98-402 E

CRS Report for Congress

Received through the CRS Web

NATO and the European Union: Economic Capacity of New Member Countries and Opportunity Costs

April 23, 1998

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ABSTRACT

Formal accession agreements with the Czech Republic, Hungary, and Poland joining the North Atlantic Treaty Organization (NATO) are scheduled for spring 1999, with accession to the European Union (EU) several years later. In tight budgets over the coming decade these security requirements for assuring integration into NATO structures and force modernization would have to compete with other incremental programs designed to further economic transition and meet European Union (EU) accession requirements. How well the likely new members to NATO and EU assess their opportunity costs in formulating their budgets in the decade ahead may be of special interest to the U.S. Congress in discharging its foreign and appropriations policy responsibilities.

This report will be updated as justified by events.

NATO and the European Union: Economic Capacity of New Member Countries and Opportunity Costs

Summary

Formal entry of the Czech Republic, Hungary, and Poland into the North Atlantic Treaty Organization (NATO) is scheduled for spring 1999, with accession to the European Union (EU) several years later. In tight budgets over the coming decade defense spending in these three nations, with or without NATO membership, would have to compete with other incremental programs designed to further economic transition and meet European Union (EU) accession requirements. The cost of opportunities foregone by choice of one required program over another could represent significant opportunity costs when all desired appropriations can not be fit into tight budgets.

Providing adequate budgetary outlays for satisfying the full requirements of security plans — with or without NATO accessions; full requirements for fulfilling economic and political plans — with or without European Union accession will be difficult for even the most successful transition economies in the region. Joining NATO and the European Union may ease these tough decisions as both organizations provide financial and technical support and offer integrative advantages that would facilitate transitions in each acceding country. Tight budgets and opportunity costs will make judicious decisions on budgetary inclusion a central factor in the success of comprehensive transitions. Although the three candidate countries are the success stories of transition to date and may well be the best performing in the future their state budgets constrained by a tight cap on deficit financing, will not have the capacity to simultaneously meet all the priority claimants of both "guns and butter." Each of the three new NATO members has more incremental programs especially critical to economic transition than can be funded in projected budgets, e.g., pension fund recapitalization, restructuring and retraining costs for privatization efforts in critical sectors, contributions to construction of an the EU-sponsored railroad/road network, increased debt servicing burdens, health, education, and administrative reforms. These programs are the key requirements for stabilization, liberalization, and privatization, which are all interlinked as they determine economic growth, economic assistance, and investment from abroad. Each of these programs and more are part of the EU accession requirements. The EU assistance programs are now being tied to meeting these criteria. These are critical programs in the decade 1999-2009 when both the NATO and the EU enlargement costs are projected to be concentrated.

How well the likely new members to NATO assess their opportunity costs in formulating their budgets in the decade ahead may be of special interest to the U.S. Congress in discharging its foreign and appropriations policy responsibilities. These first accessions may set precedents for successive accessions to both NATO and to the EU. The rising opportunity costs in countries with less economic capacity may affect how quickly the EU and/or NATO will decide to integrate new members. For NATO and the EU, the timing and the conditions of subsequent accessions will pose continuing questions.

This report will be updated as justified by events.

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The North Atlantic Treaty Organization (NATO) has invited the Czech Republic, Hungary, and Poland to join; the three are scheduled to join when they and all current 16 members have completed their national processes of ratification and submit their instruments to the United States government. A formal ceremony welcoming the three new members is scheduled to take place in Washington in April 1999. By joining NATO, the new members gain the security and larger transitional benefits from an organization with a new "community of values."

> Today, the members have moved beyond the collective defense commitment to employ NATO's strengths as a defense cooperation organization for additional purposes. These purposes include creating political/military options for dealing with crises and challenges to the interests of the member states, spreading stability to Central and Eastern Europe, and encouraging cooperation with Russia and other countries.[2]

The synergism of improved security is important to the success of economic transition to market systems and political benefits from increased democratization under a rule of law. The three countries seek membership in both NATO and the European Union (EU) because of the complementary benefits of security enhancement, economic growth, and the development of democratic systems.

While benefits are complementary, costs for necessary new programs in the state budgets of the three candidate countries are not. Tight budgets constrained by a limit of three percent or less deficit spending in the Gross Domestic Product provide a procrustean bed for the incremental claimants in the decade ahead. Increasing pressures for financing strongly supported programs by deficit financing has been turned back by reformers' desires to maintain a balanced budget, facilitating reduction in the inflation rate and keeping a stable exchange rate regime. While the EU enforces a three percent deficit-to-GDP cap, Poland is now projecting a zero deficit for 1999.

In the decade 1999-2009 incremental budgetary outlays will be required to enhance interoperability of new and old members in NATO and to modernize and restructure forces of the new members. During the same decade incremental budgetary outlays will be required to provide the bases for these advanced transition economies to proceed toward a stage of sustained economic growth. Without accession to NATO or to the EU, these requirements for effective transition would be greater as integration into the NATO and EU systems provides benefits that are

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[2] U.S. Library of Congress, Congressional Research Service, *NATO's Evolving Role and Mission*, by Stanley Sloan with the assistance of J. Michelle Forrest, CRS Report No. 97-708 F, updated March 11, 1998.

not funded by the new members.[3] The funding dilemma, however, is not caused by aspirations for NATO membership. The governments of all candidates for NATO membership believe their defense expenditures, and therefore their spending dilemmas, would be more challenging if they had to provide their defense as a non-NATO member.

The three candidate countries demonstrated capability to support requirements of their defense plans in the initial development period of NATO expansion through 1999 and rising requirements into the next decade:

> The Czech Republic defense spending may rise from 1.7 percent of GDP in 1997 to 2 percent in 2000 ($1.5 billion). The "National Defense Concept 2005" program calls for 20 percent of the budget for modernization, including purchase of Western fighter aircraft and upgrading their main battle tanks. . . .
>
> Hungary has increased their defense allocations to 1.5 percent of GDP and projects 2.0 percent in 2000. "Force 2000" program calls for force modernization to rise from 12 percent in 1997 to 25 percent of defense spending in 2001. . . .
>
> Poland supports the largest force and military budget in the prospective candidates. Their defense budget at 2.4 percent of GDP in 1997 may rise to 3 percent in 2000. Their fifteen-year (1998-2012) study projects modernization of forces to grow at 3 percent and procurement to grow at a 2 percent annual rate.[4]

The NATO Common Funds will be helpful in providing resources for required military and security investment programs to meet collective needs in pipelines, road transport, communications and military coordination activities. As the costs for the some $1.7 billion program is allocated largely on the basis of GDP and population the impact on new members' budgets would be small and the benefits substantial.[5]

Each of the candidate countries with defense and NATO accession plans currently project their security requirements as manageable. Indeed, the relatively troubled Czech Republic is increasing its percent of GDP to defense in 1998-1999

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[3] Report to the Congress on the Enlargement of NATO: Rationale, Benefits, Costs and Implications, February 1997. A report submitted to Congress pursuant to Section 1048 of the Fiscal Year 1997 Defense Authorization Act, that describes the rationale, benefits, costs and other considerations related to NATO's enlargement. NATO Enlargement, Cost Estimates Developed to Date are Notional, General Accounting Office report to Committee on International Relations, August 1997. See: U.S. Library of Congress. Congressional Research Service. NATO Expansion: Cost Issues. By (name redacted), CRS Rpt. No. 97-668F. July 2, 1997; *NATO: July 1997 Madrid Summit Agenda*. By (name redacted). CRS Rpt. No. 97-443 F. Updated June 5, 1997; NATO: Congress Addresses Expansion of the Alliance. By (name redacted) IB95036. Updated regularly; NATO Enlargement: The Process and Allied Views. By (name redacted). CRS Rpt. No. 97-666F. July 1, 1997.

