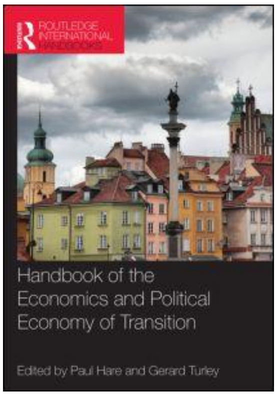

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EU ACCESSION AS AN INSTRUMENT FOR SPEEDING UP TRANSITION

Mojmir Mrak and Matija Rojec

Introduction

EU accession and transition processes are two sides of the same coin. The heart of the transition process is a transformation from a one-party political system and a centrally planned economic system to a democratic, multi-party political system and a functioning market economy. This is also the heart of the EU accession process. According to the June 1993 Copenhagen European Council 'accession will take place as soon as a country is able to assume the obligations of membership by satisfying the economic and political conditions. As far as economic conditions are concerned, the membership requires: (i) that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; (ii) the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the EU; (iii) the ability to take on obligations of membership, including adherence to the aims of political, economic and monetary union'.

The aim of this contribution is to assess how far the EU – and specifically the realistic prospect of accession – has been an instrument for speeding up transition. The first impact of the EU accession on launching of the transition processes dates back to the pre-transition era. At the political level, the idea of EU membership was often an important factor motivating populations in the still communist and centrally planned economies to support systemic changes of their socio-economic and political systems and in some cases also to create new sovereign states.[1]

Later on, the EU accession has helped in speeding up transition via processes of nominal and real convergence of the EU candidate countries. In terms of nominal convergence, the speeding up of transition by EU accession has proceeded via the instruments of economic policy dialogue between the Commission and candidate countries. By achieving candidate status, a country in fact decides to adopt the EU type of market economy, the instruments of economic policy dialogue assure more efficient and thorough implementation of the reform processes due to the external pressures of the European Commission, and the provision of pre-accession assistance (funds and technical assistance) also provides some push to the reform processes. In terms of real convergence, preferential access of candidate countries to the internal market of the EU has provided them with an important lever of growth and economic restructuring, the same goes for the increased interest of multinational companies (MNCs) from the EU (and elsewhere) to invest in acceding countries. Below we provide arguments in favour of these channels of positive impact of EU accession for the transition process.

EU accession process as a means of speeding up transition reforms

The fact that a transition country decided to apply for EU membership and its consequent achievement of candidate status meant that the country had opted for a specific type of market economy, i.e. for the EU type of market economy with all its specifics and institutional arrangements. This fact quite precisely defined the type of transition reforms the country would have to go through. It also helped a candidate country to avoid, or at least to ease, some of the normally long-running and difficult political discussions over the concept, content and implementation of every single reform. The decision in favour of EU accession, more or less also meant a decision about the basic concepts of reforms, including the legal and institutional system. What remained was mostly the political will to implement these reforms, which has never really been questioned in most of the candidate countries. In this way, many unknowns about the direction and intensity of reforms have been avoided and, as a result, the risks and the time necessary for the preparation and adoption of reforms were reduced.

Gaining EU candidate country status also meant that a country undertook commitments *vis-à-vis* the European Commission as far as the implementation of the reforms was concerned. The economic content and pace of reforms was planned and monitored via the economic policy dialogue between the European Commission and candidate countries. The two main instruments of this dialogue were Progress Reports and the so called Pre-Accession Economic Programmes.[2] In Progress reports, which assess candidate countries' accession progress in the previous year, the Commission used the so called Copenhagen criteria as a yardstick to judge their readiness for EU membership. The Copenhagen criteria – existence of a functioning market economy, capacity to cope with competitive pressure and market forces within the EU – are in fact nothing else but a list of transition reforms to be implemented by countries in order to become viable EU member states.

