

Transition in and towards Europe: Economic Development and EU Accession of Post-Communist States

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The post-communist states of Central and Eastern Europe have successfully managed the transition from plan to market economy. Through law harmonisation, acquis screening and demanding requirements imposed by the Commission, EU accession helped the economies entering a growth path, receiving foreign investment and reorienting their trade. On the other hand, since the Central and Eastern European states have joined one of the slowest growing regions in the world economy, the Union in its present shape will no more contribute to the acceleration of endogenous growth. This implies a need for reassessing the politico-economic strategies of the new member states. Salient features include professional talk in public debates, sustainable public finances and a major fiscal adjustment as well as fostering long-term financial savings. Structural reforms faced by old and new EU member states are thus overlapping to a large degree.

Die post-kommunistischen Staaten Mittel- und Osteuropas haben den Übergang von der Plan- zur Marktwirtschaft erfolgreich vollzogen. Durch Rechtsangleichung, die Übernahme des acquis sowie weitergehende Auflagen der Kommission hat die Osterweiterung dazu beigetragen, dass sich die Volkswirtschaften auf Wachstumskurs befinden, Auslandsinvestitionen anziehen und ihre Handelsstrukturen neu ausgerichtet haben. Da die mittel- und osteuropäischen Staaten nun jedoch einer der am wenigsten dynamischen Region der Weltökonomie angehören, wird die EU in ihrer derzeitigen Form keine Beschleunigung des endogenen Wirtschaftswachstums mehr induzieren. Daher müssen die neuen Mitgliedstaaten ihre politökonomischen Strategien überdenken. Von zentraler Bedeutung erscheinen „professionalisierte“ öffentliche Debatten, solide Fiskalpolitiken sowie die Förderung langfristiger Rücklagen. Der Bedarf an sozioökonomischen Strukturreformen stellt sich mithin in alten und neuen EU-Staaten weitgehend ähnlich dar.¹

I. Introduction

With the historic enlargement of the EU towards Central and Eastern Europe, post-communist transition has come to an end in the new member states and to a watershed in the rest. Most of the post-communist countries are still struggling with serious social and economic difficulties, whereby *the new entrants constitute*

¹ Useful comments by *Julius Horvath* on an earlier draft of this contribution are appreciated, with the usual caveats.

the exception rather than the general rule. It is too often being forgotten that, according to the long term time series provided by the UN Economic Commission for Europe, the vast majority of formerly socialist countries have yet to regain their pre-crisis levels of output, despite the impressive growth rates recorded during the first years of the 2000s. Even the Baltic States, as well as the economies of Romania, Bulgaria and Croatia, have still 10–15 per cent to grow in order to get back to the pre-1989 levels. True, due to structural and quality changes any long-term statistical comparison is of limited value. Facing this elementary fact may, however, explain why systemic change is so infrequently associated with liberation and so widely identified with economic hardship and social strain. On average, the levels of unemployment in the transition economies exceed, with a considerable margin, that of the European Union. While the EU considers joblessness to be one of its major problems, having reached 8.8 per cent by end-2003 in the Euro area and 8 per cent in the EU at large, some new members, such as Poland, registered 19.1 per cent, Slovakia 16.7 per cent, and Lithuania 11.6 per cent unemployment.² The really frightening issue about these numbers is not only their relatively high level in societies where full employment used to be the norm for several decades, but also that these low employment figures are registered at times when the respective new members grow considerably faster than the core EU economies. In other words, the return of economic dynamism is a necessary, but insufficient condition for systemic change to the vast majority of the population.

Against this generally gloomy background, it is all the more intriguing to inquire, if and how some post-communist countries, the front-runners, managed to transform their economic order so that they could qualify for OECD, NATO and eventually EU membership. In the following, we shall try to assess the achievements also in terms of the “package” the new members bring to the enlarged European Union, constraining ourselves to a broad-brush picture of the overall landscape.

II. Institutional Design and Learning by Doing

When Communism collapsed, first in Central Europe in 1989 and later in the Soviet Union and elsewhere, it came as a surprise for most analysts. Even those who not only hoped for but even forecasted the disintegration of the Empire³

² Numbers according to *ECB Statistics Pocket Book*, Brussels, 2004, here 40.

³ *Csaba, L.*: Eastern Europe in the Year 2000, in: *The Nordic Journal of Soviet and Eastern European Studies* 5/1 (1988), 11–32.

have been struck by the sudden, peaceful and radical nature of changes. Contemporary optimists were hoping for a gradual Finlandisation, a gradual change from one stage to another, managed or co-managed by the superpowers. For this very reason even in social science discussions, including the debates in the opposition/*samizdat* literature, democratic socialism and “third road” alternatives were considered, and more radical ideas aspiring for “the real thing” were marginalised and branded as adventurism.⁴

This has created a strange situation, characterised by an overall lack of preparedness as well as misperceptions, applying to professional analysts and the general public alike. Professionals included mainly the area studies community and defense analysts, none of them allowing for the disappearing of their subject matter. The story that the Central Intelligence Agency regularly over-estimated Soviet economic and military might, in order to ensure an ever growing share of budgetary allocations, is well documented and has been told many times. More recent accounts also report about how this mainstream view crowded out dissenting – and generally more critical – voices from both the Sovietological profession and from policy advice.⁵ The vain hope of *Gorbachev* bringing about long-awaited and long sabotaged reforms – thereby lengthening the lifetime of the ossified system – has also been present as a dominant trend in both the analytical literature and policy advising institutions. Therefore, specialists have by and large neglected mainstream thinking about economic developments as being irrelevant to their peculiar subject matter. When the system collapsed, the best qualified had the least idea about what to do when none of the features having defined the *status quo ante* held any longer.

