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DIVERGENT DYNAMICS OF TRANSFORMATION: THE ROLE OF THE EUROPEAN UNION

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Motto: The only thing worse than being the member of
the European Union is not being the member of it.
/Oscar Wilde reloaded/

Motivation of the research

I have begun my PhD studies with the intention that my master degree was not enough, I by no means know enough and I still do not understand everything I would like to. I was still ready to discover new fields in economics.

My international interest was latently behind my choice of international specialization at the university but it come to light during my semester in Jyväskylä, Finland where I was an exchange student in 2004. Here I was not tied by the curriculum of studies but I was free to choose from countless interesting courses and I met countless interesting people from many countries. This "intellectual freedom" and multicultural environment "put me in a different context" and helped me a lot to find my field of interest. It came out, that I am interested in international issues.

Still, when I decided to start PhD studies, my willing to learn was not accompanied with a clear research agenda. I only knew that I was interested in European integration, in particular the widening of the integration. With these foundations I was "roaming about the scientific world" when the Europeanization and Croatia have found me. It would be bumptious to say that I have found my topic, but the historical fidelity requires to say that my topic has found me – with not little contribution of my supervisor László Csaba, for whom I cannot be enough grateful. After I possessed a research topic, life became easier but the long and hard road just began. What really brought me into the orbit of research was my second semester in Jyväskylä in 2007, where under ideal conditions for research I became even if not ideal but researcher. This I did not "manage" to shake off after returning home and my department accepted my newly institutionalized research days with understanding and support. My weeks in Zagreb mean also invaluable contribution, where I had the opportunity for a "real time" examination of Croatia.

I. Introduction

The puzzle we have faced and aimed to resolve was that Croatia, our original object of examination, "behaves" different from the expectations. We aimed to find out whether the expectations were wrong, i.e. without any foundation, or Croatia misbehaved and if it did, what was the reason to do so. In order to solve this puzzle, we drew Slovakia into the examination as a control-case.

Some years ago one would have predicted very different scenarios for Slovakia and Croatia. The difference was twofold. On the one hand, both paths have shaped significantly different from the previous expectations. On the other hand, the paths of the two have been very different from each other, although some initial conditions seem to be highly similar.

1 Research question

This paper aims to examine why some countries are frontrunners in transformation and European integration and others lagging behind. Why some countries grasp the opportunity to join the European Union and others do not. Is it a conscious decision that a country takes part in the Europeanization process or rather "it just happens"? Under what conditions is a country more likely to Europeanize than the other. Why do governments implement measures in order to fulfil EU requirements and why others do not?

The final outcome is always the result of an interaction between external and internal factors. The puzzling question is which conditions play more determinant role. External or internal conditions will determine the level of Europeanization of a country? Or be more precise, what is the "good mixture" of external and internal factors that result in successful Europeanization. Is external pressure in itself able to reach Europeanization? Under what conditions is external pressure effective? Are there certain factors, which determine whether external incentives produce domestic institutional change and whether these changes are sustainable?

After such list of questions about the dynamics of Europeanization one may ask the simplest one: Is Europeanization *good*? Is it necessary in order to be a "happy country"? Is the EU anchor *necessary* for democratic transformation to market economy?

2 Method

The theoretical framework with which this paper tries to answer the above defined questions is Europeanization. The theory of Europeanization tends to explore how European factors influence domestic structures. However, this task is far from being unambiguous. As Haughton (2007:2) notes, social scientists do not have the luxury to isolate individual factors and then re-run control-experiments to see if the result changes. As a consequence, demonstrating chains of causation is extremely difficult, if not impossible. The conclusions of the argumentation are often vague and less than robust: whether the development of a country makes it ready for EU accession or the development itself is the impact of the EU. Csaba (2009:178) points to an even broader methodological problem of social sciences: researchers (even form the same line of thought) are unable to agree even upon the meaning of basic concepts of the analysis. Haverland (2006) shows the methodological difficulties of case selection as well. Concerning the establishment of causal effect or relative importance of the EU, the author shows also evidence for biases towards EU-level explanations. The model of Cernat (2006) demonstrates that Europeanization is not the only external factor but the impact of globalization and other international organization may be also taken into account.

This study aims to discover the countries' economic and social *system*. We suppose that the answer to our puzzle cannot be found only by examining economic issues. Thus the scope of the study is widened and extended to political, social, ideological and cultural aspects. The theory of Europeanization, as we understand, provides space for this "expanded approach". In other words, the frame-theory of Europeanization can be used in all above mentioned sphere of social sciences. All the economy, politics, society, ideology and culture can be Europeanized. Europeanization pressure reaches every sphere of a country's life, the whole *system* of a country. That is why beyond the umbrella-theory of Europeanization the theory of transformation, comparative and institutional economics, public choice theory, sociology and psychology provide the framework for the analysis in order to be able to explain the overall development of our case study countries.

All in all, the approach of this study is *close* to what Kornai (1999:7-10) calls system paradigm. (1) We are interested in the system as a whole (in the Europeanization of the whole system). (2) We pay attention to the interaction between various spheres of the

functioning of society. (3) We pay attention to the distinction between institutions which emerge historically and which are ad hoc construction of a bureaucratic decision. (4) We aim to search for an explanatory theory in historical terms. (5) We are interested in the transformation from "nationalist" to "Europeanist". (6) We are interested in the dysfunctional features of the system. (7) The method of our paper is comparative analysis. Our starting point is that by comparing the two cases, we can understand better the factors behind each of them. Croatia and Slovakia are similar and different cases at the same time. The similar characteristics provide the possibility of comparison. They are two Central European countries with a number of common conditions. They did not follow the "mainstream" path of Europeanization, which is also an important common characteristic. At the same time we cannot omit that the countries differ in some fundamental characteristics. However, the differences in the two countries' initial conditions *do not explain* the different outcomes of their development. This is the basis of our puzzle and this provides the possibility to compare them as the most similar cases.

Those who embark on comparing economic system, shall count with the possibility that they have to work out new theoretical categories instead of using ready-made schemes, and have to struggle for huge methodological difficulties (Kornai 1983:7). Moreover, understanding the economy as a system is far from being an unambiguous approach. *Lévai* (2006) presents a competing theory about how the system is understood, based on the system's theory. Lévai (2006:23) argues that historicism, analytical structuralism and functionalism and holism are the principles of any social sciences using the system approach. The transdisciplinary (not inter- or multidisciplinary) paradigm that provides the common language and methodology for all social sciences is the theory of complexity[1]. *Eucken* describes two opposing systems: the centrally directed economy and exchange economy. At the same time, *Wallerstein* argues that there is no socialist system in the world-system since the world economy is a capitalist one (Bara et al. 2007:25-27).

The comparative economics also define itself as a discipline that examines economic systems, in which not only the elements are important but also their relations. The definition of the economic system makes it possible to see the economy as a whole and as the most important subsystem of the society. It is also possible to examine the

[1] The theory of complexity is the deterministic school of system's theory which generalizes nonlinear relations.

impact-mechanism of the elements and their role in the system. According to Bara et al. (2007:6-7) the conceptual framework of the comparative economics is Kornai's system paradigm. Concerning methodology, comparative economics does not consider economic system and institutions[2] as given.

Altogether, this study does *not follow strictly* either Kornai's or Lévai's approach. The study does not attempt to unite the system paradigm with Europeanization or the system's theory with Europeanization. However, as noted before, we understand Europeanization as an inter/transdisciplinary theory where the economic, political and social system of the countries is seen as a whole. Although Europeanization may be seen as an episode in system's theory, the architecture of connection is not trivial and may be the subject of another examination.

As mentioned above, the method of the study is comparison. We compare the institutions/systems of the two countries according the principles of Europeanization. In both countries five aspects of Europeanization (market economy, democracy, acquis communautaire adoption, European identity and common foreign and security policy) are examined. The in-depth case studies are compared according to the keywords of Europeanization theory (misfit, perception, adaptation pressure and responding capacity). The comparison of the two countries is embedded in the context of Central and Eastern and Southeastern European countries. We argue that we can only understand the development of the two case study countries when we expound them in relation to the peer transformation countries. The case studies are composed on a "two countries–four cases" basis. This means that both case study countries are examined in two periods in order to explore the different mechanism during the two regimes. Both periods are examined according to the five aspects of Europeanization, expounded in the theoretical section. The comparative section is also composed on a "two countries–four cases" basis. Here the results of the previous case studies are elaborated. The countries and cases are compared according to the keywords of Europeanization.

3 The initial hypotheses and puzzles

This study has two initial hypotheses.

1. At the time of regime changes in Eastern Europe, Croatia (as one of the successor states of Yugoslavia) is an "outstanding pupil" in transformation and

[2] Which can be seen as systems as well, cf. Lévai 2006.

European integration and thus has very favourable prospects for quick and successful Europeanization.

2. At the time of regime changes in Eastern Europe, Slovakia (as one of the successor states of Czechoslovakia) is a brand new state with the prospects of backwardness and lagging behind in transformation and European integration.

3.1 The puzzle of Croatia

According to the concept of transformation at the beginning of the 1990', Croatia was an expectant of a quick and successful Europeanization process and EU membership. First, during the socialist times Yugoslavia (and especially its two developed republics, Slovenia and Croatia) was a frontrunner in reforming and softening the socialist system. In Yugoslavia the Croatian elite belonged to the pro-Europe group. Second, Germany and Italy were in favour of independent Croatia and early membership. Of course the war put everything in a different context, but still according to the expectations, with the end of the war Croatia would have joined the EU immediately – as the previous example of Greece showed. Third, Croatians have never felt themselves a Balkan country but they have had a strong Central European identity that would show the way to Europeanization.

In less than ten years this hypothesis proved false. Croatia has moved from one of the post-communist states most likely to "join Europe" to a place at the end of the queue. When Croatia seceded from the Federal Republic of Yugoslavia in 1991, Croats were optimistic about their newly independent country. They had two hopes. First, Croatia would become a sovereign state. Second, side by side with the newly gained independence, Croatia would (re)join Europe and (re)appropriate the standards of civil society and the economic prosperity, which they felt that they had been denied as part of Yugoslavia (Lindstrom–Razsa 1999:3). This latter period was considered as a "short Balkan episode" in Croatia's history compared to the centuries when it belonged to Central Europe (Tudjman 1997). That is why the prefix "re" is very important as it symbolises the Croatian attitude towards Europe and European identity. These hopes were not unrealistic; moreover Croatia had promising prospects to realize it.

Contrary to the expectations, Croatia was not eager to join the EU as soon as possible. Moreover, the country has missed two rounds of EU enlargements, one in 2004 and the other in 2007. The surrounding countries with similar (or even less) economic development level have already joined the EU. Croatia is the only country in the region,

i.e. the transformation countries of Central and Eastern Europe and Southeastern Europe that even though could be ready with EU-entry, still out of the club.

Categorizing the transformation countries has been a common tool in the international literature (Csaba 2007c:338). The "classic" frontrunners of transformation have been Hungary, Czech Republic, Poland, Estonia and Slovenia. The "second best" group of countries has consisted of Slovakia, Latvia, Lithuania, Bulgaria, Romania and Croatia. The other Southeastern European (beyond Ukraine and Russia) countries belong to the third group, which is struggling with half-solutions on the way of transformation. In the fourth group of countries the transformation is in most part only rhetoric, Belorussia and the other former CIS countries belong here. In the second group Croatia is the only one that is not an EU member yet. Some years ago it was not obvious at all that Croatia will be an exception.

Thus the question arises why it is so. Was it a conscious decision to stay out or rather the consequence of several external factors? The second question is whether the delay from the mainstream Europeanization process (i.e. with the 2004 or 2007 round) was/is advantageous or rather disadvantageous for Croatia. Has Croatia won with the years out of EU or rather wasted time?

3.2 Why compare with Slovakia?

Slovakia is a similar case from more aspects. The country emerged in 1993 as a brand new state without almost any experience of independence. As part of Czechoslovakia, Slovakia belonged to the Visegrád three, that is, to the group of most promising transformation countries, although Slovakia was regarded as the weaker part of Czechoslovakia. When Czechoslovakia disunited, the newly independent country did not follow the path of the other Visegrád countries. The new government of Vladimír Mečiar established a rather authoritarian, nationalistic and contra-EU regime that also meant a third way concept of the Slovak foreign policy and ambitions of cooperation with Russia and the EU at the same time.

The structural backwardness together with the lack of willingness of fulfilling EU-conditions made Slovakia less and less attractive in the eyes of the West. Referring back to the previous categorization of transformation countries, Slovakia belonged to the "second best" group. Although the Slovak national identity has been Central European, which would pave the way to Europeanization, the newly independent Slovak nation

first in its history had more ambitions to step on its own way without following anyone else's will. That was regarded as the interest of the nation.

Contrary to the hypothesis of a nationalist and lagging-behind country, in some years Slovakia became the "Tatra Tiger". Quick and attractive measures were needed to convince the international community and the EU about the determination of the government. By May 2004 the country joined the European Union with a consolidated democracy and well-functioning market economy. The reorientation and policy measures of two Dzurinda governments between 1998 and 2006 were able to change the image of Slovakia and place the country among the frontrunners of Europeanization. Nowadays Slovakia is among the most reform-minded member states of the EU and by January 2009 Slovakia introduced the euro, first among the Visegrád states.

The question arises what origin of the willingness in Slovakia was to turn to Europeanization and not just fulfil the requirements but overfulfil them in reforming the state. Was it purely the fear of lagging behind? Another puzzling question is whether the quick and rather deep reforms of the Slovak state are reversible or durable enough after 2006.

When analysing the Croatian Europeanization process in a comparative perspective, at least two reference countries are possible: Slovenia and Slovakia. The case of Slovenia is more evident for the first look because of their common past in Yugoslavia and before. On the one hand, however, Slovenia seems to step very soon to a far different road of Europeanization after the break up of Yugoslavia. On the other hand, Slovakia and Croatia share numerous characteristics that make the comparison of the two reasonable and confirmed. They both "come from" a multinational federal state, but previously they also share the history of being part of the Austro-Hungarian Monarchy. Both countries became newly independent at the beginning of their transformation process. Both countries experienced the similar kind of rising of nationalism after gaining independence. Both countries had a "fellow republic" i.e. the Czech Republic and Slovenia whose progress toward membership has been more rapid and smooth, and who both belonged to the so-called "Luxemburg group[3]". Both countries felt itself under suppression during their years as part of federal states (Czechoslovakia and Yugoslavia). For Croatia, Serbia was the suppressor who had ambitions to dominate the

[3] Poland, Czech Republic, Hungary, Slovenia and Estonia

federal republic. In Czechoslovakia obviously the Czech Republic was the counterpart of Slovakia. In her paper, Heather Field (2000) argues (maybe a bit exaggerative) that Slovakia and Croatia[4] are "awkward" states concerning EU enlargement because their integration progress had been slower than that of the other CEE countries in their neighbourhood.

In spite of the highly similar initial conditions of Slovakia and Croatia, we should not neglect one significant difference. The type of socialism in Yugoslavia and Czechoslovakia were highly dissimilar. The Yugoslavian socialism was more a third way approach that contained numerous elements of market economy. On the contrary Czechoslovakia conducted one of the most rigid and strict socialist system without market economic features. This characteristic of the two republics influence the prospects of the successor states as well. The Western-oriented Yugoslav heritage pointed ahead more advantageous transformation and European integration prospects than in Czechoslovakia where the changes had only few antecedents.

We will see that although the countries are examined with the tool of comparing the most similar cases, from the aspect of Europeanization they prove to be the two more dissimilar cases.

[4] Heather Field also counts Serbia to the awkward states in her study. At the same time, most probably the rest of the Western Balkan states could also be labelled as "awkward" in 2000.

II. Theoretical and conceptional framework

1 Europeanization: the theory

The definition of Europeanization is a rather debated issue in the international literature. The concept itself comes from the field of political science and European studies and the majority of authors agree that Europeanization occurs when something in the domestic political or economic system is affected by something "European" (Vink 2002:1). The term "European" most usually refers to the European Union, therefore Europeanization very often examines the influence of the European integration.

Anastasakis (2005:77-78) summarizes what should be known about Europeanization. The meaning of the term can be concrete and specific, elusive and all-encompassing at the same time. It is a means and an end; it is method as well as substance; it is a project and a vision. It has a certain political, socioeconomic, and cultural meaning, but it is also an ideology, a symbol, and a myth. It has both internal consequences for Europe and external impact for the rest of the world. Europeanization has different meanings in the different countries or regions that are involved in the process.

Caporaso, Green Cowles and Risse (2001:3) define Europeanization as "the emergence and the development at the European level of distinct structures of governance, that is of political, legal, and social institutions associated with political problem solving that formalize interactions among the actors, and of policy networks specializing in the creation of authoritative European rules". Other authors understand Europeanization more widely, that is, beyond politics they consider also the citizenship and national identity as subject of Europeanization. Radaelli (2000:2), in his often quoted paper, states that the problem is not that different authors link different meanings to Europeanization – it is rather an indicator of a vital debate. Instead, the potential risks lie in concept misformation, conceptual stretching and "degreeism", that is, differences in kind are replaced by differences of degrees. According to Radaelli's own definition, "Europeanization refers to the processes of construction, diffusion and institutionalization of formal and informal rules, procedures, policy paradigms, styles, 'ways of doing things' and shared beliefs and norms which are first defined and consolidated in the making of EU decisions and then incorporated in the logic of domestic discourse, identities, political structures and public policies" (Radaelli 2000:4).

In Olsen's view, the different conceptions of Europeanization complement, rather than exclude each other since they refer to related phenomena. Olsen argues that the dynamics of Europeanization can be understood in terms of change. He distinguishes five possibilities. (1) Europeanization means changes in external territorial boundaries, in course of which Europe as a continent becomes a single political space. For example Europeanization is taking place with the enlargement of European Union as it expands its boundaries. (2) Europeanization means the development of institutions of governance at the European level that realizes as a result of collective action capacity. (3) Europeanization means central penetration of national and sub-national systems of governance that involves the division of responsibilities and powers between different levels of governance. (4) Europeanization means the export of forms of political organization and governance which are typical and distinct for Europe beyond the European territory. This export/import balance is mostly positive, i.e. non-European countries import more from Europe than vice versa. (5) Finally, Europeanization means a political project aiming at a unified and politically stronger Europe (Olsen 2001:3-4). Olsen does not see necessarily positive correlation between the first four types of Europeanization, and neither between each of them and a politically stronger Europe.

To avoid the conceptual stretching, it is worth indicating not only what Europeanization means, but also what it does not mean. Radaelli points out the importance to draw the line between Europeanization and the concepts of convergence, harmonization and integration. Europeanization does not equal *convergence*. Instead, latter can be a consequence of Europeanization. Europeanization does not accord necessarily with *harmonization*. Moreover, Europeanization can end up in regulatory competition. Europeanization is not *political integration*, although Europeanization would not exist without European integration. Here the question of relationship arises between Europeanization and the integration theories. The theories of integration focus on issues whether European integration strengthens or weakens the state and whether it triggers multi-level governance[5]. The focus of Europeanization is the role of domestic institutions in the process of adaption to "Europe" (Radaelli 2000:6).

Radaelli and Exadaktylos (2009) in their review article systematize the literature of Europeanization according to the following three categories: (1) the nature of

[5] Börzel (1999:576-577),cited in Radaelli 2000:6

Europeanization, its mechanisms and outcomes, (2) the issues of change in domestic institutions, actors, procedures and paradigms, (3) the impact of the EU on new member countries or beyond Europe. The authors argue that methodological discussion is relatively rare (the exception is e.g. Haverland 2005) and the awareness in research design is still low. The authors (2009:512-514) examine the methodological issue of causality in European studies and especially in Europeanization literature. They identify seven categories of trade-offs in causal analysis.

(1) "Cause of effects" versus "effects of causes" approach. The former stands for arguments that start with a dependent variable in terms of outcomes and examine the possible cause (e.g. European integration). The latter approach is used in studies that investigate how a specific cause (e.g. European integration) has different effects on domestic factors. (2) Concept formation versus measurement: the choice of generalization and simplicity in conceptualization, and measurement. (3) Complex notions of causation versus singular linear causation. (4) Omitted variables bias versus multi-collinearity: trade-off between trying to reduce bias arising from neglecting important variables and bias arising from the correlation between independent variables. This is also seen as a trade-off between parsimony (the way to avoid multi-collinearity) and rich explanation (the way to avoid omitted variables).

(5) Time as a qualitative factor versus time as quantity of years: there is a trade-off at the level of initial assumptions whether the argumentation start from hypotheses about slow, complex causal chains of events through time, or from more basic assumptions about "time as number of years". (6) Mechanism-oriented research versus variable-oriented analysis; prioritizing one or the other. A focus on variables risks overshadowing the role of mechanisms in causal analysis, while mechanism-oriented research designs carry the danger of neglecting the necessary and sufficient conditions under which these mechanisms are triggered. (7) Top-down versus bottom-up design is a specific issue concerning the empirical research design of Europeanization (Radaelli and Exadaktylos 2009:510-511). The *top-down* models empirical research's starting point is the presence of integration, then it examines the level of fit or misfit of the EU-level policy vis-à-vis the member countries or candidates, and it explains the presence or absence of domestic change. The model is recursive in the sense that there are no exogenous variables. The model can be seen as a system of linear equations that are solved simultaneously. The *bottom-up* research design makes the EU level exogenous. Its starting point is the domestic system (set of actors, ideas, problems, rules, styles and

outcomes at a given time, then it examines the system over the years and identifies the critical junctures or turning points. In every turning-point the question is whether the cause of the change was domestic, or the change came from exogenous (EU-level or global-level) variables.

Whichever definition of Europeanization we consider, there are two conditions that make it possible to talk about Europeanization (Börzel–Risse 2000:5). First, there must be a misfit or incompatibility between domestic and European institutions, policies or processes. This misfit should generate adaptation pressure, which is necessary but not sufficient for changes. The second condition is the existence of factors (actors or institutions) that foster a respond to the adaptation pressure.

It is important to raise the issue whether Europeanization concerns only the impact of the European Union. Europeanization is not necessarily EU-ization, although the term is often dispossessed by scholars who are interested in the unification process between the European Union and its member states, and who concentrates on requirements coming from Brussels. The European Union is the most dominant institution of the European integration, but undoubtedly not the only one (Vink 2002:6). However, the identity or principles of the European Free Trade Area (EFTA), the Organization for Security and Co-operation in Europe (OSCE) or the Council of Europe (CoE) often intertwine with the European Union.

Narayanan (2005:4) argues that Europeanization did exist in a latent state before the existence of the European Union. The author calls the creation of the European Union (1 November 1993) as the "Christendom of the Europeanization process".

1.1 Internal vs. external Europeanization

Europeanization can be interpreted both as internal and external impact. The internal point of view reflects on the internal process of changing in the European Community and the adaptation capacity of the member states. This "self-contained" (Demetropoulou 2004:6) type is called *Europeanization Western-style*[6]. The process of this type of Europeanization is mutual i.e., not only the domestic systems are adapting to the European entity but the European entity is influenced by the national systems as well, since it is constructed from the institutions and policies of its member states (Wallace–

[6] See for example Goezt (2000) or Héritier (2005).

Wallace 2000:6). As Csaba (2007b:148) highlights, Europeanization means not only the adjustment of national systems, but also the adjustment of the European level, since the European Union builds upon institutions and policies of its own member states.

Concerning third, mostly applicant countries, the self-contained approach of Europeanization is not relevant. The "outward looking" perception conceptualize Europeanization as an external (mostly EU-led) process guiding applicant countries' complex domestic economic, social and political transformations (Demetropoulou 2004:6). The external Europeanization process differs from the interaction between the EU and its member states: it is not mutual but unilateral acceptance instead (Csaba 2007b:149). An organic connection occurs between the international and domestic factors with the dominance of the former (Ágh 1998:37). However, the uneven relationship between the EU and the applicants does not mean that the latter has no influence on the former. They inspire new principles and practices and along with their accession the EU itself has to be renewed as well. Their impact is rather indirect though (Anastasakis 2005:83).

The external Europeanization has more types. The example of the Europeanization process in Southern Europe i.e. in Spain, Portugal, and Greece is often called *Europeanization Southern-style* and cited as an example of successful democratization and economic development where the effective EC/EU impact led the late-developing countries to the advanced capitalist Europe (Anastasakis 2005:79).

The external concept of Europeanization raises also the relation of transition/transformation and Europeanization. Transformation has been much more than the implementation of recipe of stabilization, liberalization and privatization. It also means the restructuring of economic, social and political order, formal and informal institutions. After the collapse of communist regimes in Central and Eastern Europe the concept of Europeanization got a new meaning. In the context of transition countries, *Europeanization Eastern-style* offers a general conceptual framework for transition because it is not only about democratization and marketization, but about a particular type of political, economic and social system change (Ágh 1998:49). Europeanization has a general historical meaning of "return to Europe" after the years of communism. At the same time it has a particular meaning as well, a set of requirements in order to gain full EU membership. Here being more "European" means also being richer and freer (Fisher 2006:3). EU membership became part of the national interest because it offered such benefits (Vachudova 2005:63).

As Grabbe (2002:253) highlights, the European Union has played twofold role in the process of post-communist transformation. On the one hand, the EU is an aid donor that imposes conditions on countries. On the other hand, it is guiding these countries towards membership, within which the EU creates incentives and judges progress in fulfilling EU models. The question arises whether these goals are compatible. According to official EU publications, accession and transition are part of the same process and preparations for EU entry are identical with overall development goals. As Grabbe (2002) points out, we have reasons to be sceptical about this assumption since EU policies and regulatory models were not designed for transition countries. They often require a complex institutional structure for implementation that has not always been present in the applicant countries. That is why some EU policy models are suboptimal for them. Grabbe (2002:253) argues that there is an inherent contradiction between the two roles ("regulatory state" and "developmental state") of the EU.

Still, EU-driven institutional change has two key benefits that may outweigh the possibility that these EU-recipes are suboptimal choices for the applicants. First, EU's conditionality may provide a framework to overcome inertia and avoid a lengthy search for a domestic political consensus on institutional models in some areas. Second, the EU accession process provides a set of incentives for rapid institutional change and protects them from lobbying and backsliding (Grabbe 2002:263).

The question arises, whether the Europeanization process of countries in the Western Balkans or Southeastern Europe differs from Europeanization Eastern-style. Although the basic approaches of Europeanization concerning this region correspond to that of the Central and Eastern European countries, the countries of Southeastern Europe have a more asymmetric position with the EU than Central and Eastern European countries had. That is why E*uropeanization Southeastern-style* is increasingly demanding and mostly coercive, based on conditionality (Anastasakis 2005:80).

The former characteristic means that compared to the accession of the Central and Eastern European countries the EU agenda has widened, simply because it reflects the permanently improving process of European integration: the gradual building up of the acquis communautaire with more and more rules, regulations, and international agreements. Southeastern European countries face a "moving target that runs faster and becomes more demanding by the day" – as Anastasakis (2005:84) aptly describes it. The countries are affected by the general Copenhagen criteria and the country-specific

conditions laid down in SAAs. Special conditions arise from peace agreements as well i.e., beyond the "usual" economic, political and social issues, security-related ones are also present (Anastasakis – Bechev 2003:8).
The latter characteristic i.e., that the dominant mechanism of Europeanization is coercion, is mostly the result of the more asymmetric balance of power. The EU set the rule of the games and the countries of Southeastern Europe have little or no space for influence the rules. The more asymmetric balance of power originates from the weakness of states, softness of borders, hardness of identities and failed reform policies, all of which makes their future cloudy (Krastev 2002:39).

All the subjects of the above mentioned external Europeanization types are expectants of internal Europeanization, i.e. full EU membership. Schimmelfennig and Sedelmeier (2004:669) point out the difference between the internal and external dimension of governance. The internal dimension comprises the creation of rules, while the external dimension means only rule transfer and adaptation. On the contrary with the EU-entrance, the country is no more able to adopt ready-made solutions but it has to take part in producing the solutions (Csaba 2007b:27).
Still, the passage between the period of internal and external Europeanization could be manipulated. Negotiating governments have tended to lobby for transition periods in certain sensitive policy areas. Thus certain institutional, administrative, economic and social measures have been postponed after the EU entry. These delays provide the new EU members some extra room for manoeuvre, when the state is no longer the object of EU decisions, but is rather a co-decision-maker (Malová 2004:2).
With full membership the EU does not serve any more as the trivial institutional anchor to the systemic and policy choices of the countries.

1.2 Mechanisms of Europeanization

In the context of post-communist countries, two different mechanisms of Europeanization can be identified. The *first mechanism* is coercion, based on control and conditionality. In course of control, certain policies are inspired by positive or negative sanctions. In this case the EU plays an active role, i.e. it is an "actor" (Demetropoulou 2002:89-90; Noutcheva 2003:2). Conditionality means that specific conditions are attached to distribution of benefits. In other words, the EU's bargaining

strategy is reinforced by rewards. The presence of conditionality, however, does not necessarily cause successful rule transfer (Schimmelfennig–Sedelmeier 2004:670).

There are at least two levels of external pressure. As Schimmelfennig and Sedelmeier (2004) show, on the *level of informal institutions*, the EU pressure is ineffective in the absence of internal persuasion. However, regarding *formal rules* the EU pressure has considerable effect (in form of conditionality).

The instrument of conditionality is not invented by EU but it is widely used by international organizations. Grabbe (2001:1020) groups the mechanisms used by the EU to effect change through conditionality: (1) Gate-keeping (access to negotiations and further stages in the accession process), (2) benchmarking and monitoring, models (provision of legislative and institutional templates), (3) money (aid and technical assistance), (4) policy advice and twinning, (5) monitoring, demarches and public criticism. Grabbe argues that gate-keeping is the most powerful conditionality tool in the hand of the EU, particularly the access to different stages in the accession process, particularly achieving candidate status and starting negotiations. The geographical proximity of the EU and the large number of contacts between the two regions, the policy learning and the provision of models of best practices have also major influence on applicants. Indirect influence and pressure (e.g. bilateral contact with member states) can also be effective, even though these mechanisms work over time and are not necessarily coordinated at EU level Grabbe (2002:256).

The effectiveness of EU conditionality is constrained by several factors. First, the reward of accession and the adaptation costs are far from each other in time. As a result, conditionality is less able to persuade countries to change their practices. There are intermediate rewards, such as aid and trade liberalization but accession is tied to overall readiness. Second, the effectiveness is reduced by the inconsistencies in the EU's advice to applicants. For example, applicants are encouraged to maintain fiscal and monetary discipline, but at the same time, the EU also demands major investments in infrastructure, environmental protection, etc. while it is willing to provide only small proportion of funding (Grabbe 2002:263).

According to the generally accepted opinion, the Europeanization process of the CEE countries is an example of the above mentioned where the visible and realistic prospect of membership was the main carrot along way. The effects of conditionality have been more apparent and tangible in the Central and Eastern European countries compared to the Western Balkans: in most of these countries the conditions of the EU catalysed the

process of marketization and democratization and encouraged the adaptation of the EU norms and practices (Anastasakis–Bechev 2003:49).

The *second mechanism* is mimicry, based on contagion and consent. Via demonstration effect and interactions between international processes and domestic groups the EU plays an inactive and indirect role i.e. it serves as a point of reference and as a framework (Demetropoulou 2002:89-90; Noutcheva 2003:2). In other words, through processes of persuasion and learning EU socialize the countries rather than coerce them. Furthermore, the countries might consider EU rules as effective benchmarks for domestic policy changes and adopt them independently of EU conditionality Schimmelfennig and Sedelmeier (2004:670).

The two types of mechanisms are also called "active" and "passive leverage" in Vachudova's terms. Passive leverage stands for the attraction of EU membership while active leverage means intended conditionality exercised by the EU during the pre-accession process (Vachudova 2005:63).

Schimmelfennig and Sedelmeier (2004) found that EU rule transfer to the CEE countries and the variation of its effectiveness are best explained by the *external incentives model*. The external incentives model is a rationalist bargaining model in which the actors are assumed to be strategic utility-maximizers. In a bargaining process, they exchange information, threats and promises. The outcome of the process depends on their relative bargaining power. According to model, the EU mainly follows the strategy of conditionality in which the EU sets its rules as conditions and the CEE countries have to fulfil in order to receive rewards. The EU rewards include assistance and institutional ties such as trade and co-operation agreements, association agreements and even membership. The main proposition of the model is that a state adopts EU rules if the benefits of EU rewards exceed the domestic adoption costs. The cost-benefit balance depends on the determinacy of conditions, the size and speed of rewards, the credibility of threats and promises, and the size of adoption costs.

The authors present two other models to describe the external governance process. The *social learning model builds* on the logic of appropriateness, according to which the actors involved are motivated by internalized identities, values, and norms. In this model bargaining about conditions and rewards turns to arguing about the legitimacy of rules and the appropriateness of behaviour. The process of rule transfer is characterized by persuasion rather than coercion. The most general proposition of the social learning

model is that a state adopts EU rules if it is persuaded of the appropriateness of EU rules. As a result, whether a third state adopts EU rules depends on the degree how it concerns rule adoption appropriate in light of the collective identity, values, and norms.

The third model is the *lesson-drawing model*[7], according to which non-member countries adopt EU rules without EU incentives or persuasion. In case of domestic dissatisfaction with the status quo, policy-makers review policies and rules being in force elsewhere and evaluate their transferability. The most general proposition of the lesson-drawing model is that a state adopts EU rule, if it expects these rules to solve domestic policy problems effectively. As the internal factors change in time in different countries, the misfit may change (reduce) also because some of the previously external formal institution, value or norm become *internalized*. This also means that countries may change their model of EU's external governance (cf. Schimmelfennig–Sedelmeier 2004).

1.3 EU as an anchor

Csaba (2007b:12) highlights that the logic of Europeanization does require immediate and continuous action. The economic and political convergence of the countries in question does not emerge spontaneously without an anchor. The external Europeanization impact could catalyze the process of changes. One of the core issues of Europeanization is whether the EU serves as an anchor during the transformation process of the post-communist countries, i.e. whether the EU is able to be the point of reference and catalyze the process of changes. As it was described above, post-communist transformation and European integration have intertwined specifically in case of Central and Eastern European countries.

There is certain evidence that in case of CEE countries, the EU served as an anchor. The most policy decision – whether left or right – were determined or suggested by the formal and informal requirements of the European Union. The momentum of reforms of 1989-1990 could be lengthened by the presence of the EU. The impetus has two components. The one are the formal EU requirements themselves and the wish to approximate to "the best", the "European". Beyond this the informal contest among the applicant countries serves as a second line of motivation. These motivations also protected the achievements from the influence of vested interests in the frontrunner

[7] Richard Rose (1991): What is lesson-drawing, Journal of Public Policy Vol. 11, No. 1, pp. 3–30. Cited by Schimmelfennig–Sedelmeier 2004:676

countries. In laggards the inherited structures and related industry-banking-political class networks survived the changes and fought back. The EU possesses an unprecedented leverage in influencing domestic choices of its applicant countries. Moreover this influence is far from being proportional to the assistance towards the accession countries (Csaba 2004:338-339).

In case of Southeastern European countries the role of the EU as an anchor is weaker. Number of authors[8] agree on the fact that the promise of membership was a crucial element in the Europeanization process of the CEE countries. This promise has been absent form the agenda of the EU towards more Southeastern European countries what is highly damaging. In recent years the EU moved to the direction of being clearer about the future prospects of the countries[9].

Ágh detects two major factors for the success of Europeanization process in case of Eastern and Central European countries. The first is the determination of the EU for the great project. The second factor has been the commitment of the domestic political elite. In order to meet the requirements of the EU, these countries had to overcome their unclear and ideological approach of "return to Europe" and change it to a pragmatic view and the process of systematic accommodation. The consolidation of democracy and the European integration are interrelated processes; the one is not without the other (Ágh 1998:44).

In Fisher (2006:3)'s opinion there was a choice in the countries at the beginning of the transition whether they move towards democracy and market economy or towards illiberal democracy and authoritarianism. Ágh writes about "forced democratization" in case of transition countries that had both negative and positive sides. The progress can be considered negative because it imposed alien standards, sometimes over-generalized and over-simplified. At the same time it protects against the renewal of authoritarianism and the renewal nationalistic anti-democratic forces, as it happened in the case of the forced democratization of South European countries (Ágh 1998:34). This process seems to have been failed for the first run both in Slovakia and Croatia.

From where does the *bargaining power* of the EU emerge? At the time of formulating the Copenhagen criteria, the eventuality of the Eastern enlargement was not close

[8] See for example Demetrepoulou (2004), Anastasakis (2005), Anastasakis–Bechev (2003), Gligorov (2004c).

[9] To mention some events from the recent past: EU signed stabilisation and association agreement with Bosnia and Herzegovina on 17.06.2008 or "If all conditions are met it will be possible to give candidate status to Serbia in 2009" said Jose Manuel Barroso on 03.09.2008

because other common projects such as the single currency and the EFTA-enlargement of the EU were under way. Csaba (2004:339) argues that because of this circumstance the bargaining power of the European Commission appreciated considerably. The regular reports of the Commission stood in the limelight in CEE countries during these years. At the same time the Commission did its best to maximize its influence arising form its broad mandate.

All in all the power of the EU aroused in great part due to the attitude of the candidates during the accession period of 1993-2004. The EU holds all the cards *only until* the candidates are interested and can be motivated. Győrffy (2008b) finds evidence that the EU is powerless even regarding its own member states when the requirements did not reflect the domestic political and social convictions but they appear only as external expectations.

As a consequence of the above described, we see no evidence whether the EU has more influence in form of external *or* internal Europeanization. That is, whether the EU has more influence on its member states or hard-working candidates.

1.4 Adaptation capacity

Assume that the first condition of Europeanization, misfit is given and the adaptation pressure is generated. The second condition, the capacity that foster a respond to the adaptation pressure varies between countries and also between policy areas. It is partly the result of the fact that institution-building and policy-making are unevenly developed across countries, and partly the result of the way these adaptation pressures are "refracted" by different domestic circumstances (Buller 2003:533). Green Cowles, Caporaso and Risse (2001:222) argue that the greater the misfit between domestic and European factors, the more likely Europeanization to occur. On the contrary Knill (2001:201-202) argues that a more differentiated conception of European adaptation pressure distinguishes different levels of misfit: whether European policy demands are in contradiction with institutionally strongly embedded core patterns of the domestic structures or adjustment is possible within the given domestic context. As a consequence, adaptation pressure is more likely to induce changes in cases where Europeanization requires minor or incremental changes and resistance to change is more likely when it has a revolutionary character.

One of the core questions of Europeanization is why the countries respond differently to the same adaptation pressure. Vachudova (2005:72-78) outline some theoretical explanations. First of all, the author argues that the *domestic costs* of complying with EU rules are in some countries much higher for the ruling elite than in other countries. In liberal democracies the agendas of the ruling elite in many cases overlapped with the EU requirements, that is why the cost of complying with EU rules was lower compared to illiberal democracies. In illiberal democracies the ruling elites often depend on restricted political competition, economic corruption and ethnic nationalism. As a result, fulfilling the EU requirements threat the power of the ruling elite. Fisher (2006) calls the two types of ruling elite as "nationalist" and "Europeanist".

Vachudova (2005) sketches four other approach of the diversity of responds as well, although she does not see them confirmed. The second explanation is *coercion*: the EU uses its economic and political power to impose its rules and regulations on post-communist states against the will of their ruling elites. The weaker is the state, the sooner it bows to the EU. However, basically the EU did not force cooperation to the post-communist states. The third explanation is *geographic proximity*: the closer is the country to the EU, the bigger is its willingness to implement democratic reforms. The fourth possible explanation is *economic prosperity*. This approach stresses their importance of the initial economic conditions of post-communist states: higher level of income increase the ability to meet EU requirements. In broader sense, the industrialization and urbanization before the communist rule may determine the country's transition prospects after the communist rule has collapsed. The fifth explanation says that because of its internal reasons, the *EU "likes more"* some countries than the others. Different states may enjoy different membership prospects, and thus different level of attention and aid.

Demetropoulou (2002:90) – based on Huntington (1993:209-210) and Ágh (1998) – describes three types of problem that is able to hinder the Europeanization process of new democracies. The structural obstacles emerge form the nature of the whole society in its historical development. Transitional barriers stem from the nature of the recent transformation between two social systems. Systematic obstacles characterise the given social system dominating the concerned state. And state-building and nation-formation issues arise when a new state or a new nation is formed.

In the context of the Western Balkan countries, Demetropoulou (2004:8) notes that countries have to possess a certain degree of political and economic "maturity", i.e.

strong states capable of enforcing the rule of law, a vibrant civil society and a self-sustaining economic and social development. The author argues that taking the Europeanization process of the CEE as an example, the EU-style adaptation could follow only after all the above mentioned was in practice.

2 Five aspects of Europeanization

According to our approach, the process of Europeanization may be caught in several fields of the economy, politics and society. In our study we examine the Europeanization on five particular fields. We give a review on the theoretical background of each field and later on the case studies will detect the realization of the theory in Croatia and Slovakia.

2.1 Exporting democracy

With the end of the Cold War democracy promotion became part of development strategies of global international organizations such as the UN and the World Bank, but also on European level. As Ágh (1999:266) puts it, a new kind of supreme authority through the web of all-European institutions was created, together with a series of all-European arrangements like the Paris Charter.

Regulations like the Paris Charter – vital for democratization – became binding for all European states, including the transition countries of Eastern Europe. Moreover, these regulations became the preconditions for the Europeanization of these countries as during the 1990' they have witnessed the increasing activity of all-European institutions as quasi supreme authorities in the region.

The EU is certainly among the all-European institutions that requires democracy from its members. The EC/EU has been among the first international organizations that included human rights, democracy, and the rule of war into its agreements with third partners (Börzel–Risse 2004:1). However, the Treaty of Rome in 1957 did not contain any reference to democracy and human rights as conditions for entering the European Community; but it stipulated that any European state could apply for membership (Article 237). The Treaty of Rome mentioned democracy promotion only in the EC's external affairs. It was the Copenhagen European Council on 7-8 August 1978 when the "Declaration on Democracy"[10] clarified the meaning of Article 237 and entailed a

[10] EC Bulletin No. 3 (1978), at. 6.

constitutional guarantee of democratic principles and human rights. In 1992 Treaty of Maastricht was the one that included democracy and human rights as constitutive principles of the European Union (Article 6.1), while the Amsterdam Treaty in 1997 incorporated the Copenhagen criteria into the EU's primary law (Börzel–Risse 2004:21). According to the Treaty in effect "any European State which respects the values referred to in Article 2[11] and is committed to promoting them may apply to become a member of the Union" (Article 49).

The evolution of EU democracy promotion programs were not created by a grand design, but it has been an incremental process of "learning by doing." The first policy instruments of *conditionality* were developed in relations with the ACP countries as part of the 1990 Lomé IV agreement. During the early 1990' conditionality was transferred to the Europe Agreements with the Central and Eastern European countries and by the mid-1990' political conditionality became an essential part of the EU democracy promotion strategy (Börzel–Risse 2004:29).

The Copenhagen criteria made it clear, that democracy plays the role of entrance condition to the EU. To put it more precise, democracy is the condition of even the thought of EU membership. Democracy is the entrance condition even to the establishment of institutional ties, such as association, and also to the opening of accession negotiations (Schimmelfennig–Sedelmeier 2004:677). After the accession negotiations have started, the Commission continues to monitor the condition of democracy and a "bad result" implies also the threat of breaking off negotiations.

Both conceptually and practically democratization has been closely connected with the European integration. Democratic transition has coincided with the association to the EU, and not only chronologically. They are rather the two sides of the same coin, that is they are the internal and external dimension of the same process, as Ágh (1999:276) interprets it. The strategies and policies of democracy promotion are similar regarding any type of external connections of EU: accession, association, neighbours or other third world countries. However, the Eastern enlargement has been the EU's most ambitious effort to promote democracy, human rights, and the rule of law in third countries (Börzel–Risse 2004:2-10).

[11] Article 2: The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail. Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union. Official Journal C 115 , 09/05/2008 P. 0001 - 0388

Schimmelfennig and Sedelmeier (2004:677-678) argues that the effectiveness of EU external governance concerning democratic conditionality is highly determined by the initial conditions in the country. In countries that are front-runners in democracy-building, the effect of democratic conditionality is rather small. The authors argue that these countries were already on the way of democratic consolidation when the EU's democratic conditionality was created and thus they most probably would have continued on this path without EU conditionality. In undemocratic countries democratic conditionality was not sufficient for successful rule transfer. The successful rule transfer required prior political change at the domestic level, i.e. that democratic and reform-oriented political forces get into power.

Debate persists on whether the EU was able to influence the electoral defeat of nationalist / authoritarian governments. (Schimmelfennig 2005) argues that the EU's influence is limited to the intergovernmental channel (once favourable governments are in power). On the contrary, Vachudova (2005:98-104) suggests that the EU influenced domestic politics in an indirect way and contributed to the emergence of more competitive political systems in illiberal, autocratic states. The EU empowered liberal political actors when it informed electorates about the implication of their choices for the country's accession prospects. This indirect influence played significant role in forming the nature of the opposition elites.

Following Ágh's argumentation, after the end of the bipolar view the condition of democracy was "in the air" in Europe and not only connected to the EU but also to other European institutions. We may suppose that the transition countries of Eastern Europe could not shake off this all-European effect. That is, they have already responded to the new "time-spirit" when they faced the EU's democratic conditionality.

Referring back to the general theory of Europeanization, in the front-runners of democratization either liberal democracy was the domestic equilibrium and as such the misfit was minor, or the costs of adoption were low. On the contrary in countries with nationalist or authoritarian governments, the misfit was huge and the political costs of complying with the democratization pressure proved to be high because democratic rules would have required giving up the essence of their political power.

The main influence on party formation in Central and Eastern Europe has been the example of the Western European party system. Ágh (2004:1) argues that only those parties have survived that have received an "accreditation" from the West and could fit

into the party-types with an "EU license". The author identifies Europeanization process in "the painful road from politics to policy", which means a shift from ideologically-driven political battles to concrete policy-making.

Malová and Dolný (2008:67-68) argee that in Central Eastern European countries the EU played direct role in promoting democratic institutions and policies that stabilized the horizontal division of powers, rule of law, human and minority rights protection, and also the corresponding behaviour of the elite. At the same time, the authors agree that the approach of the EU has been rapid and technocratic and it has neglected the norms and rules of participatory democracy. The pressure of political accountability towards the EU and other external organizations such as the World Bank or the Council of Europe has also weakened the horizontal accountability towards local electorates.

Ágh (2004:1) distinguishes the stages of democratic transition and consolidation according to those of Europeanization as stages of association and accession. In this context the association period is understood general Europeanization of parties and governments, while the accession period is identified as thorough Europeanization, that is the acceptance of the acquis communautaire. The role of external factors and actors has been overwhelming and domestic actors in Eastern Europe have been weak, their room for manoeuvre has been minimal.

Ágh (1999:269) highlights the importance of making a distinction between the terms of re-democratization and democratization, which refers to basic difference between CEE and the Balkans. Most of the CEE countries had considerable democratic legacy and experience because they have always been in a reiterated cycle of re-democratization. On the contrary, the Balkan states usually had much less democratic legacy and experience and thus they began their serious democratization process only in the early 1990'. In the CEE countries the population with the democratic experience developed an active resistance against state socialism and therefore in the late 1980' they empowered the counter-elites to negotiate a transition. In the Balkans the ruling elites acted first under the pressure of external changes and tried to avoid the spill-over of democratization. The mostly passive and unorganized masses only reacted to the manipulations of the ruling elite.

2.2 Market economy

For a long time (and similar to other Western countries and organizations), the EU did not force democracy, human rights, and the rule of law. Its development policy mainly

focused on economic cooperation. We argue that the expansion of EU's common market is the Europeanization states[12]. This economic aspect of Europeanization is threefold. *From one side* it means that the economic system became "European". At the very beginning of the transition this means that the economic system is restructured according to the standards of European/continental style of capitalism.

Just like democracy, market economy is "default" for all European states. The transition from socialist to capitalist economy has been the fundamental task of the countries in Central and Eastern Europe after the regime changes. Since the transition of the economic systems and the process of European integration have run parallel[13], the two processes became entwined with each other. The economic transformation of Eastern European countries has been governed and supervised by the European Union and thus it became one dimension of Europeanization.

"Functioning market economy" was understood as a matter of fact according to the taste of the EU. The final outcome of the economic transformation was also influenced by other international organizations such as the World Bank or IMF and by globalization itself. The final outcome is called "cocktail capitalism" by Cernat (2006) indicating varied mixture of the external impacts in different countries.

According to Agenda 2000, functioning market economy requires the following conditions: (1) equilibrium between demand and supply is established by the free interplay of market forces; (2) prices, as well as trade, are liberalised; (3) significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent; (4) the legal system, including the regulation of property rights, is in place; (5) laws and contracts can be enforced; (6) macroeconomic stability has been achieved including adequate price stability and sustainable public finances and external accounts; (7) broad consensus about the essentials of economic policy; (8) the financial sector is sufficiently well-developed to channel savings towards productive investments (Commission 1997c:56).

The second aspect is economic integration is that the market of the Eastern European countries "merge" with EU market. The second pillar of the Copenhagen criteria (establishing a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union) relate to both aspects of economic Europeanization. The second part of the economic criterion relate to the market

[12] See the argumentation of Dyson (2000) for the EMU as Europeanization.
[13] See the argumentation above about Europeanization Eastern-style.

integration as it requires the capacity to withstand competitive pressure and market forces within the Union. The key question is whether firms in applicant countries have the necessary capacity to adapt, and whether their environment supports further adaptation to EU circumstances. The elements to be taken into account include: (1) the existence of a functioning market economy, with a sufficient degree of macroeconomic stability for economic agents to make decisions in a climate of stability and predictability; (2) a sufficient amount, at an appropriate cost, of human and physical capital, including infrastructure (energy supply, telecommunication, transport, etc.), education and research, and future developments in this field; (3) the extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aids, support for SMEs, etc.; (4) the degree and the pace of trade integration a country achieves with the Union before enlargement (that applies both to the volume and the nature of goods already traded with member states); (5) the proportion of small firms, partly because small firms tend to benefit more from improved market access, and partly because a dominance of large firms could indicate a greater reluctance to adjust (Commission 1997c:57).

Accession of the new member states implies a move first towards an almost free-trade area (established by the association agreements) and then further towards a customs union. Apart from abolishing bilateral trade barriers, the external tariffs with respect to third countries are set equal to the common external tariff of the EU.

Economic integration means at least three shocks both for the EU and for newcomers: (1) a gradual removal of formal trade barriers in agriculture and food processing and the adoption of the common external tariff, (2) accession to the internal market, and (3) free movement of labour (Lejour et al. 2001). The accession of the countries to the internal market affects the economies of the newcomers and old EU members via trade, FDI, domestic investment, etc. Accession to the internal market may increase trade for at least three reasons. First, a number of administrative barriers to trade are to be eliminated or at least reduced and also costs of passing customs at the frontier are to be reduced: less time delays, less formalities etc. Second, technical barriers to trade are to be reduced with the adoption of mutual recognition of technical standards, minimum requirements and harmonization of rules and regulations. Third, accession to the EU may also decrease the risk and uncertainty towards the countries. These risks include that export credit guarantees are less well developed in the CEE countries and SEE

countries and political risk as democracies are thought to be less stable in these countries ((Lejour et al. 2001:19-28).
We should keep in mind that the market of the EU exists in space (Krugman 1993:2) and it is self-acting for a certain extent. As a consequence, market integration may happen without Europeanization as well as Wolczuk (2004) explains it in case of Ukraine.

The case of the Eastern European applicant was the first time in the history of enlargement policy that democratic and market economy conditions were introduced, although they were implicitly in use before. The newly introduced explicit conditions were inspired by the plan of "large scale" Eastern enlargement and they were designed to minimize the risk that new entrants become politically unstable and economically burdensome for the EU and for the old member states (Grabbe 2002:251).
The two above expounded aspects of Europeanization set very general conditions. The Copenhagen criteria do not define how a market economy or a stable democracy looks like. Are the new member states required to establish German economy, British civil service, Swedish welfare state, and French electoral system? Here one should not forget that the EU itself does not represent a uniform model of democracy or capitalism. Moreover, it has neither made any attempt to define one common model because diversity and respecting difference is considered as a key feature of the EU integration. Beyond the EU diversity itself, one should not forget about the several other external impacts, which are also ingredients of the "cocktail" (cf. Cernat 2007). Grabbe (2002:250) raises the question of how the principle of respecting diversity concerns the applicant countries. As the author argues, it is not self-evident what the minimum standards of political institutions, public administration and economic performance are. Thus what kind of economies and political systems would meet the Copenhagen criteria? Since the current member states have never been judged on the Copenhagen conditions, it is even dubious whether all of them would reach the "ready to join" standards.

2.3 Acquis communautaire

The third Copenhagen criterion is the acceptance of the Community acquis: ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union. Ágh (2004:1) argues that the association period

demands only a general Europeanization of Central and Eastern European governments, while the acceptance of the acquis communautaire during the accession period presupposes a *thorough* Europeanization. However, the legal approximation started well before the Copenhagen criteria were formulated in 1993. Before this event a considerable amount of unilateral adjustment happened in CEE countries (Csaba 2004:338).

Petrov (2007:2-3) describes two dimensions in the application of the acquis. The internal application refers to the present member states, while the external application concerns candidate countries (and other third countries). On the one hand, the aim of the internal acquis dimension is to enable the consistent development of the EU while preserving EC/EU legal heritage. On the other hand, the aim of the external acquis dimension are to achieve specific objectives of the EU external policy towards third countries, and to promote reforms (economic, political and legal) in third countries that are interested in close cooperation with the EU. Petrov (2008) distinguishes two types of acquis–export regarding the external agreements of the EU: fixed and dynamic. The export of the fixed or "pre-signature" acquis means a fixed scope of the acquis communautaire at the point of the formal signature of an agreement. Still, the fixed scope does not exclude further revision. The EU's external agreements, which are targeted at either full membership or an association with the EU (such as Stabilization and Association Agreements or Europe Agreements), prioritize the export of a dynamic or "post-signature" acquis.

The acquis communautaire covers the whole of the legal system of the EU published in the Official Journal: all the treaties about the European Union and the European Community, the whole of the secondary legislation in force, all international treaties signed by the EC, all the judgements of the Court of Justice, and also the soft law. That is why it is hard to define the entire acquis (Kesner-Škreb 2008:405). Petrov (2007:8) – among others – introduces the notion of "accession acquis" that embraces not only the whole acquis communautaire but all that has been accumulated under the three EU pillars, including "the real and potential rights" and the "political objectives of the treaties"[14]. In this sense the "accession acquis" exceeds the scope of the internal dimension of the acquis communautaire in a sense that the fulfilment of the third Copenhagen criterion means not only the implementation of the acquis communautaire,

[14] EC Bulletin Supplement 3/92, at 12. Cited in Petrov (2007:8)

but also the candidate countries' alignment towards present and even future political actions of the EU.

New member states must accept the acquis as a whole. The Agenda 2000 (Commission 1997) argued that the adoption and implementation of the acquis is a difficult challenge for the applicants to meet and it is a far greater challenge than in earlier enlargements. Partly because community legislation has expanded considerably: certain policies which were previously limited today consist of an impressive set of principles and obligations. New obligations have arisen regarding the single market, common foreign and security policy, EMU, and justice and home affairs. There is no possibility for partial adoption of the acquis. According to the European Council "a partial adoption of the acquis without solving the underlying problem, whose solution would merely be postponed, could create new difficulties which would be even more considerable. If one or the other party obtained such an exception, it is clear that this would not be without compensation. Little by little, a process would begin, going beyond the principle that problems of integration can be gradually solved by transformational measures which would considerably dilute the acquis as a whole. In addition, the problem would arise of the institutions' capacity to take decisions on policies which would no longer be common (Commission 1997:60). Beyond the adoption of the acquis the applicant countries' administrative and judicial capacity is of crucial importance. The common legislation is to be transposed into national law, implemented and enforced.

Since the Amsterdam Treaty there is no possibility to gain opt-outs. This means that the new member states have been "forced to become, willy-nilly, 110 per cent Europeans" (Csaba 2009a:179). However, as Petrov (2007:2) highlights the scope of the acquis communautaire is not identical even for all member states.

Thus the "obligations of membership" is open to interpretation. In previous enlargements, these obligations were understood as the implementation of the acquis communautaire (which keeps growing as the Union develops). The acquis is not a static but rather a dynamic concept, because its scope changes with every enlargement. The 1995 accession acquis for Austria, Sweden and Finland was not the same as the 2004 accession acquis for the ten countries of Eastern Europe. For the Eastern enlargement the acquis has been defined more broadly: for example the Commission argued that the social dialogue is part of the acquis, even though every member states accept it (Grabbe 2002:253). As Petrov (2007:10-16) highlights, the scope of the acquis may vary even within the same wave of accession because it reflects the particular candidate country's

"costs and benefits" during of accession negotiations. At the same time, the scope of the accession acquis reflects also the state of a candidate country's bargaining power at the time of accession negotiations. With enough strong bargaining power or with sufficient evidence of its need to protect indispensable national economic and/or social interests, the adoption may be the limited, until it does not undermine the foundations of the acquis. As a result, Petrov (2007:16) argues that no new member state complies fully with the acquis communautaire at the time of its entry.

Beyond the simple adoption, candidate countries are also expected to ensure appropriate administrative and judicial structures in order to enable the effective application of the acquis. The acquis criterion may be fulfilled through the implementation of the acquis in the legal system, and the effective functioning of the administrative and judicial structures. Therefore, the acquis does not cover mere legal rules and practices, but requires that the candidates ensure the proper functioning of their national economic, political and judicial systems as envisaged by the Copenhagen criteria (Petrov 2007:18).

The third Copenhagen condition reflects the anxiety of member states about the possible impact of new entrants on EU institutions and policies concerning the increased diversity, as well as the specific problems that CEE countries entail. Grabbe (2002: 251-252) argues that the acquis adaption is a condition for enlargement, while the first two Copenhagen criteria are conditions for entry. The acquis is also the basis for the chapters on which the applicant countries negotiate with the EU. This dimension of Europeanization is the most measurable one because countries can present how many chapters have been opened and closed.

2.4 Common foreign and security policy

Since the end of the 1980' the EC has formulated a common and consistent policy towards Eastern Europe. The priority was to support the economic and political transformation of the countries and to ensure security. During the Cold War there was a special interconnection between security and economic relations: trade and increased economic contacts were seen as impetus of political and economic liberalization in Eastern Europe. Security was more the table of NATO (Smith 1999:162). At the end of the Cold War there was a wave of optimism about the European Community's ability to become a new and more influential actor in the international arena. What had been a relatively modest attempt to co-ordinate foreign policies of EC member states within the

framework of European Political Cooperation, was aimed to develop into a *common* foreign policy with the Treaty of the European Union (Sjursen 1998).

There was a need to ensure the successful transformation of Eastern Europe in order to ensure security in Europe. Security was understood not only as military security but also the prevention of ethnic conflicts, violation of human rights and economic deprivation. To prevent conflicts, the EC/EU has used its civilian instruments such as trade and aid, often connected to conditions (Smith 1999: 163). The enlargement of the European Union itself is a form of EU foreign policy (Sjursen 1998). The issue of enlargement became the predominant policy of the EU's towards Eastern Europe right after the end of the Cold War. Smith (1999) argues that the common policy with supranational elements was feasible in case of Eastern Europe because of its geographic proximity, the sense of a shared history between Eastern and Western Europe and a belief that the EU has a particular responsibility for events in that part of Europe. The Commission has been involved in formulating this foreign policy to a unique extent. Several times the Commission "upgraded the common interest" and reached solutions that were more than the lowest common denominator of the member states.

Focusing to common foreign and security policy (CFSP) in a narrow sense, according to the Maastricht Treaty "the objectives of the CFSP shall be to safeguard the common values, fundamental interests and independence of the Union; to strengthen the security of the Union and its Member States in all ways; to preserve peace and strengthen international security, in accordance with the principles of the United Nations Charter as well as the principles of the Helsinki Final Act and the objectives of the Paris Charter; to promote international cooperation; to develop and consolidate democracy and the rule of law, and respect for human rights and fundamental freedoms". The CFSP as an external policy is an instrument of exporting values and interests of the EU to third countries. Surely the common foreign and security policy was intended to play active role in influencing security issues in rest of Europe. As a matter of fact CFSP is considered as an instrument of external Europeanization. The enlargement of the EC/EU has been and is a quintessential security policy for two reasons (Missiroli 2003:1). On the one hand, the transfer of EU's norms, rules, opportunities and constraints to the applicant countries makes instability and conflict much less likely in the wider region. On the other hand, the entrants bring in interests and skills that broaden the scope of the common external policies.

On the eve of the Yugoslav war of succession Jacques Poos (foreign minister of Luxembourg) announced grandly that "the hour of Europe has come"[15]. However, the first real test of the common foreign and security policy did not work as it was designed.

2.5 Europeanization in narrow sense: from Europe to Europe?

In the context of Central and Eastern European countries, talking about Europeanization in grammatical or geographical sense is certainly meaningless (Csaba 2005:48). This region is part of *Europe* not only from geographical but also from economic, cultural and historical point of view. In this narrow sense it is also meaningless to talk about the Europeanization of every region of *Europe*. The solution for this contradiction is the definition of Europeanization that was described above. However, Europeanization still has a "soft" meaning when it refers to influence on identity.

Jansen (1999:27-29) argues that even a precise definition cannot dissociate European identity from that of the European Union, even though since its foundation, the European Union has never embraced more than a part of Europe. The author also argues that the historical, cultural, social and political factors of European identity which bind the continent together will certainly become more important with the enlargement of the EU. Jansen (1999) understands the *historical factors* that since the early Middle Ages, all political processes in Europe have been interconnected, Europe as a whole shared history over many centuries. A differentiated but in many respects interconnected and mutually dependent community of destiny was created. Proximity and the shared nature of individual and collective experience have fashioned a special relationship between the peoples of Europe which, whether consciously or unconsciously, has had the effect of forging an identity and has left a deep imprint on Europeans. By *cultural factors* the author means a considerable degree of cultural unity of which diversity has been also a constituent part. This diversity roots in the combination of the Mediterranean Greco-Roman culture and the continental Germanic-Slavonic culture, while the synthesis was powered by Christianity. This European world has never lacked awareness of unity and this awareness has survived even the bloodiest wars waged in the name of national differentiation. *Social factors* mean that along similar pattern of economic development, social life progressed also similar even if typical differences between regions have always existed. Among the significant economic patterns are the large-scale exchange

[15] Europe's Hour: Come and Gone? by Denis MacShane, Newsweek, August 2006

of goods, labour and know-how. The parallel social development in the regions of Europe meant also simultaneous social crisis and radical change and then formation of social groupings and classes. A radical break in this movement occurred only with the division of Europe. Finally the *political factors* are understood as the post-second World War history impelled Europeans to develop a new self-awareness. The European identity expressed in that new self-awareness is characterised by a marked drive for organised action. The European Community as a significant group of democratic states created a model of peaceful cooperation, peaceful change and unity. After the fall of the Berlin wall the transformation of the Eastern European countries was described as "returning to Europe". The ideological, political and economic "return to Europe" meant among others that Eastern European nations return to the big family of (Western) European nations.

As Risse (2001:200) highlights, adaptation pressure has little sense regarding collective identities. The preambles of the EC and EU treaties refer to some kind of European identity but as a matter of fact, there is no contractual obligation to develop such common European identity. At the same time, the values and norm that are also listed in the preamble of EC and EU treaties and in other all-European agreements (see Ágh 1999) connect to or rather are part of the European identity. In this sense European identity has already existed when these treaties referred to it. At the same time the all-European institutions also reinforce and contribute to the development of this common identity.

Risse (2001:200) identifies two developments that might challenge the collective nation-state identities from the side of "Europe". The one is the transnational European discourse and the emergence of a European public space, which became particularly salient during the 1950'. The other is the European integration and the emergence of a European polity.

Individuals and social groups has multiple identities and the thus the question is how much space there is for "Europe" in collective identities. The goodness of fit in this sense is understood as the degree of resonance between ideas about European order and identity and collective nation-state identities. When nation-state identities resonate more with European, it is expected that they faster incorporate understandings of Europe. Beyond the *resonance* hypothesis Risse identifies two other explanatory factors. The political elites in general and party elites continuously pursue instrumental interest

towards identities. That is, they try to promote ideas (including identity) with the aim of gaining power or remaining in power. This is the *interest* hypothesis. The collective nation-state identity became consensual and sticky once it is successfully selected by the political elite. This is the *socialization* hypothesis, according to which collective nation-state identity become taken for granted and do not change frequently once it is internalized (Risse 2001:202-203).

