CHAPTER 8

THE IMPACT ON TRADE

1. INTRODUCTION

This chapter analyses the impact on trade of closer interaction with the economies and societies of Central and Eastern Europe. In keeping with the analytical approach outlined in Chapter 7, it proceeds on the basis that current and future developments will mean that the CEECs are gradually integrated into a wider European economic area through a series of formal agreements and informal developments. As a result, many of the issues discussed arise irrespective of the timing of Eastern enlargement and are determined fundamentally by the fact that the EU must fashion new policy relationships with its Eastern neighbours.

Ireland, along with other EU countries, will face new competition from the CEECs in manufactured goods and service markets. However, any element of new competition in these areas will be accompanied by new market opportunities. Taken with the analysis in succeeding chapters, the aim is to elaborate clearly the relative weight which should be accorded to particular substantive (economic and social) issues, on the one hand, and institutional and procedural issues on the other, in formulating Ireland's approach to EU issues.

EU policy on trade is governed by the Common Commercial Policy set out in the Treaty of Rome and subsequent treaties and in compliance with EU obligations as members of GATT. As far as the CEECs are concerned, the major determining factors on the trade regime are the Europe Agreements which have greatly liberalised trade between the two areas. Section 2 provides an outline of the main provisions of the Europe Agreements related to trade and traces recent developments in the volume of trade between the two regions under these agreements. It shows that the CEECs, from being among the most excluded trade partners, have progressed to enjoying a relatively liberal trade regime with the EU. Although there is no intention on the part of the EU to purposely discriminate between the various states which comprise the CEECs, the structure of trade of individual countries and the provisions of the Europe

Agreements mean that some countries, such as the Czech and Slovak Republics, enjoy a more liberalised trade regime than others. The rapid growth in recent years of trade between the two regions means that the EU is now the CEECs' major partner, with Germany being the most important individual country.

Section 3 examines the impact which closer interaction in the future will have on EU trade flows. It examines the general impact on the EU and finds that, while the overall effect will be positive, certain regions and sub-sectors could be severely affected by competition from the CEECs. However, the greatest effects are likely to fall on non-member countries who have been exporting to the EU. These are mostly concentrated in the Mediterranean region. This section also examines Ireland's trade with the CEECs. It shows that trade flows between the two regions have been quite small to date, but can be expected to rise in future years. While the overall impact on Ireland of this direct effect may not be great, Ireland is likely to experience increasing competition from the CEECs in third markets, with the competitive effect in the German market being particularly important. However, the importance of this effect will depend on the future structure of exports from the CEECs, which will in turn depend on the sectoral destination of investment flows in the near future. The implications of closer interaction with the CEECs on investment, and, in particular, competition for FDI, is the subject of Chapter 9.

2. TRADE AND TRADE POLICY

(i) EU Trade Agreements with Central and Eastern Europe

The Context: The Common Commercial Policy

The European Union's external trade policy is based on Articles 110-116 of the Treaty of Rome, which set out the basis for a Common Commercial Policy. The Commission conducts this policy on the basis of mandates agreed by the Council of Ministers. In the case of most goods entering the EU from third countries, tariffs are of limited significance. There are two reasons for this. First, as a result of the successive rounds of negotiations in the General Agreement on Tariffs and Trade (GATT), tariffs in the EU and elsewhere are now fairly low. Second, greater restrictions to trade now arise from non-tariff barriers. This is reflected in the fact that

non-tariff barriers figured significantly in the Uruguay Round of negotiations, completed in December 1993. Overall, the impact of GATT on international trade has been limited by two related factors. First, despite the principle of multilateralism, there has been a proliferation of bilateral and multilateral trade agreements of various sorts over the years. Second, a number of sensitive sectors have remained outside, or have not been resolved within the context of, the standard GATT process of tariff reduction. Like other major trading nations, the EU has participated in these developments.

The external trade policy of the EU has been governed by the articles of the GATT within which a complex system of trade preferences has emerged. Table 8.1 gives an indication of the various types of preferences which have been extended by the EU. These have concentrated on attempting to liberalise certain trade flows with developing countries and close neighbours in the Mediterranean region, while discriminating against highly industrialised competitor countries and communist regimes. Table 8.1 identifies six stages of increasing liberalisation, with the EFTA countries and the CEECs which have signed Europe Agreements, at the most liberalised stage. It can be seen that the CEECs, as a result of the various agreements concluded with the EU, have progressed from being among the most highly excluded countries to a relatively liberal trade regime. The initial move, in this table from stage 1 to stage 3, was achieved by the Trade and Co-Operation Agreements, negotiated in the late 1980s and enforced in 1990. The Europe Agreements, concluded from late 1992 on, moved these countries into the inner circle of close trade partners with the EU. The key point which differentiates the Europe Agreements from the preferences extended to other countries is that the Europe Agreements involve the reciprocal lifting of customs duties and quantitative restrictions. While this is phased in order to aid transition in the CEECs, it is an important point, being a pre-requisite for the creation of a common market. Rapid expansion of trade between the EU and the CEECs has coincided with this radical trade liberalisation which aims to establish a free trade area within ten years.

Main Points of Europe Agreements

Four main points regarding trade, are contained in the Europe Agreements. First, the general aim and effect is to liberalise trade between the EU and the CEECs, with the EU unilaterally reducing

TABLE 8.1

System of EU Trade Preferences

Stage	Examples	Conventions
1	CMEA pre-1989	Customs duties, numerous quantitative restrictions
2	Industrial countries, e.g. Japan	Customs duties, some QRs
3	Developing countries CEECs 1990-91 Former USSR 1992-93	Unilateral lifting of customs duties for restricted quantities, QRs for textiles (MFA)
4	Mediterranean Countries e.g. Turkey	Lifting of most customs duties and QRs, except textiles (MFA)
5	ACP Countries (Lomé Signitories)	Unilateral lifting of customs duties and QRs
6	EFTA, Europe Agreements (CEECs (1992-98))	Reciprocal lifting of customs duties and QRs

Source: Based on *European Economy*, No. 6 (1994), Graph 1.

barriers in return for a later reduction of barriers by the CEECs. Second, there are exceptions to this general rule and the EU has identified certain sensitive sectors, particularly in textiles and food, where the degree of liberalisation will be a lot less. However, as pointed out by the Commission, these sensitive sectors unfortunately coincide with the sectors in which the CEECs have the strongest prospects for development (*European Economy*, 1994). Third, the Europe Agreements contain measures which give the EU the opportunity to revert to protection if the CEECs exceed certain quotas or otherwise infringe the terms of the Agreements. These are mostly designed to avoid dumping in certain sectors. Finally, the Europe Agreements provide a basis on which to clarify the rules regarding country-of-origin for imports to the EU. This will be achieved by the agreement on pan-European accumulation which will be introduced in stages during 1997.

The structure of the Europe Agreements (EAs) in relation to trade

is worth analysing. The Agreements envisage a progressive elimination of trade barriers over a five year period by the EU, reciprocated over a ten year period by the CEECs. Table 8.2 gives a summary of the programme of tariff reduction envisaged in the Agreements. For the Visegrad countries with whom agreements were first concluded, most tariffs have already been eliminated and all will be eliminated by 1997. Romania and Bulgaria are following at a slightly slower pace with a lag of about one year. However, by 1998, it is envisaged that all tariffs will have been eliminated. This does not mean, of course, that all forms of trade protection will be eliminated, since a number of quantitative restrictions continue to apply, especially in sensitive products. Furthermore, non-tariff barriers to trade, which have proven so difficult to eliminate in the internal market programme of the EU have not been substantially addressed by the EAs and the penalty clauses to avoid dumping on the EU market remain.

Although the Europe Agreements fall short of providing a fully free trade area with the CEECs, their overall effect has greatly liberalised trade between the two regions. Work reported in *European Economy* (1994) classified the exports of the countries of the CEECs according to whether they were allowed to trade freely, or were subjected to weak, average, or high protectionist measures. Table 8.3 gives the results of this work for 1990 and 1993, i.e. the period immediately before and immediately after the

TABLE 8.2

Programme of Tariff Reduction under Europe Agreements (Average Percentage Rates)

	1991	1992	1993	1994	1995	1996	1997	1998
CSFR	4.4	2.1	:	1.4	0.7	:	0.0	0.0
Hungary	4.5	2.5	:	1.9	1.2	:	0.0	0.0
Poland	4.0	2.4	:	1.7	1.1	:	0.0	0.0
Romania	6.2	:	4.8	:	3.6	2.2	:	0.0
Bulgaria	5.2	:	3.0	:	2.3	1.6	:	0.0

Note: CSFR refers to Czech and Slovak Federal Republic.

Source: *European Economy*, No. 6, (1994).

TABLE 8.3

Share of CEEC Exports to EU by Intensity of EU Trade Protection 1990 and 1993

	None		Weak		Average		High	
	1990	1993	1990	1993	1990	1993	1990	1993
CSFR	4	39	27	37	32	12	37	12
Hungary	0	53	26	25	44	2	30	20
Poland	1	36	34	35	42	11	23	18
Romania	0	17	36	40	30	6	34	37
Bulgaria	1	44	31	23	21	9	47	24

Source: *European Economy*, No. 6 (1994), Tables 11 and 36.

implementation of the Europe Agreements. Although the Agreements aimed to liberalise trade on a progressive scale over a number of years, Table 8.3 shows very rapid progress in liberalisation in these years. In 1990, only a tiny proportion of the CEEC exports were allowed into the EU free from any form of trade protection. This placed the CEECs at the bottom of the EU's system of preferences as described in Table 8.1. In contrast, by 1993, close to 40 per cent of CEEC exports were not subjected to any trade protection by the EU, the exception being Romania. By 1993, only about one-third of their exports were subjected to average or high rates of protection. It is noticeable that the incidence of relatively high rates of protection is greatest in the case of Romania and Bulgaria. However, given that the EAs were not enacted with these countries until 1993, only the very early effects of the Europe Agreements would have been included in this table.

It might be inferred from Tables 8.2 and 8.3 that the Europe Agreements differentiated substantially between countries. In reality, however, this impression arises because of differences in the structure of exports by these countries, although, in general, the elimination of duties will occur one year later for Romania. While 1994 was the date for the elimination of most duties on basic products, the elimination of trade barriers in areas such as textiles, coal and steel will be delayed somewhat. In addition, the EU retains

the right to delay the elimination of duties on some basic products if developments show that the CEECs are dumping products in this category on the EU market.

Protective measures against imports of manufactured goods from the CEECs are concentrated in five sectors. These are: iron, steel and other metals; chemicals; textiles, clothing and leather; floor coverings; and various rubber products. Given the likelihood of continuing pressure within the EU to maintain protection against products in these sectors, future success of the CEECs in gaining free access to the EU market may depend, to an extent, on their ability to diversify out of these sectors which have traditionally been their strong areas.

Thus, the effects of the Europe Agreements will differ between countries of Central and Eastern Europe, depending on the structure of their trade and their ability to diversify from products which are most highly protected in the EU. However, to date their exports remain concentrated in sectors in which there is restricted access. Their overall export structure has not adjusted significantly in response to the Europe Agreements, except in the case of the Czech and Slovak Republics. In fact, since liberalisation began, the CEECs have changed the sectoral pattern of their *imports* from the EU much more than the pattern of their *exports*. This reflects the relative responsiveness of consumer demand to the availability of new products, compared to the difficulties of changing the CEECs' supply structure. There is some evidence, however, that the rate of change in import structure has begun to slow while the export structure has shown some change in recent years.

(ii) EU Trade with Central and Eastern Europe

EU Trade in a Global Context

International trade displays a strong regional character. Thus, a very high proportion of the trade of EU member countries is within Western Europe. In 1990, intra-EU trade plus trade with EFTA countries amounted to 70 per cent of total trade by member states. Eastern and Southern neighbouring states accounted for just over 8 per cent of total trade, slightly more than the percentage accounted for by developing countries. Other industrial countries accounted for the remainder. The figure for trade within Western Europe has in fact been increasing slowly as the EU has evolved, due primarily to

the increasing integration of EU economies and the creation of the European Economic Area. This increase in the importance of trade within Western Europe has meant a reduction in the percentages accounted for by both developing and other industrialised countries, although the total volume of trade with both has increased over this period.

The external trade of the EU amounts to over 1,000 billion ECUs. In most years, the EU has shown a slight deficit on its trade account. Table 8.4 shows the geographical structure of EU external trade in 1990. This shows that EFTA countries represented the largest supplier of imports (23.5 per cent), while the US remained the single most important trading partner (supplying 18.4 per cent of EC imports and taking 18.2 per cent of EC exports). The recent enlargement of the EU (to include Austria, Sweden and Finland) means that much of EU trade with EFTA, recorded in Table 8.4, is now intra-EU trade. Indeed, the merging of the EU and (most of) EFTA simply reflects the regional character of European trade. It is clear from the data in Table 8.4, that the US and Japan are Europe's most significant trade partners. Indeed, the three members of the Triad – the EU, the US and Japan – are roughly of equal size, and are about equally open, each exporting between 8 and 10 per cent of their GDP.

TABLE 8.4

EU External Trade (1990)
% of Total

Countries	Imports	Exports
USA	18.4	18.2
Japan	10.0	5.4
EFTA	23.5	26.5
OPEC	9.7	8.4
Eastern Europe	6.8	6.7
Other Industrialised	7.8	9.6
Developing	21.4	23.6
Others	2.4	1.6

Source: European Economy.

The developing countries account for over one-fifth of imports to the EU and almost a quarter of exports, with the EU showing a slight trade surplus on this account. Eastern Europe, which includes the former USSR in this table, is seen to have been a relatively minor area for trade, despite its close proximity on the borders of the EU. This overview of the EU's place in the international trade system provides the context within which its evolving relations with the CEECs must be considered.

Trade with Central and Eastern Europe

The EU's trade relations with Central and Eastern Europe are marked by distinct asymmetry. Taken as a group, but excluding the former USSR, trade with the CEECs accounts for less than 6 per cent of total EU external trade. Indeed, trade with the CEECs is less than 2 per cent of external trade of EU member countries, when intra-EU trade is included. However, the EU is now the dominant trading partner of the CEECs, accounting for over 50 per cent of their external trade. Table 8.5 shows the increasing importance of trade with the EU for various CEECs. In all cases, the EU is a major trade partner and, despite the recessions in these countries, there has been rapid growth in trade in all of the CEECs. As their economies continue to grow again, it is expected that trade flows will grow at more than 10 per cent per annum in the medium-term.

TABLE 8.5

Percentage of Total CEEC Trade Accounted for by the EU

	Exports		Imports	
	1988	1992	1988	1992
CSFR	24	50	18	42
Hungary	23	50	25	42
Poland	30	56	27	53
Romania	24	33	6	38
Bulgaria	6	31	17	33
Total	**23**	**48**	**19**	**45**

Source: Costello and Laredo (1994).

Germany now accounts for around 60 per cent of the EU's imports from the CEECs and about 55 per cent of the EU's exports. Italy is the second most important country, but accounts for only around 13 per cent of trade between the EU and the CEECs. These shares have both been increasing but, in contrast, the share absorbed by the Southern states of the EU has been declining during this period, from 6 per cent in 1988 to only 3.4 per cent in 1993. It would appear, therefore, that the types of manufacturing products currently exported by the CEECs correspond much more to the demand of Northern EU states, but it cannot be ruled out that the protectionist measures which remain in the Europe Agreements to protect sensitive sectors within the EU may be causing this effect. Despite this growth in CEEC exports to the EU, their products have not yet managed to achieve anything other than a very small share of total consumption in the EU market. In fact, it is widely believed that much of the growth of imports to the EU is not for final consumption but for further processing and export from the EU. This further underlines the importance of policy and practice within the EU in determining the ability of the CEECs to penetrate markets.

The CEECs' exports to the Community tend to be concentrated in a small number of sectors. For most countries, the five largest NACE 2 digit sectors account for over two-thirds of all exports. The strongest sectors have been textiles, engineering, chemicals, basic electrical appliances and paper products. The Czech and Slovak Republics are something of an exception to this pattern, having managed to diversify their exports to a degree in recent years.

The rapid growth which has occurred in trade between the EU and CEECs in recent years is shown in Table 8.6. The Czech and Slovak Republics and Poland have experienced rapid growth in both exports and imports to the EU in the period 1989-1993. Hungarian trade growth has been somewhat slower, due in part to the fact that Hungary had developed much more sophisticated trade relationships with the EU prior to 1989. The enormity of the economic recession in Romania and Bulgaria has meant that Romanian exports to the EU have actually declined in this period. Bulgarian imports from the EU have also declined, as it concentrates its efforts on acquiring foreign sources of energy which are generally available on the world market at lower prices. Overall, EU trade with the CEECs grew over four times as quickly as world trade in this period.

TABLE 8.6

EU-CEEC Trade Growth, 1989-1993

	Exports to EU	Imports from EU
CSFR	25.4	32.9
Hungary	12.7	14.4
Poland	23.3	27.0
Romania	-1.1	32.0
Bulgaria	18.6	-3.3
CEEC 5	17.9	22.8
World	3.8	4.9

Source: European Economy, No. 6 (1994), Table 3.

This growth in external trade of the CEECs, and its reorientation towards Western Europe at a time when these countries were experiencing recession, is the result of a number of factors. First, these countries have undergone enormous transformations of their economies since 1989 and an opening to trade outside the CMEA area. Second, the EU has instituted the measures described above to liberalise its trade relationships with the CEECs. Third, these countries have lost a number of their most important export markets, particularly due to the disintegration of the USSR, and the dissolution of the CMEA.

At the depth of the recession in Eastern Europe, in 1993, every country in the region experienced a balance of trade deficit. These varied from a relatively minor deficit of around 1 per cent of GDP in the Czech Republic and Slovenia to around 8 per cent in Bulgaria, Hungary and Slovakia. In total, the CEEC-10 as a group had a deficit of over 4.3 per cent, most of which was with the EU. Since then, the impact of various stabilisation programmes has altered the balance in some countries but in 1996 it is forecast that every country in the region, except Bulgaria, will continue to run trade deficits. These deficits are particularly high in the Czech Republic and Baltic States, while less serious in Slovakia and Poland. The whole region continues to run a trade deficit in excess of 4 per cent of GDP with a combined deficit projected to exceed US$12 billion. The continuing reorientation of trade towards the EU

indicates that this deficit is principally with EU countries and, in a number of cases, reflects rapidly growing inflows of investment in the past two years. In addition, the economic recovery has meant that domestic demand has begun to replace exports as the engine of growth.

In such circumstances, it is of interest to enquire whether the recent re-orientation of trade towards Western Europe is indicative of a new long-term pattern, or simply a reflection of temporary problems in the East. Collins and Rodrik (1991) have predicted that trade flows within Europe in the future will conform to patterns observed in the early years of the century, before the diversion of trade caused by the creation of the Iron Curtain and the CMEA. Their results are given in Table 8.7. In each case, their prediction of the percentage of trade of each of these countries which will be with the EU is close to their calculation of trade between these countries and the current members of the EU before 1928. Thus, for example, Collins and Rodrik predict that Poland, Romania and Bulgaria will eventually send over 50 per cent of their exports to, and purchase more than half of their imports from, the EU. Their results also indicate that, in effect, the EU will replace the USSR as these countries' main trade partner. Indeed, they predict that, in the short run, these effects could be even more dramatic because economic disruption in Eastern Europe has caused a loss of markets in the former USSR and among CEECs, but these are likely to re-emerge in the future. These predictions suggest that the CEECs must achieve a major change in the structure and quality of their exports if they are to penetrate Western European markets. In addition, the patterns predicted require a liberal trade policy on the part of the EU, especially in those products in which the CEECs are strongest.

Trade Liberalisation and the CEECs

The recent growth of trade between the EU and the CEECs, and increased future interaction between the two regions, is taking place against a changing background of trade relationships within the EU and the world in general. The developing relationship with the CEECs is clearly preparation for a future Eastern enlargement of the EU. This is happening at a time of increasing trade liberalisation under the auspices of the GATT, following the successful completion of the Uruguay Round, the continuing evolution of the

TABLE 8.7

East European Trade with the EU and USSR (% of Total)

	Imports			Exports		
	1928	1989	Predicted	1928	1989	Predicted
Bulgaria						
EU	62	14	57	64	8	57
USSR	0	57	10	0	58	9
Czechoslovakia						
EU	55	15	55	44	16	46
USSR	1	46	10	1	43	14
Hungary						
EU	32	31	47	25	24	37
USSR	0	24	15	0	28	18
Poland						
EU	54	28	56	56	30	51
USSR	1	26	9	2	25	14
Romania						
EU	50	8	53	54	18	50
USSR	1	36	12	0	30	14

Source: Collins and Rodrik (1991).

EU and the ever closer integration of the economies of member states.

A major factor determining EU external trade flows is the structure and impact of the Common Commercial Policy. This, in turn, is greatly influenced by developments in the GATT. It has been argued that the EU should simultaneously increase its external protective barriers while removing internal barriers to trade, in order to ensure that the gains from greater efficiency resulting from the completed internal market will accrue to firms producing in Europe, rather than abroad. However, arguments such as this are greatly at odds with the EU's vision of liberalising world trade and the progress

achieved in the Uruguay Round. This argument will be further weakened in relation to the CEECs, since it obviously contravenes the spirit of the Europe Agreements and would also pose particular problems as many of the countries of the region are members of the GATT. Czechoslovakia was an original signatory in 1947, and Poland, Romania and Hungary joined in the late 1960s and early 1970s. However, the terms of accession were unusual for these non-market economies and, consequently, a process of normalisation of participation must be undergone.

In the past, Western countries tended to view the economic system adopted in the CMEA as in direct contravention to the GATT. They objected that state supported industries with state control of foreign trade, was fundamentally incompatible with the rules of the GATT. As a result, admission of the pre-reform USSR or full participation by the CEECs was believed to be potentially damaging to the GATT. The current belief is that implementation of the expanded GATT rules, under the WTO, is likely to aid the process of reform and transition in these economies. In this, there are similarities with the role adopted by the EU where transformation of the Eastern economies is seen as not necessarily a matter for them alone, but requires a pro-active policy by the Western world.

