LESSONS FROM FINANCING THE EU'S 'SILENT' EASTERN ENLARGEMENT OF 1990

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The 'silent' enlargement of the EU

On 3 October 1990, the unification of Germany produced the first eastern enlargement of the European Union (EU). In contrast to all previous enlargements, this was managed without protracted negotiations. On the day of unification, the entire Community law entered into effect for the *Neue Länder*, with brief transitional periods in the fields of agricultural, structural and environmental policies. The experience of eastern Germany's economic reconstruction may thus help in formulating advice on how to finance further eastern enlargements without either ruining the budget of the EU or those of the Central and East European countries (CEECs). This commentary does not aim at an evaluation of financial aid to eastern Germany, nor at an evaluation of the EU's structural policy.[1] Its central question is instead: what lessons can both the EU and the applicant CEECs learn from the EU's 'silent' enlargement of 1990?

To answer this question, I proceed in three sections:

1. Description and analysis of the financing of the transformation process of eastern Germany, and development of general principles from this analysis
2. Examination of whether these principles can be applied to the 10 CEECs (Bulgaria, the Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, Slovakia, and Slovenia)
3. Formulation of policy recommendations with regard to future eastern enlargements.

To what extent is the case of eastern Germany comparable to the applicant countries of Central Europe? It could be argued that there were critical differences between the case of eastern Germany and the CEECs. Overnight integration into the Western trading system, social market economy and democracy, along with adoption of the D-Mark, meant that conditions for adjustment were particularly pressing in eastern Germany, whereas the CEECs have had more time to restructure their economies. Nevertheless, in both cases a twofold transformation, political and economic, occurred in the 1990s. All these countries have suffered from a non-competitive economy, low productivity, hidden unemployment and an antiquated infrastructure. Hence, it is valuable to develop general principles on the use of financial aid that are applicable to all countries in transition.

Spain, Portugal and Greece at least showed some characteristics of a market economy when they entered the EU in the 1980s. Moreover, the southern enlargements are inappropriate for comparison since the EU has undergone many changes in the last decade, with implementation of the Single European Act and the internal market programme, as well as adoption of the Maastricht Treaty. In particular, Structural and Cohesion Policies have become central only since the EU's enlargement towards the south. Between 1988 and 1999, the Structural Fund allocation quadrupled from EURO6.3b to EURO27.4b, accounting for 35 percent of the total EU budget. In contrast to what might have been expected, the southern member states did not express concerns about losing payments from the Structural Funds on the incorporation of eastern Germany, partly because Germany is the largest contributor to these measures. Nevertheless, during the period from 1994 to 1999 the share of EU structural interventions (Structural Funds, the Cohesion Fund and Community Initiatives) decreased significantly in the southern member states (with the exception of Spain), while it increased in Germany (Bache, 1998: 89).

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Financing eastern enlargement is currently a major issue in European affairs. Since all potential member states will still be relatively poor at the time of accession, they will all be eligible for structural assistance. Estimates suggest that transfers to the CEECs will reach between EURO10b and EURO32b per year, depending on economic factors in the accession countries and the scope of EU reforms.[2] The Berlin European Council of March 1999 allocated EURO195b for the Structural Funds in the EU budget for the years 2000–6 and EURO18b for the Cohesion Fund. Almost 70 percent of structural expenditures will be disbursed into Objective 1 regions, but member states will not be eligible for transfers that exceed 4 percent of their Gross Domestic Product (GDP).

Financing eastern Germany's reconstruction

In this first section, I provide an analysis of EU and national contributions to the Neue Länder based on various criteria.[3] To what extent were such contributions made? Which programmes and instruments have been developed? What areas are being financed? Who are the key actors at the EU level and at the national German level regarding Structural Policy measures? On the basis of these questions, general principles concerning the financing of enlargement to include transition countries are generated.

