FIFTY YEARS LATER: A NEW MARSHALL PLAN FOR EASTERN EUROPE?

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Arbeitspapier Nr. 9814
Juli 1998

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* An earlier version of this paper was presented at the conference "THE MARSHALL PLAN IN AUSTRIA", University of New Orleans, May 5-7, 1998. Thanks are due to Günter Bischof for several helpful discussions on Marshall Plan issues, and to Rudi Winter-Ebmer and Herbert Matis for commenting on the first version. The simulation results reported on in the final part of the paper go back to a research project entitled "The Economic Consequences of EU's Eastern Enlargement", conducted under the auspices of the Institute for Advanced Studies, Vienna, and funded by the Kreisky Forum for International Dialogue as well as the Austrian Government.

Abstract

Against the background of the 50th anniversary of the Marshall Plan, this paper addresses the issue of Western aid for Central and East European countries in transition. Based on a critical review of the principal arguments for foreign aid, emphasizing a distinction between humanitarian and efficiency arguments and drawing on recent research on the economic effects of the Marshall Plan, I argue that, despite Eastern progress, conditional Western European aid may still be a sensible policy option. I then identify differences between post-war Western Europe and Eastern Europe in the 1990s and explore their implications for "New Marshall Plan" proposals for the East. The paper then investigates whether an Eastern Enlargement of the EU constitutes a reasonable aid package. It describes the relevant elements of this package, including estimates of the amount of transfer payments involved. Finally, drawing on an applied general equilibrium model for Austria, the paper presents evidence that, contrary to widespread concern, an Eastern Enlargement may be advantageous also for incumbent EU countries, thus substantiating the efficiency argument, outlined in the beginning, which holds that conditional aid may benefit both the recipient and the donor country.

Keywords: Marshall Plan, Central and Eastern Europe, Economies in transition, European Union, Foreign aid, Economic integration

JEL classification: C68, D58, F15, F35, N14

1 INTRODUCTION

When several countries in Central and Eastern Europe (CEE) embarked on a path of systemic transformation in 1989/90, it soon became evident that their initial conditions were extremely bad, and catching up to Western-European income levels would be a long and painful process. People felt deprived of cherished safety nets and were faced with a hitherto unknown degree and kind of uncertainty, while policy makers were confronted with the formidable task of keeping society on a sustainable track of reform which soon turned out to inflict significant income losses. There was very little help from historical experience on which to draw, or firm theoretical knowledge on which to rely. Adding to all of this the simple fact that people had meanwhile turned into a true electorate, transformation certainly was a risky endeavor.

If all of this had happened on a group of far-away islands, it would probably not have caught too much of our attention. The fact, however, that it took place at the very frontier of the Cold War made it a world event of major importance, in particular for Western Europe. For humanitarian reasons and manifold Western self-interest alike, the West could not simply take a backseat and let things go their way in the East. But what should it do? On the one hand it is true that the experiment of systemic transformation on such a grand scale was pretty much unique. On the other hand, groups of countries trying to catch up from bad initial conditions is by no means without precedence in history. After all, it is the perennial concern of development policy, and Western Europe had itself been in such a catching-up position after World-War-II. In all such cases, international aid had been an integral part of the strategies adopted. Hence, the issue of aid was bound to come on the agenda also for post-communist Central and Eastern Europe. For rather obvious reasons, a question often raised is whether there was - or still is - a case for a new Marshall Plan initiative for Eastern Europe. Indeed, one might even argue that the beneficiaries of

the original Marshall Plan aid now have a moral obligation to step in with aid, thus facilitating a belated correction of the Yalta conference.

Obligation or not, if the Marshall Plan was successful for post-World-War-II Western Europe, might it now serve as a useful model for Western aid to the post-communist East? Not all observers have come up with an affirmative answer, even in the early nineties. And now, almost ten years after the onset of transformation, the misgivings no doubt have increased. Overall, one might argue, transformation went reasonably well, and the gloomy picture starts getting brightened by success stories on business formation and growth. Big differences between individual CEE countries notwithstanding, one may therefore be tempted to forego the conclusion that at this stage a "New Marshall Plan" for these countries funded by Western Europe has no place in a well-guided strategy. This paper takes a closer look at various aspects pertaining to this issue. Specifically, section 2 offers a critical review of principle arguments that one can put forward in favor of Western aid for Eastern Europe, placing due emphasis on the distinction between humanitarian and efficiency reasons, and drawing on recent economic research on the Marshall Plan. In section 3, I shall then highlight some various differences between the present position of the CEECs and the post-World-War-II situation and explore their potential implications in the context of Marshall-Plan-type Western help for CEECs. This will be followed a detailed discussion of the idea, sometimes coming up in policy debates, that an Eastern enlargement of the EU involves certain key parallels to the Marshall Plan. More specifically, section 4 briefly characterizes EU accession from an Eastern newcomer's perspective, with special emphasis on the potential amount of transfers received, in comparison with the Marshall Plan funds that Western Europe has benefited from fifty years ago. Section 5 then returns to a principle argument for aid expounded in general terms in section 2, viz. that aid may be beneficial to the donor country if tied to trade liberalization measures. Relying on a simulation model for the Austrian economy, I shall present empirical support for this claim. Section 6 closes the paper by a brief summary.

2 ARGUMENTS FOR AID: A BRIEF SURVEY

2.1 Helping to catch up: the simple mechanics of growth

The most obvious argument for international aid in a catching-up situation is *humanitarian* in nature: offering help to disadvantaged people. Anecdotal evidence from individual success stories can easily lead one to forget just how big the income gap between Eastern Europe and the West still is. Table 1 gives an idea of the "distance" of some of the potential CEE EU-candidates from the EU-average in 1996. Even the most advanced countries exhibit a more than 40 percent income gap, and Bulgaria trails the list with a per-capita GDP which is a mere 20 percent of the EU-average. Poland which has recently been praised as a high growth performer still lags behind by as much as 70 percent. True, these gaps are still small compared to many third world countries. But, as pointed out by Murrell (1991), what makes this a special case is that some of these countries were in positions quite similar to EU countries no more than 40 years ago. An example here is Austria and Hungary in the 1950s. Nor will these gaps be closed very quickly by growth differentials. For the sake of a quick numerical example we may draw on table 1 and assume (very optimistically) that Poland continues to grow at a rate of 6.1 percent p.a., while growth in the EU remains at 1.6 percent on average. The gap would then be narrowed from 70 percent to about 53.7 percent in 10 years, and it would take as much as 20 years for the gap to be narrowed to less than 30 percent which, in turn, is the largest income gap presently observable within the EU (for Greece).

Might aid make a big difference? Not if catching-up works only through the neoclassical mechanics of growth. First of all, we should not expect countries to catch up to a common level of income, even in the very long run. They may differ in their long-run equilibrium levels of income, in which case the notion of catching-up makes sense only with respect to an individual country's long run (steady state) income level, not in the sense of an international comparison. While this is

an important point in principle, it is not clear a priori why the CEECs should have lower long run income levels than Western European countries, let alone to pin down the difference in terms of numbers. Moreover, judging from Western countries experience, convergence to a country's own steady state is likely to be a rather slow process.[1]

In any case, the question coming up next is whether aid will have any impact on this long run income level. Here again, traditional growth theory is pessimistic: If growth takes place subject to diminishing returns of whatever is accumulated (physical capital, human capital etc.), then temporary aid will have no lasting effect. History, according to this view, plainly doesn't matter for where a country will end up in the long run! This, no doubt, is almost anathema to historians discussing aid. Nor does it fully capture the way that economics would want to think about it. Even from a narrow growth theory perspective, economists have pointed out several reasons why the conditions prevailing at the outset and during early phases of catching up, including transfer payments received from abroad, might have lasting effects. Modern growth theory emphasizes that path-dependence of this sort will arise whenever accumulated factors exhibit constant, rather than diminishing, marginal returns. Notice that this coin, too, has two sides. On the positive side, the effect of aid will be felt ad infinitum. On the negative side, however, if the marginal return to accumulated capital is constant, then a very low capital stock to start with does not carry the advantage of a high initial marginal productivity of capital. Instead, poor initial conditions will likewise leave an indefinite imprint on the development path of the economy. There is no catching-up at all![2] Typically, in such cases aid may not only affect long-run income levels, but

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[1] See Sala-i-Martin (1996) for a discussion on the empirics of this kind of convergence.