Ruiz Jimenez et al. (2004) present three theories about the emergence of European identity. According to the *cultural* theory the identities are based on ethno-cultural factors generated through a historical process. The *instrumental* theory conceive identity as based on – whether political or economic – self-interested calculation. The *civic* theory understands identities that are based on agreement over rules for peaceful political coexistence and shared cultural norms (Ruiz Jimenez et al. 2004). The authors show that national and European identities are compatible, partly because national identities are more "cultural" and European identities are primarily "instrumental" and partly because they are seen as identities of different level. The authors also found that there is a certain common European "cultural" ground for a European identity and that the development of a European identity does not necessarily imply the transfer of loyalties from national to supranational level.

Hooghe and Marks (2004) argues that national identity can both reinforce and undermine support for European integration. The key factor that distinguishes the two scenarios is the issue of exclusive and inclusive national identity. Citizens who consider their national identity as exclusive (i.e. Hungarian *or* European) are likely to be more Euroskeptical than those who consider their national identity as inclusive (i.e. Hungarian *and* European). Exclusive national identity is mobilized against European integration in countries where the divisions among national elites is sharper on the issue of European integration. The authors argue that national identities are formed early in life but the political implications of national identity emerge from debate and conflict.

3 Costs and benefits of Europeanization

Although our examination is supposed to be free from value judgement, intentionally or unintentionally we suggest that Europeanization is some kind of *desirable* outcome. In the following we try to align facts on both sides.

Europeanization process and EU membership has both cost and benefits without a doubt. Many authors have examined in many papers both sides of the balance. They usually agree on the result: the newcomers benefit from the membership more than they pay as the cost of membership. The experience of previous enlargements (primarily that of the Mediterranean enlargement) also supports this statement.

On the economic side, one of the largest benefits is the easier access to the EU market due to the abolition of trade burdens and the adoption of EU regulations and standards. EU membership makes the countries more attractive in the eyes of the investors that contribute to increasing FDI inflow. The foreign capital is often connected to new technology and know-how transfer.

On the political side, if a country gets into the club, it will be able to take part in its institutions and decision-making processes. The integration also contributes to the improvement of the administration capacity, and to the maintenance of stable democratic order and security (Samardžija et al. 2000:126-128; Grabbe 2001:30-33).

It is very difficult if not possible to separate the costs of transformation from the costs of changes required by the EU since the two processes are interrelated. However, some costs can be identified as a result of fulfilling the EU commitments. Dezséri (1999) distinguishes direct and indirect costs of the accession. The direct costs are to be paid to the common budget by each member state. The indirect costs are adaptation costs. These costs derive from changes in the trade system, harmonization of laws, the adjustment of the administration institutions, technological lag and lack of know-how both in the private and public sector. These costs are covered not only by the national governments but are also supported by the financial and technical aid of the EU.

The above mentioned consists of tangible costs, that can be (even if not simply) counted in terms of money. However, there is another form, more intangible cost of cooperation and integration: social cost.

The cost of integration differs between countries. To refer back to the theory of Europeanization: the bigger the misfit the higher the cost. The costs are even higher when EU requirements threaten the interest of the ruling elite. In case of crony capitalism where the political competition is limited the ruling elite has more opportunity to resist the pressure of change whether it comes from the opposition (if any) or outside of the country. Changes require the strengthening of opposition forces, limiting of rent-seeking opportunities. The “opportunity cost” of illiberal politics is high (Vachudova 2005:75).

When drawing up the balance, one has to compare the cost and the benefits. However, the comparison is not unambiguous. Most of the benefits have dynamic characteristic, i.e. they can be achieved over longer term, while on the short term the static effects tends to cause repercussion first. For example the growing trade deficit in the first years with EU countries, as it was the experience of the CEE countries. Additionally, most of the costs occur also on the short run, caused by the need of restructuring, harmonization of legislation, adoption of EU standards, etc. (Samardžija et al. 2000:126-128).

One may ask why the CEE countries were so ambitious about their future EC membership right after regime changes and in many cases right after their newly gained independence. Gruber (2000:47) argues that even those states that prefer the pre-cooperation status quo will take part in an international organization simply to avoid being left behind. In other words, their main motivation is not to gain something but to minimize the losses. Vachudova (2005:68) highlights that this motivation has been present in case of the CEE countries: the membership offered better prospects, both economic and geopolitical, than being the weak neighbours of the powerful entity. Even if organizations are usually built around the interests of the founders rather than that of the newcomers.

Another important issue is whether the enlargement concerns one or more country. In case of the CEE countries the decision to join or not to join the EU was by no means an individual decision. On the one hand the countries had to consider how their neighbours decide: it was about serious economic and geopolitical consequences. Large part of the cost of staying-out arises from the negative externalities[16] of the fact that the others have joined the club. On the other hand the EU adopted a "group approach" in its enlargement policy: it dealt with the countries in groups instead of individually. Thus the willingness for accession was highly influenced by a sort of herd-effect. Vachudova (2005:71) argues that the CEE countries cannot afford the cost of exclusion.

4 External factors – the comparison of the association agreements

As it was described above, the aim of this study is to examine the interaction between the external impact of the EU and internal factors of particular countries. It is important

[16] See: Mattli (1999).

to examine whether the external factors of Europeanization were different in Croatia and Slovakia. Did the EU "send the same signals" to the two countries? In other words, was the EU-pressure the same in the two cases? It is important to find out because if the two were not the same, we could not expect the same outcome.

The impact of the European Union can be grabbed numerous ways. However, we argue that the elemental attitude of the EU is "summarized" in its contractual relations. That is why we examine and compare the agreements constituted by the European Union towards these countries.

4.1 The two agreements

When Slovakia became the partner of the EU in its own right, it did not follow the path of a "frontrunner Visegrád" country. Still, Slovakia was the subject of Europe Agreements. At the same time, as a consequence of the war Croatia did not participate in the Europe Agreements but became the subject of the next "version" of associations. The Stabilisation and Association Agreements (SAAs) meant a new initiative in the line of association agreements of the EC/EU and were devised for the countries of the Western Balkans in 1999. On the one hand, the SAAs were fashioned after the Europe Agreements in terms of integration and harmonization and they offered the perspective of EU membership to the countries. The EU intended the same purpose for the SAAs as the Europe Agreements: the formal mechanisms and agreed benchmarks which allow the EU to work with each country to bring them closer to the standards which apply in the EU (Gligorov 2004a:4-5). On the other hand, a detailed comparison between the Europe Agreement with Slovakia (EA 1994) and the Stabilisation and Association Agreement with Croatia (SAA 2005) helps to highlight why there was a need to introduce a new version of association agreements. The comparison are based on the framework of Balázs (2002:133-143) who examine seven key elements: free trade of industrial products, agricultural concessions, protection provisions, promotion of economic development, admission of labour force, institutions and the evolution possibilities of the agreement.

4.1.1 Industrial products

In the Europe Agreement with Slovakia the Community and the Slovak Republic gradually establishes a free trade area in a transformational period lasting a maximum of 10 years. Customs duties on imports originating in the Slovak Republic are abolished,

with long list of exceptions. The measures are asymmetric in favour of Slovakia. First, the liberalization steps of Slovakia are delayed by four years in average. Second, the extent of liberalization is also favourable for Slovakia, although the measures only reduce the EC's advantage in foreign trade.

The Croatian SAA stipulates about a free trade area during maximum seven years in an asymmetric way in favour of Croatia. The SAA took over the preferential treatment that was established in a previous Council Regulation (CR 2007/2000) (Christie 2004).

In both cases the textile and steel products are regulated separately from the rest of industrial products: the EU protects its sensitive sectors.

4.1.2 Agricultural concessions

The Europe Agreement with Slovakia states that the Community and Slovakia grant each other concessions on a harmonious and reciprocal basis. The Community abolishes the quantitative restrictions on imports of agricultural products originating in Slovakia according to the Council Regulation (EEC) No 288/82. Imports into Slovakia originating in the Community are free of quantitative restrictions. The timing of the concessions was asymmetric in favour of Slovakia.

According to the SAA with Croatia, both the Community and Croatia abolishes all quantitative restrictions on imports of agricultural products. The tariffs are abolished with certain exceptions on both sides.

4.1.3 Protection provisions

The association agreement with Slovakia contains provisions for dumping, re-export, market disturbances and shortage. Slovakia has the right for exceptional measures of limited duration concerning infant industries and certain sectors undergoing restructuring or facing serious difficulties. The Member States and the Slovak Republic progressively adjust state monopolies within five years, avoid discriminations in procuring and marketing goods.

The SAA contains similar measures regarding dumping, re-export, market disturbances and shortage. The agreement with Croatia establishes shorter deadline (within four years) for adjusting state monopolies.

4.1.4 Promotion of economic development

The preamble of the Europe Agreement with Slovakia refers to the economic and social disparities between the Community and Slovakia. The preamble also declares the readiness of the Community to contribute to the strengthening of the new democratic order and the principles of a free market economy in Slovakia. The agreement contains several field of economic cooperation (Title VI): industry, science and technology, agriculture, energy, environment, transport, telecommunication, banking, regional development, tourism, etc., aiming the establishment of a functioning market economy. In order to achieve the objectives of the agreement, Slovakia benefits from temporary financial assistance from the Community in the form of grants and loans from the PHARE program and the European Investment Bank. The financial assistance is based on conditionality, takes into account the absorption capacity of Slovakia and its ability to repay loans and accomplishment of a market economy system and restructuring.

The preamble of the Stabilization and Association Agreement with Croatia does not mention the economic and social disparities between the parties. At the same time, the preamble declares the readiness of the Community to contribute to the economic reforms in Croatia. The fields of economic cooperation (Title VII) are rather similar than in the Europe Agreements. In order to achieve the objectives of the agreement, Croatia receives financial assistance from the Community in the forms of grants and loans, including loans from the European Investment Bank. Interestingly enough, the financial assistance does not depend on the absorption capacity of Croatia and its ability to repay loans.

4.1.5 Admission of labour force

The Europe Agreement declares that the treatment of workers of Slovak nationality, legally employed in the territory of a member state is free from any discrimination based on nationality, as regards working conditions, remuneration or dismissal, as compared to its own nationals. At the same time Slovakia accords the same treatment to workers who are nationals of a member state and are legally employed in its territory. Both parties facilitate the setting up of operations on their territory by companies and nationals, with timing asymmetry in favour of Slovakia.

The SAA declares similar provisions for prohibition of discrimination based on nationality, as regards working conditions, remuneration or dismissal, on a reciprocal

basis. The conditions are also similar regarding setting up of operations on their territory by companies and nationals, with timing asymmetry in favour of Croatia.

4.1.6 Institutions

The Europe Agreement establishes the Association Council that consists of the members of the Council of the European Communities and members of the European Commission, and of members appointed by the Slovak Government. The decisions of the Council are binding on the Parties. The Association Parliamentary Committee and the Association Committee is also established. The agreement created the framework for political dialogue, intended to be an effective means to accompany and consolidate the rapprochement between the parties.

The institutions established in the Croatian SAA are in parallel with the institutions in the Europe Agreements. Stabilisation and Association Council, the Stabilisation and Association Parliamentary Committee and the Stabilisation and Association Committee work the same way. The political dialogue is also established with bigger emphasis on multilateral framework and regional dialogue including other countries of the region. Regional cooperation is inspired only among the Europe Agreement countries, but it is required among the SAA countries and it become one of the conditions for the further development of bilateral relations with the EU (Anastasakis – Bojicic-Dzelilovic 2002:24).

4.1.7 Evolution possibilities of the agreement

The preamble of the Europe Agreement with Slovakia recognizes the fact that Slovakia's ultimate objective is to accede to the Community. Moreover, the association is to help the Slovak Republic to achieve this objective. However, the Community does not express its will to accept the country as a future member state. The agreement includes a transition period of a maximum 10 years divided into two five-year-long stages. The Association Council proceeds regularly to examine the application of the agreement. The future highly depends on the decisions of the Association Council. The conditions of the possible membership were described separately in the Copenhagen criteria but were not included to the association agreement.

The preamble of the Croatian SAA refers to the strong links between the parties and the values that they share. "Their desire to strengthen those links and establish a close and lasting relationship based on reciprocity and mutual interest, which should allow

Croatia to further strengthen and extend the relations with the Community". The preamble does not refer to Croatia's objective to accede to the EU. The EU expresses its readiness to integrate to the fullest possible extent Croatia into the political and economic mainstream of Europe. The EU recognizes Croatia's status as a potential candidate for EU membership on the basis of the Treaty on European Union and fulfilment of the Copenhagen criteria. The condition of the EU is the successful implementation of the agreement, notably regarding regional cooperation.

Gligorov, Holzner and Landesmann (2003) conclude that the best development instrument that the EU has is integration itself. This requires clear membership prospect. In case of Slovakia and the CEE countries, the membership prospect was not clear in the association agreements but it became tangible after the Essen summit in December 1994.

The SAA recognises Croatia as "potential candidate". However, number of authors[17] blamed this term saying that neither the Stabilisation and Association Agreements, nor the European Partnership outlined clear membership prospect for the Western Balkan countries. At the same time the term "potential candidate" means also that the EU considers the country as a possible future member state and that "the ball is in their court": if they fulfil the conditions, the potential will became real.

4.1.8 Conclusion

To sum up, the comparison of the two types of association agreements show that trade, agriculture and labour market provisions are highly similar. The architecture of institutions is the same. One of the main differences is the post-war *"stabilization" dimension*, which is, as a matter of course, missing from the Europe Agreements. The *context* is another difference. The Europe Agreement with Slovakia was signed in 1993 while the Stabilisation and Association Agreement with Croatia was signed in 2001. During the eight years passed between the two the EU enlargement policy changed as well. The package of conditions concerning Croatia has been more demanding than it was in case of Slovakia and the other CEE countries. First, the later the candidate arrives, the longer the integration agenda is. Second, beyond the Copenhagen criteria and the Stabilisation and Association Agreement there have also been conditions of peace agreements. In other words, beyond the "usual" agenda of economic

[17] See e.g. Gligorov (2004c) and Anastasakis – Bechev (2003).

transformation and political democratization, in Croatia the EU agenda also includes security, post-war reconstruction, border questions and peace-building issues (Anastasakis 2005:84). The SAA with Croatia recognizes Croatia as potential candidate, while the Europe Agreement with Slovakia does not recognizes the country as a possible future member state. However, the Europe Agreement countries later gained the possibility.

The signing dates of the two agreements highlight that Slovakia had contractual relations with the EC from the very beginning. The independent Slovak Republic came into existence by 1993 and in the same year it signed the association agreement that came into force in 1995 (together with the Czech Republic!). Croatia was recognized by the EC in 1991 but it signed the association agreement only ten years later in 2001. Moreover, the agreement finally came into force in 2005. The "nationalist" period passed in Slovakia with an association agreement in the background. At the same time Croatia was disengaged during its "nationalist" period, which indicates larger distance from the EU and from its impact. The association relation was established only after the changes in 2000. In case of Slovakia, the pre-accession process started in December 1999 while in Croatia in June 2004. These details lead on to the responding capacity of the countries, i.e. how the external EU factor realized in each of the countries[18].

We can conclude that the attitude of the EU towards the countries *in effect* was never *the same.* As a matter of fact it, does not purely spring from the EU but it always contains reaction to the countries' acts. However, the *original intend* of the EU can be considered the *same* towards the two countries.

5 Preliminary conclusions and hypotheses

5.1 External and internal factors

The theory of Europeanization suggest that the outcome of Europeanization process is explained by the "concerted action" of the country's own internal factors and the external impact coming from the European entity. When we expect the same outcome in two countries, there are two theoretical possibilities. The one is when the same external impetus reaches the countries that give the same response to the impetus. In this theoretical case the two countries react the same or very similar way. There is another

[18] See section V.

theoretical possibility when the external impetus is different in the two cases and the countries give different response. However, the outcome may be the same or highly similar in the two cases. Although this is a probable scenario, it is very difficult if not impossible to compare these two cases.

The different outcome is possible in two theoretical cases. The one is when two countries respond differently to the same or very similar external impetus. In this case the final outcome depends on the internal respond of the countries. In the other theoretical case the external entity sends different impetus to the two countries. As a result, the countries are unable to respond the same or highly similar way to the different impetus.

This sort review shows that the method of comparison is viable only when the external impetus is the same or highly similar in the two cases. The collapse of socialism and the need for transformation was a common impetus in both countries, just like the pressure towards European integration. The previous section examined the attitude of the EU towards the two countries and concluded that the original intend of the countries has been the same.

These findings make it possible to analogize one country's development with one another since the point of departure in the analysis is the external impetus. Thus according to the theory, the final outcome should depend on the internal response capacity of the countries. We will test this hypothesis in our case studies.

5.2 The size of the misfit

Green Cowles, Caporaso and Risse (2001:222) argue that greater misfit makes Europeanization more likely to occur. The initial misfit of the EU–Croatia relations was far smaller compared to the misfit of the EU–Slovakia relations. According to the theory of Green Cowles et al. (2001) Slovakia should have been a front-runner in Europeanization.

On the contrary, Knill (2001:201-202) argues that adaptation pressure is more likely to induce changes when Europeanization requires minor or incremental changes. Regarding this concept, we should keep in mind that in case of transformation countries, the misfit is huge per definition. At the same time, our preliminary conclusion based on this concept would be that Croatia should have been a front-runner in Europeanization because its misfit was far smaller than in Slovakia.

The two theoretical insights suggest opposite results and do not solve our puzzle. Based on this "failure" of the theory our preliminary conclusion is that even though the size of the misfit is an important dimension, it cannot explain the outcome of the Europeanization process. Further dimensions may be drawn into the examination as well.

5.3 EU membership vs. Europeanization

The geographical proximity and geopolitical reasons make the countries under consideration important for the EU, which considers these countries as its "sphere of operation". There are examples in the European continent that countries stays out of the integration of their own will. All of these countries have their own special circumstances and interests that make non-EU membership more advantageous for them. Nevertheless, non-EU membership does not mean that they stay out from the Europeanization process. The theory Europeanization states that although the European Union has the dominant role, it is not the only organization that determines the phenomenon of Europeanization. In our case study countries (as in the other post-communist countries) Europeanization and EU membership go closely together and non-EU membership means also that they stay out from Europeanization as well. Our hypothesis is that their there is no "alternative way" of Europeanization in case of Croatia and Slovakia.

5.4 Transformation and Europeanization

As the theoretical considerations have showed, transformation and Europeanization intertwine in the Eastern European countries. This is a new phenomena compared to previous enlargements, although the Southern enlargement in the 1980' had similar patterns (i.e. regime changes and consolidation of new order). Even the definition of Europeanization Eastern and Southeaster Europe-style comprises the notion of transformation, although the two concepts in general do not necessarily connect to each other. Slovakia and Croatia tried to separate the two processes when they left the "mainstream" road of transformation and Europeanization. However, our hypothesis is that Slovakia and Croatia are not exceptions from this aspect. We expect that their transformation and Europeanization process determine each other and the success of the one determine the success of the other as well.

5.5 Testing the hypotheses

The next two sections are detailed country-studies. The aims of the country-studies are to introduce the development paths of the two examined countries. The examination involves macroeconomic and political development, structural changes and EU-relations and it is conducted according to the five aspects of Europeanization introduced in Section 2.

After we outline the two development paths, the comparative section highlights the differences of Europeanization dynamics. The comparative section is conducted according to the keywords of Europeanization theory.

III. Transformation and European integration in Croatia

Bićanić and Franičević (2003) identify three phases of the Croatian transformation process. The first phase started with the Yugoslavian transformation in 1988. With the break-up of Yugoslavia, Croatia stepped into the second phase of transformation. This Croato-specific transformation plan had a very important characteristic: to be different from the inherited one. The third phase has begun in 2000 when the decade long domination of the HDZ ended and Croatia stepped onto an internationally accepted path of transformation. The authors describe the process with the three phases as "Croatia's transformation U" with the lowest point at the 1998 bank-crises.

1 The initial conditions: Yugoslavia

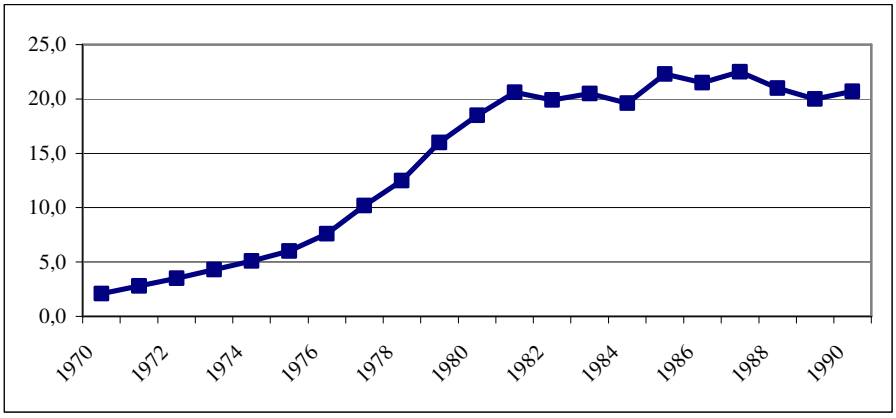
After World War II Yugoslavia was the first country in Eastern Europe that introduced central planning economic system, of its own will. And Yugoslavia was also the first that questioned the system. It did not restore a fully fledged market economy but tried to combine the basic elements of the two systems. The Yugoslavian type of market socialism seemed to be a third-way system between capitalism and the strict Soviet type of central planning. In some fields of the economy, market control gained sphere. At the same time, new socialist elements were introduced already in 1952 (UNECE 1990:261). The Yugoslav model was based on two principles: decentralization and self-governance (Csaba 2007b:315). The decentralization did not only exist in the economic autonomy of the federal republics but on the level of firms as well. Central planning was abolished and workers self-management was introduced. The socially owned companies were governed by the managers and employees.

Mencinger (1991:71) distinguishes four periods of the Yugoslav economic system between 1945 and 1988: administrative socialism (1945-52), administrative market socialism (1953-62), market socialism: (1963-73) and contractual socialism (1974-88). While until 1974 the shift from central planning towards market dominated, from 1974 there was a move from markets towards bureaucracy and bargaining. The latter period started with the constitution of 1974 and the associated labour law in 1976 that institutionalized social ownership. Although the Yugoslav system enjoyed international popularity, the reality was never so positive. Traditional socialist system-elements remained and from time to time re-emerged while the orientation towards market

economy was often hesitant and inconsistent. The Yugoslavian way proved to be successful until the late 1970'. The conceptual and political debates of the 1970' turned Yugoslavia more back to socialist economy and towards a hybrid which was difficult to describe as an economic "system" (UNECE 1990:261). The economic reforms were not followed by democratic development although the political conditions were more favourable than in other socialist countries. With the evolution of economic downturn, the pressure for democratization intensified. The political dominance over economic issues led to soft budged constraints and the existence of unofficial economy. Despite the softening the socialist system, the structure of the economy beard the marks of socialism, the large firms outweighed the small firms, and the economy functioned on a wasteful way. Ironically, by 1985 Yugoslavia's economic system was rather similar to the decentralized planning of Hungary than a market economy. By 1989 similar reforms were placed on agenda as in Central and Eastern Europe (Estrin 1991:188).

The internal problems lead to huge external borrowing (Figure 1) but by 1980 this possibility reached its limits (UNECE 1990:261).

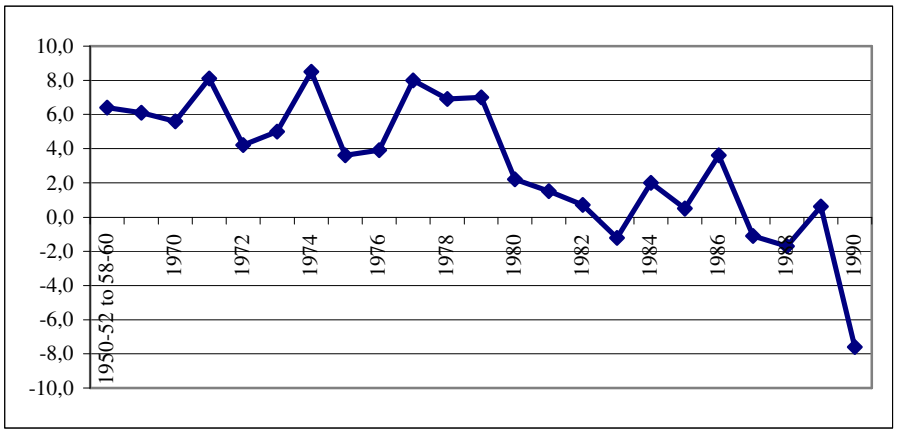
Figure 1: Gross foreign debt in Yugoslavia 1975-1988, in billion USD



Note: Data for 1975-1982 includes IMF funds
Source: UNECE Economic Survey of Europe, various issues

The beginning of the economic downturn coincided also with Tito's death in 1980. The reforms faced huge resistance and were softer compared to the original reforms. Despite foreign loans and policy efforts, growth experienced a slowdown even from the late 1950' (Figure 2). The diminishing growth and the enlarging gap with Western European were visible for the population because of openness and mobility.

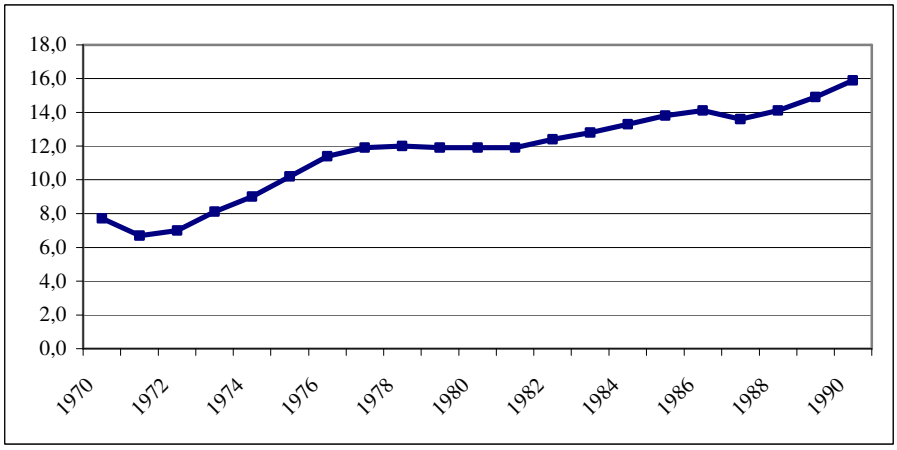
Figure 2: Gross material product in Yugoslavia 1950-1990 (annual % change)



Note: Data for 1950-1969 is based on compound rates of growth.
Source: World Debt Tables, World Bank

Unlike other post-communist countries, open unemployment existed in Yugoslavia during the communist regime and only part of the unemployment was hidden (Figure 3).

Figure 3: Annual unemployment rate in Yugoslavia 1970-1990 (percentage of total labour force)



Source: UNECE Economic Survey of Europe in 1990-1991

The openness of Yugoslavia was twofold. It was relatively open compared to other socialist economies in terms of free movement of persons. The 1965 reforms opened the borders for people and a mass guest-worker migration started to the West. It reached its peak in 1973 when 1.1 million workers were abroad (Table 1). The most people left Croatia. The remittances of the guest-workers were the largest contribution to the invisible account (World Bank 1983:25).

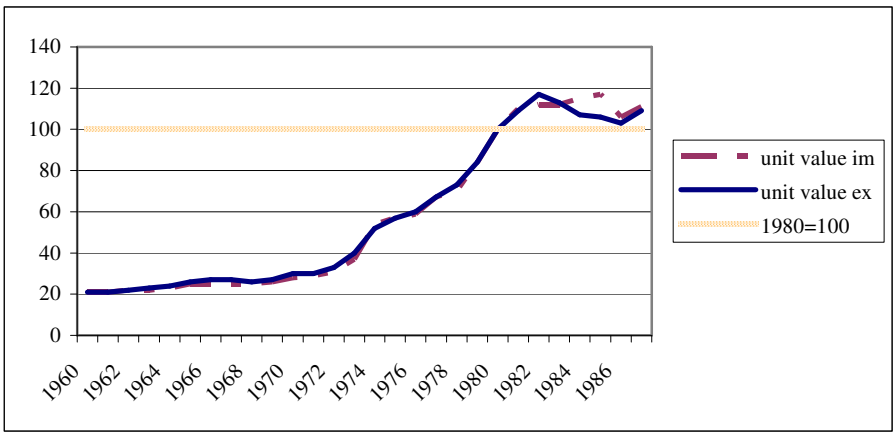
Table 1: Migration and workers' remittances

	1973	1976	1977	1978	1979	1980
net worker migrants (thousands)	1100	870	825	800	790	770
net workers' remittances (in million		1772	1730	2034	2055	1902

Source: World Bank (1983:25-26)

The volume of foreign trade continued to increase between the 1960' and 1980', while with the overall downturn the export performance also deteriorated (Figure 4). Yugoslavia was in a favourable relation with the European Community. As the "shining star" of Eastern Europe (Lindstrom–Razsa 1999:4), it get rid of the "state-trading country" label and enjoyed a "quasi Mediterranean" status (Balázs 2002:183). The contractual relations of Yugoslavia and the European Community date back to 1970 when the non-preferential agreement was signed. In 1976 in a joint agreement Yugoslavia expressed its wish to strengthen its cooperation with the Community. In 1980 the Cooperation Agreement was signed between the parties. The joint EFTA-Yugoslavia Committee was established in 1978, both long before CEE peers.

Figure 4: Unit value index of the Yugoslav foreign trade, 1960-1987



Source: International Trade Statistics Yearbooks, various issues

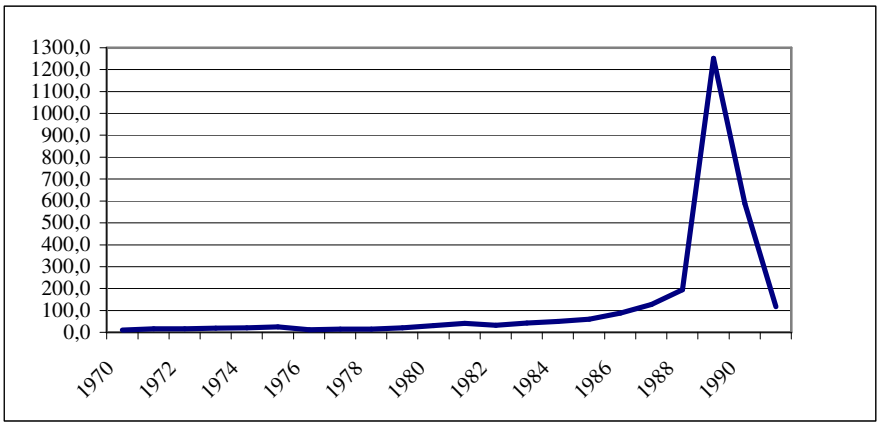
The openness of the economy from other aspects was limited. The average tariff rate was around 15% in 1973-79, the rates varied between 0% and 35%. The use of quantitative restrictions was also widespread. Until the mid-1980' most prices were administratively determined by self-management agreements. The rigid price system was coupled with the high level of protection that lead to substantial distortions in the product market. The Yugoslav dinar was not convertible until December 1989, when a fixed link to the Deutschmark was established. These features burdened the openness of the country and made it close compared to market economies (Yagci–Kamin 1987:9).

By 1988 the collapse of the "contractual socialism" became obvious and structural changes were inevitable. The system was based on ideologically inspired concept of reality and important principles of the economic theory was overlooked. At the end of the 1980' most of previously taboo topics were opened (Mencinger 1991:80). In 1988 the "Program of economic reform" was launched that required the creation of an integral market including product, labour and capital. The constitutional conditions of the reform were created by amendments in the constitution in November 1988. The enterprise act adopted in December 1988 allowed the emergence of legal alternative to social ownership; four types of ownerships were introduced (social, co-operative, mixed and private) and abolished the system of self-management (Estrin 1991:194; Mencinger 1991:81). However, it was a contradictory situation, which required urgent radical changes on the one hand but suffered from lack of support for such changes on the federal level on the other hand. As a result, the federal government resigned in late 1988. The new government was created in spring 1989, led by Ante Marković (UNECE 1990:261).

The continuous macroeconomic instability ended up in hyperinflation in 1989, reaching yearly 1250% (Figure 5) and currency substitution with Deutschmark. The high inflation was a permanent sickness of the federal state, between 1970 and 1988 the average inflation rate was 44%. Contracts were often indexed to the exchange rate of Deutschmark and people kept their savings possibly in foreign currency (Škreb 1995:58).

The last Yugoslav government introduced an austere stabilization plan in January 1990 that built on currency convertibility, wage and partial price freeze and restrictive monetary and fiscal targets. The program successfully reduced inflation from around monthly 60% in December 1989 to one-digit rate in April 1990 but in autumn the inflation was two-digit again and reached a yearly rate of 588%.

Figure 5: Cost of living index in Yugoslavia 1970-1991 (annual percentage change)



Source: UNECE Economic Survey of Europe in 1990-1991 and EUI 1996

The government drew up plans to consolidate and reform the economy. The package was passed by the federal parliament in December 1989 and contained the following: introduction of a fully fledged market economy, establishment of pluralistic forms of ownership, clear identification of ownership rights in the social (public) sector, integration of the Yugoslav economy into the international division of labour, separation of economic management from politics and consistent application of rule of law (UNECE 1990:262). The apparent consensus on the reforms diminished during 1990 when the republics challenged the right of the federal level to exert any macro-economic control. The economic discussion was pushed to the second place behind the dispute over the future constitutional arrangements of the country (UNECE 1991:138). The stabilization program was introduced in 1990 did not have an explicit European dimension and due to this deficiency, only a partial break was made with legacies of the self-management, and the credibility of commitment towards European model was very low (Bićanić–Franičević 2003:6).

1.1 The dissolution – in practice

Contrary to Slovenia, which was rather geographically insulated in Yugoslavia, Croatia experienced more the potential of centralization intentions from Belgrade. Croatia and Slovenia were allies in the centralist–decentralist debate (Lane 2004:169-170). In 1971, known as the Croatian Spring, the Croatian communist leadership claimed greater autonomy within a confederal Yugoslavia. After some hesitation, Tito decided to dismiss and replace the whole leadership because he was afraid that the relatively moderate communist nationalists would be replaced by pure nationalists who would question communism (EUI 1996:27). However, the new constitution in 1974 increased

the autonomy of the republics. During the 1980' Croatia was characterized by silence, they gave the way to the Slovenes in challenging the Belgrade policies. Defining the republic's interest was not an unambiguous issue in Croatia. Beside the old-fashioned communists, liberal and nationalist elements existed as well (Lane 2004:169-170). Partly inspired by multiparty developments in Slovenia, new political parties were created in 1989, representing these different political views. f

Yugoslavia effectively ended with the Fourteenth Extraordinary Congress of the League of Communist of Yugoslavia on 20-22 January 1990. The Serbian delegates were in favour of recentralization while the Slovenian delegates wished to speed up the democratization and decentralization process. The dispute finished when the Slovenian and Croatian delegates left the congress (Ádám 2000:17). The break-up of the League of Communist of Yugoslavia was followed by the first multiparty elections, in April 1990. The Hrvatska Demokratska Zajednica (Croatian Democratic Union, HDZ) won with 42% of the votes and attained the vast majority of seats in the Croatian parliament, called Sabor. As a result, *communism was defeated* by a peaceful multiparty election. The new Croatian leaders called for a new constitution which would have created a confederation of independent states. This idea was vetoed by Slobodan Milošević Serbian President who had opposite ambitions, i.e. to recentralize power in Belgrade (Bartlett 2003:36).

After the first multiparty elections the new Sabor held its first meeting in May 1990. Franjo Tudjman was elected as the president of Croatia and Stjepan Mesić as prime minister. Franjo Tudjman used to be a Partisan and was retired from the army as a major general. He drafted a nationalist view of Croatia that was counter to Serbia (Lane 2004:170). The new Sabor adopted a new constitution in December, which declared Croatia as a homeland of the Croatian nation, proclaimed the sovereignty of the republic and its right to leave the federation (Bartlett 2003:36). The session of the parliament, which introduced the new constitution, was boycotted by Serbian deputies. Although Tudjman had an ultimate goal of establishing the independent Croatia, he kept open the possibility of a renewed Yugoslav community. But once Slovenia decided to leave Yugoslavia, Croatia followed it, for tactical reason i.e., if a trouble broke up, two republics would be better equipped to handle it (Glenny 1993:87).

The HDZ government raised the emphasis of the Croatian nationalist symbology. The new citizenship law gave the right to ethnic Croats living abroad to apply for Croatian

citizenship[19]. The statue of Ban Josip Jelačić, the symbol of independent Croatia was returned to the main square of Zagreb. These steps caused dismay among the Serb population in Croatia, who became a national minority from being previously a constituent nation (Bartlett 2003:36-37).

At the same time, the party of the Krajina Serb elite, the Serbian Democratic Party (SDS) was formed in spring 1990. The party leader was in favour of the autonomy of the Serbian districts of Croatia and this idea was supported by Slobodan Milošević as well. In August the Autonomous Province of Serb Krajina was declared following an unofficial referendum. The rebellion spread to Serb populated parts of Slavonia as well. The Serbian idea was to cut off the Serb populated area of Croatia (Bartlett 2003:35-38).

Simultaneously, Tudjman and Milošević had plans about the territorial division and population transfer of Bosnia and Herzegovina, the republic with a delicate balance of three nations, Muslims (44%), Serbs (31%) and Croats (17%) (Woodward 1995:172).

In May 1991 the referendum on Croatia's independence was held. With a turnout of 84%, the 93% of the voters were in favour of an independent country. The independence of the Republic of Croatia was declared on 25 June, at the same time with Slovenia.

The common talk and number of authors discussed the responsibility of the international community regarding the dissolution of Yugoslavia. Klemenčič (2006) gives a realistic summary when he writes "it is unlikely that any policy by the international community could have kept Yugoslavia in one piece. Nevertheless, it is possible that the dissolution process might have been more peaceful if the superpowers had acted differently and if they were less ignorant".

1.2 The dissolution – in theory

One of the reasons of the creation of Yugoslavia was the unification of the South Slavic peoples into a single state in order to defend themselves against their larger neighbours and to ensure their economic progress. The similarity of their language served as a basis for the unified state but the different culture often caused conflicts as well. Despite the similarity, South Slavic peoples were and are ethnically and religiously mixed.

[19] At the same time non-ethnic Croats who wanted to apply for citizenship or prove their citizenship had to be resident in Croatia for five years and be proficient in Croatian language. This rule caused difficulties later when Serbian refugees returned back to Croatia.

Moreover, differences appeared in the political concept of Yugoslavia as well. On the one hand, leaders of Serbia were in favour of a more politically unified state with a strong central government. On the other hand, leaders of Slovenia and Croatia preferred larger national freedom (Radelić 2007:13). All in all, Yugoslavia was a highly heterogeneous federal state with significant differences: two alphabets, three religions, four languages and six rivalrous republics (Lipton–Sachs 1989). In economical, political and sociological terms there was a huge gap between the Western and the Eastern part of the country. Because of its Habsburg legacy, geopolitical proximity, strong export production and tourist industries, Croatia (together with Slovenia) has been much more integrated into Western European networks than other Yugoslavian republics, whose cultural and historical heritage has been more connected to the Balkans.

The dissolution of Yugoslavia was a complex process and there is no single explanation for it. Thereinafter we highlight the main arguments in the plentiful literature.

Without a doubt, there were *economic* reasons. First, the regional disparities were huge in Yugoslavia (Table 2); the income of the most developed Slovenia was almost 8 times as much as in the least developed Kosovo in 1989. Despite the large transfers from the richer to the poorer regions, the differences remained roughly stable between 1952 and 1989, with the exception of Kosovo where the difference even doubled. The regionalization of Yugoslavia contributed to the subsistence of such large differences. The capital, labour and foreign exchange mobility among the regions was very limited because firms were regionally based, and they preferred to establish vertically integrated production units within their own regions. As a result, the spread of technical and managerial skills was hindered and specialization and the division of labour were constrained. It severely affected the overall efficiency and productivity of the economy and produced large interregional differences in productivity and income (Yagci–Kamin 1987:9).

Table 2: Gross Social Product per capita in Yugoslavia[20] 1952-1989, Slovenia=100

	1952	1965	1974	1980	1989
Slovenia	100.0	100.0	100.0	100.0	100.0
Croatia	66.7	65.8	62.5	64.1	64.1
Vojvodina	49.1	60.9	58.0	57.1	59.6
Serbia excl. Vojvodina and Kosovo	56.7	52.2	48.0	49.5	52.0
Serbia incl. Vojvodina and Kosovo	51.5	50.0	45.0	45.5	46.0
Montenegro	48.5	41.3	34.0	36.9	36.9
Bosnia and Herzegovina	52.6	39.1	33.0	33.3	34.3
Macedonia	39.2	36.4	34.0	33.8	33.3
Kosovo	25.7	19.6	16.0	14.1	12.6

Source: Gligorov 2004b:84

The second part of the explanation argues that there were very different approaches in Yugoslavia towards transformation and integration into the world economy and particularly to the EU. The more developed regions were expecting to gain more benefits from openness and integration than the less developed ones (Gligorov 2004b.83-85)

The *historical and political* processes that lead to dissolution of federal states may prevail economic processes (Csaba 2007b:42). In case of Yugoslavia, economic reasons were not among the most important ones either that led to the dissolution (Gligorov 2004b:83; Radelić 2007:23). Gligorov (1994:7-8) states that the dissolution did not happen because Yugoslavia was an inferior economic arrangement, rather because it was the "only way to settle the accumulated political accounts". The primary political motive was a strong sense of injustice that originated from the insecurity around people's individual and collective identities.

There were several political and cultural reasons. The one is the thesis of "ancient hatreds" between Croats and Serbs, which made Yugoslavia unviable. Therewith the existence of the Serbo-Croat struggle, this theory is already discredited (Lane 2004:3-5). Gligorov (1994:7) also argues that the dissolution "is not a typical Balkan crisis" and the armed conflict is "not a Balkan war", as Glenny (1993) labels it. In 1994 Gligorov saw it as it was not about the unfinished business of the two previous Balkan wars but the consequence of unsettled accounts from the two world wars.

The other theory focuses on the cultural roots of the dispute and the lack of a single culturally defined entity. Yugoslavia was a compromise of various international interests. The history of the communist Yugoslavianism was a combination of, on the

[20] Gross social product (also known as Material Product): gross national product of a centrally planned socialist economy (Routledge dictionary of economics)

one hand the principled recognition of differences and on the other hand the suppression of those differences in the political practice. The suppression of these differences caused resistance and the efforts taken to assure the survival of the state had very often the opposite effect (Radelić 2007:23). As Radelić (2007:23) argues, the main cause of Yugoslavia's disintegration was the simple fact that each of the nations aspired to be sovereign within a fully independent state.

The internal problems experienced by Yugoslavia were compounded by dramatic changes in its international environment. The Cold War came to an end and thus Yugoslavia's special *third-way position also became meaningless*. It was no longer an important buffer between the Soviet Union and Western Europe. As a consequence, in 1989 the United States skipped Yugoslavia from the group of countries eligible for Western credits (Bissett 1999). Lane (2004:3-5) notes that the dissolution of Yugoslavia happened in line with end of the Cold War and argues that the political system of the federal state was incapable for producing a new generation of leaders who carry its project beyond the communism. The constituent part of Yugoslavia recognized the need of internal restructuring but none of them had the power to coerce the others to cooperate. At the same time, the international community did not provide the necessary power until the dissolution was inevitable (Lane 2004:172). Juhász (1999:187-188) highlights that the end of the bipolar world made the Yugoslavian non-aligned strategy meaningless. It meant the loss of common power that connected the republics together and the loss of Yugoslavia's successful external role.

The convoy effect i.e., when the slowest member of the convoy determines the speed of the whole convoy was apparent in Yugoslavia. After the split of the convoy, the Yugoslav succession states stepped on very different transformation paths (Bićanić 1994:19-20). Gligorov (1994:8, 2004d:83) argues that the break-up of Yugoslavia was not random and irrational, but a rational choice of the participants, even if it has had disastrous consequences.

2 The „nationalist" period of economic transformation and European integration – the Tudjman regime

2.1 Building market economy

In 1989 Croatia was the second most developed republic of Yugoslavia and when it became independent, it was one of the most developed transformation economies, particularly among Southeastern European countries. It began its transformation as a relatively industrialized and open country. The openness was not only significant in terms of trade, but also because of the large tourist sector and the notable size of Croatian diaspora who worked in the West as guest-workers[21]. The relative liberalization and prosperity and the freedom to travel and work abroad made peer countries envy. The share of the tertiary sector was relatively high undoubtedly due to the tourism sector that also profited from the relative openness of the borders. In the late 1980' Croatia had every chance to shift from a middle-income country to a developed one (Bićanić 2001:158-159; Bartlett 2003: 28-29).

In spite of the macroeconomic imbalances outlined above, at the time of the regime changes in Eastern Europe, Yugoslavia *was better positioned* to make a successful economic and political transformation than most of the peer countries in the region (Woodward 1995:1). It is a telling fact enough that UNECE classified Yugoslavia among "Western Europe and North America" instead of "Eastern Europe and Soviet Union" in its Economic Survey of Europe until 1993, although Yugoslavia was a planned economy, even if not a classical central planned one.

As noted before, the transformation of Croatia did not begin in 1991 when it became independent but well before, during the Yugoslav times. Therefore Croatia has *inherited the Yugoslav path* of transformation.

Although the establishment of the independent statehood was not reached peacefully, the creation of the individual Croatian economy was smooth and its costs were low. Due to the federal structure of Yugoslavia, the republics enjoyed high level of independence regarding their economic policy. With the dissolution of the federal state, Croatia quitted form the convoy of Yugoslavia and got the opportunity to shape its own transformation policy and concentrate on specific Croatian problems. The decision-

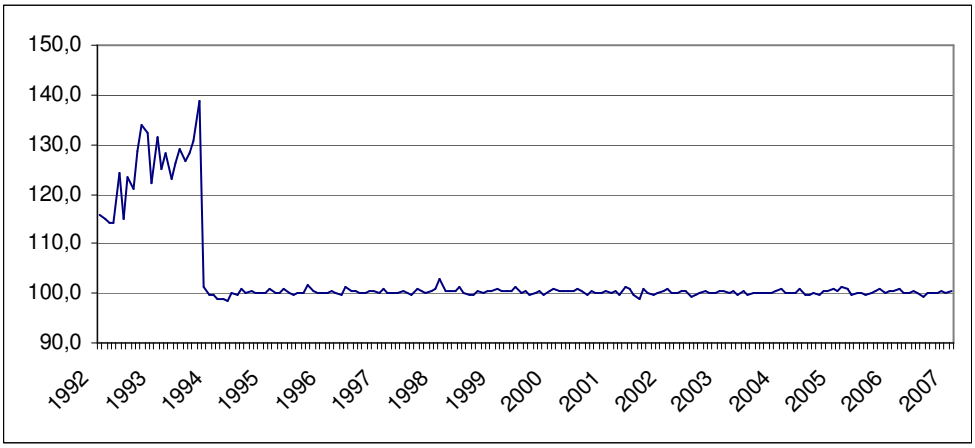
[21] After the 1965 reforms until the oil crisis in 1974 almost half a million guest-workers left Croatia mainly to Germany, Austria and Switzerland to exploit the economic boom in these countries.

making simplified due to the independence because there was no need for extensive negotiations and compromises with other republics (Bićanić 1994:19-20). With the independence of the country, the Croato-specific transformation plan had a very important characteristic: to be different from the inherited one (Bićanić–Franičević 2003:10).

At the time when Croatia gained independence, its economy (and the whole Yugoslavian economy) was in a middle of recession. As outlined before, the Yugoslav economy experienced severe problems since the 1970' that manifested in growing external debt, accelerating inflation, stagnating or even decreasing output and increasing unemployment. The war in 1991 led to acceleration of prices again (EUI 1996:40). Although in December 1991 the temporary Croatian currency, the Croatian dinar was introduced, price increase continued to accelerate. The consumer prices increased in 1992 by 1038% and in 1993 by 1249%.

The stabilization steps proved to be very successful, retail price inflation decreased from a monthly rate of 38.7% to 1.4% in November, i.e. in the next month, and it was even negative (-0.5) in December. The low inflation proved to be *sustainable* (Figure 6). The World Bank labelled the stabilization program as one of the most successful in the region (World Bank 1997:1). In answering the question of why was the program successful, Škreb (1998:73) highlights that the initial conditions were so bad that hardly anything could have worsened it. At the same time, the program included a good mix of monetary and fiscal policy, and enjoyed strong political and popular support that made both the government and the HNB enable to implement it. Kraft (1995:483) argues that the reason of success is rather administrative than market measures. The significant ownership share of the Croatian state meant also that it was possible to dictate pricing behaviour to large state-owned firms and to give large impetus to anti-inflation policy.

Figure 6: Consumer price indices in Croatia 1992-2007, Monthly chain indices, previous month=100



Source: HNB

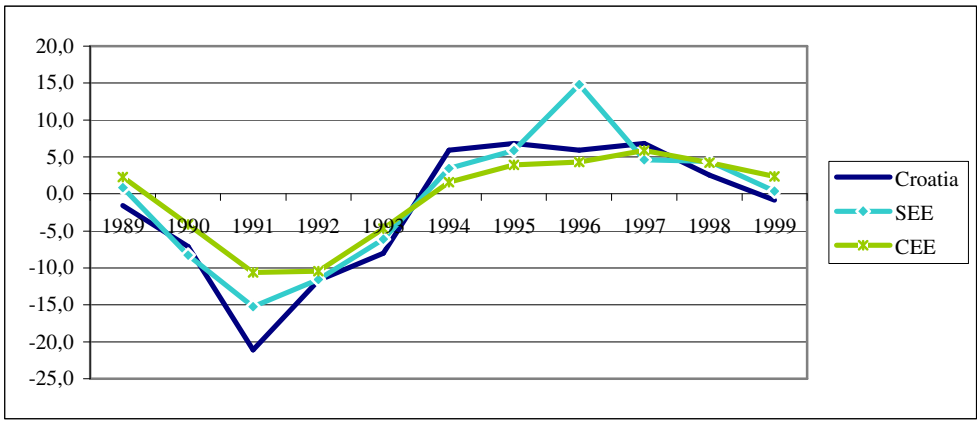
2.1.1 Macroeconomic development during the "nationalist" period [22]

The *GDP per capita* in 1990 in Croatia was around the average of the Central and Eastern European (CEE) countries. However, the decline of the GDP of the early 1990' was deeper in Croatia than that of the CEE or Southeastern European (SEE) countries (Figure 7). The transformational recession (cf. Kornai 1993) of Croatia was exacerbated by the break-up of the Yugoslav market and by the Yugoslav war. In 1991, partly due to the explosion of the war, the GDP fell with 21.1% and by 1994 it reduced to two-third of the pre-war level. However, the magnitude of fall in the GDP per capita was in line with the CEE average (Figure 8). The cost of the dissolution was less severe than in the CIS region.

As a result of the macro-stabilization programs, the negative growth of the GDP stopped and it turned into a positive trend. The post-war reconstruction activity, among others housing and infrastructure spending, provided another important impetus to growth. Consumer spending and private-sector investment, both of which were postponed during the war, also contributed to the growth in 1995-97. However, the consumer boom was disrupted when the economy went into recession in mid-1998. The reason of the downturn was the 1998-1999 bank crises, during which 14 banks went bankrupt[23].

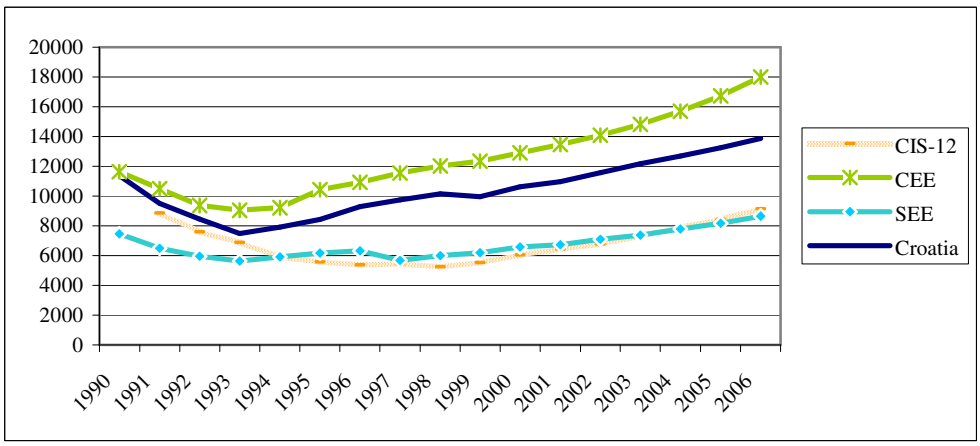
[22] This section is based on EUI country profiles about Croatia, if not otherwise noted.
[23] We will expound the financial crisis in the next section.

Figure 7: GDP year-on-year rate of growth in real terms in Croatia, 1989-1999



Note: In 1996 and 1997 Bosnia and Herzegovina experienced an extraordinary growth rate (86% and 37% respectively) that increases the SEE average as well.
Source: EBRD Economic statistics & forecasts

Figure 8: GDP per capita, in international comparable prices by expenditure, at prices and PPPs of 2005 in USD



Source: UNECE statistical database

Concerning the *structure of the economy*, the share of the tertiary sector has been relatively high since the beginning of the 1990', undoubtedly due to the tourism sector. The structural problems and the lack of competitiveness of many export sectors, which were common among the transformation economies, were exacerbareted by the disruption caused by the war and the loss of much of the Yugoslav market. (EUI 2000:20). During the war heavy industries such as shipbuilding and metal products were regarded as strategic important and thus were kept afloat by the government with generous subsidies. The importance of shipbuilding continued after the war. Its output

rose by 20.6% year on year in 1998 and by 12.6% in 1999. Shipbuilding exports reached 782 million in 1998, making shipbuilding the largest single export sector[24].

As mentioned before, open *unemployment* already existed in Yugoslavia. That is why the initial transformation effect on the unemployment rate in Croatia was smaller than in other countries. At the same time, the war made the transformation recession deeper that was reflected in the labour market as well. The consistently high unemployment rate was partly a consequence of the insufficient FDI inflow but also the legacy of the Yugoslav self-management system and thus the insider capitalism (Soós 1986).

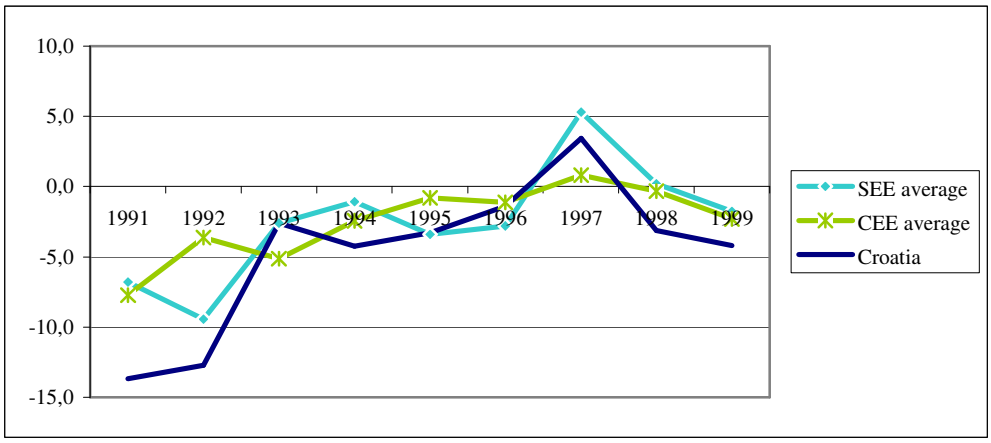
In the Croatian case the data available is highly contradictory. The administrative rate of unemployment was significantly higher than that of based on ILO survey[25]. If we consider the administrative rate, the rate of unemployment belonged to the higher group. On the contrary, considering the ILO rates (Figure 10), the Croatian unemployment was well below the SEE average and between 1995 and 1999 in line with the CEE average. The Croatian difference between the two types of rates is among the highest in the region, which indicates the existence of a moderately large informal sector (Cazes et al. 2006:14). On the contrary, according to Luo (2007:4) the administrative data may overestimate the actual magnitude of the unemployment rate.

The overall employment fell dramatically in 1991-1992, partly due to the war-related loss of population (Figure 9). From 1993 change in employment converged to with the peer countries average and until 1997 the change in employment was negative, in line with the peer countries average. The labour productivity per person employed in Croatia was in line with that of the CEE countries.

[24] Although the sector has been major earner of foreign exchange through exports, it also has high import content, accounting for about 80% of the total value, that made net exports are far less than gross export figures suggest.

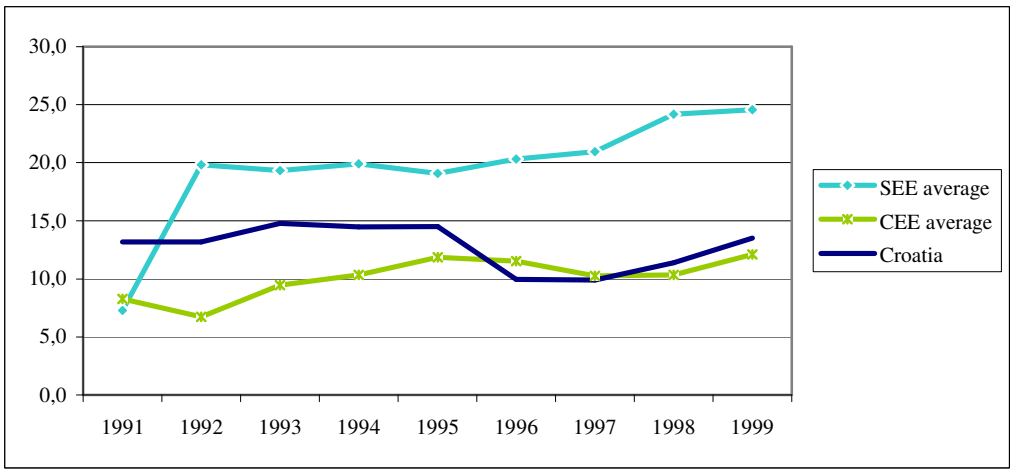
25 A further specific feature of the Croatian labour market was that one-third of the country was effectively under occupation until 1995, which made the collection of labour market statistics more difficult (Šonje–Vujčić 1999:28-29).

Figure 9: Percentage change in employment (end-year) in Croatia, 1991-1999



Source: EBRD Economic statistics & forecasts, data based on labour force surveys (LFS)

Figure 10: Unemployment (end-year) in Croatia, in per cent of labour force, 1991-1999



Source: EBRD Economic statistics & forecasts, data based on labour force surveys (LFS)

With the dissolution of Yugoslavia, the inland *trade* with the former federal republics became foreign trade that, by definition, made the Croatian economy more open. When declaring its independence in 1991, Croatia's imports of goods and services in percent of GDP ratio was 86% i.e. at was much more open than former Yugoslavia ever was (Vujčić–Šošić 2004:7). However, the economy of Croatia was rather closed during the 1990'. By 1994 the openness ratio declined to 46% and it stayed between 49 and 57% during the decade.

The war disrupted the trade links with the Eastern parts of the former Yugoslavia and as a result, the Croatian export focused more towards the EU. The share of the EU decreased slightly in the post-war years (Table 3). Whereas the CEE peer countries had association agreements with the EU, which gave them tariff-free access to EU markets, it was missing in case of Croatia. Among EU countries Germany, Italy and Austria were

the main trade partners of the country while Slovenia and Bosnia and Herzegovina among the former Yugoslav republics.

Most non-tariff barriers were removed in 1996. The growth of import was stronger during the 1990' than the export growth, leading to near tripling of the trade deficit. The the post-war GDP recovery was based on an expansion in domestic demand (Šonje–Vujčić 1999:25). The export underperformed; its growth rate was much under the CEE average.

Table 3: Trade by main export partners 1994-1999

	1994	1995	1996	1997	1998	1999
Exports	100%	100%	100%	100%	100%	100%
EU	59%	58%	51%	51%	48%	49%
Italy			21%	21%	18%	18%
Germany			19%	18%	17%	16%
FYR	23%	23%	27%			
Slovenia	13%	13%	14%	12%	10%	11%
BiH	8%	8%	12%	15%	14%	13%
Imports	100%	100%	100%	100%	100%	100%
EU	59%	62%	59%	60%	59%	57%
Germany			18%	20%	19%	19%
Italy			21%	19%	18%	16%
FYR	11%	11%	11%			
Slovenia	10%	11%	10%	8%	9%	8%

Source: EUI Country Profiles

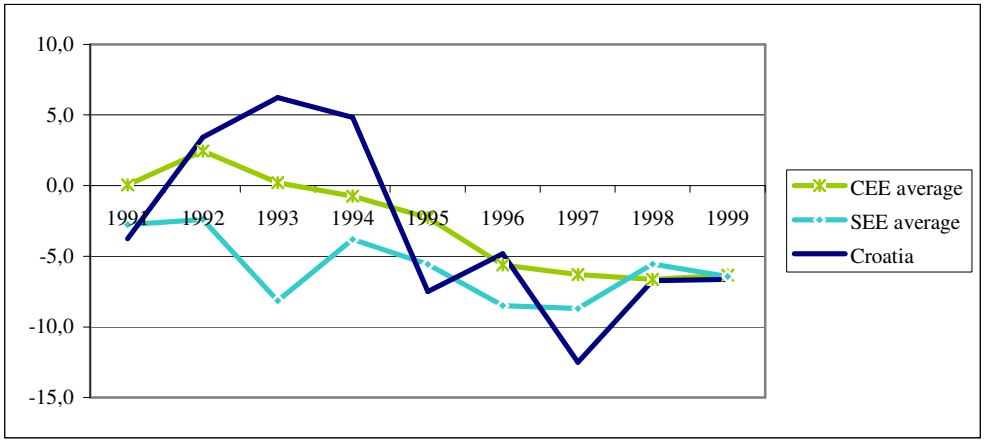
Traditionally Croatia always had trade deficit that was compensated by the strong surplus of tourism and remittances. However, tourism is highly sensitive to bad news and the armed conflict in 1991 virtually eliminated tourism incomes. The *current account* balance was positive during 1992-94 due to some recovery in tourism and to the depressed shape of the economy that kept the imports on low level. In 1995 the current account deficit reached 7.5% of GDP (Figure 11) as a result of the huge trade deficit that was not compensated by the tourist earnings due to the repeated armed conflict. The tourism industry recovered further in 1996 and 1997 but was still far from the pre-war level and it could only narrow but not eliminate the current-account deficit. In 1999 the tourism incomes were disturbed again by the Kosovo conflict, but the current account balance stayed at the level of the peer countries average.

