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COMMISSION STAFF WORKING PAPER

Impact of Enlargement on Industry

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INTRODUCTION

In December 2002, the European Council in Copenhagen concluded accession negotiations with ten candidate countries. With the aim of reaching the goal of an enlarged EU, the candidate countries have made enormous efforts to align their legislation with the Community *acquis* and build the necessary institutions to implement it. The Commission's 2002 Strategy Paper and Regular Reports issued in October are largely an account of the progress achieved by governments in candidate countries in meeting these objectives. This paper takes a different approach. It focuses on the actual degree of preparedness of industry in both the EU and candidate countries, to assess the potential implications of enlargement and the available policy tools.[1]

Economic integration has been developing well ahead of enlargement. In economic terms, the actual accession of candidate countries will reinforce an integration process that is well underway and that has already brought increasing opportunities for enterprises in both the current and future Member States. Along this process of tighter economic integration with the EU, Candidate countries have benefited from growing investment, higher productivity growth and a more efficient allocation of resources. They have also received important technology and financial transfers from the EU, that should be reinforced in the future by the Cohesion and Structural funds. The EU Industry has also taken advantage of new trade and investment opportunities.

As a result, the enterprise sector is a strong supporter of enlargement. Even in candidate countries most entrepreneurs and local companies are quite optimistic about their prospects in the Single Market. Although they are aware that competition will be tougher on their domestic market, they are looking forward to easier access to EU markets, enhanced transparency in business practices, larger inflows of FDI and more competitive conditions for acquiring new capital equipment and IT.

However, the integration of countries that still have markedly different industrial structures will also inevitably entail a number of risks. The economic transition of the candidate countries is virtually complete, but their industry still suffers from certain weaknesses. Globally positive productivity and competitiveness developments in the future Member States mask significant differences in the performance of companies and sectors. While large privatised and foreign-owned corporations do very well in global markets, the outlook for SMEs and locally owned companies is not always so satisfactory. In addition, in a few sectors like steel, restructuring is not complete. Finally, despite major efforts undertaken to reinforce the legal framework in which companies operate, in most cases its implementation should still be further enhanced.

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1 The analysis covers the eight countries of Central and Eastern Europe (CEECs) that should join the EU in 2004, i.e. the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. Cyprus and Malta are not included, they have been functioning market economies for a long time. For Bulgaria, Romania and Turkey enlargement is not an immediate prospect.

This is not to say that the impact of enlargement will be dramatic. After a decade of transition, many of the expected adjustments have already taken place. Enlargement is mostly a source of major opportunities for European companies in both present and future Member States. Nevertheless, to make the most of the opportunities and minimise the risks, EU industrial policy will need to fully take into account the specific characteristics and needs of candidate countries' industrial sector.

The paper reflects part of the analysis underlying the Commission Communication on industrial policy in an enlarged Europe[2]. Hence the main focus on manufacturing industry, although many parts of the analysis are equally valid for the services sector. As in the present Member States, in candidate countries the services sector represents a growing share of output[3]. However, as developed in the communication on industrial policy, in a context of increasing outsourcing and tight inter-linkages between industry and services, industrial developments in future Member States will be of key importance.

The paper is structured as follows. The first section takes a close look at the competitiveness situation of candidate countries industry and its degree of preparedness for enlargement. Secondly, we turn to the opportunities and challenges for the current EU. The third section broadens the scope of the analysis to look at the emerging specialisation patterns of the industry of the enlarged EU as a whole. The rest of the paper shifts the focus to policy issues. Section four briefly discusses the industrial policy mindset prevailing in the candidate countries and how it has evolved over the period of transition. The integration of candidate countries in the recently revisited EU industrial policy approach will be a crucial issue. Finally, the last section discusses the remaining challenges faced by industry in the candidate countries and the policy tools that have been developed to meet these challenges. Potential areas for further policy action are also identified.

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2 "Industrial policy in an enlarged Europe" COM (2002) 714

3 The relative weight of industry and services in GDP is actually very similar in present and future Member states. Industry in the EU and candidate countries represents respectively 29 and 33% of GDP. Services have a slightly higher weight in the EU, 67% of GDP versus 54% in candidate countries, as in the latter the agricultural sector is larger. (Data from 2001, Eurostat)

1. INDUSTRIAL COMPETITIVENESS IN THE CANDIDATE COUNTRIES

1.1 Macroeconomic aspects and legal framework

It is in the candidate countries, and not in the current EU, that enlargement should have the greater impact. A lot of efforts have been made in the pre-accession phase to achieve macroeconomic stability, liberalise markets and create a climate of predictability for investors. Candidate countries have achieved stable and relatively low inflation levels and attracted significant levels of foreign investment which have largely contributed to restructuring their enterprise sector. If the commitment to reforms remains the same, enlargement should boost GDP growth in the future Member States by 1.5-2 additional percentage points annually[4].

This year's Regular reports from the Commission have confirmed the good track record of candidate countries and that sustained efforts in their current reform paths should enable them to cope with competitive pressures within the Union. According to the reports, ten candidate countries are able to meet the economic accession criteria which were defined at the 1993 Copenhagen European Council[5]. Last December, again in Copenhagen, the European Council closed the enlargement negotiations with these ten countries, which are now expected to join the Union in May 2004.

Research from the European Bank for Reconstruction and Development and from the World Bank has endorsed the diagnosis from the Commission reports[6]. The World Bank even suggests using the Central and Eastern European countries as benchmarks for the structural reforms that still need to be conducted in the CIS and the Balkans.

Economic reforms have been accompanied by measures aimed at developing the legal framework for commercial activities including property rights, market entry and exit conditions or competition law. Bearing in mind the fact that legislation in all these fields had to be developed from scratch at the beginning of transition, the progress achieved is impressive. The candidate countries have now also started to undertake a "second generation of reforms" such as those of their labour and financial markets. In several countries, attention is already devoted to medium-term challenges such as the development of a knowledge-based economy. Also the demographic evolution and environmental issues are being addressed.

However, despite the enormous progress some gaps still remain in most countries, particularly at the level of implementation and administrative capacity. In order to match the conditions of efficiency and legal certainty prevailing in the EU, additional efforts will still be necessary in these areas.

In addition, even if candidate countries have achieved a high level of economic integration with the EU, macroeconomic growth is nevertheless fragile and needs to be further sustained. Despite the fact that, by 2000, most countries had surpassed their 1990 GDP levels, the

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4 "The economic impact of enlargement", Directorate-General for Economic and Financial Affairs, European Commission, Enlargement paper N° 4, June 2001

5 These criteria refer to (i) the 'existence of a functioning market economy', and to (ii) the 'capacity to cope with the competitive pressure and market forces within the Union'.

6 See the EBRD annual "Transition Reports", and the World Bank report "Transition - the first ten years - analysis and lessons for Eastern Europe and the former Societ Union" (2002).

development gaps with current Member States are still very significant. Per capita incomes are well below those in the EU: around 40% of the EU average, ranging from 30% in Latvia to 69% in Slovenia. On the basis of current growth rates it should take candidate countries between 15 and 40 years to catch up with the current Member States, even if additional growth resulting from enlargement could accelerate this process.

In this context, adopting the Lisbon agenda –which is part of the *acquis*- will also require major efforts from candidate countries. The Communication recently adopted by the Commission on the future of the European Employment Strategy[7] recalls the structural weaknesses shared by both present and future Member States and stresses the major challenges faced by candidate countries to fulfil the Lisbon objectives. These include: the need to increase labour supply; the need for employment rates to catch up, especially for men and with particular attention for older workers; the need to ensure an orderly flow from agriculture and industry to services without generating increasing regional disparities; and the need to upgrade and update skills.

1.2 The EU is already the main market for candidate countries' industry

The economic integration between candidate countries and the EU started at the beginning of the 1990s, when these countries opened up their economies and re-oriented their trade towards the EU. This integration was facilitated by the launch of the pre-accession process and the entry into force as of 1992 of the Interim Agreements, followed by the Europe Agreements. Thereby the framework for bilateral relations with each candidate country and the means to establish free trade were progressively put in place as of 1992 in advance of enlargement.