[2] See Saint-Paul (1993) for more details on Marshall-Plan-type catching up in various growth models.

also long run rates of income growth. However, to policy makers and people alike, short to medium run effects are no doubt of more concern than the long run steady state. Hence, even if aid were devoid of any long run effects, the truly important question seems whether it can foster growth and well-being in the short run.

But in the short run as well, the effect of aid is likely to be rather modest, if it operates only through the mechanics of investment and growth. Much depends on the details of how investment is determined, but by way of a first approximation we may draw on the famous Solow growth model.[3] In this model it can be shown that, ceteris paribus, aid in the amount of x percent of GDP increases the contemporaneous growth rate of GDP per capita by $sxy\theta_K$ percentage points, where s is the marginal rate of savings, y is the inverse of the capital/output ratio and θ_K is the share of capital in overall income. Invoking a Marshall Plan order of magnitude for $x = 5$, the Austrian value of $y = 0.3$ for 1992,[4] a consensus value of $\theta_K = 0.3$, and using the savings ratios from national accounts for CEECs to obtain a rough value of $s = 0.3$,[5] we obtain a temporary growth rate effect in the amount of 0.135 percentage points. Interestingly, this is pretty much what Eichengreen and Uzan (1992) have found in one of their econometric investigations of the growth effect of the Marshall Plan allotments in the Austrian case: 0.14 percent for 1948-1949, and 0.11 percent for 1949-1950. However, a-priori expectations would

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[3] See Barro and Sala-i-Martin (1995) for a detailed account of this model.

[4] This is derived from the capital stock estimates produced by the Austrian Institute for Economic Research (WIFO), and the GDP figure in the Austrian national accounts statistics.

[5] See WIIW (1998).

rise if we were to take a more extensive view on capital, for instance by including human capital as suggested by the augmented Solow model. This would, in effect, increase the value of θ_K , but even doubling its value would still not give a big stake. Also, the Solow model is, admittedly, somewhat crude in that it assumes a constant marginal savings ratio and simply equates investment with savings. Alternative models of growth, as for instance the so-called Ramsey model or much of modern growth theory, treat investment and savings in a more elaborate and satisfactory way. Within such models, one would have to be more precise as to how exactly aid is used, in order to be able to say anything about its effect. The crucial question here is how aid changes the incentives for investors.[6] Suffice it to say, without going into any detail, that in an extreme case where aid is channeled through to pure household transfers it could be devoid of any growth effect at all, but simply increase consumption. This sheds some light on why aid is seldom granted unconditionally. But still, the simple mechanics of growth strike a rather pessimistic tone on the likely effects of foreign aid on the performance of CEECs. [7]

But in their above mentioned study on the effects of the Marshall Plan, Eichengreen and Uzan (1992) carry out a counterfactual exercise which gives rise to a somewhat more optimistic view. They estimate econometric equations using - among other things - Marshall Plan allotments to explain investment, the current account, and government spending. All of these are then in turn used to explain individual countries' GDP growth. Assuming that all Marshall Plan effects have

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[6] See again Barro and Sala-i-Martin (1995) for accounts of these models. For a discussion of the implications in the context of the Marshall Plan, see Saint-Paul (1993).

[7] This pessimistic view is further strengthened by evidence on the disappointing growth effects of aid granted to poor third world countries; see Kostrzewa, Nunnenkamp and Schmieding (1989).

operated through either investment, the current account, or government spending gives the above mentioned minuscule effect. However, changing the econometric specification by allowing aid to explain GDP growth directly generates a wholly different picture: The Marshall Plan apparently has played a big role through channels other than the mechanics of investment and growth. To see just what it is that gives international aid a higher leverage we have to do two things: a) leave the realm of growth theory for a more realistic view on key problems of systemic transformation, and b) introduce the notion of conditionality in more explicit terms. In doing so, we shall not only expand our understanding of how aid might work, but also why it might be in the interest of the donor country to grant it. More specifically, we shall encounter efficiency reasons for aid, in addition to the humanitarian reason that we have stipulated at the outset above.

2.2 Aiming at collective rationality: the efficiency case for aid

In its most general form, the efficiency argument for international aid runs as follows. Suppose there is room for mutual economic improvement for two countries, but for some reason one country is either unwilling or unable to undertake whatever action is necessary for such an improvement. Then the other country might consider "bribing" its partner country into such action, hoping of course that the benefits received will over-compensate the transfers paid. To put it in less disreputable terms: It might offer aid with appropriate conditionality attached to it.[8]

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[8] Of course, improvement may also take the form of damage avoided. A very popular argument which is often mentioned in this vein is that transfer payments may help stabilize (or shift) the geopolitical balance of power and, thus, be advantageous for security reasons. The underlying premise here is that aid is cheaper than the military spending which would otherwise

This is nothing but a variant of the compensation argument which was introduced 60 years ago by Hicks and Kaldor to facilitate an evaluation of situations which cannot be Pareto-ranked.

A simple example might illustrate the point. Trade liberalization may be perceived detrimental by a large country because it fears a terms of trade deterioration. This country might then resist giving up its protectionist measures. Yet, given gains from trade and barring information problems, its partner country should be able to find some compensatory arrangement under which dismantling trade barriers is attractive for both countries. Lahiri and Raimondos-Møller (1997) have recently substantiated this point, using a theoretical model to demonstrate that tying aid to tariff reform can be used to ensure Pareto improvements. And history is replete with practical examples, including the Marshall Plan, where aid packages include a more or less explicit element of conditionality on trade liberalization. Perhaps a more realistic view would not so much emphasize that a country as a whole may lose through trade liberalization, but that its government may be unable to handle internal pressure opposing such reform. More specifically, it may for some reason not be in a position to devise and implement suitable measures to compensate those groups among its electorate who would suffer from a loss of protection. Receiving aid from abroad may put it in a position to do so.

A somewhat subtler way that a country may gain is via trade as a channel of transmission for technological knowledge. Just as knowledge created by research and development in a given firm is to some extent transmitted to other firms and sectors within an economy through a complex

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be necessary to achieve the desired outcome; see Baldwin (1997). I shall, however, not pursue this peace-dividend argument any further in this paper.

input-output structure and the associated exchange relations, so it will be transmitted to other countries by trade. The crucial thing to note here is the externality: Due to the public good nature of knowledge, a (potentially large) part of the benefits of R&D is external to the innovator, ready to be used without further cost by other firms whose productivity is then increased for free. Quite naturally, such an inventor cannot be expected to carry out costly R&D to a socially optimal extent. This is why most governments engage in subsidizing domestic R&D activities. If they do so in a non-cooperative way, however, they will not take into account the benefits accruing to other countries via trade. As a result, a situation might arise where they collectively under-subsidize R&D. Obviously, the first-best solution would be to aim at cooperative government behavior. But if for some reason this is unachievable directly, a government may contemplate granting its neighbor-country conditional aid, particularly if that country's R&D policy is additionally plagued by fiscal constraints. Note that the argument runs in both ways, suggesting that trade liberalization may also be a very cheap and efficient way for a technologically superior country to help its neighbor to catch up. Indeed, this seems the more relevant variant of the argument in the present context. It is difficult to tell how important this aspect is in reality, but available evidence suggests it is far from trivial.[9]

The argument may be put into an even broader perspective by saying that economic prosperity as such is a public good transcending country borders.[10] We are, admittedly, entering vague and shaky ground here, but the general idea is not entirely unconvincing if applied to neighboring transition economies in the following way. To people and policy makers in the CEECs

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[9] See, for instance, Ben-David and Loewy (1997), Helpman (1997), and Keller (1997).