[4] *NATO Prospective Members: Military Modernization*, by (name redacted), CRS Report 98-154 F, February 24, 1998..

[5] NATO Common Fund Burden Sharing: Background and Issues, by (name redacted), CRS Report 98-239 F, March 11, 1998.

while holding non-defense increases to zero. Likewise, as they proceed into specific discussions on accession requirements with the European Union, they postulate that meeting the accession requirements of the EU are manageable. Projections and requirements for programs enhancing security, economic growth, or democratization will need to be translated into budgeting outlays into annual budgets of these candidate countries when programs needed for all transitional requirements increase. The non-defense requirements alone will exceed the likely state budgets as these economies move toward improving enterprise efficiency, repairing their social safety nets, building modern infrastructures, providing effective debt management and other mandatory programs. These substantial incremental economic programs may be considered mandatory by judgments of the EU, foreign assistance providers, foreign investors, reform leadership and the electorates. Whether actually mandatory or discretionary, all these priority economic programs cannot be assured of full funding within the tight budgets of the next decade.

In this oversubscribed budget context security programs will have strong competition. No doubt the requirements for defense programs and NATO enlargement costs will be strongly supported. However, the decision in each budget year and throughout the decade ahead are likely to require difficult choices and managing the shortfalls is likely to be complex.

All the countries in the region in transition will have difficulty meeting their multiple requirements from their state budgets. Economic growth of GDP provides a basis for generating increased tax revenue, attracting the foreign assistance and investment necessary to fund programs without deficit financing. The candidate countries must all limit deficit financing to fight inflation effectively and ensure a stable exchange rate regime. These three candidate countries may have the greatest economic capacity for absorbing incremental costs of accession. These three have been and may continue to be the "success stories" of transition in the region, best able to generate the economic capacity to bear the costs of enlargement (Table 1). They have recovered early from post-revolutionary recession, have shown positive growth, have attracted the most foreign investment, and are deemed most likely to attain sustainable growth of about five percent per annum or better in the decade of NATO and EU enlargement (1999-2009). Most investment advisory and risk assessment agencies project Czech economic recovery to a sustainable growth rate comparable to that expected for Hungary and Poland.[6]

[6] Appendix, Country Profiles, *op cit.*

Table 1. Economic Indicators[1]

	1	2			3		4		5	6		
Countries	**Population**	**Output (GDP Growth)**			**Stabilization**		**Liberalization**		**Privatization**	**Integration**		
	(millions, 1996)	1990 (annual % change)	1997	1997 (1989=100)	Inflation rate 1991 (annual % change)	1997	Domestic prices (1-4+)[2]	Open economy	(% of large, medium & small-scale enterprises)	FDI per capita US $	Trade Turnover 1991 (billions US $)	1997
Advanced States												
Czech Republic	10.3	-1.2	1	90	52	9	3	3	75	123	21	52.9
Estonia	1.5	-8.1	7	76	304	12	3	3-	67	71	8	6.8
Hungary	10.3	-3.5	3	89	32	17	3+	3	78	195	21	40.2
Poland	38.5	-11.6	6	110	60	15	3+	3	65	71	25.4	64.7
Slovenia	2	-4.7	4	99	247	9	3+	2	55	90	8	17.5
Less Advanced States												
Bulgaria	8.4	-9	-7	63	339	592	3	2	46	12	7.4	9.1
Latvia	2.5	2.9	8	54	262	8	3	3-	55	92	1.6	4.5
Lithuania	3,7	-.	..	.4	345	10	3	2+	68	41	2.2	9.1
Romania	22.7	-5.6	1.5	87	223	116	2	2	55	9	10.1	19.6
Slovak Republic	5.3	-2.5	5	94	58	7	3	3	70	33	12.8	20

[1]European Bank for Reconstruction and Development (EBRD) in Transition Report 1997: Enterprise Performance and Growth, December 1997; PlanEcon, Review and Outlook for Eastern Europe, December 1997 with selected country PlanEcon Reports; Nicholas Stern, The Transition in Eastern Europe and the former Soviet Union: some strategic lessons from the experience of 25 countries over six years, EBRD Working Paper No. 18, April 1997.

[2]Scoring from one to five as highest score in transition: Price liberalization scores from 1 (most prices formally controlled by the government) to 4+ (comprehensive price liberalization of advanced industrial countries); 2 indicates that state procurement at non-market prices remains substantial, and 3 stands for substantial price liberalization; Open economy also ranges from 1 (limited access to foreign markets, no competition legislation and institution) to 4+ (unrestricted entry to most markets; effective enforcement of competition policy), Transition, World Bank Newsletter, September 1997.

Opportunity Costs and Tight Budgets

In the annual budgetary deliberations in the candidate countries for both NATO and the EU the governments, parliaments and electorate will raise questions on the opportunity costs of choosing among desirable programs with valid requirements. An essential characteristic of budget formulation everywhere is the consideration of the opportunities foregone by choosing one program over another. Opportunity costs in tight budgets are a particular concern for countries in transition. Increasing demands for funding programs that foster economic transition through stabilization, liberalization, and privatization have crowded on to the state budgets. With strong popular and leadership support for NATO accession, security programs will have strong supporters. Each of the candidate countries to NATO will have to decide where in their priority list for new programs the NATO enlargement and related defense costs fit in competition with programs designed to further the transition to a market economy and to meet the requirements of European Union (the EU).

The European Union and the European Bank for Reconstruction and Development (EBRD) have made detailed, complementary appraisals of progress in transition and requirements for accession to the EU and integration into the global economy. Advanced countries such as Poland, Hungary, and the Czech Republic are considered to be in their second stage of transition. In this advanced stage of transition, more resource demands on the state budgets will be required for building on first-stage success in macrostabilization, liberalization, and privatization. Attention to institution building, enterprise reform, and improvements in quality of life programs are to be needed to qualify for accession and make strides toward transition to a well functioning market economy. Looking ahead, the EBRD notes "large additional investments" would require major new programs in the respective state budgets, along with increases in private domestic and foreign investment.[7] Successful transition to date has created a favorable environment for foreign direct investment (FDI) channeled into restructured productive assets which play a critical role in generating increased productivity. This synergistic character of the programs supporting transition and EU membership strengthens their claim on scarce budget outlays. As each of the three have begun serious discussion on EU accession requirements in March 1998, the leverage from current accession requirements further strengthens the claims of non-defense programs.