As a result of the Interim/Europe Agreements, almost all industrial products from the candidate countries have enjoyed free access to the EU since 1 January 1995[8]. Under the Agreements, the candidate countries also commit themselves to approximating their legislation to that of the European Union, particularly in the areas relevant to the internal market. They also envisage the conclusion of agreements on mutual recognition in the fields of technical regulations, European standardisation and conformity assessment procedures. The EU has completed or is in the process of negotiating such agreements with a number of candidate countries in the form of Protocols to the Europe Agreements on Conformity Assessment and Acceptance of Industrial Products (PECAs). The aim is to facilitate the integration of candidate countries into the internal market before accession. In concrete terms, products from a candidate country in sectors covered by a PECA can enter the Single Market freely, without additional testing and certification. PECAs have already entered into force with Hungary, the Czech Republic, Latvia and Lithuania, and have been initialised with Slovenia.

Future Member States display a high degree of openness as showed by the volume of exports as a percentage of GDP, which in 2001 ranged from 23% in Poland to 63% in the Slovak Republic. The largest share of trade corresponds to the EU: 62% of candidate countries' exports are directed at Member States and 58% of their imports come from the EU. Trade between the Central European Candidate Countries (CEEC) and the EU in manufacturing exports and imports is in fact almost as important as in the internal market for the current

7 "Communication on the future of the European Employment Strategy" COM (2003) 006

8 The remaining tariffs on steel products were abolished a year later; the remaining tariffs and quantitative restrictions on some coal and textile products were abolished in the following years.

Member States. As a result, business cycles of the EU and candidate countries have shown rapid and rising synchronisation. Even in the deteriorated current economic situation candidate countries exports, mostly directed to the EU, are expected to grow at around 5%, 8% and 10%, respectively in the years 2002-2004. Overall, as far as trade in goods is concerned the candidate countries are already almost fully integrated in the EU.

1.3 Dramatic changes in industry during the transition process

The candidate countries have inherited from the centrally planned economic systems and from the Council for Mutual Economic Assistance a production system not adapted to a competitive environment but to the requirements of a command economy. In most countries, industry was characterised by geographic specialisation, huge production capacities, and a strong focus on heavy sectors. Nearly all enterprises were state-owned. Technologies and organisational structures were not geared towards competition. The production system was based on cheap energy and subsidised transport, and expertise in areas such as marketing, product design and accountancy virtually did not exist. In addition, on the eve of transition, industry was suffering from a lack of maintenance in equipment and infrastructure and most technologies were outdated.

The abrupt external liberalisation at the beginning of transition and the related loss of traditional export markets brought about disruptions in production and a sharp decrease in industrial employment. The most spectacular changes took place in the small Baltic economies rather than in the countries of Central Europe, which had already started trading with the EU. The cumulative decline of industrial output between 1990 and 1993 amounted to nearly 25% in Central Europe, and to 50% in the Baltic States. This decline has been partially offset by an increasing expansion of services, which were underdeveloped under the old system.

The pace and order of reforms have had a significant impact on industrial restructuring. The patterns were similar in all countries: liberalisation of trade and investment, small-scale privatisation, large-scale privatisation, elimination of administered prices and of market entry/exit barriers, development of market-supporting institutions and promotion of a business friendly environment. However, some countries chose to open up their economies and to implement painful reforms in terms of social consequences more rapidly than others did. This was especially the case in Estonia, Hungary and Poland.

The massive industry reconstruction operation started with the privatisation process. Privatisation methods proved crucial for determining the degree of restructuring and modernisation of industry. The early sale of state assets through transparent tenders or auctions to strategic investors, and in particular to foreign investors belonging to the same sector they take over (Hungary), have led to the most profound restructuring. By contrast, mass privatisation programmes using vouchers (Czech Republic, Slovakia, Lithuania) and, to a lesser extent, the transfer of ownership to insiders have in most cases led to ineffective corporate governance and increased organisational and technological deficiencies, delaying the emergence of competitive market structures.

Vulnerable industrial branches concentrated in secluded regions -typically mining, steel, and shipbuilding- have faced difficulties to attract strategic investors. In these cases, governments have to conduct restructuring before privatisation. This implies that they have to develop and implement viability plans involving capacity reductions, which they sometimes have done with great reluctance. Restructuring in these sensitive sectors still needs to be completed (see section 5).

Restructuring is an area where some of the worst mistakes have been made during the transition period. For instance, in the Czech Republic, Slovakia and Lithuania, the State has postponed the pain of liquidation and restructuring, by not imposing sufficient market discipline in the banking sector and inherited enterprises. Protection took several forms, e.g. subsidies granted through the budget or through the energy and banking sectors, tax arrears or inadequate bankruptcy procedures. In the absence of hard budget constraints, efficient exit mechanisms and institutions of corporate governance to monitor managerial behaviour, no transfer of resources from the old companies to the new ones could take place. The three countries have now partially solved these problems.

By the end of the transition decade, privatisation of the manufacturing industry was largely complete, a notable exception being the steel sector in the Czech Republic and Poland. Restructuring was deeper in those countries and sectors where privatisation schemes had favoured the attraction of foreign strategic investors. Only Hungary and Poland produced more industrial goods than in 1990 (by 50% and 70% respectively). In contrast, in the Baltic States, industry had shrunk by half, while in other countries the decline amounted to 10-15%. Employment has declined even more than output. Losses in manufacturing employment between 1990 and 1999 amounted to 25% in Poland or 40% in the Czech Republic, Estonia, Hungary, Slovakia and Slovenia.

As small and medium enterprises have only developed slowly during the transition, employment creation by the SME sector has not been sufficient to absorb the lay-offs induced by industrial downsizing. This has been mainly due to the fact that the business environment in most candidate countries remains to be further improved in order to stimulate SME growth and entrepreneurial activity. Particularly financial systems and supporting infrastructure are still insufficiently developed.

Finally, at the time of accession substantial investments will have to be undertaken by many companies in order to comply with the Community *acquis* in such diverse areas as environmental regulations, health and safety requirements or working conditions. This will entail an additional burden on candidate countries' industry. While investments in these fields, when completed, will allow for full access to the Single Market and for improved competitiveness, in the short run increased costs may threaten the viability of certain companies.

1.4 Industrial competitiveness after ten years of transition: a diversity of convergence patterns emerges [9]

After a decade of downsizing and reorganisation, globally the structure of the manufacturing industry in the CEECs has gradually become closer to the EU pattern, both in terms of production and employment structures. Specialisation is however still centred on labour intensive industries; they have higher shares of food and beverages, textiles, wood products, and basic metal industries, and lower shares in machinery and equipment, chemicals, and electrical and optical equipment (with the exception of Hungary regarding the latter sector).

9 This section draws largely on the study "Competitiveness of industry in CEE Candidate Countries" conducted by the Vienna Institute for International Economic Studies (WIIW) in 2000-2001, for the Enterprise Directorate-General of the Commission.

Overall, industry is still more diversified than in the current Member States, but production specialisation keeps increasing. The top five branches now account for 60%-70% of the industrial output.

Looking at the production structure of different countries, the Baltic States stand out more distinct from the EU than the rest. In these countries foodstuffs, textiles and wood products have the lion's share in output. On the contrary, in some countries – notably Hungary – production is markedly shifting towards more sophisticated sectors.

Although sometimes interrupted by temporary downturns, since 1995 industrial labour productivity has increased fast in most future Member States. Labour productivity is usually higher than in 1990 but significant divergences persist, with Hungary being the productivity leader around 50% of the EU average and Latvia lagging behind at 33%. In the mid-1990s, an uneven pattern of productivity growth emerged in different sectors: winners are the electrical, optical sectors and transport equipment as well as furniture; losers are food, beverages and tobacco, textiles, leather, wood products and chemicals. The winner branches have increased their comparative advantage vis-à-vis the present Member States, while loser sectors, despite low wages, have higher unit labour costs than in the EU. Those countries more specialised in the best performing branches are consequently also doing better in productivity terms.

Wages have for some periods grown quickly, mitigating the positive impact of productivity increases on international competitiveness and contributing to cuts in employment. At present, wage developments in most Candidate countries seem to be broadly in line with economy-wide productivity trends, but given the low or declining levels of employment there would be room for wage developments to contribute further to job creation.

Manufacturing has largely relied on foreign direct investment (FDI) for restructuring and modernisation. The deeper the foreign penetration, the faster the speed of structural change. GDP growth, productivity growth, structural change and profit rates were higher in countries and sectors with a stronger presence of FDI. The Czech Republic, Hungary and Poland have been the most successful countries in attracting high levels of FDI (see section 2). The sectoral distribution of FDI has been highly uneven reflecting the specific strengths of individual countries as well as the different privatisation strategies. FDI has however not met all needs in terms of new skills and technologies. As a result, the dichotomy of productivity and profit rates between foreign and domestic-owned companies is substantial in some countries.

