

# **Beyond accession conditionality and negotiations: Privatization, trade dynamics and the political economy of early post-communist economic transition**

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## **Abstract**

Although the impact of the EU on the economic transformation of Central and Eastern Europe (CEE) is undisputed, contemporary causal explanations focus primarily on the impact of accession negotiations and conditionality on CEE transformation and, as such, are limited to the post-1997 period. This poses a challenging empirical puzzle, because, in terms of their pace of transition, the CEECs distanced themselves from the rest of the post-communist countries in the pre-1997 period, i.e. at a time when accession negotiations and conditionality could not have had a causal impact. To fill in this vacuum in our understanding of transition and enhance our ability to explain the various forms of variation that have emerged since the early 1990s, this paper challenges the established view of the way in which the EU impacts domestic transformations in its periphery. Specifically the focus in this paper is shifted from accession negotiations and conditionality to establishing the significance of trade and privatization dynamics in early patterns of differentiation within the broader set of post-communist countries. Emphasis is placed on the impact of EU policies – in particular EU trade policy and the offer of the prospect of EU membership – on these dynamics.

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## Introduction

How can we explain variation in the transition trajectories of post-communist countries? This rather broad question can be broken down to two sub-questions. What form do patterns of variation take over time and across transition countries? And how can we explain these patterns? With regard to the first question, we know that these patterns show (a) an increasing convergence and clustering among ten Central and Eastern European (CEE) countries<sup>1</sup>, the front-runners of transition, in core transition reforms that starts from fairly early on in the transition process, and (b) an increasing distancing of the CEE front-runners from the rest of the post-communist countries that starts in the period 1989-1993 and is maximised in the period 1993-1997, i.e. before the accession negotiations were opened and before pre-accession strategies and tools were applied (Georgiadis 2005). This pattern will be referred to in the remainder of this paper as the ‘big picture’ of transformation or simply ‘the pattern’.

This paper, however, deals with the second sub-question: how can we explain these patterns? In particular, which reforms account for the accelerated pace of transition in the CEECs, what are their determinants, and what causal mechanisms are at play? The main underlying logic of the analysis in this paper is that economic reforms may be more or less politically costly and technically complex. Political costliness is of primary interest for this paper. The assumption that is axiomatically accepted as true here is that, *ceteris paribus*, more politically costly reforms are less likely to be adopted and implemented. This paper is concerned with showing how external factors interfere with and alter this calculus.

Before going further into the analysis, it is useful to provide in this introduction a selective overview of the broader debate, since the domestic or external origins of the determinants of post-communist economic transformation have preoccupied scholarly debate for years since the fall of communism and for good reason. After all, this was a historical process of tremendous political, economic and social implications affecting the transforming countries themselves but also the architecture, structure and units of the broader international system that surrounded them. A number of competing approaches have attempted to explain individual trajectories but also broader patterns

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<sup>1</sup> The CEE group consists of Bulgaria, Czech Republic, Estonia, Hungary Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

of transformation by emphasizing domestic or external determinants of the transitional process. Prominent arguments included path dependency, historical legacies, domestic politics, structural determinants, Europeanization, globalization and/or regionalization and have indeed made significant contributions to this debate<sup>2</sup>. This paper focuses on the impact of EU policies on the transformation process – an impact studied primarily by the Europeanization literature – since that source of external influence appears to be the most consequential among the various alternatives.

The predominant view in the Europeanization literature is that the decisive impact of the EU on the accelerated economic transformation in Central and Eastern Europe has been largely achieved by means of accession conditionality and negotiations. The focus on the accession process *per se* is so pervasive that Grabbe (2001) defined the Europeanization of the Central and Eastern European (CEE) countries in terms of the impact of the accession negotiations on national patterns of governance.<sup>3</sup> Others like Schimmelfennig and Sedelmeier (2005a) have placed prominent focus on accession conditionality. Even Vachudova (2005), who studied the impact of passive leverage (the *prospect* of membership, i.e. not negotiations and conditionality *per se*), seems to discount it in favour of active leverage (i.e. accession negotiations and conditionality).

With regard to the accession negotiations and the pre-accession period, Grabbe points towards conditionality as a Europeanizing force in CEE countries<sup>4</sup>. She identifies five ways through which the EU conditions domestic outcomes in the transition countries: (1) gate-keeping (opening of negotiations), (2) monitoring, (3) prescription of institutional blueprints, (4) aid and technical assistance, (5) twinning (Grabbe 2001,

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<sup>2</sup> Scholarly analyses with quite diverse assumptions regarding the transitional process have attempted to address the causes behind individual and/or collective transformation trajectories. Among analyses with a domestic focus, prominent approaches included path-dependence (see for example Lane 2002; Stark and Bruszt 1998; Stark 1996; Winieck 2004; Alexander 2001; Kovacs 2000; Cook 2002) and domestic politics (see for example Grzymala-Busse and Innes 2003; Vachudova 2001; Lane 2002; Fish 1998). Among analyses with an international/external focus, besides the literature on Europeanization, prominent approaches included globalization and regionalization (see for example Verdun 2003; Stewart and Berry 1999; Bruszt and Stark 2003; Oman 1999; DeMartino and Gabel 1999).

<sup>3</sup> For a more detailed account of alternative definitions of Europeanization in the literature see Papadimitriou and Phinnemore 2003.