With tight budgets going into the next decade, even with optimistic growth projections and a promising climate for investment, the choices among meritorious programs will be increasingly difficult. The projected requirements for the mature capability development of NATO enlargement with increasing costs for the candidate countries from 1999-2009 will be paralleled by a period of increasingly expensive programs in the state budgets for fostering transition and meeting the EU accession requirements. On the one hand, some programs for force modernization to meet minimum security needs may have to be foregone or deferred to meet economic transition requirements. On the other hand, effective restructuring of industries and agriculture, addressing critical reform requirements in pensions, health, and other reform programs may come to be considered hostages to meeting some NATO commitments.

Each of the three countries has a similar list of major incremental claimants on their future state budgets. The specific sectors, social programs, and debt obligations vary, but are deemed by the EU/EBRD and reform governments to be critical to transitional success and therefore priority claimants on the state budgets.

The European Union Agenda 2000 provides qualitative bases for assessing progress for the Czech Republic, Hungary, and Poland. Critiques on economic transition indicates specific changes requiring large investments through their state budgets that will be needed to satisfy the EU accession requirements. Each of the countries is judged to be *"functioning market economies, but*":[8]

The Czech in Republic: Further progress will need to be made over the next few years strengthening corporate governance and the financial system. The banking sector is dominated by a few, partly state-owned banks and its competitive position is not strong. The country should be able to cope with competitive pressure and market forces within the Union in the medium term, provided that change at the enterprise level (restructuring) is accelerated.

Hungary: The reform of pensions and social security needs to advance rapidly. (Parliament approved in July 1997 the new pension law, reforming the system). Hungary should be well able to cope with competitive pressure and market

EBRD, Transition Report 1997, Enterprise Performance and Growth, December 1997.

[8] "The Commission's Report Card" European EU views were supplemented by grades based on ratings given by the Hungarian Economic Weekly (Budapest), while the grades for compliance are all four or more on a scale of five, major changes are still needed. Transition Newsletter of World Bank, August 1997.

forces within the Union in the medium term, provided the macroeconomic conditions for strong investment growth remain in place.

Poland: Pension and social security system need to be reformed. Financial services are underdeveloped. The banking sector needs further reform. Poland should be well able to cope with competitive pressure and market forces within the Union in the medium term. Agriculture needs to be modernized. Polish industry is characterized by the existence of both a dynamic competitive new private sector and large mostly state-owned sectors that need restructuring.

Each of the three new prospective NATO members must consider programs tailored for meeting accession requirements to the European Union. These programs will be specific and are, in the main, reinforced by conditionality of the International Monetary Fund, the World Bank family, and the Organization for Economic Co-operation and Development (OECD). Conditionality of all these assisting institutions means that aid funds are provided conditionally related to fulfillment of performance criteria. The EU in 1997 made compliance with their accession criteria a condition for providing financial and technical assistance, through their PHARE and TACIS programs. The list of transition programs also are the same programs that are important to the investment risk assessments of the three countries. When investment risk ratings by Standard and Poor's and Moody's improved, foreign direct investment to the three countries increased, with the reverse being true. Foreign investment improves the financial position and facilitates transition in the three enlargement countries.

Poland, the largest economy in the region with the largest share of NATO enlargement and defense costs, is also considered to have the best capability for absorbing accession costs because of current high growth rate and a projected surge of foreign investment. Specific programs and estimates of costs provide substance to both NATO and EU accession requirements.[9] These EU-related programs will be especially large and difficult to squeeze into the future state budgets of Poland, Hungary and the Czech Republic. The fall 1997 election in Poland a provided a broad consensus supporting the Polish economic strategy. This provided a basis for more reliable estimates on the budgetary implications of future economic programs. Upcoming spring, 1998 elections in Hungary and the Czech Republic may provide similar bases for more detailed budgetary projections. These incremental claimants for inclusion in Poland's budgets are expected to be similar by category to the specific future programs of the two other new candidate countries.

- **Debt service for external debt.** Poland's annual servicing requirements for rescheduled debt from governments (the Paris Club agreement) comes back with a vengeance in 2000 when a surge of maturities begins with servicing

[9] Polish Ministry of Finance, Medium-term Strategy for Poland, passed by Economic Committee of Council of Ministers. Reported in *News from Poland*, Newsletter of Embassy of Poland, April 1998.

and payment of about $40 billion in the next decade.[10] Hungary continues to service a substantial foreign debt through its state budget while the Czech Republic has a negligible external debt service burden.

- **Privatization of key sectors.** Preparation of Polish coal mines for sale will necessitate state assumption of state-owned mines' interenterprise debts, currently 11 billion zloty ($8.1 billion). Payment of arrears in wages and other benefits for coal miners are substantial but estimates are not available. Other sectors such as steel may be added with similar Polish state budget implications. Interenterprise debt is a costly problem in Czech and Hungarian privatization and restructuring, requiring increments to their state budgets for resolution.

- **Restructuring and recapitalization of pension funds for employees of formerly state owned enterprises.** In 1999-2001 and thereafter, the Polish annual budgetary cost is estimated to be around 1.0-1.6 percent of GDP. Czech and Hungarian transition have a similar requirement, as noted by the EU Report Card, cited above. Pension funds are not the only welfare program that will need funding in the next decade.
- **Comprehensive health reform requires not only taking over from former state enterprises health benefit obligations, but modernizing the health care system.** In Poland, from 2000 through the decade, an estimated 0.4 to 0.6 percent of the GDP per year has been ticketed for health reform.[11] The majority Solidarity party negotiated a larger health reform budget, closer to one percent of GDP.[12] While there is a common requirement for Czech Republic and Hungary, budgetary priority of health reform programs are not yet clear in those countries.

- **Education reform with revamping the curriculum and modernizing facilities.** The scale of budgetary implications probably depends on costs for constructing new facilities in all three countries.[13]

- **Administrative reform involving decentralization of government.** With a major shift of economic and political governance to the localities, substantial costs in new facilities may be incurred.[14] A new tax code may also be required.

- **Infrastructure costs borne by state for trans-European rail and road network contributions in each country.** The overall program projected to cost $395 billion is supported by the EU and EBRD with each country expected to provide some public support. Four major highways are ticketed for completion in Poland over the next decade. Although private toll road

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[10] A. Slozewska, "Zamiana Rezerw Dewizowych na Papiery Suarbowe" ("The Exchange of Hard Currency Reserves for Government Securities"), Rzeczpospolita, September 13, 1996.

[11] Solidarity in call to speed up reforms, Christopher Bobinski, *Financial Times*, April 9, 1998.