Not surprisingly, the growth patterns in FDI, labour productivity and production structure have been reflected in the trade specialisation patterns. The analysis of trade performance suggests that candidate countries have revealed comparative advantages (RCAs) in textiles, wood products (but more advanced countries have deteriorating RCAs in these labour-intensive branches), furniture and basic metals (except Hungary). Conversely, they have comparative disadvantages in chemicals, rubber and plastics, pulp and paper (except Slovenia), machinery (except Slovenia), and electrical and optical equipment (except Hungary). All candidate countries record improvements in transport equipment, and most of them in food and beverages.

In the more advanced countries, export specialisation is evolving towards more sophisticated and less capital-intensive industries. Actually technology-driven industries account for growing shares of exports in nearly all countries, but the biggest shares are observed in the Czech Republic, Estonia, Hungary and Slovakia. Hungary even has an overrepresentation of technology-driven industries in its exports to the EU, comparable to the United Kingdom and Ireland. Estonia and Hungary show the biggest shares of exports requiring high-skilled and white-collar workers. On the whole, the Czech Republic, Hungary, Slovakia and Slovenia count less on labour-intensive industries in their exports to Member States than Greece and Portugal. Conversely, labour-intensive industries account for the major part of export gains in Latvia and Lithuania. (See emerging specialisation map in Annex 2).

Using export unit prices as product quality indicators, the quality gap between CEEC and EU producers seems to have narrowed substantially for Hungary and Slovenia. The largest gaps exist in technology-driven and mainstream industry and in high skill-intensive branches, the lowest gaps in capital-intensive and low skill-intensive sectors.

The overall picture of candidate countries is one of significant convergence with the EU in terms of competitiveness, industrial structures and trade specialisation. However, substantial divergences have gradually emerged within the group. While certain countries have showed a pattern of relatively fast catching up, specialising in technological sectors and moving to higher intra-branch product quality positions, other countries seem to be ‘stuck’ in more traditional sectors, mainly concentrated on low-skill labour intensive activities[10]. These different developments, if they were to be confirmed in the medium-term, will have important consequences for regional or industrial policy. The challenge will be to ensure that no country or region is confined to industrial backwardness. With that aim, policy action should assist new Member States in developing the capabilities necessary for industry to embark in a path of growing competitiveness and better economic performance. These policy issues will be tackled in section 5.

10 This has been recently highlighted by M.Landesmann and R. Stehrer, “The CEECs in the enlarged Europe: convergence patterns, specialization and labour market implications” (2002), Research Reports of the WIIW.

2. The impact for EU companies of enlarging the Single Market eastwards

When assessing the impact of enlargement, it is very difficult to dissociate the effects of enlargement from the overall effects of globalisation. Furthermore, there is relatively little information about the state of preparedness of businesses and their strategies, and in general about the likely microeconomic consequences of enlargement. Most studies on the impact of enlargement cover macro-economic issues, suggesting that the consequences for the EU would be limited, but overall positive. They indicate that there is already a high level of economic integration between the EU and CEECs. EU companies have already largely benefited from the investment opportunities offered by privatisation, from the liberalisation of trade in industrial products under the Europe Agreements and from the progressive implementation of the Community *acquis* in most sectors.

The countries that have strong ties with candidate countries will benefit most from enlargement. This holds especially true for Austria, Germany and Italy, which account for the bulk of trade and FDI inflows between the EU and CEECs. However, it is also in these countries that certain companies located close to the border with the future Member States will have to face the biggest adjustments.

In any case, business in the EU has been aware of the future enlargement for at least eight years. Along this time, enlargement has gradually become a reality. Available information and feedback from business federations points that, although some inevitable adjustments may remain ahead, companies have fully anticipated changes and have had the time to make the necessary preparations.

2.1 Enlargement is bringing major trade and investment opportunities for the EU

A growing new market for EU exports

The candidate countries are one of the main markets for EU exports. Their share in extra EU trade in goods has kept increasing since the beginning of transition: it represented almost 5% of exports and less than 4% of imports in 1990 and now accounts for some 16% of exports and 14% of imports. It is well above half of the US share and more than Japan’s share. Even if the gap has been narrowing over the last five years, Member States still benefit from significant trade surpluses with all candidate countries except Hungary and Slovakia.

Machinery, transport equipment, chemicals, textiles and base metals have the lion’s share in the structure of exports; machinery, transport equipment, textiles, and base metals account for two thirds of imports. The structure of exchanges in general points towards the significance of outward processing trade (OPT) arrangements. On the other hand, the prominent share of machinery in exports reflects the increasing investment of candidate countries’ companies in new equipment and technologies. Also, as CEEC businesses need to comply with EU environmental, safety and hygiene standards, EU companies working in the environmental and health sectors benefit from increased demand.

Generally, the EU industry has gained from an additional customer base (approximately 75 million, 106 million with Bulgaria and Romania, and 170 million with Turkey), allowing increased production levels, more economies of scale and higher productivity. Strong income growth in future Member States and accession will further enhance exports.

Enlargement will also open new trade opportunities for SMEs. Small and medium companies should benefit from reductions in transaction costs (i.e. transport costs, reduction of border formalities, easier movement of labour across borders) more than large companies. They have strong competitive advantages in the areas of business, financial, environmental and IT services. SMEs in human capital and technology-intensive industries such as transport equipment, metal products, electronics, and electrical equipment that are located in border regions will benefit from better access to markets and from a wider choice of inputs (subcontracting). Economic ties between SMEs on both sides of the present EU border are tight as economic trade between bordering Member States and the CEECs is already dominated by SMEs.

Taking Advantage of Investment Opportunities

The EU has also largely taken advantage of new investment opportunities in Central and Eastern Europe: EU enterprises are by and large the main investors in candidate countries, much more than US-based multinational companies. Germany, Austria, Italy and the Scandinavian countries are the biggest investors. Germany is the only Member State to have invested in all countries, while other Member States have mostly targeted neighbouring countries. As commented above the largest shares of FDI in volume have been attracted by the Czech Republic, Hungary and Poland; the highest FDI inflows per capita correspond to the Czech Republic, Hungary and Estonia (see table below).

Foreign direct investments (inflows recorded in the balance of payments, 2001)

Country	Net FDI inflow in % of GDP	Cumulative FDI inflows per capita (in €)
Czech Republic	8.7	2 280
Estonia	9.7	2 080
Hungary	4.7	1 790
Slovenia	1.9	1 530
Latvia	2.3	970
Poland	3.2	950
Lithuania	3.7	720
Slovakia	6.3	520

Source: Eurostat from national sources (balance of payments data). Stock in € per capita accumulated over the transition years has been calculated using the population figures from National Accounts, which may differ from those used in demographic statistics.

The main destination of investments during the transition period has been the manufacturing sector, which has attracted nearly half of the FDI stock in Central Europe and approximately one fourth in the Baltic States. In 1998, in Hungary, 70% of manufacturing sales came from foreign-owned companies. FDI has concentrated in a few successful industries and companies, in export-oriented branches (such as automobiles, electrical and optical equipment) or in activities with stable domestic markets (typically, tobacco and beverages). Most companies under foreign control are now among the main exporters in their countries. In Slovakia for instance, Volkswagen and US-Steel account each for 15% of the country's exports, and together with their suppliers produce more than 20% of GDP[11].

The motivations for investing have evolved over time. Initially, investment choices were mostly influenced by geographical proximity and the opportunities offered by privatisation schemes. Investors' main preoccupations were to gain a foothold in local markets and to use some countries as springboards for exporting to other countries in the region. The perspective of lower production costs, the high growth potential of the new markets, and improvements in the business environment have then driven continuous FDI inflows. The motivation for investing has also benefited from a low-cost and educated labour force, which has led to some dislocations of production from the EU to candidate countries, notably in the textile and apparel sector.

With the completion of large-scale privatisation, the nature of investment is changing towards more efficiency-seeking greenfield investment and cross-border mergers and acquisitions in the private sector. So far, this trend mainly concerns countries that are more advanced in reforms (the increase of greenfield investment in total FDI was particularly notable in Hungary in 2001). To foster these new inflows of FDI, some countries such as Poland, Hungary and Slovakia have been granting foreign entrepreneurs special investment incentives. Those are no longer available since the countries have aligned their incentive systems with the EU State aid rules as part of the accession preparations.

Higher macroeconomic stability and expansion of financial markets stemming from enlargement should make investments even safer in the near future and further increase foreign capital inflows. Likewise, with a common regulatory framework in all areas, access to market will further improve. The lasting restrictions to trade (in particular, non-tariff barriers in big markets such as Poland) and investment will be dismantled.