Table 4: Current account balance in Croatia 1991-1999, in million USD

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Merchandise exports fob	3292	na	3903	4260	4633	4512	4206	4605	4372
Merchandise imports cif	-3828	na	-4666	-5229	-7510	-7009	-9430	-8774	-7674
Trade balance	-536	-303	-763	-969	-2877	-2497	-5224	-4169	-3302
Service balance	37	364	632	738	612	312	2022	2072	1626
Net private transfers	-7	391	126	224	366				
Current account balance	-589	329	104	103	-1712	-1452	-2434	-1554	-1537

Note: Data for 1991 and 1992 excludes trade with former Yugoslav republics
Source: EUI Country profiles

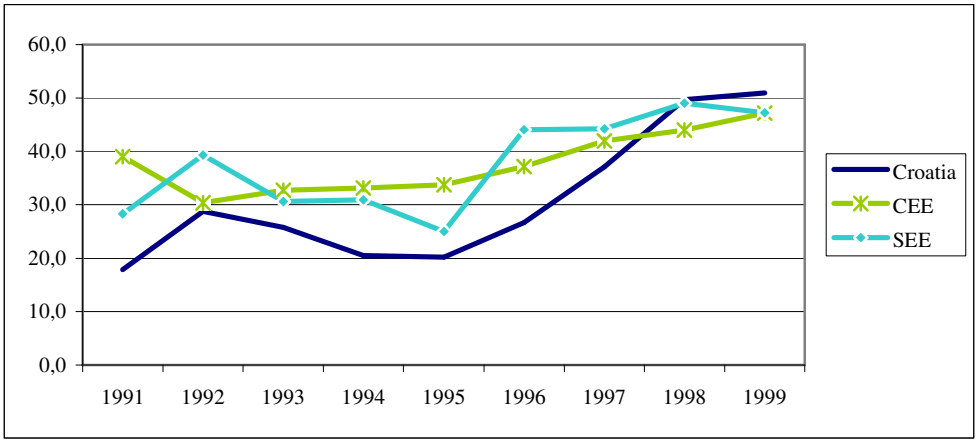
Figure 11: Current account in % of GDP in Croatia, 1991-1999



Source: EBRD Selected economic indicators

Throughout the 1970' Yugoslavia (as other countries) had borrowed heavily from the IMF and commercial banks. However, Croatia began its individual statehood with relative low amount of *external debt* stock because the Yugoslav debt was not shared at the beginning. The volume of the debt increased slightly until 1995 but in the second half of the 1990' its yearly growth rate was about 40%. In March 1995 Croatia agreed with the Paris Club of creditor governments about the schedule of the debt redemption and Croatia took 28.5% of the former Yugoslavia's previously non-allocated debt over 14 years. In July 1996 an agreement was reached with the London Club of commercial creditors as well, assuming responsibility for 29.5% of the former Yugoslavia's previously non-allocated debt to commercial banks. In 1997 around 60% of Croatia's external debt was inherited from the former Yugoslav government, either directly or due to the Paris and London Club agreement (Škreb 1998:72). With the end of the war the international markets were ready to borrow again to Croatia. Both Croatian banks and corporations and the Croatian government borrowed substantial amount during 1996-1999. Concerning the external debt per GDP ratio, Croatia reached 50% in 1999 and exceeded the level of the peer county averages (Figure 12).

Figure 12: External debt in Croatia, as % of GDP, 1991-1999



Source: EBRD Selected economic indicators

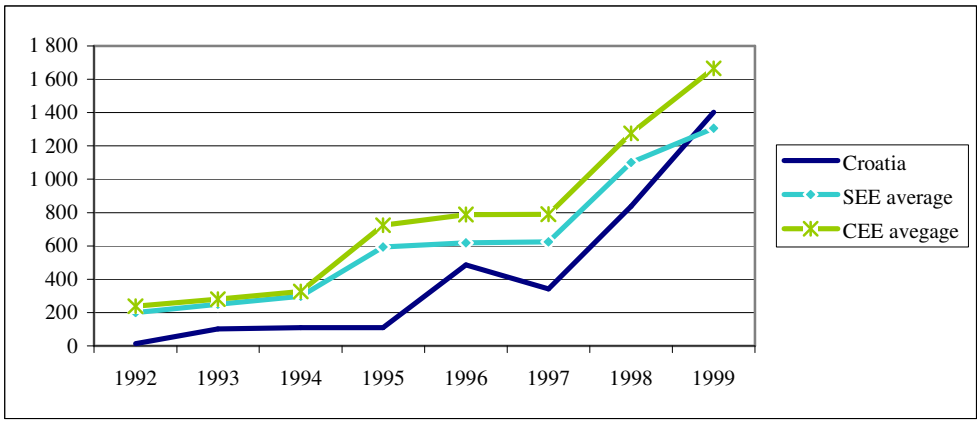
The amount of net *foreign direct investments* into Croatia remained low during the first half of the 1990', mainly due to the war. In the mid-1990' the country's current-account deficits was mainly covered by external borrowing, whereas FDI inflows were weak. After the war, in the second half of the 1990' a substantial increase in annual FDI flows took place peaking in 1999, when the government sold its 35% stake of the public fixed-line telecommunications operator, Hrvatski Telekom (HT) to Deutsche Telekom (Figure 13). However, the FDI per capita stayed significantly below the CEE average during the Tudjman regime, albeit it exceeded the average of Romania and Bulgaria. Although the war was over, the legacy of the Yugoslav self-management model and the economic nationalism in the country made the investors cautious. Foreign investors were deterred by non-transparent relationship between HDZ party and favoured businesspersons. There were many incidents reported by foreign investors that they had been defrauded by local partners (EBRD 2000:151).

The low level of FDI was interconnected with the underperformance of the export. The lack of trade associations with EU and CEFTA, i.e. less advantageous trade relations with the European market made Croatia less attractive in the eyes of foreign investors. As a result, the FDI's positive impact on export performance was also missing (Šonje–Vujčić 1999:27). Many Croatian companies that were internationally competitive in the early 1990' have lost their markets, because firms from other transformation countries have restructured faster, often with the contribution of foreign investors.

The largest investor countries were Germany, Austria and the USA between 1993 and 1999. Germany became one of the biggest investor when the Deutsche Telekom bought

35% of the Hrvatski Telekom in 1999 (Table 5). However, this large investor did not contributed to export growth.

Figure 13: Net foreign direct investment in Croatia, in millions of USD, 1992-1999



Source: EBRD Economic statistics & forecasts

Table 5: FDI in Croatia by country of origin, 1993-1999, in million EUR and USD

	1993	1994	1995	1996	1997	1998	1999
Germany	39.7	6.9	14.2	2.0	-54.8	53.8	880.2
USA	3.9	2.4	-10.4	222.9	86.2	469.1	132.6
Austria	8.5	38.6	6.0	45.6	249.6	198.1	163.7
Netherlands	3.7	13.4	0.2	8.1	17.4	86.4	60.2
Slovenia	5.6	0.2	2.5	3.9	21.0	29.0	24.3
United Kingdom	0.6	0.5	4.3	0.1	50.1	3.5	20.5
Italy	9.7	2.8	2.8	7.6	9.0	1.3	33.4
Sweden	0.4	0.0	25.8	5.9	5.9	16.8	4.7
EU-15	69.6	64.9	57.3	86.4	310.7	383.0	1 166.5
EU-8	5.4	0.2	2.5	10.7	26.3	36.8	25.3
Other developed countries	25.7	29.8	23.5	235.7	98.5	454.0	142.5

Note: Data for individual countries are in euro, while data for aggregates are in USD. EU-8 stands for 2004 new member states.
Source: HNB

2.1.2 Structural transformation during the Tudjman era

After two years of the successful stabilization program, Franičević and Kraft (1997) warned that the economic growth had not materialized, because of the complex structural problems of the economy. The agenda of restructuring was undoubtedly delayed due to the war, when the economic policy had other emphasis. The pace of economic restructuring increased little after the war ended in 1995.

The *privatization* procedure started with the federal privatization plan in July 1990 in the framework of the Marković reforms. It relied on spontaneous privatization and allowed the subsistence of social ownership, while it reintroduced state ownership in

any sector chosen by the government. Croatia inherited this path of privatization with all of its consequences. Privatization was already considered necessary and favourable, the institutional framework was already established, while the possibility was also created to build an extensive state-owned sector (Bićanić 1993:423-425). The individual Croatian privatization was first set out in a law of April 1991 that completely replaced the inherited Yugoslav laws. The social ownership was converted into state ownership (Bićanić 2001:164). The privatization law was modified several times until 1993 when the Croatian Privatization Fund (Hrvatski fond za privatizaciju HFP) was created, as a successor of two previous institutions. The HFP had responsibility for restructuring companies and selling shares.

The primary form of the Croatian privatization process was the management and employee buyouts, while the secondary form was voucher privatization. About half the shares in each company was to be sold at a discount price to employees. By mid-1995 about 3000 schemes were submitted and two-thirds of them were approved. Out of the 3000 more than 1000 were privatized by 100 percent (EBRD 1995). Utility firms remained in state ownership. According to EIU estimates, by late 1995 half of the estimated total assets of "socially owned" companies of 12 billion USD were privatized in principle. The amount paid up in mid-1995 was only 220 million USD, of which 70 million USD was foreign capital. Many shares were bought by employees at discount value and for long-term loans (EUI 1996:35).

Bićanić (1993:438-439) noted already in 1993 that the government showed decreasing interest in establishing a transparent privatization process and in reducing the state sector. Instead the government chose a privatization path in which the state played major role both in the regulation side and in becoming owner of capital goods. This was partly a consequence of the inherited privatization plan and also that of the war.

A next phase of privatization came in 1998, when the first round of mass voucher privatization scheme was introduced. Primarily it intended to benefit the victims of the war and communism. In October 1999 the government completed the first major utility privatization when it sold the 35% of Hrvatski Telekom (EUI 2000:23). However, by end of 1999 the state still kept stakes in 1610 enterprises, of which 851 were loss-making, and in 329 companies it held majority stakes (EBRD 2000:150). The state kept many firms out of privatization; other firms could not find buyers and the state acted as a buyer of last resort. Again others were used as "milk-cows", which were returned to the state after their assets were taken out (Bićanić 2001:170).

Contrary to the slowness of privatization, according to EBRD index of large-scale privatization (Table 53), between 1995 and 1999 Croatia earned level 3, which means that 50% of the assets were privatized. This level was in line with Slovenia, two Baltic state and Bulgaria.

The *small-scale privatization* had a different starting point in post-Yugoslavia than in other transformation countries because of the special features of the Yugoslav socialist system. All the post-Yugoslav successor states started form level 3 according to EBRD index of small-scale privatization (Table 54) but some of them fell back later on. Croatia reached the highest level 4.33[26] relatively soon in 1996.

The delay in enterprise restructuring has been one of the main challenges in the Croatian economy. In lack of effective bankruptcy legislation, the insolvent companies often worked further as a "shell", and were not formally closed up. Due to the weak judicial system, contracts were difficult to enforce in the culture of chronic non-payment (World Bank 1999:3). The progress in EBRD index of enterprise reform (Table 55) shows that Croatia reached level 2.67 only in 1996 that was late relative to most of the CEE countries. However, the performance of Croatia was the best in SEE region. The delay in restructuring had a crucial impact on the economic growth perspective as well.

The weaknesses of the enterprise sector were reflected in the *banking system* as well during the 1990'. The bank's portfolios deteriorated because of the bad loans of insolvent companies. At the same time, the banking supervision was weak. The banks had foreign borrowings and the domestic portfolio was mostly indexed to the Deutschmark, which made the banks vulnerable. Croatia had numerous banks, some of which were small and uncompetitive (World Bank 1999:3-4).

The number of banks was growing until 1998 due to the low capital requirements (Table 7). At the same time the concentration of assets was high although it moderated by the end of the decade (Table 6). In 1999 there were 53 banks in Croatia and the four largest possessed 58% of the total assets. The problems of the Croatian banking system were not unique though. In the mid-1990' the banking system of the transformation countries in CEE and SEE were highly concentrated, with significant state-ownership and limited presence of foreign banks. They also struggled with bad loans and immature technology. Resistance against foreign banks was also common (Wachtel 1997:15).

[26] Level 4.33 refers to the following: standards and performance typical of advanced industrial economies, no state ownership of small enterprises.

Table 6: Concentration index - share of assets of the largest banks in total bank assets in Croatia, 1994-1999

	Two largest banks	Four largest banks
1994	55	na
1995	54	68
1996	46	60
1997	40	53
1998	41	53
1999	44	58

Source: HNB

Table 7: Number of banks in Croatia, 1993-1999

	State owned banks	Private domestic banks	Foreign owned banks	Total
1993	25	18	0	43
1994	26	23	1	50
1995	14	39	1	54
1996	10	43	5	58
1997	7	46	7	60
1998	8	42	10	60
1999	10	30	13	53

Source: HNB

The rehabilitation led to bank nationalization as well. The capital-increase with government bond increased the ownership of the state. Although the state-ownership started to decrease after 1996, due to the consolidation in 1998 and 1999 state remained a dominant owner in the banking system (Table 8). The foreign bank entry was rather slow and cautious at the beginning of the 1990'. The first foreign bank was the Raiffeisen in 1995. Following the crises foreign ownership increased significantly with the beginning of the bank privatization in 1998 and especially in 1999 when three of the largest banks were sold to foreign investors (Table 9). Although in 1999 the entry of foreign banks was in an early phase, Galac and Kraft (2000:19) concluded, that their entry has mainly been beneficial, because it brought significant funds into Croatia and mildly stimulated competition and new product and service development. The negative effects on domestic banks seemed to be fairly mild

Table 8: Banking system by ownership in Croatia 1996-1999

	1996	1997	1998	1999
State owned banks or private with a significant public stake	78.4	41.9	43.1	45.6
Private domestic banks	20.7	54.1	50.3	14.5
Foreign owned banks	1.0	4.0	6.7	39.9

Source: HNB

Table 9: Large bank privatization in Croatia 1998-1999

	Bank	Acquired by	Stake (%)
1998	Slavonska banka	Kartner Landes- und Hypothekenbank	na
1999	Privredna banka	Banca Commerciale Italiana	66
	Zagrebačka banka	Allianz	10
		Bankers Trust Co.	63

Source: EBRD Transition reports

According to the EBRD index of bank sector reform (Table 58), following the 1993 banking law Croatia reached 2.67. In 1998 a new banking law was announced as a

consequence of the crisis and privatization of the large banks began. With these steps Croatia reached 3.00 in the reform index in 1999.

According to the EBRD Business Environment and Enterprise Performance Survey (BEEPS 1999), the quality of the Croatian *business environment* faced more obstacles than the peer country average. The issues of policy instability, corruption, functioning of the judiciary, financing and the exchange rate proved to be larger obstacle in Croatia than in the CEE countries. At the same time, the inflation, infrastructure and anti-competitive practices meant smaller obstacles.

Table 10: Key obstacles to business operation and growth of enterprises, Business Environment and Enterprise Performance Survey 1999

	Bulgaria	Croatia	Czech R.	Estonia	Hungary	Lithuania	Poland	Romania	Slovakia	Slovenia	average
Taxes and Regulations	3.2	3.3	3.3	2.7	3.2	3.3	3.1	3.6	3.3	2.9	3.19
Inflation	3.0	2.6	3.0	2.3	2.7	2.6	2.7	3.8	3.2	2.2	2.81
Financing	3.2	3.2	3.2	2.5	2.8	2.8	2.5	3.2	3.3	2.3	2.9
Policy instability/Uncertainty	3.2	3.1	2.8	2.4	2.7	2.4	2.8	3.4	1.5	2.6	2.69
Exchange Rate	2.5	2.9	2.3	1.8	1.6	1.8	2.4	3.1	2.5	2.1	2.3
Corruption	2.6	2.7	2.2	1.9	2.0	2.5	2.5	2.8	2.4	1.7	2.33
Street Crime/Theft/ Disorder	2.7	2.1	2.1	2.2	1.8	2.8	2.6	2.4	2.4	1.7	2.28
Anti-competitive practices by government or private enterprises	2.4	2.1	2.2	1.8	2.2	2.6	2.4	2.4	2.2	2.4	2.27
Organised Crime/Mafia	2.7	2.1	1.8	1.6	1.7	2.6	2.1	2.2	2.3	1.6	2.07
Functioning of the Judiciary	2.2	2.7	2.1	1.7	1.3	2.2	2.4	2.7	2.1	2.4	2.18
Infrastructure	2.4	1.8	2.4	1.6	1.6	1.8	1.7	2.5	1.9	1.8	1.95

Note: Each issue is rated on a scale from 1 (no obstacle) to 4 (major obstacle).
Source: BEEPS 1999:40

Corruption has to be examined in more details. Corruption is defined by the World Bank as the "abuse of public office for private gain". Thus corruption is interrelated with the state; it arises from public authority and its discretionary power in decision-making (Budak 2006:35). That is why the size of the state matters.

Grubiša (2005:66) argues that the origin of political corruption in Croatia trace back to the process of insider privatization started in 1991, when socially owned enterprises were transformed into private ones, during unsettled political and social conditions, i.e., the war. Under such circumstances a new political class appeared, legitimized by the war and the struggle for independence. Štulhofer (2002) shows that from 1995 to 1999,

the level of trust (trust in general, trust in institutions and norms) decreased considerably in Croatia.

Croatia started from a relatively favourable position regarding the *share of private sector in GDP* as a consequence of the Yugoslavian type of worker's self-management and social ownership. In 1999 the private sector share reached 60% in the GDP[27] that was significantly lower than in the CEE countries but lower as the SEE average as well (Table 57). The public sector was particularly large by European standards, the public administration and defence amounted for 10.7% of GDP in 1998, health and social services for 4.9% of GDP in 1998, and education for 4.4% of GDP in 1998. The method of privatization contributed to the increase of state ownership because the unsold shares were transferred to state funds, although the manufacturing sector had previously not explicitly been in state hands. (EUI 2000:20-22).

The size of the state sector also reflected in the *general government expenditure* that peaked at 56.6% of GDP in 1999. This level was the highest in whole Europe in that year. The war-finances had long-lasting impact on the size of the state. The war was financed mainly through inflation and it led also to large budget deficit and very high level of budget expenditures (Bićanić 2001:169). Despite the end of the war, during 1996-99 the public expenditure rose sharply mainly due to four factors: the significant rise in public sector wages and also public sector employment; the significant rise in healthcare and pension spending; defence expenditure remained high despite the end of the war, the ministry of defence channelled funds to the Bosnian Croats and financed various questionable businesses; and the government spent heavily on road-building. The government budget deficit rose from 1.8% of GDP in 1996 to 8.4% of GDP in 1999 (EUI 2002:22).

2.2 The common foreign and security policy in action: the Yugoslav war[28] and the role of the EC/EU

The EU's role in the Yugoslav conflict was influenced by three factors (Lavdas 1996:216): first of all, the foreign policies of EU member states; second, the independent impact of EU's institutional norms and processes; and third, the external relations of the EU with the USA, on the one hand, and with the former communist

[27] Other sources estimate a higher share of private sector.

28 Although the chronicle of the war does not connect strictly to the process of Europeanization, it is inevitable to understand the reasons of the conflict in order to understand the integration process of Croatia.

states, on the other. Lavdas (1996:218-219) suggests a periodization in four phases of the EC/EU involvement between 1991 and 1995. The first phase is dominated by the German-led EC recognition of Slovenia and Croatia. Having played a major role in the early phases of the Yugoslav conflict, German foreign policy resumed the back seat after 1992. The second phase, between 1992 and the Goražde crisis[29] in April 1994, was dominated by considerable fragmentation. The third phase, which began in mid-1994, was characterized mainly by the emergence of Anglo-French initiatives and increased Russian involvement, while factual elements remained significant. The fourth phase, which began in the summer of 1995, was marked by increased US involvement.

Textbox 1: War in Croatia

In May 1991 Jacques Delors, the president of the Commission and Jacques Santer, prime minister of Luxemburg (which held the presidency that time) travelled to Yugoslavia, but due to the lack of unified support of the members states, the mediation failed (Lukács 1997).
Following the unilateral declaration of independence in Croatia and Slovenia in June 1991, the Serbian-dominated JNA (Yugoslav People's Army) moved into Slovenia. With the out-break of the war, the Troika of European foreign ministers travelled to Belgrade and Zagreb (Glenny 1993:98). The parties signed a cease-fire agreement in Brioni under a European Community peace plan (Rich 1993:39). The European Community Monitoring Mission (ECMM) was established, aiming to contribute to the effective formulation of European Union policy towards the Western Balkans. The Yugoslav parties agreed to a three month moratorium on the implementation of the independence declarations.
The Croatian situation was different from the Slovene because of the Serb populated regions already in conflict. The Serb question was a central feature of Croatian politics (Glenny 1993:87). Altogether the question of ethic minorities had a crucial role in the Yugoslav conflict.
During these three months the Croatian war began. Serb paramilitaries blocked main road and railway routes and as a result the tourism activity was blocked and the country was cut into two. The war increased transport costs dramatically (Bićanić 1994:6).
In July 1991 the European Commission prohibited the export of arms to the Yugoslav area. In August the Croatian National Army was created. After further widespread violence in Croatia, in August the European Community established an arbitration commission known as the Badinter Commission. It comprised five presidents of constitutional courts from various EC countries (Rich 1993:39).
In September a peace conference was opened in The Hague, summoned by the EC as well, chaired by Lord Peter Carrington, former NATO secretary general. The Carrington plan, which suggested a loose confederation of six independent republics, was resisted. In October Croatia noted the expiration of the three month moratorium accepted at Brioni and decided to cut state-legal ties with Yugoslavia and to recognize the independence of the other republics of the former Yugoslavia on the basis of a mutual principle. All countries and the UN were called

[29] In April 1994 hundreds of Serbian mortars and heavy guns and 60 tanks fired at the Bosnian city Goražde for three weeks. More than 700 people have died (The New York Times April 25 1994).

upon to establish diplomatic relations with the Republic of Croatia (Rich 1993:40).
On 23 November a promising cease-fire agreement was sign in Geneva by Cyrus Vance from the side of UN. In December 1991 Germany[30] recognized Slovenia and Croatia unilaterally, i.e. not in the framework of a common EC decision. France was in favour of the recognition only after arrangements on human rights and common relations were achieved. However, following the German decision, the EC recognized Croatia in January 1992 (Woodward 1995:180-188). At the same time, Serbs declared the Krajina Serb Republic in December 1991, which meant one third of Croatia's territory. The Vance Plan, came into effect in January 1992, created four demilitarized zones (UN Protected Areas, UNPAs) in Krajina and Slavonia and legitimized the Krajina Serb Republic. The war ended in January 1992. The UN "blue helmets" were to ensure that the UNPAs stayed demilitarised and to ensure the conditions for return of refugees to their homes (EUI 1996:28).
There was a growing dissatisfaction in Croatia during 1994 because the UN Protection Force (UNPROFOR) failed to bring the Vance Plan into effect and because of the fact that the country still did not have control over the third of its previous territory (EUI 1996:28). The Croatian government had the opinion that the international community preserved the status quo instead of resolving the problem of the Croatian statehood. The Croatian army strengthened since the end of the war and was ready to initiate military actions in order to regain the lost territories in Slavonia and Krajina from May 1994. In August the operation Storm (Oluja) was launched and within few days the whole Krajina was reclaimed and around 150,000-200,000 Serb people left the territory to Bosnia and Serbia. Tudjman was more popular and powerful than ever before and he had an ambition to incorporate Herzegovina into Croatia (Bartlett 2003:47).

The governments of the EC appeared to be unprepared for the challenge of the Yugoslav dissolution and were far not unified. The Western fragmentation had presented a window of opportunity for Russian foreign policy too.

After 1994 when the Bosnian Serbs successfully attacked Goražde, the member states became convinced that a non-political solution would be either impossible or it would have to include arms. The Goražde case underlined the limitation of the UN Protected Area policy as well (Lavdas 1996:223).

In April 1994 the meeting of EU foreign ministers in Luxembourg centred on an Anglo-French initiative for a united diplomatic action. Although the Western European Union (WEU) could in principle offer military instruments, the EU's role had been primarily diplomatic, economic and peacekeeping. The attempt to intervene in the framework of the WEU failed because the ministers for foreign affairs could not agree. Finally the WEU played only minor role next to NATO in solving the armed conflict (Kostovicova 2004:4). At the diplomatic level, the EU had intervened in a number of ways, through the special mediator and the relevant commissioner, holding regular meetings and trying to broker a diplomatic solution. The diplomatic involvement in the crisis was

[30] This recognition is considered as the first large foreign policy initiative of the newly recognized Germany (Frydman et al. 1998:67).

accompanied by a complex structure of military command, from the side of the UN and NATO forces[31] (Lavdas 1996:225).

The recognition of the Yugoslav successor states was a rather ambiguous issue within the EC. The EC recognition did not lead immediately to the establishment of contractual relations or to economic aid because of the war and the country's failure to meet the requirements of democracy. In 1995 the EU started negotiation about a cooperation agreement with Croatia and about the country's involvement in the PHARE program. However, the negotiations were suspended in the same year following the military offensives in Krajina.

On 12 November 1995 in Erdut (Croatia) an agreement on the future of Eastern Slavonia was signed by the heads of the Serbian and Croatian Negotiating Delegation and was witnessed by the US Ambassador and the UN Mediator. According to the agreement, after 12 months of transformation period (extendable to 24 months) the Croatian administration shall be gradually established; the region shall be demilitarized from Serb units under the supervision of international forces and the possibility for the return of refugees and displaced persons shall be ensured (Erdut 1995). The region was gradually reintegrated into Croatia in 1997, and Zagreb gained its full control at the beginning of 1998.

The Dayton Agreement for Peace in Bosnia and Herzegovina was signed on 21 November 1995 by the Republic of Bosnia and Herzegovina, the Republic of Croatia, and the Federal Republic of Yugoslavia, and witnessed by representatives of the United States, Great-Britain, France, Germany, Russia and the European Union Special Negotiator. According to the agreement, Bosnia and Herzegovina, Croatia, and the Federal Republic of Yugoslavia agreed to fully respect the sovereign equality of one another and to settle disputes by peaceful means; they obligated themselves to respect human rights and the rights of refugees and displaced persons; and the parties agreed to cooperate fully with all entities, including those authorized by the United Nations Security Council, in implementing the peace settlement and investigating and prosecuting war crimes and other violations of international humanitarian law (Dayton 1995).

The Southeast European Cooperative Initiative (SECI) was launched in 1996 by the EU, the USA and the UN Economic Commission for Europe, as an alternative to the Dayton

[31] From 1995 on the structure included also the Rapid Reaction Force of French, British and Dutch troops.

Agreement and an innovative strategy to help the Southeast European region to come out of the crisis.

2.2.1 ICTY

The International Criminal Tribunal on the former Yugoslavia (ICTY) was established with the UN Security Council Resolution 827 passed in May 1993, based on Chapter VII of the UN Charter[32]. The Tribunal was located in The Hague. The proposition of the ICTY has been to prosecute persons responsible for serious crimes and incidents against international humanitarian law committed in the territory of the former Yugoslavia since 1991. The Security Council argued that these violations constituted a threat to international peace and security and the prosecution of the responsible persons would contribute to the restoration and maintenance of peace.

The cooperation with the ICTY became a key factor in international relations and also in the EU–Croatia relations. It was first stated in the Regional Approach in 1997. It would have been the condition to join the PHARE program and to negotiate a cooperation agreement but the condition was never fulfilled.

President Tudjman supported the establishment of the ICTY because he counted that Serbian war criminals will be prosecuted there. A constitutional law was approved in 1996 on cooperation with the Tribunal but the Tudjman government was reluctant to cooperate with the ICTY (Jović 2006:93). In Tudjman's opinion the country only liberated its occupied territories using its armed forces in accordance with the United Nations Charter and the norms of international law. He also argued that the lukewarm attitude of the international community served the occupiers (Tudjman 1997). The government argued that Croat "defenders" could not be cited to The Hague. In Tudjman's (and many Croat people's) conception Croatia was the innocent victim of the Serb aggression. The refusal of cooperation with the ICTY became the core element in the state-built myth of the Homeland war (Jović 2006:93). However, even the opposition press in Croatia reported about atrocities carried out by Croatian forces during the war 1992-1994 against Bosnian Muslim people and in 1995 during the operation Storm and Flash against Serbs. The unwillingness to cooperate also decreased the international support towards Croatia. There were trials of war crimes in Croatia as well but only against Croatian Serbs (Bartlett 2003:78-81; Fisher 2006:178-179).

[32] Action with respect of threats to the peace, breaches of the peace, and acts of aggression

In August 1999 the president of the Tribunal requested the UN Security Council to impose sanctions against Croatia because the lack of cooperation. However, the EU resumed the EU–Croatia political dialogue in July that was suspended previously in 1995[33].

2.3 Pressure to build democracy and the strengthening of HDZ's power

Despite the loss of territories to the Serbian army in 1991, Tudjman became a popular and powerful leader in Croatia. To capitalize this post-war popularity, he called for new elections for the lower house of the parliament[34] in August 1992. The HDZ won the elections with 44% of the votes and got the absolute majority of the seats. The elections for the upper house were held in 1993 that was won by the HDZ too. The opposition was fragmented. Tudjman won also the presidential election with 57% of the votes (Bartlett 2003:42-43).

Following the victory of the offensive Storm, the end of the war in Bosnia, the recapture of Krajina and the conclusion of the Dayton peace agreement, new elections were held in October 1995 in order to capitalize the military success and the popularity of the HDZ (Bartlett 2003:48). The HDZ won again with 45% of the votes and reached absolute majority in the Sabor. Pursuant to the 1991 law on Croatian citizenship, members of the Croatian diaspora and Croats living in the Herzegovina were able to vote as well. The local elections were held at the same time where the opposition made significant gains and the HDZ lost control of the Zagreb City Council (EUI 1996:29). Although the system of multiparty elections worked in Croatia, many observers noted the authoritarian tendencies of the government and Franjo Tudjman. The authoritarian style of governance, which is accepted and even necessary in wartime, began to look more and more anachronistic and out of place. The HDZ was unaccustomed to defeat and the tools of oppression emerged. Tudjman vetoed four times the opposition nominee as mayor of Zagreb. Finally the government appointed its own nominee (Bartlett 2003:49-50; Frydman et al. 1998:66-68).

[33] The Human Rights Watch noted this development with anxiety because if the EU relaxed its previous human rights conditionality, it might worsen Croatia's performance in cooperation with ICTY (HRW 1999).

[34] The constitution adopted in 1990 established a bicameral parliament in Croatia.

Croatia applied for Council of Europe (CoE) membership in September 1992, but the approval was postponed following the Croatian Army's offensives in western Slavonia and Krajina.

The Dayton agreement (November 1995) was expected to be the turning point and a new perspective for stabilization and rebuilding in Croatia. Four years after Croatia's admission application, in March 1996 the Council of Europe and Croatia signed a document about twenty-one conditions required for the admission to the Council[35]. The conditions signed by Croatia seemed to point in the direction of democracy, free markets, and European integration (Frydman et al. 1998:66). The Council of Europe's parliamentary assembly voted to admit Croatia as a member on 24 April 1996 but the Council's Committee of Ministers decided to postpone Croatia's membership. During May and June 1996 fourteen conditions were specified that Croatia had to fulfil before its membership of the Council of Europe, among others unconditional cooperation with the ICTY, and the return of Serb refugees from Krajina (HRW 1996). Frydman et al. (1998:77) argues that Tudjman did nothing at all during the six month delay of membership talks. However, Croatia became the 40th member of the CoE in November 1996.

The 1996 Human Rights Watch report clearly stated that "the human rights situation in Croatia remained poor in 1996". The report emphasized the discrimination against ethnic Serbs, the increasingly autocratic ruling style of HDZ party, the frequently suppressed political opponent and the independent media (HRW 1996).

In June 1997 Tudjman obtained victory in the presidential election. The elections were considered as generally fair and democratic. However, the ruling party was criticized for influencing the results through the domination of the media. Independent journalists were often dismissed and the government was able to limit the opposition media. The government controlled newspapers through ownership links as well (Bartlett 2003:51-53). The modification of the constitution conferred on Tudjman nearly absolute executive power. The repeatedly modified election law was constructed according to the meet of HDZ (Frydman et al. 1998:71).

[35] Among the commitments were the sign and ratification of regional human rights and other instruments and conventions; the protection of rights of Serbs in the former UNPAs and the facilitation of their right to repatriation; the compliance with the terms of the Dayton accords and with the United Nations Transitional Authority for Eastern Slavonia (UNTAES) mission; the democratic reform of the media; and the end the government's refusal to allow a member of the opposition to become mayor of Zagreb.

The popularity of president Tudjman and the HDZ diminished throughout the post-war years. The increasingly independent and outspoken press published variety of scandals about the president and the party (Bartlett 2003:50). Opposition victories in local elections were considered as a sign of changes. However, the opposition stayed divided. At the same time the HDZ lacked a clear concept of a better future in Croatia. The leader did not have an ideological policy blueprint, the main guideline was opportunism. Holding the power was one of the party's constant aims (Frydman et al. 1998:70).

The Eurobarometer surveyed Croatia in November 1995 for the first time (Eurobarometer 1996). In Croatia there was widespread (66%) satisfaction regarding the country's direction. People had mainly positive opinion on the market economy (65% said that it is good and 18% wrong). However, 15% said the financial situation of their household "got better", while 38% said it "got worse". More people were satisfied with democracy (52%) than those who were unsatisfied (42%); and Croatia was among the three of all the nineteen countries surveyed, where more people were satisfied. The same pattern appeared regarding the respect of human rights, 74% said that they are respected compared to 20%; and Croatia was among four of the nineteen countries surveyed where more people said yes. Moreover, in Croatia the level of people dissatisfied with the respect for human rights was the lowest of all the countries surveyed. This result highly contradicts with the Human Rights Watch report of 1995, which warned about human rights violations against ethics Serbs in the recaptured areas (HRW 1995).

2.4 Conditionality towards "the rights and obligations that EU countries share"[36]

With the dissolution the Yugoslavia–EC cooperation agreement was abolished. The once preferential Yugoslav status disappeared and left the successor states in an unclear situation without contractual framework (Balázs 2002:263).

In contrast to the CEE countries (incl. Bulgaria and Romania), Croatia did not sign association agreements (Europe Agreements) with the EU and as a result the country was not member of the CEFTA. It did not have bilateral agreement with the EFTA and was not a WTO member. Because of the lack of EU association agreement, the Croatian

[36] That is how the EU glossary explains acquis communautaire (http://europa.eu/abc/eurojargon/index_en.htm).

exporters faced generally higher tariffs than those from the peer countries. From 1991-1999, the EU provided 349 million euro to Croatia for reconstruction in the framework of the Obnova program, humanitarian aid in the framework of ECHO, and supported the media, removing mines and human rights (EP 2001).

Table 11: Trade agreements and EU integration process in CEE countries, Croatia, Bulgaria and Romania, as of 1999

	WTO	CEFTA	PHARE	Bilateral agreement with EFTA	EU Trade Cooperation Agreement	EU Autonomous Preferential Trade Regime	EU Interim Agreement	EU Association Agreement	EU membership application and Commission opinion
Bulgaria	Yes	No	Yes	Yes	November 1990	No	December 1993	February 1995	December 1995 Negative
Croatia	No	No	No	No	November 1990	Yes	No	No	No
Czech R.	Yes	Yes	Yes	Yes	November 1990	No	March 1992	February 1995	January 1996 Positive
Estonia	Yes	No	Yes	Yes	March 1993	No	No	February 1998	November 1995 Positive
Hungary	Yes	Yes	Yes	Yes	December 1988	No	March 1992	February 1994	March 1994 Positive
Latvia	Yes	Yes	Yes	Yes	February 1993	No	No	February 1998	October 1995 Negative
Lithuania	Yes	No	Yes	Yes	February 1994	No	No	February 1994	December 1995 Negative
Poland	Yes	Yes	Yes	Yes	December 1989	No	March 1992	February 1995	April 1994 Positive
Romania	Yes	No	Yes	Yes	May 1991	No	May 1993	February 1995	June 1995 Negative
Slovakia	Yes	Yes	Yes	Yes	November 1990	No	March 1992	February 1995	June 1995 Negative
Slovenia	Yes	Yes	Yes	Yes	September 1993	No	January 1997	under ratification	June 1996 Positive

Source: Šonje–Vujčić 1999:41

In February 1996, the EU adopted a "Regional Approach" to the countries of Southeastern Europe to underpin the implementation of the Dayton and Erdut agreements. It promised financial assistance, unilateral trade preferences and contractual relations in the form of bilateral cooperation agreements. The prospective of membership was not mentioned. The EU fostered good-neighbourly relations and regional cooperation among the countries in Southeastern Europe. In April 1997, the Council established political and economic conditions for these countries, as the basis for the development of bilateral relations and monitored their realization in the conditionality reports.

The EU-Croatian relationship worsened after the introduction of the Regional Approach because it placed Croatia among the Balkan states, which was unacceptable for the government. The Regional Approach was considered in Tudjman's opinion as a break of the country's European integration and as a pressure towards a Southeastern European or Balkan integration. With the latter community Croatia would get into a worse situation than it had in Yugoslavia – he argued. Croatia protested against the principle that the regional integration of the countries is put as a precondition of their individual relations with the EU saying that the country does not need a "Euro-Yugoslavian and Balkan integration" as pre-association. According to President Tudjman, it would have meant economic decline and political dependence. At the same time, CEFTA-membership was considered as favourable and one of the most important foreign policy aims of the country (Tudjman 1997).

Against all the aversion to the EU, the country was keen on establishing preferential trade relations with it since most of the Croatian export went to the EU-market (Bartlett 2003:74). The political disintegration of Yugoslavia led to economic disintegration too, trade and investment relations both diminished among the republics. The newly, internationally forced regional integration among these countries also interfered with the existing political conflicts. Most of the successor countries turned towards the EU concerning both their trade and investment needs. However, the political nationalism of the successor states led to political disintegration from the EU. Political nationalism seems not to be consistent with economic Europeanization. The regional integration among post-Yugoslav states is connected to EU integration as well; the former gained momentum with the interest and expectation of the latter. In this context, there is a price of economic cosmopolitanism in terms of political nationalism (Gligorov 2004b:95).

The EU set *two types of conditions* towards Croatia. The general conditions covered the entire Southeastern Europe region, while there were also country-specific conditions. The conditions reflected the general values and principles of the EU i.e., respect for democracy, the rule of law, human rights, minority rights and transformation to market economy. *Country-specific conditions* towards Croatia were the following. Compliance with the obligations under the Basic Agreement on Eastern Slavonia and cooperation with United Nations Transitional Authority in Eastern Slavonia, Baranja and Western Sirmium (UNTAES) and Organization for Security and Co-operation in Europe

(OSCE). Opening of the customs border between Croatia and Republika Srpska[37]. Evidence of credible pressure on the Bosnian Croats to dissolve Herceg-Bosna[38] structures and to cooperate in the establishment and functioning of the Federation. Evidence of the implementation of a truly unified City Council in Mostar and of effective functioning of the United Police Force of Mostar (UPFM). Evidence that the Government of Croatia is using its influence in bringing Bosnian Croat war criminals to justice before the International Tribunal (Bulletin 1997).

The fulfilment of the conditions was regularly monitored by the Commission. The conditionality reports monitored the following issues: democratic principles; human rights and the rule of law; respect for and protection of minorities; market economy reforms; regional cooperation; and compliance with obligations under the Dayton and Erdut Agreements.

The First Conditionality Report (autumn 1997) reported that "although some progress has been achieved, Croatia has not adequately complied with its obligations under the Dayton or Erdut Agreements, or the conditionality of the Regional Approach" (Commission 1997a:11).

In spring 1998 the Second Conditionality Report concluded that although many Croatian commitments to European norms and principles had been published, the progress in the country did not reach the commitments. At the same time Croatia had the real opportunity to archive its aspiration but it required compliance with the relevant conditions – the report stated. The benefits form autonomous trade preferences were also questioned unless Croatia fulfils the conditions. Because of the poor performance of the country, the Commission decided to suspend its eligibility for the PHARE program (Commission 1998a). In autumn 1998 the Third Report stated that the autonomous trade preferences stayed in force but the suspension of its eligibility for the PHARE program as well. The report recognized some progress in the field of market economy reform and substantial progress in cooperation with neighbour countries, but little or no progress in other cases (Commission 1998b).

The Fourth Conditionality Report (spring 1999) found still deficiencies in most of the monitored issues. The report noted that in more cases formal commitments were undertaken without real implementation. The Commission considered the suspension of

[37] Republika Srpska is one of the political entities in Bosnia and Herzegovina. (The other is the Bosniak/Croat Federation of Bosnia and Herzegovina.

[38] Herceg-Bosna was an unrecognised entity in Bosnia and Herzegovina between 1991 and 1994 during the Bosnian War.

PHARE program still necessary (Commission 1999a). The outage from the PHARE did not only mean financial losses for Croatia, but also reduced possibilities of participation in international projects and experience exchange (Samardžija et al. 2000:112).

In 1999 two new initiatives were formed for Southeastern Europe and accordingly for Croatia. The one was the Stability Pact for South Eastern Europe and the other was the Stabilisation and Association Process. The Stability Pact was formed by the international community, aiming at conflict prevention; supporting the countries' efforts towards peace, democracy, respect for human rights and economic prosperity; and stimulating regional co-operation and European and Euro-Atlantic integration. The Stability Pact had several partners beyond the participant countries[39] such as the EU Member States and the European Commission, USA, Russia, UN, OSCE, Council of Europe, NATO, OECD, etc.

At the same time, the EU set its own upgraded vision for the region. The Commission declared in 1999 that the EU is ready for a long-term and substantial commitment to the stabilization of the Southeastern European countries and it proposed the creation of a Stabilisation and Association Process (SAP) for the region. The SAP added further economic and legal conditionality to the political conditionality of the Regional Approach and for the first time the EU offered the prospect of EU membership.

Tudjman itself expressed its fears about being excluded from EU and NATO: the European peace, stability is threatened by exclusion that creates opportunity for destructive forces. That is why the alliances have to count with those who do not belong to their membership (Tudjman 1997).

As Jović (2006:85) argues, the integration process delayed primarily because of Croatia's self-made obstacles. These obstacles had mainly political character; the authoritarian style of governance was unacceptable for the EU. The domestic political costs of satisfying EU democratic conditionality proved extremely high, since applying democratic rules would have required the government to give up essential instruments on which its political power was based.

[39] Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Moldova, Montenegro, Romania, Serbia and The Former Yugoslav Republic of Macedonia

2.5 National identity vs. European identity: Europe but not European Union – unwilling or unable?

Tudjman accused Europe that it did not support the dissolution of Yugoslavia, but wanted to save it too long and doing so it pushed Croatia towards the role it played in the destruction of the federal state (Tudjman 1997). It was a widespread view (not only in Croatia) that Europe failed to prevent or restrain the military conflict. Tudjman's counter-Europe rhetoric became more and more similar to the previous counter-Yugoslavia rhetoric, the role of Belgrade was replaced by the role of Brussels. He saw a close parallelism between Yugoslavia and the integrating Europe. The idea that Croatia can prosper on its own and be self-sufficient was similar to Tito's concept about balancing between East and West (Jović 2006: 90-92).

Tudjman declared that Croatia was ready to accept the values that were established by the member states of the European Union from Rome to Maastricht. Croatia is devoted to the democratic principles on which the European integration was built. At the same time, Croatia expected that it should get a place in European alliances on the basis of its particular achievements in developing democracy and economy[40]. "We are not going to Europe. Croatia is in Europe where it always was – said Tudjman in 1997" (Tudjman 1997).

Hence the concept of "return to Europe" was not accompanied with concrete steps in Croatia; the government ignored the recommendations and conditions coming from the EU or other Western institutions. As a result, a highly *contradictory* approach evolved towards "Europe".

Apart from the official rhetoric, there were opinions highly in favour of EU integration. In 1998 the Institute for International Relations (Institut za Medjunarodne Odnose, IMO) and the Institute of Economics (Ekonomski institute Zagreb, EIZ), with the financial assistance of the Ministry of Economy carried out a project about the *costs and benefits* of an associated membership in the EU. Two years later the IMO published an updated study about the findings (Samardžija et al. 2000). The study stated that a contractual relationship would be very important for the development of the Croatian economy, moreover a prerequisite for the export-based development of Croatia. The

[40] In his speech at the Hungarian Parliament on 21 April 1997, Franjo Tudjman also highlighted that the common features in the history of Hungary and Croatia are Christianity and belonging to Central European peoples. He spoke about the hard life of small nations, whose right and will for independence was often neglected but whose consciousness could not be broken down by Panslavism, Austrian rule, pacifism or communism (Tudjman 1997).

preparations and major economic changes and adjustments, which the EU would require, would also encourage the economic development. The study did not idealize the integration process but it identified that some sectors would experience drawbacks, the cost of adjustment would be high in the short-term. However, on the long run the integration was assumed to bring more benefits than costs. Considering that Croatia is a small country with small domestic market, the issue of its participation in the EU integration should be considered as an imperative both in economic and political terms, instead of an alternative. When examining the cost of the integration, it should not be viewed exclusively as the price of integration. The study stressed the widely acknowledged view that that major part of these costs arises irrespectively of the EU's requirement but simply due to the necessary adjustment and restructuring of the Croatian economy.

Textbox 2: How Croatia became a "Western Balkan" country?

From 1998 the EU introduced the terminus technicus "Western Balkans" that was used also by NATO and referred to Bosnia and Herzegovina, Croatia, Federal Republic of Yugoslavia, FYR of Macedonia and Albania. However, the very concept of the "Western Balkans" was unacceptable for Tudjman's Croatia because it linked Croatia with the former Yugoslavia and Albania and not with Central and Eastern European countries where Croatia felt to belong to. Croatian officials used the term in inverted commas or put "so called" in front of it (Jović 2006:90). The usefulness and appropriateness of the term was and is highly discussed. Van Meurs (2001:13) considers it as a misnomer and highly inappropriate because it places the region outside Europe and contradicts all European objectives and expectations for the region. He suggests the reintroduction of the now almost empty term "Southeastern Europe". As Delević (2007:11) notes, being categorized as part of the Balkans was never a title that the countries strove for.

We argue that the question of "Europe or the Balkan" is meaningless considering that the Balkan *is part* of Europe both in geographic and historical terms. Thus putting "Balkan" and "Europe" as each other's opposite is highly damaging. Whether the term "Western Balkans" is a misnomer or not, "Europe" is a phenomenon of diversity that contains the Balkans and not contradicts with it. To find the border of the Balkan in political and historical terms is far to be an easy and unambiguous task. Another slippery question is whether Croatia belongs to the Balkan in positive terms[41].

At the time of the regime changes in Central and Eastern Europe, the Croatian population was considerably richer and more Westernized than most of the countries in the region (Fisher 2000). Slovenia is an example of transition "from Yugoslavia to Central and Eastern Europe" and towards EU integration. Croatia stepped on a different path and did not get into group of Central and Eastern European countries as Slovenia. On the contrary, it became "Western Balkan" country according to the categorization of the EU and other international institutions. However, this labelling contradicts with the self-perception of Croats that is often expressed. They do not regard themselves as Balkanians but rather as Central Europeans and Mediterraneans.

When comparing the cultural and historical heritage of Central Europe with that of the Balkans (still both in Europe!), Ágh (1998:4-6) points out the following differences. Central Europe has

[41] For further discussion see Todorova (1996: 21-37).

always been in the geographical proximity of the West. The region belonged in historical sense to the first wave of Europeanization or Westernization; it followed directly the West European models. Western Christianity became a common cultural tradition versus the rival tradition of Eastern Christianity. Since the 16th century the region had a semi-peripheral status in the Western European world system and developed a modern economy, society and polity earlier and better than in the Balkans. The Central European identity has existed since the 16th century and connected closely to the Habsburg Empire. At the same time, the Balkans are connected to the Ottoman Empire. With the post-communist transition, the Central European region has gone through a re-democratization process in contrast to the Balkans, which have experienced the first democratization process. Based on this description, Croatia clearly belongs to Central Europe.

The putative or real Balkan identity of Croatia was used in political discourse as well. For example Franjo Tudjman won the presidential elections 1997 with a slogan "Tudjman, not the Balkan". According to the rhetoric, the Southeast European Cooperation Initiative (SECI), which proposed economic cooperation within Southeastern Europe including the states of the former Yugoslavia, meant a danger of a USA and EU conspiracy to force Croatia back to the Balkans. Tudjman refused any kind of close cooperation with the former Yugoslav neighbours, it was even stated in the Croatian constitution (article 141): "It is prohibited to initiate any process of association of the Republic of Croatia with other states, if such an association would or could lead to restoration of Yugoslav state community or any new Balkan state union in any form." (Jović 2006:88-90). He considered that the "Balkan episode" was a short one in Croatia's history compared to the centuries when it belonged to the West. Differentiation has been a crucial element in the Croatian national identity. The Croatian identity needed to be maximally differentiated from the Yugoslav identity and most significantly from the Serbian (Lindstrom–Razsa 1999:8). According to the rhetoric, Tudjman was the one who could save Croatia from this danger (Lindstrom–Razsa 1999:11-12). However, paradoxically it was Tudjman's policy that politically distanced Croatia from Europe and placed it to the Balkans and was more often compared to Serbia than to its Central European neighbours (Jović 2006:92).

Gligorov (2004b:97-98) set Balkanization against Europeanization. In the former case there is an interest for political independence but not as a consequence of liberalization or democratization, rather against those two processes. It went together with authoritarianism and economic nationalism (and with huge redistribution of resources). In the latter case the political motive is behind economic integration. The EU is designed to weaken political nationalism. Since political nationalism goes together with economic nationalism and economic integration is the first instrument to weaken political nationalism. Lindstrom and Razsa (1999:3) argue the irony is that Croatia used the "Balkan stereotypes" to differentiate and distance itself from the other Yugoslav nations when it defined itself as more progressive, prosperous, hard-working, tolerant, democratic, namely European, in contrast to their primitive, lazy, intolerant, i.e. Balkan neighbours. Its aim for being independent was justified as necessary liberation from its "Balkan burden" and the way of return to its rightful place in Europe. However, the gap between the self-perception of the Croats and the perception of the national community widened during the 1990'. They looked with bewilderment how they turned from a promising emerging democracy to a lagging-behind country in the eyes of the international community. The fact that the Central European identity of Croatia is not really recognized in the only place where it matters – in the European Union, caused a deep frustration in Croatia and extreme response to everything that is connected to Balkan. In the second half of the 1990', when two new democracies in the neighbourhood, Slovenia and Hungary had already applied for membership, Croatia's illiberal democracy looked more similar to Serbia (Jović 2006:93).

Eurobarometer (1996) results showed that the population was not significantly counter-EU. The positive impressions (37%) of the European Union outnumbered negative ones (13%), while 30% was neutral. The positive image of the European Union was based on

hopes of general progress thanks to its aid (23%), although in August the EU suspended the implementation of the PHARE program for Croatia and also the negotiations on the trade and cooperation agreement. The negative opinion of the Union was based on lack of visible results (6%). The relations between Croatia and the European Union were considered equally beneficial for both parties by 44%, which was one of the highest among the nineteen countries surveyed.

2.6 Conclusion

All in all, the international *isolation of Croatia grew* in the second half of the 1990'. The foreign relations were undermined mainly by four factors (EUI 2000:12). First, Croatia resisted allowing the return of Serb refugees who fled during the Croatian offensives of 1995. Croatia maintained its resistance even after an internationally approved refugee return programme, which was introduced in June 1998. Second, the Croatian democracy struggled with several deficiencies. Third, the country's will to cooperate with the ICTY was on low level. Fourth, most importantly, the Croatian government made little effort to encourage the Bosnian Croats to support the reintegration of Bosnia and Herzegovina; moreover Tudjman openly expressed doubts about the long-term survival of the state[42] (EUI 2000:12).

Mrak et al. (2004) argues that there were three main features that distinguished Slovenia's transformation: the gradualist approach, the transformation from a regional to a national economy and the legacy of the former Yugoslavia. Croatia shared the two latter features with Slovenia. The World Bank (1997:1) notes the new independence also as special feature. However, if we consider the eight CEE countries[43], six out of the eight gained independence at the time of the regime changes. In effect, Hungary and Poland are exceptions rather than rules. Thus the new independence of *Croatia is not a significant distinctive factor*. However, Croatia's transformation differed in key aspects from most of the CEE's transformation. First, the Yugoslav economic system was far less centralized that of the CEE's. Second, Croatia was involved in a war from the very beginning of its own transformation process. The war caused tremendous cost for the country, in form of cost of defence, damages in infrastructure and many refugees. The

[42] The viability of Bosnia and Herzegovina is still a hot topic in academic discussions. The presidency of BiH rotates between a Serb, a Bosnian Muslim and a Croat. The State is supervised by United Nations (UN) High Representative. According to The Fund for Peace's Failed States Index 2008, BiH has 84.3 scores on a scale where Somalia is the most failed state with 114.2 scores while Norway is the less with 16.8 scores.

[43] Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia

losses were huge both in terms of human life and forced resource allocation. As a consequence of the war, the transformation process of Croatia was delayed and the uncertainty enhanced the unofficial economy and non-transparent economic structures (Bićanić 1994:6). In October 1999 the Croatian government adopted a final report on war damage, according to which the damage Croatia suffered during the war amounted to 65.3 billion Deutschmark, referring to the period between 15 August 1990 and 15 January 1998. Up to 20,000 persons were killed or had gone missing during the aggression (News…1999).

Croatia inherited the structures of Yugoslavia and the transformation of the country started during these years as well. The legacy of the former Yugoslavia with both of its advantages and disadvantages *a distinctive one* because it differed from the other Eastern European countries in elementary features. The Yugoslav model meant a third-way system of socialism with quasi-market. Beyond the economic structure Yugoslavia also drifted Croatia towards the "Balkan in historical-political sense", which had an ambivalent effect upon the collective consciousness of Croats (cf. Szilágyi 2005:855). The Yugoslavian heritage seems to be an *advantage* for the first look. The Yugoslavian type of socialism had several different characteristics compared to the classical type of socialism and it provided more freedom for market forces. Widespread elements of market economy, the presence of the private sector since the 1950', the well-trained labour force and the experience in entrepreneurship were the factors considered as advantages. The openness of the Yugoslav economy was relatively large compared to other socialist economies in terms of free movement of persons. The managers of the large socially owned firms acquired certain experience in entrepreneurship. The markets for goods and services were relatively developed and the governmental intervention was only minor. Based on these preconditions, Croatia could have expected a rather smooth transformation process (Lejour 2007:13). However, some authors (e.g. Bićanić 2001:160-162; Mrak et al. 2004:xxiv) consider the Yugoslavian path also *disadvantageous*. The tradition of self-management influenced the approach towards privatization. As a consequence of the strong role of worker's, the enterprise ownership structure was dispersed, with a strong role for internal ownership, by managers, workers, and pensioners. It also hampered efficient corporate governance and restructuring. The self-management was partly disadvantageous form the market's point of view because it served as a base for the Croatian type of crony capitalism.

The privatization process had an *insider character* and was considered slow by the international actors (EU, IMF, EBRD). In case of insider privatization, the economy cannot make a use of foreign expertise and know-how, but has to utilize the resources available "at home". Because of the delay in the process itself and in the restructuring, the privatization could not raise the efficiency and productivity enough. The management of the companies was to a great extent in the hands of HDZ members or those who had close contacts with the ruling party (EUI 1996:35). The method of privatization perpetuated the worst features of the Yugoslav social ownership model. The evolved crony capitalism was not in favour of restructuring. The new owners did not inject new capital into the economy and their main strategy was self-aggrandizement (EUI 2000:22).

The Croatian transformation was interrupted by the armed conflict from the beginning. After the war had finished, its legacy burdened the transformation process. This feature of the Croatian economy is *a distinctive one*. In the early 1990' among the more developed transformation countries (referring to the Visegrád countries, the Baltic states and two post-Yugoslav republics of Slovenia and Croatia, and Bulgaria and Romania) Croatia was the only one, which faced an armed conflict. The war itself and its consequences created additional factors, cost and challenges that were missing in the mentioned peer countries. The decision of Croatia to conduct the war and the transformation parallel undoubtedly created unique circumstances. At the same time, the war *should not unconditionally mean* the burden that it means in Croatia. The quick EU orientation might have given the chance to overstep the memory of the war.

The Croatian type of crony capitalism, which emerged in the 1990', was a consequence of the Yugoslav legacy, on the one hand (Bićanić 2001:162). The relatively large private sector meant large space for unofficial activities. The social capital that developed under these circumstances had little respect for the rule of law but showed large inclination to work in informal networks.

On the other hand, the war and the economic and social structures that emerged as a consequence of the war contributed further to the shape of the crony capitalism. The war reshaped the priorities in the country and created opportunities for free-riding and rent-seeking. After the war, these structures, however, continued to exist.

The inability for structural change has been the continuous feature of the Croatian economy since the beginning of the transformation process (Bićanić–Franičević 2003:38). One of the reasons is the weak and captured state. In 2000 the World Bank

labelled Croatia as high captured state with medium level of administrative corruption. The cause of the state capture was the weakly accountable political regime based on nationalist politicians having close relationships to powerful enterprises. Although the countries enjoyed the advantages of the capacity of the state, the capture of the state can be seen as a repression of this advantage. Once the state capture is reduced, it could give way to a powerful potential for further reforms (Anticorruption… 2000:66). In Croatia the HDZ had the opportunity to force the structural reform because the position of the party was uncontested. However, it did not use this potential, for various reasons. First, the HDZ was a conservative and ethno-centric party, many times declaredly anti-liberal. Second, the HDZ was not only a political party but a broad based movement with clientelistic expectations and obligations. Third, the HDZ served also as a transmission for individual and group strategies for rent-seeking (Bićanić–Franičević 2003:13).

The manipulation of the media, the dissatisfaction with the privatization, the authoritarian style of governance and dissatisfaction with the international position of the country brought forth that the HDZ government lost its popularity and finally its power at the end of the 1990' decade. The EUI report (2000:12) detected that large share of the population was discontent with the policy towards Bosnia and Herzegovina and considered that with supporting extremists among the Bosnian Croats, and that Croatia had to pay too high price regarding its international isolation. The economic crisis in 1998-1999 contributed to the defeat in a large extent as well (Bartlett 2003:57).
In autumn 1999 Tudjman came seriously ill and died in December. The new parliamentary elections were held at the beginning of January 2000. There was a fear that HDZ would win with sympathy votes but this time the opposition was able to unite and the six-party coalition won 52% of the votes. The election was also a practical proof of the existence of fair and free elections in Croatia (Bartlett 2003:76). Fisher (2006:20) argues that without western assistance it is unlikely that the opposition would have won by large margins.

3 The "Europeanist" phase of economic transformation and European integration

3.1 Building democracy II

3.1.1 The trial of the opposition: 2000-2003

The coalition of SDP (Socijaldemokratska partija Hrvatske, Social Democratic Party of Croatia) and HSLS (Hrvatska socijalno liberalna stranka, Croatian Social Liberal Party) won 39%, while the coalition of the four other opposition parties[44] won 13% in January 2000. The prime minister became Ivica Račan, the reform communist, who initiated the first multiparty elections in 1990. The HDZ lost the presidential elections as well; it was won by Stjepan Mesić, who broke with Franjo Tudjman and the HDZ in 1994, particularly because the policy towards Herzegovina (Bartlett 2003:57-58, 76).

The result of the elections meant a major change of power without violation and brought the end of political monopoly of the HDZ. The change of the government also showed that leaders can be voted out of office (Bićanić 2001:166).

The new government had highly different views about Croatia and its international position. The isolation was recognised as undesirable and unviable in the long run. The country was also recognized as a small state that must join European institutions. The aspiration of being a regional power was diminished and for the first time since independence, Croatia was ready to play a constructive role in the region of Southeastern Europe. Croatia wanted to be a "normal" country, not an exception of Europeanization among peer countries. The former political identity that was based more on the opposition of "others" seemed to be replaced by own positive definitions. The coalition of parties was dedicated to quick political and economic reforms, in order to compensate the time lost previously. The ambitions of the new government were warmly welcomed in the West. Both the EU and the NATO responded to the changes with enthusiasm. There were huge expectations towards a democratic and market oriented turn. The support of the West also enhanced the credibility of the new policy orientation of the government (Bićanić–Franičević 2003:24; Jović 2006:93-94). Bićanić labelled the new era as "second transition" (Bićanić 2001:166).

[44] Croatian Peasant Party (Hrvatska seljačka stranka, HSS), Istrian Democratic Assembly (Istarski demokratski sabor, IDS), Liberal Party (Liberalna stranka, LP), Croatian People's Party (Hrvatska narodna stranka, HNS)

The new government promised to transform the country into a liberal democracy and to correct many of the flaws of Croatian democracy. It announced also to stop meddling in Bosnia and Herzegovina. The government modified the constitution to reduce the power of the president, and strengthened the role of parliament and the government. The new government appeared to be far more cooperative with the ICTY than the previous ones. Despite the public constraints, in the middle of 2000 the government modified legislation discriminating against the Serbian people, minority language rights were strengthened and clauses were removed that made it difficult for Serb refugees to obtain state funding to rebuild their homes (HRW 2000). However, the government's situation was difficult when it wanted to satisfy the Western conditions. The return of ethnic Serb refugees was challenged by the large citizen opposition. The same occurred around the idea of extraditing war criminals to ICTY (EUI 2000:12-13).

Conflicts within the coalition hampered the pace of reform process, particularly in field of economy. The coalition *was more of an "anti-platform"* and had no well-defined agenda for change. Additionally, important parts of the administration, such as intelligence service, police, judiciary and the army stayed almost *unreformed* during the Račan governments that indisputable slowed down the implementation of new policy initiatives (Jović 2006: 96).

Each of the coalition parties wanted to have their members installed in public positions and ideological differences enhanced further division. The Istrian Democratic Assembly (IDS) left the government in May 2001. A controversy over war crimes caused a split within the HSLS between a nationalist wing that opposed to cooperation with the ICTY, and a moderate wing that supported the cooperative policies of the government led by the SDP. Prime Minister Račan realised that the coalition could not function any more and offered his resignation, thus the government collapsed. President Mesić did not called early elections but asked Račan to form a new government. After weeks of negotiations, a new coalition of four parties (SDP, HSS, LS and HNS[45]) was assembled that had a narrow majority (EUI 2002:7-8).

The ruling coalition remained on unsteady footing in late 2002 and in 2003 and the polls showed that its public support waned. On the other hand the position of HDZ strengthened. Since 1999 a moderate wing of the party broke away and found a new party Democratic Centre (Demokratski centar, DC). The nationalist wing led with the

[45] Social Democratic Party of Croatia (SDP), Croatian Peasant Party (HSS), Liberal Party (LP), Croatian People's Party (HNS)

new leader Ivo Sanader also sought to move the party towards the centre-right. Sanader worked hard in 2002 and 2003 to convince both the local public in Croatia and the international community that the party had took off its nationalist heritage and transformed itself into a modern European conservative one. The increased popularity of the HDZ was a response to the economic situation on the one hand. On the other, the new HDZ publicly opposed the government's support for the ICTY (EUI 2003:11-12). In October 2003 the parliament dissolved itself and the election was held in November 2003 (OSCE 2004).

3.1.2 HDZ reloaded

The elections in November resulted with the defeat of the ruling coalition. The new government was formed by HDZ in coalition with the Social Liberal Party (HSLS) and the Democratic Centre (DC). Ivo Sanader was elected as new prime minister. The international community acknowledged the return of the HDZ with anxiety. Sanader rushed to affirm that the HDZ is a reformed, democratic centre-right party and the government's aim was to speed up the EU accession process and to cooperate with ICTY[46] (Jović 2006:98). The political platform of Croatia's ethnic Serbs, the Independent Serb Democratic Party (Samostalna Demokratska Srpska Stranka, SDSS) also gained three seats in the new parliament. They decided to support the government that came as a minor surprise, in the light of the HDZ's previous nationalist approach. The new government faced large expectations from the electorate, who were discontent with the lack of leadership of the previous government (EUI 2004:11-12).

Sanader initiated the return of Serb refugees and in November 2004 Serbia and Montenegro and Croatia signed a bilateral agreement on protecting minority rights.

The HDZ faced difficulties during its first year in office, because of the slowdown in economic growth and because it could not decrease unemployment. IMF pressure forced it to withdraw from reducing value-added tax (VAT). As a result its popular support declined steadily during 2004 and 2005. In January 2005 President Stjepan Mesić was re-elected on the presidential election against the nominee of the HDZ.

[46] Sanader decided to keep out the far-right Croatian Party of Rights (Hrvatska Stranka Prava, HSP) of the government because of the pressure of the international community and the fear that the inclusion of the HSP would damage his party's new image.

In 2006 Human Rights Watch expressed its worry that Croatian authorities make inadequate progress to facilitate the return of refugee Serbs, although the issue of resolving lost housing rights for returning Serbs was a qualified exception (HRW 2006). According to the 2004 Eurobarometer Croatian national report[47], judiciary system had poor reputation because of corruption scandals and the huge backlog of unresolved cases. The church continued to be an important moral authority. Political parties were often perceived as interest groups, whose members use it for acquiring their personal wealth. The fact that all Croatian governments are perceived to have been associated with scandals has resulted in a lack of confidence in the executive's power. The confidence in the media was also poor. Only one-quarter of citizens in Croatia said that they were satisfied with way how democracy works in their country (compared to three-fifths of citizens in the EU-25) (Eurobarometer 62/2004). Over three-quarters of Croatian respondents were dissatisfied with the functioning of democracy in Croatia, while they had a much better opinion regarding democracy in the EU (Eurobarometer 63/2005). In 2006, the justice system has gained the trust of only 23% of Croatian people and the government only a quarter (Eurobarometer 65 2006). Trust in political parties and all institutions was 7% in Croatia in the second half of 2006 (Eurobarometer 66/2006). Confidence in European institutions was significantly higher than in the Croatian government. In 2007 a relative majority of Croatian respondents believed that affairs in Croatia were going in the wrong direction (43%).