National distribution from western to eastern Germany

Economic developments

Integration of eastern Germany into the EU and the world economy required a wide-ranging restructuring of markets. After the dissolution of COMECON, eastern Germany suffered from a massive decline in industrial production due to a lack of competitiveness and the breakdown of traditional export markets. The economic situation in eastern Germany recovered significantly between 1991 and 1994 with a rise in GDP of nearly 10 percent in 1994. The rate of GDP growth decreased, however, in the following years, to 2.5 percent in 1998 (Bedau, 1998; Riedel and Scharr, 1998: 7). Nevertheless, eastern Germany's GDP per capita approached the EU level relatively quickly. While in 1991 GDP per capita was only about 37 percent of the EU average, it rose to almost 65 percent in 1996 (Riedel and Scharr, 1998: 8). Between 1991 and 1997 the unemployment rate in the Neue Länder doubled, however.

Ten years after unification, transformation in eastern Germany is still not complete. With an estimated GDP growth of 2.3 percent and an unemployment rate of 18 percent in 1999, and serious problems of long-term unemployment (Schultz, 1998), the reconstruction of eastern Germany is still progressing (DIW et al., 1998c). Yet, regardless of all the difficulties, eastern Germany's economy seems to be moving in a promising direction (DIW et al., 1998a). Competitive enterprises have been established in regions such as Frankfurt/Oder, Leipzig-Halle and Dresden – mainly in the sectors of telecommunications, computer science and biotechnology. While in 1994 almost no high-technology enterprises existed in the Neue Länder, this situation has changed significantly within the past few years. In Dresden (Saxony), for example, 500 micro-electronic firms (with more than 17,000 employees) and 120 computer firms have already been founded. In Jena (Thuringia) 23 biotechnology enterprises have been established since 1996 (*Die Zeit*, 1999: 41f). This sectoral concentration of enterprises can be viewed as an approach to building up regional clusters (OECD, 1999). Despite these positive examples, it will still take time to reach an economic level comparable to that of western Germany or other EU member states.

Transfers

The German Federal State (*Bund*), the German Länder and the EU have transferred funds to support eastern Germany's transformation process. During the period from 1991 to 1998, the contributions from the German Federal budget and other sources such as the 'German Unity' Fund (Fonds 'Deutsche Einheit') amounted to over DM1,400b (Federal Government, 1998: 70; Federal Ministry for Economics, 1998d). In 1996, the transfers amounted to 4.5 percent of western Germany's GDP and 34 percent of eastern Germany's GDP. In 1991, resource transfers to eastern Germany even amounted to 60 percent of national income in the former GDR (Welfens, 1993: 165). For comparison, the support to West Germany by the Marshall Plan in the years from 1948 to 1951 made up about 3 percent of Germany's GNP (Boss, 1998: 16).

Programmes and instruments

The programmes and instruments[4] implemented by the German Federal Government to facilitate economic recovery in eastern Germany have focused mainly on four areas (Federal Ministry for Economics, 1998d). These are: investment in manufacturing businesses, especially small and medium-sized enterprises (SMEs); investment in infrastructure; investment in so-called 'soft' location factors; and regional policy.

First, instruments to attract business activities to eastern Germany consist of measures based on taxation, the promotion of investment through loans at reduced interest rates, guarantees (*Bürgschaften*), and special funds such as the 'Participation Fund East' (Beteiligungsfonds Ost) and the 'Consolidation Fund' (Konsolidierungsfonds), with the latter aimed at helping SMEs suffering from temporary liquidity problems. In general, taxation measures can be defined as investment allowances (*Investitionszulagen*) for mobile goods, special depreciations (*Sonderabschreibungen*) granted for the purchase and production of mobile and immobile goods as well as for the expansion of enterprise buildings, or the total exemption from taxes for reinvested profits of SMEs that have been realized through the sale of shares. These measures aim to foster rapid and broad investment dynamics in order to produce structural changes and economic modernization as well as to promote the foundation of SMEs (Federal Ministry for Economics, 1998b: 13). Between 1991 and 1997, DM22b was spent in investment allowances and DM47b in special depreciations (Federal Ministry for Economics, 1998d: 7).

The promotion of investment through reduced interest rate loans is provided through the 'ERP-Eigenkapitalhilfe-Programm' (ERP-Programme for the Formation of Capital) as well as through the Kreditanstalt für Wiederaufbau (German Bank for Reconstruction) and the Deutsche Ausgleichsbank (German Bank for Settlement) to those wishing to establish or consolidate a business. This financial aid amounted to DM72b until 1997 (Federal Ministry for Economics, 1998d: 7). Guarantees to secure loans are conferred through special banks dealing with guarantees (*Bürgschaftsbanken*), the Deutsche Ausgleichsbank and the Bund/Länder. Investments totalling DM35b have been made possible through this instrument (Federal Ministry for Economics, 1998d: 7).