2.2 But localised risks cannot be excluded

In the Member States neighbouring the candidate countries, many small and medium sized enterprises still view enlargement as a dangerous prospect. However, the negative consequences of enlargement on EU companies should actually be very limited, although they are indeed likely to be concentrated in certain sectors and companies in bordering regions.

In 1999-2000 a consortium led by the Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI) carried out a study on the impact of enlargement on EU SMEs. It was based on four regional case studies. Two regions bordering future Member States and two non-border regions with different patterns of development were selected for the analysis: Bavaria (strong manufacturing sector, high income levels), North East Austria (large agricultural sector, low income levels), Scotland (below average income levels), and Catalonia (strong international exposure, above average income levels). The study concluded to a small impact of enlargement for SMEs in the EU. The highest risks identified concern medium-sized enterprises that are located in border regions. For the micro and small enterprises serving the local market, the impact would be neutral. In terms of sectors, labour intensive industries such as textiles and clothing, and food processing, as well as transport

11 Source: EBRD "2001 Transition Report".

services, would suffer from wage competition. According to this study, the risks faced by companies located in non-border regions are expected to be very limited.

Similar conclusions were reached by a study on the economic impact of enlargement on German border regions commissioned by the German Ministry of Economic affairs and co-financed by the Regional Affairs Directorate-General of the Commission. Border regions (located on the territory of new *Länder*) are mainly rural and have much higher segments in labour-intensive productions than the rest of Germany. They will be disadvantaged in the competition with Poland and the Czech Republic, because of their relatively low levels of productivity and higher wage structures. In particular, the construction industry and the sector of lower quality services will be put under strong pressure as a result of accession.

As for fears of delocalisation, there is no reason to believe that dislocations of production will be massive after enlargement. Most relocations due to lower costs and wages have already taken place, e.g. in the textile and apparel sector. It should also be kept in mind that many of the production processes that have been shifted to the CEECs seeking lower costs would otherwise have moved to Asia. There is already evidence that, as wages are rising in the CEECs, some producers are now considering moving further east.

There will certainly be additional dislocations to the candidate countries, but those will be mostly driven by more strategic considerations. However, the political sensitivity of these dislocations in incumbent Member States should not be underestimated. Even when they have a limited economic and social impact, they get strong echoes in the media and may damage the corporate image of companies.

Another fear concerns potential distortions in competition that could arise from the active policies carried out in CEECs to attract FDI. In many cases governments have extensively used fiscal incentives, mainly because they could not afford more costly and less distortive forms of aid such as grants for training or research and development. Although there remains room for further improving the enforcement of state aid rules, the Commission has worked together with the state aid control authorities of the candidate countries on the alignment of this type of fiscal incentives with the Community state aid discipline. As a result, all major fiscal systems have been adjusted.

A more tangible threat to the competitiveness of EU industry lies in the steel sector. After two periods of intense restructuring the EU steel industry is now competitive. Further delays in steel restructuring in candidate countries could threaten this competitiveness and weaken the position of the EU industry after accession, in particular in the case of international trade conflicts. In this context, particular attention will be paid by the Commission to close monitoring of the implementation of restructuring plans.

Overall, the most justified fears concern the competitiveness position of medium-sized companies in regions neighbouring the future Member States. According to the RWI study, promoting the development of skills and the availability of business services for local companies would reduce the negative impact of enlargement in these regions. Indeed, companies facing tough price competition should develop the means to diversify their production away from labour-intensive tasks and specialise in higher value added products and services. At the same time, pressure from cheaper Eastern products may shake some EU companies that were settled in routine and standard production processes and push them to modernise and search for innovative niches. Although the process will certainly lead to some locally painful adjustments, in the long term it should result in the emergence of more efficient and competitive companies in both existing and new Member States.

3. MAKING THE MOST OF COMPLEMENTARY CAPABILITIES AND SKILLS IN THE ENLARGED EUROPE

As mentioned in the preceding sections, many businesses in both the candidate countries and the EU have already largely benefited from the process of enlargement. In addition to the new trade and investment opportunities, or the larger possibilities of rationalisation of production in an enlarged single market, it is the heterogeneity of wage structures, technological capacities and skills in the enlarged EU that may prove the most valuable asset for European companies to substantially improve their competitive position in world markets. To exploit the complementary features of economies in candidate countries and Member States and make the most of enlargement, industry both in the EU and in candidate countries will need to review and adapt its strategies.

Since the beginning of transition, the predominant feature of industrial integration of candidate countries has been the outward processing of labour intensive activities by EU companies. In the face of growing competitive pressures from low labour-cost countries, mainly in South-East Asia, delocalisation of labour-intensive phases of the production process to the CEECs has allowed European companies to obtain substantial cost reductions and remain competitive in world markets[12]. The strategy of outward processing has thereby been effective in allowing European producers to retain in the EU high-skill segments of the production chain, such as design, marketing, input supply, management of producer-customer relations or distribution network. If the organisation of different links in the value chain had not been fragmented, in the face of countries with lower wages and weaker labour protection the erosion of European competitiveness would have been very important. As a result, in many cases all activities related to the production and commercialisation of labour-intensive products would have been lost.

So far, the integration of candidate countries industry has largely proceeded through such low-cost delocalisation strategies. These strategies have allowed local producers to benefit from certain knowledge and technological transfers from the firms delocalising production. However, this sort of industrial integration process rarely allows for long-term catching-up. Simply assembling components manufactured abroad, or specialising in specific and isolated segments of the supply chain hardly leads domestic companies to develop the necessary competencies for acquiring autonomy in the medium to long run. In addition, as wages in the candidate countries gradually converge with those in the EU, standardised labour-intensive tasks tend to be re-localised further east in countries with still lower wages, such as Ukraine, Russia, other CIS countries or East Asia. In the medium term a competitive advantage mainly based on low labour-cost is neither desirable nor sustainable in candidate countries.

Encouragingly, the industrial relations between the EU and CEECs are already going beyond these simple outward processing arrangements. There are emerging signs of the creation of more complex EU-wide production networks that draw on complementary patterns of specialisation and involve more local technological inputs and skills[13]. These international production networks, are based on the reshuffling of value chains integrating Eastern skills

12 Baldone et al. estimate cost savings due to international fragmentation of production in the textile and apparel sectors to more than 50% for German firms and between 40 and 50% for Italian ones.

13 See for instance the research work co-ordinated by J. Zysman and A. Schwartz, published under the title 'Enlarging Europe: The industrial foundations of a new political reality'.

and capabilities in a way that truly complements those of Western producers. This second path of industrial integration allows the EU industry to fully exploit the possibilities offered by the full array of complementary competencies existing in the enlarged EU while at the same time fostering long term technological and economic catching-up in the future Member States.

The development of international networks relies on the availability of local human capital. Albeit the levels of education and skills in candidate countries are relatively high, further promoting investments in the labour force and increasing labour participation will have a direct impact on the industrial competitiveness of future Member States and their regions. Developing the adequate strategies of complementary specialisation also involves long-term planning. It requires redefining the relationships between companies and developing the ability to draw on the innovative capacities of specific nodes in networks. Cross-border R&D, product definition and design, procurement, manufacturing, distribution, and support services have to be organised. A key aspect in the process is the capacity of local producers to create linkages with foreign firms that maximise technology and knowledge transfers. Inter-firm co-operation will be the basis for local subsidiaries and suppliers to move up the value chain. The increase in the scope of complementary activities will also have a positive impact on the development of SMEs, which is a major preoccupation in candidate countries. Hence, identifying and developing the innovative and entrepreneurial capacities of local nodes will be a key issue.

First hints of the emergence of network-based production and nodes of local high-skill activity in the CEECs appear in several fields. The Skoda-Volkswagen deal in the automotive sector is a well-known example of this type of reorganisation of the value chain involving subcontracting of technology/skill-based activities to candidate countries. This arrangement has led to other take-over deals and greenfield investment of supplier firms in the Czech Republic having also a positive impact on local companies, which had to improve their cost effectiveness and quality standards. It also marks a change in the strategy of EU manufacturers, as the Czech plant is developing cars for the domestic markets (as opposed to merely adapting existing models at low costs). The textile and clothing industries, where outward processing trade has been progressively combined with subcontracting of more sophisticated production processes, provide other examples of this tendency.