[12] Prime Minister Jerzy Buzak termed health, education and administrative reforms "urgent and important." News from Poland, newsletter of Polish embassy, Washington, DC, March 1998.

[13] Ibid.

[14] Ibid.

financing is anticipated, Poland will have to budget at least $10 billion for land right of way purchases and to provide credit guarantees for about 50 percent of the toll road indebtedness.[15] Rail modernization under way will also require public financing. Foreign investment requirements for infrastructure sectors — transportation, energy and telecommunications — would be between $15-$17 billion a year in Poland.[16] The Czech Republic and Hungary have similar claimants, that may be made clear after their elections.

- **Emergency funding.** Natural disasters such as flooding and droughts seem to be recurrent priority claimants on the state budgets of each country.

So when there is a step-up in defense claimants for resources in annual budgets in 1999-2009, they will compete with increased economically necessary programs as viewed by reformers, the EU, other international economic institutions, and credit rating organizations, whether or not these countries join NATO. In this balanced budget competition for appropriations, neither economic nor security programs will consistently win out.

Success from transition programs generates growth, assistance from many donors supporting transition and foreign investment that all generate revenue and financial flows that may ease the pressure of tight budgets. Current unexpectedly high Polish growth, seven percent increase in Gross Domestic Product (GDP) in 1997, generates more revenue, providing more funds for both transitional, EU programs and support for NATO enlargement and defense. Slow growth in the Czech economy, one percent in GDP, limits the choices among new programs. However, high growth prospects in Poland is not an unmixed blessing for budgeters as the high growth puts pressure on the exchange rates and price levels and account for the lowering of the current deficit financing cap to 1.6 percent of GDP, with a future prospect of a zero-deficit budget policy. High growth may thus lead to inflation and exchange-rate problems requiring tighter deficit control.

The opportunity cost problems for defense costs are not just competition on the margin with popular and critical economic and politically desirable programs but from the overall synergism of economic programs required for transition and attaining sustainable economic growth. These complementarities make it more costly to postpone any one of the priority transition programs. Only by simultaneous economic transitional progress would sustainable growth be attained. Enterprise productivity and competition would be improved if there were better stabilization, liberalization, and privatization and if the appropriate institutions were assuring improved corporate governance and technological change. When looking at the more detailed interrelationships of programs and performance as we do in the appendix profiles, we are especially struck by this synergism of economic and political transition programs. The degree of interdependency of transitional variables as they affect economic performance is noteworthy. Still, military programs also exhibit interdependencies, especially in the new definition of NATO roles and

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[15] "Corridors promise efficient transport, Brussels grand rail/road network for Eastern Europe is dogged by financial uncertainties," Financial Times, July 1, 1997.

[16] From U.S.-EU Polish Action Commission report cited in News from Poland, op. cit.

missions.[17] Infrastructure programs for pipelines, roads, communications in the NATO Common Fund support both security and economic requirements. Infrastructure development is important for both security and economic transitions. This synergism of both security and economic transition programs raises the complexity of opportunity cost deliberations. Although both programs for facilitating transition and improved economic performance and programs designed to meet defense needs are synergistic, they will not all be easily absorbed in future budgets.

Once the opportunity costs are evident, they may become the subjects of political debate. If a program for fostering economic transition is not supported because funds are put in a needed security program, the central European policymaker may find that less revenue is generated, less aid money is available, foreign direct investment is reduced and the electorate is unhappy. The EU and IMF may withhold assistance, and lower growth prospects may result in a lower investment risk ratings. Finally, the electorate may vote against politicians favoring defense costs over transition and EU accession programs. If a modern tank or fighter aircraft were not purchased abroad to meet modernization requirements of NATO enlargement a negative reaction might be expressed in Brussels. To be sure, offset agreements and production of military equipment in the candidate countries may soften a possible negative reaction to these hardware purchases. However, if aircraft and tank-related purchases were perceived as budgetary outlays that squeezed out funds for pension reform or training unemployed mine workers, the political reaction in the new member countries might be quite vocal. Elected officials in the new member states may consider many programs for supporting transition and EU accession are "third rail" issues, i.e., too politically hot to touch. For this reason, NATO has discouraged candidate countries from initially focusing on "big ticket" modernization projects like new fighter aircraft and have emphasized lower-cost but important improvements in communications interoperability, for example. U.S. and European weapons manufacturers, also sensitive to budgeting limitations, are packaging sales proposals with a variety of co-production and offset arrangements.

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[17] Cf. Stanley Sloan, *supra*, p. 1.

The United States Stake in Opportunity Cost Debates in Prospective NATO and EU Countries

When transition and enlargement requirements are made more explicit in the upcoming decade and new member countries begin to factor them into their annual budgetary deliberations the debates on opportunity costs may develop and become contentious. Tight budgets, escalating demands for funding, and the opportunity costs of programs for security, economic and political programs will require difficult choices that U.S. policy makers may wish to reassess as our benefits and costs are influenced by choices made in the new NATO and EU member countries among competing programs.[18] The United States benefits from the improvement in European security that enlargement of NATO may be expected to produce. Security improvements would be expected to facilitate democratic market development under a rule of law. More regional security, in turn, facilitates developments of profitable U.S. commerce with the region. Some sharing of the cost of NATO enlargement has therefore been deemed justified in our national interests for improved security alone. "For the American people, clearly, the costs will be far less in lives and money to expand the bounds of democracy and security than it would be if we had to involve our people in another conflict in Europe."[19] The European Union criteria for their part include both economic and political reform criteria in their accession requirements, but not security requirements. The interrelationship of economic and political reforms of importance to the EU may even be quantifiable according to a World Bank study correlating economic liberalization and political freedom. The Central European countries are adjudged to do especially well in transition because they combine economic liberalization and political freedom. By matching country rankings of the cumulative liberalization index to a comparative index of political rights and civil liberties, it has been found that economic liberalization has been typically associated with a similar degree of political change. The direction of causality, it is further argued, is determined to be two-way, since economic liberalization is an essential step in breaking the power of established structures, especially line ministries that previously controlled industry and trade.[20]

While the benefits from accession to the European Union and NATO are complementary in enhancing security, political stabilization, and economic welfare in the three candidate states, their costs are generally not. For this reason, some former U.S. officials here suggested the NATO debate be recast to link NATO and the EU expansion, to assess both the costs and the conflicts in serving multiple objectives.[21] They argue that the policy of cost sharing adopted for supporting NATO enlargement may adversely affect economic and political reform, and thus some security gains might adversely affect overall transition. With attention to opportunity

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[18] Cf. Estimated Cost of NATO Enlargement, A Contribution to the Debate, prepared by Euro-Atlantic Associates; provided by Embassy of Republic of Poland, Washington, DC, December 12, 1997.

[19] Speech by President Clinton, NATO summit in Madrid, July 8, 1997, Newsletter of the Embassy of the Czech Republic, July-August 1997.