[10] In such general terms, the argument has been put forward in the present context by Collins (1991).

systemic transformation may look like a trade off: current sacrifice for the sake of future prosperity. If that prosperity exerts an externality on neighboring West-European countries, transformation is likely to proceed at a sub-optimally slow speed, and maybe also to a sub-optimal extent in the long run, if optimality is defined from a global perspective. The reason again is that domestic agents are unlikely to take account of the transnational externality.[11] As before, conditional aid may be an appropriate response. In principle, this argument can be applied to all government policies aiming at domestic prosperity, but it is arguably more relevant in the present context than in others. It is worth pointing out that for this problem, and the above mentioned R&D-problem alike, international capital markets are of no help. They may be important in facilitating international borrowing for a government which temporarily faces a low tax base, but the fundamental problem here is not really one of financing. Instead, it is the cross-border external effect of prosperity which implies that the government does not do enough even if it has access to a perfect world capital market.

The efficiency arguments for aid presented so far do not shed much light on why Marshall Plan aid might have been so important. A further argument, however, arises in the realm of macroeconomic stabilization policy which recent research suggests was decisive for post-war Western Europe. The underlying premise here is that any country gains from a stable macroeconomic environment in its neighboring economies. Countries with big differences in inflation rates will need periodic changes in their nominal exchange rates, with the possibility of recurring exchange rate misalignments, particularly if nominal prices are sticky. As a result, trade

[11] Notice that such a coordination problem will surely also exist between domestic agents. To the extent that it remains unresolved even domestically, it reinforces the case for foreign aid as a means to speed up transformation.

flows between such countries will likely be disrupted from time to time. One would presumably not go as far as postulating a unified rate of inflation for neighboring countries, i.e., a monetary union. But it is certainly also in Western European countries' interest that CEECs close the inflation gaps (see table 1). One would actually expect that such stability gaps are easier to close in short periods of time than income gaps. Why, then, are inflation rates still so much higher in the East, and what can aid do to bring them down? Macroeconomic theory tells us that switching from an inflationary to a non-inflationary path may involve a significant temporary output loss, unless agents correctly anticipate such a switch. By the same token, if monetary authorities credibly announce such a policy shift, the output loss may, at least in theory, largely be avoided.[12] While it is plausible that policy makers in CEECs may lack credibility in this regard, it is not immediately clear why aid received from the West should be of much help in achieving lower inflation. Yet, this is precisely what Eichengreen and Uzan (1992) as well as De Long and Eichengreen (1993) argue the Marshall Plan did in post-World-War-II Europe.

To grasp the underlying argument, one first has to recognize that inflation typically is the result of inconsistent claims on national output. Such claims are partly negotiated in nominal terms ex ante, for instance through wage settlements and government budgets. If they turn out ex post to add up to more than what is available to distribute, the resulting conflict is very often "resolved" by means of inflation which may sufficiently reduce the claims on output in real terms. Now, if it were possible in a unified way to play this game of ex ante negotiation plus ex post inflation on a lower level of nominal claims and proportionally lower expected (and realized) inflation, the outcome would be the same in real terms for everybody. It would then be difficult to see why anybody should oppose doing so, and we would expect a quick and undelayed

[12] See Romer (1996) for a general review of the dynamics of anti-inflationary policy.

implementation of stabilization. However, in practice stabilization often involves one group giving in first, or at least not all groups giving in proportionally at the same time. In this case stabilization policy inflicts a temporary loss on certain groups (in terms of their share in real national output), to the benefit of others. In the long run, all groups will benefit from lower inflation, but only at a temporary sacrifice which is shared unequally by different groups. One can easily imagine that this gives rise to a "war of attrition" where each group hopes to avoid paying its share by delaying stabilization, and waiting until other groups have run out of either their political power or their ability to bear the cost of prolonged inflation.[13] Such a "war of attrition" analogy seems particularly relevant for periods following repressed inflation and monetary overhangs, as in post-World-War-II Europe or in post-communist Eastern European countries, where it is clear that the inflationary way of dealing with unresolved distributional conflicts cannot go on forever. But where in this game does foreign aid play a role? Eichengreen and Uzan (1992) and De Long and Eichengreen (1993) simply argue that by increasing the size of the pie it alleviates the conflict over how it should be distributed. More specifically, it may lower the cost of giving in first, so stabilization will succeed earlier than without aid.

A different scenario with a similar outcome is envisaged by Saint-Paul (1993). Any government facing a shortage of revenue has three ways to close its budget: Finance all expenditures by means of higher contemporaneous taxation, finance a deficit through borrowing on capital markets, i.e., by future taxation, or — if allowed to do so — resort to money creation to finance its deficit, thereby causing an increase in the price level. The crucial point now is that, given its fiscal shortage, the government's temptation to use money creation may vary with the ongoing rate of inflation. At a given rate of inflation, the incentives may just happen to be such that the

[13] This idea has been formalized by Alesina and Drazen (1991).

government ends up choosing money creation to an extent which is consistent with this rate of inflation, in which case the rate of inflation is an equilibrium phenomenon and, therefore, stays constant. If, however, the incentives happen to be such that the government chooses a larger (or smaller) amount of money creation than is consistent with the ongoing rate of inflation, then instead of staying constant the rate of inflation will increase (fall), thereby approaching its higher (lower) equilibrium rate. Using a simple formal model, Saint-Paul (1993) argues that the underlying incentive structure may be such that there are multiple equilibrium rates of inflation.[14] Whether an economy ends up in a high or low inflation equilibrium then depends on its initial combination of inflation and fiscal needs. Suppose, for instance, that the government faces a severe revenue shortage while repressed inflation is released during transformation. As a result, the economy might jump too close to the precipice of a high inflation equilibrium for it to avoid it. If, however, foreign aid provides sufficient fiscal relief, the government might find it easier and more attractive to avoid money creation, thus initiating a virtuous movement to a low inflation equilibrium instead. What aid does in this case is placing the economy sufficiently close, in terms of the combination of inflation and fiscal shortage, to the desired low inflation equilibrium at a critical stage of transition. Notice that temporary aid has a permanent effect: It helps reaching a low, instead of a high, inflation path which, once reached, remains sustainable without further aid.

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[14] A sufficient condition for such multiple equilibria to arise is that, for a given shortage of revenue, the incentive to resort to money creation increases with the rate of inflation, at least over a certain range. This obviously introduces an element of instability, with the usual consequence of multiple equilibria.