The question is now how to further promote the development of these international production networks. If there is room for policy makers to enhance such processes (see section 5), the leading role clearly corresponds to businesses. Increased competition in the Single Market will surely lead to higher efficiencies and improved competitiveness, but will not always trigger the necessary reshuffling of corporate organisation. Enterprises in Member States need to start looking at the enlarged Single Market as their home market and see candidate countries' producers as partners rather than market rivals. European business organisations so far have insisted on the application of EU rules in candidate countries, they should now also start focusing attention on the possibilities opened by complementary industrial strategies in an enlarged Europe.

4. INDUSTRIAL POLICY IN CANDIDATE COUNTRIES: FROM TRANSITION TO THE EU INDUSTRIAL POLICY APPROACH

Industrial policy in transition

Before turning to the implications of enlargement for EU industrial and enterprise policy, it is useful to bear in mind what the state of policy thinking and industrial policy implementation is in the candidate countries. Actually, in the relatively short period of time since the beginning of economic transition the approach of these countries to industrial policy has substantially evolved.

It was mainly policy choices, more than historical factors, geographical location or natural endowments, which at the beginning of the 1990s strongly influenced the speed of economic recovery and restructuring. Trade and investment liberalisation, the imposition of financial discipline on old enterprises, the privatisation to strategic investors, and the creation of an enabling environment for business development as well as the setting up of market-supporting institutions at an early stage proved to be key factors of success. They largely explain the economic performance of the front-runners, in particular Hungary and Estonia, and to a lesser extent Slovenia.

For several years, the commitment to macroeconomic stabilisation and structural reforms has outcast the debate around industrial policy at government level and the potential needs for micro adjustments to the new macroeconomic conditions. It was believed that privatisation and market forces would be sufficient to trigger growth. It does not necessarily mean that the Ministries in charge of industry have not tried to implement policies that differed from this neo-liberal approach (in the worst cases, protectionist measures such as subsidies to ailing companies and import substitution, in the best cases, positive measures aimed at supporting SME creation). However, they lacked the necessary resources, both human and financial, for implementation. In Poland and Slovenia, attempts were made to develop a pro-active policy to tackle the difficult issue of industrial restructuring.

The opening of accession negotiations on the Industrial Policy chapter in 1998 had the merit to trigger the debate about the role of the state in improving industrial competitiveness.[14] The Commission decided to present the major industrial policy Communications (both horizontal and vertical) as being the Community *acquis* in this area during the so-called ‘screening exercise’. Candidate Countries were asked to demonstrate in their negotiating positions how they intended to comply with this conceptual *acquis*. They were also asked to submit strategy documents showing that their policy was ‘market-based, predictable and non-distortive’.

The documents varied a lot from one country to another. On the one hand, Estonia in a very short statement affirmed that their industrial policy was their economic policy and that the market should be left to allocate resources. On the other hand, Poland argued that they were at a different stage of development and that they needed a sectoral approach. In Poland’s view, the main issue was applying ‘market-based rules of competition and free enterprise’ to sectoral restructuring and privatisation plans. In general, candidate countries, especially the

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14 The Industrial Policy Chapter was opened with the Czech Republic, Estonia, Hungary, Poland and Slovenia in 1998 and was closed provisionally with these countries in 1999. The chapter was opened with Latvia, Lithuania and Slovakia during the second semester 2000 and closed provisionally quite immediately, but preparations had started as early as 1998 at the moment of the screening exercise.

ones which started negotiations in 2000 tried to work on strategies which they would actually implement. As a result, the process proved useful to convince some countries to definitively turn away from winner-picking policies, revise their bankruptcy legislation, and put the focus on establishing framework conditions for growth.

The *acquis* proved of more limited help to tackle transition-related problems, and in particular to increase effective real sector restructuring. Some candidate countries still need to promote structural adjustments to the new rules of international competition, and purely horizontal policy tools may be insufficient. In this context, some examples of a more proactive approach to real sector restructuring already exist[15].In all cases industrial restructuring has relied on FDI to help build up national capabilities. This has been critical in helping local companies to become competitive in world markets through the integration of foreign technology and managerial know-how.

Integrating candidate countries in the revisited EU industrial policy framework

The continuous progress in transition, the negotiations on chapters having a bearing on industrial development (competition, enterprise, regional policy, external relations, company law, free movement of goods, taxation…), and the preparations for the Structural funds are all factors that have given an impetus to the development of enterprise policies in the candidate countries. Their approaches to industrial policy increasingly resemble those followed at EU level.

Candidate countries already participated with great enthusiasm in the CC Best exercise that the Enterprise Directorate-General carried out in 2001 and which was modelled on the Best implementation report for Member States. The follow up of the CC Best process has led to the adoption of the Charter for Small Enterprises by Candidate countries in Maribor in April 2002, and to the preparations of the 2003 report on its implementation. By end 2002, candidate countries have become full participants in the Multiannual Programme for Enterprise and Entrepreneurship, and therefore in the 'Best procedure projects'.

Social dialogue has also become at EU level an instrument for managing change since trade unions' and employers' organisations are the closest to microeconomic reality and thus the best placed to find the right balance at enterprise level between search for greater competitiveness and the necessary social security of the labour force. In the context of enlargement, transversal dialogues between social partners from both current and future Member States have been strengthened becoming a forum of discussion on sensitive issues such as restructuring, social dumping, or transposition of the Community acquis. Also through this dialogue social partners have been providing useful contributions to EC policies such as on employment, social policy, agriculture, transports or industry

Reinforcing the progressive integration of new Member States in EU initiatives and programmes will be a key issue for EU industrial policy. These countries will also have to be progressively integrated into the analysis instruments developed by the European

15 The Slovenian government for instance, working on the assumption that the market failure approach was not sufficient to improve competitiveness, has on occasion played a strong role in enhancing a wide dissemination of know-how in the areas of SME creation and turn around management. The project 'Revitalisation of enterprises in Slovenia' consisted in the in-depth analysis of the five sectors that were main contributors to the economy, and of the benchmarking of sector leaders against their world's best competitors.

Commission. These include the competitiveness reports, the SME Observatory, the entrepreneurship and innovation scoreboards and all the official instruments of statistical analysis.

The emphasis developed by the 2002 Communication on Industrial Policy[16] on the new approaches to regulation and the instruments of the open method of co-ordination, will also be particularly relevant for the new Member States. Actually, candidate countries already increasingly acknowledge analysis, benchmarking, and bottom-up approaches involving stakeholders as prerequisites for policy action. Future Member States are also conscious of the importance of the coherent integration of various policies affecting competitiveness, even if this does not always translate into facts. Finally, some of them have even started to implement a new generation of policies, which places an emphasis on the development of innovation systems.

Overall, the new policy methods and tools of the EU industrial policy will be of great relevance for new Member States. The EU experience in benchmarking and best practice exchange may be particularly instrumental in helping the candidate countries improve the framework for business activity.

However, we have seen that candidate countries' industry displays a number of specific characteristics and is still faced with a few challenges distinct from those faced by the EU companies. Consequently, in order to realise to the full candidate countries' potential for economic convergence, the horizontal industrial policy tools may have to be complemented with more tailor made actions focused on the specific weaknesses of candidate countries' industry and institutional framework.

16 COM (2002) 714

5. REMAINING CHALLENGES FACED BY INDUSTRY IN CANDIDATE COUNTRIES AND POLICY STRATEGIES.

It is in the candidate countries that the major challenges stemming from enlargement will have to be taken up. They will feel strong competitive pressures resulting from economic integration that will keep gradually strengthening. Adopting the Lisbon agenda and the sustainable strategy -with its three pillars on economic, social and environmental development- will also require intensive efforts from all new Member States.

These are going to be long-term challenges. But the potential problems to be encountered right after accession should not be overstated. Business and governments have been preparing for enlargement for over a decade now. Most weaknesses, as well as possible policy responses, have been well identified along the accession period. This notwithstanding, in a number of areas an appropriate policy-mix and resolute action by policy makers will be needed in order to ensure a smooth integration of the candidate countries' industry in the Internal Market and help them embark on a path of sustainable growth and long-term catching up of productivity and competitiveness.

Albeit major adjustments have already taken place along the transition years, the Commission has identified five major areas where there will still be a need for specific policy action.

5.1 Completing industrial restructuring

The most notable restructuring needs are well identified. These concern the steel sector, and in particular Poland and the Czech Republic. In these two countries there have been significant delays in restructuring, due to the reluctance of the state to tackle the social and regional consequences and the very high costs at stake. There are evident over-capacity problems, steel mills are still overstaffed despite a harsh decline in employment since the beginning of transition (in Poland, the workforce in the sector has declined from 147 000 in 1990 to 32 000 in 2002). Management also lacks the necessary turn-around skills. The restructuring plans prepared by Poland have so far failed to address adequately these key issues and to demonstrate convincingly the viability of companies after the envisaged restructuring. Hence the persistent difficulties to attract strategic investors.