The election in November 2007 resulted in the re-election of HDZ, i.e. it was the party that received the more votes (35%). However, SDP also won 32% of the votes and both parties started negotiations about forming the new governing. Both big parties were in favour of EU accession. Finally the government coalition was formed by HDZ, the alliance of HSS-HSLS and SDSS. The incumbent prime minister, Ivo Sanader stayed on (EUI 2008:3).

3.2 Legal conditionality towards the "Europeanist" governments

The European Commission in its Fifth Conditionality Report (early 2000) welcomed the political changes, which were considered as "radical" political changes and as crucially important for the democratic development in Croatia. In the Commission's opinion the

[47] Eurobarometer publishes Croatian national report since autumn 2004.

new political line could mean a turning point and provided the opportunity to put Croatia on a fully democratic path (Commission 2000a). Stjepan Mesić, the newly elected president of Croatia has said that he hopes Croatia will earn EU membership before his terms ended in early 2005 (Fisher 2000).

In May 2000 the Commission published a feasibility report on possible negotiations for the Stabilisation and Association Agreement with Croatia (Commission 2000c). The Commission concluded that the new government was committed to full democratization and long-term stabilisation of the country and already serious work started to revise earlier political shortcomings. The Commission commended the progress in field of return of refugees and displaced people, full cooperation with ICTY, improved regional cooperation and democratization of the media. First encouraging steps in the economic sector were acknowledged as well. Although the report called for further steps in both field, the Commission considered that the conditions for the opening of negotiations for a Stabilisation and Association Agreement with Croatia were met.

With the Stabilization and Association Process (SAP) the prospect of a Cooperation Agreement was replaced with the prospect of a Stabilisation and Association Agreement. According to the official EU approach, the SAP is based on the "recognition that one of the main motivators for the reforms is a relationship with the EU that is based on a credible prospect of membership once the relevant conditions have been met". The assistance to the Southeastern European countries is "designed to deliver the EU's strategic objective of anchoring the region permanently to the development of the EU itself" (Commission 2001a). The instruments of the process were formulated at the summit in November 2000 that was hosted by Zagreb.

The final declaration of the Zagreb summit stated that the Union commended the scale of the efforts and the success of the reforms initiated by the new government since the beginning of the year. As a result, the summit enabled the start of SAP negotiations and it expressed its hope of a rapid progress.

In December 2000 new financial instrument was adopted with the objective of supporting the participation of the countries in the SAP. The CARDS (Community Assistance for Reconstruction, Development and Stabilisation) program announced 4.6 billion euro for the region in the period 2000 to 2006. The development of the SAP has been monitored in stabilisation and association reports.

On 29 October 2001 the *Stabilisation and Association Agreement (SAA)* with Croatia was signed, which was the first comprehensive contract between the EU and Croatia

and therefore was a sign of improvement in the EU–Croatia relations. The agreement established several joint bodies at ministerial level (Stabilisation and Association Council), at high official level (Stabilisation and Association Committee), on parliamentary level (Joint Parliamentary Committee) and at technical level (subcommittees). The Croatian Parliament ratified the SAA on 5 December 2001 and notified of its ratification on 30 January 2002, although the Tudjmanist opposition and veteran groups were strongly against the SAA and also the fact that the summit was held in Zagreb. They saw these events as Croatia's "return to the Balkan" (Jović 2006:95).

For its entry into force, all the national parliaments of the EU member states had to ratify the agreement, but some of them (the United Kingdom and the Netherlands) suspended the ratification procedure, and linked it to the cooperation with ICTY. Because of its pending entry into force, an Interim Agreement covering trade and trade-related matters was applied temporarily on 1 January 2002 and it entered into force on 1 March 2002 (Commission 2002a, 2003a). The SAA itself finally entered into force in 2005.

Croatia was recognized "as a *potential candidate* for EU membership" (SAA 2005:4). The Stabilisation and Association Agreement was criticized by the HDZ (main opposition party that time) because it did not offer a clear membership prospect. As a reflection, in its first Stabilisation and Association Report the Commission stated that a guarantee of future membership was not a purpose of the SAA. However, the report also stated that the credibility of Croatia's aspirations to become a candidate for EU membership depends in mostly on how successfully it implements the SAA. The SAA was mentioned as "a clear route to bringing the country closer to European standards" (Commission 2002a:3-18). Bartlett (2003) argues that although several joint bodies were established, Croatian politicians had little impact on decisions that affected Croatia. On the contrary, Croatia was required to adopt and implement laws and regulations unilaterally. Bartlett (2003:161) compares this method to association negotiated between Croatia and the Hungarian Kingdom in the 11th century.

However, according to the Commission, the SAA was generally welcomed in Croatia. The Report also welcomed the radical political changes and stated that the new government had shown determination to establish a fully fledged democracy and had ended the political and economical isolation of the country. One of the main challenges of the new government was described as "to implement a comprehensive programme of

structural reforms to achieve political and economic transition". In 2002 the government's effort in the process of economic and structural reform were recognized, but the implementation went at a slower pace than expected.

According to a decision in December 2002, the Croatian parliament defined Croatia's accession to the EU as a strategic national goal and asked the government to summit the country's application for EU membership. The National Program for 2003 outlined the assessment, guidelines and tasks to be carried out in order to speed up the relevant activities in view of preparing the Republic of Croatia for full membership by 2006. In the light of this ambitious aim Croatia *applied for membership* of the European Union on 21 February 2003, just before the 2003 Stabilisation and Association Report was published.

In its second Stabilisation and Association Report (Commission 2003a) the Commission was not able to reply to the membership application. The report recognized some positive developments but did not find them enough to fulfil all the short-term priorities identified in the previous report. The overall progress of structural reforms was considered to be slow because of the fragile government coalition and public opposition to unpopular measures. At the same time the government showed a strong commitment to implement the SAA and adopted the "National Programme for the Integration of Croatia into the EU". One of the main obstacles in the EU–Croatia relations, the co-operation with the ICTY was still not solved. The Commission labelled the Croatian cooperation as "lukewarm".

In his statement on 21 February 2003, Romano Prodi, president of the Commission evaluated Croatia's application as "very good news". Since he was in Skopje that time, he seized the opportunity to express its hope in future development, stability and growth and for peaceful coexistence throughout the whole Balkan region. He also recalled that the EU's enlargement and Europe's reorganization can only be considered complete once the Balkan countries are members of it (Prodi 2003).

In April 2003, Neven Mimica, Croatian Minister for European integration highlighted four crucial factors that led to the membership application of Croatia. First, the consensus of all Croatian parliamentary parties regarding the European path of Croatia; second, the high public support for Croatia's membership (75-78 % over the three past years); Third, the government's assessment that Croatia has made substantial progress in fulfilling the necessary political, economic, legal and institutional commitments undertaken in the Stabilisation and Association Agreement. Fourth, the overall

understanding and firm support in most of the European Union member states towards Croatia's application. He considered as a realistic scenario to accomplishing the accession negotiations in less than two years period from mid 2004 to mid 2006 (Mimica 2003).

The Thessaloniki European Council (19-20 June 2003) declared that "the Western Balkans countries will become an integral part of the EU, once they meet the established criteria". This rather careful phrasing avoided the word "membership" but it introduced the European Partnerships.

The Commission's opinion on Croatia's application for membership was published in April 2004, shortly after the ICTY Chief Prosecutor's statement that Croatia was fully cooperating with ICTY. This statement paved the way for a positive opinion about the country's readiness to begin EU membership negotiations (EUI 2005:11-12). The Commission set out that the cross-party consensus on the political goal of EU membership did not changed after November 2003. The Croatian application was assessed as "part of an historic process, in which the Western Balkan countries are overcoming the political crisis of their region and orienting themselves to join the area of peace, stability and prosperity created by the Union" (Commission 2004a:4). The Opinion published the analysis on the bases of the Copenhagen criteria and the conditions set for the Stabilisation and Association Process. The Opinion did not set any date for the accession, but a medium-term time horizon of approximately five years, which is longer time horizon than the National Program for 2003 estimated. The government's working program for 2004-2007 that was published in 2003, set an internal goal to be ready by the end of 2007 and *catch up with Bulgaria and Romania* (Samardžija 2005:52).

Regarding the Copenhagen criteria, the Opinion stated the following: First, Croatia is a functioning democracy, with stable institutions guaranteeing the rule of law. Croatia needs to maintain full cooperation with ICTY. Second, Croatia is a functioning market economy and in the medium term it should be able to cope with the competitive pressure and market forces within the EU, supposing that it continues to implement the reform program. Third, Croatia will be in a position to take on the other obligations of membership in the medium term, supposing that considerable efforts are made to align its legislation with the acquis and ensure its implementation and enforcement. Based on these statements, the Commission *recommended* opening the accession negotiations

with Croatia. Following the decision of the European Council of 17-18 June 2004, Croatia became a *candidate country*.

The European Partnership for Croatia, initiated by the Thessaloniki summit in 2003, was adopted by a Council decision of 13 September 2004. It listed short and medium term priorities for its preparations for further integration with the European Union identified in the Commission's Opinion on Croatia's application. It also served as a checklist to measure the progress of the country. The main priorities set for Croatia related to its capacity to meet the Copenhagen criteria and the conditions set for the Stabilisation and Association Process, notably the conditions defined by the Council in its conclusions of 29 April 1997 and 21-22 June 1999, the content of the final declaration of the Zagreb Summit of 24 November 2000 and the Thessaloniki agenda (Commission 2004b).

On 1 February 2005 the Stabilisation and Association Agreement (SAA) with Croatia entered into force. The implementation of the SAA and the preparations for EU membership were connected together, since the progress in the accession negotiations was also dependent on Croatia's fulfilment of its commitments under the SAA (SAA enters…2005).

The cooperation with the ICTY again proved to be a crucial condition concerning the start of the accession negotiations, which were postponed in the absence of Croatia's full cooperation. It began to appear in 2005 that Sanader's strategy of concentrating the government's efforts almost exclusively on the EU accession process would fail (EUI 2006:9). Based on the positive assessment from the ICTY Chief Prosecutor, the Council concluded that Croatia had met the outstanding condition for the opening of accession negotiations. However, Olli Rehn, Commissioner for enlargement declared that Croatia must have solved the issue of arresting and transferring of General Ante Gotovina to The Hague (EU opens…2005). The Council also agreed that less than full cooperation with ICTY could be a basis for the suspension of the negotiations (GAERC 2005).

The Chief negotiator of Croatia, Vladimir Drobnjak, stated in an interview[48] in October 2005 that Croatia could learn form the Slovakian experience since this country went through the negotiations rather quickly, having joined the accession talks at a later stage, due to political reasons. He also stated that Croatia would try to take advantage of its smallness in terms of territory and population. Croatia did not want to be a part of a

[48] Slobodna Dalmacija, 17 October 2005, cited in Jović (2006:102).

"package deal" with Turkey, nor wait for the other countries of the Western Balkans (Jović 2006:102). Hidajet Biščević, State Secretary for Political Affairs at the Ministry of Foreign Affairs and European Integration stated also in an interview[49], that Croatia's future EU membership is seen as a "second recognition", and is compared to the official recognition of its independence in January 1992.

Following the opening of accession negotiations, in February 2006 the Council adopted an Accession Partnership which updated the European Partnership of 2004. The first Progress Report (Commission 2005) the Commission stated that Croatia had to a great extent implemented its obligations under the SAA and made some progress in reaching the priorities of the Accession Partnership. However, further steps were considered to be necessary in several fields, considering both political and economic criteria. Judiciary reform required "serious attention". In the field of economic structural reforms the Report urged the implementation of number of measures. To assume the obligations of membership, strengthening administrative and judicial structures considered to be necessary.

In June 2006 the first chapter of the accession negotiations - science and research - was formally opened and provisionally closed. After one year of the opening of the negotiations, the screening was completed in October 2006. The second Progress Report (Commission 2006a) stated that Croatia made a good start in the accession negotiations. The general opinion of the Report was that some progress had been made in every field but further efforts were needed. Concerning political criteria, the short-term priorities of the Accession Partnership have been partially addressed. A key Accession Partnership priority, the judicial reform has begun, but the reform was considered to be in an early stage. Civil service and the media were under undue political influence. In field of the economy, the pace of structural reforms was reported to be generally slow, privatization and enterprise restructuring needed more effort and state invention remained significant. Croatia's ability to take on the obligations of membership has improved according to the Report; however, short-term priorities of the Accession Partnership remained to be fulfilled in many fields.

The third Progress Report (Commission 2007) concluded that the accession negotiations were advancing well and were entering a decisive phase. Some progress had been made in every field, but further efforts were needed. The first results showed up in the fight

[49] Vjesnik, 15 October 2005, cited in Jović (2006:87).

against corruption, but further steps were needed in the area of judicial and administrative reform, minority rights, and refugee return, and in restructuring of steel and shipbuilding industries.

Textbox 3: ZERP

In late 2003 Croatia declared a protected ecological and fishing zone (zaštićeni ekološko-ribolovni pojas, ZERP) on its Adriatic coast, aiming to protect the fish stocks and the beauty of the coastline that are vital to Croatia's tourism industry. The EUI report (2004:24) labelled this action as an "ostensible bid". It blocked Slovenia's direct access to international waters. There were several international disputes going on between Croatia and Slovenia that time, stemmed from the break-up of Yugoslavia in 1991. There have been sea border disputes in the Piran Bay and also land border disputes, disputes over the ownership of the Krško nuclear-power station and over the return of Croatian citizens' frozen foreign exchange deposits at Ljubljanska banka, the largest regional bank in Slovenia in the Yugoslav era (EUI 2004:20).

The diplomatic tensions threatened with the possibility that Italy and Slovenia might veto Croatia's EU membership application. As a result, the government agreed in June 2004 to apply the ZERP to non-EU members only. However, tension over border issues escalated briefly in 2004 and in 2005, when Slovenia announced the creation of an exclusive economic zone on its own Adriatic coastline (EUI 2006:18). At the same time, Croatia's obligation to improve regional co-operation arose also from its membership ambitions.

In late 2006 the Croatian parliament passed again the law on establishing a ZERP zone that applies to EU member states by no later than 1 January 2008 (EUI 2007). In autumn 2007 before the parliamentary elections, Ivo Sanader has promised to representatives of the European Commission that if the HDZ won the elections, the government would not activate the ZERP provisions by 1 January 2008, but it would be put off from the agenda until the chapter of fisheries is closed. With this step Sanader avoided the suspension of accession talks that Brussels has announced (Nacional 2007a). In December 2007 in its conclusion the Council called on Croatia to fully respect the 4 June 2004 agreement concerning the ZERP. President Mesić also lobbied for the abolition of ZERP in December 2007 (Nacional 2007b).

However, the *ZERP came into force* on 1 January 2008, just with the beginning of the Slovenian presidency and resulted in the slowdown of membership negotiations. In February 2008 the Council recalled its conclusions of December 2007. President Mesić challenged the government to choose between the fisheries zone and the country's European future (Reuters 2008). In its communication in early March 2008, the Commission (2008a) reminded Croatia to pay increasing attention to solving disputes with its neighbours and consider the Council Conclusions of February 2008 on ZERP. In March Sanader announced that the country will not implement the ZERP until Croatia joins the EU. Officials in Brussels welcomed the decision. Sanader said that EU membership was more important than the implementation of ZERP at this time. Olli Rehn in his reflection said that the negotiations with Croatia can accelerate (SET 2008). Before Ivo Sanader resigned in July 2009, he declared concerning the border dispute that Croatia will not pay with territory for entering the EU. If this is the price then the country will prefer to stay out (nol 2009). In September 2009 Jadranka Kosor, newly elected prime minister of Croatia, come to an agreement with the Slovenian prime minister that they continue negotiations under international supervision and that the border-dispute cannot influence the Croatian accession negotiations (Euvonal 2009).

In February the Council adopted a revised accession partnership with Croatia. The document highlighted the key priorities, including judicial reform, public administration reform, anti-corruption program, the Constitutional Law on National Minorities,

completing the return of refugees, resolving the ZERP issue, maintaining full cooperation with ICTY, and improving the business environment and economic growth potential (Council 2008).

The Slovenian presidency was not in favour of accelerating the Croatian integration, although the European perspective of the Western Balkans has been among the presidency priorities.

On 12 June 2008 the Lisbon Treaty referendum took place in Ireland[50]. The result of the referendum has had important impact on Croatia since the Nice Treaty was designed for 27 members and the Lisbon Treaty would have enabled the EU to further enlargement. French President Nicolas Sarkozy[51] argued that the enlargement must be put on hold, as long as the reform treaty has not come into force, any further expansion of the EU would be unthinkable. It is nothing against Croatia, he said" (Spiegel 2008). Stjepan Mesić Croatian president expressed his hope that the EU would find a way out of the institutional crisis. Dmitrij Rupel Slovenian foreign minister expressed his doubts that Zagreb manage to close all the chapters of its EU accession negotiations package by late 2009 (EUobserver 2008).

In its communication in March 2008 the Commission (2008a) considered Croatia and its progress as a benchmark to the other Western Balkan countries that demonstrates that the European perspective is real, once the necessary conditions are fulfilled. According to the fourth Progress Report (Commission 2008b), negotiations have been opened on 21 out of 35 chapters[52] and provisionally closed on four (science and research, education and culture, enterprise and industrial policy, external relations). Implementation of the Stabilisation and Association Agreement has continued without major difficulties, except for continued non-compliance with certain state aid provisions, in particular as regards aid granted to the shipbuilding sector. Croatia has still a lot to do in the area of judicial reform, in the fight against corruption and organised crime. Olli Rehn EU Commissioner for enlargement presented the Enlargement package in November 2008. He stated that 2009 may become a historic year for Croatia, when the country reaches the final stages of its EU accession process.

[50] 53.13% of the electorate took part in the referendum and 53.4% of them voted for "no" (against 46.6% "yes").

[51] The EU summit under French presidency was held on 19-20 June 2008.

[52] science and research, education and culture, economic and monetary policy, enterprise and industrial policy, customs, intellectual property rights, services, company law, statistics, financial services, financial control, information society and media, consumer and health protection, external relations, financial and budgetary provisions, TENs, transport, energy, free movement of workers, social policy and employment, free movement of goods

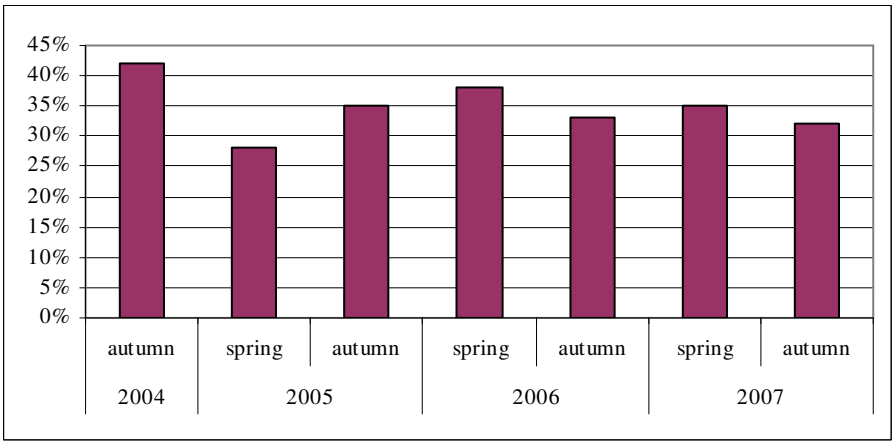
The Commission presented a conditional and indicative roadmap for Croatia to conclude the technical negotiations by the end of 2009.

3.3 European identity

The term "Western Balkans" was still disliked in Croatia during the Račan government. In his lecture, minister Neven Mimica mentioned the term Western Balkans, as "South East Europe is called in the Brussels terminology" (Mimica 2003).

According to Eurobarometer reports, although Croatia's application for EU membership received a positive opinion from the European Commission, the Euroscepticism of Croatian people increased in 2004 and the support for EU membership dropped from three-quarters of the population to around 50% during the year. The relatively low level of confidence (Figure 14) in the European Union may be attributed to both the ineffectiveness it is perceived to have displayed during the war in Croatia and in Bosnia and Herzegovina, and the perception that it is unfairly using stricter criteria when assessing Croatia than for other countries. In spring 2005, most probably because the accession negotiations has been postponed, the confidence of the Croatian public in the EU fell to only 28%, from 42% in 2004 and Euroscepticism increased among Croatian respondents. At the same time, the Eurobarometer noted that the rise was caused by momentary events, while in the medium to long term, a great majority of Croat people favour EU membership. The confidence of Croatian public in the European Union has begun to rise slowly in autumn 2005 after the opening of the accession negotiations to 35%. Trust in the European Union, at 38%, was significantly higher than in state institutions. In 2007 43% of Croatian citizens expected benefits from EU membership but still 48% did not (Eurobarometer 67 2007). The support for membership decreased slightly in spring 2008 (Eurobarometer 69 2008).

Figure 14: Confidence in the EU in Croatia



Source: Eurobarometer surveys 2004-2007

3.4 The common foreign and security policy after the Yugoslav war

Although the armed conflict was over by the mid-1990', the aftermath of the war was still present when the new government gained power in 2000. Bićanić (2001:168) expressed his hopes that the new government would re-evaluate delicate issues around the war, including the highly ambiguous issue of the Bosnia and "Greater Croatia" policy that transformed Croatia from victim of the Serbian aggression to an aggressor.

The common foreign and security policy (CFSP) did not play such an active role in this period as during the armed conflict. However, the cooperation commitment of the Croatian government with the ICTY ran through the years of peace as well and it became the top priority of the common foreign and security policy towards Croatia.

NATO invited Croatia to the Partnership for Peace program and the country officially joined the program in May 2000. NATO Secretary General George Robertson evaluated this step as "Croatia is proof that a country does not have to remain a victim of history" (News… 2000). The Croatian foreign minister declared that Croatia is intent on joining the NATO. In April 2008, Croatia was invited to start accession talks. The accession protocols were signed in July 2008 and Croatia officially became a NATO member on 1 April 2009.

3.4.1 ICTY

The cooperation with the ICTY was the issue, the lack of which caused informal economic and political isolation of the country. In April 2000 the chief prosecutor and deputy prosecutor visited Zagreb. The Račan government allowed for the first time ICTY representatives to investigate war crimes committed in Croatian territory and

handed over requested documents. The government extradited two indicted war criminals as well. By June 2000 the ICTY prosecutor indicated that the organization had "full access" in Croatia. The Račan government gave the impression that it cooperated with the ICTY because of international pressure. The commitment of the government was embarrassed by demonstrations of veterans who were in partnership with HDZ.

Two former generals of the Croatian Army, Ante Gotovina and Janko Bobetko were indicted on 8 June 2001 and on 23 August 2002. The two generals were key figures of the Homeland war, Bobetko was also the founder of the Croatian Army in 1991. His indictment was contested by the government as unlawful, but the ICTY rejected the appeal. Bobetko's death in early 2003 closed the episode (EUI 2003:15). General Gotovina had gone into hiding. The ICTY insisted that the government knew where he was, while the government claimed that he had fled the country (EUI 2004:20). President Mesić proved to be the one who encouraged Croats to deal with their past[53]. He insisted from the beginning that suspected war criminals should be brought to justice in order to avoid the collective guilt of the nation. Mesić believed that Croatia does not act like this in order to obey the international pressure or interests but on behalf of its own future that is nothing else but the united Europe (Mesić 2003:II).

With the indictment of Gotovina and Bobetko, Croatia faced the most delicate situation that occurred since the end of the war in 1995. The hesitation of the Croatian government was furthermore in contrast with the decisive extradition of Slobodan Milošević by the government of Serbia in June 2001. The international community became doubtful whether Croatian politics had really changed (Jović 2006:97).

When it came into power in 2003, contrary to the expectations, the new HDZ government committed to cooperate with the ICTY. The government extradited (in some cases, voluntarily) of a number of indictees to The Hague, and as a result Chief Prosecutor Carla Del Ponte declared in April 2004 that Croatia was fully co-operating with the Tribunal[54]. In March 2005 the Chief Prosecutor concluded that Croatia still

[53] However, due to the changes in the constitution, the president's power was reduced to a near ceremonial level.

[54] However, Gotovina was still not arrested. The public support towards Gotovina significantly lowered since 2001, but the requirement to arrest him proved to be very difficult for the government. The Chief Prosecutor became increasingly sceptical about the government's willingness or ability to extradite the general (EUI 2005:11). In spring 2004, the Croatian government accepted the appearance of foreign intelligence services in Croatia whose aim was to find Ante Gotovina. Thus in November 2004 the Chief Prosecutor revised her statement, indicating that Croatia will be cooperating fully once Gotovina is handed over to the ICTY (HRW 2004).

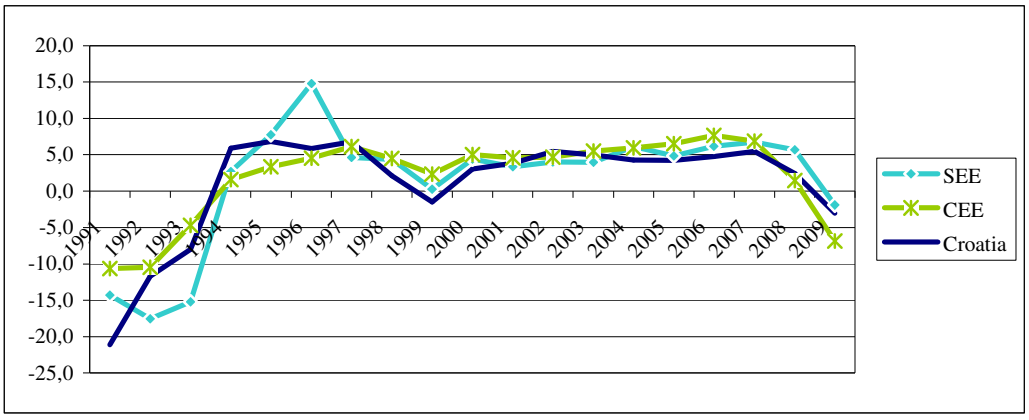
needed to improve its cooperation with the ICTY. But surprisingly, in her report to the EU General Affairs and External Relations Council on 3 October 2005, the ICTY Chief Prosecutor concluded that Croatia was *fully cooperating* with the Tribunal. Since Ante Gotovina was still at large, many observers interpreted the statement of Del Ponte that the political pressure from some EU member states contributed to it (HRW 2005). Finally, Ante Gotovina was arrested in Spain in December 2005.

3.5 Building market economy

3.5.1 Macroeconomic performance in the 2000'

After a costly consolidation, Croatia emerged from the recession in the final quarter of 1999 and the growth picked up in 2000. Until 2003 the Croatian economic growth increased or even exceeded the average trend in SEE and CEE. It was the *revival of private consumption*, which brought the country out of recession, reflecting partly the delayed impact of a strong real wage growth in 1999, and also the increased consumer confidence due to political change in the January 2000. However, a growth path based on domestic consumption is dangerous and unsustainable on the long run in case of a small open economy like Croatia. From 2004 the growth has lost momentum and stayed below the peer country average (Figure 15). This solid economic performance leaves room for improvement. The recent growth has been driven by domestic investment (Moore–Vamvakidis 2007:5).

Figure 15: GDP year-on-year rate of growth in real terms in Croatia, 1991-2009

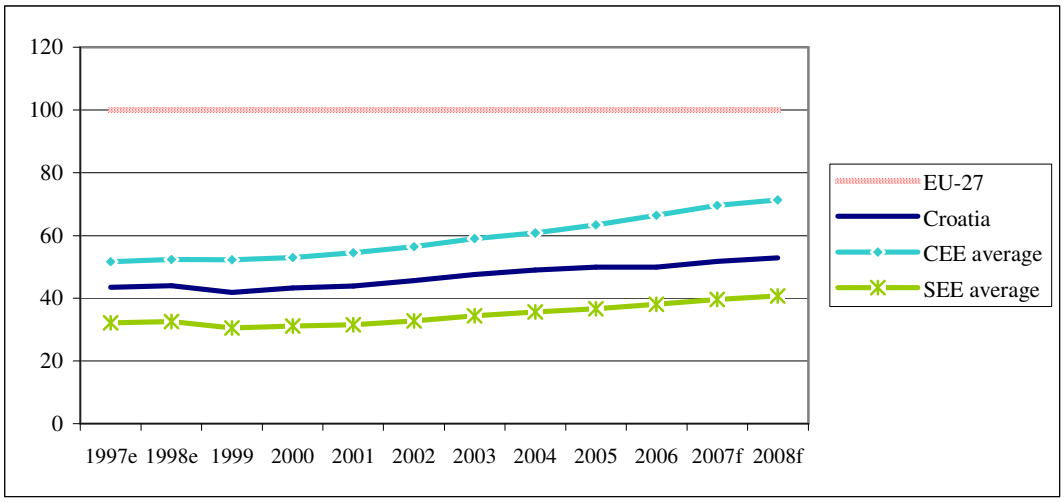


Data for 2008 is estimation, data for 2009 is projection
Source: EBRD Selected economic indicators

The GDP per capita reached the level of 1990 in 2003, which shows a slower pace of catch up than in the Visegrád countries but faster than the Latvian and Lithuanian pace.

Considering the GDP per capita compared to EU average, Croatia has reached the 50% of the EU-27 average in 2007 according to Eurostat forecasts (Figure 16).

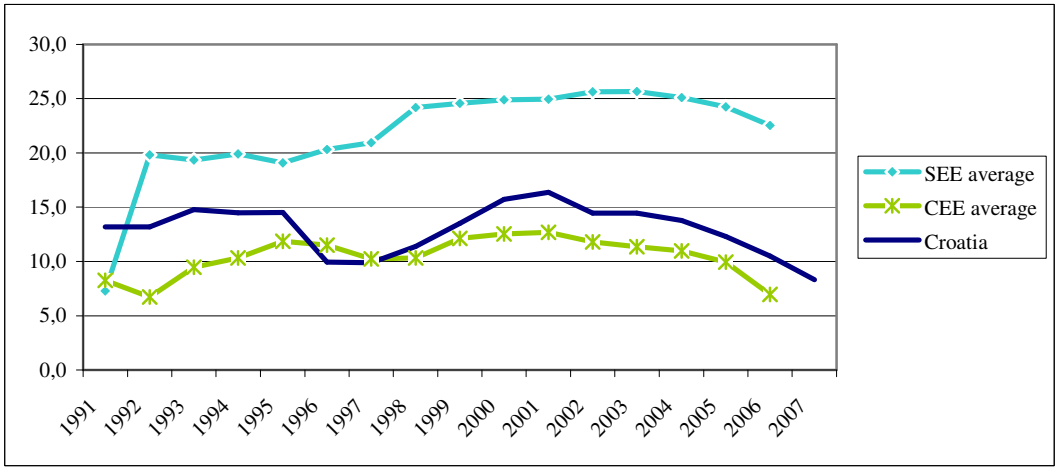
Figure 16: GDP per capita in Purchasing Power Standards (PPS), 1997-2008, EU-27 = 100



Note: The data for 1997 and 1998 is estimated value. The data for 2007 and 2008 is forecast. The data for Croatia from 1997 to 2003 is estimation and from 2004 to 2008 is forecast.
Source: Eurostat

The relatively slow enterprise restructuring process and implicit labour shedding may have prevented higher rate of unemployment (Cazes 2006:11; Commission 2005:39) (Figure 17). Long-term unemployment is a severe issue in Croatia. The moderately high long-term unemployment (along with low employment rate) reflects to the rigidity of the labour market. The limited job turnover and job creation remain some of the most compelling economic problems in Croatia (Commission 2006a:19).

Figure 17: ILO unemployment rate in CEE and SEE countries, in percentage



Source: EBRD, Selected economic indicators, data based on labour force surveys (LFS)

Following political changes in 2000, the EU withdrew most of the barriers to Croatian *exports*, and granted preferential access for exports of textiles. The change in government also removed the political obstacles of the WTO membership; in July 2000 Croatia joined the WTO. According to the agreement, Croatia committed to agricultural and industrial protection by 2005 and to the liberalization of fixed-line telecommunication services by 2003 (EBRD 2000:150). Croatia requested to accede to the Central European Free Trade Agreement (CEFTA) in July 2001 and the accession treaty was signed in December 2002[55].

Despite the improvement in access to global markets, the real export growth remained lower than that of the import, as in most of the countries under consideration. The Croatian growth rate has been the one of the lowest among the peer countries, considering both import and export growth. The weak growth in export volumes reflected the slow pace of industrial restructuring, and the lack of foreign direct investment in manufacturing industry.

Concerning the *direction of trade*, the main trading partner of Croatia has been the EU, without a doubt (Table 12). In the past 10 years the share of the euro area among the trade partners of Croatia has remained by and large stable at 50%. According to the gravity model of Bussière et al. (2005:29) Croatia still has significant potential in its trade intensity with the euro area. In 2001-05 Croatian trade with the euro zone grew by 6%, well below the average of 9.3% for the central European countries. Despite its small size, Croatia was a relatively closed economy at the new millennium. Exports of goods and services represented only 45% of GDP in 2000, compared with 60-75% for most countries in Eastern and Central Europe.

Table 12: Trade with the EU 1994-2006, as % of total

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Exports from EU	59%	58%	51%	51%	48%	49%	54%	54%	53%	55%	51%	63%	63%
Imports to EU	59%	62%	59%	60%	59%	57%	56%	56%	56%	57%	51%	66%	65%

Note: Data for 2005 covers Jan-Nov.
Source: EUI country profiles

Concerning the *structure of export* to the European Union, it developed unfavourable during the second half of the 1990'. The current structure is characterized by a high

[55] The CEFTA was redesigned in 2006 in the framework of the Stability Pact and was extended to the countries in SEE. The aim of the CEFTA remained to improve the readiness of parties for membership in the European Union.

share of labour- and capital-intensive industries and a low share of technology-driven industries. The most important export product group has been machinery and transport equipment (36.1%). Within this sector, shipbuilding still accounts for around 30% of total export (Table 13). The export performance of the manufacturing industry is poor even though the high level of FDI inflow into this sector. This suggests the low return on investments. Since the export performance depends largely on FDI-attracting capacity, the export performance can be understood as the benchmark of how effective the regime change was (Csaba 2007b:64).

The diversification of Croatia's export base is in line with CEE countries. According to World Bank statistics, high-technology exports' share of manufactured exports was 12% in 2005 and 13% in 2004 in Croatia. It is higher than the average of SEE countries and even that of the CEE average.

Table 13: Croatian export to European Union and import from the European Union, 2006

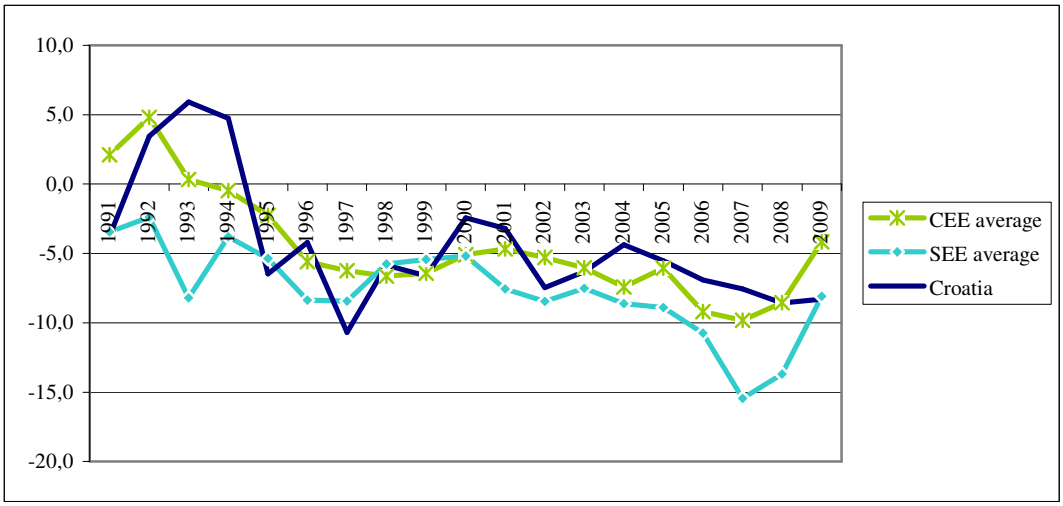
EXPORT TO EU Product group	**Million euro**	**%**	**IMPORT FROM EU Product group**	**Million euro**	**%**
Machinery and transport equipment	1157	24.3	Machinery and transport equipment	4351	36.1
Miscellaneous manufactured articles	928	19.5	Manufactured goods classified chiefly by material	2464	20.4
Manufactured goods classified chiefly by material	831	17.4	Miscellaneous manufactured articles	1551	12.9
Food and live animals	445	9.3	Chemicals and related products, n.e.s.	1488	12.3
Crude materials inedible, except fuels	437	9.2	Food and live animals	848	7.0
Chemicals and related products, n.e.s.	389	8.2	Mineral fuels, lubricants and related materials	685	5.7
Mineral fuels, lubricants and related materials	177	3.7	Crude materials, inedible, except fuels	252	2.1
Commodities and transactions n.e.c.	29	0.6	Commodities and transactions n.e.c.	204	1.7
Beverages and tobacco	20	0.4	Beverages and tobacco	90	0.8
Animal and vegetable oils, fats and waxes	5	0.1	Animal and vegetable oils, fats and waxes	19	0.2
TOTAL	**4 762**	**100.0**	**TOTAL**	**12 058**	**100.0**

Notes: Product groups mentioned by Standard International Trade Classification
n.e.s.: Not Elsewhere Specified; n.e.c.: Not Classified Elsewhere
Source: European Commission, DG Trade

During the examined period net tourism revenue has continued to increase and thus played a major role in sustaining Croatia's *current account balance* (Figure 18). It has financed about two-third of the trade gap (Table 14). Another significant factor on the positive side is the remittances of Croats working in foreign countries. Croatia's current account performance has been largely driven by the strong growth in investment. Total

gross fixed capital formation rose markedly from around 24% of GDP in 2001 to around 33% in 2006, while the domestic savings ratio rose too, from 20% to 25% of GDP (Stamm–Macovei 2007:3).

Figure 18: Current account in % of GDP in Croatia, 1991-2009



Note: Data for 2008 is estimation, for 2009 is projection by EBRD
Source: EBRD Selected economic indicators

Table 14: Current account balance in Croatia, in million EUR

	2000	2001	2002	2003	2004	2005	2006	2007
Goods	-3 492.1	-4 595.2	-5 957.9	-6 971.2	-6 724.2	-7 518.0	-8 344.2	-9 434.0
Services	2 470.5	3 302.8	3 284.8	4 933.0	4 768.9	5 317.7	5 710.4	6 319.9
Current account balance	-568.1	-820.8	-2 098.7	-1 888.8	-1 433.7	-1 975.6	-2 692.4	-3 206.4
Current account/GDP (%)	-2.8	-3.7	-8.6	-7.2	-5.0	-6.3	-7.9	-8.6

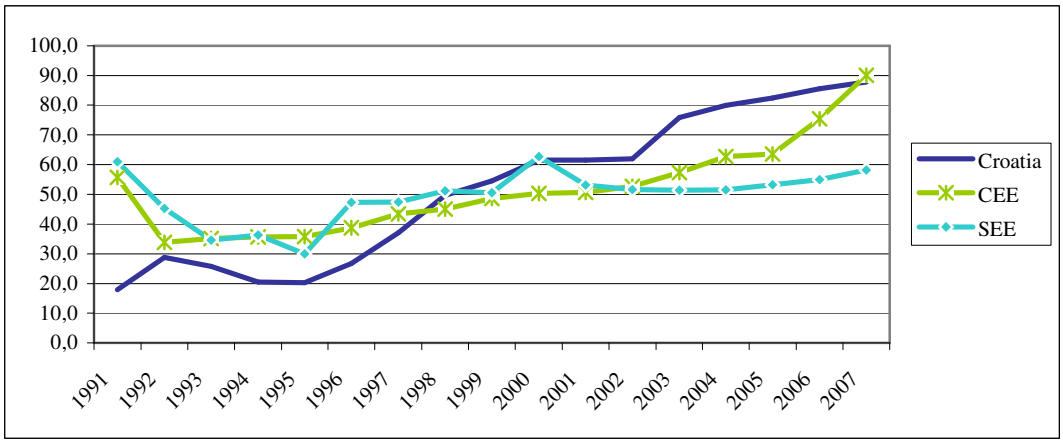
Source: HNB and EBRD

The stock external indebtedness of Croatia has been rising since the beginning of the 1990'. In the 2000' the external debt stock grew by 22% in average. Since 2004 Croatia belongs to the severely indebted group of countries according to the World Development Indicators categories (Figure 19). Considering other indicators as debt service to GDP, interest payments to exports, or net external debt, the indebtedness problem appears to be less severe.

The composition of the external debt has changed in the 2000' years. Prior to 2001 foreign borrowing was driven primarily by the public sector due to massive reconstruction needs. Since 2002 the external debt of the private sector has started to

grow, by a strong increase in foreign borrowing by domestic banks and by direct external borrowing of firms (Stamm–Macovei 2007:1-2). In summer 2008 the Croatian media reported about a possible "Argentinian scenario" financial crisis because of the high debt figures that were disclaimed by exports (FR-online 2008).

Figure 19: External debt in Croatia, 1991-2007, as % of the GDP



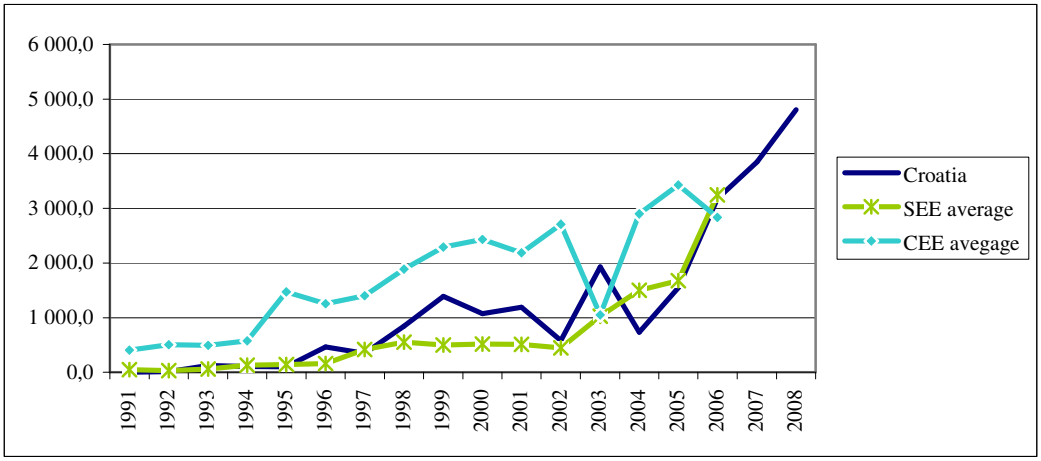
Source: EBRD Selected economic indicators

The amount of net *foreign direct investment* into Croatia has approached both SEE and CEE average recently (Figure 20). Considering FDI per capita data, Croatia outstrips all the SEE countries and several CEE countries as well. Among SEE countries Croatia has the second largest inward stock of FDI after Romania, this amount is much higher than the SEE average, but well below the CEE average. On the other hand Croatia has the largest amount of outward stock among the SEE countries, almost as high as the CEE average (Figure 21). Considering the stock amount of FDI and FDI per capita indicators, Croatia belongs to the more attractive destinations of FDI in the region (WIR 2006:134).

The most important motivation of foreign investors in the majority of Central and Eastern European countries have been the low labour costs. In Croatia most of the investors either entered the country in order to increase their market share by capital increases and takeovers or to take part in the privatization process as strategic investors, although the method of privatization (manager and employee buy-out and later voucher privatization) was not really in favour of FDI. Accordingly, most of the foreign investments took place in already existing capacities. The number of greenfield projects has been below potential (Table 15), partly due to the unfavourable business environment. The innovation activity in Croatia has been in line with peer countries, measured by new patents (Moore–Vamvakidis 2007:19) According to the comparison

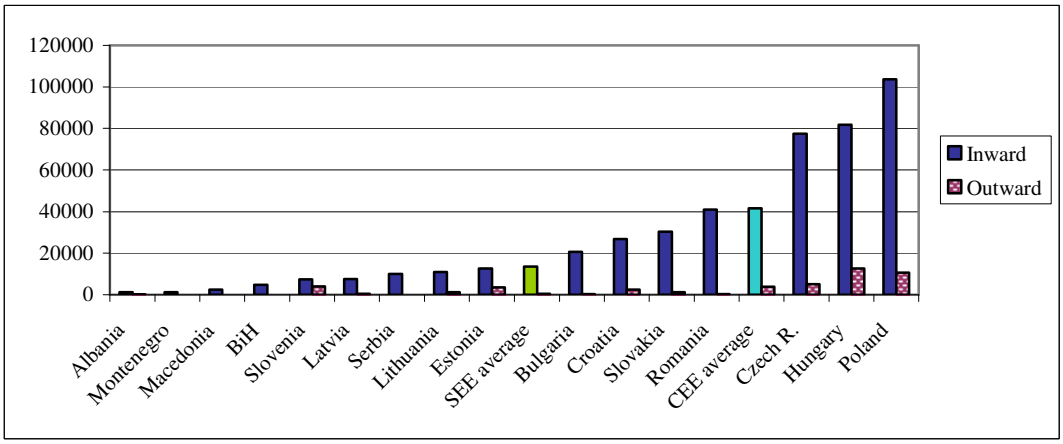
between potential and actual non-privatization FDI at the end of 2003 (Demekas et al. 2005:25), Croatia is among the countries that could gain the most in terms of additional FDI. The UNCTAD World Investment Report (WIR 2007:14) has found both Croatia and Slovakia a front-runner in reference to inward FDI, both its FDI performance and FDI potential in 2005.

Figure 20: Net foreign direct investment in CEE and SEE countries, in millions of USD



Source: EBRD Selected economic indicators

Figure 21: FDI stocks 2006, inward and outward in CEE and SEE countries, millions of USD



Source: UNCTAD, World Investment Report 2007

Table 15: Number of greenfield FDI projects, by destination region, 2002-2007 (concluded)

	2002	2003	2004	2005	2006	2007	total
Croatia	33	46	41	46	39	32	237

Source: World Investment Report 2008

Concerning *origin of FDI*, the EU has been the largest investor in Croatia. Since 1993 the share of the EU-15 has grown, while the share of the 2004 new member states and

other developed countries has decreased (Figure 16). On the basis of inward stock in 2008, the top three investment partners were Austria, Germany and the Netherlands. On the other hand the most important destination countries of Croatian outward stock FDI were Netherlands, Bosnia and Herzegovina and Serbia by 2008 (HNB 2009).

Most of the foreign investments took place in the service sector and the largest beneficiary of the inward FDI has been the financial sector (Table 17), reflecting to bank privatization and capital injections to foreign-owned banks (Moore-Vamvakidis 2007:5). On the other hand, FDI had less impact on manufacturing in Croatia.

Table 16: The origin of FDI in Croatia, 1993-2007, in percentage

	1993-2007	2007
EU-15	82.1	84.0
2004 EU member countries	11.5	12.0
Other developed countries	3.7	0.0
International fin. institutions	1.4	1.0

Source: Croatian National Bank

Table 17: FDI in Croatia by sectors, 1993-2007, in percentage

	1993-2007	2007
Financial intermediation, except insurance and pension funds	35.5	61.1
Manufacture of chemicals and chemical products	12.0	8.1
Post and telecommunications	10.0	6.0
Wholesale trade and commission trade	5.2	5.8
Extraction of crude petroleum and natural gas	4.4	4.7
Manufacture of coke, refined petroleum products	4.1	3.2
Real estate activities	3.4	3.2
Manufacture of other non-metallic mineral products	3.3	1.9
Retail trade, except of motor vehicles and motorcy	3.2	1.8
Manufacture of food products and beverages	3.2	1.6
Other activities	15.7	2.6

Source: Croatian National Bank

3.5.2 Structural changes since 2000[56]

One of the main tasks of the Račan government faced with in 2000 was to reduce the government budget deficit. In March 2001 the government signed a Stand-By Agreement (SBA) with the IMF for 200 million SDR, with the aim to reduce the government deficit to from 5.7% of GDP in 2000 to 5.3% in 2001 and 4.3% in 2002. In order to cut public spending, the government introduced a framework for public sector wages and set to reduce government employees. The arrangement ended in May 2002.

[56] If not indicated otherwise, the chapter is based on EUI country reports 2000-2007 and EBRD Transition Reports 2000-2007.

The central government deficit reduced somewhat but with extra-budgetary activities included, the deficit increased further mainly due to the construction of the Zagreb–Split motorway. The delays in reducing public sector employment and in implementation of health care sector reform endangered the further consolidation. In February 2003 the government signed a new Stand-By Agreement with the IMF for 140 million USD. Despite the failure to complete the former SBA, in August 2004 the IMF approved a new agreement worth 141 million USD.

A three-pillar pension system was established in January 2002, after three years of adopting the law. The pension system introduced mandatory and voluntary private pension pillars to supplement the state pension. The reform appeared to be one of the most successful among transformation economies since the privately managed mandatory (second) pillar managed to preserve 98% of all contributors for actual capital utilization in the first year. Despite the successful start, less than 9 000 people participated in the third pillar of voluntary pension contracts by 2004. In 2005 a new indexation system was introduced to restore financial sustainability. Administrative fees for medical services were introduced in July 2005. In July 2006 a more broad health care reform was adopted, but until autumn 2007 slow progress has been made.

The *Croatian Competition Agency* was established in early 1997, but state aid control only became one of its tasks in 2003. The first state aid act entered into force in April 2003. In December 2005 a new state aid law came into force which increased the competences of the Croatian Competition Agency (Commission 2006b:16-18). However, state aid kept on rising, from 2.8% of GDP in 2002, to 3.2% in 2003 and 3.4% in 2004, compared to EU-25 average of 0.6 percent and a EU-10 average of 1.1% in 2004 (EPC 2006). In 2005 the government intended to finalise plans for the restructure the state-owned steel companies and shipyards, in co-operation with the EU and international financial institutions, with the aim of reducing government subsidies. As of 2006 tourism do not receive aid.

The Račan government decided to consolidate state holdings of shares into the *privatization fund* (HFP). In 2000 the EBRD reported about renewed determination to privatize the remaining state shares in strategic companies (Table 18), such as Hrvatski Telekom, INA (Industrija Nafte) the oil and gas company of Croatia and HEP (Hrvatska Elekrtoprivredna) the Croatian energy company. By September 2001 there were 1598 companies in the HFP portfolio, compared to 1852 in mid-2000. By June 2002 the number of enterprises in HFP's portfolio further reduced to 1150.

In July 2001 energy laws were adopted concerning electricity, gas, oil and other energy sector that provide a framework for liberalization and privatization. In March 2002 the parliament approved a plan for partial privatization of HEP (15%) and INA (25% plus one share). In May an international tender was launched and finally the stake was sold to MOL (Hungary) for 505 million USD. The privatization of HEP was delayed again and again.

Table 18: Selected large-scale privatization in Croatia 2001-2005

year	company	sector	value (in million USD)	investor origin
2000	Privredna Banka Zagreb	bank	300	Italy
2001	Ecelsior Hotel	tourism	36.3	na
	Hrvatski Telekom	telecommunication	447.6	Germany
2002	Splitska Banka	bank	117.7	Italy
	Dubrovačka Banka	bank	27.5	United Kingdom
	Riječka Banka	bank	136.2	Germany
2003	INA dd.	oil and gas	505	Hungary
	Energo	electricity, gas, water	8.57	Germany and Italy
	Jelsa dd.	tourism	4.25	Croatia
	Hotel Kompas Dubrovnik	tourism	3.6	Chanel Islands
	Dakovstina dd.	agriculture	3.21	Croatia
2004	Hotel Split	tourism	14.58	Croatia
	Grand Hotel Park Dubrovnik	tourism	8.95	Croatia
	Hotel Mlini	tourism	11.6	Croatia
	Kutjevo	agriculture	1.66	Croatia
	Oranovica	agriculture	2.26	Croatia
2005	Adriatic Split	tourism	28.6	Croatia
	IPK Kandit Osijek	food	10.19	Croatia
	Istra Pula	consumer goods	5.26	Croatia
	Slobodna Dalmacija Split	publisher	4.12	Croatia
	Vrobec Vrobec	agriculture	0.17	Croatia

Source: EBRD Transition reports 2001-2006

The new HDZ-led government intended to accelerate the privatization of strategic entities and utilities that were outside the HFP's portfolio. These significant privatizations planned for 2005 included the sales of several shipyards, a further 15% stake in INA, an additional 10% of the shares in Hrvatski Telekom and the sale of the state's stake in the country's largest insurance company, Croatia Osiguranje. However, in 2004 the process appeared to stall and the sales were postponed until sometime in 2006.

In September 2006 the government announced a decision to offer 15-17% of INA and minimum 20% of Hrvatska Telekom for sale on the stock exchange of Zagreb and

London. In November 2006 the government sold 17% stake in INA. In June 2007 there was a major corruption scandal that resulted in the removal of the HFP's management. Following a repeated tendering procedure, the buyers of three metal companies were chosen in April 2007[57]. The privatization of these companies was a condition for the second tranche of World Bank Programmatic Adjustment Loan (PAL II).

According to EBRD index of large-scale privatization (Table 53), between 1995 and 2002 Croatia earned level 3, which means that 50% of the assets are privatized. From 2003 on Croatia has received 3.33 points, which is the same as in Macedonia and Poland but lower than in Romania and Bulgaria and in the CEE countries. However, among peer countries in the Western Balkan Croatia reached the higher level of large-scale privatization.

Although Croatia reached the highest level 4.33 already in 1996 on EBRD index of small-scale privatization (Table 54), there were several small and medium-sized enterprises in 2000 under the management of HFP, some of them the previous government took over in relation to bank rehabilitation. The small-scale privatization reached progress in 2002 but slowed down in 2003 after the privatization incident of Sunčani Hvar hotel chain. In 2004 the HDZ-led government announced plans to complete the small-scale privatization process and sell the entire portfolio of the HFP (more than 1000 firms) by June 2005. The process regained some momentum in early 2005 but after that it slowed down. Only 55 companies were sold. The factors behind the delay were legal problems, lack of investor interest and unrealistic sale conditions.

From 1999 to 2006 the *private sector share stayed* at 60% in the GDP[58] that has been significantly lower than in the CEE countries but lower as the SEE average as well (Table 57). In 2007 it increased to 70% in the GDP, partly because the pace of privatization has picked up during 2006-2007.

The government took several steps to reduce the extent of arrears in the economy. The bankruptcy law, which was introduced during the financial crisis in 1999, did not function effectively because of the inefficiency of the court system. At the end of 2000 there were 1454 pending bankruptcy cases. In July 2001 the government launched a

[57] Željezara Split was acquired by the Polish Złomrexa and the post-privatization restructuring is financed by EBRD loan in 2008. Valjaonica cijevi Sisak was sold to the Swiss Commercial Metals International AG. For the aluminium producer Tvornica lakih metala (TLM) Adrial, a consortium of five local firms was chosen.

[58] Other sources estimate a higher share of private sector.

project founded by the World Bank to improve judiciary effectiveness concerning bankruptcy process (EBRD 2001).

Due to the significant restructuring of the manufacturing sector, productivity grew strongly in 2001 and 2002. The financial performance of large state-owned enterprises also improved in 2002. The new bankruptcy law aimed to simplify the bankruptcy process. A new labour law also came into effect in July, which was previously met opposition from the labour unions. The law aimed to improve flexibility of the labour market and to restrict entitlement to unemployment benefits. This time the law was also a precondition of a World Bank Structural Adjustment Loan.

The progress in EBRD index of enterprise reform (Table 55) shows that Croatia reached level 3.00 only in 2004 that is late relative to most of the CEE countries. However, the performance of Croatia is best in the SEE region. The delay in enterprise restructuring is one of the main priorities of the recent Croatian economy. The reports of international actors (EU, IMF, EBRD) advise regularly a faster pace of measures. The delay in restructuring has a crucial impact on the economic growth perspective as well.

After a costly consolidation, the *restructuring of the banking sector* was carried out successfully. Large banks were privatized during the decade, mainly to foreign investors (Table 19). The Croatian banking sector belongs to the most advanced in the region according to the EBRD index of bank sector reform (Table 58). The banking sector is the success story of also the inward FDI in Croatia is. The most comprehensive privatization occurred in the sector among the transformation countries. By 2003 the share of foreign investors in the Croatian banking sector reached 90.8%. As a result of the radical capitalization and restructuring, the banking system strengthened and its creditworthiness improved. The presence of foreign banks also improved the access to financial sources in the Croatian economy. The overall size of the Croatian banking system (in terms of total assets) surpassed 100% of GDP for the first time in 2003 that put Croatia among leading transformation countries. However, it is still far from the EU average of 250 percent of GDP (Sohinger–Horvatin 2006:14). Croatia has one of the highest levels of household credit. At the same time Croatia's relatively weak performance on privatization and enterprise reform suggests lower enterprise credit demand (Kraft 2007:13).

Table 19: Large-scale bank privatization in Croatia 1998-2004

	Bank	Buyer	Acquired stake (%)
1998	Slavonska banka	Kartner Landes-und Hypothekenbank	na
1999	Privredna banka	Banca Commerciale Italiana	66
	Zagrebačka banka	Allianz	10
		Bankers Trust Co.	63
2000	Splitska banka	UniCredito	63
	Riječka banka	Bayerische Landesbank	59.9
	Varaždinska banka	Zagrebačka banka	94
	Privredna banka	IntesaBCI	66
	Dalmatinska banka	Regent	65
2002	Riječka banka	Erste bank	85
	Dubrovačka banka	Charlemagne Capital	100
	Splitska banka	Bank Austria Creditanstalt	88
	Zagrebačka banka	UniCredito	82
2004	Nova banka	OTP	96

Source: EBRD, RBA Croatia Weekly Report no. 100

The number of banks decreased significantly since the consolidation in 1999 (Table 20). Two banks remained in state ownership, Croatia banka and the Croatian Bank for Reconstruction and Development (Hrvatska banka za obnovu i razvitak, HBOR). The concentration in the banking sector remains significant (Table 21), the top two banks holds the 41% of total assets in 2007.

Table 20: Number of banks in Croatia

	State owned banks	Private owned banks	Foreign owned banks	Total
1990	22	4	0	26
1991	22	8	0	30
1992	29	13	0	42
1993	25	18	0	43
1994	26	23	1	50
1995	14	39	1	54
1996	10	43	5	58
1997	7	46	7	60
1998	8	42	10	60
1999	10	30	13	53
2000	3	20	20	43
2001	3	16	24	43
2002	2	21	23	46
2003	2	20	19	41
2004	2	20	15	37
2005	2	18	14	34
2006	2	16	15	33
2007	2	15	16	33

Source: HNB

Table 21: Concentration index - share of assets of the 2(4) largest banks in total bank assets

	Two largest banks	Four largest banks
1995	54	68
1996	46	60
1997	40	53
1998	41	53
1999	44	58
2000	48	62
2001	46	60
2002	44	59
2003	43	62
2006	43	65
2005	43	65
2006	41	64
2007	41	64

Source: HNB

According to the EBRD Business Environment and Enterprise Performance Survey (BEEPS), the quality of the Croatian *business environment* has improved from 1999 to 2002. The improvement in quality of infrastructure is significant[59] (from 1.9 to 1). The level of corruption decreased by 0.9 percentage points and reached value 2, the quality of judiciary stayed unvaried at 2.4. On the contrary, in field of regulations the level of obstacles grew from 1.3 to 1.6 (EBRD 2002:42). The BEEPS 2005 shows statistically significant improvement in field of regulations and taxes (EBRD 2005). The first one-stop shop for company registration was established in May 2005, but the inefficiency of the judicial system still caused dissatisfaction in the business community. As the third phase of the regulatory guillotine project, Hitrorez was launched in September 2006 in order to simplify or cut unnecessary or inefficient regulations.

3.5.3 Why stabilization in Croatia has not brought economic growth?

After four years of the successful stabilization program, Franičević and Kraft (1997) warned that the economic growth had not materialized, because of the complex structural problems of the economy. As Csaba (2007b:37) states, the recovery of growth does not occur necessarily and spontaneously, moreover stabilization in itself does not generate permanent growth. Croatia is an example that price and exchange rate stability alone is not sufficient to gain sustainable economy and induce growth (Bićanić 2001:172). Vojnić (2003:159) argues that two policy mistakes led to the unfavourable economic results: "tycoon privatization and mistaken stabilization level". The latter is understood as measures directed to stability of prices and mistaken exchange rate level, while all other tasks were left behind. Bićanić (2001:172) argues that the largest failure of the stabilization were the lack of fiscal changes and expanding role of the state. The recovery was not sufficiently strong and it ran out of steam too soon (World Bank 2001:3).

Franičević and Kraft considered four steps to be important in order to speed up the economic growth in 1997. (1) a high rate of domestic saving and investment[60]; (2) a thorough restructuring, both on the level of firms and of the state itself; (3) further and

[59] In BEEPS the values range from 1 to 4, where 1 indicates no obstacles to business growth and operation, and 4 indicates major obstacles.

[60] Domestic saving are important because they allow the domestic banks to co-finance projects and in this way to attract foreign investments. Foreign investors are familiar with developed technology, while the domestic banks are able to monitor the local projects to which the technology need to be adapted (Aghion et al. 2006).

consistent hardening of the soft budget constraints; (4) full rehabilitation of the banking system (Franičević–Kraft (1997:686).

Ten years later do these obstacles still hamper the Croatian economy?

(1) Both the domestic saving and investment rates have improved since 1997 (Table 22). On the side of investments, there has been a significant growth from 25.2% of GDP in 1997 to 32.8% in 2006. Government capital spending particularly in the road transport sector played a significant role initially. Over 90% of the domestic investment stands for fixed capital formation (IMF 2007:34). The domestic savings ratio rose as well from 17.6% of GDP in 1997 to 25.1% in 2006.

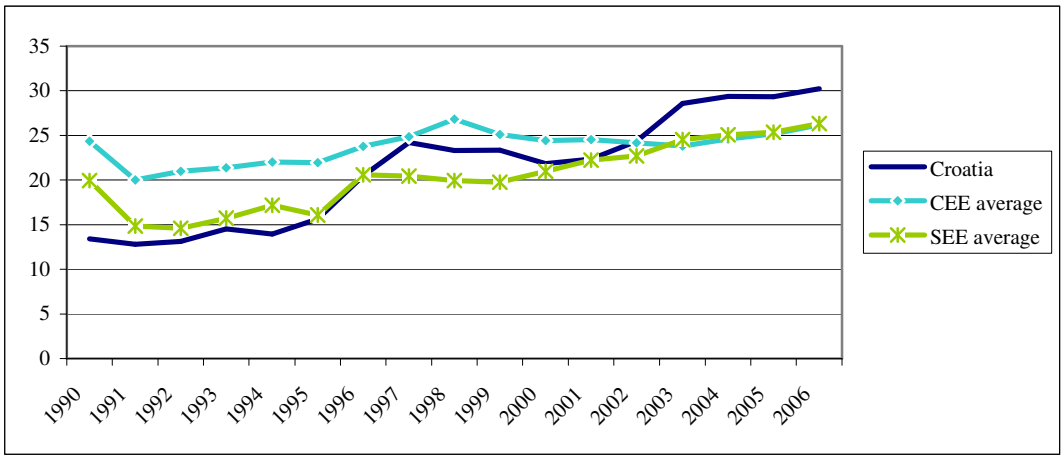
In terms of gross fixed capital formation Croatia started from a relative low rate compared to both CEE and SEE countries (Figure 22). Since 2002 the country exceeds among both group of countries. However, the high level of investments associated with low growth rate. Until the bank privatization that started in 2000 after the financial crisis, the financial intermediary system was almost entirely in state ownership that explains the inefficiency (Csaba 2007b:46).