In the Pre-Accession Economic Programmes, the candidate countries conveyed to the Commission the main characteristics of their next two–four years of economic policy measures, both as regards their macroeconomic policies, with special emphasis on their fiscal policy, and concerning their proposed structural reforms. In this way, the economic policy dialogue speeded up transition reforms as the Commission exerted pressure on the candidate countries, and provided financial and technical assistance related to the implementation of the mutually agreed reform programmes. Candidate countries also tended to use the argument of 'Commission's pressures' as an excuse to push forward unpopular domestic reforms and to neutralize internal opposition to reforms.

In the above context, we claim that the EU accession process both speeded up transition reforms in the candidate countries and also ensured that the pace and content of transition reforms would converge. This is not the case for other transition countries that are not on track for EU membership. The result is that they lag behind in their transition processes and that the pace of their respective transition reforms diverges considerably. Assuming that the extent to which transition reforms in a given country have been accomplished can be objectively measured, we test this proposal by looking at the most commonly used indicators of reform progress, namely the EBRD Transition Indicators. We use three different summary transition indices: (i) overall transition index as average for all nine reforms taken into account by the EBRD Transition Index; (ii) Stage 1 reforms index, which we calculate as an average of the indicators of price liberalization, trade and foreign exchange system, and small privatization; and (iii) Stage 2 reforms index, which we calculate as an average of the indicators of large scale privatization, enterprise restructuring, competition policy, banking reforms and interest rate liberalization, securities markets and non-bank financial institutions, and infrastructure reform. It is the Stage 2 structural reforms which represent the core of the transition process, the difficult and time-consuming part of it. We claim that it is here in particular, where the EU accession process makes the biggest contribution to speeding up the reforms.

To test this we compare trends in EBRD Transition Indicators for nine new member states (NMS-9: Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia), seven formal and informal candidate countries (CC: Albania, Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro and Serbia) and three European CIS countries (Belarus, Russia and Ukraine). Each index ranges from 1 to 4+: 1 meaning only the initiation of transition reforms (little or no change from central planning) and 4+ meaning more or less the situation in advanced market economies. Thus, once a country approaches level 4, its institutional setting is near to that in the advanced market economy countries (EBRD, 1999).

Figure 16.1 shows average transition indices for overall, Stage 1 and Stage 2 reforms and within-group standard deviations of these averages for NMS-9, CC and European CIS countries. *Averages* show the pace of reforms, while *standard deviations* show whether the level of transition reforms tended to converge or not. The EU accession process was supposed to contribute positively to the pace as well as to the convergence. In Stage 1 reforms, the NMS-9, by the late 1990s, had almost achieved the maximum possible value of the transition index. The increase in the Stage 1 reforms index for CC countries was more gradual and still rising, but they gradually caught up with NMS-9 countries. The situation in European CIS countries shows that Stage 1 reforms lagged behind the CC and especially the NMS-9 countries, and that since 2003 there has not been much further progress with these reforms. The standard deviation of the Stage 1 reforms index has been almost zero for the NMS-9 since the late 1990s, the standard deviation for CC countries was higher, but has been decreasing quickly since the late 1990s and gradually approached the level of the NMS-9. The situation is again very different for European CIS countries, where the standard deviation was initially quite high and showed little real tendency to decrease.

The situation is very different as far as the Stage 2 reforms index is concerned. Here, all three groups of countries still show increasing trends in the average values of the index and obviously need more time to reach the maximum level of the index of around 4. More interesting is the point that, somewhere in the second half of the 1990s, the NMS-9 had reached a certain level of advantage over CC, which they have held onto until the present day. In other words, after gaining an initial advantage over the CC countries, the NMS-9 countries maintained their lead over the CC countries in implementing Stage 2 reforms. The trend and the level of the average Stage 2 reforms index of European CIS countries is surprisingly similar to that of CC countries. As far as the standard deviation is concerned the situation is similar, as it is least in the case of NMS-9, followed by CC and the European CIS countries. The level of these differences is somehow kept in the last five years, but while the standard deviation for NMS-9 and CC countries has been constantly decreasing, this is not so for European CIS countries. It thus seems that EU accession process has given an important initial push to the Stage 2 transition reforms of NMS-9 and somewhat later to CC countries and it also makes the pace and level of their transition indicators converge.