State aid to the steel sector is an area which is strictly regulated at Community level. According to the EU rules on the steel sector, by which candidate countries have to abide under the Protocol 2 of the Europe Agreements, aid is only authorised for research and development, environmental purposes and for enterprise closures. Candidate countries were, however, authorised exceptional grace periods, during which they could grant aid for restructuring purposes. These grace periods have now expired. The Czech Republic and Poland have both requested their extension to finalise restructuring. The approval of a second grace period by the Council is conditional upon the presentation of a strategy leading to the viability of the firms benefiting from the aid.

The Czech Republic adopted in June 2002 a steel restructuring plan, which has been assessed by independent experts and the Commission services. This plan addresses the key issues of reduction of overall capacities, viability at the end of the restructuring process, and information on the amount, intensity and purpose of state aids granted. On the basis of this plan, the grace period for the Czech Republic has been extended until the date of its accession to the European Union, and in no case later than 1st January 2005. As for Poland's restructuring and business plans, they are being assessed by the Commission assisted by independent experts. The implementation of the restructuring plans will have to continue after accession.

Further restructuring of a few large industrial companies in other traditional sectors is also needed in some countries. This holds especially true in the Czech Republic, the Slovak Republic and Lithuania, where some low-productivity companies have not been sold to strategic investors and the State has delayed the imposition of hard budget constraints for a long time.

Enlargement, when it becomes effective, will probably speed up the structural adjustments which have not taken place that far. The investment needed to comply with the Community *acquis*, the effective abolition of borders, and further reform of the agriculture sector, although already largely anticipated, are all factors that will influence the behaviour of enterprises, investors and public authorities, and bring about further restructuring.

– A wide array of tools, which might eventually be reinforced, are already in place so as to help solve these issues. As far as steel is concerned, the Commission provides technical advice to help prepare acceptable restructuring strategies. Technical support is provided under the Phare programme. The Europe Agreements have so far been the framework for monitoring closely progress in restructuring. As restructuring plans will have to be implemented until after accession, specific provisions are foreseen in the accession treaties to allow for the continued monitoring of the viability of restructuring plans. Structural funds should contribute to the restructuring of these activities and the shift of labour and production factors towards other industrial and service activities.

– In general, Phare (until accession) and the Structural and Cohesion funds (after accession) will be the most suitable instruments for assisting in alleviating the social and regional consequences of restructuring. The danger of increasing regional disparities will be an important issue for the employment policies in the candidate countries. Downsizing in many formerly highly industrialised regions, often remote from the capital cities, has already led to significant levels of unemployment. New enterprises, FDI or the emerging service sector have not everywhere absorbed existing employment capacities and many regions face difficulties in adapting to the new market conditions. In this area it is important to draw up on the experience gained by current Member States and to identify good practice and provide for its dissemination in all countries.

5.2 Facilitating and strengthening the development of SMEs

With a few exceptions like Hungary and Slovenia, the development of the SME sector in candidate countries only started at the beginning of the transition, and has proceeded slowly. The level of entrepreneurial activity measured in terms of the number of active SME per 1,000 inhabitants differs considerably from one country to another: it is much below the EU average in the Baltic States and well above in the Czech Republic, Hungary and Slovakia. However in the latter countries the SME sector is dominated by one-person and micro companies. Start-ups are still mainly concentrated in the traditional services sector and there are few innovative companies. The survival rate of SMEs is also lower than in the EU.

Insufficient access to finance has been identified as a key constraint on SME growth and development, both on the supply and demand sides. The banking sector is not sensitive to the needs of small and medium-sized businesses. SMEs in several candidate countries are still faced with very unfavourable conditions when asking for loans: they are asked to provide disproportionate collateral or significantly higher interest rates. On the other hand, non-traditional financial instruments, like Venture Capital, are either unknown to SMEs or often not appropriate to their needs, as these instruments are mostly targeted to companies in sophisticated technological sectors with high growth potential.

Other problems hampering the development of SMEs in most Candidate countries include the high level of taxation –particularly payroll taxes-, high costs for setting and running businesses, lack of managerial, organisational and technological know-how, difficulties to integrate production networks and deficiencies in supporting institutions and business support services. Overall, and despite enormous improvements, the business environment still impinges too much on the development of SMEs. Again, in most countries the entrepreneurial mindset was virtually non-existent at the beginning of transition and it is taking a long time to develop.

Improving the environment in which SMEs operate will be a crucial issue for the competitiveness of the new Member States. In these countries, SMEs tend to perform better than large companies in terms of employment creation and productivity growth, which shows their potential as major engines for growth.

Fostering entrepreneurship to create sustainable jobs of higher productivity and better quality is also one of the priorities of the new European Employment Strategy. Fostering entrepreneurship depends on a broad policy-mix encompassing in particular: better regulatory and administrative framework, access to skilled labour force, positive attitudes towards entrepreneurship, managerial skills, a supportive financial environment or well functioning product and labour markets. The European Employment Strategy highlights that special attention will have to be devoted to all these factors in order to create the best possible conditions for the development of small and medium enterprises.

In fact, Candidate countries have already gone a long way into aligning their enterprise policies with those in place in the EU:

– In April 2002, they fully adopted the principles of the European Charter for Small Enterprises as the basis for policy action in the field. In the context of the Charter, they have undertaken important efforts to simplify administrative procedures, including the creation of one-stop-shops, and reduction of administrative costs. The first report on the implementation of the Charter identified in detail the areas where further progress is needed[17].

– In addition to the Charter, since 2002 the Multiannual Programme for enterprises and entrepreneurship has been opened to participation of Candidate countries. In 2003 keeping on improving their business environment will be a top priority.

17 Commission Staff Working Paper "Report on the implementation of the European Charter for small enterprises in the candidate countries", 21st January 2003, SEC (2003) 57

– As far as access to finance is concerned, where necessary, public authorities should enhance the availability of finance to SMEs by introducing loan guarantee or risk-sharing schemes, based on co-operation with banks and public-private partnerships.

– As to innovation capacity, with the signature of the memoranda of understanding by Candidate Countries in October 2002, the sixth framework programme of the European Community for research, technological development and demonstration activities (2002-2006) has been opened to participants from Candidate Countries. This will open new opportunities to enterprises, including SMEs, to strengthen their technology base and enhance their contribution to European competitiveness.

– The PHARE programme, and subsequently the Structural funds, are the main financial instruments to be mobilised to back all the projects supporting enterprise development. These are largely those aimed at implementing the principles of the Charter in areas like innovation, business support services, education for entrepreneurship, reducing administrative burdens or improving access to finance.

5.3 Financing accession costs related to complying with the acquis

Complying with the Community *acquis* means improving the reliability and quality of products and easing their access to EU markets, all aspects that contribute to the improvement of competitiveness. If the benefits are unquestionable in the long term, in the short and medium term compliance will require large additional investments, as well as changes in production processes and working conditions, increased indirect costs and harder budget constraints for some industries. Overall the extra burden imposed on some sectors will be considerable. The most concerned include chemicals, pharmaceuticals, food processing, basic metals and fabricated metal products, and transport equipment.

Legislation on industrial products, consumer protection, and occupational and safety requirements will entail high compliance costs. But the higher investments will have to be undertaken for the implementation of the environmental *acquis*[18]. A long period of lacking or insufficient investments has rendered necessary for industry, in order to adhere to the EU environmental regulations, substantial investments in upgrading production facilities and technology[19]. Tansitional periods and measures have been granted to all candidate countries. They are limited in time and scope and should help alleviate the difficulties without leading to significant distortions of competition.

The investment costs should largely be largely balanced by the long-term benefits of compliance in the form of social benefits like public health, but also lower costs through resource efficient and clean production.

The time paths of costs and benefits are likely to differ for companies, depending on the degree to which they have adjusted to changes in advance. Some companies might suffer in the short term. According to the WIIW study cited above, sectors with low levels of readiness include food processing, basic metals, machinery and equipment sectors as well as wood processing, other non mineral products and refinery industry. Large companies having

18 A study commissioned by the Environment Directorate-General showed that the environmental acquis would require an estimated total investment of € 80-120 billion in CEECs.