On the other hand, generalists, represented in the media by *Jeffrey Sachs*, but in reality composed of many scholars, from *Douglass North* through to *Olivier Blanchard*, *Rüdiger Dornbusch* until *Gur Ofer*, following calls either by the State Department, *George Soros* or the Soviet Government and its Reform Commission headed by Academician *Leonid Abalkin*, flooded to the area and offered a variety of advice. They also created the atmosphere favorable – at the time – for privatisation and stabilisation as a way to prosperity. For the same understandable rea-

4 For broad overviews supportive of this point cf. *Wagener, H.-J.* (ed.): *Economic Thought in Communist and Post-Communist Europe*, London, 1998; *Kaase, M./Sparschuch, V./Weninger, A.* (eds.): *Handbook of Three Social Sciences in Eastern Europe*, Budapest/Berlin/Brussels, 2002; *Laki, M.*: The Economic Platforms of Former Opposition Parties, in: *East European Politics and Societies* 5/1 (1992), 73–92; *Lányi, K.*: *Szocialis piacgazdasag, nalunk, most?* [Social market economy in Hungary, now?], in: 2000 (Budapest) 8/4 (1996), 8–17.

5 *Wilhelem, J. H.*: The failure of the American Sovietological Profession, in: *Europe-Asia Studies* 55/1 (2003), 59–72.

sons, this advice tended to be improvised, piecemeal and lacking political context. While correctly drawing attention to lessons learned from stabilisation policies in developing countries, as well as from democratisation experiences in Latin America, most of these propositions missed the crucial point. The *task was not a narrow, but a holistic one*: redrawing the entire macro-system, political and economic alike. While some advisors and policy makers were paying lip service to this insight, in reality their policy proposals remained partial at best. Though in this context stabilisation proved to be inevitable, it constituted just a minor component of large-scale institutional rearrangement. It is hardly by chance that even *János Kornai*, himself a major bridge builder between eastern and western economics and at the time full professor at Harvard, has found it difficult to come up with a feasible economic and political platform. In his extremely sincere retrospection,⁶ he self-critically calls into attention the contemporary over-emphasis of macroeconomic policies and under-estimation of the time needed for the evolution and internalisation of newly introduced institutions. In this state of affairs a major role was played by the fact that macro-economics as basically void of institutions has been an elaborate discipline, while institutionalism at the time existed only at the margin of the economics profession.

This was more than a minor nuisance. If the crux of the matter is stabilisation, the operation should – and does – yield results in 9–12 months. No major contraction of output is to be expected: This was the time when *the non-Keynesian interpretation of fiscal consolidation* has gained acceptance in mainstream financial literature.⁷ Similarly, it may well be a policy priority to opt for monetary stability at the cost of temporary output lost, in order to boost credibility. But also in the latter case contraction is a transient phenomenon at worst. If this is the case – and indeed, the experience of OECD countries for 1991–2003 has supplied evidence for the validity of this point⁸ –, it could be legitimate to expect relatively quick improvements once “we get the basics right”. This feeling, instinctively cherished by the general public seeing communism at the root of all evils, has been in consonance with the expectations of mainstream economics: Once distortions are overcome and malpractices discontinued, improvements in terms of income and welfare should be forthcoming immediately. This is why the first transition programmes – not only the *Yavlinsky-Shatalin* programme for Russia,

6 *Kornai, J.*: Ten Years After “The Road to the Free Economy”: the Author’s Self-Evaluation, mimeo (Paper Presented to the Annual Bank Conference on Development Economics), The World Bank, Washington, D. C., 18–20 April 2000.

7 *Giavazzi, F./Pagano, M.*: Can Severe Fiscal Contractions Be Expansionary?, in: NBER Macroeconomics Annual, Cambridge/Mass., 1990, 75–116.

8 *Hughes-Hallett, A./Lewis, A./von Hagen, J.*: Fiscal Policy in Europe in 1991–2003, London, 2003, 43f.

but also the *Balcerowicz* “therapy” for Poland and the *Kupa* plan for Hungary – envisaged relatively painless and short periods of austerity in the 1990–93 period to be followed by quick and sustained recovery in the immediate aftermath.

This expectation has not materialised. Growth started to pick up in 1993–94 only in Eastern Europe, followed by slowdowns and a new upswing in the post-1999 period, when the New Independent States also started to grow. Regaining lost output levels took typically a decade or more in the frontrunner countries, with the exception of Poland where the (relatively low) pre-crisis levels were recovered already by 1997. If we consider that the lavish and unfulfilled promises of economic prosperity have played a major role in undermining the legitimacy of communist power all across the region, this development is disquieting. The absolute distance in terms of per capita GDP between Eastern and Western Europe has not diminished but increased during the first decade of political freedom. This factor is only exacerbated by the fact that in some capitals, such as Prague or Budapest, the way of life today is not much dissimilar to that in Berlin or Vienna for that matter, while in some backward areas lifestyles are closer to that in the Balkans.

This fact justifies a major re-assessment of the nature of the tasks faced by the transforming economies, as well as of the pluses and minuses of individual policies in various states. The overall landscape suggests that it is misleading to attribute major significance to circumstances and measures that vary across countries and times, such as the indebtedness of Hungary, the erosion of the social fabric in Poland, ossification and cynicism in *Husák’s* Czechoslovakia, or the unquestionable series of policy mistakes committed by *Gorbachev* in the 1987–90 period. These might have contributed to the concrete form of agony within the old system. However, the major point is not uncovered by contemporary statistics: The *ancien régime* was far from any point of equilibrium, in either economic or social terms. It entered in a developmental dead end. There was not even a faint hope for growth under the old arrangements – and *this prompted the elite of the socialist regimes to give up power in a peaceful manner*. This also implies that reconstructed post-communist parties are part and parcel of the legitimate democratic landscape. On the other hand, rearranging a developmental model and stabilising a current account deficit are two different cups of tea.