2.3 Caveats

Lest the reader obtains an overly optimistic impression from this discussion, let me add a few important caveats. All of the above efficiency arguments for aid fall under the category of international policy coordination to avoid collective irrationality. Economists have primarily analyzed this issue in various contexts of macroeconomic policies, but our discussion has shown that the issue really extends to other areas of economic policy. However, the relevant literature suggests that international aid is not the only, and in many instances certainly not the best way to deal with the problem. But in some cases it may nonetheless be more viable than in others. And one can argue that the specific forms in which efficiency problems arise in the context of CEE countries in transition make aid a more promising candidate, in particular if combined with a humanitarian and/or geopolitical motive, than in the typical case considered in the economic policy coordination literature.[15]

Important additional caveats remain, nonetheless. Perhaps most importantly, it is one thing to identify an efficiency case for aid in principle, but moving from such principles to the successful implementation of a specific aid plan is a different matter. More specifically, aid has opportunity cost in the donor country, and using this aid to support a specific industry or firm likewise has an opportunity cost in the recipient country: Once received, it could have been used for a different industry or firm. In other words: Often when it comes to implementing such a policy the big question is how to pick "winners" that the aid should be spent on. Obviously, the success of an aid program very much depends on the right pick. Even worse, and particularly relevant for the present case of the CEECs, an aid program may retard necessary economic reforms by relieving

[15] For a recent survey of this literature, see Persson and Tabellini (1995).

governments of the need to correct misguided policies. Conditionality may not be sufficiently precise to set the right incentives, or it may even set the wrong incentives. Indeed, this is precisely what some observers argue the Marshall Plan did, and it is therefore not surprising that these observers are highly skeptical as to whether the Marshall Plan could possibly act as a model for how the West should react to the challenge at the Eastern border.[16] This view which, in a sense, carries Milward's (1984) criticisms of the "folk image" of the Marshall Plan to the extreme, is by no means commonly accepted, however. We have seen above that economists have recently identified less obvious and less directly observable ways in which the Marshall Plan may have been successful or even decisive.[17] Not surprisingly, these authors are also less skeptical as to drawing on the post-War experience to suggest a Marshall Plan kind of response to the present day challenge, or at least to emphasize certain parallels. But where, exactly, do we find suggestive analogies and, perhaps more importantly, are there differences which should warrant caution?

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[16] It is perhaps worth quoting such a critic verbatim: "… the ideas that informed the original Marshall Plan, namely that conscious, planned political intervention and design are needed to create economic institutions and guide economic growth, are the very same ideas responsible for the current economic disaster in Eastern Europe. Given this, proposing a new Marshall Plan to solve its problems can be likened to giving free liquor to an alcoholic", see Horwitz (1994). Kostrzewa, Nunnenkamp and Schmieding (1989) go into great detail to argue that the Marshall Plan did retard urgent economic policy reform, particularly in Germany.

[17] See Eichengreen and Uzan (1992), Eichengreen (1992), De Long and Eichengreen (1993) [as well as several other authors in Dornbusch, Nölling and Layard, eds. (1993)], Reichlin (1995), and Esposito (1995).

3 LIMITS TO THE MARSHALL PLAN ANALOGY

3.1 Restructuring versus reconstruction

Perhaps most importantly, the theoretical paradigm which guides our thinking about post-World-War-II Europe and the Marshall plan may be misleading for Eastern Europe, at least up to a certain point in time. While the Marshall Plan period was essentially one of reconstruction, the challenge for CEECs is restructuring which involves a significant element of destruction. By 1945, destruction had already taken place, and post-war times were dominated by a strong sense of reconstruction. By way of contrast, the post-communist reform process, particularly in its early phases, carried a very strong flavor of destruction (see Murrell, 1991). Figure 1 may serve to highlight and discuss this point. It juxtaposes real GDP for Marshall Plan recipient countries during and after World-War-II[18] with real GDP for CEECs subsequent to the start of transformation in 1989. Anchoring the comparison by placing 1989 at 1945 and by setting 1939 and 1989 equal to 100 is, admittedly, somewhat arbitrary and should be left open to debate. However, the basic message seems quite clear: While strong reconstruction-type growth in MP countries had set in immediately after the war, particularly for the most depressed economies like Austria and Germany, the onset of transformation in 1989 has released strong forces of destruction. Including such countries as Russia and Ukraine, Eastern GDP growth was negative throughout until 1996. Even for the more advantageous CEECs, it took 4 years until very moderate GDP growth has set in. Indeed, the figure suggests the metaphor of "rubber band"

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[18] The aggregate figures exclude Greece, Ireland and Portugal. For these countries, Maddison (1995) presents figures only beginning 1947.

growth for post-war Europe,[19] while no such "rubber band" appears to have been present in 1989/90 when Eastern countries started abandoning their planning systems. The contractionary forces released thereafter may be explained along several ways. The following subsections give a brief overview.[20]

3.2 The curse of distortions and missing institutions

Prior to 1989/90, Eastern economies had been characterized by a heavily distorted price system dictated by central planning. Exposing them more or less over night to world prices and competition had a devastating effect on the utilization of resources. By way of contrast, in the MP recipient countries price incentives had not been distorted all that much and, more importantly, for a relatively short amount of time. The price system dictates that, if prices change, those activities where the opportunity cost of resources is higher than the value of what they produce should be shut down. This part of restructuring seems to have worked quite well in the CEECs. Ideally, however, the resources freed in this way will be put to use where they generate a market

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[19] See, however, De Long and Eichengreen (1993) who emphasize that there was more to post-war European growth than such a "rubber band" effect, and that it was by no means unavoidable. On the other hand, the fact that such strong growth was experienced by countries which followed markedly different policies does indicate that there was an common factor. In addition to a "rubber band" effect, the Marshall Plan is an obvious candidate? See also the discussion by Blanchard (1993).

[20] See Blanchard (1997) and Mundell (1997) for a related discussion.

value in excess of their opportunity cost. And this complementary piece of restructuring seems to have failed in early phases of transition.

Much has been said and written on the cause of this failure, and in one way or another almost all explanations revolve around the idea of missing institutions. The legal systems and institutions necessary for the price system to deliver its success were absent to a much higher degree in the CEECs in the early 90s than was the case in post-war Western Europe. Here, the term institutions should be interpreted in the broadest possible sense. The most crucial aspects are the regulatory system pertaining to business formation, property rights, the tax system, and - most important of all - a sound banking system and capital markets. Depending on the circumstances, public attitude towards these institutions may be supportive, or a retarding factor. Even though the inter-war depression had left certain misgivings, the price system was widely accepted in post-World-War Western Europe as a means to allocate scarce resources. Destruction was associated with the war, and the price system was by and large seen as supportive of reconstruction. In sharp contrast, in Eastern countries, now or at least in the early transformation periods, the price system is more or less directly associated with destruction and therefore embraced much less emphatically. Indeed, if appropriate legal systems and institutions are absent, the price system may be installed improperly, giving rise to large wind-fall gains and being open to misuse by economic crime, instead of playing the Smithian role of a beneficial invisible hand. This is certainly not conducive to a general acceptance of the price system.[21]

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[21] To put it in somewhat blunter terms, systemic change does not look too attractive to the masses if the only perceivable change is that from state monopolies to private monopolies (see Melloan, 1998).

Getting rid of distortions is particularly difficult if macroeconomic stabilization is a simultaneous policy objective. On the one hand, adopting an undistorted price system while at the same time reducing inflation may require large reductions in nominal prices, including nominal incomes, which people are often reluctant to accept if they have money illusion. On the other hand, the above mentioned "war of attrition" is more likely to arise if macroeconomic stabilization is pursued at a time of large relative price adjustments. This gives rise to a policy dilemma: It proves difficult to achieve both, an undistorted price system and lower inflation, at the same time. Indeed, policy makers may feel tempted to trade in one objective for the other.[22]

3.3 High aspirations

Falling incomes are particularly hard to bear, and survive politically, if they come at a time of high aspirations and expectations. Such times did not prevail in post-war Europe. In post-communist Eastern Europe, however, the Cold War rituals of mutually overselling economic success on both sides, coupled with the final defeat of the Soviet side, has left a somewhat distorted view in several parts of society of how much the Western economic model could deliver, and how fast. Not only is it important to realize that the price system at times imposes painful adjustment, but also to acknowledge that it is not equally applicable to all sectors of the economy. On all of these accounts, the aforementioned Cold War ritual was hardly helpful to the

[22] Coorey, Mecagni and Offerdal (1998) argue on empirical grounds that the more frequent need of relative price adjustment makes achieving low inflation rates more difficult in transition economies than in other countries.