<sup>4</sup> For a more elaborate analysis of the impact of conditionality on the CEE countries see Hughes et al 2004. They argue that it is necessary to be cautious towards the idea of a uniform impact of conditionality; following their study of the impact of conditionality in the areas of regional policy and regionalization they observe differentiated outcomes in different CEE countries.

pp. 1020-1024). Beyond the post-communist context, a broader list of ways through which Europeanization results in domestic transformation has been proposed by Papadimitriou and Phinnemore (2003, p. 4): (1) EU prescription of domestic institutional adaptation, (2) alteration of domestic opportunity structures and, subsequently, of domestic winners and losers, (3) changes of beliefs and expectations of domestic agents that in turn affect the formation of preferences at the domestic level, (4) formation of European ideas as a legitimizing force for domestic reform.

Through its substantive findings, this paper addresses two areas of concern with regard to the way the literature on Europeanization has been portrayed thus far. The first area concerns the selection of countries for comparative purposes in order to capture the effect of EU policies on their transformation. A common feature is that much, if not most, of the comparative work on the link between Europeanization and post-communist transformation focuses on comparisons between EU candidate countries<sup>5</sup>. One way to moderate the selection bias would be to expand the sample in order to include countries where the EU influence is not so profound, as in the case of non-candidates for EU membership. The coverage of the entire set of post-communist countries in this paper aims to address precisely this issue.

The second point concerns the emphasis on the accession negotiations and the subsequent focus on the related tools of the pre-accession period—such as conditionality and monitoring—as the mechanisms of influencing the progress of transformation<sup>6</sup>. The focus on negotiations as the shaping power of transformation allows little room for considering other significant ways through which the EU and its policies influenced the transformation of the CEE countries, especially before the negotiations began. Yet, as empirical evidence on the ‘big picture’ of transition shows, this understanding of the causal links underlying the accelerated pace of reforms in the CEE region is, at best, incomplete, since differentiation between the front-runners and laggards of economic transformation appears to be happening precisely in the pre-1997 period (Georgiadis 2005). Capturing the pace of transformation in both the early and the late stages of the transformation process

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<sup>5</sup> See for example Vachudova 2005 and Schimmelfennig and Sedelmeier (2005, 2005a), as the more representative samples of this type of work.

<sup>6</sup> One exception is Vachudova (2001, 2005), who, to some extent, looks at the earlier period as well through the prism of ‘passive leverage’.

addresses this issue and assists us in disentangling and comprehending the impact of the EU.

Following from the above, the case made by the pro-conditionality camp is weakened because, so far, it has not been able to deal adequately with the empirical and theoretical puzzles mentioned here by either: (a) addressing this disjunction between the cause (accession negotiations and conditionality) and its purported effect (accelerated economic reforms), or, more importantly, (b) showing that progress in post-1997 reforms was independent of the dynamics that led to the pre-1997 reforms. Until these issues are addressed, precisely because of the emphasis in the post-1997 period and the relative neglect of the pre-1997 period, the broader conclusions of the Europeanization literature with regard to the effectiveness and impact of conditionality and negotiations are debatable.

But, if accession conditionality and negotiations are not the drivers of reform in the early period, where should one look for alternative explanations and causal mechanisms? Domestic accounts of the patterns of transformation can be largely credited with explaining intra-group differences within the group of front-runners. For example, such account can explain convincingly why Bulgaria and Romania transformed slower than the rest of the CEE front-runners (Agh 1998, Vachudova 2001, Grzymala-Busse and Innes 2003). Yet, they have so far proven unable to account for the differentiation between the front-runners as a whole (all ten CEECs) and the laggards of transition. For example, these accounts are unable to explain why Bulgaria and Romania transformed so much better than Ukraine, despite their similar starting points in the early 1990s, or why the Baltics transformed so much better than Ukraine and Moldova, despite the fact that they were all republics of the Soviet Union before its collapse.

With regard to the ‘so what’ question, one advantage of the analysis in this paper, is that it fills that gap and allows us to explain to a large extent inter-group divergence between front-runners and laggards of transition. A second advantage it that this analysis has significant policy implications, since, clearly, accession is no longer a tool that can be relied upon in the future, certainly not at the scale that it was used in the years 1997-2007.

To sum up, this paper takes an external/European political economic view on the determinants of the pace of early economic transformation in the CEE countries and beyond. It does so by highlighting the impact of EU policies on the core areas of economic transition in the CEE countries and beyond in the period 1989-1997, i.e. a period when neither accession conditionality nor accession negotiations applied. Thus the argument and evidence proposed here are aimed at offering a better and more comprehensive understanding of the causal mechanisms that underlay the early, and in many ways more critical, post-communist period.

The argument unfolds as follows. Section 1 introduces the paper's analytical framework, which deals with the political costliness of reforms, thus distinguishing between first- and second-stage transition reforms. Section 2 outlines the empirical backbone of the paper. Finally, section 3 examines the data introduced in the second section through the analytical lenses of the first section. The paper concludes that the impact of the EU on the transitional patterns that emerged throughout the post-communist world after 1997 is clearly discernible throughout the pre-1997 period, despite the absence of accession conditionality and negotiations. However, different dynamics and causal mechanisms apply before and after the pivotal year of 1993.