How to bring about sustainable growth is still a contested issue in general and development economics alike. It would, therefore, be wrong to assess individual countries and policies against a non-existing – or subjective – standard. Furthermore, as documented above, *contemporary academic knowledge was either non-available or inadequate* in terms of the size, speed and scope of the tasks faced by policy-makers. As an advisor to more than one government in the past twenty

years, I recall endless occasions when major questions, such as what to do with massive (double digit) unemployment, or how to manage private banks having accumulated more new bad debts than their capital value, were pushed on the policy-makers' agenda without any serious prior academic analyses to resort to.

The state of affairs outlined above had two immediate ramifications. First, real processes and policy projects tended to be divorced – and not only for short periods of time – from planned ones, thus many public debates were simply missing the point. When academics discussed the best ways to institute ownership reform in an equitable manner, major pieces of assets were already spontaneously privatised by a variety of actors. Likewise, when the governments of *Yegor Gaidar*, of *Tadeusz Mazowiecki* and of *József Antall* talked about radical stabilisation, real processes went in a different direction. *The room for social engineering has remained much more limited* than the reference to the “window of opportunity” would have had it. Second, as a consequence, *learning by doing – and improvisation – played a much more important role* in shaping actual outcomes than ideological platforms would have suggested. For instance, left wing governments tended to be quite good at stabilisation. Right-wing governments, by contrast, have not slowed down the process of European integration with putting their frequently voiced claims of “protecting the interest of the nation and of the man on the street” into a rigid anti-EU bargaining position. Poetry and reality thus divorced. Learning on the job and the ability to rely on natural intelligence rather than pre-existing doctrines shaped outcomes. Furthermore, *the role of interest groups*, under-estimated by both socialist and mainstream economics, *has proven more relevant* than early theories of transition assumed.

This insight may explain why one finds more commonalities in the successful transitions than a “master plan” would have let us expect. The most hotly debated issues, such as case-by-case versus mass privatisation, shock versus gradualism, options allowing for avoiding the pains of stabilisation, the potential of protecting small national markets, or the government's role in orchestrating and generating economic growth through direct involvement and interventionism, does not seem to have proven decisive. By contrast, such *down to earth issues* as professionalism in monetary supervision, lack of corruption, the culture of law abiding behaviour, sustaining low inflation as well as the open door policy towards foreign direct investment have shown to be *of paramount importance* in finding the path to developmental success. The latter implies that the potential for sustainable growth, a development whose financing by private markets is secured, becomes a reality for the former communist economy and society.

As long as the basics of transition policies were on the agenda, a fairly clear standard seems to have emerged following the line of the international financial

agencies. The SLIP agenda – *stabilisation, liberalisation and privatisation* – followed by *institution building* has become the common features of any economy moving successfully from plan to market. The quantitative and qualitative assessments – pioneered by the European Bank for Reconstruction and Development in its regular *Transition Reports* – have been complemented and enriched by a variety of competing indicators produced by different rating agencies. Unsurprisingly, the ranking by these region-specific assessments show a strong correlation with global competitiveness assessments, such as those produced by the World Economic Forum in Geneva, the Freedom House in Washington as well as the Institute for Management Development in Lausanne. The latter evaluations, based on surveys – in the end subjective assessments of those deciding over major investments – go, in the long run, hand in hand with the more formal assessments. And these leave no doubt about the importance of the SLIP agenda and rule of law considerations dominating other matters propping up in the more scientific literature. In sum, and contrary to frequent claims still made in the academic discussion, there has been no alternative way to eschew the pains of stabilisation. Likewise, the dispute if liberalisation poses a precondition for micro-economic adjustment and structural change at the macro-economic level has been settled. Those who liberalised slowly or next to nil – like Ukraine, Moldova or Serbia – continue to be among the laggards also in terms of activity levels and welfare. Last but not least, privatisation has proven to be the way to bring about changes in corporate governance and dynamic efficiency, despite the large amount of anecdotal evidence to the contrary, and despite the well-established fact that the logical chain between private property and efficiency is a long and indirect one.⁹

There is similarly overwhelming empirical evidence about the importance of institutions. Indeed, following the financial crisis of 1997–99 as well as the burst of the bubble of the new economy in 2000 and the accounting scandals of Enron and WorldCom, the role of institutions is no longer questioned in international economic debates. The focus of the debate has thus shifted to a different, and no less controversial, issue: *How do institutions matter and which are the ones that matter most?* An extension of the same argument is the more frequent reference to factors that used to be banned to outside the professional debate, such as the role of social intangibles, trust, the lack of corruption, the rule of law and formalised contract enforcement in general.

9 Meggison, W./Netter, J.: From State to Market: A Survey of Empirical Studies on Privatization, in: The Journal of Economic Literature 39/2 (2001), 321–390; Djankov, S./Murrell, P.: Enterprise Restructuring in Transition: A Quantitative Survey, in: The Journal of Economic Literature 40/3 (2002), 739–792.

Under this angle, it is less than surprising to observe that institution building does constitute a part and parcel of the theoretical and policy consensus on how to manage successful transition from plan to market; it is, however, a quite vague and general formula. When it comes to practical implementation, disagreements emerge immediately. Therefore, it is hardly by chance that the European Union has been playing a formative role in shaping the outcomes of what is commonly termed as “second generation tasks of transformation”.

III. The European Union as an Institutional Anchor

What has been outlined above implies a number of insights. First, while in terms of the SLIP agenda – the first generation tasks – there is a fair amount of professional consensus on what is to be done and how (at least with the benefit of hindsight), but much less agreement when it comes to institution building. And there might be even less approval when turning to third generation of reforms, i.e. re-tailoring the welfare state, finding environmentally sustainable solutions for farming and industry, or introducing concepts and techniques of New Public Management.

