subject to very strict regulations in the rest of the EU. It seems that the new flexibility will not necessarily be to the advantage of CEECS in that it will mostly allow a margin of flexibility *upwards.* In the long run this may be on the interest of CEEC consumers and producers but in the medium term it will mean higher costs for producers and consumers with less risk averse tastes.