Table 22: Domestic saving and investment in Croatia, selected years, in % of GDP

	1995	**1996**	**1997**	**1998**	**1999**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006e**
Domestic saving	11.6	19.5	13.2	17.6	18.5	20.3	20.4	23.8	25.5	24.6	25.1
Government	2.7	4.9	3.3	5.2	1.4	-4.0	-0.2	-0.2	0.3	0.1	1.2
Private	8.9	14.6	9.9	12.4	17.1	24.3	20.6	24.0	25.2	24.5	23.8
Domestic investment	18.4	23.9	25.2	24.7	24.7	23.9	29.1	31.1	30.6	31.0	32.8
Government	na	na	na	na	na	2.5	3.9	5.3	4.4	3.9	3.5
Private	na	na	na	na	na	21.5	25.2	25.8	26.2	27.1	29.3
Savings-investment gap	-6.8	-4.4	-12.0	-7.1	-6.2	-3.7	-8.7	-7.3	-5.1	-6.4	-7.7

Source: Hurst–Uppenberg (2002) for 1995-1999 and Stamm–Macovei (2007) for 2001-2006

Figure 22: Gross fixed capital formation, as % of GDP



Source: United Nations Statistical Division, National Accounts Main Aggregates Database

(2) Even in the latest Progress Report (2008), the Commission urged important structural reforms, so did the latest IMF Country Report (2008). Considering the state, further steps are needed in the area of judicial and administrative reform; fight against corruption and in reducing the role of the state in the economy. The enterprise restructuring has not been finished and the business climate is still unfavourable compared to peer countries. The government shows commitment towards the reform agenda, but the pace of implementation has been slow.

(3) With the progress of privatization the soft budget constraint has hardened. The successful privatization of the banking sector created hard budget constraints in the financial sector. However, the delay in the privatization process of the remaining state-owned companies sustains the risk of the soft budget constraint. As shown previously, state subsidies have a significant level in Croatia that also hampers the efforts of establishing hard budget constraints. As a consequence, bank privatization could not eliminate the system of crony capitalism.

(4) The restructuring of the banking sector was carried out successfully. After the banking crisis in 1998-99 new bank law was adopted. Banks were consolidated and privatized during the decade, mainly by foreign investors. By 2003 the share of foreign investors in the Croatian banking sector was 90.8%.

After the banking crisis from 2000 until 2002 the Croatian economic growth increased, while from 2004 the growth has lost momentum and stayed below 5% and also below the peer country average. Moore and Vamvakidis (2007:22) in their study on Croatian economic growth highlight that without fast progress in the above mentioned reforms, the Croatian economy could grow even slower in the future because the country losts

the growth "bonus" coming from the transformation. At the same time with depending on the reforms, there is a potential for further improvement. Croatia is not as good place as it could be.

Textbox 4: An example of a long delayed but essentially important measure: tax numbers[61]

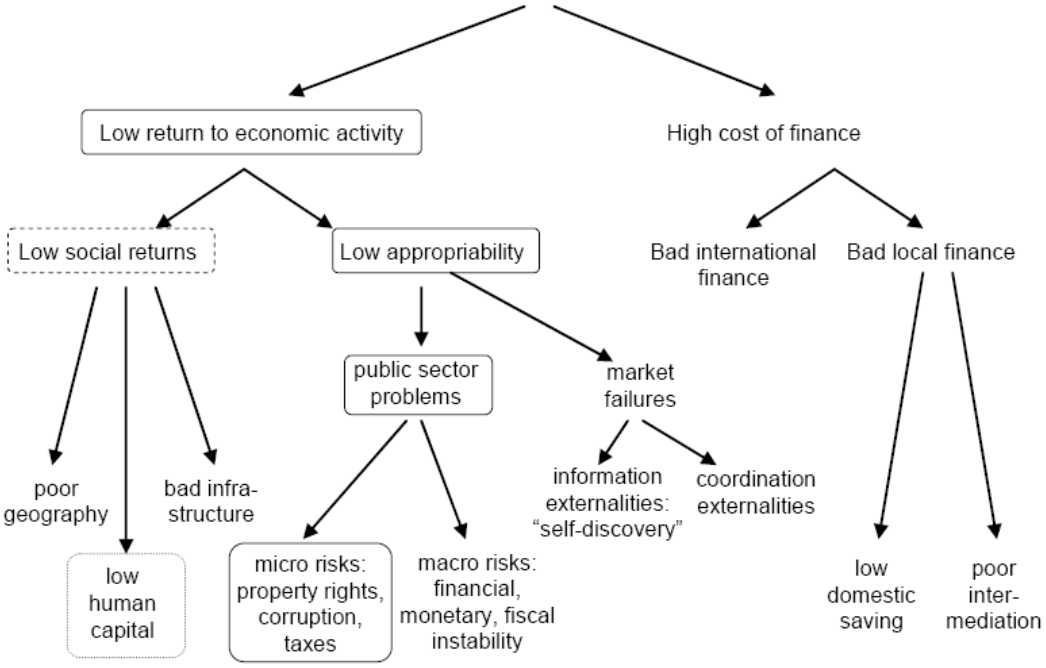
In the absence of tax identification numbers it is impossible to monitor the revenues and taxes paid of both citizens and legal entities, which limits transparency of state finances and creates space for corruption and rent-seeking. The introduction of tax number is a criterion established by the EU negotiations and is also an important anti-corruption measure. After several years of preparation with 1 January 2009 the government started the introduction of tax identification numbers for newborns and legal entities upon establishment, and by the end of 2010 for other personalities (Vlada 2006 and 2008). The modernization of Croatian tax system is also supported by the World Bank with a loan of 50 million euro (World Bank 2007).

Using the model of Hausmann, Rodrik and Velasco (2005), Moore and Vamvakidis (2007:14-21) argue that main constraint of growth in Croatia are micro-level risks from the public sector. The growth diagnosis of Hausmann et al. starts with the determination of whether the growth is hampered by low returns to economic activity or high cost of finance (Figure 23). The latter i.e., high cost of finance can be excluded. Croatia has abundant access to international finance that is also demonstrated by the high level of its external debt stock. The local financial situation is also appropriate, domestic saving is ample (see Table 22) and the financial intermediation is strong. The banking sector that went through a rehabilitation process and foreign banks entered the market. The financial sector is supporting rather than burdening economic growth in Croatia.

Turning to the other branch of the diagnosis tree i.e. the problem of low returns of economic activity, the starting point is that overall investment is high by regional standards, while the level of FDI is relatively low. Private investment and real GDP growth is somewhat below average and export performance is well below average. Behind the low return of economic activity there can be two reasons: low social returns that is, low total returns on factor accumulation, or low appropriability that is, low private returns even if social returns are high. Examining the possibility of low social returns, three factors arise. The geographical location of Croatia is favourable both in terms of trade and tourism. The infrastructure is also favourable by regional standards (Table 56).

[61] I am grateful to Maruška Vizek (Ekonomski Institute Zagreb) who called my attention to this topic.

Figure 23: Growth diagnosis tree in Croatia: identifying the constraints

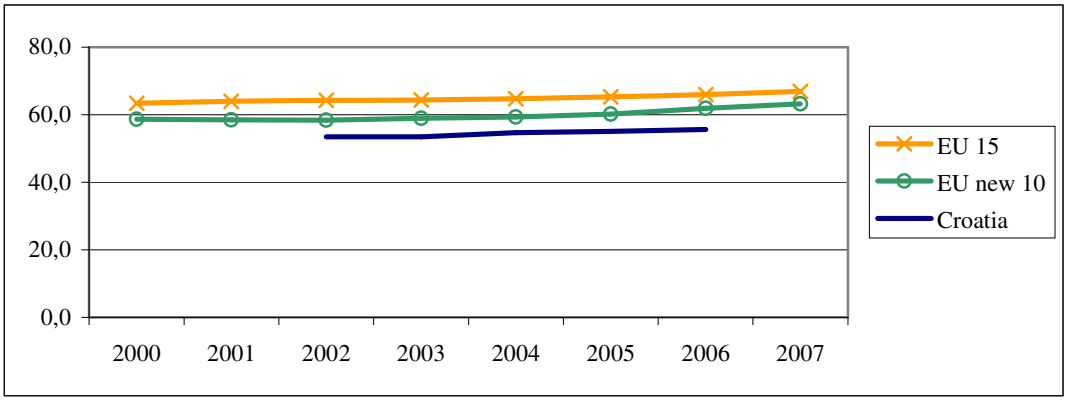


Source: Moore-Vamvakidis (2007:15), based on Hausmann et al. (2005:27)

The third factor, *human capital* is one of the explanations of constraint on growth. The Institute of Public Finance in Zagreb carried out a study in 2004 that had damn results (Bejaković–Lowther 2004). The research showed that employees in Croatia do not possess the skills, knowledge, and abilities necessary to enable local companies to produce globally competitive products and services and to compete in the European Union. The study described the Croatian workforce in general as old, inflexible, inadequately educated and trained, and lacking necessary foreign language, and information and communication technology skills. The employment rate[62] is low (Figure 24) that can reflect low demand for labour but also the limited supply of educated workers. The growth in employment in Croatia has been around the peer country average, but since 2005 it is above it. The performance of the labour market failed to keep step with the overall macroeconomic development.

[62] The employment rate is calculated by dividing the number of persons aged 15 to 64 in employment by the total population of the same age group. The indicator is based on the EU Labour Force Survey.

Figure 24: Total employment rate in Croatia, in percentage



Source: Eurostat Structural Indicators, data based on labour force surveys (LFS)

Labour productivity in Croatia is around 70% of the level of EU-27 recently according to Eurostat estimates, which is about the CEE average, and much higher than that of peer countries in SEE region, i.e. Bulgaria and Romania (estimated 35.9% and 41.6% respectively in 2008). The dynamic of productivity growth is estimated to increase in 2007 and 2008.

On the side of low appropriability, the diagnostic approach identifies market failures and public sector problems. Moore and Vamvakidis argue that the reasonable level of innovation in Croatia eliminate the possibility that market failures in form of information externalities would be the major problem. The diversification of export base and innovations measured by new patents are in line with regional (EU new member states) standards. Turning to public sector problems, public sector is not likely to produce macro risks that obviously constraints growth. Monetary risks are low: Hrvatska Narodna Banka has successfully maintained low inflation and broad exchange rate stability since the mid-1990'. The authors argue that despite the high level of public debt, the fiscal stance of the country is not a direct and immediate constraint of growth. However, Csaba (2007b:64) highlights that the external finance has become a structural burden on growth.

The other branch of public sector problems is the possibility of micro-risks. The quality of the country's business environment has been ranked among the less favourable among CEE and SEE counties (Table 23). The World Bank Doing Business Report 2008 ranked Croatia to 107th place, which meant Croatia earned place before Albania and Bosnia and Herzegovina among SEE and CEE countries. The report for 2009

ranked the country to 106th place, which means one step decline in the regional subranking as well However, Doing Business Report 2007 and 2008, Croatia can be found *among the Top Reformers*[63]. The progress reports of the European Commission mention the importance of fight against corruption. According to the reports, the operation of courts is insufficient, the procedures are too long and the enforcement of judgements is hurdled. The selection and education of judges are inefficient (Commission 2005-2008).

Table 23: Rankings on the ease of doing business in CEE and SEE countries, 2007 and 2008

Regional subrank	Country	Rank[64] in 2008	Country	Rank in 2009
1.	Estonia	18	Estonia	22
2.	Latvia	26	Lithuania	28
3.	Lithuania	28	Latvia	29
4.	Slovakia	37	Slovakia	36
5.	Bulgaria	44	Hungary	41
6.	Romania	47	Bulgaria	46
7.	Hungary	50	Romania	47
8.	Slovenia	64	Slovenia	54
9.	Czech Republic	65	Macedonia FRY	71
10.	Poland	72	Czech Republic	75
11.	Macedonia FYR	79	Poland	76
12.	Montenegro	84	Albania	86
13.	Serbia	91	Montenegro	90
14.	Croatia	107	Serbia	94
15.	BiH	117	Croatia	106
16.	Albania	135	BiH	119

Source: World Bank Doing Business 2009:6

3.6 Conclusion

Both the Yugoslav legacy and the war created *path dependence* in Croatia (cf. Bićanić 2001:168). These factors have acted as constraints when shaping the new transformation path in the 2000' years. The governments with reform ambitions

[63] Doing Business uses the following method to determine the top reformers. First, it selects the economies that reformed in 3 or more of the 10 Doing Business topics. Second, it ranks these economies on the increase in their ranking on the ease of doing business from the previous year.

[64] Rankings on the ease of doing business are the average of the country rankings on the ten topics covered in Doing Business reports: Getting credit, Registering property, Dealing with licenses, Employing workers, Starting a business, Protecting investors, Trading across borders, Paying taxes, Enforcing contracts, Closing a business.

(whether the opposition or the HDZ) did not have easy task neither in political nor in economic field.

The path dependence appeared both in terms of transformation process and economic restructuring, and in terms of European integration. The EC–Yugoslav relations changed dramatically in the early 1990'. Later vested interest whose interest was against the structural changes required by EU membership, and the legacy of the war (especially the commitment towards the ICTY) burdened the acceleration of integration process. The coalition governments after 2000 proved not to be enough encouraged to go through with a broad and deep reform package. On the contrary, the serious reform steps were very often postponed as longest as possible. The income from the tourism sector has helped to cover the shortcomings of the restructuring. The successful transformation of financial sector could not materialize in the real sector, most probably because of the above described shortcomings. In other words, there was no spill-over effect.

Based on the above mentioned we can conclude that the social, political and economic circumstances in Croatia are more complicated as a result of the war and a special form of nationalism that connects to it. The role of the state in Croatia has included not only transformation and development, but also reconstruction all at the same time (Gligorov 2002).

The Croatian development of the 1990' is characterised by the personality of Franjo Tudjman. His personality was more dominant than the movement of HDZ, which could change its profile after Tudjman's death. The approach and personality of Stjepan Mesić has characterized the 2000' years, but this impact has been rather milder compared to that of Tudjman's. Partly because the sphere of authority of the president became weaker since 2000.

The macroeconomic performance shows that the economy of the country integrated strongly to the EU market, both in terms of trade and FDI flows. The economic integration is present since the beginning of their transformation, even though during the "nationalist" period it was less remarkable. That is, the geographical proximity of the EU market had strong impact of the Croatian economy during both periods.

The pressure from the EU and from other international organizations had strong impact of the Croatian policy making even if in a slower pace than in the CEE countries. The characteristic of these relations did not change radically with the end of the Tudjman

era. Even after 2000 the EU has used wide range of political conditionality in order to enforce important steps in Croatia.

The EBRD (2007:118) stated in its 2007 report that cooperation with international financial institutions and the accession negotiations with the *EU remain important anchors* for structural reforms in Croatia. It has been a long road until this statement. Our original expectation (i.e. that Croatia would be frontrunner in Europeanization) was based on the country's identity, historical and cultural heritage. These expectations were based on deeper roots of the Croatian identity, historical and cultural heritage. The realization of this expectation seems to be only delayed but not overwritten. The middle or long term development of the country points towards Europeanization. Croatia has experienced a detour from the "mainstream" Europeanization path. The latest intent of the country suggests that the end of the detour is close.

The accession of Romania and Bulgaria in 2007 woke up latent European identity and desire towards EU in Croatia. This notion was further enhanced by the failure of the Lisbon Treaty that shed special light on what could be the consequences of missing the 2007 enlargement round. At the moment the EU is not ready to accept Croatia as a new member state.

IV. Transformation and European integration in Slovakia

The Europeanization prospects of the newly independent Slovakia of were promising. However, with the dissolution of Czechoslovakia, Slovakia stepped on a different road than its Czech counterpart and this different road was not clearly in the direction of Europe. After some years of following this "third" road, the orientation of Slovakia changed dramatically and became a success story of Central Europe.

1 The initial conditions: Czechoslovakia

When was created in 1918, Czechoslovakia consisted of two different parts. Czech and Slovaks came together to fashion a "united state out of their desperate ethnic and historical backgrounds and with totally different economic and educational heritage" (Wallace 1988:9). The two lands have never formed an administrative unity before, although they were both part of the Austro-Hungarian Monarchy. The Czech lands were administrated under the Austrian side and the Czech language was accepted as official language in the 19th century. On the contrary, the Slovak lands were administrated by the Hungarian side of the Monarchy, the Slovak language was never accepted as an official one and Slovakia has never been recognised as an administrative unit (OECD 1994:42). Thus the newly established Czechoslovakia had two distinctive regions. The Czech parts inherited the most developed and most industrialized territories of the Monarchy. On the other hand, Slovak industries, which were competitive in the structure of Hungary, became unviable and uneconomical under the new circumstances. The relation of the industrial and agrarian population was 40:32 in the Czech lands and 17:67 in Slovakia (Berend–Ránki 1976:456-459). However, Czechoslovakia experienced considerable industrial development during the 1920' years that was stopped only by the Great Depression of 1929 (Table 24). The production was export-oriented and the trade balance was positive (Table 25) During the 1930' the structural crisis flared in Czechoslovakia, but still it remained among the 10 most developed countries in the world (OECD 1991:9). It produced as much steel and pig iron as the other East and Central European countries combined (World Bank 1991:1). Considering the occupation of the population in 1930, Czechoslovakia counted among the developed industrial countries together with England and Germany, while Hungary belonged to the

agrarian-industrial group and Yugoslavia was among the agrarian countries (Berend–Ránki 1976:481).

Table 24: Index of industrial production in Czechoslovakia, 1913=100

Year	Index
1913	100
1920	60
1924	102
1929	141
1933	73
1937	107

Source: Berend – Ránki 1976:459

Table 25: Czechoslovak foreign trade in million UDS and current prices

Year	Export	Import
1920	391	332
1924	839	781
1929	1027	1001
1932	370	374
1937	417	383

Source: Berend – Ránki 1976:496

Hamberger argues that the first common Czech and Slovak state was created in the light of the Czech state-formation ambition and of the Slovak national emancipation efforts. With the creation of the common state, the Czech ambitions were settled but the Slovak emancipation efforts remained latent and unresolved. The majority of the Czech society did not accept that the Slovak society is another one and a different one than the Czech (Hamberger 1997:8-12). The Czech people entered Czechoslovakia with the previous experience of their own statehood and they felt the common state as their own one. On the contrary, Slovak people did not have own their statehood previously that is why they looked differently to the issue of statehood (Hamberger 1997:43).

In 1939 the shade of the German expansion and the pressure of Adolf Hitler, the first independent Slovak state was established in March 1939 with the leadership of Jozef Tiso. The establishment was not the logic consequence of the previous processes but the result of the international situation and a side-effect of the aggression against the Czech territories (Hamberger 1997:24-25). The war boom, the secession from the competition of the Czech industry and the development followed by the German demands resulted in industrial prosperity. The German liabilities (including the catering of German troops) reached 1 billion Deutschmark during 1939-1944. The Slovak industrial sector increased its production by 63% and its employees by 50% from 1937 to 1943 (Berend–Ránki 1976:579-580).

This Slovak state had national socialistic character that made it discredited in the eyes of the international community. The uprising in August 1944 erupted against the Tiso regime and the fascism of Hitler but also in favour of a democratic Czechoslovakia.

However, the previous form of the common state was unacceptable for the Slovak National Council that was established as a result of the uprising. They even considered the possibility of joining the Soviet Union instead of joining the type of Czechoslovakia as it was before 1938. However, the Czech party rejected the idea of a symmetric federal state, partly because the Czech population was twice as much as the Slovak. At the same time, the Czech society began to accept that the Slovak is a separate nation. Finally Slovakia joined the second Czechoslovakia in 1945 (Hamberger 1997:26-30).

With the start of the Cold War, Moscow pressed the Communist Party of Czechoslovakia to consolidate its position. In February 1948 the party was able to take the power and destruct all open opposition. The economy was reoriented from the pre-war structure of consumer goods export towards heavy industry. It seemed to an economic structure that offered stability and secured export markets (EUI 1996:3). In the Slovak part the heavy industrialization gathered another momentum that had started already under the Tiso's Slovakia. Due to the industrialization and fiscal transfers, the gap in the level of economic and social development between the two parts of the state lessened (OECD 1991 and 1994). During the 1950' the centralization and "Czechoslovakism" intensified (Hamberger 1997:31).

By 1962 the industrial growth halted. The Stalinist industrialization policy, which was mostly applied in underdeveloped rural economies, had ambiguous results in the already developed and industrialized Czechoslovakia. In the following years the centralized planning was replaced by regulated-planned market socialism (Berend 1999:173). In January 1968 new party leadership was formed under Alexander Dubček. In 1968 the events known as the Prague Spring included the virtual collapse of censorship, calls for the democratization of the political system, for a review of the entire past record of communist rule, and for a radical development of economic reform towards a self-managed market economy (EUI 1996:4). In spite of its inner contradictions and limitedness, the Czechoslovak reform-model was the most radical approach among Central and Eastern European countries (Berend 1999:179).

By April 1969 the position of reformist leaders was whittled away and Gustáv Husák, a leading Slovak communist became the head of the party. The Soviet leadership decided on armed intervention by Warsaw Pact forces in August. The "socialism with human face" was over. The period from 1970 was called "normalization": the economic reforms were reversed and the system reverted to the traditional centralist mode (EUI 1996:4). "Husák presided over one of the sternest, least tolerant governments in Eastern

Europe for the next 20 years" (NYT 1991). The Husák regime did not forgive and gave no quarter. The country sunk into isolation (Berend 1999:183). Gustav Husák also became the first Slovak elected president of Czechoslovakia in May 1975 and held his office until 1989.

From 1 January 1969 on the constitution became explicitly federal, with a federal government located in Prague. The constitutional law founded two national republics, the Slovak Socialistic Republic and the Czech Socialist Republic that made up the Czecho-Slovak Federation. National Councils became regional legislative institutions, while regional executive power was delegated to the national governments and ministries. The basic aim of the federation was to balance power between Czech and Slovak Republics (Žatkuliak 1998:261). Slovak politicians got to the Czechoslovak political elite. With the process of "normalization" the federal structure became an empty shell as a result of insufficient democratic conditions. Political power centralised the economy and rejected Czech and Slovak national constitutions thus the regional (i.e. Czech and Slovak) institutions became only formal. The 1970 constitution utterly weakened the power of the republics and re-established Prague centralism. The role of the federal executive organizations was strengthened also in line with a unified economy through central planning and budgeting (Hamberger 1997:40-42). Hamberger calls this type of federalism "unitarized federation". The so called economic-production units took away financial management responsibilities from national governments. Slovak institutions lost their "administrator" role for Slovakia. Their duties diminished to fulfil federal regulations. The space for independent policy-making, which took into account the specific economic and social needs of Slovakia, was limited (Žatkuliak 1998:264).

Slovakia achieved major gains in industrial production in the 1960' and 1970'. Its industrial production has been equal to that of the Czech lands for quite some time. Slovakia's per capita income rose from only 50% of Bohemia and Moravia in the late 1930' to around 60% in 1948 and to nearly 80% in 1968. By the early 1970' it was equalized with that of the Czechs (World Bank 1991:1).

Czechoslovakia's economic performance over the 1970' and 1980' was relatively good. Per capita income was improving steadily, although the rate of growth slowed down considerably in the second half of the 1980' (Table 26). Both internal and external financial stability was maintained. Open inflation stayed under 2% on average during the 1980'. The supply of basic consumer goods was adequate. Unemployment was

virtually non-existent. The country's social indicators showed a relatively good picture. Although Czechoslovakia performed well compared to other centrally planned economies in the region, a World Bank study highlights that such a comparison may be regarded as misleading since the country (to be more precise the Czech lands) belonged to the group of industrialized countries before World War II. If we compare the performance of Czechoslovakia with that of the OECD countries, growth rates were some 30% below those of the OECD countries in the 1970', and the gap between the respective average growth rates actually widened during the 1980'. Czechoslovakia's terms of trade deteriorated significantly during the second half of the 1970', which was partly due to the lagged adjustment of oil prices within the CMEA (Council for Mutual Economic Assistance). The serious economic inefficiencies were felt during the 1980'. Together with adverse external factors, these inefficiencies led to a period of slow growth and then stagnation during the 1980' (World Bank 1991:20-23).

Table 26: Index of national income produced, based on Net Material Product, 1980=100

year	1970	1980	1985	1986	1987	1988	1989
index	64.2	100.0	114.4	117.2	119.9	124.7	127.0

Note: data for 1989 is estimation
Source: World Bank 1991:21

Industry (covering manufacturing, energy, mining, chemicals), which accounted for 60% of Net Material Product (NMP) and 37% of employment, was the largest sector and played a dominant role in Czechoslovakia's economy (Table 27). Even among socialist countries, Czechoslovakia's economy was characterized by exceptionally high share of large state owned enterprises. At the end of 1989, there were 1,511 large state owned enterprises in the industrial and agro-industrial sectors, employing 3.92 million people, for an average firm size of 2,600 employees (World Bank 1991:9).

Table 27: Industrial production in Czechoslovakia in 1988

sector	share in total industrial production (%)
machine	22.0
iron metallurgy and nonferrous metals	11.3
chemicals and rubber	13.5
electrotechnical and metalworks (incl. plastics)	8.9
fuel	4.4
power	3.9
food, beverages and tobacco	14.6
leather, textiles and clothing	7.7
wood processing, cellulose and paper	4.8
construction parts	3.4
glass, ceramics, porcelain	1.3
other	4.1

Source: World Bank (1991:142)

Until 1990 Czechoslovakia had a mono-bank system. The State Bank of Czechoslovakia (Státní banka československá, SBČS) acted as the central bank and performed the functions of a commercial credit bank for the whole economy.

Czechoslovakia became a founding member of the CMEA but maintained its membership in the GATT where it was a co-founding member. Foreign trade was characterized by bilateral trade agreements. Domestic prices were controlled and had little relationship with world market prices. Planners' were hesitant to integrate uncertain world market events, which were beyond their control, into domestic production and distribution plans. External effects were neutralized through taxes and subsidies. However, foreign trade represented a substantial proportion of the country's total economic activity. The delinking of prices, the inconvertibility of the Czechoslovak koruna and the cumbersome organization of foreign trade resulted in the reduction of foreign trade to a passive balancing item rather than an engine of economic growth (World Bank 1991:30-31).

The openness of the country is ambiguous to examine because of the isolation of world markets. During the 1980', Czechoslovakia's openness ratio, defined as the share of combined exports and imports to GDP, was around 60%, which is roughly equivalent to the 50-60% observed in the European Free Trade Area (EFTA) members and higher than the 40-50% of Greece and Spain. Within CMEA, Czechoslovakia was given the role of providing investment goods required for other member states' development. This

led to the concentration on investment goods, especially heavy machinery and, in turn, to a strong trade dependency on the Soviet raw materials. Table 29 demonstrates that Czechoslovakia exported different selection of goods to CMEA and to OECD countries. The iron and steel sector exported evenly to both trade blocks (World Bank 1991:33).

Table 28: The openness of machine industry in some small European countries around 1980

Country	Share of export in machine industry (%)	Share of import in machine industry input (%)
Czechoslovakia	28.4	22.3
Belgium	66.4	70.9
The Netherlands	58.0	64.9
Sweden	51.4	42.1
Austria	48.5	61.5

Note: The figure of Czechoslovakia was equal to average of small Eastern European countries
Source: Zeman (1981), cited in Csaba (1984:288)

Table 29: Czechoslovakia's export shares by selected sectors and countries[65], 1986-87

	East				West			rest of the world
	USSR	DDR	Hungary	Poland	EU 12	BRD	EFTA	
All sectors	73.0	74.2	70.3	76.6	65.7	69.6	64.4	75.0
67 Iron and steel	4.6	6.6	3.2	8.2	12.6	14.1	8.8	7.3
Sectors 1 to 66	0.0	10.7	21.4	4.5	35.8	47.7	52.6	3.1
Sectors 69 to 77	37.0	44.5	25.6	37.2	3.3	0.0	0.0	59.4

Note: Based on SITC-2 digit level COMTRAD data in dollars at official exchange rate.
Source: World Bank (1991:160

Czechoslovakia had a prudent external debt policy and accumulated only moderate external debt compared to other countries in the region. Long-term debt rose in the second half of the 1980' but the net external debt in convertible currency (excluding foreign exchange reserves) was only 200 million USD at the end of 1989, compared to 2.9 billion USD at the end of 1980.

In 1989 convertible currency debt amounted to 19% of estimated NMP (World Bank 1991:35) or 15.7% of the GNP (Table 30), while the hard currency debt of the government was 1% of the GDP in 1989 (OECD 1991:14).

[65] The table shows all exports representing at least 3% of total trade to one of the considered zones. Sectors 1 to 66 consists of 1 Meat and preparations, 11 Beverages, 24 Cork and wood, 25 Pulp and waste paper, 32 Coal and coke, 33 Petroleum and products, 51 Organic chemicals, 58 Plastic materials, 63 Wood, cork manufactures nes, 65 Textile yarn, fabrics and 66 Non-metal minerals. Sectors 69 to 77 consists of 69 Metal manufactures nes, 71 Power generating equipment, 72 Machines for spec. industry, 73 Metalworking machinery, 74 General machinery, 75 Office machines and 77 Electric machinery.

Table 30: Foreign debt in Czechoslovakia

	1985	1986	1987	1988	1989	1990	1991	1992
Long-term debt, in million USD	2689	2877	3582	3875	4328	5460	5913	5560
Total debt stock/GNP (%)	11.7	12.1	12.8	14.2	15.7	18.4	29.7	28.8

Source: World Debt Tables 1992-93, p.114

To sum up, at the time of the Velvet Revolution in 1989, some starting conditions for transformation were less favourable in Czechoslovakia compared to peer countries in CEE. The system of central planning was stricter than in other Visegrád countries. The private sector did not really existed; that is why the legal and institutional base of the market economy neither existed. Prices were almost totally controlled and the economic activity was extremely concentrated in large companies. The economy was more closed and the country was more dependent on CMEA trade. At the same time the Czechoslovakian economy did not suffer from serious macroeconomic imbalances: inflationary pressure was never serious, the hard currency debt was 15% of the GDP in 1989 and the government debt was 1% of the GDP in 1989 (OECD 1991:11-15). While the other Visegrád countries could rely on earlier reforms, it was less significant in Czechoslovakia (Schmögnerova 1991: 27). As Dyba and Svenjar (1991:185) describe, "Czechoslovakia provides a unique example of a country that became underdeveloped as a result of an externally imposed system".

1.1 The dissolution

The Velvet Revolution of November 1989 resulted in a liberally oriented transformational government, and thus the start of a radical economic transformation from a centrally planned to a market economy (Dyba–Svejnar 1991:186). Václav Havel became the president. As a result of the "hyphen-war", in April 1990 the country's name changed to the Czech and Slovak Federal Republic[66]. The so called "competence law", adopted in November, strengthened the role of the national governments and important economic policy competences were delegated to the republics. Difficult negotiations began about the future of federation. The democratic political and

[66] The aim of the new name was to express the equal status of the two nations in the federation. The Czech notion was to continue with "Czechoslovakia" while the Slovak side preferred "Czecho-Slovak" (Hamberger 1997: 167).

economic transformation resulted also in the strengthening of the Slovak national identity. Although Václav Havel did all efforts to keep the country together, the two republics could not agree on the form the future common state (Hamberger 1997:75).

However, Slovakia appeared to benefit from the federal system through significant transfers coming from the Czech lands. The distribution of the common budget was based on the size of the population, that is 2:1 and not based on the economic performance. This meant annually 25-50 billion koruna redistribution from the Czech lands to Slovakia (Hamberger 1997:136). In 1992 the GDP of the Czech and the Slovak Republic was 771 and 286 billion koruna, while the GDP per capita was 74,754 and 53,943 koruna, respectively (OECD 1994:45)

The switch to market economy caused much more serious problems in the Slovak part of Czechoslovakia. During the period of 1989 and 1993 GDP fell by almost one quarter. Slovakia experienced a deep recession, as a result of the loss of traditional CMEA markets and Slovakia was also more dependent on the trade with the former Soviet Union. The distinct impact of the regime change in the two parts of the republic enhanced frictions between them and polarized the discussion about the future (OECD 1991).

The industrialization had deeper roots in the Czech lands and the overweight of the heavy industry was present in Slovakia. The closing down of the Czechoslovak heavy armament sector was only a federal decision but also an international pressure. Since two-third of the sector located in Slovakia, in this republic it has serious economic and social consequences. The economic reforms, which were formed on federal level, *affected Slovakia more seriously*. The general view considered the market reform too fast and not adapted to the Slovak economic structure. Some politicians and advisors favoured the idea of the "Slovak third way" that put more emphasis on social questions. The Slovak policy-makers had different views about the method of privatization and they even called out for own central bank and right to money emission. Václav Klaus federal fiscal minister refused the idea of implementing the same package of reform differently in the two republics, although he recognized the different needs of regions among the federation. The characteristics and the timing of the reforms became a national question in Slovakia (OECD 1994:43-44; Hamberger 1997:128-135).

Not only policy-makers, the average Slovak and Czech people had significantly different views on the post-communist situation, on the advantages and disadvantages of the federation, and on the desirable future path. The different views were reflected in

the political preferences created a difficult political situation after the 1992 elections. The Civic Democratic Party, which won the elections in the Czech lands and was led by Václav Klaus, presented a final proposal to the Slovak counterparts. The Czechs preferred either a common Czech-Slovak state with a strong central government and radical economic reforms, or no state at all. From the Slovak side, Vladimír Mečiar and his rather populist, reform-sceptical and Slovak-patriotic Movement for a Democratic Slovakia (HZDS) were not willing to accept the Czech terms and they chose the latter version (Hilde 1999:647-648). In July 1992 the Slovak parliament adopted a sovereignty declaration and in September the constitution of the new Slovak Republic was adopted that came into force on 1 January 1993.

The break-up was a two-step one. On 1 January the country disintegrated as a political union, while the Czech–Slovak monetary union collapsed on 8 February. Fidrmuc, Horvath and Fidrmuc (1999) found that the stability of Czechoslovakia as an economic entity was undermined by the low correlation of permanent output shocks, low labour mobility, and higher concentration of heavy and military industries in Slovakia. The Czech and Slovak economies were vulnerable to asymmetric economic shocks, for example to those induced by the economic transition.

From the Czech side, the goal of a "return to Europe" was put over the value of the federation. Hilde goes against the general view that the secession of the Czechoslovak state was a consequence of the growing Slovak nationalism. He argues that the Czech standpoint had the same if not larger role. They considered the Slovak politics as an obstacle to stabilization and economic reforms (Hilde 1999:649). As it was described previously, the difference in political views was not a new phenomena but it accompanied the history of the common state. The dissolution of the common Czech and Slovak state was a consequence of the differences between the two nations in terms of their character and values. The break of the federal state itself went smoothly and was called the Velvet Divorce.

2 The „nationalist" period of economic transformation and European integration

2.1 Building democracy in the brand new state: "Mečiar's counterrevolution"

After the separation of the Czech and Slovak Federal Republic, Slovakia was held the weaker successor state. The administrative infrastructure of the federal republic existed, and it was not the first time that Slovakia had its own statehood. However, there was a lack of experience in governance and some ministries had to be newly created, such as the ministry of foreign affairs (OECD 1994:42).

With the division of the Czech and Slovak Federal Republic, the continuation of the post-1989 systemic changes was hindered. After the 1994 elections the nationalist Slovak National Party (SNS) and a new extreme left party, the Association of Workers of Slovakia (ZRS), joined HZDS. Vladimír Mečiar became the first prime minister of the independent country. His third government was established in 1994, after winning the third elections since 1989. For the first time, the government was able to remain in office for the full term.

It came clear that Slovakia turned off from the Czechoslovak transformation path and from the promising Central European path of transformation followed by the other three Visegrád countries[67] – where Slovakia belonged both historically and culturally. This process resulted in the exclusion from the first round of the Euro-Atlantic integration processes. Frydman et al. (1998:56) called this turn "Mečiar's counterrevolution". In the evaluation of Szomolanyi (2003:163), this development can only be seen as a failure of Slovakia's national elite and the supremacy of the personal interests over the national interests. Slovakia possessed the basics of democracy; democratic institutions have been in place but the behaviour of the elite eroded their effectiveness, undermined their integrity and they were unable to satisfy the political prerequisites for the EU. The major reason of the fragile democracy rooted in the divisions among the elites over the subtle issues of national identity and sovereignty, the issues, which have dominated the Slovak public discussion for centuries. The establishment of the independent Slovakia

[67] The Northern Hungarian town of Visegrád hosted the royal summit of the Central European emperors in the 14th century. The modern from of Visegrád cooperation started on 15 February 1991 with the meeting of the President of Czechoslovakia, Václav Havel, the Prime Minister of Hungary, József Antall, and the President of Poland, Lech Walesa.

on 1 January 1993 failed to resolve these issues and it did not abolish the elite divisions. The nationalist elite sought the opportunities in the Slovak government to keep their political power and control over the privatization and they appeared to defend national sovereignty against internal and external enemies – as they interpreted.

The victory of the HZDS meant that the politicians of the former era kept considerable control over the forthcoming progress of the country. Mečiar and the party were very popular among factory towns and other beneficiaries of the old regime. According to an empirical research on the composition of the new elites in 1993, party members were over-represented in all elite segments compared to the population as a whole. This high level of personal continuity indicated first, the absence of a revolutionary exchange among the elite and second, the absence of alternative elite group claiming the power (Szomolanyi 2003:159).

Until the very end of the 1990' Slovakia was considered an "awkward" case of democratic and market transformation in CEE. The theoretical expectations were not promising for Slovakia. Reasons for the pessimistic trajectories were based on the accumulation of less favourable conditions for democratic consolidation and the higher number of tasks that Slovakia had to complete. Szomolanyi (2003:150) detects the following unfavourable conditions in Slovakia at the beginning of democratic consolidation: the ethno-cultural heterogeneity of the population[68], the lack of significant experience with independent statehood before 1993, sub-cultural conflicts, the absence of a consensually unified elite, and civil control of the security service. The additional challenge of state-building had further complicated the democratization in Slovakia.

Mečiar tended to centralize power in his own hand. The regime extended its control over the police, prosecutors and some judges as well so that the government was able to evade legal responsibility. Some of the problems regarding the new democracy were not unique Slovak issues at all. The volatility of voter preferences, the fragmentary political parties and the weak party institutions were common in CEE. However, the combination of a high degree of organization and centralization of power in the largest

[68] The ethno-cultural heterogeneity of the population should not mean unfavourable condition in any case. However, in case of Slovakia, the presence of minorities (especially the Hungarian) caused social frictions.

political party was unique in Slovakia[69]. Mečiar managed to build a powerful network of regional and local party units and at the same time he could keep the control in his own and his trusted subordinates' hand. The party had strong grassroots organization that provided wide support. The overlap among the state, the party and the economy was considerable. The HZDS government raised the role of money in politics when it linked the fortunes of economic interests and political parties through a more or less unrestricted distribution of state property (Krause 2003: 67).

Textbox 5: The NATO referendum – an example of struggles in democracy building

Slovakia held a referendum in May 1997 about the county's membership in the NATO. The referendum was not free from political conflicts. The ballots were supposed to decide whether Slovakia would try to join NATO and whether it would change the way its president is elected. The question about the NATO was threefold: 1. Do you support Slovakia joining NATO? 2. Do you favour deploying nuclear weapons on Slovakia's soil? 3. Do you favour deploying NATO military bases on Slovak soil? (Spectator 1997)
Finally, on the eve of the referendum the government altered the ballots and dropped the question about the president election. The referendum was invalid because only about 10% of the eligible voters took part. President Michal Kováč also refused to vote and stated that it was not the referendum he had declared (NYT 1997).
Later in July 1997 NATO Summit in Madrid decided not to invite Slovakia to join the Alliance.

The question arises why democratic conditionality of the EU did not have a vigorous effect on Slovakia as it had in other Visegrád countries. Slovakia differed significantly from the rest of the Visegrád group in terms of political costs of satisfying EU democratic conditionality. These costs, just as in case of Croatia, were very high. Applying democratic rules would have required the government to give up essential instruments on which its political power was based. The democratization process was dependent on the willingness of political elite. In other Visegrád countries EU pressure was almost unnecessary for democratization, while Mečiar's authoritarian government faced high adoption costs (Schimmelfennig–Sedelmeier 2004:678-679). Even though Mečiar's government accepted formally the membership strategy, in practice it conflicted continuously with the EU's democracy (Pridham 1999:1223).

[69] Usually there is a trade-off for post-communist parties regarding their degree of organization on the one hand, and the extent to which power was centralized in their leadership's hand. HZDS managed to reach high level in both fields.

2.2 EU conditionality towards accepting the acquis communautaire

The first relations with the European Community were established through Czechoslovakia and from Prague. Diplomatic relations were established in 1988 and a trade and cooperation agreement in the same year. In the autumn of 1990 the EU proposed to Czechoslovakia, Hungary and Poland to support their political and economic transformation. The Association Agreement (known as Europe Agreement) with Czechoslovakia was signed on 16 December 1991.

With the split of Czechoslovakia, the two successor states formally inherited the same status in international relations. Both were recognized by the major powers and established bilateral relations. Furthermore, both countries declared the same foreign-policy goals, namely early integration into the EU (and NATO) (Rybář 2005:90). The first government of the newly independent Slovakia accepted the rights and obligations of the Europe Agreement. The new Agreement with Slovakia (together with the Czech Republic) was signed in October 1993 and it came into force in February 1995. Slovakia took part in the related institutional procedures, in the regular highest political level meetings on bilateral bases, discussing all topics of common interest. The Association Council consisted of Slovak government members and of members of the Commission and the Council of the European Union. The Council had meetings once a year. The Association Committee was formed similar like the Council itself. The Association Parliamentary Committee composed by members of the European Parliament and the Slovak parliament, including the opposition.

In 1993 Slovakia joined other international organizations as well, like the OSCE, the UN and its constituent bodies and the Council of Europe (CoE). The membership negotiations with the CoE were complicated by minority issues and Hungary even threatened to veto the Slovak membership (Daftary–Gál 2000:10). The country joined the NATO Partnership for Peace program in 1994.

The EU representatives first published critical comments on the type of democracy in Slovakia in 1994. However, it is important to state that analysing a country's state of democracy was a rather complicated task and it seems that it was easier to qualify as negative rather than as positive, i.e. it was less problematic to identify where democratic norms were lacking compared to the case when they appeared to have firm roots (Rybář 2005:85).

The government program of January 1995 stated that the EU-membership is one of the foreign policy priorities of Slovakia and underlined the commitment of fully

implementation of the Europe Agreement. Slovakia *applied for membership* on 27 June 1995. However, Mečiar's commitment was not clear.

The Commission in its Opinion on Slovakia's Application for Membership of the European Union (Commission 1997b) concluded that Slovakia *did not fulfil the political conditions* in a satisfying manner that was set out by the Copenhagen criteria. The instability of Slovakia's institutions, their lack of rootedness in political life and the shortcomings in the functioning of democracy were mentioned as weaknesses. The following democratic shortcomings could be detected (Rybář 2005): the marginalization of the parliamentary opposition, the disrespect of minority rights and the non-observance of Constitutional Court decisions.

In economic terms, the Commission reported that Slovakia had implemented most of the necessary reforms to establish a functioning market economy. Slovakia could satisfy the economic criteria in the medium term and is firmly committed to take on the acquis communautaire. On the basis of these considerations, the Commission stated that the accession negotiations should be opened with Slovakia as soon as it had made sufficient progress in satisfying the conditions of membership laid down by the Copenhagen criteria.

As a result, Slovakia was excluded from the first group of EU (and NATO) candidate countries. At the same time, the opposition political parties, important interest groups including the trade unions and churches, various non-governmental organizations and the majority of voters (according to public opinion polls) felt anxious about the deteriorating prospects of the Euro-Atlantic integration of their country (Rybář 2005:82). The fear of international isolation made Slovaks aware that there was simply no alternative to EU. Isolation also meant the possibility that Slovakia's border with the Visegrád countries would be the external border of the EU, which would cut them off even from their former peer-state, the Czech Republic. Different accession dates would have caused difficulties also about the existing customs union between the two republics because the EU could not allow such an arrangement between a member and a non-member state[70] (Sheeran 2000).

In November 1995 the European Parliament adopted a resolution on the respect for basic democratic principles and human rights as well. It also warned the government that the EU might terminate the Europe Agreement in the absence improvement in

[70] Another example of the Czech and Slovak possible cooperation was the translation of the acquis: the similarity of the Czech and Slovak languages made it possible to save time and duplication of efforts.

political practices. In December 1996 the European Parliament adopted a second resolution that stressed again the respect for fundamental democratic principles and pointed out that it is also a condition of further improvement of cooperation with the EU (Rybář 2005:86-90). The warnings and their refusal were not without risk, there was even a danger of terminating the Europe Agreement with Slovakia (Samson 1999:19).

In December 1997 the Luxembourg European Council decided to open accession negotiations with the Czech Republic, Estonia, Hungary, Poland, Slovenia and Cyprus. Slovakia was the only Visegrád country that stayed out of this round. The negotiations with the "Luxembourg Six" were launched at the end of March 1998. Slovakia was the only applicant that failed the political criteria; the other applicants (Bulgaria, Latvia, Lithuania and Romania) were considered to have shortcomings in the economic criteria.

The EU-Slovakia political dialogue provided opportunity for EU-influence. The Association Council served as a forum where the EU representatives tried to influence the Slovak counterparts to adopt the EU principles about democracy in Slovakia. The meetings of the Council usually resulted in disagreements between the Slovak and EU officials. In February 1997 the EU expressed their hope that the rights of the opposition shall be respected and the legislation on the use of minority languages shall be enacted[71]. Next year in April the EU representatives emphasized that concrete steps at improving the situation in Slovakia needed to be taken before the Slovak integration aspiration can be fulfilled[72]. The Slovak counterparts could not agree and stated that the EU opinions were based on biased sources[73]. The Association had meeting more often and adopted critical resolutions more frequently. The composition of the Slovak counterparts (except for the Parliamentary Committee), and the views they represented were the official position of the Slovak government. It did not represent the views of the whole national elite; moreover the opposition often accepted and even welcomed the EU judgement and criticism. The government reactions to this criticism did not really resulted in recognition of need to adjust in order to achieve membership. Part of the official standpoint was that the EU (and NATO) used more critical standards towards Slovakia than other countries of Central and Eastern Europe (Rybář 2005:84-90). Regarding the respect of democratic norms, the distance between the government and the European Union was progressively increasing in 1994-98. Samson (1999) argues

[71] Sme, February 26 1997
[72] Pravda, April 29 1998
[73] Sme, March 19 1998

that the state-building was lighter tasks for Slovakia than that of the European integration. The former did not have any external obstacle, the split was peaceful and the newly independent country was recognized by the international community.

2.3 The common foreign and security policy towards the new Slovak state

The EU had two strategies to express its views on Slovakia. First, it used the traditional tool of diplomacy as demarches and resolutions and second, the political dialogue mechanism of the Europe Agreement. Following the dismissal of opposition nominees from the public mass media and intelligence services supervisory bodies in November 1994, the EU presidency issued a demarche to Slovakia about its concerns towards power transfer to the new Mečiar government. The second EU demarche was issued in October 1995, right after a demarche from the USA administration. The demarches called for the respect of plurality in political opinions, of the constitution and of Slovakia's international obligations (Rybář 2005:86-90).

It was a fairly common practice among applicant countries that they had inside patrons among the member states. Slovakia was a lack of this inside sponsorship. Its case was complicated because previously the foreign affairs with the member states were conducted by Prague, therefore Bratislava had to develop these bilateral relations from the beginning. Germany and its Ostpolitik were particularly important in supporting the applicants from CEE. Slovakia had a rather uneasy start with Bonn because of various mutual misunderstandings and some diplomatic blunders on the Slovak side.[74]. Some EU member states functioned even as reverse-patron (the UK and the Netherlands as well as Germany) because of their critical view on Slovak affairs. The various demarches, initiated by leading Western politicians worried about the growing executive power in Slovak politics, attempt to undermine parliamentary control and the opposition parties, assaults on the independent media and discriminations against the Hungarian minority in official matters (Pridham 2002: 211-213).

2.4 European identity

The two simultaneous processes of nation-state building and democratization are often contradictory – as they were in Slovakia. The question of Slovak national identity and

[74] Chancellor Helmut Kohl had a personalised approach in European policy making and he was lack of sympathy towards Vladimír Mečiar. However, beyond Kohl's personal animosity, also his own democratic sensitivity was offended by internal developments in Slovakia (Interview with Pavol Hamžík, cited by Pridham 2003:226.)

independence has always been highly divisive both among the elite and the population as a whole. In 1993 when the independent statehood came true, the split within the society, concerning national identity, ethnic questions, and economic transformation was significant (Szomolanyi 2003:153-156).

One fundamental characteristic of the Slovak national identity has been its determination against primarily the Hungarian and also against the Czech, since both Hungarian and Czech politics rejected the existence of an independent ethnic Slovak nation. As a consequence a complex of inferiority and overvaluation of their values and position were formed[75].

The Slovak national identity was developed in the name of belonging to the Western Slavs and strongly attracted to Eastern Slav area as well. In other words the Slovak national identity balanced between Western Europe and Eastern Europe, which had serious impact on the integration policy of the young state as well (Hamberger 2003:345-363). Mečiar had the notion of Slovakia as a bridge between West and East. The government tried to be in good relationship with Moscow and this effort questioned the redirection of external policy towards Western Europe. Mečiar was not good in Western foreign languages but was good in Russian. He appeared regularly in Brussels and Strasbourg but he had difficulties in the field of diplomatic games. The absence of engagement with Western representatives was apparent even with top officials in the Mečiar government. The foreign affairs suffered from small size and lack of experienced staff that was heighten by the frequent changes of foreign minister (Henderson 2002:87). The meetings of the Joint Parliamentary Committee of the European and Slovak Parliaments, in Bratislava were often held in confrontational climate between government and opposition parties.

Mečiar did not share the ideological or historically inspired idea of European unity. His interest regarding European integration was rather instrumental. He was aware that an invitation to the EU (and NATO) would mean economic and security advantages and international recognition for the newly independent Slovakia. However, this scope was principally short-term. The government considered European affairs from the point of domestic politics' view. In order not to lose political control over the economy through

[75] The state language law was adopted in 1995, which did not specify any conditions for the usage of minority languages in public bodies. The disrespect of minority language rights created pressure on Slovakia to respect its commitments in the field of minority rights in line with its membership of the Council of Europe, but also according to the provisions of the Slovak–Hungarian Basic Treaty signed in March 1995.

a closer involvement with the EU, the pace of development of EU-relations was slowed down (Pridham 2002: 210-211).

The demarches and the threats had little impact on the position of the Mečiar government towards the EU. Moreover, the Western criticism even reinforced cabinet solidarity around the Slovak position and balanced the differences over EU affairs between the three coalition parties[76]. The reactions varied from partial denial of the problem, through the misunderstanding of the Slovak position, to accuse of intervention in internal affairs. In autumn 1995 EU ambassadors handed Mečiar an EU demarche and his answer was that he ran "a sovereign country" thus he did not care about the EU protest[77]. The opposition parties were attacked as well, for discrediting Slovakia abroad because they provided evidence of abuses of power for the EU (Pridham 2002:212-213).

Regarding the public feeling, in 1995 November the Central and Eastern Eurobarometer (CEEB 6) reported that in most of the Europe Agreement countries the positive impressions of the European Union outnumber negative ones, but in Slovakia (together with other three countries) a more neutral view predominates.

The CEEB 8 from 1997 reported that the ordinary Slovak citizens had an increasingly positive opinion of the EU in practically all fields despite the sometimes less than positive discussions between the Slovak government and the European Union. The Eurobarometer concluded that the rather negative evaluation of the country's internal situation led many Slovak people to look for an external point of reference for their hopes and ambitions. Although Slovakia was not one of the five countries included in the first wave, the EU notably improved its standing from 1996 to 1997 when 48% answered positively. There was also a substantial increase of intended pro-membership votes in the Slovak Republic (62%).

2.5 Transformation towards market economy

2.5.1 The macroeconomic performance of the Mečiar regime

In the first years of independence many analysts had pessimistic forecasts about Slovakia's economic performance. First, Slovakia was regarded as the weaker part of Czechoslovakia because of the historical legacy of relative under-development and the

[76] Interview with Olga Keltošová, HZDS parliamentary deputy, Bratislava, October 2000, cited by Pridham 2003:226.

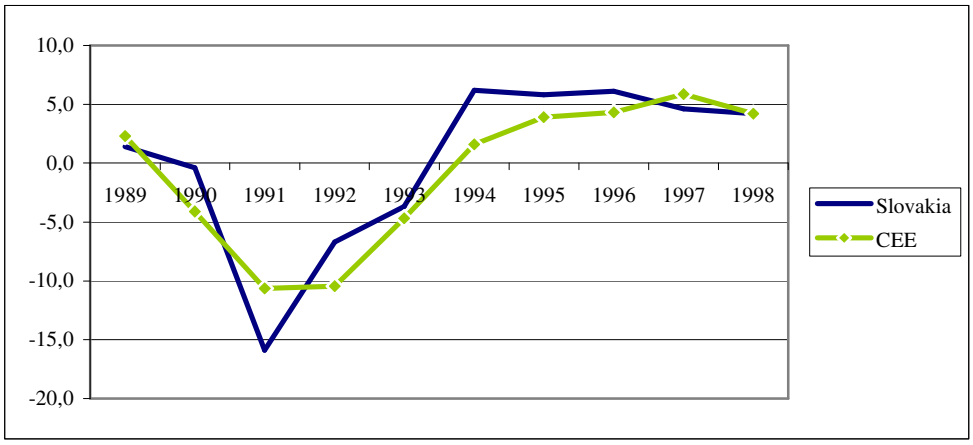
[77] Interview with Petr Greger, EU delegation to the Czech Republic, Prague, March 2000, cited by Pridham 2003:226.

large heavy industry sector. Second, the direction of policies created uncertainty about the path of development. The establishment of a market-based economy was burdened by interventionist government policy (OECD 1996:1-2).

In contrast to these pessimistic scenarios, the newly born Slovak Republic experienced a rapid economic growth from 1994 that was common among the CEE countries (Figure 25). After a sharp decrease in 1991-1993, GDP grew by 6.2% in 1994, 5.8% in 1995 and 6.1% in 1996. The growth only in 1994 was led by export[78], while in 1995 and 1996 mostly by domestic demand (OECD 1999:26). From 1997 Slovakian growth rate decreased under CEE average and stayed there until 2006 when the GDP grew by 8.3%. The economic slowdown was a result of governmental efforts to slow down investment and consumption, aiming lower imports and reduce the trade and current account deficits (Commission 1999c:20).

The increase in employment and real wages can underpin growth in household consumption in 1995. At the same time, the government expenditures contributed a smaller part to growth in 1995. The gross fixed capital formation had some salient quarterly value during 1993-1995. The improvement in investment spending is very important in more ways: for the growth prospects and for the adjustment potential of the economy. It indicates the creation of new productive capacity and the increase in business confidence towards Slovakia (OECD 1996:7).

Figure 25: GDP year-on-year rate of growth in real terms, 1989-1998



Source: EBRD Selected economic indicators

The economic profile of Slovakia was characterized by the domination of heavy industry, especially armaments. Czechoslovakia was the second largest weapon

[78] The revival of Western European economies created an opportunity for export-led growth.

producer of the Warsaw Pact and the Slovak part occupied 65% of this capacity with 80000 employees. After the dissolution of Czechoslovakia, in Slovak rhetoric the armaments industry became the symbol of national sovereignty and prime minister Mečiar tried to preserve and promote the sector, but the decline was inevitable. The transformation of the defence industry had a high price (Kiss 2005). However, the sectoral structure of the Slovakian economy has changed considerably since the beginning of the 1990'. The share of heavy industry declined from 60% in 1991 to 33% in the middle of the decade, which indicates a quick realignment in the economy. In 1995 the service sector (mainly market services, e.g. transportation and communication) generated 61% of the GDP compared to 34% in 1991.

After 1989 the trade between Czechoslovakia and the EC begun to increase as the direction of trade of all CEE countries turned to west. With the dissolution of the Czech and Slovak Federal Republic, the Czech Republic became the main trading partner of Slovakia, with a share of 36% in import and 42% in export in 1993. The two new countries formed a custom union with common external tariffs, but without free movement of goods coming from third countries. The share of the EU increased steadily during the years (Table 31). The export growth in 1994 occurred mostly in the field of semi-finished products (iron and steel, chemicals, machinery, textiles, timber and paper). In 1996 the Slovak export was still dominated by intermediate goods (38.3%), mainly steel (Table 32). Further important sectors were machinery and transport (23.1%) and chemical products (12.1%). The most important import commodity group was machinery and transport equipment, followed by fuels and chemicals in 1996. The Russian Federation was an important import partner regarding energy and raw materials.

Table 31: Partners of imports and export by main countries in Slovakia, as % of total[79]

Imports	**1993**	**1995**	**1999**
EU	20.6	34.8	51.7
CEFTA	39.3	33.1	23.4
Russian Federation	19.5	16.6	12.0
Export	**1993**	**1995**	**1999**
EU	24.1	37.4	59.4
CEFTA	49.8	44.3	29.8

Source: IMF, WTO and European Commission

[79] Note: Until 2001 EU means EU-15, in 2005 means EU-25. Central European Free Trade Association (CEFTA) here includes Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia. Trade with Romania is not included.

Table 32: Structure of Slovakian foreign trade, breakdown by commodity group, millions of USD at current prices and in percentage of total

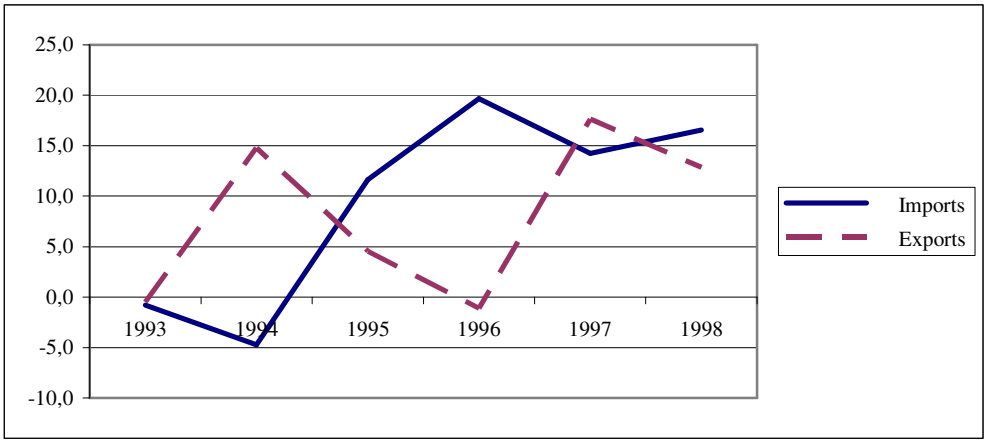
	1993				1996				1998			
	USD	**%**	**USD**	**%**	**USD**	**%**	**USD**	**%**	**USD**	**%**	**USD**	**%**
	Import		**Export**		**Import**		**Export**		**Import**		**Export**	
Agricultural products	***723***	***11%***	***551***	***10%***	***1019***	***11%***	***663***	***8%***	***1072***	***8%***	***695***	***7%***
Food	580	9%	364	7%	827	9%	396	5%	845	7%	446	4%
Fuels and mining products	***1555***	***25%***	***457***	***8%***	***1748***	***19%***	***808***	***9%***	***1885***	***14%***	***772***	***7%***
Fuels	1322	21%	na		1890	20%	435	5%	1427	11%	376	4%
Manufactures	***4038***	***64%***	***4449***	***82%***	***6673***	***71%***	***7246***	***83%***	***10108***	***77%***	***9216***	***86%***
Iron and steel	na		888		417	4%	1308	15%	429	3%	1224	12%
Chemicals	719	11%		0%	1348	14%	1120	13%	1386	11%	953	9%
Machinery and transport equipment	1850	29%	1058	19%	3809	40%	2044	23%	5267	40%	4004	38%
Office and telecom equipment	337	5%	73	1%	700	7%	129	2%	894	7%	313	3%
Automotive products	267	4%	221	4%	1106	12%	630	7%	1642	13%	1944	18%
Textiles	179	3%	268	5%	303	3%	303	4%	559	4%	350	3%
Clothing	92	2%	198	4%	106	1%	271	3%	174	1%	540	5%
TOTAL	**6313**		**5457**		**9440**		**8717**		**13065**		**10683**	

Source: WTO Statistic Database, own calculations

Slovakia has been a very open economy and the country was strongly dependent on the external sector. Both the consumers and investors had a large demand for imported goods and it requires a strong export sector as well.

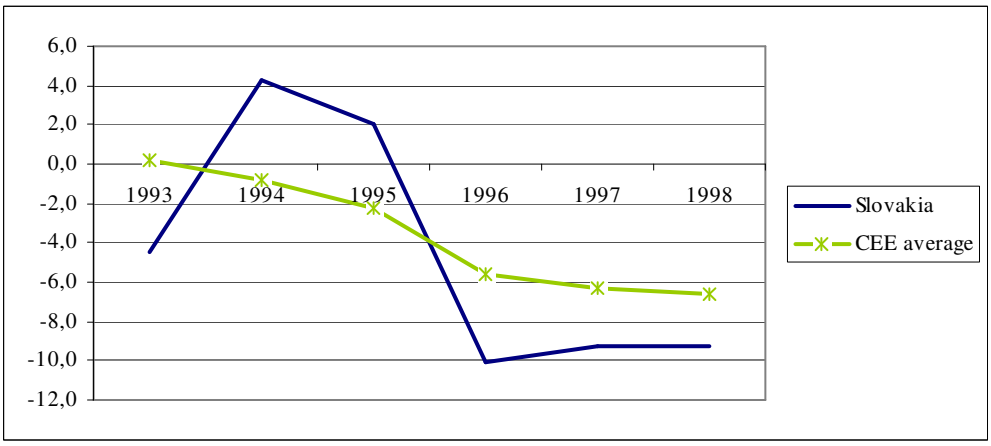
The import growth rate exceeded the export in 1995 and in 1996 the deficit exceeded even the CEE average (Figure 26). Although in the next two years export grew rapidly, the *current account* deficit per GDP ratio was around 10% in 1996-1998. After being negative in 1993, the current account balance turned into positive for two years (1994-1995). The growing current account deficit reached 11% of GDP in 1996, 9.7% in 1997 and 10% in 1998 (Figure 27).

Figure 26: Import and export of goods and services in Slovakia, percentage change in real terms, 1993-1998



Source: EBRD Selected economic indicators

Figure 27: Current account in Slovakia, in millions of USD, 1993-1998



Source: EBRD Selected economic indicators

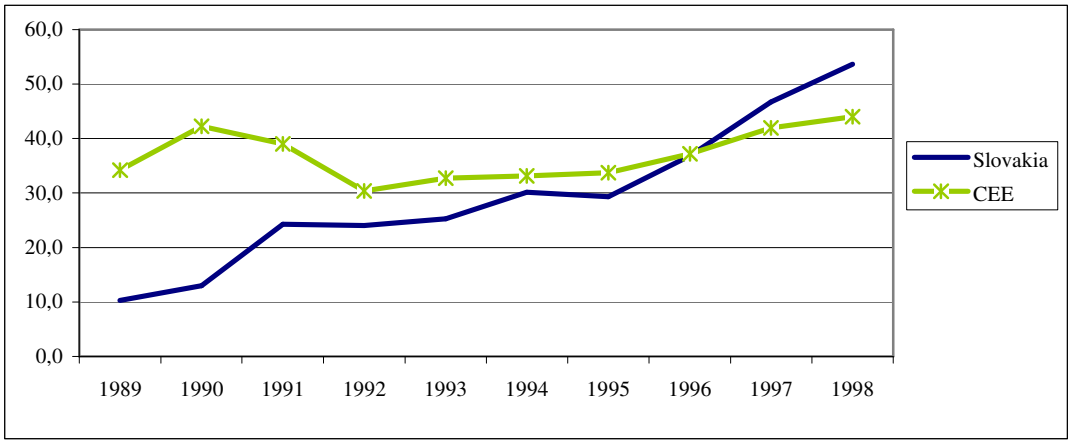
Pursuant to Article VIII of the IMF Articles of Agreement, on 1 October 1995 the Slovak koruna became convertible within the current account of the balance of payments. From 1 October 1998, the National Bank of Slovakia (Národná banka Slovenska, NBS) gave up the fixed nominal exchange rate of the koruna against a currency basket within a fluctuation band.

The Slovak monetary policy was kept tight since 1993; the NBS followed a strict anti-inflationary program and resisted the pressure for looser monetary policy that came from the government and the banking and industrial sectors. The NBS maintained its independence of the government, in spite of government proposals to limit it (EUI 1998 and 1999). From May 1997 the koruna faced a significant selling pressure because of the large current account deficit. After an expensive defence action the NBS decided to allow the koruna float in October 1998. The beginning of the flotation coincided with

the entry of the new government (November 1998). The koruna depreciated but less than previously expected.