19 Necessary investments and charges related to the environmental acquis include mainly waste water treatment, water supply, power plant upgrading and waste management installations.

operated in EU markets or with high levels of FDI are better prepared to meet this challenge than small firms. This is mainly because governments have so far put more emphasis on adopting the legislation and setting up the appropriate implementation structures and surveillance mechanisms than on informing companies about their obligations.

Under the Phare Business Support Programme, Eurochambres and the Slovenian Business and Research Association conducted in 2001 and 2002 a survey to assess corporate readiness for enlargement in CEECs[20]. According to the 2002 results, less than 10% of companies deem to be fully informed about the obligations and benefits of the *acquis communautaire*. One third claims to be not informed at all. Half of the companies have not yet started preparations for compliance, while 10% are confident that they will be ready by end 2003. If the current levels of compliance are low, it seems that companies are better prepared to meet obligations in the area of the free movement of goods, notably in terms of conformity assessment, an area which they consider very important. Only 12% of companies have made attempts to estimate compliance costs and most of them believe that costs will be below € 0.5 million.

Industry representation is also relatively underdeveloped in candidate countries. Business representative organisations are generally weak. As a result, the interests of industry are poorly represented in the policy definition process.

Preparations in these areas are underway and could be stepped up:

– The information gap about the *acquis* in the enterprise sector has been identified early on. This was the main reason for setting up the Business Support Programme (BSP) in 1999, one of the few Phare multi-country programmes. The main thrust of the BSP is to strengthen business representative organisations in candidate countries and to use them as relays to familiarise their associates with the requirements of the *acquis*. Besides, the formation of interest groups at industry level can facilitate the dialogue with government institutions. The second phase of the BSP has been launched in Autumn 2002 with again a strong focus on the *acquis*. The enlargement communication strategy also targets businesses and aims at informing them about the costs and benefits of membership. Finally, the network of Euro Info Centres (EICs) also provides information on the *acquis*. Some EICs have even specialised in the EU legislation on industrial products, standardisation and conformity assessment procedures. The co-financing of the investments required to comply with the *acquis* is possible under the Phare component that targets economic and social cohesion, and under ISPA, the precursor of the Structural funds, in the field of environmental protection and infrastructure development.

5.4 Strengthening administrative capacity and the legal framework

A lot has been done by candidate countries to reform the institutional environment and provide a stable framework for entrepreneurial decision-making. The prospect of accession has stimulated the pace of reform. The adoption and implementation of the *acquis*, even if sometimes a real challenge for administrations and business, has been crucial to strengthen the legal and administrative framework. The *acquis* has been largely transposed and as a result candidate countries' legislation has reached a high degree of alignment with the EU.

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20 1 658 companies participated in the 2001 survey and 2 575 in the 2002 survey.

However, if much progress has been achieved, in most countries the administrative and judicial capacity needs to be further reinforced. The 2002 Regular reports identify a number of specific areas where further and new efforts should be targeted. These concern amongst others: enforcement of intellectual, commercial and industrial property rights; effective application of competition rules and environmental legislation; completing the transposition of public procurement legislation; or completing the transposition and implementation of consumer policy.

Overall, in addition to completing the transposition of legislation in several areas, continued and strengthened efforts are required to develop administrative capacity to and ensure the effective implementation and enforcement of the acquis.

Social dialogue also represents an important tool at local level to ensure the implementation of the Community legislation. In this regard, social dialogue structures should also be reinforced, with a particular emphasis on the capacity building of the social partners' organisations at enterprise and sectoral levels. The governments of future Member States also need to develop their capacity on social dialogue and ensure an effective tripartite consultative process with the social partners, including on industrial policy.

– The continuation of current efforts along the final stages of the accession process should enable the candidate countries to complete their legal frameworks in line with the community *acquis*. As for its implementation capacity, very considerable funds from the EC pre-accession assistance have been directed to assist candidate countries in building and developing their administrative and judicial structures. In co-operation with each of the negotiating candidate countries, in 2002 the Commission prepared Action Plans to reinforce their administrative and judicial capacity. They identify the concrete measures that remain to be taken for each country to achieve an adequate level of administrative capacity by the time of accession. Furthermore, additional monitoring actions, including peer reviews, have been foreseen in order to follow-up each country's progress.

– Monitoring will also be necessary to ensure the continuity of reforms in such diverse fields as the banking and financial system, labour markets, education system, business environment including competition, intellectual property rights or public procurement. Until accession, the monitoring of commitments made during negotiations will continue through established channels such as the structures of the Europe (Association) Agreements. Targeted actions such as peer reviews and technical meetings will continue to be used in specific fields. After accession, the ongoing monitoring process will be subsumed by the existing Community mechanisms. These include benchmarking, annual reporting on implementation of community law, peer pressure from Members States and, if necessary, the launching of infringement procedures in the European Court of Justice.

– Finally, the issue of the informal sector will also be addressed. The need to transform undeclared work into regular employment, particularly in several large future Member States, has received renewed emphasis in the revised European employment strategy.

5.5 Developing national competencies so that industry can effectively integrate international production networks and develop a high-value added specialisation.

As seen in previous sections, in most candidate countries competitiveness is still fragile. Governments will have to maintain a pace of reform that further boosts competitiveness and narrows the income gap with current Member States without worsening the fiscal and external deficits.

But for industrial policy, the major challenges are linked to the opportunities opened by the competitive reorganisation of the European industry in the enlarged EU.

Even if EU firms have mostly used CEEC producers as least-cost suppliers there are also increasing examples of integration of Eastern European producers into EU production systems (typically, in the automotive industry, the electronic sector and textiles). However, these examples are still limited, and have not always been encouraged by the CEECs themselves. While it is mostly FDI which can drive the integration of local firms into supply chains, public authorities can play a role in reinforcing this process. So far, only Hungary and the Czech Republic have actively promoted the development of such suppliers' networks. With the foreseeable gradual disappearance of the labour cost advantage in CEECs, strengthening complementary specialisation patterns will be a key challenge.

There is also a need for policy makers at different levels to foster the development of clusters of local innovative firms, pursuing complementary national strategies. Many innovative firms have developed in the IT sector, but there have also been examples of cluster development in more traditional branches such as transport and tool-making (in Slovenia), and forestry (in Latvia).

Overall, we have seen that most candidate countries already display patterns of convergence with the production structure of the EU industry. But competitiveness developments have differed substantially from one candidate country to another and not all have succeeded in dynamically improving their specialisation patterns. In a time where growth is increasingly based on innovation, all countries should gradually modernise their industry and shift production resources to technological and knowledge intensive sectors as the safest way to achieve sustained economic convergence.

A number of initiatives aimed at meeting these challenges are already underway. These include mainly the following:

– Actions to strengthen and develop the human capital of future Member States. The development of high-value activities in these countries hinges upon the availability of pools of highly skilled and qualified human capital. The European Employment Strategy and the European Social Fund are key instruments to promote investment in human capital. This in turn should help increase the volume and level of employment, essential to achieve real convergence of incomes in the enlarged EU. The financial contribution of the Structural funds –notably the European Social Fund-, albeit crucial, will not be sufficient to meet the challenges faced by the future Member States and the EU as a whole. Public authorities should review their public spending with a view to redirecting it towards human capital accumulation, education and R&D. Finally, as emphasised by the European Employment Strategy, governments in the future Member States will also have to play a role in defining a framework and providing for quality standards and incentives to enhance the volume and quality of private investment in human capital.

– Further, enhancing inter-firm co-operation as well as co-operation between industry, research, the banking system and public authorities will be essential for developing growth-generating activities. It will also provide a channel to stimulate sustainable, environment-friendly and resource efficient production processes. This requires a vital change in culture in most countries, where active co-operation between economic actors is limited. The EU framework programme for research, technological development and demonstration activities as well as the network of Innovation Relay Centres (IRCs) set up by the Enterprise Directorate-General, will also help building and promoting networking partnerships, which is one of their central objectives.

– Reinforcing regional integration. So far, economic co-operation with neighbouring countries has also remained very limited, as the focus was mainly on re-orientating trade towards EU markets. This is also an avenue for development. Regional integration should increase rapidly, when all countries are part of the enlarged Union. Phare has supported cross-border co-operation between candidate countries and between candidate countries and Member States. This has provided opportunities for developing regional economic integration and should not be discontinued when the Phare programs come to an end.