## 1. Conceptual framework: political costliness and first- and second-stage reforms

What causal mechanisms might link EU's engagement in Central and Eastern Europe with the higher pace of economic reforms in the front-runners of transition? To answer that question, causal mechanisms are examined here at the substantive/policy level<sup>7</sup> of the politics of enlargement and transition, linking supply-side EU policies with demand-side CEE policies. This substantive/policy-level analysis is assisted greatly by a causal mechanism proposed by Mattli and Plümpfer (2005) that links EU policies, and in particular the prospect of membership, directly with the pace of economic transformation at the substantive/policy level<sup>8</sup>. As we shall see, the ideas of Mattli and Plümpfer enable us to explain post-1993 patterns but not the pre-1993 ones. Nevertheless, when these ideas are enriched with trade dynamics, which are not captured by their typology, our explanation may account for the pre-1993 period as well.

According to Mattli and Plümpfer, there exist two types of transition reforms, the 'first-stage' and 'second-stage' ones. The 'first stage' reforms are quick and of relatively low political cost, whereas the 'second stage' reforms are protracted, potentially more complicated, and of relatively high political cost for incumbent governments. More specifically, they posit that fairly early on in the transition process, '...virtually all political leaders in the CEECs had successfully implemented quick "first stage" reforms, such as price liberalization and small-scale privatization, bringing economic crises under control. With the worst over, the leaders now responded quite differently to the need for implementing politically much more costly and protracted "second stage" reforms, including large-scale privatization, enterprise restructuring, and legal and administrative reforms' (Mattli and Plümpfer 2005, p. 53).

The prospect of membership, in their view, empowers incumbent governments to make internationally credible and domestically tolerable, if unpopular, commitments in such politically costly areas of reform. They suggest that the CEECs application for

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<sup>7</sup> i.e. not the macro/polity one. The analytical distinction belongs to Schimmelfennig and Sedelmeier (2005). According to them the macro/polity level politics of enlargement address such questions as the selection of countries and the choice of the type of association with them (trade, association/Europe agreements, or membership). The substantive/policy level politics of enlargement are concerned more with the transformation of the candidates and the actual reforms undertaken by them.

<sup>8</sup> What follows is largely inspired by their argument, although, as will become evident, I further refine and expand it here.

membership was the logical step following the credible offer of the prospect of membership by the EU<sup>9</sup>. For ‘indeed, by submitting an application, they expressed confidence in their country’s ability and willingness to hurdle remaining internal obstacles to EU membership and work towards satisfying all membership requirements. An application thus represented a very public form of commitment to continuing deep institutional reforms’ (*ibid*). I will term this ‘the Mattli-Plümper hypothesis’, and will examine in section 3 if it holds empirically, since the authors do not offer any significant empirical support in their original paper. To summarise, the original Mattli-Plümper hypothesis, then, predicts quick progress in the pre-1993 period with regard to first-stage reforms, such as small scale privatization and price liberalisation. In the same period, slow progress is predicted with regard to second-stage reforms, such as large scale privatization, which is expected to increase substantially after 1993 when the prospect of membership arises.

Although Mattli and Plümper do not discuss transition countries beyond the CEECs in their work, it is possible to expand their argument to incorporate those of the former Soviet Union and former Yugoslavia. In such a scenario, first-stage reforms should be expected to move relatively fast in the rest of the transition countries as well. Unlike first-stage reforms, second-stage reforms would lag significantly behind those of the CEECs, due to the absence of a credible offer of the prospect of membership to these countries. This might be termed an ‘expanded Mattli-Plümper hypothesis’. It follows that, if the Mattli-Plümper hypothesis holds, then its expanded version would be well equipped to explain differentiation between the CEECs and the rest of the transition countries after 1993 but not before it.

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<sup>9</sup> Membership applications came in in: 1994 for Hungary and Poland, 1995 for Bulgaria, Estonia, Latvia, Lithuania, Romania, and Slovakia; and in 1996 for the Czech Republic and Slovenia.

## 2. Empirical data on economic reforms

To address the questions posed in the introduction, it is necessary to establish whether progress is uniform across all areas of reform and, if not, which areas are characterised by a faster pace of change. To establish that, this paper explores data on the pace of reforms in eight core areas of economic adjustment in twenty seven post-communist countries for the years 1989-2002. The choice of countries is consistent with the questioning earlier in the paper of the unrepresentative sampling for comparative purposes that is often observed in the literature. The choice of years follows from the call to challenge causal analyses that are limited in the post-1997 era. The cut-off year of 2002 is selected because that is the end date of EU accession negotiations for eight out of ten post-communist CEE candidates. Because none of the CEECs became an EU member state before 2004, the countries are referred to in the remainder of the paper as ‘candidates’.

Regarding the choice of indicators, various measures of post-communist economic transformation have been used in the literature<sup>10</sup>. This paper uses eight EBRD indicators that cover the three key areas of economic reforms—enterprises, markets and trade, and financial institutions—for the period 1989–2002<sup>11</sup>. The eight EBRD indicators are divided into three categories. The first category, *Privatization and Restructuring*, includes three indicators: large scale privatization, small-scale privatization, and governance and enterprise restructuring. The second category, *Market Liberalisation and Competition*, also includes three indicators: price liberalization, trade and foreign exchange system, and competition policy. The third category, *Financial Markets Reform*, includes two indicators: banking reform and interest rate liberalization, and securities markets and non-bank financial institutions. “On enterprises, the transition indicators are designed to measure the extent to which enterprises have been shifted into private ownership and have begun to alter their operations and governance structures in response to the market. On markets and trade, the transition indicators gauge how well these markets are functioning. In this regard they indicate the openness of markets, the extent of competitive practices and the degree to which prices reflect costs. On financial institutions, the indicators

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<sup>10</sup> Another widely used measure is the Frazer Institute’s *Economic Freedom of the World 2000 Index* (Fish 1998, Lane 2002).