These trends in averages and standard deviations of transition indices support the proposal that the EU accession process has been an instrument for speeding up transition reforms in NMS and candidate countries. To some extent it is surprising that this impact has been more apparent for Stage 1 reforms, meaning mostly liberalization and stabilization, than for the more difficult and time consuming structural and institutional reforms of Stage 2. It seems that the European

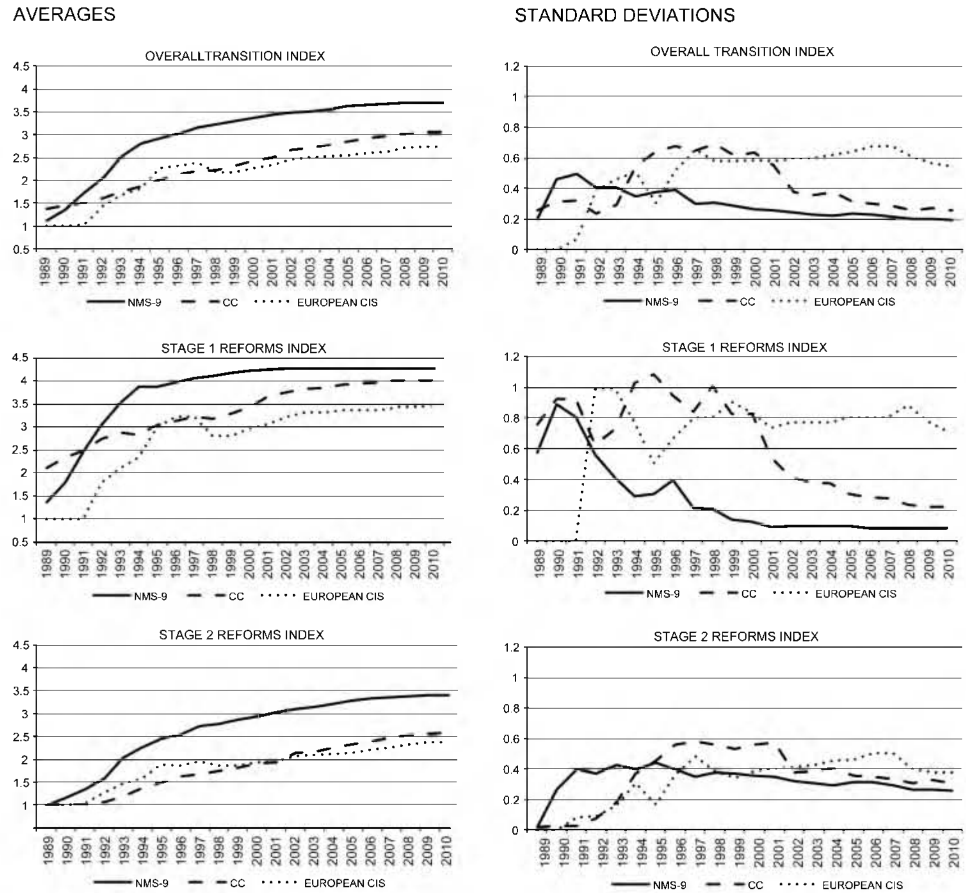

Figure 16.1 Overall Transition Index, Stage 1 reforms Index and Stage 2 reforms Index for NMS-9, CC and European CIS countries: Group averages and standard deviations in 1989–2010

Source: Calculated from EBRD Transition Indicators by Country, www.ebrd.com/pages/research/economics/data/macro.shtml#ti

Commission has been more successful in promoting stabilization and liberalization than structural and institutional reforms. This highlights the problem of a possible implementation gap.