CEECs when it came to establishing a well-balanced view of what a decentralized system based on competition and prices can, and cannot achieve.

Returning to aspirations, it is easy to get confused by different income figures that are reported on the success of economies in transition. Thus, compare figure 1 to figure 2 which depicts GDP per capita, calculated at purchasing power parities (PPP) instead of ongoing market exchange rates. Although one still observes successive periods of decline in the early 90s, the picture is no doubt somewhat brighter than was the case with figure 1 above. Which one is right? In a sense both are. Figure 1 gives a more or less accurate impression of how severe real contraction was in these countries, while figure 2 tells us that we should not take this as an appropriate measure for real income losses relative to Western European countries. The difference is best understood by the following thought experiment. Imagine two regions one of which experiences a contraction, the other experiencing a boom. Assume that prices of tradable commodities are given from world markets and remain unchanged during the period in question, assuming constant exchange rates. Under many circumstances, we would then expect prices for non-traded goods to fall in the depressed region, and to rise in the region with economic expansion. In calculating PPP, one tries to take these differential price movements into account in order to obtain comparable real income figures. Not surprisingly, applying such PPP instead of market exchange rates to obtain Eastern GDP figures gives a more favorable view of the CEECs. At the risk of oversimplification, we may say that figure 2 takes a potential migrant's point of view, while figure 1 is relevant to those who, for whatever reason, are determined to stay. And it is the right figure to look at if the amount of contraction is at issue.

3.4 Trade

Not only were distortions less prevalent in post-war Western Europe, but they were also felt with less severity than in present day Eastern Europe. The reason is that European post-war

reconstruction took place in a much less globalized world than transformation in Eastern Europe. After the war, European economies were almost closed to start with. Indeed, one of the key intentions of the Marshall Plan and the European Payments Union was to foster trade between European countries. Intra-European trade was deemed an essential ingredient of European post-war recovery, and these intentions were no doubt borne out. Given the limited possibility to trade with the rest of the world, and given that European countries were all in a more or less equally bad shape, domestic producers felt very little competition from world markets. By way of contrast, one of the leading ideas of transformation in CEE is to quickly integrate these countries into the world economy which has meanwhile become a global market place. For the countries in transition, this comes as a mixed blessing. On the one hand, being exposed to world prices almost over night is a tremendous shock for these distorted economies, particularly since distance in almost all of its meanings has lost importance, and since some of the strongest competition comes from neighboring Western countries.[23] On the other hand, there is ample evidence from Western economies that integrated commodity markets and trade may be a powerful engine of growth.[24] Hence the long run growth perspectives should be brighter in a globalized world. In the short run, however, the destructive forces à la Schumpeter may dominate and lead to a picture like the one portrayed by figure 1.

The past 7 years have already witnessed a significant increase in trade between CEECs and EU-countries. Rodrik (1994) argues that this is not a pure reorientation effect. On the other hand, if judged by overall Eastern trade/GDP ratios, trade creation effects have so far been rather

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[23] It is therefore not surprising that the contractionary element of restructuring was particularly strong in the industrial sector where traded goods loom large (see figure 1).

[24] See, again, Ben-David and Loewy (1997), Helpman (1997) and Keller (1997).

modest (see WIIW, 1998). Hence, we have reason to believe that there is room for further trade creation. This view is also supported by projections based on the gravity model of trade (see, for instance, Baldwin, 1994).[25] Whatever the merit of these projections, observed trade already points to an important difference to the Marshall Plan days: CEECs will likely turn out to be more important trading partners to Western European countries than the MP recipients were for the US. This is important if trade liberalization figures prominently in the conditionality element as in the case of EU enlargement (see below). Figure 5 tries to highlight this point by depicting the relevant share of imports and exports in US GNP for the post-war period, and in Austrian GNP for the 80s and 90s, respectively. Even though the CEECs covered are much smaller in their entirety than the group of MP recipient countries, Austrian trade with these countries is more important if expressed in percent of GNP than were the MP countries for the US after World-War-II. If we believe in the projections based on the gravity model, the difference is even more pronounced. One might argue that an export share of 3.5 percent is not a lot, but this figure may substantially understate the leverage of trade liberalization. After all, trade is relatively low because there are trade barriers. As we shall see in the simulation exercise reported on below, even a 3 percent share is enough for sizable welfare gains from trade liberalization.

[25] See, however, Gros and Gonciarz (1996) who argue that most of the trade potential has already been achieved. The simple gravity model postulates that the level of aggregate trade flows between any two countries is determined by size and distance.

3.5 Foreign capital

World regions with a relatively low per capita level of an up-to-date capital stock should boast a high rate of return on investment and should, therefore, be able to draw foreign investment, provided only that capital markets are duly integrated so that savings can flow freely between regions. And it is in this regard that we observe another difference between the Marshall Plan days and present day Europe. Presently, world capital markets are integrated to a degree which was last observed prior to World-War-I. In the aftermath of World-War-II, international capital mobility was virtually nil. Quite apart from the question of convertibility, American investors were particularly shy with respect to Europe where they had sunk large amounts of money during the inter-war years. Hence, European nations found it much more difficult to gain access to world capital markets in the 40s than after World-War-I (see, for instance, De Long and Eichengreen, 1993). By way of contrast, once opened to the Western world in the 90s, Eastern European countries saw a highly receptive international capital market which had meanwhile become even more global than commodity markets. While it is true that in the early phases of transition the CEECs were facing high risk premia when drawing on foreign financing, such premia were successively reduced once investor confidence in transformation policies had been established.

Meanwhile, private capital inflows into CEECs and Eastern countries have picked up substantially, as evidenced by figure 3 which depicts end of period stocks in percent of GDP for 1992 and 1996. Figure 4 shows that the share of private capital inflows, and in particular foreign direct investment, has increased impressively during the first half of the decade. It is tempting to draw a quick conclusion on the premise that a high responsiveness of private foreign investors to the relatively high marginal productivity of capital in Eastern Europe renders any public foreign aid program unnecessary. However, such a conclusion is valid only to the extent that the case for international aid as such relies on the lack of international capital mobility. And we have seen in section 2 above that there are a number of efficiency arguments for aid that in no way rest on the

absence of international capital market. Hence, while private international capital inflows no doubt are important for the CEECs' recovery and catching- up, it would be wrong to view them as a perfect substitute for aid.

3.6 Any lesson?

What are we to conclude from all of this? One might conclude from figures 1 and 2 that by now it is simply too late. The most dire phases, so the argument might run, are over and things look brighter, hence aid is no longer necessary, particularly since private capital inflows have picked up quite impressively. However, in my view the opposite conclusion is also possible, and more convincing: Aid could have come too early. Given the restructuring (as opposed to the reconstruction) paradigm relevant for the early nineties and the evidence highlighted in figure 1, one can argue that it is only now that Eastern countries are approaching a position comparable to that of the MP recipients in 1948, where a reasonably self-supporting growth path makes them a fertile ground for foreign aid. In other words, while such aid might have impeded necessary restructuring in times of poor institutions, it is a more promising option once institutions have started to emerge and the destructive forces of restructuring have petered out and the reconstruction paradigm starts to prevail, as it did in the Marshall Plan days. This seems particularly relevant if the efficiency view of aid is adopted. It is admittedly less convincing if the humanitarian cause is in the foreground. Moreover, the above discussion supports the widely held view that aid should not be granted unconditionally. But framing such conditionality so as to make an aid package mutually advantageous for both the donor and the recipient countries is an arduous task. I shall now turn to the idea that an Eastern enlargement of the EU might constitute an appropriate design for such an aid package.