<sup>11</sup> I am indebted to Martin Raiser for sharing data of the EBRD, including unpublished data for the period between 1989 and 1993.

attempt to capture the extent to which the financial system provides financial discipline, effective intermediation between savers and investors and an efficient system of clearing and settlement” (EBRD Transition Report 1998, p. 25).

An indicator score of 4.3 shows an advanced market economy by Western economic standards in the specific indicator, whereas a score of 1 shows no difference from a communist-type economy<sup>12</sup>.

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<sup>12</sup> The only difference is that the EBRD scores are linearized in this paper by assigning a value of 1/3 to a ‘+’ sign and  $-1/3$  to a ‘-’ sign. Thus the maximum score of the EBRD indicators is 4+ whereas the maximum score in the dataset of indicators is 4.3. IMF’s *World Outlook 2000* (2000) has followed the same practice in order to construct its index of aggregate transition indicator for 1999.

### **3. Causal mechanisms at the policy/substantive level: the impact of EU policies on first- and second-stage transition reforms**

This section takes a closer and more analytical look at the specific types of transition reforms measured by the eight EBRD indicators introduced in section 2. Section 1 introduced a typology of reforms (first-stage and second-stage) on the basis of their political costliness and complexity. The aim of this section is to understand (a) if and how variation in the political costliness and complexity associated with each of these types of reform is empirically related to the ‘big picture’ of transformation trajectories, and, importantly, (b) the differential causal impact of different EU policies on each of these types of reforms.

A preliminary review of data largely confirms the Mattli-Plümper hypothesis. This conclusion is based on the scrutiny of the eight EBRD transition indicators introduced in section 2 for the period 1989-2002 for the twenty-seven transition countries. A quick note on the notation that follows is in order here. At any given year, I examine means of group country scores on a specific indicator for that year. I denote as ‘T10’ the ten CEE countries and as ‘T17’ the rest of the transition countries<sup>13</sup>. Thus, variable ‘MLSP\_T10’ gives us the mean score of the CEEC countries with regard to large scale privatization (LSP) and ‘MLSP\_T17’ the same measure but for the rest of the transition countries. Similar notation is used for the analysis of other indicators in this paper.

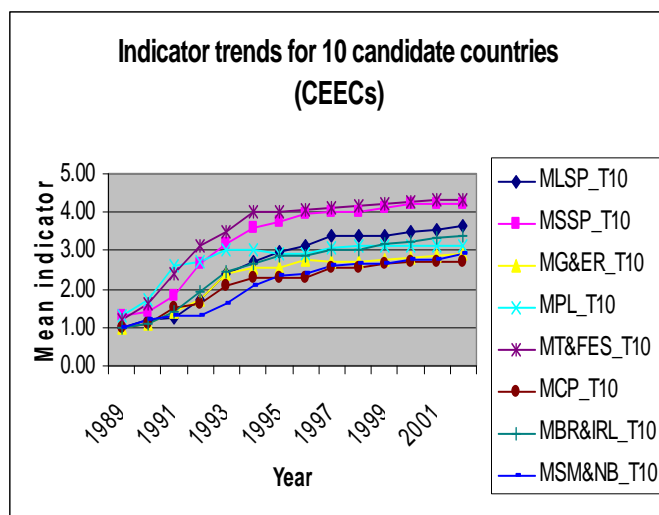
Not all indicators behave in a uniform way since the start of the transition process. As data on the CEECs in figure 1 show, quick progress is observed in the case of the mean Small Scale Privatization (MSSP). Striking is the progress of the mean Trade and Foreign Exchange Systems (MTFES) indicator, an indicator that is not covered by the Mattli-Plümper hypothesis, which surpasses even that of Small Scale Privatization. More on this indicator follows in section 3.1. Mean price liberalisation also rises fast, as the hypothesis would predict, but then stagnates. A fourth indicator of interest is Large Scale Privatization which appears to be quite influential in the

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<sup>13</sup> Albania, Armenia, Azerbaijan, Belarus, Bosnia, Croatia, Georgia, Kazakhstan, Kyrgyzstan, Federal Republic of Yugoslavia, Former Yugoslav Republic of Macedonia, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan. Note that I refer to the ‘Federal Republic of Yugoslavia’, since the country changed its official name to ‘Serbia and Montenegro’ and afterward split into two independent states (Serbia and Montenegro) at a time later than the one covered in the study.

CEECs. Indeed in 2002 it is third only to SSP and TFES in the case of the CEECs. The remaining four indicators<sup>14</sup> appear to be less influential in the early years and will therefore not be discussed further here.