Looking from this angle, it has been particularly important for the economies of Central Europe that they had a point of orientation all across the past fifteen years of their systemic change. This insight becomes all the more compelling, if we analyse new EU members in comparison with other post-communist countries like Russia, Ukraine or Serbia, not having had a European perspective in the same period. A detailed overview of Russian transition to the market¹⁰ has underscored the pivotal role of deep divisions within the Russian elite in terms of policy alternatives and developmental strategies. The latter may explain why no consensus emerged on a number of strategic and institutional options that might define the genre of the Russian market economy. As a consequence, all structural reforms tended to remain half-hearted also during the *Putin* presidency, when organised and confrontational contest of crucial policies have been severely curtailed. Similar half-heartedness can be observed in most other countries in the laggard group, reflecting primarily the division over how to address the challenge of transnationalisation and how to redefine the role of the state in the post-communist and developmental context.¹¹

10 Sutela, P.: The Russian Market Economy, Helsinki, 2004, 73–75.

11 Csaba, L.: The New Political Economy of Emerging Europe, Budapest, 2004.

By contrast, in the front-runner group of Central Europe the deepening project of the EU, evolving after 1992, has exerted an immediate and detailed influence on institutional and policy choices. While academic analysts have engaged themselves in endless debates about the proper choice of “East European capitalism” and its alternative models, for both Left and Right policy-makers most decisions have been either determined or suggested by the exigency of adjusting to the formal and informal requirements of the European Union.

This deliberation has only been strengthened by the rather reserved attitude of the incumbent EU, when the prospect of enlargement has been put on the agenda. In late 1991, when the first Europe Agreements were signed, the Union representatives resisted attempts by the new democracies to make explicit reference to the prospect of full EU membership, even less to come up with a detailed schedule or road-map for eventual accession.¹² While the EU, pre-occupied with deepening the community and shocked over the costs and unforeseen consequences of German reunification, has been fearful of watering down the Political Union project, the new democracies interpreted even fully legitimate caution over their administrative and policy capacities as an extreme form of denial. By the same token, they have been stepping up efforts to cope with the requirements of the EU, providing the latter with *an unprecedented leverage in influencing domestic choices* of the applicants, irrespective of the miniscule amounts having been channeled in form of assistance to the accession countries. *Zabrowski* distinguishes five planes of this influence: conditionality, EU-isation, persuasive pressures, policy transfer by foreign institutions and policy transfer by inspiration.¹³

In Hungary, for instance, the democratically elected Parliament of 1990–94 passed as one of its first measures the Law on Legislation, positively requiring that any piece of draft law to be submitted for consideration ought to be pre-screened if this is in contradiction to existing and evolving European legislation in the relevant area. This allowed for a lengthy process of legal harmonisation, where new normative acts could first be adopted into the law books and then be checked for implementation and internal consistency. Unlike in southern EU member states, institutional and legal approximation has had a considerable pre-history. The unilateral adjustment of pre-existing domestic arrangements to EU procedures has been decisive for the evolution of the former.

12 *Winters, L. A.*: The Europe Agreements – With a Little Help from Our Friends, in: *Winters, L. A./Wang, Z. K.* (eds.): *Eastern Europe's International Trade*, Manchester/New York, 1994, 32–52.

13 *Zabrowski, M.*: External Influences in the Transition Politics of Central and Eastern Europe, in: *Perspectives – The Central European Review of International Affairs 2002/2003*, 11–15.

These adjustment processes have been only strengthened by the watershed decisions of the 1993 Copenhagen Council formulating the criteria for accession. On the one hand, the period of non-reciprocated love was over, and real membership perspectives were opened. On the other hand, the EU formulated the conditions for membership in very broad terms, thus opening them up for interpretation. This was on purpose, since it allowed the Commission experts a more technocratic or political, literal or intentional reading of any legislative act and any policy adopted by the accession countries. Since eastern enlargement could not be seen as a close eventuality – as the projects of the single currency and nordic enlargement were still underway –, this circumstance *has unduly appreciated the bargaining power of the Commission*. Assessments coming from Brussels hardly ever make headlines in any of the old EU member states, particularly in the larger countries. By contrast, the opinion of the Commission in the form of Regular Reports as well as separate communications have earned unprecedented prominence in the domestic politics of the accession countries. Both governing parties and opposition tried to make extensive use of the formulæ and evaluations found in these basically technical working documents.

The Commission did its best to maximise the leverage following from its broad mandate as well as from its being the conductor of negotiations. Signaling and screening were widely used in formal and informal plans as well. In formal terms, the White Book of 1995 already indicated, how extendedly the Commission interpreted its own prerogatives in checking the practices of the applicants and qualifying them as commendable or deplorable. From the safety of water boilers to the appropriate techniques of monetising the fiscal debt or taxing investors and granting them exemptions, a large number of issues, normally remaining within the exclusive competence of national administration, have become subject to scrutiny and public evaluation. This circumstance has, of course, played a favourable role insofar, as the reformist zeal of the 1989/90 period could not ebb as easily as in established democracies. Everything needed a justification, and this allowed for approximation to “best”, i.e. European, practices across the board. But over and above the formal pressure, the informal “beauty contest” among the accession countries *did help sustain the reformist momentum in otherwise controversial areas*, such as trade liberalisation or privatisation. In both areas vested interests were trying to fight back – with limited success in the frontrunner group, but with more vigor in the laggards.¹⁴ In systemic terms, this implied that the newly

14 Aslund, A.: Building Capitalism, Cambridge/New York, 2002; Winters, L. A. (ed.): Foundations of an Open Economy, London, 1995. Voszka, É.: Versenyteremtés – alkuval [Creating Competition Through Bargains], Budapest, 2003.

won prerogatives of the Commission were used, in most of the cases, to sustain and support the momentum for structural reform. By contrast, in laggard countries the inherited structures and the related industry-banking-political class networks could survive the political changes and shape the rules of the game in their own favour.¹⁵ Thereby, *the external – European – influence acted as a catalyst of change*, while in cases where this role was either entirely missing – as in Russia or Serbia – or proved to be marginal – as in Romania or Croatia – path dependence became the dominant feature.