3. THE IMPACT OF CLOSER INTERACTION ON EU TRADE

(i) Impact on EU Regions

As a result of increasing integration stimulating demand within the EU, policy towards the CEECs which has aimed at liberalising the trade regime, and the increasing participation of the CEECs in the WTO, trade flows are likely to continue growing between the two regions at a rate well above world growth rates – perhaps resulting in a trade pattern approximating the Collins and Rodrik estimates discussed in Table 8.7, within a reasonably short period of time. These developments are taking place through the increased interaction of the economies of the two regions and do not depend on the CEECs obtaining membership of the EU. Thus, the impact of these increased trade flows on the EU will take place irrespective of the viability, or otherwise, of an early Eastern enlargement.

The economic basis for the EU wishing to liberalise trade is

provided by the opportunity to gain access to a new market of 110 million consumers. (The accession of the CEEC-10 would increase the EU customer base to 480 million). However, this also implies greater access to EU markets for their products. In a recent study, Faini and Portes (1995) attempt to quantify the significance of the impact of trade liberalisation with Eastern Europe on European Union economies. Their report shows that, aside from the definite benefits which will accrue to consumers, trade liberalisation will affect EU economies in several ways. First, there will be some disruption to previously protected sectors within the EU, which will now face increased competition from the CEECs. Second, EU exporters will face tougher competition in third markets from firms in Eastern Europe. Finally, and importantly, the impact will be spread unevenly and could cause difficulties for specific sectors or regions of the European Union. Their unambiguous conclusion, however, is that the impact of trade liberalisation on EU economies is likely either to be favourable or, at worst, only minimally negative.

> We find no evidence supporting the contention that any of these costs may be sufficiently large to be a major cause of concern to EU policy-makers. We conclude that the process of trade and economic opening with the CEECs could proceed at a faster pace than envisaged in the EAs. This would ease the transition in the CEECs and would not inflict substantial costs even in the short-run on EU producers (Faini and Portes, 1995, p.7).

Thus, the general conclusion reached by Faini and Portes is that the overall effect on the EU may not be as great as feared. Trade flows between the two regions remain relatively small and a successful export performance by the CEECs will result in new markets which may be penetrated by EU exports. While recognising the existence of sensitive sectors, the authors conclude that the vulnerability of these sectors may have been exaggerated. Analysis of the comparative advantage of CEEC industry indicates that the main effect on South European countries will be due to new competition for their exports to North European countries, rather than competition on their domestic markets. In fact, for many of the South European countries – Greece, in particular – the availability of new markets in the CEECs is likely to result in a net beneficial effect on producers. Northern European producers, particularly

those in labour-intensive industries, are indeed likely to face stiff competition from CEEC products on their domestic markets. As a result, calls for protection are likely to emerge.

These results confirm the earlier findings of the Centre for Economic Policy Research (CEPR, 1992) which indicated that the costs of trade liberalisation with the CEECs would be quite low. That study found that the CEECs are likely to engage substantially in intra-industry trade with the EU, and that this intra-industry trade could form a more important part of the total in the case of EU-CEEC trade than is the case for Greece or Portugal. In general, intra-industry trade, being based on differentiated products, creates smaller adjustment costs. In addition, they point out that trade liberalisation in conjunction with rapidly growing economies among the CEECs, could facilitate decades of export-led growth for Europe as a whole. Given the importance of increased exports to facilitate growth in the CEECs, the only viable option for the EU is to liberalise the trade regime as far as possible.

Where Will the Costs Appear?

The general conclusion of research on this topic is that, although some trade diversion within the EU will undoubtedly take place, trade creation will dominate overall, thus restricting problems in the EU to a specific number of sub-sectors. However, this is not the full picture. As the CEECs become gradually more integrated into the EU trade system, their position relative to other countries, as regards trade protection measures, will have improved (see Table 8.1 above). Consequently, it can be argued that the true competitors of the CEECs, over which they are gaining an advantage, are countries outside the EU who supply similar products to the EU market. Exploring this, Bucher *et al* (1994) compare the structure of CEEC exports, at the NACE 3-digit level, with those of other non-EU countries. This suggests that the CEECs are in competition with a group of Mediterranean, non-EU, countries. They find that of the 25 largest individual sectors where both the CEECs and Mediterranean countries supply at least 1 per cent of the Community market, 17 of these sectors are shared. They conclude that the impact of CEEC trade will be concentrated in these sectors and will fall most heavily on the EU's trade partners in the Mediterranean region. The exports of the Czech and Slovak Republics are something of an exception, but the authors find that

the world to the EU. Overall, the impact of increased trade liberalisation with the CEECs will fall on third countries and not on countries within the EU, who may gain from the increased growth rate in Europe as a whole as a result of trade liberalisation. Consequently, relations between the EU and its Mediterranean neighbours is an issue receiving considerable attention at present.

(ii) Irish Trade with Eastern Europe

Trade with Eastern Europe constitutes a relatively minor part of Irish trade. In 1990 and 1994, imports and exports each constituted about 1 per cent of the total. A trade deficit in 1989 had become a surplus of £30 million in 1990. This is substantial in relation to the overall level of trade. Trade is fairly restricted to a small number of sub-sectors. Among the imports, rubber, textiles, machinery, coal and chemicals are dominant. Ireland's exports are concentrated in office machinery, metal ores and a small number of food products.

Table 8.8 shows the trade performance of Ireland with ten CEEC countries in 1993 and 1995. Total Irish exports to these countries amounted for under 1 per cent of Irish exports in 1995 but the substantial trade surplus accounted for over 2 per cent of the total Irish trade surplus in 1995. Ireland has a trade surplus with every country in the region and Table 8.8 shows the strong growth in exports, in excess of 140 per cent, which occurred between 1993 and 1995. As a result, a small positive balance in 1993 had grown to almost £150 million by 1995.

Three countries, Poland, Hungary and the Czech Republic, account for the majority of trade in the region. Partly as a result of German investment in the Czech Republic, imports from this country to Ireland have grown rapidly, but it is also clear that, as the economy of the Czech Republic has begun to prosper, exports have grown even faster, by a factor of 3 between 1993 and 1995. Examination of these facts give an indication of the opportunities for Ireland to export to this area as its economies recover from the deep recessions of the transition period in the early 1990s.

The CEECs will almost inevitably become more important as trade partners for Ireland in the near future. They present a major marketing opportunity with the potential for Irish business to access an additional 110 million consumers. Further integration with the EU will underpin stability in these countries, enhance prosperity and redefine tastes towards the products EU exporters have to offer.

TABLE 8.8

Irish Trade with the CEECs

	Imports £m		Exports £m		As % of Total 1995	
	1993	1995	1993	1995	Trade Surplus	Exports
Poland	51.33	45.22	33.38	85.66	0.57	0.31
Hungary	4.69	12.59	16.66	44.28	0.44	0.16
Czech Rep	8.76	20.56	23.76	67.69	0.66	0.25
Slovakia	0.19	3.68	0.07	11.14	0.11	0.04
Slovenia	5.90	5.08	4.52	10.57	0.08	0.04
Romania	1.67	5.14	2.70	11.87	0.09	0.04
Bulgaria	0.89	2.87	1.98	7.28	0.06	0.03
Lithuania	0.34	1.30	1.14	2.21	0.01	0.01
Latvia	8.21	6.35	0.58	7.29	0.01	0.03
Estonia	0.08	1.85	0.93	5.88	0.06	0.02
CEEC-10	82.06	104.64	85.72	253.87	2.09	0.93

While providing potentially valuable markets for Irish exports, products from these countries will provide increasing competition on EU markets. IBEC (1996) has identified that this competition will be most intense in labour intensive, low output sectors. It identifies the Irish clothing, textile and engineering sectors as particularly vulnerable to increased competition from the CEECs, particularly in the UK market. However, it is likely that even in the medium-term the greatest impact on Ireland of increased trade liberalisation with the CEECs is likely to be felt as a result of increased competition in third markets, particularly in Germany. However, even in this case, it is likely that much of the growth in trade – between countries, such as the Czech Republic or Poland and Germany – will be as a result of the reallocation of industries currently operating in Germany, to low cost centres in the CEECs. Ireland must be ready to meet this new challenge if the opportunities to benefit from increased trade, as a result of the

opening up of the CEECs, are to be availed of. It is essential that Ireland maintains and continues to improve the competitiveness of its exports. In this respect, the Council believes that the importance of continuing to pursue national policies which facilitate competitiveness cannot be over emphasised. In addition, a number of specific actions are required to meet these new challenges. A major role exists for state agencies to aid Irish companies developing new markets in the CEECs or meeting new competition in third markets. This role will involve the acquisition and provision of information on developments and assistance with promotion. An Bord Tráchtála has a major role to play in this regard. The Council recognises the many successes of state bodies in meeting similar challenges in the past and supports initiatives to ensure the undoubted new opportunities which have emerged can be availed of by Irish exporters.

The pattern of future trade, and as a result the areas in which competition is likely to be most keenly felt, will, to a large extent, be determined by the sectoral pattern of FDI in the CEECs in coming years. Thus, FDI is seen to have two effects. First, it will provide the CEECs with the capacity to compete with Irish exports in third markets. The importance of this effect, however, is unknown. Second, the CEECs will compete with Ireland for flows of FDI.

4. CONCLUSION

This chapter has examined the implications of closer interaction between the EU and the CEECs for trade and the likely impact of further liberalisation on trade flows in the future. These developments are occurring, and will continue, even without formal enlargement to the East. As a matter of policy, the EU has generally sought a more liberalised world trade regime. In fact, its external relations have, to a large extent, been developed in terms of its trade relationships with its neighbours. As a result, it is no surprise that the development of trade relationships with the CEECs, has been the first step towards developing a set of relationships with these countries.

Recent years have witnessed rapid growth in the volume of trade between the two regions. This trend looks set to continue as further liberalising measures, contained in the Europe Agreements, are

gradually implemented and as economic recovery continues in the CEECs. However, while the EU is, and is likely to remain, the main trade partner for the CEECs, these countries constitute a relatively minor part of the external trade of the EU. The trade balance has shifted in the EU's favour in recent years and a surplus is likely to continue for the immediate future. In general, research shows that this growth in trade with the CEECs, despite the increased competition it implies in product markets, will have an overall beneficial effect on welfare in the EU. However, it is also expected that there will be localised instances where increased competition will have a detrimental effect on economic performance. To a large extent, a disaggregated analysis of the export structure of the CEECs would indicate that the greatest costs are likely to be borne not by EU members, but by its trade partners, particularly those in the Mediterranean region.

Trade with the CEECs constitutes only about 1 per cent of Ireland's external trade. In line with other EU countries, this trade has grown in recent years and, is expected to become more important in the near future as economic recovery continues in these countries. In addition, the trade deficit which existed prior to 1990, has now become a substantial surplus, amounting to £150 million in 1995 and representing over 2 per cent of Ireland's overall trade surplus. It is thus clear that while there is increased competition from these countries, the direct effect is that the opportunities for exports to the CEECs are likely to mean that increased trade will have beneficial effects on the Irish economy. However, the most important effects may be seen in third markets, particularly in Germany, where exports from the CEECs could pose a threat to Ireland's market share. The extent of this threat is, as yet, unclear and will depend on the success of economic restructuring and, in particular, the sectoral destination of investment in the CEECs. The Council believes that provided sufficient and appropriate actions are undertaken to ensure the competitiveness of Irish exports, the integration of the CEECs into the European trade regime provides a major opportunity for further growth in Irish exports.

CHAPTER 9

EUROPEAN INVESTMENT PATTERNS

1. INTRODUCTION

Foreign direct investment plays a very important role in the Irish economy. The output of, and employment in, foreign firms constitute much larger proportions of GDP and total employment, respectively, in Ireland, than in most other countries. It is widely believed that the CEECs, as a result of a low cost base and locational advantages, will attract substantial inflows of FDI in the future. The impact of this development on flows of FDI in Europe, and in particular in Ireland, is of major importance.

Section 2 of this chapter examines the determinants of the locational patterns of FDI. It shows that globally, FDI grew very rapidly during the 1980s, with FDI from Japan being particularly important. As with trade flows, there is strong evidence of the regional integration of FDI flows. As a result, most FDI generated in Europe is also located in Europe. Among the major European locations for FDI, the UK has been particularly successful in attracting FDI from outside Europe and has accounted for the majority of Japanese investment into the EU. This section also examines the pattern of FDI and FDI policy in the CEECs.

Section 3 assesses the strengths and weaknesses of the CEECs as locations for FDI. It is noticeable that their most important strengths – low wage costs, potentially large domestic markets and locational advantages – would not be considered particular strengths in attracting FDI to Ireland. However, flows of FDI to the CEECs, to date, have been well short of expectations. Section 4 examines in detail the volume, origin and sectoral destination of FDI to Ireland in recent years. It is particularly noticeable that FDI has become concentrated in a very small number of sectors and that Ireland increasingly relies on the US as the origin for FDI. Section 5 assesses the performance of Ireland in attracting FDI and finds that, although Ireland has received a substantial share of US FDI to Europe in recent years, its global share has declined and its share, relative to FDI locating in a range of small neighbouring European countries, has also declined substantially. It is increasingly obvious

that the main competitors for Ireland in attracting FDI are the relatively developed countries in the EU – the UK, Belgium and the Netherlands – which have offered attractive incentive packages over recent years. The chapter concludes with an assessment of the competitive threat posed to FDI in Ireland by the emergence of the CEECs as locations for foreign investment.

2. FDI FLOWS AND LOCATION

(i) Locational Pattern of FDI

Predicting future patterns of FDI is extremely difficult. However, the importance of FDI in the economy of Ireland means that global developments which could affect future flows and locational patterns should be examined closely. The emergence of the CEECs as locations for FDI could have an important impact on European investment patterns. To attempt to assess the importance of this development for Ireland, it is necessary to analyse, not only the volume of recent FDI flows to the CEECs, but also to analyse the factors which determine the location of FDI, the factors which are likely to influence investors' decisions regarding the CEECs and, finally, recent developments in the volume and structure of FDI in Ireland.

Traditional Views

An important early analysis of FDI was Vernon's theory of the product life-cycle. This suggested that new products were initially produced in advanced economies, and the location of production changed as the product moved through its life-cycle. This approach led many to expect that leading US and other corporations would move production from intermediate countries, to less developed countries. While Vernon's approach may explain some location changes, patterns of FDI have become much more complex. These complexities are relevant to any assessment of the likely impact of Eastern enlargement on the EU. Such an assessment requires identification of important aspects of modern FDI and identification of Ireland's place in international investment flows and production.

This identification can begin by distinguishing between different types of foreign direct investment. Dunning distinguishes four types of FDI, and these are illustrated in Table 9.1. He argues that the first

two types – resource seeking and market seeking investment – represent the main motives for an initial foreign entry by a firm, while the latter two embrace the main modes of expansion by established foreign investors. Dunning sees the *sequential* nature of FDI in the 1980s and 1990s as one of its most important characteristics. As much as 90 per cent of that activity is currently undertaken by established TNCs. Indeed, he shows that in the 1960s and 1970s, most FDI was natural resource seeking or market seeking. In the 1980s and early 1990s, FDI has increasingly been efficiency seeking and strategic asset seeking.

Partly as a result of the enlargement of markets – occasioned *inter alia* by rising living standards and

TABLE 9.1

The Main Types of Foreign Direct Investment

Type	Motive
1. (Natural) resource-seeking • Physical resources • Human resources	Mainly motives for initial foreign direct investment
2. Marketing-seeking • Domestic markets • Adjacent (e.g. regional) markets	
3. Efficiency-seeking Rationalisation of production to exploit economies of specialisation and scope • Across value chains (i.e., product specialisation) • Along value chains (i.e., process specialisation)	Mainly motives for sequential foreign direct investment
4. Strategic (created) asset-seeking To advance regional or global strategy To link into foreign networks of created assets • Technology • Organisational capabilities • Markets	

Source: Dunning (1994).

> regional economic integration – and partly as a consequence of changes in the production and marketing strategies of MNEs, the factors influencing the geographic distribution of FDI have dramatically changed, (Dunning, 1993, p.131).

Indeed, he considers that the factors influencing locational choices have become very different in the early 1990s, from those of only a decade or so ago. Another important factor is the emergence of TNCs as co-ordinators of a network of inter-related value-added activities:

> The systemic view of TNCs implies very different governance structures than those implemented by traditional foreign investors. Rather than acting as an owner of a number of fairly autonomous, or 'stand alone' foreign affiliates, each of which is expected to earn the maximum economic rent on the resources invested in it, a systemic TNC aims at managing its portfolio of spatially diffused human and physical assets – including those owned by other firms over which it has some property rights – as a holistic production, financial and marketing system (Dunning, 1994, p.29).

These changing characteristics of FDI are related, in Dunning's view, to the key ingredients of contemporary economic growth. One of these key ingredients is the fact that created assets – such as technology, intellectual capital, learning experience and organisational competence – are not only becoming more mobile across national boundaries, but are also increasingly housed in TNCs' systems. Another is that competition in internationally orientated industries is becoming increasingly oligopolistic. This, too, is likely to have implications for the future locational pattern of international investment.

(ii) Global FDI Patterns

The growth of world trade has been accompanied by enormous growth in foreign investment. The most dynamic element of this has been private long-term investment by companies. As is well known, such investment may take one of two forms. Portfolio investment is the purchase of interest bearing overseas securities. Although such investment was predominant up to the First World War, it is now

being superseded by the growth of direct investment in productive capacity. In comparison with trade, FDI has taken quite distinct patterns in space, time and across industries. Its direction has shifted significantly in the past thirty years. Its nationality has also changed – with a fall in the share of the UK and the US, and an increase in the shares of Germany and Japan, among others. Its timing is also uneven: after growing faster than world trade in the 1960s there is some evidence that it grew somewhat slower in the 1970s, but revived strongly in the 1980s. Indeed, since 1981, the annual growth of FDI stock has consistently outstripped that of world gross domestic product, gross domestic investment and the exports of goods and non-factor services (Dunning, 1994). Overseas investment has also displayed very definite sectoral patterns and these differ between different nationalities. Furthermore, foreign direct investment, and the associated emergence of TNCs, influences trade and trade patterns. Where TNCs account for a large proportion of world trade, the pattern of international trade will be determined by their decisions. In addition, significant proportions of international trade is *intra-firm*. Consequently, FDI may either increase or decrease observed trade flows.

World flows of foreign direct investment have increased very rapidly since the early 1980s. FDI in 1993 was approximately four times as great as in 1981. The total inflow of FDI in 1993 was estimated at US$194 billion, while the total stock of FDI is estimated at close to US$2,500 billion. This flow of FDI per annum is equivalent to approximately 0.7 per cent of world output, while the sales of foreign affiliates have now risen to over 120 per cent of world exports. In 1993, developed countries accounted for approximately 55 per cent of inflows and almost 93 per cent of outflows. The world stock of FDI in the early 1990s was composed of almost 40,000 parent firms that control over 200,000 foreign affiliates world-wide. Fourteen developed countries account for about 65 per cent of these firms.

The main source countries for FDI are shown in Table 9.2. It can be seen that five countries – France, Germany, Japan, the United Kingdom and the United States – account for approximately 70 per cent of FDI.

The main development during the 1980s, apart from the rapid overall growth, was the growth in the importance of Japan, which more than doubled its share of FDI. This was at the expense of the

TABLE 9.2

Sources of FDI (Per Cent of Total)
(All countries)

	1980-84	1985-90
France	6.0	10.0
Germany	7.4	8.3
Japan	8.9	19.5
UK	19.4	17.4
US	28.1	13.9
Other developed countries	28.6	27.5
Others	1.6	3.3

Source: Dunning (1993).

United States, but the period since 1990, which has seen a deep and prolonged recession in the Japanese economy, has reversed these trends somewhat.

The magnitude of outflows of FDI per annum from the major sources are shown in Table 9.3. The United States remains the largest source of FDI and is also the largest host country, with an inflow reaching almost $32 billion in 1993. FDI to the developing

TABLE 9.3

Average Annual Outflows of FDI from Major Sources 1981-1993 (US$ billion)

	1981-1985	1986-1990	1991-93
France	3	17	25
Germany	4	16	18
Japan	5	32	20
UK	9	28	19
US	11	22	39

Source: UNCTAD, World Investment Report.

countries has grown rapidly but has been very unevenly spread, being concentrated mostly in Asia and Latin America. China has become the largest host country in the developing world with $26 billion of inflows in 1993 and the second largest host country in the whole world.

The Overall Patterns of FDI: The Emerging Triad

The importance of international investment linkages is seen in the development of regionally integrated production systems in East Asia and has given a major impetus to the development of the North American Free Trade Agreement (NAFTA). In line with tràde flows, world foreign direct investment is dominated by the three groups: Europe, North America and Japan. Table 9.4 shows the flows of FDI between the major world economies in 1990, in percentage terms.

The top half of this table shows the extent to which the Triad dominates flows of FDI. A very significant proportion of FDI occurs within each regional zone. The lower figure for North American FDI (24 per cent) reflects the small number of very large

TABLE 9.4

Share of FDI from Major Investors
(Per Cent)

	Host				
Investor	**North America**	**Europe**	**East Asia**	**Other**	**Total**
North America	24	44	14	18	100
Europe	34	49	8	9	100
Japan	44	19	22	15	100
Germany	28	59	5	8	100
France	33	59	2	6	100
Italy	11	69	3	17	100
UK	47	27	15	11	100

Source: Petri (1994).

countries in North America, whereas Europe and Asia are divided into many nation states. Allowing for this, there is undoubtedly some difference between the patterns of North American, European and Japanese FDI. Thus, while the evidence concerning Europe would appear to suggest that foreign direct investment is closely related to trade flows and the degree of integration between economies, Petri (1994) finds that this correlation between integration and interaction is much stronger for trade than for FDI. This is possibly a function of lower transaction costs with FDI and suggests that the emphasis given by some to the emergence of regional blocs in the world economic system may exaggerate the

TABLE 9.5

FDI Flow in EU Member States
(Per Cent of Total EU Inflows and Outflows, and US $millions)

	Inflows	Outflows	Balance
Austria	0.5	1.3	-929
Belgium-Lux	12.3	6.0	2855
Denmark	2.1	1.8	-321
Finland	0.3	1.1	-817
France	15.2	20.4	-9456
Germany	4.4	22.2	-19156
Italy	3.5	6.6	-4130
Netherlands	7.0	11.9	-6918
Portugal	3.4	0.5	1977
Spain	14.3	3.6	6851
Sweden	7.9	6.8	-1024
UK	29.0	17.8	3276
Ireland	0.1	n.a.	n.a.
EU Total	**100.0**	**100.0**	**-27792**

Note: Negative figures in the balance column indicate net outflows.