**Figure 1:** Indicator trends for the front-runners of transition (N=10)<sup>15</sup>

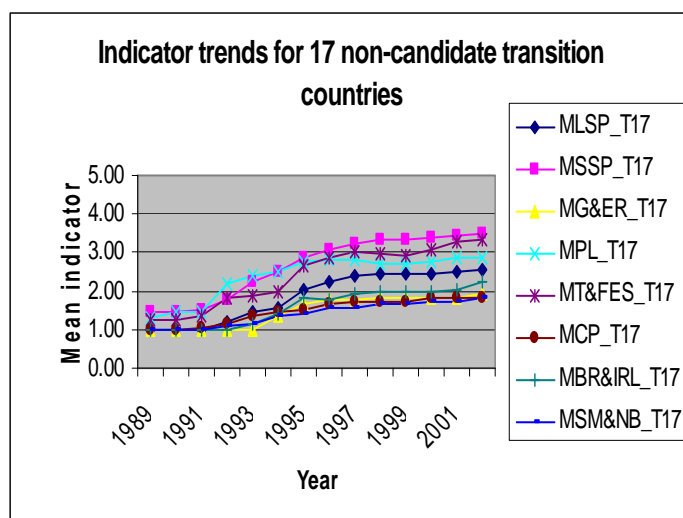


A review of the same indicators in the case of the 17 non-candidate countries (figure 2) shows that price liberalisation, small scale privatization, and large scale privatization appear to behave in ways that are consistent with our expectations of first-stage and second-stage reforms. Trade and foreign exchange system appears to develop very slowly in the first years of transition.

<sup>14</sup> Governance and Enterprise Restructuring (MG&ER), Competition Policy (MCP), Banking Reform and Interest Rate Liberalisation (MBR&IRL), and Securities Markets and Non-Bank Financial Institutions (MSM&NB).

<sup>15</sup> Year-points reflect means of the indicators in each of the ten countries CEECs in the specific year. The same sources and methods hold for the remaining diagrams in this paper.

**Figure 2:** Indicator trends for the laggards of transition (N=17)



In the following two subsections I focus on these four indicators, namely Small Scale Privatization (SSP), Large Scale Privatization (LSP), Price liberalization (PL), and Trade and Foreign Exchange Systems (TFES). In particular I compare their trajectories in the case of the two groups of countries (CEECs and the rest), in search for evidence in support of the expanded Mattli-Plümper hypothesis. The choice of these indicators is partly related to their analysis but, as the previous paragraph suggests with regard to TFES, is also partly empirically driven, based on insights coming from figures 1 and 2.

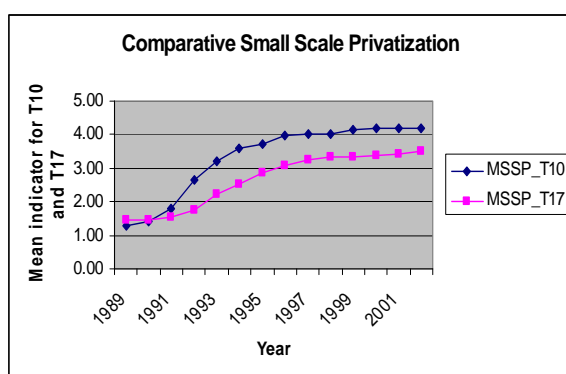
### 3.1 First-stage reforms, trade-related reforms and the impact of EU's involvement

Some indicators appear to rise very sharply in the early years of the transition period. Indeed, as figure 3 shows clearly, Small Scale Privatization (SSP) increases rapidly in the pre-1993 period in both front-runners (MSSP\_T10) and laggards (MSSP\_T17), as the expanded Mattli and Plümper hypothesis would predict. In 2002 the distance between the CEECs and the rest stood at roughly half a point and it did not exceed significantly one point at any stage during the fourteen years of measurement in figure 3. This empirical reality must be testament to the relative low political costliness of this type of reforms.

The EBRD's 1999 Transition Report, which took stock of ten years of transition in its commemorative edition that year, is in agreement with the expanded hypothesis: 'In contrast to the difficulties in privatising medium-sized and large enterprises,

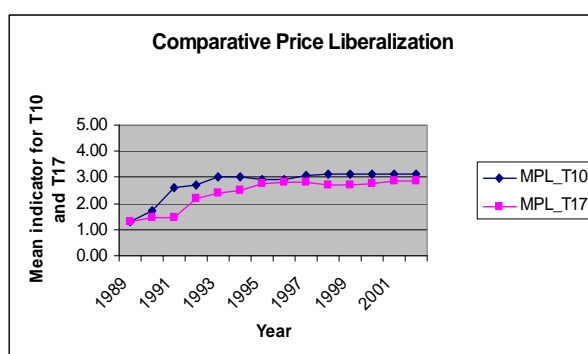
privatization of small firms has been much easier' (Transition report 1999, p.34). The reason, according to the transition report, is that 'Most small firms were in the trade and services sectors and the power of their managers and employees was not significant. Moreover, the administration of small-scale privatization, either in the form of competitive auctions or concessions to insiders was often devoted to local governments, making rapid implementation possible' (*ibid*). Therefore, the report concludes, 'most countries advanced rapidly with small scale privatization' (*ibid*).

**Figure 3: Comparative Small Scale Privatization**



A clear implication of the consistency of SSP with the expanded Mattli-Plümper hypothesis is that this indicator can only have a moderate contribution to the explanation of the early accelerated transition of the CEECs, since that pattern shows that the CEECs distanced themselves rapidly and at increasing speed from the rest of the transition countries in the pre-1993 period.