The differentiating role of Europeanisation has become even more pronounced by the decisions of the Luxembourg Council of December 1997. By dividing the applicant countries in two groups, the stakes have been increasing. For the pro-western governments of Romania, under President *Constantinescu*, the hurdle has proven too high. In other cases – such as Slovakia – the change from seclusive to open door policies have largely been triggered by the dim prospect of missing the train to Brussels.

There is plenty of empirical evidence supporting our claim that the ever more intensive competition for EU membership has been *a major factor triggering some of the controversial but necessary decisions over structural reforms* in the then accession countries. In the case of Hungary, following the foot-dragging of nearly two years, 1995 saw a major wave of privatisation in the banking and the energy sector, i.e. in areas where several old EU members – such as France, Italy or Spain – have refrained from more radical steps. The constitutional limitation of the maximum size of public debt in Poland would have been hard to understand without thinking of the Maastricht project. The radical dis-inflation *cum* privatisation policy in Bulgaria since mid-1997 must also be seen in this context. Ensuring and especially sustaining the *de facto* independence of central banks in Poland, the Czech Republic, Hungary and Romania have at times created major political controversy, given that the tenure of the governor is not the same as the parliamentary cycle. Setting up and strengthening the banking supervision as an independent and technocratic agency, as well as sustaining the independence of the competition agency¹⁶ have all shown the considerable influence of the European screening process. The fact that Constitutional Courts of Hungary, Poland and other countries could revert government decisions of major political significance, such as the cutting of entitlements by the 1995 *Bokros* austerity package in Hungary, and these rulings were obeyed by the executive, have set important pre-

15 *Bruszt, L./Stark, D.*: Postsocialist Pathways, Cambridge/New York, 1998.

16 *Kravtseniouk, T.*: Merger Regulation in Central and Eastern Europe, in: *Acta Oeconomica* 52/3 (2002), 327–346.

cedents and strengthened the rule of law and the division of powers as major constituents in the daily workings of the new democracies.

While the Helsinki Council of December 1999 reverted the trend of small group enlargement to the later adopted Big Bang strategy, the theory of individual treatment of the applicants have never been formally withdrawn. Faced with the prospect of taking a large number of poor neighbours on board in a club whose decision-making structures have remained largely unreformed, the enthusiasm for enlargement, that has never been so great anyway, cooled down. This further appreciated the bargaining power of the Commission, since none of the twelve applicants wanted to be left out. It resulted in some major compromises on the terms of accession. The biggest ever enlargement of the EU could take place at the cost of 0.15 per cent of the combined GDP of the old Union, provided that the new members will be able to make use of all funds earmarked to them (a very unrealistic assumption).

Despite this “enlargement on the cheap” the Commission has amassed further powers of using peer pressure by the formulations adopted in its Regular Reports. Issues such as the state of stray dogs in the streets of Bucharest, or the way public broadcasting, covering a minor share of the market, is being managed in Hungary, the treatment of the gypsies in Slovakia – all emerged in the policy documents. Pressure from the European Central Bank helped to further cement the independence of national banks and to focus their activity exclusively on fighting inflation. Setting up agencies independent of the state administration to manage EU funds for regional and rural development, enforcing environmental and health standards by technocratic agencies, even restructuring the system of higher education, were all taking place under the influence of EU projects and policies.

It would be hard to overlook the fact that the over-extension of *peer pressure has led to some paradoxical outcomes*, irrespective of the generally favourable trend of meddling in the domestic affairs of the applicants. Empirical analysis has shown that the pre-accession funds earmarked primarily to enhance the administrative capacities of the new members have not brought about palpable improvement; due to the delay, their positive influence in the targeted areas remained negligible by the time of accession.¹⁷ In the case of Poland, the Commission, clearly overstepping its mandate, was actively involved in restructuring the territorial set-up of the country in a manner not necessarily conducive to the appropriate use of European resources and even less to attending long neglected issues of regional disparities. In other countries – as in the Czech Republic – the EU has

17 Vojteková, Z.: Are the New Member-States Ready for the Structural Funds?, MA Thesis, Central European University, Budapest, 2004.

triggered basically formal changes with no obvious improvement in managing regional funds in an efficient way.¹⁸ In more controversial cases, such as environmental policy and management, the EU has finally been putting up with long transition periods, not insisting in delivering more than a merely formal adoption of standards, irrespective of enforcement capacities. In the farming sector, the EU insisted in introducing the sizable bureaucracy needed for the management of direct income support schemes (a close to nonsensical arrangement), but failed to communicate the idea of de-coupling and non-farm based rural development in a clear-cut fashion.

Likewise – and perhaps due to the weak fiscal performance of the core EU members – the Union fell short of constraining major fiscal derailments in all central European countries and the Mediterranean islands in the 2001–04 period. This is surprising in formal terms, since the accession agreements oblige new members to adopt the whole *acquis*, including the arrangements for the single currency (with a timely derogation). One might have seen this as a window of opportunity for consolidating public finances before EU accession, with an eye on the chances of quick adoption of the Euro.¹⁹ In reality, however, an opposite political economy logic has prevailed. The governments based on fragmented political support and disembedded political parties have proved both unwilling and unable to control the explosion of public expenditures. Given that these never followed other conceivable priorities, such as supporting research and development, improving human capital and physical infrastructure or financing major welfare reforms, these deficits will constitute a major stumbling block on the road to full membership in the European Union. In this respect, we see the political logic in the soft stance taken by Ecofin and the Commission on the less than ambitious convergence plans of the new member states, requiring them to reach the Maastricht deficit criteria by 2008 only.²⁰ However, it must be regarded as a missed opportunity to help orchestrating more ambitious and, therefore, more sustainable fiscal stances. If this is the case, old member states and existing policies bare a co-responsibility in the foreseeable growth slowdown in the new EU countries.