4 EASTERN ENLARGEMENT OF THE EU: ANY PARALLELS TO THE MARSHALL PLAN?

4.1 The policy package: a brief outline

The European Union has reacted quite promptly to the new situation at its Eastern border by negotiating so-called Europe Agreements (EA) with several CEECs. The purpose of these agreements was to achieve a quick integration of commodity markets which is hoped to contribute to the catching-up process. Formal trade barriers are to be mutually abolished, except for agriculture and sensitive products like textiles and steel. The agreements, reached on a bilateral basis with 10 CEECs,[26] mention full EU membership as a long term objective. While it is true that the EAs do not contain any time schedule for negotiations on accession, it is probably fair to say that the prospect of membership was crucial for the concession that CEECs made on trade liberalization. EU enlargement and trade liberalization should thus be seen as integral parts of a single initiative. This is important in view of the simulation exercise reported on below.

However, membership would extend beyond trade liberalization in various key respects. a) It would imply enlarging the customs union. More generally, Eastern countries would have to accept the common EU foreign trade policy, in addition to applying the EU tariff schedule, which is lower on average than their present tariff schedule, to their trade with third countries. b) They would be granted, and have to grant, Single Market status vis-à-vis all fellow EU members. This includes,

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[26] These are (in alphabetical order): Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

but goes well beyond, commodity trade, featuring several provisions aiming at free movements of goods, services, capital and people. Broadly speaking, the main elements are mutual acceptance of commodity standards, adoption of a common competition policy (including provisions against state aids), and a removal of all border controls.[27] c) The CEECs would have to adopt the whole "acquis communautaire", i.e., the entire stock of treaties and regulations which form the legal basis of the EU, including all provisions pertaining to future steps of integration such as, for instance, monetary union and foreign policy. d) By far the most important part of these regulations, from a CEEC's point of view, relate to the EU spending policies under the common agricultural policy (CAP) and the European structural funds (ESF). Here, of course, the Eastern members would be net beneficiaries because all of them are a lot poorer and at the same time more agricultural than the present EU-average (see table 1).

Of course, expected aid from Brussels makes EU-accession seem like a very attractive policy package to CEECs. And it is in this net transfer from Western to Eastern countries that we find an important parallel between EU enlargement and the Marshall Plan. Note that such transfers follow certain rules and guidelines, not unlike the kind of conditionality attached to ERP funds. As regards the ESF, the general aim is to reduce intra-European prosperity gaps and thus increase cohesion among European regions. More specifically, the Commission in collaboration with national authorities works out criteria subject to which countries and regions shall receive financial support from Brussels. We need not go into any detail here, but a point worth mentioning is that, among other things, these criteria envisage that funds from Brussels are but complementary (or even subsidiary) elements in the respective development programs. Accordingly, an important

[27] See Baldwin, Francois and Portes (1997) for more details.

part of financing is required from domestic sources. This gives the Commission a certain leverage on the use of domestic funds, not unlike the counterpart funds of the ERP program.

4.2 How much aid is involved?

The EU has emphasized at the Copenhagen summit of 1993, and reiterated several times since that its capacity to absorb new members from the East is limited, precisely because of the aforementioned net transfer. In the so-called Agenda 2000 the Commission has suggested that a first round of accession negotiations with the Czech Republic, Estonia, Hungary, Poland, and Slovenia (henceforth called CEECs-5) be started in 1998, while accession talks with the remaining 5 candidates (Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic) should be delayed until these countries have made further economic and political progress.[28] The Commission presents rough estimates for agricultural and structural funds that would flow into the above mentioned group of CEECs-5, totalling 15.5 Bn ECU for 2006. This is a gross expenditure figure. The CEECs would also have to pay contributions, of course, but there will no doubt remain a significant net cost for incumbent EU countries. For obvious reasons, the Commission report leaves entirely open how this net cost should be financed. This is a political issue that will have to be resolved in future inter-governmental negotiations.

Breuss and Schebeck (1996) present a more detailed view on how individual countries might be affected through the need to finance future net transfers to CEECs. Their estimates are based on an econometric model of EU expenditures and receipts, focusing on relevant economic

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[28] See Europäische Kommission (1997). The CEECs-5 plus these countries will henceforth be indicated by CEECs-10.

characteristics of each country, and on the status quo EU expenditure policy. The overall picture is more pessimistic than the Commission estimates would suggest: the net cost of a CEECs-5 enlargement is 16.155 Bn ECU, and a CEECs-10 enlargement would impose an amount of 30.281 Bn ECU.

What are reasonable scenarios for how these costs are borne by different incumbent countries, and how important is the net inflow of funds to different new members? Figure 6 shows the effect of three different scenarios for incumbent countries: a) Proportionally increasing contribution payments for both, incumbents and new members in such an amount that the overall EU budget is balanced.[29] b) Proportionally reducing CAP return payments, and c) proportionally reducing ESF funds such as would be required to balance the budget. The figure juxtaposes the increases in net contribution rates, as required according to each of these scenarios, with Marshall Plan allotments expressed in percent of GNP.[30] Figure 7 depicts net contribution payments for the CEECs-10. Several points are worth stressing. First, for all countries it does matter a lot whether the enlarged EU will balance its budget through adjustments on the revenue or the expenditure side. Austria, for instance, would rather have it reduce its ESF funds than increase contribution payments. This sheds some light on the conflict that is likely to arise in future inter-governmental negotiations dealing with the precise terms of enlargement. Secondly, even under a balanced EU budget, net inflows of resources into the CEECs would be substantial, way above the post-war

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[29] EU rule does not allow the European Commission to engage in borrowing. Hence, the EU budget has to be balanced on an annual basis.

[30] I have crudely "annualized" the Marshall Plan figures by dividing total allotments that have come in during the period 1948-1951 by 4 and then expressed this in percent of 1950 GNP figures (both figures were taken from Kostrzewa, Nunnenkamp and Schmieding, 1989).

Marshall Plan allotments on average. Thirdly, the increases in net contribution payments by incumbent members necessary to finance such aid are very modest, less than half a percentage point for most countries.[31] It thus takes a number of years until the Western European countries would have suffered an accumulated enlargement burden equal in magnitude to the funds that they have themselves received way back in the Marshall Plan years. As regards the Marshall Plan analogy, we must of course also bear in mind a further difference: Then it was a one time gift, here we are talking about a more or less permanent transfer stream. It is less than perfectly permanent, however, because the CAP and ESF policies themselves will surely be subject to periodic change, for instance depending on the amount of inter-regional cohesion achieved. Hence, the above figures should likewise be interpreted as transitory, albeit with a time-span much less specific than that of Marshall Plan aid.

Before we proceed, it is worth pointing out that other authors have come to less pessimistic estimates of the financial aspects of enlargement for incumbent members. Relying on a power politics model, Baldwin, Francois and Portes (1997) conclude that the cost of enlargement is much lower, about half of the Breuss-Schebeck estimates. Which of the two approaches is more appropriate must remain open to debate and, finally, experience. However, if we are interested in whether enlargement is advantageous for an incumbent like Austria, the pessimistic Breuss-Schebeck numbers seem more appropriate to work with.

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[31] According to these estimates, the major exceptions are Greece and Ireland whose net receipts would shrink considerably in an enlarged EU.