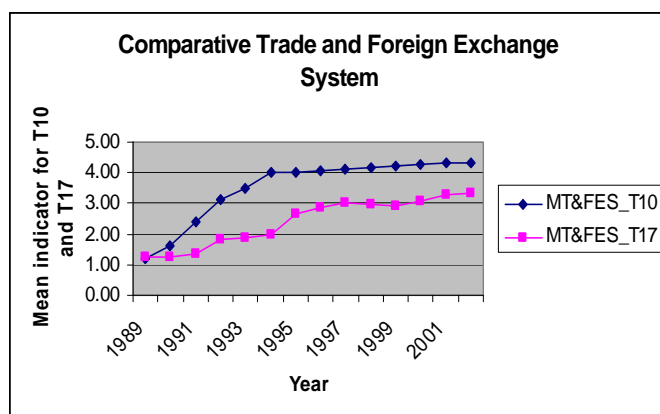
**Figure 4: Comparative Price Liberalization**



A slightly different pattern can be seen with regard to price liberalization, which increases rapidly in the early years both in the ten CEECs (MPL\_T10 – figure 4) and

in the remaining transition countries (MPL\_T17) but then stagnates. Although the prediction regarding the early development of the indicator holds as expected, the subsequent stagnation of the indicator suggests that the assumption of low political costliness may not be entirely correct. It is nevertheless a fact that the early development of this indicator is consistent with the hypothesis. It follows that, as in the case of the Small Scale Privatization, Price Liberalization cannot account for the early patterns of the ‘big picture’ of transition.

**Figure 5:** Comparative Trade and Foreign Exchange System indicator



Another indicator however - Trade and Foreign Exchange Systems (TFES-figure 5) – appears better suited to account for that pattern. What is of particular interest in those early years is variation with regard to the behaviour of TFES in the front-runners and laggards or transition respectively. Indeed, in the case of the CEECs (MTFES\_T10) this indicator increases even faster than the SSP one (see figure 1) and stays at that level, unlike the behaviour of its counterpart in the laggards of transition (figure 2), where the indicator progresses at a significantly lower pace and clearly lags behind SSP. Comparing the development of the indicator in the two groups of countries (figure 5) confirms this analysis. The indicator increases significantly faster in the CEECs (MTFES\_T10) than it does in the remaining transition countries (MTFES\_T17). Although in 2002 the distance between the two groups is roughly one point, in 1993-1994 frontrunners were in front by fully two points (figure 5). Clearly this indicator impacts greatly the early, pre-1993 patterns of transition.

Despite their significant impact on the early patterns of transition, trade and foreign exchange reforms are not covered by the Mattli-Plümper hypothesis. How, then, can

we explain the discrepancy in this specific indicator? The explanation is a two-step one: the first step concerns the patterns of trade diversion and their causes in the early years of transition and the second links these patterns with variation in the collective development of the trade (TFES) indicator. Discussing patterns of trade throughout the post-communist area, the 1999 Transition Report concludes that ‘the biggest change to the geographical composition of trade flows happened early in transition and has changed little since’ (Transition Report 1999, p.90). Whereas CEECs, the report notes, redirected their trade towards the EU, ‘the most striking feature [of these patterns of trade diversion] is the extent to which CIS countries are still dependent on trade links with other transition countries’ (*ibid*).<sup>16</sup>

It is clear that trade developments in the CEECs were impacted by the inclusion of the CEECs in EU policies, in particular the Trade and Cooperation Agreements of the late 1980s and early 1990s<sup>17</sup>. Hungary was the only case of a country where a TCA had been signed and put into force before 1989<sup>18</sup>. In all other countries TCAs followed the collapse of communism, including Poland (1989), Czechoslovakia (1990), Bulgaria (1990), Romania (1991), Soviet Union (1990), Albania (1992), Latvia, Lithuania and Estonia (1993), and Slovenia (1993). In terms of their subject matter, the TCAs did not cover sensitive goods, coal and steel products, textiles and some agricultural products which are covered by voluntary restraint agreements. They also had provisions on economic cooperation in a variety of areas such as industry, agriculture, energy, transport and environmental protection. The TCAs were followed by enhanced Association Agreements better known as ‘Europe Agreements’<sup>19</sup> (Torreblanca 2001, Smith 1999, Henderson and Robinson 1997).

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<sup>16</sup> The aim of this section is not to explain why these trade patterns emerged but how they affect the Trade and Foreign Exchange Systems indicator. Nevertheless, the transition report offers the following convincing explanation: ‘In large measure, this reflects dependence on the Russian market rather than an intensification of intraregional trade’ (*ibid*).

<sup>17</sup> For a list of states that signed TCAs and dates when TCAs went into force see Smith (1999, p. 55; also *ibid*, note 48 on page 201). The reference covers all CEE countries that are of interest to this paper.

<sup>18</sup> See Torreblanca (2001, p30) on the politics of the 1998 Joint EC-CMEA declaration that opened the way for the 1998 TCA with Hungary.