18 Ferry, M.: The EU and the Recent Regional Reform in Poland, in: *Europe-Asia Studies* 55/7 (2003), 1097–1116; Baun, M.: EU Regional Policy and the Candidate Countries: Poland and the Czech Republic, in: *Journal of European Integration* 24/3 (2002), 261–280; Rózsás, Á.: Regional Policy in Hungary: Institutional Preparations for EU-Accession, in: Ágh, A. (ed.): *Europeanization and Regionalization*, Budapest, 2004, 89–91.

19 Csaba, L.: The Euro – a New Entry Barrier?, in: Venard, B. (ed.): *Economie et management dans les pays en transition*, Paris-Angers, 2001, 81–101.

20 See *Népszabadság* and *Népszava*, both of 24 June 2004.

IV. The Third Generation Transition within the European Union

What has been said in rudimentary terms may be summarised as follows. On the one hand, transition from plan to market economy and from totalitarianism to democracy has indeed been accomplished by the new member states. NATO, OECD and EU membership each served as a test case for their efforts. Especially EU accession, with its multiple entrance examinations – through Europe Agreements, law harmonisation, *acquis* screening and not the least by imposing more demanding requirements on new members than on the old ones²¹ has resulted in *palpable and testable delivery, not mere declarations of good intent*. As a result, these economies entered the growth path, receive substantial amounts of foreign direct and portfolio investment, and have reoriented their trade to EU markets. What matters most from the perspective of monetary integration, these economies – with the exception of the Baltic states – have more synchronised business cycles to the core EU than the southern member states or Great Britain.²²

At this very general level, the difference between the Polish or Czech market economy from the British or German version is not greater than that of the Greek or Portuguese: *It is a difference of magnitude rather than of quality*. On the other hand, it would be misleading to follow the current mood of the political class and lean back, just waiting for high rates of growth to materialise. By a paradox of transition that included unilateral adoption of the *acquis communautaire*, new EU members have already been enjoying the benefits of joining a larger market and a more effective regulatory frame. Direct investors and money markets alike have already built in the prospective benefits to their calculations – this explains the sustaining expectations for currency appreciation and low inflation also at times of expansionary fiscal policies and lavish public sector payroll increases in the 2001–04 period.

To put it differently, the new members have joined one of the slowest growing regions of the world economy. Moreover, *the political act of accession has been unable to replace the diminishing momentum in terms of savings, investments and growth friendly policies in general* (including the limited spending on research and development or the neglect of research at universities, both known to be major components of human capital formation and endogenous growth). The EU in its present shape is unlikely to contribute to the acceleration of endogenous growth

21 The Amsterdam and Nice Treaties exclude opt-outs from the *acquis* for the new member states, while Britain, Denmark, Sweden and Ireland continue to enjoy these.

22 Korhonen, I.: Some Empirical Tests on the Integration of Economic Activity Between the Euro Area and the Accession Countries: A Note, in: *Economics of Transition* 11/1 (2003), 177–196.

in the new member states significantly, as it will continue to spend basically on farming and cohesion rather than on competitiveness in the 2007–2013 period; as a consequence and due to the small economic significance of the new members – together adding up a mere 5 per cent of the total GDP of EU-15 –, the growth generating impulses emanating from European policies are likely to remain very limited at best.²³ Limited if any progress in meeting the quantitative and qualitative targets of the Lisbon Strategy, that has prompted the sending out of the reflection committee headed by former Dutch Premier *Wim Kok* in the Brussels Council of March 2004, is indicative of the deep structural and institutional nature of slow growth in Europe. Without getting into the debate on Euro-sclerosis, it should be axiomatic to face the fact that *conditions of high* – and even globally catching up – *rates of growth are not given* at present in the EU, without considering – and improving – *the quality of economic policy and institutions*.²⁴

This insight implies *a need for reassessing the strategies of the new members*. First, the EU can no longer serve as the trivial institutional anchor to their systemic and policy options. Accession has already been accomplished, and Europeanisation is known to be a mutual adjustment process between the Union level and national policies – this has not been the case in the accession period. Second, having accomplished the SLIP agenda and having established the basic institutions of a market economy, new members have not yet created the conditions for long-term sustainable growth. In EU parlance, “real convergence” needs to be orchestrated, it is unlikely to evolve automatically, since catching up to the level of more advanced countries is, according to trade theory, *a potential conditioned by a variety of factors, not a given one*. As the overall level of per capita GDP in purchasing power parity terms is around 50 per cent of EU-15 (with Slovenia at 77 per cent, Latvia 42 per cent and Hungary with 61 per cent in between),²⁵ the catch-up potential of the new members is sizable. Likewise, social expectations are strong, pushing governments for expansionary policies. However, there is precious little what the government can do in terms of immediate activity to foster growth: It is an outcome of interplay among many actors, coordinated by a set of institutions, defined as rules of the game.²⁶ This means that a wide variety of acti-

23 *Lammers, K.*: How Will Enlargement Affect the Old Members of the European Union?, in: *Inter-economics* 39/3 (2004), 132–142.

24 *Kolodko, G.W.*: Globalization and Catching Up in Emerging Market Economies, in: id. (ed.): *Emerging Market Economies*, Aldershot, 2003, 3–43, here 35.

25 Numbers refer to recent Eurostat data, reported in *Világgazdaság* of 4 June 2004.

26 *Lucas, R. E.*: On the Mechanics of Economic Development, in: *The Journal of Monetary Economics* 22/2 (1988), 3–42.

vities need to be coordinated and conducted in order to be able to manage complexity, a major feature of contemporary economic systems.