Since 1996 the 'Participation Fund East' has been an important fund in raising risk capital for those SMEs in the Neue Länder which need capital to finance their expansions, want to enter new markets or are in the process of developing new products (Federal Government, 1998: 65). This fund, with a total budget of DM1.5b, is administered by the Kreditanstalt für Wiederaufbau and the Deutsche Ausgleichsbank.

In addition, infrastructure and 'soft' location factors have received massive investments. Between 1990 and 1997 almost DM162b was invested in the infrastructure of transport[5] and telecommunication, as well as in projects connected to business activities such as industrial estates. 'Soft' location factors such as housing and urban projects, reorganization of the brown coal industry and support for research and development have been promoted by the German government with close to DM300b since 1990 (Federal Ministry for Economics, 1998d: 9–13).

Finally, the western German 'Joint Task for the Improvement of Regional Structures' (Gemeinschaftsaufgabe 'Verbesserung der regionalen Wirtschaftsstruktur') co-financed by the Bund and the Länder was extended to eastern Germany[6] in order to encourage the creation of durable jobs and skilled workers. Moreover, the financial aid of the European Regional Development Fund is channelled through this programme by most of the eastern German Länder (Riedel and Scharr, 1998: 18).

Actors

The patchwork of actors in this 'distribution game' is somewhat confusing. While for most programmes the Bund or the Länder are the financial aid donors[7] the distribution of the capital is done by many different actors. The Kreditanstalt für Wiederaufbau and the Deutsche Ausgleichsbank are the most important actors entrusted with distributional tasks (granting special loans, and administering the 'Participation Fund East'). The administration of the 'Consolidation Fund' differs among the Neue Länder. With regard to regional policies and the 'Joint Task', responsibilities are shared between the Federal Government and the Länder governments, while prime responsibility lies with the Länder (Drerup, 1997: 337).

The EU's Structural Policy in eastern Germany

In 1994, the EU assigned the Neue Länder the status of Objective 1, since eastern Germany belongs to the poorest EU regions measured in terms of GDP per capita. Before 1994, EU assistance was provided by a Special Regulation. The Structural Funds of the EU are coordinated by the so-called 'Joint Assistance Concept' (*Gemeinschaftliches Förderkonzept*) which was negotiated between the Bund, the Länder and the European Commission in July 1994.

Transfers

Between 1994 and 1999 financial assistance from the four Structural Funds – the European Regional Development Fund (ERDF), the European Social Fund (ESF), the European Agricultural Guarantee and Guidance Fund (EAGGF), and the Fishery Guidance Fund (FIGF) – reached approximately EURO20b (DM39b) or 14.3 percent of the EU's total Structural Funds budget for Germany (European Commission, 1997a: 30). Nearly two-thirds of the EU's structural transfers for Germany, that is EURO13.7b (DM26.7b), were reserved for the Neue Länder (see Schuster, 1996: 185).

Instruments

The 'Joint Assistance Concept' formulates several general goals with regard to the transposition of Structural Funds in eastern Germany, such as the creation of durable jobs or the need to raise income and to improve location factors. Some of the goals are specified in quantitative terms, for example in respect of the reduction of unemployment (Riedel and Scharr, 1998: 17). The 'Joint Assistance Concept' provided a total budget of approximately EURO51.3b (DM100b) for the years 1994 to 1999. In general, this instrument is enforced by the German 'Joint Task' (*Gemeinschaftsaufgabe*). Both approaches stand for two independent concepts of regional policy. In the light of German unification, the national concept had to be brought into agreement with that of the Community (Schrumpf, 1997: 249; Voelzkow and Hoppe, 1996: 119–25). Nevertheless, the 'Joint Assistance Concept' includes a clause enabling the Länder to spend money outside the frame of the 'Joint Task'. This flexibility allows for regional differentiation.