Provision of pre-accession assistance (funds and technical assistance)

In 1989, when the process of transition started in the countries of Central and Eastern Europe, the EU responded impressively quickly with financial aid to Poland and Hungary aimed at assisting their efforts to restructure and reform their economies (Programme PHARE: *Pologne-Hongrie Aide à la reconstruction économique*). During its initial years, PHARE primarily took the form of technical assistance, while already by 1991, the programme had become a technical assistance and know-how transfer programme covering a wider range of transition economies in the region. The second important reorganization of PHARE occurred in the mid-1990s when PHARE was turned into an actual pre-accession instrument adapted to the priorities and needs of each individual recipient country. As progress was made and the demand for technical assistance declined, the programme was reoriented towards investment aid, particularly in areas such as infrastructure and environmental protection. Further, the programme started to be operated on the basis of instruments from the Structural Funds.

The third major reorganization of PHARE accompanied the beginning of the EU accession negotiations. Following the Commission discussions around Agenda 2000, PHARE was redirected towards two crucial priorities associated with the adoption of the *acquis communautaire*, namely institution building and investment support. The instrument was accompanied by two new pre-accession instruments – the Instrument for Structural Policies for Pre-accession (ISPA) and the Special Accession Programme for Agriculture and Rural Development (SAPARD). Some 3.1 billion Euros a year was made available from these funds for the 10 Central and Eastern European candidate countries during the 2000–06 period, with some additional pre-accession funds available also to Malta, Cyprus and Turkey as well as to Western Balkan countries through the Community Assistance for Reconstruction, Development and Stabilization (CARDS) programme.

In the current financial perspective of the EU covering the period 2007–13, pre-accession assistance has been integrated into a single instrument called Instrument for Pre-accession Assistance (IPA). In a similar way to the previous programming period, the pre-accession assistance has two basic objectives: first, to assist candidate countries in their transposition of the *acquis*, and, second, to assist the candidate countries in the efficient use of Structural Funds and the Cohesion Fund. For the IPA, amounting to around 1.5 billion Euros a year, all seven EU candidate and potential candidate countries from the western Balkans plus Turkey are eligible. The programme is made up of five components: (i) support for transition and institution building; (ii) cross-border co-operation; (iii) regional development; (iv) human resource development; and (v) rural development. The first two components are available to all the candidate and potential candidate countries while only the candidate countries enjoy access to the remaining three components.

Preferential access to the internal market of the EU

Preferential access to the EU internal market has helped transition countries to strengthen their competitive position and exports to the EU markets and thus to advance their real convergence. In the period 1990–2004, i.e. from the beginning of transition to their accession to the EU, eight transition countries which acceded to the EU in 2004 (NMS-8: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) recorded an extremely high growth of exports in absolute as well as in relative terms, that was accompanied by increasing market shares abroad and by the domination of the EU-15 as the main market (see Table 16.1). Most of this development is explained by gravity theory, i.e. by the fact that pre-transition trade with CMEA countries, was much above the 'normal' level and with the EU-15 much below the 'normal' level. Size, proximity and the development level of the EU-15 add up to an extremely strong gravity force for transition countries' exports. Additionally, the EU integration process provided these countries with preferential access to EU-15 markets. The literature suggests that preferential market access, especially the Europe Agreements, has clearly been an important additional factor in increasing the volume of NMS-8 trade (particularly with the EU-15).

The access of transition countries to OECD markets has evolved in three stages. The first stage was the removal of discriminatory measures (non-tariff barriers) aimed specifically against state-trading economies, in fact the granting of Most Favoured Nation status. The EU was the first to do that. The second stage was granting preferential market access under the General System of Preferences, which put transition economies on a par with developing countries with quota-limited free access for most products. Again, the EU was the first to take that step. The

Table 16.1 Main exports related indicators of NMS-8 in 1990–2004

	1990	*1995*	*2000*	*2001*	*2002*	*2003*	*2004*
Exports of goods (billion EUR)	31.4	61.7	129.1	148.1	159.7	173.1	209.2
Exports index (1990 = 100)	100.0	196.8	411.6	472.1	509.4	552.1	667.2
Exports as % of GDP	n.a.	29.3	36.7	37.4	37.8	41.5	46.0
Exports as % of World imports	1.11	1.54	1.80	2.08	2.28	2.55	2.81
Exports to EU-15 as % of EU-15 total imports	n.a.	2.53	3.69	4.19	4.57	4.94	5.38
Exports to EU-15 as % of total exports	46.0	60.6	68.4	67.8	67.5	67.1	65.9