4.3 Is there a downside for the CEECs?

With so much aid coming in through EU membership, is there also a downside for the new members? Some observers might point out that the CEECs would enter a Union which stands for outdated and ill-guided models of economic policy and which is, therefore, quite unattractive save for transfer reasons. In line with the "Euro-sclerosis" paradigm, such observers would argue that the EU is regulation-prone and protectionist against the outside world, and that it is plagued by over-sized welfare systems and labor market rigidities which will be felt all the more severely under Monetary Union.[32] Based on this view, one might even conclude that EU membership is not worth it despite the huge inflow of transfers. However, the view can be challenged on several grounds. First, some of these problems - labor market rigidities in particular - have very little to do with the EU, but are instead largely home-made within the countries. More generally, it is difficult to see why EU membership as such should keep the CEECs from avoiding many of the mistakes that their Western fellow members have made in the past. Secondly, the "Euro-sclerosis" stereotype is quite often overdone. It is not hard to find evidence that Europe today seems on the brink of a new start, and various integration efforts of the EU, starting with the Single Market initiative back in 1985, no doubt deserve a fair amount of credit. Moreover, it can be argued that broadening integration by Eastern enlargement of the EU will, in itself, further strengthen Europe's nascent liberalism, and should therefore receive priority over measures towards deepening integration.[33]

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[32] As an example for such a view, see Kristol (1998).

[33] As an example for this more optimistic view on Europe, see Kamm (1998) and Melloan (1998).

There is, admittedly, much to be said in the way of criticizing EU policies, but overall it is fair to say that they are based on a clear commitment to a) free trade and capital movements, b) restricting government subsidies, c) enforce competition to have a working price mechanism, and d) to sound macroeconomic policies. Furthermore, in its Agenda 2000 the Commission has set the stage for a fundamental overhaul of its agricultural policy which no doubt is the weakest element of all EU structures. At any rate, given the huge transfer inflows involved (see above), the EU-CAP would hardly be a downside for new members from the East, whatever its demerits from a more global point of view. In all the aforementioned respects the incremental effect of EU membership on the reform process in CEECs should, on the whole, be positive. I would not dismiss outright the concern that entering the EU may involve adopting misguided policies and reiterating errors that might seem avoidable if institutions could designed from scratch. However, history tells that a pure "blueprint-approach" towards establishing an institutional framework for a functioning market economy is very hard to implement. Instead, the evolution of such institutions normally draws on a complex web of social traditions and expectations. And EU membership offers a convenient way of importing these where ones own history does not offer much support, as in the case of CEECs. Overall, then, it seems fundamentally wrong to view EU membership for the CEECs as a simple package containing aid which has to be paid for by accepting certain disadvantages in various realms of economic policy. Instead, the appropriate paradigm is one of aid with a complex element of conditionality which, in itself, is beneficial to the CEECs. Returning to the efficiency arguments for aid expounded in section 2.2 above, one may now ask whether EU enlargement is also beneficial to incumbent EU countries. The following section tries to answer this question from an Austrian perspective.

5 ENLARGEMENT FROM AN INCUMBENT COUNTRY'S POINT OF VIEW: THE CASE OF AUSTRIA

Public debates in EU countries on an Eastern enlargement are dominated by skepticism. In addition to the financial burden mentioned above, there is concern about import competition from the East which causes hardships for certain sectors and individuals, potentially aggravated by labor market disruptions due to East-West migration. This does not seem to square well with the claim, indicated several times above, that the donor countries might view aid payments as a means to achieve otherwise unlikely beneficial changes. The problem with this debate is that it tends to emphasize the budgetary implications because they are highly visible and easy to understand, and to ignore the gainful effects from trade liberalization because these are less obvious and more difficult to quantify. One way to get a more even-sided view on the issue is to carry out a simulation study based on a theoretical model which duly captures the welfare effects from reducing trade barriers, in addition to the budgetary burden of enlargement. Such a study was carried out by Keuschnigg and Kohler (1997, 1998a and 1998b).[34] The result there, indeed, is that the trade liberalization effect of enlargement should involve efficiency gains which are likely to over-compensate the Austrian budgetary burden. This section offers a few words on the kind of approach chosen, and then highlights some of the key results.

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[34] Keuschnigg and Kohler (1998b) groups the accession countries in accordance with the Agenda 2000 proposal, whereas the earlier papers (1997 and 1998a) are based on the initial perception with the Slovak Republic, instead of Estonia, being part of the first round of enlargement talks.

5.1 A simulation approach

Our approach is to calibrate an enriched textbook model to real world Austrian data, duly emphasizing East-West trade relations, and then do "theory with numbers". I.e., we start with a numerical model which is able to reproduce a given historical data set as an equilibrium solution, we then "shock" this model by a policy scenario which captures the essential ingredients of enlargement, calculate the new equilibrium and, finally, compare this as a sort of counterfactual equilibrium with the initial benchmark equilibrium.

We use a neoclassical model featuring optimizing agents on both the consumption and the production side of the economy. Optimization extends to savings and investment, hence the model allows for accumulation and growth effects. We distinguish between 18 different sectors, each producing differentiated goods using three kinds of primary inputs: physical capital, high-skilled labor, and low-skilled labor. In addition, we incorporate a full input-output structure for intermediates, including imported inputs. The model envisages Austrian imports and exports of goods and services coming from and going to the EU, the potential member countries from CEE, and the rest of the world. Imports are imperfect substitutes for home produced goods. Commodity markets are characterized by monopolistic competition where free entry competes away all profits in equilibrium. In addition, we assume that Austria has unhindered access to world capital markets at a given interest rate. Given the transfer payments to the Union, a crucial aspect is government finance. We explicitly model government expenditures, including such transfer payments, as well as revenues through an elaborate tax system. Specifically, the model requires that any increase in government expenditures be either financed through increased taxation or increased government borrowing which, in turn, will either drain the savings available for investment or imply an increase in foreign debt. We thus fully account for all relevant budget constraints.

The benchmark equilibrium that we obtain by calibrating this model to real world data must be thought of as portraying the Austrian economy in an equilibrium position on its long-run growth path, equilibrium meaning fulfillment of all relevant optimality conditions as well as market clearing.[35] Now comes an enlargement scenario: a) Austrian exports to the CEECs are no longer subject to tariffs (6 percent on average), nor are imports from the new Eastern members subject to the EU external tariff (3.7 percent on average). b) There will no longer be border controls, and commodity standards shall be mutually accepted. In line with other studies we incorporate this as a fall in real trade costs from 5 percent of transaction values to zero.[36] c) There will be additional import competition in food and agriculture where Eastern countries are known to be low cost suppliers. In line with estimates pertaining to Austria's own EU accession, we stipulate a fall in agricultural and food import prices from CEECs in the amount of 23 and 5 percent, respectively. And finally, d) Austria will need to finance the increase in net transfers to the EU, whereby the relevant figures may be seen from figure 6 above. All of these changes will displace the model economy from the initial growth path and have it run through an adjustment path approaching a new long run equilibrium, as depicted in a schematic way by figure 8 where it is assumed that a

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[35] To arrive at such a benchmark equilibrium, one draws on data from a large array of sources which inevitably pertain to different periods and which need to be adjusted to be mutually consistent. In our case, we use the most recent Austrian input output table originally dating back to 1983. We have updated it to 1992 and merged it with long-run trend values from national accounts statistics, as well as trade shares for different countries and sectors from 1994.

[36] This figure may be seen as conservative consensus estimate. See Baldwin, Francois and Portes (1997) who assume a more optimistic value of 10 percent.

temporary reduction in consumption is required to facilitate investment and a subsequent shift to a higher-level growth path.