The prime principle of the 'Joint Assistance Concept' is the cofinancing of projects (so-called 'additionality'). Consequently, while only 24 percent of the transfers indicated in the 'Joint Assistance Concept' originate from the EU's structural assistance, 58 percent come from private investors and 18 percent from public budgets. While private investors and investments by the ERDF concentrate on infrastructure, non-material investments (research and development, management consultancy) and the establishment of new enterprises, public-sector investments focus on the development of human capital and employment promotion (Riedel and Scharr, 1998: 18).

Actors

The 'Fund Administrators' (*Fondsverwalter*) play a vital role in distributing EU funding within the five Neue Länder on all levels (Mauer, 1996). They enjoy executive functions and decision-making competences. At the EU level, a variety of committees assist the Commission in the implementation of Structural Funds (Pollack, 1995). In connection with Objective 1 measures, the 'Committee on the Development and Transposition of the Regions' is concerned with all matters of Structural Fund implementation. The Committee consists of experts from all implementation levels and is again assisted by regional committees which arrange the main Committee meetings (Heimpold, 1999: 15).

In its 1999 Structural Policy reform, the European Union sought the decentralization and simplification of Fund implementation. While the Commission concentrated its activities on strategic issues, the regions gained more responsibility. Detailed financial programming at the operational level is now the responsibility of the regions (or the member states). This step towards more self-accountability for the regions and the member states should have a positive influence on Structural Policy outcomes, since it will be possible to react faster to regional economic problems. In spite of these reforms, the Commission still has to approve the member states´ operational programmes.

Developing principles from the financing of eastern Germany's reconstruction

It is unrealistic to believe that any of the CEECs or the EU is able (or willing) to raise a similar amount of money for the transition countries as West Germany did for the former GDR. Therefore, it seems even more important to draw lessons from a decade of financing the reconstruction of a former socialist planned economy.

There are various problems concerning the evaluation of reconstruction programmes. The causal effects of structural measures and economic promotion are not always obvious or even positive. Schrumpf (1997: 253) points out fundamental issues in this regard, first stating that:

> . . . when a massive amount of funds is provided by the national government in addition to the programmes co-financed by the EU for the expansion of infrastructure, housing, the tertiary sector and the establishment of general administration, the effects of promotion can no longer be clearly assigned to any particular programme.

He also mentions the classic 'counterfactual' problem: What would have happened without the programmes?

Nevertheless, evaluations of the financing of eastern Germany's reconstruction show positive effects in terms of the promotion of capital formation. Moreover, modern infrastructure is a precondition for private investment activities. New communication systems and acceptable traffic infrastructures decrease costs for firms and increase the attractiveness of location. Even though some studies raise scepticism about economic promotion in eastern Germany (Hagen and Toepel, 1997: 802; Riedel and Scharr, 1998: 19, 22), others stress the importance of financial assistance with regard to job creation and investment activites (European Commission, 1997a: 58). Moreover, one should note the institutional capacity to absorb massive transfers of funds, a point that is developed in more detail for the CEECs below. An insufficient institutional capacity leads to a lack of speed, efficiency, effectiveness and transparency in administering structural aid.

In general, any kind of subsidy must be treated with caution. In eastern Germany, the financing of the so-called 'second' market has become an important employment factor. Subsidizing non-competitive jobs leads to market distortions if salaries paid by subsidized enterprises are higher than those paid by unsubsidized companies. In the long run, subsidies endanger the recovery of the regular job market (DIW et al., 1997). Furthermore, subsidies are likely to lead to a mentality of 'rent-seeking', and enterprises may view economic promotion not as a means of reducing locational disadvantage, but as a source of regular income. The promotion of business education by the Neue Länder is an example of this. While financial support increased year by year, the number of vacancies for on-the-job training stagnated (*Handelsblatt*, 1999). A joint study by three German economic research institutes argues that in eastern Germany the danger of taking subsidies as a 'normal' income factor is rising (DIW et al., 1998b).

There is no doubt that locational disadvantages in eastern Germany require the use of special instruments to facilitate the establishment of new firms and the creation of jobs. Nevertheless, economic promotion has also helped to produce structures that are not capable of existing without further financial aid. For example, attractive special depreciations led to real estate speculation instead of industry equipment investment. Moreover, investment allowances failed to consider that not every sector of the economy suffered from locational disadvantages. A poll among investors in Saxony discovered that one-third of the projects would have been realized even without ERDF support (Hagen and Toepel, 1997: 803).