[20] Martha de Melo, Cevdet Denizer, Alan Gelb, "Plan to Market: Patterns of Transition," Policy Research Working Paper, World Bank, 1996.

[21] Howard Baker, Jr., Sam Nunn, Alan Gelb, "NATO: A Debate Recast." Op. Ed. *New York Times*, February 4, 1998.

costs, we may conclude that a blend of programs needed for accession to each organization may be deemed most cost effective.[22]

This broader approach has other advocates. The Organization for Security and Cooperation in Europe (OSCE) Parliamentary Assembly developed a model to interconnect adverse economic developments to security considerations. They noted in their Stockholm Declaration,

> . . . security in the OSCE region as a whole and, more particularly, security in Central and Eastern Europe and the CIS region can be substantially affected negatively through economic, social and environmental developments that undermine public support for democratic governments and exacerbate ethnic rivalries and tensions.[23]

This negative interconnection of security, economic and political aspects of successful transition in the OSCE model broadens the resolution of the costs sharing questions because it recognizes that economic, political and security objectives are competitive and involve tradeoffs.

Not only security and economic programs are competitive, political and economic costs are also in conflict. In bankruptcy procedures in restructuring loss making enterprises in key sectors, political and human benefits of employment have to be weighed against the benefits of fiscal discipline. Helmut Becker, Vice President of the German Bundestag relating political stability to economic growth noted,

> No society can remain stable over the long term if its economy is unstable. Good economic policies must walk a chalk line: if they make the economy dynamic, then they will also set loose the forces of social tension as well. If they emphasize maintenance of the status quo, then deficits and mismanagement will cause political unrest. A functioning economy and a stable society are mutual prerequisites. We will either be successful in achieving both or both will fail in the long run. Increasing unemployment and social distress may seriously jeopardize consolidation of the new democratic structure.[24]

Substantially higher costs with stringent budget constraints on the new member countries would tend to escalate opportunity costs and further elevate the concern over costly tradeoffs. However, these popular choices for growth over security costs are reinforced by specific European Union criteria for accession which in turn are tied to availability of the EU aid through their financial and technical assistance

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[22] Chairman Pete V. Domenici of the Budget Committee of the United States Senate posed the question: "Do you believe the EU and NATO expansion complement each other or does one sap interests from the other?" Hearing on "Europe's Monetary Union and its Potential Impact on the United States Economy." October 21, 1997.

[23] Stockholm Declaration of the OSCE Parliamentary Assembly Toward a Common and Comprehensive Security Model for Europe and the Twenty-First Century. Stockholm, Sweden, July 9, 1996.

[24] (name redacted), Jean F. Boone, Stephen B. Heintz and Aaron Presnall, *Parliamentary Responsibility for Economic Transition in Central and Eastern Europe*, prepared by the Congressional Research Service with assistance from the Institute of East-West Studies for the Commission on Security and Cooperation in Europe (CSCE). GPO: Washington, DC, July 30, 1996, p. 10.

programs, PHARE and TACIS. This EU pressure may not fully consider the need for security programs.

If the rationale on overall transition adopted and supported by the United States requires more difficult tradeoffs than has been currently acknowledged, the question of cost sharing by the new members may become a policy concern in the United States. We may feel EU pressure leads to underrating the importance of security programs to an extent requiring use of our influence for proper consideration of defense requirements. At the same time, if we were to press for the inclusion of some military expenditures in the budget of the new member countries that might be seen as taking funds for recapitalizing workers' pension funds or restructuring loss-making enterprises of these new member countries, this decision may lead to retardation of economic transition and a negative popular reaction within central European countries and European members of NATO. The opportunity costs from supporting programs related to either EU or NATO requirements might be considered especially onerous in those cases where the candidate countries paid the lion's share of the costs.

The United States may be faced after accessions to both NATO and EU with the broader consequences of judgments related to opportunity cost assessments. How should the costs be shared if the new members cannot or should not afford a greater share of costs and the other NATO members are unwilling to accept a larger burden? Can we and should we leverage acceptance of more enlargement cost sharing?[25] If we have the leverage on Central Europe, would it be wise to use it unless we are sure the net effect would be beneficial to the overall transition in the region and in our broader interests? How should we differentiate among the three countries in terms of judging the appropriate enlargement costs each should bear? If one country is less capable of bearing the cost in the year 1999, should we favor reducing their burden or deferring a heavy burden for later years, i.e., should new members front-load or back-load their budgets with the required new programs?

As there are many countries lined up to join, precedents set now may be considered in the context of future accession to NATO and the EU (Table 2). The countries seeking future admission to NATO and the EU are likely to have less economic capacity as judged by conventional success indicators (Table 1, page 3 above). Each of the future candidates in the region pose equal or greater problems of opportunity costs for meeting requirements of NATO and EU enlargement. Those who qualify would merit careful attention for appropriate blending of security, economic, and political costs of transition in NATO and EU accessions.

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[25] Carl W. Ek, *NATO Common Funds Burdensharing: Background and Current Issues*, CRS Report 98-239 F, March 11 1998.

Table 2. Accession to the EU and NATO

	European Union[1]		NATO[2]	
Countries	Negotiations	Expected Accession	Negotiations	Expected Accession
Advanced				
Czech Republic	March 1998	2002-2003	Completed	1999
Estonia	March 1998	-	[3]	-
Hungary	March 1998	2002-2003	Completed	1999
Poland	March 1998	2002-2003	Completed	1999
Slovenia	March 1998	-	[4]	-
Less Advanced				
Bulgaria	Annual appraisal		[4]	
Latvia	-	-	[3]	-
Lithuania	-	-	[3]	-
Romania	-	-	[4]	-
Slovak Republic	-	-	[4]	-

[1]Agenda 2000. Address by Jacques Santer, President of the European Commission, Strasbourg, France, 16 July 1997. Cyprus is also proposed for the first group to EU, but not to NATO.
[2]Report to the Congress on Enlargement of NATO: Rationale, Benefits, Costs and Implications, August, 1997, op. cit.
[3]President Clinton voiced support of NATO accession in Washington meeting with three Baltic nation presidents.
[4]Some support in NATO for joining first three but not approved.

Appendix

Country Profiles for Assessing Performance and Economic Capacity to Meet Accession Requirements into the 21st Century[26]

Sustained growth in the gross domestic product will be directly affected by further progress in stabilization, liberalization, and privatization, with market friendly institutions building. Integration, through opening to the external markets especially generating more foreign direct investment, will stimulate growth and commerce. All these elements of a transition policy are interactive with a multiplier effect on generating economic capacity that may support accession programs by providing the economic capacity to support accession costs.

A more detailed examination of the transition profiles of the Czech Republic, Hungary, and Poland will provide in-depth assessments of the ability and willingness of the new members joining NATO under likely agreement terms to share NATO enlargement costs. The importance of interrelationships of economic and political transition and overall economic growth and support by the EU, other international aid providers, and investors, is illustrated. The synergy in democratic market transition is important in assessing the economic capacity to simultaneously support NATO enlargement, the EU accession, and transition programs.