Source: OECD.

degree to which economic activity is regionally divided, and underestimate the degree of economic linkages between these regions. However, others continue to interpret the emerging world economy as highly regionalised (Hirst and Thompson, 1996).

Inter- and Intra-EU FDI

Despite inter-triad investment, the bottom half of Table 9.4 shows that most of FDI from the major European economies – such as Germany, France and Italy – goes to other European countries. France, Germany and the UK account for over 60 per cent of foreign direct investment originating in EU countries. Table 9.5 shows that the destination of FDI flows is similarly concentrated in a small number of countries, with Belgium, France, Spain and the UK accounting for over 70 per cent of FDI investments. Taken as a whole, the EU has a net outflow of FDI equivalent to about 25 per cent of total FDI generated in member states. By far the largest net investor is Germany, with France, the Netherlands and Italy also recording major outflows. The major net recipients are Spain, Portugal, Belgium and the UK. As shown in Table 9.4, UK FDI follows a different pattern than other major European countries, relying much more on investments to and from outside Europe. The UK has received almost 40 per cent of the total stock of Japanese FDI in Europe, with the Netherlands and Luxembourg accounting for a further 30 per cent.

3. FDI AND THE CEECS

(i) The Importance of FDI for the CEECs

Competition for FDI is a noticeable and world-wide development among countries at almost all stages of development. Although it must be recognised that encouraging FDI may have drawbacks for a host country, the evidence suggests that on balance it bestows a positive effect on the country (Dunning, 1994). The European Commission has concluded that the problems which will face the CEECs once they attract FDI will be much less significant than the problems posed by the failure to do so (*European Economy*, 1994). Given that growth will be export-led, the basic aim of the CEECs is to become competitive on world markets. To achieve this, their economies need to be developed and restructured. Three essential

requirements can be identified to successfully achieve competitiveness: to improve productivity and efficiency, to improve the quality of output, and to develop the process through which new products can be developed. While it is perhaps possible that domestic resources could ultimately achieve these effects, inward investment is necessary to achieve it at the pace required by the CEECs.

Sheehy (1994) suggests a number of reasons why obtaining FDI will be particularly important in the case of the CEECs, if a successful outcome of the transition process is to be achieved. First, one of the main difficulties which the CEECs will face in attempting to penetrate EU markets arises due to the technological backwardness of their production systems compared to the EU. FDI often results in a transfer of technology from the origin country to the host country. Since the EU is a major source of FDI for the CEECs, and given the difference in technological levels in the two regions, FDI flows could result in a very rapid improvement in the CEECs on this measure. Second, although the CEECs are relatively industrialised and, in some cases, possess skilled and experienced workforces, they are particularly backward in terms of management skills and techniques. FDI transfers could potentially allow the host countries to rapidly progress from a very poor level of management development to levels comparable to those obtained within the EU. Third, CEEC domestic savings are particularly low. In addition, the under-development of the financial services sector means that those savings that do exist are not easily transferred to industry. Fourth, each CEEC has comparative advantages in certain sectors only. The previous, centrally planned, regimes often tried to develop all sectors instead of concentrating on those where comparative advantage may have existed. Multinational firms, on the other hand, will target investment in the sectors which are perceived to be strongest.

(ii) FDI Policy in the CEECs

Before the transformation to a market economy began, the CEECs did not seek to obtain FDI flows to any great extent. The relationship between trade and FDI is complex, but there is some agreement that a substantial degree of co-ordination between trade and FDI policy is required if the benefits from FDI are to be maximised. Recognising its importance for future development, the

CEECs have recently tried to ensure their economies present a favourable environment for FDI. In general terms, this involves ensuring a stable and predictable macroeconomic and political environment in their countries. In addition, substantial price reform and privatisation will be required to allow foreign firms assess the risks and potential for investment in various sectors and acquire indigenous partners. In addition, major institutional and legal reform is required to facilitate inflows of FDI. Such general characteristics and developments are requirements for both trade and investment and, arguably, for the stability of the newly independent states and CEECs. In addition, a number of specific policies have been adopted which aim to promote FDI.

Regulatory Framework for FDI

The CEECs have adopted a fairly liberal approach to FDI policy. Foreign firms are entitled to obtain 100 per cent of equity in companies in all CEECs. In addition, joint ventures are encouraged and company law, similar to Western limited liability law, has been adopted. Company registration for foreign firms is similar to domestic investors, but institutional reform has been slow and the procedures still involve administration by what could be considered excessive layers of bureaucracy. Investment in certain sensitive sectors, such as defence and state security, is prohibited in most CEECs, while foreign investment in banking and insurance requires special authorisation. Foreign investors are entitled to borrow from banks operating in the CEECs or to obtain finance through the fledgling stock markets which have appeared. Most countries have adopted a liberal approach towards the repatriation of profits. All FDI will be liable to profit tax, but numerous exemptions have been included in the tax code for firms with a high percentage of foreign ownership. In many of the CEECs, a complete tax exemption for a period of two years or more is available for new investments. Many FDI companies will also be able to avail of exemptions from other parts of the tax regime and from customs duties and tariffs.

To attract FDI and reduce administration, many of the CEECs have linked the privatisation process to foreign direct investment. The Visegrad countries have led the way in this development, allowing the direct sale of public-owned companies to foreign investors, retaining preference for domestic investors only in certain sectors such as agriculture. In some cases, the acquisition of more than 10

per cent of a formerly public-owned company may require authorisation. Where voucher-based privatisation has been adopted, a two stage process is required, foreign investors being allowed to buy, relatively freely, shares distributed to residents who are willing to sell. In addition, where privatisation to nationals has proven difficult, some of the CEECs have allowed foreign investors to form joint stock companies with the state.

As the transition process further develops, other problems in encouraging FDI, such as the importance of a stable exchange rate, have emerged. To date, attention has focused on ensuring convertibility, but the CEECs – with the exception of the Czech Republic – have been quite hesitant in allowing capital account convertibility, many believing that general economic conditions do not yet allow this move. For as long as the risk of capital flight exists, the threat to the balance of payments is likely to prevent such a development. However, the OECD notes that recent studies indicate that non-convertibility of the capital account is not unusual among IMF member countries which rely, as the CEECs have done, on specific FDI regulations to attract investors (OECD, 1994).

The Europe Agreements have aimed to strengthen the liberalisation policies already implemented while allowing the CEECs retain certain safeguards concerning newly established firms for a limited time. This allows the CEECs to restrict the inflows of firms from the EU in sectors which are undergoing major restructuring or facing serious difficulties, thus preventing serious social problems in the CEECs. In addition, any sectors which have experienced a drastic reduction in market share held by the CEECs, or sectors which are newly emerging in these countries, may be protected from foreign firms. This is particularly the case in agriculture, where rapid capital investment from abroad could lead to rural unemployment and depopulation. It is envisaged, however, that, within a limited time period, the CEECs will be obliged to adopt existing international rules and OECD codes, if they wish to obtain full credibility as host countries for FDI, and reduce the risks perceived by investors.

(iii) FDI Flows and the CEECs

At the beginning of the 1990s, it was generally believed that the opening up of the CEECs would lead to substantial flows of capital from Western Europe. However, structural inefficiencies and the

TABLE 9.6

FDI Flows to the CEECs (US$ million)

	1990-93(1)	Up to 1992(2)	1992-93(3)	1994 (4)
Bulgaria	164	300	92	n.a.
Czech Republic	2600	n.a.	1544	779
Hungary	5441	3900	2671	1097
Poland	839	680	864	527
Romania	140	502	123	n.a.
Slovakia	600	n.a.	146	79
Czechoslovakia	n.a.	1100	n.a.	n.a.

Sources: (1) *Financial Times* (11 November 1994)
(2) Brewer (1994)
(3) *European Economy* (1994)
(4) Lansbury, Pain and Smidkova (1996)

underdeveloped financial systems in these countries meant that FDI was initially very slow to arrive. While estimates of the volume of FDI going to the CEECs vary, some patterns are beginning to emerge. Table 9.6 gives the figures for flows of FDI to the CEECs drawn from a range of sources.

In 1993, FDI inflows to all CEECs are estimated to have totalled around $5 billion or 2.6 per cent of the world total, with a total stock of FDI around $13 billion, or 0.5 per cent of world FDI. This is approximately equal to the stock of FDI in Thailand. In recent years, however, flows have increased but, to date, remain concentrated in four countries: Hungary, which accounted for most of the early flows; the Czech Republic which has become important; Poland, which is emerging as a destination with potential and Estonia. Within these countries there has been quite a difference between the performance of different regions, with regions close to the EU border performing well ahead of other regions.

In a survey carried out by Ernst and Young in 1995 (see Financial Times, 24/10/95) the Czech Republic achieved the best rating as a location for FDI in Central and Eastern Europe. Among the headings included in the ranking were business opportunities,

political risk, credit rating, the status of the economy, stability and business infrastructure. The Czech Republic was the highest ranked CEEC in all categories except business opportunities where it was ranked second to Poland. In terms of overall assessment, the relative ranking were: Czech Republic, Poland, Hungary and Slovenia. The next best locations were the Baltic Republics, followed by Bulgaria and Romania. The sharp division, in investors' perceptions, between the Czech Republic and Slovakia is clear with the latter being ranked lower than Russia on a similar level to former USSR Republics in Europe and Central Asia.

The slower than expected growth in FDI has prompted the UNCTAD *World Investment Report* (1994) to conclude that the expected role of FDI in transition may have been exaggerated and that even with locational advantages being fully exploited:

> it is not likely that the result would be a large scale transfer of production capacities from developed countries to those of Central and Eastern Europe. Rather, what is more likely is an incremental increase in production located there, partly to satisfy local markets, partly as a result of regionally integrated production, (p.8).

The origin of FDI in the CEECs is shown in Table 9.7. To date, European countries and firms have dominated flows, with the US emerging as important only in Poland and part of the Czech Republic. Among the EU countries, Germany is by far the most important. However, in certain cases, other EU countries are important investors. In Hungary, Austrian investment is particularly large; in Poland, Italian investors, particularly motor manufacturers, supply a large proportion of FDI. The UK has been a very minor player in these countries, while flows of FDI from Japan have been almost negligible. It is not expected that Japan will become the major player it is in world FDI, although some increase could be expected. It is unknown to what extent the United States will invest in Eastern Europe, but it has been suggested that up to 20 per cent of American FDI arriving in Europe could, in the future, be destined for these countries. These early patterns of FDI would appear to indicate that FDI flows to Eastern Europe will be similar, in terms of origin, to intra-European flows.

Figures for the sub-sectoral destination of FDI in Hungary taken from *European Economy* (1994) show that three sectors – refining

TABLE 9.7

Origin of FDI to CEECs (Per Cent of Total)

	Czech Republic	Poland	Hungary
Germany	32.2	6.5	18.4
France	13.8	2.0	5.9
Italy	0.0	30.1	3.9
UK	0.0	2.6	3.2
Other EU	11.5	17.3	45.8
Japan	0.0	0.2	0.5
US	29.5	38.9	5.1
Others	13.0	2.4	17.5

Source: European Economy.

and chemicals, food and tobacco and machinery and equipment – have dominated, although a number of sectors received sizeable proportions of FDI. This wide base contrasts to the situation in Ireland, described below, where FDI is concentrated in a small number of sectors. The sectoral distribution of FDI at this early stage is intrinsically linked with the privatisation programme, which is still underway in these countries, and, as a result, the proportion in a sector such as food and tobacco, which was privatised at an early stage, may decline over time.

About 59 per cent of investment into the CEECs is used for acquisition of existing companies or formation of ventures with companies in these countries. The remaining 41 per cent is used to set up new companies or subsidiaries.

Although the rate of growth of FDI inflows improved in 1994 and 1995, forecasts indicate that initial expectations will remain overly optimistic. This is particularly true for countries such as Slovakia, Romania and Bulargia. IBEC (1996) puts this down to fears over political stability and serious deficits in the regulatory and legislative environment. Table 9.8 provides an indication of the expected value of FDI flows to the CEECs.

TABLE 9.8

CEEC Net Foreign Direct Investment (US$ million)

	1994	1995 (estimate)	1996 (estimate)	1994 % of GDP
Czech Rep.	749	2200	1500	2.2
Slovakia	156	187	225	1.5
Hungary	1147	2500	1700	2.8
Poland	542	900	1250	0.5
Romania	341	400	450	1.1
Bulgaria	105	115	130	1.1
Slovenia	140	160	175	1.0
Estonia	253	200	200	9.5
Latvia	155	165	175	3.9
Lithuania	60	70	90	1.7
Total CEEC (10)	**3679**	**6910**	**5895**	**1.5**

Source: IBEC (1996).

(iv) Strengths and Weaknesses of the CEECs in Attracting FDI

Strengths

The major strength of the CEECs, as locations for FDI, is low wage costs in comparison to all countries of the EU. There are suggestions that currency appreciation in the CEECs may mean that the current wage differential over EU countries may not be maintained. However, wages in the CEECs are substantially below EU levels and must be expected to remain so in the foreseeable future. This will be of particular importance in a country such as Poland, with its enormous reserves of under-employed labour, particularly in rural areas. The extent to which this attracts FDI to the CEECs, rather than the reverse flow of labour migration, to Germany in particular, remains to be seen.

The second major strength arises due to the geographical location of the CEECs. While they might be seen as peripheral at present, it is inevitable that with closer interaction the political and economic centre of gravity of Europe will shift Eastwards. The CEECs have major advantages over other peripheral locations – such as Greece, Southern Italy, Portugal, Ireland or Scotland – in being close to the main economic centre of Germany and linked to the EU by the rail and road network, although this infrastructure may need upgrading. In addition, the CEECs are likely to attract FDI as a base for future expansion by EU companies into emerging markets in the former USSR.

A third important strength is the potentially large domestic markets of the CEECs, both internally, and in terms of further export to the countries of the former USSR and Central Asia. Large domestic markets confer economies of scale on firms operating in those countries. Fourth, in comparison to many other low cost destinations in Europe and other parts of the world, the CEECs possess developed educational systems and a highly educated workforce. The extent to which this can be mobilised in terms of the development of higher skills in firms remains to be seen. Fifth, most of the CEECs have an industrial base and an industrial tradition, although some would see this as a drawback, due to the inefficiency of that industrial base and the sub-optimal practices which may exist. However, if that base can be reformed it could provide a sound foundation for the creation of a new industrial economy. Finally, such is the lack of development of infrastructure in these economies – for example, in telecommunications – that the creation of a new infrastructure will allow the use of the most advanced technology. As a result, where new infrastructure is created – as for example, in the Eastern Germany – it will be among the most modern in Europe.

Lansbury, Pain and Smidkova (1996) found that the timing and form of privatisation programmes, relative labour costs and the availability of knowledge and skills were key determinants of the pattern of inward FDI in the CEECs. In the immediate future, further privatisation programmes will be important, with relative costs and domestic demand being important in the medium-term. They also found strong evidence that FDI patterns were determined by existing trade patterns particularly in the case of Germany. This supports the hypothesis that some German industry may migrate, particularly to the Czech Republic, to avail of low costs and to service local markets.

Weaknesses

FDI flows have fallen well short of initial expectations due to a number of problems perceived by investors. Among the most important has been uncertainty over the economic and political environment, the lack of a developed market economy, the lack of suitable business partners and legal problems. A survey by the European Bank of Reconstruction and Development (EBRD) of potential investors identified bureaucratic inertia, the weak financial system, telecommunications problems, political instability and a lack of managerial skills as the greatest problems encountered by companies operating in the CEECs. Labour has generally been found to be relatively skilled, but serious problems exist in managerial skills, where accounting, stock control and marketing are very poorly developed. Productivity is low by international standards, and the under-development of markets has led to major problems in the distribution of output and unreliable supply lines.

A survey reported in *European Economy* (1994) indicates that the most important short-term problems experienced by firms investing in the CEECs arise due to the administrative structure which has been inherited from the former regimes. Firms are experiencing major administrative delays and a lack of ability on the part of officials to fully comprehend the new market environment. These problems are greatly magnified by weaknesses in the legal and taxation system of many of the CEECs. Many legal reforms have been implemented, but the systems evolving appear to differ substantially between countries and very often maintain controls over industries, or investment in industries, which are seen to be of vital national interest. These are not problems which will be overcome in the short-term, although reforms have taken place. Of greater importance over the medium-term may be problems arising due to a lack of credibility of the new administrations. Any semblance of political instability will greatly diminish FDI. A similar set of concerns exist on the macroeconomic problems which many of the CEECs have been experiencing, where very high inflation is now being replaced by high unemployment. It remains to be seen whether or not this is a phenomenon of the transition process only, or is indicative of longer run problems. However, macroeconomic instability can be expected to inhibit the development of the industrial base.

In addition to the infrastructural deficiencies, which may be overcome in the medium-term, the business systems in many of the CEECs, particularly in financial areas, but also in the professions, are very underdeveloped. This is a barrier to FDI, as a strong and efficient backup in terms of the national business system can greatly affect the competitiveness and profitability of industry in a particular country. This is not a problem which is likely to be overcome in the short or even medium-term. Similarly, where new industry is being set up in the CEECs, it generally has to operate on a stand-alone basis within that country, since the availability of reliable high quality sub-supplies is uncommon.

(v) Impact of Closer Integration with the CEECs on FDI Flows in the EU

Factors Affecting FDI Flows

Global FDI flows grew at rates up to 25 per cent per annum during the 1980s to in excess of $200 bn per annum in the early 1990s. While this rate of growth is expected to slow somewhat, a growth rate of 10 per cent per annum into the first decade of the next century would mean a fourfold increase in the volume of FDI flows by the year 2010.

A number of factors are combining to stimulate this growth. These include the increase in international trade as a result of the emergence of trade blocs and trade liberalisation, increasing deregulation and privatisation of industry, company strategies, technology, the globalisation of capital markets and increasingly elaborate state aids from a growing number of countries aiming to attract FDI. Developments in the CEECs will complement these global tendencies and, in what is likely to be a period of catch-up, FDI in this area will probably grow in excess of world rates.

On the other hand, FDI will still be attracted to the most favourable locations which will grow well in advance of global trends. Japan is increasingly a major source of FDI and will probably be the main player over the coming years. To date, Japan has shown little interest in investing in the CEECs and is forecast to continue to locate FDI to other Asian countries and the US. The emergence of a Japan-centred Pacific rim trading bloc and NAFTA, are likely to divert Japanese investment even more from Europe to these areas. The forecast, therefore, would appear to be that, due to the rapid

increase in flows of FDI, the CEECs will obtain substantial inward investment of capital over coming years and, due to the very low starting base, a growing proportion of world FDI. However, it should be remembered that they will remain relatively minor players in world terms and that while their growing share means a smaller share for the rest of Europe, it will be a smaller share of a much larger volume. In addition, the evidence is that FDI will not be evenly spread, and thus it is highly simplistic to draw the conclusion that simply because investment flows to the CEECs will increase, that there will be any decrease in flows to another specified area.

It is important to recognise that, in some senses, East European countries are not direct competitors for FDI with EU countries. This arises due to three factors. First, much investment will take place into Eastern Europe due to the availability of new markets in those countries. This is FDI *creation* and, as such, does not *divert* investment from the EU. This investment will take place mostly in infrastructure and will probably form the bulk of investment in the early years. Second, the availability of particular resources is one of the determining factors in attracting foreign investment to any area. As these country-specific opportunities are identified they will result in FDI creation in the CEECs, without any diversion from Western Europe. Possibly the most important of such resources in the CEECs is their geographical location in terms of providing a relatively low-risk base for European companies wishing to enter the emerging economies of Eastern Europe and Russia. Third, and possibly most important, the major competitive advantage of these countries as destinations for FDI is their low cost labour. This, however, is combined with relatively unsophisticated production methods and serious skill shortages. Since it is highly improbable that the CEECs will be able to compete with the EU in attracting knowledge-based industry in the foreseeable future, FDI diversion will occur from previous destinations which have relied on cost competitiveness of labour to attract investment. Such areas are limited within the EU, largely concentrated in the Mediterranean regions. However, it is possible that some sub-sectors in other areas of the EU, which have traditionally depended on cost competitiveness, could be adversely affected.

Estimate of Impact on EU

Success in attracting FDI has been credited with providing one of the main sources of Southern Europe's strong economic growth during the 1980s, following integration into the EU. However, income per capita remains lower than the EU average and relatively high levels of unemployment remain. It has thus been suggested that the main impact of the CEECs in attracting FDI will be on Southern European states. It is generally thought, however, that this will not be felt for a few years, since much of the investment which will initially take place will be to create the infrastructure to service local markets in the CEECs, while the total volume of FDI to the CEECs will be suppressed somewhat by uncertainty over the stability of the new regimes. It has also been pointed out that the countries which are providing most of the FDI to the CEECs, namely Germany and Austria, have not been the main sources of investment into Southern European states in recent years. Surveys of companies reported in *European Economy* also suggest that where investment has been occurring into the CEECs, it is additional rather than a diversion from potential flows to the Southern European countries. Other work reported, using Spain as a case study, shows that much of the large scale investment which took place during the 1980s into Spain was, and continues to be, to develop market share within Spain. Thus, although Spain has a low cost advantage over much of Northern Europe, FDI has generally not been attracted to develop Spain as a base for exporting to other parts of the EU. The growth in FDI in services further strengthens this trend. The regional distribution of FDI within Spain also indicates that lower labour costs are possibly a minor determinant of inward investment, since new FDI has concentrated in relatively developed regions of the country which are also relatively high cost areas. If the richer Spanish regions are not being overwhelmed by low cost regions within Spain, they seem unlikely to lose out to the CEECs.