By weighing the costs and benefits of economic promotion in the five Neue Länder, the following four principles can be deduced:

1. *Regional differentiation*: financial aid is best made available in areas where spillover effects can be expected. Industrial agglomerations are areas that profit most from transaction cost advantages. Growth effects in the centre will have positive effects on the periphery. Moreover, the concentration of innovative enterprises leads to high synergy and network effects, thus fostering a self-enforcing process of innovation and growth. In practice, this approach led to the foundation of many technology centres in eastern Germany (Franz, 1999: 3).
2. *Focusing*: judging from the experience of eastern Germany, it seems important to focus financial funds (Piehl, 1996: 329). To avoid the durable establishment of a 'second' job market, assistance might be concentrated on the regular job market, for example on qualifications for existing employees, on the training of management staff, on the promotion of technology and marketing, on measures to establish new, innovative SMEs and on programmes to increase the number of self-employed persons. These activities might be accompanied by the promotion of capital formation and infrastructure measures.
3. *Subsidiarity*: in eastern Germany the greatest success has been achieved in regions that developed their own initiatives and mobilized available potential. People and actors *within* regions know best what is needed in their respective regions. The application of the principle of subsidiarity may be limited in cases where regional actors do not have such a strong influence on decision-making as in the German Länder, as may be the case in the CEEC candidates with less developed federal structures. As Staeck (1996: 100) found, the potential of the Länder to influence the Commission is noteworthy. Since in the planning process the Länder could only officially get in contact with the Commission through the Federal Government, a growing number of informal contacts to the Commission have been established.
4. *Conditionality* aims at the improvement of efficiency. This principle should include the frequent use of repayable loans instead of grants, as well as time limitation on funding. Repayable loans ensure that the recipient calculates more carefully. Moreover, the problem of 'rent-seeking' can be restricted. The temporal limitation of measures avoids the effects of 'habit' and 'subsidy mentality'.

The following section investigates the extent to which these principles are already found in the EU's financial assistance to Central and Eastern Europe.

Future eastern enlargements to the EU

AGENDA 2000 and the pre-accession instruments

This section provides a brief description and analysis of the EU's programmes for the CEECs and the pre-accession instrument in the field of structural measures, the Instrument for Structural Policies for Pre-Accession (ISPA).[8] Enlargement negotiations with five CEECs (the Czech Republic, Estonia, Hungary, Poland, Slovenia) and Cyprus started in November 1998. In February 2000, the Council of Ministers launched negotiations with Bulgaria, Latvia, Lithuania, Romania, Slovakia, and Malta as well. Not only do the candidate countries need to adapt, but the EU must also undergo substantial reforms in its structural, agricultural and budgetary policies. The European Commission addressed the necessary reforms in its document *AGENDA 2000* (European Commission, 1997b; European Commission, 1997c), adopted by the Council in June 1999.

Commission plans suggest that pre-accession aid will amount to EURO21.8b between 2000 and 2006 (including agricultural and structural aid, and PHARE). Assuming that in 2002 five CEEC candidates – for example Poland, Hungary, the Czech Republic, Slovenia, Estonia – join the EU, each of the new member states will benefit from an average amount of EURO2.05b per year until 2006, first in the form of pre-accession aid, and later through the Structural Funds. The remaining five will receive EURO0.6b per year as pre-accession aid in this same period. Notably, this is a much smaller contribution compared to the EURO24.6b which the Neue Länder received from the EU during a similar time period (Federal Government, 1998: 70).

PHARE

The PHARE programme was initiated in 1989 first to support just Poland and Hungary, but soon 13 eastern European countries[9] were participating. PHARE contributes to the transformation of economic and political systems in eastern Europe by focusing financial aid in areas like qualifications of employees, industrial restructuring, infrastructure, privatization and environmental awareness. Whereas in the first years the emphasis was on privatization and the establishment of SMEs, since 1995 a special focus has been put on infrastructure projects, and since 1997 on institution building and investment support. PHARE only provides non-repayable grants.