Translating these abstract insights into policy language, *there is an urgent need for a third generation of structural reforms in and for the new EU members*. It must be clear: Many analysts – more recently Nobel Prize winner *Robert Mundell*²⁷ – called for a supply side revolution in Europe (meaning the EU-15). However, this reference does not invalidate the imminent pressure on the slowing economies of Central Europe to act now in order to avoid a further deceleration of growth in the future. This follows quite directly from well-established theoretical approaches.

Let us briefly refer to the major components of growth: *Human capital* is, though abundant in terms of formal qualifications, especially following the big push in university/college level education due to the so-called Bologna process. By now, enrollment rates in the new members are around 40 per cent in higher education, in line with western European standards. However, feedbacks from the labour market do not allow for complacency. Unemployment rates are high in several new member states – Slovakia, Poland, Slovenia, recently also in the Czech Republic –, and this applies increasingly to people with college and university degrees. Even in Hungary, university graduates have to wait 9–15 months until their first enrollment. About 20 per cent of them must take up jobs with lesser qualifications. At the same time, patents and other signs of innovation, including publication records in leading academic journals, do not show much improvement over the past 15 years. These are indicators of a strain between quantitative and qualitative aspects of growth. Hungary, for one, having spent less than 1 per cent of its GDP on research and development, is unlikely to be a center for innovation and resultant endogenous growth. Regretfully this example can be generalised.

Physical capital may be seen as adequate, investment rates never dropped in such a catastrophic manner as in the New Independent States, nor inflicted civil wars wounds as in Southeast Europe and the Caucasus. However, the development of capital markets is limited, banking is still underdeveloped, the scope of services provided restricted.²⁸ True, the big corporations can and do raise funds in global capital markets, but banking is still inefficient. Capital markets – once the hope for many radical reformers – have proven to be unable to fill the vacu-

27 *Mundell, R.*: One Global Economy – One Global Currency?, in: TIGER Distinguished Lecture Series No. 12, Warsaw, October 2003.

28 *Móré, C./Nagy, M.*: A piaci struktúra hatása a bankok teljesítményére: empirikus vizsgálat Közép- és Kelet-Európára [Relationship between Market Structure and Bank Performance: Empirical Evidence for Central and Eastern Europe], MNB Working Papers No. 12, Budapest, 2003.

um, not least because major firms tended to be privatised through direct sales to strategic owners, not through floating on the local capital markets. There are very low numbers of new floatations in the 2000s in each of the stock exchanges. Merger initiatives – between Vienna and Budapest, Frankfurt and Warsaw – already foreshadow the dominance of bank-based financial systems for a longer time. Be it as it may – and whatever the historic and other possible explanations are –, this implies that the capital market, the most efficient form of resource allocation, is unlikely to play a major role for the new EU states. This in turn implies that *allocative efficiency is definitely not a factor that could be easily reckoned with* when calculating growth trajectories and catch-up scenarios.

Foreign direct investment (FDI) has been a key in accelerating development in many countries of the global periphery. However, it is important to see that FDI is only a temporary and additional factor among the determinants of long-term growth. First, technological development is a function of the stock, not the flow of capital, thus FDI is bound to have a limited impact. Second, under normal conditions capital inflows are followed by capital outflows. In the case of Hungary, already the 2001–04 period witnessed massive acquisitions of major Hungarian corporations, such as MOL (the oil giant) and OTP (the big savings bank) in neighbouring countries. Finally, if catching up is real, the difference between technological levels diminishes, the *additional* growth generating effects are thus limited.²⁹

Besides that, locational advantage of the new members does not seem to have hold for the long run. As long as the Czech and Polish – as well as Baltic – big privatisations were over, *the FDI inflow has come down to the previous low levels*, despite the obvious investment opportunities in lagging physical infrastructure or in health care. Meanwhile *outward direct investment is also on the healthy increase*. Therefore FDI as a source of growth financing, or as a source significantly improving the level of endogenously determined technological progress is unlikely to play a lasting role in the decades to come.

In the tradition of classical economics *land* also counts as a factor of production. However, in the context of over-production of agricultural commodities, known to be a major concern for the evolving reform of the Common Agricultural Policy (CAP), this factor is unlikely to contribute to quicker growth in the new member states. All the less so as these are to become part and parcel of the CAP, oriented towards limiting output, in view of the global oversupply and WTO commitments.³⁰ Here, we face one of the crucial – and largely unresolved –

29 Erdős, T.: Fenntartható gazdasági növekedés [Sustainable Economic Growth], Budapest 2003, 294–303.

30 Whalley, J.: The WTO and the New Development-Oriented Trade Round, in: Krizsan, A./Zentai, V. (eds.): Reshaping Globalization, New York/London/Budapest, 2003, 181–196.

issues of possible incongruity among the political and economic institutions that may result in wealth levels below the potential.

In short, traditional quantitative components of growth do not vouch warranty for the quick catching up type of growth that is required by the societies of the new EU members. Also, the slow growth of the core EU does not provide a market expansion that could quasi-automatically translate into higher growth in the new member states. *Therefore – by default – there remains the institutional component and policies fostering endogenous growth that may allow for the real convergence scenario to materialise.* This process, however, is likely to be much slower than the broad economic policy guidelines of the new member states (as of June 2004) would suggest (in case of Hungary, the trend rate of growth is put by the BEPG at 4.5 per cent against the 3 per cent of the consensus of analysts).

What do we know *positively about the salient features* of policies and institutions that would add up to a growth promoting environment for the long run, that we dubbed in the chapter heading the third generation reforms? In answering, these at some – academic – level next to trivial normative suggestions need to be translated into a policy practice that is currently dominated by short term considerations, populism and double talk. While these features are hardly unknown in the core EU, their consequences are much more weighty for the new members, given that their growth is to decelerate already at much lower levels of development (a feature known from the post-1997 East German developments).