The aspects of current FDI outlined above suggest that factors determining the location of FDI have changed considerably over the past two decades. 'As their share of total production costs declined, so did the drawing power of natural resources and unskilled labour, while that of created assets and opportunities of networking with local firms rose' (Dunning, 1994, p.42). Dunning suggests that intending investors usually place their need for state of the art

facilities for cross-border transmission of information, technology and finance at the top of their locational priorities. He suggests that an effective and trustworthy legal framework – particularly in its ability to enforce property rights and resolve contractual disputes – comes a close second. Finally, at higher levels of economic development the quality of a country's educational and technological infrastructure becomes critical.

He also cites two recent surveys, one on the determinants of Japanese FDI in the United Kingdom's manufacturing sector, and the other on location of international offices. In both surveys, transaction and co-ordinating cost variables (such as those related to inter-personal relations, information asymmetries, language and culture, searching for and dealing with sub-contractors, learning about the quality of communications and adapting to local business practices and customer needs and bureaucratic controls) were ranked considerably higher as investment determinants than more traditional production-cost related variables.

Based on these arguments, it does not appear likely that the CEECs are competitors for FDI with the countries on the EU's western periphery. For Greece and Southern Italy, which are geographically much closer to the CEECs, the potential for competition is much greater. However, in the immediate future, the underdevelopment of Bulgaria and Romania means that even here competition will be limited. Rather than competition from the CEECs, FDI flows into EU countries could be more the result of future US strategy, lower growth in the Japanese economy, restraint as a result of over-capacity created in Europe during the 1980s, the success of policies to attract FDI and, especially in the case of Spain, a levelling off of FDI flows from the high levels during the 1980s now that the industrial base has been created.

4. IRELAND AS A DESTINATION FOR FDI

(i) FDI in the Irish Economy

Since the early 1960s, Ireland has pursued an industrial development policy centred on attracting mobile foreign capital. Ireland has succeeded in attracting a share of foreign industry greater than might be expected on the basis of its population and economic size. As a result, the foreign sector constitutes a much

more important part of the economy than in most countries. The share of foreign industry in gross output, at over 55 per cent, is much higher than the European norm. Similarly, the share of employment accounted for by foreign firms, at over 44 per cent, greatly exceeds other European countries. For example, the figures for the UK are 25 and 16 per cent, respectively.

The Changing Sectoral Composition of FDI

The number of foreign firms operating in Ireland almost doubled in the period 1972 to 1992, while employment in foreign firms increased by almost 36 per cent in this period. Table 9.9 shows the

TABLE 9.9

Overseas Industry in Ireland

Sector	1972		1992	
	No. of Firms	Employment	No. of Firms	Employment
Electronics & Engineering	148	19,645	367	39,951
Pharmaceuticals & Chemicals	66	5,592	118	12,083
Food	63	9,635	64	7,826
Services	10	465	220	6,926
Textiles	49	7,232	44	6,399
Drink & Tobacco	23	7,471	26	4,380
Clothing & Footwear	66	6,701	45	3,693
Non-Metallic Minerals	32	3,167	25	1,878
Paper & Printing	25	1,966	23	1,848
Miscellaneous	58	4,180	83	4,715
Total	**540**	**66,054**	**1,015**	**89,699**

Source: IDA Annual Report, 1992.

sectoral character of foreign firms in Ireland. The table shows that major changes have occurred within the foreign sector in this period. Three sectors – electronics and engineering, pharmaceuticals and chemicals, and services – account for almost 70 per cent of foreign firms in Ireland and over 65 per cent of employment in the foreign sector. By contrast, in 1972 less than 39 per cent of employment in foreign firms was in these three sectors. In most sectors, with the exception of the 'miscellaneous' grouping, employment in foreign firms declined significantly in this period. Indeed, in most sectors, with the further exception of the drink and tobacco industry, the number of foreign firms declined between 1972 and 1992. The fall in employment is particularly serious in the drink and tobacco, and clothing and footwear industries. This contrasts with a more than doubling of the numbers employed in the two growth sectors – electronics and engineering and pharmaceuticals and chemicals.

Recent figures show these trends continuing, with 13,500 employed in the pharmaceutical and chemical sector, and just under 45,000 employed in electronics and engineering at the end of June 1995. In contrast, the total for the textile, clothing and footwear sectors has declined to just over 8,500.

These trends reflect the sectoral composition of FDI inflows to Ireland over recent years, as shown in Table 9.10. The table shows the extent to which these inflows have been concentrated in the two growth sectors. Fully 49 per cent of FDI to Ireland in the period 1983 to 1994 was in the metals and engineering sector, which includes electronics, with 18.7 per cent invested in the chemical and pharmaceutical industry. The table shows, however, that Ireland continues to attract a quantity of FDI in the food, drink and tobacco and textiles industries, but comparison with Table 9.9 shows that the rate of job creation as a result of this FDI was insufficient to replace jobs lost in these sectors.

Table 9.10 also shows that this concentration in a limited number of sectors has, in fact, increased in recent years, as the level of FDI in Ireland has recovered from a slump during the 1980s. Apart from the two growth sectors, and a modest recovery in FDI in the food industry, Ireland no longer appears to be an attractive location for FDI in any of the other main manufacturing sectors.

TABLE 9.10

FDI to Ireland by Sector, 1983-94 (% of Total)

	1983-94	**1992-94**
Non-Metallic Minerals	3.0	0.4
Chemicals	18.7	24.0
Metals & Engineering	49.0	51.7
Food	7.9	8.7
Drink & Tobacco	5.9	2.4
Textiles	4.7	4.3
Clothing, Footwear & Leather	1.6	1.1
Timber & Furniture	1.3	0.8
Paper & Printing	0.7	0.3
Miscellaneous Industries	4.6	3.5
Non-Manufacturing	2.6	2.8
Total	**100.0**	**100.0**

Source: Forfás Database.

Foreign Investment in Services

These tables, based on information supplied by IDA Ireland, relate to FDI in grant assisted projects only. This accounts for virtually all foreign investment in manufacturing industry in Ireland. However, inward investment in services – only 2.8 per cent of the total – is remarkably low given the high level of outward investment in services from the major source countries in recent years. FDI in the service sectors has been increasing rapidly, accounting for up 50 per cent of outflows from the main countries. Due to the relatively low cost per job in services, employment has, in fact, grown rapidly and service firms, which tend to be smaller than firms in other sectors, account for about 50 per cent of new foreign projects grant-aided each year in Ireland. One reason for the particularly low level of FDI in services in Ireland is that much world FDI in services has been to finance acquisitions or joint ventures in the financial sector in other countries. While there has undoubtedly been some FDI in Ireland for this purpose, the IDA does not assist or grant-aid

investment in acquisition or mergers. Thus, it is not known to what extent Ireland has participated in the observed world-wide growth in FDI for this purpose.

(ii) The Origin of FDI in Ireland

This concentration of FDI in a small number of sectors is reflected in a similar concentration in countries of origin of FDI in Ireland in the period 1983 to 1994. This is shown in Table 9.11. It is clear that the origin of FDI in Ireland differs from that of other EU countries, as shown in Table 9.4 above. Flows from the US dominate, accounting for 57.6 per cent of the total over the period, and in excess of 70 per cent in most years. Table 9.11 shows that in recent years, as FDI has recovered, this reliance on the US has greatly increased, with all other countries accounting for a diminishing share. In many years, the US has accounted for in excess of 75 per cent of FDI in Ireland. This concentration does not reflect the relative importance of the US as a source of world FDI, nor growth rates over the recent period. Nor does it reflect Irish trade patterns, or a policy to concentrate on the US. Rather, it would seem to be the result of IDA policy to concentrate on a small number of sectors which it has identified as compatible with Ireland's competitive advantage and which will result in high value-added in the Irish economy. Similarly, much of the 'Other Europe' group in recent

TABLE 9.11

Origin of FDI Inflows to Ireland
1983-94 (% of total)

	1983-94	1992-94
US	57.6	72.2
UK	10.4	5.3
Germany	7.6	5.0
Other Europe	14.0	10.9
S.E. Asia (incl. Japan)	7.8	5.8
Other	2.7	0.8

Source: Forfás Database.

years is accounted for by FDI from Switzerland, rather than other EU countries, reflecting the importance of Swiss firms in the pharmaceutical sector. The other point emerging from this table is that Ireland did not obtain substantial inflows of investment from Japan, which has emerged as an important source since the early 1980s. In fact, not only does Japan provide a relatively small share of capital inflows, but the proportion of the total accounted for by Japan did not increase perceptively during the 1980s, and declined in recent years.

During the 1970s and early 1980s, Ireland was remarkably successful in attracting FDI, to the extent that the Telesis Report (NESC, 1982) concluded that the IDA must have been overly generous in its support for FDI. FDI inflows declined somewhat after 1985, but have recovered in the period since 1992. In absolute values, FDI which stood at £193m in 1983, had risen to only £200m in 1994. However, total growth of 17 per cent for this period is nowhere near sufficient to maintain the real value of FDI or Ireland's world share, given the very rapid growth in world FDI which took place during the 1980s. As a result, Ireland's share of OECD FDI has declined substantially, from 0.43 per cent in the period 1983-85, to less than 0.1 per cent in recent years. Similarly, net inflows of FDI to Ireland as a per cent of Irish GDP have declined from 0.9 per cent in the early period to just over 0.3 per cent in recent years. This is not explained simply in terms of a change in policy towards promoting indigenous industry since the ratio of grant-aided Irish investment to FDI has fallen sharply in this period, from 1:1.7 in 1983-85, to 1:2.1 in 1986-92 to 1:3.3 in 1992-94. This poor investment performance by indigenous industry is the subject of a forthcoming report by the Council.

Sub-Sectoral Analysis

The single most important industrial sector for FDI has been the engineering sector which encompasses a wide range of manufacturing firms. Table 9.12 breaks this sector down into a number of sub-sectors and shows the share of each sub-sector in 1983-88 and 1989-94. It can be seen that electrical engineering and data processing equipment accounts for the bulk of investment in this sector. Changes have occurred over the period. Of particular importance is the growth of this sub-sector, which includes electronics, and which accounted for just under 60 per cent of FDI

TABLE 9.12

FDI to Engineering Industries 1983-1994 (Per Cent of total)

	1983-1988	1989-1994
Electrical and Data Processing Equipment	54.1	59.5
Mechanical Engineering	9.6	4.5
Instrument Engineering	9.9	11.9
Metal Articles	10.9	6.2
Motor Vehicles	13.0	10.4
Transport Equipment	1.8	7.5
Metal Processing	0.7	0.0

Source: Forfás Database.

in the period 1989-1994. All other sub-sectors are minor in comparison. It is particularly evident that heavier engineering industries – such as mechanical engineering, metal articles, motor vehicles and metal processing – have all lost share, declining from a total proportion of just over 34 per cent in the earlier period to only 21 per cent since 1989. This confirms the importance of the electronics sector in FDI to Ireland.

A similar picture emerges when the pharmaceutical and chemical sector is broken down into its most important industries, as shown in Table 9.13. The dominance of pharmaceutical firms in this sector is evident from this table. Its share has increased and, in the period 1989-1994, accounted for over 93 per cent of total investment in this sector. Again, the lower-technology heavier industries – in particular, the production of basic industrial chemicals and other chemicals – declined in importance, with the proportion dropping from just under 20 per cent of the total FDI in 1983-1988, to only 3.5 per cent in the later period. It is generally thought that Ireland's low tax rate accounts for this change, given the very high profitability of pharmaceutical firms. Since the engineering and chemical sectors have come to account for the bulk of FDI in Ireland in recent years, these developments are of vital importance.

Not surprisingly, investment by US companies is of great

TABLE 9.13

FDI to Chemical Industries 1983-1994

	1983-1988	1989-1994
Pharmaceuticals	72.7	93.3
Basic Industrial Chemicals	10.2	0.6
Toiletries	7.7	3.2
Other Chemicals	9.4	2.9

Source: Forfás Database.

importance in these two sectors. In the period 1989-1994, US companies accounted for 71.5 per cent of investment in the engineering sector and for 59.1 per cent of the total in the chemical sector. In line with the growing importance of US companies in overall investment in Ireland, these percentages have increased since the 1983-1988 period. Taken together, these two sectors accounted for just under 76 per cent of total US investment in this period. The concentration of US firms in the chemical and pharmaceutical sector is similar to that of FDI as a whole. However, with 58 per cent of total US investment being channelled into the engineering sector, this sector is more important as a destination for FDI by American firms than for FDI from other countries.

5. PERFORMANCE OF IRELAND IN ATTRACTING FDI

(i) Relative Performance

The previous section have shown that, in absolute terms, the volume of grant-aided FDI in Ireland, has barely increased over the past ten years, in a period in which world FDI flows have expanded hugely. For example, inflows of FDI into Europe in the period 1976 to 1980 amounted to $14.3 billion per annum. By 1990, this had risen to over $60 billion per annum and, despite the recent recession, stood at just under $70 billion per annum in the period since 1990. As a result, Ireland is obtaining a much smaller share of world FDI flows than previously. Table 9.14 compares Ireland's market share in 1978 and 1991 with a range of key competitors as identified by the Telesis Report. The figures show the extent to which Ireland's

TABLE 9.14

Ireland's Market Share Compared to Key Competitors Identified by Telesis

	1978/79		1990/91	
	No. Projects	**%**	**No. Projects**	**%**
Ireland	185	80	25	41
Wales	21	9	11	18
Scotland	13	6	12	20
N. Ireland	9	4	4	6
Belgium	2	1	9	15
Total	**230**	**100**	**61**	**100**

Source: IDA.

dominant position among these competitors has been eroded in this period. A reflection of these developments is Ireland's failure to avail of either the boom in FDI from Japan during the late 1980s, or the rapid increases in intra-EU FDI which have been occurring.

A number of reasons have been put forward for these developments. The first is that Ireland has concentrated on attracting inward investment into greenfield sites or expansion projects in a relatively narrow range of manufacturing sectors and services. The total figures for world FDI include the growth which has taken place in types of FDI for which Ireland either does not, or could not, compete. Among the latter types are outward investment from Japan to avail of extremely low cost production in countries such as China, or other parts of Southeast Asia, FDI to exploit natural resources which Ireland does not possess, for example, oil, and the huge boom in FDI to finance mergers and acquisitions which has taken place during the 1980s. The IDA does not attempt to attract investment inflows for types of FDI other than greenfield and expansion. While arguments may be put forward for this policy, it may also be argued that such FDI is worth pursuing.[1] Within those types of FDI for which Ireland does compete, there has been a huge increase in competition from other countries, now pursuing policies and incentives such as those available in Ireland. At the same time as other countries have reduced their corporate tax rates (although most countries remain well above those in Ireland) and increased their incentive packages, Ireland has tended to move in the opposite direction. In addition, the development of the economy over the past two decades has meant that Ireland has lost much of the cost competitiveness which might have attracted FDI in the early stages of development. It should be noted, however, that conclusions drawn from analysis of total FDI flows may miss important aspects since, ultimately, it is job creation and the strategic importance of FDI flows which count.

1 Other types of FDI in Ireland occur independently of the IDA, for example, acquisitions in the retail sector.

(ii) Ireland's Main Competitors for FDI

Competition for FDI has made it increasingly difficult for Ireland to attract inflows. The main competitors which can be identified include neighbouring areas such as England, Scotland, Northern Ireland and Wales, the smaller European countries such as the Netherlands, Belgium, Luxembourg, Switzerland and Portugal, and, increasingly, the larger countries of the EU such as Spain, France and Italy which have improved their incentives packages in recent years.

The factors which determine an area's competitiveness in attracting FDI can be classified under the general headings of quantitative factors, which are immediately available to attract FDI, and qualitative factors which will affect long run performance. Among quantitative factors, those which are most instrumental in enticing new investment are probably tax incentives, grants and cost competitiveness. Among the qualitative factors are the general skills of the workforce, the sophistication of physical infrastructure and other characteristics such as the availability of high-quality sub-supply, or research institutes. These qualitative factors are ultimately the main determinants of a country's competitive advantage but are extremely difficult to develop and may be available only in the longer term. Ireland's strategy has been to attract investment by maximising as far as possible the attractiveness of its quantitative factors while implementing a long-term strategy to develop the qualitative factors.

During the earlier stages of industrial development in Ireland, these qualitative factors were extremely weak and Ireland relied on the quantitative factors. Since the 1980s, the situation has changed somewhat and, although the 10 per cent corporation tax probably remains the most important factor in attracting FDI to Ireland, it would seem that the qualitative factors are becoming increasingly important.

Among competitors, Switzerland, the Benelux countries and Singapore have become increasingly tax aggressive in recent years. Ireland's main competitors in the UK rely on extremely competitive packages of grants to new industry, while cost competitiveness, which was once an important selling point for Ireland, is the main attraction of European countries such as Portugal and Greece and emerging economies in Southeast Asia and Eastern Europe.

In an evaluation of Ireland as a location for FDI, Clarke (1994) identified the most important competitors for FDI, the basis of Ireland's and others' competitiveness and the factors which influence the decision of firms on a particular location. Despite Ireland's position on the periphery of the EU, and as a relatively underdeveloped member of the EU, Clarke found that Ireland's main competitors across all sectors were not other peripheral members of the EU, but the more highly developed members, such as the UK in particular, but also France and the Benelux countries. Ireland's main weakness was its peripheral location; but the incentive package offered, in particular, low corporate tax rates, was sufficiently generous to enable Ireland gain a sizeable proportion of FDI in the EU in greenfield projects. However, Clarke found that Ireland's ranking as an attractive location on a global basis for FDI was low. Clarke suggests that Ireland's membership of the EU is an important determining factor. Thus, as the EU expands, this will serve to enhance Ireland's attractiveness, due to the increased size of the market which it can serve, but it will also increase the number of competitors for FDI.

The main competitors within each industrial sector are shown in Table 9.15. The importance of the UK and its regions as a competitor in all sectors is clear from this table. Equally important, when one analyses the basis on which these competitors have formed their strengths, is the incentive package and, in particular, the increasing use of tax breaks or holidays. As far as the CEECs are concerned, Clarke found that only in two of the sectors examined –

TABLE 9.15

Competitors by Industry Sector (in order of importance 1994)

Sector	Competitors
Pharmaceuticals	Puerto Rico (US companies), Singapore, Switzerland, Spain, England/Scotland/France, Netherlands.
Healthcare	Puerto Rico, Singapore, Switzerland/Netherlands, UK/France.
Electronics	Scotland, France, Singapore
Engineering	UK, Hungary, Czechoslovakia, East Germany, Spain, Portugal.
Automotive Components	Czechoslovakia, Hungary, Poland, Turkey, Scotland, Northern Ireland, Wales
Aerospace	France, Wales, Singapore, Netherlands, (Czech Rep. in the future for components).
Consumer Products	UK, Netherlands, France, Luxembourg, Portugal.
Food & Beverages	Northern Ireland, Wales, Netherlands, France
Software	UK, Netherlands, France, Belgium, India, E. Europe (in the future).
International Services	Scotland/UK, Netherlands/Belgium, France.
Financial Services	Luxembourg/Netherlands/Belgium, Switzerland/Channel Islands, various offshore centres.

Sources: Clarke (1994).

engineering, excluding electronics, and automotive components – can they be considered important competitors; although it is likely that the Czech Republic could emerge in the future as a competitor in software production and aerospace components. These results are borne out by information from the IDA, analysed by Clarke, which showed that of nineteen projects lost to Ireland in 1993, twelve went to the UK, four to other EU countries, two to Singapore and one project, in automotive components (totalling fifty jobs) went to the Czech Republic. The CEECs main basis of competition in these sectors is the availability of skilled labour, in engineering, at low cost. However, incentives introduced in recent years by the CEECs have not generally proven very successful, and some have been reversed.

Attracting FDI is becoming increasingly competitive. The main threat for Ireland, in the sectors in which it is hoping to attract new inflows, come not from the emerging economies of Eastern Europe, but rather from the current developed economies of Europe. Countries in mainland Europe have become increasingly aggressive in the use of tax packages and incentives. They have a major advantage over Ireland, some having large domestic markets and all having much closer access to the main markets. These countries pose the greatest threats to Ireland in attracting new FDI. In fact, the provisions and application of EU policy on state aids are issues which need to be addressed at Community and national level as matters of priority.

The main strengths of a country will to a large extent determine the projects attracted. Cost competitiveness, in terms of wage levels, has decreased as a factor of importance in attracting FDI to Ireland, while other factors – such as the availability of infrastructure, workforce skills and an established industrial base – have increased in importance. As shown above, the sectoral breakdown of FDI has changed and sectors such as textiles, clothing and furniture, which attracted flows of FDI during the 1970s have become much less important. In contrast, electronics, pharmaceuticals, healthcare and international services, which rely on the new strengths which Ireland has developed, have accounted for the vast bulk of FDI projects in recent years.

These views correspond with the findings of O'Malley (1986 and 1993). He showed the evolution of FDI in Ireland, where the initially high growth sectors had gone into decline by the mid-

1980s, to be replaced by new sectors. The major threat emerging, however, is that other countries in the EU, with equally developed qualitative factors have now begun offering incentive packages at least as attractive as Ireland. Their lowering of corporate tax rates, and the increase in the value of grants, combined with their closer location to the main centres of demand and a highly developed industrial base, have increasingly won projects for which Ireland competes. The emergence of new low-cost destinations has also increased the competition for world FDI. However, it would be false to suggest that Ireland could compete solely on a cost basis, given the huge divergence in wage costs between Ireland, Southeast Asia and Eastern Europe.