Subsidiarity is reached by a so-called 'demand-driven approach' in which the partner countries decide how and where they use the financial aid. Nevertheless, in the planning phase, the Commission has to agree to an indicative programme which lays down the framework for the projects to be supported (Harsay, 1994). During the implementation phase, a PHARE Coordinator is responsible for implementing the programme at the national level. At the EU level, an Administrative Board, composed of representatives of the member states and of the Commission, and the Commission's Directorate-General for Enlargement, decide upon the proposed projects. Between 1990 and 1999, the European Union has provided more than EURO10b under the PHARE programme. The Berlin Council granted the same sum for the period until 2006 as pre-accession aid.

ISPA

Since 1 January 2000 ISPA has been the new pre-accession instrument of the EU in the field of structural policies. This assistance, to be granted at a constant rate of EURO1.04b per year, is initially offered to all the applicant countries and will subsequently be focused on countries joining the EU at a later stage. In total, the financial volume for the 10 CEEC candidates amounts to EURO7.3b between 2000 and 2006. The Council Regulation on ISPA determines that funds will be granted for measures which help transpose the environmental acquis and improve traffic infrastructure. Consequently, this aid serves to align the laws of the CEECs to Community rules. The concentration on environment and infrastructure complies with the principle of focusing financial aid on selected sectors.

In contrast to PHARE, ISPA not only provides aid in the form of non-repayable grants, but also through repayable loans, reduced interest payments, participation in risk capital, and other instruments as well. The principle of conditionality is further strengthened by the requirement that a project or a group of projects must be large enough (at least EURO5m) in order to be sustainable. Similar to PHARE contributions, the national proposals for ISPA financial measures are approved and reviewed by the Commission (Directorate-General for Regional Policy).

While the candidate countries made significant progress in building up PHARE implementation structures, thus reducing the absorption problem (European Commission, 1999a; 1999b; 1999c), they face bigger challenges with the implementation of the new pre-accession instruments. With the doubling of pre-accession aid during the period 2000–6, absorption problems will certainly rise. In order to help avoid such problems, the Commission requires the candidate countries to establish management and control systems not later than 1 January 2002. Though the CEECs have made various efforts to satisfy the accession criteria with respect to structural and cohesion policies, the Commission still has doubts about the ability of the candidate countries to implement structural instruments. With regard to Poland, for example, the Commission concludes that 'the new regional administrations in Poland are not yet sufficiently prepared to implement the EU structural instruments' (European Commission, 1999b).

In search of parallels

This section examines how far the four principles (focusing, subsidiarity, conditionality and regional differentiation) can already be found in EU assistance for CEECs. The above analysis showed that only the principle of focusing financial measures is sufficiently fulfilled in the EU's pre-accession strategy. The PHARE programme, as well as the ISPA instrument, concentrate budgets on measures such as the promotion of SMEs, qualification measures, and infrastructure projects. According to the European Court of Auditors, financial mechanisms in favour of SME promotion led to the most positive effects of PHARE financing (European Court of Auditors, 1998).

The principle of 'subsidiarity' remains vague. Even though each instrument has administrators at the national level, they only have limited decision-making power.[10] In addition, regional or local actors are hardly involved during the implementation process. This may be due to the fact that ISPA is modelled according to the Cohesion Fund and thus only involves national governments (Brusis, 1999: 18). The European Parliamant directed the Commission to this point and required that, in future, regional and local decision levels should be involved in managing PHARE and ISPA aid (European Parliament, 1999: 6). Experience from Hungary, for example, where a number of Fund Implementing Agencies have been established, shows that involving the regional level contributes to a more efficient use of funds and helps to solve the absorption problem (European Commission, 1999a).

'Conditionality' has been introduced with the 'Instrument for Structural Policies for Pre-Accession'. ISPA provides the possibility to supply repayable loans whereas PHARE totally lacks this possibility. It can be assumed that conditionality for ISPA measures, together with a frequent ex-post evaluation of the projects, might lead to greater efficiency in the distribution of financial aid. Finally, it is not clear if the programmes pay attention to regional differentiation. PHARE pays attention to regional factors through the PHARE Cross-Border Cooperation Programme. Yet, as its name indicates, this programme does not aim at promoting agglomerations, but at facilitating the development of isolated border regions. In sum, the principles that have been developed from the eastern German experience have so far not been well integrated into the pre-accession concepts of the European Union, nor into the EU's Structural Policies.