5.2 Simulation results

I shall restrict myself to only a few key results. Table 2 indicates that enlargement should in the long run be expansionary on the capital stock by an amount of 1 to 1.3 percent, depending on underlying scenario. The reason is that the return to investment increases, due to higher export demand and cheaper imported intermediates from CEECs. Perhaps less importantly, investors will also benefit from cheaper imported capital goods from the East. Higher capital stocks facilitate higher output, hence long run GDP will be higher too. Indeed, the percentage increase is larger for GDP than for the capital stock, due to higher producer prices and a reallocation of all primary input towards sectors where such price increases are largest. It is interesting to see how the sectoral adjustment looks like in more detail. Thus, figure 9 depicts long run changes in sector outputs due to enlargement. Not surprisingly, agriculture experiences a severe depression, while all other sectors (except services) expand, notably chemicals and textiles where the removal of trade barriers has the largest effect. Notice that this is perfectly consistent with textiles being on a long run decline for other reasons. Here we are talking about a differential effect from EU enlargement.

Textiles and various other expanding sectors, like paper and paper products, are among the less skill-intensive sectors. Hence the particular kind of expansion caused by Eastern enlargement is coupled with strong demand for unskilled labor. Looking back to table 2, we are therefore not too surprised to find out that the wage spread between the two types of labor is only marginally widened under the CAP scenario (agricultural return payments reduced), and even narrowed under the CONTR scenario (contribution payments increased). Rather than taking it as a foregone conclusion that integrating poorer regions into richer ones will deprive low-skilled relative to high-

skilled labor in rich regions, we should have a close look at what integration actually means on a sectoral level. In our case, both wage rates are up in the long run. Moreover, comparing these increases with the changes in the consumer price index, we identify them as real wage improvements. The explanation, of course, is that an increased capital stock affords labor a higher marginal productivity. Notice also that, far from imposing a fiscal burden on the government, enlargement swells the tax base through overall expansion, thus allowing the government to raise its lump-sum transfers to domestic households by as much as 2.2 percent under the CEECs-5-CAP scenario, for instance. Disposable wage income therefore increases by even more than wage income alone.

All of these are long run changes. Figure 8 suggests that long run growth may require a significant sacrifice in terms of forgone consumption which is required to finance investment and accumulation during the transition process. What about generations unfortunate enough to live during early periods of adjustment? The most unfortunate generations of all are those entering the economy right at the time of, or shortly after, enlargement when adjustment lies ahead and the fruits of an enlarged capital stock cannot yet be reaped. Looking at the results in more detail would tell us that even they stand to gain, but a bottom line evaluation requires a more comprehensive summary measure which we have calculated in the following way. For each and every generation we ask: How much would it have to receive, or give away, by way of a compensatory transfer so as to find out that it fares just as well under enlargement than without, considering its entire life span. To do so, one has to indulge into complex utility calculations which need not bother us here. Suppose, instead, we have succeeded and such compensation figures are at hand for each generation. It is then tempting to add them up, applying a social discount rate to give more weight to present than to future effects. Finally, we convert the aggregate figure so obtained into a permanent income stream, and express it in percent of initial benchmark GDP. This is how one should read the welfare-equivalent variation in table 2. In other words, if Austria were to receive a yearly transfer payment equal to 0.7 percent of present GDP, granted

forever throughout the entire future, then it would of course be possible to raise the well-being of all its present and future generations. Our simulation results imply that EU enlargement to CEECs-5 under the CAP scenario would have an effect equal to such a permanent transfer payment. Notice that this figure is substantially lower than the GDP growth figure, which is what we would expect from the above discussion pertaining to figure 8. But it is still positive, suggesting that it is in the Austrian self-interest that the EU be enlarged. We may convey the same message from a different and slightly more provocative angle by asking: How much could we allow the government to increase its EU net contribution rate for Austrians to find out that they are just as well-off under enlargement than without? The NEUTR-columns in table 2 reveal that these hypothetical contribution rates substantially exceed the actual rates of slightly more than 1 percent, given in the final line of table 1 for the two scenarios considered (CAP and CONTR).

It is important to point out that our model assumes a frictionless labor market. Hence we rule out that Eastern enlargement causes additional unemployment. Nor do we consider migration in our simulation exercise. As regards unemployment, it seems reasonable to assume, as a reference case at least, that workers displaced in one sector will in the long run be re-employed in other sectors. In the short run, however, labor reallocation tends to contribute to unemployment, adding to the plight of adjustment which, therefore, is to some extent underestimated by our results. As regards migration, incentives no doubt are there, but it seems rather difficult to gauge likely orders of magnitude.[37] At any rate, we know from theory that an immigrant country's initial residents as a whole stand to gain, provided only that incoming labor is subject to diminishing marginal productivity and is paid its marginal product.[38] Hence, in the aggregate at least,

[37] See the above discussion pertaining to figure 2.

[38] This is the well-known "immigration surplus"; see Borjas (1995).

migration is likely to improve the picture for a Western country, rather than worsen it. But this comes with a potentially troublesome distribution effect, whereby domestic workers who are substitutes for incoming labor suffer from wage pressure. Notice, however, that absent migration our results indicate wages would increase upon enlargement (see table 2), since an increased capital stock improves the marginal productivity of labor. Immigration would thus first moderate this wage increase, rather than directly causing a wage reduction.

6 CONCLUSION

Let me conclude by summarizing. Comparing postwar real growth for Marshall Plan recipient countries with growth experience of CEECs in the 90s, we have identified a crucial difference: There was immediate take-off after the war, largely dominated by reconstruction, while the economies in transition have suffered enormous contraction, essentially due to the devastating effects of initial distortions which, once removed, require enormous restructuring. It is only at the end of this decade that the CEECs come into the reconstruction phase characteristic of MP recipients after the war. Another important difference is that restructuring and reconstruction in the 90s takes place in a world where commodity and capital markets have become truly global, while the European countries of the Marshall Plan days were essentially closed economies. To the economies in transition this comes as a mixed blessing: it makes restructuring all the more painful, but it also offers more opportunities for gains through international exchange of goods, ideas, and savings.

Against this background, a quick analogy to the Marshall Plan seems a doubtful justification for Western aid to the East. However, a more general discussion of aid from both a humanitarian and an efficiency point of view leaves one equally skeptical of an outright dismissal of any Marshall-Plan-type aid proposal for Eastern countries in transition. We have to look into specific proposals

in more detail. One such proposal holds that an enlargement of the EU towards the East would include several important Marshall-Plan-type elements. For most Western EU countries, the aid involved is somewhat less than the ERP funds they have received (if expressed in percent of GDP). The burden is also less to them than it was to the US in the case of the Marshall Plan. To the Eastern countries in transition, the transfers received would be substantial, surpassing Marshall-Plan magnitudes by several percentage points. Such aid would, however, come in under conditionality in the form of Eastern countries having to accept the "acquis communautaire" in all areas where the EU has adopted a common policy approach. While, admittedly, the EU may not have adopted ideal policy approaches in all these areas, the institutions and legal systems imported in this way by the CEECs are likely to be superior in many respects to what they would be able to implement on their own, given the legacy from their recent history.

Contrary to the premise underlying much of the public debate, an incumbent EU member like Austria may significantly gain by an Eastern expansion of the Union. The reason lies in gains due to trade liberalization. Such liberalization, already initiated in the so-called Europe Agreements, would have been unlikely to unravel so quickly without the prospect of EU membership for Eastern countries. Hence it should be seen as an integral part of EU enlargement. If these gains are larger in magnitude than the budgetary burden of the transfer payments to the new members, then EU enlargement as a whole may be seen as an example for an efficiency case for aid, with transfer payments as a means to facilitate specific changes in recipient countries that are, in turn, beneficial also for the donor country. Simulation exercises carried out on the basis of a neoclassical model calibrated to real world data show that such is the case from an Austrian perspective.

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