Czech Republic. ***Policy Highlights.*** Even with a crisis in transition and scandals, the Czech Republic is a leading performer in transition. Past success in transition of the Czech Republic has been attributed to a social contract that combined political and economic reforms and brought the Czech leadership and their electorate to a consensus on the need for an effective economic transition strategy. Until recently the most stable of the new democracies of Central and Eastern Europe, the Czech government is heading for elections in June 1998, caused by the collapse of the center-right government. The Czech monetary and fiscal crisis led to a sharp turndown in growth and significant government deficits. The caretaker prime minister, Joseph Tosovsky, former central bank head, promised that with the elections adoption of new monetary and fiscal policies would revive growth, strengthen the currency, reduce the deficit, and attract more foreign investment. A new broad coalition supporting effective reform will be needed from the upcoming elections in order to return the Czech Republic to its former position in the front line of transition economies. With popular support for NATO less than that of the other new members, the prospects of broad public support for Czech burden sharing of NATO enlargement costs are not as bright as for Poland and Hungary. The Czech government will have to make some tough budgetary choices in supporting financial, monetary, and enterprise policies while discharging their commitment to support NATO enlargement costs. Consensus on this issues would be important not just for successful economic transition, but also for attracting more foreign investment, aid, and other means of financial support for facilitating accession to both the EU and NATO.

Domestic Performance and Prospects. The Czech Republic came out of the transition-induced recession from 1994 and sustained its economic growth at 4 per cent throughout 1996. In 1995, the GDP expanded by 4.8 per cent compared to 1% in 1997. GDP was indexed at 90

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[26] Primary Sources for these success indicators are the EBRD, *Transition Report 1997 Enterprise Performance and Growth*, December 1997; Plan ECON, *Review and Outlook for Eastern Europe , December 1997; Review and Outlook*; WEFA, November 1997; *Eurasia Economic Outlook*, World Bank Newsletter, *Transition*, September-December 1997, and February 1998. See Table 1 *supra* for summary indicators.

in 1997, with 1989 equal to 100. Post-Klaus policy is expected to return growth to 1995 level by the year 2000. Slow growth and increased unemployment would make accession debates more contentious. Investment ratings may be reduced, causing a slowdown in foreign investment, weaken support of transition policy, making the EU and NATO accession processes more difficult. The projected budget deficit is 1 percent of GDP in 1998, tighter than the 3 percent GDP cap set by the European Union requirements. A continuation of slow growth in 1998 would generate less revenues available to fund other critical programs, thus putting pressure on the deficit financing cap. It is possible for the Czech government to partially offset budget imbalances by selling assets or attracting more FDI. Funding of programs critical to successful transition would be favored by the EU as they would tend to increase economic growth and gain wider support from the public. The uncertain election outcome in Spring 1998 will be a key factor in projecting future economic performance. Only a strong government with a broad support base can move the Czech economy back toward sustained growth and a low investment risk rating needed to attract foreign capital. The government is trying to bring the economy back into balance by trying to keep inflation at 8 per cent in 1998, with zero nominal increase in public sector wages, no indexation of pensions and social benefits and a zero increase in nominal government expenditure, except for defense. Their domestic state budget has been further constrained by low collection of tax revenues and continued subsidies. The Czech Republic would thus have to pay a high opportunity cost price to meet costs of NATO enlargement by fitting costs into the new budget. Czechs need both austerity and growth. NATO enlargement costs will not help either. Moreover, zero increase in government expenditures in 1990 would hamper a transition toward a sustained growth and early accession to the EU.

Stabilization. Full current account and partial capital account convertibility were accomplished in 1995. The Czech Republic is adjudged to be a functioning market economy. Despite tight fiscal policies, both trade and current account deficits grew in 1996. Koruna, the national currency of the Czech Republic, was pegged to the German mark in 1997, and the authorities were forced to devalue the koruna, ending several years of foreign exchange stability. The Czech Central Bank spent more than $2.5 billion to support the currency in May 1997.

Liberalization. Price liberalization commenced in January 1991, and most of the prices were freed. The only remaining significant controls pertain to utility charges, such as fuels and energy, residential rents, public transport, postal service and telecommunication, health care, and selected agricultural products. The Czech Republic has almost complete liberalization of quantitative controls on imports and exports. They became a member of World Trade Organization (WTO) in 1995 and maintain a very liberal trade regime, virtually free of non-tariff barriers and export restrictions.

Privatization. Privatization of small and large enterprises in the Czech Republic was carried out through a variety of methods, including the transfer of state property to municipalities, restitution and the privatization and transformation of agricultural and other cooperatives. The vaunted method of mass privatization through vouchers given to the population to exchange for shares has had unhappy consequences. Ownership of many major enterprises and banks were concentrated through investment funds in the hands of a very few without adequate fiscal and monetary openness and accountability. A dramatic banking and influence scandal brought this faulty reform to crisis and led to the demise of the Klaus government. This oligarchy, or financial industrial group [FIG], control is a major cause of Czech reform problems. In January 1998 the Czech lower house of parliament set up capital market watchdogs to reduce the influence of banks over non-financial companies. The cabinet has also agreed to the sale of the stakes in the four leading banks, opening the way to significant foreign direct investment. It is important for the Czech Republic to reinforce the rule of contract law to meet the obligations for the accession to the EU and in order to receive more foreign assistance to encourage foreign investment. The programs for the FIG reform would have be squeezed into a tight budget reinforced by a more restrictive deficit financing cap. Incremental costs of NATO expansion would have to be within the tight Czech budget and at the expense of some programs important to economic transition and the EU accession.

Market Institutions. Czech republic is a stable democracy, guaranteeing the rule of law in human rights and respect for and protection of minorities. There are still some weaknesses in laws governing freedom of press and discrimination problems that affect the population. While the country has followed the European legal pattern harmonizing with the EU rules and legal framework in the area of financial services and taxation, it is in this area that most radical institutional changes are needed. Further progress in regulation is also required in agriculture, environmental protection, and the energy sector. The European Union's critique highlighted the inefficiencies of the courts and the need to modernize and remove from politics the cumbersome old regime bureaucracy. The EU also faulted them on their slowness in building a regional government system. These shortcomings are related to the EU accession criteria and would require programs in the budget to support resolution.

Integration. The Czech Republic should be able to cope with competitive pressure and market forces within the Union in the medium term, provided restructuring on the enterprise level is accelerated. The Czech Republic has a high economic transition grade from EBRD with low investment risk and relatively high foreign direct investment (FDI) per capita. The substantial foreign investment has had the effect of integrating Czech enterprises into the European market for commerce and finance. The Czech Republic was the first in the region to join the OECD. They do not have an external debt servicing burden. With the projected 2.5 percent of GDP growth for 1998, the Czech society would still have to face serious policy and budgetary choices. If high rates of growth, high capital inflows, and low inflation are attained, the Czech Republic would regain the benefits of a normal country on the road to full integration into the global economy and financial markets. But for the first time since the "Velvet" revolution, the Czech economic future is considered uncertain and sacrifices in real income and quality of life may be necessary to get the Czech economy back on a successful transition track.