(iii) Assessment of the Competitiveness in FDI of the CEECs

In recent years, industrial development policy has meant that Ireland has increasingly attracted high-tech, high-profit industries such as pharmaceuticals, electronics and software development. The relative loss of previous wage competitiveness and the country's peripheral location, mean that Ireland is progressively less competitive in attracting FDI in a number of sectors which were important in the early years of industrialisation. These would include industries in the engineering sector (such as automotive components), food and beverages and some consumer products such as textiles. The emergence of low cost bases in Eastern Europe, which have locational advantages over Ireland, means that it will be increasingly difficult for Ireland to attract industries in these sectors in the future, while the continued existence of these sectors in Ireland is threatened. However, this is not a new development and, as shown by O'Malley, not only do foreign firms tend to have a life cycle, estimated to be seven years on average, but sectors tend to go through a cycle. It is estimated that the complete industrial base of Ireland in the foreign sector may change every twenty years or so. This process is ongoing and does not depend on the emergence of Eastern Europe. As a result, the type of industry for which Ireland will prove an attractive location in the future will differ substantially from that of the past and the FDI attracted to Eastern Europe will correspond more to the older FDI existing in Ireland, rather than new inflows for which Ireland can now compete. It is estimated, however, that this older FDI may account

for up to 50 per cent of the total stock of FDI in Ireland. This is the main threat posed by the opening up of the CEECs to FDI.

The second area in which the CEECs will prove competitive is in the attraction of certain services firms which depend on low wages. Again, however, many such low-wage sectors have already emerged in Latin America and Asia. Ireland's main advantage in this case would be a head start in the attraction of certain services, its communications infrastructure and English-speaking workforce.

Assessment of the strengths and weaknesses of the CEECs leads the Council to conclude that they will prove most attractive for a particular segment of FDI. The FDI which will be attracted will be that which requires proximity to the major markets, a sufficient supply of low cost labour and an ability to operate without sophisticated backup systems. In many ways, this industry – concentrated in areas such as textiles, heavy engineering, low tech manufactured goods such as furniture and certain service industries – is equivalent to the type of FDI which Ireland attracted up to the 1970s. However, the weaknesses listed above will largely preclude the CEECs from effective competition in the area of information-based industries and high-tech production which rely on the availability of a highly skilled workforce and efficient, sophisticated backup systems. Strengths based on low cost competition will be insufficient to overcome these problems in the short or medium-term.

The loss of existing plants in Ireland is a problem which attracts considerable attention. However, it is debatable to what extent Irish policy can, or even should, attempt to reverse this process. Ireland cannot hope to compete in terms of cost competitiveness in some sectors, or in terms of location, with many centres. As a result, it is essential that its resources are channelled into competing for FDI which does not rely on proximity to markets or a low cost base. Ultimately, it is likely that this type of investment will prove a lot less mobile in the long-run. This is the policy pursued by the development agencies in Ireland and the indications are that, for the foreseeable future, the CEECs will be unable to compete effectively for new inflows in these sectors. However, in order to ensure that Ireland remains competitive with other developed EU countries, ongoing assessment of the incentive packages and strategies will be required. The range of incentives now being offered by the more highly developed countries of the EU has attracted attention

recently, since it greatly restricts the ability of Ireland and other peripheral locations, to overcome their disadvantages. It is obvious that EU policy regarding state aids to industry requires reassessment. This issue is discussed in greater detail in Chapter 6 of the report.

Two further areas of particular concern emerging from this analysis are first, Ireland's extremely heavy reliance on FDI from the US and apparent failure to fully participate in European or Japanese FDI growth, and, second, the failure to develop policies to attract FDI other than new start-up and expansion types of investment. In particular, the huge growth which has occurred in world FDI in investment in joint ventures, particularly in the growth of services FDI, would appear to be a market which Ireland has, to date, failed to fully exploit.

In summary, therefore, while the CEECs will prove competitive and may attract some of the FDI currently located in Ireland, and may, in the future, be competitive in the attraction of some services sectors, the main threats to the FDI in manufacturing which Ireland is targeting will come from the more developed members of the EU. Ireland must try to enhance its competitiveness in these sectors, since attempting to compete with low cost centres in Eastern Europe will ultimately prove futile.

6. CONCLUSION

This chapter assesses the implications for FDI of closer interaction of the economies and societies of Central and Eastern Europe with the EU. FDI plays an important role in the Irish economy. However, the analysis shows that while Ireland remains an important destination for FDI, it is increasingly concentrated in a small number of sectors and increasingly relies on FDI from the US. In fact, Ireland's share of world FDI has been progressively declining. The sectoral pattern of FDI in Ireland has changed substantially in recent years and Ireland increasingly attracts industries which rely on qualitative factors, such as backup services, as opposed to low labour costs. The main strengths of the CEECs, on the other hand, are their low costs and proximity to EU markets, particularly Germany. As a result, the analysis concludes that the CEECs will not be direct competitors for FDI to Ireland in the near future. However, much of the stock of FDI currently in Ireland exists in

sectors which were originally attracted to Ireland as a relatively low cost destination within the EU. It is likely that the CEECs could pose a threat to the continued existence of these industries in Ireland. However, this is an ongoing process and research has shown that the stock of FDI in Ireland has a limited life-span irrespective of developments in Eastern Europe.

This chapter has shown the extent to which the environment within which Ireland competes for FDI has changed and continues to change. The emergence of the CEECs as a destination for FDI further adds to this process. The Council generally supports the overall strategy adopted by the development agencies in the face of this changing environment but emphasises the need to ensure ongoing assessment of strategy and the importance of being capable of adopting a flexible response to new developments. The concentration of Irish FDI in a small number of sectors may be an inevitable result of concentrating on our strengths. The Council supports this strategy but believes this adds further importance to the need to develop new strengths and further integrate the foreign and indigenous sectors. It also means that policies in many areas to further develop our qualitative strengths have an increasingly important role to play in industrial development. The Council is concerned that the gradual erosion of the incentive package differential, which previously existed between Ireland and the more developed members of the EU, continues. Examination of EU state aids, and the application of state aid policy in various countries, requires examination. The Council stresses the need to ensure that this differential is adequate to compensate for the disadvantages under which Ireland competes, while pursuing an overall policy to reduce state aid competition in the EU and the overall level of aid offered to foreign firms.

This chapter has argued that it is unlikely that more than a very small proportion – which will be compensated for by a general increase in the volume of FDI – of the FDI going to the CEECs would have been destined for Ireland under current conditions. FDI inflows to Ireland in coming years will be governed by the success of policies to attract investment and the ability of Ireland to further capitalise on its competitive strengths.

CHAPTER 10

ENLARGEMENT, THE CAP AND COHESION

1. INTRODUCTION

Enlargement of the EU to include the countries of Central and Eastern Europe will be an event unlike previous enlargements of the Union. As a result, the EU is currently faced with some important decisions which will have a major bearing on its future. The importance of the agricultural sectors in the countries of Central and Eastern Europe, and the importance of the CAP to Ireland, means the outcome of any decisions concerning its future will have an effect on Irish economic well being. Similarly, as a major net recipient of EU social, structural and cohesion funds, Ireland has an important national interest in ensuring that the principle of cohesion is reiterated and maintained at EU level. In addition, it is important that strong backing is given to the Community's view that cohesion, far from being in conflict with the integration of the CEEC's, is, in fact, an important mechanism in driving forward the concept of European integration.

Section 2 of this chapter begins by giving a brief overview of the size, structure and recent performance of agriculture in the CEECs. It is shown that despite a large fall in output during the period of transition in the early 1990s, agriculture plays a major part in the economies of these countries and will have an important role in their economic recovery. In general, agriculture accounts for a much larger part of output and employment in the CEECs than in the EU, but is relatively inefficient and is not competitive on world markets.

Section 3 examines the means by which the CEECs could be brought within the CAP and argues that a straightforward extension of its current provisions is neither likely nor desirable. Irrespective of either the timing of enlargement or the conditions negotiated by the CEECs, a number of factors both internal and external will determine that the reform process which the CAP had been undergoing, culminating in the McSharry reforms of 1992, is likely to be continued in the future. Perhaps the most important factor will be the next round of World Trade Negotiations, in which agricultural issues will be to the fore. This section sets out current

thinking in the Commission regarding how these problems could be overcome.

A number of uncertainties exist concerning the extent of the problems which will arise in the area of agriculture as a result of integration of the CEECs and also concerning what outcome will result from WTO negotiations. Section 4 shows that research which does not fully take account of the extent of the reform of the CAP which took place in 1992 exaggerates the budgetary implications of Eastern enlargement. An important point for Ireland is that, where further reforms are necessary, the principle of compensation, established in the McSharry Reform, is fully maintained. This section also examines the arguments put forward for the idea that member states must, in future, bear the costs of financing the CAP. These arguments are rejected and the issue of renationalisation of the CAP is identified as one of major importance as far as Ireland's interests are concerned.

Section 5 outlines the Commission's approach to cohesion in the context of an Eastern enlargement. The principle of promoting cohesion between the countries and regions of the Union is one which may be traced right back to the original Treaty of Rome. Successive enlargements have, to an extent, strengthened the basis of cohesion in the EU, and the Commission has emphasised the importance of the transfer of funds to the CEEC's under its PHARE programme as an aid to prepare them for accession. It is important that the EU-15 accept that there will be costs to be borne as a result of Eastern enlargement. However, it is vital that these costs are not borne disproportionately by the current net recipients of EU structural and cohesion funds. In this respect, Section 6 of this chapter outlines and presents a critique of a line of argument which leads to the conclusion that in order to make an Eastern enlargement politically and economically feasible within the medium-term, the EU must limit the power of the smaller, poorer, member states. Such an argument has obvious implications for Ireland's interests and is strongly refuted. Overall, the chapter concludes that, while Eastern enlargement will involve costs for the EU-15, Ireland should support the Commission in its efforts to bring about the integration of the CEECs in the next decade. However, it is vital that this move strengthens rather than weakens the supranational decision-making institutions of the EU, and that sufficient resources are allocated in the EU budget to facilitate successful integration.

2. AGRICULTURE IN THE CEECS

(i) Size and Structure of the Sector

Natural and geographical features mean that the countries of Central and Eastern Europe possess considerable potential for the production of agricultural products. Economic and social disruption during the transition period have resulted in a dramatic fall in output and the net importation of many agricultural and food items, but recovery will mean that they will once again become self-sufficient in many food items. The longer-term forecast is that they will be capable of producing surpluses across a broad range of agricultural products in the next century. However, a number of severe upstream and downstream constraints are operating at present to ensure that, even in areas where the CEECs possess considerable advantages, production remains inefficient and food processing, beyond the supply of basic products, is under-developed.

The agricultural resources of the CEEC-6 and the EU-15 in 1993 are compared in Table 10.1. It should be noted that 1993 represents a period in which the decline in output associated with transition from Communist to market-led economic systems in the CEECs had taken place, but recovery had not yet begun. As a result, employment in agriculture had risen somewhat while output throughout the economy had fallen. The table shows that the total area of the CEECs amounts to 27 per cent of the current EU area. When Slovenia and the three Baltic states are included, this share rises to one third. In general, the arable area in the CEECs represents a considerably higher proportion of the total area than in the EU. The arable area of the CEEC-6 represents 47 per cent of total arable land currently in the EU. When Slovenia and the Baltic states are included this rises to over 55 per cent. The potential for the CEECs to become net exporters of agricultural products is obvious when one compares the arable area per head of population available in the CEECs, with that in the EU. The table shows that arable area per capita in the CEEC-6 is 80 per cent greater than that available in the EU. This underlines the extent of the productivity gap which exists in agriculture between the EU and the CEECs, and also the potential for increased volume which exists, if supply constraints and structural inefficiencies can be overcome.

In general, agriculture plays a much more important role in the economies of the CEECs than in the EU. Its output as a share of

TABLE 10.1

Comparison of Agriculture in the EU and CEECs (1993)

	Poland	Czech Rep.	Slovakia	Hungary	Bulgaria	Romania	EU	CEEC/EU
Total area (millions hectares)	31.3	7.9	4.9	9.3	11.1	23.8	323.4	0.27
Arable area (% of total)	37.0	31.0	28.0	46.0	48.0	41.0	21.0	0.47
% share of agriculture in GDP	6.8	4.2	5.9	8.5	9.2	23.7	2.8	n.a.
Arable area per capita (hectares)	0.37	0.31	0.28	0.46	0.48	0.42	0.21	1.8
% share of agriculture in employment	25.2	6.5	8.6	9.9	17.4	32.2	5.8	n.a.
Number employed in agriculture (1000)	3700	724	n.a.	517	485	2053	8353	0.90
Arable area per person employed (hectares)	3.9	4.4	n.a.	9.1	8.2	4.5	9.2	0.53

Sources: Buckwell *et al* (1994) and European Commission.

GDP in the EU-15 stands at 2.8 per cent, but is considerably higher in all the CEECs, although it is possible that these figures are somewhat inflated, especially in the case of Romania, given the general economic collapse which occurred in the early 1990s in these countries. This importance, and also the relative inefficiency of agriculture in the CEECs, is also borne out by its large share of employment. Of particular note is the very high figure for Poland at over 25 per cent. This is important given the relative size of Poland (it accounts for approximately 35 per cent of total population in the CEECs). The agricultural sector obviously represents an enormous pool of under-employed labour in Poland and, given its proximity to Germany plus cultural and linguistic linkages, (especially in the Eastern regions of Poland), it could represent a source of relatively low cost labour in future years which could be accessed either through investment in Poland or by migration to the West. In the immediate future, however, the importance of the agricultural sector in the CEECs may be seen from the fact that the numbers employed in agriculture are equal to 90 per cent of total agricultural employment in the EU. As a result, agriculture is relatively labour intensive in the CEECs and the arable area per person employed is only just over 50 per cent of the area available in the EU. There are thus important differences in the structure of inputs in the agricultural sectors of the two regions.

(ii) Agricultural Performance During Transition

Table 10.2 shows that total output in the CEEC in 1993 remained a sizeable proportion of EU output in most broad agricultural categories. Given that productivity levels are well below those achieved in the EU, and that costs are perhaps 50 per cent of those in the EU, it appears likely that potential output is well in excess of these figures.

The early 1990s saw a major fall in the output of the agricultural sector in the CEECs. The main cause of this was the impact of the transition process, in which subsidies were cut, markets disappeared and producers experienced a large terms of trade decline. There were also problems, which still persist, with the allocation of resources and access to credit along with difficulties concerning the security of tenure, even where privatisation has officially taken place.

TABLE 10.2

Agricultural Output in the CEECs in 1993
(As % of EU Output)

Milk	22.3
Beef/Veal	14.9
Pigmeat	30.5
Coarse Grain	44.5
Wheat	29.3

Source: European Commission.

There are some important structural differences between these countries. Agriculture was collectivised in most countries under the Communist regimes but private ownership continued to varying degrees. The most notable examples are Poland and Slovenia, where small private holdings form a substantial proportion of total arable land.

A major objective during the transition period has been to decollectivise agriculture and re-establish private ownership. Experience has differed between countries and some systems have resulted in considerably more fragmented ownership structures than others. However, the dualistic character of ownership which previously existed, where land was generally owned either in very large collective farms or very small individual plots, is gradually being reformed. This ownership structure is a major source of inefficient production and has, along with problems concerning property rights, prohibited the emergence of functioning land markets in many CEECs.

The fall in agricultural output in the CEECs has contributed to the deterioration in their trade balance with the EU. This situation has been exacerbated by the loss of other markets within the CMEA, competition from subsidised EU exports, strong demand for value-added imports within the CEECs and some difficulties which have emerged with agreements made with the EU. The extent of the decline which took place in the early 1990s is evident from Table 10.3, with clear evidence that the situation improved for most countries after 1993.

TABLE 10.3

CEEC Agricultural Output
(Total Percentage Change)

	1990-93	1994
Poland	-13.3	13.0[1]
Czech Republic	-21.7	4.0[1]
Slovakia	-28.3	-7.0
Hungary	-34.5	2.0
Bulgaria	-34.0	10.8
Romania	-2.4	4.9

Note: (1) 1995 figure.

Source: OECD and European Commission.

Agriculture has performed better than many other sectors in the economies of the CEECs and it is likely that recovery will be most rapid in the agricultural sector. As a result, self-sufficiency in many basic food products is likely in the near future. There are reasons to believe that this will be achieved, not by the application of high price supports in these countries, but by attempting to overcome the constraints on production which currently exist. This approach will underlie the pre-accession strategy of the EU.

Some of the CEECs have reversed previous policy and reintroduced measures to stabilise the agricultural sector. These have taken various forms, with some elements of a CAP-like structure emerging. For the future, however, the major objectives for these countries, along with correcting the property rights issue, must to be attempt to eliminate the considerable downstream inefficiencies which exist. These mean that although prices paid to producers are relatively low, the high costs of handling, processing and transporting products mean that the CEEC's outputs, wherever a surplus may exist, are not competitive on world markets. In the medium-term, achieving a more competitive agricultural sector will mean that much better quality output must be produced and international standards, in particular, the disease control measures required in the EU, must be adopted. It is important to remember

that, while containing considerable potential and despite low costs, these problems mean that agriculture and agricultural products from the CEECs are not yet competitive on world markets.

(iii) EU-CEEC Trade in Agriculture

The Europe Agreements contained clauses aimed at liberalising and promoting trade in agricultural products between the EU and the CEECs. As with most other products, import quotas were scheduled to increase progressively each year while tariffs and levies would be reduced. In some respects, the provisions negotiated were less liberal than in manufactured products, due to many agricultural products being considered sensitive products by the EU. The surprising result, however, has been that the CEECs have failed to fill quotas in many cases, the exceptions being dairy products and live animals.

A number of reasons have been put forward to explain this outcome. The severe decline in production has meant that quotas based on previous export potential very often could not be filled. Where supplies were available, they have not always met the required quality and health standards of the EU. As a result, markets have been difficult to find. It has also been claimed that the ability of CEEC producers to market their products in the EU is further weakened by the dominance of West European countries in distribution and marketing. The existence of complex regulations and controls has further inhibited the development of markets. There are also doubts concerning the appropriateness of the measures contained in the Europe Agreements. These were based on trade patterns in the previous regimes in the CEECs which did not necessarily reflect the comparative advantage of their agricultural sectors. As a result, it is now realised that merely increasing these quotas proportionately over time will not necessarily aid the development of strong export sectors in the CEECs. Some recent measures have been proposed by the Commission to further liberalise agricultural trade and overcome some of the problems emerging as a result of the Europe Agreements.

It can be claimed, with some validity, that unilateral liberalisation of the import regime by the EU may be insufficient to develop CEEC export sectors. It is notable that agricultural trade *between* the

CEECs accounts for only a small proportion of their total imports and exports of agricultural products. This is, in part, the result of trade barriers, but also an indication of the extent to which output is concentrated in basic undifferentiated products. The development of agricultural trade between CEEC markets may be a route to developing their ability to trade internationally in agricultural products. Currently, CEEC exports are poorly differentiated with a general absence of processed value-added food products. The elimination of any trade barriers which exist between the CEECs would allow the development of regional specialisation and comparative advantage and enable the CEECs exploit economies of scale. Until such developments take place, the penetration of CEEC agricultural products into EU markets is likely to remain limited.

3. INTEGRATION WITH THE EU

(i) The Cost of Extending the CAP

The 1992 McSharry reforms and subsequent Uruguay Round Agreement (URA) have provided a period of relative stability in the CAP. Even so, changes have been implemented in the past year in the beef regime to restore balance to this market following the impact of the BSE scare. In addition, further proposals are expected during 1997 in both the beef and dairy industries. The current period is but one stage of an ongoing process of reform. A number of factors lead to this conclusion. First, the next round of world trade negotiations are scheduled to begin before the end of the decade. Previous experience would certainly indicate that these talks will attempt to progress towards further reform and liberalisation of the world trade regime in agricultural products. These negotiations are thus likely to further inhibit the EU's ability to provide export subsidies and import restrictions to maintain agricultural prices above the world levels. Second, internal pressures for reform, while temporarily in abeyance, have not been fully diffused. For its critics, the existing budgetary costs of the CAP, practices such as land set aside, higher than world-market consumer prices, and the perceived failure of the CAP to support broadly based rural development, mean that further reforms are required. The possible re-emergence of surpluses in certain commodities as productivity continues to grow in the EU-15 will ensure that these demands increasingly put pressure on the CAP. Third, the commitment to eventual integration

of the CEECs increases the probability that the CAP will be reformed in advance of enlargement to avoid the need to compensate CEEC producers for reforms after enlargement. Finally, there have been indications from a number of the prospective new members that they do not wish the CAP in its current form to be extended. Although it would entail substantial transfers of money from the current EU-15, it would also involve significant price rises in the CEECs. Given that a much higher proportion of income in the CEECs is spent on food, these price rises would be likely to be politically upsetting and unacceptable. The general agreement appears to be that such transfers as may be required should be enacted by other means, to avoid price rises and to target funds towards overcoming the constraints which may be inhibiting improvement in productivity and competitiveness in the agricultural sectors of the CEECs. These pressures mean that detailed consideration of the next round of CAP reform will soon begin.

Factors Affecting the Cost of Extending the CAP

There are three distinct factors which will impact on the cost of extending the CAP to the CEECs. These are the timing of such a move, the conditions of accession which will determine the structure of the CAP and the volume and structure of output of the agricultural sectors of the CEECs, including the response of output to the CAP after enlargement. These factors are inter-related and, while subject to a number of uncontrollable variables, the EU itself will have a substantial input into determining the outcome of each factor. For example, while the provisions of the CAP will, to an extent, be determined by WTO negotiations and world conditions, it is also a factor over which the EU will have considerable influence. The EU can also have a major impact on the structure and output of CEEC agriculture, both through the provisions of the CAP and through its pre-accession strategy. Finally, the EU will have a major say in the timing of Eastern enlargement. However, it is probable that enlargement will take place in response to a very wide range of factors including, for example, the situation in Russia and political developments in EU countries themselves, with agricultural considerations possibly playing no more than a minor role.

Obviously, the timing of accession will impact on the cost burden of extending the CAP, in terms of both the date of accession and the state of development of agriculture in the CEECs at that time. Some

authors, for example Baldwin (1994), have reversed this argument, and attempt to estimate the timing of enlargement on the basis that it will not occur until the cost of doing so is reduced to a level acceptable to current EU members. However, it may be more rational to accept that political factors – such as the desire of Germany to secure its Eastern borders and the Eastern borders of the EU, and the desire of the UK to expand rather than deepen the EU – will determine the pace and timing of enlargement.