Conclusions and policy recommendations

The eastern German case shows that the *amount* of money spent may not be the decisive factor in the reconstruction of transition countries. Aid should rather be 'efficient' and 'effective': these are commonly used keywords (Funkschmidt, 1997: 220; Stahl, 1997: 204; Toepel, 1998: 466). Many authors have made proposals on how to reform the Structural Funds (see for example Bachtler and Turok, 1997; Bollen, 1999; Stehn, 1997; Toepel, 1998; Weise, 1996). These proposals often comprise the concentration of aid in terms of objectives, population, and geography, and the decentralization of fund management. This analysis of financing reform in eastern Germany has specified principles that may help finance Central and Eastern Europe's reconstruction more effectively and efficiently. They are just as valid for EU measures as for national ones.

The following policy recommendations may therefore be made:

1. Measures that promote spillover effects might be favoured (see Geppert, 1997).
2. Financial aid might be focused on programmes that foster human capital formation, the establishment of SMEs, and the modernization of infrastructure.
3. Regional actors should become the most powerful decision-making bodies. The effectiveness of projects is best guaranteed if people who are familiar with the region are allowed a 'voice' in project decisions.
4. Financing should be made conditional. Conditionality guarantees a more careful calculation of beneficiaries and may help to avoid a 'subsidy mentality'.

Some practical problems restrict the extent to which it is possible to apply lessons derived from the eastern German experience to the CEECs. The underdeveloped institutional framework continues to be an obstacle in the CEECs. The applicant countries are still in the process of implementing adequate structures and institutions in order to take part in the Structural Funds after EU accession, including systems of regional government (see, for instance, Ministry for Regional Development of the Czech Republic, 2000). Certain principles from the financing of eastern Germany's economic reconstruction nonetheless seem highly relevant for the EU's further eastern enlargements. Until now, they have been partly neglected, even though there are strong indications that financial transfers are used more efficiently if these principles are applied. The limited EU financial resources available for restructuring the CEECs and the immense demand for financial transfers to the east require a principled enlargement approach. In *Agenda 2000*, the Commission addresses the historical significance of enlargements to the east, underlines its role as a guarantor for stability, and points out that the more tangible the advantages of enlargement, the easier it will be to deal with the burdens of the adjustment process (European Commission, 1997b). It is thus particularly appropriate to draw lessons as widely as possible.

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Notes

1 This is done elsewhere, for example by Beutel (1993), Hödl and Weida (1997), Holtzmann (1996).

2 This is an estimate by the German Institute for Economic Research (DIW) for the CEFTA-5 countries (Weise, 1996). For further estimates see Baldwin (1997), Eser and Hallet (1993).

3 The division between national and EU contributions to the Neue Länder is not always easy, as some regional measures are cofinanced between the EU and the German Federal state, especially the 'Joint Task for the Improvement of Regional Structures' (*Gemeinschafts-aufgabe zur Verbesserung der regionalen Wirtschafts-struktur*).

4 A special 'solidarity tax' (*Solidaritätszuschlag*), applied in western and eastern Germany, has provided the financial basis for this patchwork of measures. This tax (a 7.5% income tax surcharge) was first limited to a one-year period between July 1991 and June 1992, but was later reintroduced.

5 The 'Traffic Project German Unity' (*Verkehrsprojekt Deutsche Einheit*) is the most important pillar concerning traffic infrastructure in eastern Germany.

6 According to the Treaty on the Unification of Germany (*Einigungsvertrag*) the same rules for economic promotion shall be applied in both parts of Germany (Article 28).

7 With the exception of the Consolidation Fund where in cooperation with the *Treuhandanstalt*, the political parties and the Länder form the group of donors.

8 Financial aid from development banks such as the EBRD and the EIB is not considered here, nor is SAPARD, the Special Accession Programme for Agriculture and Rural Development.

9 Albania, Bosnia and Herzegovina, Bulgaria, the Czech Republic, Estonia, the former Yugoslav Republic of Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. Croatia, originally the 14th partner country, was suspended from the PHARE programme in August 1995.

10 By contrast, Rupp (1999: 102) sees the PHARE programme as highly decentralized and the national administrators endowed with sufficient decision-making power.

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