Slovakia inherited a slight stock of *external indebtedness* (25.3% in 1993) therefore Slovakia was among the less indebted countries. It increased steadily but the external debt per GDP ratio stayed under peer country average until the middle of the 1990'. However, between 1993 and 1998 the external debt doubled relative to the GDP (Figure 28) and more than tripled in million US dollars (3,380 million in 1993 and 11,902 million in 1998). From 1996 the government increased spending on large public investments as highway construction and other infrastructure projects (EUI 1999:18).

Figure 28: External debt in Slovakia, as percentage of the GDP, 1989-1998



Source: EBRD Selected economic indicators, own calculations

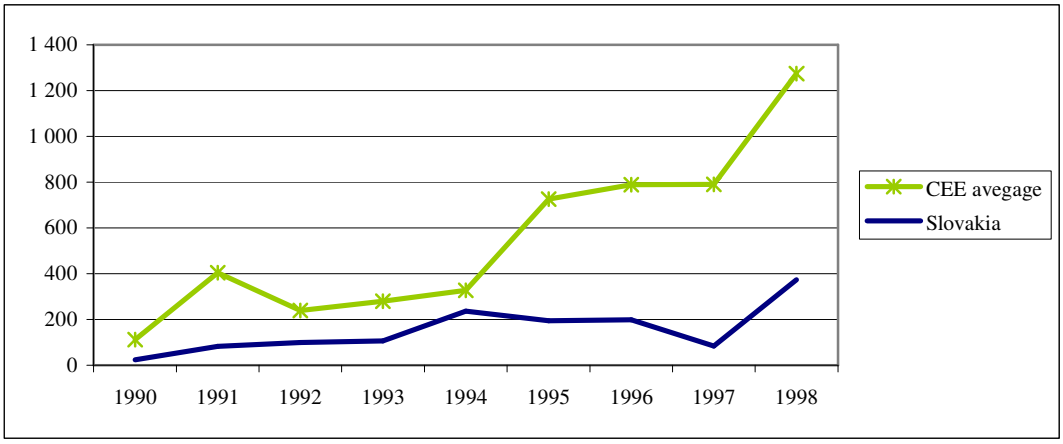
The external debt rose also and reached 62% of GDP in 1998 (almost 30% in net terms). The amount of the debt and the speed of its accumulation resulted in a deterioration of Slovakia's credit rating (OECD 1999:10-11) (Table 43).

The *capital movement* liberalization process started on 1 February 1995 when the direct investments in European Union member countries were liberalized. FDI flows were small compared to peer countries during the 1990', the net stock of FDI stayed under CEE average during the decade (Figure 29). Foreign investors had cautious approach towards the country; they had no confidence in the commitment of the authorities toward market reform. The amount of foreign capital invested in Slovakia was modest compared to the investment needs, the inward FDI performance was less than the potential (WIR 2008). Slovakia was not committed in allowing foreign participation in privatization process, in most cases foreigners were excluded (OECD 1996,

Commission 1997b). The openness of the country (that also realized on the side of trade) contradicted with the approach towards foreign investors, i.e., that the authorities had strong preference for domestic ownership and control (OECD 1999:110).

In 1998 the government started to make efforts to attract foreign investors. As a result, a Volkswagen plant and a joint venture with US Steel settled down in Slovakia (EBRD 1998).

Figure 29: Net foreign direct investment, in millions of USD



Source: EBRD Selected economic indicators

Regarding the origin of FDI, Germany and Austria were the biggest investors in the first years of the newly born Slovak Republic, holding 23.4% and 23.3% of total FDI stock in 1993 respectively. The EU altogether possessed around three-fourth of the FDI stock (Table 33).

Table 33: The origin of FDI stock in Slovakia, 1993-1997, in millions of USD and in percentage of total

	1993		1995		1997	
	USD	%	USD	%	USD	%
The Netherlands	91.8	7.4	312.3	14.7	907.8	24.3
Germany	292.2	23.4	431.6	20.3	1063.6	28.5
Austria	291.0	23.3	411.0	19.3	539.3	14.4
Italy	27.8	2.2	37.1	1.7	57.9	1.6
Hungary	7.7	0.6	18.2	0.9	181.8	4.9
United Kingdom	133.2	10.7	229	10.8	118.9	3.2
Czech Republic	128.6	10.3	205.2	9.6	217.8	5.8
EU	965.1	77.4	1583.2	74.4	2915.9	78.1

Source: UNCTAD FDI Country profiles and National Bank of Slovakia, Monetary Surveys

Huge part of FDI (69.6% in 1998) arrived to the export-oriented manufacturing sector, which contributed to capacity and output growth (Table 34).

Table 34: FDI in Slovakia by sectors in 1998, in percentage of total

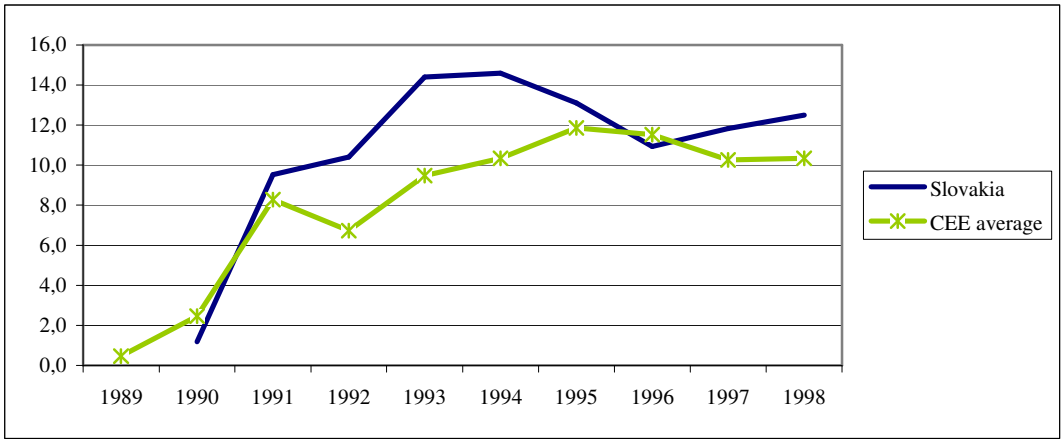
	1998
Manufacturing	69.6
Construction	1.1
Wholesale and retail trade, repairs of motor vehicles	15.4
Hotels and restaurants	-0.2
Transport, storage, post and telecommunications	2.4
Financial intermediation	8.4
Real estate, renting and business activities	3.5
Other community, social, and personal services	-0.2

Source: National Bank of Slovakia, Monetary Surveys

Along with the transformation of Slovakia, *unemployment* rose quickly high above the CEE average (Figure 30). The proportion of long-term unemployment was extremely high and there were large differences among regional unemployment rates over the country: ranging from less than 5% in Bratislava to more than 25% in predominantly agricultural regions in South and East Slovakia (EUI 1999:21).

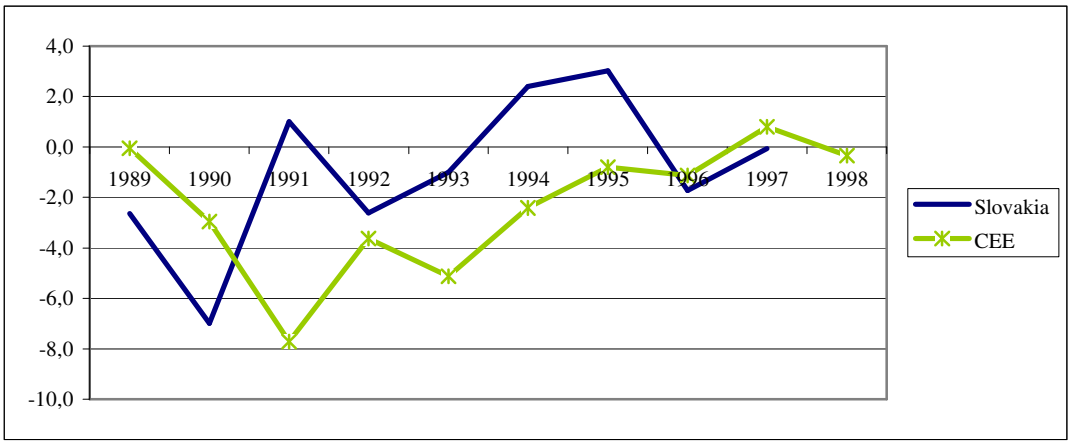
Most privatisations were conducted through management buy-outs, which accompanied by mandatory conditions on the maintenance of employment levels (EUI 1998:17). As a consequence, the Slovak employment level changed less drastic than the average of the CEE countries (Figure 31).

Figure 30: Unemployment rate in Slovakia, in percentage, 1989-1998



Source: EBRD Selected economic indicators

Figure 31: Percentage change in employment (end-year) in Slovakia, 1989-1998



Source: EBRD Selected economic indicators, data based on labour force surveys (LFS)

The Commission's Opinion on Slovakia's Application for Membership (Commission 1997b) reported that Slovakia had implemented most of the necessary reforms to establish a functioning market economy. Slovakia could satisfy the economic criteria in the medium term and is firmly committed to take on the acquis communautaire.

2.5.2 Structural changes during the Mečiar regime

The Slovak *privatization* began in 1991 under the Czech and Slovak Federation. It began with the restoration of many small units of property for former owners or their heirs and with the sale of small retail trade and service sector establishments by public auction. The first wave of large scale privatization started in 1992, mainly through voucher privatization, and to lesser extent through direct sales. From 1993 the pace of large-scale privatization slowed down, however, in EBRD of large-scale privatization index (Table 53) Slovakia reached level 3 i.e. "more than 25% of large-scale enterprise assets were in private hands or in the process of being privatized with possibly major unresolved issues regarding corporate governance". During 1995 and 1996 the government continued both direct sales and bond privatization. Bonds were issued instead of the second wave of voucher privatization, which was cancelled in 1995. Strategic partners were excluded from direct sales; the emphasis appeared to be placed on promoting local entrepreneurs through sales to domestic managers and employees, both insider stake-holders and outsiders. Sales were supported by favourable financial conditions. The cancellation of the voucher scheme and turn to direct sales reflected the desire of the Slovak authorities to sell the property to knowledgeable owners who would take a strategic interest in the companies under their control. In case of insider

privatization, the economy cannot make a use of foreign expertise and know-how, but has to utilize the resources available "at home". This practice ran some risk, because Slovakia was a lack of business experience and skills (OECD 1996:59-62). At the same time, direct sales provide some positive potential as well since local managers and owners know very well the company and its environment (OECD 1999:108).

In 1994 15 out of the top 20 companies in Slovakia was *owned by the state* or the National Property Fund or was declared strategic and the state own a golden share (OECD 1996:72). By 1997 the share of publicly owned companies accounted for less than 3% of enterprises, but in terms of output the state sill played a dominant role in several sectors of the economy. Among private enterprises the proportion of foreign owned was under 10% and of mixed ownership was around 10%. Share of private sector in GDP reached the CEE average already in 1993 but the average of the Visegrád countries in 1996 (Table 57).

In 1989 in Czechoslovakia 90% of the companies had more than 500 employees and these accounted for 98.8% of the employment, which shows an extremely concentrated economic structure (OECD 1996:67). The small and medium-size sector was almost missing. With the beginning of the transformation, Slovakia (and the Czech Republic) was in a less favourable situation regarding small and medium-size enterprises (SMEs) than most of the peer countries. However, after 1989 the number and importance of SMEs and private entrepreneurs grew quickly. By the end of 1994, the SMEs accounted for 35% of gross output in the industrial sector; and together with self-employed, they represented around 40% of total employment. By this time Slovakia earned level 4 in EBRD index of small-scale privatization i.e., "complete privatization of small companies with tradable ownership rights" (Table 54).

A critical mass of enterprises had begun its restructuring. OECD suggested in its 1998-1999 Survey, that the level of transparency of the privatization process was still not satisfying (OECD 1999:101). In EBRD index of enterprise reform (Table 55) in 1993 Slovakia reached level 3 i.e. "significant and sustained actions to harden budget constrains and to promote corporate governance effectively". However, in 1997 and 1998 it was even throw back to level 2.67.

During the communist regime one-tier *banking system*, the Státní Banka Československá (SBCS, State Bank of Czechoslovakia), was both the central bank and the only commercial bank in Czechoslovakia. Resources to enterprises were allocated

primarily on the basis of central plans. There was one saving bank in each republic to collect household savings. Československá obchodní banka (ČSOB, Czechoslovak Trade Bank) handled foreign exchange transactions in both republics. The two-tier banking system was created in 1990 when SBCS became exclusively the central bank and the regulator of the banking system. The commercial functions were transferred to newly created banks, Všeobecná úverová banka (VÚB, General Credit Bank) in the Slovak Republic and Investičná banka (IB, Investment Bank) in both republics. The saving bank (later Slovenská sporiteľňa, SLSP, Slovak Saving Bank) and ČSOB became universal commercial banks and entry was liberalized. A state owned Konsolidačná banka (KBB, Consolidation Bank) was established in 1991 (and later separated to Czech and Slovak successor) to take over special credits that were issued for inventory financing and carried low interest rate. These credits consisted of 20% credits to enterprises and 11% of GDP. KBB was the instrument of recapitalization of banks and later took part in enterprise restructuring by purchasing debts of enterprises in bankruptcy proceeding. During 1991 a second turn of recapitalization occurred in October, equivalent to 5% of GDP (EBRD 1995:57,158).

The National Bank of Slovakia was established as a successor of SBCS in January 1993. In 1993 foreign banks entered the market of the newly independent Slovak Republic and there were 13 foreign-owned banks out of 28 (EBRD 1995). Through coupon privatization 49% of the equity of VÚB and 66% of Investičná a rozvojová banka (IRB, Investment and Development Bank, assumed Slovakia's share of IB's assets) were transferred to private sector (World Bank 1994:25-26).

In 1996 banks without foreign capital participation owned 55% of the total equity capital. Banks with foreign capital participation had 31% and branch offices of foreign banks owned 14%. The Slovak banking system was highly concentrated, the three large banks (VÚB, IRB and SLSP) accounted for 62% of total bank assets (EBRD 1997).

During the decade the market share of the three large banks continually reduced (47% of total assets in 1998), while domestic and foreign owned private banks raised their shares (from 30% in 1995 to 50% in 1998). However, the state ownership remained significant. The foreign ownership reached only 23.7% in 1998 in spite of the relative large number of foreign owned banks (Table 35).

The three large banks endured losses from 1996, because most of the bad loans were in the books of these three. At the end of December 1997 IRB had to be placed under conservatorship because of financial difficulties. The three large banks owned the 70%

of the total lost claims of the banking system. The amount of bad debt seemed to be manageable although it increased significantly during between 1993 and 1998 (Table 36).

Table 35: Number of banks /foreign-owned, 1989-1998

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Slovakia	na	na	na	na	28 /13	29 /14	33 /18	29 /14	29 /13	27 /10

Source: EBRD Structural and institutional change indicators

Table 36: Selected indicators of the banking system, 1993-1998

	1993	1994	1995	1996	1997	1998
Asset share of state-owned banks (in percent)	70.7	66.9	61.2	54.2	48.7	50.0
Asset share of foreign-owned banks (in percent)	na	na	na	12.7	19.3	23.7
Non-performing loans (in percent of total loans)	12.2	30.3	41.3	31.8	33.4	44.3

Source: EBRD Structural and institutional change indicators

Concerning EBRD banking sector reform index (Table 58), Slovakia reached the level 2.67 among the firsts in 1992, but stayed at the same level until 1999, which meant the last place in the CEE group.

2.6 Conclusion

Pridham (2002:214) concludes about the Mečiar era that the EU-influence was limited. The demarches had little impact on the Slovak government; moreover often they had even reverse effect. At the same time, as Krause (2003:69) highlights, Mečiar's authoritarian style helped the Slovak democratization process in an indirect way, evoking an active commitment from the civil society to defend the democratization itself. Therefore the European influence was quite significant although not direct. As the government policies became more extreme in terms of nationalism and authoritarianism, it became more repellent in the eyes of the voters.

Slovakia's initial path of democratic transformations was characterized by the absence of elite settlement (Szomolanyi 2003:153-156).

When marking the Mečiar regime as isolated and unaffected by the pressure from Brussels, that does not mean that the pressure had no effect at all. First, the government showed certain defensiveness in contrast to EU criticisms. From this point of view, the

effect of democratic conditionality on the state was rather reverse but not insignificant. Second, at the level of society, various actors and particularly NGOs were indeed encouraged by outside support and a critical awareness in Europe. The role of this international influence in the turning-point of 1998 was significant (Pridham 1999:1238).

The economic legacy Mečiar regime were large fiscal and current account deficits, increasing pressure on the fixed exchange rate regime and the subsequent floating of the currency, delays in enterprise and financial restructuring. The high public infrastructure investment, extra-budgetary spending and borrowing led to an overheated economy with twin deficit problem. The large regional disparities were another crucial task to deal with. The GDP per capita in PPP terms in Bratislava region was around the EU average, while in the Eastern rural areas possessed only one third the capital level. The disparity rooted in several factors such as high rate of unemployment, insufficient infrastructure and uneven allocation of investments among the country (OECD 1999:9-23; EBRD 1999:262-263).

Geographic location of Slovakia, i.e. the proximity of European Community/ European Union and the fact that it is surrounded by the Visegrád states, made the economic isolation less intensive in terms of trade. However, the low economic respectability of the country made foreign investors suspicious.

The end of the Mečiar regime was not only the result of the worsening macroeconomic indicators. It was also the consequence of the fear of being excluded from EU enlargement both from the side of political elite (that time in opposition) and from the side of the people.

3 The "Europeanist" phase of economic transformation and European integration – the Dzurinda administration

3.1 Building democracy with EU anchor

In 1998 a broad centre-right coalition of five opposition parties (KDH, DU, DS, SDSS, and SZS[80]) formed a single movement called the Slovak Democratic Coalition (SDK). At the same time, other opposition parties committed not to enter into a coalition with

[80] Christian-Democratic Movement, Democratic Union, Democratic Party, Social Democratic Party of Slovakia and Green Party of Slovakia, respectively

HZDS after the elections. The HZDS won with a little plurality of 0.7 percent over the SDK coalition, but according to the pre-election agreement, it became virtually isolated on the political spectrum. The prime minister became Mikuláš Dzurinda.

Both the internal and external expectations towards the new government were huge because it could answer such questions like whether the foreign policy orientation would face East or West; whether rule of law would vanquish over clientelism and corruption and whether the political atmosphere would be calm and cooperative instead of aggressive and confrontational (Fisher 1999).

Still, in 1998 the Dzurinda government had to face scepticism of the international community. Accordingly, the reform process had to be quick and effective. The reform process was driven by international pressure and by the promise of international integration. The promise of integration served as a unifying factor that made possible for the left-right coalition to stay in power for the full term.

The government operated under pressure coming from several sides. First, there was an external pressure from the European Union to prove the democratic turn in Slovakia and the commitment of the new government towards the EU. Second, there was an internal pressure within the four-party coalition to follow the line of EU integration and democracy. The government had a constitutional majority (three fifths of the seats in the National Council) that was necessary for passing constitutional legislation in accordance with EU requirements. However, apart from this common line, it was not easy to manage the coalition and the internal tensions made Brussels worried sometimes (Pridham 2002:218).

The EU motivation proved to be strong regarding the survival of the coalition. For example the inclusion of the Party of the Hungarian Coalition (SMK) was motivated by EU considerations referring minority rights. Ethnic Hungarians got into the government for the first time since Slovakia's independence, and Pál Csáky, member of SMK became the deputy prime minister for human and minority rights. The adoption of a new language law about the use of minority languages was moreover a political condition for opening the negotiations (Fisher 1999; Pridham 2003:218).

The Eurobarometer (2002) survey showed that people in Slovakia were not satisfied (77%) with the national democracy. The result of the 2002 elections, i.e. the defeat of the return of the nationalist authoritarianism represented by Vladimír Mečiar and the reelection of Mikuláš Dzurinda's center-right coalition was considered an important indication of democratic consolidation (Krause 2003:65). Dzurinda was among the few

in the CEE who was re-elected. The participation rate was less than in 1998 (70%, as compared to 84%) and fewer parties could get into the parliament (7 parties compared to 10 in 1998). The second Dzurinda government's coalition was a much more ideologically homogeneous one that offered the opportunity to continue the reform process and complete Slovakia's integration into the EU (Mathernová–Renčko 2006:636).

The opposition party Smer, led by Robert Fico, and the trade unions initiated a referendum on early parliamentary elections. The referendum was held in April 2004 together with the presidential election but the participation rate was not enough to be valid. Therefore the reform process could be continued. The political consensus proved to be enough strong and citizens enough prepared to accept the reforms.

The parliamentary elections in 2006 came early (in June) because the ruling coalition struggled with growing disunity and strong opposition. Some parts of the reform program created deep unpopularity that provided an opportunity for the opposition to do an effective anti-government campaign (EUI 2007:5-6). As a result of the elections, the new left-wing government coalition was formed by the centre-left Smer–Social Democracy (Smer–SD), the far-right Slovak National Party (SNS) led by Ján Slota and the populist People's Party–Movement for Democratic Slovakia (LS–HZDS) whose leader has been Vladimír Mečiar. The prime minister, Robert Fico came from the Smer–SD.

Textbox 6: Smer in the European Parliament

In October 2006 in the European Parliament the members of Party of European Socialists (PES) voted for suspend the membership of the Smer-SD because of its coalition of the SNS and especially the discriminative and xenophobic approach of Ján Slota (PES 2006). At the same time the admission of LS-HZDS to the European People's Party was refused by KDH (Christian-Democratic Movement), which was a member of it (EUI 2007:6). PES provisionally lifted the suspension of Smer because the "government policy has proved fully social democratic" (PES 2008).

The coalition partners of the Smer-SD (the SNS and the LS-HZDS) made the international community worried about Slovakia's international reputation because of possible withdrawal of several Dzurinda reforms and tensions with the Hungarian minority. The new Fico government decided to stop some large privatization programs and keep its ownership in strategic companies. The suspension meant disappointed foreign investors whose offers were approved. The lost privatization revenues reached

3.5% of GDP. Some reforms of the previous government regarding the health care sector and labour market were recalled. Despite these steps, the government did not endangered overall public finances. The government also aimed to win back foreign investor's confidence and committed itself towards euro adoption in 2009. The budget plan for 2007 was considered credible. After the koruna appreciated, in March 2007 the ERM II parity was removed by 8.5% to 35.4424 koruna per euro. Real growth accelerated in 2006 due to the continued vigorous domestic demand and the export-oriented car and electronics industry. The strong growth made possible a government deficit of 3.4% of GDP in 2006 (EBRD 2007:186-187). GDP growth rate reached 10.4% in 2007, that was the highest in the EU. At the same time, Slovakia still had the highest unemployment rate in the EU in mid-2008 and a very large proportion of the unemployed are long-term in nature (EUI 2008:3)

According to EUI country profile (2007:8), the government change had no impact on the functioning of the country's institutions. Therewith, key institutional leaders and lower-ranking bureaucrats were gradually replaced, which is in line with the usual political practice in country.

3.2 EU conditionality towards accepting the acquis communautaire

The fear of international isolation made Slovaks aware that there was simply no alternative to the EU. In September 1998 Slovakia stepped back to the "mainstream" path. The Dzurinda government implemented most political requirements that were recommended to the Mečiar government. The first Regular Report (Commission 1998c) was very optimistic about the result of the parliamentary elections in September 1998. The Commission concluded that the new government was offered an important opportunity to address the political weaknesses to demonstrate Slovakia's commitment to democratic principles, respect for human rights and the rule of law. However, the Report mentioned that the deficiencies in political terms (lack of stability in the institutions guaranteeing democracy, the rule of law and protection of human rights) still existed. In economic terms, the Commission reported a lack of transparency, due to government interference. The general statement on the economy did not changed since the latest Report; Slovakia should be able to cope with competitive pressure and market forces within the Union in the medium term, assuming that the market economy is allowed to function.

The second Regular Report (Commission 1999b) concluded major changes compared to the previous year since it stated that Slovakia *fulfilled the Copenhagen political criteria* although further attention was needed to improve the situation of the Roma minority and to fight discriminatory attitudes in society. The Commission noted that in spite of the internal tensions, the four-party coalition government endured since the elections. Concerning the economic criteria, Slovakia was close to being a functioning market economy thanks to the impressive reform agenda of the new government. The progress towards sustainable macroeconomic stability and the implementation of the structural reforms should enable Slovakia to cope with competitive pressure and market forces within the Union, still in the medium term. Despite the difficulties among four parties, the government managed to take a number of unpopular steps that were necessary in the economic field (Fisher 1999).

The Dzurinda government was able to benefit from the preparatory steps in EU integration taken by the previous government and it did not have to start all from the beginning. In February 1999 an Action Plan for intensifying Slovakia's integration was accepted. An EU delegation to Bratislava in June pronounced that the country hopefully receive a delayed invitation to the first EU enlargement round and would join the other Visgrád countries in their negotiations trajectory after the Helsinki summit (Fisher 1999). At the European Council summit in Cologne in June 1999 the new government was to present a new image of Slovakia and shift Slovakia into the first group of applicant countries (Slivkova 1999:4). The government enhanced its relations with influential EU members, in particular in the weeks before the Helsinki summit in December when there were further diplomatic visits to confirm their support for Slovakia (Pridham 2003:217).

The Helsinki European Council in December 1999 decided to *open negotiations* in February 2000 with the "Helsinki Six": Bulgaria, Latvia, Lithuania, Romania, Slovakia and Malta. The positive outcome of the Helsinki summit was almost foreseeable because the second Regular Report had appreciative opinion on the development on Slovakia. It became clear soon that Slovakia could catch up with the rest of the Visegrád Four and join the EU together with them. The government began its race to open (and close) as many chapters as possible and narrow the gap with the countries that began negotiations two years before.

The year 2000 was important in international relations. In March the EU accession negotiations begun and in December the country gained OECD membership. The third

Regular Report (Commission 2000b), noted that Slovakia advanced further in the consolidation of its democratic system and in the normal functioning of its institutions. The Commission stated that the speed of the reform process had lost some momentum, partly because of the dissension within the governing coalition. Macroeconomic stability had been restored and the statement on Slovakia's ability to cope with competitive pressure and market forces within the Union in the medium term remained unchanged. Slovakia made significant progress in legislative harmonization with the acquis. The working relations between Bratislava and Brussels were altogether good and there was a substantial degree of mutual understanding on both sides that was missing during the Mečiar era. Difficulties related to political conditions and complicated negotiation chapters stayed under control (Pridham (2003:219-220). At the same time, the government had to prove its commitment again and again in order to dissolve the doubts in Brussels.

The fourth Regular Report (Commission 2001b) stated that Slovakia continued to fulfil the Copenhagen political criteria and the country made considerable progress in further consolidating and deepening the stability of its institutions guaranteeing democracy, the rule of law, human rights and respect for minorities. The economy of Slovakia should be able to cope with the competitive pressure and market forces within the Union in the near term supposing that it made further efforts in medium term fiscal consolidation and in the structural reform program. Overall, macroeconomic stability had been maintained. Slovakia continued to improve legislative harmonization with the acquis communautaire.

The fifth Regular Report of 2002 (Commission 2002b) did not really deal with the fact of the re-election of the Dzurinda government. It was only noted that the parliamentary elections ran freely and fairly. The Report stated that the process of consolidation of democratic institutions continued and EU accession remained a high political priority. It reported considerable efforts in further developing to protect minority rights. Considering the economy, macroeconomic stability had been achieved and reforms accelerated. The commitment of the Slovak authorities to the economic requirements of EU accession has been sustained. According to the Report, the continuation of the reform path should enable the Slovak Republic to cope with competitive pressure and market forces within the Union. For the first time, the term "in the medium term" was not added. Slovakia has further advanced in harmonization with the acquis communautaire and in strengthening its administrative capacity.

The Laeken Summit (14-15 December 2001) decided about big bang enlargement so that the European Union completed accession negotiations by the end of 2002 with the candidate countries that were ready to a successful conclusion. The European Council agreed with the Commission that, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, the Czech Republic and Slovenia could be ready by that time and thus these countries could take part in the European Parliament elections in 2004 as members (Council 2001).

The *accession negotiations* with Slovakia were finished on 13 December 2002. The Treaty of Accession was signed on 16 April 2003. The Comprehensive Monitoring Report (Commission 2003b) was published in 2003. It reported considerably improved macroeconomic performance, although some imbalances remain significant. In field of the reform path, also in the public finance area, the Report detected strong new impetus. Slovakia reached a high level of harmonization with the acquis in most policy areas. However, in certain areas further efforts were still necessary until 1 May 2004 and even after the accession date.

3.3 The common foreign and security policy

After one year of governance Slovakia was successfully put back on the path of European integration. The new Prime Minister Dzurinda and other cabinet members among their first tasks visited Brussels and other Western European countries and opened up a high political level dialogue that had been missing previously. The aim was to get Slovakia in similar position like its Visegrád neighbours (Fisher 1999). Dzurinda and Hans van den Broek, Commissioner for enlargement decided to set up a High Level Working Group between the European Commission and Slovakia in order to support Slovakia's efforts to regain momentum for accession preparations. It worked through policy consultation on accession-related matters and it also provided training in Brussels for Slovak parliamentary deputies, government officials and NGO representatives. It contributed to establish a new atmosphere of mutual trust. The new Slovak approach expressed a very different mentality and indicated a different elite culture (Pridham 2002:215-216). The time of demarches has gone.

3.4 Building fully fledged market economy[81]

At the time when the Dzurinda government appeared, the Slovak economy stood at turning point because the previous growth path reached its limits. The required reforms were not only important in order to step on a sustainable growth path but also in order to improve the image of the country.

The reform package had three pillars: macroeconononomic stabilization, structural reform in the enterprise and banking sector, and legal and institutional changes. It was clear from the beginning that quick steps were necessary to stabilize the macroeconomy and avoid a recession. The response for economic challenges was further complicated by coalition disputes because the governing parties had different approaches. To find effective stabilizing measures that are acceptable for every party within coalition seemed to be impossible. The turning point came in May 1999 after the presidential elections. The government announced a second set of difficult measures and broad structural reforms. The markets believed them, and the government kept its promise (Mathernová–Renčko 2006:631-632). Thus the measures helped to rebuild the investor's confidence (OECD 1999:14)

The new government introduced the *stabilization program* in December 1998. It cut public spending and raised revenues: froze the wages in the public sector, raised infrastructure tariffs, increased the lower rate of VAT and excise tax on cigarettes and petrol, and reduced public infrastructure investments. The result of measures was likely to reduce the fiscal deficit to 3% and the current account deficit to 5% of GDP in 1999 (EBRD 1999:262). The elaboration of the reform measures were supported by a group of young Slovak people educated abroad than returned home (Mathernová–Renčko 2006:636).

3.4.1 Structural changes

The reform measures are usually named after prime minister Mikuláš Dzurinda but he was not the only person that countermarked it. The person of Ivan Mikloš accompanied through both terms of the Dzurinda government. He was the first deputy prime minister for the economy during 1998-2002 and he assumed the position of finance minister in the 2002-2006 government. He has managed to push through several contentious

[81] This section heavily builds on OECD 2002:9-19, OECD 2004:9-21, OECD 2005:8-17 and OECD 2007:9-17, EBRD 2000:206-207, EBRD 2001:190-19, EBRD 2002:194-195, EBRD 2003:192-193 and EBRD 2004:174-175.

measures, such as the privatization of public utilities and tax reform. Foreign investors and international financial institutions regarded him as the main guarantor of Slovakia's reform efforts (EUI 2004:25).

Structural reforms were necessary in the enterprise sector to solve the problem of the survival of unprofitable large firms and intransparency of the privatization process. The design and implementation of the reform package was coordinated with the World Bank and partly assisted by its Enterprise and Financial Sector Adjustment Loan. The restructuring was rather expensive. In 1998 35% of the loans in the banking sector were classified as non-performing and the restructuring of the sector cost 13% of GDP of 2000 (Mathernová–Renčko 2006:634).

There was a critical mass of enterprises that already went through the first steps of restructuring. However, some large enterprises or even sectors lagged behind and were able to draw on a complex web of direct and implicit financial support. The new government developed a plan to in order to improve the efficiency of bankruptcy that was not used as an instrument of restructuring before. The questionable Revitalization Act (proving state support to large loss-making firms) was cancelled.

In June 1999 the Dzurinda government cancelled the 1995 law that excluded "strategic enterprises" from *privatization*, in order to privatize them, involving strategic investors. The National Property Fund started a review of past privatizations, focusing on illegalities and arrears of instalments. The government decided to re-privatize the Nafta Gbely oil and gas storage company because it was sold for a fraction of its market price in 1996. In 2000 the Hungarian oil and gas company MOL acquired one-third of the Slovnaft oil refinery, which was the largest single foreign investment in Slovakia until that date. In 2000 U.S. Steel took over the core business the giant steel mill Východoslovenské železiarne (VSŽ) and 51% of Slovak Telekom was also sold to strategic investor Deutsche Telekom. In 2002 the government sold 49% of the gas monopoly company Slovenský plynárenský priemysel (SPP) to a consortium of Gaz de France, Ruhrgas and Gazprom. Three regional power distribution companies were also sold to foreign investors. The law which did not allowed the state to lower its stake in strategic enterprises below 51% was amended at the end of 2003, opening to way for further privatization. In 2005 Austrian Airlines increased its share in Slovenské Aerolínie. By 2006 66% stake of the main electricity generator Slovenské elektrárne to the Italian ENEL company (EBRD 1999-2008).

The large privatization projects did not change Slovakia's large scale privatization index since it had already reached 4.00 in 1997 (Table 53). At the same time, the enterprise reform index (Table 54) reached back its pre-1997 level in 1999 and improved to 3.67 by 2005 owing to several important laws amended by the government in order to improve corporate governance. Among others bankruptcy law in 2000, banking law in 2001, commercial code amendments, investment funds law, financial market regulation and labour market legislation in 2002, energy market liberalization in 2003.
A result of the big privatization projects, the share of private sector in GDP reached 80% in 2000 according to EBRD indicator (Table 57). Interestingly enough, the further privatizations of the 2000' did not reflect in the share of private sector in GDP rate.

The legal and institutional changes aimed among others to enhance the business environment of Slovakia. A package of investment incentives were introduced in 1999 and further strengthened during 2000. In 2000 a set of new laws were adopted, regarding bankruptcy and telecommunication. An independent financial market regulator was established. More large companies were sold to strategic investors as well in 2000.
In the next year in 2001 a new banking law was adopted and the two largest state owned banks were privatized. In the first half of 2002, the commercial code was modified and regulations were adopted for financial markets, labour market and investment funds; an independent regulator for network industries was established; the electricity market was partially opened and the gas monopoly and power distribution companies were privatized.
The OECD economic survey (2004) identified three main challenges for the new government. First, to fulfil the criteria of joining the euro area. Second, to raise the employment rate. And third, to lessen the size of the public sector and improve its efficiency.
The new government announced a multi-year fiscal plan in order to lower the general governmental deficit by 2006 to 3% of GDP, the level required by the Maastricht criteria.
Despite the measures taken already, Slovakia had still the highest unemployment (about 40%) among low skilled and the lowest employment (about 20%) rate among the 55 and 64 year-old population in the OECD area. The long unemployment among the Roma minority was extremely high. The new labour market law came into force in 2003

which intended to improve the flexibility of the market in line with the acquis. The cuts in generous welfare benefits came together with simplified procedures of hiring, firing and reassigning of employees. Early 2006 a new bankruptcy law came into force and bankruptcy reform became completed.

The energy market was further opened and the regulated energy prices were approximated to the market price level. The increase in energy prices created inflationary pressure. In the framework of the railway reform, the passenger and freight transport sector was divided.

The reform of the health care and pension system was initiated in June 2003. The qualifications and the maximum amount of social benefits were restricted. Patient co-payments were introduced for hospital stays and visits to general practitioner and specialist. In 2004 the government paid 0.8% of GDP for the debt of the health sector.

The pension-reform aimed at enhancing the connection between contributions and benefits of the pay-as-you system that is, improved incentives to work. In January 2004 the government continued the pension reform with the introduction of a second pillar with mandatory privately managed pension funds, so as to complement the pay-as-you-go system and the voluntary private pension funds. The new second pillar became more popular than it was expected previously. The revenues from the partial privatization of the gas utility Slovenský plynárenský priemysel were set aside for the costs of the pension reform. The retirement age was increased from 60 for men and 55 for women to 62 years for both genders. In 2005 the pension reform went further and a new indexation scale was introduced.

In 2004 the government introduced a flat tax rate of 19% on personal and corporate incomes and the VAT rate was also unified at 19%. Following Estonia, Lithuania, Latvia, Russia, Serbia and Ukraine, Slovakia was the seventh country in Europe introducing flat tax rate on personal income. This measure meant a shift from direct to indirect taxation. Many tax exemptions were eliminated and while some form of taxes were also abolished, for example real estate transfer, gift and inheritance taxes. The double taxation of income (e.g. tax on dividend) was eliminated as well. The government predicted that the balance of the tax reform would be revenue-natural. In 2004 the tax revenues exceeded both the data of the previous year and the planned data for 2004. Western European countries with much higher corporate taxation accused Slovakia for tax-dumping and called for tax harmonization within the EU. Their point of view was that new EU members are able to lower their taxes because they receive a

substantial amount of support from the EU regional policy that is from the richer Western EU countries (Goliaš–Kičina 2005:2).

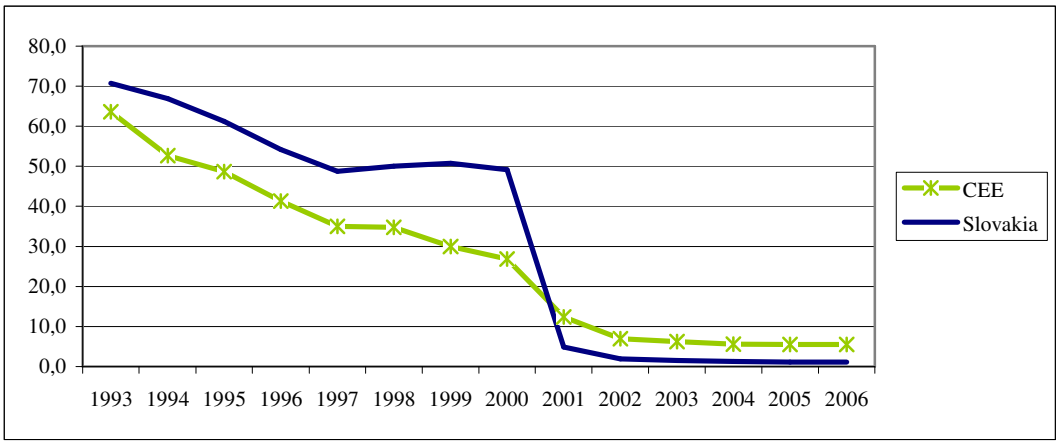
In May 1999 the government published a package of bank privatization measures aimed to stabilize the economy. It promised the privatization of IRB and Banka Slovakia in 1999, and VÚB and partially Slovenská sporiteľňa in 2000 (Planned…1999). At the end of 1999 the government transferred 74 billion SKK (equivalent to almost 10% of GDP) to the Slovenská konsolidačná (consolidation agency) and the KBB at a charge of the bad loans of the three large banks and increased their capital by 18.9 SKK (EBRD 2000:207). The privatization plans of the government have been completed (Table 37). By May 2006 foreign ownership was above 90% in the banking sector (Figure 32) that has been the second largest proportion in CEE and a rather dramatic change from about 10% in 1998. The foreign ownership has been spread relatively evenly over the number of foreign banks (EBRD 2006:28). The majority (over 90%) of the foreign owners comes from the EU, considering the number of foreign owned bank; Austria and the United Kingdom have been the largest investors as of 30 June 2005 (NBS 2005).
Concerning EBRD banking sector reform index (Table 58), Slovakia has caught up with peer countries in the field of bank sector reforms by 2000.

Table 37: Bank privatization in Slovakia

Name	Share	Purchaser	Purchase Price (in SKK)	Signing Date
Slovenská sporiteľňa a.s.	87.18%	Erste Bank der Oest. Sparkassen AG, Austria	18 530 000 000	11.01.2001
VÚB a.s.	15.96%	Slovenská konsolidačná, a.s.	1 303 134 990	09.02.2001
VÚB a.s.	68.58%	Comit Holding International S.A., Luxembourg	17 006 187 000	04.07.2001
Investičná a rozvojová banka a.s.	69.56%	OTP Bank Rt., Hungary	526 115 000	07.12.2001
Slovenská sporiteľňa a.s.	10.00%	Erste Bank der Oest. Sparkassen AG, Austria	2 888 280 000	15.04.2004
Banka Slovakia, a.s.	60.03%	Meinl Bank AG, Austria	360 000 000	05.05.2003

Source: National Property Fund of the Slovak Republic (Fond národného majetku, FNM)

Figure 32: Asset share of state-owned banks, in %, 1993-2006



Source: EBRD Structural and institutional change indicators 2008

The structural reform of the social security system was inevitable because the growth in social assistance had been 22% annually since 1997. The level of unemployment (almost 20% of the labour force) and other social assistance, the lack of their time limits and the high rate of taxes created an incentive to stay unemployed. The rate of unemployment is Slovakia has been the one of the largest economic and social problem. The task for the government was to make participation more attractive and cut the social benefits, and at the same time to reduce tax wedge by cutting the labour cost. The combined contribution rate to finance the social insurance exceeded 50% of gross wages that was extremely high among OECD countries. In spring 2002 the new labour market law came into force. To combat corruption, an anti-corruption plan was adopted in 2001. Utility prices increased significantly during 2001 aiming to reach cost recovery level.

According to the EBRD Business Environment and Enterprise Performance Survey (BEEPS), the quality of the Slovakian *business environment* has improved from 1999 to 2002 considering five aspects out of seven. The improvement of quality of infrastructure is significant[82] (from 1.9 to 1); there are no more obstacles to business growth and operation in this field. The level of corruption decreased by 0.8 percentage points and reached a value of 2.1, which was still higher than in Croatia. Obstacles caused by taxes and crime decreased slightly. The quality of judiciary and regulations stayed unvaried (EBRD 2002:42).

More big automobile manufacturer companies started new investments in 2003 and 2004, highlighting the improvements in the country's business environment. According

[82] In BEEPS the values range from 1 to 4, where 1 indicate no obstacles to business growth and operation, and 4 indicating major obstacles.

to the Doing Business report, in 2003 Slovakia was the top reformer and was the fourth among the top reformers in 2004 (Doing Business 2005 and 2006).

The results of the BEEPS from 2005 demonstrate considerable improvement concerning all the factors of business environment of Slovakia, especially in the macroeconomic environment. The obstacles were relatively higher in labour and infrastructure (EBRD 2005:22).

The World Bank Doing Business 2008 ranked Slovakia to the 37th place, while the Report for 2009 to the 36th place. In both years Slovakia earned the 4th place among SEE and CEE countries, only the Baltic states have more favourable business environment (Table 38).

Table 38: Rankings on the ease of doing business in CEE and SEE countries, 2007 and 2008

Regional subrank	Country	Rank[83] in 2008	Country	Rank in 2009
1.	Estonia	18	Estonia	22
2.	Latvia	26	Lithuania	28
3.	Lithuania	28	Latvia	29
4.	Slovakia	37	Slovakia	36
5.	Bulgaria	44	Hungary	41
6.	Romania	47	Bulgaria	46
7.	Hungary	50	Romania	47
8.	Slovenia	64	Slovenia	54
9.	Czech Republic	65	Macedonia FRY	71
10.	Poland	72	Czech Republic	75
11.	Macedonia FYR	79	Poland	76
12.	Montenegro	84	Albania	86
13.	Serbia	91	Montenegro	90
14.	Croatia	107	Serbia	94
15.	Bosnia and Herzegovina	117	Croatia	106
16.	Albania	135	Bosnia and Herzegovina	119

Source: World Bank Doing Business 2009:6

As a result of the Dzurinda reform agenda, the level of public expenses (Table 39) decreased from 50.5% in 2000 to 37.3% in 2006. Considering this data, Slovakia get among the countries with lowest government redistribution in the EU and it is more

[83] Rankings on the ease of doing business are the average of the country rankings on the ten topics covered in Doing Business reports: Getting credit, Registering property, Dealing with licenses, Employing workers, Starting a business, Protecting investors, Trading across borders, Paying taxes, Enforcing contracts, Closing a business.

close to the level of Baltic and South Eastern European member states than the other Visegrád countries.

Table 39: Total general government expenditure in % of GDP

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Estonia	:	:	:	:	43.6	42.3	39.2	39.5	42.8	36.5	35.1	35.6	34.6	34.1	33.4	33.0	33.7
Lithuania	:	:	:	:	35.7	37.4	50.3	40.4	40.1	39.1	36.8	34.8	33.2	33.4	33.6	34.0	35.6
Ireland	:	:	:	44.4	41.1	39.1	36.6	34.4	34.0	31.5	33.3	33.6	33.4	33.9	34.2	34.2	36.4
Romania	:	:	:	:	:	:	:	45.2	46.6	40.6	38.8	39.6	33.6	32.7	33.6	35.0	36.9
Slovakia	:	:	78.8	57.8	48.0	52.9	48.3	45.5	47.3	50.5	44.3	44.8	40.5	38.0	38.4	37.7	36.9
Luxembourg	43.9	45.7	45.5	44.5	39.7	41.1	40.7	41.1	39.2	37.6	38.1	41.5	41.9	42.5	41.8	39.0	37.5
Bulgaria	:	:	:	:	:	:	:	:	:	:	:	39.7	40.3	39.7	39.6	37.1	37.8
Latvia	26.8	24.7	35.1	38.5	38.9	37.0	36.2	40.6	41.8	37.3	34.6	35.6	34.8	35.8	35.6	37.2	38.0
Spain	:	:	:	:	44.4	43.2	41.6	41.1	39.9	39.1	38.6	38.9	38.4	38.9	38.5	38.6	38.8
Czech Republic	:	:	:	:	54.5	42.6	43.2	43.2	42.3	41.8	44.5	46.3	47.3	45.1	44.9	43.6	42.4
Poland	:	:	:	:	47.7	51.0	46.4	44.3	42.7	41.1	43.8	44.2	44.6	42.6	43.3	43.9	42.4
Malta	:	:	:	:	39.7	42.6	42.9	43.0	43.0	41.0	43.1	43.2	47.8	45.8	45.1	44.1	42.5
Greece	:	:	:	49.9	45.5	43.9	44.8	44.2	44.3	46.7	45.0	44.8	45.0	45.4	43.2	42.3	43.3
Slovenia	:	:	:	:	54.0	45.6	46.1	46.9	47.8	47.4	48.2	47.1	47.1	46.5	46.0	45.3	43.3
United Kingdom	43.4	45.5	45.6	45.0	44.5	42.9	41.3	40.2	39.6	39.8	40.7	41.8	42.9	43.3	44.5	44.6	43.7
Cyprus	:	:	:	:	:	:	:	36.7	36.8	37.0	38.2	40.3	45.1	42.9	43.7	43.9	43.9
Germany	46.3	47.2	48.2	47.9	54.8	49.3	48.4	48.0	48.1	45.1	47.6	48.1	48.5	47.1	46.9	45.4	43.9
Portugal	:	:	:	46.0	42.8	43.6	42.6	41.9	43.2	43.1	44.4	44.3	45.5	46.5	47.7	46.4	45.8
EU-27	:	:	:	:	:	:	:	:	:	:	:	*46.9*	*47.5*	*47.0*	*47.1*	*46.8*	*45.8*
Netherlands	54.9	55.7	55.7	53.5	56.4	49.4	47.5	46.7	46.0	44.2	45.4	46.2	47.1	46.1	45.2	46.1	45.9
EU-25	:	:	:	:	:	:	:	*47.6*	*47.1*	*45.5*	*46.5*	*47.0*	*47.6*	*47.1*	*47.2*	*46.9*	*45.9*
EU-15	:	:	:	:	*52.6*	*50.3*	*48.7*	*47.7*	*47.2*	*45.6*	*46.6*	*47.1*	*47.7*	*47.3*	*47.4*	*47.1*	*46.1*
Finland	56.7	62.3	64.7	63.9	61.6	60.0	56.2	52.5	51.5	48.3	47.7	48.8	50.0	50.2	50.5	48.8	47.5
Croatia	:	38.9	37.3	25.3	48.9	45.3	44.4	54.6	56.6	52.7	50.7	50.8	51.3	49.7	48.5	47.7	47.6
Austria	52.4	52.9	56.0	55.5	56.0	55.4	53.1	53.4	53.2	51.4	50.8	50.7	51.1	50.2	49.9	49.3	48.2
Italy	54.0	55.3	56.3	53.5	52.5	52.5	50.3	49.2	48.2	46.2	48.0	47.4	48.3	47.7	48.3	50.1	48.5
Belgium	:	:	:	53.9	51.9	52.3	51.0	50.3	50.1	49.1	49.1	49.8	51.1	49.2	49.9	48.9	48.9
Denmark	56.5	57.0	60.1	60.5	59.6	59.3	57.3	57.0	56.1	54.2	54.8	55.2	55.7	55.4	53.1	51.5	50.6
Hungary	:	:	:	:	:	52.6	52.2	52.8	49.9	46.5	47.3	51.3	49.1	48.9	49.9	51.9	50.1
France	50.6	51.9	54.9	54.2	54.4	54.5	54.1	52.7	52.6	51.6	51.6	52.6	53.4	53.2	53.7	53.4	52.6
Sweden	:	:	71.7	70.3	67.1	64.9	62.6	60.4	60.0	57.1	56.7	58.1	58.3	56.9	56.6	55.6	52.6

Source: Eurostat, Economy and finance, Government statistics and EBRD Structural change indicators

3.4.2 The macroeconomic performance of the Dzurinda governments

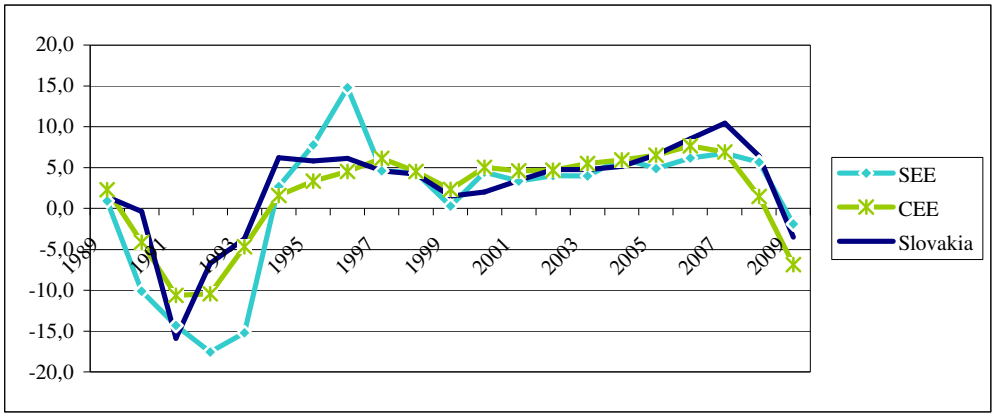
As a result of the stabilization policies, Slovakia could evade a recession (Figure 33). The final domestic demand fell by almost 10% from 1998 to 2000, while the current account deficit halved to less than 4% of GDP. The external demand contributed significantly to the 2% output growth rate per year in 1999 and 2000.

The service sector contributed 64% of GDP, which is equal to CEE average in 2006, but much lower than that of the Eurozone countries (72%). The share of agriculture stayed

at 6% during the first half of the 1990' and since 2000 at 4%. The sectoral breakdown of the Slovakian economy has not changed during the 2000' decade.

The output growth and the inflow of foreign direct investment increased. However, because of a world trade slowdown, the strength of domestic demand reduced the growth of Slovak exports and lead to a growing current account deficit (almost 9% of GDP in 2001). The deficit was partly the result of the rapid restructuring of the economy and the related foreign direct investment inflows and imports of capital goods. The core inflation slowed slightly; the National Bank was able to create credibility for its program.

Figure 33: GDP year-on-year rate of growth in real terms, 1989-2009



Note: Data for 2008 is estimation, data for 2009 is projection
Source: EBRD Selected economic indicators

The share of the EU in Slovakia's *foreign trade* grew significantly from 1998 and reached to 63% in imports and 85.4% in exports in 2005 (Table 40). The share of the CEFTA countries decreased somewhat, but with the 2004 and 2007 EU-enlargement the old CEFTA members left to EU and CEFTA membership has changed almost completely. The Russian Federation remained an important import partner, mainly in energy and raw materials. Among the EU-27 the Czech Republic and Germany have been the main partners.

Table 40: Partners of imports and export by main countries in Slovakia, as % of total[84]

Imports	**1993**	**1995**	**1999**	**2001**	**2003**	**2005**	**2007**
EU	20.6	34.8	51.7	49.8	51.2	63.0	61.1
CEFTA	39.3	33.1	23.4	22.6	23.5	na	na
Russian Federation	19.5	16.6	12.0	14.8	12.5	10.7	9.4
Export	**1993**	**1995**	**1999**	**2001**	**2003**	**2005**	**2007**
EU	24.1	37.4	59.4	59.9	60.7	85.4	86.7
CEFTA	49.8	44.3	29.8	30.0	25.3	na	na

Source: IMF, WTO and European Commission

Table 41: Structure of Slovakian foreign trade, breakdown by commodity group, millions of USD at current prices and in percentage of total

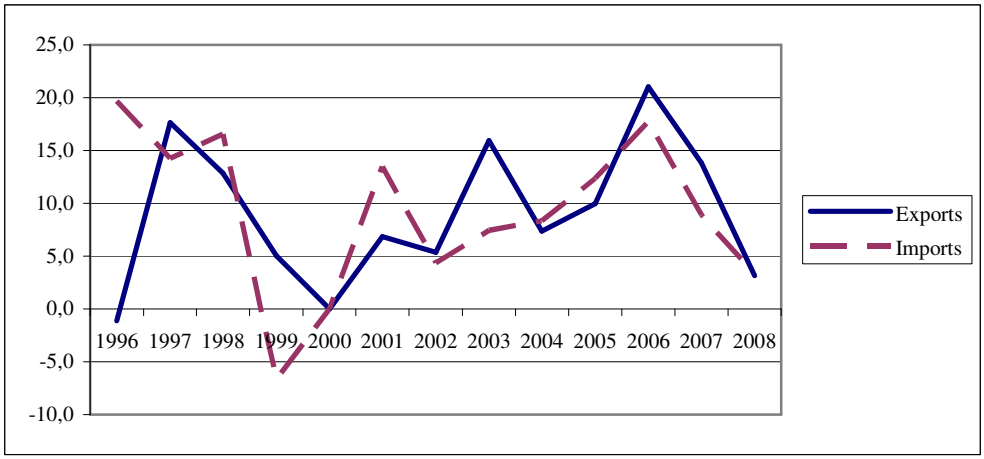
	1999				**2003**				**2007**			
	USD	**%**	**USD**	**%**	**USD**	**%**	**USD**	**%**	**USD**	**%**	**USD**	**%**
	Import		**Export**		**Import**		**Export**		**Import**		**Export**	
Agricultural products	***927***	***8%***	***652***	***7%***	***1357***	***6%***	***997***	***5%***	***3843***	***6%***	***2683***	***5%***
Food	732	7%	402	4%	1021	5%	654	3%	3141	5%	2114	4%
Fuels and mining products	***1814***	***16%***	***840***	***8%***	***3381***	***15%***	***1640***	***8%***	***8335***	***14%***	***4343***	***8%***
Fuels	1440	13%	478	5%	2712	12%	1123	5%	6469	11%	2797	5%
Manufactures	***8371***	***75%***	***8536***	***85%***	***17628***	***79%***	***19043***	***88%***	***47720***	***80%***	***50549***	***88%***
Iron and steel	294	3%	897	9%	629	3%	1757	8%	2802	5%	4381	8%
Chemicals	1255	11%	794	8%	2207	10%	1096	5%	5228	9%	2806	5%
Machinery and transport equipment	4200	38%	3964	40%	9170	41%	10344	48%	26584	44%	31187	54%
Office and telecom equipment	684	6%	333	3%	1473	7%	852	4%	7591	13%	8471	15%
Automotive products	1244	11%	1847	18%	3700	17%	6008	28%	9495	16%	13907	24%
Textiles	na	na	297	3%	na	na	471	2%	na	na	860	1%
Clothing	na	na	527	5%	na	na	708	3%	na	na	1045	2%
TOTAL	**11112**		**10028**		**22366**		**21680**		**59898**		**57575**	

Source: WTO online statistics database: Time Series, own calculations

Following an import boom in 2001 and then an export boom in 2003, export and import growth rates developed neck and neck (Figure 34Figure 26). Slovakia has been a very open economy, the exports of goods and services accounted for 73% in 2001 and 86% in 2006, which was the highest among peer countries and highly above the average in CEE (66% in 2006) (Table 42). Exports grew also due to the car industry.

[84] Note: Until 2001 EU means EU-15, in 2005 means EU-25. Central European Free Trade Association (CEFTA) here includes Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia. Trade with Romania is not included.

Figure 34: Import and export of goods and services in Slovakia, % change in real terms, 1993-2006



Note: Due to a revision of GDP data for the period 2000 to 2005, no consistent growth rates are available for the year 2000, Data for 2008 is estimation
Source: EBRD Selected economic indicators

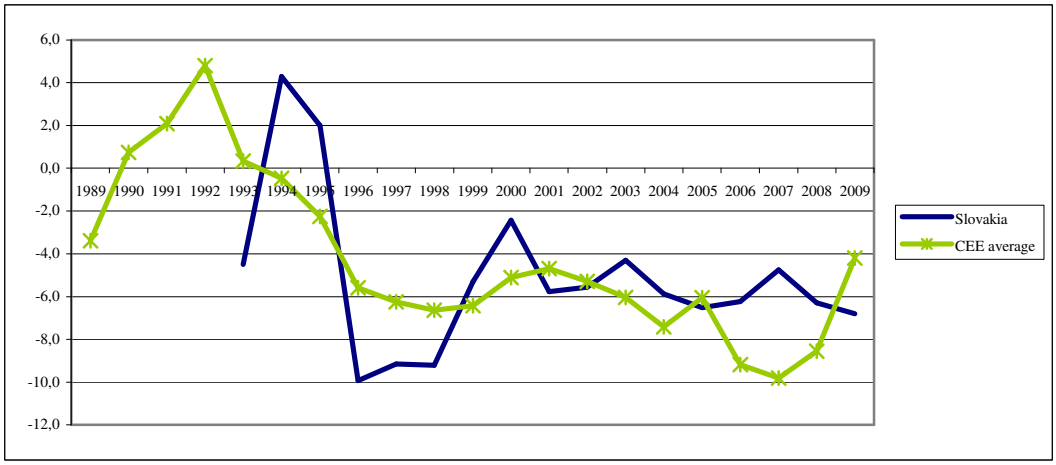
Table 42: Exports of goods and services in the CEE and SEE countries, in % of GDP

	2001	2002	2003	2004	2005	2006	2007
Slovakia	73	71	76	74	76	84	86
CEE average	57	58	55	56	59	62	66
SEE average	37	36	33	34	37	40	43

Source: World Bank, World Development Indicators online

As a result of a strong export performance and import contraction, and despite the sharp price increase of imported energy products, in 1999 the *current account deficit* almost halved and stayed above the CEE average. It was 8% in 2002 and 0.9% in 2003. In 2004 it increased to 3.5%. In 2005 it more than doubled to 8.6% because a sharp increase in investment related imports and a change in the accounting methodology.

Figure 35: Current account in Slovakia, in % of GDP



Note: Data for 2008 is estimation, data for 2009 is projection
Source: EBRD Selected economic indicators 2009

Based on the stabilization, from 2001 a recovery started and Slovakia's credit rating was upgraded. From 1998 to 2006 Slovakia became from a BB+ country with negative outlook to an A country with stable outlook (Table 43). The international markets appreciated the restructuring efforts made by the Dzurinda governments and the trust of the markets stayed stable after the 2006 elections.

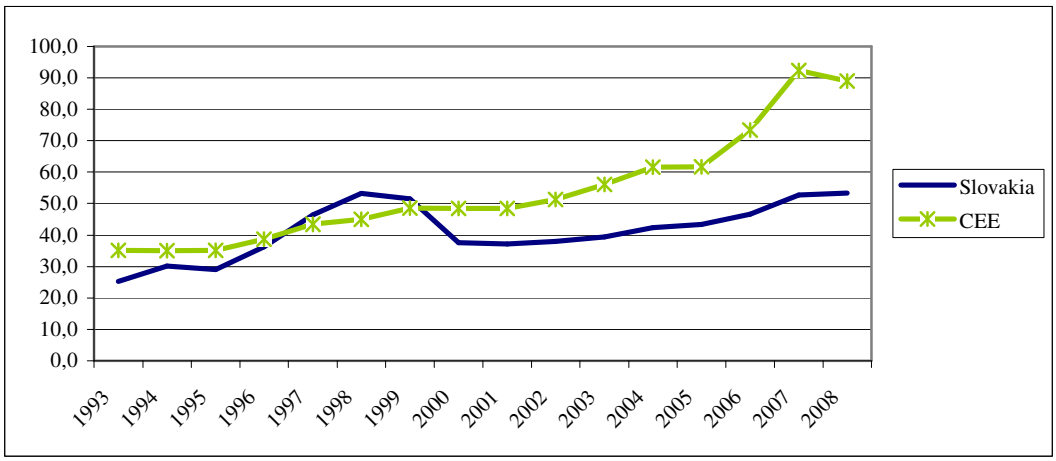
Table 43: Credit-Rating History of the Slovak Republic

	Standard & Poor's	Moody's
1994	**BB-** stable outlook *(since February)*	
1995	**BB+** stable outlook *(since April)*	**Baa3** *(since May)*
1996	**BBB-** stable outlook *(since April)*	**Baa3**
1997	**BBB-** stable outlook	**Baa3**
1998	**BBB-** negative outlook *(since April)* **BB+** negative outlook *(since September)*	**Baa3** negative outlook *(since February)* **Ba1** negative outlook *(since March)*
1999	**BB+ stable outlook** *(since November)*	**Ba1 stable outlook** *(since October)*
2000	**BB+ positive outlook** *(since November)*	**Ba1 positive outlook** *(since November)*
2001	**BBB- positive outlook** *(since October)*	**Baa3 stable outlook** *(since November)*
2002	**BBB positive outlook** *(since December)*	**A3 stable outlook** *(since November)*
2003	**BBB positive outlook**	**A3 stable outlook**
2004	**A- positive outlook** *(since December)* **BBB+ positive outlook** *(since March)*	**A3 positive outlook** *(since June)*
2005	**A stable outlook** *(since December)*	**A2 positive outlook** *(since January)*
2006	**A stable outlook**	**A1 stable outlook** *(since October)*
2007	**A stable outlook**	**A1 stable outlook**
2008	**A positive outlook** *(since March)* **A+ stable outlook** *(since November)*	**A1 positive outlook** *(since July)*
2009	**A+ stable outlook**	**A1 stable outlook** *(since March)*

Source: National Bank of Slovakia

Between 1998 and 2006 the stock of external debt almost tripled in absolute terms. However, the external debt per GDP stayed relatively stable, around 54% and in 2003 it went under CEE average (Figure 36). Slovakia belongs to the middle indebted group of countries in the region.