Estimates of the Cost of Extending the CAP

Some estimates have appeared in recent years concerning the cost of extending the current provisions of the CAP to the CEECs, assuming that they all join in the year 2000 with no transition periods. As argued below, and elsewhere in this report, a model such as this, which views the totality of EU relationships with the CEECs as a straight forward division between membership and non-membership, ignores many of the possible relationships which are likely to evolve. In addition, it ignores the probability that alterations in the provisions of the CAP are likely before accession takes place. This research has generally concluded that an Eastern extension of the CAP would be very costly. In its research, the Commission have assumed that prices of agricultural produce in the CEECs would align to EU levels in the first five years after enlargement. Increases in supply would be likely to occur while demand would be reduced somewhat, leading to increased CEEC net exports for the main agricultural commodities. The Commission concluded that, even with the application of current quotas and set-a-side rules, significant surpluses would arise in most cereals, dairy and meat products. They concluded that this will place considerable strain on the EU budget, with an additional cost of around ECU 12 billion per year, compared to a projected expenditure under the CAP of ECU 42 billion per year for the EU-15 within ten years of enlargement.

A number of other researchers have published estimates of the cost of inclusion of the CEECs in the CAP. In general, these appear to have assumed a much more rapid supply response to price increases by producers in the CEECs. On this point, the Commission was relatively cautious, believing that it would take a considerable period of time for upstream and downstream constraints to be overcome. Some of this research is reviewed in Buckwell *et al*

1994) and indicates that the cost of extending the CAP to the CEECs-6 would vary between 5 and 42 billion ECU per annum, depending on the extent of the supply response assumed. Obviously, costs towards the upper end of this range would place a great strain on the EU budget and have led some to the conclusion that either Eastern enlargement must be postponed for a considerable period, such as at least two decades (Baldwin 1994) or, more commonly, that the CAP must undergo considerable reform before enlargement to the East can be considered.

The validity of this conclusion is challenged below, since it appears to assume an approximately fixed budget for the CAP, with the result that extra expenditure in the East must be paid for by a reduction of expenditure on agriculture in the EU-15. In other words, it does not accept the fact that the EU must provide the necessary resources to achieve stated objectives. The basis of the argument, that Eastern enlargement would be extremely costly in a short period after enlargement, may be challenged. The EU will probably implement transition periods for the CEECs, which will tend to control the impact on the budget. In addition, the calculation on which this outcome is based has been challenged. Matthews (1995) concludes that as a result of the 1992 reforms, buoyant growth in world food markets and adjustments to comply with GATT commitments, EU expenditure on agriculture will be comfortably within guidelines by the end of the decade. In fact, his application of a FEOGA budget forecasting model predicts that there could be substantial resources available within the agricultural guideline by the year 2005 to fund an Eastern extension of the CAP. He concludes that, unlike previous CAP reforms, the prospect of budgetary difficulties is not an argument in favour of reforming the CAP in advance of enlargement to the East. Instead, pressures arising from WTO negotiations and internal lobbies in the EU provide a much stronger rationale for future reforms. Although the expenditures incurred as a result of the BSE would alter these budgetary calculations somewhat, it is probable that the conclusion reached by Matthews remains valid.

Options Facing the EU

Apart from specific reforms of the CAP – which may take place in response to pressures from negotiation of a new world trade agreement, or internal pressures arising out of the cost or perceived

failures of the CAP – a number of options which have been put forward concerning the EU agricultural policy to be extended to the CEECs. In practice, however, the final proposals will not be derived from one model, but will draw on a number of different approaches.

Admitting the CEECs to the EU, either individually or as a group, but not extending the CAP has the advantage that it allows for a rapid and relatively inexpensive enlargement with no direct price effects. However, this implies membership of the Community without acceptance of the *acquis* which would be an important divergence from precedent. It would also be an important step towards the creation of an *a la carte* Europe, which the Commission, and probably a majority of members, would wish to restrict.

The creation of a modified or alternative form of the CAP which would be extended to new members on a permanent basis has the advantage of reducing the budgetary impact of enlargement, without the need for major reform of the CAP. The main problem is that this implies the creation of an extreme form of a two tier Europe. In effect, the CAP would be designed to keep the agricultural sectors of one region of the Community under-developed to ensure budgetary costs are minimised. Such a policy is obviously in contrast to the cohesion principles of the EU and does not appear either viable or desirable for the Community.

Adopting a step-by-step approach to Eastern enlargement, whereby countries become members at different times, would restrict the immediate budgetary impact, while not discriminating between current members. Under this option, the CAP in its entirety would be extended to countries, such as the Czech Republic and perhaps Slovenia, which would not place great strains on the EU budget. Enlargement, if determined solely by the goal of reducing the cost on the CAP, would then gradually progress over the years, probably in the order Hungary, Slovakia, Bulgaria, Poland and Romania. The main problem with this is that Poland is a very large agricultural country and would be well down the list of applicants. This may be politically unacceptable, in particular to Germany. As a result, enlargement may take place on a step-by-step basis, although not necessarily in the order which would minimise the budgetary impact on the CAP.

One possible option which may be open to the EU would be to

design and negotiate transition periods with the CEECs. These have been used before by the EU, most notably in the case of Spain, where a ten-year period of transition, ending in 1996, was implemented. This option is attractive since it introduces a substantial degree of flexibility, allowing the EU to avail of the advantages of the approaches above, while avoiding the disadvantages. For example, it could allow the EU to differentiate between various countries, since the order in which they join will not necessarily be the order in which they adjust to the CAP, this being extended in whatever is deemed the optimal manner. This approach would also allow the EU to design the provisions of the CAP, but in an explicit and temporary framework, to promote, rather than restrict, development. The downside of this proposal is that a transition period would require the maintenance of trade barriers just for agricultural trade. This runs counter to the principle of the single market and was the main reason transition periods were not used in the Nordic enlargement. A restricted mechanism could be used, whereby common prices prevail from the date of accession but direct supports are phased in over a longer period. It would appear that step-by-step enlargement with some form of transition period will be required.

Thus, the CEECs will probably be admitted as full members of the EU and within the CAP. There may be some elements of the step-by-step approach and it is very likely that accession pressures will be eased by using a transition period. However, the introduction of this flexibility does not show the whole picture since the CAP they will accommodate to will itself be changed. Thus, the most important topic will not be, when they join, or specific derogations which may be negotiated, but the reforms which will have occurred to the CAP prior to their accession. These will occur in response to a range of issues, including the prospect of integration of the CEECs.

(ii) The Commission's Analysis of Future Developments

The Commission's thinking on the future of the CAP was outlined in a discussion document presented to the Madrid meeting of the European Council. This document, presented by Agriculture Commissioner Fischler, shows that the Commission views the impending Eastern enlargement as an important factor shaping the CAP, but as only one element among a number which will determine the path of future reform. It views the 1992 McSharry

reforms as having been reasonably successful in adapting the CAP to changes which had occurred, but as insufficient to accommodate changes which will take place in the future. The Commission is faced with three possible options:

(i) Preserving the status quo;

(ii) Radical reform of the CAP,

(iii) Further development of the approach taken in the 1992 reform.

The first two of these it forcefully rejects. While trying to maintain the status quo might be feasible for a number of years, and appealing due to the stability it implies, the Commission argues that this policy would make it difficult to meet WTO commitments and would place strains on the EU budget, while inhibiting the competitive development of EU agriculture to meet growing world markets. Even without enlargement, these problems would be likely to emerge and, as a result, reform of the CAP should not be seen as a consequence of the wish to expand the EU. Ultimately, the strains would impose a major reform of the CAP on an unwilling Community. The resulting compensation payments would then need to be applied to all farmers in the new expanded union. Thus, the Commission argues, there is an undeniable rationale for the sequence, that CAP reform must take place prior to enlargement.

The case for radical reform of the CAP has generally been based on claims, principally but not exclusively from economists, that in its current form it is inefficient, distortionary, bureaucratic and inappropriate for either the development of agriculture in the EU-15 or integration of the CEECs. Radical reform would imply a move towards a free market for agriculture, with time limits being placed on compensatory payments. In addition, simplification of the policy would require a much reduced role for centralised administration with a correspondingly increased role for national governments. The Commission rejects this option, due to the high risks involved, in terms of social and environmental damage, and the fact that in the early years, compensation would imply a huge increase in Community expenditure. Serious problems are also likely to arise concerning the impact of this policy on cohesion within the existing EU.

The third option, to develop the approach set out in the McSharry reforms, is favoured by the Commission. It suggests that improving

competitiveness will involve the reduction of price supports and the need for export subsidies, with compensation wherever necessary. It further suggests that these compensatory payments could, in time, be linked to specific objectives, such as the achievement of objectives under environmental or rural development policies of the Community. These payments would involve cross compliance requirements. Arguments concerning the sustainability of current agricultural policy have been invoked in this respect, apparently accepting the premise that the promotion of agricultural economic activity appears to have dominated environmental preservation and the achievement of rural social objectives. This suggestion, if it led to a change in policy, would basically mean that farmers would be paid to a lesser extent for agricultural output and, to a greater extent, to achieve these other objectives. The document also argues that achieving simplification of the CAP will require a much clearer distinction between market policy and income support.

The document is concerned with enhancing the subsidiarity of the CAP. It suggests that greater subsidiarity in the CAP means delegating more responsibility and freedom to member states in the implementation of EU legislation, while also promoting more responsibility at the national level, particularly as regards joint funding of the CAP. It is claimed that this will lead to a more adaptable and relevant CAP and also the adoption of more stable five year policy frameworks. Thus, three themes can be discerned in the Commission's approach to CAP reform:

(i) Movement towards a freer market in agricultural produce;

(ii) The integration of agricultural policy with rural, social and environmental policy in the EU;

(iii) The achievement of greater subsidiarity in the field of agricultural policy.

Two further points are worth noting. First, it is becoming clear that the Commission believes that the policies which may need to be adopted to meet current and future WTO commitments of the EU would also reduce the impact of Eastern enlargement on the EU budget, while not overly inhibiting the development of agriculture in those countries. This is a coincidence which the Commission will hope to exploit. The second point is that considerable uncertainty exists concerning the impact on commodity balances, farm incomes, the food industry and the budget of CAP reforms which

fully decouple payments from production and aim to integrate agricultural policy with other objectives such as the environment and rural development.

(iii) The Commission's Pre-Accession Strategy

The Commission has outlined a course of reform which it believes will minimise the budgetary impact of inclusion of the CEEC within the CAP. However, this, in itself, is an inadequate approach since it is likely the agricultural sectors of the CEECs would remain under-developed at the time of accession. As a result, the Commission is proposing to implement a series of measures to upgrade and develop agriculture and agricultural competitiveness in these countries in advance of accession to the EU.

The objectives which have been envisaged for a pre-accession strategy are therefore not only to implement reforms of the CAP to meet the EU's GATT commitments, since these may also reduce the costs of an extension to the CEECs, but also to implement policies to ensure the agricultural sectors in the CEECs develop and achieve competitiveness, thus helping to avoid the existence of a large under-developed region of the Community following accession.

Apart from the costs of following such a strategy, there are two further problems. The first arises from the uncertainty introduced by the prospect of reform of the CAP. In the implementation of their own agricultural development policies, the CEECs are attempting to align with what is, in effect, a moving target. Second, the strategy must be designed to avoid the CEECs having problems absorbing any funds supplied by the EU, either before or after accession, and to avoid the creation of income disparities between sectors within the CEECs.

In the period before accession, economic recovery in the CEECs will probably result in rising incomes and prices for food in these countries. At the same time, the 1992, and any further, reform of the CAP will mean that EU prices will be moving down towards world market levels. This convergence will be less obvious in some sectors, in particular, beef and dairy. The provisions of the CAP mean that prices are substantially above world prices in these sectors. The extent of reform required to bring about a movement to world levels would be likely to lead to strong opposition so as to make it politically unacceptable. In fact, Keane and Collins (1995)

found that, in the Irish dairy sector, losses as a result of tightened quotas would be offset by the higher prices which would result. However, any tightening of quotas would further inhibit the ability of EU dairy products to compete in a liberalised world food market, in the longer term.

It is likely, however, that EU prices will still remain above those in the CEECs in most sectors. As a result, there is no rationale for providing compensatory payments to CEECs farmers following accession, since they will not be subjected to price cuts. This will allow the EU a certain flexibility in the use of funds it provides. During a transition period it is envisaged that EU funds could be used to overcome structural and infrastructural problems in the CEECs to allow agriculture to develop its potential. It is proposed that the PHARE programme, discussed below, and schemes under the Association Agreements, should be fully utilised to meet this objective.

Some of the CEECs have implemented CAP-like policies to stabilise the agricultural sectors in their countries. Price supports may have some role to play, but the EU will attempt to ensure that these are limited. Instead, the CEECs will be encouraged to open their markets to each other to develop export potential. At the same time, measures to provide EU market access under the Europe Agreements will be accelerated, with the further reduction of tariffs, raising of quotas and introduction of transferable quotas. It has been claimed that EU subsidised exports to the CEECs are damaging market prospects within those countries. However, it is likely that the CEECs are deriving considerable benefits from these cheap sources of food, while the withdrawal of subsidies by the EU would cause world prices to rise and leave the market open for other countries to exploit. In addition, a role exists for the EU in the provision of information, training and expertise. It may also help promote the restructuring of farm ownership in the CEECs, aid the privatisation process and improve the capitalisation of agriculture.

The pre-accession modernisation programme will require a full integration of foreign development and regional development programmes with the possibility of LEADER-type intervention. Along with the aim of increasing the general competitiveness and marketability of CEEC produce, a number of more specific objectives may also be laid out. These will include measures to achieve environmental and social objectives in rural areas, to encourage higher standards and quality in food products, increase diversification of farm produce and importantly, to tighten up on and initiate projects aimed at disease control in the CEECs. In many ways, the proposed EU strategy may be somewhat similar to what the CAP will look like a decade from now, but without the compensatory payments or income and price supports. It is the Commission's aim that, as a result of this dual approach of internal reform of the CAP and improving competitiveness in CEEC agriculture, the costs of accession on the EU budget and impact on the CEECs will be minimised.

4. IMPLICATIONS FOR IRELAND

(i) Current CAP Transfers in the EU

The Common Agricultural Policy is the largest single item of expenditure in the EU budget. That this remains so is in part testimony to the success of the policy in achieving the aims as originally set out and the failure to develop similar programmes of centralised expenditure in other sectors. Not only has it ensured stable food supplies, but the EU is now capable of producing large surpluses. In addition, it performs an important redistributive role, transferring resources to rural residents and, since the poorer members of the EU are generally the least urbanised countries, the CAP performs a role in improving cohesion within the EU. This, in itself, is not a total endorsement of the policy, not only because of the tensions with multilateral trade liberalisation outlined above, but also because the CAP may be an inefficient way to achieve these aims, in addition to containing some important deficiencies.

The economic effect and financial flows which result from the CAP in its immediate post-1992 form, as calculated by the Ministry of Agriculture, Fisheries and Food (MAFF) in the UK, are shown in Table 10.4.[1] A number of points are worth noting. First, the figures for net transfers represent actual flows from the EU to individual countries. As such, the validity of presenting the figures in this form is not open to question. The calculation of the income effects is less straight forward. The two main components here are the gains made by producers and the losses incurred by consumers as a result of

1 The methodology used by the MAFF has been questioned. As a result, the results obtained, and conclusions drawn, may not be definitive.

TABLE 10.4

Net Transfers Under the CAP in 1993 (million ECU)

	B/Lux	Den.	F.	Ger.	Gr.	Irl.	It.	N.	Por.	Sp.	UK	EU12
Net transfer	-14	906	2738	-5404	2153	1788	-2423	715	-326	1207	-1438	-98
as % of GDP	0	0.8	0.3	-0.3	2.8	4.4	-0.3	0.3	-0.5	0.3	-0.2	0
Income Effect	-1153	643	1333	-10783	1226	1701	-3555	-646	-1006	-538	-6110	-18862
as % of GDP	-0.6	0.6	0.1	-0.7	1.6	4.2	-0.4	-0.2	-1.4	-0.1	-0.8	-0.3

Source: Extract from MAFF (1995) Annex II.

higher prices for farm produce. The figures are calculated against the level of incomes and prices if a free market in agricultural produce existed in the EU. The problem is that this is a hypothetical situation and it cannot be claimed that the income effects are simply as a result of the existence of the Common Agricultural Policy and would be removed by the elimination of that policy.

The second point of note is that, for most countries, transfers under the CAP are a relatively small, if not insignificant, part of GDP. Income effects, on the other hand, are generally larger and tend to be more negative. It is this growing perception, that the Common Agricultural Policy represents an inefficient means to transfer resources between sectors within countries, rather than between countries, which has increased the pressure for reform. It is noticeable, however, that the often cited criticism of the CAP, that it is an anti-competitiveness policy, which is inhibiting growth in the EU, may be overly exaggerated, since the income effects at EU level amount to only 0.3 per cent of GDP.

The third point of note is that the CAP continues to be generally pro-cohesion within the EU. There are a number of exceptions, for example, Portugal, which is a poorer member, is a net contributor, while France and Denmark are net recipients. In the latter two cases, however, due to regional income disparities within these countries, the actual recipients may not be high income residents. It is important to ensure that any reform of the CAP which takes place enhances its role as a force towards cohesion.

The final and most important point of note is the huge importance of the CAP to the Irish economy, compared to all other member countries. In almost all other cases, net transfers as a result of the CAP amount to less than half of one per cent of GDP, while only for Greece and Portugal do the income effects amounts to over one per cent. The situation in Ireland is very different, with transfers amounting to 4.4 per cent of GDP and the income effect, despite consumer losses (as in all other countries), amounting to 4.2 per cent of GDP. When one includes the fact that GNP is substantially less than GDP in Ireland, and is thus a more legitimate measure of national income, Ireland is recognised as even more of an outlier. The result is that reforms of the CAP which will have a marginal effect on GDP in most countries, may be of crucial importance to the Irish economy. On the other hand, the relative unimportance of CAP transfers to the economies of most countries means that

pressures for reform, especially those which are related to World Trade Agreements, will be increasingly difficult for national governments to resist.

Irish agriculture's dependence on subsidised non-EU market sales illustrates the cost of peripherality in agriculture and the problems which would be faced in attempting to find new markets should export subsidies be reduced. The extent to which Ireland relies on subsidised exports suggests that Irish agriculture remains vulnerable to cuts in supports. The small size of Irish farms, with approximately 60 per cent considered small or moderately small, means that greater efficiency is difficult to achieve. This difficult size structure is further compounded by an ageing population in the farming community in many areas, with younger age groups unable to produce due to quota restrictions. This is most obvious in the dairy sector where up to half the number of producers may be operating on only 22 per cent of the quota.

Irish agriculture is thus caught in a difficult position. While the provisions of the CAP have maintained incomes in many sectors, they are inadequate or inappropriate to overcome many of problems which exist. Further reform of the CAP, even if it protects incomes, may be inadequate to fully compensate for the structural problems which are allowed to persist and the costs of any adjustment required to avail of new provisions.

(ii) Irish Interests

On the basis of Section 3, it seems likely that some reform of the CAP is likely to occur to accommodate WTO commitments and facilitate enlargement to the East. Ireland should seek to influence the direction of reform to ensure that it is undertaken by measures which preserve the role of the CAP in protecting farm incomes. The principle of compensatory payments has now been established, but the future value of such payments will require negotiation. With recognition of the structural and geographical problems which face Irish farming, it is important that funds concentrate on overcoming structural and peripherality problems. The age and ownership profiles in Ireland mean that the Common Agricultural Policy should take account of costs arising as a result of the structural adjustments required in response to reforms in the CAP. It is particularly important that sufficient new investment is

forthcoming. However, it is essential that new investment is appropriate to the improved efficiency and competitiveness of the farming sector.

The Commission have set out in broad outline their approach to dealing with future developments. However, considerable uncertainty exists in regard to many of these issues. While it is known that there will be efforts towards the end of this decade to conclude a new round of WTO negotiations, which will focus on agricultural issues along the lines of the Uruguay Round Agreement – involving progressively less support for agriculture – and while the commitment to Eastern enlargement is beyond doubt, there are many uncertainties attendant upon these events. The Uruguay Round showed that World Trade Negotiations can be long, protracted and complicated, with compromise solutions often emerging in unforeseen areas. It has also become clear that CAP reforms, as a result of the Uruguay Round, have been substantial in effect and have relieved many of the pressures on the CAP which led to reforms in previous decades. It is important not to prejudge either the timing, the outcome or the necessary concessions to win agreement of the next round. Similarly, as shown above, Eastern enlargement is not going to entail a straightforward extension of the EU and the CAP simultaneously to all the CEECs. Many permutations are possible and there are good grounds for concluding that projections of the cost of Eastern enlargement, based on a rapid extension of the CAP, are not a good basis upon which to form policies. The Council believes Ireland should continue to adopt the position that the EU should reform the CAP along the lines which will provide the optimal outcome for European and Irish agriculture. This means ensuring that the pace of change is not excessive and should be such as to allow the structural change, which is required, to take place. It must also maintain the principle of compensation which has been established and ensure that the common financing of the CAP is not undermined.

Irrespective of the actual timing of enlargement to the East, it should be a clear objective of the Irish approach to negotiations that the EU member states will provide the necessary financial resources to achieve this objective. Previous enlargements have often coincided with a new impetus to European integration. Failure to adequately finance the integration of the CEECs would inhibit rather than advance the further development of the EU.

proposed for EU farmers in the future, particularly to the extent that the competitiveness of EU agriculture may be hindered by the requirement to achieve a number of objectives such as enhancement of the environment. Furthermore, issues such as the legal use in US agriculture of artificial growth promoters in beef production and BST in milk production, and the banning of the same products in the EU, must be taken into account in the WTO negotiations.

One central theme running through this is that it is important that the common element of agricultural policy in the EU is protected, while accepting that the policy needs to be adapted to specific local needs and problems. However, there are indications, as discussed in the next section, that this commonality will come under increasing threat in the future.