<sup>19</sup> Europe agreements were initially signed with Czechoslovakia (which had to re-sign separate agreements for the Czech and Slovak Republics in October 1993), Hungary, and Poland in December 1991. Similar agreements followed in 1993, in February with Romania, and in March with Bulgaria. Agreements with the Baltic States were signed in June 1995 and with Slovenia in June 1996. The primary aim of the Europe Agreements was the creation of a free trade area with the associated members, following an asymmetric liberalization scheme according to which the EU would reduce its tariffs faster than the associated members. However, Europe Agreements (EAs) were much more than free trade agreements. They also included elements of political dialogue, and economic and financial

The TCAs were very significant agreements at the time because member states agreed, albeit reluctantly, to eliminate eventually their numerous national quantitative restrictions on imports from the CEECs, a development that impacted significantly trade between the CEECs and the EU. In addition to the effect on trade between the CEECs and the EU, a secondary but important outcome of the trade agreements of the time was that the CEECs had to raise tariffs on (and thus discourage) trade with the Soviet Union and later the CIS.

The combined effects of the trade agreements of the time are particularly significant from the point of view of this paper, because they had a considerable impact on trade patterns, and in particular trade re-direction towards the EU. Once the trade patterns and the impact of EU policies on these patterns are integrated in our analysis, the second step in our explanation, i.e. how these trade patterns affected the differential development of TFES in the two groups of countries, is quite straightforward. CEECs, having signed Trade and Cooperation Agreements with the EC/EU in the early years experienced a significant re-direction of their trade from the former Soviet area to the EEC; such a redirection of trade clearly necessitated developing the structures and systems to facilitate it, which is what the TFES indicator measures. The same simply did not happen in the case of the former Soviet Republics, which traded largely with the same trading partners before and after the collapse of the Soviet Union.

It follows from this analysis that the pre-1993 patterns of transition reflect mainly developments on trade more than anything else, and these trade-related developments were decisively conditioned by EU trade policy towards the CEE region. This is, then, a significant substantive mechanism linking EU policies with the pace of transition in the pre-1993 period. But if trade-related developments and structural change explain the pre-1993 patterns of variation between the two groups, what accounts for the differentiation phase between 1993 and 1997? There is little doubt, looking at figures

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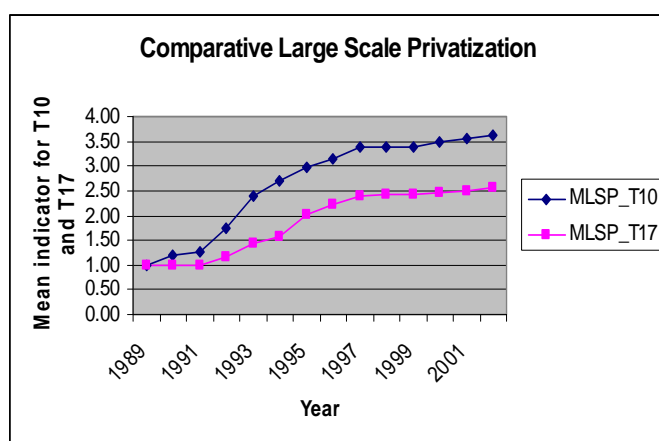
cooperation. The asymmetric scheme in reality didn't work as originally envisioned, since it only applied to non-sensitive areas for existing EU member states, which often blocked trade of goods that affected domestic production (Mayhew 2000, 1998). Europe Agreements did not affect the existing trade between the associated countries but they meant that they would have to levy customs duties on imports from their former partners in the Council for Mutual Economic Assistance-COMECON (Van De Bempt and Theelen 1996, p. 28).

1 and 2, that large scale privatization is the primary driver, as the expanded hypothesis would predict and section 3.2 elaborates in more detail.

### 3.2 Second-stage reforms: privatization, FDI, and the prospect of membership

Figure 6 plots the way mean Large Scale Privatization (MLSP) developed over time in the two groups of countries. The pattern here is indeed quite different than in the first-stage reforms. Observe how slowly MLSP increases for both groups before 1993 and how differently it develops afterwards. In the CEECs, the indicator (MLSP\_T10) begins to accelerate after 1993 and until 1997. After 1997 it appears to stabilise. In the remaining transition countries (MLSP\_T17) the indicator progresses at a much more modest pace in the post-1993 period and never really manages to reduce the distance from the CEECs, distance which appears to increase over time with some fluctuations. Clearly, given the significant variation between the two groups in the area of large scale privatization (LSP) in the post-1993 period, LSP plays an influential role in the transition patterns of the period 1993-1997 (much like the indicator on trade and foreign exchange systems (TFES) was highly influential in the pre-1993 period).

**Figure 6:** Comparative Large Scale Privatization



With regard to large scale privatization, the 1999 Transition Report also distinguishes the CEECs from the rest of the transition countries. ‘For many CIS countries and countries of the former Yugoslavia, privatization has significantly benefited insiders either through voucher privatization with significant concessions to insiders or through MEBOs [Management/employee buy-outs]. In contrast, a number of countries in Central and Eastern Europe and the Baltic region benefited from more

favourable initial conditions and were restricted to insider privatization by the power of incumbent managers or employees' (Transition report 1999, p. 33). However the manner of privatization was not simply determined domestically. Because 'to the extent that privatization methods varied within countries, the choice of method for a particular enterprise often reflected its potential viability under market conditions. The best enterprises or parts of enterprises have frequently been singled out for sale to strategic investors'<sup>20</sup> (Transition report 1999, p. 33). By 'strategic investors' the transition report refers to external foreign direct investors.