– At the EU level, the future Structural and Cohesion funds, which will replace the Phare component for investment in economic and social cohesion, are going to be an important instrument in the process of addressing the required structural changes and providing the capital necessary for catching-up. Given the considerable needs, institutional and conceptual preparations to ensure a proper use of Structural funds have started well ahead of accession. Absorption capacity problems already encountered will have to be addressed so that the resources available to new Member States can be gradually increased. By the end of 2002, most negotiating countries prepared their Development Plans, which will be translated into "Single Programming Documents" for the smaller countries (Baltic States, Slovenia, Malta and Cyprus) and into "Community Support Frameworks" for the larger ones' (Poland, Czech Republic, Hungary, Slovakia) for the years 2004-2006. The EU enterprise policy, and the principles of the European charter for small enterprises will be reflected in the Single Programming documents and Operational Programmes for the implementation of Structural funds in the new Member States. Furthermore, it will be important to focus strategically public investment, rather than scattering it over many objectives. This should allow maximising the cumulative effects of knowledge accumulation and innovation. In the area of business promotion, the Commission is insisting on integrated approaches that combine infrastructure development, training measures and the provision of quality business support services around identified investment projects. It stresses the need for innovative approaches that would encourage enterprise networking and co-operation, and the development of public-private partnerships.

CONCLUDING REMARKS.

Beyond its positive macro-economic impact on trade, investment and GDP growth, enlargement will be a source of unique opportunities for the European industry. After nearly a decade of preparations, most of the necessary adjustments have already taken place and industry in both the EU and candidate countries is broadly ready for enlargement.

Certainly, the specific characteristics of the candidate countries' enterprise sector will entail a number of challenges for both industry and policy makers alike. These challenges are however well identified. They mainly concern finalising the restructuring of a few large industrial companies -notably in the steel sector-, the slow development of small enterprises and entrepreneurship, the financial costs associated with the necessary investments to comply with the *acquis*, and certain *lacunae* in the administrative capacity. In bordering regions of the EU, increased competition will create new opportunities for trade but may also impose some further adjustments upon a reduced number of local companies.

The EU, together with the candidate countries, has foreseen action in all these areas. A wide array of policy tools, not least the Structural and Cohesion funds, will be appropriately modulated in order to assist companies meeting these challenges in the most effective possible way. In addition, monitoring mechanisms will be put in place to make sure that commitments taken by candidate countries during the enlargement process are met, and that further assistance is provided when needed. Special attention will also be placed on the social and regional dimension of future structural adjustments.

But the major challenge of enlargement will be to make the most of expanded opportunities. The main opportunity will be for industry to reorganise production systems in a way that fully exploits the diversity of skills and competencies existing in the enlarged EU, thereby enhancing rapid economic convergence of the future Member States. If candidate countries' industry is still mainly specialised in labour-intensive sectors, there is growing evidence of Eastern companies integrating international production networks (IPNs) on the basis of local technological inputs and know-how. The most advanced candidate countries – Hungary is a distinct front-runner – have been turning to a pattern of specialisation centred on technologically sophisticated and skill-intensive industries. This path of complementary industrial specialisation should be conducive to sustained catching-up.

However, not all candidate countries have succeeded to the same extent in moving up the technological ladder and diversifying their industrial structure. So far, laggards have kept deeply specialised in low-skill labour-intensive activities. Although the main responsibility for integrating IPNs and reinforcing specialisation in high value added activities lies with businesses, there is also a role for policy-makers to play.

The full integration of candidate countries in the instruments and programmes of the recently revisited EU industrial policy will assist candidate countries in devising effective national policies aimed at improving their institutional and business framework. But in addition, as with the other challenges associated to enlargement, in order to maximise its effectiveness the horizontal industrial policy tools will have to be used in a tailor made manner that fully integrates the specific needs of candidate countries' industry.

Promoting an environment conducive to entrepreneurship – one of the central themes of the EU industrial policy approach – will be particularly important in candidate countries. Enlargement will also raise the stakes of the sustainable development strategy. Analytical and benchmarking tools should lead to detecting the necessary improvements in local institutions, infrastructures and skills development. Other aspects that may require special attention in the future Member States include developing the dialogue with the business community, promoting inter-firm co-operation and enhancing the development of innovative clusters.

The candidate countries have already proved their ability to reform and adapt quickly. As the business community, they are looking forward to embracing the new opportunities opened by enlargement. The remaining challenges ahead should not be overstated. If these are tackled effectively, enlargement may foster the emergence of competitive and innovative firms, release the candidate countries high potential for dynamic catching-up, and further enhance the competitiveness of the industry of the enlarged EU.

ANNEX 1

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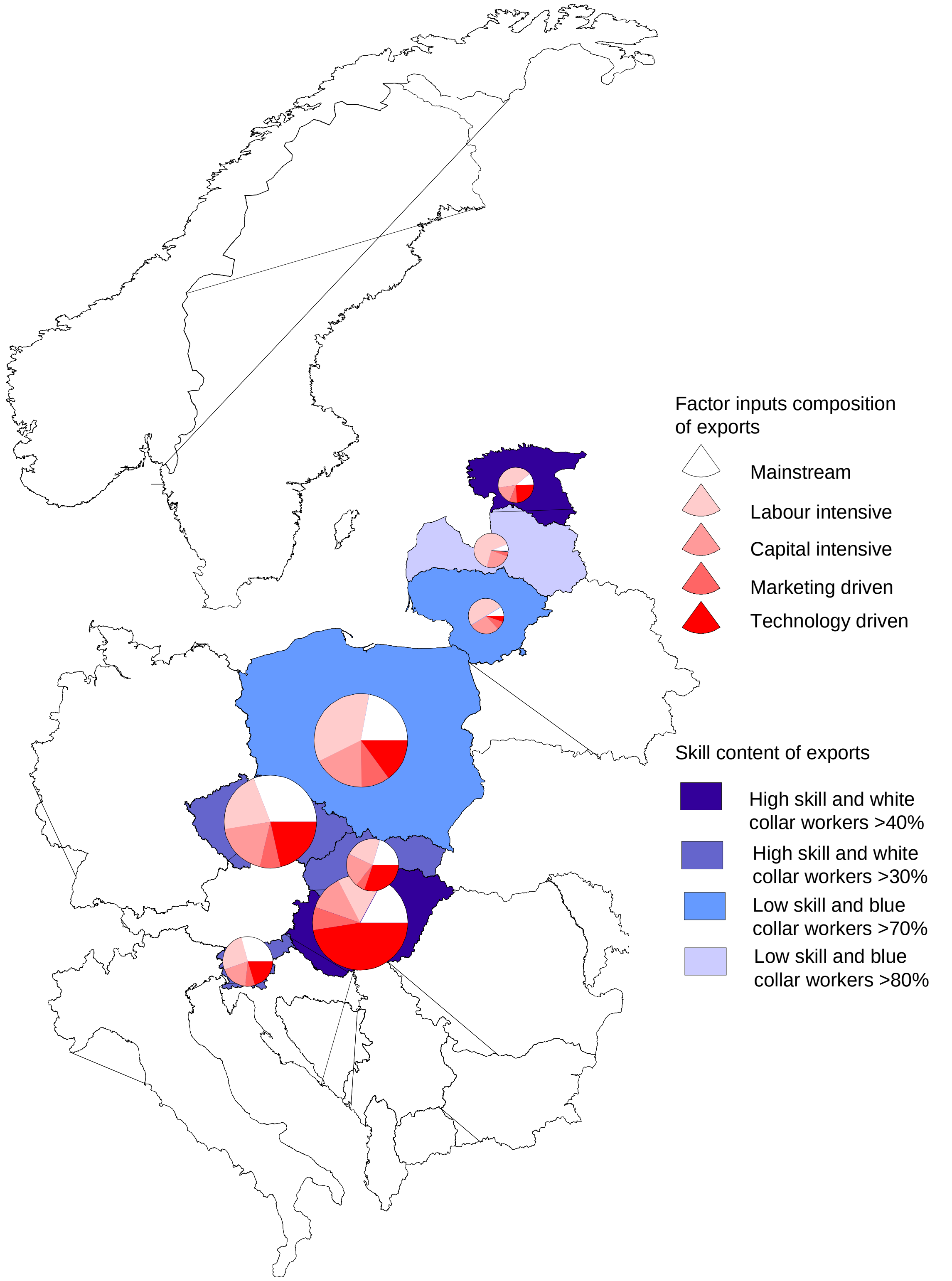
ANNEX 2

Emerging specialisation of Central and Eastern Europe industries,
SHARES IN EXPORTS TO THE EU - 1999:



Note: The size of the pies corresponds to the volume of exports to the EU.
Source: WIIW calculation based on COMEXT Database.