Renationalisation

Table 10.4 above showed that, for most countries in the EU, the introduction of co-financing by national governments, as a means to reduce the burden of the CAP on the EU central budget, would have only small, and in some cases positive, effects on their economies. As a result, this is an idea which is likely to gain some support and only moderate opposition from some EU member states.

Two main arguments have been used in favour of some renationalisation of the CAP. The first arises out of the reforms which have been undertaken, and which are likely to be further developed in the next decade. The general trend, as identified above, is to move away from price supports towards direct income supplements, in as far as possible unrelated to current levels of production. It is claimed that there is less rationale for decoupled payments to remain centralised. Fully decoupled payments and the total removal of price supports would mean that the CAP consisted almost entirely of a transfer of resources between different sectors. In almost all other circumstances, this is a role which is undertaken at state level.

The second argument arises out of the increasing diversity of the Community and resulting complexity of the CAP. It is argued that, in order to improve efficiency and comprehension of the CAP, more flexibility is required, along with the delegation of more authority to

suggested this route towards simplifying the CAP and there are indications that the granting of additional authority to the member states, to design the CAP according to local or national needs, could add extra weight to arguments which favour a role for co-financing.

> Taking into account the degree of complexity the CAP system has reached over time, and bearing in mind the considerable diversity of regional situations and problems which characterises the Union, there is a strong case for a radical simplification of what is done at the EU level, and to close the gap of understanding which exists between the CAP and the citizen. This will probably imply that more latitude would have to be conceded to Member States and/or regional authorities. (Agricultural Strategy Paper presented to Madrid Council, December 1995).

The Commission then suggests that

> More freedom to Member States when it comes to the implementation of EU legislation (in particular, in the field of accompanying policies) should also imply more joint responsibility (*ibid*).

Without wishing to suggest that this means a definite move towards a weakening of central funding of the CAP, it does indicate that this issue is likely to continue to figure in future discussions concerning the budgetary impact of the CAP.

The principal argument against renationalisation of financing the CAP is that this would conflict with cohesion objectives in the EU. The two major beneficiaries, in terms of the impact on GDP, Greece and Ireland, are also among the poorer members of the EU while Spain, which also receives substantial transfers, is another poor member. On the other hand, the main financing countries, Germany, Italy and the UK, are among the larger, richer countries. As stated earlier, even among those apparently rich countries which are net recipients, most notably France and Denmark, the CAP performs an important inter-regional transfer role. The Commission accepts that this move would have important cohesion reversing implications and thus would need to be fully compensated. However, it is unclear over what time period this compensation would be extended.

The second argument against this development contests the idea that

remove any role for a centralised administration. The clearest argument here cites the proposal that, in future, direct payments to farmers will be related, not to output, but to issues such as the achievement of environmental or social objectives. Achieving environmental objectives has long been recognised as requiring a multinational programme, while renationalisation would obviously weaken the incentive among states to promote social objectives, such as rural development and the development of lagging regions. It is important that these objectives remain at EU level.

Third, renationalisation of financing the CAP must inevitably lead to a disintegration of the common element of agricultural policy in the EU. This has important implications for the EU in attempting to negotiate as a unit in the next round of World Trade Negotiations and is in obvious contrast to efforts to integrate national policies further and strengthen EU competency in external relations.

Fourth, it is far from clear that the argument above – that the need for greater flexibility in the CAP provides a rationale for renationalisation – is valid. It is true that the CAP is highly complex and not always ideally suited to local needs. Delegating some authority to local actors who would operate within strict budgetary criteria is one way to ease these problems. However, it does not follow from this that co-financing must inevitably accompany this measure. In fact, this is a quite separate argument and a measure which neither follows from, nor is necessary for, either simplification or subsidiarity of the CAP.

Finally, and related to the arguments concerning cohesion above, renationalisation will have serious implications regarding the integration and development of the agricultural sectors in the CEECs. One of the main themes in the Commission's arguments is that reform of the CAP, in response to pressures both internal to the EU and from external sources, are likely to be compatible with the reforms required to ease the burden of integrating the CEECs. However, renationalisation may have the opposite effect and could result in the continuation of under-developed agricultural sectors in the CEECs. The development of strong competitive food industries is a vital prerequisite for national recovery in these countries. The EU has an important role to play in this process and it is difficult to see how retaining responsibility for the development of their

The Council is convinced that any movement towards renationalisation of financing of agricultural policy in the EU has potentially very costly consequences for Ireland. These costs will be borne not only by the farming sector and the rural community in general, but also by the whole economy. It must be recognised, however, that further reform of the Common Agricultural Policy, along the lines of the 1992 reform, is possible within the next decade. Two objectives of the Commission appear to be in Ireland's favour. The first is that the policy reforms, while moving away from price supports, will aim to preserve incomes. It must be emphasised that the Fischler paper once again reiterates the need for compensation. The second Commission objective, arising partly from the above, is that, in future, transfers under the Common Agricultural Policy will be more closely integrated with transfers under other funds to achieve community objectives. In particular, payments to achieve environmental objectives, rural development and social objectives in under-developed areas will be of crucial importance to both the Irish agricultural sector and the Irish economy in general. This funding will also be available to the CEECs, in time, provided they meet the environmental criteria laid down. The Council believes that Ireland must ensure that these funds are not related to crude measures, such as relative GDP per capita, but are positively targeted to ensure clear objectives are met. A guiding principle should be that the poorest and most vulnerable sectors and regions within the Community are not required to pay for any costs arising out of the increasing liberalisation of the world trade regime.

5. COHESION IN AN ENLARGED EU

(i) The Commission's Thinking on EU-CEEC Cohesion

The Commission's approach to cohesion funding in the context of Eastern enlargement was set out as a series of principles in a communication to the European Council meeting in Madrid in October 1995. These were as follows:

(i) The objective of strengthening economic and social cohesion will continue to be a fundamental element of EU policy;

(ii) The current poorer states of the EU-15 must be given a guarantee that policy will continue to promote cohesion within the EU-15, even though there will be a greater need to concentrate funding on specific regions or policy priorities;

(iii) Cohesion policy and its application within the EU-15 will undergo a major review within the near future;

(iv) The Commission will shape its cohesion policies in such a way as to ensure that it fully respects the wishes of national governments to meet the Maastricht criteria regarding budgetary deficits;

(v) The CEECs will be fully entitled to receive funds under cohesion policies although a period of transition will be required to integrate them gradually;

(vi) Ensuring the effectiveness of funds will be given priority by the Commission as regards both new members and the existing EU-15.

Enlargement to the East could potentially have a major impact on cohesion policies in the EU. The Community is faced with something of a balancing act. The full application of currently existing cohesion policy to the CEECs would be very expensive, while there is considerable opposition to the idea of expanding the EU budget sufficiently. In fact, the Commission has been working on the assumption that the proportion of EU expenditure devoted to regional aid would remain at about 0.4 per cent of EU GDP for the next ten years. However, if present policies on cohesion were extended to the CEECs, it is projected that the EU budget would need to rise by close to 40 bn ECU per annum. Obviously, therefore, ensuring that cohesion funds in the future are flexible and targeted towards the most needful regions, along with transitional arrangements, will be of huge importance in balancing this budgetary constraint with the commitment to ensuring cohesion continues within the EU-15 and is extended fully to new applicants. Thus, while enlargement will prove costly for the EU-15, and the rules regarding eligibility for funding could have a major impact on a country such as Ireland, crude assessments of the budgetary impact based on straight extrapolation of current policy, or recommendations such as those examined in Section 6 below, are of little value in outlining the likely path which will be adopted in the

upcoming review of cohesion policy in the EU. Commissioner Wulf-Mathies has stated that:

> Enlargement towards the East with no political guarantee of the Continuation of the cohesion policy in the poorest of the fifteen member states would be neither socially justifiable nor politically conceivable. In my opinion, therefore, it is important to avoid the growth of any opposition between the current main beneficiaries of structural assistance and possible future member states. (Wulf-Mathies, 19 October, 1995).

As in the case of agriculture, the Commission believes that the best way to integrate the CEECs while minimising opposition within the EU-15, is to prepare a pre-accession strategy of Community policy towards the CEECs over the next five to ten years, in conjunction with an ongoing review of policy in the relevant area. This approach could be identified from the Fischler document on Agricultural policy, discussed above, and is evident in the current review of cohesion policy.

(ii) The Pre-Accession Strategy of the EU

Since the early 1990s, the PHARE programme has developed into the Community's main financial instrument in its dealings with Eastern Europe. In this same period, the EU has developed into the CEECs' main trade and investment partner, as described earlier, as well as the chief source of overseas financial aid. This is particularly important in the case of countries such as Romania, which aspire to EU membership, but have undergone very severe recessions and have failed to acquire substantial inflows of FDI.

The PHARE programme has grown rapidly in every year since its inception in 1989. A commitment by the EU that, with the help of the programme, the CEECs who so wished would join the EU, has provided it with a clear goal and a major impetus. It is now a clear objective of the programme that it will aid these countries in satisfying the economic and political conditions required for membership.

In 1994, funds contracted under the programme increased by 15 per cent over 1993 and amounted to 660mn ECU. Total commitments over the life of the programme amount to 4.3bn ECU. Over 50 per

cent of total commitments by the EU under the programme have now been contracted, while a very successful 96 per cent of the funds contracted have been paid. The programme has been designed to concentrate primarily on small scale projects concerned with the transfer of knowledge from the EU to the CEECs. The Commission sees the, rather limited, areas in which the PHARE programme has been working to date being extended to a wider number of areas, as the CEECs progress towards membership.

Four Steps to Membership

The EU has recently identified what it describes as four stages which are the necessary steps towards accession and which the PHARE programme will be designed to help the CEECs pass through. The first stage involves support for macroeconomic stabilisation, humanitarian assistance and a supply of basic imports, to be used as inputs into agriculture and industry. This is the PHARE programme operating as a basic aid programme to these countries. The second stage, and the one in which the PHARE programme has concentrated most of its resources to date, has been in the provision of assistance to the CEECs to acquire information and know-how. This is a broadly-based sectoral approach, and while described as a stage through which the CEECs must pass, will probably involve a long period of gradual technological catch-up. The third stage involves the PHARE programme being used to support and develop infrastructure and investment in the CEECs. The aim is to consolidate the reform process in the CEECs through the creation of soundly-based, sustainable, economic growth. Stage four is more closely aligned with preparing the CEECs for accession, in particular, the development of infrastructure and the preparation and implementation of new legislation to closely align the CEECs, in as far as possible, with the legal structures and standards operating in the EU.

Since 1994, the focus has begun to shift towards stage three, while the fourth stage was designed and outlined as a result of the Essen European Council meeting. It is reasonable to assume, therefore, that further development of the PHARE programme into stages three and four will form the basis of the future emerging cohesion policy of the EU as regards the CEECs. The consolidation of reform in these countries means that PHARE support will be focused on the development of market-oriented economic and social systems. This

will involve adapting the social security systems in these countries, developing and implementing new legislation and reforming the public administration system. It is obvious that the transfer of know-how is a major part of this process. However, the other side of the PHARE programme, infrastructure and investment support, will have an increasing role to play in coming years. In keeping with the Community's approach to integration in the EU-15, integration of the CEECs will emphasise the improvement of physical links between these countries and the EU. The Commission is now proposing that the CEECs will be dealt with in the context of the development of trans-European networks, in particular, the development of transport infrastructure. In addition, the elimination of bottlenecks at border crossings is a priority for the programme. In what may be an important new departure for the Community, the PHARE programme has also set the promotion of political stability in these countries as a objective. To achieve this, it has placed a special emphasis on co-operation between these countries by funding projects which are specifically multinational in nature.

The Community has undertaken measures in recent years to improve flexibility in the programme and ensure it is properly targeted where necessary. This has involved a growing recognition that the countries of Eastern Europe are progressing at differing paces in the reform process and that PHARE, which has always been designed to operate in a demand driven manner, must be sufficiently flexible to ensure that each country is allocated funds in a manner which is complimentary to its reform process.

The performance of the PHARE programme is measured through a series of performance indicators for these countries. As such, it can be seen that this programme is designed to operate independently of existing cohesion and structural policies in the EU. However, its emphasis on ensuring that funds are allocated in an effective and flexible manner, according to the needs of each country, may be an indication of thinking regarding the future of cohesion policy in the EU.

(iii) Implications for Current Cohesion Countries

While it remains extremely difficult to identify the Community's future policy to promote cohesion between the EU and the CEECs, and as a result the financial implications of extension of cohesion

policies to Eastern Europe remain vague, two themes are emerging regarding the Commission's views on this matter. The first is that measures must be put in place to ensure that the application of structural and cohesion funds is not seen as an obstacle to enlargement 'but as an instrument that will help the enlargement process and create a balance between the interests of the old and new member states'. To achieve this the EU have set out a number of pre-accession strategy objectives, and developed the PHARE programme as the Community's main financial instrument in its relationships with the CEECs. The second theme evident is that the cohesion policies of the EU will undergo change during the coming years making it impossible to predict the financial implications of enlargement based on current conditions. It would appear that the Commission favours an approach which preserves the objective of European cohesion, but adopts a much longer time-frame.

> At the present it is difficult to predict the Union's future policy for cohesion or its financial implications, even for the existing Union: as regards the enlarged Union, theoretical estimates based on extrapolation of present arrangements cannot be a valid basis ... A smooth and acceptable reform of cohesion policies will need to be progressive and will therefore take time. (European Commission, 1995b, p.10).

It would appear, therefore, that the principle of cohesion will not be neglected or diluted in the EU as a result of Eastern enlargement. However, this does not mean, in the case of individual countries such as Ireland, that Eastern enlargement may not have major implications for cohesion policy as applied. According to the Commission, 'the general application of the cohesion policy throughout the Union should be maintained, even if there is a need for concentration', (*ibid*, p.10). In other words, while maintaining that the EU should continue to pursue cohesion, it is likely that the greatest concentration will be on those areas or regions which are most severely disadvantaged, while the application of policy to areas which have benefited from funds in the past will be curtailed.

Overly pessimistic conclusions as regards the applications of funds to Ireland should not be drawn on the basis of this approach. It is proposed that cohesion policy will be redesigned to ensure it is more flexible in meeting the needs of regions. Communications and publications by the Commission during 1996 have provided an

indication of the nature of these new measures. The problem of unemployment, and its regional concentration will be a key consideration in the distribution of funds. The Commissioner has outlined the structure of the new Employment Pact initiative and stressed the need to ensure that funds distributed under all existing Objectives are increasingly directed towards the creation of sustainable employment, rather than infrastructure. It has also become clear that there will not be a sudden disappearance of funds received by Ireland after 1999, although the precise allocation for which Ireland will qualify remains unclear. Further details of these developments are outlined in Chapter 6 above, but it is clear that, similar to the situation regarding the impact of the CEECs on the CAP, reform of Community funds will be undertaken to meet the objectives of the Commission as they evolve, irrespective of enlargement to the East. However, the prospect of enlargement will undoubtedly be taken into consideration.

While the CEECs should be entitled to the full application of cohesion policy, the Commission insists that transitional arrangements will be necessary to gradually integrate these countries into the policy. The basis for this approach is to ensure that any transfer of funds is economically effective. Thus, the ability of these countries to absorb EU funds, and to co-finance where necessary, will be a limiting factor concerning their impact on the flow of funds in the EU. The extent to which the ability of the CEECs to absorb funds will affect the way in which they are to be distributed is clearly illustrated in Table 10.5. Based on Rollo (1996), this table assumes a straight application of Structural Funds and the CAP to the CEECs under existing rules. The table shows that for most of the CEECs, transfers from the EU would account for between 16 and 29 per cent of their GDP. Romania would be a clear outlier receiving almost 56 per cent of GDP in the form of transfers. This contrasts with a transfer of only 7.6 per cent of GDP – 4.8 per cent under structural funding and 2.8 per cent under the CAP – to Greece, which is the largest recipient of EU funds among current member states.

Transfers of these proportions would obviously pose major problems for the CEECs in absorbing the funds and using them effectively. There is a clear case, therefore, that a straight extension of current funding rules to the CEECs is not desirable from the point of view of either the EU or the recipient countries themselves. The

TABLE 10.5

Hypothetical EU Transfers to CEECs (% of GDP)

	Structural Funds	CAP	Total
Czech Rep.	11.2	7.0	18.2
Hungary	10.1	6.7	16.8
Poland	12.6	9.6	22.2
Slovakia	16.9	6.7	23.6
Bulgaria	18.3	10.6	28.9
Romania	30.6	25.3	55.9

Source: Based on Rollo (1996), Table 5.

proposed new emphasis by the Commission on ensuring that any funds are used effectively to achieve stated objectives provides a much better indication of future measures.

An enhanced concentration by the Community on the effectiveness of funds should mean that a country such as Ireland, which has begun to benefit from EU funds and which is recognised as having used those funds effectively, can expect to enter a period of transition, whereby national co-financing of projects becomes increasingly important, rather than a straight withdrawal of cohesion funding.

In a situation such as this, it is obvious that decision-making at EU level will be important in determining the outcome of negotiations regarding cohesion funds. The current structure of EU institutions means that no permanent single-interest coalitions of states have emerged to oppose integration. On the contrary, the negotiated settlements have generally reached outcomes which have balanced the interests of individual states in favour of progressing towards greater integration. The development of cohesion policy as the number of members has increased is the result of this process. The EU is now faced with the prospect of growth in the number of member states beyond any level originally envisaged by the founders of the EEC and, possibly, to a level where current decision-making institutions may fail to operate in an efficient manner. As a result, the IGC is reviewing the structure and working

of the institutions of the EU. The discussion above indicates that the outcome of this review, rather than predictions based on budgetary arithmetic, will be the chief determinant of the impact of the enlargement on Ireland. As shown in the next section, there are pressures for a range of outcomes which would greatly inhibit Ireland's ability to pursue its interests.

6. PROTECTING THE PRINCIPLE OF COHESION IN THE EUROPEAN UNION

(i) Towards an Integrated Europe

The European Commission requested the London-based Centre for Economic Policy Research to prepare a major study by Richard Baldwin (co-director of the CEPR's International Trade Programme) of the external trade environment for Central and Eastern Europe and its broader ramifications. That study, entitled *Towards an Integrated Europe* (1994) has been heralded as the most important, and most general, study of the economic issues confronting pan-European development. Its analytical approach and central arguments are indicative of a line of reasoning which could gain support from some EU states. Among these is the argument that the future effectiveness of the European Union, and Eastern Enlargement, require a reduction in the influence of smaller, and especially poorer, member states.

This argument rests on two premises. The first is that, under current conditions, an Eastern enlargement is improbable for at least two decades. The CEECs are poor, heavily dependant on agriculture and quite large relative to the total size of the current EU. Thus, an early enlargement would be very costly. This would require either a drastic cut in existing EU spending, or an increase of about 70 per cent in the EU budget. However, since the spending cuts would fall on two powerful interest groups – farmers and poor regions – large enough cuts in expenditure are likely to prove impossible to achieve. On the other hand, there is considerable opposition to increasing the budgetary contributions of member states. Thus, Eastern enlargement will not happen until the CEECs become much richer and much less dependent on agriculture. The second premise is that accession of even the Visegrad group would greatly alter the balance of power in the Council of Ministers. The main losers would be the current small states and, as a result, 'small incumbents

may have to choose in 1996 between preserving their power and enlarging eastwards' (Baldwin, 1994). This change in the balance of power would have serious effects on EU decision-making which can only be overcome by reform of EU institutions to limit the power of small and poor states.

(ii) The Logic of this Argument

The argument that an Eastern enlargement is unlikely for at least two decades is based on a number of factors, much the most important of which is the budgetary cost of an Eastern enlargement. The following line of argument can be discerned:

(i) The budgetary cost of even a first Eastern enlargement would be very high;

(ii) West European voters will refuse to pay additional revenue;

therefore

(iii) The budgetary cost of an Eastern enlargement would fall on Europe's poor regions and farmers;

(iv) Member states representing poor regions and farmers will veto an Eastern enlargement until accession of the CEECs would be budget neutral;

(v) Given their low GDP and high shares of agriculture, this will take two decades, at least;

therefore

(vi) Eastern enlargement is unlikely for at least two decades.

Two particular links in this argument, points (ii) and (iv), require consideration. If these two propositions are doubtful, then it may not be correct that, despite its budgetary implications, an Eastern enlargement is unlikely for at least two decades.

Baldwin calculates that an Eastern enlargement by the year 2000, that included only the Visegrad-4, would require an increase in the EU budget of about 70 per cent. He argues that this cannot be met by increased EU revenues and asserts that 'the logic of this statement is elementary'. In support of this he cites the *controversy* over the Delor's package. However, the *outcome* of this debate was

a significant increase in the EU budget and a doubling of the Structural Funds.

Thus, the second proposition, that EU budget revenue cannot be increased, is questionable. It follows that the third proposition, that the burden of an Eastern enlargement is likely to fall mainly on the shoulders of the poor and the farmers in the EU, is also uncertain. This, in turn, has implications for the validity of the fourth link, that an Eastern enlargement would be vetoed by the poorer member states until the CEECs reach a level of income at which their accession would be budget neutral.

There are several problems with this analysis of decision-making in the European Union. First, it assumes that member states, particularly poorer member states, feel free to use a veto. Second, it assumes that direct budgetary calculations determine voting positions in the European Council. In fact, if an Eastern enlargement was viewed as necessary by one powerful member state, it is unlikely to be vetoed by the poorer member states, and may give rise to a new budgetary compromise or package.

(iii) Enlargement and Voting Power

There are implications from accession of the CEECs for the size and pattern of blocking coalitions – assuming that a qualified majority remains 71 per cent of the Council of Ministers. In order to assess the importance of this, it is necessary to make some projection of the number of votes each CEEC is likely to receive as members, if current practice is continued. Baldwin's calculations of the implications of various Eastern enlargements are shown in Table 10.6. The table reflects his over-riding concern to identify the possibility that poor countries and/or Eastern countries could form a blocking coalition.

The Visegrad-4 would have 22 votes, 11 votes short of a blocking minority. This would mean that 'the new poor four' would have more votes than 'the old poor four'. Substituting Slovenia for Slovakia would give the first CEEC entrants 21 votes. Once the EU gets to the point where the Visegrad-4 plus Slovenia and the Baltic states were admitted, the Eastern countries would have a blocking coalition. Enlarging even further East and South makes the possibility of blocking coalitions even greater.