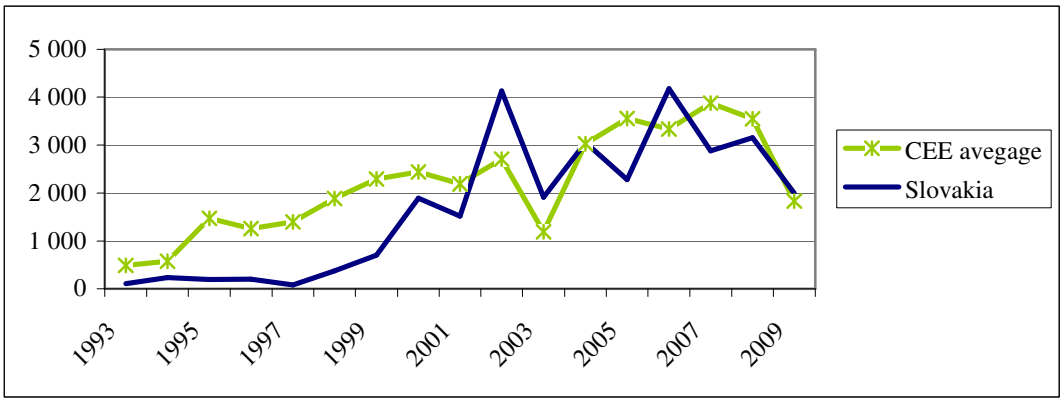
Figure 36: External debt in Slovakia, as % of GDP



Note: Data for 2008 is estimation
Source: EBRD Selected economic indicators 2009

With the new millennium, the reputation of Slovakia changed dramatically. From highly unpredictable and risky country it became an open and macroeconomically stable economy. Moreover, FDI was inspired by tax allowances, direct investment subsidies, training subsidies, newly created industrial parks and by a set of laws in regulatory, administrative and judiciary field (OECD 2005:25). There was a substantial increase in foreign direct investment inflows as well, it reached 10% of GDP in 2000. In 2002 Slovakia received the highest amount of FDI per capita flow in the region (it reached a 17% of GDP) and got the 8th place in UNCTAD Inward FDI Performance Index out of 141 countries, in contrast to the estimated potential 47th place. In 2003 the net FDI inflow accounted for 1.8% of GDP, 2.4% in 2004. In 2005 it increased further due to the 49% privatization of an electric generator Slovenske Elektrarne for 120 billion SKK. It covered a large part of the current account deficit as well. In 2006 the pace of privatization slowed down because of the elections and the measures taken by the new government (Figure 37).

Figure 37: Net foreign direct investment, in millions of USD



Note: Data for 2008 is estimation, data for 2009 is projection
Source: EBRD Selected economic indicators 2009

By the end of the decade the Netherlands became the largest investor, followed by Germany (17.9%) and Austria (14.8%) remained the second and third in 2006 (Table 44). Among peer countries Hungary and the Czech Republic are the main investors. Concerning annual FDI inflow, Korea was the largest investor in 2005, while Italy in 2006.

Table 44: The origin of FDI stock in Slovakia, 2004-2008, millions of USD and EUR

	2004		2006		2008	
	USD	%	USD	%	EUR	%
The Netherlands	3197	23.0	3518	19.1	5339	19.9
Germany	2682	19.3	3293	17.9	3474	12.9
Austria	1994	14.3	2728	14.8	3819	14.2
Italy	1023	7.4	2258	12.3	3631	13.5
Hungary	1028	7.4	1112	6.0	2073	7.7
United Kingdom	959	6.9	966	5.2	401	1,5
Czech Republic	720	5.2	871	4.7	2062	7.7

Source: UNCTAD FDI Country profiles and National Bank of Slovakia FDI statistics

Taking FDI intensity[85] as a measure of market integration, the position of Slovakia changed dramatically since 2000. The FDI capacity strengthened and came around to CEE average.

FDI has flown both to privatized enterprises and to greenfield investments. Huge part of FDI arrived to the export-oriented manufacturing sector, which contributed to capacity and output growth (Table 45). Other important receivers were the financial intermediation (11.4%) and wholesale and retail trade (15.9%). In 2002 due to the sale

[85] Average value of inward and outward Foreign Direct Investment flows divided by GDP, multiplied by 100. A higher index indicates higher new FDI during the period in relation to the size of the economy as measured by GDP. With an increase over time, the country/zone is becoming more integrated within the international economy.

of SPP, the share of public utilities was huge. Concerning the number of greenfield investments, in 2002-2005 Slovakia received 287 greenfield investments (Table 46) and the number of them increased from year to year. Concerning the regional distribution, the FDI inflow is highly concentrated; in 2005 about two-third of the total investment stock was located in Bratislava region.

Table 45: Inward FDI flows in Slovakia by sectors, in % of total

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Agriculture, hunting, and forestry	2.1	0.0	0.3	0.0	0.8	1.0	-0.1	0.0	0.1
Mineral raw materials extraction	na	1.2	0.7	0.1	0.2	0.0	0.0	0.4	0.2
Manufacturing	36.9	17.2	43.7	6.8	46.3	75.2	49.0	24.5	25.7
Electricity, gas, and water supply	na	0.0	0.2	74.7	-1.5	-0.7	1.5	0.0	-0.5
Construction	0	0.0	0.8	0.1	2.2	1.4	0.9	0.3	-0.2
Wholesale and retail trade, repairs of motor vehicles	48	3.8	10.6	5.0	13.6	25.4	14.5	6.8	10.5
Hotels and restaurants	5.6	0.1	0.7	0.0	0.2	0.0	0.1	0.1	0.0
Transport, storage, post and telecommunications	0.1	74.5	13.8	-0.6	0.9	-24.7	5.8	2.9	0.4
Financial intermediation	2.2	2.5	25.8	10.9	7.2	18.4	19.2	7.6	35.8
Real estate, renting and business activities	5	0.6	3.1	1.3	2.3	3.6	8.6	5.7	26.3
Public administration and defence, compulsory social security	na	na	na	0.0	27.9	0.0	0.0	51.5	0.7
Education	na	na	na	0.0	0.0	0.0	0.0	0.0	0.0
Health and social work	na	0.1	0.0	1.4	0.0	0.1	0.2	0.0	0.0
Other community, social, and personal services	0.1	0.0	0.3	0.1	0.0	0.4	0.3	0.1	1.0
Activities of private households	na	na	0.0	0.1	0.0	0.0	0.0	0.0	0.0

Note: Data for 2007 is preliminary
Source: National Bank of Slovakia, Monetary Surveys

Table 46: Number of greenfield FDI projects, by destination region

	2003	2004	2005	2006	2007	total
Slovakia	63	89	119	118	100	489

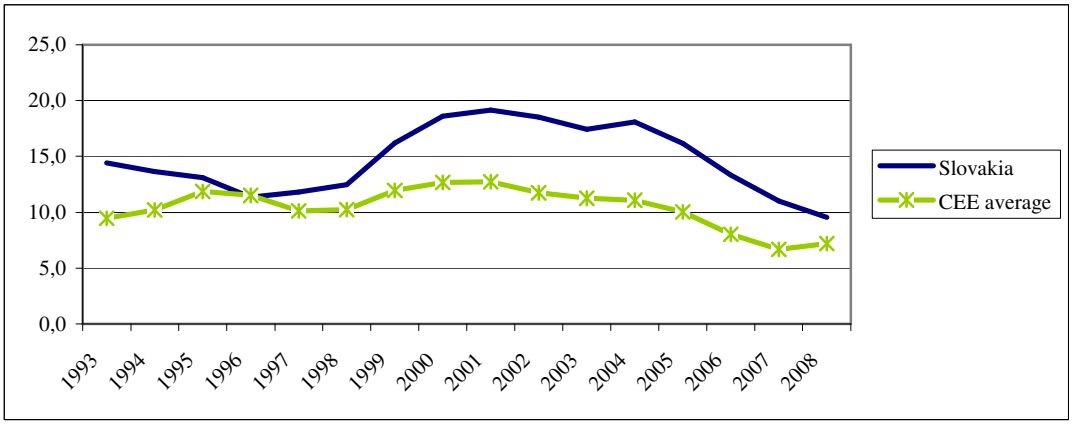
Source: World Investment Report 2008, p.199

In order to combat long-term unemployment and regional disparities, several steps were taken, the flexibility of the labour market improved. Tax and welfare reforms have increased incentives for work-seeking. However, the problem of long-term

unemployment was not solved; it stayed at 10% of the labour force. The high demand for skilled workers widened wage differentials and prospects for the low-skilled remained poor. The tax wedge remained high between main earners and second earners. From the beginning of 2005 the reform efforts have been rewarded by improved standards of living, higher employment, lower unemployment and strong growth in real wages (EUI 2007:28) (Figure 38). Short-term unemployment has decreased notably in recent years on the back of strong employment expansion OECD (2007b).

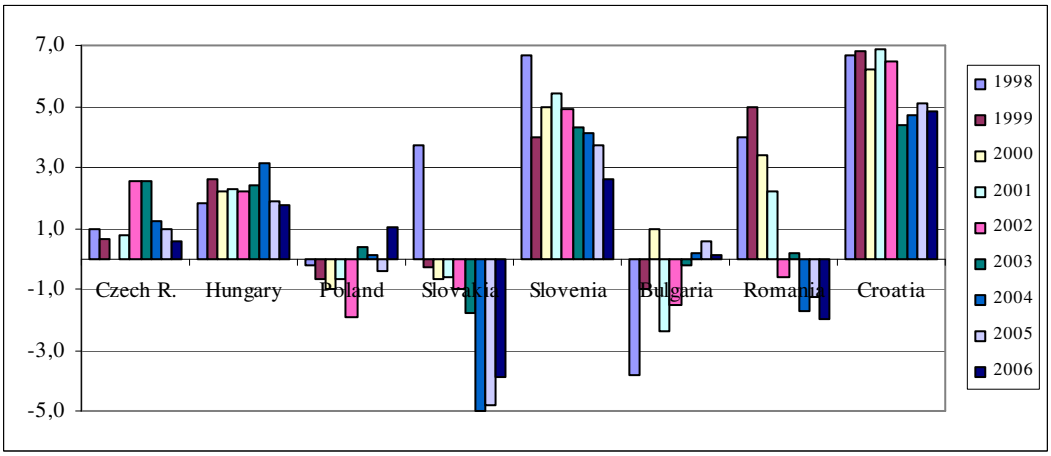
Comparing the LFS figure with the administrative data, the administrative figure seems to overestimate the actual rate of unemployment (Figure 39). During 2006 the broad based economic growth strengthened further, driven by rapid productivity growth. It was boosted by the coming on stream of two new car plants. Employment growth accelerated to 2.3% and thus unemployment rate decreased to 13% in 2006.

Figure 38: Unemployment rate in Slovakia, in percentage



Note: Data for 2008 is estimation
Source: EBRD, Selected economic indicators 2009

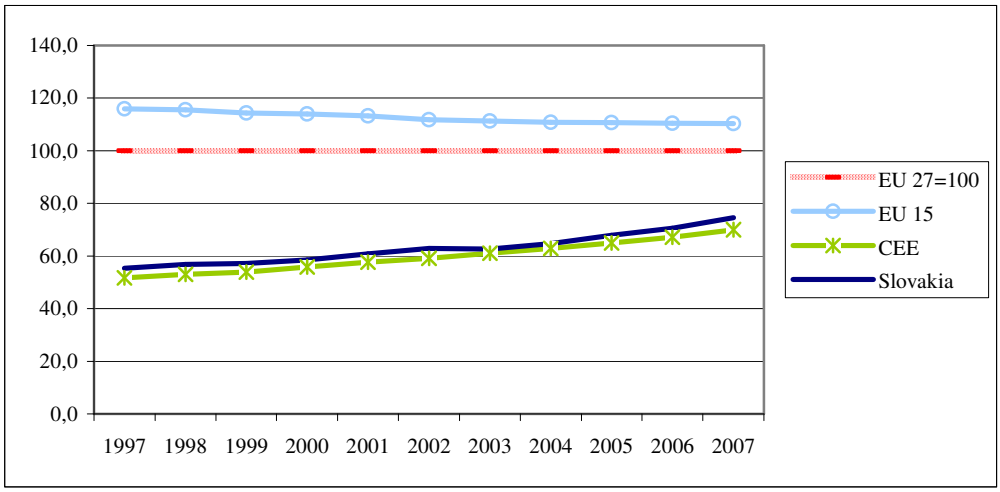
Figure 39: Administrative vs. ILO unemployment rate in various CEE and SEE countries, difference in percentage point



Source: Croatian National Bank, own calculations

The productivity of labour force in Slovakia became has been among the highest in CEE region, 70.5% of EU-27 in 2006 (Figure 40). Starting from a relatively low initial level, hourly labour productivity over 1998-2005 grew by 4.2%, compared to the EU average of 1.3% (OECD 2007a:21). The productivity growth has been generated mainly by FDI, it has brought new technology and better business practices, many of which have trickled down to domestic firms as well. On the other hand the degree of vertical integration has been low. During 2006 the broad based economic growth strengthened further, driven by rapid productivity growth. Real wages increased during 2005 and 2006 on average around the labour productivity growth rate that was close to 5% per employee.

Figure 40: Labour productivity per person employed in CEE and SEE countries, GDP in Purchasing Power Standards per person employed relative to EU-27 = 100



Note: Data for 2007 is forecast by Eurostat. Data on Poland and Croatia is estimated value.
Source: Eurostat

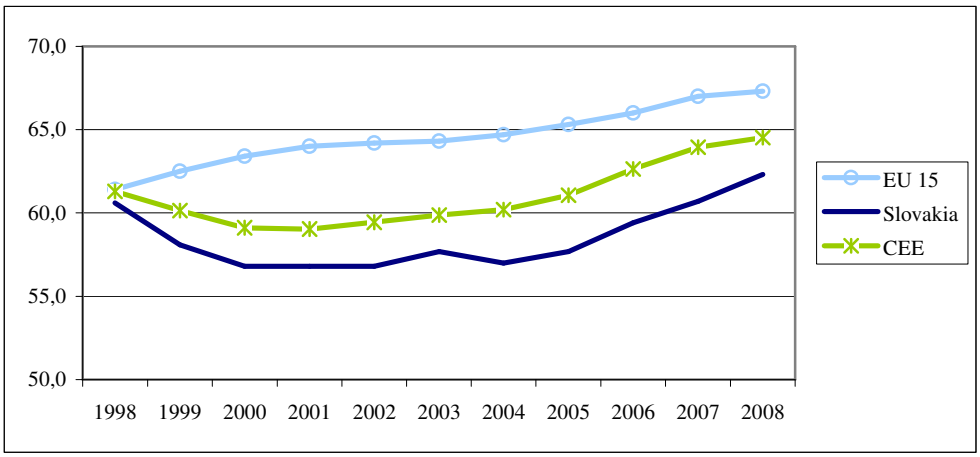
Job creation in newly developing sectors and self-employment has been dynamic, but job losses in declining activities have counteracted this improvement (OECD 2005:31). Concerning recent years, the job creation has begun to outweigh job shedding. The rate of employment growth has tended to exceed the CEE average growth in 2005 and 2006. However, the employment rate in Slovakia (59.4% in 2006) has been under CEE average (Figure 41).

Since 2000 net employment creation picked up but the unemployment rate remained very high among the low skilled workers and the regional disparities remained.

Employment growth accelerated to 2.3% and thus unemployment rate decreased to 13% in 2006.

At the same time, the gap between the employment rate in Slovakia and the EU-15 countries was growing because of detracted labour utilization.

Figure 41: Total employment rate, in percentage



Note: Total employment rate is the number of persons aged 15 to 64 in employment by the total population of the same age group.
Source: Eurostat Structural Indicators, data based on labour force surveys (LFS)

3.4.3 The euro

In July 2003 the second Dzurinda government together with the NBS adopted a joint strategy document for introducing the euro in the Slovak Republic that is, to meet the Maastricht criteria by 2006. In the same month the Executive Board of the International Monetary Fund (IMF) welcomed the authorities' strategy and concluded that the plan was feasible if the planned fiscal consolidation and structural reforms would be implemented fully (IMF 2003). In its Convergence report (2004:15), the European Commission reported that the Act on the National Bank of Slovakia was not fully compatible with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute. The average inflation rate did fulfil neither the criterion on price stability, nor the criterion on the government budgetary position. The koruna was not part of ERM II and did not fulfil the exchange rate criterion. Slovakia fulfilled only one criterion, the convergence of long-term interest rates.

A broad national changeover plan was adopted in July 2005. In November 2005 the koruna stepped into the ERM II with a central parity of 38.4550 koruna per euro. The 2006 Convergence report (2006:25-26) reported that new legislation on the National Bank of Slovakia was passed in 2004 and in 2005, but the incompatibilities subsisted.

Mainly due to the impact of external factors and adjustments in administered prices and indirect taxes, Slovakia experienced volatile and sometimes high HICP inflation in 2002-2005. Domestic demand pressures and energy prices have to a pick-up in inflation as well. Slovakia was above the reference value since its accession and did not fulfil the criterion on price stability.

In July 2004 Slovakia was subject of a Council decision on the existence of an excessive deficit. The general government deficit reached 7% of GDP at the beginning of the decade but was reduced significantly since 2002 and reached 3.1% of GDP in 2005. General government debt declined substantially since 2000 as well, when it was about 50%. In 2005 it stood at 34.5% of GDP. Considering these numbers, Slovakia did not fulfil the criterion on the government budgetary position.

Since 28 November 2005 the Slovak koruna has participated in ERM II that is, it stepped into the second stage of euro-introduction. After 12 months the Commission reported that the koruna remained above the central rate except for a shorter period in the summer of 2006, reflecting post-election uncertainty about the euro adoption date and a broader pressure on Central European currencies. Slovakia did fulfil the exchange rate criterion since the koruna was only for one year in the ERM II. Average long-term interest rates in Slovakia were below the reference value of 6.2% since EU accession. Accordingly Slovakia continued to fulfil the criterion on the convergence of long-term interest rates.

To sum up, the Convergence report 2006 had the same conclusion as the previous one: Slovakia fulfilled only one criterion, the convergence of long-term interest rates. This also meant that the Dzurinda agenda on meeting the Maastricht criteria by 2006 could not be fulfilled.

The euro adaptation remained on the agenda of the Fico government. Contrary to the fears in 2006 that the Fico government may abandon the euro-project, it did not happen. However, introducing the euro first among the Visegrád states is a big deal also for the Fico government and conforms to the national interest. In March 2007, an update of the national changeover plan was approved. In the Convergence report (2008) the Commission stated that Slovakia fulfilled the convergence criteria and gained legal compatibility. In July 2008 the Council abrogated the derogation of Slovakia not to fulfil the necessary conditions for the adoption of the single currency and the SKK/EUR conversion rate was set on 30,1260. By 1 January 2009 Slovakia entered into the euro area.

3.5 European identity

The 2001 Eurobarometer found that people in Slovakia felt European only (7%), while in other accession countries 5% or less of the population shared this feeling. When we include people who feel somewhat European, Slovakia tops the list at 63%. At the same time, in Slovakia the least people reported *only* national feelings. The national pride in Slovakia was reported lower than the accession countries and also the EU-15. At the same time, the European pride was considerably higher than the accession countries and also the EU-15. In 2002 and 2003 Slovakia was the country where most people reported itself only European and considerable of people were proud to be European. The national pride in Slovakia was reported still lower than the accession countries and also the EU-15.

Concerning the image of the European Union, the trust in the EU and the support for membership, Slovakia was among the more pro-EU accession countries during candidacy. In 2001–2003, the support was very stable and also relatively very high – i.e. rangin 58%-60%. The first Standard Eurobarometer (2004) reported that right before the actual accession the membership support was relatively low (46%).

The referendum on the EU accession was held on 16-17 May 2003 with a final turnout of 52.2%. The Slovak Republic proved to be the most unanimously pro-EU candidate state, with 93% of the votes in favour of membership (Henderson 2003:1-2). Concerning the low rate of participation, altogether 48.5% of the electorate voted for yes (Table 47).

Table 47: Results in referenda on EU accession

Country	Turnout %	Yes %	No %	Support %	Date
Cyprus	na	58	25	na	Autumn 2002
Malta	91.0	54	46	49.1	March 8, 2003
Slovenia	60.3	90	10	54.3	March 23, 2003
Hungary	45.6	84	16	38.3	April 12, 2003
Lithuania	63.3	91	9	57.6	May 10-11, 2003
Slovakia	52.2	93	7	48.5	May 17, 2003
Poland	58.9	77	23	45.4	June 7-8, 2003
Czech Republic	55.2	77	23	42.5	June 13-14, 2003
Estonia	63.0	67	33	42.1	September 14, 2003
Latvia	72.5	67	32	48.6	September 20, 2003

Source: European Economy (2006:21)

The people of Slovakia stepped into the EU with more optimistic expected membership impacts. EU policies enjoyed also a high support compared to the new member states' average. The European Monetary Union was supported by 68% of the respondents, which is above the new member states average. The Slovaks declared less often some negative features but they declared more often the loss of cultural identity. Still, even if their cultural identity has been perceived in sensitive way but not as endangered by EU membership. The comparison of European Union's image in the Slovak public indicates a higher level of idealization.

Political and cultural elites in Slovakia understood national and the European identity as not exclusive. This approach has been wide among the society as well. The most frequent answer on the national and European identity question is the answer "the national and European identity".

In 2008 for a majority of Slovaks the European Union means the freedom to travel, study and work, even though this number has decreased since 2007. The reason could be that these freedoms are no longer something extraordinary after four years of EU membership. Since 2004 for more and more Slovaks the European Union means the euro. The Eurobarometer in 2008 reported that Slovakia is the country with the highest level of trust in the European Union among all member states: 70% of Slovak citizens trust in the EU, which is 23 % points above the EU-27 average. The high level of trust of Slovaks in the European Union has also a long-term character. Slovaks are among the EU citizens who believe that the Slovak Republic has benefited from being a member of the European Union (77% in 2008).

3.6 Conclusion

Due to the sound macroeconomic policy, the product, capital and labour market liberalization, and the fundamental tax and welfare reform, the Slovak economic environment have changed profoundly since the late 1990'. During the first Dzurinda government the Slovak macroeconomy was stabilised and the reform gap with its neighbours became more than closed. This created a stable basis for accelerated real convergence and financial sector growth, while stability challenges remained on the agenda (Steinlein 2005:1). According to the OECD (2005:20), Slovakia can be considered as a model case of how macroeconomic stabilization, along liberalization, can accelerate the catching-up process of a country. The coherence of the reforms together with the EU membership persuaded the international business actors that it was

worth to invest in Slovakia. Growth responded rapidly to the reforms, and the EU accession in 2004 further supported the credibility of policies. The credibility took the form of growing foreign direct investment and trade flows as well. FDI, particular in the export-oriented manufacturing-sector, became a major diving force of capacity and productivity growth, and it helped the economy to reach a strong and well-balanced growth path. New technologies and modern business practices arrived with the FDI and many of them trickled down to domestic firms. At the same time the business environment became more dynamic. Foreign direct investment had an important role in productivity growth, in improving the innovative capacity and in opening of the economy.

The interest rates, inflation, and the public deficit converged to European Union benchmarks and the aim of the Maastricht criteria by 2007 proved to be credible. As a consequence of the sustained high economic growth, the gap of living standards between Slovakia and advanced European countries has been gradually narrowing, GDP per capita (in PPP terms) rose from 44% of the EU-15 average in 1998 to 51% in 2005.

Under the two terms of Dzurinda government the face of Slovak economy and politics changed significantly. A set of highly important structural reforms were implemented. The government was able to reduce many unnecessary administrative burdens on businesses and to enhance competition in product markets. Public management reforms successfully began and they also had the potential to improve the overall performance of the public sector.

Slovakia became the member of the European Union together with its Visegrád neighbours; moreover it transformed from a disqualified EU candidate to one of the most successful pupils and got back its historical, political and geographic place among the new democracies in Central Europe (Harris 2004:206). The EU accession process meant a pressure on Slovakia to create new institutions, including a professional civil service and regional governments. However, according to the European Commission, as in other new post-communist EU members, Slovakia's progress has been more noticeable in legislative developments than in the strengthening of capacities for implementation and enforcement. Since the EU entry in 2004 the consolidation of democratic institutions has further improved. Even with the sound reform steps Slovakia has not finished the building of a modern, flexible and diversified economy.

As of 1 January 2009 Slovakia became the first euro-country among the Visegrád countries and second among CEE countries after Slovenia.

Textbox 7: What factors supported the reform process of Slovakia? An application of the Williamson-hypotheses

Williamson (1994:478-481) and his co-authors examined several countries around the world (Australia, New Zealand, Spain, Portugal, Poland, Turkey, Chile, Mexico, Colombia, Brazil, Peru, Ukraine, Russia, and Bulgaria) and built hypotheses for identifying factors that support policy reform (Table 48). In more cases the public *perception of crisis* created conditions under which it was politically possible to conduct radical reforms. Again, in many cases the *"honeymoon hypothesis"* was verified that is the extensive reforms were implemented right after the government took its office. Similarly, the hypothesis that extensive reforms need a demoralized and *fragmented opposition* (that is unable to act as effective resistance) was also verified in many cases. The hypothesis that reform requires an *authoritarian regime* proved to be invalid just as the one that reform would be an inherently *right-wing* project. In most cases the party with reform intention needed to disguise its intent in order to get elected. That phenomenon is called *"voodoo politics"* by the author. The need for a *visionary leader* and an effective and *coherent economic team* were strongly supported by the case studies. The proposition that the successful reform program needs rapid implementation of a *comprehensive agenda* was verified by most of the cases. There was rather little support for the hypothesis of the conscious *use of the media*, the conscious effort to *compensate the losers* of the measures or *accelerate the gains* to the winners. Most countries received financial or intellectual *external help* for their measures. The governments had solid *political base* in most of the countries where the reform took root.

Table 48: Hypotheses for identifying factors that support policy reform

Hypothesis	General assessment	Slovak case
visionary leader	strong support	valid
coherent economic team	strong support	valid
political base	strong support	valid
"voodoo politics"	most cases	invalid
comprehensive agenda	most cases	valid
external help	most cases	valid
perception of crisis	many cases	valid
"honeymoon hypothesis"	many cases	valid
fragmented opposition	usual in democracies	
use of the media	little support	
compensate the losers	little support	invalid
accelerate the gains	little support	valid
authoritarian regime	invalid	invalid
right-wing	invalid	invalid

Source: Williamson 1994:479

Can we identify some of these factors in Slovakia during 1998-2006?
By 1998 there was a critical mass of non-populist reform leaders and there was a *visionary leader* in the person of Dzurinda.
After the years of the Mečiar government the people of Slovakia had a great appetite for reforms. The use of *"voodoo politics"* was not necessary. The population was afraid of isolation and lag in the international integration. The participation level was over 84% (Slivkova 1999:3) on the elections in 1998 which reflected the desire for change. The centre-right coalition provided a wide public base that helped to legitimize the reforms among the citizens. The Dzurinda governments had *solid political base*.
The state administration lacked the necessary skills to implement quick and broad reforms, to create proper regulatory environment for a modern market economy and to counter vested interests opposing the reform initiatives. The *coherent reform management team* combined members of the cabinet with external experts. This structure enabled to apply foreign know-how to the specific conditions of Slovakia. The external experts were not beholden to interest

groups, therefore were very effective in driving the reform process forward. At the same time, the vested interest groups (for example trade unions and indebted enterprises) often lacked capacity to obstruct the reform process. The *external help* was both present in form of intellectual support and motivation factor. The promise of international integration and the international pressure fuelled the reform, although the first Dzurinda government faced also international scepticism.
There was also a *motivating crisis*. The threat of a financial crisis made even the moderate reformers agree with (or at least not oppose) the ambitious reform arrangements. The downward pressure on the Slovak koruna and the follow-up panic in the market in May 1999 speeded up the progress. The fear of staying out from EU enlargement worked also as a crisis.
The first reforms were designed under time pressure, whereas the draft was also prepared for a *comprehensive agenda*. The government could use the opportunity to implement the most difficult and painful reforms first until the demand for them remained high. Maybe these measures would have not been possible later on because the election cycle and other political developments. One of the most important lessons of the first Dzurinda government was not to delay the deepest reforms, i.e. they fulfilled the *"honeymoon hypothesis"*. The second government undertook them during the first year. This strategy gave a chance to the economy to recover for the next elections. Thus the reform powers had eight years to conduct their program (Mathernová–Renčko 2006:637-639). However, the people run out of reform appetite by 2006. The reform measures were not costless. The reforms, especially that concerned welfare benefits faced a difficult trade-off between handling benefit dependency and risking deteriorating poverty. The losers of the reforms were most probably the previous beneficiaries of the generous welfare allowances. Although curbing benefit dependency and encouraging work effort were necessary for long-term reduction of poverty and unemployment, the short-run costs of the reforms were high for the poorest Slovak families, particularly in regions where there were not enough job opportunities to absorb newly willing labour supply (Moore 2005:28). Although the reforms were accepted by the population, we cannot talk about a successful social partnership. In Central and Eastern Europe (also in Slovakia) social partnerships were not launched or revitalized, as it happened in several EU member states during the 1990' connected to euro adaptation (Benczes 2006). The compensation of the losers was not proper that also contributed to the election failure in 2006. The acceleration of gains to the winners was more successful. The tax and welfare reforms reduced distortions in the economy and strengthened incentives to work and invest. The tax system became easier to administer and the elimination of most exemptions resulted in better resource allocation.
Altogether, based on the statements of Williamson (1994), the Slovak reforms were well founded.

The European integration and transformation process in Slovakia started during the years of Czechoslovakia, which (together with the other Visegrád countries) signed accession agreement with the European Community. In the bond of Czechoslovakia Slovakia belonged to the "mainstream" Central European transformation and European integration process. The legacy of the former Czechoslovakia meant more rigid planned economy than in the other Visegrád states, but the difference was slight compared to the specialities of Yugoslavia. That is why the Czechoslovakian legacy is *not a distinctive factor* among the examined SEE and CEE countries because it did not differ from the other Eastern European countries in elementary features.

The new independence of Slovakia is *neither a significant distinctive* factor among the SEE and CEE countries, since the majority of them started their transformation process

as newly independent country. The *only distinctive factor* is that after the dissolution of Czechoslovakia, Slovakia left the "mainstream" road of transformation and European integration. Frydman et al. (1998:56) called this turn "Mečiar's counterrevolution". Slovakia was the only candidate country that could not fulfil the Copenhagen democratic criteria. The newly independent, relatively backward country seemed to step on the road of path dependence, where the disadvantageous initial conditions determine the future of the country.

The reform path, which was appointed by the Dzurinda governments, seems to be deep and more or less durable. The common priorities as EU accession and euro adoption keep party alliances of the Fico coalitions alive. The outside pressures served as anchor in policymaking. Slovakia was able to change the rather pessimistic scenarios about its Europeanization process. It was shown that the disadvantageous initial conditions of the country could be corrected by reform measures. The "nationalist detour" ended surprising quick from 1998. However, since 2006 the "ghost of nationalism" seems to be unlaid.

Both periods of Slovakia were characterized by determinant role of personalities. The personality of Vladimír Mečiar in the "nationalist" period and later Mikuláš Dzurinda, Ivan Mikloš and Robert Fico determined the image of the country and they also functioned as an agent between the EU and the country.

V. The comparison: Realization of Europeanization in Croatia and Slovakia

In the previous chapters both countries were examined minutely. We have described and analyzed five the countries from five aspects: democracy-building, transition to market economy, accepting the acquis commnautaire, common foreign and security policy towards the countries, issues of European identity in the countries. Based upon these country studies, we attempt to identify what are the distinctive factors of the two paths that led to the different outcomes. Our assumption has been that the two countries' initial conditions at the time of the regime changes are similar from a number of aspects that makes the comparison reasonable.

This comparative section starts with a descriptive part that aims to identify the decisive divergence points of the transformation paths. Then in the second part we examine numerical data whether they show different realization of Europeanization in the two countries. In the third section we examine the mechanism of Europeanization in the two cases.

1 The parting of the ways

We point out that Croatia and Slovakia are the most similar cases and the most different cases at the same time. They started their transformation with very similar initial conditions from a number of aspects, shown in Table 49. The first years of their independence have also shown highly similar characteristics, except for one. However, the out come of the Europeanization process proved to be very different. In the following we highlight the causes of the different outcome. Some features (1-4.) appeared in both countries during the "Europeanist" era, only their intensity was different. Some other features (5-7.) proved to be unique in case of Croatia.

Table 49: Similar and different features in Croatia's and Slovakia's paths of transformation

Similar	*Different*
Initial conditions	
leverage of the Austro-Hungarian monarchy	
socialism	form of socialism: very strict vs. soft
multinational federal state	
feeling of being under suppression	
good prospects for Europeanization based on Yugoslavia's Western orientation and Czechoslovakia's participation in the frontrunner Visegrád-group	even better prospects for Europeanization in Yugoslavia (Croatia)
First years of independence	
post-socialist transformation	
new statehood	
frontrunner fellow-republic	war of Yugoslav succession
rise of nationalism	
non-mainstream path of Europeanization	
Parting of the ways	
1. victory of the opposition (1998 in Slovakia and 2000 in Croatia)	1. durability of the democratic government
2. change in political orientation	2. sharpness of change
3. changes in the economic system	3. speed of economic changes
4. feeling of „Europeanness"	4. „Europeanness" vs. EU membership
5.	5. role of tourism
6.	6. border disputes
7.	7. legacy of the war

1. In both countries the end of the nationalistic regime occurred due to the victory of the opposition (1998 in Slovakia and 2000 in Croatia). In Slovakia, although there were frictions, the governing coalition stayed together, and could stay in power for two terms. The elite consensus was present about the future of the country and the population was ready to accept the reform measures[86]. In Croatia, the reforming coalition was not enough strong to keep in power for two turns, partly because of inner disputes but also because of the public opposition towards reforms. After the elections in 2003 the HDZ get back to power, however, in a restructured form.
2. In both countries the political obstacles of EU integration were stronger than the economic obstacles. In Slovakia, the political orientation changed dramatically with the Dzurinda regime. In Croatia, the political orientation also changed after 2000, but the

[86] However, the Slovak people seemed to be run out of reform appetite by 2006. But until then the direction of public policy has changed already.

situation was more complicated than just the abolition of the nationalistic ruling system. Thus the turn was not enough sharp, although the expectations from the side of international actors were huge. Slovakia could manage its nationalistic heritage more easily because it was not complicated by the legacy of the war that burdened the quick political change in Croatia.

3. In Slovakia the political change was followed by radical reform in the countries economic system and the size of the state was reduced dramatically. In Croatia, the restructuring process was burdened by continuous delay. The system of crony capitalism was not abolished with the changes of the foreign policy orientation. The size of the state remained huge and the role of the state in the economy remained dominant.

4. Although authoritarianism was discredited in both countries, the attitude of the population differed. In Slovakia, the majority of the people has been pro-EU and ready to accept reform measures initiated by the EU. The attitude of the population about being "European" in Slovakia was one of the driving forces of the quick reorientation and European integration. „Europeanness" in Slovakia has been almost equivalent to the EU. „Europeanness" in Croatia does not equal the EU by all means. At the same time, in Croatia the level of Euroscepticism has been very high. The armed conflict resulted in a different approach of the "national interest" and "national unity" than in Slovakia. As a result, the battle between "nationalists" and "Europeanists" (Fisher 2006) had different conditions in the two countries. The rise of the Europeanists in Croatia was significantly slower and more painful than it was in Slovakia. The Croatian society has been more divided concerning their attitude towards "Europe".

5. The tourism sector and its revenues have created tempting opportunities to delay crucial restructuring decisions in Croatia. It may help to close the loophole which would otherwise emerge in the current account of Croatia due to its trade balance deficit and slow export growth. Moreover, these advantageous circumstances turned into *rents* (see Csaba 2007b:371). In Slovakia there was no opportunity for such an "alternative way". Slovakia had no choice but to carry through the reform measures.

6. Slovakia could succeed from Czechoslovakia without border disputes. Beyond the war with Serbia and Bosnia and Herzegovina, Croatia has further border disputes with Slovenia that are actual until today. This dispute (together with the argument on the frozen deposits) has overshadowed the relation of the two countries and they have become enemies rather than allies in the integration process of Croatia.

7. Rupnik (2000:273) considers as major difference between the dissolution of the two federations that unlike in Czechoslovakia, in Yugoslavia the separation was initiated by the more democratic, more Western and more prosperous member of the federation. More important difference is that the sovereignty of Croatia was achieved in an armed violence. The Yugoslav war of secession lasted from 1991 to 1995 and it was 1998 when Croatia was "re-unified". Slovakia's sovereignty was achieved peacefully. The Yugoslav counter-example made the Czech and Slovak parties aware of the risk of an armed conflict and thus it contributed to the peaceful and negotiated outcome Rupnik (2000:273). The legacy of the war differentiates Croatia from the new EU member states. The Yugoslav war proved to be a unique and crucial factor in Croatia's transformation process. The cooperation commitment with the ICTY was also the result of the war. This cooperation proved to be overall important regarding EU-relations, but it was burdened by public opposition that made the governments hesitate. The extremely mixed feelings of the society towards the ICTY and the indicted generals excluded the possibility of consensus on society level. Such a commitment was not present in the EU-Slovakia relations. In Croatia the war and its consequences caused *lock-in and higher social cost of Europeanization*.

2 What the numbers tell us?

If we compare the EBRD transition indicators of Slovakia and Croatia (Table 50 and Table 51), the following results appear. In 1989 all of the Slovak indicators were 1, meaning a rigid centrally planned economy. In the Croatian case the average score was 1.56 in 1989 because four out of the nine examined areas had higher score than 1. Due to the Yugoslav type of socialism Croatia was in a more favourable initial position. In other words, it was closer to the European model.

The numbers show that the structural change started quicker and with larger steps in Slovakia: by 1991 the Slovak average score reached 2.11 (compared with the Croatian 1.78) mainly as a result of small scale privatization developments, price and forex liberalization. In other words, by 1991 Croatia lost its advantage coming form its soft socialist regime. Slovakia took the lead and until 2007 it had higher average structural and institutional change scores than Croatia. In 2007 the average Slovak score was 3.74 and every area was at minimum 3. Croatia had 3.52 average score in 2007 and the only competition policy was under 3.

The developments of the first years were more unbalanced. Considering standard deviation scores, the first years of transformation show divergent transformation speed among the examined sectors. Some sector stayed in the status of rigid planned economy until 1995 in Croatia and 1994 in Slovakia. Later the standard deviation decreased as every sector started to transform. The Slovak transformation show higher standard deviation scores between 1997 and 2000 due to the slow changes in field of infrastructure. Later on the Croatian scores tends to be higher as a result of slow changes in competition policy. The small scale privatization has been at a highly advanced stage from the very beginning. Price liberalization is another "success story" in Croatia. At the same time the securities markets and non-bank financial institutions appeared relatively late. Slovakia was also a frontrunner in small scale privatization and in field of trade and forex system. The overall infrastructure reform appeared relatively late in Slovakia.

Table 50: Croatia: Transition indicators

	Large scale privatization	Small scale privatization	Enterprise restructuring	Price liberalization	Trade & Forex system	Competition Policy	Banking reform & interest rate liberalization	Securities markets & non-bank financial institutions	Overall infrastructure reform
1989	1.00	3.00	1.00	2.67	2.00	1.00	1.00	1.00	1.33
1990	1.00	3.00	1.00	3.67	2.00	1.00	1.00	1.00	1.33
1991	1.00	3.00	1.00	3.67	3.00	1.00	1.00	1.00	1.33
1992	2.00	3.00	1.00	4.00	3.00	1.00	1.00	1.00	1.33
1993	2.00	4.00	1.00	4.00	3.00	1.00	2.00	1.00	1.33
1994	2.00	4.00	2.00	4.00	4.00	1.00	2.67	2.00	1.67
1995	3.00	4.00	2.00	4.00	4.00	1.00	2.67	2.00	1.67
1996	3.00	4.33	2.67	4.00	4.00	2.00	2.67	2.00	2.00
1997	3.00	4.33	2.67	4.00	4.00	2.33	2.67	2.33	2.00
1998	3.00	4.33	2.67	4.00	4.00	2.33	2.67	2.33	2.00
1999	3.00	4.33	2.67	4.00	4.00	2.33	3.00	2.33	2.33
2000	3.00	4.33	2.67	4.00	4.33	2.33	3.33	2.33	2.33
2001	3.00	4.33	2.67	4.00	4.33	2.33	3.33	2.33	2.67
2002	3.00	4.33	2.67	4.00	4.33	2.33	3.67	2.67	2.67
2003	3.33	4.33	2.67	4.00	4.33	2.33	3.67	2.67	3.00
2004	3.33	4.33	3.00	4.00	4.33	2.33	4.00	2.67	3.00
2005	3.33	4.33	3.00	4.00	4.33	2.33	4.00	2.67	3.00
2006	3.33	4.33	3.00	4.00	4.33	2.33	4.00	3.00	3.00
2007	3.33	4.33	3.00	4.00	4.33	2.67	4.00	3.00	3.00
2008	3.33	4.33	3.00	4.00	4.33	2.67	4.00	3.00	3.00

Source: EBRD Transition indicators

Table 51: Slovakia: Transition indicators

	Large scale privatization	Small scale privatization	Enterprise restructuring	Price liberalization	Trade & Forex system	Competition Policy	Banking reform & interest rate liberalization	Securities markets & non-bank financial institutions	Overall infrastructure reform
1989	1.00	1.00	1.00	1.00	1.00	1.00	1.00	NA	1.00
1990	1.00	1.00	1.00	1.00	1.00	1.00	1.00	NA	1.00
1991	4.00	3.00	2.00	2.00	1.00	1.00	1.00	NA	1.00
1992	4.00	4.00	2.00	2.67	1.00	1.00	1.00	NA	1.00
1993	4.00	4.00	2.00	2.67	2.00	1.00	1.00	NA	1.00
1994	4.00	4.00	3.00	2.67	2.67	1.00	1.00	NA	2.00
1995	4.00	4.00	3.00	2.67	2.67	1.67	2.33	NA	2.00
1996	4.00	4.33	3.00	2.67	2.67	1.67	2.33	NA	2.00
1997	4.00	4.00	3.00	2.67	2.33	1.67	2.33	NA	2.00
1998	4.00	4.33	3.00	2.67	2.33	1.67	2.33	2.00	2.00
1999	4.00	4.33	3.00	2.67	2.33	2.00	2.33	2.00	2.00
2000	4.00	4.33	3.00	3.00	2.33	2.00	2.33	2.33	2.00
2001	4.00	4.33	3.00	3.33	2.33	2.33	3.00	2.33	3.00
2002	4.33	4.33	3.00	3.33	2.33	2.67	3.33	2.67	4.00
2003	4.33	4.33	3.00	3.33	2.67	3.00	3.33	2.67	4.00
2004	4.33	4.33	3.33	3.67	2.67	3.00	3.33	2.67	4.00
2005	4.33	4.33	3.33	3.67	2.67	3.00	3.67	3.00	4.00
2006	4.33	4.33	3.33	3.67	3.00	3.00	3.67	3.00	4.00
2007	4.33	4.33	3.33	3.67	3.00	3.00	3.67	3.00	4.00
2008	4.33	4.33	3.33	3.67	3.00	3.00	3.67	3.00	4.00

Source: EBRD Transition indicators

If we compare the 2008 scores one by one, Slovakia has maximum scores (4.33) in three fields: small scale privatization, trade and forex, and price liberalization. At the same time, these are the fields where Slovakia reached high scores in less time. Croatia has maximum scores in small scale privatization and price liberalization. Croatia has higher scores than Slovakia in banking reform and interest rate liberalization. In all other sectors Slovakia has higher or equal scores than Croatia. The scores of Croatia show higher standard deviation.

This short review shows rather small (0.22 score) average difference between the two countries (3.52 average score for Croatia and 3.74 for Slovakia) in 2008, although the one is a frontrunner in transformation reforms and the other follows far behind.

The transition indicators show little difference between the two countries, although this study suggests considerable gap between the two. The explanation of the phenomenon is threefold. (1) Undoubtedly the result partly derives from the limits of the EBRD

indicators, to which the EBRD itself calls our attention[87]. (2) The two countries are close to each other on a scale from rigid centrally planned economy to an industrialised market economy. However, this similarity does not reflect in their business environment, as the Doing Business rankings show (see Table 23). The foundations for a well functioning market economy are present in both cases according to the transition indicators. As we have highlighted previously in the section 3.5.3, problems with property rights and contract enforcement; the large size of the government, inefficient bureaucracy and high regulatory burden; and corruption are the four most important micro risks that determine the quality of market economy in Croatia. (3) The rather close result of the countries, and thus the relative good results of Croatia refer also to the issue how Croatia "survives" relatively successful outside the European Union. Part of this "success" is based on the performance of the tourist sector.

Another numerical data shows clear difference is to be seen between Croatia and Slovakia. The smaller state redistribution – among other favourable impacts – limits the rent-seeking possibilities (Csaba 2007a:761; Sajó 2008:694). As it was highlighted previously, both countries suffered from state capture and high level of rent-seeking as a result of crony capitalism. The Dzurinda reform agenda decreased the level of public expenses from 50.5% in 2000 to 37.3% in 2006. Considering this data, Slovakia is among the countries with lowest government redistribution in the EU and it is more close to the level of Baltic and South Eastern European member states than the other Visegrád countries (Table 39).

Although the size of state decreased by 9 percentage points since the end of the Tudjman regime, the Croatian state still among the largest compared to CEE states, but also compared to all EU states. The size of public expenditures relative to GDP show interesting picture in Croatia, in comparison with Yugoslavian times. In communist countries the public expenditures are high by definition. Yugoslavia was an exception, where there was a difference between state and social sector. Still, the level of state expenditure was high in Yugoslavia, but from a number of respects it was lower than it has been nowadays in Croatia (Gligorov 2002).

[87] "These data help to describe the process of transition in a particular country, but they are not intended to be comprehensive. Given the inherited difficulties of measuring institutional change, they cannot give a complete account or precise measurement of progress in transition." "The data should be interpreted with caution also because their quality varies across countries and categories. The data are based on a wide variety of sources." (EBRD 2000:125)

3 Internal factors - the respond to the Europeanization pressure

The outcome of the Europeanization process is explained by the "concerted action" of the internal and external factors. When the internal factors respond to the external ones, the outcome depends on their interplay. In the context of transformation countries the interplay is seen successful when the EU serves as anchor during the transformation process. The countries vary how they response to EU adaption pressure.

At the beginning of this study we have highlighted that the external factors were present in both countries and can be considered as same factors. The domestic factors are responsible for the perception of the misfit and for the presence of the responding factors. How did the two countries respond to the impetus coming from the EU? What were the factors that hindered or fostered Europeanization?

The comparison shows several common points in the development of the two countries. Based on the people national feelings, there was a potential for nationalistic regimes. In both countries a nationalistic leader took this opportunity but their regime was not accepted by the international and European community. The new governments in both countries promised the end of the previous regime, reforms and a turn to European integration. As we demonstrate, the internal factors were quite similar in the "nationalist" phase and they have been rather different in the "Europeanist" period in the two countries. The outcome of the changes is rather different in the two countries

In order to detect the key factors of Europeanization in the two countries, we examine them in three periods (Table 52). We start with the initial conditions. Then we turn to the period that was marked by nationalism and we call it "nationalist" period. We consider the next period from the time when opposition governments got into power and call it "Europeanist" period. The turning point is 1998 in Slovakia and 2000 in Croatia. The three keywords of Europeanization (misfit, perception and responding factors) are examined in all cases. We also examine whether the EU anchored the transition of the countries.

Table 52: Overview of realization of Europeanization

	Croatia	***Slovakia***
initial conditions	yes	yes
nationalist	no	no
Europeanist	well…	yes

3.1 Initial conditions

The Europeanization impact, in the sense of the impact parallel to the transition of post-communist Eastern European countries, reached both of our case study countries when they were not independent countries. Croatia started as a member state of Yugoslavia, while Slovakia was part of Czechoslovakia. Thus the early stage of their Europeanization was not an "independent" choice in these countries but a result of a collective action.

Yugoslavia's special status with the European Communities was enviable among the CEE countries during the Cold War. The third way, non-aligned approach of the Socialist Federal Republic of Yugoslavia made the country special in the eyes of the West and seemed to be highly advantageous basis for Europeanization.

Contrary to the advantageous prospects, the developments during the last years of Yugoslavia set aside the Europeanization process on federal level. Yugoslavia (understood as a country of six republics until 1991) gave plenty to think about for the European Community. On the one hand, Yugoslavia had special problems compared to the rest of the Central European countries. On the other hand, it was not the only "hot" issue that time, but the transformation of Eastern Europe, the collapse of the Soviet Union, the unification of Germany, the Gulf War and last but not least the preparation of the Maastricht Treaty occupied the attention of the Community. At the same time, the end of the bipolar world overthrew the internal balance of the republics and their heterogeneity became more accented than ever before. They had very different attitude towards the process of European integration. The Northern republics strove much more for the integration process, than the Southern Republics (Juhász 1999:188). All in all, although the special status of Yugoslavia disappeared with the regime changes – since the end of the bipolar world cut the ground from under the country's strategy –, at least the Northern republics (Slovenia and Croatia) had every chance to build on their privileged Yugoslav antecedents and to have favourable prospects for Europeanization.

Czechoslovakia was among the Eastern European countries that followed the strictest socialist regime. Contrary to these antecedents, as the regime changes have started it was also among the first countries that started negotiations about EC association agreements (Europe Agreements) in December 1990. Czechoslovakia got to the Visegrád states that were the frontrunners in transition. From 1989 to 1992 the privileged aim of the common Czechoslovak foreign policy was to get into integration

organization. In favour of the new geopolitical aim, Czechoslovakia pushed the Visegrád cooperation, the opening towards Western countries, especially Germany. However, after the 1992 elections the Czech and Slovak foreign policy interest started to diverge (Hamberger 1997:175-176).

To sum up, at the time when Croatia and Slovakia became independent, the development in their successor states pointed to the direction of Europeanization already. The Europeanization *pressure* existed in both cases and continued to be present in every successor state's development. The *misfit* was perceived in both cases. Czechoslovakia was ready to *respond* to the adaptation pressure and to accept the EC as an anchor to its transformation. Yugoslavia (understood as a country of six republics) was closer to the EC than any other country in the region. However, the misfit in case of Yugoslavia grew huge when the armed conflict broke up and ability to respond to the adaptation pressure was overshadowed by the internal developments.

3.2 Two countries – four cases

We start the comparison of Slovakia and Croatia with an application of Vachudova's theoretical explanation[88] on why countries vary in their response to EU adaption pressure. The *geographical proximity* does not explain the willingness of the two countries to participate in EU integration: although both are in the direct neighbourhood of the EU, the countries tried to ignore the influence of the EU during the 1990'. On the logic of *initial economic conditions*, both Yugoslavia and Czechoslovakia should perform well since they were relatively rich. Some of the successor states performed well but some not. Of course not all the Yugoslav republics were rich. The regional disparities were huge but the relative richness of Croatia and Slovenia did not determine their paths either. The initial economic conditions are surely important but not all: one has to take into consideration the political, historical and sociological initial conditions as well.

Turning to the next explanation, did the EU *dislike* any of the countries? Czechoslovakia (both part of it) belonged to the Visegrád countries, which were considered as the most favoured group of transformation countries. Yugoslavia was in a special relationship with the EC until its disintegration that meant preferential treatment compared to the other communist countries. However, during the last months of

[88] The theory is outlined in section "1.1 Internal vs. external Europeanization"

Yugoslavia this picture changed completely. Still, as the example of Slovenia shows, it did not mean that the EC excluded (disliked) the successor states of Yugoslavia.

On the whole, both countries had at least not bad or even good reputation in the eyes of the EC at the beginning. However, the dissolutions changed the picture. Where pro-EC governments got the power in the successor states, the good relation sustained. At the same time, if nationalist powers got to the government, it changed the attitude of the EU as well. In this latter period the EU "disliked" those countries, but it was not unilateral.

None of Vachudova's factors explain the different outcome of Europeanization process in Croatia and Slovakia. We argue that the self-interpretation and scope for action of the political elite matters. This elite dynamic roots in the cultural and historical heritage of the country. Since the Europeanization process depends primarily on policy decision, the attitude of the political elite is essentially important.

3.3 Croatia in the Tudjman era – the nationalist period

As outlined above, there are two conditions to be able to talk about Europeanization. First, there must be a *misfit* or incompatibility between the domestic and the European institutions, policies or processes. Considering the development of Croatia during the 1990', the misfit is undoubted.

This misfit was perceived very differently in Croatia and in the EU. On the one hand, Croatia saw itself as an independent democratic state with a stable economy whose European integration process was hindered by other European states (Tudjman 1997). On the other hand, from the side of the EU a large misfit was perceived and pronounced. The main elements of the misfit were the war, the undemocratic political style and abuse of minority rights. The outcome of the two perceptions scarcely overlapped. The difference in perception of the misfit – we argue – rooted in the different perception of the war: in the Croatian reading it was the Homeland war and Croatia was the victim of the Serbian aggression. Although the EU and most of the international community also considered Serbia as aggressor, they still blamed Croatia because of its ambitions against Bosnia and Herzegovina. As a result, the perception of the misfit was wrapped into the national interest of Croatia as an independent country and nation.

The existence of factors (actors or institutions) that *foster responding* to the adaptation pressure were almost missing during the Tudjman regime in Croatia. The country was isolated from the EU (less economically and more politically). The governing party

(HDZ) responded rather defensive than cooperative to make Croatia EU-conform. In fact, the need of being EU-conform did not arise. Instead, the pressure of the EU was seen as a danger to the national interest. As a result, there were no or little efforts made in order to meet EU requirements and European integration had very low priority. Croatia did not become a Europe Agreement country and as a result the EU membership was less than real prospect. The role of the EU in the transformation process was minor.

According to the above described, can we talk about Europeanization during this period in Croatia? The evidence shows that the three conditions did not realize. Thus the EU did not play the role of *anchor* in the Croatian transformation process; it rather went on its own way dictated by the "national interest". The Croatian system proved to be EU-resistant. However, this does not mean that the EU was not present in Croatia's life. The presence of the EU-pressure had impact on the country's life even if not towards the direction of Europeanization.

The fact that Croatia did not become a Europe Agreement country was the result of policy decisions made by the political elite. In the next section we examine what kind of factors made the political elite to do so. We will find that the two main reasons were the war and the national identity.

3.3.1 Is Croatia different?

Every country and every transformation is different. However, there are several factors that all or at least the vast majority of the transformation countries shares. In Croatia the following factors are potentially different.

First, the transformation process of Croatia began in 1988 during the last years of Yugoslavia; therefore the Croatia inherited this path. This factor is *special but not unique*: Slovenia inherited the same background but it is the first euro country among the CEE countries.

Second, Croatia became a newly independent state in 1991, which also influenced the agenda of transformation. However, as it was highlighted previously, the new independence of Croatia *is not a significant distinctive factor*. State- and nation-building connects to transformation in most of the cases. At the same time, albeit new independence is not a distinctive factor, the way *how* it was gained needs to be examined further.

Here we arrive to the third possible distinctive factor: the first years of transformation in Croatia were complicated by a war, which caused a shift in the priorities. We argue that

this feature of the Croatian (and other post-Yugoslav) economy is *a distinctive one* since the Central and Eastern European countries did not face an armed conflict; the dissolution of Czechoslovakia and the secession of the Baltic states went peacefully.

As Kornai (2005:915) highlights, a very important characteristic of the transformation paths in CEE is that they happened peacefully and without violence. Croatia looks fundamentally different. Although the armed conflict did not connect directly to the regime change, the Yugoslav war of secession has had deep impact of the Croatian transformation path and therefore of its EU integration agenda. The war itself and its consequences created unique additional factors, cost and challenges that were missing in the CEE peer countries. *We do not find any example of successful transformation which was complicated by long armed conflict among all the transformation countries In Eastern Europe*.

Among others the war was the factor that placed Croatia from the CEE group to the Western Balkans. Usually Croatia is labelled as a delayed country from the perspective of Europeanization. From another point of view, Croatia is a frontrunner among the Western Balkan countries. Croatia always wanted to get out from the group of Western Balkans and join its "own group" of countries in the region. However, the war and its consequences distinguished Croatia from the rest of the CEE countries.

3.3.2 What can be placed to the account of the war?

The war led first of all to loss of lives and it also forced many people to leave their homes. The war inflicted severe physical destruction on infrastructure and housing. It also meant the occupation of about one-third of Croatian territory that resulted in a four year long interruption of main traffic links between Slavonia and the costal area. The image of Croatia in the eyes of the international community was unfavourable, the war led to increasing international isolation, which continued in post-war times as well. The isolation deprived Croatia from important flows of international assistance and international integration.

Regarding the economy, the war led to heavy direct economic losses (27.5 billion UDS that was more than a year's GDP of Croatia). The country lost its main traditional foreign markets and trade flows with other former Yugoslav republics were interrupted. The armed conflict seriously hurt the Croatian tourism industry. In the eyes of foreign investors, the war increased the country's risk that was followed by loss of foreign direct investment flows. The transformational recession was combined with war

recession that contributed to a particularly severe economic crisis. The country's GDP fell by almost 30% that was the most severe decline among CEE countries (including Bulgaria and Romania). The war increased the role of the state: beyond defence expenditure, huge demand for social protection aroused from people affected by the war (World Bank 2001:2-3). Powerful interest groups benefited from the armed conflict who continued to benefit from various supports after the war as well, e.g. rents, pensions. The grey and back economy (including criminal activities) flourished during the war that continued after it as well, with a different character compared to Central European states (Inotai 2007:233-235).

The war and its legacies changed policy priorities fundamentally. The importance of this legacy is particularly visible after 1995. In spite of the end of the war, the foreign policy priorities did not change.

With the end of the war it did not disappeared from collective mind of politicians and the people. The reference to the war continued to influence policy decision. The size of the state did not decrease after the end of war but the effects of war have contributed to the culture of interventionism in post-war times as well. The war and its consequences changed economic and political preferences and conditions, put several issues into new context and changed the balance of power among interest groups of the society. The political and economic sphere became highly interconnected. The non-transparent circumstances and delayed structural changes contributed to the evolution of crony capitalism.

The war had special impact also on the national identity, which is essential concerning the above mentioned state- and nation-building that connected to the transformation.

3.3.3 Born to be "European"?

Although CEE countries declared that they have always been in "Europe", every country strived to demonstrate its alignment to EU norms and rules. Their "Europeanness" had to be proven by accepting EU conditionality. Croatia experienced its "Europeanness" differently. In this country the view of "we have always been in Europe" was understood more literally. The Croatian elite did not felt that Croatia should strive to demonstrate its alignment to EU norms and rules. They only referred to their roots in Europe (also historically, culturally and geographically) and kept it as their inalienable characteristic. Moreover, the myth of "Europeanism" was overwritten by the new myth of the war that influenced the national identity of people more vigorously.

The "national interest" was to save this national identity from the pressure of the European Union.

As a result, during the first decade of transformation the cost of Europeanization was very high in Croatia and the political elite were not willing to pay. Some EU conditions (especially the cooperation with The Hague) was unacceptable for the population. Both the transformation and European integration were subordinate to the "national interest" that was often the interest of the narrow political elite.

To sum up, the choice in Croatia was not only whether "Europeanist" or "nationalist" (Fisher 2006) leaders get to power, as it was in Slovakia. The legacy of the armed conflict made the picture much more complicated. When Croatia was placed among the less Europeanized Western Balkan countries, it changed also the idea of "inalienable Europeanness".

3.4 Croatia after Tudjman – attempts towards European integration

The *misfit* was obviously still present when the opposition won the elections in 2000. But this misfit was perceived differently by the new government than the previous one. The new conception was more close to the perception of the EU although it was not the same. The idea of the national interest changed somewhat. However, key components of the misfit, namely the war (by that time its consequences) and the abuses of minority rights remained on the agenda and were attached to real or putative national interest.

The existence of *responding factors* changed after 2000. Following the elections the opposition gained power and the orientation of the external relations turned to the EU. The EU integration became a pronounced political priority.

Since 2000 the dynamics of Europeanization is visible. During the period of the opposition and also later when the renewed HDZ regained power, the EU was always a high a priority in the government's rhetoric and it presented ambitious integration schedules from time to time. Willingness for responding to the adaptation pressure strengthened significantly. The responding capacity was much stronger in rhetoric than in practice. The political goal of EU membership was also maintained after the change of government following the November 2003 parliamentary elections when the renewed HDZ won. The return of the HDZ highlighted two issues: the infirmness of the coalition and the will of the electorate. The return if the HDZ did not go along with the return of nationalistic rule, inter alia because the emblematic HDZ leader Franjo Tudjman died in 1999. Stjepan Mesić, president of Croatia said in 2000 that he hoped Croatia would

have earned EU membership before his terms ended in early 2005. However, Croatia applied for EU membership in February 2003, became candidate country in June 2004 and only the negotiations could start in 2005, mainly because of the delay in cooperation with ICTY. The aim of Croatian membership was still overwritten by the national interest, which was threatened by The Hague. The unexampled high level of Euroscepticism in Croatia has also burdened the integration process and the respond to adaptation pressure.

The main mechanism of Europeanization did not change in Croatia with the political turn. The dominant mechanism has been *coercion based on control and conditionality.* The Croatian experience showed that the mainly negative conditionality of the EU and also other international actors played highly important role in several crucial steps in the Croatian policy.

The hint of Schimmelfennig and Sedelmeier (2004:670) that the presence of conditionality does not necessarily cause successful rule transfer is particularly relevant in Croatia. In many cases the EU-conditionality proved to be ineffective, although the EU's bargaining strategy was connected to positive or negative sanctions. On the one hand, an example of negative sanction was the suspension of assistance to Croatia under the PHARE program. It was suspended on 7 August 1995 when Croatia mounted a military offensive in Krajina. Until November 1999, Croatia was excluded from the PHARE programme because of its failure to strengthen its democratic institutions (e.g. reforming the electoral law, decentralising the media, respect for minorities and the return of refugees). Another negative sanction was the postponement of the accession negotiations because Croatia did not cooperate fully with the ICTY. On the other hand, an example of positive sanction was when following a positive assessment from the ICTY Chief Prosecutor, the Council concluded immediately that Croatia had met the crucial condition and the negotiations could be opened on 3 October 2005.

3.4.1 EU as an anchor

Several authors (e.g. Gligorov 2004a and 2004b; Anastasakis–Bechev 2003), agree that the EU can serve as a credible anchor during the transformation process only in case of clear membership prospect. The Feira European Council in June 2000 vaguely stated that the Western Balkan countries (including Croatia) were potential candidates for EU membership. The European Council confirmed that its objective remained the fullest possible integration of these countries into the political and economic mainstream of

Europe. The EU itself interpreted the Feira council conclusion that it recognized that the main motivator for in these countries was a relationship with the EU based on a credible prospect of membership once the relevant conditions had been met. This prospect was offered at Feira (Western Balkans…2000). The term "potential candidates" reflects that these countries are in principle eligible for membership but the relevant conditions have not been met yet (Balázs 2002:264).

The political elite were not only struggling with the conditions of the EU itself but also with its own agenda. The integration schedules have been delayed regularly. The EU perspective has been still complicated by unclosed issues of the Yugoslav succession and the consequences of the war. Thus it could not become the overall priority of foreign relations. The government had to balance between fulfilling the conditions of the EU and other international actors and fulfilling the expectations of the electorate. The two requirements were sometimes the opposite of each other.

As a consequence, the role of the EU and its *anchoring* possibilities has been limited in Croatia. The country kept the distance from the EU after 2000 as well. Contrary to Croatia's resistance, the evidences show that the EU has been an important factor in Croatia's life. The country is already a candidate country and the Progress Reports finds some progress every year. The question is the pace of progress and integration.

It is important to note that the structural reforms are necessary in Croatia regardless of the conditions of the EU. First of all, the improvement is the interest of the country and the interest of the EU is only placed second. Lejour et al. (2007:10) argue that Croatia could follow the reform path without the EU accession as well. However, the experience of the Croatian transformation path showed that the (mainly negative) conditionality of the international actors played highly important role in several crucial steps in the Croatian policy.

Regardless of politics, the Europeanization of economic relations was significant. The EU became the most important trade and investment partner of Croatia, already during the "nationalist" period. The evidence shows that the geographical proximity determines most of the economic relations of the country. From strictly economic point of view, Croatia differs from the CEE countries with respect to the following features. The private sector investment and FDI as share of GDP is relatively low, the size of the government and the role of the state are relatively large, the business environment is less friendly, the legal system is less favourable and the labour market is less flexible (Lejour et al. 2007). The transformation is legging behind in several fields.

3.4.2 Europeanness and war

The two constraints mentioned in the previous section (the war and national identity) has been still valid in the "Europeanist" period, even though their intensity decreased.

The perception of "Europe" did not change principally after 2000 in Croatia. The political elite still did not feel the need that their "Europeanness" should be proved by accepting EU conditionality. This feeling changed only after the realization that the Eastern EU enlargement was over when Bulgaria and Romania joined the community in 2007. These two countries' level of development has been well below Croatia's level according to the common talk. The membership of the latter two countries "opened the eyes" in Croatia and brought to both the population's and the political elite's consciousness that Croatia *missed* the trains of EU enlargement.

At the same time the myth of the war and as a consequence, the legacy of the war became less and less intensive with the rolling years. In the second half of the 2000' the perception of "Europeanness" became increasingly "instrumental", as it was in Slovakia.