Apart from observing that the CEECs appear not to fall to the same extent as the remaining transition countries in the 'trap' of the vicious political cycle of corruption and insider deals, the 1999 report does not attempt to explain why that is the case. The reference in passing to initial conditions in the previous paragraph as a possible explanation does not fare well empirically, for not all CEECs started from equally favourable initial conditions. For example, the Baltics started from roughly the same starting positions as Ukraine and Moldova, but clearly performed dramatically better subsequently<sup>21</sup>. Compared to this limited explanation, the political economy-based Mattli-Plümper explanation is more convincing.

The expanded Mattli-Plümper hypothesis predicts higher differentiation with regard to second-stage reforms than with first-stage reforms. The reason is that the former type of reforms is politically costly domestically and therefore not easy to adopt and implement by even the more reform-oriented incumbent governments. According to the hypothesis, there is a direct link between the offer of the prospect of membership in 1993 and the acceleration of the pace of politically costly reforms, because the prospect of membership acts as an enabling factor that allows incumbent governments in CEECs to make credible internationally and acceptable domestically commitments. This is clearly not the case in countries where the prospect of membership is not credibly offered by the EU.

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<sup>20</sup> Since the purchases of LSP assets from foreign investors is registered in international accounts as FDI, the capturing of the 'gems' of privatization by strategic external investors probably explains why FDI flows to and stocks in the CEECs originating from EU member states dwarfed all other sources of FDI in the region (see later in this section).

<sup>21</sup> *Initial Conditions Index*, EBRD Transition Report 2000, p. 21.

A good measure of the extent of large scale privatization is its financial imprint, and in this case a good proxy for that imprint is the level of foreign direct investment. European FDI (aimed at privatization and non-privatization investment areas) is generally acknowledged to be of higher significance and gravity than non-European FDI in the transformation process (Oman 1999 on redirection of European FDI). Aggregate data from Eurostat further corroborate this conclusion. For example, in 1997, EU member states held 61% of the FDI stocks invested in the acceding CEE countries; in 2000 this percentage rose to 73%<sup>22</sup>. Some countries including the Czech Republic, Estonia, and Slovenia registered as high as 84% of FDI stocks coming from EU member states (*ibid*). The lowest percentage (44%) was to be found in Latvia (*ibid*). The situation with FDI flows is not different from that of FDI stocks: cumulative EU FDI flows dwarfed US flows in the period 1996-1999, standing at 20,835 million EUR vs 2,488 million EUR respectively<sup>23</sup>.

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<sup>22</sup> 'Acceding Countries: Still Attractive for Foreign Direct Investors', *Statistics in focus, Economy and Finance*, Theme 2 – 51/2003, p.6.

<sup>23</sup> 'EU Member States Largest Foreign Direct Investors in Candidate Countries', *Statistics in focus, Economy and Finance*, Theme 2 – 24/2002, p.5.

#### 4. Conclusion

Established wisdom has it that accession negotiations and conditionality drove reforms in the post-1997 period. This may be so, but this paper added a substantive/policy-level mechanism linking differentiated EU policies to the pace of transition in the pre-1997 period, thus filling a vacuum in our understanding of the transition process itself. This mechanism makes it clear that what drives patterns of variation in the early years of transition is rather different from what drives the same patterns in the post-1993 and post-1997 period. In particular, trade dynamics appear to be more significant in the pre-1993 period, whereas large scale privatization is more consequential in the period between 1993 and 1997.

How are EU policies linked to this narrative? The answer to this question was greatly assisted by the Mattli-Plümper hypothesis, which was expanded here to integrate the non-CEE transition countries and was enriched with trade dynamics, in order to capture empirical patterns that emerged from the analysis of individual EBRD indicators. The link between EU policies and the early differentiation is fairly straightforward: by offering Trade and Cooperation Agreements and opening its markets (even reluctantly) in the early years to the CEECs, EU policies encouraged and necessitated transition reforms geared towards integrating the countries by facilitating trade and foreign exchange systems.

The link with post-1993 patterns is potentially even more interesting. The financial impact of EU member states in large scale privatization is captured by measures of FDI in the region. FDI by the EU in the CEECs has been shown to dwarf non-EU FDI. The story of what appears to be happening is that significant assets in the CEECs were bought and modernised by European investors, but that process began to take off in the post-1993 period. The explicit connection that Mattli and Plümper propose between the prospect of membership and the way it facilitates progress in the politically costly area of large scale privatization is verified by the relevant statistics. Progress with large scale privatization impacted the development of the LSP indicator, which, in turn, was influential in shaping our aggregate measure of the pace of transition in the period 1993-1997. Thus, the 'prospect of membership' thesis contributes in two levels. First it explains partly internal transformation within the ten CEECs. Second, it potentially accounts for the 'pattern' of transformation after 1993:

differentiated transformation between the front-runners (CEECs) and laggards of transformation may be to a significant extent a reflection of the differentiated EU policy towards the non-CEECs, since the prospect was never extended to them credibly in the period studied here.

These findings are of particular policy relevance, since clearly the EU no longer possesses the tools of accession negotiations and conditionality to define the course of change in its Eastern neighbours. It is therefore important to understand the causal mechanisms that underlay the adoption and implementation of reforms at times when these accession-related tools were not applied, which is primarily what this paper tried to capture and explain.

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