First and foremost, *plain, professional and sincere talk in public debates* is needed in order to allow for those choices to be made that can shape the high growth strategy of the new members. This calls for a sober analysis of the situation, so that unpleasant realities could be discussed in the open. For instance, one of the most frequently voiced statements of the fiscal authority in the 2001–04 period in Hungary was the denial of the need for any austerity.³¹ Meanwhile, in the entire transition period the Hungarian fiscal balance tended to be in the red, the average order of magnitude running 5 per cent of GDP in the 1989–2004 period. Improvement of the situation could be observed only due to the 1995 austerity package and the follow-up spending of privatisation revenues on amortising external debt in 1996. When such one-shot measures do not apply, the deficit – and as a result public debt – grows. This is less of a problem with an eye at meeting the criteria for entering the single currency, and more of a problem of the state regularly crowding out private investment. Furthermore, as quoted earlier, if good times of high growth are not used for diminishing the public debt burden, at bad times the

31 See, for example, Figyelő 48/26 (2004).

fiscal situation may get out of control – a process already observable in Germany, Italy, Greece and France. Furthermore, if the implicit debt following from the pension entitlements of a greying population are taken into account, and the foreseeable costs of servicing the current debt are realistically calculated, it can be proven that *the “straightjacket of Maastricht” is actually too soft* for countries such as Hungary and the Czech Republic, where reproduction rates are negative. According to a recent analysis by the National Bank of Hungary³² sustainable debt levels should be in the range of 40–45 per cent of GDP at maximum, whereas the current level is exceeding 60 per cent,³³ and the Convergence Plan of June 2004 does not envisage major improvements until the period of its operation expires.

The first requirement is, thus, breeding a second one: *the need for sustainable public finances and a major fiscal adjustment* allowing for these to come about. It goes without saying that this is not a call for budget cuts for their own sake, irrespective of social and economic costs. As the above mentioned literature on fiscal sustainability explains, *the structure and the quality* of rearranging expenditure priorities is perhaps even more important than their actual size; it should aim at a growth-friendly, expansionary consolidation of public finances.

The third related maxim is *the supreme commandment of fostering savings in financial form*. This is needed for the safe financing of investment projects with a longer maturity. As the banking sector is involved in transforming the maturity structure, this task is manageable only if the amount of long-term financial savings is on the increase (from the current average maturity of 6–9 months in the banking sector). This requires support for a variety of old-new forms of savings such as life insurance, private health care and pension funds, corporate bonds, and a variety of new investment instruments. By contrast, the tradition of putting savings, into fixed asset investment, primarily in the form of building second and third homes, should be reverted. This is also easier said than done, as home support schemes have become the prey of petty politicking, each major political force coming out as the protector of middle classes in need of larger and better homes as a “basic necessity”. It is well known – not least from the East Asian asset bubble – that this type of investment is not healthy for sustainable growth. First, savings of this form can not be re-channeled to finance ongoing business operations. Second, especially in the context of EU accession, misplaced expectations on asset price convergence may create separate asset bubbles, as in the case of

32 Orbán, G./Szapáry, G.: The Stability and Growth Pact from the Perspective of New Member-States, MNB Working Papers No. 4, Budapest, 2004.

33 Unsurprisingly, the fiscal authority openly disagrees with the methodology of the ECB resulting in this embarrassing number.

Spain. Bursting these bubbles tends to undermine investor confidence, hardly a panacea for investment-led growth for the long run.

As subsidies to production have been radically reduced – to 3–4 per cent of GDP – in transition, the new member states can hardly manage their public finances in a sustainable fashion, unless they address the major components of the expenditure side, i.e. *transfers related to the welfare state*. Public pensions, public provision of health care and education, public transport, the size of the state administration (in its capacity as a major employer in both the central and local levels) constitute the major expenditure items, added up by the regular cover-up of losses made by public firms, such as the railways, the national air carrier and public broadcasting agencies. While these are reforms on their own right, each in need of time and funding, not addressing these issues is likely to replicate the growth sclerosis experienced in some of the core EU economies.

The good news is that the reform – rather than the abolition – of the welfare state has proven to be a realistic option, especially in countries that used to struggle most with their entrenched entitlement systems. Sweden has managed to introduce a 2.5 per cent surplus requirement for its fiscal balance anchored in the Constitution. Great Britain was able to fight unemployment and foster innovation also under the Labour Government. Denmark, once also known for its over-extended welfare state, is currently one of the few countries that could easily join EMU, should its population agree to it. Spain and more recently Belgium have all made important steps towards improving the sustainability of their public finances.

I do not share the opinion of those authors³⁴ who contend that free market textbook solutions to the complex political economy issues of these areas are easy to operationalise and politically possible to implement, if sufficient central political will is shown to this end. Rather, these reforms require a lot of learning by doing and experimentation along the *Hayekian* lines, before practically feasible institutional and policy solutions may emerge. However, sustainable public finances do set the limits to both the size and the genre of arrangements that may become policy relevant. To give but one example: Hungarian state administration currently employs around 830,000 people against one million under communism. In the same period, over two million jobs were lost in Hungary, all in the competitive sector. For the time being, public sector wages in Hungary exceed private/competitive sector earnings by 20 per cent, although the adjustment to the market – not to speak to the requirements of public-private partnerships – have yet to start. Therefore, recent propositions envisaging – though not deliver-

34 Bokros, L.: *Verseny és szolidaritás* [Competition and Solidarity], Budapest, 2004.

ing – a cut of a mere 6,000 (sic!) people from public sector payrolls do certainly not fall in the line of our normative reasoning.

It would be naïve to pretend that the author has a solution to all the problems raised in this essay. However, by highlighting some of the crucial issues we hope to have contributed to a better understanding of the transitions in and towards the European Union. Our major finding is perhaps surprising: *Structural reforms faced by old and new members of the European Union are to a large degree overlapping.* There is, therefore, both a need and a possibility for engaging in a truly pan-European exchange of views, conducting divergent experiences in different countries on similar issues, quite in line with the life vest of the EU called *subsidiarity*.