Sources: UNCTAD, World Bank and WIIW (The Vienna Institute for International Economic Studies) databases.

third stage was the conclusion of Europe Agreements between the EU-15 and most of the NMS-8 by the mid-1990s, and their anticipated accession to the EU after the Copenhagen EU summit. General System of Preferences represented a big step in tariff liberalization, but there is little evidence that, 'with its limitations and exclusions (quantity limits, special treatment of sensitive products, uncertainty of access), it alone can explain changes in transition economies' shares in OECD imports' (Kaminski *et al.*, 1996).

Clearly, the Europe Agreements have been far more important than General System of Preferences. Kaminski *et al.* (1996) analysed the effects of the Europe Agreements with Czechoslovakia, Hungary, Poland, Romania and Bulgaria signed in 1991 and 1992. They claim that provisions on trade with industrial products, which affected about 80 per cent of the exports of these five countries to the EU, significantly improved their access to EU markets. In 1992 the first year they were in force in Hungary, Poland and former Czechoslovakia, the Agreements freed slightly less than 50 per cent of total exports to the EU from import duties and non-tariff barriers. According to the Agreements, these shares were to increase over five years to about 80 per cent for the former Czechoslovakia, 60 per cent for Hungary and 70 per cent for Poland. Apart from that, tariffs were reduced for a number of other products, and the Copenhagen summit further cut the time to reach the top of the EU preferential trade pyramid, at that time occupied by the EFTA countries. These reductions in trade barriers translated into a competitive edge over suppliers from other countries. Still, the Europe Agreements retained a number of restrictions characteristic for the General System of Preferences (delays in liberalizing imports of sensitive products, tight rules of origin, continuing threats of antidumping, and the virtual exclusion of agriculture), which were then gradually removed in the process of EU integration.

Increased interest of MNCs to invest in acceding countries

The opening up of transition countries for inward FDI has been one of the most visible effects of the transition process. At the same time, the EU accession process fundamentally changed the position of transition countries in MNCs' considerations and reduced the perception of investment risks. This increased the interest of foreign investors from the EU (and elsewhere) to invest in the transition countries, which in turn speeded up their real convergence. Why was that so?

Economic theory suggests that economic integration increases FDI inflows in the region because: (i) the size of the market increases, and this led to the replacement of exports with FDI; the consequence was an increase of FDI inflows in the NMS; (ii) MNCs reorganized their investments in the region in response to the new configuration of locational advantages (new structure of costs, benefits, economies of scale) among member countries; the consequence was increased FDI in some old and new member states, and even some retreat of FDI from others;

and (iii) new investment opportunities arising from the restructuring of activities between countries, sectors and firms triggered by economic integration. The consequence was an increase of FDI inflows in NMS (Dunning, 1993). In the case of transition countries, EU accession itself also reduced transaction costs and perceptions of investment risks because it gave important assurances to foreign investors about the timing of accession, as well as about the type of economic and legal system the transition countries were heading towards (Baldwin *et al.*, 1997).

Empirical evidence (Table 16.2) quite clearly confirms the above pattern, i.e. the tremendous increase of absolute and relative (increasing inward FDI stock to GDP ratio, increasing share of NMS-8 in world inward FDI stock, and increasing NMS-8 to EU-15 inward FDI stock ratio) values of FDI in the NMS-8, and the major importance of EU investors in this increase. In this context, it is important to note that the relative increase of FDI inflows in NMS-8 (measured by NMS-8 to EU-15 FDI inflows ratio; Table 16.2) happened before their accession in the EU, indicating that the impact of EU accession on FDI inflows was already anticipated to a considerable extent before accession. In other words, foreign investors tended to plan on the basis of a country's likely future membership of the EU.