TABLE 10.6

Blocking Coalitions After Enlargements

EU	Total Votes in Council	Total Poor	Total Eastern	Total Required
EU-12	76	21	0	23
EU-15	87	21	0	26
EU-19	109	43	22	32
EU-23	122	56	35	35
EU-22	124	58	37	36
EU-25	134	68	47	39

Note: EU-15=EU-12 plus Austria, Sweden and Finland.
EU-19=EU-15 plus Visegrad.
EU-23=EU-19 plus Slovenia and Baltic States.
EU-22=EU-19 plus Slovenia, Bulgaria and Romania.
EU-25=EU-22 plus Baltic States.

Source: Baldwin (1994) Table 7.14.

In considering the implications of Eastern enlargement for EU decision-making, Baldwin's focus is exclusively on the possible implications for the Structural Funds and the cohesion policies of the Union. The limits of this preoccupation with one aspect of the EU agenda, are starkly revealed when Baldwin considers possible reforms of EU voting procedures which might precede an Eastern enlargement. He opens this discussion by noting that 'to maintain the momentum of European integration, the EU's Council of Ministers must be able to take difficult decisions' (Baldwin, 1994, p.189). There is a very wide consensus that the EU lacks effectiveness, authority and legitimacy and that, in consequence, it has on many occasions been unable to make sufficient, high-quality, decisions on all its key agendas.

Baldwin sees decision-making problems in the EU purely in terms of the power of small, and especially poor, member states:

> One of the most important problems with the current EU voting system is the over representation of EU citizens that happen to live in small nations... Various Eastern enlargements will make a solution much more important ... What has so far been the difficulty of small countries could turn into a nightmare of small countries (Baldwin, 1994, p.189).

Examination of the history of the EU, however, makes it far from obvious, that problems with EU decision-making have, over the course of European integration, been caused by the relative power of smaller member states. Consequently, Baldwin's argument that 'clearly, the power of the small countries must be trimmed' must be seen as a partial, and normative, judgement. When combined with his preoccupation with cohesion policies of the EU, it leads him to the following statement:

> Since the schism of poor versus rich is an important factor that has hindered EU decision-making, it would seem that the faster an enlargement occurs, the more severe must be the reform of the voting process (Baldwin, 1994, p.189).

If we consider the main milestones and reversals in European integration there is, in fact, considerable evidence in the opposite direction[1]. In general, smaller member states recognise that the supranational institutions, particularly the Commission, frequently acts in such a way as to protect their interests. By the same token, they recognise that in traditional intergovernmental bargaining or diplomacy, size and power have greater salience. Consequently, small member states tend to support the role and power of the

1 It was a large, not a small, member state which blocked the first enlargement of the European Community. It was a large member state which created the empty chair crisis of 1965/66, thereby establishing the Luxembourg compromise or veto, which may, more than any other single factor, have limited decision-making ability of the EC. The abandonment of the original plan for Economic and Monetary Union (in the late 1960s and early 1970s) was no more the responsibility of small states than large ones. With the establishment of the European Monetary System in 1979, all small member states joined the Exchange Rate Mechanism (ERM), and only a large member state declined to join. It seems equally difficult to attribute the period of Euro-sclerosis, from the late 1970s to 1985, to small and poor member states. In research on the internal market, it is widely acknowledged that large countries have a greater ability to use non-tariff barriers (NTBs) – such as government procurement or technical standards – to circumvent the spirit of the common market. The re-launching of the Community, with the internal market programme and the Single European Act, cannot be seen as proposed by large member states and resisted by smaller and poorer ones. Nor does a distinction between large, rich, member states and small, poor, member states, have any

Commission in its various functions. One of these functions, the right to initiate EU legalisation, has proven absolutely fundamental to progress of European integration since 1957. In this context, it is simply untenable to argue that smaller and poorer member states are the cause of the limitations or ineffectiveness of EU decision-making.

(iv) Alternative Understandings of the Cohesion Agenda

The arguments which lead to Baldwin's conclusion arise from a perspective on cohesion, many aspects of which are questionable. First, the Structural Funds and the Cohesion Fund are not 'massive transfers'. In fact, the budgetary and redistributive policies of the EU are under-developed for the degree of political union and joint decision-making which has developed. It is not accurate to say that 'no-one predicted the Cohesion Fund when Spain and Portugal were admitted', when the public finance and redistributive requirements for integration were deeply analysed and debated as far back as the MacDougall report of 1977. Indeed, the enlargement of 1973 is widely considered as one of the factors which prompted the establishment of the European Regional Development Fund (ERDF) (NESC, 1989). Furthermore, in attributing the increases in the Structural Funds to the 'drastic alteration' in EU politics created by the accession of Spain and Portugal, this argument completely ignores the role of the Commission. This is an important omission since the Commission has developed the theme of economic and social cohesion, partly by reference to its analysis and

power to explain different attitudes to the next great milestone in European integration – EMU. Most small and poor member states are enthusiastic supporters of EMU, the main opponent is a large member state (with one smaller state also entering reservations). Indeed, the Treaty on European Union saw the formalisation of a constitutional/legal principle, the 'opt out', which may, in the long-run, prove to be a major obstacle to coherent EU decision-making. This was forced on the system not by a small member state, but by a large and relatively rich one. Nor is there any evidence that it was the smaller member states, rather than large ones, which pushed for different decision-making procedures in the three pillars of the Treaty on European Union. Indeed, it seems likely that it is larger member states, with global geo-political and diplomatic interests, who favour retention of a strongly intergovernmental procedure in the EUs Common Foreign and Security Policy (CFSP). The Schengen Agreement, which embodies the most advanced form of market integration, is the product of both large and small member states.

understanding of the role of public finance and redistribution in the integration process. This development can be traced back well before the accession of poor countries. In this argument, the economic and social cohesion policies are attributable, purely and simply, to the power of the 'poor country coalition' of Ireland, Spain, Portugal and Greece. There is, however, little evidence of such a poor country coalition. On the contrary, it seems that each of these countries recognises the need to form multiple alliances and, more generally, to link their concern for economic and social cohesion with the problems confronting the Community as a whole.

This perspective on cohesion can be contrasted with that which has developed in Ireland, and elsewhere. While Ireland's approach to the EU, and that of a number of other countries, does undoubtedly focus on the cohesion question and the Structural Funds, an attempt has been made in recent years to put the cohesion issue in correct perspective. Economic research on membership of the EU has highlighted the continuing importance of domestic policy. A perspective has also emerged on how the cohesion question relates to the wider set of EU goals and policies. NESC (1989) emphasised that to establish a given objective as an actual EU priority, it must be consistent with the resolution of the major problems facing the EU as a whole, and it has drawn attention to the destructive effect of concentration of any member state on any one objective.

More recently, an attempt has been made to interpret the place of cohesion in the EU system since the Treaty of Rome (O'Donnell, 1991). This revealed that, what is now known as, the cohesion question has a long and complex history in the process of formal European integration. Three points from this analysis are relevant in shaping a perspective on cohesion.

First, although the Treaty of Rome made no provision for a Community regional policy, three different kinds of reference to regional problems can be identified. These are: first, implicit references to regional problems and regional objectives; second, derogations from the general rules governing common market; third, references to Community methods and instruments which were intended to reduce regional and social inequality. Consequently, it is clear that the cohesion objective significantly predates the accession of the poor countries. It follows that in attempting to understand cohesion politics, one must adopt an

approach which can explain the existence and nature of a cohesion agenda, even among the founding six member states of the EEC.

Second, although there has been considerable development of both regional and social policy, the original formulation in the Treaty of Rome can be seen to have shaped these policies, and the overall place of the cohesion question, in three important ways. First, EU social and, especially, regional policy were, and largely remain, national policies part-funded by the Community. Second, member states remained free to pursue regional and social policies which may cut across a Community cohesion objective. Third, although the objective of cohesion was, to some extent, a stated Community objective, its pursuit through national instruments meant that it was not taken into account in the main body of Community policies.

The third finding which emerges from the study of the place of cohesion in the EU system since the Treaty of Rome, is that the cohesion goals and policies exist in a complex relationship with other policy goals, such as the common market. Indeed, the place of the cohesion issue is related to the overall nature of the system. It is clear that, from the start, the Community recognised the existence of regional problems and had among its objectives harmonious development by reducing regional disparities. However, that recognition of regional problems was primarily a recognition of the regional problems facing *member states*. It would be incorrect, however, to infer from this that the relationship between the two objectives was simply that the efficiency objective of a common market was uniformly given precedence over the regional objective, and that this reflects a general feature of the Community as a *laissez faire* project. The extensive derogations in Article 92 and elsewhere show that *even in the Treaty* – let alone in practice -the common market was frequently sacrificed to regional and other objectives. The key point, however, is that the common market was sacrificed, not for other *Community* objectives and policies, but for *national*, regional and industrial policy aims. Interpreting this system, it has been argued that the relationship between the regional objective and the common market objective is tied up with, and a product of, the relationship between Community objectives, policies and institutions, on the one hand, and a national objectives, policies and institutions on the other (O'Donnell, 1991).

Though complex, this interpretation implies a perspective on cohesion which differs sharply from one which sees cohesion

policies as the direct result of inter-governmental bargaining and, particularly, the relative strength within such bargaining of poor member states. The perspective outlined here, sees EU cohesion policies as, more or less, inversely related to the strength of inter-governmental bargaining, and positively related to the strength of the supranational elements in the system. While this is, perhaps, put too bluntly, the point can be seen in the close long-run relationship between political union, fiscal union and cohesion. In this perspective, it is necessary to look beyond the voting rules governing inter-governmental bargaining – indeed, beyond inter-governmental bargaining itself – in order to understand the past and likely future development of economic and social cohesion.

Arguments such as Baldwin's convey a strong message: that in preparing for Eastern enlargement, the EU must limit the power of smaller, and especially poorer, member states in order to ensure that future development of European integration does not involve further development of policies for economic and social cohesion. The fact is that this argument is both strongly normative and based on numerous propositions which are simply incorrect.

7. CONCLUSION

(i) Trade and Investment

The analysis in this and preceding chapters has led the Council to conclude that the major impact of Eastern Enlargement on Ireland will arise as a result of changes in EU institutions and policies. However, enlargement will also impact directly on the economy through increased competition from the CEECs for trade and FDI.

It is likely that the main impact of increased trade competition from the East will be felt in third markets, particularly Germany. This increased competition could pose a threat to Ireland's market share, although the Council agrees with the view expressed in IBEC (1996) that this challenge should not be overstated in the light of Ireland's ability to overcome the challenges posed by previous enlargements. The Council is keenly aware of the importance of exports to the Irish economy. While accepting that Ireland's export performance has been impressive, the Council believes that there is room for the further development of international marketing of Irish products. A role exists for greater collaboration between state

agencies and the private sector in ensuring that the products of Irish industry are competitive on world markets and continue to be aggressively promoted. While recognising the importance of increased competition from the East, the Council believes that the opportunities which have arisen to further develop Ireland's export markets, mean that further liberalisation of trade, and initiatives to integrate the countries of Central and Eastern Europe into the world trade system, are welcome. The Council wishes to re-emphasise the importance attached in its recent *Strategy* Report to ensuring that Irish products remain competitive on international markets. In this regard, issues such as the costs of transport play an important role.

The second direct affect arises from the impact of the CEECs on FDI patterns in Europe. This also will impact on the future trading potential of these countries. FDI is extremely important to the performance of the Irish economy. Increased competition from CEECs will pose a threat to the continued operation of foreign firms in certain sectors within Ireland. This is already becoming evident in sectors such as automotive components. However, the Council believes that the emergence of the CEECs as destinations for FDI is only one factor impacting on Ireland's performance in attracting inflows of investment. Of greatest importance to the future attractiveness of Ireland as a location for foreign firms are a range of qualitative factors, such as workforce skills, sub-supply and infrastructure, which Ireland has developed in recent years. The CEECs will be unable to compete within the sectors where Ireland has attracted most of its FDI in recent years. Instead, the greatest competition is likely to come from other developed EU countries who have increasingly offered attractive packages and incentives to foreign firms. The Council is fully supportive of efforts to prioritise the issue of state aids within the EU and believes that the growth in the volume of resources applied to state aids over recent years represents an inefficient use of state resources and provides a sub-optimal counter balance to funds supplied under cohesion policies. The Council also believes that while certain cases might warrant flexibility in the application of EU social policy in the CEECs, there are no justifiable grounds for a major derogation for new entrants from what is an intrinsic element of the *acquis communitaire*.

(ii) The CAP

Developments relating to the Common Agricultural Policy are of

major importance to Ireland. It is essential, therefore, that Ireland pursues a clear strategy to protect the Common Agricultural Policy and Ireland's interests in its provisions. Developments in the world trade environment and pressures from within the EU mean that further reform of the CAP is very likely within the next decade. The probability is that this will occur irrespective of the timing or outcome of negotiations regarding an Eastern enlargement of the Union. To protect its interests, Ireland must take a positive role in influencing the path of reform to ensure that other interests do not bring about a radical and costly disintegration of the Community's agricultural policy.

This chapter argues that the new members of the EU will eventually be full participants in the CAP, following a lengthy period of transition after accession. The question then centres on what form this CAP is likely to take. Drawing on Commission documents and other sources, it appears very likely that proposals for future reform of the CAP will follow three themes:

(i) That price supports for agricultural products will be reduced in response to WTO requirements. This will ease the need for supply constraint measures;

(ii) That the EU's agricultural policy will be much more substantially integrated with other EU policies, in particular, environment policy and general policies for rural development. WTO pressures mean that in the future payments to farmers are likely to be made in response to the achievement of objectives unrelated to agricultural output.

(iii) That agricultural policy in the EU will be made more responsive and adaptable to local needs, be greatly simplified overall and become more subject to subsidiarity.

The Commission's strategy is based on the calculation that reforms along these lines would reduce the cost of including the CEECs in the CAP as well as meeting WTO requirements.

The huge importance of the CAP to Ireland, both in terms of direct transfers and income effects, means that any changes will have a much greater impact on the Irish economy than on other member states. Likely future reforms present a number of opportunities for Ireland to negotiate its interests and ensure that the commitment to a

more liberalised world trading regime is not made at the expense of the agricultural sector and, in particular, the agricultural sector in the poorer member states. Similarly, it will be necessary to ensure that the costs of Eastern enlargement are distributed in a desirable manner. Not all the suggestions emanating from the Commission fill these criteria. In particular, the issue of subsidiarity has been put forward as an argument in favour of a renationalisation or co-financing of the CAP by national governments. The Council stresses that, not only would this be a major regressive step in terms of advancing cohesion in the Union, but that it is unnecessary and would make accession of the CEECs more difficult. Ireland's interests lie in ensuring that policies are implemented to enable the development of competitive agricultural sectors in these countries and in the EU in general.

The Council believes that Ireland's strategy should be to actively influence the reform of the CAP to accommodate any pressures which emerge in the near future. However, it is important that the budgetary threats of future developments are not exaggerated, and to recognise that considerable uncertainty still exists concerning what demands will be placed on the CAP as a result of WTO negotiations. Ultimately, it is important to ensure that the commitment to freer world trade is not achieved at the expense of an integral, coherent and common policy at EU level and that, where reforms are necessary, the principle of compensation is fully upheld. Regarding pressures which result from enlargement to the East, Ireland must ensure that CAP reform does not discriminate against the poorer or more rural members of the EU by implementing policies which would effectively mean that they bear the major cost of the expansion of the EU.

There is also a lot of uncertainty concerning the impact which reforms to further decouple payments from production would have on output, incomes, the food industry and the budget. To ease this uncertainty, and to allow Irish agriculture to undertake the structural change required, it is essential that an appropriate time frame for reform is adopted. The Council believes that the burden of reforms resulting from WTO negotiations and Eastern enlargement must be shared. This point must also be recognised by the WTO since the EU is bearing the greatest part of the cost of incorporating the CEECs into the world trade regime. In addition, EU policies have objectives, such as environmental and consumer protection, which

inhibit the full efficiency of EU agriculture. Over-adherence to the goal of free trade in agriculture may not be consistent with the pursuit of these objectives. The Council believes a balance must be struck in this regard.

(iii) Cohesion

The discussion of cohesion in this chapter shows that, while the Commission accepts that enlargement will have a major impact on the future design of cohesion policies in the EU, this does not mean that the principle of cohesion in the EU needs to be undermined. On the contrary, the Commission is determined that cohesion will remain a unifying force both within the EU-15 and within an enlarged Union. Enlargement will mean that costs will have to be borne by the current members of the EU. The Commission recognises, and in fact appears to base its projections on, the fact that a major expansion of the EU budget to fund the extension of cohesion policies as they currently exist, to the CEECs would be politically unacceptable within the existing Community and of limited benefit to the CEECs. Its strategy is based on ensuring that the effectiveness of structural and cohesion funding is enhanced and guaranteeing current recipients that the principle of cohesion will be maintained. The aim is to ensure that opposition to enlargement does not grow from fears that the current cohesion countries will be the main losers from such a development.

The main financial instrument to date in the EU's relationship with the CEECs has been the PHARE programme. As a result of conclusions reached at the Essen European Council, this programme will be expanded in coming years to create a comprehensive aid programme to help the CEECs prepare for, and fulfil the obligations of, membership.

Cohesion policy in the EU will be under continuous review, and will need to take account of the prospect of Eastern enlargement. As a result, the future design and budgetary impact of EU cohesion policies is unclear. The situation of the CEECs in regard to participation in the ERM2 also remains unclear. It is becoming increasingly clear, however, that there will be many areas for discussion and that the ability of Ireland to achieve its objectives will be intrinsically linked to any reform of EU decision-making institutions which emerges from the forthcoming IGC (Brown

1994). As a result, the Council has concluded that any institutional reform will be a key determinant of the impact of enlargement on Ireland.

The importance of this point is illustrated by the arguments and critique in Section 6 of this chapter. This section showed that a particular and unjustified perspective on cohesion and decision-making in the EU, led to the conclusion that institutional reforms to limit the power and influence of the smaller, poorer member states, is required in advance of enlargement, if such enlargement is to occur within the foreseeable future. If accepted such an argument obviously has serious implications for Ireland. It was shown, however, that serious flaws exist in the argument that the cohesion policies of the EU are solely, or even primarily, the result of a powerful coalition of small states in the EU. Instead, it was shown that the principle of cohesion has been an integral part of the movement towards European integration since the Treaty of Rome, and that the role of the Commission in advancing the cohesion agenda should not be underestimated. The Commission's role as guarantor of the wider European interest and consequently of cohesion remains and, as a result, it is in Ireland's interest to ensure that the decision-making system retains its supra-national element. In fact, history shows that successive enlargements of the EEC and the EC have provided an impetus to further integration. Ireland's interests lie in ensuring that the chosen path to Eastern enlargement is one which complements further integration, rather than accepting a false dichotomy of enlargement versus European integration as has, on occasion, been presented in the 'widening' versus 'deepening' debates.

The key theme running throughout this chapter is that Eastern enlargement will have an impact on important EU policies and decision-making. However, this development must be assessed in the context of a rapidly changing environment which will impose costs on the EU (Joint Committee on Foreign Affairs, 1994). The Council stresses the importance of ensuring that these costs are fairly distributed and not disproportionately borne by one sector or group of countries in the EU. In this regard, the Council welcomes and supports the positions adopted in the White Paper on Foreign Policy:

> [The Government] will enter the enlargement negotiations determined to ensure terms which will protect our

> agricultural and other interests and allow the agriculture sector sufficient time to adapt to the challenges of an enlarged Union. (White Paper on Foreign Policy, paragraph 3.74)

Regarding the impact of enlargement on cohesion it is similarly clear.

> The enlargement of the Union to include, in particular, the countries of central and Eastern Europe ... should not undermine the application of cohesion policies to existing member states. (ibid., paragraph 3.53).

The Council welcomes this clear outline of government policy and supports the conclusion that provided an even and just distribution of the costs of Eastern enlargement is achieved, the prospect of inclusion of the CEECs within the EU is to be welcomed.

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NATIONAL ECONOMIC AND SOCIAL COUNCIL PUBLICATIONS

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	Title	*Date*
1.	Report on the Economy in 1973 and the Prospects for 1974	April 1974
2.	Comments on Capital Taxation Proposals	July 1974
3.	The Economy in 1974 and Outlook for 1975	Nov 1974
4.	Regional Policy in Ireland A Review	Jan 1975
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19.	Rural Areas: Social Planning Problems	July 1976
20.	The Future of Public Expenditure in Ireland	July 1976
21.	Report on Public Expenditure	July 1976
22.	Institutional Arrangements for Regional Economic Development	July 1976
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28.	Service-type Employment and Regional Development	July 1977
29.	Some Major Issues in Health Policy	July 1977
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32.	The Work of the NESC: 1974-1976	Sept 1977
33.	Comments on Economic and Social Development, 1976-1980	July 1977
34.	Alternative Growth Rates in Irish Agriculture	Oct 1977
35.	Population and Employment Projections 1986: A Reassessment	Oct 1977
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39.	The Work of the NESC: 1977	June 1978
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42.	Report on Policies for Agricultural and Rural Development	Sept 1978
43.	Productivity and Management	Feb 1979
44.	Comments on Development for Full Employment	Dec 1978
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50.	Major Issues in Planning Services for Mentally and Physically Handicapped Persons.	Oct 1980
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52.	Tourism Policy	Dec 1980
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63.	Population and Labour Force Projections by County and Region, 1979-1991	Oct 1982
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65.	Farm Incomes	Nov 1982
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94.	The Association between Economic Growth and Employment Growth in Ireland	Feb 1993
95.	Education and Training Policies for Economic and Social Development	Oct 1993
96.	A Strategy for Competitiveness, Growth and Employment	Nov 1993
97.	New Approaches to Rural Development	Feb 1995
98.	Strategy into the 21st Century: Conclusions and Recommendations	Oct 1996
99.	Strategy into the 21st Century	Nov 1996
100.	Networking for Competitive Advantage	Nov 1996