Hungary. ***Policy Highlights.*** The upcoming Hungarian elections in May 1998 will reaffirm the Hungarian's broad consensus on successful transition strategy. Even an optimistic forecast on policy and performance may not allow Hungary to meet their obligations for accession to both the EU and NATO. Hungary's strategy of transition has been supported by the current coalition of the Hungarian Socialist Party and the Free Democrats who are together in their strongest position since 1994. The government recently won a referendum on NATO membership with 85 per cent of voters in favor, although turnout was just under 50 per cent. The booming economy is boosting the coalition's prospects for the next election. The outcome of the elections will depend on whether voters decide to punish the coalition parties for three years of lower living standards and painful economic and social adjustments, or reward the government for their transition strategy leading to the current high growth for Hungary. Success of the coalition government would reinforce Hungarian commitments to the consensus strategy of transition and policy of simultaneous accession to both the EU and NATO. The next five years will be a period of decisive importance for Hungarian transition and integration prospects into Western systems. The election outcome solidifying the consensus on transition and integration into Europe may thus be pivotal.

Domestic Performance and Prospects. Hungary's situation is the result of a remarkable turnaround since early 1995 when it faced a Mexican-style debt crisis. It now approaches 1998 with some of the strongest economic fundamentals of any post-communist country in the region. Their depression is over, and recovery is underway. Their projected level of real GDP in 1997 was 89 (1989=100). GDP growth increased from 1 per cent in 1996 to 3 per cent in 1997 and is projected to accelerate to 4.4 per cent by the year 2000. Projected budget deficit is 3.6 percent of GDP but should be lower to meet EU accession criteria. Critically needed pension reforms would especially require funding in their already oversubscribed budget.

Stabilization. Hungary may be considered a functioning market economy. Still, inflation has been slow to fall and is 17 per cent in 1997 compare to 32 per cent in 1991. The reduction in inflation may speed up in the next two years. The Hungarian forint became convertible for current account transactions in 1996. The exchange rate has been pegged to a basket of currencies that consists of 30 per cent of US$ and 70 per cent Deutsche mark. The positive interest rate imposed by the Central Bank encouraged domestic savings, tightened supervision, and prevented excessive Czech-style currency appreciation by regular monthly crawling peg devaluation of the forint. Servicing what has been the highest per capita external foreign debt still burdens the balance of payments and state budget but is becoming more manageable. Hungary's accession to OECD in 1996 and compliance with the EU requirements reinforced the Hungarian desire to join the West and be first among those integrating into the Western systems of both the EU and NATO.

Liberalization. Liberalization in Hungary has been impressive. About 84 per cent of consumer prices are free of administrative controls. Hungary is increasingly competitive in the world market. Foreign trade was one of the brightest spots in the Hungarian economy in 1997; exports were up 16.7 percent in the first seven months of the year, the best performance in Central Europe.

Privatization. Hungary went further in its transition in the first stage of their reform than many countries in the region to develop increased enterprise competitiveness, resulting from their choice of privatization policies. The Hungarian government opted for a policy of rapid privatization by the quickest and simplest method to obtain what it needed most—cash from sales to strategic investors. Banks, industrial enterprises, power stations, water, sewerage and other utilities including telecoms have been involved in this privatization process. Sales to strategic investors brought new management and access to new technologies and foreign markets, which resulted in increased productivity and increased standards of living for Hungarians. The influx of fresh capital to replace obsolete capital assets, and the transformation of formerly state-owned banks and enterprises from serious loss-makers into tax-payers, has helped to raise tax revenues and employment, although servicing the foreign debt drew off a share of the financial inflow. The banking system in particular benefitted from the influx of foreign owners and managers who made possible the restructuring of many former state-owned banks and industrial enterprises. Critics of Hungarian economic policy argue that the government has concentrated too much on attracting foreign investment and not enough on creating an environment for a Polish-style explosion of native entrepreneurial talent, especially in small-scale private enterprises. However, the availability of competent Hungarian managers and skilled labor is often cited by foreign investors as one of the attractions of investing in Hungary. Hungarian deep enterprise and institutional reforms contrast sharply with the Czech experience. A continued high level of foreign direct investment would strengthen the economic conditions for strong growth, facilitating fulfillment of the accession criteria for both the EU and NATO.

Market Institutions. EBRD has rated Hungary as a stable democracy with institutions guaranteeing the rule of law, human rights and respect for and protection of minorities. Hungary's political institutions function well, but improvements are still needed in the operation of the judicial system. The legislative foundation harmonized with the EU rules and directives is almost complete in areas such as competition, public procurement, intellectual property, and company and accounting law. Effective administrative reform is, however, still required. The health system should be improved and the EU health and "safety at work" standards need to be applied. By contrast, further efforts will be necessary to set up regulatory frameworks in consumer protection and customs controls. Further monetary, financial, and competitive institutions development would be significant for Hungarian accession to the EU and would facilitate sharing the enlargement costs of NATO.

Integration. Hungary's international position is comparatively stable, secure and hopeful. Hungarian foreign, economic and security policies are dominated by the process of accession to the EU. The EU accession opens opportunities for more financial and technical assistance for Hungary and provides the basis for a greater surge of trade with Europe, especially with Germany. Integration into the global market system would provide Hungary with improved infrastructure, a favorable credit rating for future foreign financing at lower cost, further expansion in commercial activities, reduced trade restrictions, ability to compete with market forces within the European Union, increased FDI, and assured political stability. Hungary is now highly rated by many credit-risk agencies, although their outlook is still not positive enough for further upgrading. NATO accession is a popular issue in Hungary although without the benefit of a public debate on opportunity costs of enlargement. By some estimates, Hungary may expect an annual $50 million additional capital inflow from increasing military production related to NATO accession. This new output would derive from being a NATO member and would include various kinds of aid and long-term loans granted on better terms than usual under international conditions. The future interactions between the budget and policy will depend on opportunity costs and choices made by the government towards accession guidelines for both NATO and the EU.

Poland. ***Policy Highlights.*** The outcome of parliamentary elections on September 21, 1997 reaffirmed Poland's broad consensus on transition strategy and reinforced their accession commitments to the EU and NATO. A strategy of transition has been broadly supported in spite of differences on the tactics of stabilization, privatization, liberalization, and market friendly institution building by eight successive governments from 1990-1997 and has been reinforced by recent polls. The major shift in Polish attitude towards the EU came from a reversal of the nationalistic, even xenophobic position of the Polish Roman Catholic Church. This changed foreign policy demonstrated a readiness to join the EU on its economic, political, and social merits. This also represented not only a willingness to follow the rules of the global market place. This broader view on external affiliations adopted by the Polish church presumably applies to NATO accession as well.