Vojnić (2003:158-165) argues that the performance of Croatia could be explained exclusively neither by the imposed war nor by the explosion of the Balkan nationalism. Vojnić argues that the performance of the country is also the result of crony privatization and the insufficient extent of stabilization. However, we argue that the two (war and the Balkan nationalism on the one hand and crony privatization and insufficient extent of stabilization on the other) are not unrelated. On the contrary, the latter are to a large extent the consequence of the former. The interrelation of politics and economy continued to determine the direction of policymaking, and the willingness and scope for action of the political elite.

3.4.3 The role of crisis

Crisis has been identified as one factor that can be conducive to economic policy changes, reforms and thus to accelerate growth. At the same time, crises are not unequivocally beneficial for reforms and also the eruption of crisis is not a necessary precondition for reforming measures. Gligorov (2004b:21) argues that in Southeastern European countries crisis does not play an unambiguous role. One crisis that had important role in a number of cases is hyperinflation. In Croatia a highly successful stabilization package was introduced after a period of hyperinflation. The inflation rate

has been low and stable since than. In Croatia another economic success story, the restructuring of the banking sector occurred also in consequence of a financial crisis in 1998-1999. However, neither the restructuring of the financial sector nor the post-hyperinflation stabilization package were followed by overall restructuring in the economy. In other words, there was no "life-threatening" crisis in other sectors – neither benefit. The crisis of e.g. the shipbuilding sector has not been enough deep to move the balance of the crony system. As highlighted in the detailed country-study, the revenues from the tourism sector and the remittances of Croatian citizens working abroad has helped to maintain the possibility of policy making towards vested interest. As a result it has not enforced any radical structural changes. Croatia locked in and became the subject of institutional inertia.

3.4.4 What would Croatia win with the EU membership?

There is a wide consensus among the researchers that there is no other chance for Croatia than to join the EU, on the long term there is no life outside the EU[89]. But what about the short term? The classical problem arises: the costs are to be paid in the short term, while the benefits are to be appeared on medium or long term. There is no doubt that cost of integration for Croatia is high. Nevertheless, the possible benefits are also huge. Estimates already show that the welfare effect of the EU will be positive; the Croatian society and economy will earn with the EU (Švaljek 2007). The experience of Slovakia demonstrates that an effective and efficient package of economic reforms is able to generate economic result and political benefits even on the short-term. However, there will be both winners and losers on individual level and the winners have to compensate the losers somehow.

Lejour et al. (2007) examined the possible effects of Croatia's accession to the internal market and of the improvement in Croatia's institutions. The country's accession to the EU's internal market could increase the volume of *trade* between the EU and Croatia. Both administrative and technical barriers to trade will be eliminated and the country risk of Croatia will be reduced with the accession. The authors estimated that compared to the situation in 2001, the aggregate trade with the EU can increase by 34% in weighed average if Croatia joins the internal market. The increase in agricultural, in food processing products and in trade services are the highest, over 100%. The 34%

[89] See: Samardžija et al. (2000), Švaljek (2007), Lejour et al. (2007)

increase in trade with the EU suggests an increase of 23% in the aggregate trade volume of Croatia. The authors interpret non-tariff barriers as the trade costs associated with the non-membership of Croatia, which creates rents. Standardizing technical regulation is considered as a technical barrier to trade which could lower costs but also eliminate rents. These trade costs are in agriculture, in business services, in food processing and in trade services the highest (Lejour et al. 2007:22-24).

The delay in institutional reforms is one of the highest priorities in Croatia's transformation agenda. The EU-membership can provoke *institutional reforms* in Croatia and reduce bureaucracy, lack of transparency on government regulation and policy implementation. The improvements in institutions and transparency would contribute to the economic development of Croatia by improving its competitive position. In order to conform to the internal EU market and the acquis communautaire, the reforms have to be done. Croatia could reform its institutions without EU-membership as well, but the potential membership could serve as an extra stimulus. According to Lejour et al. (2007:25-27), the improvements in institutional quality would also contribute to Croatia's aggregate trade volume.

According to a report of the Institute of Economics, Zagreb (EIZ), EU membership will be beneficial for Croatia in increasing manner**Hiba! A hivatkozási forrás nem található.**. The EIZ started from the presumption that Croatia will be member of the EU in 2009. Croatia's net position regarding payments to and from the EU budget is increasingly positive from 2009. At the same time, the EU agenda has considerable pressure on the Croatian budget (1.4% of GDP in 2009), even if the EIZ predicts decreasing level.

Croatia as a possible new member state would be eligible for *EU funds*. Compared to the EU average, Croatia is a relatively poor country with a relatively large agricultural sector. The GDP per capita in PPS was about 50% of the EU-27 average in 2006, which means that the country would be eligible for the Convergence objective[90] in the structural policy. The value added of the agriculture sector was 6.1%[91] in 2007, which is a rather high level compared to the EU-27 average (1.8 in 2007) and comparable with the result of Romania (6.4 in 2007) and Bulgaria (6.2 in 2007). Because of the large agriculture sector, fund from the Common Agriculture Policy is also considerable.

[90] Regions with GDP per capita at less than 75 % of the Community average are eligible for the Convergence objective.

[91] Eurostat online: National Accounts by 6 branches - aggregates at current prices

Lejour et al. (2007:27) have calculated a total amount of funds to Croatia about 1 billion euro per year. Švaljek (2007:36-37) predicts lower amount of funds, 512 million euro in 2009 and 1954 million if the first three years. The reform of these funds are continuous, therefore it is difficult to predict how they look like at the time of Croatia's accession.

Croatia has a small population (4.4 million) relative to the population of the EU-27 (494.7 million). With the accession of Croatia, the population of the EU would increase by less than 1%. Therefore the impact of *free movement of labour* would be rather modest for the EU as a whole. Considering the standard of living in Croatia, the number of possible immigrants might be smaller than from Bulgaria or Romania because the GDP per capita in the latter countries are lower (around 40% of the EU-27) than in Croatia. However, the volume of emigration from Croatia is already considerable; the stock of emigrants was 16% of the population in 2006 (compared to 10% of the population in Europe and Central Asia). The officially recorded remittances ran up to the 3% of GDP in 2006. The emigration rate of tertiary educated was 29.4% in 2000, which was the highest level in the region. Croatia is also a popular destination of immigrants, the stock of immigrants was 14.5% of the population in 2006, mainly from the neighbouring Western Balkan countries.

Textbox 8: The challenge of EU membership for the shipbuilding sector

The delicate situation of the Croatian shipbuilding industry is a key element of the accession negotiations and the government of Croatia decided to initiate a series of restructuring and privatizing measures. At the end of 2005 the government established the High Level Group for the preparation of a proposal for the National Programme for Restructuring of the Croatian Shipbuilding Industry with the aim of enabling the five largest Croatian state-owned shipyards to operate independently in the global market. The High Level Group adopted the Strategic Guidelines in February 2006 and at the same time through a competition by invitation an independent consultancy consortium, HVB Global Shipping was selected. By September 2006 HVB Global Shipping prepared a comprehensive analysis of the Croatian shipbuilding sector and provided its opinion on how to resolve the problems of the sector. In the meantime, until the restructuring program has been prepared, and with the aim of maintaining current operations, the Croatian Competition Agency allocated a 4.2 billion kuna one-off state aid for recovery to shipyards (OECD 2006b). The plan of HVB Global Shipping cost 2.5 billion euro and the EU rejected it. The second plan of the government also faces opposition from the side of the EU. The government's plan is to fund the shipyards in form of indemnification for land, so called marine demesne, on which the shipyards are situated and which was illegally became part of their equity capital during the 1990'. According to EU regulation, the companies are obliged to take part in their restructuring with at least 40% of the funds used. Since the shipyards are struggling with huge amount of losses (8.4 billion kuna), this 40% would mean further difficulties. However, what makes Nacional[92] suspicious is that the total indemnification amounts 1.65 billion kuna and the total amount of restructuring stands for 4.1 billion, while the indemnification exactly covers the required 40% (Nacional 2008). The latest Progress Report of the Commission (2008b:49) stated Croatia has taken the decision to

[92] Croatian weekly newsmagazine

privatize the shipbuilding industry, but further significant efforts will be needed to fully restructure it.

The *tourist sector* contributes to a great extent to the economic growth and it partly compensates the huge merchandise trade deficit. Due to the EU accession, the country is likely to become a more attractive tourist destination. The accession could stimulate inward FDI in the sector as well. The membership of the Schengen area and the acceptance of the euro could further improve the image of Croatia (Lejour et al. 2007:28).

Most of the authors agree that there is a correlation between the speed of economic growth and inflows of *foreign direct investment*. However, the direction of causality is not clear. On one hand the direct inflows of capital stimulate economic growth and transformation. On the other hand the direct inflows of capital also react to the opportunities coming from economic growth and transformation. Considering the first effect, FDI can stimulate economic growth in a number of ways: through additional investment, transfers of technology and know-how, implementation of advanced management structures. The modernization of the manufacturing sector contributes to the competitiveness of the economy and to better access to export markets. Concerning the reaction side, foreign investors respond positively to economic growth and to reforms in favour of market economy rules.

The experience of the transformation in CEE countries demonstrates that the knowledge and the capital of foreign direct investors were crucial for the rapid and successful transformation to a market economy. Slovenia seems to be the only exception. Inward FDI plays an important role in strengthening the private sector, in the emergence of market economy behaviour and in the restructuring of firms and the whole economy. Foreign investors often take part in privatization process as well (Hunya–Skudar 2007:15).

EU accession has accelerated the reform process in CEE countries and in Bulgaria and Romania. However, implementing the acquis communautaire is not sufficient. More need to be done in other areas that are not directly connected to the acquis, such as regulatory reform, investment promotion and human capital (OECD 2006a:15). The unfriendly business environment is one of the major obstacles of the inward FDI. EU membership (and the required measurements associated) usually strengthens the confidence of foreign investors and we could assume that it would happen in case of

Croatia as well. The common market in the Western Balkans could also considerably increase the attractiveness of this region to foreign investors (Kušić–Zakharov 2003:44). The reclaim of the freedom, independence and democracy after the communist rule is particularly connected to the involvement of European integration process among the Eastern European countries. In case of Slovakia and Croatia the acceptance of the newly independent state was also an issue. In case of these states, as Jović (2006:87-88) highlights, their first recognition was the formal acceptance that the state exists in terms of international law and international relations. Their second recognition is seen as a confirmation of its democratic credentials that is in the context of democratic Europe, where only states with recognised democratic credentials are to be accepted as equal and credible. Thus, through membership of the club, the countries become a "proper" (i.e. "sovereign") states.

3.5 Slovakia during the Mečiar-years

The *misfit* between the domestic and the European institutions, policies or processes was present in Slovakia undoubtedly. However, the misfit was only partly perceived. On the one hand, the Slovak government saw the country as a newly independent democratic state that may serve as a bridge between the West and the East. The misfit was not regarded as some kind of deficiency but rather the national interest of Slovakia as an independent country and nation. The perception of the misfit was different from the side of the EU, which expressed its aversion even in form of demarches. The main elements of the misfit were the undemocratic political style, the instability of Slovakia's institutions and abuse of minority rights.

The existence of factors that foster *respond* to the adaptation pressure were almost missing in Mečiar's Slovakia. The country was formally in favour of the EU and it made an application for EU membership in June 1995. At the same time, in practice it rather isolated from the EU. The governing party (HZDS) followed nationalistic principles and stayed resistant to EU-pressure.

The dominant *mechanism* of Europeanization was coercion. The control with negative and positive sanctions played an important role during the Mečiar years. The most apparent example was the decision on the candidate status. The shortcomings regarding the political criteria were sanctioned with the delay of the start of negotiations. Slovakia stayed out of the first wave (the Luxembourg group) of EU-candidate countries, while

the neighbouring countries (Czech Republic, Hungary and Poland) could join the Luxembourg group and get along with their integration process.

3.5.1 Is Slovakia different?

Previously we argued that both Croatia and Slovakia followed a "non-mainstream" road of Europeanization. We have examined whether we could identify distinctive factors in Croatia's "nationalist" period. Are there distinctive factors in Croatia's "nationalist" period that could explain the "non-mainstream" path of the country?

First, the transformation process of Slovakia began during the last years of Czechoslovakia; therefore the Slovakia inherited this path. This factor is *special but not unique*: the Czech Republic inherited the same background but it became a frontrunner country among the CEE countries.

Second, Slovakia became a newly independent state in 1993, which also influenced the agenda of transformation. However, as it was highlighted previously, the new independence of Slovakia *is not a significant distinctive factor*. State- and nation-building connects to transformation in most of the cases.

At the same time, albeit new independence is not a distinctive factor, the Slovak statehood has been undoubtedly younger than most of the peer countries'. This feature differentiated Slovakia among the Visegrád countries; it left its mark on the Slovak national identity, on their "Europeanness" feeling and served as a basis for inferiority complex. Slovakia most probably felt *different* and differentiated itself from the rest of the Visegrád (and other CEE) countries when it identified itself as a bridge between East and West.

3.5.2 Being "European"

During the Mečiar years Slovakia was not making efforts to "return to Europe". Slovakia first refused the commitment of proving its "Europeanness" by accepting EU conditionality and became the "black hole of Europe"[93]. Being "European" was less important than the "national interest" of the newly born Slovak state. This approach was realized in the third way policy of the political elite.

A special duality was present in Slovakia's Europeanization process in this period. Regardless of its resistance towards the EU, it was one of the Europe Agreement

[93] As Madelaine Albright US Secretary of State referred to Slovakia in 1995 (Haughton–Malová 2007).

countries. At the same time, the refusal of cooperation was more political and less economic since the EU was the most important partner of Slovakia in terms of trade and investments. In fact, Slovakia was closer to the EU than Croatia. It was on the way of integration at half-steam and its refusal was less vigorous. The pressure from the EU and from other international organizations had some impact of the Slovakian policy making.

3.6 Slovakia after the turning point

The *misfit* continued to be present in Slovakia when the new government won the elections in 1998. At the same time, the *perception* of the misfit changed dramatically. The new government detected the lag in the country's integration process and thus in adopting EU-style institutions, policies and structures of the country compared to the other Visegrád states. This lag was considered as undesirable not only for the government but for the population as well.

The willingness to *respond* to the adaptation pressure strengthened significantly. The possibility of being excluded from the first round of enlargement made large impression to the population. The political goal of EU membership was maintained with the use of every means. The national interest changed compared to the previous era. The new interest was to catch up with peer countries and join the EU together with them. The first Dzurinda government had to face the scepticism of the international community. Accordingly, the reform process had to be quick and effective in order to start negotiations on Slovakia's entry into the EU. The reform process was driven by the promise of international integration and by international pressure. The promise of integration served as a unifying factor that made possible for the left-right coalition to stay in power for the full term. From 2002, the second Dzurinda government continued the reform process in order to complete Slovakia's integration into the EU (Mathernová–Renčko 2006:638).

In order to change the image of Slovakia that was created under Mečiar and gain credibility to the measures, the Dzurinda governments were ready to overfulfil the EU-requirements. The EU proved to be a strong *anchor* but the radical restructuring was less for the sake of the EU but more in the country's own interest.

The mechanism of *coercion* and the instrument of conditionality were obviously present during the accession process as in case of every candidate country. However, this stage of Slovakia's Europeanization process was more driven by the *mimicry* mechanism. The

EU served as a clear point of reference and destination as well. The integration process was the aim of the major part of the population and of the ruling government. They both consented to the EU integration and were ready to make efforts in favour of this aim. However, the reform measures both in economic and political field were necessary regardless of the EU membership and the conditions of the EU. The attitude of the Visegrád countries and other transformation countries had a crucial impact on Slovakia's attitude and worked as a contagion effect. Slovakia did not want to act differently because it would have been more costly for the country. The social cost of Europeanization was significantly lower than in Croatia.

3.6.1 "Europeanness" in crisis

In Slovakia the perception of crisis was present both in the field of economy and that of national identity. The decision about the Luxembourg group made Slovakian people feel excluded and reclaim their own place among the European democracies. People considered their country culturally and historically part of "Europe" and they thought it was capable for the same level of international acceptance like its neighbours. The country realized in the second half of the 1990' that in the new post-communist context "being European" is connected to the EU, which became the only game in town. In Slovakia "Europeanness" was something to reach and this feeling was present both in the political elite (after 1998) and among the population. Contrary to the Croatian case, Slovakia apprehended "Europeanness" more instrumentally.

The perception of economic crisis worked as a motivation factor as well, to which the political elite answered with deep structural reforms.

3.6.2 EU as an anchor

The role played by the EU in the transformation of Slovakia is understood highly differently among the authors. Malová (2004:1-2) is the one extreme, who notes a bit satirically that Slovakia (together with the two Baltic states, which were later invited) acted like "an obedient dog faithfully following its master's instructions". Most of the authors agree that the EU (and other international institutions like NATO and OECD) served as a strong anchor during the reform process. The technical assistance proved to be crucial for the success of Slovakia's reforms (the financial aid was less important). The international assistance gave also credibility to the reform measures. Mathernová and Renčko (2006:638) note that the assistance was not driven by supply but by demand

i.e., the local experts and decision-makers had influence on the donors' agenda. The conditions represented by the acquis communautaire had a significant role in the deep Slovak reform agenda. On the other extreme Haughton (2007:10) argues that the Slovak case highlights very clearly that the change in the domestic political elite and their commitment was indispensable. Real change comes from within – says the author.

Contrary to the first look, the two reasoning did not oppose each other. At the beginning of the Dzurinda-turn the EU-anchor was extremely important since that was the factor that kept the often instable governing coalition together. The anchor was also important as it was the basis of building external credibility for the "new Slovakia". In order to gain the invitation to the club in Helsinki in December 1999, Slovakia had to act like "an obedient dog" and follow its master's instructions, i.e. consolidate politics and stabilize the economy. After the invitation was gained, the race against time began in order to catch up with Visegrád neighbours. The EU accession anchored the Slovak transformation without a doubt.

The reforms of the first Dzurinda government were far from popular. However, the government regained the confidence of international community that also helped to stay in power following the elections in 2002. The accession negotiations with Slovakia were closed in December 2002. The second Dzurinda government was free from EU-pressure when they began the series of radical reforms (Győrffy 2008a:16). Thus it is important to note that the drastic state reform was *not* among requirements of the EU. The performance of the second Dzurinda government supports the reasoning of Haughton (2007) that is real change comes from within.

Most probably the Slovak case is the coincidence of an effective EU anchoring and determined inner motivation for change. The two crucial factors reinforced each other. The EU accession provided an opportunity and the appropriate human factor was in right time, in the right place and grasped the opportunity (Győrffy 2008a:19). The external incentive has a special role when it lessens or even hinders reverse efforts. Altogether, the success of the Slovak reforms points beyond the success if Europeanization.

3.6.3 From external to internal

Slovakia changed its direction of development on time and the reorientation was enough quick not to miss the train of enlargement. By 2004 the misfit decreased to such a level that the country was welcome in the club. Slovakia entered the EU and thus the nature

of Europeanization changed from external to an internal impact. The entrance conditions were replaced by a new set of internal rules. However, the role of external anchor continued to be present via the new priority of the euro introduction.

Vachudova (2005:241) argues that the EU's active leverage in the accession countries, i.e. the leverage of pre-accession conditionality was diminished well before 1 May 2004, once the invitation for full membership was already happened. At the same time, many expected that the new members will easily meet the requirements of the Economic and Monetary Union (Csaba 2008:602). However, Slovakia (together with Slovenia) has been the exception but not the rule when the countries actually fulfilled the euro-zone entrance conditions and thus continued their way of fulfilling EU conditions. In these two countries the accent shifted from external persuasion to internal one.

3.6.4 What did Slovakia gain from the EU entry?

The EU integration played a very important role in Slovakia's transformation. The fact of the EU entry increased the confidence of foreign investors, has reflected in the amount of inward FDI as well. The internal market has provided better export conditions. The implementation of the acquis accelerated the structural reform process in the tax, pension, social and health care systems. These reforms have increased incentives for work, for job-creation and for investments, and have thus fostered economic growth and catching-up. However, these positive developments do not mean that every problem of the Slovakian economy has been solved. There are still problems on the labour market, there is a lack of sufficiently skilled labour force, but young and unskilled unemployed do not really benefit from the strong employment growth. The public education system does not ensure sufficient skills for everybody in order to participate in the labour market. Research and development investments have been low and falling in recent years (Jevčák 2007). Apart from the existing problems, Slovakia gained a strong anchor and a set of benchmarks for its transformation through the EU. The radical reform agenda of the Dzurinda governments were not purely EU-driven. As outlined above there are several methods for delaying and softening the pre-accession EU requirements. However, the first Dzurinda government had little ambitions to use these techniques. The negotiations were finished by December 2002 after the elections in 2002. The government could lie back and slow down the restructuring. But the reform agenda continued, now with less pressure from the EU. By the end of the turn of

the second Dzurinda government, the character of Slovakia has changed concerning economic policy-making and the role of the government. The agenda that the EU presented during the accession process aimed at the transformation to the market economy. This coincides with the general international agreement about the reconstruction of post-communist economics and the process of privatization and marketization of the former plan economies has led to the desirable outcome. Even before EU membership some CEE governments have gone further in privatizing and deregulating banking, telecoms, transport and energy than some of the existing member-states. As a candidate, Slovakia benefited from pre-accession funds as well.

VI. Conclusions

1 Answers to research question and theses

The puzzle of our research has been that two small and open economies typically and permanently react different to the same external impulses. We saw that the two countries share deep initial conditions, which creates the starting point of our comparison. Of course, the countries have possessed several different characteristics during the examined period. Based on these characteristics we have formulated our hypotheses: Croatia was an expectant of quick and smooth Europeanization process, while Slovakia was expected to lag behind. Both countries "behaved" other than the expectations. To find the answers to our puzzle we have conducted a multidisciplinary analysis. The in-depth country studies were followed by a comparative section where we also reflected to the theory of Europeanization.

In the following we refer back the preliminary hypotheses whether they are confirmed, and we conclude other findings based on the case studies.

1.1 External and internal factors

1. thesis: In order to reach successful Europeanization, internal conviction is inevitable. Just like external pressure. The impulse from outside is able to put domestic processes and structures into new context, and move them out from dead-lock. The responsive capacity of a country depends on the will and determination of the political elite. The political elite will commit themselves to changes only if its costs are lower than its benefits *for the elite*.

Our results show that the outside pressure of the EU and other international organizations cannot induce deep reforms without the inside will of the political elite and the population, i.e. without sufficient responsive capacity. The external incentive is necessary[94] but not sufficient condition of changes. In other words changes do not appear automatically in the presence of external Europeanization pressure. At the same time, our results confirm that although international assistance in itself is insufficient, it is crucial and contributed to successful transformation (cf. Åslund 2007:297). Where the

[94] As a matter of fact the whole concept of Europeanization is empty without the importance of external pressure, since Europeanization pressure is seen as an external impact on national economic, political and sociological structures.

state is captured and vested interests block important reform steps, the outside pressure is often the only chance to break this dead-lock, even if these countries look first resistant.

The experience of Slovakia shows both the importance of external anchor of discipline and that the will of change should come from inside. The EU can anchor a process effectively only if it goes with an inside will of changing. The outside pressure is not enough to achieve deep changes in economic, political and social structures. At the same time the impulse from outside is able to put domestic processes and structures into new context, and move them out from dead-lock. Examining the policy turn in Slovakia, Fisher, Gould and Haughton (2007:996) describe what the most commonly accepted view about Slovakia is: "While international pressures certainly played a role as well, they were less important than domestic political factors". "Less important" definitely does not mean "not important" though. For small and open economies like Croatia and Slovakia, the international commitments cannot be ignored.

On the one hand, both in our case studies the evidence is that internal factors show the way for policy makers. Countries are fundamentally determined *by their own (inner) factors*. External factors, let it be Europeanization pressure, is able to play secondary role only. On the other hand, Europeanization theory tends to explore how domestic structures are *influenced* by European pressure. The case studies have showed that both countries have been influenced. However, we have also seen that Europeanization process is not automatic in a sense that the receiver has to lie back and wait for the result. In the studied countries the intensity of influence varied during time and depended on domestic political attitude.

"Real change comes from within" – from the political elite. As Dollar and Svensson (1998:4) point out regarding World Bank-supported reform programs, the governments willing to reform cannot be created but only identified. Some of the countries do not see Europeanization as a beneficial opportunity and thus they do not grasp it. The decision, whether to grasp the opportunity or not is the result of the decision of the political elite. However, this cost–benefit balance of the political leaders is often different than that of the whole economy and society. The determination of the elite depends highly on its perception, latitude and social basis. The scope for action of the decision-makers is not infinite but determined by deep identity questions, history and culture. These rather stable informal institutions cause path dependence and burden the scope for action of

decision-makers. This set of initial conditions should be taken for granted (cf. Hodgson 2006).

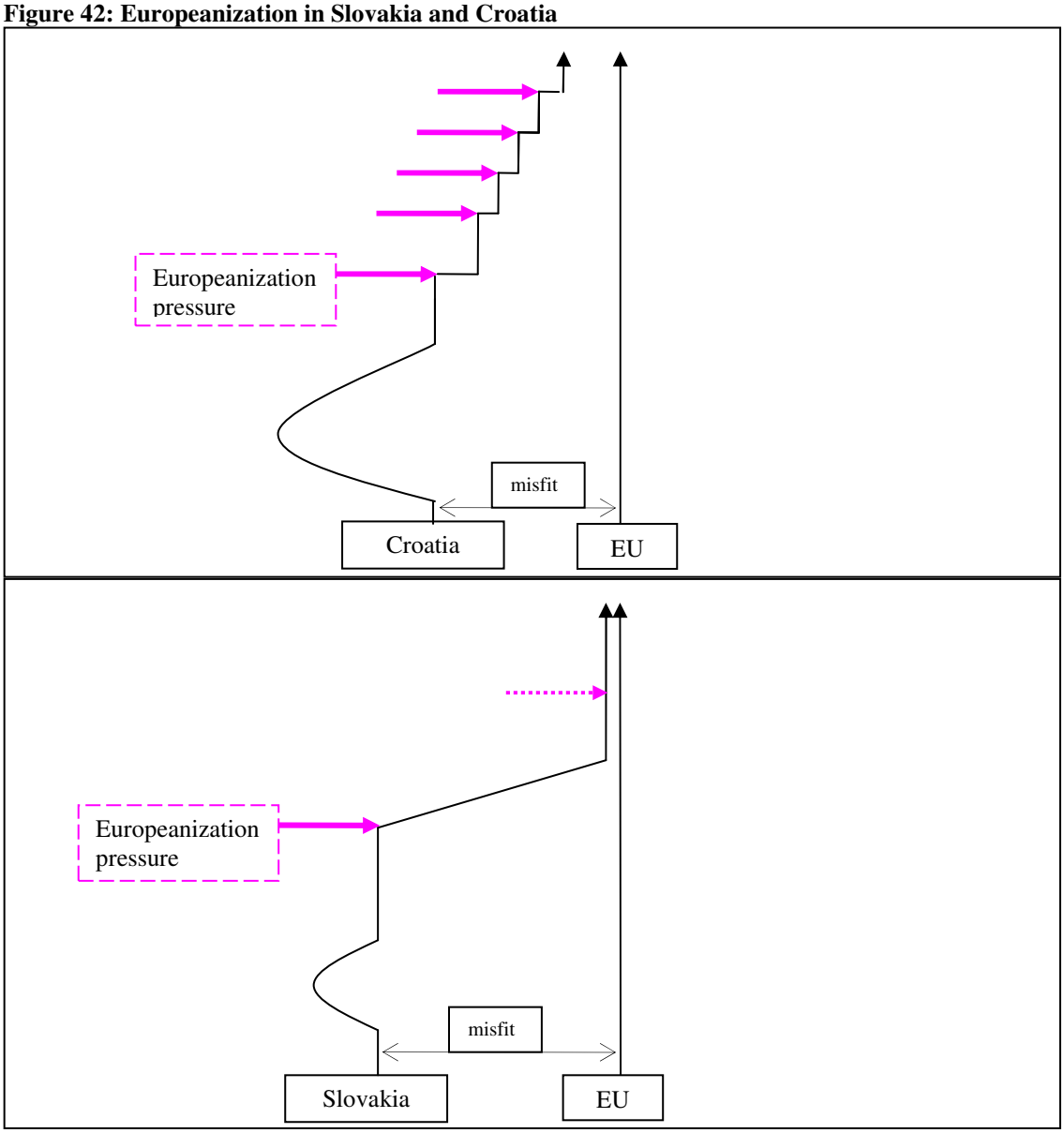
1.2 Rethinking the theory of Europeanization

1.2.1 The size of the misfit

Even though the size of the misfit is an important dimension, it cannot explain the outcome of the Europeanization process. The size of the misfit does not tell everything about the circumstances, how the misfit is perceived.

The initial misfit was much larger in Slovakia than in Croatia. However, this relative position changed soon. The misfit grew enormous and the Croatian situation became totally incompatible when the war broke out. It is also visible in the transformation indicator scores that in Slovakia the structural change started quicker and with larger steps, i.e. the country could "work off" its drawback compared to the more favourable Croatia. Still, the misfit in Slovakia in economic terms started to reduce quicker than the misfit in political terms. In Croatia the misfit continued to be irreconcilable until the end of the war, and even further on until the consequences of the war meant the main obstacle in the EU–Croatia relations. Referring back to the competing theory of Green Cowles, Caporaso and Risse (2001:222) and Knill (2001:201-202), we have suggested that the case of Slovakia confirms the former theory. In Slovakia the misfit was huge enough in 1998 that it worked as a stimulus. That is it confirm the hint that "the greater the misfit, the more likely Europeanization to occur". At the same time, the case of Croatia confirms the suggestion of Knill (2001), i.e. Europeanization is more likely to occur when it requires minor or incremental changes. In Croatia Europeanization has occurred in minor and incremental steps. The evolution of the misfit and the influence-mechanism of Europeanization in the two countries are illustrated in Figure 42. The highly different Europeanization paths of the two countries confirm both theories. The cases have showed that the two theories do not expel each other but rather complement. The often contradictory behaviour of the countries cannot be explained by one single theory.

Figure 42: Europeanization in Slovakia and Croatia



Source: own construction

1.2.2 Misfit versus adaptation pressure

2. thesis: Misfit in itself does not induce adaptation pressure in economic, political and social structures unless the misfit is perceived and acknowledged.

As it was described in the theoretical chapter, Börzel and Risse (2000:5) identify two conditions of Europeanization (misfit and responding factors). They argue that if there is a misfit between European (Union) and domestic structures, it constitutes adaptation pressure. The second condition is the existence of factors that foster a respond to the adaptation pressure.

Our cases showed that it is far from being automatic. The European and domestic structures may be compared according to several aspects. In our study we have used five aspects of Europeanization and identified misfits. The presence of misfit can be identified more or less objectively. Whether the misfit creates adaptation pressure, is dependent on more subjective factors. The misfit in itself was given in both of our case studies. The outcome, i.e. whether the responding factors appeared – the second condition of Europeanization according to Börzel and Risse (2000) – depended on how the political elite related to Europeanization processes. The keyword in exploring the willingness of the political elite proved to be *perception*. Perception is a rather subjective term. The same misfit may be perceived and interpreted in a different way depending on the approach of the political elite. If the elite is pro-Europe, the misfit may appear as a challenge to solve and it induces adaptation pressure. On the contrary, if the elite is counter-Europe, the misfit may appear as undesirable external influence and it induces resistance rather than adaptation pressure. In other words the elite serves as a filter between the European and domestic structures. Often key personalities of the elite function as a filter of the EU pressure[95]. Both countries show evidence for "leader matters". As Colombatto (2003:13) writes, the leader, i.e. the ideological entrepreneur is able "to transform latent or shared beliefs into an institutional project and possibly enforce it". Franjo Tudjman and Stjepan Mesić in Croatia, while Vladimír Mečiar, Mikuláš Dzurinda, Ivan Mikloš and Robert Fico in Slovakia played determinant role in changes of direction. Although they have connected to parties and movements, their personality determined the frame of reference for their countries.

To sum up, we argue that the adaptation pressure only show up when the misfit is perceived and acknowledged. Therefore we introduce an additional condition. The first condition continues to be the misfit or incompatibility between domestic and European institutions, policies or processes. Second, this misfit should generate adaptation pressure when the misfit is *perceived*. Perception is the additional condition. The third condition continues to be the existence of factors (actors or institutions) that foster a respond to the adaptation pressure.

[95] I am grateful to my opponent István Benczes for calling my attention to this fact.

1.3 EU membership vs. Europeanization

3. thesis: The presence of Europeanization impact is *inevitable*; the countries under Europeanization pressure have to count with it whether they choose positive or negative respond. Europeanization pressure does not appear ineffective even in the absence of internal response. This indirect Europeanization impact possesses different degree of efficiency, sometimes even opposite to the intended impact.

The rules of the European Union are relevant and important whether the country intends or objects to join the club, and moreover when it is a member already. The regulations of the European Union affect also those who are not members of it. This external barrier plays stronger or weaker role in every actor's behaviour that gets into contact with the EU[96].

The economies of both countries have showed strong integration with the EU market regarding both trade and FDI flows since the beginning of their transformation. Europeanization does not only mean political decisions and that is why it does not only develop along politics. Our arguments are based on the fact that politics and economy is highly interrelated. The two determine each other, usually the former determine the latter. That is why economic cosmopolitanism and political nationalism do not fit to each other. In other words economic cosmopolitanism requires the give-up of political nationalism. There is a trade-off between the two (Gligorov 2004b:94-95). At the same time, several examinations show that the logic of economy goes beyond politics. The logic and dynamics of market actors are inevitable and geographical proximity builds trade links well before politics or even against politics. Piazolo (1996:1-2) shows that Eastern Europe[97] trade reorientation towards the Western Europe has been driven by market forces and politics give only an institutionalised framework to trade structures that were created by market dynamics. Therefore, the political actions towards

[96] Győrffy (2008b:983) finds that the regulations of the Economic and Monetary Union were neither necessary, nor sufficient conditions of a successful fiscal consolidation in the EU-15. Even if the EMU regulations enforce fiscal consolidation, its sustainability will be weaker compared to countries where consolidation occurred purely from internal commitment. In case of the Eastern European countries, the relation of internal commitment and external pressure is different than in the old member states described above. Unfortunately we do not have the possibility to examine the development of these countries *in the absence* of EMU regulations. Only in this case could we disregard the effect of them. At the same time, the rules of the club consist of its members' own rules, i.e. the club itself does not exist in a vacuum, apart from its members (Wallace–Wallace 2000:6). Thus the members' own rules may overlap with the club's rule as well.

[97] Piazolo examined the ten "Europe Agreement countries". Sigér (2006) found similar results for the Western Balkan countries.

integration only follow the facts created by the market. Our two cases show that during the "nationalist" period their economic integration intensity was poorer than that of the Europeanizing peer countries. This fact supports Gligorov's argument. At the same time, even if their economic integration intensity was poorer, it was a decisive extent and it did not moved tight together with politics and international relations.

Continuing the previous argument, "geography matters" (Krugman 2003). The geographical proximity determines the scope for action for a country. In case of Croatia this proximity strengthened the feeling of "being European" without being EU member and it counter-motivated the country towards reforms. In case of Slovakia the geographical proximity strengthened the "herd effect": fear of staying out while all the peer countries join.

As Vachudova (2005:5) points out, the fact that a country is a credible future member state of the EU, makes the country subsequently exposed to the pressure of Europeanization. This perspective also strengthens the position of liberal and pro-EU forces against illiberal ones. Probably that is why sooner or later most political actors see the benefits of moving their political agenda toward a direction that makes the country compatible with EU membership. The author concludes the above mentioned by examining six countries[98], including Slovakia. Fisher (2006:20) extends this reasoning to Croatia. Furthermore our examination tends to confirm it as well.

1.4 Transformation and Europeanization

Our two case study countries made a detour from the "mainstream" path of transformation and Europeanization. Both Croatia and Slovakia made an attempt to separate the two processes. However, the experience of the countries has showed that where and when the process of Europeanization was lagging behind, the transformation did as well.

We raised the question at the very beginning of our study whether Europeanization is good and whether EU anchor is necessary for democratic transformation to market economy? The cost-benefit analysis that was conducted in this study concluded that "Europeanization is good". The calculation shows that Europeanization is desirable; the benefits of the process overreach its costs in the long term.

[98] Czech Republic, Hungary, Poland, Bulgaria, Romania and Slovakia

The transformation paths of the two countries highlight that price stability is necessary but not sufficient condition of growth. Structural reforms are essential. However, it is not trivial whether a country is able to carry through an adequate set of structural reforms, which leads to economic growth and development. Among others Csaba (2007b:374) and Åslund (2007:3) found that the EU offered clearly better solutions for transformation than any home-made solutions in any transformation country. That is, the EU anchor impressively contributed to the success of the transformation countries in Central and Eastern European countries.

The transformation and European integration are two overlapping processes, which enhance each other. Croatia and Slovakia made an attempt to be exception. However, the success of their decision was not confirmed. The experience of the countries also highlight that even the possibility of separating the two processes is rather limited.

1.5 The power of initial conditions

4. thesis: A set of initial conditions may be "corrected" by policy decisions. Concerning this level of (mostly formal) institutions, the will of the prevailing political elite is able to overwrite path dependence and initial conditions.

Croatia is a textbook example of path dependence, where "the institutional framework makes it difficult to alter the direction of an economy once it is on the particular institutional path. The organizations of the economy and the interest groups they produce are the consequence of the opportunity set provided by the existing institutional framework. The resulting complementarities, economies of scope and network externalities reflect a symbiotic interdependence among the existing formal rules, the complementary informal constraints and the interest of members of organizations created as a consequence of the institutional framework" (North 1997:15). Croatia also shows what Sajó (2008:690) describes as the operating problems of the state reflect the operating problems of the society. The organizations of the state, the institutions of society and the majority of the citizens do not operate according to norms accepted by social consensus and laid down in legislation because in the short term they have no incentive to do so, even though this behaviour creates disorder and is damaging for the society as a whole. Path dependence and thus the lock-in and institutional inertia root in the legacy of Yugoslavia and in the circumstances created by the armed conflict.

Slovakia is a textbook example of "policies matter". That is, the effects of unfavourable initial conditions may be compensated by a larger amount of structural reforms (Havrylyshyn et al. 1998:34). The initial conditions also matter, but their impact weakens in time (de Melo et al. 1997; Soós 2000:274). The case of Slovakia also confirms the finding that although institutional change is path dependent, policy decision may overwrite this dependence to some extent, partly with the help of an external anchor such as the perspective of European Union membership (Di Tommaso et al. 2007).

The original expectations drafted that according to the identity, historical and cultural heritage of Central Europe and the legacy of the Habsburg Empire, Croatia and Slovakia "should have moved" together with the Central and Eastern European countries towards the European Union. However, in both countries this heritage was covered up by the legacy socialism. Croatia has had to count with the legacy of Yugoslavia: insider approach, crony capitalism, openness in trade but closeness in institutions. Croatia also has had to count with legacy of the Balkan: predominance of national consciousness and corruption. The Croatian experience was also determined by an armed conflict. Slovakia has had to count with the Czechoslovak legacy: high level of etatism and redistribution, strict socialist economy. Slovakia also has had to count with the lack of experience of independent statehood, and the impact of this fact to the national identity.

The predominance of national consciousness is experienced in both countries but in Slovakia it is not the burden of European Union membership any more. The Habsburg legacy has been in the subconsciousness of Slovakia and the experience of lag in Europeanization "re-activated" the legacy. In Croatia it seems to be more forgotten or deeper in the subconsciousness of the country. The realization of expectations based on these deeper (i.e. older) roots of the Croatian identity, historical and cultural heritage seems to be only delayed but not overwritten – we argue. The legacy of the communist past diminishes with time (Csaba 2007b:68) but as Hodgson (2006) concludes, some deeper-rooted conditions determine the long-time prospects of a country[99]. As it is shown in our analysis, the power of initial conditions is stochastic rather than determinative. The Croatian example shows that it can be almost forgotten and the Slovak experience shows that it can be revived.

[99] Hodgson identifies among others ethnic fractionalization, western Christendom and limited historical and cultural legacy of nationhood as long-term determinants.

Based on long-term determinants both countries' development point towards Europeanization and both countries have experienced a detour. The detour of Slovakia has been smaller and shallower, while Croatia's has been much deeper and long-lasting. In Slovakia the detour did not interrupt so much the organic development and the Dzurinda administration as able to activate the dynamism and trend of the transformation and Europeanization path. The country was able to change rather quickly and deeply. Croatia locked in a stagnating and inertial path and the motivation to change was rather ambiguous and came relatively late.

1.6 Timing

5. thesis: Timing is fundamental. The invited country may not have the chance to decide *when* it prefers to accept the invitation. Once the possibility was not utilized, it is doubtful when the next will come because the preferences of the European Union may change with time.

It is not possible to join the club at any time: whether then and there, or the possibility may swim away. It is fundamental whether the applicant applies to a booming or busting European Union. This throws new light upon the debates of rashness of EU or euro integration. The latest developments of the European Union show that Slovakia changed „on time", could catch up with the Visegrád group and join the European Union in 2004. In case of Croatia the "enlargement train has gone", i.e. the enlargement conditions of the European Union have changed considerably since the signing of the Nice Treaty that created the framework for the enlargement rounds in 2004 and 2007. Croatia has already reached the point when the decision-makers see the benefits of turning towards European Union membership. Even if Croatia fulfils the three Copenhagen criteria, the European Union itself has to fulfil the fourth one. Without the European Union's ability to receive a new member state, the preparedness of a candidate has no worth. Fulfilling the fourth Copenhagen criterion became more fragile than ever before.

1.7 The importance of an armed conflict

6. thesis: War matters for economic, political and institutional dynamics. An armed conflict changes fundamental rules of the society, creates special conditions, where the

exception becomes the rule. The end of the war does not mean the end of this special period and it can create path dependence in economic, political and institutional dynamics.

Not only the armed conflict matters, but the post-war period as well. First, it takes time to get back to "normal life" not only in economic but more in social and psychological terms. Second, the war influences the dynamics of interest groups. It serves as a basis of reference for several groups long after the end of the armed conflict and put nationalism in different costume. In other words, the war can create special burden and path dependence. Still, the long-lasting impact of the war is not universal; it depends on the context of the country.

Porter (1994:3) summarizes the basic characteristic of the armed conflict. Whatever causes war, is by definition a more basic causal agent than war itself. The war is never the prime driving force but a secondary phenomenon. The war may not be seen as an exogenous force in states and societies, it derives rather from inside. To say that war causes given political effect is only simplification. What really happens is that state leaders, governments and populations, which are waging war, cause those effects. War may transcend its original causes and become a powerful force for change in its own right. Thus the rich and complex spheres of the society and state often evolve at least partial independence from the war.

Concerning the development of state, the effects of the war fall into three categories: (1) formative and organizing effects, (2) disintegrative effects and (3) reformative effects. The first group of effects stands for the extraordinary activism of the state as a catalyst of collective action. State waging war remakes, reinvents and reorders itself. It becomes more organized, more rational and more centralized. It gets better equipped to exert power and dominium at home. The formative and organizing effects advance state formation and increase the power, authority, size, capabilities and jurisdiction of the state. The second group of effects diminishes, limits or dilutes the power, size, authority and capacity of the state. These destructive forces may overwhelm and negate the organizing impetus of the armed conflict. That is, war sometimes breaks states instead of makes them. The third group of effects refers to the experience that unmasks the defect of a given political system more intensely than in peacetime. Both the defeat and a hard achieved victory may force nations to confront the need for reform. The mechanism of this reform impetus is the destruction or weakening of entrenched social

strata and institutions that act as barriers to reform, or creating or energizing new groups of the society like veterans, war heroes or taxpayers (Porter 1994:11-19).

The effect of nationalism span all the above three categories. War is a powerful catalyst of nationalism because it fills the collective consciousness of peoples with a sense of their national identity and at the same time it links this identity closely with the state itself. Nationalism magnifies the unifying effect of the war and promotes a sense of shared destiny. However, the violence of a war in most cases does not directly cause these effects. They rather spring from the collective responses of human beings to the violence. As a consequence, referring to the war as a willful agent of action is misleading. It is rather a phenomenon that serves to elicit human action (whether positive or negative) (Porter 1994:19-20).

The case of Croatia is an example for formative and organizing effects of war. The new state of Republic of Croatia was created at the expense of an armed conflict. The territory of the former Yugoslav member republic was attacked and partly occupied by the Serbian army (former Yugoslav National Army). The Serbian enemy unified state and society. This process was accompanied by centralization and the growth of the government. "War makes death and taxes" (Porter 1994:14) has been certainly valid in case of Croatia. The expenses of the war increased taxes considerably, including inflation tax. The war created an opportunity for leadership. General Franjo Tudjman was seen as "state-maker". He led his country during the war and became the architect of domestic politics in post-war times as well up until his death in 1999.

The above mentioned effects do not cease to exist in the post-war period. This is called "ratchet effect" by Porter (1994:14). Ratchet effect occurs when the fast growth of government and large scale tax increase, which appear during the war, level off in post-war times much higher than they were before the armed conflict. In other words, the size of the government and the level of taxes do not get back to their pre-war level but settle on a higher level. The population accepts centralization, large government and high taxes during the period of war and the acceptance remains after the crisis as well.

The Yugoslav war of secession serves also as an example for disintegrative effects from Yugoslavia's point of view. Yugoslavia (understood as a federal state of six republics) disappeared from the map of Europe as a result of the armed conflict.

In Croatia the end of the war did not result in major reform measures. Partly because the aftermath of the war lasted until 1998 when the territorial integrity of Croatia was re-established. Instead of the reformative effects, Croatia has showed rather long lasting

formative and organizing effects of the armed conflict side by side with nationalism. The evolution of the post-war reformative effects was also hindered by the contradictory legacy of the war: whether Croatia was the innocent victim of the Serbian aggression or (beside the homeland war) Croatia was also an aggressor in the war against Bosnia and Herzegovina. We argue that this "unclosedness" of the armed conflict contributed to the long-lasting formative and organizing effects of the war. It burdened the quick reorientation of the country towards European integration. Moreover, the consequence of the war (the cooperation commitment with the ICTY) occurred as the major obstacle in this process.

1.8 Finding the good mixture

7. thesis: The *same* external pressure may induce *different* internal response and thus different outcomes. The same external pressure may fertile domestic factors if they are compatible, but may induce resistance if they are incompatible. The "good mixture" of external and internal factors that results in successful Europeanization may depend on whether (1) the external pressure finds linkage point with the internal factors (actors and institutions), (2) the external factors are able to compete with initial conditions and path dependence and (3) the internal response arrives on time.

Our research question aimed to find the "good mixture" of external and internal factors that result in successful Europeanization. We have seen that the development of countries is determined fundamentally by their own factors. At the same time every country under consideration is under the influence of several external factors, including the European Union's impact. This external influence is inevitable, i.e. it is given for the countries. As a result, in a given country the internal factors alone cannot determine decision-making. The final outcome comes from the reaction of internal and external factor.

We have argued that the European Union offered clearly better solutions for transformation than any domestic solutions. Moreover, our cost-benefit analysis has showed that the potential benefits of European Union membership overweight its costs. That is why we have considered Europeanization as desirable and argued that the European Union anchor impressively contributed to the success of the transformation countries in Central and Eastern Europe.

The “good mixture” we are searching for is the combination of external and internal factors when the external factors fertilize that domestic ones, consequently when the benefits of EU membership overweight its costs, and when the EU anchor contributes to the success of the transformation.

The “good mixture” has thus two main elements, the external and the domestic factors. At the beginning of this study we have confirmed that the external factors originating from the European Union can be considered as same factors in case of Croatia and Slovakia (and every other Europe Agreement countries). If the same external factor is given and the outcome is different in two cases, the cause of the difference may be found in different domestic reactions. In other words the external impact is filtered by domestic actors, re-interpreted and internalized. As a result, the final impact of external factors may be different than the original impact was.

Whether the original intention of the external actor (namely the European Union) results in successful Europeanization, may depend on three factors. First, the original intend has to find fruitful linkage point with the domestic factors. If the linkage point does not exist, or they “do not fit” each other properly, the original intend will be distorted and it does not reach its aim. Second, the implementation of any external policy is the domestic arena of interests. As a result, the external factors shall be able to find their way in this arena. They may face resistance in form of initial conditions of the country. Initial conditions may cause path dependence, in which case the external factor “has the duty” of moving the domestic processes to another path. Third, the domestic response to external impetus may be rewarded by the external actor. If the two previous conditions are realized late, the reward by the external actor does not occur.

As we stated at the beginning, Europeanization is understood as an umbrella theory covering every social science. Similarly, the above train of thoughts about the impact mechanism of external and internal factors – that is, as a matter of fact, the impact mechanism of Europeanization – is also considered as valid in every segment of social science.

2 Summary and research potentials – used and unused

As noted at the beginning of our study, the concept of Europeanization comes from European studies, but our approach has been a broader, inter- or transdisciplinary approach where the economic, political and social system of the countries is seen as a

whole. Csaba (2009b) highlights that the field of European studies covers a variety of disciplines, mainly legal and political approaches, while economics is also exported into the European studies framework. Since our findings spring from economics, we integrate the findings of the field of economics to European studies. Thus – according to our intentions – we both contribute to the field of economics and European studies. As we have argued at the beginning of our paper, a pure economic approach does not provide enough broad scope to understand transformation and European integration. Even the international economic relations between the European Union and third countries are organized mainly on the basis of political priorities, not to mention the decisions about enlargements that have always been political decisions (cf. Balázs 2003).

The presented cost-benefit balances of Europeanization have suggested positive balance. Beyond this promising outlook what determines success? We have found the determinant role of perception, and political and institutional dynamics induced by perception. We have showed two dissimilar paths of this. We have also confirmed that informal institutions dominate formal ones (cf. North 1992). Formal institutions were presented by EBRD indices, while informal institutions were introduced by, among others, Eurobarometer surveys.

Our research is only a thin slice of Europeanization, even though it desired to be a comprehensive approach. As every research approach, it leaves many doors open for further examination.

The five aspects of Europeanization in our study were chosen according to the scope and profile of this study and according to our research question. Still, other aspects of Europeanization can be examined to test similar research question. We suggest that similar results would appear.

The war of Yugoslav succession proved to be a determinant factor in the development of the Croatian economy and society. The frame of this study did not allow a detailed examination on the relation of war and economy, and its impact on Europeanization processes. We limited to the most important factors only. However, it is certainly an interesting and not fully explored topic, and as a result, a potential direction for further research.

Europeanization as a theory is relatively young and it stands in the crossfire of discussion. The application of Europeanization in economic theory is even younger.

That is why this direction of academic discussion is certainly open and has the potential of further research. Europeanization may be also seen as an episode in system's theory. The architecture of connection is not trivial, and it was not the aim of this study to find it out. Thus we leave open the question of linkage of Europeanization and system's theory and consider it as a topic for further research.

As it was described previously, Croatia has been the original object of the author's curiosity and Slovakia was chosen as the best control case. The method of case selection was the most similar cases but the most divergent Europeanization dynamics. Our detailed case studies confirmed the selection method. As a further research direction, the comparative study may be extended by third country, namely Romania. The case of Romania would provide further example of how Europeanization dynamics may change according to external impetus. The most important lesson of the Romanian story is that one "wasted" decade does not automatically result in a second "wasted" decade.

Our study leaves the question open whether the European Union is the *cause* of a successful regime change (cf. Csaba 2004 or Åslund 2007) or rather the European Union is the *result* of a successful regime change (cf. Balázs 2003). We have argued that the EU works as an anchor thus our study tends to confirm the first argumentation. Still, the second one is the approach of the European Union itself: the EU sets membership as a prize of successful regime change. Since the European Union is the origin of Europeanization pressure, its approach determines Europeanization process, especially EU conditionality. Thus our study tends to confirm the second argumentation as well. As a result, we do not take a stand on either approach, although our research contributes to the debate.

Annex

Table 53: EBRD index of large-scale privatization [100]

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Serbia	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	2.00	2.33	2.33	2.67	2.67	2.67	2.67
Bosnia and Herzegovina	1.00	1.00	1.00	1.00	1.00	1.00	1.00	2.00	2.00	2.00	2.33	2.33	2.33	2.33	2.67	2.67	3.00	3.00
Albania	1.00	1.00	1.00	1.00	2.00	2.33	2.33	2.33	2.67	2.67	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Slovenia	1.00	1.00	2.00	2.00	2.67	2.67	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Montenegro	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.67	1.67	1.67	2.67	2.67	2.67	3.33	3.33	3.33	3.33
Macedonia FYR	1.00	1.00	2.00	2.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.33
Croatia	1.00	2.00	2.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.33	3.33
Poland	2.00	2.00	2.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33
Romania	1.67	1.67	2.00	2.00	2.00	2.67	2.67	2.67	2.67	3.00	3.33	3.33	3.33	3.67	3.67	3.67	3.67	3.67
Latvia	1.00	2.00	2.00	2.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.67	3.67	3.67	3.67	3.67	3.67
Bulgaria	1.00	1.67	2.00	2.00	2.00	2.00	3.00	3.00	3.00	3.67	3.67	3.67	3.67	4.00	4.00	4.00	4.00	4.00
Lithuania	1.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.67	3.67	3.67	4.00	4.00	4.00	4.00
Czech R.	1.00	2.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Estonia	1.00	1.00	2.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Hungary	2.00	2.00	3.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Slovakia	1.00	2.00	3.00	3.00	3.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00

Source: EBRD Transition indicators

Table 54: EBRD index of small-scale privatization

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Croatia	3.00	3.00	4.00	4.00	4.00	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33
Slovenia	3.00	3.00	4.00	4.00	4.00	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33
Poland	3.00	4.00	4.00	4.00	4.00	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33
Czech R.	3.00	4.00	4.00	4.00	4.00	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	na
Estonia	1.00	2.00	3.00	4.00	4.00	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33
Hungary	1.00	2.00	3.00	3.67	3.67	4.00	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33
Latvia	1.00	2.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33
Lithuania	1.00	2.67	3.33	4.00	4.00	4.00	4.00	4.00	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33
Slovakia	3.00	4.00	4.00	4.00	4.00	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33	4.33
Macedonia FYR	3.00	3.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Albania	2.00	2.00	3.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Bulgaria	1.00	1.00	1.67	2.00	3.00	3.00	3.00	3.00	3.33	3.67	3.67	3.67	3.67	3.67	3.67	4.00	4.00	4.00
Serbia	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.67	3.67	3.67
Romania	1.00	2.00	2.00	2.33	2.67	3.00	3.33	3.33	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Bosnia and Herzegovina	3.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.33	2.67	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Montenegro	3.00	3.00	3.00	3.00	3.00	3.00	3.00	1.00	2.00	2.00	2.00	3.00	3.00	3.00	3.00	3.00	3.67	3.67

Source: EBRD Transition indicators

[100] EBRD Structural and institutional change indicators range from 1 to 4.33, where 1 represents little or no change from a rigid centrally planned economy and 4.33 represents the standards of an industrialised market economy. Assessments are made in nine areas: Large scale privatization, small scale privatization, governance and enterprise restructuring, price liberalisation, trade and foreign exchange system, competition policy, banking reform and interest rate liberalisation, securities markets and non-bank financial institutions, and infrastructure.

Table 55: EBRD index of enterprise reform

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Hungary	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.67	3.67	3.67	3.67
Estonia	1.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.67	3.67	3.67	3.67
Poland	2.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.67	3.67	3.67	3.67
Slovakia	2.00	2.00	3.00	3.00	3.00	3.00	2.67	2.67	3.00	3.00	3.00	3.33	3.33	3.33	3.67	3.67	3.67	3.67
Czech R.	2.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33	na
Croatia	1.00	1.00	1.00	2.00	2.00	2.67	2.67	2.67	2.67	2.67	2.67	2.67	2.67	3.00	3.00	3.00	3.00	3.00
Latvia	1.00	2.00	2.00	2.00	2.00	3.00	2.67	2.67	2.67	2.67	2.67	2.67	3.00	3.00	3.00	3.00	3.00	3.00
Lithuania	1.00	1.00	2.00	2.00	2.00	3.00	2.67	2.67	2.67	2.67	2.67	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Slovenia	1.00	1.00	2.00	2.67	2.67	2.67	2.67	2.67	2.67	2.67	2.67	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Bulgaria	1.00	1.00	1.00	2.00	2.00	2.00	2.33	2.33	2.33	2.33	2.33	2.33	2.67	2.67	2.67	2.67	2.67	2.67
FYR Macedonia	1.00	1.00	1.00	2.00	2.00	2.00	2.00	2.00	2.00	2.33	2.33	2.33	2.33	2.33	2.33	2.67	2.67	2.67
Romania	1.00	1.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.33	2.67	2.67	2.67
Albania	1.00	1.00	1.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.33	2.33	2.33
Serbia	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	2.00	2.00	2.00	2.33	2.33	2.33	2.33
Bosnia and Herzegovina	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.67	1.67	1.67	1.67	1.67	2.00	2.00	2.00	2.00	2.00	2.00
Montenegro	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.67	1.67	2.00	2.00	2.00	2.00	2.00

Source: EBRD Transition indicators

Table 56: Overall infrastructure reform in CEE and SEE countries

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Hungary	1.33	1.33	2.00	2.33	2.33	2.67	3.00	3.00	3.00	3.33	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Poland	1.00	1.67	2.00	2.00	2.00	2.00	2.33	2.67	2.67	3.00	3.00	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33
Estonia	1.00	1.33	1.67	2.00	2.33	2.33	2.33	2.33	2.33	3.00	3.00	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33
Czech Republic	1.00	1.00	1.00	1.67	2.00	2.33	2.33	2.33	2.67	2.67	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.33
Romania	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.67	2.67	2.67	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33
CEE average	**1.03**	**1.13**	**1.37**	**1.60**	**1.67**	**1.83**	**2.03**	**2.23**	**2.30**	**2.67**	**2.77**	**2.87**	**3.03**	**3.07**	**3.13**	**3.13**	**3.13**	**3.17**	**3.17**
Latvia	1.00	1.00	1.00	1.00	1.00	2.00	2.00	2.33	2.33	2.67	2.67	2.67	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Slovenia	1.00	1.00	1.33	1.67	1.67	1.67	1.67	2.00	2.00	2.67	2.67	2.67	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Bulgaria	1.00	1.00	1.00	1.00	1.33	1.33	1.33	1.67	2.00	2.00	2.67	2.67	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Croatia	1.33	1.33	1.33	1.33	1.33	1.67	1.67	2.00	2.00	2.00	2.33	2.33	2.67	2.67	3.00	3.00	3.00	3.00	3.00
Slovakia	1.00	1.00	1.00	1.00	1.00	1.00	1.67	1.67	1.67	1.67	2.00	2.00	2.33	2.67	3.00	3.00	3.00	3.00	3.00
Lithuania	1.00	1.00	1.00	1.00	1.00	1.00	1.67	2.00	2.33	2.33	2.33	2.67	2.67	2.67	2.67	2.67	2.67	3.00	3.00
SEE average	**1.04**	**1.08**	**1.08**	**1.17**	**1.21**	**1.25**	**1.29**	**1.46**	**1.67**	**1.71**	**1.88**	**2.17**	**2.25**	**2.29**	**2.38**	**2.46**	**2.50**	**2.50**	**2.54**
Bosnia and Herzegovina	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.33	1.33	1.33	1.33	2.00	2.00	2.33	2.33	2.33	2.33	2.33	2.33
Macedonia FYR	1.00	1.33	1.33	1.33	1.33	1.33	1.33	1.67	1.67	1.67	1.67	2.00	2.00	2.00	2.00	2.33	2.33	2.33	2.33
Albania	1.00	1.00	1.00	1.00	1.00	1.00	1.33	1.33	1.33	1.33	1.33	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.33
Serbia	1.00	1.00	1.00	1.33	1.33	1.33	1.33	1.33	1.67	1.67	1.67	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Montenegro	1.00	1.00	1.00	1.33	1.33	1.33	1.33	1.33	1.67	1.00	1.33	1.33	1.33	1.33	1.67	1.67	2.00	2.00	2.00

Source: EBRD Economic statistics & forecasts, Transition indicators

Table 57: Private sector share in GDP, in percentage

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Serbia	na	na	na	na	na	na	na	na	na	40	40	45	45	50	55	55	55	60
Bosnia and Herzegovina	na	na	na	na	na	na	na	35	35	35	40	45	50	50	55	55	60	60
SEE 1											**59**	**60**	**61**	**64**	**65**	**65**	**67**	**68**
Croatia	20	25	30	35	40	50	55	55	60	60	60	60	65	65	65	65	70	70
Slovenia	20	30	40	45	50	55	60	60	60	65	65	65	65	65	65	65	70	70
Macedonia FYR	15	15	35	35	40	50	50	55	55	55	60	60	60	65	65	65	65	70
Latvia	10	25	30	40	55	60	60	65	65	65	65	70	70	70	70	70	70	70
Romania	25	25	35	40	45	55	60	60	60	60	65	65	65	70	70	70	70	70
SEE 2	**17**	**20**	**35**	**40**	**47**	**57**	**60**	**62**	**64**	**64**	**66**	**66**	**67**	**69**	**69**	**69**	**71**	**72**
Lithuania	10	20	35	60	65	70	70	70	70	70	70	75	75	75	75	75	75	75
Poland	40	45	50	55	60	60	65	65	65	70	75	75	75	75	75	75	75	75
Albania	5	10	40	50	60	75	75	75	75	75	75	75	75	75	75	75	75	75
Bulgaria	20	25	35	40	50	55	60	65	70	70	70	70	75	75	75	75	75	75
CEE	**19**	**31**	**42**	**54**	**61**	**66**	**69**	**70**	**71**	**73**	**74**	**76**	**76**	**76**	**76**	**76**	**76**	**76**
Slovakia	15	30	45	55	60	70	75	75	75	80	80	80	80	80	80	80	80	80
Czech R.	15	30	45	65	70	75	75	75	80	80	80	80	80	80	80	80	80	80
Estonia	10	25	40	55	65	70	70	70	75	75	75	80	80	80	80	80	80	80
Hungary	30	40	50	55	60	70	75	80	80	80	80	80	80	80	80	80	80	80

Note: SEE 1: Without Serbia and Bosnia and Herzegovina, SEE 2: With Serbia and Bosnia and Herzegovina

Source: EBRD Structural and institutional change indicators

Table 58: EBRD index of bank sector reform

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Hungary	2.00	2.00	3.00	3.00	3.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Estonia	1.00	2.00	3.00	3.00	3.00	3.00	3.33	3.33	3.67	3.67	3.67	3.67	3.67	4.00	4.00	4.00	4.00
Croatia	1.00	1.00	2.00	2.67	2.67	2.67	2.67	2.67	3.00	3.33	3.33	3.67	3.67	4.00	4.00	4.00	4.00
Czech R.	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.67	3.67	3.67	3.67	4.00	4.00	4.00
Latvia	1.00	2.00	2.00	3.00	3.00	3.00	3.00	2.67	3.00	3.00	3.33	3.67	3.67	3.67	3.67	3.67	4.00
Bulgaria	1.00	1.67	2.00	2.00	2.00	2.00	2.67	2.67	2.67	3.00	3.00	3.33	3.33	3.67	3.67	3.67	3.67
Lithuania	1.00	1.00	2.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.67	3.67	3.67
Poland	2.00	2.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.67	3.67	3.67
Slovakia	2.00	2.67	2.67	2.67	2.67	2.67	2.67	2.67	2.67	3.00	3.33	3.33	3.33	3.67	3.67	3.67	3.67
Slovenia	1.00	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33	3.33
Romania	1.00	1.00	1.00	2.00	3.00	3.00	2.67	2.33	2.67	2.67	2.67	2.67	2.67	3.00	3.00	3.00	3.33
Albania	1.00	1.00	1.33	2.00	2.00	2.00	2.00	2.00	2.00	2.33	2.33	2.33	2.33	2.67	2.67	2.67	2.67
Bosnia-Herzegovina	1.00	1.00	1.00	1.00	1.00	1.00	1.00	2.33	2.33	2.33	2.33	2.33	2.33	2.67	2.67	2.67	2.67
Macedonia FYR	1.00	1.00	1.33	2.00	2.67	2.67	2.67	2.67	2.67	2.67	2.67	2.67	2.67	2.67	2.67	2.67	2.67
Montenegro	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.67	1.67	1.67	2.00	2.00	2.33	2.33	2.67	2.67
Serbia	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	2.33	2.33	2.33	2.67	2.67	2.67

Source: EBRD Transition indicators

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