This positive impact of the EU accession process on inward FDI is important for the transition process, as FDI has traditionally been seen as an important means for structural upgrading and increasing the productivity of transition economies and, thus, for their catching up with the EU. Most of the relevant literature tends to confirm these expectations, more precisely: (i) foreign subsidiaries in transition countries deepen trade linkages by having disproportionately high shares in exports and imports; (ii) direct effects of FDI are significantly higher productivity of acquired companies/greenfields than of domestic firms; (iii) in terms of industrial and market structure, FDI plays a dual role as restructuring agents by building new sectors (electronics, automotive), and as market seekers (food, banking, telecoms); and (iv) the effects of FDI are mostly concentrated on the acquired or newly erected plants, with the extent of spillovers generally rather limited, depending on local companies' absorption capacity (Djankov and Hoekman, 2000; Hunya, 2000; Damijan *et al.*, 2008; Smarzynska, 2003).

Conclusions

The process of transition of the centrally planned economies from Central and Eastern Europe into market economies has been implemented simultaneously with the accession of these

Table16.2 Main indicators related to inward FDI stocks in NMS-8 in 1990–2004

	1990	*1995*	*2000*	*2001*	*2002*	*2003*	*2004*
Value (billion EUR)	4.0	32.1	93.4	112.1	146.8	187.7	257.1
FDI stock index (1990=100)	100	803	2335	2803	3670	4693	6428
FDI stock as % of GDP*	7.3**	12.3	30.0	32.2	37.4	40.9	45.9
NMS-8 in World inward FDI stock (%)	0.19	0.95	1.26	1.50	1.95	2.00	2.33
NMS-8 to EU-15 inward FDI stock ratio (%)	0.52	2.88	4.22	4.77	5.27	5.12	5.78
Share of EU-15 investors in NMS-8 inward FDI stock (%)	n.a.	n.a.	n.a.	n.a.	87.2	80.3	80.5
NMS-8 to EU-15 FDI inflows ratio (%)	0.9	13.7	3.5	6.7	8.0	5.3	16.4

Sources: UNCTAD, FDI/TNC (www.unctad.org/fdistatistics) and WIIW (The Vienna Institute for International Economic Studies) databases.

Notes: * Non-weighted average.

** Data for 1993.

countries to the EU. The two processes have been strongly intertwined and it can be empirically confirmed that those countries of the region which became members of the EU during the 2004/07 enlargement have by and large also come closer to completion of their transition process than those transition countries that are still EU candidate countries. Interestingly, though, many of the new member states of the EU continue to experience considerable problems with actual implementation of the *acquis communautaire*. This is also the main reason why EU accession negotiations are now even more structured than they were during the big Eastern enlargement.

Moreover, the current financial and economic crisis has interrupted the almost two-decades long period of real convergence of the new EU member states. There is a growing consensus that the pre-crisis model of economic growth in most countries of the region, based on strong domestic demand and large capital inflows, is not sustainable any more and needs substantial adjustment. The key elements of a revised economic growth model will have to incorporate the following three components: first, the increase of domestic savings and consequently a reduction of these countries' reliance on foreign savings. Second, adjustments in macroeconomic and financial policy oriented towards more proactive channeling of capital inflows towards tradeable, export-oriented activities. And third, radical Lisbon Strategy-type structural reforms aimed at increasing productivity, that is needed to restart a dynamic and sustainable economic growth in the region.

Notes

1 In Slovenia, for example, a slogan of the Slovenian Communist Party in the later 1980s, i.e. at the time when the winds of change began to blow, was 'Europe now'. It may be said that some mention of EU membership was never omitted whenever requests for independence, a democratic parliamentary system and a market economy were put forward.

2 Pre-Accession Economic Programme is a policy dialogue instrument for candidate countries, while the respective instrument for countries which have not yet acquired formal candidate status is an Economic and Fiscal Programme. Their content, however, is more or less the same.

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