As paradoxical as Polish politics might often seem, once the election was held and the new government was formed, the new right center coalition and the left were clearly both committed to continue "Strategy for Poland." That economic program contributed to accelerated growth, increased investment and membership in the OECD. The OECD accession and detailed compliance with IMF, World Bank, EBRD conditions reinforced the EU criteria and increased Polish commitment to fulfill its obligations for accession to NATO. Accelerated structural reforms, institutional reforms in banking and finance, and a more active role of the state are going to be the main features of future economic policy. All these programs require substantial funding and popular support. Public support in recent polls for both the EU and NATO has been about 75 percent. However, NATO and the EU accession and acceptance of enlargement costs are supported in principle but not in detail. There has to date not been public or parliamentary budgetary debate on opportunity costs of NATO. Costs of enlargement was not included in latest questionnaires in public opinion polls. Poland may well await clarification of rationale and full costs of the NATO enlargement in more detail before debate and approval in the Polish parliament. Opportunity costs for NATO enlargement may be perceived as too high for Poland, slowing down Polish economic growth, resulting in less FDI flows into Poland, and impairing accession to the EU.

Domestic Performance and Prospects. The first stage of economic transition at the macroeconomic level included success in stabilization, liberalization, and privatization. Macro stabilization improvement was facilitated by a stabilization fund and restructuring of foreign debt mainly initiated by the substantial international aid programs with the significant U.S. Congressional support.[27] Recovery of Polish economy began in 1992 in gross domestic product, exports and incomes, with accelerated progress in stabilization, liberalization, privatization and market institution building throughout the 1994-1997 period. Poland weathered the transitional storms of emerging economies well: its level of GDP for 1997 was 110 (with 1989 equal to 100), with a seven percent GDP growth. Poland is projected for 5.5 per cent growth in 1998 and just under five percent to 2000. The projected budget deficit of 1.6 percent of GDP is to facilitate a further reduction in inflation and curb trade deficit growth. Due to inflow of investment a zero deficit cap is the new goal to keep the zloty from appreciating too much. Poland has promising growth prospects but would face difficult choices due to substantial opportunity costs.

Stabilization. Poland may be considered a functioning market economy. Hyperinflation has been brought down from 1,000 per cent in 1990 to 38 per cent in 1993, and to 15 per cent in 1997. Inflation should continue to decline to around 10 per cent in 1998 and is likely to reach the single-digit level on the eve of Poland's anticipated accession to the European Union. Due to macroeconomic reforms and the openness of the Polish economy, the national currency—the zloty—became convertible in 1994. The encouraging results of the September parliamentary elections and the creation of a strong reform supporting coalition boosted the confidence of foreign investors in the zloty and the zloty was heavily traded in world financial markets in September and October 1997. Problems in generating tax revenues, trade imbalances, balance of payments deficits would all make transition slower, growth lower, inflow of foreign investment smaller, and Polish ability to fulfill the EU criteria less likely. There is broadly shared optimism on improved Polish performance across the board. Still, NATO enlargement would require substantial defense expenditures and could dry up budget funds by competing with funding of programs critical to successful transition. Transition and the EU-related programs are likely to rise in the same 1999-2009 period when NATO enlargement costs peak.

Liberalization. Even though prices are substantially freed, state procurement at non-market prices still exists, and prices for district heating, electricity, gas, domestically produced medicines, rents in local authority housing still remain centrally administered. Coal, steel, agriculture, and other state-owned industries are protected in foreign, trade and the failure to adopt a clear strategy to restructure those enterprises would delay further price liberalization and might slow Poland's EU membership drive. Restructuring costs in these critical loss-making sectors will have priority in the budget.

Privatization. Polish industry is characterized by the existence of both a dynamic competitive new small- and medium-scale private sector and a large, mostly state-owned sector that needs restructuring. Small-scale privatization has been the engine of Poland's steady

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[27] "The Congressional Role in United States Assistance Policy in Central-East European Economies in Transition," William F. Schuerch, *East-Central Europe in Transition*, Joint Economic Committee, November, 1994, pp. 336ff.

economic growth and rising living standards: the average real income has risen 80 per cent over the past four years. The first phase of reforms ended state ownership in two-thirds of the enterprises but did not proceed toward restructuring and corporatization of many large enterprises. Poland has been engaged in more extensive corporate reforms in small private enterprises, resulting in lower labor costs, increased productivity, and decreased unemployment. The Polish government may still have to support some of the giant, still state-owned, shipyards and coal mines that cannot survive without huge subsidies for some years. The qualitative change in privatization in the second stage will require accelerated mass large-scale privatization and corporatizing with foreign participation in key sectors such as in telecommunication, insurance, banking, mining, agriculture, and defense. There are a number of controversial tactical issues still being debated with regards to what sectors to privatize first, how fast the process should be, and the extent of foreign participation in privatization process in many sensitive sectors. Poland has privatized five of the nine original state-owned commercial banks. Of the four state-owned specialized banks, only Bank Handlowe has been privatized. However, the pace of bank privatization has been slow and strengthening of the banking system remains a priority. Mass privatization in Poland is currently projected to involve foreign assistance and auctions open to foreign bidders and bankruptcy when appropriate. Selling off state assets, especially through auctions involving foreign participation, is a major future source of income for the budget with some of the foreign sales income dedicated to pension reform. The "third rail issues" such as welfare reform, pension funds, education, health benefits, and administrative reform, are at the center of Poland's budgetary debate as they endanger survival of elected politicians and are calculated in the opportunity costs relevant to NATO enlargement and EU accession.

Market Institutions. EBRD has rated Poland as a country that is close to the highest in development of market-supporting institutions. Poland is already a stable democracy, with institutions guaranteeing the rule of law, human rights, and respect for and protection of minorities. However, there is still a necessity to set up regulatory institutions to improve the operation of the judicial system; intensify the fight against corruption; apply the EU norms in agriculture, environment, and transport; liberalize capital movements; open up public procurement; reform pensions, social security; modernize the agricultural and defense sectors. The costs of these institutional developments necessary for effective transition and the EU accession would likely be weighed against NATO enlargement costs.

Integration. Accession would provide more Polish access to the EU, especially the German market, technological facilitation, restructuring and corporatization, financing, and technical assistance to Polish enterprises. By opening up its economy further, Poland will be able to finance infrastructure such as the road and railroads network in Europe and integration into the world economy. Through favorable credit ratings Poland will receive greater access to global financial markets for more funds at lower costs. Acceptance of World Trade Organization norms and mechanisms will open trade prospects for Poland and will make foreign and domestic investment more attractive in the future. However, Poland will be pressured to restructure non competitive industries and make a larger share of their economy more open to foreign competition. Poland would like the EU to open itself to labor movement from Poland and more access to EU agricultural markets. These are among many issues under negotiation. Accession to NATO may facilitate an increase in growth through assuring the country's political stability and security, but will also compete with claimants keyed to economic transition.